Goldman Sachs

Europe

Strategy Matters

Portfolio Strategy Research

QE and the case for European equities...the story in 15 pictures

The ECB has announced a programme of asset purchases totaling €60 bn per month running to September 2016. Falling inflation expectations alongside declining bond yields and the euro have been the main drivers for European equities since the middle of last year. The introduction of QE is likely to moderate deflationary tail risks and, in turn, push the equity risk premium down (from elevated levels) and raise the forward multiple. Any upgrades to European growth expectations via a lower exchange rate and oil prices would further support this trend.

Deflationary fears have grown

Around the middle of last year the slowdown of European and German, growth momentum, coupled with collapsing oil prices, pushed inflation expectations lower and with it, bond yields. At the same time the equity risk premium (ERP) rose to reflect the tail risk of deflation. The introduction of QE should push the ERP lower and support higher equity prices and a higher multiple.

Growth is the key

While lower deflation fears should bring the ERP down, any increases in growth expectations arising from the lower oil price and weaker euro should support this trend. We continue to forecast SXXP at 390 in 12 month and SX5E at 3800.

Where to invest?

The sectors that are most sensitive to a lower ERP tend to be higher beta. Financials and cyclicals have most to gain, in our view. However we maintain our view that consumer and dollar-sensitive cyclicals should benefit relative to commodity and industrial cyclicals (whose earnings are vulnerable to capex cuts in the oil sector and from EM infrastructure demand). We remain long MIB and IBEX and prefer SX5E relative to SXXP and UKX.

Stocks to watch

We compile a screen of Conviction List-Buy and Buy-rated stocks we believe capture these themes.

Stocks benefitting from QE				
Daimler	Intesa Sanpaolo	BBVA	Erste Group Bank	BHP Billiton
Norsk Hydro	Eiffage	Azimut Holding	Anima Holding	Anheuser-Busch Inbev
Atlantia	BAE Systems	Philips Eltn.Koninklijke	St.James'S Place	Prudential
Mediaset	Salvatore Ferragamo	Burberry Group	Christian Dior	Beni Stabili
Icade	Yoox	Altice	Intercontinental Hotels Group	Sodexo
Hera	Enagas			

Source: Goldman Sachs Global Investment Research.

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QE and the case for European equities…the story in 15 pictures

The ECB has announced a programme of asset purchases totaling €60 bn per month running to September 2016, encompassing the previous ABS and covered bond purchase programmes and including sovereign debt. A programme of this magnitude was widely expected. Framing the announcement around a required improvement in the inflation outlook was the main innovation. See *European Economics Analyst: 15/03, ECB QE - Fighting falling inflation expectations,* January 22, 2015.

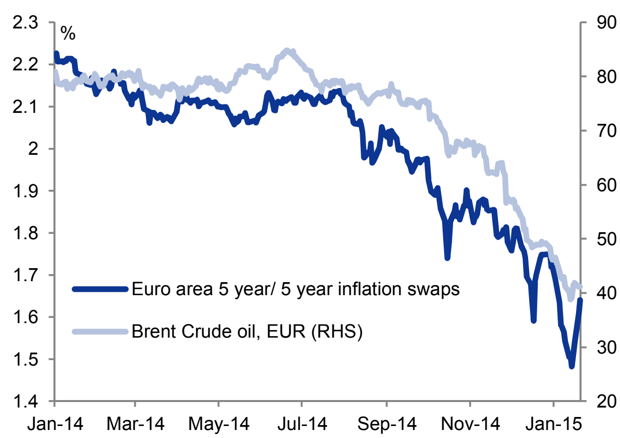
The summer of 2014 was an important watershed for European equities. It was at this time that a number of important factors coincided and resulted in a higher risk of deflation being priced into markets.

First there was an important roll over of macro data in the Eurozone. It wasn't just the periphery, but Germany also saw a loss of momentum heightening concerns that the Eurozone was at risk of heading back into recession. Alongside this, bond yields (which had already been trending down), took a more pronounced step lower.

Exhibit 1: European growth slowed and bond yields fell…

Source: Datastream, Goldman Sachs Global Investment Research.

Exhibit 2: …while deflationary fears have been accelerated by the oil price collapse

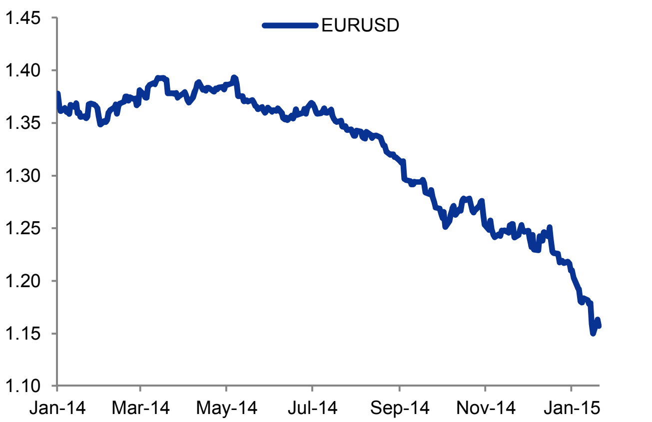


Source: Bloomberg, Datastream, Goldman Sachs Global Investment Research.

Perhaps, most importantly, inflation expectations (measured by 5 year 5 year forward expectations) dropped sharply. The collapse in oil prices added to these concerns. The fears about deflation shifted interest rates expectations down and prompted the ECB to start to talk about further policy easing; the euro started to fall.

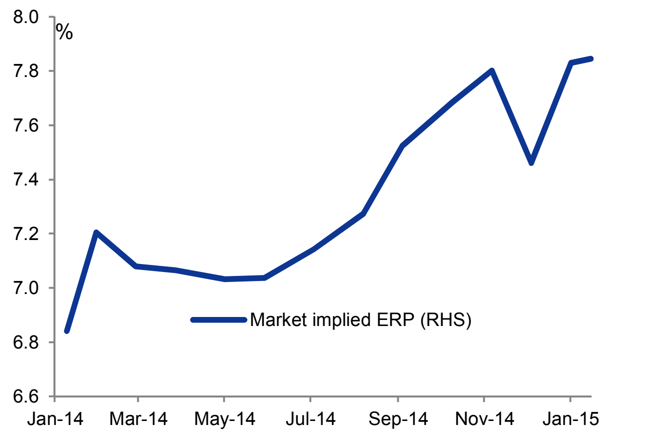
While on the surface, lower bond yields and a weaker currency might have otherwise been cheered, in the context of the weakening of activity and lower inflation, these were seen as a reflection of deflationary forces rather than a trigger for economic recovery. Falls in the bond yield were therefore offset by a rise in the required return in equities and the equity risk premium (ERP) moved higher. In effect the discount rate increased while growth expectations decreased; a bad cocktail for risky assets.

Exhibit 3: The euro fell alongside lower yields



Source: Bloomberg: Goldman Sachs Global Investment Research.

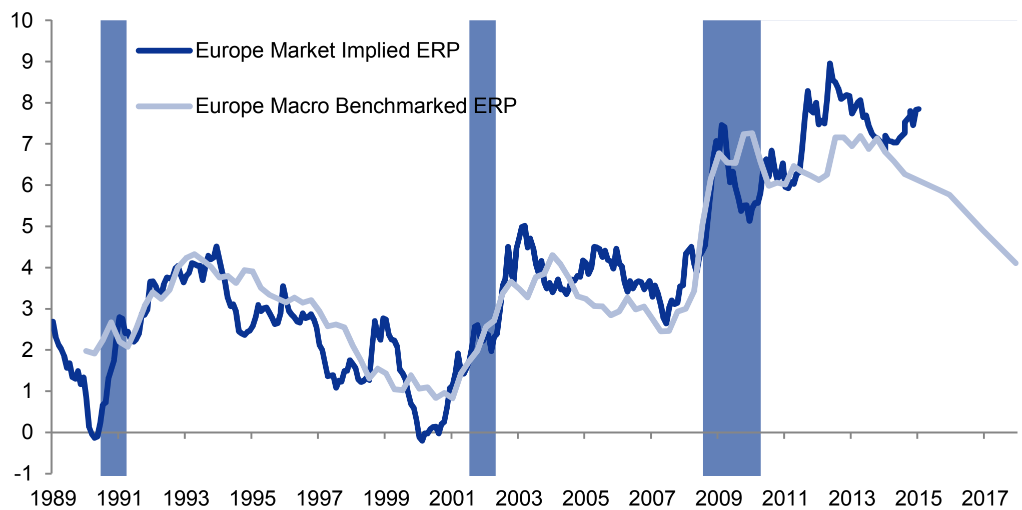
Exhibit 4: …and the required return (ERP) rose to reflect higher deflation risks



Source: Goldman Sachs Global Investment Research.

As Exhibit 5 shows the ERP backed out of our dividend discount model decoupled from the 'macro-benchmarked' ERP based on economic variables. This suggests that investors were pricing growth and deflation fears that had not yet been reflected in the hard macro data.

Exhibit 5: Market implied and macro benchmarked ERP
Pan Europe



Source: Goldman Sachs Global Investment Research.

How does the vicious cycle reverse?

We believe there are three major channels through which appetite towards European equities can improve:

1) Real bond yields have turned negative and financial conditions have collapsed;

2) Lower oil prices and the euro may ultimately lead to growth and earnings upgrades;

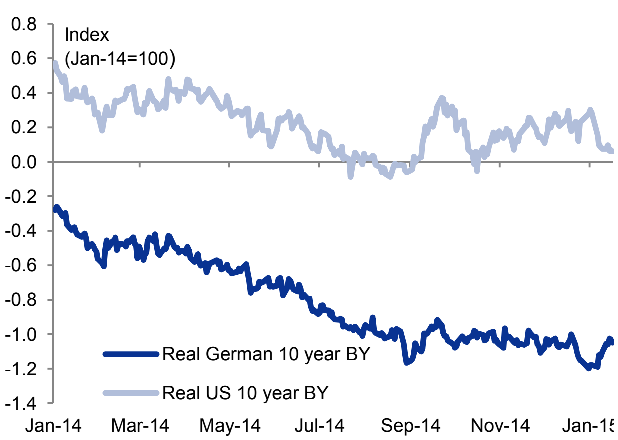
3) The introduction of QE should, via the exchange rate, reduce deflationary fears and push the ERP down, and the equity market up.

Yields and financial conditions

While bond yields in Europe have fallen (and sovereign spreads have narrowed**) real rates are negative on many measures**. The feared liquidity trap triggered by inflation expectations falling faster than nominal yields has not yet materialised.

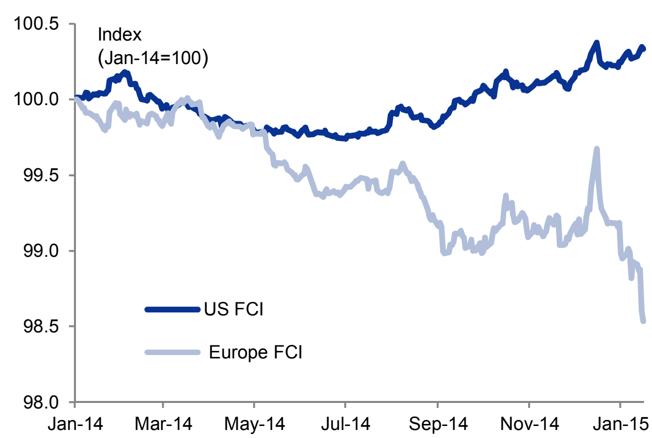
Furthermore on our economist's measure, financial conditions in Europe have fallen to the lowest level ever, in sharp contrast to the US where they have been rising. This should, at least indirectly, reduce deflationary risks and support the economy.

Exhibit 6: Real rates have turned negative in Europe….



Source: Bloomberg, Datastream, Goldman Sachs Global Investment Research.

Exhibit 7: …while financial conditions have fallen to historical lows

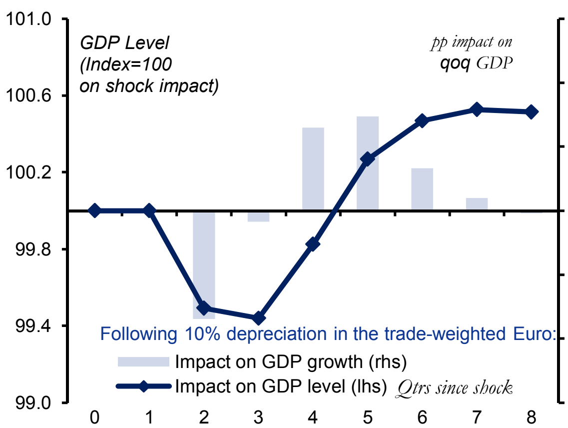


Source: Bloomberg, Datastream, Goldman Sachs Global Investment Research.

Growth prospect and earnings

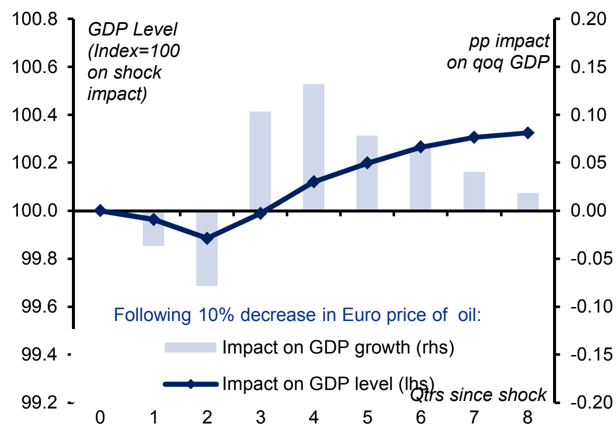
After years of disappointments, we might just be at the brink of some growth upgrades for Europe. There should be a reasonably positive impact both from the falls in the euro and the declines in oil prices (see Exhibits 8-9). Our economists have just revised up their forecast for Euro-area growth to 1.2% from 0.9% for 2015 and to 1.6% from 1.4% for 2016.

Exhibit 8: There should be a reasonably positive impact to GDP growth from the deprecation of the euro…



Source: Goldman Sachs Global Investment Research.

Exhibit 9: …and from the decline in oil price



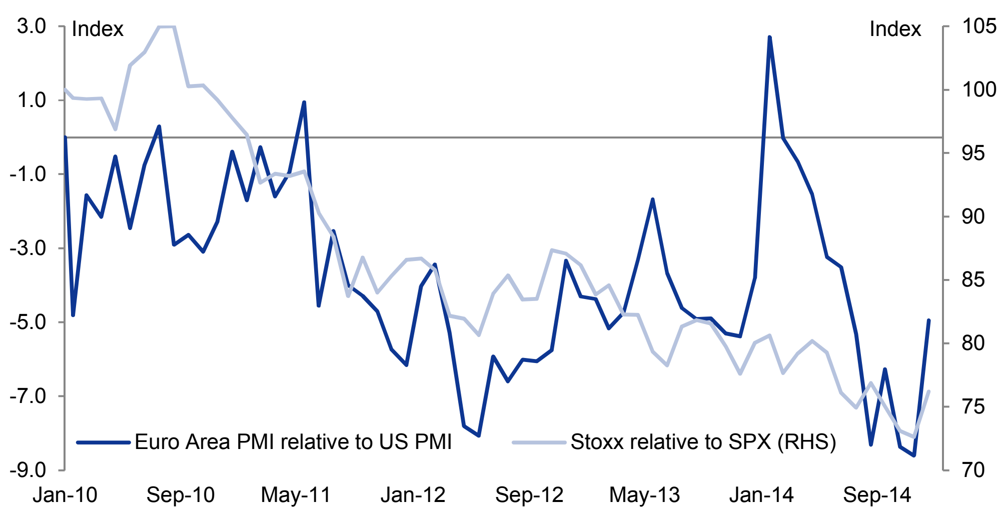
Source: Goldman Sachs Global Investment Research.

However, as yet, consensus expectations have not risen and the range of forecasts is very tight.

Interestingly, **from a low base, macro surprises in Europe have also just turned positive. Our economists Euro-area MAP score – which tracks macro data relative to expectations – has turned higher.** The Euro-area PMI picked up slightly in December to 50.6 from 50.1 in November, and Germany rose from 49.5 to 51.2. There have also been decent improvements in the New Orders to Inventory balances across Europe. **While the gains have not yet been strong they have moved in the opposite direction to the US where momentum of activity has slowed, albeit from a high level. Nevertheless it is changes at the margin that matter most and it appears that these are starting to move more in favour of Europe.**

Exhibit 10: The momentum of relative leading indicators has an impact on relative stock returns

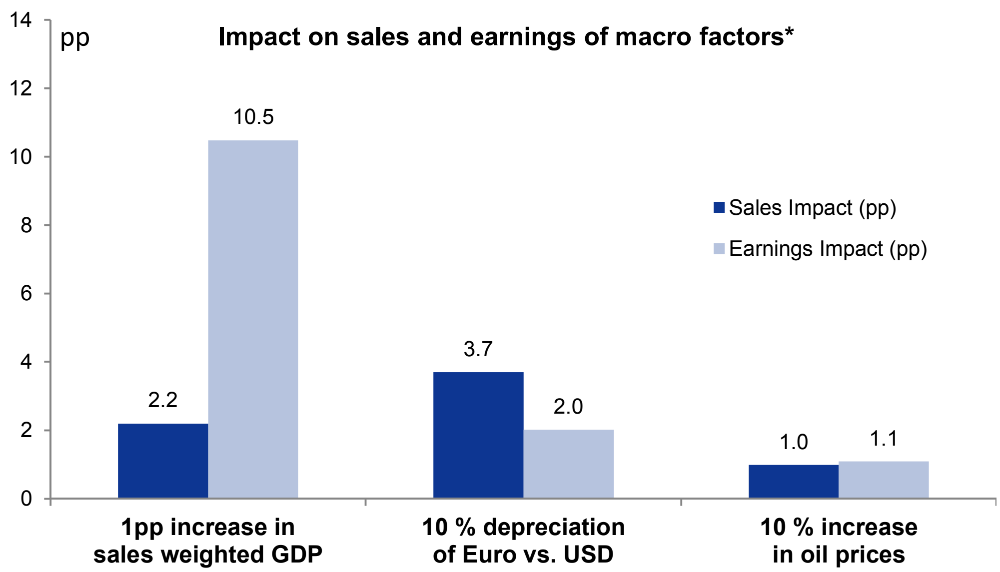
Euro area PMI relative to US PMI and Stoxx 600 relative performance to S&P 500



Source: Haver Analytics, Goldman Sachs Global Investment Research.

Our central forecast for the SXXP profit growth for this year is low, at 6% (4% ex financials). The impact of falling oil prices has, so far, broadly offset the positive impact of a lower euro. **We expect consensus numbers to fall further in the near term as analysts continue to cut estimates in the commodity and other related sectors**. However, any second-round benefits from lower oil on global demand may lead, in time, to somewhat better earnings expectations from a low base. After all, we estimate that a **1% improvement in global sales weighted GDP (GDP weighted by the revenue exposure of the aggregate corporate sector) would boost earnings by a little over 10%. Stronger growth would, therefore, boost earnings by offsetting the negative drag from lower oil prices.**

Exhibit 11: Macro sensitivities at the index level: Sales-weighted GDP matters most
*Oil prices and exchange rates are more volatile than sales-weighted GDP. We scale the size of the change we consider for each macro factor to be similar in standard deviation terms



Source: Goldman Sachs Global Investment Research.

In terms of QE – the direct impact on growth may be difficult to measure. But it is via the exchange rate and expectations that the impact on equities should be most felt. If QE reduced the probability of deflation then the ERP should fall. Exhibit 12 shows the sensitivity.

Exhibit 12: Fair value of the STOXX 600
Sensitivity is centered around current values of our market implied ERP and the current level of the nominal bond yield (using a 75%/25% of German 10 year and UK 10 year)

Nominal risk-free rate \ Equity Risk Premium	6.6%	6.8%	7.1%	7.3%	7.6%	7.8%	8.1%	8.3%	8.6%	8.8%	9.1%
0.0%	544	537	501	469	440	**414**	391	369	350	332	315
0.1%	552	515	482	452	424	**400**	378	357	339	322	306
0.3%	529	495	463	435	409	**386**	365	346	328	312	297
0.4%	508	475	446	419	395	**373**	353	335	318	303	289
0.6%	488	457	430	405	382	**361**	342	325	309	294	281
0.7%	**469**	**440**	**414**	**391**	**369**	**350**	**332**	**315**	**300**	**286**	**273**
0.9%	452	424	400	378	357	**339**	322	306	291	278	266
1.0%	435	409	386	365	346	**328**	312	297	283	271	259
1.2%	419	395	373	353	335	**318**	303	289	275	263	252
1.3%	405	382	361	342	325	**309**	294	281	268	256	246
1.5%	391	369	350	332	315	**300**	286	273	261	250	240

Source: Goldman Sachs Global Investment Research.

Just a 0.5% fall in the ERP would, all things equal, push the market up by around 10%. Any stronger growth expectations flowing from the weakness in the euro, demand effects from lower oil prices or stronger global growth expectations would likely boost the market further.

After Mr. Draghi's 'do whatever it takes speech' in 2012, and the introduction of the OMT, the ERP fell meaningfully. With no improvement in profits, Italy and Spain saw their markets rise 31% and 38% respectively over the following year. The Stoxx 600 went up 20%. The market went from being 'un-investable' as it faced a realistic risk or Eurozone break up, to an attractive value play.

We do not expect the boost to be as big this time. Valuations are higher and the ERP lower today compared with 2012. Nonetheless deflationary risks have also made Europe appear un-investable to many investors. Fading this risk could be worth a lot on current prices and we believe it wouldn't take much to turn a vicious cycle into a virtuous cycle - at least for a while. We continue to forecast the SXXP at 390 in 12 month and the SX5E at 3800, partly driven by a rising forward multiple.

What to buy?

First and foremost we see this as a risk premium contraction opportunity. Less risk of deflation should reduce the ERP and push the market higher. There is a currency angle to this as well of course, suggesting that companies geared to dollar sales should benefit. From this perspective we continue to like our basket of dollar sensitive stocks, GSSTEURO. Also, due to the ongoing strong search for yield, we continue to like our high dividend yield and growth basket (GSSTHIDY), which combines high dividend yields with the prospect for dividend growth.

Looking at sector performance relative to movements in the ERP is, of course, similar to looking at beta. Financials should benefit from both beta and lower risk of deflation.

Typically cyclicals would do best but we continue to have a strong preference for consumer vs. industrial cyclicals. The latter, while high beta and cyclical, are facing greater headwinds from capex cuts in the commodity industry as well as weaker EM infrastructure spend (see *Strategy Matters: From Industrial to Consumer, the secular shift,* January 16, 2015).

We prefer consumer-facing cyclicals which also enjoy a relative boost from dollar exposure and stronger US consumer demand.

Exhibit 13: STOXX 600 sector beta and correlation to pan-European market-implied ERP
1-month change in market implied ERP with monthly price returns of STOXX 600 sectors

Sector	Beta	Correlation
Banks	-17.5	-0.74
Basic Resource	-16.3	-0.67
Auto & Parts	-15.0	-0.61
Insurance	-14.1	-0.70
Con & Mat	-12.9	-0.69
Financial Svs	-12.7	-0.76
Inds Gds & Svs	-11.5	-0.73
Technology	-11.5	-0.68
Chemicals	-10.9	-0.70
Oil & Gas	-10.6	-0.68
Travel & Leis	-9.1	-0.61
Realstate	-8.9	-0.54
Media	-8.6	-0.65
Utilities	-8.6	-0.66
Pers & H/H Gds	-7.5	-0.60
Retail	-7.1	-0.56
Telecom	-5.6	-0.47
Food & Bev	-4.1	-0.40
Health Care	-2.8	-0.28

Source: Datastream, Goldman Sachs Global Investment Research.

There should also be a country skew to QE and the decline in the ERP too. The table below shows the correlations between country index returns to ERP and also the beta.

The MIB should benefit from these effects and while the IBEX is lower in the table, the prospects from further sovereign spread compression should benefit this market too. We continue to recommend a long position in both IBEX and MIB.

Exhibit 14: Country index beta and correlation
1-month change in market implied ERP with monthly price returns of country indices in local currency

Country	Beta	Correlation
MIB	-14.4	-0.76
OBX	-13.5	-0.70
DAX	-12.5	-0.77
MDAX	-12.4	-0.68
Euro stoxx 50	-12.2	-0.79
AEX	-12.2	-0.76
CAC	-11.8	-0.80
IBEX	-11.8	-0.66
FTSE 250	-9.8	-0.65
OMX	-8.8	-0.62
FTSE 100	-8.7	-0.71
SMI	-7.1	-0.66

Source: Datastream, Goldman Sachs Global Investment Research.

Stocks that should benefit

We take our analysts strongest views at the stock level reflected in Conviction List-Buys and Buy-rated names that are also in sectors that are highly correlated to movements in the ERP, have high beta, and/or have high dollar and consumer cyclical exposure.

Exhibit 15: Stocks benefitting from QE

Company	Current Price (21 Jan 2015)	Currency	MV (Bil. EUR)	Sector	Country of domicile	12m forward P/E	Analyst Recommendation
Daimler	74.90	E	80.1	Automobiles & Parts	Germany	10.8	Buy*
Intesa Sanpaolo	2.55	E	40.5	Banks	Italy	13.6	Buy*
BBVA	7.86	E	48.9	Banks	Spain	12.1	Buy*
Erste Group Bank	19.98	E	8.6	Banks	Austria	9.7	Buy*
BHP Billiton	1427.00	£	39.3	Basic Resources	United Kingdom	12.3	Buy*
Norsk Hydro	41.90	NK	9.8	Basic Resources	Norway	13.3	Buy*
Eiffage	45.95	E	4.2	Construction & Materials	France	12.3	Buy
Azimut Holding	19.04	E	2.7	Financial Services (Supersector)	Italy	14.0	Buy*
Anima Holding	3.94	E	1.2	Financial Services (Supersector)	Italy	9.6	Buy
Anheuser-Busch Inbev	102.10	E	164.2	Food & Beverage	Belgium	21.1	Buy*
Atlantia	21.46	E	17.7	Industrial Goods & Services	Italy	19.9	Buy*
BAE Systems	502.00	£	20.6	Industrial Goods & Services	United Kingdom	12.7	Buy
Philips Eltn.Koninklijke	25.50	E	23.8	Industrial Goods & Services	Netherlands	15.4	Buy
St.James'S Place	827.00	£	5.6	Insurance	United Kingdom	23.5	Buy
Prudential	1577.50	£	52.8	Insurance	United Kingdom	13.4	Buy
Mediaset	3.73	E	4.4	Media	Italy	36.2	Buy*
Salvatore Ferragamo	23.27	E	3.9	Personal & Household Goods	Italy	22.3	Buy*
Burberry Group	1743.00	£	10.1	Personal & Household Goods	United Kingdom	21.1	Buy*
Christian Dior	148.40	E	27.0	Personal & Household Goods	France	14.5	Buy
Beni Stabili	0.62	E	1.4	Real Estate	Italy	14.6	Buy*
Icade	73.79	E	5.5	Real Estate	France	15.6	Buy
Yoox	18.14	E	1.1	Retail	Italy	51.9	Buy
Altice	65.00	E	16.1	Telecommunications	Netherlands	56.3	Buy*
Intercontinental Hotels Group	2648.00	£	8.2	Travel & Leisure	United Kingdom	21.7	Buy
Sodexo	86.43	E	13.6	Travel & Leisure	France	21.0	Buy
Hera	2.07	E	3.1	Utilities	Italy	18.3	Buy*
Enagas	26.95	E	6.4	Utilities	Spain	15.8	Buy

** denotes conviction list membership*

Source: I/B/E/S, Datastream, Goldman Sachs Global Investment Research.

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Reg AC

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