Confidence must be earned

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INVESTMENT INSIGHTS | BLUE PAPER | October 2017

European renaissance: The case for a selective approach

EUROPEAN RENAISSANCE
5 Reasons to consider

OCT 2017

1 Broad based recovery

The economic recovery is now more robust and synchronised across countries. It has translated into tangible employment gains and decreasing macroeconomic imbalances. Accommodative monetary conditions have also helped to increase credit to the private sectors, creating a positive backdrop for further economic expansion. Against this backdrop, the ongoing recovery is widely expected to continue.

Eurozone PMI at highest level since April 2011

The Markit Purchasing Managers' Index PMI is a business activity indicator

2 Structural reforms ongoing

Structural reforms have already played a pivotal role in increasing competitiveness, especially in peripheral countries. In the future, we should see further gains from structural reforms, as many have not yet been implemented, and the full impact of the reforms tend to materialise only in the medium to long-term.

Rise in competitiveness and future growth potential

3 Eased geopolitical risk

On the political side, the outlook has improved and we expect the Franco-German alliance to lead the reforms in the Eurozone. Overall, we believe reduced uncertainty in European politics will remain for a while, and could contribute to improved risk sentiment towards European risk assets. Moving into 2018, politics is set to regain the stage with elections in Italy that could bring volatility back.

73%

For Euro Area highest support to the EMU since 2004

4 Improved earnings outlook

The improved business confidence and the European recovery have finally started to translate into corporate earnings growth. We believe selection will be key to assess the impact that the Euro appreciation can have at a single stock and sector level, and also to identify the companies that can best translate sales growth into earnings growth and therefore be favoured in the future.

+11% EPS growth

Amundi forecast for Europe to June 2018

5 Valuations and potential for upside

On valuations, Europe does not appear particularly cheap in absolute terms, but it is an attractive market especially when compared to the expensive US market. For the future, we believe that current valuations in Europe leave room for further price appreciation, provided companies continue to grow their earnings. A revamp in M&A and corporate buybacks is also a potential driver for further price appreciation in future.

Upside potential from M&A, corporate buybacks and valuations

Source: Amundi analysis on Bloomberg, Eurobarometer 2017. Data as at October 5, 2017. Icons designed by **Flaticoin**.

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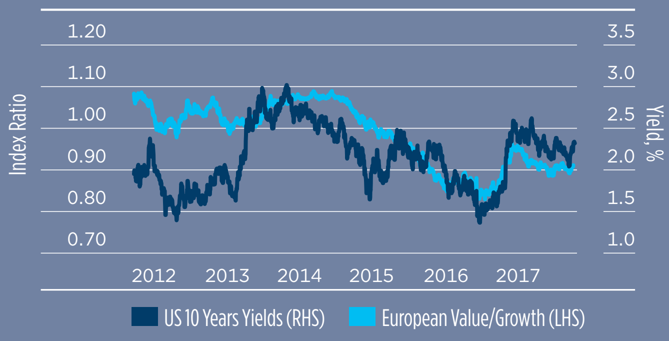
A GUIDE TO INVESTING IN European Equities

OCT 2017

Value style with high conviction

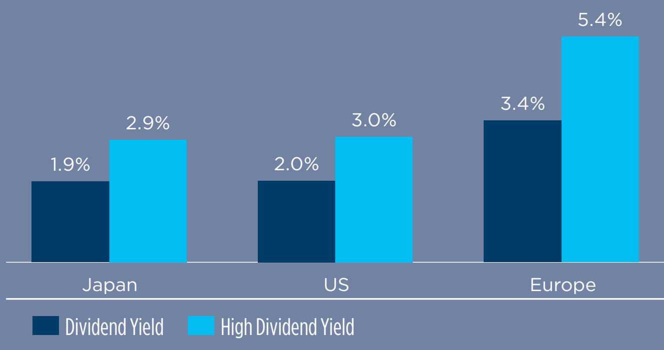
European equities are generally pro-cyclical and therefore tend to benefit from a good economic backdrop. Looking forward, we believe that value investing could be favoured versus growth as growth stocks might suffer from expectations of higher bond yields. To select the best opportunities in value terms we believe that it is important to focus on each company's potential for further earnings growth.

European value could outperform if yields rise



Dividend yields in the search for income

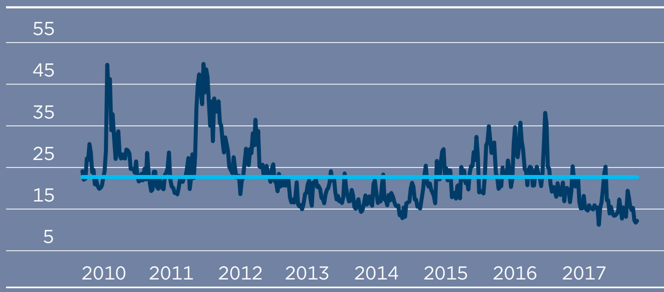
In an era of low bond yields, investors may wish to exploit yield opportunities across the board to meet their income objectives. In this respect, we think that a focus on dividend yields in the European markets could offer the potential to participate in the growth opportunities that the trends underpinning the potential European renaissance story offer, while at the same time benefitting from high dividend yields.



Embrace a selective and risk-aware approach

In 2018, we believe that the business cycle could start moving towards a more mature phase where European equities could continue to deliver positive performance, but volatility could be back on the radar. Against this backdrop, we believe that investors should consider a selective and risk-aware approach to exploit market opportunities and identify the players that could adapt more easily to changing conditions.

Implied Volatility on the EuroStoxx (VSTOXX) stands well below long-term average



Source: Amundi analysis on Bloomberg. Data as at September 30, 2017. MSCI Indexes for European Value, European Growth, Japan, US and Europe. Dividend Yields at September 30, 2017.

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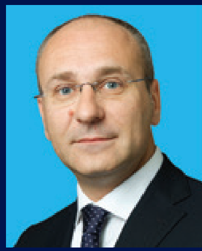

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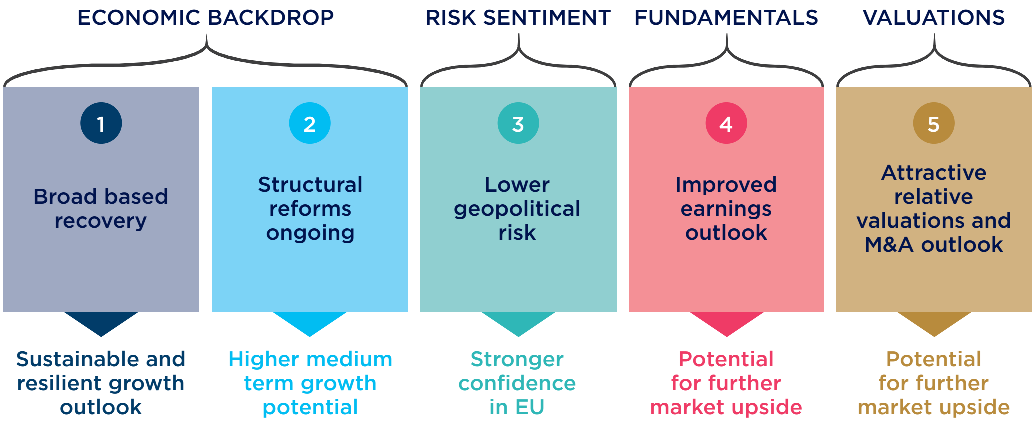
Investing in the European renaissance in 10 Tweets

1. Positive macro and micro dynamics, gathered together are creating the basis for a European renaissance (Fig.1)
2. The European economic recovery is now robust and more synchronised across countries and it is translating into employment gains (Fig.2)
3. Structural reforms in Europe are set to deliver further gains in competitiveness in the medium/long term as the full impact of the reforms materialise (Fig.6)
4. We see less uncertainty regarding European politics: this could help to improve risk sentiment regarding the region (Fig.7)
5. The European recovery has finally started to be reflected in corporate earnings growth (Fig.9)
6. A possible steepening in the yield curve could be beneficial for financials, an important sector in European stock markets (Fig.10)
7. Attractive valuations and a resurgence in M&A are potential drivers for further price appreciation in European equities (Fig.11)
8. European value could outperform growth if yields rise (Fig.12)
9. For investors in search of income, European equity markets could offer growth opportunities along with high dividend yields (Fig.13)
10. In our view, the focus on stock selection will continue to be crucial to invest in European equity markets (Fig. 15)

Why a European renaissance?

In our view, the concept of a "European renaissance" reflects the current phase in which multiple positive dynamics are unfolding in Europe. Such dynamics, virtuously interplaying, are creating a case that supports a sustainable growth path in Europe and a favourable environment for European risk assets.
We have identified five developments which point to a European renaissance:

Figure 1: Why a European renaissance? Five reasons to consider:



Source: Amundi. Data as at 30 September 2017

Positive macro and micro dynamics together are creating the basis for a European renaissance.

1. **Improved macroeconomic outlook.** This is characterised by a recovery that is now strong and broad-based. Euro area GDP is now above the 2007 level, meaning a recovery from the losses seen after the financial crisis. The recovery is now broad based across the Eurozone.

2. **Stronger efforts from politicians to push reforms.** Progress in implementing reforms at both the EU and at single country levels is crucial for the adjustment of macroeconomic imbalances and – on a longer-term perspective – supports a rise in the potential growth rate of the economy.

3. **Lower geopolitical risk in the Eurozone.** This is due to improved political stability, and reduced uncertainty about the whole EU architecture. European citizens have become more optimistic about the EU and the Euro as a single currency. A strong leaders' commitment to strengthen the European project will continue to be crucial to attract domestic and foreign investors.

4. **Improved earnings outlook.** Based on the persistence of accommodative monetary policies, and helped by the robust domestic demand, companies are enjoying a more positive business environment which is translating into solid profit growth.

5. **Attractive valuations and market conditions.** We believe that all these dynamics will support a continuation of growth which could benefit European assets, and equities in particular. Here, attractive valuations (relative to other markets) and a solid M&A outlook are positive drivers which should support further market appreciation in the coming months.

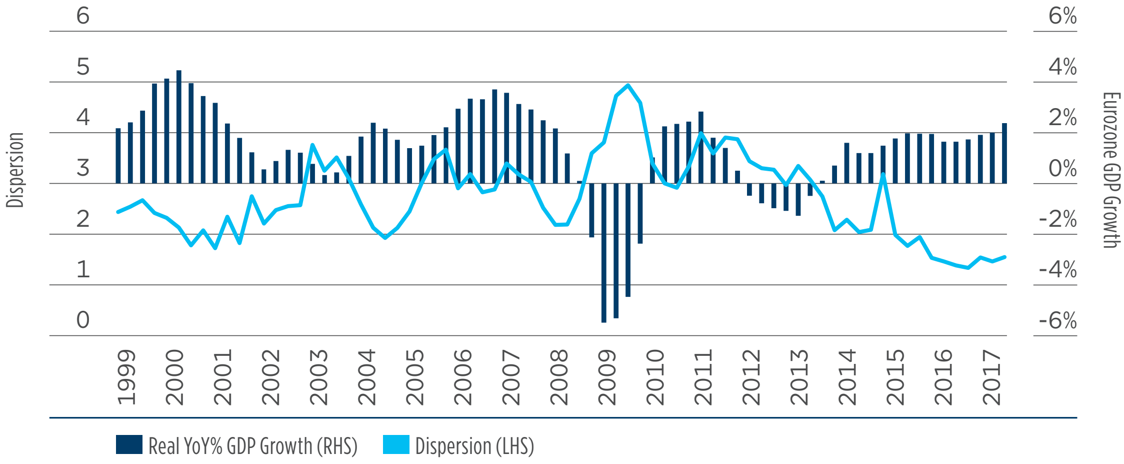
Overall, we think that the concept of a European renaissance implies interesting opportunities in European equity markets for investors with a selective and risk aware mind-set. In the second part of this paper, we present ways to seize these opportunities while maintaining a strong focus on risk.

1. A broad-based recovery is under way

The economic recovery is now robust and more synchronised across countries.

In 2017, Eurozone GDP has recorded exceptional growth, and business surveys point to the continuation of this trend over the next quarters.
The recovery now appears to be robust, broad-based among sectors, and synchronised across countries as shown by the decline in the dispersion of real GDP growth rates (Figure 2). This growth has mainly been driven by domestic demand, but it has also benefited from the strength of the global economic cycle and the subsequent rebound in world trade.

Figure 2: Decreasing dispersion of real GDP growth across Euro area countries



Source: Amundi estimates based on Eurostat data. Data as at 20 September 2017. Dispersion is calculated as the standard deviation of the single Euro area countries year-on-year % real GDP growth.

The recovery has translated into tangible employment gains and a decrease in macroeconomic imbalances.

Tangible employment gains have underpinned the robust internal demand. In the Eurozone, over six million new jobs have been created since 2013. In the same period, the unemployment rate has dropped to 9.2%, from a peak of above 12%, with improvements also in the peripheral countries mostly affected by the crisis. The youth unemployment rate fell from almost 24% to around 19%. However, this is still about 4 percentage points higher than at the beginning of the crisis in 2007, leaving room for further employment gains in the coming months.

The robust recovery in the Euro area is also helping to ease major macroeconomic imbalances which arose before and during the crisis. Fiscal deficits have improved noticeably thanks to the reduction in interest payments and – in many countries – as a result of the implementation of fiscal consolidation efforts. These two forces helped the Eurozone debt/GDP ratio to stabilise at around 90% of GDP, even if differences across countries persist. In our view, an acceleration of growth could support the continuation of this positive trend and further improve the sustainability of debt/GDP ratio going forward.

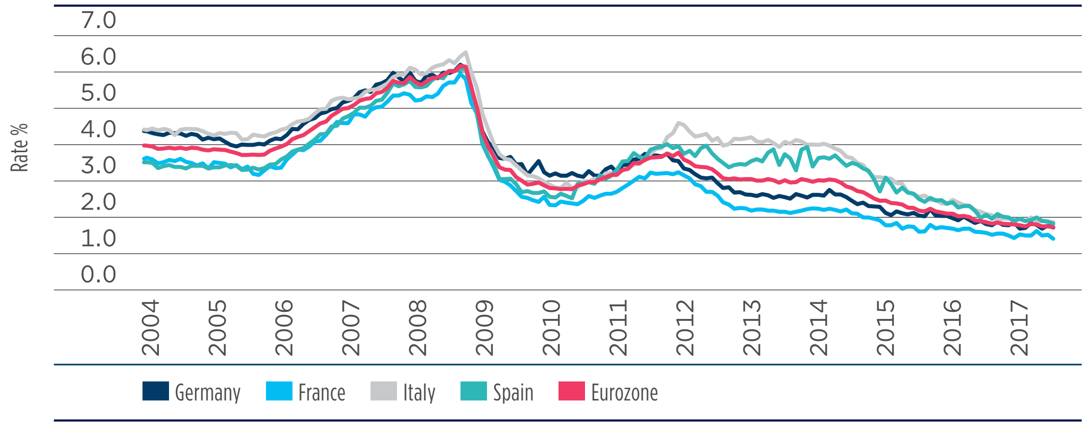
Accommodative monetary conditions are translating into credit to private sectors, creating a positive feedback loop into the real economy.

The current account surplus is close to an all-time high at 3% of GDP in contrast to the UK and the US, both of which have deficits to finance. Large external deficits have declined in many countries of the periphery, or even turned into surpluses. More importantly, unsustainable external imbalances in peripheral economies have disappeared thanks to the convergence in competitiveness.

The Eurozone continues to benefit from highly accommodative monetary conditions. Indeed, thanks to the ECB commitment in 2012 to do "whatever it takes" to save the Eurozone, and to the subsequent measures (including QE[1], see Box 1), sovereign bond yields (and spreads) have fallen and bank interest rates charged to small and medium enterprises have re-converged, creating a positive backdrop for further economic expansion.

[1]Quantitative easing (QE) is a type of monetary policy used by central banks to stimulate the economy by buying financial assets from commercial banks and other financial institutions.

Figure 3: Composite cost of borrowing indicator for non-financial corporations



Source: Amundi analysis on ECB data. Data as at July 31, 2017.

As inflation remains low and set to rise only moderately, the ECB should remove monetary accommodation at a gradual pace, keeping financial conditions relatively benign for corporations.

As a result, there has been a general upturn in bank credit to the private sector which bodes well for the sustainability of the recovery. In this context, the ECB tapering has to be closely monitored: we believe it will be gradual and well managed but could create some resurgence in market volatility from the current low levels.

Inflation is low and expected to remain subdued by historical standards. Wage inflation has started to materialise, but should remain moderate in the current environment. The low inflation environment should provide the ECB with scope to remove monetary accommodation at a very gradual pace, keeping financial conditions still relatively benign for corporations.

Against this backdrop, the ongoing recovery is expected to continue. In fact, the Eurozone is the only area that has experienced a double dip since the Great Financial Crisis and consequently it is now at mid-cycle. The catch-up process that is taking place is therefore expected to continue and to result in GDP growth above potential in the years to come. Despite this positive cyclical outlook, the Eurozone still faces some structural challenges, such as high public and private debt levels, weak productivity growth, and a shortage of long-term investment. It will be important, in the coming months, to assess the evolution in these three areas together with the improvement in the field of structural reforms, as they will shape the medium-long term macro framework for Europe driving future market directions.

BOX 1: Risks to watch to assess the medium-long term macro framework

Some vulnerabilities remain across different areas and it will be important to assess the ways taken to address them, because they will affect the perspective of future growth and market opportunities.

- Banks have doubled their capital ratios since the crisis and non-performing loans are gradually declining, but bank profitability, while improving, is still low, notably vs the US. Looking ahead, this may limit banks' capabilities to finance business investment.
- The governance in Europe is complex and a democratic deficit is perceived by populations. That has probably fuelled scepticism about the EU project.
- As a legacy of the crisis, economies have decoupled in terms of debt. Concerning public debt (% of GDP), France (97%, up from 66% in 2007), Italy (133%, up from 102% in 2007), and Spain (100%, up from 35% in 2007) have clearly decoupled from Germany (68%, in line with 64% in 2007).
- Private debt (households and non-financial corporates) seems to have stabilised, on average, in the Eurozone. But, there has been a strong decoupling between France and Germany (or even between France on the one hand and Italy and Spain on the other).
- The deleveraging has hardly started in the Eurozone and debt will thus remain one of the Achilles' heels of Europe.

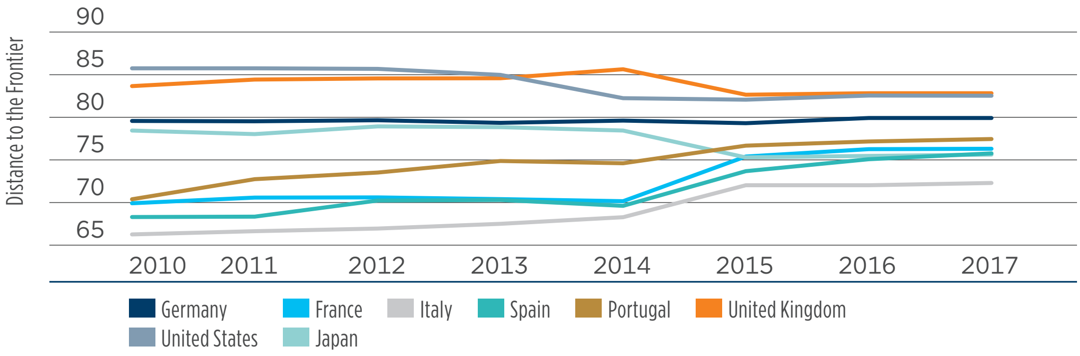
European banks are still buying large amounts of their home governments' bonds. The interdependence of states and financial institutions risk re-starting the so-called 'doom loop'. Banks, which have doubled their holdings of their own states' debt since 2008, thus remain vulnerable. Governments depend on banks purchasing their debt. That being said, debt – either public or private – has increased worldwide since the Great Recession: it is a global phenomenon and not a peculiarity of the Eurozone. At the end of 2016, total debt (from governments, non-financial corporations and households) stood at around 250% of GDP in the US, the Eurozone, the UK and China.

Structural reforms have already played a relevant role in increasing competitiveness, especially in peripheral countries.

2. Ongoing structural reforms

Typical structural reforms fall into the areas of labour markets, product markets and the financial sector, as well as taxation and public sector reforms. Structural reforms are an important pillar for the future outlook of Europe and have already played a relevant role in strengthening the euro area. Structural reforms in many areas (labour market and service sectors) have helped to improve competitiveness, especially in peripheral countries which have seen a strong improvement in the ease of doing business based on World Bank data[2].

Figure 4: Ease of doing business



Source: Amundi analysis on World Bank data. Data as at 21 August 2017.

In our view, these reforms must and will continue to be put in place.
On the financial side, we believe it is necessary to complete the banking union in order to avoid a new systemic crisis in the future and adopt new prudential rules, including: a permanent common backstop for the Single Resolution Fund and a common European Deposit Insurance Scheme. The ultimate objective would be to limit potential contagion between banking and sovereign risks and prevent deposit flight in countries in which banking sectors face a crisis of confidence. While we recognise that banking union is still a very long way off, we believe that the good news is that banking union is not a prerequisite for further progress on the integration of capital markets in the European Union – the Capital Markets Union (CMU), that is key to improve access to funding for European companies and therefore unlock additional growth opportunities.

BOX 2: Ambitious reforms already implemented

Ambitious reforms were introduced and have successfully alleviated market tensions and made the Eurozone more resilient. These reforms include the following:

- **Economic and fiscal governance rules were tightened** in order to support fiscal discipline and ensure fiscal sustainability across the Eurozone countries.
- **New sovereign debt crisis management mechanisms were introduced.** The European Stability Mechanism (ESM) provides financial assistance to vulnerable Eurozone countries. The ESM is a permanent, €700bn firewall that can provide sovereign bailout loans to solvent Eurozone countries in the event of a liquidity crisis (the condition is that the country implements an agreed programme of economic policy reforms).
- **Foundations for a banking union.** New rules on prudential requirements and new institutions to supervise the European banking sector have been put in place. In particular, we refer to the establishment of: the single supervisory mechanism (SSM) which oversees the Eurozone banking sector (supervising systemically important banks); a new single resolution mechanism (SRM) which would limit the negative feedback loop between sovereign debt and bank debt, and prevents bank losses from impacting public finances; and the single resolution fund (SRF) which is financed by the banking sector.
- **The ECB has played a key role in cooling market tensions with several programmes.** 1) Outright Monetary Transactions (OMT, 2012) is a programme that allows the ECB to make uncapped purchases, on sovereign bond markets, of bonds issued by EU countries under a financial assistance programme. The announcement of this programme relieved tensions in the sovereign debt market. 2) The ECB's credit easing (TLTRO) programme (June 2014). 3) The quantitative easing measures (March 2015).

[2] A high ease of doing business ranking means the regulatory environment is more conducive to the starting up of and operation of a local firm. The rankings are determined by sorting the aggregate distance to frontier scores on 10 topics, each consisting of several indicators, giving equal weight to each topic. The rankings for all economies are benchmarked to June 2016. Read the methodology, explaining how the ease of doing business rankings and the distance to frontier measure are calculated. Source World Bank. http://www.doingbusiness.org/data/distance-to-frontier

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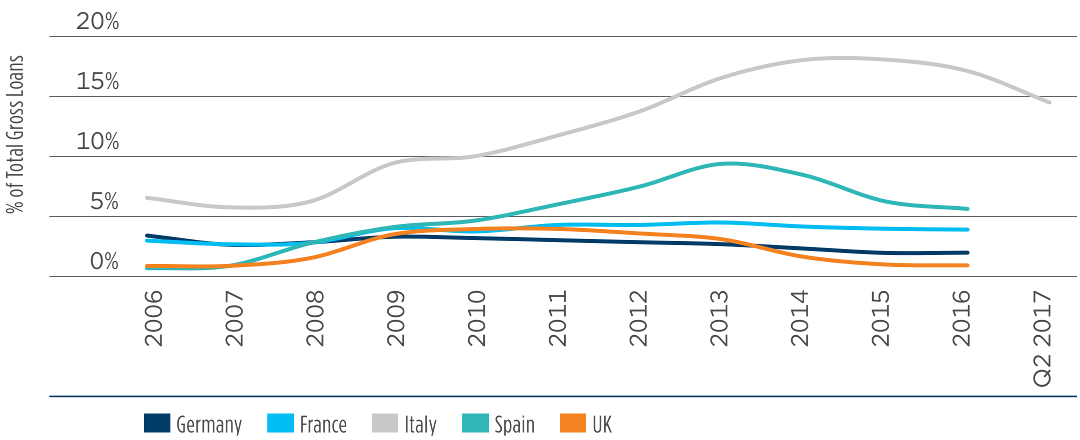
Achieving the CMU is, in fact, one of the most urgent goals at the union level to improve private-sector risk-sharing and reduce market fragmentation. Stronger capital markets are also needed to strengthen investment. Indeed, while the economic recovery is gaining momentum, the investment rate is still below pre-crisis levels. Substantial progress has been made since 2015 and further progress should be achievable, as this is a key priority for the European Commission, and there is a consensus that a full CMU is necessary to promote job creation, growth and investments in Europe. The objectives are clear: to facilitate access to markets by SMEs and to lessen their dependence on the banking sector, to expand equity financing, and to facilitate business access to financial markets and cross-border investments.

The relief in the NPLs issue could also further support the case for a European renaissance.

Finally, in addition to these common goals, each European country is engaging in specific reforms regarding multiple areas, such as labour and product markets, as well as ad hoc reforms to tackle the non-performing loans issues. The latest of these are particularly relevant, as the decrease in Non- Performing Loans (NPLs) can also lead to a rise in loan supply and be an additional boost for the economic recovery.

Figure 5: Evolution in bank non-performing loans

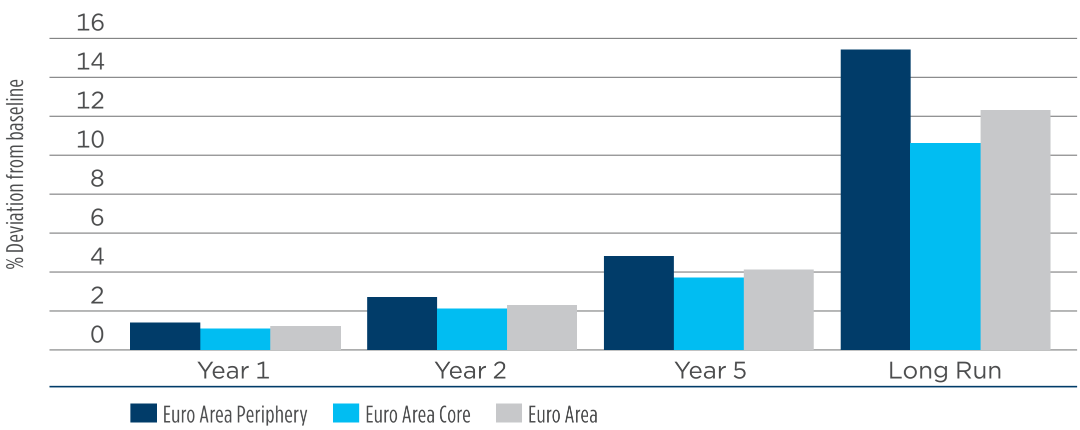


Source: ECB, IMF, latest data available as of October 2017.

We should see further gains from structural reforms in the future, as many reforms have not yet been implemented and the full impact of the reforms will materialise only in the medium/long term.

Looking into the future, we believe that all these reforms can further support the economic recovery. In fact, structural reforms tend to deliver most of their induced economic gains over the medium to long-term. So, what we have seen in terms of economic impact is only a fraction of future possible gains in terms of future GDP growth.

Figure 6: Simultaneous reform packages, base line scenario impact on GDP



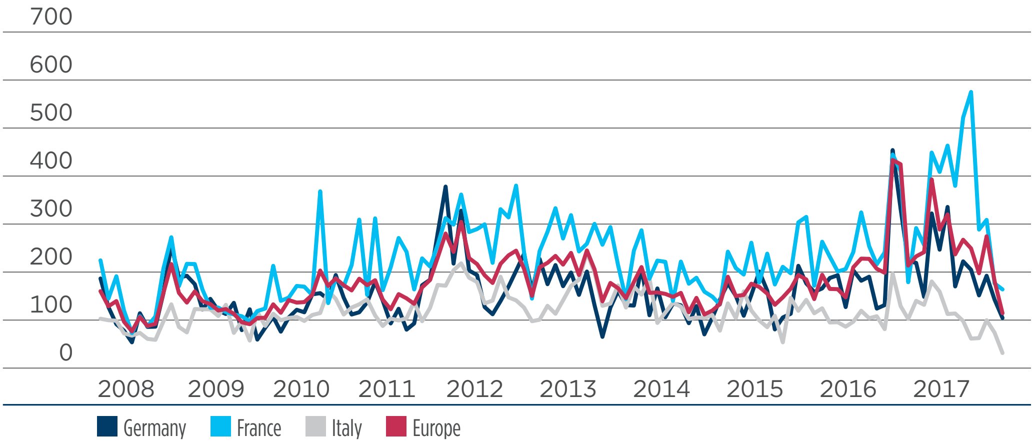
Source: IMF (assessing the gains from structural reforms for jobs and growth, Jobs and Growth: Supporting the European Recovery, 2014).

On the political side, the outlook has clearly improved. We expect France and Germany to lead the reforms in the Eurozone.

3. Lower geopolitical risks pave the way for more integration

On the political side, the outlook has clearly improved. The election of Emmanuel Macron as president of France is probably a game changer for Europe in general and for the Eurozone in particular. Political risks have diminished, at least in the short term and our perception has not changed radically, nor has the result of German election or the situation in Catalonia. We believe that the Catalonia crisis will not carry immediate systemic risk to the Eurozone, but has to be closely monitored, as any advance towards independence would have major spillover implications for countries that are facing similar movements.

Figure 7: Relief regarding European policy uncertainty indexes



Source: Amundi analysis on data from Economic Policy Uncertainty website. Data as at 18 September 2017.

We expect France and Germany to lead the reforms in the Eurozone and progress in terms of financial architecture.

Macron and Merkel share the view that the status quo is not an option with regard to the Eurozone (which is an incomplete monetary union that needs to be strengthened). They certainly appear to share the view that a strong and determined union is the best way to promote the EU's values and interests. While probably not completely aligned regarding the specific measures to be taken, they appear strongly committed to deepening European integration, both from a financial and political standpoint. There is an "implicit deal" between France and Germany: if the French government succeeds in implementing structural reforms (starting with the job market) and respects fiscal rules (public deficit below 3% of GDP), Germany would be ready to make some concessions—in particular concerning the joint budget, parliament and finance minister for the Eurozone that Macron aims to create.

Macron and Merkel pledged to draw up a "common road map" for Europe with a change in treaties if required. At this stage, however, that is clearly not the priority. There is much to be done on other issues, on both sides, if only in terms of policy coordination. However, it shows that both Macron and Merkel appear to want to leave the door open to some institutional reforms in the years to come. Political and financial integration is viewed as a medium-to long-term process on both sides. We would not expect a "quantum leap" in the short term. Rather, we would expect the French and German governments to launch joint initiatives, reinforcing the EU and the Eurozone step by step.

Mr Macron's recent proposals are received with varying levels of enthusiasm in Berlin. Not surprisingly, many Germans are resistant to the idea of a European budget because they see in that a disguised plan to move towards a federalist model of debt mutualisation. This is undoubtedly a red line for the next coalition government in Germany. The prospect of further fiscal integration remains a long way off. Governments will probably focus on issues that will strengthen the cohesion and resilience of the Eurozone, without putting in place mechanisms that could negatively affect taxpayers in the event of a crisis.

Governments need to focus on going beyond the framework of structural reforms or financial integration.

Governments need to focus on going beyond the framework of structural reforms or financial integration. Macron and Merkel share the belief that Europe is above all a political project and that it suffers from a deficit of democracy. It is likely that Europe will initially make progress on the least controversial issues (defense, border police, cooperation between security services, environment, digitalisation, education). On all these issues, a common vision can emerge, followed by actions that will increase efficiency and reduce costs. Highly symbolic for Europeans, the progress made in these areas would strengthen the cohesion of Europe. And that is a common objective before the 2019 European elections.

Overall, we believe that in the wake of the election of Macron and the re-election of Merkel, there is a new political landscape that will contribute to improved sentiment regarding European risk assets, even though come 2018, elections in Italy could cause a re-emergence of volatility and the evolution of the Brexit negotiations will also be an important factor to watch.

4. Improved earnings outlook

Improved business confidence and the European recovery have finally started to pass through to corporate sales and earnings growth.

The improved business confidence highlighted by the recent European PMI surveys[3] (with the Eurozone PMI reading in September being the highest since April 2011) and the sustained European recovery have finally started to pass through to corporate earnings growth, the key catalyst that the market has been waiting for.
Revenue has received a boost from solid domestic consumption and from a pick-up in capital expenditures, which have only started to recover after a period of prolonged weakness. Corporate revenue has increased as well thanks to broader and synchronised global growth: for example, more than a quarter of European revenue is directed to Emerging Markets (EMs), so stronger demand from EMs has benefitted European corporates. In addition, during the financial crisis, European corporates were particularly active in terms of cost reduction, and reducing financial leverage quite aggressively. These steps were important, as companies made significant efficiency gains, and this has ultimately placed them in a very strong position to benefit from the current supportive economic backdrop.

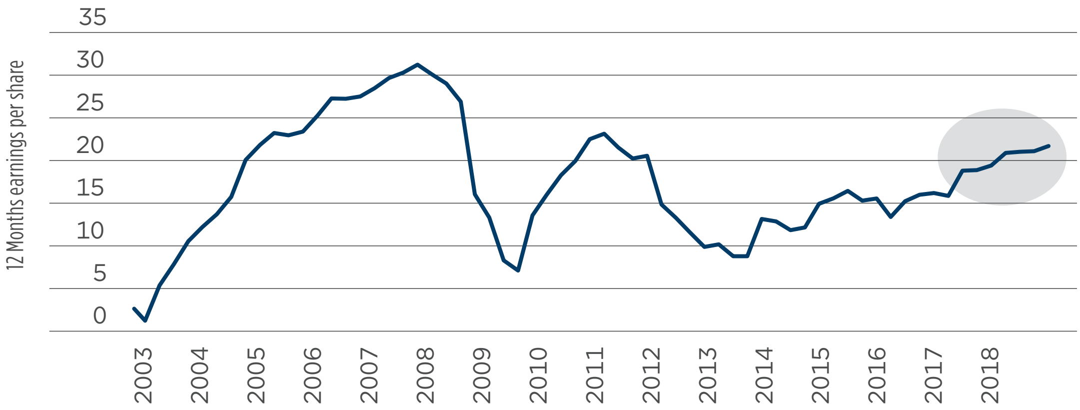
Figure 8: Sales growth for the STOXX Europe 600 index

Source: Amundi analysis on Bloomberg data as at 29 September 2017. Analysis of the evolution on the one year growth in the trailing 12 months sales per share for the STOXX Europe 600 Index.

Yet, the appreciation of the Euro has grabbed investors' attention in recent months, as it could be a drag on earnings growth forecasts. It is important to note that the recent currency strength has largely been a result of the improved fundamental picture, so in our opinion it should not be seen as overly detrimental. Our view remains, that while the shorter-term volatility in the currency may impact certain names and sectors (such as the exporters), we see the underlying economic improvements outweighing any currency headwind. And therefore, even including the Euro effect, we forecast EPS growth to June 2018 of 11.3% for Europe (the highest level globally) compared to 9.8% at a global level.

[3] The Markit Purchasing Managers' Index PMI is a business activity indicator

Figure 9: Positive corporate earnings outlook in Europe



Source: Amundi multi-asset analysis and forecasts on Bloomberg, Factset data. Data as at 14 September 2017. Data refers to the Stoxx Europe 600 index.

We believe it is important to be selective, focusing on companies that can translate revenue growth into higher income growth.

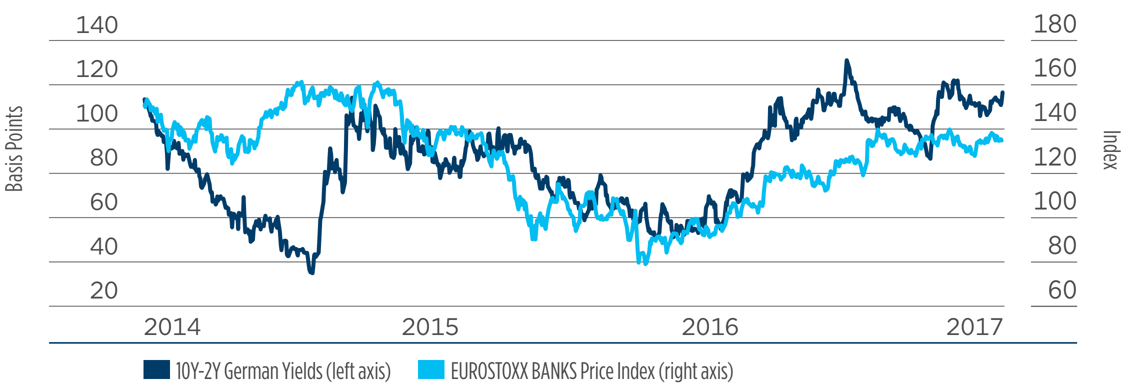
Going forward, we believe it is important to carefully assess investment opportunities with a selective approach, to be able to identify companies that can continue to deliver attractive earnings growth. Companies with the higher operational leverage[4] are, for instance, particularly attractive given these more macro-driven dynamics. At a sector level, cyclicals, such as auto, construction and consumer durables, typically show the highest levels of operational leverage.
Selection is key also to assess the potential currency impacts in the shorter-term both on the cost and revenue base of a given company, in order to mitigate risk due to excessive currency appreciation.

From a sector perspective, the financial sector, which represents a significant share of European equity indexes (around 21% of the Stoxx Europe 600), could be a potential beneficiary. Firstly, the sector is highly sensitive to the underlying economy, and therefore should benefit from improved economic sentiment driving lending growth. Another key support for profitability in the sector is a possible rise in interest rates, and, more importantly, the steepness of the yield curve. We might be entering a period of less accommodative Central Banks policy, whereby the ECB is getting ready to withdraw some of the stimulus in a measured and controlled way. Against this backdrop, we see the potential for a steeper yield curve which would be helpful for profitability – especially amongst the banking names.

However, we are aware that the financial sector globally, and especially within the Eurozone, is impacted heavily by the more stringent regulatory measures implemented following the financial crisis. Therefore we believe that investors should be selective and focus on companies with adequate capital reserves on the balance sheet, and which are operating in compelling underlying markets.

A possible steepening in the yield curve could benefit financials, a relevant sector in Europe.

Figure 10: Yield curve steepening would benefit financial stocks in the Eurozone



Source: Amundi analysis on Bloomberg data as at 27 September 2017.

[4] Operational leverage is a multiplier factor that indicates what proportion of revenue growth would translate into operating income (i.e., earnings before interest and taxes).

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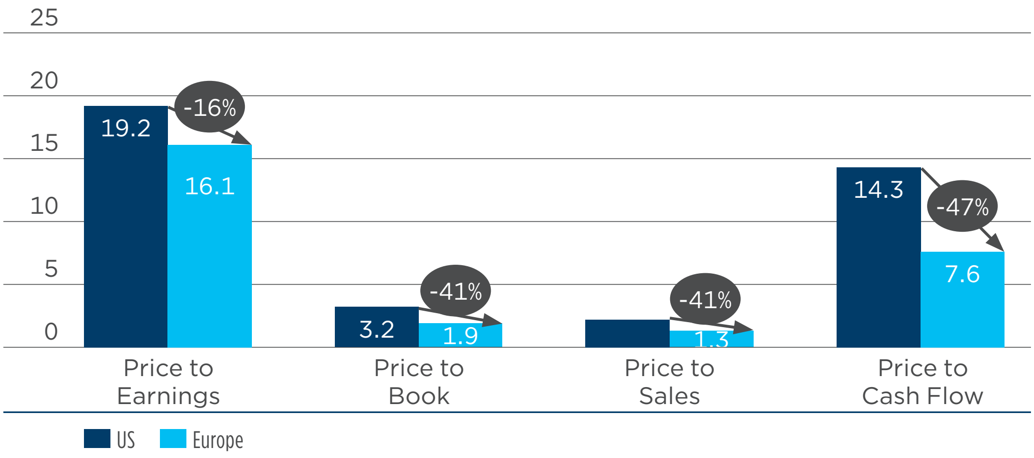
In terms of valuations, Europe is attractive vs other markets such as the US.

5. Compelling valuations vs other markets

Looking at valuations, Europe does not appear particularly cheap in absolute terms. However, relative to other asset classes, or regions, Europe looks quite compelling – especially versus US peers. Ultimately, to see further upside, we need a continuation of EPS growth, and we believe that the current fundamentals should allow this to materialise.

Figure 11: Eurozone valuation metrics more attractive vs US

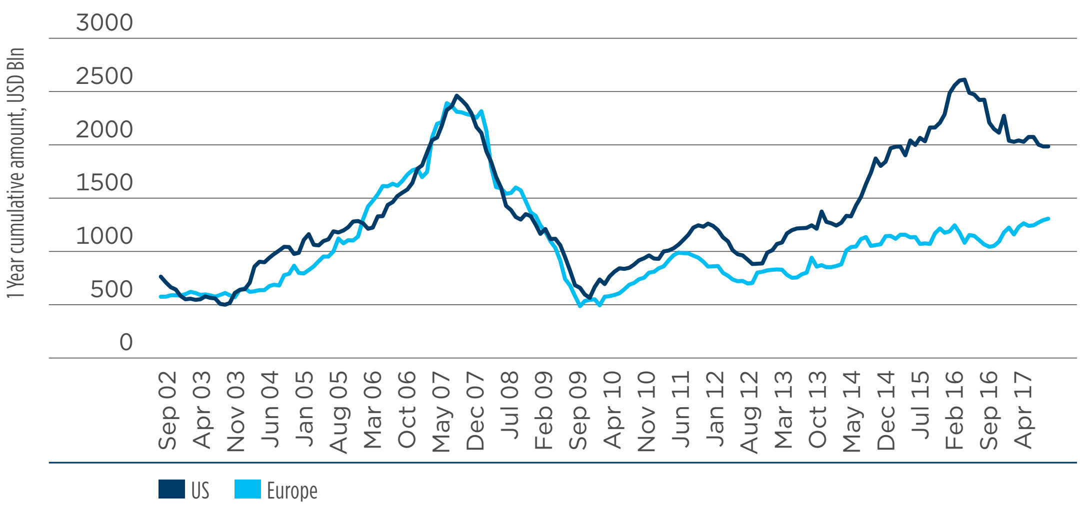


Source: Amundi analysis on Bloomberg data as at October 3, 2017. Index S&P 500 for US and Stoxx Europe 600 fpr Europe. Price/earnings is the ratio of market's current share price compared to its estimated per share earnings for the current year. The Price to Book Value is the ratio of market price of a company's shares (share price) over its book value of equity. The price to sales is the ratio of the market's price to its revenue per share for the trailing 12 months. The price to cash flow compares market's price to its level of annual cash flow.

A resurgence in M&A and corporate buyback is also a potential driver for further price appreciation.

Another potential driver for a move higher would be a resurgence of M&A activity and corporate buy-backs within the region, especially now that growth for Europe looks more robust and political uncertainty has declined. Currently, we are seeing companies with strong balance sheets, high cash levels which, coupled with the low interest rate environment we are experiencing, should lead to fertile ground for an uptick in M&A and buyback activity.

Figure 12: Announced M&A Transactions: Europe has lagged, but there is room to catch up



Source Amundi analysis on Bloomberg. Data as at September 30, 2017. Amount of announced M&A involving either a European (or US in case of US) target or acquirer.

In this context. M&A activity is expected to pick up in 2018, with positive impact on value creation. As corporations focus on core business activities and carve out non-core but profitable assets, foreign (and domestic) buyers will have a larger pool of attractive acquisition targets in Europe.

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How to play European growth

European equities are generally pro-cyclical and exposed to global growth. The recent improvements in the macroeconomic backdrop should be a natural tailwind for the asset class. As we previously highlighted, some sectors and stocks may be more exposed to this positive economic backdrop more than others. Therefore, we believe that a focus on stock selection will also be crucial to identifying structural winners that could have significant upside potential (i.e., quality companies with strategic competitive advantage, sustainable growth in profitability, and clear upside in valuation).

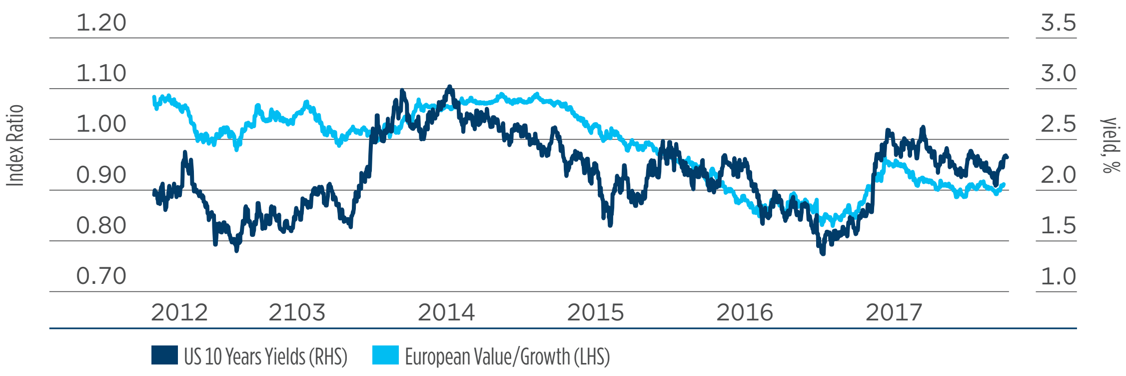
We identify three investment themes for playing European growth.

High conviction, value style offering opportunities

With rising yields, value areas of the market could be favoured.

In an environment of improving economic fundamentals, potentially higher inflation and growth, rising interest rates, and growing earnings, value areas of the market could be favoured. In particular, rising bond yields have historically been associated with outperformance of the value stocks (which are priced at a discount) vs growth stocks which are valued on future earnings (that could suffer when future earnings are discounted at higher interest rates). Combining value with earnings growth, we believe, could be the sweet spot over the coming months.
Cyclical sectors, in particular, could benefit in this phase being more economically sensitive, but as cyclicals have already outperformed over the last year, we think that a strong focus on companies that have the ability to continue to deliver solid earnings growth is needed.

Figure 13: European value could outperform growth if yields rise



Source: Amundi analysis on Bloomberg data. Data as at 27 September 2017.

Selecting dividend yield opportunities for income enhancement

For investors in search of income, European equity markets could offer growth opportunities while also offering high dividend yields.

European markets offer among the highest dividend yields globally. In an era of low bond yields, investors may wish to exploit yield opportunities across the board to meet their income objectives, and European equities in our view are an interesting hunting ground for income opportunities.

The drivers behind the Renaissance of Europe, as previously mentioned, have placed companies in much stronger financial health and this also translates into higher dividend yields in the region. To best exploit income opportunities, however, we believe it is important to focus not only on current dividend yields, but also on each company potential to further deliver dividend growth.

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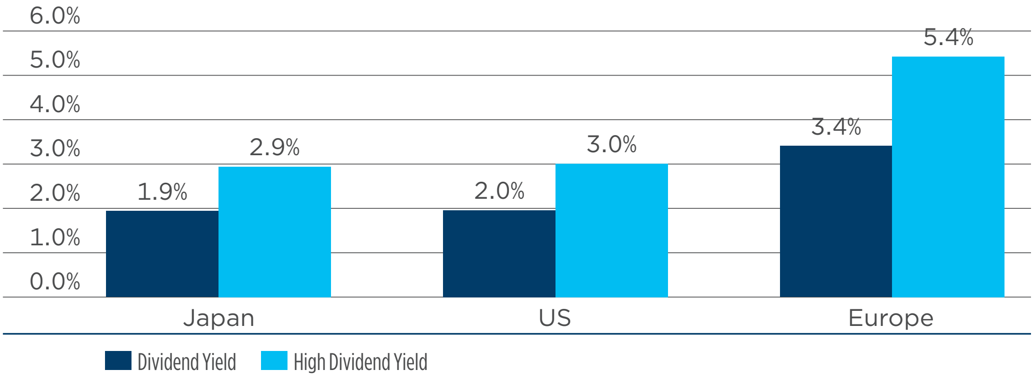
Figure 14: Investors could also benefit from attractive dividend yields in Europe



Source: Amundi analysis on Bloomberg data. Data as at 27 September 2017. Dividend Yields are the 12-month dividend yields for the local MSCI indexes, High Dividend Yields are the 12-month dividend yields for the local MSCI High Dividends indexes.

While we continue to remain optimistic regarding the outlook for risk-assets in Europe, we are aware of the potential for short-term bouts of volatility, from the current historical lows.

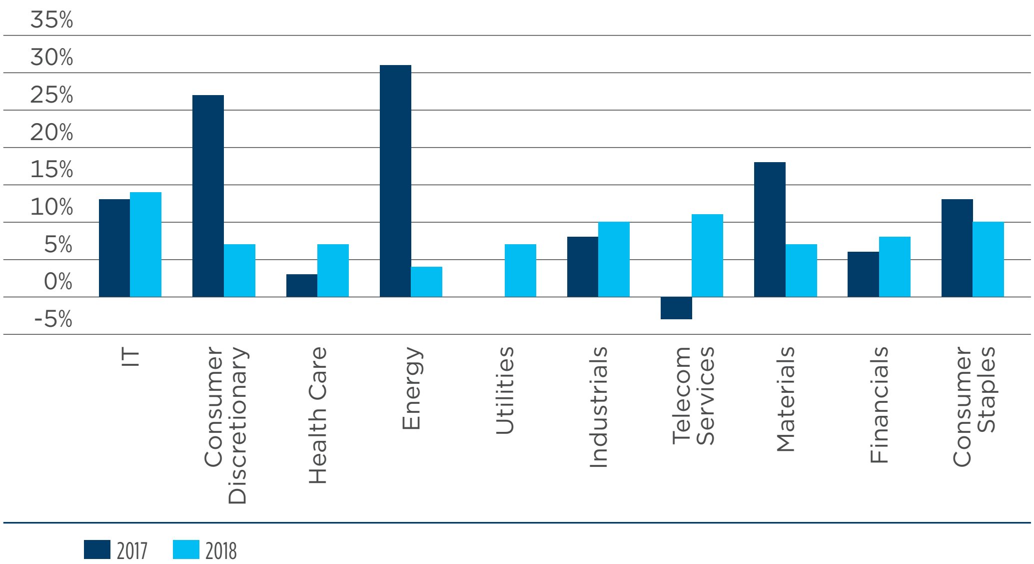
Embrace a selective and risk-aware approach

The positive backdrop that we have analysed previously will, in our view, drive a positive phase for European equities. However, in 2018, we believe that the business cycle will start to move towards a more mature phase where equities could continue to deliver positive performance, but volatility could be back on the radar.

In fact, while we continue to remain optimistic regarding the outlook for risk-assets in Europe, we are aware of the potential for short-term bouts of volatility, from the current historical lows and therefore believe that a risk-aware approach is recommended. In our view, the greatest potential for volatility at this point is the high level of investor expectations in terms of both economic growth, and earnings delivery. Other catalysts for volatility would be a further rapid appreciation of the Euro (not our base case), or a more aggressive than expected tapering programme from the ECB.

Against this backdrop, a rotation among sectors and stock selection could become more relevant to exploit market opportunities.
In fact, in 2017 earnings growth has been mainly driven by a few sectors with consumer discretionary, energy and materials delivering together 60% of the MSCI EMU earnings growth vs a 27% combined weight in the index.

Figure 15: EPS growth by sector more balanced in 2018



Source: Datastream, Amundi. Data as at October 9, 2017. Data refers to MSCI EMU Index.

Moving towards 2018 we foresee a more balanced contribution among sectors and therefore stock selection within the sectors could become more relevant to exploit the most compelling opportunities in terms of earnings growth.

The focus on stock selection will also be crucial in identifying the players that could more easily adapt to changing conditions. In our view, understanding each company business model, the quality of the balance sheet and the management ability to translate the current positive economic environment into future success will be key to identify future winners and avoid companies that could be penalized in case of a resurgence in market volatility.

Conclusion

The Renaissance of Europe is firmly in place, and is a clear tailwind for European equity markets. The economic recovery is more broad-based than before, with structural reforms underway helping to integrate more aligned policy decisions.

The lower level of geopolitical risk that followed the elections in France and Germany is supporting an improvement in risk sentiment. Equity markets are also somewhat underpinned by improving corporate fundamentals, namely earnings growth and some attractive valuations when compared to other asset classes and geographies. Finally, for investors with an income objective, European equities offer a very compelling yield compared to other markets, which may act as an additional source of interest for the asset class.

These factors clearly pave the way for a brighter outlook for European equities. Recognising that volatility remains very suppressed, and the potential for an uptick, we believe that the best way to exploit the Renaissance is to focus on the individual companies which are best placed to benefit from the improving trends.

Important Information

Date of First Use: October 16, 2017.

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