

Summary

- European equity markets have become increasingly sentiment driven in recent months, causing investors to overlook fundamentals.
- This has resulted in extreme crowding in certain sectors, leaving investors vulnerable to market rotations.
- For active managers, this has created idiosyncratic opportunities, particularly in undervalued and neglected sectors.
- In fixed income markets, we expect European corporate and sovereign bonds to defend the positive performance seen so far this year into the close of the fourth quarter.

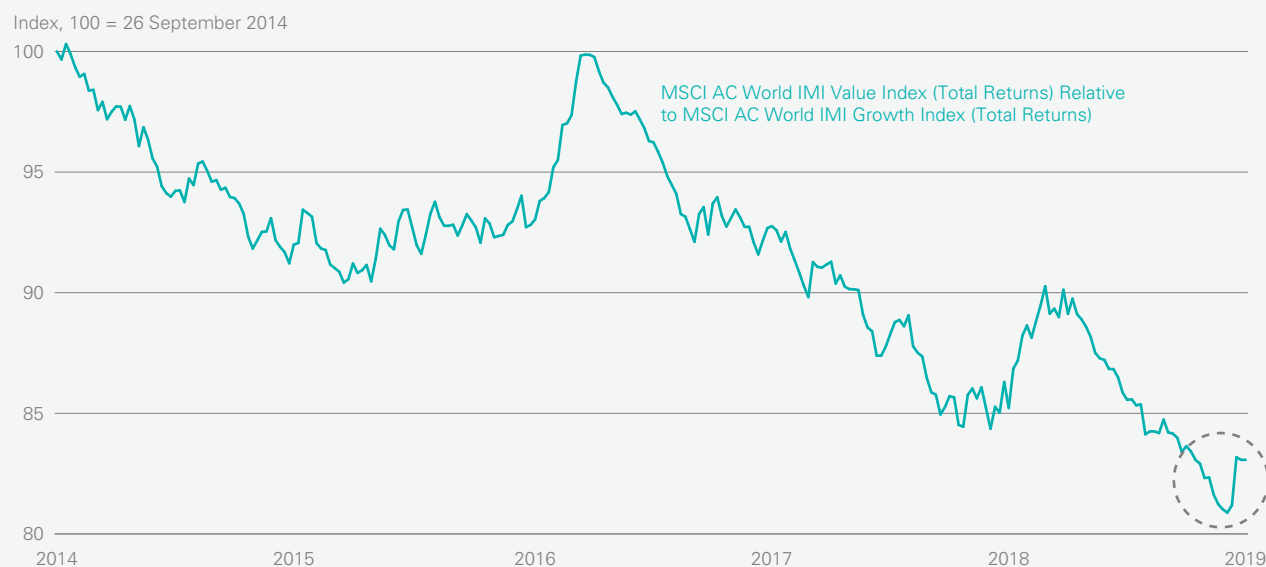
European Equities

Macroeconomic and political news flow—in particular monetary policy announcements in Europe and the United States, economic releases, and US-China trade negotiations—has dominated European equities in recent months and in September spurred a sharp rotation out of growth stocks in favour of value. Whether this rotation persists into year-end will largely rest on news flow and sentiment. However, a number of catalysts could extend this market reversal, especially when considering valuations and positioning in some areas remain extreme by historical standards.

A bounce in bond yields into the close of the third quarter was a key trigger for the style rotation (Exhibit 1), but the drivers behind the yield pickup were multi-faceted and, in some cases, nuanced. Investors, who have arguably been bearish about economic growth and corporate fundamentals since the start of the year, were forced to adjust their expectations in light of easing geopolitical tail risks, signs of stabilisation in the US economy, and increasingly dovish central bank policy.

In mid-September, the European Central Bank (ECB) delivered its biggest package of measures in three years, as it cut the deposit rate further into negative territory and restarted its bond-buying programme with €20 billion of open-ended monthly purchases.¹ The central bank also eased lending terms for banks in the euro zone and implemented tiered interest rates in a bid to ease the pressure on their lending margins. The ECB's move to insulate European banks from the harmful consequences of negative interest rates caused investors to warm to the sector after months of shunning it, resulting in a bounce alongside other value stocks and economically sensitive areas of the market.

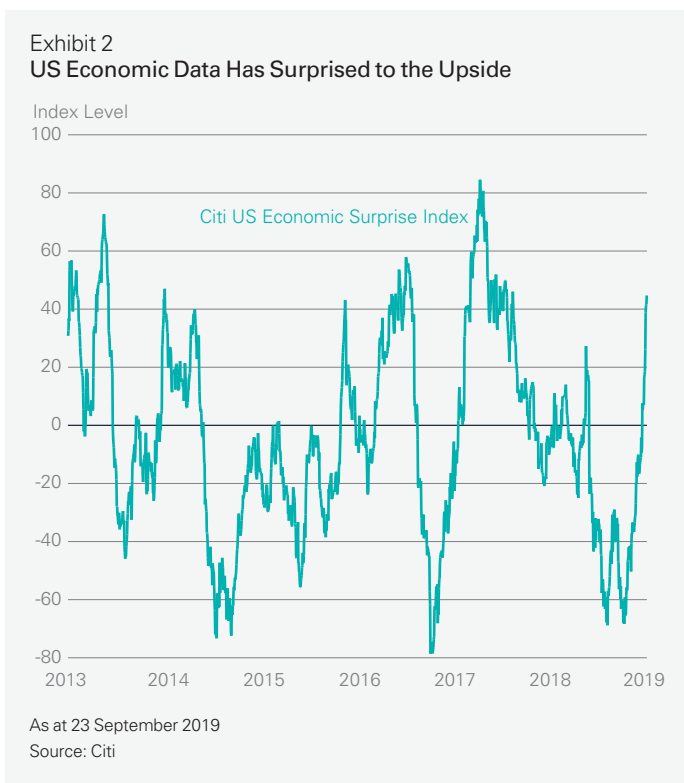
Exhibit 1
Value Has Rebounded versus Growth from Suppressed Levels



As at 27 September 2019
Source: MSCI

Outgoing ECB President Mario Draghi also stressed that fiscal policy needed to pick up the baton from monetary policy, through tax cuts and more spending, particularly by those countries in a position to do so. Meanwhile, the Federal Reserve (Fed) lowered interest rates by a quarter of a percentage point in September, its second cut since late July, and signalled it was prepared to take more aggressive action if the US economy showed signs of weakening.

Accommodative monetary policy decisions came against the backdrop of uneven economic conditions. There were signs of stabilisation in the US economy during September as the services and manufacturing sectors experienced a small uptick in growth. More broadly, US economic data has outpaced expectations, with the US Citi Economic Surprise Index currently at its highest level since April 2018 (Exhibit 2).



Data in the euro zone, however, has been more downbeat. Manufacturing activity fell to a near seven-year low in September, although services sector activity remained in expansion territory. The US-China trade dispute has heavily weighed on the manufacturing sector and on car producers globally. Germany accounts for a significant proportion of auto production, and it has been additionally affected by the introduction of new European Union emission tests. However, some of the overhangs could start to ease. European volumes were heavily disrupted by new emissions standards—the worldwide light vehicles test procedure—but year-on-year numbers could start to improve as the volatility in automotive production and delivery washes out of annual readings.

The drag from autos has contributed to a loss in momentum for Germany's economy. Recent data suggests the euro zone's largest economy is flirting with recession but, if realised, it is likely to be shallow and short-lived. Calls are growing for Germany's government—which has run a budget surplus for the past five years—to take more decisive fiscal action to revive its flagging economy. Indeed, Germany appears willing to take tentative steps toward launching a fiscal stimulus programme as part of achieving its ambitious ecological targets. Germany is looking to reduce greenhouse gas emissions by 55% by 2030 (compared with 1990 levels)² and, under proposals submitted so far, this could cost more than €30 billion over the next four years³. Such measures could be financed in part by the government's energy and climate fund, but it would also likely require borrowing new debt—an option made more appealing by the ECB's commitment to keep interest rates low for a prolonged period.

Meanwhile, tensions between the United States and China have eased slightly in recent weeks. China announced in September that some US products would be exempt from new tariffs—including agricultural products like soybeans and pork—and added that it planned to announce more exemptions in coming weeks. The United States extended some goodwill by delaying the implementation of some upcoming tariffs on key imports from China, raising hopes that an interim deal could be struck in a bid to resolve the two-year-long trade dispute.

The political backdrop in Europe also improved after a new left-leaning, EU-friendly government took power in Italy in September. The new coalition, formed of the anti-establishment Five Star Movement and the centre-left Democratic party, is expected to be less confrontational with Brussels than the previous government and likely more willing to attempt to balance growth-boosting economic measures with budget discipline. Still, political risks remain in Europe, given the heightened uncertainty around Brexit. The EU summit in October is seen as the final opportunity for UK Prime Minister Boris Johnson to agree to a deal before the 31 October departure date.

Investors have arguably been extremely pessimistic since the start of the year on the outlook for economic growth and geopolitical developments in Europe and abroad. This led to crowding in certain areas of the European market, in particular growth stocks, while flows into defensive sectors relative to cyclicals also became stretched, reflecting the underlying cautious sentiment. As we have previously argued, the macro trade around bond-sensitive stocks has become overextended, and the backup in bond yields and sharp rotation that resulted in equity markets in September was evidence of this.

We incrementally sold growth stocks in our portfolios over the third quarter as they became more expensive and some reached their price targets. At the same time, we gradually added to our value holdings, including some bank stocks. We also added to cyclicals and construction—which would benefit from fiscal easing—and maintained our exposure to autos. We believe that asymmetry in the market continues to persist and that valuations remain attractive in a number of under-owned sectors. While the recent style shift unwound some excesses,

there are areas of the market that remain stretched by historical standards. As such, the reward profile on some economically sensitive stocks looks attractive, in our view, given the pessimism reflected in valuations.

Extremes in market positioning and investor sentiment means that even an incremental improvement in sentiment could be powerful enough to spark a further rotation of capital out of heavily crowded sectors in favour of those that have been neglected. Catalysts for another move could include an improvement in economic data, increased fiscal spending, or signs of an agreement between China and the United States, and between the United Kingdom and the European Union.

In this increasingly complex environment, we believe that our active, bottom-up stock selection approach focused on company fundamentals is best suited to uncovering investment opportunities at attractive valuations.

European Fixed Income

Investor sentiment at the end of the third quarter was broadly risk on as credit spreads tightened, sovereign bond yields bounced from fresh lows, and credit default swap indices in Europe pushed lower. Additional measures from the ECB, improving corporate fundamentals, and a new government in Italy helped to underpin sentiment, although economic data globally remained downbeat.

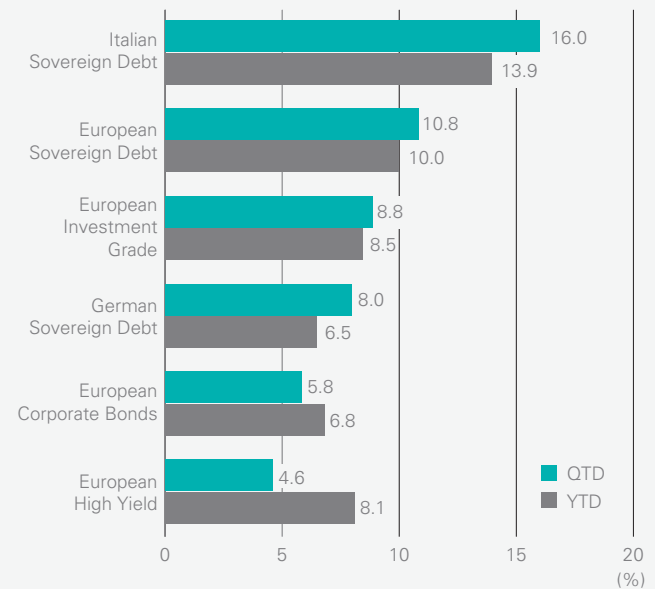
Italian government bonds were one of the strongest-performing fixed income assets during the period (Exhibit 3). The installation of a new Italian government in September narrowed the spread between German and Italian 10-year sovereign bonds to 130 basis points (bps) from 240 bps at the end of June. Additionally, the growth slowdown in Italy was less severe than foreseen earlier this year, suggesting the 2019 budget deficit may not overshoot initial forecasts. However some risks remain, as the new government's fiscal plans are not yet settled.

Economic data has been downbeat in Europe and globally. The manufacturing sector has particularly weighed on growth, especially in Germany. The ongoing trade dispute between the United States and China, the possibility of a no-deal Brexit, and the prospect of weaker growth across key economic countries globally has added further uncertainty and made companies reluctant to invest in capacity.

However, there have been some positive economic signals in Europe, particularly among domestically oriented services and construction sectors. Additionally, private consumption has held up, despite the decline in consumer confidence in August. We believe that the euro zone and the United States are able to withstand a slowdown in manufacturing sector activity and avoid a recession, as long as private consumption and activity in the services sectors remain robust.

As well as introducing a package of measures, the ECB also scaled back its growth projections for 2019 to 1.1% from an earlier estimate of 1.2% and lowered its 2020 forecast to 1.2% from 1.4%⁴. The central bank also lowered its inflation forecast by 10 bps to 1.2% this year,

Exhibit 3
Italian Bonds Had a Strong Quarter



As at 23 September 2019

European Corporate Bonds represented by the iBoxx Euro Corporates Overall Total Return Index; European High Yield represented by iBoxx Euro Liquid High Yield Total Return Index; European Investment Grade represented by the iBoxx Euro Overall Total Return Index; European Sovereign Debt represented by the iBoxx Euro Sovereign Overall Total Return Index; Italian Sovereign Debt represented by the iBoxx Euro Italy Sovereign Overall Total Return Index; German Sovereign Debt represented by the iBoxx Euro Germany Sovereign Overall Total Return Index.

Source: iBoxx

and by 40 bps to 1.0% next year⁴. European corporate and government bonds gave up some of their positive performance following the ECB announcement.

We believe the outlook for European fixed income markets will heavily depend on the trajectory of economic growth and inflation. We expect the ECB will continue to do its utmost to support growth and inflation in the euro zone. Additionally, the change at the helm of the ECB—from Mario Draghi to Christine Lagarde—could result in the implementation of more innovative measures and more pressure on national governments to stimulate their economies through fiscal measures.

We believe sovereign bond yields should stay at historically low levels and would expect yield curves to steepen if expectations begin to reflect the possibility of moderately rising inflation. Credit spreads are well supported by the mixed economic outlook, resilient corporate balance sheets, and positive momentum in corporate earnings. We expect defaults will continue to run at low levels, though we continue to believe that rigorous fundamental credit analysis is required to avoid underperforming corporate bonds. Broadly, we expect European corporate and sovereign bonds to defend the positive performance seen so far this year into the close of the fourth quarter.

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Notes

1. The European Central Bank, as at 12 September 2019.
2. The Washington Post, as at 20 September 2019.
3. Deutsche Welle, as at 20 September 2019.
4. The European Central Bank, as at 12 September 2019

Important Information

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