



PRICE POINT

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Europe **EUROPE'S RECOVERY CONTINUES, BUT RISKS LOOM**

KEY POINTS

- We expect the European economic recovery to continue in 2018, supporting the Continent's bond and equity markets.
- However, lingering political risks, the prospect of European Central Bank tightening, and stretched credit valuations mean that periods of volatility are possible.
- In equities, we see potential opportunities in high-quality, growth-generating companies that are well placed to benefit from Europe's economic recovery.
- The most effective approach to active bond selection may be to identify corporate issuers whose "stories" are likely to improve irrespective of how credit benchmarks perform.

Underpinned by strong fundamentals, the European economic recovery should continue in 2018, providing support for the Continent's equity and bond markets. However, lingering political risks, the prospect of central bank tightening, and stretched valuations mean that periods of volatility cannot be ruled out. We believe investors could benefit from adopting a highly selective approach, with an emphasis on identifying strong companies within sectors that appear likely to benefit from the European recovery but potentially could be less exposed to periods of market instability.

POPULIST THREAT HAS SUBSIDED, NOT DISAPPEARED

Following the UK's watershed decision to exit the European Union, the established order in Europe seemed under threat from populist movements in a number of countries in 2017. Elections in the Netherlands, France, and Germany—and a planned unofficial referendum on

independence for Catalonia from Spain—all were seen as potential flashpoints that could challenge the EU's attempts at closer integration.

In the end, mainstream parties prevailed in the Netherlands and France, but anti-immigration, anti-EU candidates made some headway in Germany and in Austria's early election. Although the "yes" vote in October's Catalan referendum was driven more by long-standing regional grievances against the Spanish government than by anti-immigration or anti-EU sentiment, the issue of Catalan independence still could play a decisive role in influencing other separatist movements in Europe.

Despite these risks, the eurozone grew at a healthy rate throughout the year—consistent with economies in other parts of the world that proved similarly impervious to negative geopolitical events. The big question for 2018 is

whether this resilience will continue. At a fundamental level, the prospects look good: Europe is at an earlier stage in the credit cycle than the U.S., corporate earnings are strong, and the recovery seems to be broad-based enough to sustain itself.

Risks remain, however. While the threat from anti-EU and other separatist forces has abated, it has not disappeared. The situation in Catalonia could take a while to resolve, the euroskeptic Five Star Movement and Northern League parties both are expected to perform well in the Italian general election due in March, and negotiations over Brexit could yet collapse. The possibility remains that other member states will seek to leave the EU or that populist movements will gain stronger footholds in their national parliaments, influencing policy. Any such developments would be regarded as threats to EU unity.

ECB TO PLAY A MAJOR ROLE

The prospect of central bank tightening is another potential risk to the 2018 outlook. In October, the European Central Bank (ECB) announced plans to scale back its monthly asset purchase program from €60bn to €30bn beginning in early 2018. But it also clarified that it would continue reinvesting the proceeds of its bond purchases for “as long as necessary” to support growth and would not raise rates until after its bond purchases have been ended.

We believe the ECB’s announcement suggests that monetary policy in the eurozone will remain highly accommodative for the next few years at least, which is good news for investors concerned about the vulnerability of the European recovery. However, if the eurozone economy expands more quickly than expected, the ECB could be forced to tighten more aggressively, which would risk putting upward pressure on credit spreads.

We believe investors could benefit from adopting a highly selective approach, with an emphasis on identifying strong companies within sectors that appear likely to benefit from the European recovery but potentially could be less exposed to periods of market instability.

FIGURE 1: European Earnings Per Share Estimates Through Time

As of October 3, 2017



Source: Morgan Stanley.

Elsewhere, the U.S. Federal Reserve is expected to raise rates three times in 2018 and adopt a fairly moderate approach to shrinking its balance sheet, but the pace could change depending on growth and inflation data. If the Fed surprises the markets with more aggressive tightening, any subsequent spike in volatility also could affect the recovery in Europe.

GROWTH-GENERATING STOCKS COULD OUTPERFORM

Investors in European equities benefited from rising corporate earnings throughout 2017 on the back of the strong fundamentals and diminishing concerns over political risk. We expect earnings growth to be slower in 2018 and in 2019 (Figure 1), mainly due to a stronger euro and the difficulties some companies could have offsetting input cost pressures

from higher raw material prices. However, as many other asset classes appear to be fully valued, we believe that further upside potential to European equities is possible if corporations continue to build on their recent solid growth.

In our view, the best European equity opportunities in 2018 are likely to be found in high-quality, growth-generating companies that are well placed to benefit from the economic recovery. The telecommunications sector is particularly interesting in this regard because consolidation is driving competition and boosting margins. European banks are generally undervalued and stand to benefit from the gradual removal of monetary stimulus by the ECB. However, we do not expect financial stocks to outperform significantly in 2018 as interest rates are unlikely to rise appreciably.

We also see potential opportunities in the software services industry, where a number of companies are innovative disruptors and are delivering excellent rates of compound growth. Although we do not generally favor automakers given their expensive valuations, regulatory issues, and complex financing structures, opportunities can be found among the industry's suppliers—particularly original equipment manufacturers using innovative technologies to develop irreplaceable parts.

Our focus on growth has led us away from defensive sectors such as consumer staples, which have fallen out of favor with the market more broadly. However, these sectors have become cheaper recently, and opportunities may arise if valuations fall further, as a number of companies offer good earnings growth, strong returns, and healthy dividends.

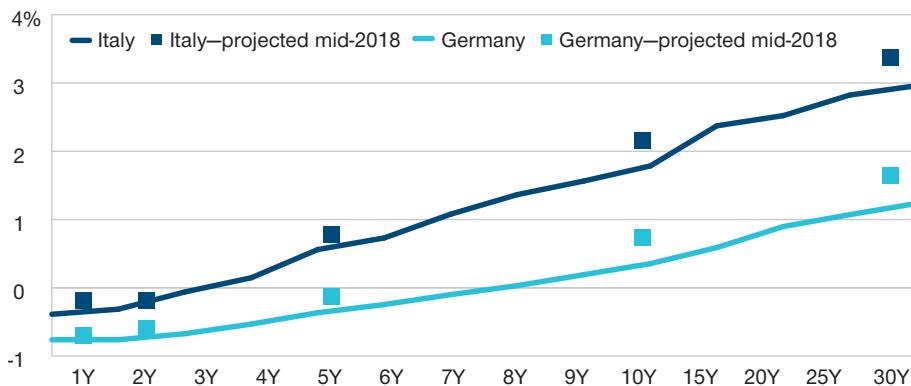
LOW YIELDS EMPHASIZE NEED FOR “STRONG STORIES”

Strong corporate fundamentals meant that European credit markets also performed well in 2017. The ECB's huge monetary stimulus program played a major role in supporting the rally by making it cheaper than ever for corporations to borrow and by reducing default risk to record-low levels, encouraging investment.

However, lower risk has also brought lower returns. Monetary stimulus has compressed yields, although the rewards available in European credit markets

FIGURE 2: Italian and German Sovereign Yield Curves, Current and Projected

As of November 10, 2017



Sources: Bloomberg Finance LP and T. Rowe Price European Fixed Income team projections. The projections are based on current data as of the date stated and projections of economic/political conditions. Information presented herein is hypothetical in nature and is shown for illustrative, informational purposes only. It is not intended to be investment advice or a recommendation to take any particular investment action. This is not intended to forecast or predict future events and does not guarantee future results. These are subject to change without further notice.

have been better than in many other markets. Assuming the ECB keeps its pledge to adopt a cautious approach to tapering, we believe that European corporate debt markets will deflate rather than burst and that yield curves will rise only gradually in 2018 (Figure 2).

Given the risk of holding low-coupon securities at a time when political risks are present and central banks are seeking to remove monetary accommodation, we believe a sensible approach for investors is to seek to identify corporate issuers whose individual “stories” have the potential to improve irrespective of how credit benchmarks perform. This strategy may lead to underperformance during market rallies, but over the longer term, it is likely to be a more effective way of navigating

a period of monetary tightening and market volatility, in our view.

Attractive European high yield issuers currently include media, cable, telecommunications, and packaging companies, all of which appear well positioned from both a cyclical and a secular perspective. We believe the most promising opportunities within investment-grade debt can be found in broadly the same sectors and also among financial companies, which form a much bigger part of the investment-grade universe. The new capital rules put in place after the 2008–2009 financial crisis are now being tested—and so far, they seem to be working. If this continues, we believe European financial debt issues can perform strongly again in 2018.

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