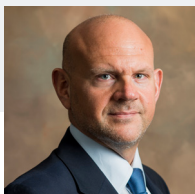




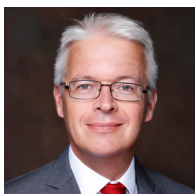
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August 2018

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## International Equity **INCREASING OPPORTUNITIES IN EUROPEAN EQUITIES**

### KEY POINTS

- Increasing market and sector volatility are resulting in more attractive valuations for select higher-quality companies—in the context of a broader market where valuations are capable of being supported by sustained earnings growth.
- Economic fundamentals continue to develop positively in most European countries, although the degree of momentum and global synchronization has lessened since earlier in the year.
- Decent earnings growth is likely this year and next, but European political upheaval and external uncertainties could create headwinds.
- Our disciplined focus on higher-quality companies trading at a discount has led us to some defensive areas that seem out of favor with investors.

### EUROPEAN STOCK VALUATIONS ARE ATTRACTIVE; UPSIDE POTENTIAL DEPENDS ON EARNINGS

Increasing market and sector volatility are resulting in more attractive valuations for select higher-quality companies—in the context of a broader market where valuations are capable of being supported by sustained earnings growth. Second-quarter earnings thus far have been encouraging, but first-quarter European earnings were weaker than in the U.S. and Japan. Although many asset classes appear to be fully valued, equities in developed European markets—following the stock market decline earlier this year, which presented us with some attractive, high-quality investment opportunities—were trading at just over 18 times the cyclically adjusted price/earnings ratio (i.e., the Shiller P/E), which is below their longer-term historical average. Our focus on higher-quality

companies that trade at a discount but have superior and sustainable return potential has led us to some defensive areas that seem out of favor with investors. Earlier this year, we added to holdings in the industrials and business services, financials, and health care sectors. More recently, we have been finding some selective opportunities in cyclical industries where we believe the market is unfairly penalizing companies.

### EXPANSION SUPPORTS EARNINGS, SHOULD COUNTER MONETARY TIGHTENING AND STRONGER EURO

Economic fundamentals continue to develop positively in most European countries, although the degree of momentum and global synchronization has lessened since earlier in the year. The eurozone economy is still expanding, although it has been

## The outlook for European earnings growth remains positive, underpinned by the continuing domestic economic expansion, solid fundamentals, and synchronized growth in most parts of the world.

slowing recently, and strengthening in the manufacturing and services sectors is broad-based. In our opinion, these factors should help corporate earnings growth, particularly because we expect that the European Central Bank (ECB) will continue its accommodative policies. The ECB recently decided to cut its monthly bond purchases in half (from €30 billion to €15 billion) after

September and to stop purchases completely at the end of 2018. The ECB also said that it would keep rates on hold until “at least through the summer of 2019.”

### **POLITICAL UNCERTAINTY AND TARIFFS ARE RISKS**

While we expect decent earnings growth in the coming year, political risks could create headwinds to the economic expansion. Among the most significant risks are the populist coalition government in Italy, the fragile new Socialist-led government in Spain, and the contentious Brexit process, which must be completed by early 2019. In addition, the Trump administration’s trade tariffs on imports from European partners and China could weigh on global economic growth. Downside risks to growth in trade-driven Asian economies, major markets for many European exporters, are a legitimate concern.

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