Select Opportunities in Europe Amid More Volatile Markets

Markets are increasingly volatile but provide fertile ground for active stock pickers.

October 2019

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KEY INSIGHTS

- We expect market volatility to continue until issues relating to trade, the slowing economy, and central bank policy are resolved.
- A more volatile market, combined with greater dispersion of returns, presents active managers with more relative opportunities to exploit.
- We are monitoring cyclical areas where uncertainty has depressed valuations (such as the banking and automotive industries) while maintaining a clear bias toward higher-quality companies capable of generating longer-term outperformance.

The European equity market rallied strongly in the first half of this year, although trading was more volatile. The overall gains masked bouts of shifting sentiment and direction caused by uncertainty surrounding trade, economic fundamentals, and central bank intentions. Investor concerns around these issues remain elevated; hence we expect further volatility may be in store.

Mounting Risks Cloud Outlook

At the start of 2019, hopes were high that economic growth and company results would pick up in the second half of the year. Instead, slowdowns in China, Germany, and the eurozone are evident—indicating perhaps that the ongoing U.S.-China trade impasse is adding significant downward pressure on global economic activity.

Our outlook for 2020 is therefore a shade less positive. Indeed, parts of Europe could tip into recession due to the slowdown in China, which is hurting the bloc's main economic engine, Germany. Second-quarter growth there fell 0.1%. Any further worsening of trade relations between the world's three largest blocs could materially undermine key European industries, including automotive and technology.

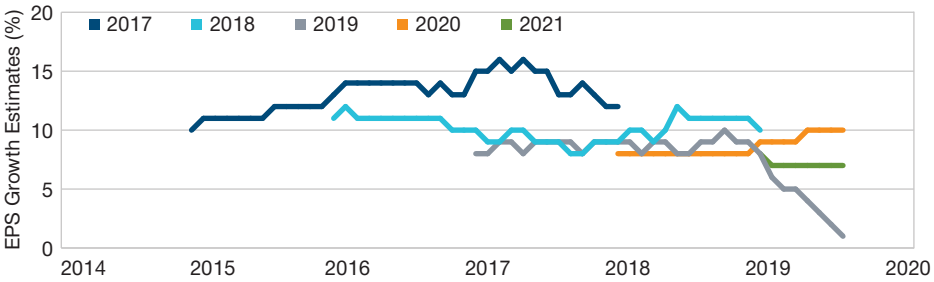
Meanwhile, political risk has intensified on two fronts, adding to uncertainty for investors. Britain's exit from the European Union remains mired in political uncertainty ahead of the extended exit date of October 31. The succession of Boris Johnson as UK prime minister appears to have raised the prospect of a no-deal Brexit, which many observers expect would result in severe disruption to trade and relations across Europe.

In Italy, political instability appears to have eased with the agreement on a

(Fig. 1) Earnings Estimates Turn Down

Earnings estimates in 2019 have been materially downgraded in recent months, and although the consensus expects growth to return next year, these hopes could well be disappointed.

MSCI Europe EPS Growth Estimates as of July 31, 2019



Source: FactSet Research Systems, Inc. (see Additional Disclosure).

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> — **Dean Tenerelli**
> *Portfolio Manager, European Equity Strategy*

new coalition government between the populist Five Star Movement and the center-left Democratic Party. But the combination of two antithetical political forces raises the question of whether the coalition can last in the face of severe challenges posed by rising budget deficits, economic stagnation, and permanently rising debt.

What does this mean for European equities? With the market still appreciably ahead for the year and aggregate valuations not especially attractive, there may not be much scope for further advances. Analysts have reduced their expectations for company earnings in the year to date and now expect little or no growth.

Consequently, in our view, material progress requires a resolution of the U.S.-China trade conflict and an accompanying increase in confidence in the global economy.

Tenerelli Seeks a Balanced Portfolio to Counter Shifts in Sentiment

As bottom-up stock pickers, our focus in the European Equity Strategy is mainly on valuation rather than top-down concerns, although we keep a weather eye open on them. In these volatile conditions, we aim to build a portfolio with a broad spread of high-quality exposures, so that even if a more positive economic scenario were to unfold, the portfolio should display a good degree of resilience.

Although valuations are now near their historical averages after the market rally, we are still finding a wider range of investments. We welcome the more volatile market and greater dispersion of returns because this gives us more relative opportunities to exploit.

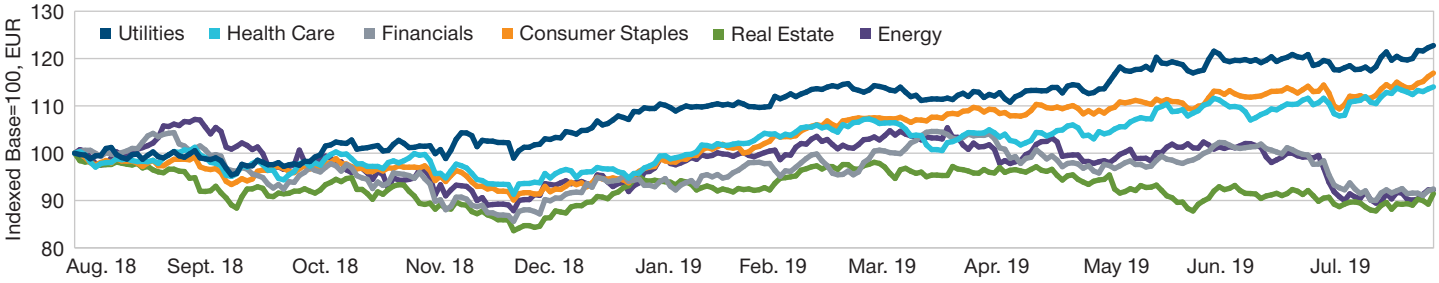
We are avoiding parts of the market that are overvalued, such as consumer staples, as we believe they could well be subject to correction. Select investment opportunities may emerge in some cyclical industries that have been beaten down by investors. These include semiconductors, banks, and automotives, where valuations generally have been unmoored by the exaggerated decline in share prices. Caution, however, is required, as we doubt there will be a rapid recovery in their fortunes.

In financials, the background for banks is unfavorable, and the poor industry fundamentals are likely to continue. Europe's economy is losing momentum, the European Central Bank acted aggressively again to bolster growth, and analysts are still downgrading earnings estimates. It is tempting to be bearish, but it is hard to see that there could be

(Fig. 2) Wide Spread of Returns Favors Stock Picking

Wide dispersion of sector returns offers more opportunities for active managers.

MSCI Europe Index (Net)[1] as of August 28, 2019



Past performance is not a reliable indicator of future performance.

Source: FactSet Research Systems, Inc. (see Additional Disclosure).

[1] Returns shown with reinvestment of dividends after the deduction of withholding taxes.

much more downside, so the valuation trade is one to keep in mind.

While we are underweight the industry, we are monitoring banking markets that still show signs of growth, such as Spain. There are high-quality lenders that are especially attractive at these levels because they have diversified income and are less sensitive to margin compression caused by the low interest rates in Europe.

Overweight in Utilities Anchors Performance

Some defensive sectors are proving more attractive because they have been more resilient amid the uncertainty. As a result, our overweight in utilities has benefited the strategy. We started investing in Italian and Spanish utilities when cyclical sectors were in demand and defensive stocks were cheaper. We hold regulated companies that have advantageous positions in consolidating markets, benefit from favorable regulatory regimes, and offer an attractive and dependable income yield.

Eclectic Health Care Opportunities

Some health care stocks are also trading at valuations that indicate markets are underestimating their potential for defensive growth. We also hold a range of high-quality pharmaceutical companies with excellent track records and growing pipelines of new products that promise steady earnings growth over the medium term.

Looking further ahead, I believe Cellnex Telecom, a Spain-listed operator of wireless telecommunications and broadcasting towers, is an ably managed business that is positioning itself as the dominant tower company in Europe. The outlook for growth is promising as more telecom companies have to outsource their towers because of capital or cash flow needs. Cellnex is at the center of this trend in an industry that is on the verge of significant expansion, in our view.

European Select Equity Strategy

As testimony of our commitment to active stock picking in Europe, we have developed a high-conviction, concentrated strategy called the European Select Equity Strategy. The portfolio manager, Tobias Mueller, previously covered the technology, medical technology, and exchange sectors as a research analyst in the Equity Division.

The strategy leverages our strong research team aiming to identify 25 to 45 stocks that display sustained growth over the medium to long term. The strategy invests in higher-quality companies with

(Fig. 3) Strategy Sector and Industry Overweights

Overweights reflect different opportunity sets for each European strategy.

European Equity Strategy

Utilities

- **Regulated Utilities—** *Attractive valuations and relatively predictable returns*

Industrial and Business Services

- **Capital Goods—** *Higher-quality cyclical exposure and attractive capital returns*

European Select Equity Strategy

Information Technology

- **Secular Growers—** *Innovative chipmakers and dominant suppliers and platform models*

Health Care

- **Innovation Drivers—** *Medical devices, health care system reform, and patient trends*

Source: T. Rowe Price.

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> *European Select Equity Strategy*

durable business models that we believe are firmly "on the right side of change." We also look for companies undergoing idiosyncratic changes that are improving their outlook and returns. Tobias believes this bottom-up approach to identify these features is the best defense against unfavorable macroeconomic developments and swings in market fortunes. Among sectors, information technology is the largest overweight, although allocations to health care and consumer discretionary are currently overweight as well.

After this year's rally, many durable defensive growth stocks are trading at extended levels. Even so, a high valuation multiple is quite often a feature of such growth stocks, so we are willing either to hold expensive names or to pay a higher price for those that we believe are likely to continue growing strongly over the medium term. Our medium- to long-term view helps us ride out episodes of extended valuation, market squalls, or value rallies and to participate in the longer-term expansion of strong companies.

Medical Technology a Focus for Durable Growth

Medical technology is another area that offers interesting opportunities. We expect the medical devices industry to grow rapidly, underpinned by the increasing demand for technology to cope with aging populations—not just in Europe, but in developing countries that have burgeoning middle classes. Innovative technologies such as the internet of things should also drive rapid expansion. Indeed, our overweight in health care is based mainly on medtech stocks.

However, there are risks posed by increased competition from innovative disruptors, regulatory oversight, and trade disputes, particularly between China and the U.S. We are particularly concerned by the growing evidence of disruption to global supply chains, which depend on frictionless trade. This is affecting almost every industry, some more than others. More friction is likely to be introduced into the system by the trade disputes between several countries. It will take time to ascertain how investors and companies will respond.

Downward pressure on medical prices in the U.S., exerted both by the presidential administration and individual states, is also an issue. We are monitoring these risks, but, on balance, the conditions for continued growth in this area are a cause for optimism. The work we have done internally suggests the outcome of this pressure on the pharmaceutical industry should be more benign than suggested by tweets from Elizabeth Warren or President Donald Trump.

Looking ahead, one of our largest investments is ASML is the dominant supplier of lithography equipment used in the production of semiconductor chips. We believe we have reached the tipping point for the widespread adoption of the company's extreme ultraviolet lithography product, a cutting-edge tool that will be used in the manufacturing of the most advanced semiconductors for mobile, server, network, and supercomputer applications. ASML predicts margins will expand significantly over the long term because of continuing demand for its tools despite escalating trade tensions between China and the U.S. and a soft market for memory chips.

WHAT WE'RE WATCHING NEXT

Dean is finding attractively valued stocks in health care and utilities, whose defensive qualities should stand the portfolio in good stead amid the current market volatility. Tobias is interested in medical technology and, as always, in information technology because both sectors are seedbeds for durable growth companies.

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. The portfolio is subject to the volatility inherent in equity investing, and its value may fluctuate more than a portfolio investing in income-oriented securities.

Additional Disclosure

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ID0002634 (10/2019)
201909-968533