European Equities
STAYING NIMBLE AND BALANCED IN UNUSUAL TIMES

KEY POINTS

- The European economy is managing to deliver a modest recovery, with the help of the European Central Bank, and there are reasonable grounds for believing that this will continue.

- Corporate earnings are currently close to a cyclical trough, and the potential for more positive momentum has improved.

- We are cautious given the increased uncertainty sparked by the Brexit vote and the potential for political turbulence in the months ahead.

- While sentiment toward European equities is negative, the reality is more balanced and should favor our approach based on fundamental research and active stock selection.

Sentiment toward European equities is negative following the unusual challenges of 2016. There were significant fund outflows throughout the first 10 months of the year, which seemed to indicate that some investors had capitulated.\(^1\) The continuing moderate pace of growth, despite unprecedented doses of central bank stimulus; several years of disappointing corporate earnings; and growing political uncertainty may have proved too much for many investors to bear. The market environment was also volatile, as quantitative easing made equity markets very rotational, often wrong-footing investors.

We believe there will be more uncertainty in the year ahead, with the prospect of further potentially sizable shifts in the European political landscape. However, in our view, the foundations for investing in Europe are more solid than investors may appreciate, once one looks below the surface. In particular, economic growth and the corporate earnings outlook are both currently meeting expectations.

\(^1\)Sources: Broadridge Financial Solutions, FFMI Fund File. As of October 31, 2016.
One encouraging sign for European equities is that the Citigroup Economic Surprise Index for Europe, which rises when economic data exceed economists’ consensus estimates, climbed to its highest level since March 2015 at the end of October 2016.² Analysts have also become more confident about the impact of the economic expansion on corporate earnings growth. The 12-month earnings revision ratio for the MSCI Europe Index advanced strongly through the first 10 months of 2016, which means that there were more upgrades than downgrades and that companies were meeting or exceeding consensus forecasts.³ In recent years, expectations have typically fallen as the year has progressed. At present, hopes for a return to earnings growth in the year ahead seem to be more soundly based.

European macroeconomic conditions seem to have improved as well. Markets, consumer sentiment, and demand have largely recovered from Brexit’s initial shock. Fears of a sharp slowdown in the UK economy have subsided, at least for the time being, as recent economic data show demand holding up. Continental Europe’s economy has, so far, continued to grow at a moderate pace, and the composite purchasing managers’ index indicates further expansion in the months ahead.

CONCERNS ABOUT EUROPEAN UNITY

However, it would be premature just yet to say that the gloomy perceptions of the European economy are beginning to lift. The UK’s exit from the European Union (EU) may still turn out to be disruptive. The European Central Bank appears to be less certain about growth in 2017, and its policy remains highly accommodative. Political uncertainty is expected to persist in the year ahead with crucial elections in Germany and France, the two largest eurozone members, which could be additional flashpoints for instability in the EU. Mainstream political parties are preparing to counter a rising tide of populism that has already upended incumbents in the UK and the U.S. and reignited concerns about European unity.

²Sources: Citi; Bloomberg Finance, L.P. As of October 31, 2016.

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Meanwhile, Donald Trump’s victory in the U.S. presidential election has triggered an unexpected change in market sentiment, providing a welcome respite for investors resigned to the idea of a prolonged period of secular stagnation. The ensuing rally has favored stocks on both sides of the Atlantic, with the main beneficiaries in Europe being in the banking, materials, and capital goods sectors. Whether this surge will extend into 2017 depends at least in part on the execution of the promised fiscal stimulus by the incoming administration. Furthermore, we have yet to see evidence that the U.S. economy is strong enough to withstand higher interest rates.

These political and economic factors all have a bearing on our assessment of market conditions. However, we believe that Europe’s market is reasonably priced, and the potential for more positive momentum has improved. European valuations are by no means extended versus historical averages. At the end of the fourth quarter 2016, investors were paying just over 16 times forward 12-month earnings for developed European equities, which only slightly exceeded the longer-term historical average.4

CONDITIONS CALL FOR BALANCED APPROACH

The UK’s vote to leave the EU is a pivotal event for Europe, and the full breadth and depth of its impact remain to be seen. We do not possess any meaningful advantage over other investors in determining how the process will ultimately play out. While we have reduced our UK holdings, selling some of our companies solely with domestic exposure, we are not attempting to position our European equity strategy to benefit from one particular scenario or another. Rather, we continue to invest in a blend of high-quality growth and value stocks that we believe could benefit whether Europe’s economy stays on course for recovery or if it falters due to Brexit-related risks.

Some of our investments may suffer in periods when markets are dominated by macroeconomic events and themes, but our experience has been that companies fall in and out of favor during these periods and other good-quality stocks often become available at more attractive prices. We are currently finding potentially attractive opportunities in retailing, where profitable European companies are operating across the globe; in communications, where some firms are benefiting from convergence and market consolidation; in technology, where e-commerce is helping firms become more efficient; and in financials, particularly banks in consolidated markets that are poised to benefit from steeper global yield curves in the wake of the U.S. election.

Whatever the prevailing economic and market conditions, we stick to our investment philosophy and process—tried and tested for more than a decade. We get to know the businesses that meet our quality criteria, we establish a price we are prepared to pay for those companies, and we act on those opportunities if and when our valuation requirements are met.

4Sources: FactSet and T. Rowe Price. As of December 31, 2016.
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