Market Bulletin

February 2016

A case for Europe

In brief

- Market confidence has been badly hurt in the opening weeks of the year as investors worry about the possibility of a global recession. We believe these fears are probably overdone and investors should take a step back and look at the big picture, particularly in the eurozone.
- The eurozone saw moderate economic growth in 2015 of around 1.5%, and we see several reasons why this momentum should be sustained this year, including further support from the European Central Bank (ECB), more supportive fiscal policy and cheaper energy.
- Some European sectors and companies will be negatively affected by weakness in global trade and the slowdown in China and other emerging markets. On balance, however, we believe that the domestic drivers for eurozone growth can offset these negatives. In this note we briefly outline those positive forces and restate the case for active investors to retain their exposure to regional risk assets.

I. WHY WE DO NOT EXPECT A RECESSION IN THE EUROZONE: SUPPORTIVE POLICY AND A MORE UPBEAT CONSUMER

Domestic demand is picking up and will get an extra boost from cheaper oil

At the start of 2015, the consensus view was that exports, with the help of a lower euro, would support GDP growth and help drive the eurozone forward. Exports did pick up, growing by 4.4% over the 12 months, but imports grew faster, so net exports detracted from growth in 2015. Instead, it has been domestic demand that has been the real engine for the economy in 2015. For example:

- New registrations of passenger cars grew by 13% year on year (y/y) in December 2015, the fastest rate of growth since March 2010.
- Retail spending rose by 3.0% in the third quarter of 2015 (y/y), the fastest rate of growth in over two years.
- Consumer confidence, particularly in the periphery, reached multi-year highs in the last six months of 2015.

Will this improvement in domestic demand continue in 2016? We still believe there is plenty of spare capacity in the eurozone to drive consumption higher. The unemployment rate is falling, but it is still in double digits, showing that there is plenty of room for improvement. Initial declines in unemployment were driven by the public sector, but we are now seeing more jobs being added in the private sector, a strong sign of a region on the mend.

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The further decline in the oil price in late 2015 and early 2016 will be another boost for consumers and businesses in a region that is heavily dependent on imported energy. Oil prices have fallen by 42% since the start of 2015 and are 26% lower than they were in November 2015.

The ECB is doing more

In December, the ECB announced an extension of the quantitative easing programme to March 2017, as well as a reduction in the deposit rate to -0.3%. The initial announcement might have underwhelmed financial markets, but the changes will see the central bank's balance sheet expand by a further 33% by March 2017.

Mario Draghi has now hinted that the ECB will introduce more easing measures at its March meeting in response to further declines in expected inflation. Although the details remain uncertain, the ECB looks set to maintain an exceptionally supportive monetary stance for at least another two years through the asset purchase scheme and further cuts to the deposit rate. This should help keep financing costs low, helping boost credit demand as well as keeping a lid on the value of the euro, which will be supportive for exports.

Fiscal policy is getting looser

Fiscal tightening has weighed on eurozone growth over the last five years. But austerity started to give way to more neutral policy in many countries in 2015 and this trend should continue into 2016, delivering a modest amount of fiscal easing across Europe as a whole. At the height of the financial crisis, 26 of 28 European Union (EU) member states were under the European Commission's excessive deficit procedure. Today only nine countries remain in that group and seven of those are set to leave by the end of 2016.

Public debt stocks as a proportion of GDP are much higher than when the financial crisis began, but may have peaked in the middle of last year. The modest improvement in the fiscal position appears to have taken some pressure off policymakers and encouraged a significant increase in eurozone government spending in the past year, as seen in **Exhibit 1**. This is likely to continue in 2016, as countries absorb the additional costs associated with the migration crisis.

Government spending makes up 20% of eurozone GDP, so an easier fiscal environment should help growth in 2016

EXHIBIT 1: EUROZONE GOVERNMENT EXPENDITURE

Change year on year

Source: ECB, FactSet, J.P. Morgan Asset Management; data as of 5 February 2016.

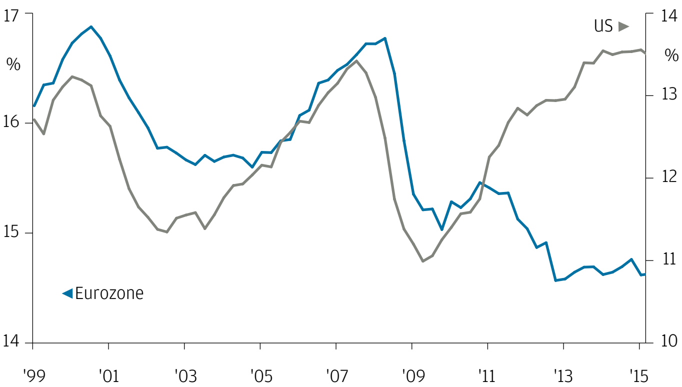
Investment still lacking, but public infrastructure spending set to rise

Investment has been missing from the recovery so far. As highlighted in **Exhibit 2**, investment fell sharply after the eurozone crisis and has yet to recover, in contrast to the US.

The eurozone crisis badly damaged business sentiment, resulting in firms choosing to hoard cash rather than invest it

EXHIBIT 2: GROSS FIXED CAPITAL FORMATION

% of GDP



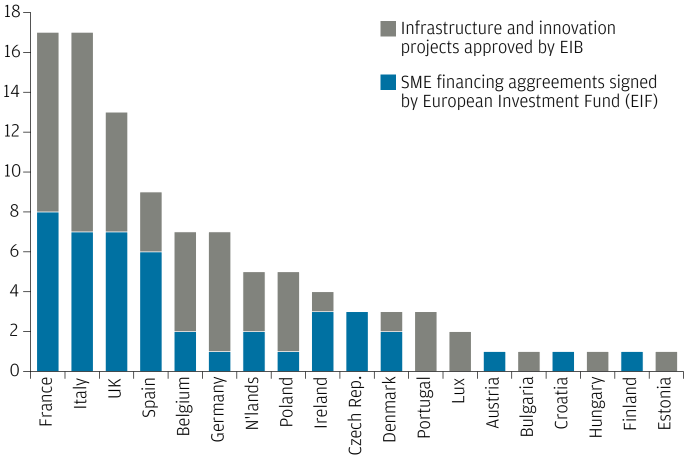
Source: BEA, Eurostat, FactSet, J.P. Morgan Asset Management; data as of 5 Feburary 2016.

There is mixed evidence for a turnaround in private investment in 2016, but we have seen business investment pick up in peripheral economies such as Spain. The first-quarter 2016 ECB credit conditions survey showed that the number of businesses seeking to borrow funds had reached its highest level since March 2006. Much of the increase in credit demand over the last year has been driven by firms looking to invest more.

There is also some prospect for public investment to pick up from 2016 onwards as the Juncker plan begins to pay dividends. This plan, supported by European leaders in 2014, aims to use the European Investment Bank (EIB) to mobilise €315 billion (3% of EU GDP) in additional investment across the EU over the next three years. These projects are now starting to multiply, as highlighted in **Exhibit 3**. As of the end of 2015, the EIB had approved 126 projects, which are expected to trigger around €50 billion in additional public investment across 22 different countries.

The Junker plan looks set to add €330-€410 billion to EU GDP over the next three years and create up to 1.3 million jobs

EXHIBIT 3: NUMBER OF PROJECTS AND FINANCING AGREEMENT APPROVED



Source: European Commission, J.P. Morgan Asset Management; data as of 5 February 2016.

Many crisis economies implemented difficult but important reforms in order to improve the business environment. These reforms are now starting to bear fruit, with several peripheral economies growing faster than "core" countries such as France and Germany. But much remains to be done. A survey looking at the ease of doing business in each country, produced by the World Bank, currently scores the eurozone at 33 compared to scores of six and seven for the UK and US respectively (the lower the score the better). Italy, for example, scores as high as 45, behind countries such as Kazakhstan and Belarus.

These structural obstacles, coupled with limited growth in private investment and a weakening global environment, help to explain why we do not expect a significant acceleration in economic growth in the eurozone in 2016. On balance, however, we believe the combined support of monetary and fiscal policy and the further boost to consumers from the latest decline in the oil price will be more than enough to keep the recovery going in 2016. This should create upside for investors in eurozone equities.

II. WHY WE SEE UPSIDE POTENTIAL IN EUROZONE EQUITIES FOR ACTIVE INVESTORS

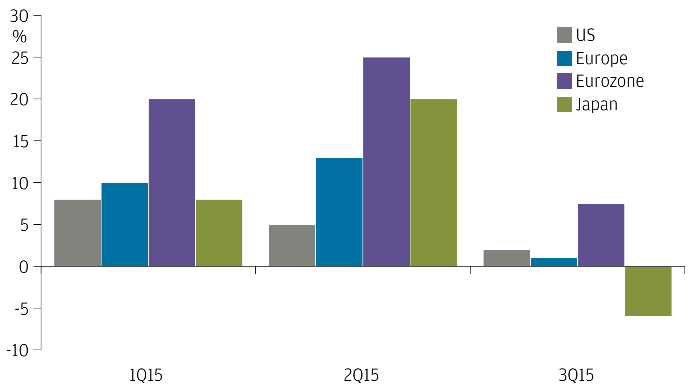
Non-energy earnings continue to grow

The weakness of corporate earnings growth has been an abiding theme of commentaries on European equities for several years, and the weak headline earnings numbers for 2015 have led some to assume that European companies are still failing to deliver rising profits. But those average numbers for the broad Euro Stoxx index give only a partial picture and are heavily distorted by the earnings of UK and Swiss companies and developments in energy and other commodities. (For more on this, see our recent paper, *European 3Q15 earnings: Positioning for cyclical outperformance*.)

Stripping out those distorting elements, we can see that the weaker euro and the domestic recovery are now supporting decent earnings growth in the eurozone. In fact, the region has experienced the fastest rate of earnings growth of all the major developed markets over the last three earnings seasons (**Exhibit 4**).

Pan-European earnings were held back by weak earnings growth in the UK and Switzerland, which together make up around 45% of the Stoxx 600.

EXHIBIT 4: REGIONAL EPS GROWTH EX-ENERGY IN Q1, Q2 AND Q3 2015



Source: Bloomberg, J.P. Morgan Economic Research, J.P. Morgan Asset Management; data as of 5 February 2016.

We believe this growth can continue in 2016, as both the domestic economy and the health of company balance sheets continue to improve. Margins for eurozone firms are also growing, with overall margins for the region coming in at 6.8% in 2015, the highest since the debt crisis.

And the market is not expensive

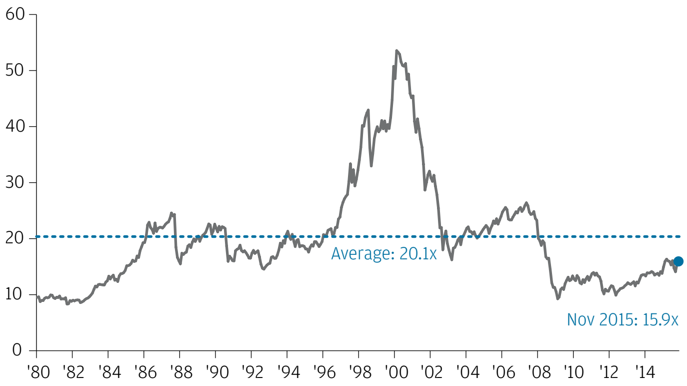
As we have described, the eurozone economy has made decent progress in the last year, but this improvement has not been reflected in the performance of regional equity markets. Thanks to the recent sell-off, the MSCI EMU—which focuses just on eurozone companies—is now 5% lower than in January 2015, when quantitative easing was first announced by the ECB. Jitters in global markets tend to have a disproportionate effect on European equity markets, with asset prices falling more in Europe than the US, almost regardless of the reason for those jitters. Abiding distrust of the eurozone recovery among investors has been exacerbated by headlines about Brexit, terrorism and migrants.

The net result of this scepticism is that valuations remain relatively attractive. **Exhibit 5** shows that the eurozone cyclically adjusted price-to-earnings ratio (CAPE) is well below its long-term average, suggesting potential upside in regional equities.

Investors are sceptical about the future of the eurozone, suppressing equity valuations

EXHIBIT 5: MSCI EMU CYCLICALLY ADJUSTED P/E RATIO

Adjusted using trailing 10-year average inflation-adjusted earnings



Source: FactSet, MSCI, J.P. Morgan Asset Management. Due to data availability index data for 1970-1980 is calculated using regression analysis against the MSCI Europe index. Data as of 5 February 2016.

For income-oriented investors, the MSCI EMU market offers further attractions in the form of an average dividend yield of 3.3%, compared with just 2.4% from the S&P 500. This dividend yield is particularly appealing in a regional context, considering that German 10-year Bunds, a traditional source of income, are yielding just 0.3%. Furthermore, dividends are expected to grow by 6% in 2016.

But the weaker global picture underscores the need to be selective

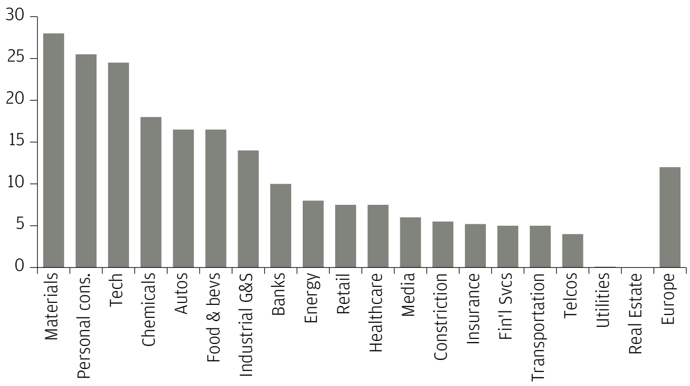
We believe that an overweight to eurozone equities continues to make sense, considering the strength of domestic consumption, supportive fiscal and monetary policy, and relatively attractive earnings growth and valuations. But the weakness of global trade is a headwind for many sectors, and investors cannot assume that all parts of the market will move ahead in the next year. This underscores a general point for investors, which is truer than ever in the current environment: it will pay to be active, and selective.

Corporate revenues generated in the Asia Pacific region account for only 12% of total pan European revenues (**Exhibit 6**). However, some sectors and companies in the eurozone will clearly be hit more than most by slower growth in emerging markets and China. Materials companies have been very adversely affected by the slump in global commodity prices and by events in China. The poor performance of these stocks, along with the decline in energy company earnings, has weighed heavily on the major European stock indices in the past year, and this is likely to continue in 2016.

European firms have only a limited amount of exposure to Asia Pacific and source approximately 50% of their revenue domestically.

EXHIBIT 6: REVENUE EXPOSURE TO ASIA PACIFIC - PAN EUROPEAN SECTORS

Adjusted using trailing 10-year average inflation-adjusted earnings

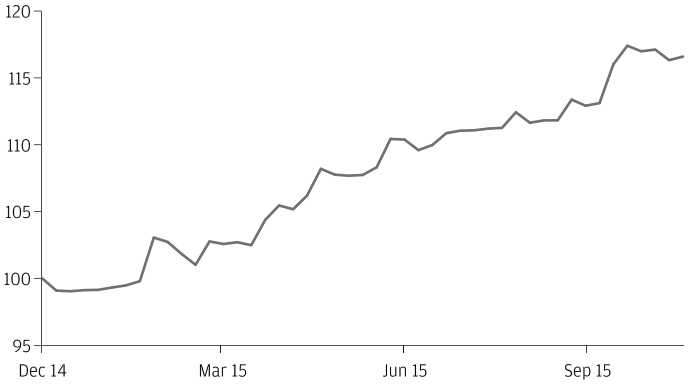


Source: Citi, J.P. Morgan Asset Management; data as of 5 February 2016.

More domestically oriented sectors, such as insurers and telecommunication companies, should continue to outperform (**Exhibit 7**). But even here there are likely to be exceptions; many banks, for example, are likely to be adversely affected by exposure to emerging markets and—in the case of Italy—by continued worries about non-performing loans. This has been reflected in the poor performance of banking stocks so far in 2016.

A falling euro has helped to boost exports to developed economies, but a lack of end demand has held back exports to emerging markets

EXHIBIT 7: EARNINGS PER SHARE OF DM-EXPOSED RELATIVE TO EM-EXPOSED EUROPEAN CORPORATES



Source: Goldman Sachs, J.P. Morgan Asset Management; data as of 5 February 2016.

The companies that will gain most from the eurozone recovery at this point are likely to be found in the small and mid cap sectors. European small cap firms typically source about 65% of their revenues domestically, compared to 50% for larger cap firms. The MSCI Europe Small Cap Index performed strongly in 2015, returning 20% on a total return basis, and could continue to push higher in 2016 given a continued positive backdrop.

INVESTMENT IMPLICATIONS

Global market sentiment has weakened since the start of 2016, and the risks of a US slowdown have risen somewhat, but there has been no deterioration in eurozone economic data. In our view, the chance of an imminent eurozone recession is low. The ECB continues to provide monetary stimulus to the region, helping credit conditions and the euro. Domestic consumption appears to be expanding at a reasonable pace and fiscal headwinds are receding.

Despite the significant economic progress the eurozone has made in 2015, investor scepticism about the recovery has meant that this improvement has not been reflected in the valuations of many risk assets. This provides an entry point for investors to increase exposure to eurozone equities at attractive valuations and in an economic recovery that is well underway.

In an improving economic environment, an overweight to eurozone equities continues to make sense in our view; however, global growth concerns, and emerging market worries in particular, are likely to hurt some companies more than others. With this in mind, investors need to continue to be selective within eurozone equities in 2016, focusing on domestically oriented companies with attractive valuations and good earnings prospects, particularly in the small and mid cap sectors.

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