Small-Caps Can Weather European Market Volatility

Innovative Growth Companies Offer Resilient Quality.

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KEY INSIGHTS

- European equity markets are likely to remain volatile in 2019.
- Europe is home to many innovative growth companies that could perform well over the medium term.
- Uncertainties caused by market dynamics, economic fundamentals, and a number of geopolitical issues have raised the bar that companies must meet to succeed.

We expect that European equity markets in 2019 will resemble the second half of 2018, when volatility sharply increased in reaction mainly to the removal of fiscal stimulus by central banks, heightened trade war fears, and evidence of a deepening economic slowdown in Europe. These events had combined to trigger an abrupt halt in the prolonged period of sustained expansion in the final months of 2018, deflating ballooning valuations.

The emergence of populist movements across the Continent, the tortuous Brexit process, and the deterioration in Italy's relationship with the European Union (EU) have also contributed to an uneasy geopolitical backdrop, which we continue to monitor.

Externally, the outlook for economic growth has grown murkier, as trade war concerns affect activity and investment intentions. Doubts remain about the U.S. economy's ability to withstand a shift to higher borrowing costs. Emerging market risks have also intensified, which may affect export markets for many European companies. Slowing growth in Asia, not least China, and geopolitical risks in the region cannot be ignored either.

ECB Stance Helps but Brexit Looms

The European Central Bank's (ECB) accommodative monetary policy stance is supporting market expectations. Corporate earnings have also registered two years' improvement after a prolonged period of disappointment. While the slowing economy has prompted analysts to reduce earnings expectations for 2019, they are still moderately positive, with expectations for the smaller end of the market slightly more favorable than for their large-cap peers.[1]

[1] IBES. As of December 31, 2018.

> The structural shift in the economy being driven by small, innovative companies has powerful momentum and is likely to last several years.
>
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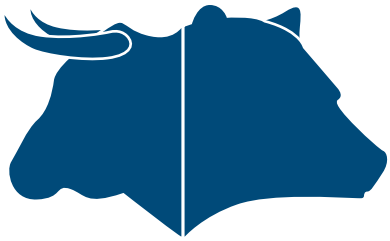
(Fig. 1) Small-Caps' Resilient Track Record

Smaller companies can outperform in bear markets as well as bull markets
As of December 31, 2018

Small-Caps outperformed versus MSCI Europe Index
December 2000–2018

66%
of the time in up markets



55%
of the time in down markets

Past performance is not a reliable indicator of future performance.
Sources: T. Rowe Price and MSCI.

Meanwhile, the political and economic instability fueled by continuing Brexit uncertainty has sapped the UK's political system and worsened the outlook for the rest of Europe. Whatever may eventually be agreed, the complex process of untangling one of Europe's largest trading partners from the single market would only then begin and would still probably have a severe impact on both economies.

We have subjected our UK exposure to greater scrutiny ever since the referendum on EU membership in June 2016. We reduced our UK holdings with only a domestic or cyclical exposure to the economy because they are the most at risk should growth falter. We have therefore sought to reinforce our focus on quality growth companies, adding to names that we like, and the same goes for elsewhere in Europe. As a result, we have taken a slightly more defensive tilt as we seek clarification on the Brexit story.

Small-Caps Have Been Resilient in Tougher Markets

Although Europe's economy is decelerating and political risks are making inroads, it is in much better shape than it was 10 years ago.

Since the financial crisis, there has been an impressively broad-based recovery. New industries have been born, and a host of exciting, innovative companies are carving out leading roles and reshaping their markets. We are encouraged by these various game-changing developments, which include internet-led transformations and innovations in medicine, that favor structural growth companies over traditional industries. This structural shift in the economy has powerful momentum and is likely to last several years.

We believe this changing dynamic has been one of the reasons why European small-caps have materially outperformed large-caps over the past 10 years—although the pace at which they have done so has recently slowed.[2] During that time, small-cap stocks have shown they can also outperform in various market environments—both bull and bear. Relative to the large-cap MSCI Europe Index, small-cap stocks have historically outperformed 66% of the time on average in up markets, while in down markets they have outperformed 55% of the time, according to T. Rowe Price analysis.

[2]The MSCI Europe Small Cap Index has grown in euro terms at a compounded annual rate of the 14%, versus 8% for the large-cap MSCI Europe Index between December 2008 and December 2018. Sources: T. Rowe Price and MSCI.

Cheaper Valuations Offer Entry Point

Valuations in the European small-cap universe are now broadly in line with their long-term history. We are also seeing that the valuations of the higher-quality, high-growth companies have contracted even more than the overall market in the recent decline. As these high-growth stocks are now more attractive on a relative basis than the market overall, they offer an attractive entry point for investors.

Our research within the European small-cap universe seeks to uncover the best innovative opportunities—high-quality companies that we believe can generate high compounded growth rates over time. Often this is within the strategy's largest relative allocations, the information technology, health care, consumer discretionary, and communication services sectors, where we continue to find names with the potential to grab and grow market share.

No Change in Focus

Consequently, our focus remains on building a diversified portfolio centered on innovative growth companies that we believe can be much larger in five to 10 years, regardless of the macroeconomic and geopolitical pressures they face.

Despite the near-term challenges facing markets, we believe that high-quality, high-growth smaller companies can continue to make progress over the coming year. We remain bullish on the longer-term outlook for European equities and, specifically, the companies we hold in the European Smaller Companies Equity Strategy.

WHAT WE'RE WATCHING NEXT

Heightened uncertainty around Brexit, the growing appeal of populist movements, as well as international trade tensions and the potential for sharper-than-expected slowdowns in the U.S., China and Europe are among the downside risks that we continue to monitor.

Key Risks—The following risks are materially relevant to the strategies highlighted in this material:
Transactions in securities of foreign currencies may be subject to fluctuations of exchange rates which may affect the value of an investment. Investment in small companies involves greater risk than is customarily associated with larger companies, since small companies often have limited product lines, markets or financial resources.

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