

Global Insight

Focus Article

French connection

The economic revival in Europe and France's "vote of confidence" in the EU increase the appeal of European equities.

Frédérique Carrier | Page 4

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All values in U.S. dollars and priced as of May 31, 2017, market close, unless otherwise noted.



Wealth Management

French connection



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- We have upgraded European equities to Overweight
- Economic revival is yielding better earnings growth while valuations are less demanding than elsewhere
- Political risk has receded in the short term

Europe's moment?

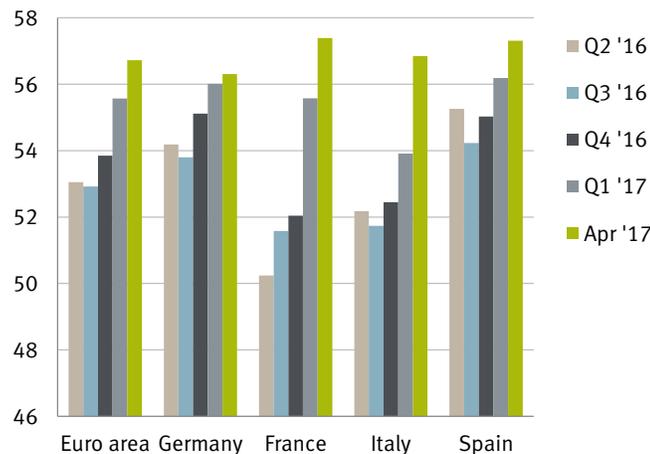
Europe has become a more attractive destination for investment as political risk has receded following the French election. But there is more to the European investment case than the victory of a centrist president at the helm of the region's second-largest economy.

Of greatest importance, the revival of Europe's economy has proven not only stronger than expected, with many leading indicators reaching a six-year high, but also much broader, with all major countries, bar Greece, now expanding at a healthy clip.

Loose monetary policy, fewer fiscal headwinds, and a credit mechanism which is now working have all helped. So have a relatively weak euro and the recovery in emerging economies, to which the region is highly exposed.

Economic activity heading in the right direction.

Euro area composite PMI quarterly average



All major countries show continued improving economic momentum.

Source - RBC Capital Markets, Haver Analytics

ECB to remain accommodative

This unexpectedly strong GDP growth may allow the European Central Bank (ECB) to plot a path towards very gradual further reductions in monetary stimulus. It has already reduced its asset purchase programme from €80B to €60B per month. For now, it is likely to stay on hold given subdued core inflation and still uncomfortably high unemployment in certain countries.

Moreover, potential upsets from Europe's heavy political cycle are still possible. While the German elections in September should produce a centrist government, the Italian elections pencilled in for Q1 2018 (though snap elections could be called before) could prove more problematic. The confluence of Italy's importance as Europe's third-largest economy, its heavy indebtedness, the precarious state of its banking system, and growing anti-EU sentiment could conspire to make this a preoccupying event. Somewhat reassuringly, the ruling Democratic Party has recently re-established its lead in the polls over the populist, anti-EU 5 Star Movement.

Conclusive evidence in several areas is needed before the ECB tightens

Decrease in political uncertainty	✓✓✓	French elections Italian elections Brexit negotiations
Macroeconomic improvements	✓✓✓	All indicators positive
Bond market stability	✓	Government bond market stable
Inflation 2% target	✓	Close at 1.9%, but core inflation only 1.2%
Inflation expectations 2% target	✓	Now at 1.6%

✓ Some evidence ✓✓✓ Conclusive evidence

Source - RBC Wealth Management

Euro no longer a headwind for equities ...

A weak euro may have improved regional competitiveness and revived growth, but it also induced a sustained outflow of foreign investor funds from European equities. However, since the turn of the year progressively stronger economic data culminated in better-than-expected Q1 GDP growth. This, together with the prospect of some additional scaling back of monthly bond purchases by the ECB, has produced a stronger euro. Centrist Emmanuel Macron's victory in France provided the icing on the cake.

Fund flows into equities have turned decidedly positive—up \$170B in the first four months of the year. At one point last year, outflows topped \$170B.

... As revenues and earnings surge

Against this positive background, the current earnings season has featured the strongest growth in seven years. With almost all results out, revenues and earnings have grown some 9% and 20% y/y, respectively, well ahead of the U.S.'s 8% and 14%. Moreover, all sectors in Europe—bar Utilities—have posted mostly double-digit earnings gains; mid-teens growth for the full year is now a real possibility.

Importantly, valuation levels in the eurozone are unusually compelling, in our view. Despite European equities' 10% rally year to date, with earnings improving more than expected, shares continue to trade at an unduly steep discount to those in the U.S. Europe is trading on a price-to-earnings ratio of 14.8x 2018E earnings versus 17.1x in the U.S., while the price-to-book value gap is even wider at 1.8x compared to 2.9x.

Despite European equities' 10% rally YTD, with earnings improving more than expected, shares continue to trade at an unduly steep discount to those in the U.S.

Is Europe's underperformance over?

MSCI Europe ex UK vs. S&P 500 in USD terms



Source - RBC Wealth Management, Bloomberg; data through 5/17/17

We have upgraded European equities to Overweight from Market Weight. Political risk has receded for now, and fundamentals have improved significantly.

Shoots of optimism

We have upgraded European equities to Overweight from Market Weight. Political risk has receded for now, and fundamentals have improved significantly. While we remain alert to the Italian elections' timing and outcome, Europe looks better now than it has for a while. We expect the recent emergence of the eurozone as a destination for international investment funds to continue.

We have been well served in the past by focusing on resilient companies with business models that do not depend on the vagaries of the European economic cycle. While we would continue to focus on these, we would also add exposure to well-capitalised banks and certain cyclicals, such as media. French domestic stocks, particularly in the retail, media, and leisure sectors, could benefit from the new government's measures to boost demand.

Appendix: Macron's moment

Even if well anticipated by polls, Macron's landslide victory, with over 60% of the vote, was more decisive than expected. With this outcome, the probability of a France-induced EU breakup recedes considerably.

Importantly, Macron is fiercely pro-European, a positive for the stability of the EU. The German elections this autumn may provide an opportunity to rekindle the EU integration project. This is key, as a eurozone breakup could still occur inadvertently if national debt trends deteriorate for too long. More integration in the region would be a step towards safeguarding against this possibility, in our view.

Macron campaigned on a platform mixing business-friendly reforms with measures to boost domestic demand. He aims to reduce unemployment from the current 10% to 7% and the fiscal deficit from over 3% of GDP to 1% by 2022.

Sceptics point to a young, untested leader, but his track record so far is interesting. Serving as France's minister of the economy for two years under then-President

President Macron's key suggested measures

Business-friendly/ labour market flexibility	<ul style="list-style-type: none"> • Reduce the corporate tax rate from 33% to 25%, the EU average • Reduce employers' social security contributions • Maintain the 35-hour work week, but allow some companies to deviate from it • Cap on severance payments • Decentralise collective bargaining from industry level to company level • Penalise companies with a large share of temporary workers
Demand boosting	<ul style="list-style-type: none"> • Abolish the housing tax for 80% of households • Increase the state-funded "employment bonus" for low-paid workers • Freeze the wealth tax on real estate • Freeze the tax on supplementary hours
Deficit cutting	<ul style="list-style-type: none"> • Cut 120,000 civil servant jobs over the next five years • Streamline public sector via non-replacement of 25% of retiring civil servants • Eliminate some government departments • Cut public spending from health insurance, unemployment insurance, and local authority spending (somewhat offset by increases in education, training, and defense) • Create universal unemployment insurance scheme that incentivises workers to get back to work

Source - RBC Wealth Management, "En Marche!" programme

François Hollande, he pushed through two laws to tackle France's overly regulated economy. One of those, the eponymous "loi Macron," includes a mixed bag of liberalising measures, ranging from streamlining labour court procedures to reducing the time needed to resolve labour disputes and loosening Sunday trading rules. Frustrated by internal opposition to his reform plans, he left the government to promote his own pro-reform movement.

But reforming the French economy is no easy task, as former Presidents Hollande and Nicolas Sarkozy both found out. France is very attached to its social institutions. Macron will have to act swiftly and decisively to avoid his predecessors' predicament.

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