EXANE BNP PARIBAS

STRATEGY – OUTLOOK 2016

She's lost control

17 NOVEMBER 2015

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WHY YOU SHOULD READ THIS REPORT

The European domestic recovery is encouraging. But this is overshadowed by a treacherous global backdrop. US financial conditions are tightening, leaving the corporate sector exposed. This at a time when cyclical pressures on EM threaten to uncover structural fault lines. Downside risks to equity markets persist.

It's hard to believe this is all in the price. Valuations suggest latent vulnerability. Dividends are facilitated by exceptionally high payout ratios and exceptionally low capex. Dividend growth will be slow even into a cyclical earnings recovery.

We think the 'surprise' will be another period of Defensive leadership. We further reduce portfolio beta and focus overweights in domestic euro recovery plays and ECB winners.

See Appendix (on p125) for Analyst Certification, Important Disclosures and Non-US Research Analyst disclosures.

STRATEGY – OUTLOOK 2016

Tue 17 Nov.
15.30 UK / 16.30 CET / 10:30 NY /
23:30 SINGAPORE

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Blue Monday

The major economies are now characterised by desynchronised economic cycles, with divergent policy regimes. This complicates the equity investment decision. Europe may be a relative winner, but too much of the globe is seeing financial conditions tighten, against lacklustre growth, to be optimistic on directional trends. We see downside risk through the opening months of 2016.

Isolation

The European economy is moving in the right direction and further ECB action promises to again ease financial conditions. Valuations may be rich and earnings forecasts too high, but on balance Europe, in isolation, looks attractive. It's the global backdrop that scares us.

Love (of the dollar) will tear us apart

US macro resilience has long been the consensus default assumption. But US financial conditions are tightening and the rate cycle looms. Corporate demand for credit has surged, and the 2016 refinancing wall looks onerous. A further rise in spreads, and the equity market may pay the price. And this at a time when EM remain vulnerable – the structural concerns are still valid.

From safety to where

We increase the Defensive bias to the portfolio. Sector allocation is skewed to the most obvious beneficiaries of ECB policy and low euro-area yields. EM exposure still offers a poor risk-return pay-off. Our Financials preference is flipped in favour of Insurance to accommodate a lower for longer interest rate trajectory. This all adds up to an increased allocation in low beta sectors.

Transmission

Against a difficult trading backdrop we look for stock selection strategies that reliably produce alpha. We focus on the risk-return trade around dividends, and identify how capex and ROIC trends interact to influence share prices. Finally we identify Europe's potential 'Juncker' winners.

Sector	Old	Change		New
Basic Resources	Overweight	**Downgraded**	↘	Neutral
Oil & Gas	Neutral	**Downgraded**	↘	Underweight
Retail	Overweight	**Downgraded**	↘	Underweight
Media	Neutral	**Upgraded**	↗	Overweight
Chemicals	Neutral	**Downgraded**	↘	Underweight
Healthcare	Neutral	**Upgraded**	↗	Overweight
Food & Beverages	Underweight	**Upgraded**	↗	Neutral
Telcos	Neutral	**Upgraded**	↗	Overweight
Utilities	Underweight	**Upgraded**	↗	Neutral
Banks	Overweight	**Downgraded**	↘	Neutral
Insurance	Neutral	**Upgraded**	↗	Overweight
Financial Services	Overweight	**Downgraded**	↘	Neutral

Source: Exane BNP Paribas estimates

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Contents

Executive summary

The front page title is borrowed from a 1979 Joy Division song. Unfortunately the reader may feel there is a limited amount of 'joy' elsewhere in this note. We understand the recent renewed enthusiasm for European equities. And relative to other global equity markets, we concur. The ECB has winked knowingly, and investors uniformly believe they are on a promise going into the December meeting. Another round of easing domestic financial conditions is underway. Combine this with robust domestic demand trends, and optimism that Household Disposable Income growth will again fuel the economy in 2016, and the European macro cocktail looks equity friendly.

It's what's going on beyond Europe's borders that concerns us. The implications of a Fed tightening cycle are still unknown. The USD has strengthened again recently as expectations have firmed on December lift-off. The implications for USD liquidity in pressured, and indebted, EM economies remain as valid a concern today as when the market fretted over such issues in August. And this ongoing worry sits alongside the debate about the resilience or otherwise of the US domestic economy to its own tightening cycle.

Directionally these global negatives dominate our enthusiasm for Europe, and we fear that global equity markets remain subject to downside risk through the first half of 2016. In this note we outline our reasoning behind this conclusion, as well as discussing how we believe investors can generate alpha against such a backdrop. We hope you enjoy the read, and the very best of luck for next year!

The directional call…liquidity and growth

The directional call – page 7

In the US, financial conditions are tightening. The corporate's sector's utilisation of debt is soaring as the financing gap deteriorates. And the corporate debt maturity calendar looks onerous in 2016. The risk is spreads move materially higher again. Given the reliance on debt funded buybacks this has direct, and negative, equity market implications.

In EM, the debate over whether there is a mini-cycle forming may continue near term. But the structural issues are not improving. Corporate debt lies at the root of the problem. The NPL cycle is only just beginning. And in China we have real concern on the Banks' capital resilience. Impaired financial intermediation points to sustained pressures on domestic liquidity and, by extension, growth. Equity negative.

For once, Europe offers a stronger story. A central bank that stands ready to escalate monetary policy support, and a domestic economy that is showing some momentum. For us, it is the one major region where macro conditions look supportive of equity markets. This should favour domestic stocks and underpin a relative trade. But we suspect that global influences are likely to weigh on the aggregate indices.

Valuation and earnings – pages 25 & 34

Valuation and earnings…behind the headline

Valuations are clearly elevated. Considering the capital structure, rather than just the equity, and European ratings have only been higher through the TMT bubble. The European CAPE is often mis-used – remove the structurally changed sectors and the rating is again at the top of the range. But perhaps the greatest mis-perception relates to dividends. Yields may look attractive against credit, but capex is extremely depressed and payout ratios close to historic highs. Even in a benign world, as these factors normalise, future dividend growth will materially lag earnings. Buying equities requires investors to stomach rather than embrace valuation.

Like 2015, our top-down model produces an earnings forecast that is below consensus for 2016. Ex Financials and Resources, we stand at 8.9% for the euro-area against a consensus of 11.1%, and 5.2% for the UK against a consensus of 8.1%. While the usual 'bottom-up' optimism is apparent in forecasts, we are not far enough away from the market to believe forecast momentum will be the defining influence on European markets next year.

Sector allocation – page 37

Sectors…ECB winners vs EM losers

Our core sector portfolio ideas are focussed on the beneficiaries of ECB policy support – an environment of sustained very low bond government bond yields. Infrastructure and Regulated Utilities stocks may feature, but at the sector level its Telecom and Real Estate that are the core buys on the theme.

We Neutralise 'secular growth', keeping Personal & Household Goods at Underweight, upgrading Healthcare to Overweight, with Neutrals in Food & Beverage and Tech. Sensitivity to any rise in the Treasury yield may work against them, their low volatility characteristics will still appeal to many though.

Construction continues to hold the allure of a margin recovery play as top line growth releases operational leverage. The quietly forgotten 'Juncker plan' may start to positively influence demand as 2016 progresses.

Household disposable income growth looks like a clear euro-area macro thematic. Unfortunately, we feel the pricing of the most obviously exposed sectors fully reflect this. We downgrade and are now Neutral across the Consumer Cyclical group, but do see a relative trade in Long Media (overweight), short Retail (underweight).

We make a significant change in Financials, upgrading Insurance to Overweight and cutting Banks to Neutral. The motivation is simple enough – in an environment of sustained QE and sovereign yield compression in Europe, which part of the Financials universe comes out best? After working to mitigate duration mismatch over the course of this year, Insurance now looks favourite.

Turning to the shorts, we look to the EM exposed sectors, with the greatest sensitivity to manufacturing, industrial production and credit conditions. Industrials, Chemicals and Autos fall into this category – we are Underweight all three.

Oils and the Miners remain very difficult – big underperformers through 2015 as the commodity price backdrop reflected both the weak demand trends and producer over-supply. We have little confidence that demand is on the verge of showing a material uplift. Oils we cut from Neutral to Underweight – on our numbers the rehabilitation is simply too far out. We see greater appeal in Basic Resources but also recognise the risks. We bite the bullet and cut to Neutral.

Figure 1: Sector allocation

Sector	Old	Change	New
Commodity sensitives			
Basic Resources	Overweight	**Downgraded**	Neutral
Oil & Gas	Neutral	**Downgraded**	Underweight
Cyclicals (non-commodity)			
Retail	Overweight	**Downgraded**	Underweight
Media	Neutral	**Upgraded**	Overweight
Technology	Neutral		Neutral
Autos & Parts	Underweight		Underweight
Travel & Leisure	Neutral		Neutral
Construction & Materials	Overweight		Overweight
Industrial Goods & Services	Underweight		Underweight
Chemicals	Neutral	**Downgraded**	Underweight
Overseas defensives			
Healthcare	Neutral	**Upgraded**	Overweight
Food & Beverages	Underweight	**Upgraded**	Neutral
Personal & Household Goods	Underweight		Underweight
Domestic defensives			
Telcos	Neutral	**Upgraded**	Overweight
Utilities	Underweight	**Upgraded**	Neutral
Financials			
Banks	Overweight	**Downgraded**	Neutral
Insurance	Neutral	**Upgraded**	Overweight
Real Estate	Overweight		Overweight
Financial Services	Overweight	**Downgraded**	Neutral

Source: Exane BNP Paribas estimates

Global view – page 65

Going global...Europe has a story to tell

For global asset allocators, there seems ample intuitive reason to prefer European equities. We stress test this presumption. 'Cheap' Emerging market valuations are illusory and should be avoided. 2016 US earnings growth relies on sectors with negative forecast momentum and elevated standard deviations. The presidential election process also carries volatility risk (especially wrt. the Republican nomination) against a calmer political outlook in Europe. Structural reform, monetary policy and the cyclical recovery look far less certain in Japan. Even within Europe, the UK continues to offer insufficient valuation support for a more advanced recovery. In relative terms, the Eurozone remains the stand-out.

UK – page 87

UK…cool on the consumer

Slowing Real Household Disposable Income growth, and a central bank that sounds increasingly stressed on unsecured consumer credit growth. Potential measures to cool consumer borrowing would represent another reason to take down UK consumer cyclical weightings.

Our High Conviction Index is on course to post strong absolute and relative performance in 2015. But Q3 has been difficult. We reposition the index with a more defensive bias. Pennon, Reckitt Benckiser, Relx, Vodafone and RBS are added. Lloyds, Ashtead, Inchcape, Glencore, Poundland and WPP are dropped.

Stock Selection – pages 100 thru to 124

Stock Selection…capturing capex, running returns

First rule - avoid the portfolio bombs. Increasing investment into a declining return on capital trajectory is often associated with the stock price disasters. We screen for the 2016 danger areas.

Go one step further and sift through the big losers to identify potential turnaround candidates. We look for examples of high legacy capex and R&D relative to EV. Couple with a trend break – current year capex reduction and ROIC improvement – and we have a turnaround trade. Historic performance is encouraging.

Finally, we look for the efficient investors – the virtuous cycle plays. Increasing ROIC year-on-year and investment exceeding depreciation by at least 20%. Maybe not the most exciting screen, but a consistent performance generator nevertheless.

Stock selection…optimising dividends

Plain vanilla buying of high yield stocks frequently results in sub-benchmark performance. High yield names are often big yielders for risk, rather than business maturity, reasons. We highlight the major dividend payers where our analysts see sustainability risk – historically avoiding the dividend cuts would have transformed the performance of an income fund.

In addition, we screen for the dividend plays to own – better than market yield, facilitated by high ROIC that can support both growth and shareholder distributions. Some of the names thrown out surprised us – but the track record of this two-stage screening process is compelling, and suggests we should take note.

Stock selection…Juncker winners (again!!!)

Remember the Juncker plan? The boost to European infrastructure that fell from the headlines after an underwhelming launch? Well, quietly progress has been made. And it really does look like this could start to create business opportunities for European companies. Our analysts identify the potential beneficiaries under our coverage.

Chance favours the prepared mind

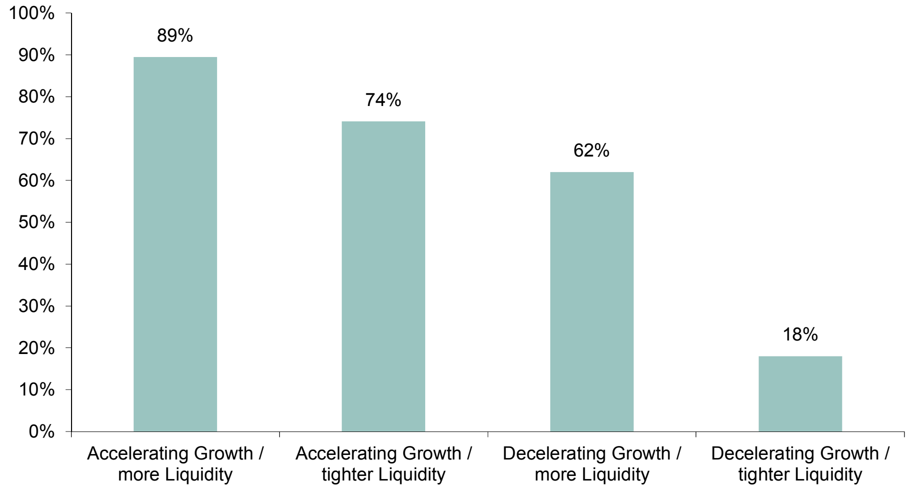
Equity pricing is typically sensitive to the evolution in financial conditions and economic growth. Right now, the outlook for these two influences diverges sharply by region. Crucially, the US looks vulnerable on both counts – and this may well set the directional trend for equity markets well beyond US borders. EM remains subject to structural concerns that arguably dominate high frequency cyclical indicators. Instead it is Europe that stands out as offering what looks like the most favourable combination of growth and liquidity momentum. This may not be enough to buck the external influences, but it should lay the foundation for a strong relative trade.

"All models are wrong, but some are useful!" – our directional framework

We have long been believers in appraising the directional call on equity markets in the context of the evolution of two broad factors: financial conditions and economic growth. The framework is simple enough but is a consistent and effective methodology in framing when the probabilities associated with rising equity prices are favourable – and when they are not.

The track record is comforting and will confirm most investors' intuition. The best chance of making money in equities occurs when monetary conditions are easing and economic growth accelerating. At the other extreme, equity exposure is best avoided or actively sold short.

Figure 2: Probability of achieving positive 3M equity returns

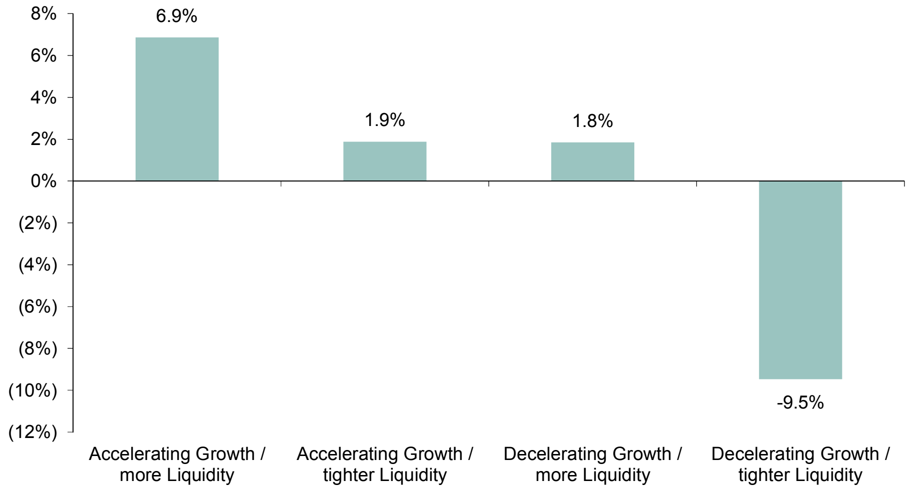


Source: Exane BNPP Strategy Team, Datastream, European equity market, last 15 years

This provides the backdrop for our discussion as to the likely direction in equity markets as we peer into 2016. But while the probabilities associated with these sets of macro conditions provide a strong guide on when to be long or short, this is not the full story.

We also need to consider the magnitude of likely returns associated with these probabilities. The following chart shows the median 3-month returns in European shares associated with these various macro phases, as measured over the last 15-years.

Figure 3: Median 3M return in European equities against macro backdrop



Source: Exane BNPP Strategy Team, Datastream

The asymmetry of return should be obvious. The quantum of potential losses during the adverse phase, in absolute terms, is significantly bigger than the positive return in the most favourable phase. And this negative outcome dwarfs the returns that are typical when the macro conditions offer mixed support to equity investors.

"We really can't forecast all that well…"

In the absence of perfect foresight, this analysis suggests investors should err on the side of caution if there is an elevated chance the macro evolution may result in an environment of growth deceleration and tighter liquidity. Put simply, if investors believe there is an above normal risk of the adverse outturn – even if not certain - investment decisions should display risk aversion not risk neutrality.

Anticipating the development in financial conditions or economic growth is particularly complicated right now. For a start, the major economic regions are clearly not experiencing a synchronised economic cycle. How mature is the US expansion? How far from the trough are the big EM economies? Will Europe's embryonic upturn gather pace? It's possible to look across the world and find examples of major economies in full blown recession, others displaying mid or late cycle characteristics and others in early phases of recovery.

Secondly, the outlook for monetary policy in the US represents a major complication. The debate around the implications of tighter Fed policy elsewhere in the world has not been settled and at present the long standing relationship between US rate expectations and the USD holds.

This presents specific risk for developing economies where USD liquidity is a very material influence. This year, across Emerging Markets, policy support has been hampered by capital flight. This effectively pushes financial conditions in the opposite direction to official policy action. In this way the US monetary policy cycle potentially still has influence far beyond the confines of the domestic US economy.

In the following discussion we look at the three elements of the global jigsaw that we feel will be most influential in setting the tone for equity markets looking into 2016 – the US, Europe and EM (with a focus on China). We attempt to appraise the risk-return around each.

US – tighter financial conditions, potential growth risks

For most of 2015, the debate on the US has focussed on the timing and path of a Fed tightening cycle. It is not over yet. Until the market turmoil of the summer, the growth outlook had attracted lesser focus. Now, there is heightened uncertainty on both counts – US interest rates and the prospects for economic activity.

Our economics team at Exane take a relaxed view – focussing on the extent of spare capacity, some traditional indicators of recession timing, and lead indicator improvement. For them, a severe US slowdown or recession is a H2 2017 event. This view is consistent with the 'usual' path of an economy over the cycle – until inflationary pressures, on the back of capacity constraints, force the central bank to over tighten, the economy is likely to sustain growth. They expect the Fed to tighten but the US economy to prove robust in 2016.

We certainly understand this view, but there is room for debate around some assumptions. Going a little further, we think it is highly likely that US financial conditions tighten. Fed policy is part of this, but crucially credit market dynamics suggest a degree of vulnerability that equity markets are yet to accommodate. We also suspect there will be a real economic cost to this and expect growth momentum to weaken. This is sufficient to warrant a cautious approach toward US equities

In reaching this conclusion we have focussed on the characteristics of the US corporate sector that have wider economic implications. Below we list the observations that concern us.

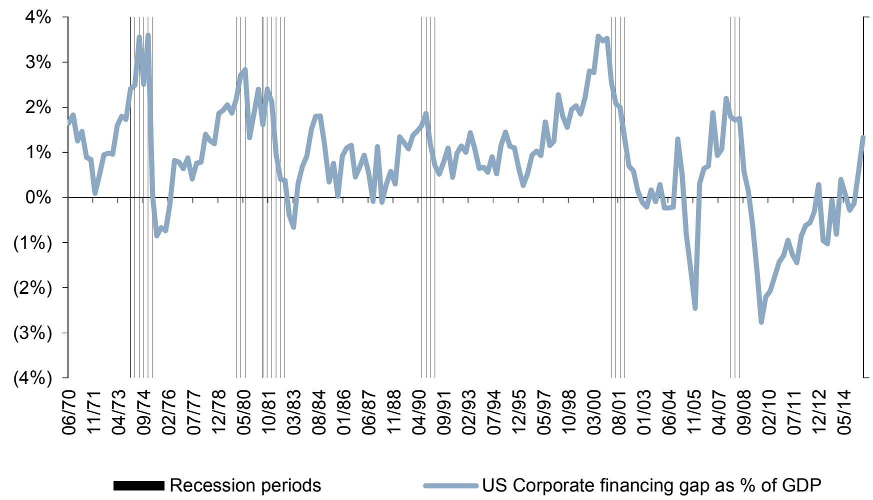
US corporate financing gap

In simple terms the corporate financing gap is capex less internally generated cash flow. And this corporate financing gap has deteriorated sharply over recent quarters.

While not at alarming levels, by Q2 of this year the financing gap has reached 1.3% of GDP. But the pace of deterioration is worth watching. For example, should the Q3 data show the same pace of deterioration as Q2, then the financing gap would have reached 2.1% of GDP through Q3. And that is a level that has typically preceded recession.

Put simply when the US corporate sector is spending significantly more cash than it generates internally, it becomes more sensitive to changes in financial conditions. And as demand for credit increases typically market interest rates start to increase to reflect the changing demand and supply balance.

Figure 4: US corporate financing gap

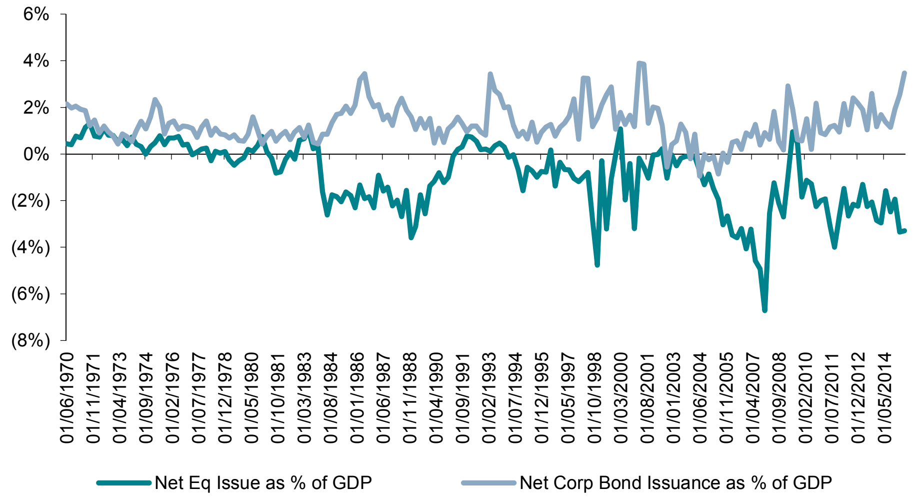


Source: Federal Reserve

A related point is that while the corporate sector appears to require external financing for normal business purposes, corporate demand for credit has also surged as equity retirement has been used to support shareholder returns – the buyback story.

As the following chart shows, the US corporate sector is currently swapping equity for debt at a run rate equivalent to 3% of GDP. This added source of credit utilisation again makes the corporate sector increasingly sensitive to credit conditions.

Figure 5: Net corporate bond issuance vs Net equity retirement, US corporates



Source: Federal Reserve

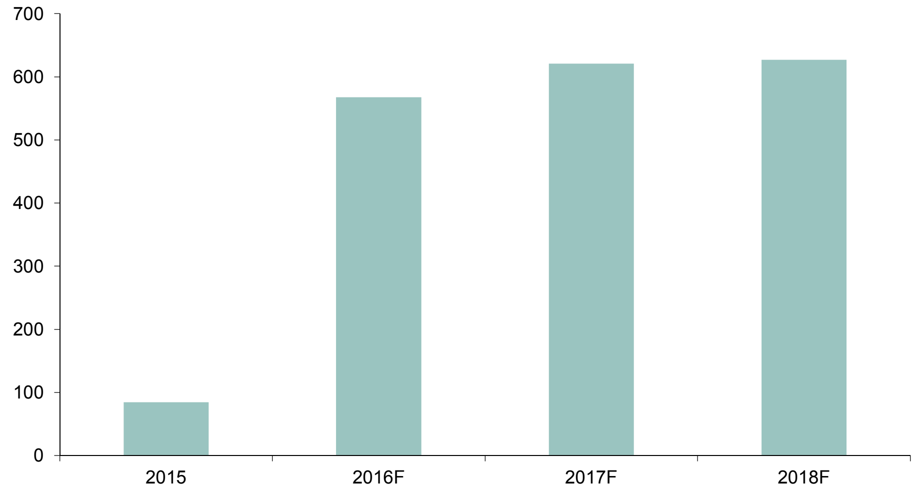
The refinancing wall

The US corporate sector has developed real appetite for taking on greater debt over recent years. As the above analysis illustrates, the combined operating and financial engineering demand for corporate debt is running at a level equivalent to around 4% of GDP – one of the highest readings on record, and this is dominated by bond financing rather than increased bank lending.

In addition, the large volume of corporate bonds issued earlier in the cycle are now starting to approach maturity in a big way. The following chart shows the maturity profile of US corporate bonds over the next few years. Put bluntly there will be a step change in the amount of corporate credit that matures in 2016 compared to recent history, and the majority of this will need to be refinanced.

Alongside new credit issuance discussed above, the credit markets will have to digest a surge of refinancing too. And potentially, this needs to play out against a Fed that is hiking the policy rate. To us the obvious risk is that credit spreads will continue to widen as supply of corporate paper outstrips demand. And that threatens to erode financial profitability, curb the extent of buybacks, and as credit becomes more expensive, potentially drag on economic activity too.

Figure 6: Corporate debt maturities by calendar year (USD, billions)

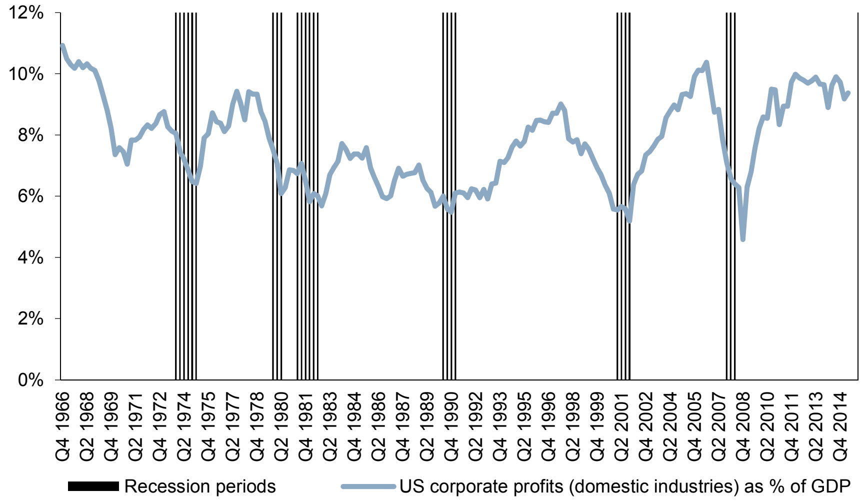


Source: Bloomberg

Corporate profitability

Corporate margins may still be holding close to their peaks and not demonstrating the usual cost-driven declines typically seen prior to a downturn. But if investors focus on domestic margins – ie excluding the impact of US corporate's overseas activities – it is notable that profitability actually peaked in Q1 2012. While margins have only faded gradually from the highs, it is also true that profitability has been in retreat for over 2-years. For context this is a longer period of margin erosion than usually precedes a US recession.

Figure 7: US corporate margins of domestic industries



Source: Datastream

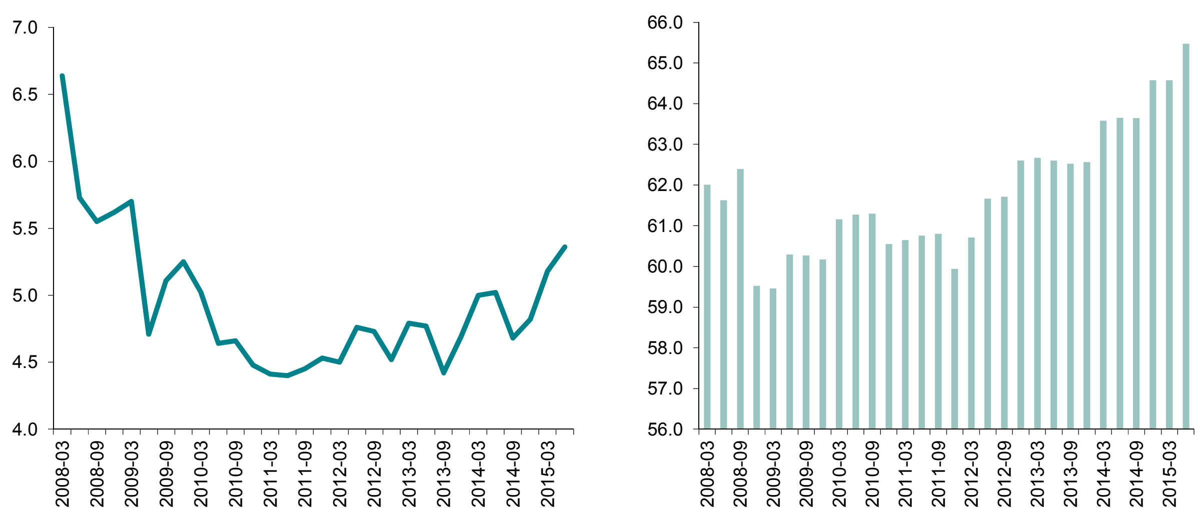
Cost of credit already increasing in some segments

Low financing costs have been held up as a support for Household big ticket expenditures such as housing and cars. This has clearly been important in spurring the demand recovery over this cycle.

But in certain key markets – such as Auto loans – the cost of finance is materially higher than the lows of 2014 or 2013. Furthermore, credit standards have eased materially so that, for example, the duration of an average US Auto loan has reached 5.5 years – how much further can this go on an asset guaranteed to depreciate, against falling residual pricing trends?

If the credit environment deteriorates along the lines we feel likely, then this is one example of an important area of consumer demand where more expensive credit can rapidly impact economic activity.

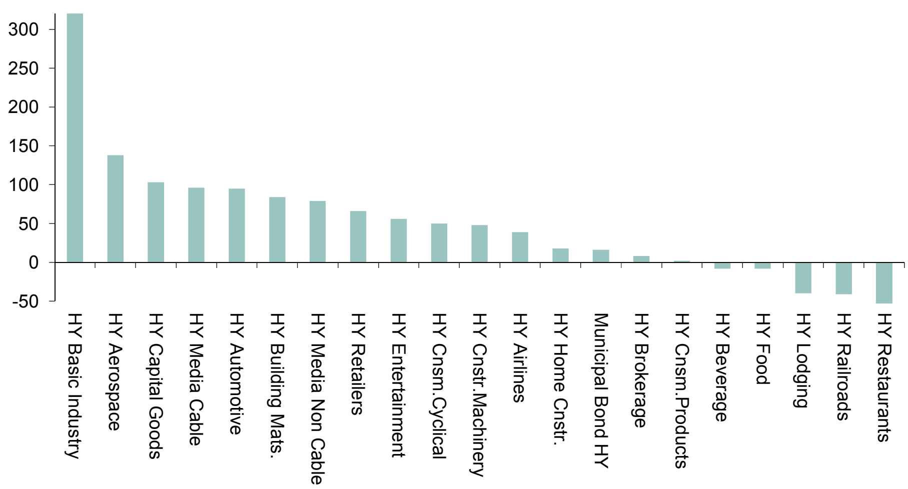
Figure 8: US Auto loans – attractive terms have fuelled the recovery in unit sales….can it get much better?



Source: Federal Reserve

Credit spreads are not at recession levels. But extrapolate the last 6-months to the next and we're in the ballpark. As the following chart demonstrates the widening in high yield spreads in the US over the last 6-months has been significant for corporates that are considered cyclical. And as we discuss above – this has happened before the big refinancing demand has hit the market, and before the Fed has lifted rates.

Figure 9: 6M change in US High Yield spreads by sector (bps)



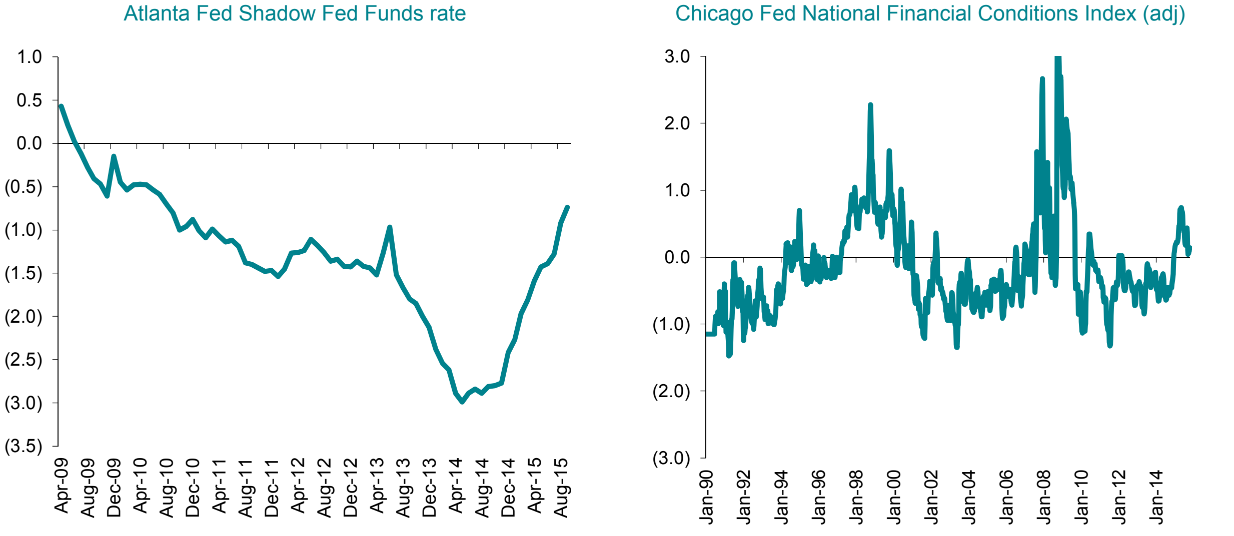
Source: Datastream

US Financials conditions already deteriorating

Even if one were to ignore the arguments to this point, simply observing what is already playing out should allow investors to reach the conclusion that financial conditions are tightening in a way that has the potential to weigh on the equity investment case.

The two following charts both give a similar impression of the trend in US financial conditions. First the Atlanta Fed's Shadow Fed Funds rate – a methodology designed to give an impression of the effective policy rate beyond the zero bound constraint – has risen sharply and is now some 225bps higher than the low reached in 2014. Second the Chicago Fed's Financial Conditions index – constructed with an average reading of zero – having spent most of the post 2009 period in negative territory (easy financial conditions) has tightened into positive territory this year.

Figure 10: US Financial conditions have tightened steadily over the last 12-months



Source: Bloomberg

There are two potential conclusions we can reach. The benign interpretation is to position the US economy in the mid to late cycle phase, where growth holds up but financial conditions tighten. The other realistic appraisal would suggest that US growth stalls at some point over the course of 2016 as a result of this tightening in financial conditions, and a corporate sector that now looks highly sensitive to credit conditions.

The uncomfortable truth for equity investors attempting to form a risk return decision around this outlook, relates to the asymmetry of market returns likely under these respective scenarios. Under the benign 'mid to late cycle' profile, equity markets are capable of generating positive returns, but history teaches us the magnitude of those returns is modest. Alternatively, if this cycle were to grind to a halt, the potential downside to stock prices is very significant. And there seems to us to be sufficient likelihood of this second, adverse, scenario playing out to warrant a cautious stance going into 2016.

Emerging Markets – "*It is the debtor that is ruined by hard times*"

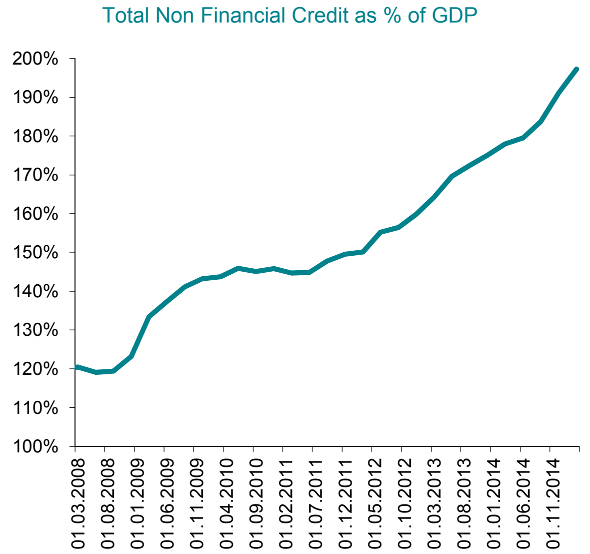
Emerging Markets represent the tail risk. That's not quite right as the probability of something going badly wrong is not particularly small. Grey swan rather than black swan.

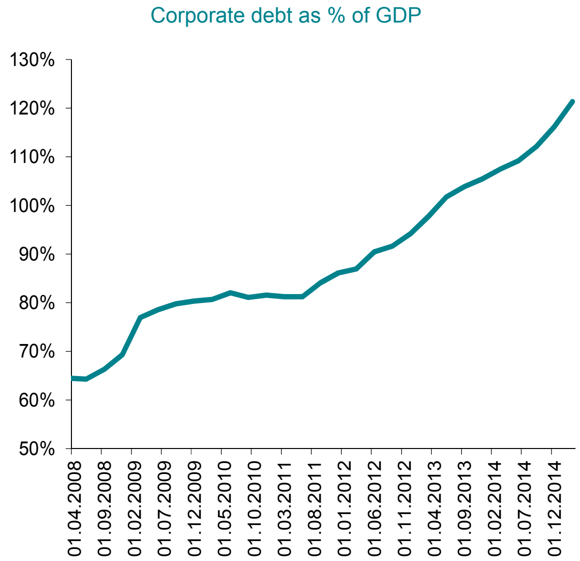
Much has been made recently of some of the high frequency lead indicators showing improvement off the depressed levels of September and October. Investors have traded this aggressively over recent weeks. But when we try and formulate a multi-month view on how the financial conditions and growth backdrop are likely to evolve there is one very, very big elephant that hasn't left the room. Debt. And because of this overhanging issue it is very difficult to be optimistic over a sustained improvement in either financial conditions or growth momentum.

We have got very used to the aftermath of a balance sheet recession across many Advanced Economies post 2008/09. Across key EM economies we are now looking at the same kind of drags on growth going forward. This is totally distinct to the rebalancing of manufacturing focussed economies toward greater services orientation.

As the majority of literature now agrees on, a rapid build-up of debt in any sector of the economy can be expected to drag against future growth prospects. On any measure Emerging Markets qualify as having fallen into the 'pulled forward growth' basket. And now they face the prospect of subdued growth persisting for many years.

Figure 11: EM Debt





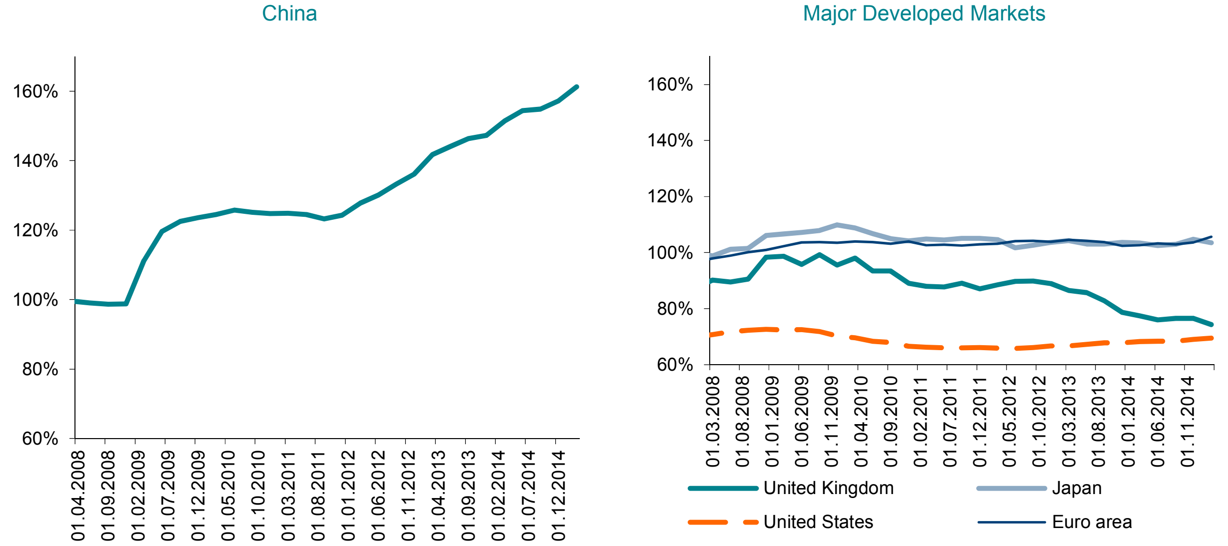
Source: BIS

There is little debate as to where the chief source of this debt build lies – the Chinese corporate sector. And coupled with the scale of the economy, this is the reason the investment debate struggles to veer away from China for any length of time.

The following charts show corporate debt to GDP in China and in the major developed markets of US, UK, Japan and the euro-area. It is not hard in the context of these data to understand the overbearing concerns around potential credit issues.

Rising bad debts have the potential to adversely impact Banks' balance sheets, and as we have seen in the West that quickly translates to lower credit growth and a consequent drag on economic activity. It is also possible that in light of sluggish economic activity corporates themselves proactively engage in a period of de-leveraging. Again cashflow devoted to debt repayment is cashflow that is not spent on investment or salary increases or returned to the owners of equity capital to fund alternative growth generators.

Figure 12: Non Financial corporate debt to GDP



Source: BIS

The IMF has shown in "Assessing China's Corporate Sector Vulnerabilities' by Chivakul and Lam, that SOEs in the Real Estate, Construction, Mining and Utilities sectors are chiefly responsible for this debt inflation.

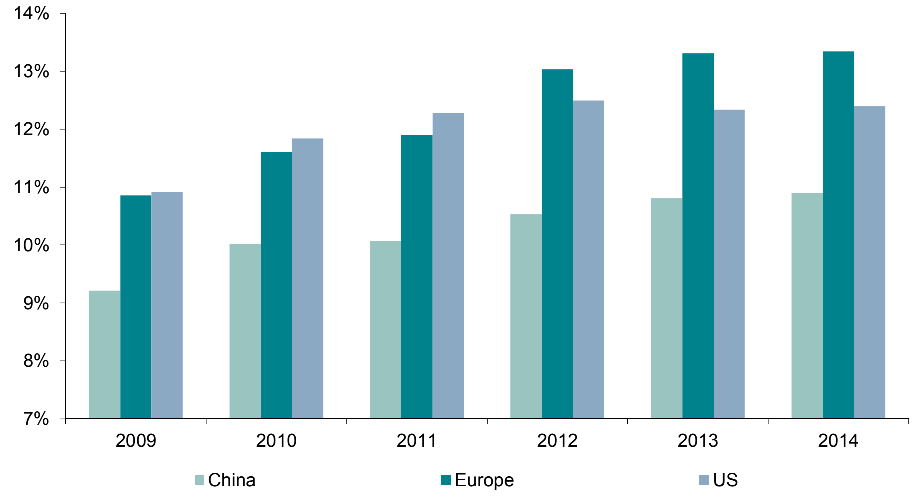
One of the interesting conclusions of this report, dated March 2015, is that a 'severe scenario' comprising of a material slowdown in the real estate and construction sectors – and defined specifically as a 20% fall in profits for real estate and construction firms – would cause significant financial distress for firms in these sectors. From a debt perspective, this paper estimates that total debt at risk (defined as interest coverage below one) would be approximately 25% of the total debt carried by the listed Chinese corporate sector.

The fact that many of these companies are SOEs complicates the analysis. Historically SOEs were seen as having an unspoken government guarantee. But in April this year a Chinese power-transformer became the first SOE to default on an onshore bond. This was taken as a signal of new appetite to allow market dynamics to influence capital allocation.

Whatever the propensity of the Chinese government to allow further SOE defaults there is clearly a risk somewhere in the financial system. Either capital remains allocated to inefficient areas dragging down growth and curtailing flows into more productive areas. Or market forces drive capital re-allocation with painful short term consequences to the Banks and other lenders who would be on the wrong side of defaults.

At his juncture it is worth emphasising that the capital position of the large Chinese banks, even on current reported numbers, looks inferior to the position of European or US banks.

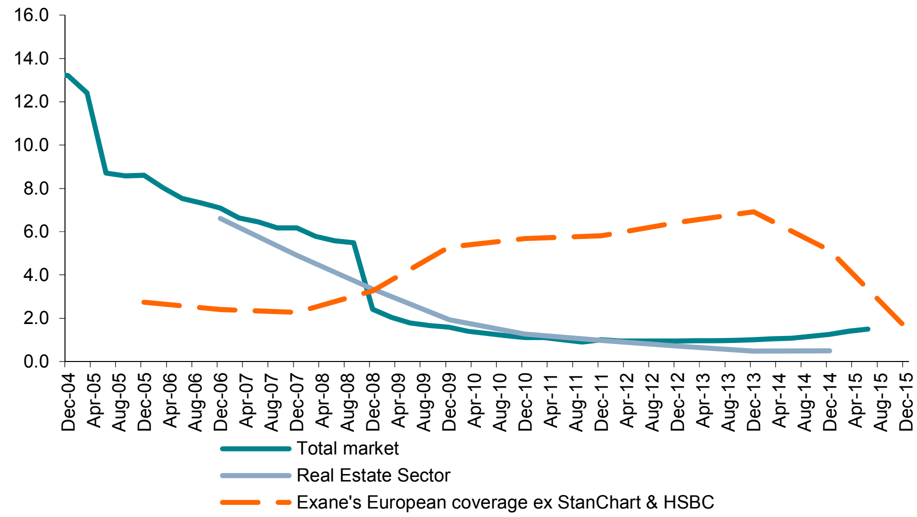
Figure 13: Banks sector, Tier 1 capital ratios, Europe vs US vs China



Source: Factset

But the stated capital ratio of the Chinese banks comes with a health warning. The NPL ratio looks very low given the macro backdrop, and a highly leveraged Chinese corporate sector. Below we show the NPL ratio for Chinese banks, and for reference the equivalent ratio for Europe's banks.

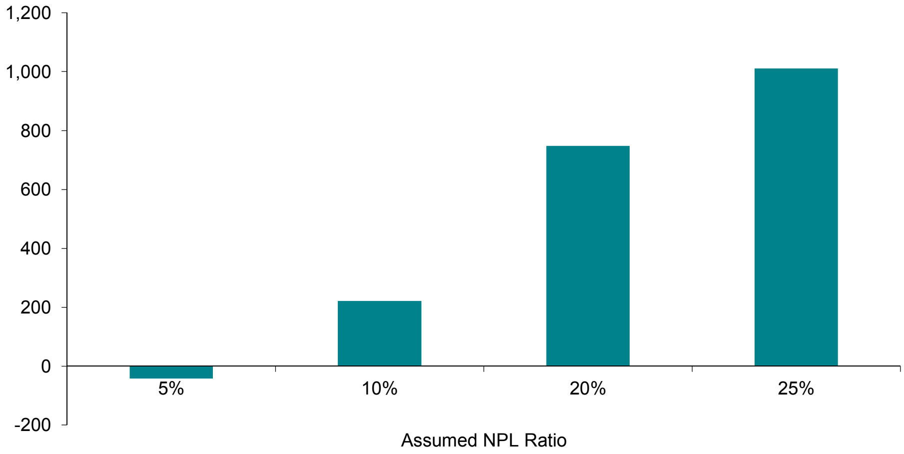
Figure 14: Chinese Banks NPL Ratio (%)



Source: Bloomberg, Exane Banks team

Stressing these metrics it is easy to see that the capital ratios could fall to levels that would require the Chinese banks to raise additional capital if the economy were to deteriorate further. For example if Chinese banks were to sustain capital ratios at current levels, the following chart shows the required capital raise under 4 NPL scenarios: a benign outturn where NPLs are 5%, a moderate downturn with 10% NPLs, an adverse scenario with 20% NPLs, and a severe scenario along the lines implied by the IMF working paper discussed above of a 25% NPL ratio.

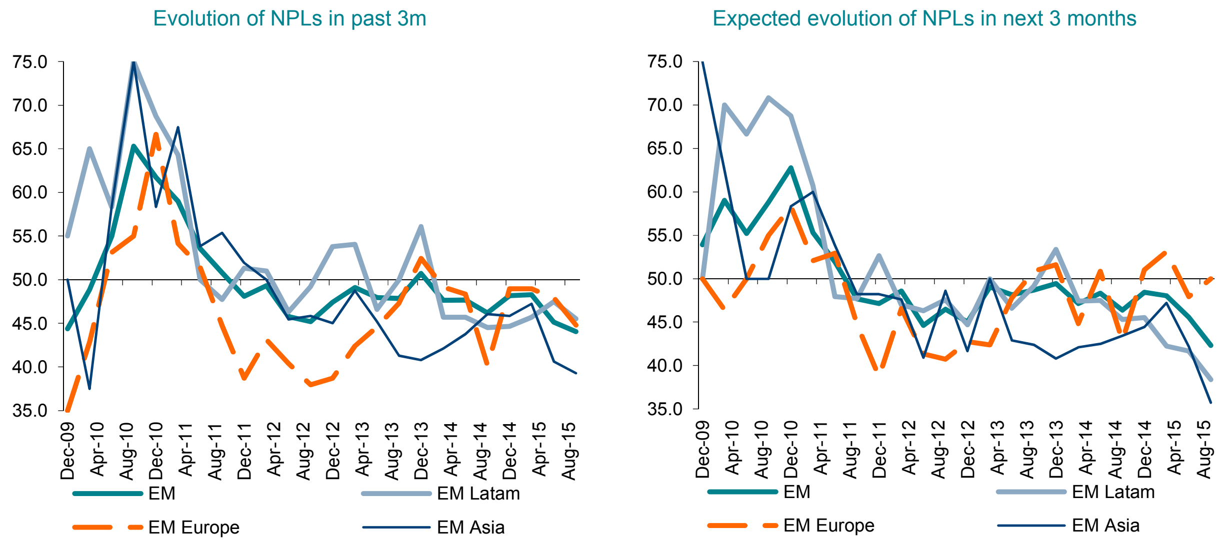
Figure 15: Implied capital shortfall of Chinese banks under various NPL scenarios (USD billions)



Source: Bloomberg, Exane estimates

As the following charts from the IIF illustrate, the NPL trajectory has started to worsen sharply across EM, especially in Asia. And the banks themselves expect this trend to become progressively more negative.

Figure 16: EM Bank Lending Conditions Survey (Q3 2015)



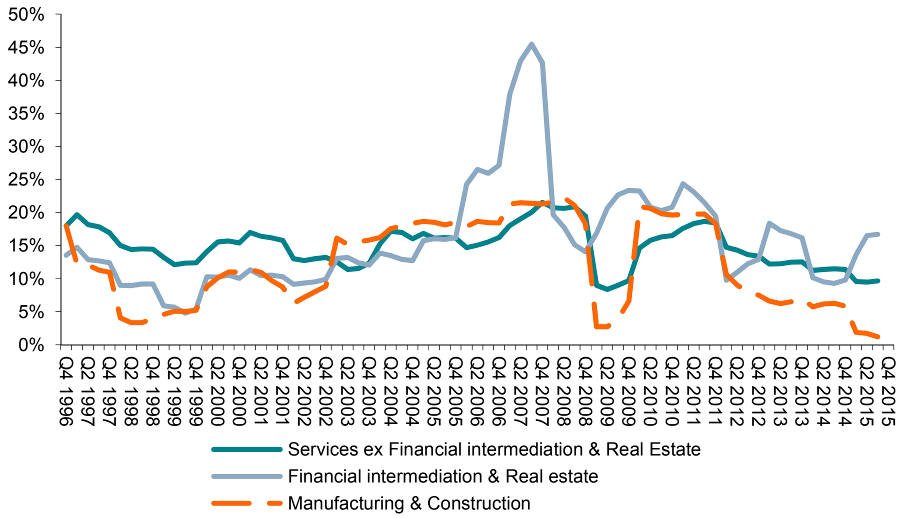
Source: IIF
Note: A reading of the NPL index below 50 implies a rise in NPLs and vice-versa

It is not the investment appeal of Chinese banks that concerns us. But rather a simple observation that it is difficult for any economy to achieve potential growth rates with a banking sector that is subject to sustained doubts over the quality of its loan book, and the fear that economic stress poses a realistic risk of crystallising capital problems.

And a healthy Banking sector looks crucial at this juncture in re-orientating capital to the services sector and supporting the desired re-balancing. As the following chart shows while the growth rate in Services is stronger than Manufacturing, the growth rate in Services ex Real Estate ex Financial Intermediation continues to trend lower. Financials Intermediation is flattering the underlying Services data – but these are not areas that most people would think of in driving the desired rebalancing.

Figure 17: Chinese rebalancing

Annual growth rate



Source: Datastream, Exane BNP Paribas estimates

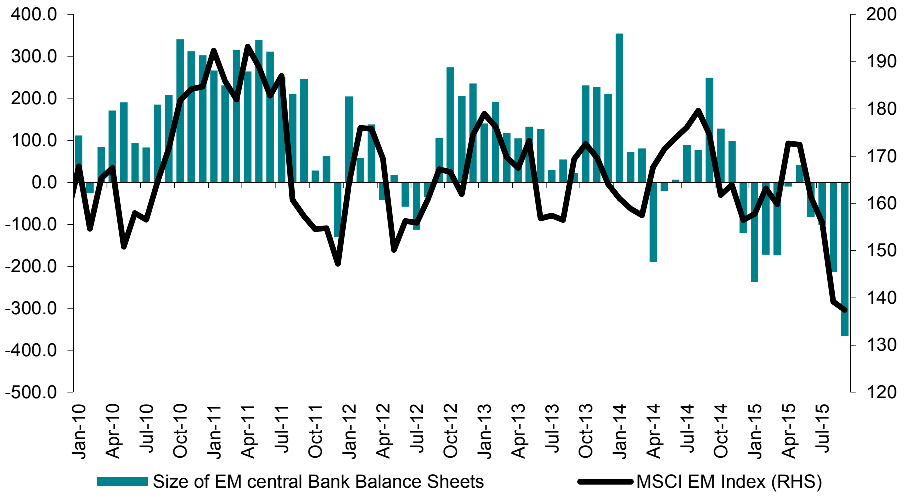
As long as there is uncertainty around the health of the Chinese banks it would seem likely that, where possible, Chinese households and corporates, would favour reallocating capital to areas of the world that perhaps offer less latent financial instability. As a result capital flight from China looks more likely to continue than abate. The way the RMB devaluation in August was structured only looks like adding to such pressures. And the prospect of higher US rates could provide a further catalyst to pressure on the RMB.

The implication here is that domestic policymakers are facing an uphill battle trying to ease financial conditions. For instance, each 100bps cut in the Chinese Reserve Requirement Ratio is estimated to add around USD200bn of liquidity to the economy. So up until mid-October, the RRR has seen cumulative cuts of 200bps, in theory releasing USD400bn into the economy. But over the period to end September, China’s foreign exchange reserves fell around USD330bn – and this can be thought of as a drag against domestic liquidity. In an economy of around USD10tn, the net easing of USD70bn implied here looks modest at best.

Returning to a wider look at financial conditions across Emerging Markets, the following chart shows the relevance for equity markets. Looking at the 3-month change in the combined size (USD) of the balance sheets of the six biggest Emerging Market economies shows a relatively close relationship with the performance of the MSCI EM index.

Emerging markets tend to trade on liquidity and the change in CB balance sheets can certainly proxy that liquidity. In this sense it's important to stress that this is a market driven tightening, predominantly through capital flight, fx reserve depletion and currency depreciation.

Figure 18: 3m change in 'Big 6' EM Central Bank balance sheets versus EM equities (USDbn)



Source: Exane BNPP Strategy Team, Datastream

To bring this back to the context of the discussion, do we feel the growth / financial conditions mix is favourable? The answer is no and we feel perhaps too much has been made of one or two cyclical indicators that appear to be off the floors reached in the summer. The bigger picture should dominate investors' focus.

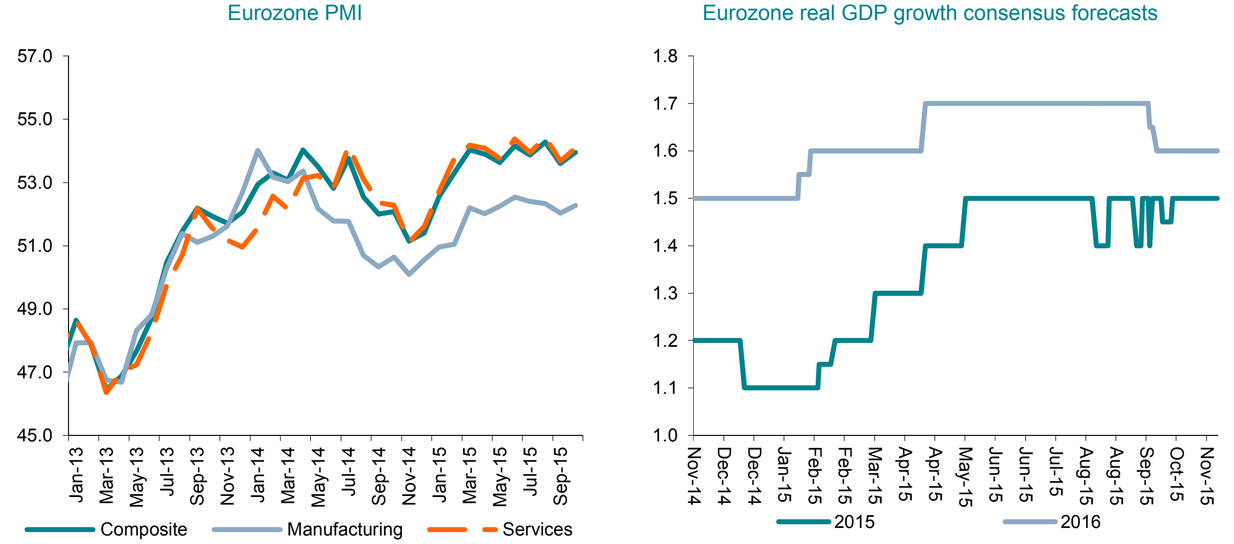
We are often asked what we need to see to offer a more positive prognosis on China. And above all else, our feeling is a credible cleaning of problem loans, and where necessary the recapitalisation of sponsoring banks, would represent a major step in the right direction. For an economy pushing to rebalance it seems crucial to us that financial intermediation has the ability and desire to re-allocate capital from low growth sectors with diminished productivity to higher potential, faster growing, industries.

Europe – "If you can't fly then run, if you can't run then walk…"

…just make sure you keep moving forward. This sums up Europe's GDP performance over the last year. And while the growth rate may not set pulses racing, in the context of a global economy blighted by a number of problem areas, 2015 represents progress.

Further, despite the global threats, the domestic side of the economy looks set to keep things moving in the right direction going into 2016. And the pace of expansion may even be a little higher than this year. Our economics team forecast 1.7% growth next year after 1.4% in 2015. Certainly there is nothing in the majority of lead indicators, or in consensus forecasts, that suggests the growth outlook is set to deteriorate.

Figure 19: Lead indicators and consensus forecasts look encouraging



Source: Markit, Bloomberg, Exane BNP Paribas estimates

Figure 20: Total employment in millions

Source: Datastream

The activity backdrop has provided encouragement, but it is generally the change in expectations that has the biggest market impact. On this point we see no real reason to believe the modest but positive growth trajectory that investors have pencilled in for the next 12-months is subject to major upward surprise, in the same way as we saw in Q1 of this year.

The other side of the macro framework – financial conditions – is likely to be a source of greater volatility and influence on European equity markets. Not least due to ECB policy support – there is now a lot resting on future central bank action.

First it is worth emphasising that the trade in European equities remains highly sensitive to the delta in domestic financial conditions – arguably more sensitive to this factor than the modest variation is growth assumptions that have characterised this year. And crucially, again, it is the change in financial conditions, rather than absolute levels, that tends to influence share prices.

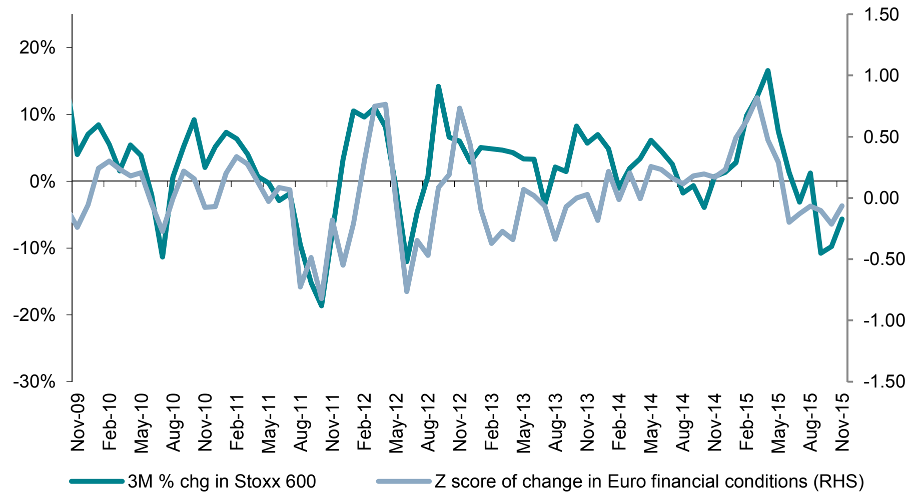
We appraise the euro-area financial conditions backdrop on the basis of the 3-month change in the following factors:

– M3 money supply growth
– Loans outstanding to non-financial corporates
– Italian and Spanish 10-year spreads over Bunds
– High Yield Corporate credit spreads
– Trade weighted euro

The following chart shows our composite indicator for these factors presented on a z-score basis alongside the 3-month change in Stoxx 600 equity index. While there are brief periods of disconnection (2013), these series have generally moved in a similar fashion over the last 5-years.

A z-score is initially calculated for each component by subtracting from the current 3-month change in each variable the average 3-monthly change through the post 2009 cycle. This is then divided by the standard deviation of the series. Finally, we take a simple arithmetic average of the components to create this aggregate indicator.

Figure 21: Euro financial conditions monitor versus Stoxx 600

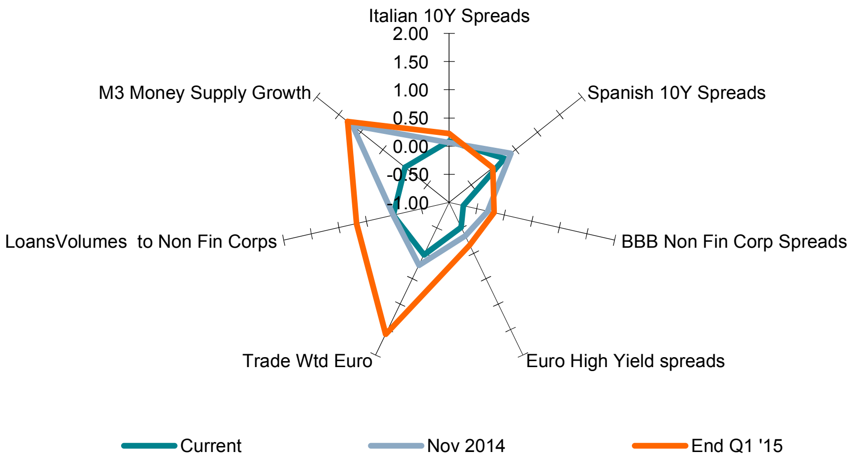


Source: Exane BNPP Strategy Team, Datastream

The following 'spider chart' provides a snapshot of current readings compared to one-year ago, and the picture at the end of Q1 2015. Again these readings illustrate the z-score in the 3-monthly change – with a reading of zero indicating neutrality and a positive reading reflecting a more positive change in financial conditions than has been typical this cycle.

Reflecting on the current reading, that captures the last 3-months, it is pretty straightforward to reconcile the negative performance from European equities. Further, the buoyant equity markets of Q1 this year are explained by the dramatic easing in financial conditions.

Figure 22: Exane Strategy Financial Conditions monitor (the higher the reading the better for financial conditions)



Source: Exane BNPP Strategy Team, Datastream

This brings us up to date, but with no obvious anomaly between equity market performance and the financial conditions backdrop over recent months, there is little steer on what the opening months of 2016 may offer. To answer this question we need to start anticipating how these financial conditions will evolve.

This brings us to the importance of the ECB. European markets jumped higher after the October 22nd ECB meeting as Draghi heavily hinted at further policy action that could be announced at the central bank's December 3rd meeting.

Indeed, re-calculating our Financial conditions indicator to reflect 1-month rather than 3-month changes demonstrates a sharp easing over the last month, largely through the renewed weakness in the euro, on this 'Draghi trade'.

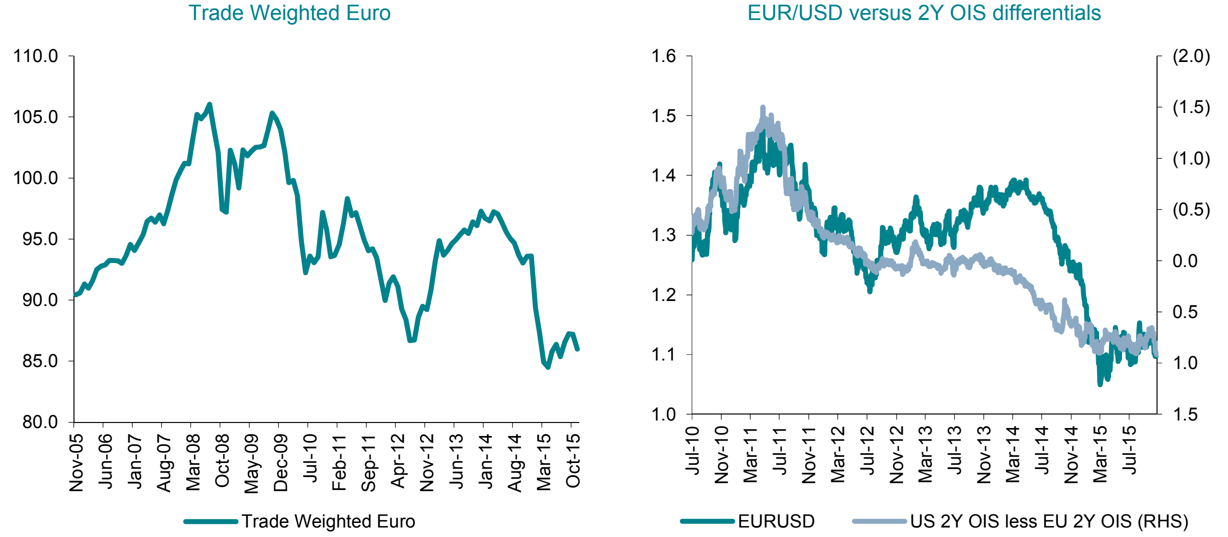
These financial conditions developments will need to be sustained, and investors will focus on the ECB in forming a view here. The exact nature of December's potential policy escalation remains subject to speculation. Our economics team feel he will follow through and cut the deposit rate by 20bps to -0.4% and extend the planned maturity of the programme from September 2016 to March 2017.

While anticipation of further ECB activism has been incrementally supportive to European markets, this round of policy escalation looks unlikely to provide the dramatic change in financial conditions witnessed through the QE announcement anticipation of late 2014 early 2015. It is also worth highlighting that history suggests the market prices the majority of the impact in before the implementation of policy even begins. On this basis, unless the ECB were to move materially beyond the policy mix outlined here, it would seem reasonable to conclude a substantial element of the policy has already had its market impact.

For instance, trade-weighted euro fell 11.5% between the highs of December '14 and the lows of March 2015. Since the October 22nd meeting trade weighted has fallen just under 2%. Can the currency continue to weaken? Certainly, but the policies that the market in now anticipating are far lower on the 'shock and awe' scale than the announcement of EUR60bn of monthly asset purchases. As a result we are doubtful the currency will adjust anywhere close to the same degree.

Furthermore, while much is made of the potential for divergent policy regimes in the US and Europe to drive a major re-pricing of the currency, as the chart below shows, as far as 2Y interest rate expectations capture this outlook, the currency looks to have reflected such an outlook. The euro does not look obviously overvalued or disconnected from market interest rates.

Figure 23: Trade weighted euro and EURUSD versus interest rate spreads



Source: Datastream

Beyond the euro, sovereign spreads are pretty close to March lows, while M3 money supply growth and loans extended to the non-financial corporate sector are not easily influenced by the kind of ECB policy options that are now on the table. Maybe credit spreads can benefit from a material increase in the scale of QE – but as we mention above, that does not look like the most likely form of policy escalation.

We do not wish to be too negative on the domestic European backdrop. Sure, the ECB bazooka trade of Q1 2015 looks unlikely to be repeated, and we emphasis the delta on financial conditions looks materially lower than we saw at the start of 2015. But there is incremental policy support, and that is at least helpful. Further the domestic growth backdrop looks reassuring.

Conclusion

The major regions of the global economy are arguably in different cyclical, as well as structural, positions. Identifying which economy is likely to dictate the performance of global equity markets is not a science, and there is room for debate. But it would take a brave investor to look beyond the US.

We assume that the US market at least needs to hold its level if we were to see decent absolute gains elsewhere. We see risks in the credit cycle, as corporate demand for credit has trended higher and the maturity roll looks aggressive in 2016. Then there is Fed policy tightening. We are at a loss to see how financial conditions could ease in such an environment, and there is a real threat that activity momentum fades on tightening pressures.

There may be some near term cyclical relief in the EM high frequency lead indicators, but the underlying structural issues, particularly in China, look onerous. The best case for investors under the currency policy regime appears to be a hope the policymakers can keep enough plates spinning to prevent the credit risk crystallising. But that represents an unstable backdrop against which to invest, with frequent periods of risk aversion likely. Capital flight and fx pressure remain clear risks as the Fed tightens and this has rapid financial conditions implications. We think the risk-return remains unattractive.

Finally, in isolation the domestic European macro influences look modestly supportive for equity markets. The question is not whether Europe offers relative appeal against other global equity markets, but whether Europe can shrug off what appears to be far more challenging, equity unfriendly, backdrops elsewhere. On this, the jury is out but our suspicion is that if the US plays in the way we outline here, or the EM tail risk crystallises, Europe will have a tough task generating absolute returns.

Valuation – looking behind the headlines

At times this cycle, investors have been forced to swallow hard and accept heady valuations as a function of a QE influenced world. Looking through elevated ratings can certainly pay-off during periods that policy support combines with confidence that material earnings growth is just around the corner. Indeed, this approach may well have been the only pragmatic option for investors over recent years.

The problem though is obvious enough. If policy support becomes less effective in influencing financial conditions, or belief in future earnings growth is shaken, stock markets suddenly look as if they have hit an air pocket. The near 20% decline in European markets between April and September is a sharp example of exactly such a phenomenon.

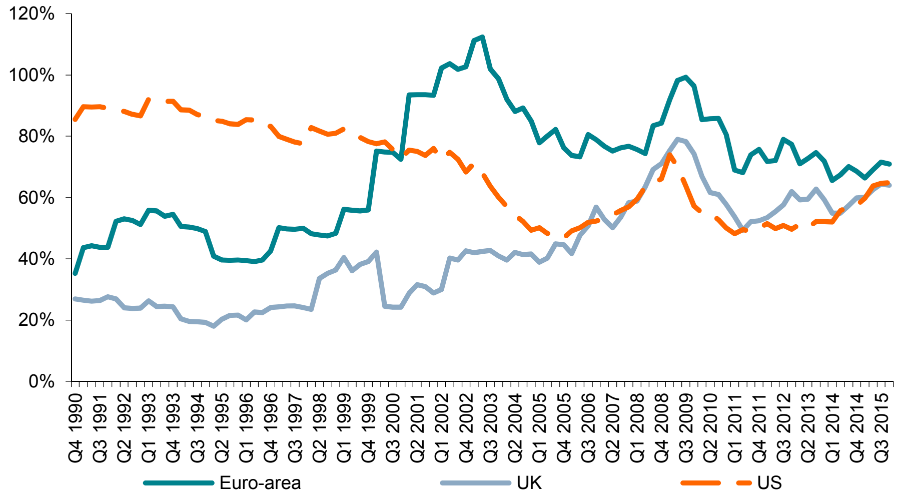
Even after August and September's sharp declines, it was difficult to argue that hard valuation support levels were reached. And this left investors at the mercy of volatile high frequency macro newsflow, while trying to second guess the extent that positioning unwind trades may have influenced share prices. Investing without fundamental support can be treacherous.

Now, as we peer into an environment of elevated policy risk, heightened uncertainty over the global growth outlook, and significant macro tail-risk in key economies, we feel valuations should play an increased role in differentiating the periods where there are attractive incentives to increase equity exposure from those where potential upside does not adequately compensate for the risk of carrying the position.

It is in this context that we must discuss the current valuation of European equities. We start with a basic observation that the degree of leverage employed in the corporate sector's capital structure has varied materially over the last 15-years. As such the basic exercise of comparing current P/E multiples with the historic range and average can be misleading in terms of representing how investors have valued the cashflow stream accruing to a corporate entity.

The Euro-area and the UK both employ greater leverage today than was the case in the 1990s, while the US less. Further, US and UK balances sheets have added leverage since 2011 (and it's the recent surge in bond issuance that concerns us), while the euro-area corporate sector has modestly reduced its balance sheet gearing. These metrics are certainly not constants over time.

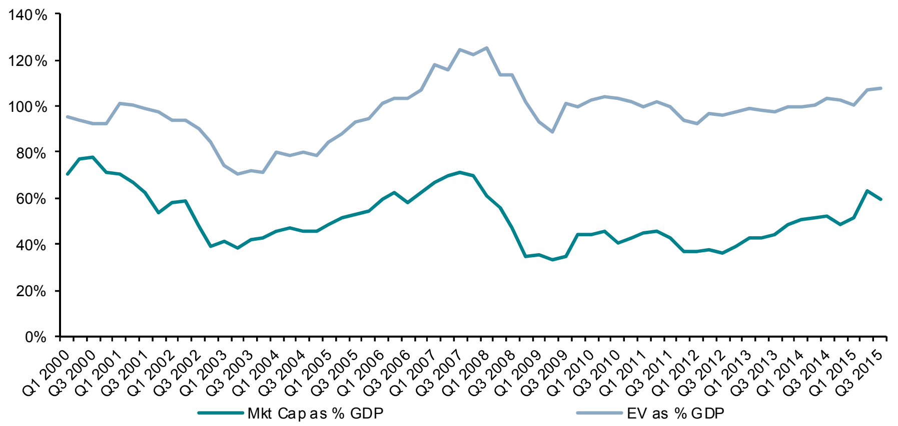
Figure 24: Net debt-to-shareholder equity (12M Trailing, Datastream indices)



Source: Datastream

The chart below expresses both the enterprise value (equity plus debt), and the equity value, of the listed euro-area corporate sector as a share of nominal GDP. It should be clear that neither series looks depressed – a function of the inflation in financial assets that has occurred across the globe as central banks have undertaken aggressive monetary stimulus. But in the last 3 years it is the equity that has climbed in value proportionately quicker relative to the size of the economy than the EV – reflecting the modest de-leveraging captured in the previous chart.

Figure 25: Euro-area EV and Market Caps as a % of nominal GDP

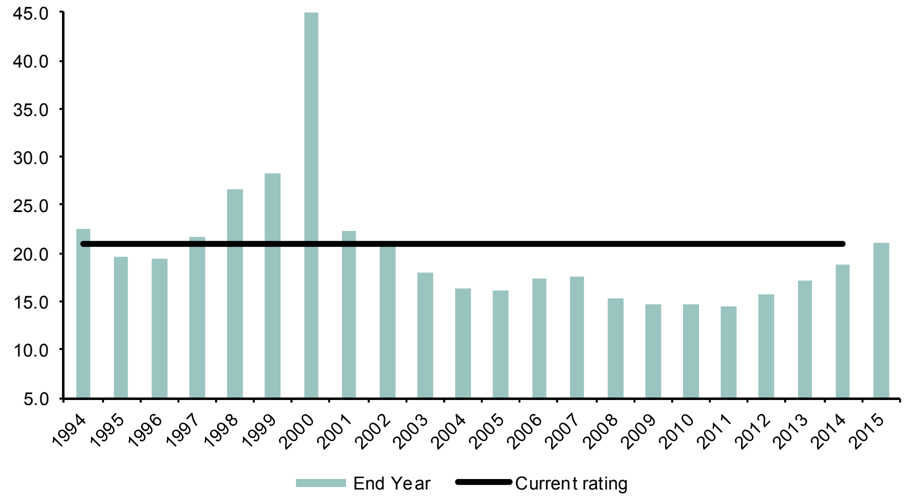


Source: Datastream

Changes in the capital structure imply valuing the equity in isolation and comparing to historic norms will not produce robust conclusions. The obvious way to resolve such concerns is to use a metric that fully reflects capital structure fluctuations, such as EV/EBIT or EV/NOPAT.

The chart below draws on Exane's Datacenter to illustrate that at least for the companies we have under coverage the 2015 EV/NOPAT ratios is as high as anything we have seen since the TMT excesses.

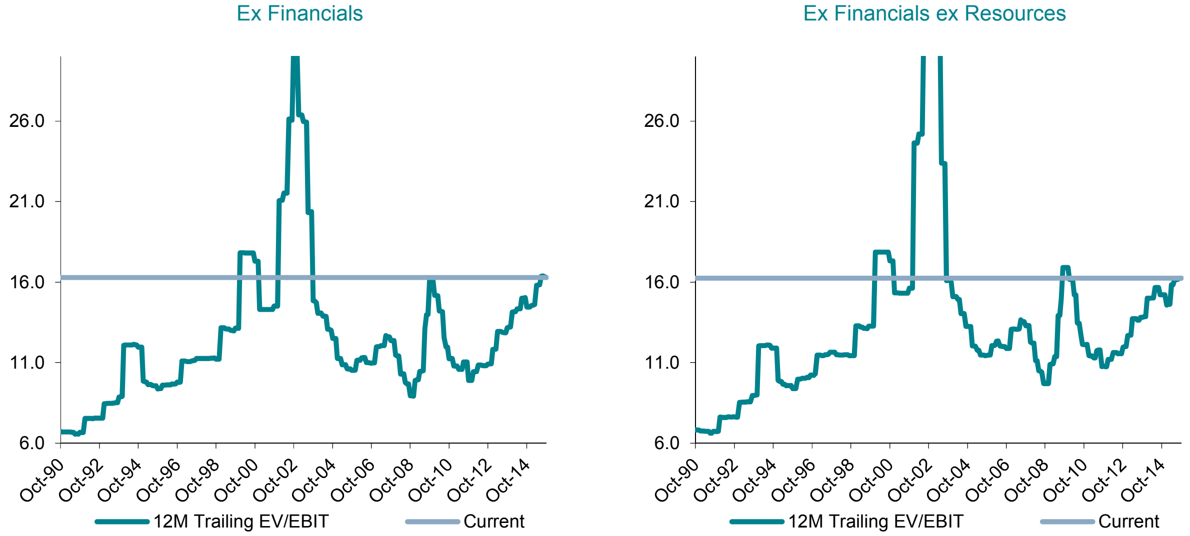
Figure 26: EV / NOPAT – Pan European Large Caps (Exane coverage)



Source: Exane Datacenter

The same picture emerges if we look at the European market on an EV/EBIT basis. The chart below shows the Euro-area market (Datastream's 'Total Market ex Financials' Index) is trading back at multiples not seen since the fall-out of the TMT bubble.

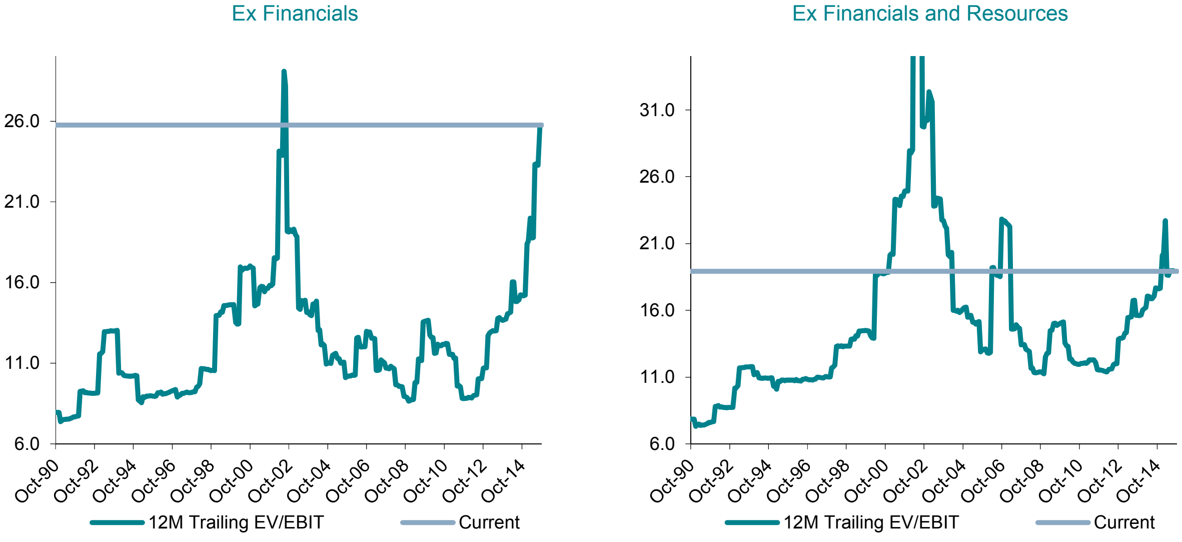
Figure 27: Datastream Euro-area Market index, trailing 12M EV/EBIT



Source: Datastream

In the UK, the headline EV/EBIT (obviously ex Financials) has reached an extreme as earnings of the big Oils and Miners have collapsed. But even when excluding the Resources influence we are looking at ratings that have only previously been seen at the very peak of equity market cycles.

Figure 28: Datastream UK Market index, trailing 12M EV/EBIT



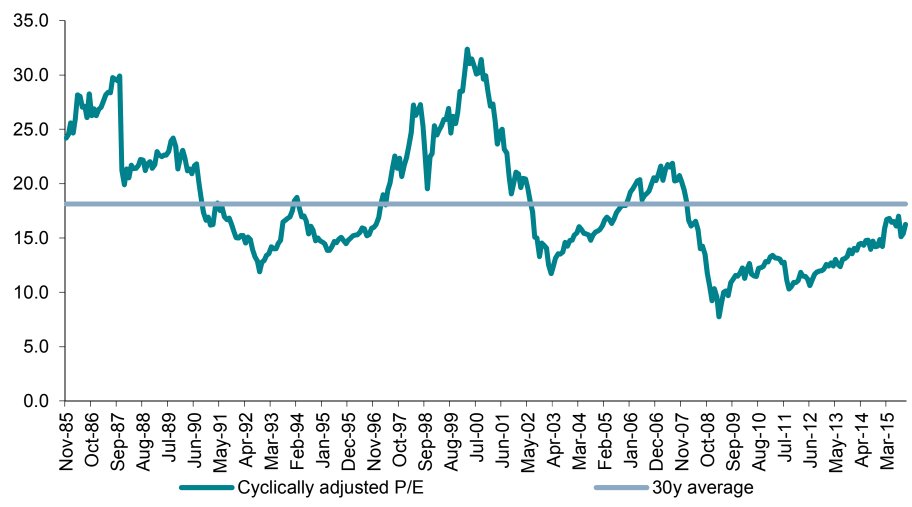
Source: Datastream

Cyclically depressed earnings…

We discuss earnings in a more detail later, but we note that there have been few prizes won for forecasting European earnings growth over recent years. The market has systematically over-estimated the likely outturns. One key debate that resurfaces at the start of every year is the extent to which European earnings will bounce back as and when economic growth recovers. We have long held the view that while some cyclical uplift is likely, the apparent cyclical 'depression' is largely a function of a small number of sectors.

One way of demonstrating this is to consider the Cyclically Adjusted P/E ratio – a valuation approach often used to demonstrate the upside in European equities as the economy recovers. The standard variant of this model is shown below.

Figure 29: Europe's Cyclically-adjusted P/E

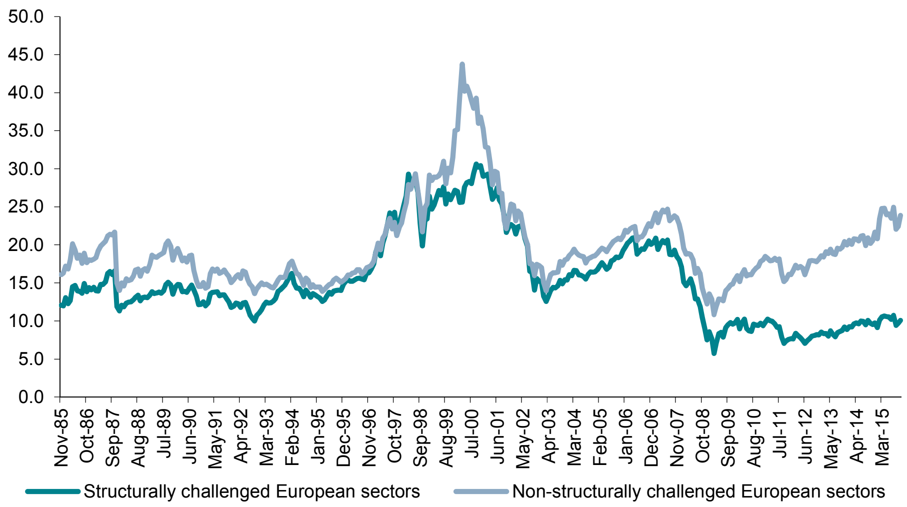


Source: Datastream, Exane BNP Paribas estimates

So far so good. But there are three areas of the European market in particular that investors have strong views on – Financials, Resources and Utilities. In each of these sectors investors generally believe that significant and permanent changes to the operating backdrop will mean future returns are sustainably lower than seen in the pre-Financial Crisis world. Financials have been hit by a raft of regulation, Resources by the end of the Chinese induced 'Supercycle', and Utilities by policy measures that have undermined profitability.

Now, reproducing the CAPE chart, but with these three sectors stripped out and identified separately presents a strikingly different picture. Here, the remainder of the market attracts a valuation that looks high by historical standards – even accommodating the cyclical position – while the three structurally impaired sectors have de-rated significantly. The is a distinct debate as to whether there is valuation appeal in the 'structurally challenged' basket – but the CAPE analysis does nothing to suggest there is widespread 'cyclical value' that can be realised on a better economy.

Figure 30: Cyclically Adjusted or Structurally Challenged PE



Source: Datastream, Exane BNP Paribas estimates. Financials, Resources and Utilities classed as structurally challenged

The relative argument

Clearly there is a relative case to be made for equities as yields are squeezed lower in other asset classes. This is a well versed argument, and a direct consequence of the portfolio effect of QE. Put bluntly it is an objective of central banks undertaking QE to force investors up the risk curve, with some re-allocations reaching the equity market. As far as it goes this process is beyond dispute and has certainly offered equity markets across the globe a degree of support over recent years that arguably the fundamentals have not justified.

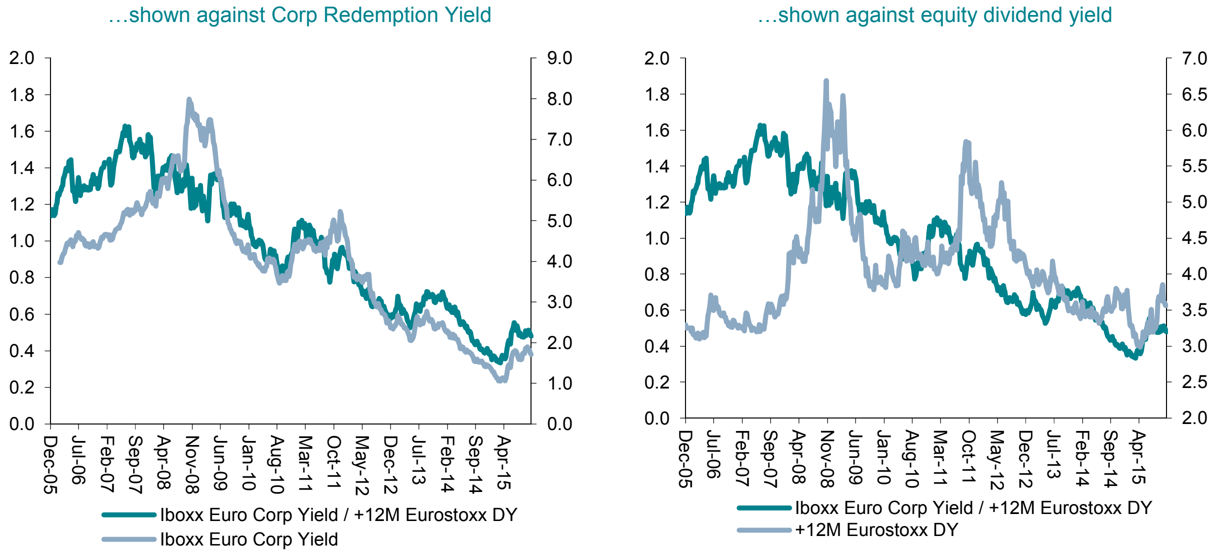
But this transmission from QE to 'forced' investor buying of equities as yields are driven down in sovereigns is not as stable as sometimes claimed. The following charts are instructive. Credit has essentially re-rated persistently against equities, and while equity dividend yields have trended lower over the cycle they have been subject to significant volatility.

The ratio of the yield on European credit to the yield on European equity has declined persistently over the last 5-years, as yields on credit have fallen against an equity dividend yield that has seen far less compression. The forward forecast yield on European equities today sits around 3.5%. This is broadly the same level the market traded on a decade ago. In contrast the Iboxx Euro Corporates index offers a redemption yield today over 250bps lower than that seen 10 year back.

This is certainly not to claim that QE and other forms of monetary stimulus cannot realise upside in equity markets. Of course, as we have seen many times, there can be powerful stimulus-led rallies. But the key point is the relationship between the performance of the equity market and interest rates – whether sovereign or credit – is pretty weak.

Look at these charts closely and it is apparent that it is the movements in yields on credit, not really equities, that have dictated the relative performance between the two asset classes. European policy stimulus has not led to 'new paradigm' equity dividend yields in the same way as has been seen in credit. The conclusion here – particularly when accounting for differences in volatility - is that investors who take the view that further ECB QE will maintain downward pressure on sovereign yields, have a more visible trade in European credit than in equities.

Figure 31: Euro Credit Redemption yield versus European dividend yields



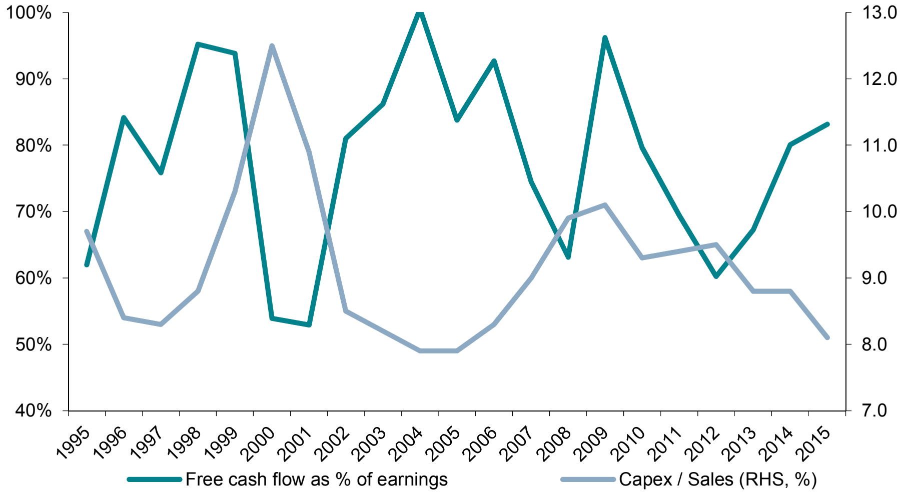
Source: Datastream

Treat dividend yield appeal with caution

The relative appeal of European equities to asset allocators, on the basis of the income premium over other assets, needs to be treated with additional caution – or at least a health warning. In our view the distribution yields in both the European and US markets flatter the underlying picture.

First, staring with Europe, the chart below shows the conversion from earnings to free cash flow is running at just over 80% - close to the middle of the 20-year range. But alongside this, the capex-to-sales ratio is toward the very bottom of its long-term range. Put bluntly free cash flow is supported by a squeeze on capex.

Figure 32: Pan European cash conversion versus CAPEX / Sales



Source: Exane Datacenter

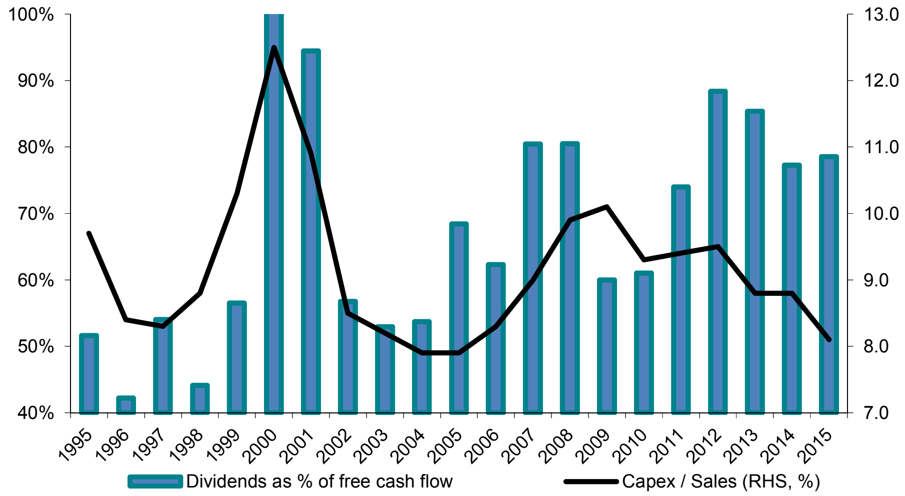
This is important in the context of the following chart. If capex is running abnormally low, the pay-out ratio is running abnormally high. As this chart demonstrates, the dividend yield has moved sideways to modestly lower over the course of this cycle, but this has been facilitated by a surge in the proportion of earnings distributed to shareholders.

Figure 33: Pan European dividend yield versus payout ratio

Source: Exane Datacenter

If we now combine the previous two charts and display the proportion of free cash flow paid out in dividends against the capex-to-sales ratio, the current picture looks anomalous. Since our dataset commences in 1995, we have not seen an example of such a high distribution of free cash flow when capex is so low. One could intuitively expect a positive correlation between these two series – high capex associated with high proportion of free cash flow paid out as free cash flow is depressed. That makes sense. But now we see the exact opposite.

Figure 34: Pan European Dividends vs Free cashflow alongside CAPEX / Sales



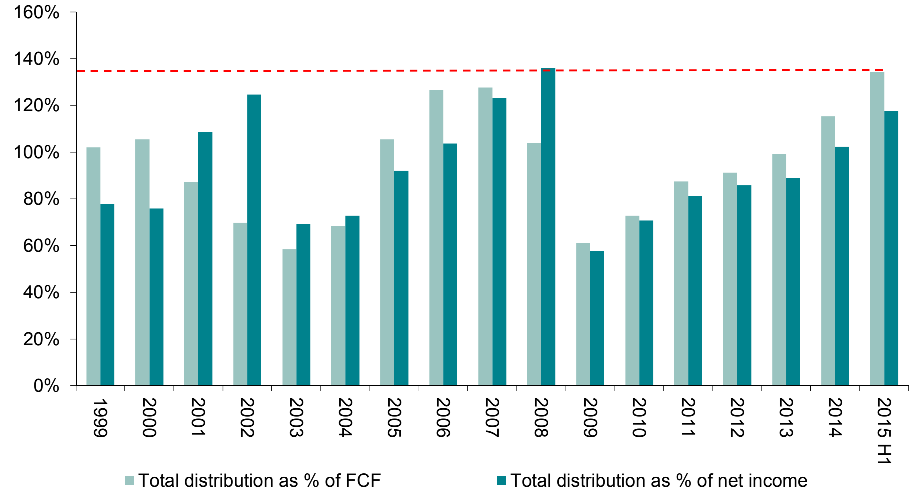
Source: Exane Datacenter

This situation could be resolved in a benign way. Economic growth may accelerate sufficiently to drive a few years of elevated earnings growth, which generate the internal funds to increase capex and normalise the pay-out ratio. This could certainly happen. But whichever way we think about this, there is a price. Even in the benign resolution to the current position it almost undoubtedly means that future dividend growth for the European market will be low and face significant drags as cashflow is devoted to the business rather than the shareholder, and the payout ratio is rebuilt to levels that we can consider prudent and sustainable.

This is a long way of saying that comparing current dividend yields to historic is like comparing apples to pears. The growth assumption associated with current dividend yields should be materially lower than an investor would have been entitled to expect in previous cycles for the same underlying forecast for economic and corporate earnings growth.

We have focussed the discussion here on the European market, but just a cursory look at the US unveils a very similar picture. The following chart shows the proportion of S&P500 free cash flow distributed to shareholders via both dividend payments and share buybacks. The results are arguably even more pronounced in this market. To us this re-enforces the point, that companies have arguably over-distributed funds to shareholders.

Figure 35: S&P500 Total Shareholder distributions – buybacks plus dividends – as a share of net profit and free cash flow



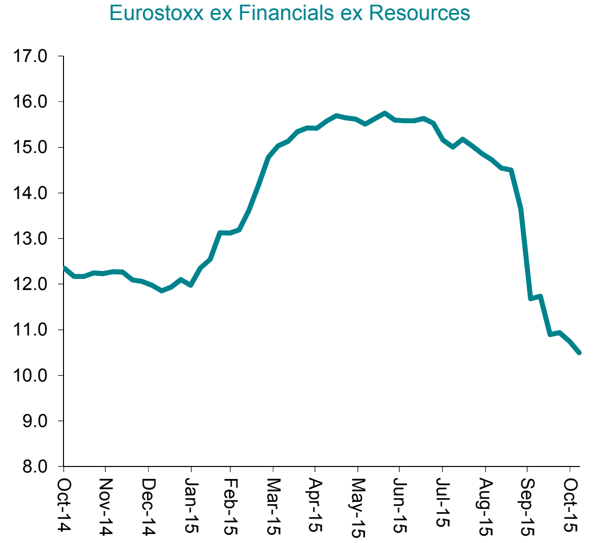
Source: Factset, Exane BNP Paribas estimates

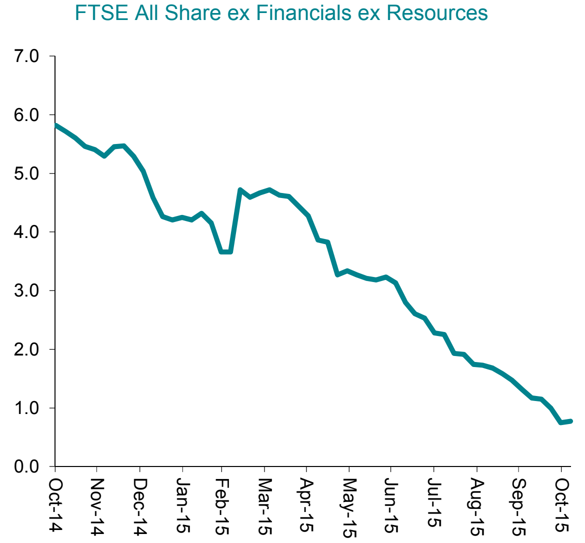
Conclusion: Equity markets look fully valued. This adds significant risk to the investment thesis. Repeats of Q1 2015 – when markets rallied sharply on policy and lead indicator optimism are always possible. But the longevity of such rallies is likely to be severely limited now, given that current stock prices suggest investors have 'pulled forward' future growth into current ratings. In the interim the lack of valuation support means that equity markets are likely to remain highly vulnerable to execution risk – should economic growth disappoint or policy support underwhelm it is difficult to highlight any valuation levels that could offer a floor to share prices anywhere close to where we currently trade.

European earnings

A lower euro and better domestic economic prospects. These were the cited drivers of stronger earnings in Europe this year…before concerns on global economic growth reignited over summer. Segments of the market with high EM exposure were hit particularly hard as currencies plunged and expectations adjusted. The charts below show how expectations for 2015 earnings growth have evolved over the last 12m in the Eurozone and the UK.

Figure 36: 2015 EPS growth expectations





Source: Factset, Exane BNP Paribas estimates

Even looking beyond the usual sources of distortion – pain in commodities and the volatility of the Banks – 2015 has arguably not been the year many investors expected.

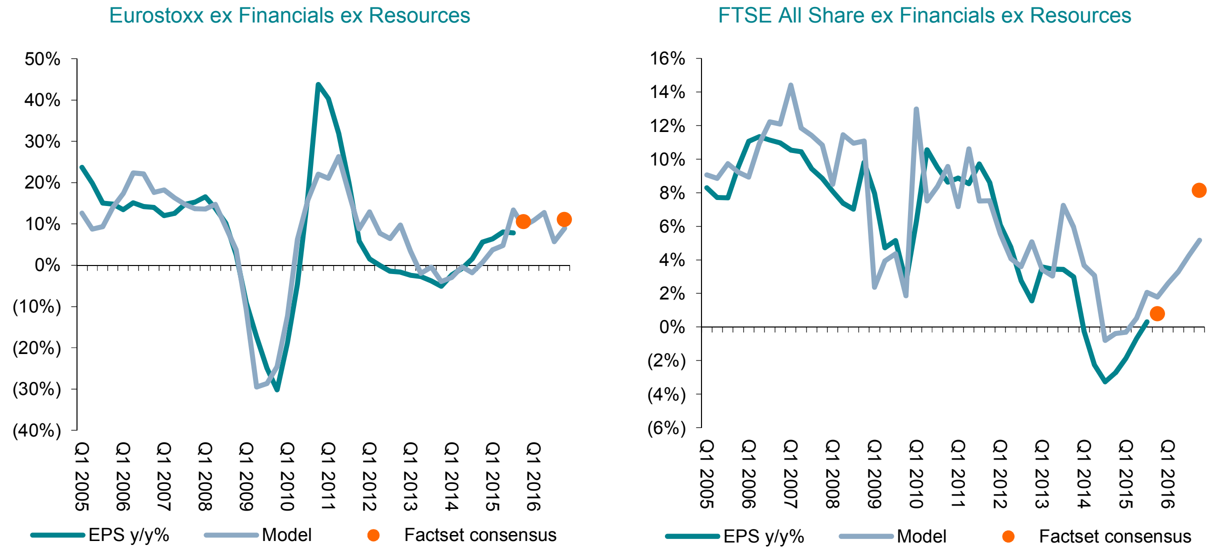
With the Eurozone and UK economies in different phases of the cycle, it is once again appropriate to model earnings for each market separately. Moreover, top-down models will struggle to capture the extreme volatility in Financials and Resources. We therefore take the approach of forecasting earnings growth for the 'clean' component of the market by excluding Financials and Resources.

We run our top-down earnings model using the following inputs:

– Domestic consensus nominal GDP growth (Eurozone and UK)
– Overseas consensus nominal GDP growth (World)
– Trade-weighted FX y/y %
– Unit labour cost y/y %

We present and discuss the results for the Eurozone and the UK below.

Figure 37: Our earnings growth model for the Eurozone and the UK



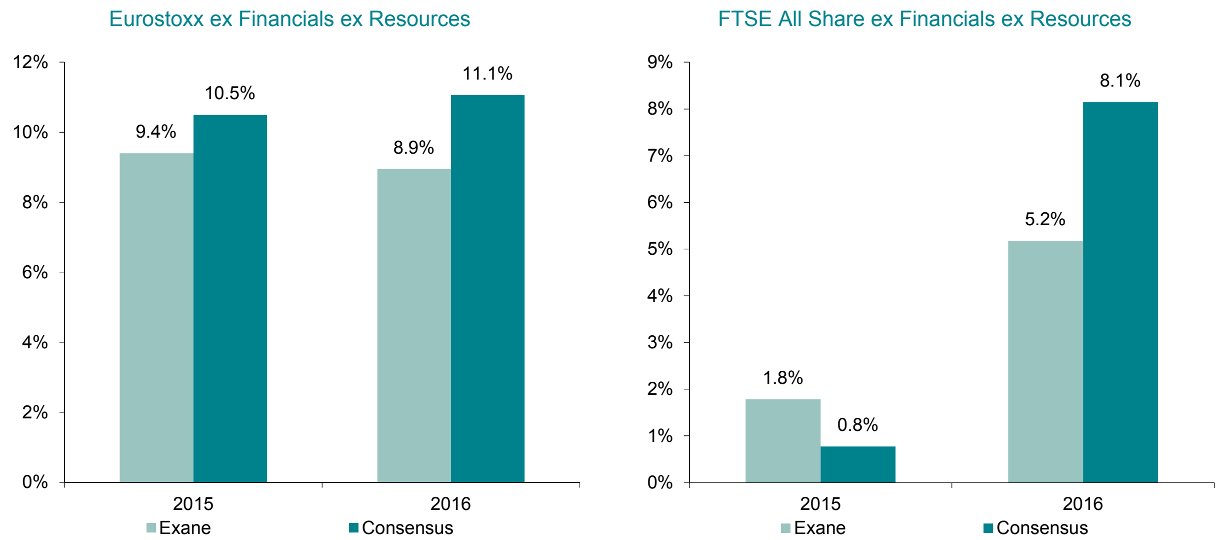
Source: Factset, Datastream, Bloomberg, Exane BNP Paribas estimates

In Europe, the expected acceleration in the domestic economy, lower euro and low unit labour cost inflation are positive contributors to better margins and better earnings growth momentum. Better growth expectations for the global economy next year also make a positive contribution.

In the UK, at current levels, Sterling should be less of a drag on earnings growth next year. Resilient domestic economic growth and moderate unit labour cost inflation means earnings should see a better outturn than in 2015.

The charts below summarise our earnings growth expectations relative to consensus for the Eurostoxx and FTSE All-Share excluding Financials and Resources. We remain more cautious than bottom-up consensus on both the Eurozone and the UK for 2016.

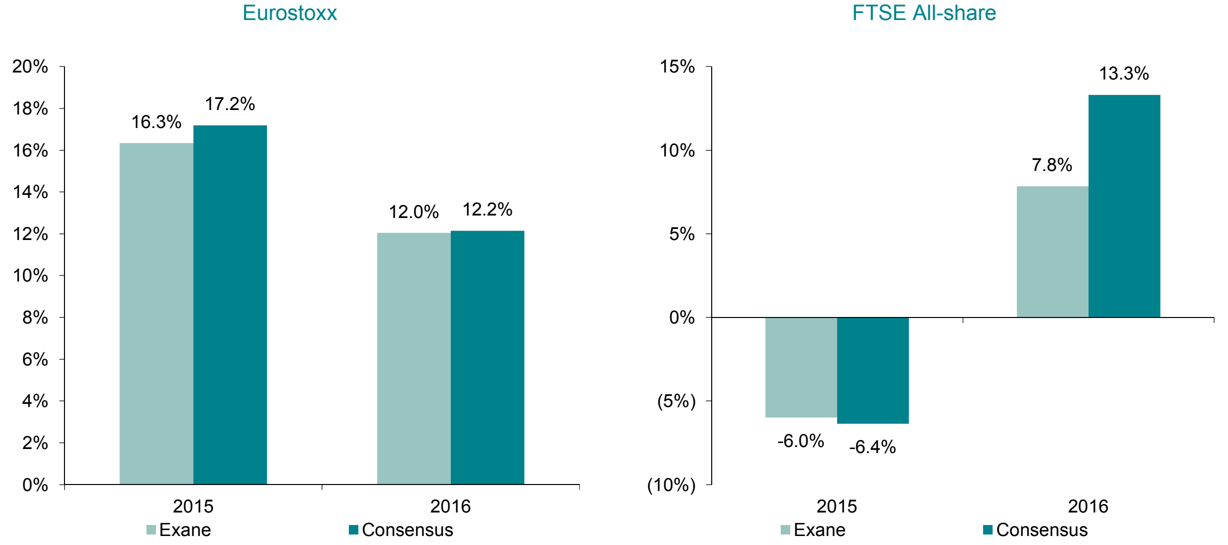
Figure 38: Exane vs Factset Consensus EPS growth expectations for the 'clean' segment of the market



Source: Factset, Exane BNP Paribas estimates

Finally, we present below our forecasts for the market as a whole by adding back consensus net income for Financials & Resources.

Figure 39: Our 'headline' forecasts when consensus for Financials & Resources is added back



Source: Factset, Exane BNP Paribas estimates

Sector allocation – more defensives

The European market outlook offers little to enthuse. Yes, we have the financial conditions boost from the ECB and the economy is generally moving in the right direction. Against these considerations, valuations, in many areas, look full and we believe shareholder distributions will materially lag earnings growth over the forthcoming cycle as dividend cover is rebuilt and increased capex drags against free cash flow.

But the major restraining factor in European share prices is the global, rather than domestic, backdrop. It now seems clear that Fed will start tightening US monetary policy by the end of 2015. The USD is climbing and the fault lines that run across Emerging Markets are as relevant now as they were through the August and September sell-offs.

In addition, the consequences of higher policy rates from the perspective of the US domestic economy are non-trivial. It is possible to argue there were more comfortable times earlier in the cycle to hike rates in the US than this. We see important areas of the US economy that look very sensitive to the price of credit. Time will tell whether the US economy will maintain momentum into this rate cycle, but the risks are there.

The implication as we see it is that investors are subject to above normal levels of risk and uncertainty. Portfolio construction needs to accommodate and reflect this backdrop. Portfolio beta should be closely monitored and controlled.

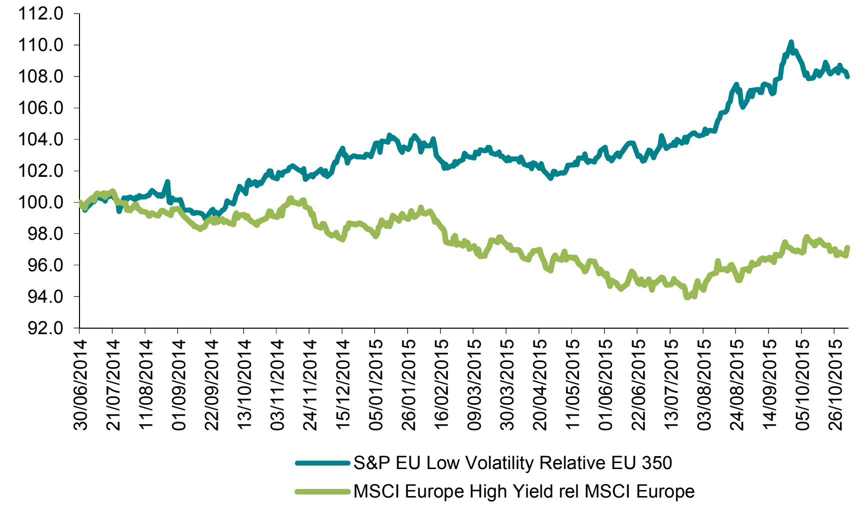
Beta management – targeting portfolio beta materially less than 1

ECB QE is leading to distinct market leadership trends. And given recent communications investors should brace for a prolonged period of this policy influence on stock market behaviour. In its most simplistic terms QE – and indeed the preceding anticipation of QE – has driven government bond yields to remarkably low levels. And spreads across the periphery bond markets have been forced tighter.

But while this policy support has arguably lifted equity prices, within the equity market it has not driven traditional ‘risk-on’ leadership. Further it is worth emphasising that this bond yield compression has not resulted in sustained performance of high dividend yield stocks.

Instead, the style factor that appears to be drawing consistent support from this backdrop is ‘low volatility’. QE has long been acknowledged as depressing financial asset price volatility. In European equity markets this translates to trending outperformance from low beta stocks.

Figure 40: Low volatility rather than high yield working on the euro QE trade



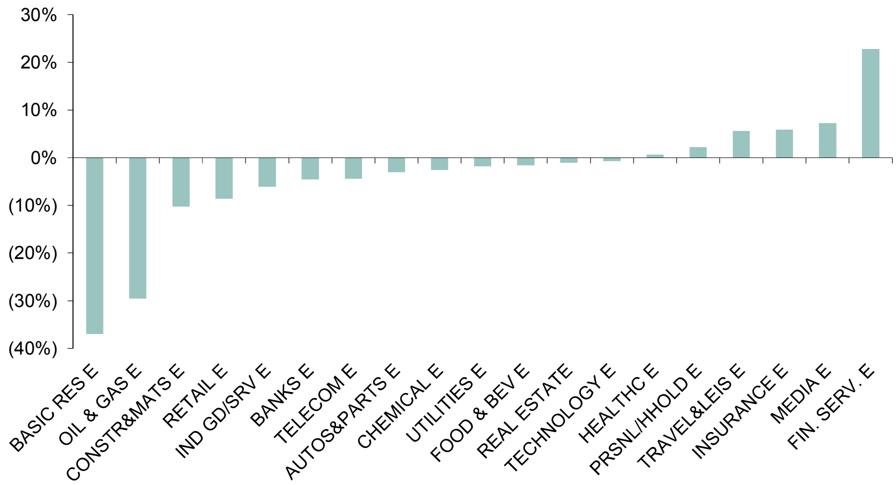
Source: Bloomberg

This trend has persisted through H2 2014 and, barring brief and very shallow reversals, through 2015 too. Intuitively it is easy to explain this as a consequence of the QE portfolio effect. Investors with holdings in sovereigns or credits who are forced to venture into equities as a result of yield compression in fixed income, may be naturally inclined to buy stocks and sectors with lower than average levels of volatility as their risk tolerance is likely lower than traditional equity investors.

The related argument is that while equities may have benefited from increased asset allocation flows, when it comes to implementation, higher beta stocks, which tend to be more cyclical, have offered little fundamental support. Global activity has not been strong enough to release the earnings growth investors had hoped to see and consequently the apparent valuation appeal has proved illusionary.

The following chart makes this point in a simple way. The earnings downgrades seen on 2015 have been largely concentrated in heavy cyclical sectors together with the Banks – mainly high beta areas of the market.

Figure 41: 2015 ytd EPS revisions by Stoxx 600 sector



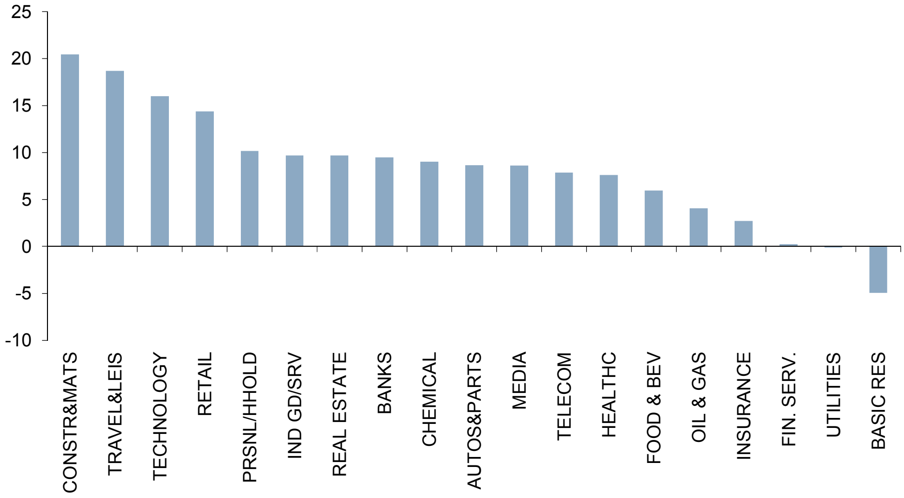
Source: IBES

The current macro debate centres on whether there is a macro 'mini-cycle' starting to form as economies, especially in EM recover from the summer weakness, as evidenced by some leading indicators of late.

But in our view, given the structural drags in EM – these will not be resolved on anything other than a multi-year timeline – and given the cyclical position of the US, we would be genuinely surprised if the 'mini-cycle' were particularly powerful. Further there is a real debate over longevity too.

This is important for two reasons. First unless one is prepared to buy into a powerful cyclical uplift in the global economy, the overwhelming evidence of the QE trading environment is to back low volatility or low beta sectors rather than Cyclicals. And second, a quick glance at earnings forecasts for next year, suggests many of the cyclicals are again attracting forecasts that will require a powerful acceleration in activity simply to meet – let alone exceed numbers.

Figure 42: 2016F consensus EPS growth forecasts by sector



Source: IBES

With the global macro outlook still highly uncertain looking into 2016, and risks elevated in key economies, we feel that portfolio strategy should once again look to incorporate a degree of beta management – with a bias toward the lower beta areas. Our recommended portfolio allocation will attract a beta materially below 1.

Macro themes, assumptions and risk – favour low rate Euro winners

In our view there are several themes we can identify that appear to offer some visibility, and as such we aim to concentrate our active calls around these themes.

- Persistent policy support in the euro-area, which is likely to cap sovereign yields
- Euro-area domestic demand driven recovery to extend into 2016
- Subdued global economic growth, as has become the new norm

Alongside, these core assumptions we also aim to manage risk prudently. This involves accommodating the potential for the following potential risk flare ups:

- Adverse Chinese credit cycle, presenting a persistent drag to the economy's growth
- A tightening of US financial conditions, potentially compounded by the rate cycle
- Further flattening in European yield curves

We stress that in our view managing these risks looks every bit as important as expressing central views given the level of visibility the global macro backdrop currently offers.

Figure 43: Sector allocation

Sector	Old	Change	New
Commodity sensitives			
Basic Resources	Overweight	**Downgraded**	Neutral
Oil & Gas	Neutral	**Downgraded**	Underweight
Cyclicals (non-commodity)			
Retail	Overweight	**Downgraded**	Underweight
Media	Neutral	**Upgraded**	Overweight
Technology	Neutral		Neutral
Autos & Parts	Underweight		Underweight
Travel & Leisure	Neutral		Neutral
Construction & Materials	Overweight		Overweight
Industrial Goods & Services	Underweight		Underweight
Chemicals	Neutral	**Downgraded**	Underweight
Overseas defensives			
Healthcare	Neutral	**Upgraded**	Overweight
Food & Beverages	Underweight	**Upgraded**	Neutral
Personal & Household Goods	Underweight		Underweight
Domestic defensives			
Telcos	Neutral	**Upgraded**	Overweight
Utilities	Underweight	**Upgraded**	Neutral
Financials			
Banks	Overweight	**Downgraded**	Neutral
Insurance	Neutral	**Upgraded**	Overweight
Real Estate	Overweight		Overweight
Financial Services	Overweight	**Downgraded**	Neutral

Source: Exane BNP Paribas estimates

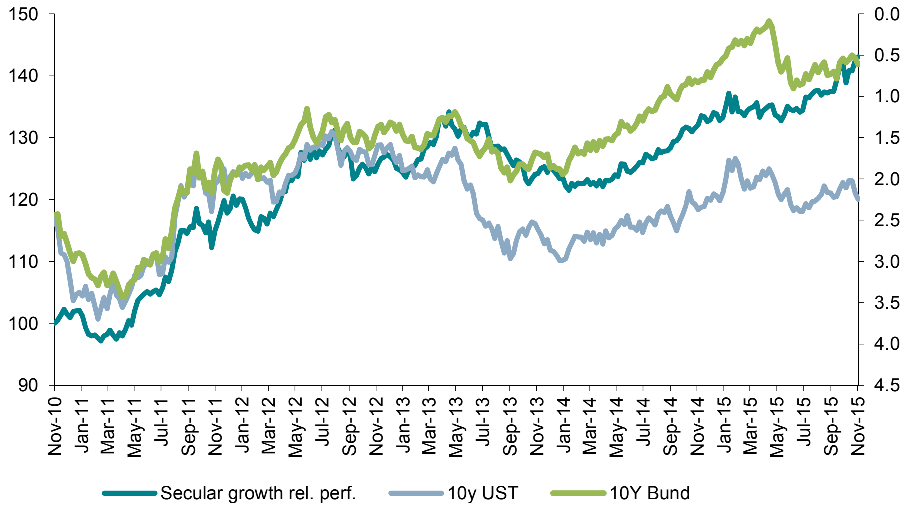
Rate sensitives – overweight, preference for Euro discount rate winners

US bond yields have remained lower than many investors, ourselves included, thought likely at the start of the year. A strong USD, lower commodity prices, macro fragility induced risk aversion, ECB arbitrage – more buyers than sellers – all sorts of explanations have been offered.

While some upward pressure on yields has resurfaced as expectations settle on a December US rate hike, the extent of the upward move likely over the coming months is still contentious. Our economics team think such moves will be modest, and given all else going on in the global economy and the upward pressure on the USD - such an assumption looks reasonable enough.

The low yield environment has been particularly supportive to Europe's secular growth sectors – we group Food & Beverage, Personal & Household Goods, Healthcare and Tech in this group. The chart below shows the relative performance of our secular growth basket against the 10Y Bund and 10Y Treasury.

Figure 44: 10Y yields versus 'secular growth' relative



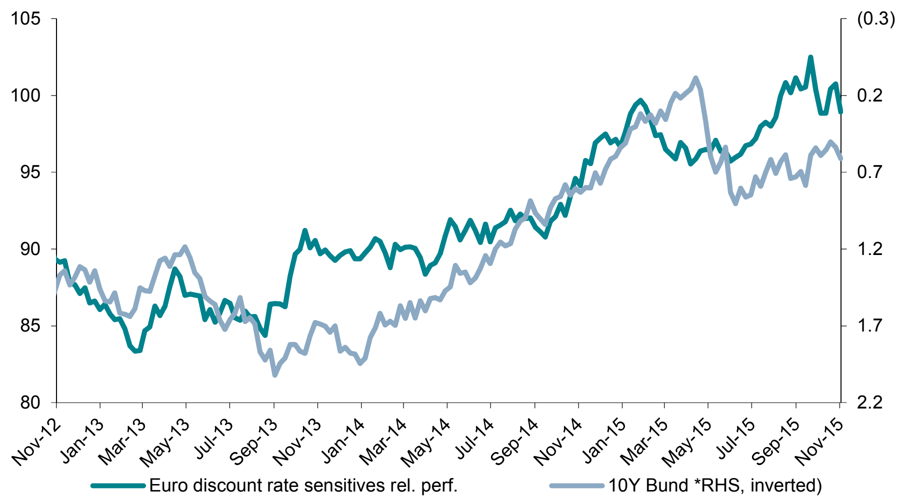
Source: Datastream

The difficulty in thinking ahead into 2016 lies in trying to identify how much additional yield support is likely. Further if US yields tick up as the policy rate is lifted, will the gap between the 10Y Bund and 10Y Treasury get progressively bigger – presumably the ECB will do whatever is required to stop Euro-area yields rising materially? And if so which yield is most important in influencing performance?

There are clear uncertainties surrounding the performance prospects of this group. We should expect domestic euro yield to remain very low, they are low beta sectors and hence meet our volatility criteria. But they are also global businesses, and as such exposed to any further stress in EM, and potentially they do react to Treasury yields not Bunds should these interest rates now diverge.

The alternative 'rate sensitive' approach is to focus on domestic European rate sensitives. In this basket we include Real Estate, Infrastructure, regulated Utilities, and Telecom. Again the chart below should not be particularly surprising. These sectors outperform on lower yields.

Figure 45: 10Y Bund yield versus euro discount rate sensitives

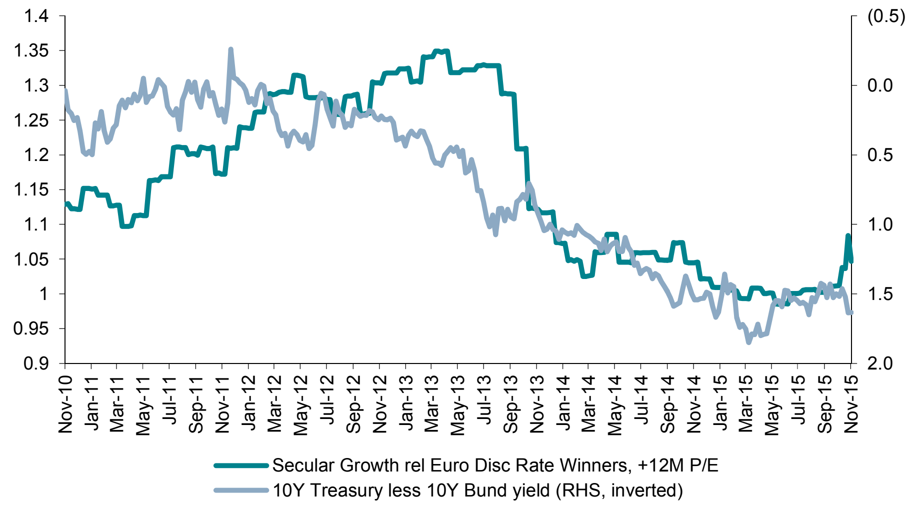


Source: Datastream

So far there is little to differentiate the secular growth from the euro-area discount rate sensitives. But if the overriding theme here is ECB QE policy support giving us greater confidence that European yields will remain capped versus US yields that could be forced upward by Fed hikes, then we can demonstrate a clear preference.

The following chart looks at the relative valuation (+12M P/E, IBES consensus) of the 'secular growth' basket against the 'euro discount rate sensitives' against the differential in yields between the 10Y Treasury and the 10Y Bund. It is clear that the secular growth basket tends to de-rate as the gap between the two bond markets moves higher.

Figure 46: Secular growth rel to Euro discount rate winners versus 10Y Treasury, 10Y Bund yield gap



Source: Datastream

In our view, given the macro thematic – ECB escalation versus US rate cycle, the balance of risks suggests investors should favour skewing their interest rate sensitive sector calls toward the euro-area domestic rate winners rather than the global 'secular growth' plays.

Euro discount rate winners – Overweight Real Estate and Telecom

Our euro discount rate winners basket traverses various different sectors. Some of the Infrastructure plays sit in Industrials, there are the regulated Utilities – which share their sector space with the commodity-sensitive names, and then there are the Telecom and Real Estate plays.

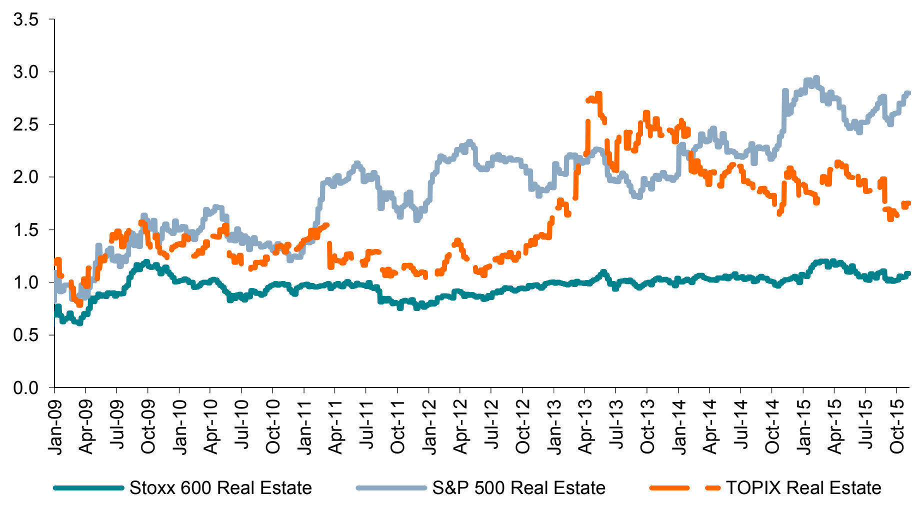
We would happily buy selectively across these areas, but in terms of forming sector strategy, the lack of homogeneity presents complications. We cannot find sufficient reason to buy the Utilities sector – but we do upgrade to Neutral. This is in part down to the observation that some of the more troubled constituents – RWE and EON for example – have been so weak that their relative influence on the sector is significantly diminished. Still, coal and gas prices are still relevant for many companies and we have no confidence that 2016 will be much better.

Real Estate - overweight

Real Estate is the sector we would put at the heart of a European portfolio for the next couple of year. A real asset play, under an environment of QE, with real interest rates in Europe set to remain at very low real levels for several years. Real asset price inflation is highly likely to result from such a backdrop.

The precedent of other markets that have seen prolonged QE support over the course of this cycle is encouraging. While there will certainly be differences in structure between these markets, on a 12-month forward basis the re-rating of the US and Japanese Real Estate sectors has been pronounced. And while European ratings are now starting to tick higher, the sector is trading at less than a 10% premium to forecast book value. This should not dissuade investors from buying into the sector.

Figure 47: Europe versus other 'QE Real Estate' markets, +12M PBV



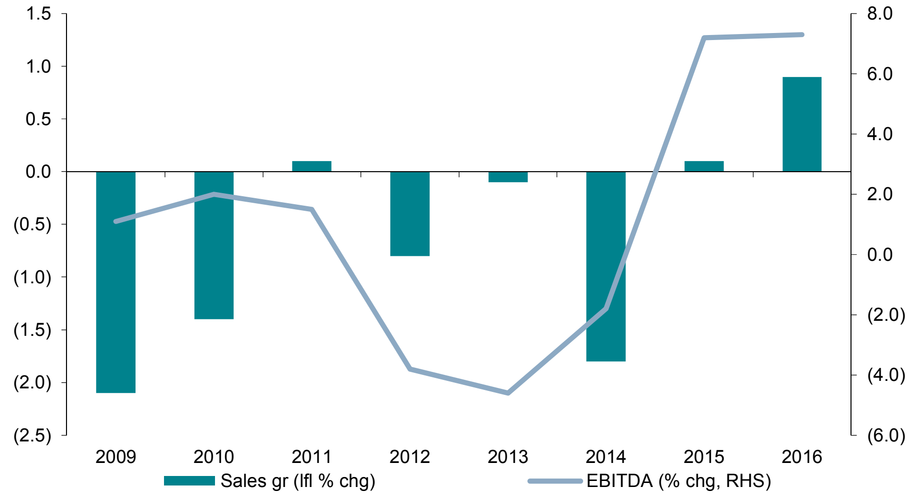
Source: IBES

Telecom – overweight

Telecom has undergone something of a rehabilitation over the last 12-months. There has been the consolidation story in light of perceived easing in regulatory stance – while the debate continues on how far this theme will go, important deals in Germany, Spain and the UK have already secured approval. The sector has also demonstrated some gearing into the improving consumer disposable income trend across Europe. New services – the uptake of 4G in particular – now appear to provide the sector with a route to revenue growth.

The following chart captures this thematic in numbers. After suffering negative year-on-year revenue trends through most of the post 2009 cycle, 2015 has seen a return to positive sales growth – small but positive. And 2016 is seen as better again. For a highly operationally geared sector, this revenue development makes all the difference – from an ex growth sector, to one capable of generating market levels of EBITDA growth.

Figure 48: Telecom, y-o-y % chg in lfl sales versus y-o-y % chg in EBITDA



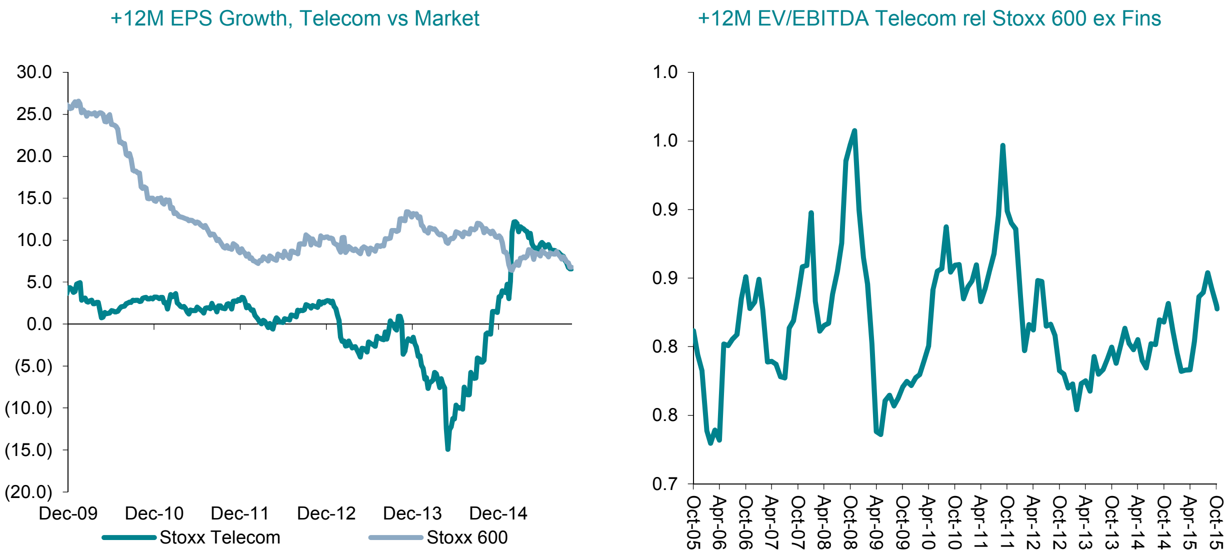
Source: Exane Datacenter. Forecasts from 2015 onwards

While this is not a new development, we are struck by the fact the sector ranks just 12th in performance out of the 19 sectors in Europe over the last 12-months. The more direct plays on European consumer disposable income growth – Travel & Leisure, Media and Retail – have materially outperformed Telecom. We touch upon these sectors in the 'consumer cyclicals' section – but its difficult to make a compelling valuation case for that group now.

Below we show that EPS growth looks competitive with the market – after a prolonged period of lagging behind, while the relative valuation sits in the middle of its long term range. Put simply it has not moved especially far to discount the improving operating backdrop.

Telecom spans the intersection of low European interest rate winners and European consumer disposable income growth. It may not the most direct play on either – but it should not be ignored. This second derivative play could now take up the performance baton.

Figure 49: Stoxx Telecom – competitive earnings growth and reasonable relative valuation



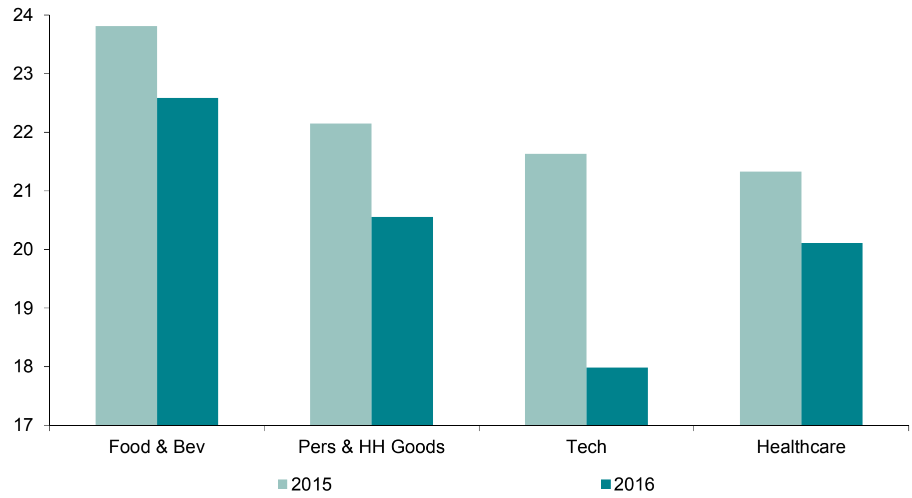
Source: Datastream

Neutral 'secular growth' – O/weight H'care, Underweight Personal & Hhold Gds

Our allocation across the secular growth basket is based on 2 key drivers. First, where do valuations look least onerous? And second, where does the currency angle offer greatest potential support?

In addressing the first of these points – valuation – the following chart shows the EV/NOPAT ratings across the group. After the underperformance of the last few months Healthcare is offering relative appeal again. Sure there will be talk of adverse newsflow through the Presidential campaign, but the reality of drug pricing in the context of incentivising future R&D remains a very strong hand for the sector to play.

Figure 50: EV / NOPAT, 2015 and 2016

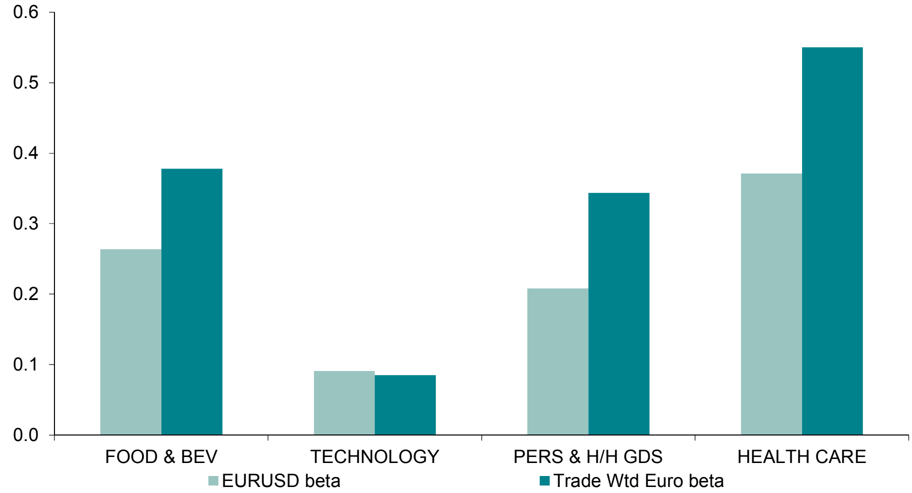


Source: Exane Datacenter

The second aspect of our decision is focussed on currency sensitivity. These are all global sectors, with a high proportion of sales from overseas markets. With ECB escalation on the agenda some further euro weakness is certainly plausible. But there are other currencies that look just as vulnerable as the euro. Perhaps the best working assumption is that the euro's move is likely to be most pronounced against the USD.

In this respect Healthcare looks particularly attractive. The US is the key market for the sector and not surprisingly Healthcare displays a high currency beta against the USD and against the trade weighted euro. The way to read this chart is that a 1% fall in EURUSD is typically associated with 0.4% relative outperformance of the Healthcare sector all else equal.

Figure 51: Currency betas, sector relative performance vs EURUSD and Trade Weighted euro (as measured over last 15 years)



Source: Datastream

In our view, Healthcare offers the better combination of valuation and 'right' end market exposure within the group. Personal & Household Goods – due to Luxury and HPC exposure - tends to be more sensitive to EM than Food & Beverage. Again this shows in the higher USD beta displayed by Food & Beverage.

In our view, given the macro constraints, and given the track record of low volatility leadership against QE, we feel a Neutral stance across the group is warranted. But we have a clear preference for US rather than EM exposure. Fortuitously Healthcare's recent underperformance has presented a reasonable valuation entry point. We upgrade from Neutral to Overweight, retain the Underweight in Personal & Household Goods, with Neutral weightings in Food & Beverage and Technology.

Construction – our favoured Euro-area recovery play; Overweight

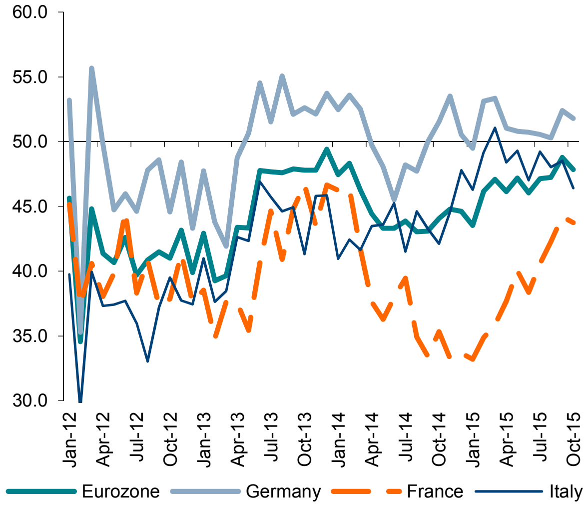
Moving beyond Europe's discount rate sensitives to a major beneficiary of the improving credit environment in Europe we get to Construction. While the sector has performed strongly in 2015, we see ample scope for further outperformance given relative valuations and potential catalysts. We maintain our Overweight call.

First and foremost Construction is a play on the European credit cycle. But, besides the positive trends here, the sector can claim a number of macro lead indicators moving in the right direction. Building activity in the Eurozone seems to be about to accelerate with Construction PMIs in major Eurozone economies showing clear signs of improvement.

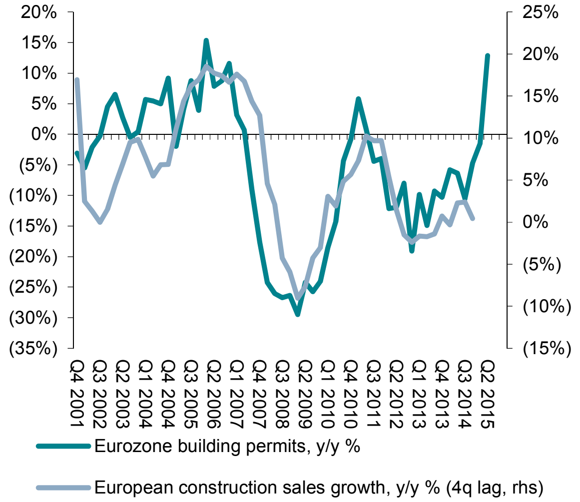
Building permits, a leading indicator on construction activity, have printed their strongest y/y growth in 9 years in the second quarter, at 12.9%. The easier lending standards and renewed business and consumer confidence in the euro-area have all helped kick-start this positive momentum. As shown below, the sector's top-line growth lags building permits by about 4 quarters.

Figure 52: Leading indicators paint a more positive outlook

Construction PMI



Eurozone 18, building permits y/y% vs European construction sector sales growth

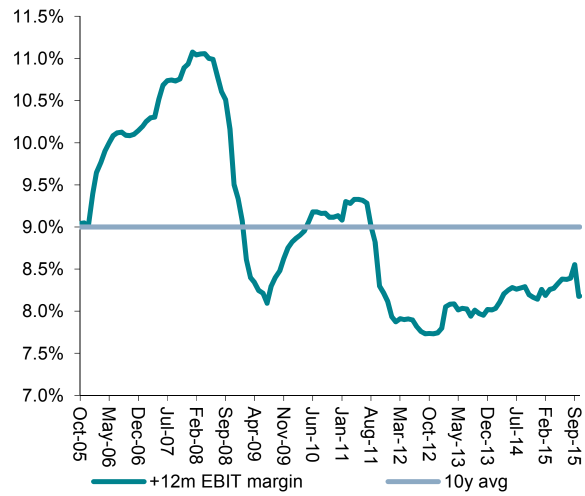


Source: Markit, Eurostat, Datastream, Exane BNP Paribas estimates

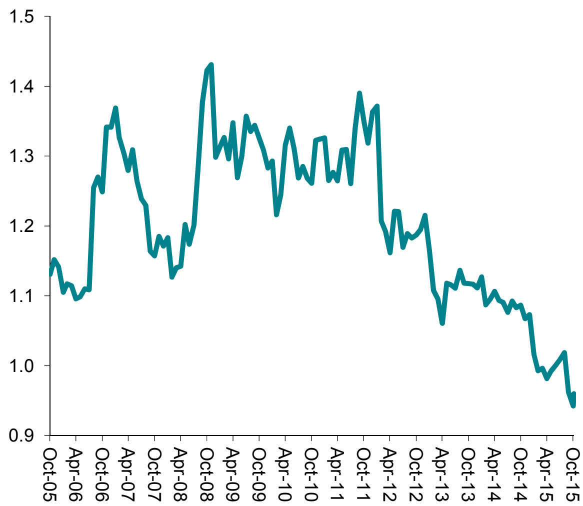
The sector could also be about to benefit from another tailwind. As discussed in a previous section of this report, 2016 is going to be the year the Juncker plan finally spurs investment in the region. With a minimum target of EUR315bn new investments over three years, most spending areas of the plan have the potential to indirectly stimulate construction activity further.

Figure 53: European Construction's metrics

+12m EBIT margin



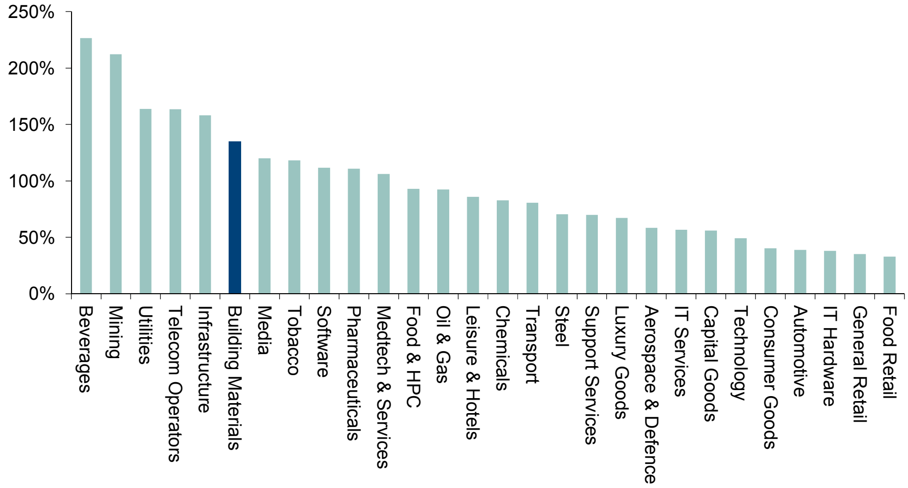
Relative +12m EV/EBIT (vs Market ex Financials)



Source: Factset, Exane BNP Paribas estimates

Despite these positive developments, future margin expectations remain at the low end of the 10y range. Relative valuations are also at their lowest level of the last 10y. Investors seem to not give much benefit of the doubt to a sector with great operational leverage. EM exposures of some companies seem to have focussed attention. As a matter of fact, Construction has a high proportion of fixed assets to sales, a measure of operational leverage. Acceleration in top-line growth should disproportionately feed into EBIT and lead to margin normalisation.

Figure 54: 2015 fixed operating assets to sales



Source: Exane Datacenter

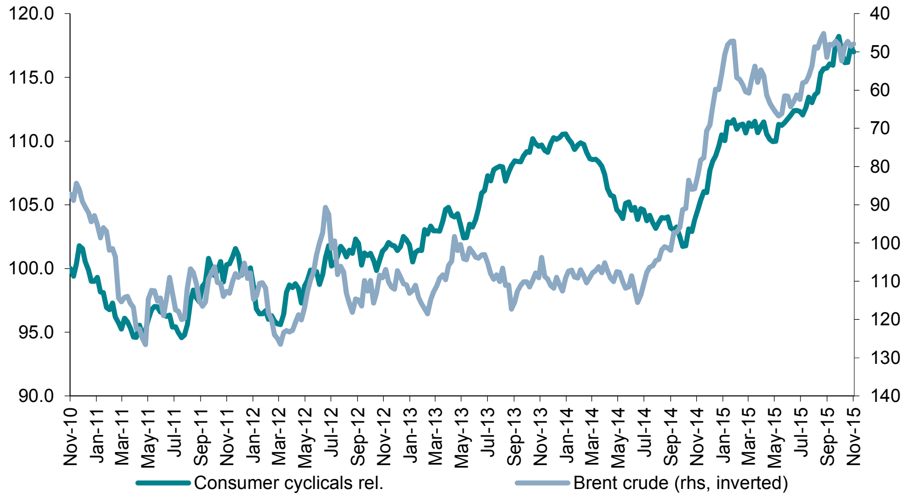
From our perspective, the sector should be investors' favourite play on the European credit cycle, investment recovery and acceleration in activity. The sector trades on trough margins and trough relative multiples and is our favourite domestic cyclical play.

European Consumer Cyclicals – Neutral; long Media short Retail pair

Consumer Cyclicals have enjoyed clear macro support over the last 12-months. Falling commodity prices, generalised disinflation, an acceleration of credit flow into the Household sector, and stabilising labour markets have combined to focus investor attention on the likely improvement in operating performance.

As the following chart shows the oil price against our basket of European consumer cyclicals – Retail, Media and Travel & Leisure – perfectly captures this dynamic.

Figure 55: European Consumer Cyclicals versus Brent Crude

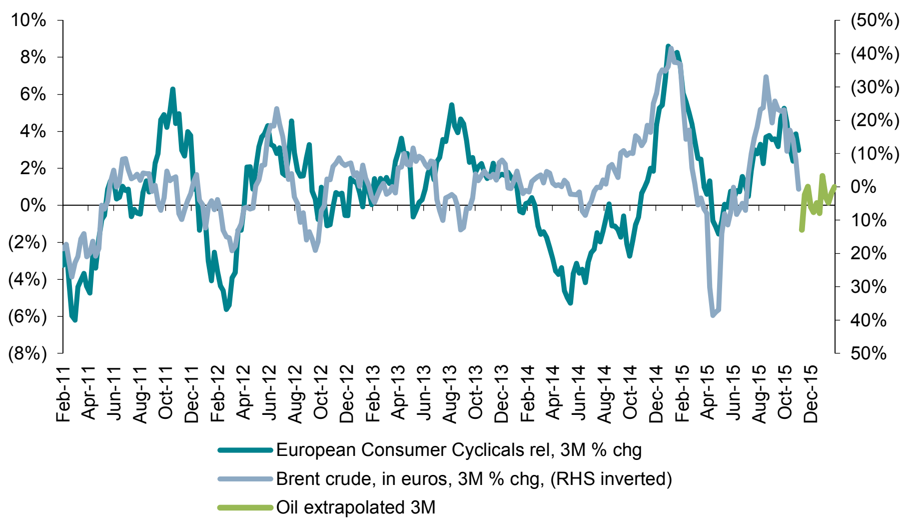


Source: Datastream

This performance correlation is not controversial and most investors would accept this as a powerful influence on share prices. But we can also illustrate this data in a slightly different way. The following chart shows the 3M % change in the euro price of oil against the % change over 3M in European consumer cyclicals. We have also charted the extrapolation of current oil prices over the next 3-months.

On this basis it should be clear that oil price support for consumer cyclical plays is likely to abate absent another round of commodity deflation. Further if the euro were to weaken further against the USD, it is entirely possible the change in the euro price of oil could become a tactical performance drag rather than a tailwind.

Figure 56: European Consumer Cyclicals, 3M % change vs Euro oil price (3M % change)

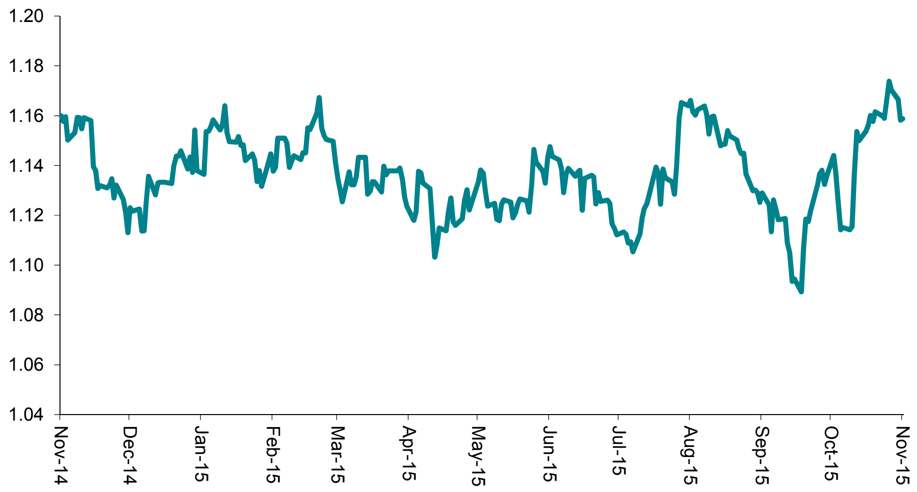


Source: Datastream

While there are other encouraging macro developments that will hopefully support Household consumption over the next year, we feel they will likely accrue only gradually. And after a year where investors piled into this area of the market in anticipation of the support to consumer incomes, valuations look full across the group.

Absent the same kind of oil tailwind reoccurring in 2016, we feel investors should be Neutral the group. But we do see an interesting relative trade between Media and Retail. As such we suggest an Overweight Media position against an Underweight Retail call – but we stress we view this as a pair trade and would not run either leg of this trade in isolation. The chart below shows that Retail is trading at a 12-month high relative to the Media sector.

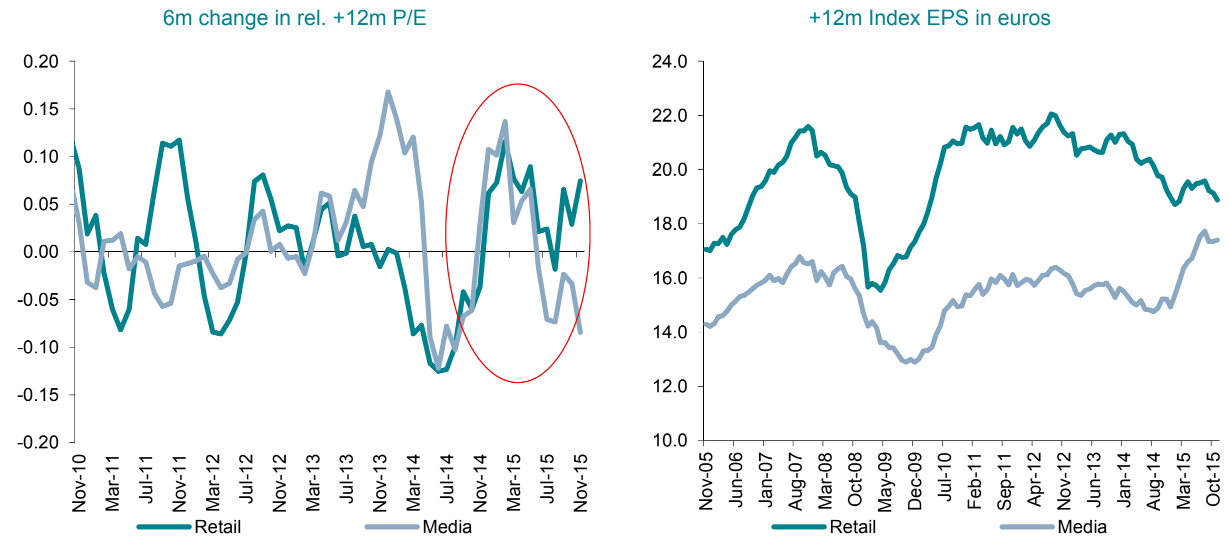
Figure 57: Stoxx Retail rel to Stoxx Media



Source: Datastream

Our contention is that European Retail has run too far on the back of the domestic disposable income growth story while Media has de-rated significantly. The following charts show the deviation in the P/E change for Retail and Media and on the right the evolution of the 12M forward EPS for the sector indices.

Figure 58: Media vs Retail



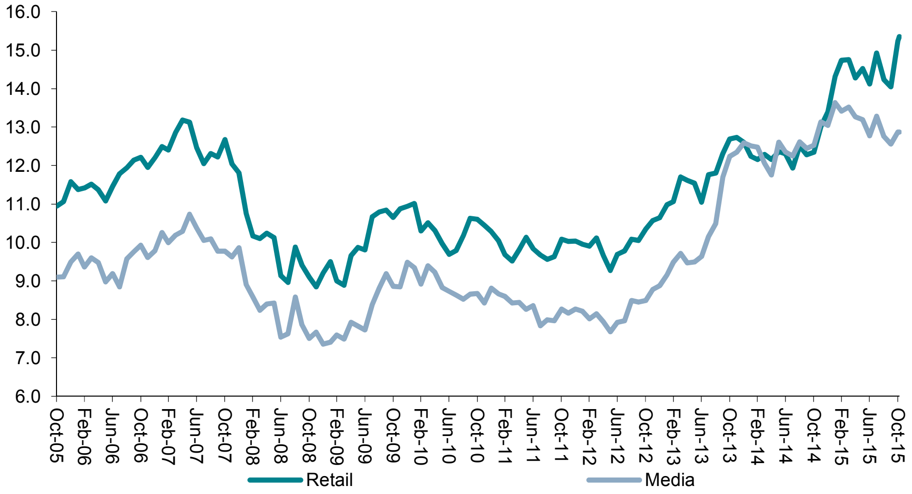
Source: Datastream, Exane BNP Paribas estimates

The slow recovery in Food Retail, and punchy growth expectations combined with an aggressive re-rating in General Retail have prompted us to downgrade the sector. We see limited risk to household consumption growth of 1.7% in the Eurozone next year, but investors have simply priced that in, and more, already.

Valuations in Media, although far from being compelling, give us more comfort than earlier in the year and are now looking interesting relative to the rest of the consumer cyclical space.

Figure 59: Media vs Retail

+12m EV/EBIT



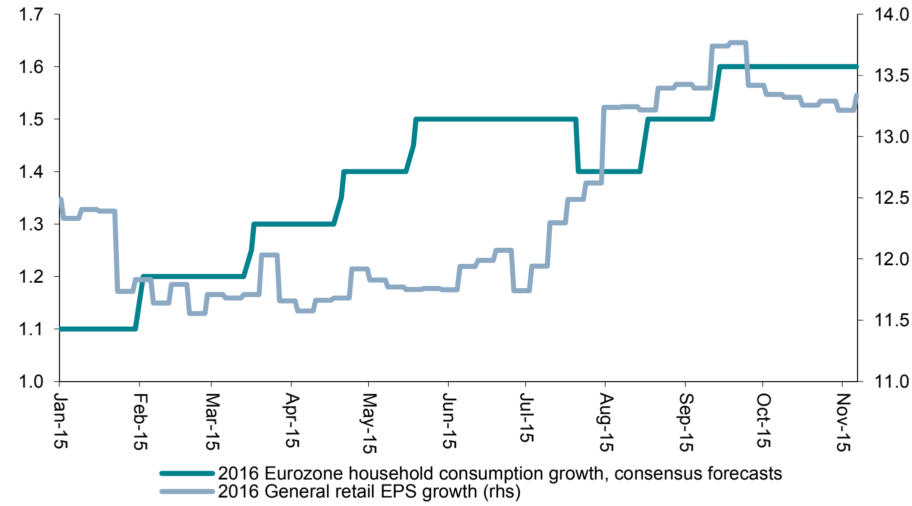
Source: Factset, Exane BNP Paribas estimates

Retail – the short leg of the trade

A 4x times multiple from household consumption growth to General retail's EPS growth is the historical norm. But this year, while consumption growth has been revised up from 1.1 to now 1.7%, 2015F earnings have only seen downward pressure.

For next year, the market is now expecting about 13% of earnings growth for the sector with 1.6% household consumption growth… an 8x multiple. And expectations are not just high in the Eurozone. In the UK, after a record year, we expect household disposable income growth to halve amid faster fiscal consolidation and dissipating base effects from lower oil prices (see London Calling - up Carney Creek).

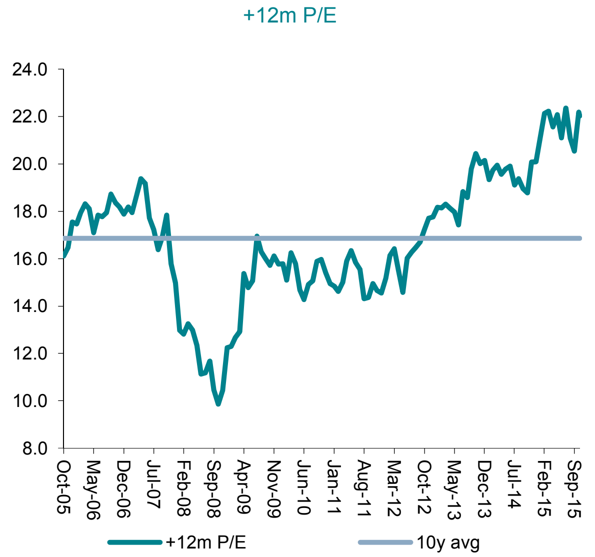
Figure 60: 2016 consensus consumption growth vs General retail EPS growth

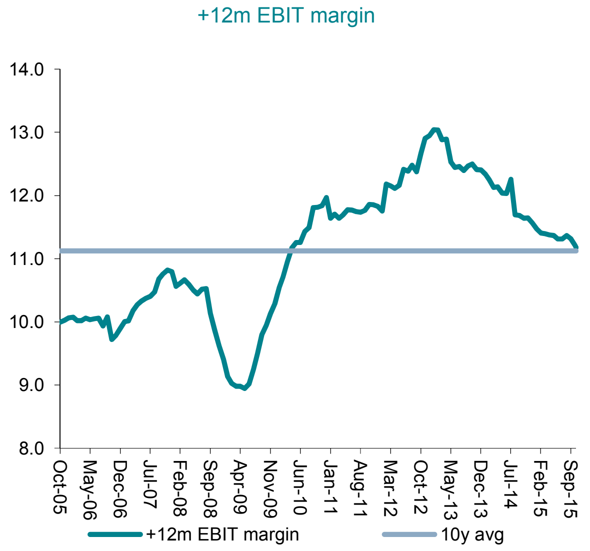


Source: Bloomberg, Factset, Exane BNP Paribas estimates

On top of punchy growth expectations, the sector has re-rated pretty aggressively, now trading on 22x 12m forward earnings while margins have normalised. We have focussed on the General rather than Food components of the sector here given that structural competitive issues in Food Retail industry are still heavily influencing valuations and forecasts. General Retail gives a clearer reflection of the level of cyclical optimism factored into expectations and share prices.

Figure 61: General retail financial metrics



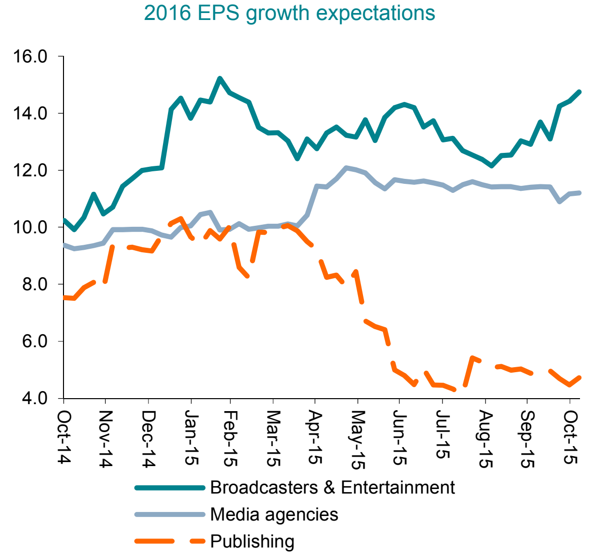


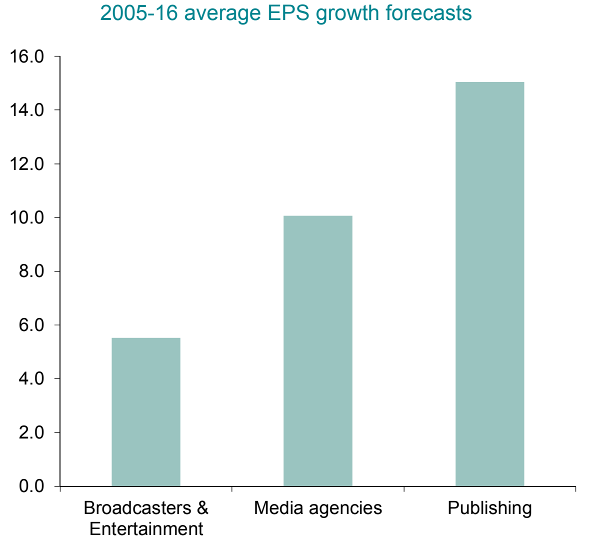
Source: Factset, Exane BNP Paribas estimates

Media – the long consumer cyclical leg

Against that, Media looks like a more reasonable relative bet in the space: a recent de-rating, earnings growth expectations that look more in line with historical norms and a great cash generation ability.

Figure 62: Media sub-sectors – Growth expectations and valuations

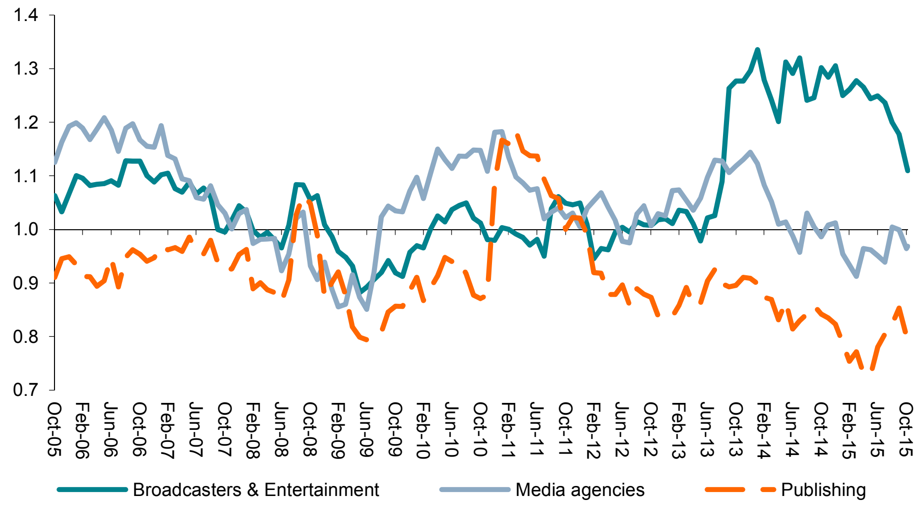




Source: Factset, Exane BNP Paribas estimates

Figure 63: Media sub-sectors –Valuations

+12m EV/EBIT



Source: Factset, Exane BNP Paribas estimates

EM exposed Cyclicals – Underweight

In this group we place Industrials, Chemicals and perhaps more controversially Autos – there are clearly several other important drivers of this sector. Our view on European Industrials and European Chemicals is straightforward. For sectors that are sensitive to the manufacturing and industrial production cycles and have a heavy orientation toward EM demand, we see valuations erring on the side of extreme optimism. And we are prepared to take the other side of that trade, with Underweights in both. Indeed it is difficult to fathom how in a year where global IP has serially disappointed and EM has flirted with crisis, that these sectors have had not underperformed to a far greater extent.

Autos is more difficult. The sector has been extremely weak – partly for macro reasons and partly for VW's 'self-generated implosion'. And the sector is extremely currency sensitive. But it is also very sensitive to credit conditions – a potential risk in key markets looking into 2016 – and its profitability looks set for further erosion. Slightly uneasily we maintain our Underweight call in the sector.

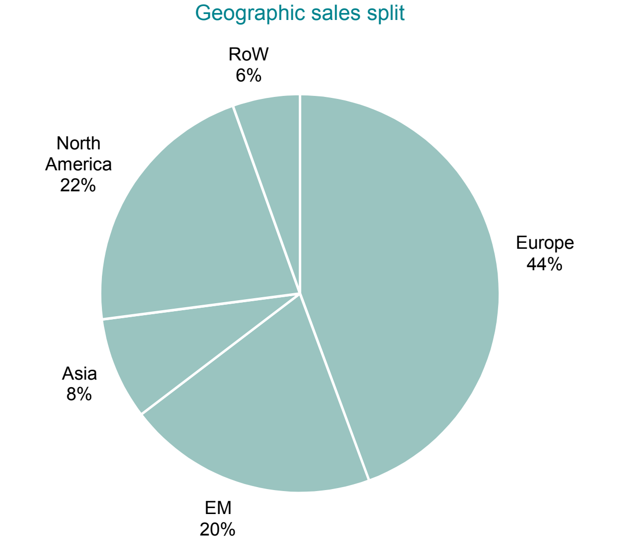
Industrials – Underweight

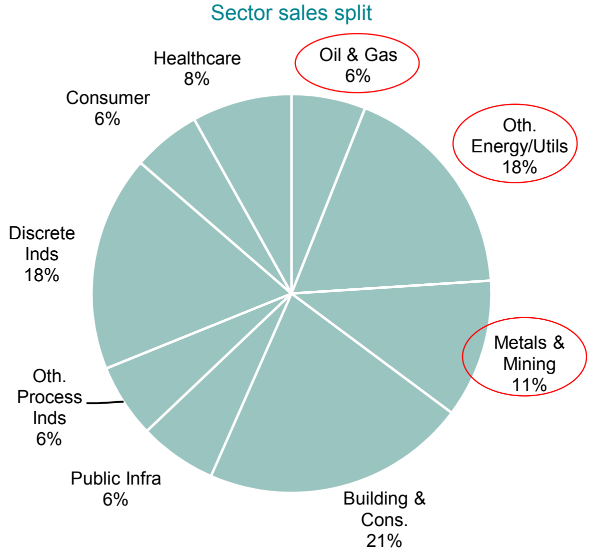
European Industrials have suffered a tough end market demand backdrop. Regionally the sector has roughly 30% direct exposure to EM. And 40% of revenues come from Europe (albeit with EM sensitivity in many areas), where domestic capex is yet to recover.

To make things worse, the sector's end markets have not been in good health. Industries currently going through a Capex discipline cycle – namely Utilities, Oil & Gas and Basic Resources – represent about 35% of European Industrials' top-line. And arguably for these industries there is something of a structural re-set underway that will take several years to fully play out.

Put simply, the sector is selling into tough markets – both from both a geographical and industrial standpoint. It would take a brave investor to back evidence of a sustained recovery gaining traction in 2016.

Figure 64: European industrials are exposed to the wrong end-markets



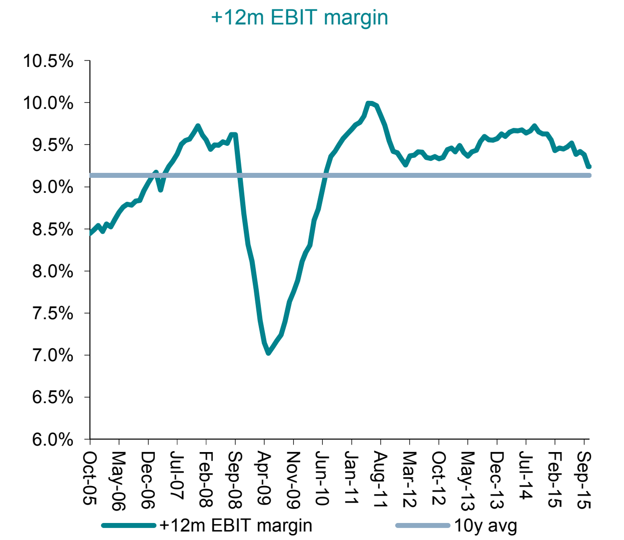


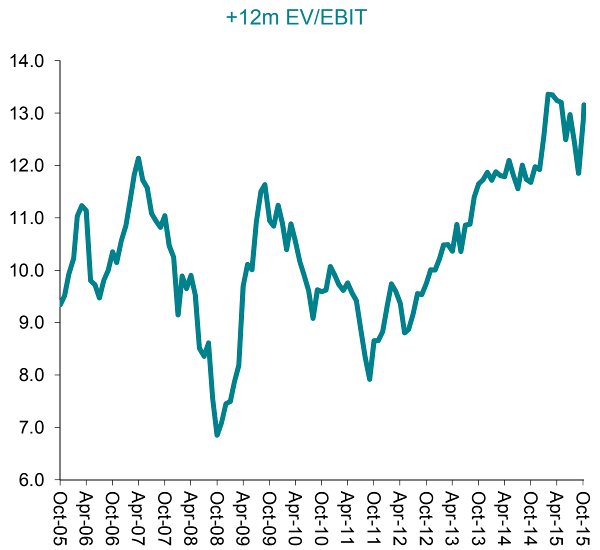
Source: Exane BNP Paribas estimates

The backdrop continues to look tough but theoretically everything has a price. The difficulty with European Industrials is that valuations look elevated and profitability has yet to deteriorate to the extent we would expect given the weakness alluded to above.

Margins have certainly fallen, but by historical standards do not look especially depressed. But the valuation being placed on the sector appears to imply that investors are already pricing a swift improvement in operating conditions going forward. The prospective EV/EBIT ratio is challenging a 10-year high at a time when demand visibility is very low.

Figure 65: European Industrials' metrics

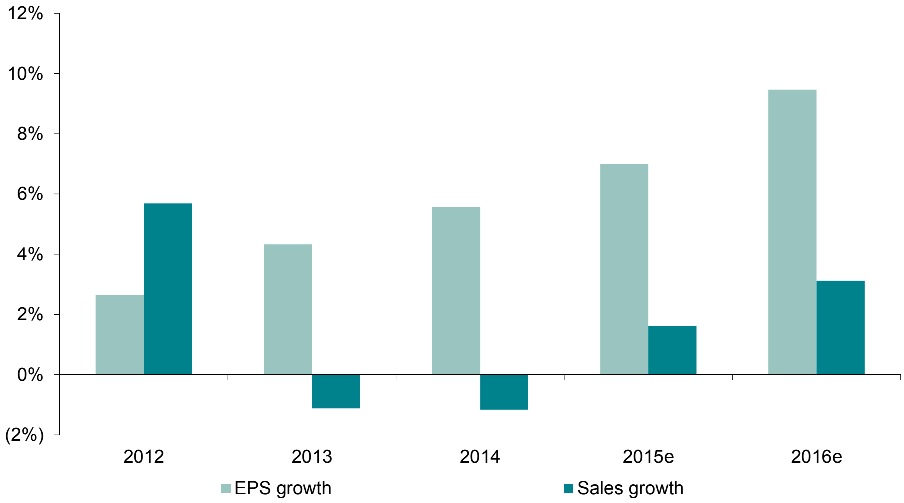




Source: Factset, Exane BNP Paribas estimates

The sector managed to deliver single digit earnings growth in 2013/14 with negative top-line growth only by squeezing costs out aggressively. With positive top-line growth expectations for 2015/16, the chances start to grow that the sector will be forced to add back some of these costs.

Figure 66: European industrials EPS and Sales growth

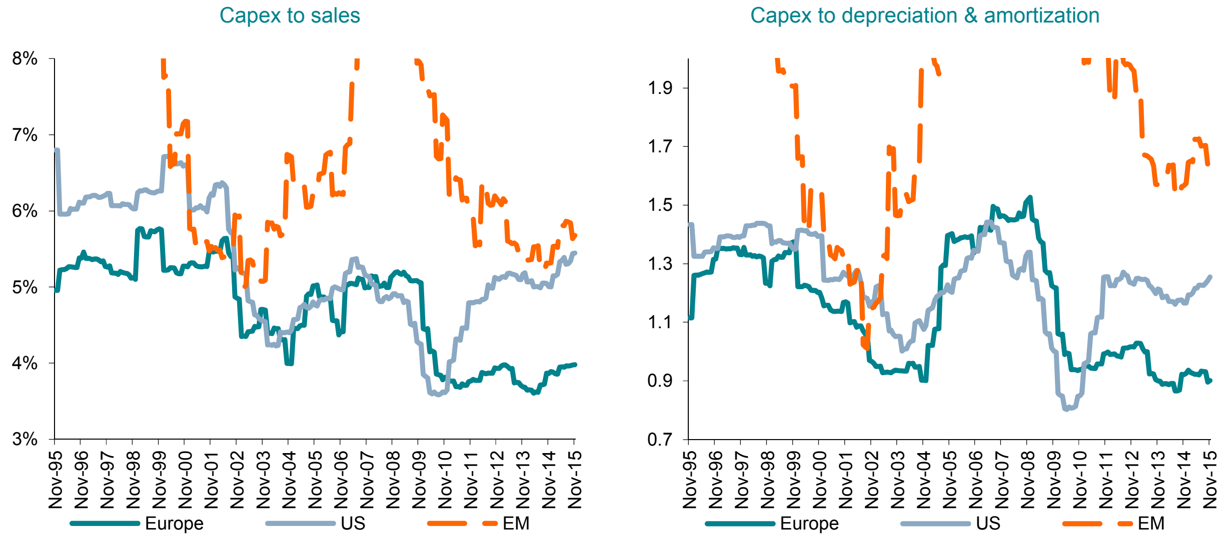


Source: Factset, Exane BNP Paribas estimates

Further, we suspect that European Industrial companies have flattered operating near-term performance metrics by squeezing capex to unsustainably low levels. This can both protect free cash flow and lead to lower depreciation charges hitting the P&L. The problem with this strategy is that is places the sector's future competitive position in some doubt.

For European and US industrial companies, the past decade has been characterised by the rise of EM competitors in global markets. European industrials are facing an increasingly fierce competitive environment. Their own investment has fallen sharply below their US competitors and remains well below EM competition too. Worryingly capex is now running below depreciation. This lack of investment could have serious repercussions for the sector's margins in the medium to long term.

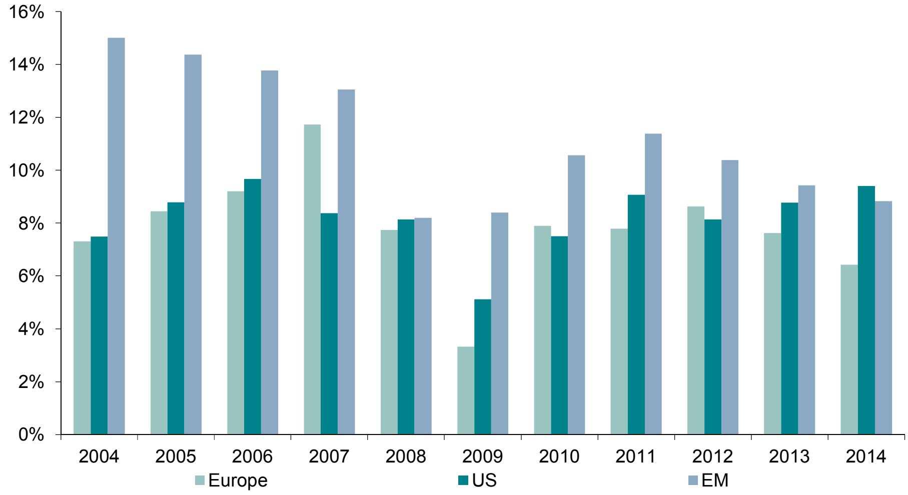
Figure 67: European Industrials have been underinvesting vs US and EM peers



Source: Datastream, Exane BNP Paribas estimates

The cruel truth is that the sector currently finds itself between a rock and a hard place. The Europeans appear to be underinvesting relative to their global competition, but their return on invested capital continues to fall. If investment were to be increased into a declining ROIC environment this would represent a huge management risk - as we argue elsewhere in this note – the combination of declining ROIC and increasing Capex is one of the clearest ways of identifying potential stock price underperformers.

Figure 68: The ROIC of European industrials is falling



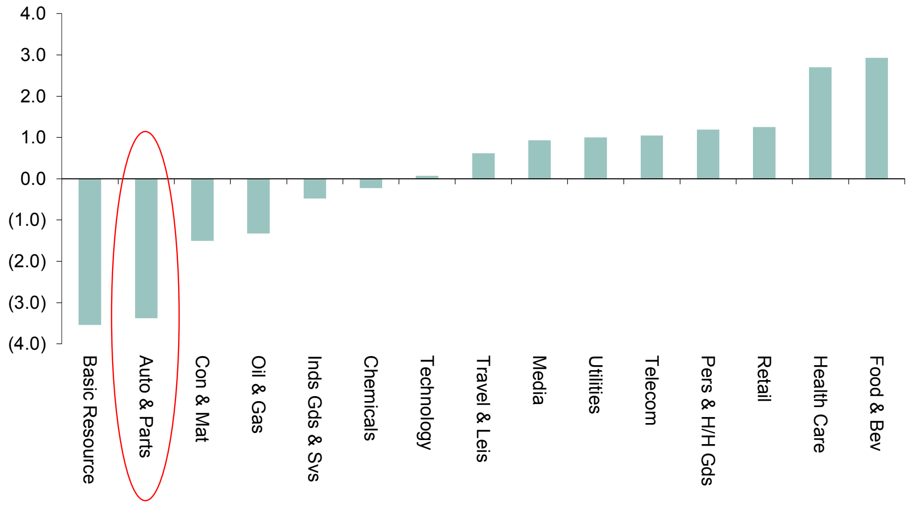
Source: Factset, Exane BNP Paribas estimates

Autos - Underweight

We are torn on Autos. Having reversed our Q1 overweight into a H2 underweight, instinctively there is an urge to buy into all the negative newsflow around the sector. Against that, EM still looks tough, and we are increasingly concerned about the US market – where current robust sales have been facilitated by very easy credit. As the price of credit creeps higher can these sales trends hold up?

It may not be perceived this way, but the Autos sector is one of the most 'credit sensitive' in the market. As we show below, the Autos sector has the highest beta to credit spreads of any non-financial sector in Europe. Forgetting the fundamentals for a moment, from a portfolio construction perspective, we feel a short Autos position acts as a good hedge against the long Insurance position we are running – another credit sensitive, but where we see a stronger fundamental argument.

Figure 69: Stoxx 600 sector beta versus US credit spreads

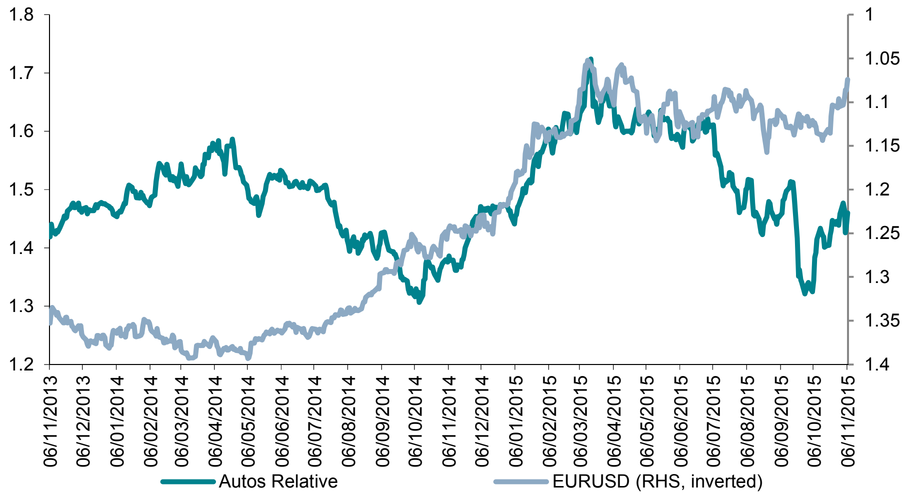


Source: Datastream, Exane BNP Paribas estimates

There is though one tactical concern. We appreciate that this sector, at times, trades with a great deal of fx sensitivity. While this may be overplayed – as it clearly was in Q1 – it can generate powerful performance during periods the euro is trending weaker.

We are certainly not currency forecasters, but the potential combination of euro QE escalation and a US rate cycle certainly raises the possibility of another round of euro weakness. We accept the risk that this sector may have a period of fx induced performance. But as the following chart shows the fundamentals that are now weighing on the sector have led to some sort of disconnection between relative performance and the euro. By definition our Underweight call relies on that disconnection holding should we get another period of material euro weakness.

Figure 70: Autos Relative to market versus EURUSD



Source: Datastream

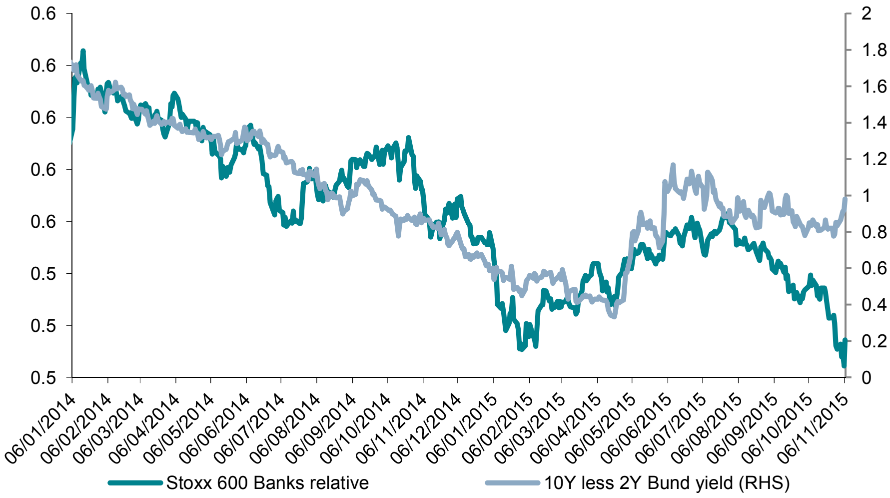
Financials – Insurance over Banks

The environment is not exactly perfect for Financials. An extended environment of uber-low bond yields does not suit this area of the market. The Banks in particular, after having shown promise earlier in the year – have been weak on the combined impact of credit spread widening, expectations of ECB QE escalation, and another round of capital raising as regulation continues to bite.

Near-term there is a case that the weakness in the sector has run too far. The sector looks disproportionately weak against the extent of yield curve flattening, spreads or the recovery in the inflation swap.

Below we show the extent of the relative underperformance of the Banks sector recently looks disproportionately negative relative to the extent of the flattening in the yield curve.

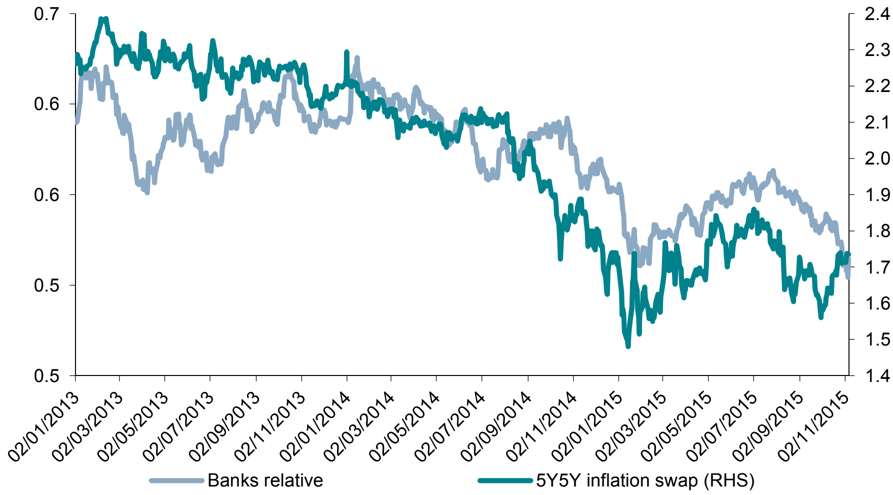
Figure 71: European yield curve versus Banks relative



Source: Datastream

And the following chart demonstrates that the movement in the inflation swap – for much of the last 12-months a pretty good guide toward sector relative performance – has not prompted a recovery in the sector despite bouncing on the ECB escalation trade.

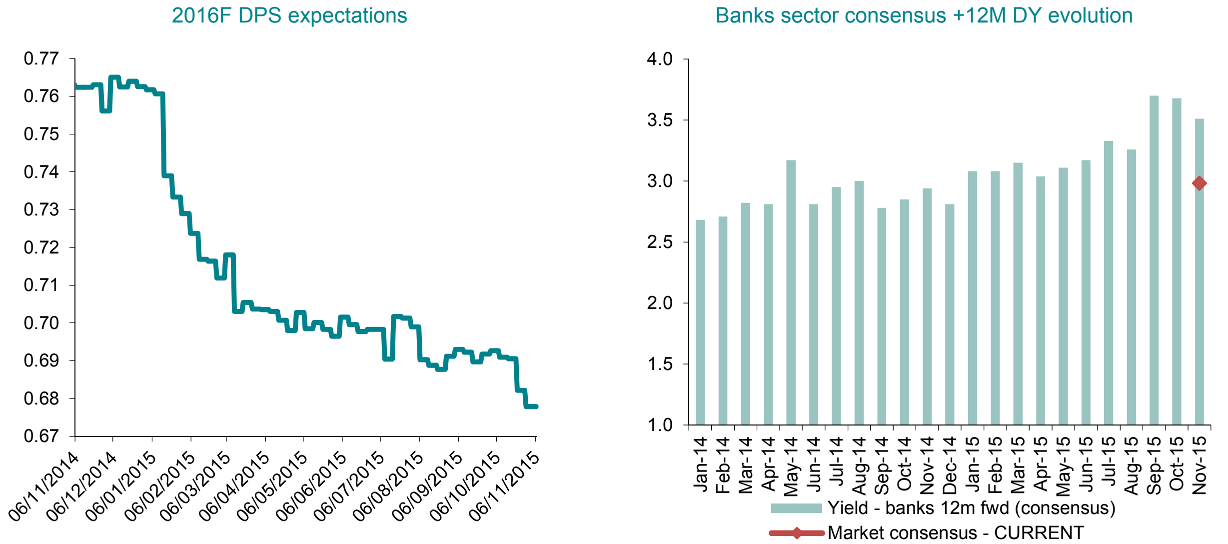
Figure 72: 5Y5Y inflation swap versus Banks relative



Source: Bloomberg

The problem – once again – is capital and earnings trends. The recent reporting season has been characterised by yet another wave of capital raisings and earnings forecasts have fallen. Perhaps more worryingly for many investors, as the capital build has slowed, dividend forecasts have suffered a sharp downgrade. And as dividend recovery has been a key thesis of the Banks investment appeal, this is clearly a negative development for relative performance potential.

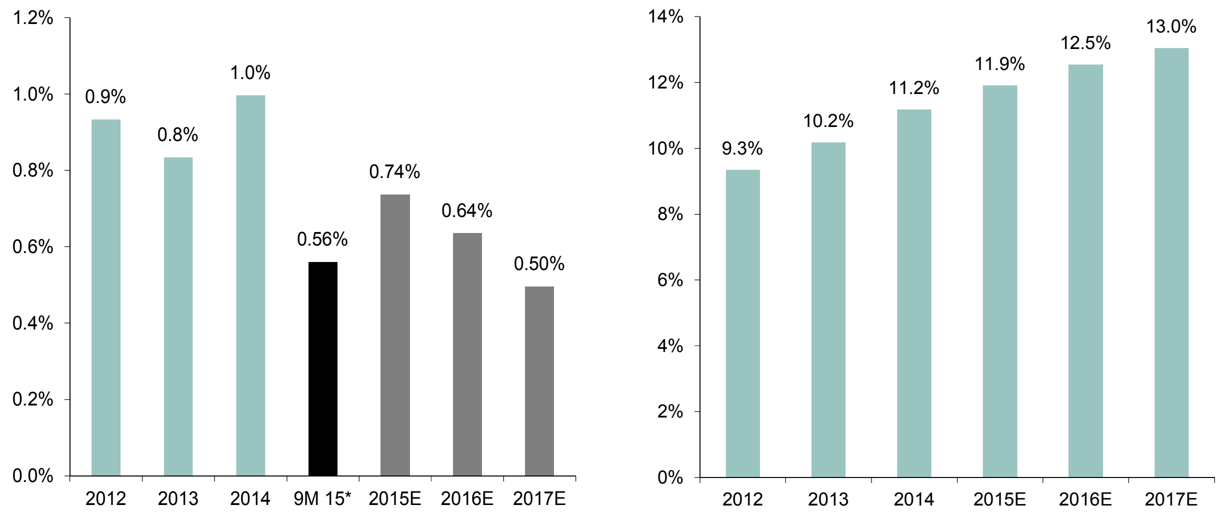
Figure 73: Banks sector dividend forecasts under pressure



Source: IBES

The related point is that the pace of capital build has slowed. As our Banks team point out in the following charts, the sector's capital position continues to improve, but the pace of capital build in the first 9-months of the year has fallen well behind what is expected for the calendar year. For more on this please see these two notes from our sector team: BANKS: Regulation - Just Can't Get Enough, BANKS: Q3 results-deteriorating earnings momentum

Figure 74: Capital build poor as ET1 shrank more than the RWA base

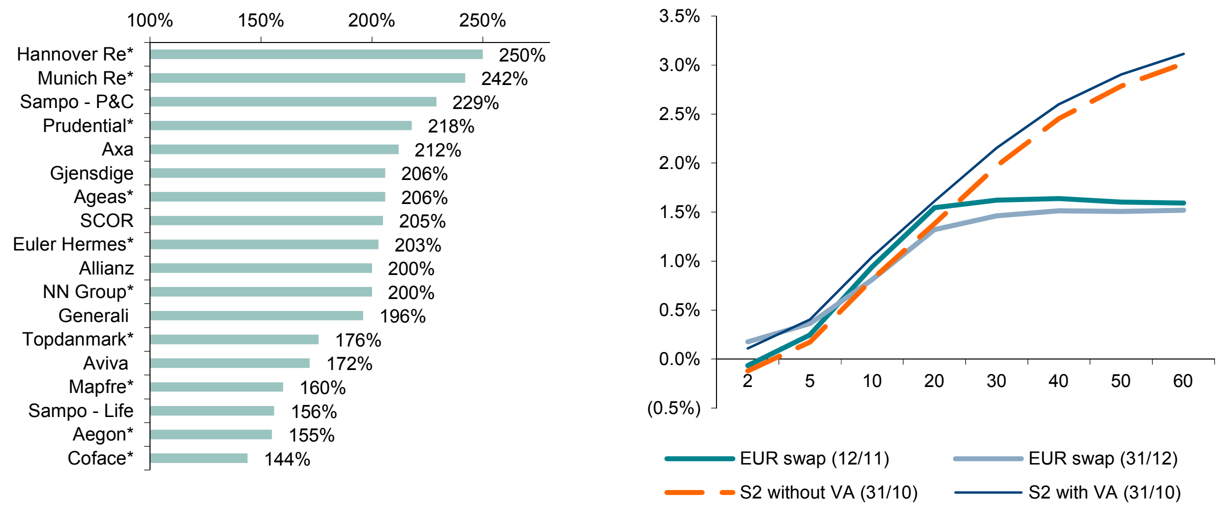


**9m 15 annualised. **includes most of the banks under our coverage universe. Source: Exane BNP Paribas estimates*

QE extension is unwelcome, the NIM recovery is going to take longer to materialise. At this point – despite the encouragement on credit flow and the provisions benefit taken in 2015 – it is becoming more difficult to construct an earnings and shareholder distribution story that looks competitive against the market over the next year. This doesn't feel like the perfect time, but if we are getting the portfolio in order for 2016, we can no longer justify the Overweight and cut the sector to Neutral.

Insurance now offers a better investment proposition. Solvency 2 will be implemented at the start of 2016 and many of the fears around this have started to dissipate. Not everything is resolved. The regulator still has to determine the discount rate applied to 60-year liabilities. It will fall from 4.2% (this 4.2% is the 1 year forward in year 60, and is equivalent to a 3% spot rate for a 60-year swap). But this has been well flagged, and the companies are sounding relatively relaxed. This decision will come by end 2016.

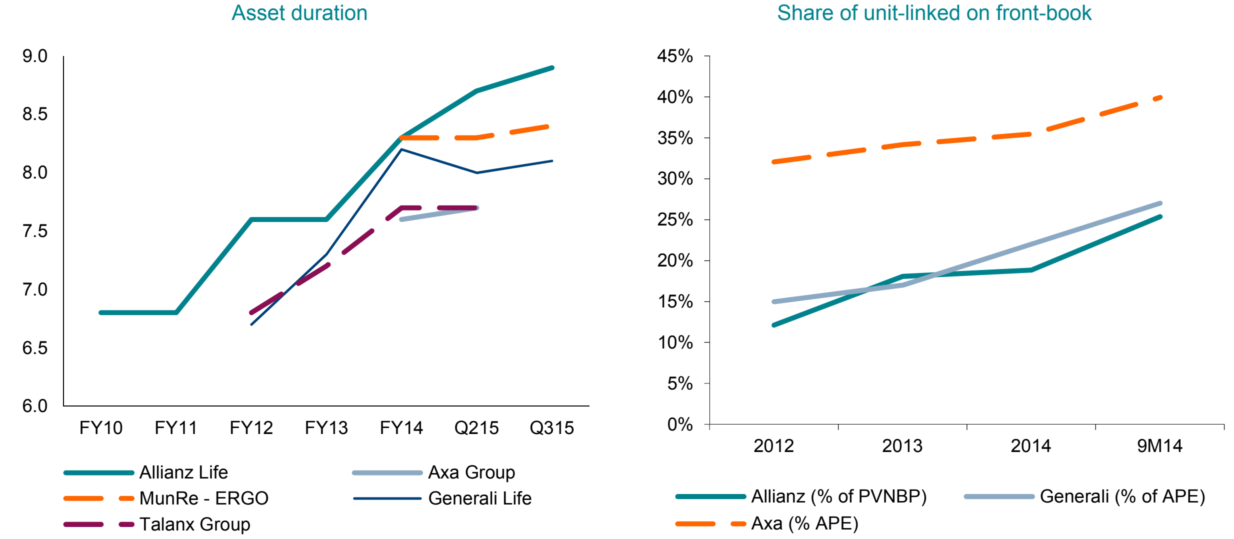
Figure 75: Capital positions should allow the absorbing of some adjustments of the discounting curve



Note: For Solvency 2 ratios we used best available proxy (Economic Solvency where S2 not available and mid-point in case of range guidance)
** Solvency 2 proxy at FY14*
Source: Exane BNP Paribas estimates. VA = Volatility adjustment

On the face of it an environment of very low yields for an extended period is bad news for companies with long duration liabilities. But the companies have worked hard to minimise the balance sheet duration mis-match – remember asking who on earth was buying 10Y Bunds at sub 20bps yields? I think we know the answer now. This may not be great economics but it's done, and it's history. Furthermore, the sector is aggressively skewing new business toward that optimised for Solvency 2 and low rates (partial guarantees, pure unit-linked, health and protection). This will take time to balance out the legacy exposure, but the mix should gradually improve going forward.

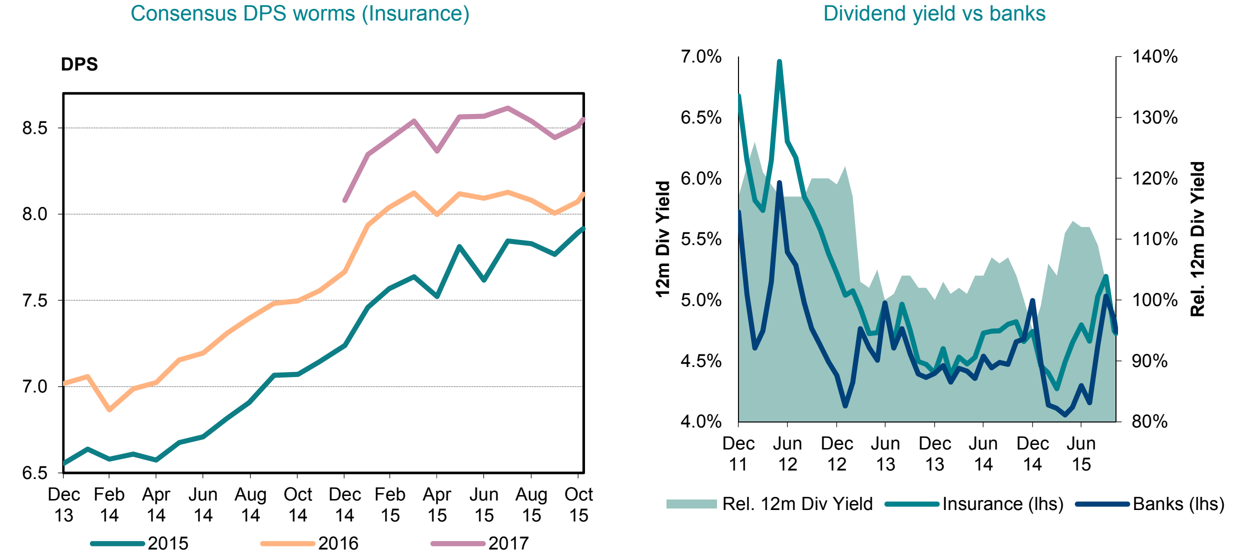
Figure 76: The march to position for low rates for longer continues



Source: Exane BNP Paribas estimates

As ever there are winners and losers – the very long duration plays with weak capital positions have already been hit in anticipation (e.g. Aegon, Delta Lloyd), but in the round the sector is managing the regulatory change with little real drama. In the interim the sector offers a 5% dividend yield, on reasonably conservative payout ratios, allowing scope for retained earnings to help with capital management. The sector again seems to be some distance ahead of the Banks. We make the preference switch and upgrade Insurance to Overweight.

Figure 77: Dividend attraction



Source: Exane BNP Paribas, Factset Estimates, MSCI

Resources – Oils to Underweight, Basic Resources Neutral

This time last year the oil price was trading at around USD80/bbl, against the current level around USD50/bbl. This approximate 40% fall in oil prices has seen the Stoxx Oil & Gas sector fall less than 10%. And some major names have done considerably better. Total, for example, is essentially flat over the last 12-months. It could have been a lot worse. Indeed it has been a lot worse in the Mining sector.

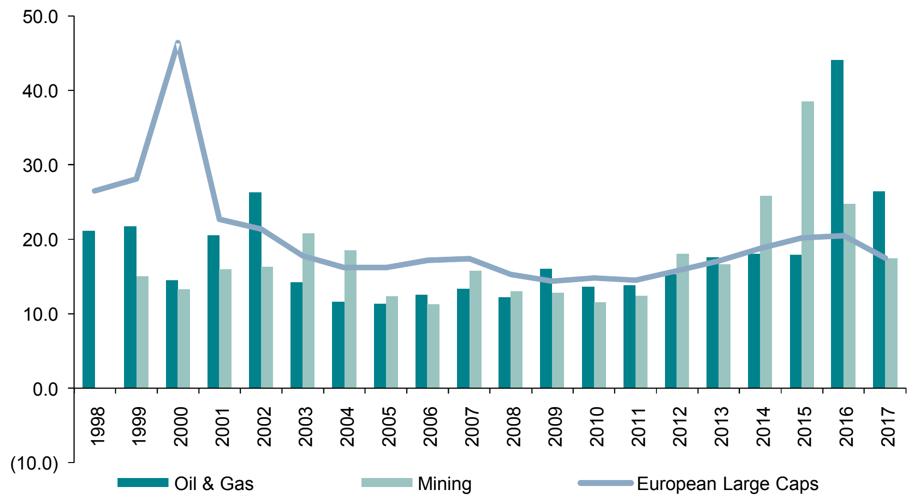
That said, both sectors have underperformed, and cutting the weighting after such a period requires explanation. We feel the argument now all comes down to numbers and to risk profile. There are two broad introductory points to make. First, protecting against the Chinese credit 'tail risk' we have identified in this note is likely to require a negative stance across the commodity sectors. Second, we see a strong relative opportunity in Miners over Oils.

When buying into recovery stories it generally comes down to valuation – how much further downside is it possible to envisage against the potential upside if companies execute a successful turnaround strategy. And as valuation upside is likely to be well into the future, how far forward are investors prepared to look – and what discount rate on those future recovery earnings is appropriate in light of the execution risk?

The points are always open to debate. But the following chart is an interesting place to start. On Exane analysts' numbers, which are close to mark-to-market oil futures curve implied prices for 2016 and 2017, the Oil sector's EV-to-NOPAT ratio is materially above the market for the next 2 years. The valuation appeal, such as it is, relies on investors buying into 2018 numbers.

In contrast the Miners, look set to see valuation multiples fall sharply next year, and fall below market in 2017. So at least on this timing angle, the turnaround story in the Mining sector looks quicker than in the Oils.

Figure 78: EV/NOPAT, Oil & Gas, Mining versus European Large Caps



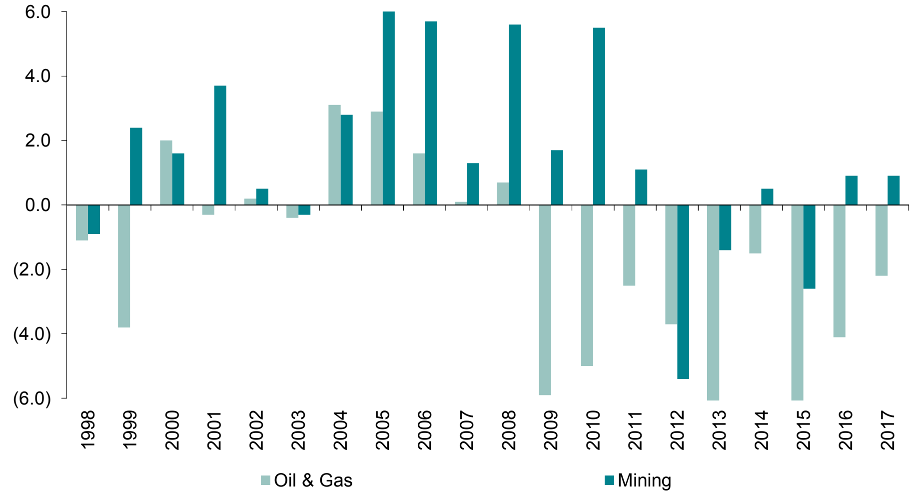
Source: Exane Datacenter

If headline valuations offer little motivation to buy – at least in the case of the Oils – any time soon, the dividends on offer in this sector are often held up as strong support. Income orientated investors will find headline appeal in the yields available across the space.

While there is clearly some truth in this – on Exane numbers the Oil sector is yielding 5.7% in 2016 and the Miners 6.1%, it is clear that these dividends cannot be considered sustainable without a material improvement in underlying free cash flow generation.

The following chart – again using Exane analysts' forecasts shows the Free Cash Flow yield less the Dividend yield of the two sectors going out to 2017. On these numbers the Oil sector will still be running a material deficit of free cash flow over dividend payments in 2017, compared to the Mining sector which should turn the corner into positive post dividend cash flow next year.

Figure 79: Free cash flow yield less dividend yield

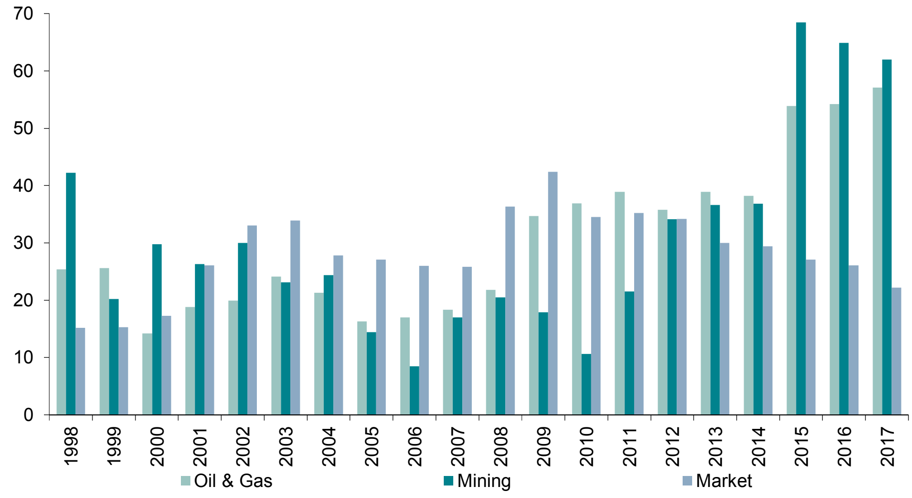


Source: Exane Datacenter

It is noticeable that the Oil sector has not run a post dividend positive cash flow position since 2008. In other words we should brace for at least 10-years of dividends being paid from the balance sheet. And that brings us to our final chart on these sectors. After the damage done in recent years, neither of these sectors now offer balance sheet positions that look better than the market.

The following chart shows debt and other liabilities as a % of market cap. It is no surprise that these metrics have deteriorated, but we have difficulty understanding why for so much of 2015 investors have preferred Oils over Miners on the back of perceived balance sheet strength. This chart at least suggests that the relative between Miners and Oils on capital structure has been a little overplayed.

Figure 80: Debt and other liabilities as % of market cap



Source: Exane Datacenter

Global View – Top of the League

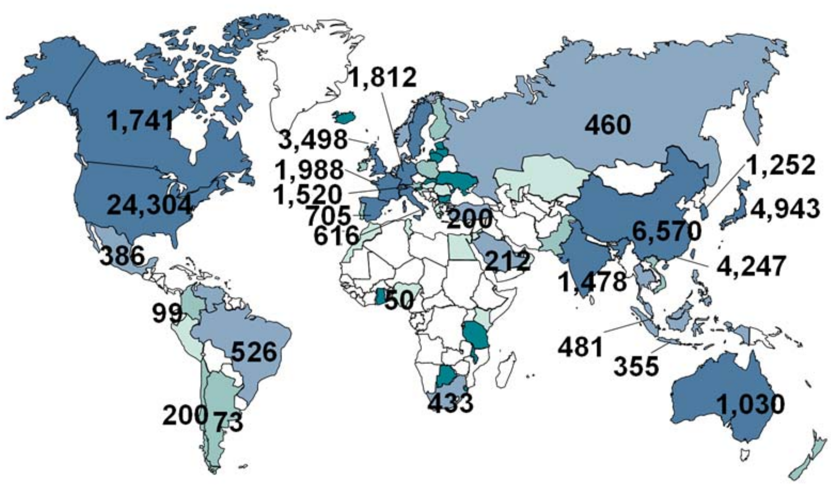
We have a cautious view on the direction of markets in 2016. But what does this mean for global asset allocators?

The best performing region (in terms of equity markets) may be the winner of a somewhat lacklustre prize, analogous to winning football's Europa League. Indeed, for the second half of 2015 (see It's a relative world, Yen in Black) our global relative preference was for Europe. Is this the right stance for 2016?

Key Regional Drivers

We keep our focus on 4 core equity regions: US, Japan, Europe and (perhaps more an asset class than a region) Emerging Markets. As shown below, these markets make up the bulk of global market cap.

Figure 81: Market cap by market, USDbn 11 Nov 2015



Source: EBNPP, Bloomberg

To assess the relative attractions of these regions we first need to determine the key drivers of equity market performance. While this involves a certain degree of generalisation, we would summarise as follows:

Figure 82: Differing Key Regional Drivers

Region	Key Drivers
US	Global and Domestic financial conditions, growth
Europe	Dividends vs low interest rates
Japan	Liquidity (domestic and international)
Emerging Markets	Liquidity (global)

Source: Exane BNP Paribas estimates

Taking the top-down view, what is the outlook for these drivers?

– Liquidity conditions are tightening in much (but not all) of the world, including in the US

– Low long-term rates look here to stay even if the Fed moves short-term rates in the coming months

– European dividends one might assume are relatively well supported by the domestic economy however as we mentioned earlier in this report payout ratios are high (and investment low) with the biggest payers perhaps also the most at risk of cuts. We outline strategies for yield investing in Europe later in this note (preferring companies with above-market ROIC) but from a high level dividend growth in Europe does seem at risk.

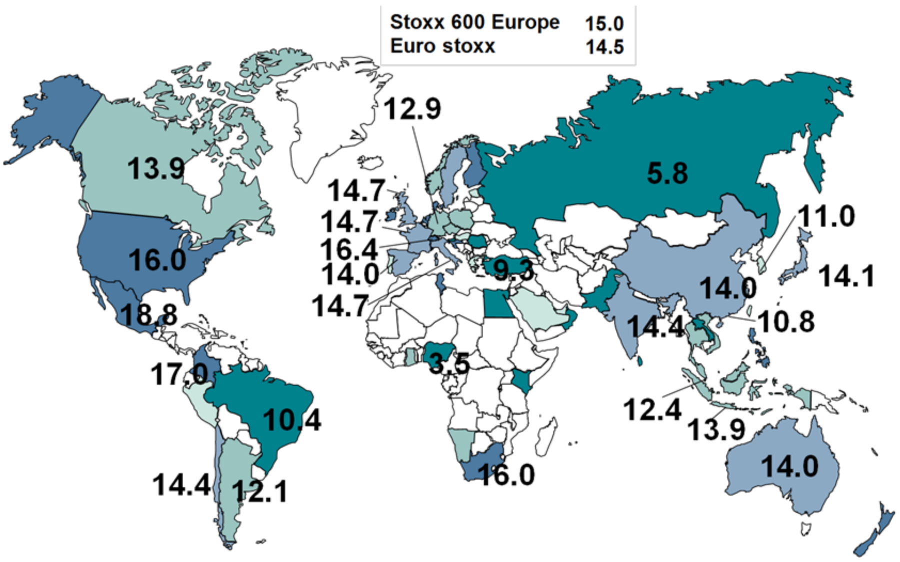
This doesn't sound tremendously positive for any of the regions, and fits with our overall cautious view. A closer examination of the market specifics is called for to take a relative stance.

Relative Valuations

Firstly we first show the Forward P/E, EV/EBITDA and Dividend yields around the world in map form here.

Figure 83: A world of valuation – P/E

2016 Fwd P/E



Source: EBNPP, Bloomberg, Main country index used

Figure 84: A world of valuation – EV/EBITDA

2016 Fwd EV/EBITDA

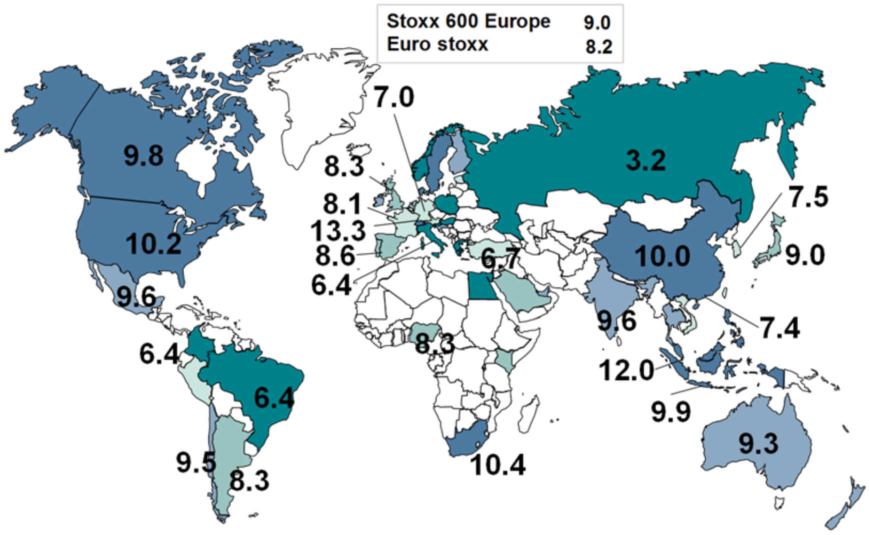
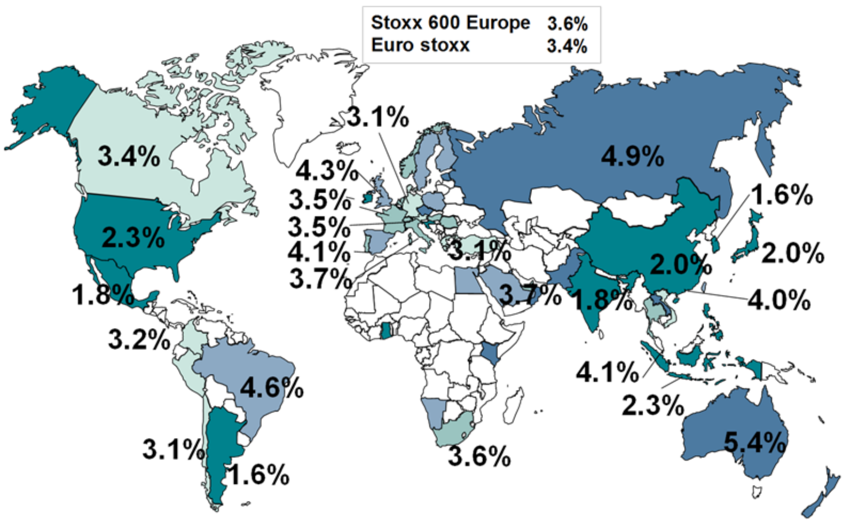


Figure 85: A world of valuation – Dividend Yield

2016e dividend yield

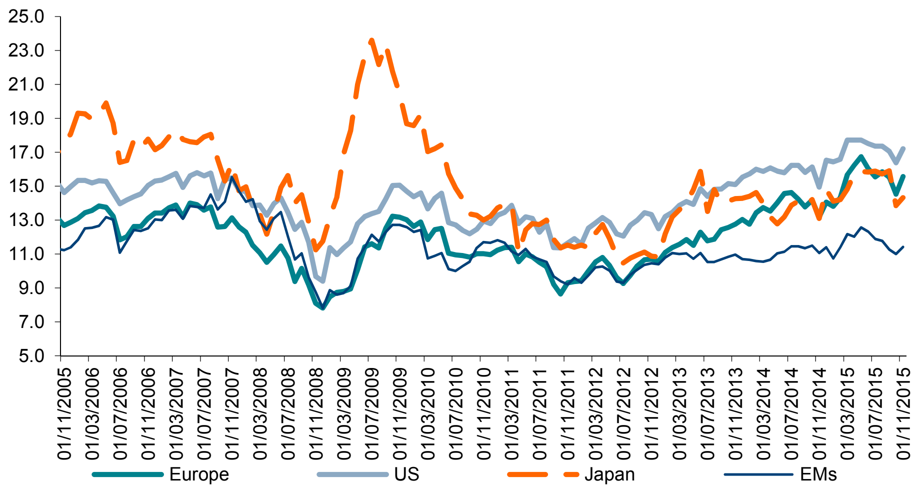


Source: EBNPP, Bloomberg, Main country index used

Now, we zone in on the key regions. We can see that on forward P/E, EMs are the 'cheapest'.

Figure 86: US at a premium, EM at a discount

Forward P/E

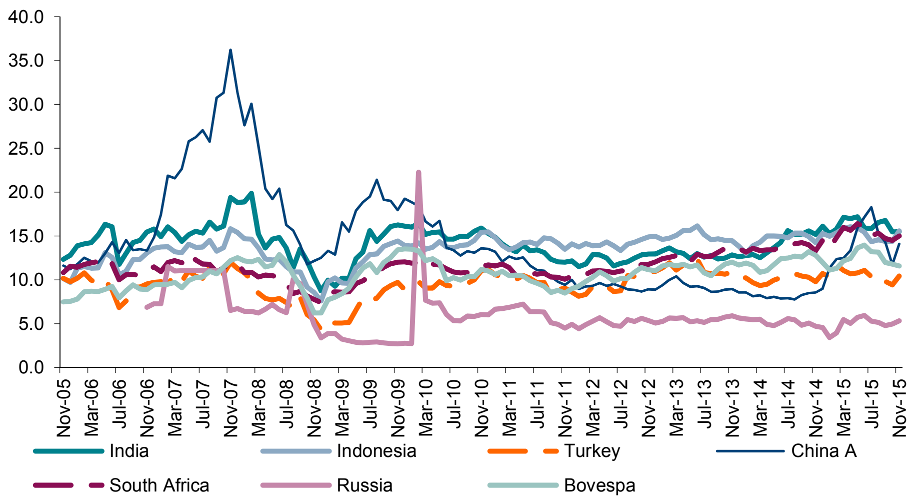


Source: Datastream

However, this 'cheapness' of EMs primarily reflects Russia, with the other main markets having P/E's much closer to (or higher than) developed market peers. See below.

Figure 87: EMs outside of Russia look less cheap

Forward P/E, major Emerging Markets

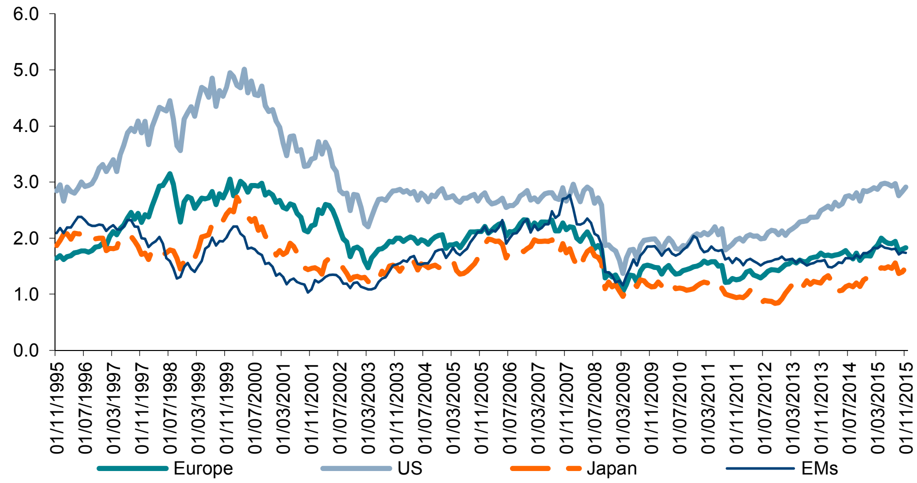


Source: Datastream

A view on P/B also shows a different picture, with EMs trading in line with Europe.

Figure 88: EMs in line with Europe on P/B

Price to Book by region

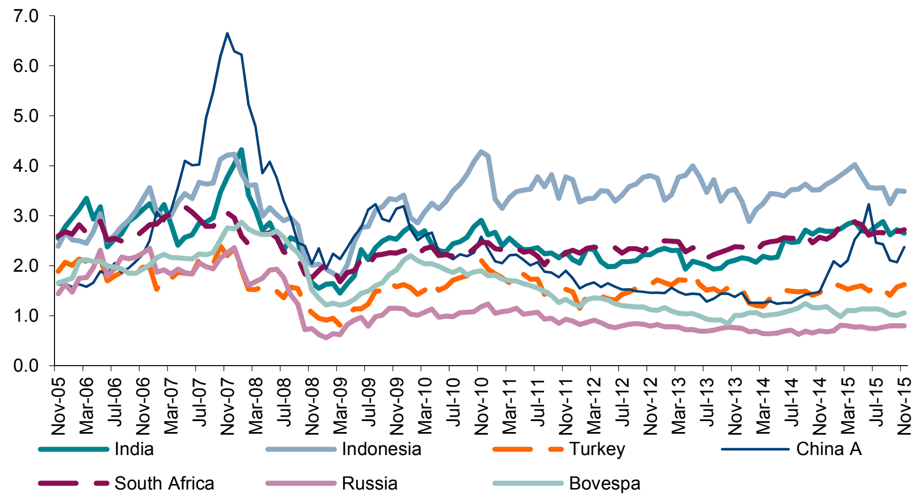


Source: Datastream

Again, the valuation of EMs is flattered by Russia, with Brazil also a drag. Given the concerns we have over the book values of EM financials in particular, the 'EM is cheap' argument seems hard to truly justify. **We do not think now is the time to buy EM equities.**

Figure 89: EMs are not cheap on P/B excl. Brazil & Russia

P/B ratios (12m trailing), key EMs

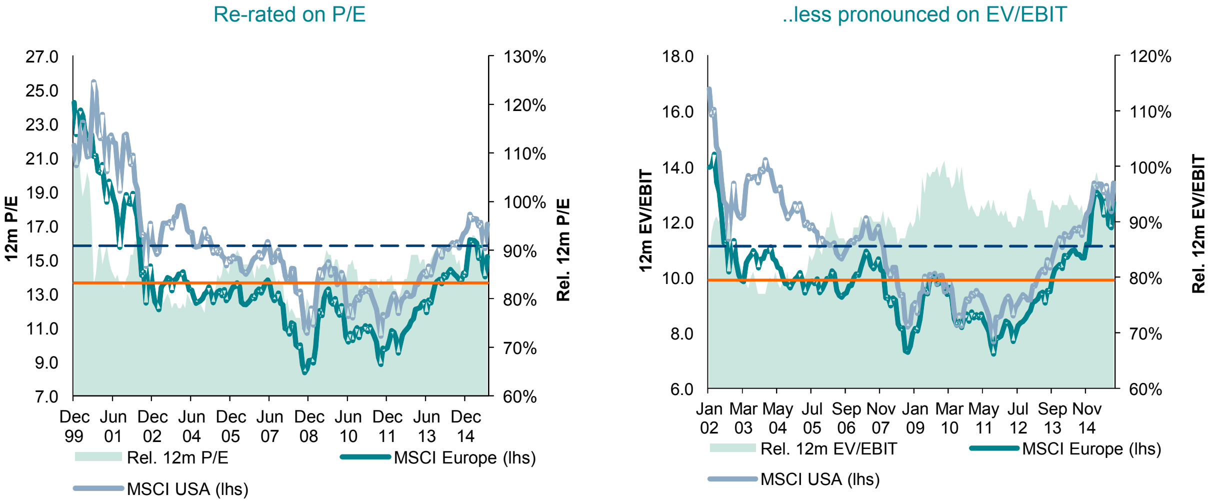


Source: Datastream

Inter-regional comparisons

What about the direct comparisons between key mature regions? Looking at these through our Euro-centric prism, a glance at the P/E relative to the US shows a small European re-rating over the past 2-3 years but (as we noted earlier in the report) leverage ratios have been rising in the US and falling in Europe. There has been little relative change on EV/EBIT with Europe still at a discount on both metrics.

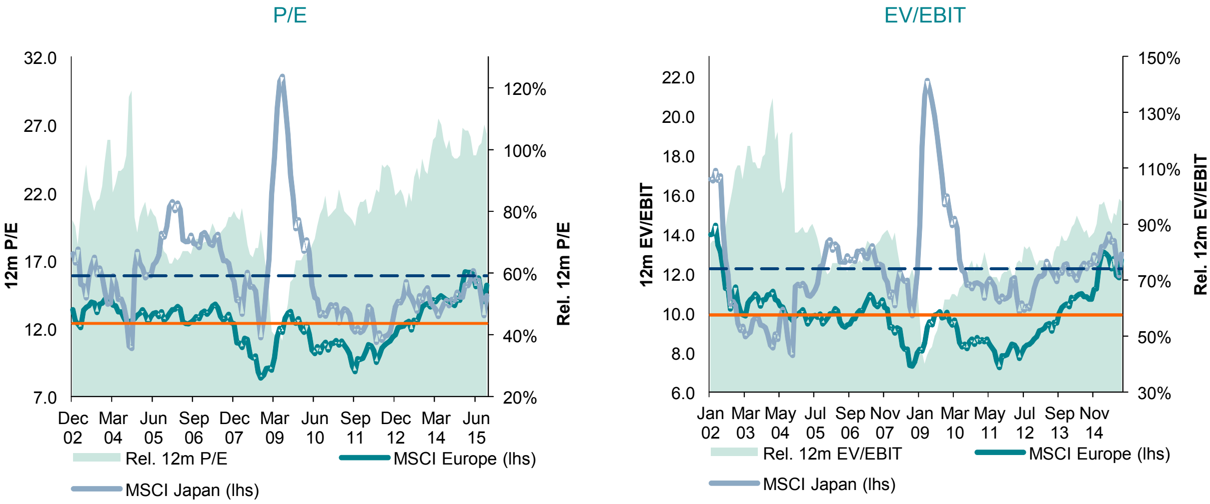
Figure 90: Europe's discount to the US remains reasonable on P/E and EV/EBIT



Source: Exane BNP Paribas, Factset Estimates, MSCI

When compared to Japan, Europe has re-rated and now sits at parity on P/E and at a modest discount on EV/EBIT. See below.

Figure 91: Europe now at P/E parity with Japan



Source: EBNPP

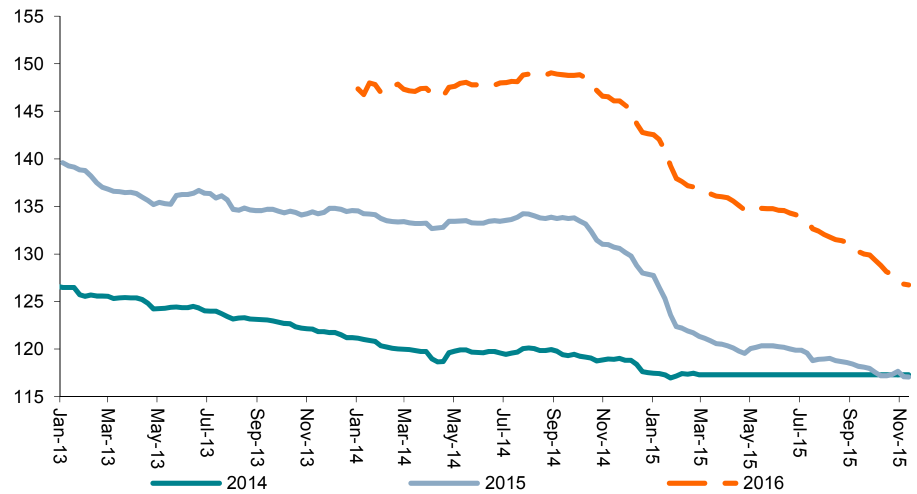
How well does this represent the market outlook? We now run through the specifics of the key inter-regional questions.

Europe vs the US

As we are clear on our investment thesis for Europe, it is the US which warrants more attention. US earnings growth is now expected to be -0.2% in 2015, having started the year with hopes of 7.7% progression. This is a common trend, both historically and in other regions (e.g. Europe started at 16.4% and now sits at 12.1%). We show the US EPS worm evolution below.

Figure 92: EPS forecasts habitually disappoint

Consensus EPS worms, S&P 500 index

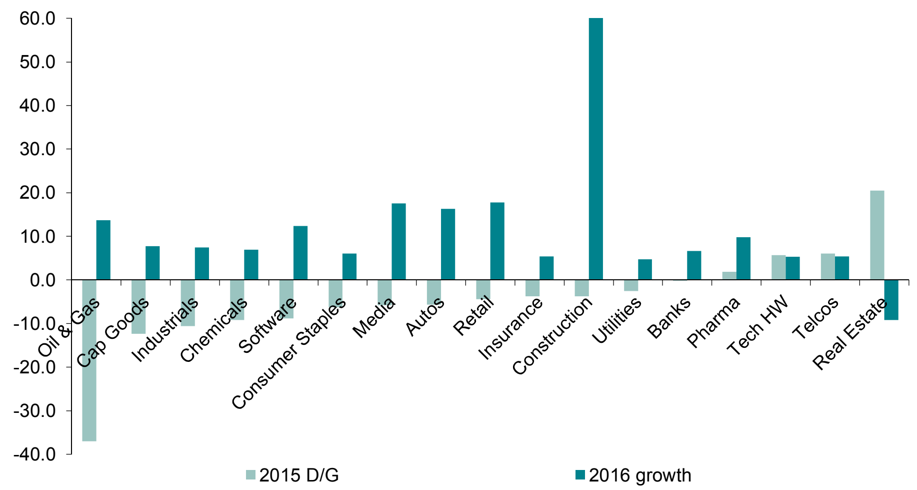


Source: Factset, Exane BNP Paribas estimates

Looking by sector only 4 of 17 groupings have seen upgrades to 2015e EPS since Jan 1st. Now in 2016 the Street looks for 8.4% growth, (vs. 9.8% in Europe). We show below that much of this US growth is pencilled in for those sectors that saw 2015 downgrades.

Figure 93: Most of the 2016e growth is from sectors with YTD downgrades

US sector 2015 EPS downgrade vs 2016e EPS consensus growth

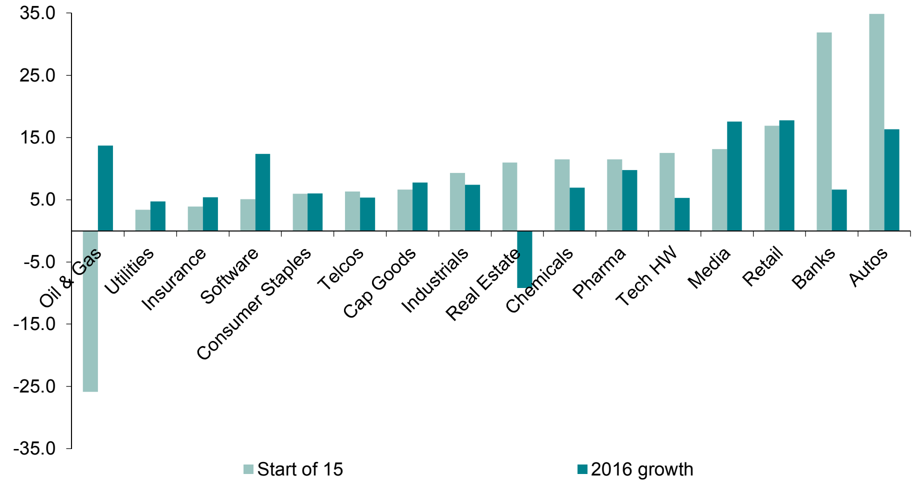


Source: Datastream, EBNPP

Indeed for many sectors, such as Insurance and Consumer Staples, US analysts have pencilled in 2016 EPS growth rates almost identical to those they had for 2015 at the start of this year. See below.

Figure 94: US 2016e growth by sector hints at 'mean reversion' forecasting

US 2015e growth at 1 Jan 2015 vs 2016e growth at 9 Nov 2015

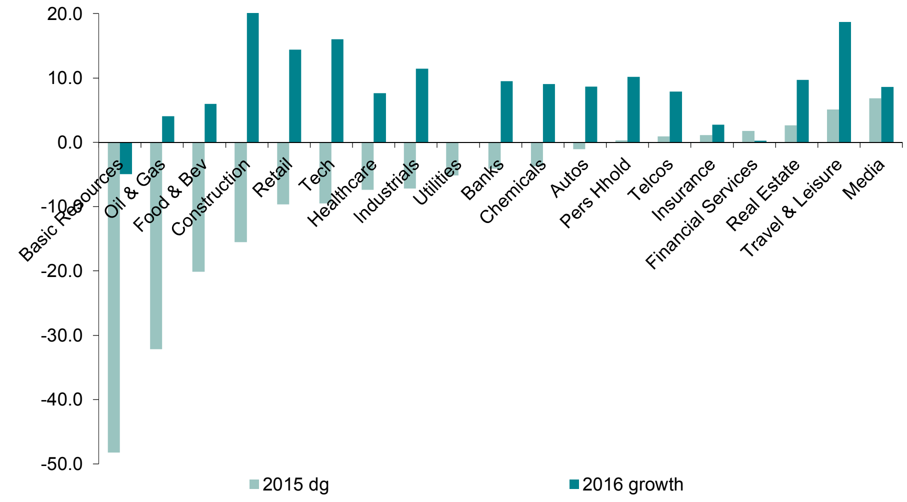


Source: Datastream, EBNPP

While this is far from a US-only phenomenon, in Europe there does seem less of a reliance on those sectors which have seen heavy downgrades to bounce back. See below.

Figure 95: Europe's growth by sector not solely recovering downgrades

Europe sector 2015 EPS downgrade vs 2016e EPS growth



Source: Datastream, EBNPP

Not a reassuring picture of 2016 earnings growth in either market…

While not wishing to unduly bang a bearish drum, we do have to say that the weighted contribution of EPS growth by sector raises a few concerns in both Europe and the US. While Pharma features as a growth driver in both, Industrials, Consumer Staples, Banks and Oil & Gas are more worrisome. See below.

Figure 96: Sector-weighted EPS growth a little concerning in both markets

%age points of market 2016e EPS growth by sector (weighted by market cap)

Europe		US	
Industrials	1.42	Pharma	1.17
Banks	1.22	Retail	1.16
Healthcare	0.96	Oil & Gas	0.97
Pers & Hhold	0.78	Industrials	0.86
Tech	0.53	Media	0.76
Construction	0.47	Consumer Staples	0.70
Retail	0.45	Software	0.65
Chemicals	0.44	Banks	0.48
Food & Bev	0.43	Tech HW	0.41
Telcos	0.37	Autos	0.24
Travel & Leisure	0.29	Insurance	0.20
Autos	0.25	Chemicals	0.19
Media	0.24	Utilities	0.16
Oil & Gas	0.24	Telcos	0.15
Real Estate	0.18	Construction	0.08
Insurance	0.17	Real Estate	-0.34
Financial Services	0.00		
Utilities	0.00		
Basic Resources	-0.10		

Source: Exane BNP Paribas estimates

How certain is this growth? Looking at the standard deviation of earnings for the biggest contributors in each market might offer some insight. Due to the strong focus on quarterly earnings and more precise guidance, the US has an inherently lower variation of market estimates. However if we compare the standard deviation of earnings vs. the average *for each market* this gives us an arguably more representative gauge of visibility.

As shown below, **the standard deviation of estimates for the key US sectors is 36% above the US average, whereas in Europe the variation is 17% lower**.

Figure 97: Less earnings certainty vs the market average in the US

Standard deviation of consensus EPS for key sectors

Standard deviation (%)

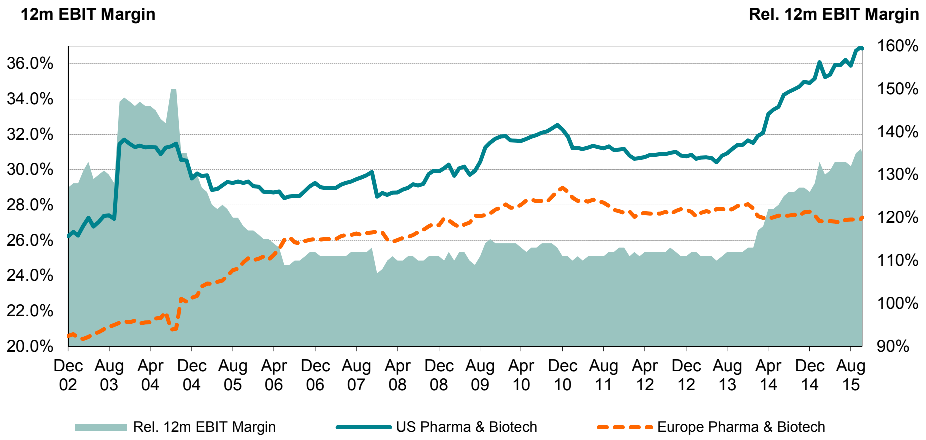
Europe	**EPS**	**US**	**EPS**
Industrials	2.35	Pharma	0.665
Banks	2.34	Retail	0.817
Healthcare	2.95	Oil & Gas	3
Personal & Household	2.039	Industrials	0.49
Technology	1.84	Media	0.5
Construction	2.36	Consumer Staples	0.26
Average	**2.31**		**0.96**
All-Sector average	2.80		0.70
Difference	**-17%**		**36%**

Source: Exane BNP Paribas estimates

Delving a little more into comparisons of some of the key sectors is also interesting. Below we show Pharma margins. While there are some notable differences on composition (the US having more high-margin biotech names) the trajectories are notably different.

Figure 98: US Pharma margins at peak…Europe not so much

US vs Europe Pharma & Biotech EBIT margins

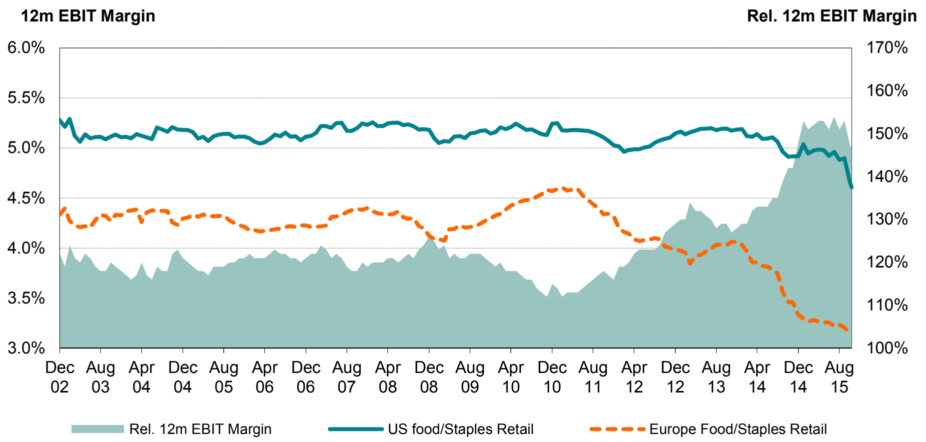


Source: Exane BNP Paribas estimates

There is a similar picture for Retail (the second biggest contributor of US growth), with both Food and General Retail margins at relative highs vs Europe. We show the chart for Food Retail below.

Figure 99: US Retail margins relative to Europe close to 10y high

US vs Europe Food & Staples Retail EBIT margins



Source: Exane BNP Paribas estimates

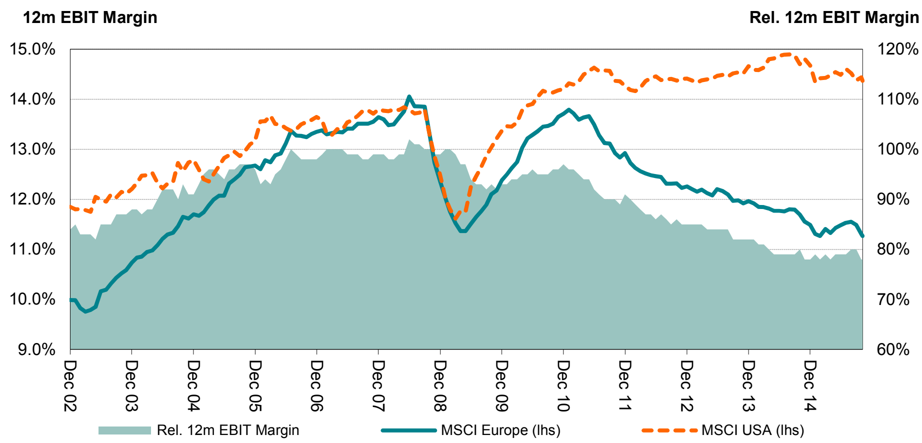
We also note that a major driver of US Retail EPS growth is Amazon where EBIT and EPS is forecast to increase +81%. However, while there is an excellent chance Amazon grows its profit strongly from its current 3% margin, the standard deviation of 31% on consensus EBIT speaks to the low visibility on profits from such a top-line driven business.

Earnings risk also 'feels' better in Europe

From a top-down perspective Europe also feels more comfortable. The well-worn chart below showing Europe's still depressed margin at all-time relative lows to the US (as the US labour market tightens further) remains valid.

Figure 100: Margins: relative chasm remains

12m Fwd EBIT margin, Europe vs US



Source: Exane BNP Paribas, Factset Estimates, MSCI

We'd add that our concerns over tightening financial conditions in the US and higher financing costs to corporates carries risk to the net profit line and to share buybacks. What about the political outlook?

The US election – Key 2016 event

While the US election itself is not until Q416, the primary process and election campaign is likely to be a huge media focus throughout the year with the potential to impact financial markets.

The key hard dates are as follows:

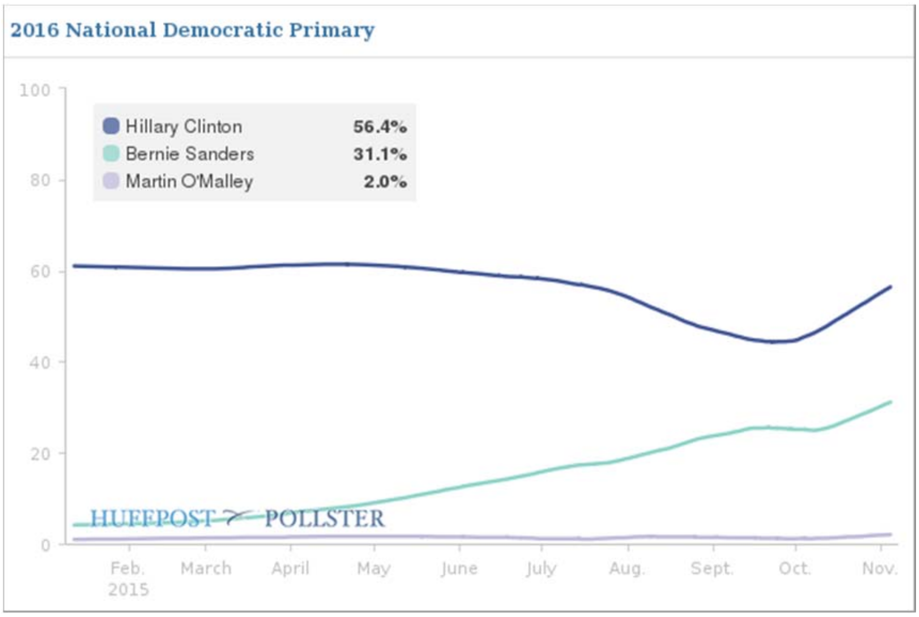
– Republican & Democrat primaries start with Iowa on 1st February 2016, New Hampshire 9th February and are likely to conclude by June 7th.

– Presidential election Nov 8th

So who is likely to win the nomination? Though not quite a foregone conclusion, Hillary Clinton looks the overwhelming favourite to top the Democrat card. See below.

Figure 101: Clinton holds the cards

Polling average

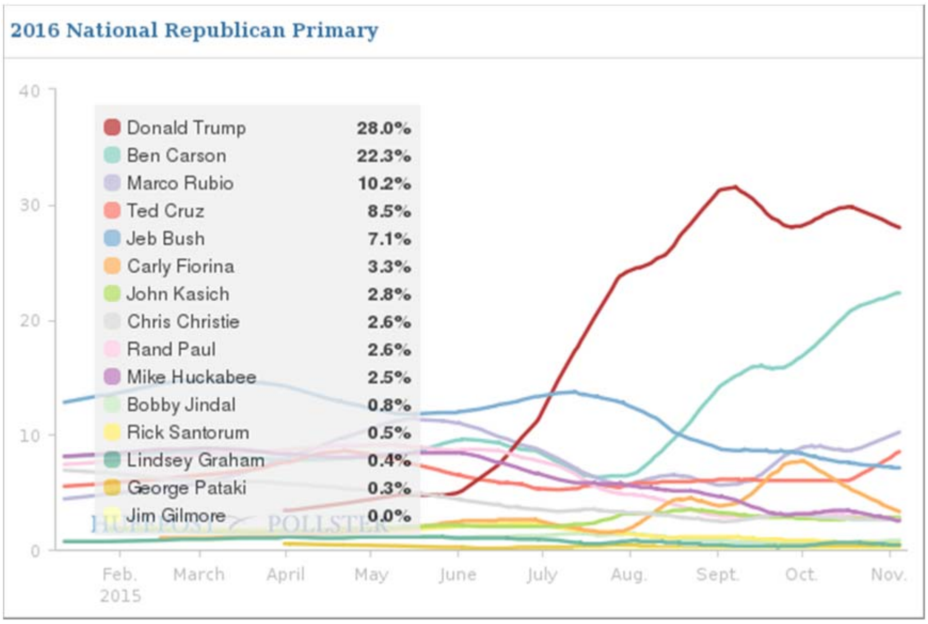


Source: Huffington Post

The Republican nomination looks less clear-cut with Donald Trump's poll leadership being increasingly challenged by Ben Carson in recent weeks (with Carson ahead in some polls). See below.

Figure 102: Looks like a Trump, Carson or Rubio for the Republicans

Polling average



Source: Huffington Post

Big Contrast with Betting markets – Rubio current favourite

It's also worth noting the big difference in the betting markets. Following a September Republican TV debate, the odds on Marco Rubio winning the nomination have shortened significantly. Rubio is currently priced at 7/2 with William Hill to be the next president, with Trump at 11/2, Bush at 14/1, and Ben Carson at 16/1. The CNN political prediction market (which factors in polls, users online predictions and other factors) also gives Rubio a 33% chance of winning, with Trump and Carson at 17% each. For reference Hillary Clinton is 4/5 to win (i.e. a c.60% chance) with William Hill.

What are the candidates' policies?

As we are the 'primary' phase of the campaign, the candidates may be playing to the party base (as opposed to the centre) in terms of policy commitments so far. With this in mind we set out some of the key policy pledges below.

Figure 103: Key Policies of main candidates

Democrats		**Republicans**		
Clinton	**Sanders**	**Trump**	**Carson**	**Rubio**
General Aims				Reduce government spending
Increase private & public investment	Reverse free-trade agreements	**Do not increase the debt/deficit which are 'already too large'**	Forced Balanced government budget	Cut taxes for business to 25%,
Invest in Infrastructure, clean energy, scientific & medical research	Invest in infrastructure	Tax cuts for middle-class Americans	Focus on defence (esp wrt countering Russia and protecting Israel)	Repeal Obamacare including associated taxes
Tax cuts for working families and small businesses	Free college tuition	Cut corporation tax to 15%	Simplify tax code	Reform energy market to allow exports, free up development
Comprehensive immigration reform	Break up the banks	No inheritance tax	Pro-life / anti-abortion	Cut taxes for small business to 25%
Raise minimum wage (but cut red tape for small businesses)	Raise minimum wage	Forced one-time repatriation of corporate cash held abroad at discounted 10% rate	Improve the education system	Focus on defence (esp wrt countering Russia and protecting Israel)
Tax break to companies who share profits with employees	Paid vacation, parental leave, sick pay	No more deferral of taxes on overseas income, but foreign tax credits remain	Protect the right to bear arms	Protect innovation from regulation
Aims to curb 'short-term activist' shareholders and 'quarterly capitalism by changing Capital Gains Tax to favour long term investing **Tackle dangerous risks in the financial sector**	Universal childcare	Immigration clampdown		Simplify personal tax code to 3 brackets
Specifics				New child tax credit $2.5k per child
Install 500m solar panels in first term		Discourage corporate inversions through low taxation	Ban abortion after more than 20 weeks	End marriage tax penalty, more paid leave for parents
Reduce criminal penalties for non-violent crime		Simplify tax code with 4 brackets instead of 7		Interest no longer taxable or deductible
Establish infrastructure bank		Reduce tax avoidance		No CGT or dividend tax for businesses
Guarantee college affordability		Limit green cards issued abroad		End diplomatic relations with Cuba
Tax high-frequency trading				Establish territorial tax system to encourage cash repatriation
Close Volcker rule loophole on bank-owned hedge funds				Reduce government spending
Reduce the costs of prescription drugs				Cut taxes for business to 25%,

Source: Candidate websites

Potential market implications

Aside from the more predictable differences between left and right in terms of government spending and general 'business-friendliness' which intuitively (but not necessarily) sees markets favouring a Republican win, there are a number of points above worth dwelling on.

a) To the outside observer, **Hillary Clinton** and **Marco Rubio** would appear to have the most 'mainstream' and potentially least divisive policy sets at the macro level and thus be a benign outcome for markets. However, in Clinton's case there are some policies with specific potential implications such as:

1) Immigration reform (i.e. allowing more immigrants to access the legal labour market) and reducing incarceration may expand the tax-paying workforce.

2) Raising the minimum wage may increase pressure on margins for labour-intensive industries.

3) The focus on drug pricing is a potential concern for Pharma (though such pledges have been made before and medical R&D is also a Clinton campaign pledge).

4) Taxing high-frequency trading and closing the Volcker 'loophole' may cause disruption to parts of the banking industry.

While he is behind in the polls, **a Rubio victory may be the most welcome outcome for markets** with promised tax cuts and pro-enterprise policies. His energy and defence policies could also have material implications for those sectors.

b) A victory for **Bernie Sanders** would be a bad outcome for markets with the focus on rebuilding trade barriers and generally anti-business tone. Based on polling this seems an unlikely event.

c) **Donald Trump'**s radical proposed tax code changes may be welcomed despite the forced repatriation of cash (or forced fee to be more precise – cash deemed necessary can be left abroad) primarily due to the cut in corporation tax. However given the perception of Mr Trump in the media as a divisive candidate it seems quite likely the market would worry about the stability and predictability of a Trump-led administration. Perceptions can change of course, but a Trump nomination (and especially any subsequent polls showing a reasonable chance of a presidential win) may be taken with nervousness.

d) **Ben Carson** currently carries some traditional conservative US causes such as a hawkish defence policy and a pro-life stance. However it is his fiscal conservatism which could appeal to markets with a plan to revise the tax code. His defence policies could have important implications for related sectors also. After Marco Rubio and Hillary Clinton, Mr Carson seems like the most benign outcome for equity markets.

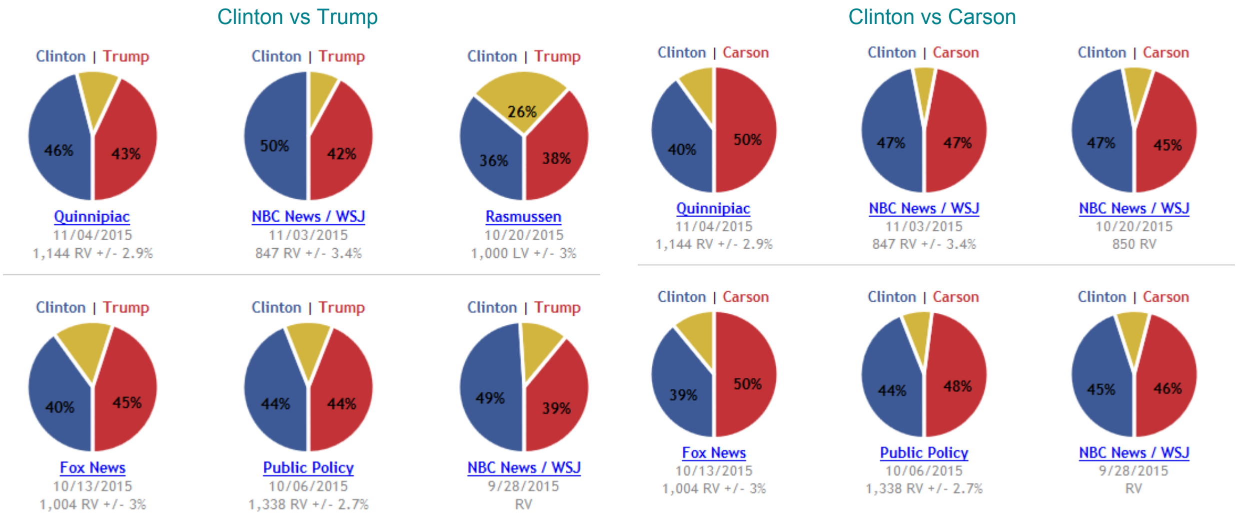
We also note that both leading candidates promise tax cuts for middle-class / working families.

Who will win the 2016 election?

At this early stage this looks difficult to call. Depending on the permutations of who wins the 2 primaries the polls show different results. It's almost a year until the election (Nov 8^{th} 2016) and the public perception of the candidates can ebb and flow, not to mention the state-by-state dynamics that can tip the balance in a close contest. However, on current polling a Clinton-led Democrat card would possibly win over a Trump Republican offer but looks much less certain against Carson or Rubio. We show polls for Clinton vs Trump and vs Carson below (where recent Clinton vs Rubio polling looks similar to Carson).

Figure 104: Clinton over Trump…but looks close vs. Carson

National Matchup polling



Source: 270 to win.com

Election Conclusion

– Providing Clinton's large lead in the polls remains, the main risk on the primaries during H1 is the Republican nomination.

– A likely Trump nomination win (with close-looking presidential polls) may provoke some nervousness.

– A Rubio nomination win (with close-looking presidential polls) could be taken positively by markets

– The focus then clearly shifts from June into which of the two candidates will win.

Trading Patterns around US elections

Each election is different, but what does history tell us about equity market performance in this phase of the political cycle? Looking at elections over the past 40 years we can see that on average the US has outperformed the MSCI World index, including in 5 of the last 6 cycles. See below.

Figure 105: The US market outperforms on average in an election year

SPX vs MSCI World

Winner	Date	-12m	-6m	-3m	+3m
Carter	02/11/1976	9%	5%	2%	-3%
Reagan	04/11/1980	-1%	1%	-2%	3%
Reagan	06/11/1984	-3%	6%	-1%	4%
GHW Bush	08/11/1988	-7%	3%	-2%	-1%
B Clinton	03/11/1992	14%	2%	0%	5%
B Clinton	05/11/1996	6%	7%	3%	7%
GW Bush	07/11/2000	4%	5%	1%	0%
GW Bush	02/11/2004	-4%	-1%	-2%	-2%
Obama	04/11/2008	5%	5%	5%	-1%
Obama	06/11/2012	4%	0%	4%	-1%
	AVERAGE	**3%**	**3%**	**1%**	**1%**

Source: Exane BNP Paribas estimates

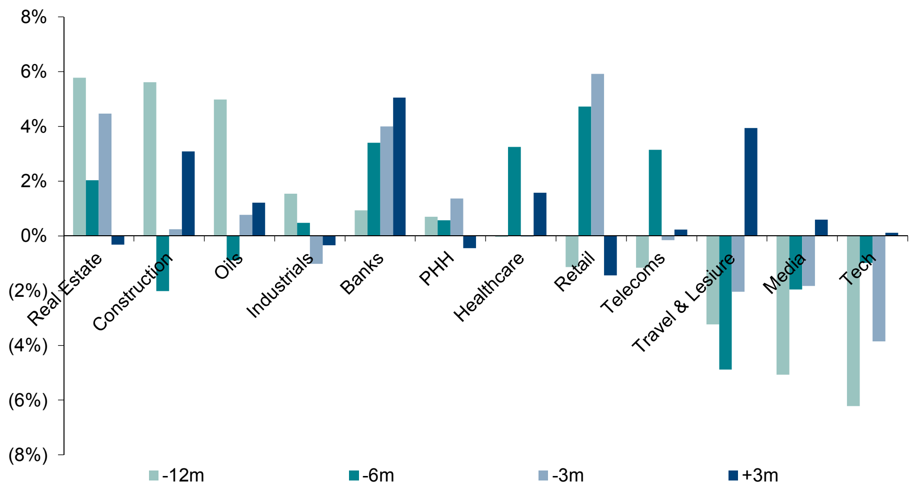
Absolute returns have also been positive (on average) in election years with an average gain of 8% in the S&P in the 12 months before an election, with most of this concentrated in the first 6 months (i.e. the primary period). There have been a number of US studies on whether elections really impact stock market performance, with no clear consensus. What is clear is that policy is influenced by the electoral cycle making less popular policies and reforms more likely earlier in presidential terms and 'giveaways' more likely as elections approach.

What about sectors?

An election year can heighten the focus on specific sectors. While the stage of the economic and monetary cycle has varied over the years, looking at the median average relative performance throws up some interesting results. While we can't claim to have anything more than speculative explanations as to why, Real Estate and Banks have generally outperformed through election years, whereas Travel & Leisure, Media and Technology have usually fared badly. See below.

Figure 106: Election years: good for financials, bad for some cyclicals

Median US sector performance relative to S&P500, last 10 elections (selected sectors)



Source: Datastream, EBNPP. Ordered by rel performance in 12m prior to election

How does this all affect our regional view of the US?

While a Clinton victory presents little obvious threat to markets, there is clearly some tail risk around the election campaign depending on which Republican wins the nomination and how they fare in the polls vs the Democrats.

It would be disingenuous to suggest that Europe's political landscape was without risk (Greece, Brexit, Portugal etc), however the 2016 political calendar looks relatively clear with elections in Spain on 20 December 2015 carrying the most uncertainty.

While we hesitate before making such a statement, 2016 looks like a rare year where the US political risk (while still relatively low) could even turn out to be higher than in Europe.

Conclusion: We still prefer Europe to the US

We have concerns on the directional movement of equity markets globally, and the US is often seen as more defensive. However in a relative sense with financial conditions tightening in the US but relatively benign in Europe, greater cyclical upside to European margins, clear risk of further USD strength and a more balanced picture of political risk between the two regions **we continue to see a better outlook for equities in the old continent.**

Europe vs Japan

As covered in the valuation section, Europe has re-rated vs Japan on both the valuation metrics we show and now sits at parity on P/E and at a modest discount on EV/EBIT.

However, as covered in our note last month (Yen in Black) we continue to see reasons to prefer Europe. Our main conclusions were as follows:

1) **The Japan QE precedent suggests limited upside from monetary easing at this stage of the ECB programme, but is largely supportive of a domestic sector bias.**

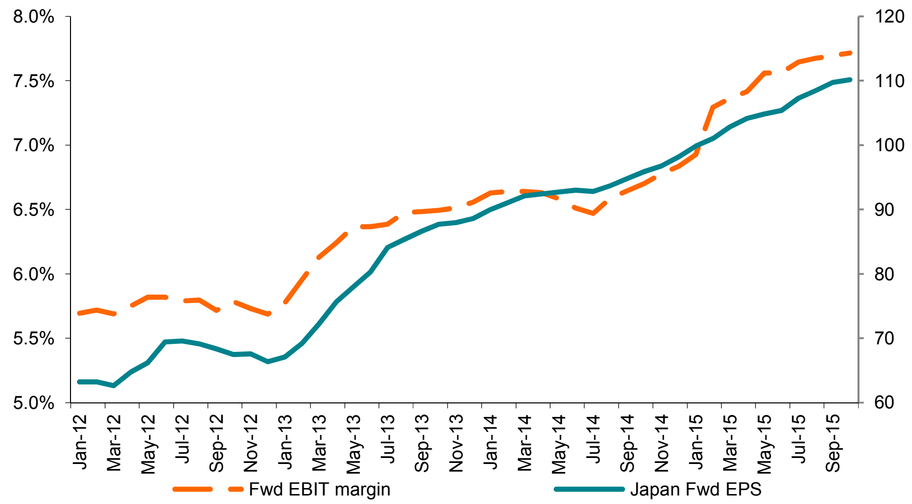
2) **The structural upside to Japanese returns is enticing, but progress looks slow. European labour market reforms are better progressed.**

3) **The cyclical upside to returns in Europe looks far stronger, and the economic indicators are also much more encouraging.**

The growth in Japanese earnings (which almost doubled) during the QE period was very much driven by a margin recovery. See below.

Figure 107: Japan EPS growth driven by margin recovery

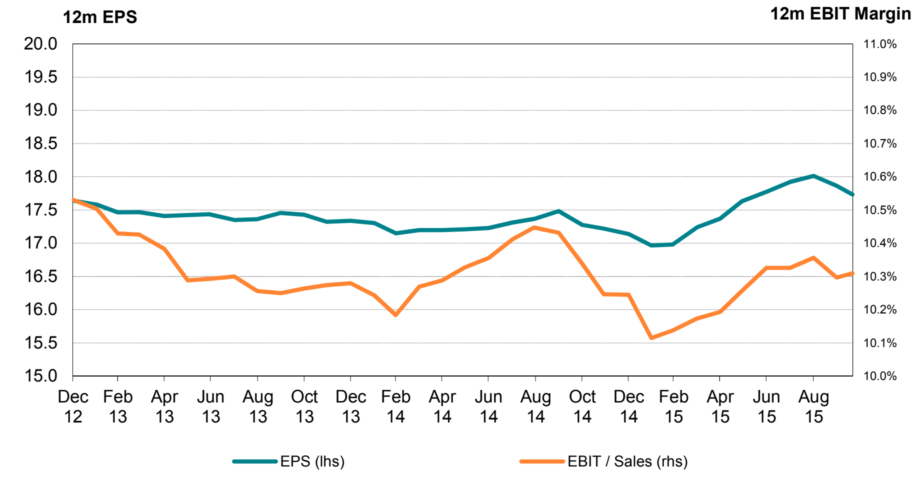
Japan consensus EPS vs EBIT



Source: Exane BNP Paribas, Factset Estimates, MSCI, Datastream,

In Europe however, we are really still waiting for a QE-led margin recovery. See below.

Figure 108: Eurozone margins have not seen the same recovery
EuroStoxx ex Financials EPS vs EBIT



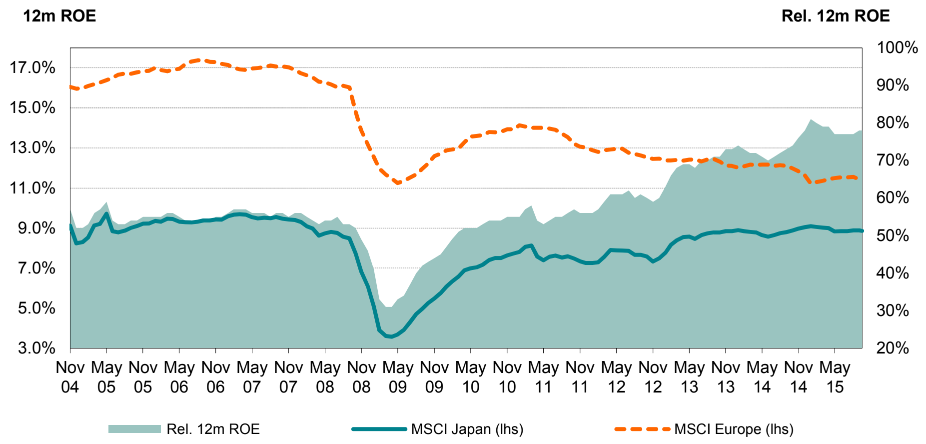
Source: Exane BNP Paribas, Factset Estimates, MSCI

Cyclical returns potential looks stronger in Europe

This brings us onto returns. The chart below shows that returns in Europe remain some way below the pre-crisis level – and this is not just a case of falling returns in Oils, Miners or Banks (the Eurostoxx ex-Financials shows a very similar picture).

Indeed, **while Japan's market ROE has improved by 200bp over the past 3 years to its pre-crisis level, Europe's has flat lined and is still 500bp below its pre-08 run rate**. See below.

Figure 109: Europe appears to have more upside on ROE
Consensus ROE, 12m Fwd



Source: Factset, Datastream, EBNPP

Structural returns upside in Japan

It has long been the case that returns in Japan fall well short of global peers with low dividend payouts and idle cash piles two of many contributory factors. **With ROE now back at pre-crisis levels one needs to believe in structural change to justify meaningful returns upside**.

There have been moves towards changing corporate behaviour from the authorities. Abe's third arrow of policies include structural reforms targeting higher female employment, a reduction in cross-holdings, lower tax rates etc. But the most significant were new corporate governance and stewardship codes focused on raising return on equity. The GPIF (Government Pension Investment Fund) which effectively owns c.10% of the domestic market has signed up to the new codes and is investing in the Nikkei 400 index which places a higher weight on ROE than profitability.

The national proxy advisor ISS has also said it would recommend against reappointing directors whose businesses don't meet an average 5 year ROE of 5%. This has not yet happened – and as **we are talking about a fundamental cultural shift in corporate behaviour, the effect of these positive moves seems likely to be slow.**

Returns: Cyclical or Structural

For investors wanting improved returns, the choice here is between cyclical upside in Europe and structural upside in Japan. **Given the more tangible signs of progress in the Eurozone economy vs the likely slower progress on changing Japanese corporate culture we think Europe is the better placed here at present**.

The Japan bull case – Macro

A separate reason to prefer Japan might be the wider economic recovery and the pro-growth structural reforms to labour markets that could help this along.

Japan Political Calendar: relatively clear

With elections for the (lower) House of Representatives completed in late-2014 with Abe re-elected, the main 2016 event is the Upper house elections in July for half of members (half of the assembly is elected every 3 years). However, as intended by the snap election called by Abe last year, the political calendar looks relatively clear for the government to press ahead with reforms..

Consumption Tax – Black Cloud remains

The pro-growth agenda of Abenomics has to operate under the consequences of two decades of failed growth initiatives. Government debt in Japan is 250% of GDP, way above the levels of c.100% or less in other mature markets. Thus as fiscal stimulus is launched there is also a perceived need to demonstrate the country can balance its books or better over the mid-to-long term. This is where the consumption tax hikes come in:

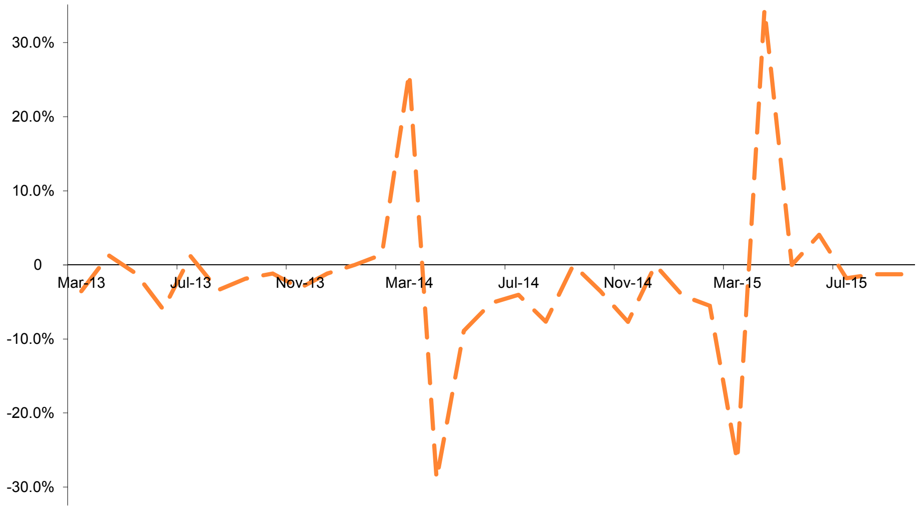
– The tax was first raised in April 2014 from 5% to 8% giving a temporary boost to inflation but also prompting a significant amount of forward buying from consumers.

– The next step is to raise from 8% to 10%, and this is currently scheduled for April 2017.

With consumer surveys showing anxiety prior to the 2014 hike and notable shifts in behaviour for what might seem (to the non-Japanese observer) a relatively modest change in prices. As an example we show below the surge in Japanese cigarette sales in March 2014 which stands in stark contrast to (for example) the UK when the last VAT rise led only to very little forward buying. This was seen in a variety of consumer categories from cosmetics to cars and consumer spending in general was clearly affected by the move.

Figure 110: The tax hike was a major event for consumers

Japan cigarette sales by volume, yoy change



Source: EBNPP

In our view this highlights the specific mindset of the Japanese consumer with regard to prices. As such we expect the 2017 hike to also weigh on the consumption-led rebound in growth hoped for by the government in late 2016.

Government micro-management also unhelpful

We also note that in the case of the April 2014 hike, the Ministry of Finance (MoF) urged all makers of consumer products to only raise prices by the consumption tax hike, effectively limiting any meaningful manufacturer pricing for 2014. While the reasons for doing this are perhaps understandable given the extreme sensitivity of consumers (and thus the economy) to price moves and the negative impact of the late-90s tax increase, **this also serves as an illustration of how Japan is often far from a 'free' market when it comes to pricing**.

The Equity Market is not the economy

We should also note that Japanese equities are more internationally exposed than the domestic economy, and weak international trade (including for Japan) is arguably dilutive from an equity market perspective. Around 45% of sales for companies listed on the Japanese equity market are overseas (per Bloomberg). The domestic economy is less open: exports make up c.18% of GDP and total trade (imports plus exports) make up 35%, as compared to Germany at 85%, the UK at 60% and the US at 30%.

Limited Labour market reform

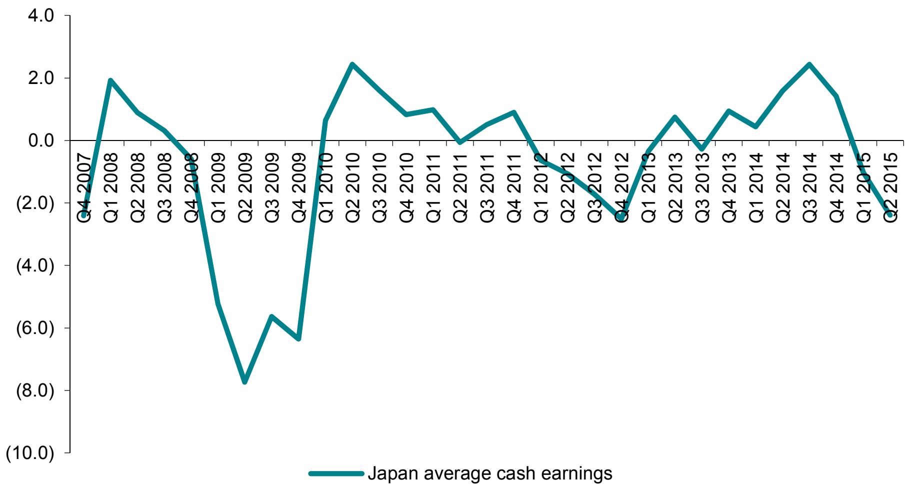
Perhaps the biggest need for reform is in the labour market. There remains a 'gulf' between the status of temporary vs permanent employees in Japan and to date this has not been tackled (highlighted as key to raising productivity by the IMF) and recent proposals for a white-collar exemption from working hours rules were dropped. Measures so far include:

– **Female participation**: A female empowerment bill was passed to encourage larger companies to hire more women (albeit this is not compulsory) and for more senior roles. Japan's female working rate at 66% does not compare badly to other mature markets but is well below the 85% among males. There are some cultural barriers here but the government does seem to be moving in the right direction.

– **Pressure to increase wages:** Given the focus on reflation, the Abe government has tried exhorting employers to raise wages. So far this has had little discernible impact as although the wage deflation of 2012/13 looks mostly to be over, monthly wage inflation is running at less than 1% year on year (and was negative in Q2). See below.

Figure 111: Wage growth anaemic

Japan growth in cash earnings, all industries



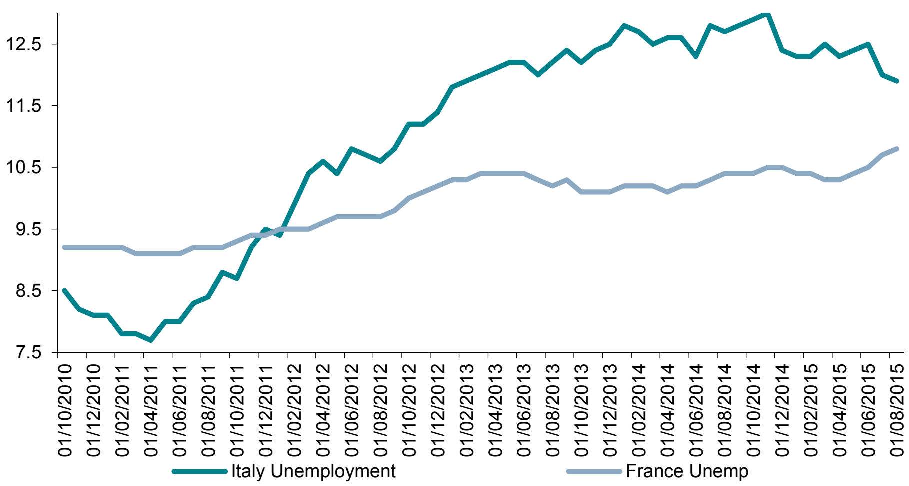
Source: Datastream

Contrast to Europe

While structural reforms in Japan may not yet be at the optimum level, it would be wrong to suggest Europe was a bed of roses. We review below the status of labour market reforms in Spain, France and Italy. In particular the two big 'swing' economies in a Eurozone recovery would arguably be France and Italy. Here we can see recent diverging unemployment rends.

Figure 112: Unemployment falling in Italy…not in France

Unemployment rates, Italy, France



Source: National statistics, Eurostat

– **Italy labour market reforms – some progress:** Italian leader Renzi's recent 'jobs act' included measures to reduce the cost of laying off workers and diminish the gap in status between permanent and temporary workers. This is all aimed to increase flexibility and the hiring of permanent employees, with the OECD forecasting the measures (and separate female participation reforms) would increase GDP by 0.6% over the next 5 years.

– **France reforms**: Things have progressed more slowly in France (see our March report STRATEGY: French enlightenment?,) with still has a long way to go in terms of reforming the labour market. However with EUR40bn of tax cuts designed to lower labour costs voted through by Parliament there is some impact to be felt over 15/16.

– **Spain – election is key:** Spain has made some progress with labour market reforms, with 2012 reforms giving more flexibility on wages and working hours, (but still leaving work to be done on the temporary vs permanent divide) and indeed unemployment has been falling markedly as the economy recovers. The main area of uncertainty is the upcoming election, which could see either a freeze or backwards developments in such moves, depending on who holds the balance of power. At present the polls are not too worrisome (with Catalan secession arguably a bigger question).

Conclusion: Europe improvement more tangible

The labour markets in Europe and Japan are different: while unemployment is seen as the core issue in the Eurozone it is wage growth that is targeted by Japan (where joblessness per se remains very low at 3.4%). However, while Japan is moving towards taking some steps in the right direction there does seem to have been more progress in the big swing economies of Europe, and falling joblessness in Italy and Spain are encouraging markers of that.

Japan vs Europe overall

From both a returns and macro perspective we continue to see a more attractive 2016 story in Europe vs Japan. With similar valuations and earnings growth this informs our conclusion that Europe remains preferable. **The key risk to this stance is monetary policy, where any material change in the respective QE programmes could influence both earnings and valuation.** Currently the ECB seems to be sending the most accommodative noises..

UK vs Europe

An important consideration for some investors (and a subject close to our hearts given our place of work) is the specific investment case on UK equities relative to the Eurozone, where the consensus view in 2015 has been a clear preference for the latter. Can we muster a contrarian buy?

Some UK comfort from European sector preferences

At the pan-European level we are implying a slight bias towards more UK-centric sectors through our sector implications, notably Media, Telecoms and Healthcare (though if one wants to play Healthcare, Switzerland is probably a better bet).

Figure 113: Sector allocation broadly Neutral for the UK

UK-centric sectors highlighted in bold (including Healthcare as comparison is to Eurozone)

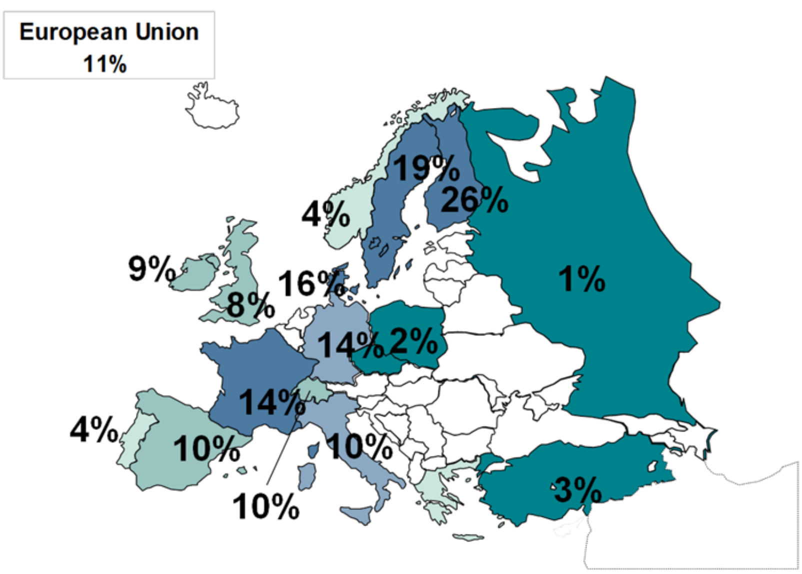
Underweight	Neutral	Overweight
Oil & Gas	**Basic Resources**	**Media**
Retail	Technology	Construction
Autos	**Travel & Leisure**	**Healthcare**
Industrials	Food & Beverages	**Telcos**
Chemicals	Utilities	Insurance
Personal & Household	Banks	Real Estate
	Financial Services	

Source: Exane BNP Paribas estimates

The UK is also 'underweight our underweights' in Autos, Chemicals and Industrials (shown below).

Figure 114: The UK is underweight Industrials

Market cap weight to Industrials



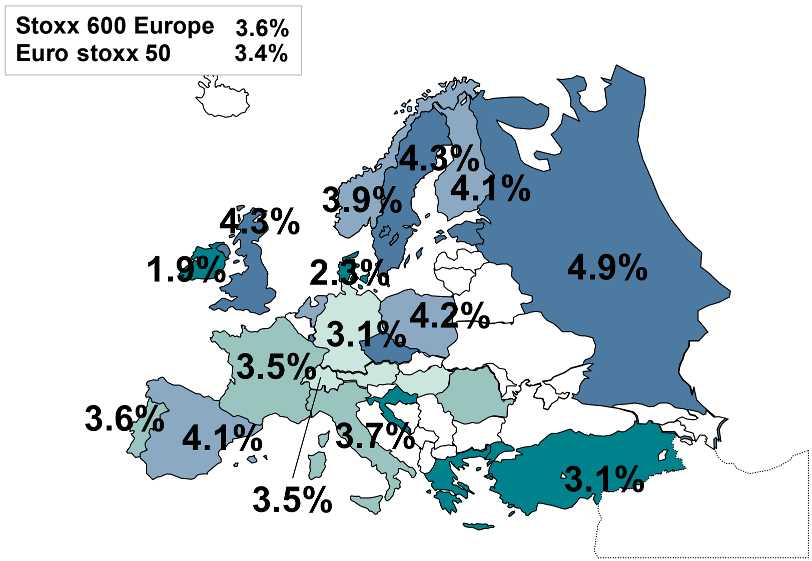
Source: Exane BNP Paribas estimates

Also a higher yield…

As we show below the UK has a higher yield than the Eurozone, and while a good portion is from Banks and Oils there is also a chunk of Pharma and Staples names that one would think allow reasonable dividend growth. This said, in the case of Staples the FX headwinds of recent (and we think future) quarters are impinging on DPS growth rates and as mentioned previously **we favour a stock-selective strategy to best play the dividend theme**. There are also non-stock specific ways (e.g. specialist dividend indices like the 'dividend aristocrats').

Figure 115: The UK is a source of yield…

2016e consensus dividend yield

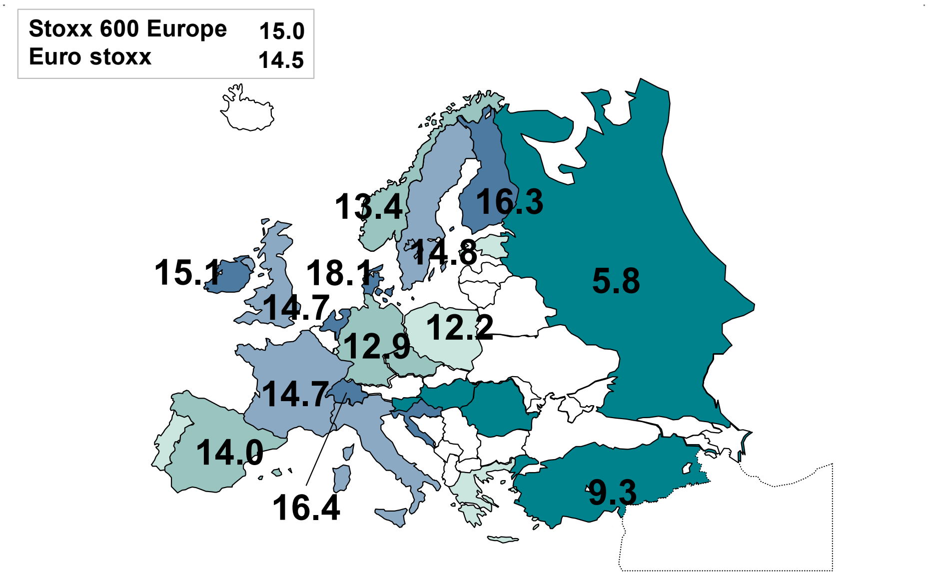


Source: EBNPP, Bloomberg

Is this enough?

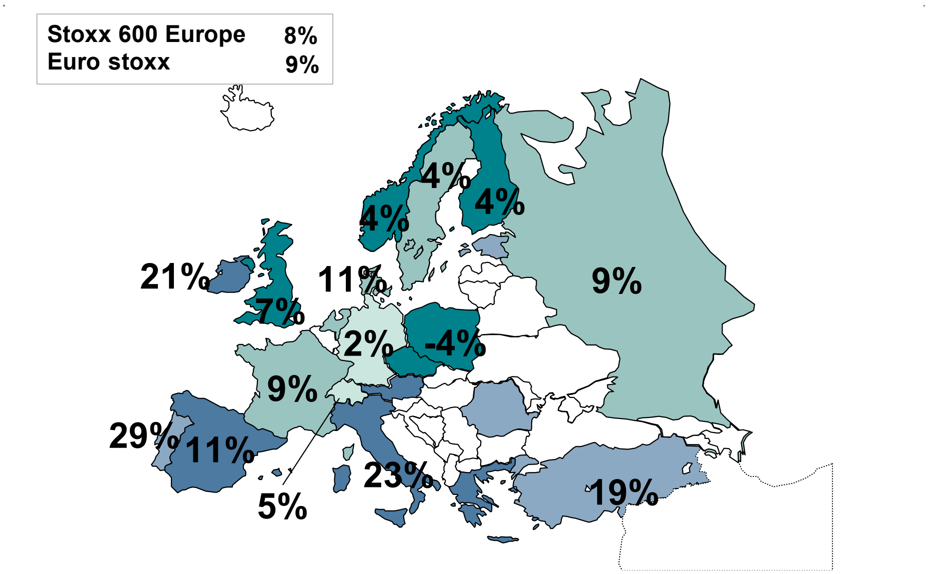
Yield may be higher in the UK, but what of multiples and earnings? We start with some high level maps.

Figure 116: Valuation is in line with the EuroStoxx..
2016e consensus P/E



Source:EBNPP, Bloomberg

Figure 117: …but UK expected EPS growth is below the EuroStoxx
Consensus 2016e EPS growth, main sector indices



Source: EBNPP, Bloomberg

UK relative valuation argument looks tough

The UK clearly has an outsize weighting to Financials and Resources relative to Europe. Most of these stocks have a below-market P/E thereby dragging down the average. We show below the UK market vs the Eurostoxx excluding these sectors where there is no relative discount (in fact a small premium) on forward P/E.

Figure 118: The UK excl. Fins & Resources trades at a small premium on P/E…

Consensus Fwd P/E, UK vs Eurostoxx (both ex-Financials)

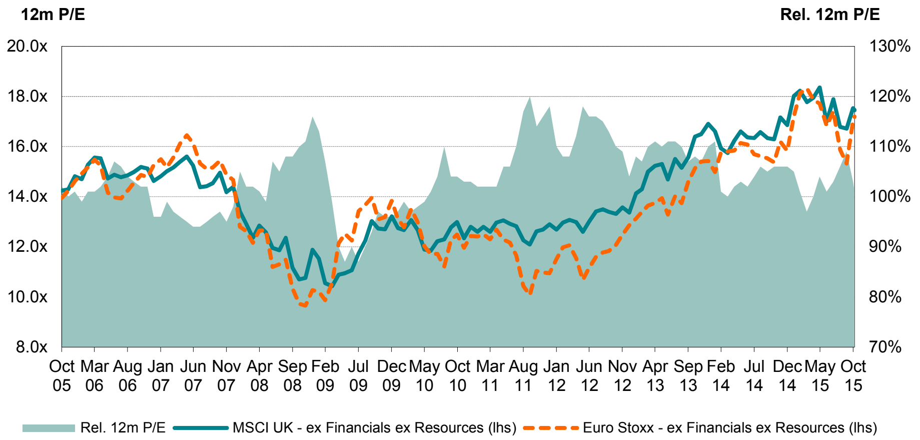
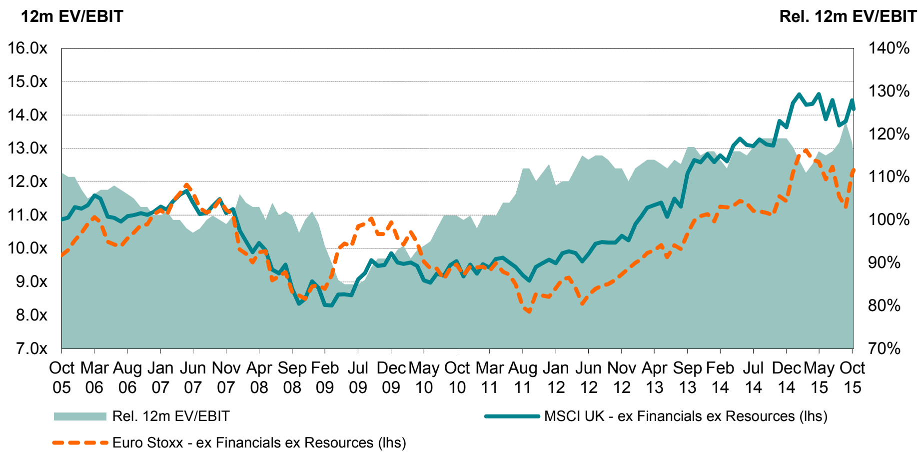


Figure 119: …and at an all-time high on EV/EBIT

Consensus Fwd EV/EBIT, UK vs Eurostoxx (both ex-Financials)



Source: Exane BNP Paribas, Factset Estimates, MSCI

Though the above metrics remain imperfect comparisons (the UK having more Staples & Pharma for instance) **with lower starting earnings growth than the Eurozone and a more mature cyclical recovery, it seems intuitively hard to make a relative valuation argument. Coupling this with our concerns on unsecured credit and disposable income growth we (sadly) cannot justify a contrarian long UK stance.**

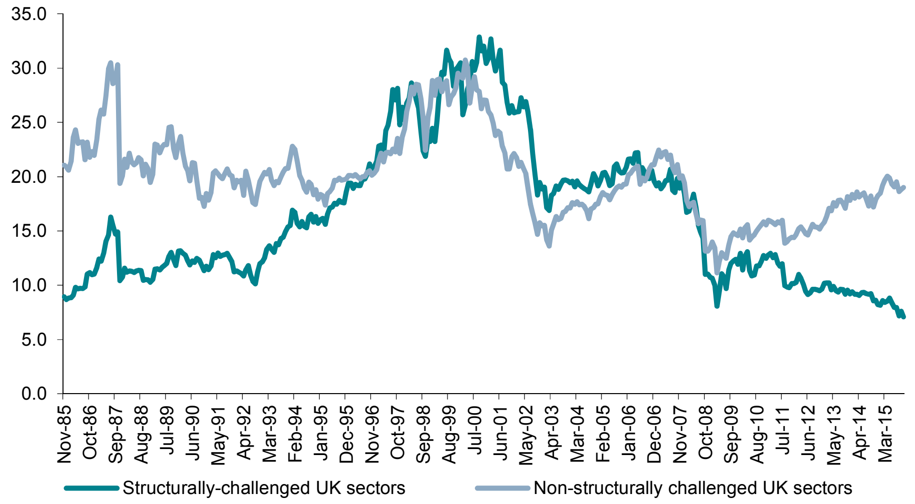
The UK – consumer cooling

"I made a killing on Wall Street…I shot my broker" – Groucho Marx. Hopefully that doesn't resonate. Perhaps JP Morgan produced a better quote when asked what the stock market was likely to do – "it will fluctuate". In the case of the FTSE 100, this looks very apt. In the summer of 1998, the FTSE 100 traded within a couple of points of the level on the screens today. Thankfully there have been dividends in the interim, but nevertheless, at the headline level the market has gone nowhere in the last 16-years. Is 2016 destined to be the breakout year? Unfortunately it doesn't look that way.

The outlook for the global economy, combined with tightening in US and potentially domestic monetary policy, do little to suggest that 2016 will prove to be a vintage year in either earnings growth or valuation expansion terms. There are certainly more aggressively valued equity markets elsewhere in the word, but the UK rating, when adjusting for the new world profile of Resources and Financials, is not overly cheap.

The following chart makes the point on a CAPE basis which smooths the earnings profile over a 10-year period. Will multiples push higher against first a US and then potentially a UK rate cycle? Doubtful in our view.

Figure 120: Cyclically Adjusted PE – splitting out the 'structurally challenged' sectors



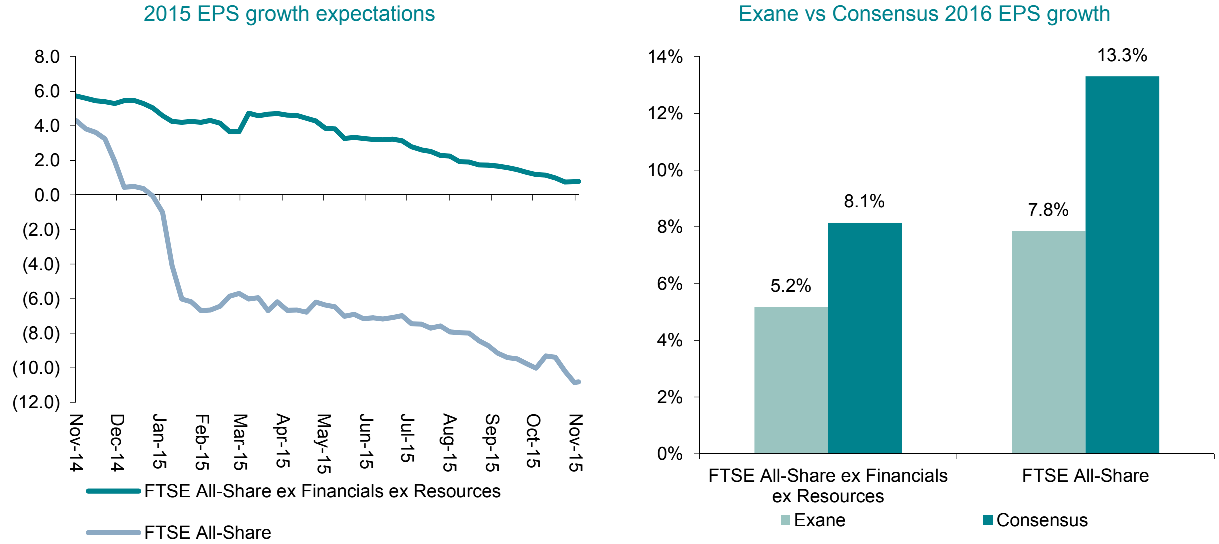
Source: Datastream. Financials and Resources classed as structurally challenged.

Away from the cyclical smoothing, we discuss the 2016 outlook for earnings growth elsewhere in this note. Our top-down model suggests downside risk to consensus market earnings next year (we model ex financials ex Resources given the volatility in these numbers).

Intuitively this squares with the minimum wage inflation, fiscal drag, trade weighted sterling strength (although we expect some relief against the USD) and business rates inflation that will take a toll on UK company margins. Not all companies are exposed to each of these factors clearly, but in the round they combine to present a significant headwind to corporate profits.

Our forecasts do not look terrible but for the FTSE All Share – but at 7.8% compared to consensus 13.3%, the gap looks large enough to present a material performance drag. And stripping out the volatile Resources and Financials components we are at 5.2% against the consensus' 8.1%. As the following charts show, 2015 forecasts have fallen steadily this year, even when excluding the dramatic impact of the Oils and the Miners or Financials. Our fear is we have another round of downgrades – hopefully not of this magnitude though – in 2016.

Figure 121: EPS growth expectations for the UK market



Source: Factset, Exane BNP Paribas estimates

In light of a valuation that has at the very least normalised, consensus earnings forecasts that look subject to downside risk, and the global influences that we discuss elsewhere in this note, we do not think there is strong case to believe a strong upward directional trend is about to form. Rather, for us at least, the start of 2016 is still likely to be dominated by downside risk.

In this environment, portfolio strategy should manage beta conservatively. And given the enthusiasm for consumer cyclicals within UK portfolios over the last 2 years, we go on to discuss here why we feel sector allocation should adopt a cautious stance on this area of the market.

UK macro

The UK story may feel very familiar. Robust labour markets, underpinning domestic demand, while manufacturing exports lag and fiscal policy drags. This is the story of the last couple of years and there is still some traction going into 2016. But while the general thematic holds there are a few nuances to this underlying picture.

First, manufacturing orders are particularly weak. Presumably this in part reflects the strength of trade weighted sterling, but no doubt this is also a function of the poor trends seen in global industrial production and trade.

Second, the pace of fiscal consolidation is accelerating. Post-election this was always going to happen, with the full force waiting to bite in the next financial year. We wait to see whether the Autumn Statement eases back a touch on current plans, but if fully implemented the planned tax credit cuts are likely to take a significant toll on Household Disposable Income growth.

Third, the 'will they won't they' debate around UK monetary policy looks to have been deferred again into the later stages of 2016. We would caution that on this point, the Bank have demonstrated a willingness to sharply change communication within a relatively short space of time so there is plenty of scope for this to re-ignite. What seems clear at this juncture though is that there is little tolerance for further appreciation in Sterling. Combine this with the Brexit debate and we suspect the appreciation of Sterling will fade, and arguably against the USD start to reverse.

But it is away from these broad macro debating points that we feel the most interesting angle is now developing. Carney made reference to unsecured consumer credit growth in his last press conference. His concern is no surprise to us. We have first-hand experience of the easing and availability of credit in the UK.

Consumer Credit – the Valentin Fily case study

This time last year, my esteemed young colleague, Valentin, accompanied me on a marketing trip. To my annoyance, sitting in the hotel bar in the evening, Vali was drinking especially slowly and showing great reluctance to get a round in. Eventually I confronted him, and all became clear – he was skint. Now, this I pointed out, was not a problem - it is convention in this industry for the company to pay one's travel expenses. But it got worse. Not just skint, but cash flow constrained too.

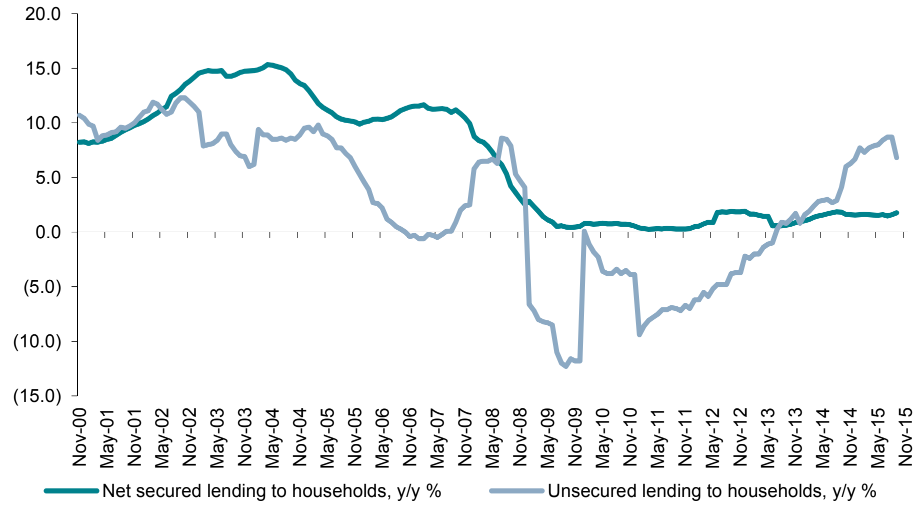
It turned out that Vali was having to cover his travel expenses on his current account debit card as no lender would approve a credit card for a young stockbroker one year into his career. This struck me as hilarious, but also quite strange – he's not exactly on the breadline with a shiny new Vespa and a flat off the King's Road.

Fast forward 12-months. Having spent a year trying and failing to get a credit card, young Valentin now has got himself 3, including a very fetching silver AMEX. Each one arriving with a higher credit limit than the last. It is no coincidence that Vali's shiny new Vespa has recently sprung a range of accessories. It is also no coincidence that Vali's 4 weeks (yes – 4 weeks!) of holiday this year consisted of trips to Mexico and Japan. When I suggested he may want to save a little more….the answer that came shooting back was that spending like this on the cards helps his credit score for a mortgage. Oh dear! It would seem that Governor Carney's concerns are well founded.

Consumer Credit – the data

Slightly more scientifically, unsecured consumer credit growth rates have accelerated sharply, with credit growth in this area now materially outstripping secured.

Figure 122: Secured vs unsecured lending growth

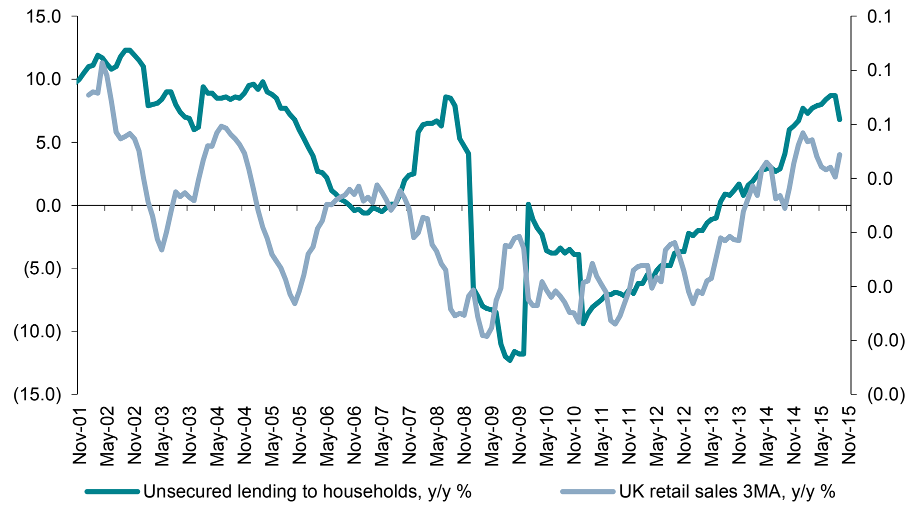


Source: Datastream, Exane BNP Paribas estimates

With this registering on the Bank of England's worry list, investors may want to question its sustainability. If lenders were asked to undertake additional affordability checks on new loan approvals or credit card applications, for example, then this could certainly impact the flow of credit to this area. The Mortgage Market Review implementation caused a significant fall in mortgage approvals for 6-months after its introduction.

The importance of this to key areas of the UK equity market should not be overlooked. Not surprisingly, consumer credit growth and Retail Sales growth are highly correlated.

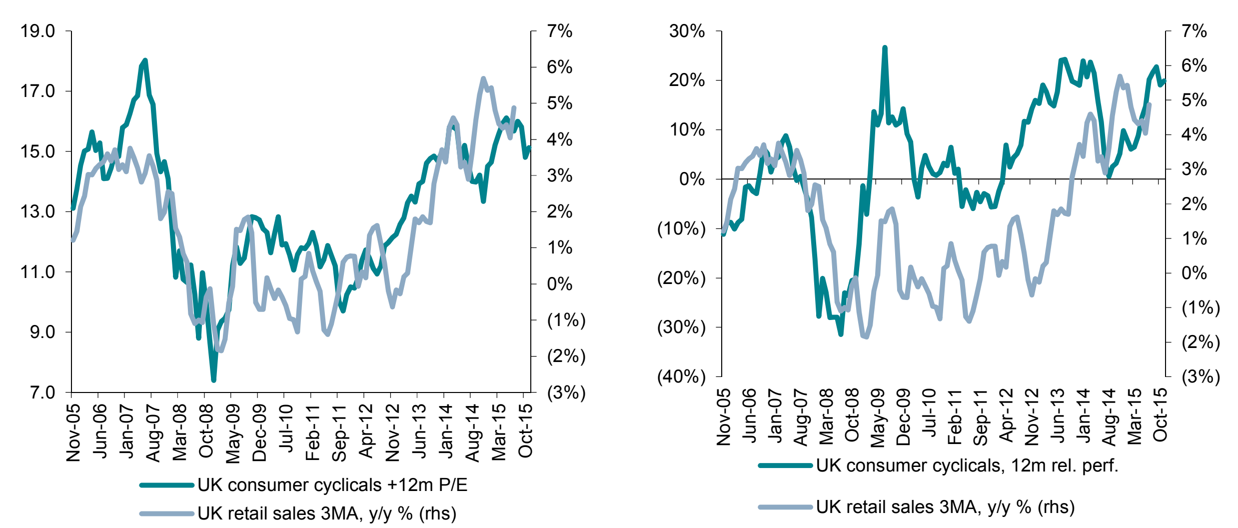
Figure 123: Unsecured lending vs Retail sales



Source: Datastream, Exane BNP Paribas estimates

And bringing this back to the performance of the related equity sectors, our basket of UK consumer cyclicals tend to correlate in relative performance terms with Retail Sales.

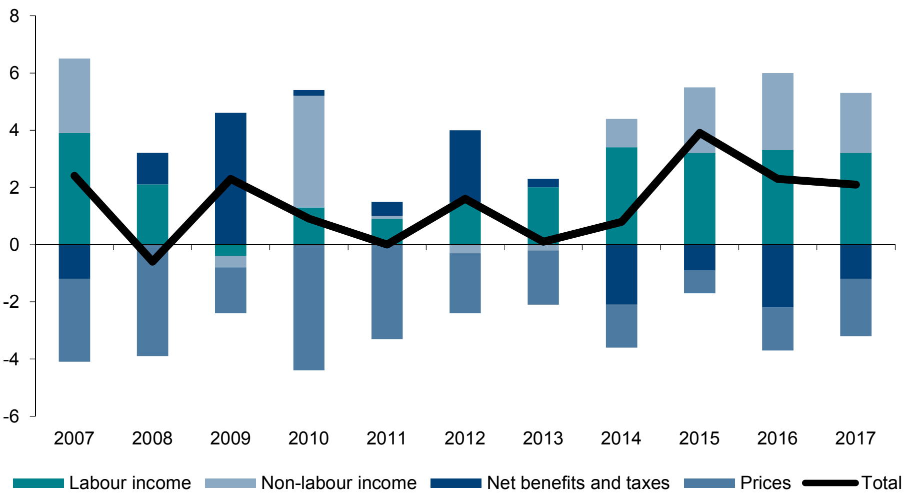
Figure 124: Our UK consumer cyclicals basket vs retail sales



Source: Datastream, Exane BNP Paribas estimates

In light of the point that we have made previously (STRATEGY: London Calling - up Carney Creek – that Real Household Disposable Income growth will be materially lower in 2016 versus 2015, as fiscal consolidation bites and inflation picks up from current levels – a negative delta on the pace of credit growth could have a tangible impact on the relevant areas of the equity market. Clearly this is sensitive to any slippage in the fiscal plan outlined in July, but it certainly does not look comforting.

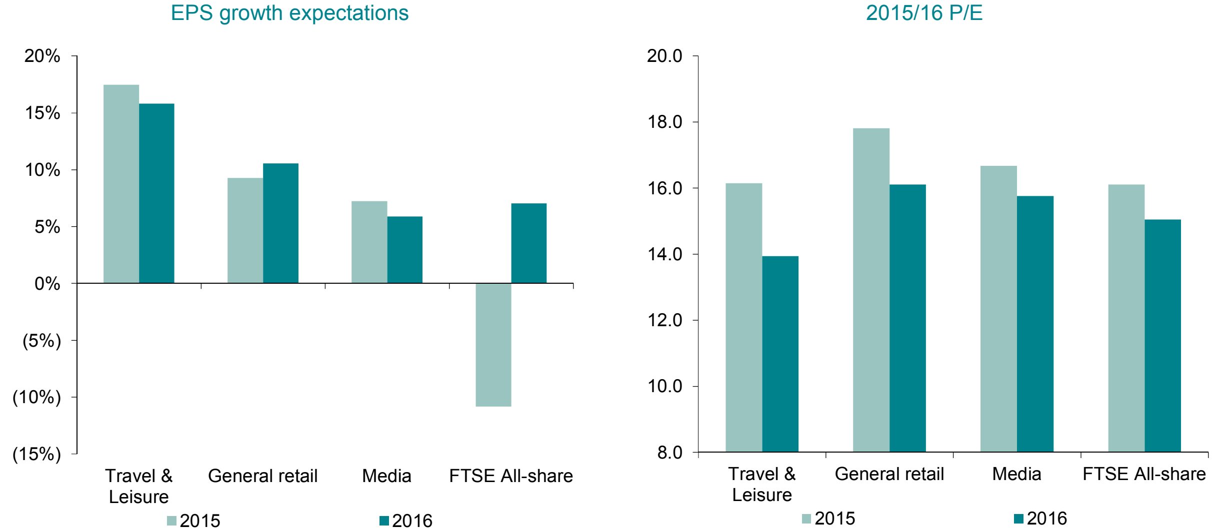
Figure 125: Household disposable income growth, 3.9% in '15 falling to 2.3% in '16



Source: OBR

From a valuation perspective, we find the UK consumer cyclical sectors command very full ratings and discount reasonably elevated EPS growth assumptions next year.

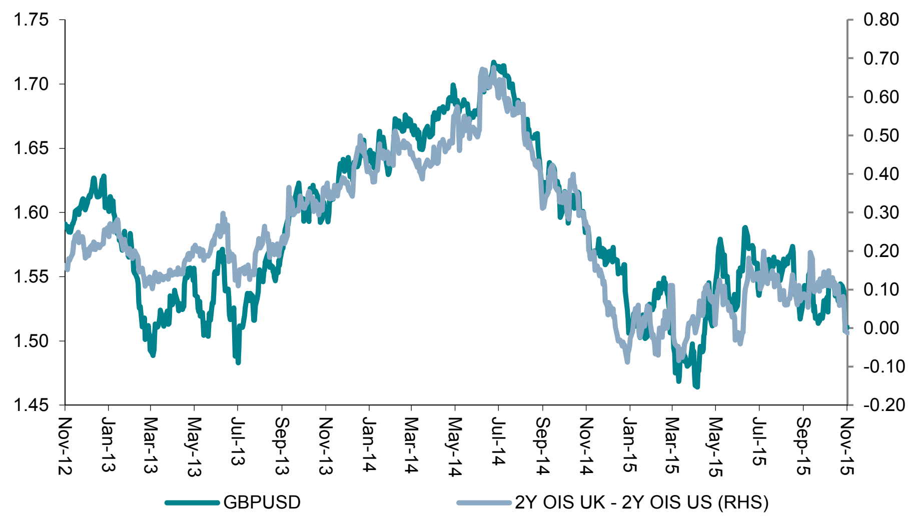
Figure 126: Consumer cyclicals growth expectations and valuations



Source: Factset, Exane BNP Paribas estimates

While we advise cutting exposure to UK consumer cyclicals, we see appeal in some USD earners and some of the low beta areas of the market where profit growth is perhaps more visible and consistent over this phase of the economic cycle. The following chart should demonstrate that after recent moves in interest rate expectations, there now appears to be downward rather than upward pressure on GBPUSD.

Figure 127: UK – US 2Y OIS differentials vs GBPUSD



Source: Datastream

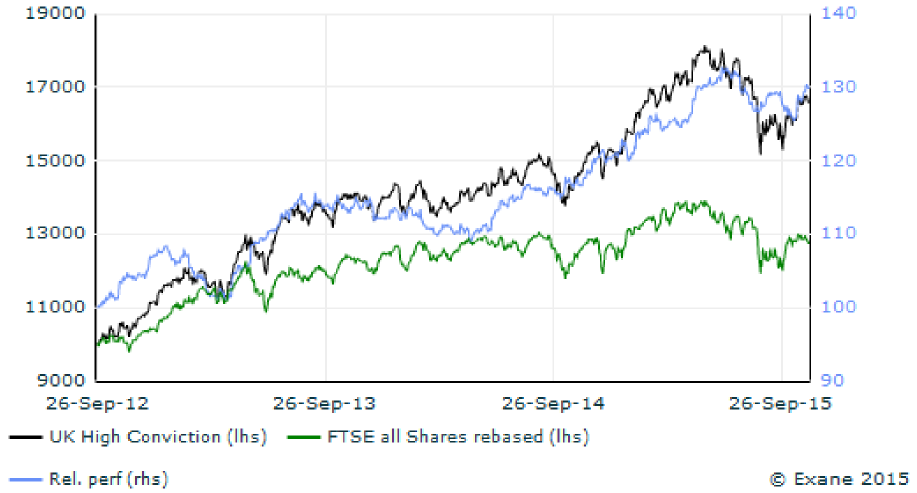
In the following sector we update our UK High Conviction list to reflect these views.

UK High Conviction

The Exane BNP Paribas UK High Conviction list (Bloomberg: EXDMHUKR Index) is designed to reflect our strategic top-down view of the market, and our analysts' best stock-picking ideas. Simply speaking, we aim to combine our thematic views – based on a number of factors such as the phase of the business cycle, valuations, style bias and earnings trends – with our colleagues' expertise in stock-selection.

The holding period for stocks included in the list is intended to be at least 3-months – but of course we will continually review this on the basis of price development and any material changes to the investment case. And we will evaluate the success or otherwise of the basket against the performance of the FTSE All Share.

Figure 128: UK High Conviction performance since inception (26 Sep 2012)



Perf	1d	1w	1m	3m	6m	12m	YTD	S.I
Abs	(1.2)	(0.5)	1.0	(3.0)	(6.8)	13.4	8.5	65.7
Rel. FTSE all Shares	(0.4)	0.3	2.3	1.7	1.1	11.3	7.5	29.8

Source: Exane BNP Paribas Datacenter as at 10 November 2015

This index is designed to showcase some of our analysts' strongest calls but also reflect how we, from a Strategy perspective, would shape a portfolio in light of the macro backdrop. It's good discipline all round. And Q3 was a harsh lesson in some of the frustrations of portfolio management.

At our last rebalance at the end of July we were up 890 bps ytd against the FTSE All Share. Since this point we have given up 140 bps to now stand 750bps over. It's not awful, but its deeply frustrating given we feel that for the most part we have been on the right side of the directional call. Put simply our implementation failed to manage risk appropriately.

We are addressing that issue today, and aim to put the index into a position we are more comfortable with as we approach 2016. The move we instigated in July to reduce domestic consumer cyclical exposure is maintained. The move to selectively buy USD earners is extended – sterling looks unlikely to materially appreciate against the US currency from here.

The changes we make are designed to reflect two additional views. First, we look to reduce portfolio beta and bias our stock selection toward lower beta stocks. This reflects the position of the cycle, with US policy rate risk. Second, we take our medicine – and it's been a bitter pill – and we further reduce the outstanding EM exposure. This predominantly means cutting Glencore. We express no view as to whether this represents poor timing or not. Thematically we do not want that exposure. And this dominates any focus on valuation. We should have reached that conclusion sooner.

The new additions to our index are Relx, Reckitt Benckiser, Pennon, Vodafone and RBS (straight swap for Lloyds reflecting analyst preference switch).

As mentioned, we drop Glencore and Lloyds, as well as Ashtead, Inchcape, Poundland and WPP. Inchcape we worry about in light of the global Autos cycle into an environment of rising US rates and potential upward pressure on credit spreads. These fixed income considerations are the reason we cut Ashtead too. WPP is dropped on its EM exposure and Poundland as we reinforce the move away from consumer exposure.

Figure 129: Exane BNP Paribas – UK High Conviction basket constituents

	Sector	Analyst	Upside (%)	3m % perf.	2016 P/E	2016 Sales % growth	2016 EPS % growth
ARM (+)	IT Hardware	Ramel, Jerome	23%	12%	32.3	20%	29%
AstraZeneca (+)	Pharmaceuticals	Baker, Simon	32%	-2%	17.5	-1%	9%
Imperial Tobacco (+)	Tobacco	Bushnell, James	9%	4%	14.5	8%	13%
Land Securities (+)	Real Estate	Burt, Michael	14%	-3%	25.9	NS	14%
Pennon Group (+) **NEW**	Utilities	Turner, Iain	20%	-1%	17.7	4%	21%
Reckitt Benckiser (+) **NEW**	Food & HPC	Stent, Jeff	12%	0%	23.2	4%	10%
Relx PLC (+) **NEW**	Media	Kassab, Sami	4%	6%	17.0	4%	10%
Rightmove (+)	Media	Packer, William	7%	6%	28.0	13%	19%
Royal Bank of Scotland (+) **NEW**	Banks	Rayner, Tom	16%	-7%	13.1	-2%	-9%
Spectris (+)	Capital Goods	Mounsey, Jonathan	13%	-8%	14.0	0%	6%
Vodafone Group (+)**NEW**	Telecom Operators	Williams, Michael	40%	-11%	57.7	1%	17%

Source: Exane BNP Paribas estimates as at 10 Nov 2015

Pennon – Iain Turner

Pennon is now our preferred pick of the UK water stocks with a 950p price target. It achieved "fast-track" status in the 2014 price review and this means that it enjoys better base returns and has more scope to outperform the regulatory settlement.

It has an unregulated waste business in which it has invested substantially over the past five years. The UK is implementing the EU landfill Directive by delegating responsibility to local waste authorities. After the financial crisis, Pennon's Viridor has been well placed to invest in the Energy from Waste plants that meet local waste authorities' needs. Once an EfW is built, with a secured long term contract from the local authority, then that local waste market is largely foreclosed to other players.

Reckitt Benckiser – Jeff Stent

We observe that one tends to make good money in Consumer Staples when companies change what they are (a good example being ABF morphing from a food conglomerate to a fast-growth retailer) as many investors can often be slow to recognise such change and continue to revert to historical pricing anchors.

We believe that Reckitt is such a case and that the valuation will continue to re-rate as the market shifts from viewing Reckitt as a conventional HPC stock to a Consumer Health play. In addition, we believe that Consumer Health will start to emerge as *THE* best sub-category within consumer staples (unlike other areas of staples there is no evidence of small more niche brands gaining share at the expense of large brands).

RBS – Jonathan Pierce, Tom Rayner, Guy Stebbings

We consider RBS' valuation to be a combination of excess capital and the value of go-forward earnings. At the current share price, we think the downside is very limited with appreciable upside. The downside floor relates to the now realised strength of the balance sheet. The equity tier 1 ratio of the bank is 16.5% (excluding Citizens RWA in full), MREL ratio is nearer 25% and the liquidity coverage ratio is 139%. The balance sheet is therefore extremely solid, capable of withstanding material litigation charges and with further capital accretion likely courtesy of another GBP80bn of RWA attached to the exit business. Our equity tier 1 ratio reaches 19% in 2017e. With go forward EPS in 2017 of 28p supported by dividends of around 15p, we see a floor of 280-300p a year out. Upside is then likely with excess capital of 75p at the end of 2016e, potential liquidity utilisation not factored into our numbers, additional restructuring of low return businesses longer term and GBP6bn of unrecognised DTA (indicative of balance sheet prudence).

Vodafone – Mike Williams

Q2's +1.2% made it five quarters in a row of improving organic service revenue growth – a positive 5.4pp swing over the period. The recovery has been broad based with 7 of Vodafone's 13 European markets now growing and good momentum in AMAP. The secular trend of mobile data consumption, the adoption of 4G and improved pricing discipline are all supportive of a further acceleration in the top line. Having absorbed cGBP500m of incremental Project Spring related technology costs over the past 18 months (45k incremental cell sites, 7.5m new fibre homes etc.) the group has now returned to organic EBITDA growth. The economic benefits of a low cost, scalable, data ready network platform should flow from this point – margins are set to expand as capital intensity falls. Visibility is improving - the combination of modest revenue growth, operational leverage and a normalisation of capex should drive FCF toward GBP5bn over the next three to four years. In a low interest rate environment Vodafone's ability to pay and sustain an attractive and growing dividend (5% yield to March 2016) should be in demand and the shares should rerate.

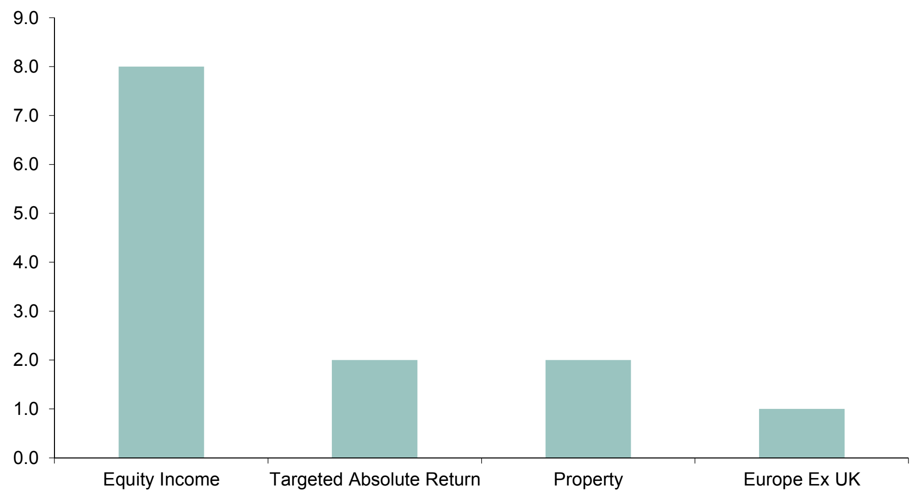
Relx – Sami Kassab

Relx offers defensive structural growth characteristics at a reasonable price. Its focus on innovative risk and information solutions coupled to solid pricing power in its core scientific information division lead us to argue that organic revenue growth is likely to start accelerating next year. Solid operating leverage coupled to its cash return policy underpins expectations of double digit TSR with a defensive profile. Relx is one of our top picks in European Media.

Stock selection….optimising dividends

Investing for dividend income is clearly in fashion. As yields have been squeezed lower across the fixed income universe, so investors have increasingly been tempted by the dividend yield available in European equities. As the following chart shows, Equity Income', at least amongst UK investors has been the most popular fund choice again over the last 12-months.

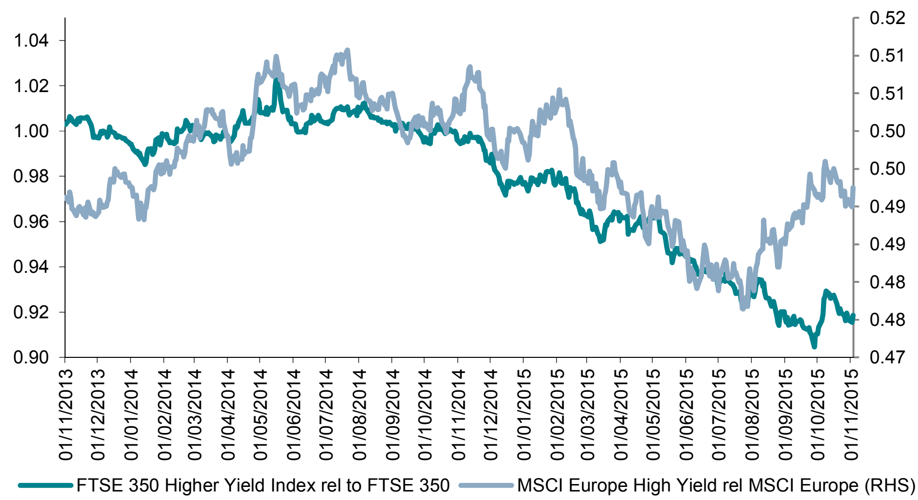
Figure 130: Number of months the investment strategy has been most popular choice amongst UK retail investors, September 2014 to September 2015



Source: UK Investment Association

With bond yields so low, and demand for equity dividend income increasing as a result, one could be forgiven for thinking that a simple strategy for buying stocks with higher than market yields would capture this new demand and outperform. But performance over the last year has contradicted this. The charts below show the relative performance of UK and Euro-area High Yield indices against the broader markets.

Figure 131: High Yield Strategies rel to market



Source: Datastream

Dividend investing needs to go some way beyond such a simplistic focus on dividends. In the following discussion we first highlight the major risk facing investors with a high dividend yield mandate, then present our view on how to construct a dividend-focussed portfolio that also offers the potential of outperforming the market.

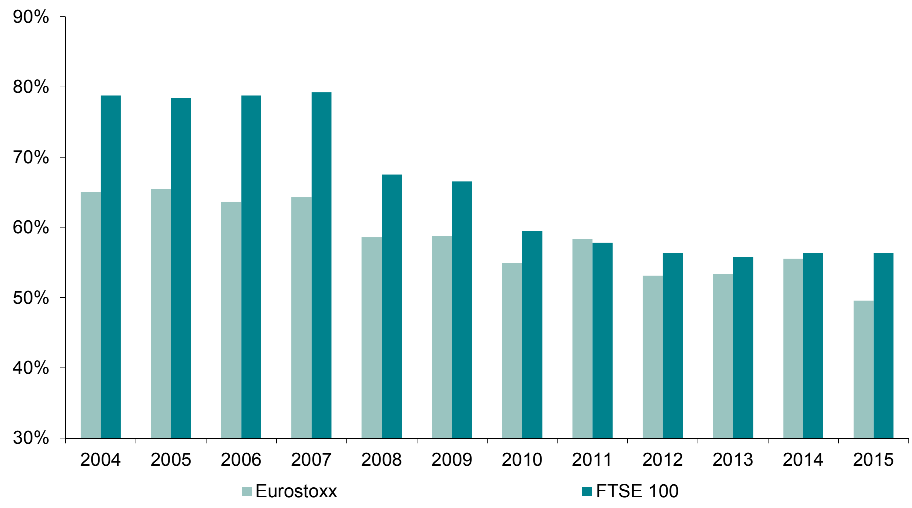
Concentration risk

The Eurostoxx is trading on a prospective 2016 dividend yield of 3.6% next year and the FTSE 100 4.2%. But it is important to realise that a high proportion of the market's total dividend distribution comes from a relatively small number of companies.

Specifically over half the total dividends paid in the market come from just 10% of the number of companies in the index. In the Eurostoxx the 29 biggest payers generate 50% of dividends and in the FTSE 100 the 10 biggest payers provide over 58% of total dividends paid.

Figure 132: Dividend payments are concentrated in a small number of names

Share of total dividend payment by the top 10% dividend payers (DPS * Number of shares)



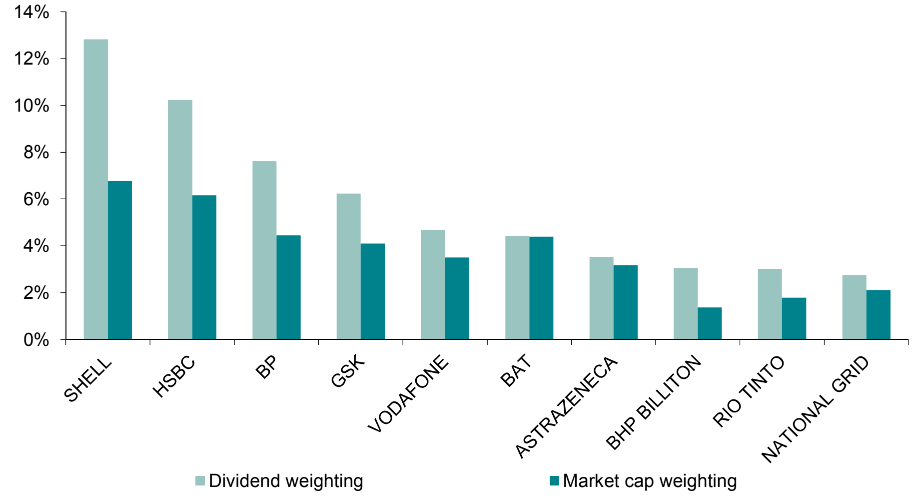
Source: Factset, Exane BNP Paribas estimates

In balancing the portfolio against market dividends there will be a natural bias to 'overweight' the big payers against the weighting these stocks would command in the benchmark index, based on market capitalisation. As such most income-orientated investors will be heavily exposed to the big dividend payers.

But the result of this approach is that investors will be exposed to a major style bias and run significant tracking error if benchmarking against the FTSE 100. And the concentration risk inherent in attempting to capture the big dividend payers can result in portfolio accidents. Should any of these names run into dividend sustainability issues there would likely be a disproportionate number of fund managers looking to sell down.

The following chart shows the mismatch in FTSE 100 names when their official index weighting and their implied dividend weighting are compared.

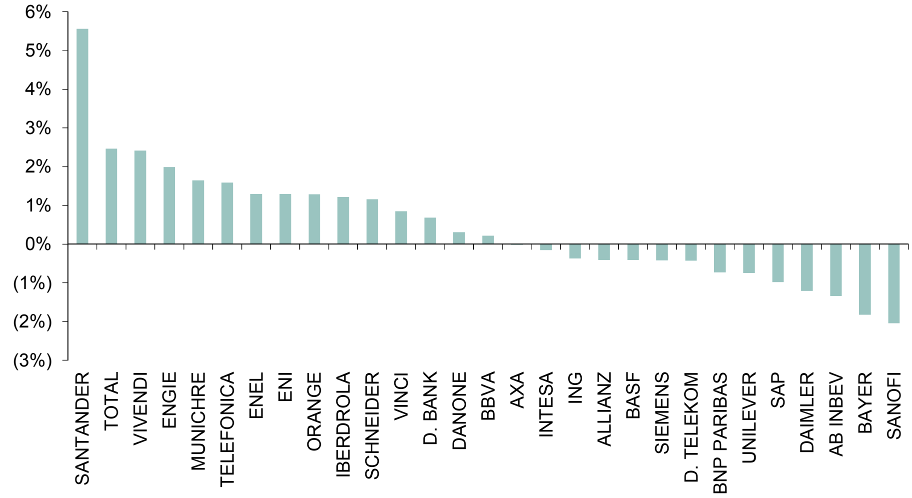
Figure 133: 10 biggest FTSE 100 dividend payers, divi weights vs mkt cap weights (12m trailing)



Source: Datastream, Exane BNP Paribas estimates

The same thematic exists in the Eurostoxx as shown below.

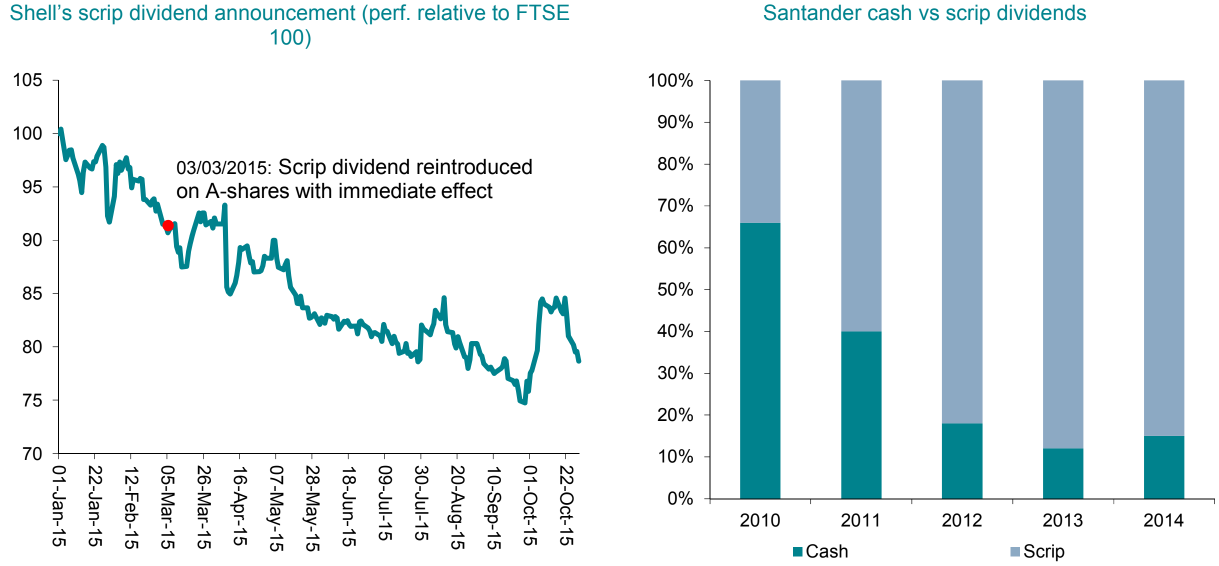
Figure 134: 29 biggest Eurostoxx dividend payers, divi weights less mkt cap weights (12m trailing)



Source: Datastream, Exane BNP Paribas estimates

Two examples of performance issues that can result from buying the big dividend exposure plays are shown below. First, Shell's share price has not recovered from the selling sparked from the reintroduction of the scrip dividend in March this year. Similarly Santander's use of scrips to protect capital in recent years has resulted in today's share price trading well below 2011 levels.

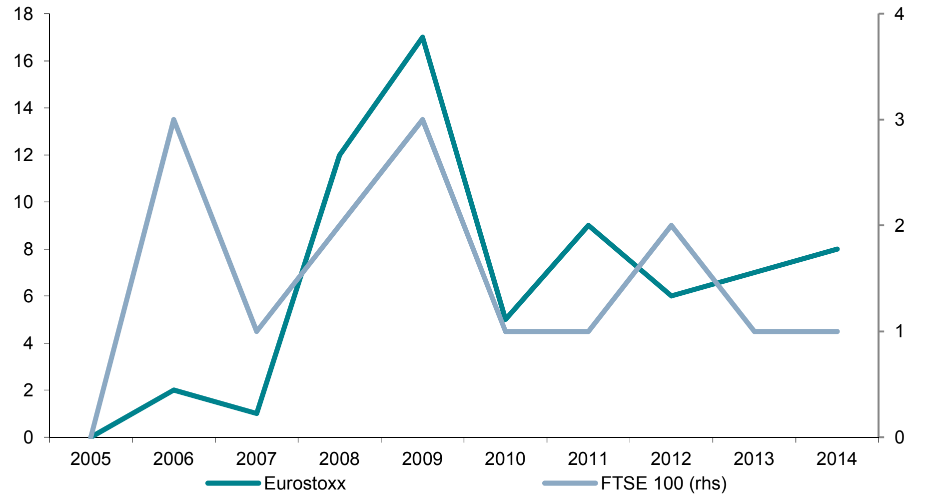
Figure 135: Top payers can be subject to dividend accidents



Source: Datastream, Exane Banks team

Scrips are one thing, dividend cuts arguably even more painful. And looking at both the Eurostoxx and FTSE 100, there has been at least one example of a company within the 'top 10% of payers' basket cutting their dividends every year.

Figure 136: Number of top payers cutting dividends

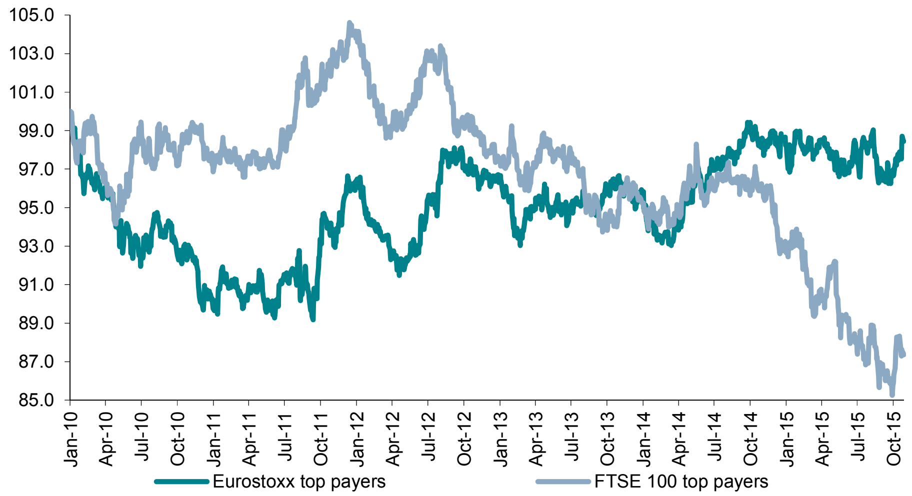


Source: Factset, Exane BNP Paribas estimates

How does this impact total relative returns? An income investor that has invested blindly in the top 10% payers, as forecast at the beginning of each year, would have suffered poor relative performance in the UK and suffered period of acute underperformance in euro-area shares – even if this strategy has held its own over the last 12-months.

Figure 137: Relative total return of top 10% dividend payers

Relative to Eurostoxx TR and FTSE 100 TR respectively, rebalanced annually

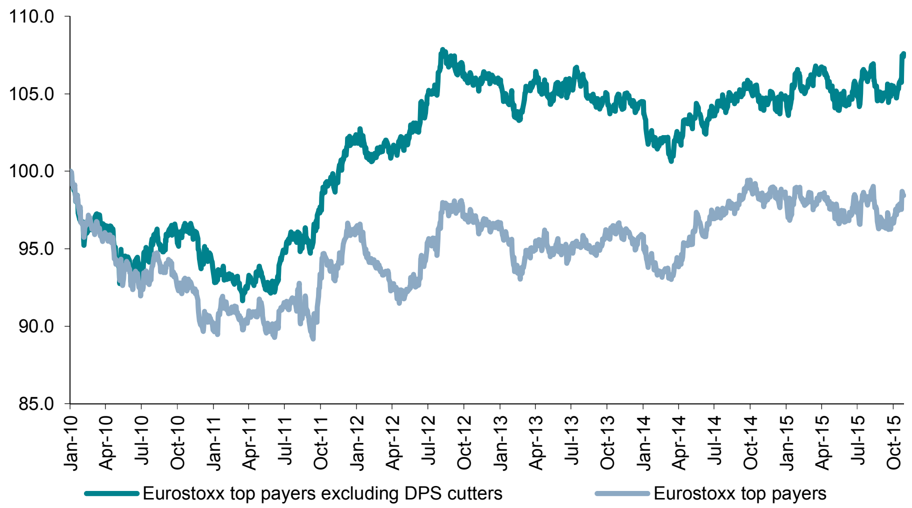


Source: Factset, Datastream, Exane BNP Paribas estimates

The relative performance of this strategy can be materially improved if, each year, investors were able to avoid 'the bombs' – the companies amongst these top 10% of payers that cut their dividends. Usually this is a small number of companies, but has a major impact on performance.

Figure 138: Avoiding DPS cutters can preserve relative performance

Relative to Eurostoxx TR, rebalanced annually



Source: Factset, Datastream, Exane BNP Paribas estimates

With this in mind, in the following tables we identify the companies within the euro-area and UK cohorts of major dividend payers, where there is some doubt on the sustainability of payments going forward.

Our first recommendation in forming a dividend strategy for 2016 is a negative recommendation – do not own these traditional dividend plays highlighted below. The risk – return is simply unattractive.

Figure 139: Top payers of the Eurostoxx on 2016 consensus

Name	Sector	Exane rating	2016 dividend weight	Index weight	2016 div yld	2016 FCF yld	2016 net debt/EBITDA vs 10y avg	Dividend risk appraisal
TOTAL	Oil & Gas	-	4.9%	3.0%	5.3%	2.9%	0.6	Low (includes scrip take up c.65%)
SANOFI	Healthcare	=	3.0%	2.9%	3.4%	5.6%	0.1	Low
TELEFONICA	Telecommunications	NR	2.8%	1.4%	6.0%	7.9%	0.3	NR
ALLIANZ	Insurance	=	2.6%	2.0%	4.6%	-	-	Low
DAIMLER	Automobiles & Parts	=	2.5%	2.1%	4.3%	8.0%	-0.4	Low
BANCO SANTANDER	Banks	-	2.5%	2.0%	4.1%	-	-	Low
ING GROEP	Banks	+	2.4%	1.4%	6.2%	-	-	Medium
SIEMENS	Ind. Goods & Services	NR	2.3%	1.9%	3.9%	6.3%	1.1	NR
BNP PARIBAS	Banks	NR	2.3%	1.7%	4.7%	-	-	NR
ANHEUSER-BUSCH INBEV	Food & Beverage	=	2.2%	2.2%	3.0%	4.8%	0.3	High
BASF	Chemicals	+	2.1%	1.9%	3.9%	6.1%	0.2	Low
INTESA SANPAOLO	Banks	=	2.0%	1.2%	5.6%	-	-	Medium
ENI	Oil & Gas	-	1.7%	1.1%	5.4%	7.6%	0.3	Low (already cut)
BAYER	Chemicals	=	1.7%	2.7%	2.2%	5.2%	0.1	Medium to Low
AXA	Insurance	+	1.6%	1.4%	4.7%	-	-	Low
BBV.ARGENTARIA	Banks	-	1.6%	1.3%	4.2%	-	-	Low
UNILEVER CERTS.	Pers & Househld Goods	+	1.6%	1.7%	3.0%	4.0%	0.0	Low
DEUTSCHE TELEKOM	Telecommunications	+	1.4%	1.4%	3.6%	7.2%	0.3	Low
ENGIE	Utilities	NR	1.3%	0.7%	6.2%	7.6%	0.9	NR
IBERDROLA	Utilities	-	1.3%	1.0%	4.4%	6.2%	-0.2	Low
VIVENDI	Media	-	1.3%	0.7%	6.2%	2.9%	-5.4	Low
SOCIETE GENERALE	Banks	=	1.3%	0.9%	4.9%	-	-	Medium
ENEL	Utilities	-	1.0%	0.8%	4.4%	7.0%	0.0	Low in '16
ORANGE	Telecommunications	=	1.0%	0.9%	3.9%	8.6%	0.0	Low
MUENCHENER RUCK.	Insurance	=	0.9%	0.7%	4.6%	-	-	Low
SCHNEIDER ELECTRIC SE	Ind. Goods & Services	NR	0.9%	0.9%	3.6%	6.6%	0.1	NR
SAP	Technology	-	0.9%	1.9%	1.7%	4.9%	0.9	Medium
DANONE	Food & Beverage	=	0.9%	1.0%	2.6%	4.1%	-0.2	Low
ASSICURAZIONI GENERALI	Insurance	=	0.9%	0.6%	4.7%	-	-	Medium

Source: Factset, Datastream, Bloomberg, Exane BNP Paribas estimates

Figure 140: Top payers of the FTSE 100 on 2016 consensus

Name	Sector	Exane rating	2016 dividend weight	Index weight	2016 div yld	2016 FCF yld	2016 net debt/EBITDA vs 10y avg	Dividend risk appraisal
ROYAL DUTCH SHELL (A + B)	Oil & Gas	+	11.5%	6.8%	7.1%	3.0%	0.5	Low (includes scrip take up c.20%)
HSBC HDG.	Banks	=	9.3%	6.0%	6.5%	-	-	Medium to Low
BP	Oil & Gas	=	6.8%	4.5%	6.5%	3.8%	0.5	Low (includes scrip take up c.10-20%)
GLAXOSMITHKLINE	Healthcare	=	5.7%	4.1%	5.9%	4.3%	0.7	Medium
VODAFONE GROUP	Telecommunications	+	4.3%	3.5%	5.2%	6.6%	0.6	Low
BRITISH AMERICAN TOBACCO	Pers & Househld Goods	=	4.3%	4.4%	4.2%	4.7%	1.0	Low
LLOYDS BANKING GROUP	Banks	=	3.4%	2.8%	5.1%	-	-	Medium
ASTRAZENECA	Healthcare	+	3.3%	3.2%	4.3%	4.9%	0.6	Low
RIO TINTO	Basic Resources	=	2.8%	1.8%	6.6%	8.5%	0.6	Low
BHP BILLITON	Basic Resources	=	2.6%	1.4%	7.8%	5.0%	1.3	High

Source: Factset, Datastream, Bloomberg, Exane BNP Paribas estimates

Consistent dividend outperformers

So far we have built a recommendation around what names NOT to own. Next we turn attention to how to identify names to buy. The Holy Grail for income investors is to find a strategy capable of generating above market levels of dividend yield while simultaneously outperforming the main, income unconstrained, benchmark – the Eurostoxx or the FTSE 100 in this discussion.

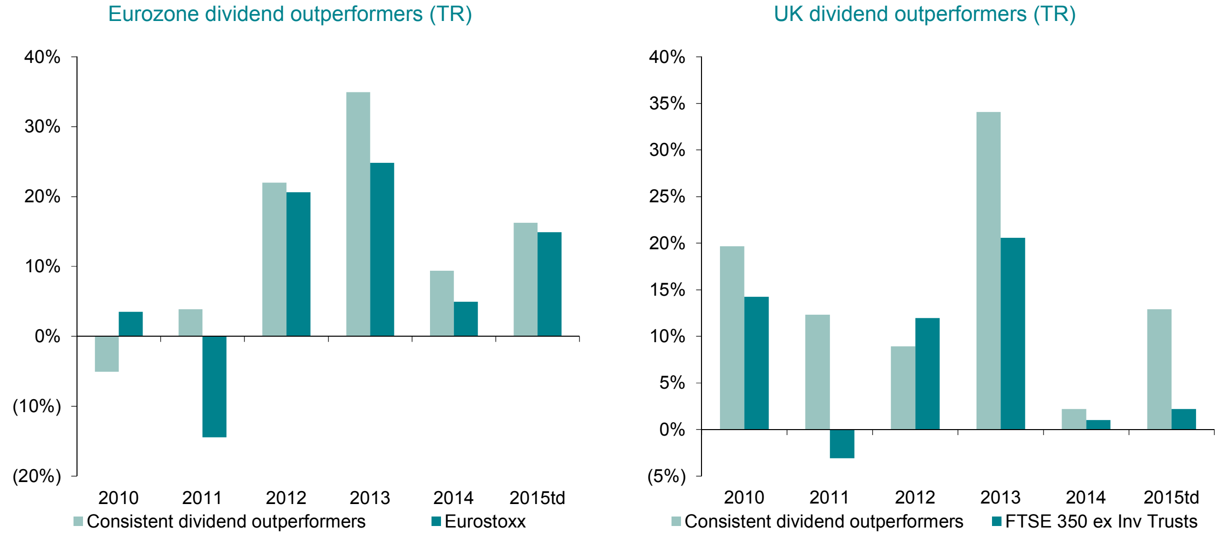
We approach this 'yield plus outperformance' objective via a 2-stage screening process. The obvious element is to identify the subset of companies that on a 12-month prospective yield offer a yield in excess of the market. The second stage requires greater thought.

There are all sorts of style factors we can discuss in identifying potential outperformance candidates. Most will work for certain periods but the consistency comes and goes as markets trade on different thematics and risk appetite swings around. There is one approach though that has generated consistent returns over this cycle – and we think is suited to the forthcoming environment.

This secondary factor is simply return-on-invested capital. To us this makes perfect sense. If a company generates high returns over time it can both distribute a high proportion of profits to shareholders – the dividend element – while still having access to sufficient internally generated resource to fund growth – the long term driver of outperformance.

The back-testing is encouraging.

Figure 141: Total absolute returns of our strategy



Source: Factset, Datastream, Exane BNP Paribas estimates

Below we show the results of our screening work on this criteria for euro-area and then UK names. Instinctively, not all of these names sit comfortably with the way we view the world in 2016. But that is probably the point of this approach – to challenge the consensus and reduce the emotion. At the very least these results should prompt a debate given the consistency of the historic back-testing work.

Figure 142: 2016 Eurozone dividend outperformance candidates

Name	Sector	Exane rating	+12m div yld	2016 ROIC/RoE
DAIMLER	Automobiles & Parts	=	4.3%	9.1%
MICHELIN	Automobiles & Parts	+	3.4%	12.5%
NOKIAN RENKAAT	Automobiles & Parts	+	4.4%	14.8%
BANKINTER 'R'	Banks	-	3.6%	11.2%
KBC GROUP	Banks	=	5.3%	14.0%
BASF	Chemicals	+	4.0%	10.4%
EVONIK INDUSTRIES	Chemicals	=	3.4%	13.6%
AZIMUT HOLDING	Financial Services	NR	5.8%	23.6%
BOLSAS Y MERCADOS ESPANOLES	Financial Services	NR	6.3%	41.2%
ORION 'B'	Healthcare	NR	3.8%	25.8%
SANOFI	Healthcare	=	3.4%	9.8%
ANDRITZ	Ind. Goods & Services	NR	3.4%	17.4%
BPOST	Ind. Goods & Services	=	5.7%	36.8%
DEUTSCHE POST	Ind. Goods & Services	NR	3.6%	15.0%
KONE 'B'	Ind. Goods & Services	-	3.7%	40.2%
LEONI	Ind. Goods & Services	=	4.0%	9.9%
METSO	Ind. Goods & Services	NR	4.7%	9.4%
RANDSTAD HOLDING	Ind. Goods & Services	=	3.4%	15.8%
SIEMENS	Ind. Goods & Services	NR	3.9%	9.6%
DELTA LLOYD GROUP	Insurance	NR	11.3%	17.4%
HANNOVER RUCK.	Insurance	-	4.3%	11.5%
SAMPO 'A'	Insurance	=	5.0%	13.2%
MEDIASET ESPANA COMUNICACION	Media	-	4.7%	16.8%
PROSIEBEN SAT 1 PF.(XET)	Media	+	4.2%	18.2%
RTL GROUP	Media	=	6.1%	23.5%
TELENET GROUP HOLDING	Media	NR	5.3%	9.0%
BOSS (HUGO)	Pers & Househld Goods	+	4.4%	32.6%
DISTRIBUIDORA INTNAC.DE ALIMENTACION	Retail	-	3.3%	22.1%
ELISA	Telecommunications	NR	4.1%	14.5%
FREENET	Telecommunications	NR	5.2%	13.5%
PROXIMUS	Telecommunications	=	4.8%	10.4%
DEUTSCHE LUFTHANSA	Travel & Leisure	NR	4.5%	11.4%
OPAP	Travel & Leisure	=	8.2%	17.8%
RUBIS	Utilities	+	3.8%	9.7%
	Constraints:		**> market**	**> market**

Source: Exane BNP Paribas estimates

Figure 143: 2016 UK dividend outperformance candidates

Name	Sector	Exane rating	+12m div yld	2016 ROIC/RoE
LLOYDS BANKING GROUP	Banks	=	5.1%	12.4%
ELEMENTIS	Chemicals	=	4.9%	14.4%
KIER GROUP	Construct. & Material	NR	5.0%	15.9%
ABERDEEN ASSET MAN.	Financial Services	-	5.6%	16.9%
ASHMORE GROUP	Financial Services	=	6.4%	16.4%
BREWIN DOLPHIN	Financial Services	NR	4.8%	20.5%
HENDERSON GROUP	Financial Services	+	4.1%	19.5%
ICAP	Financial Services	NR	4.9%	20.6%
INTERMEDIATE CAPITAL GP.	Financial Services	NR	4.1%	11.6%
INVESTEC	Financial Services	NR	4.6%	11.9%
JOHN LAING GROUP (WI)	Financial Services	NR	4.4%	13.3%
JUPITER FUND MANAGEMENT	Financial Services	=	5.6%	21.0%
MAN GROUP	Financial Services	+	4.4%	15.4%
TULLETT PREBON	Financial Services	NR	5.5%	15.4%
ASTRAZENECA	Healthcare	+	4.3%	16.4%
GLAXOSMITHKLINE	Healthcare	=	5.9%	20.3%
BAE SYSTEMS	Ind. Goods & Services	=	4.9%	17.1%
IMI	Ind. Goods & Services	-	4.1%	17.6%
MORGAN ADVANCED MATERIAL	Ind. Goods & Services	NR	4.3%	14.1%
ADMIRAL GROUP	Insurance	NR	6.0%	45.8%
AVIVA	Insurance	NR	5.0%	12.4%
DIRECT LINE IN.GROUP	Insurance	NR	5.1%	14.0%
ESURE GROUP	Insurance	NR	5.8%	22.6%
LANCASHIRE HOLDINGS	Insurance	NR	7.6%	11.9%
LEGAL & GENERAL	Insurance	NR	5.3%	17.9%
OLD MUTUAL	Insurance	NR	4.8%	12.9%
STANDARD LIFE	Insurance	NR	4.7%	12.6%
BARRATT DEVELOPMENTS	Pers & Househld Goods	NR	5.6%	13.9%
BERKELEY GROUP HDG.(THE)	Pers & Househld Goods	NR	4.9%	29.2%
BOVIS HOMES GROUP	Pers & Househld Goods	NR	4.8%	15.5%
BRITISH AMERICAN TOBACCO	Pers & Househld Goods	=	4.2%	23.5%
CREST NICHOLSON HOLDINGS	Pers & Househld Goods	NR	5.8%	18.6%
GALLIFORD TRY	Pers & Househld Goods	NR	6.2%	13.9%
IMPERIAL TOBACCO GP.	Pers & Househld Goods	+	4.5%	14.0%
PERSIMMON	Pers & Househld Goods	NR	5.6%	21.2%
TAYLOR WIMPEY	Pers & Househld Goods	NR	6.0%	18.4%
COUNTRYWIDE	Real Estate	NR	4.2%	14.6%
FOXTONS GROUP	Real Estate	NR	6.3%	23.6%
HALFORDS GROUP	Retail	NR	4.2%	14.7%
NEXT	Retail	-	5.2%	51.7%
FIDESSA GROUP	Technology	NR	4.4%	20.9%
TALKTALK TELECOM GROUP	Telecommunications	=	7.6%	22.3%
TELECOM PLUS	Telecommunications	NR	4.6%	18.3%
GO-AHEAD GROUP	Travel & Leisure	NR	4.2%	18.3%
	Constraints:		**> market**	**> market**

Source: Factset, Exane BNP Paribas estimates

Stock selection…capturing capex

Earnings based multiples can give a point estimate of valuation against current operating conditions. But in reality there is a limit to the information about future prospects embedded in such metrics. The way companies approach capital allocation, investment and the multi-year trend in return on invested capital can provide better clues as to potential future shareholder return.

Capex in Europe looks depressed in relation to Sales. Given the demand, and capacity utilisation backdrop this looks appropriate. But the trends diverge materially between sectors. Some industries are still finding it difficult to cut capex sufficiently to stabilise returns on capital. Others are scaling investment profitably, and generating returns for shareholders. And yet others are turning the corner, after periods of falling returns and aggressive capex cuts, returns are starting to show an improvement.

Using this information can help to form stock selection strategies. In this section we take 3 different approaches:

– We identifying shorts on the combination of increasing investment into a declining return on capital profile. This is indicative of companies that are becoming progressively more capital intensive in an effort to sustain growth. In simple P/E terms these stocks should de-rate. We call these the 'capital mis-allocators'.

– We look for longs amongst companies where legacy capex looks especially high in the context of the company's current enterprise value. This represents historic misallocation that has already led to substantial share price weakness. We then look for the indicators of change. A year-on-year improvement in ROIC and absolute declines in capex. We call these names the 'turnaround candidates'.

– Finally we screen for the 'efficient investors'. A simple, plain vanilla, approach to search for companies that are increasing investment into a rising return on capital trajectory. These are likely to be consistent outperformers over time.

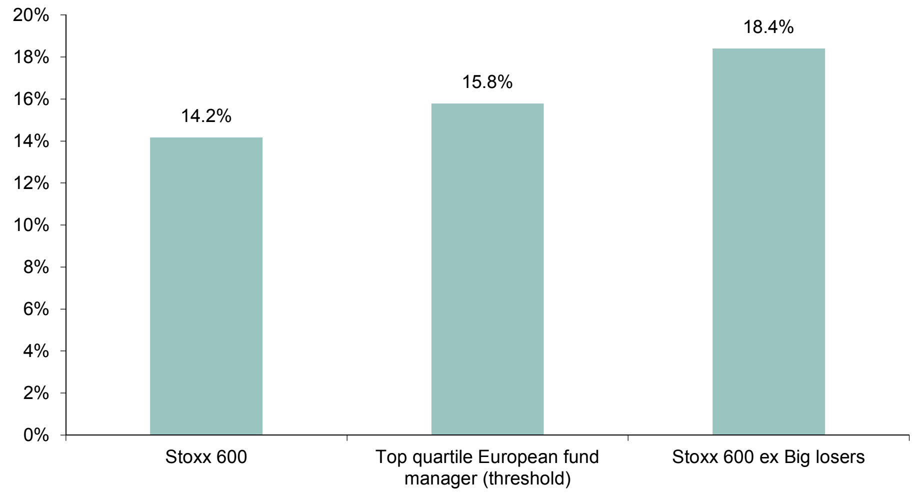
1. Capital mis-allocators

We all like to identify stocks that can shoot the lights out. But portfolio performance is every bit as sensitive to avoiding, or shorting, the major losers as picking the stars. This is a point we made in our annual outlook note this time last year, and once again over the course of 2015 it has proved to be the case.

The bottom 5% - or 30 stocks – within the STOXX 600 index have fallen by an average of 28% and taken over 8.8 points off the aggregate index so far in 2015. For context the index has added 36 points ytd so put bluntly, an investor that had simply managed to avoid the worst 30 names, would have seen the portfolio exceed the benchmark by almost 400 bps - and that should comfortably be good enough to guarantee a top quartile outcome.

This is great news. A straightforward way to consistently beat the benchmark. Simple – just avoid the worst names! Rocket science. Of course, this is much easier said than done. But we at least feel we have an approach that can skew the risk distribution and provide investors will an elevated chance of identifying the big losers, while simultaneously not overlooking too many of the eventual big winners.

Figure 144: Impact of bottom 5% index contributors (Stoxx 600)



Source: Exane BNP Paribas estimates

Our starting point in our quest to identify the big potential underperformers is to start with return on capital. Intuitively, declining ROIC does not reflect well on the performance of a company or the potential return to shareholders.

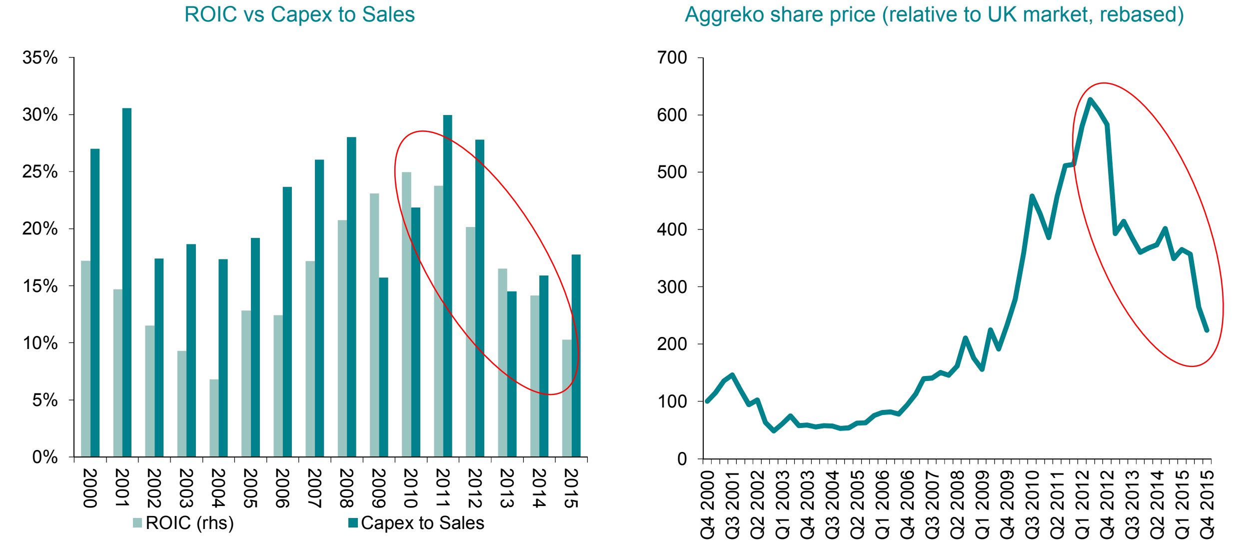
And sure enough, this one screening constraint alone skews the probability of identifying the losers materially. Importantly, this is achieved via the use of trailing data. A simple screening of companies at the start of 2015, on the basis of a comparison of 2014 versus 2013 ROIC, would have given investors an almost twice as great probability of finding the big eventual ytd losers rather than the big winners.

It is important to note, that for us, ROIC dominates EPS growth as a relevant performance factor. For example, it is certainly possible for companies to maintain a level of EPS while the underlying performance of the business is deteriorating. Indeed if companies are retaining a greater share of earnings to sustain earnings growth, investors that focus on the EPS outlook will miss the fact that the business is utilising greater capital to deliver results. And ultimately this means proportionately less funds are available for shareholders.

Put bluntly the investment appeal of this company is deteriorating. The EPS growth rate is masking the fact that the company is having to retain and re-invest more and more of the income generated simply to sustain growth – perhaps due to increased competition, or changing market preferences.

Aggreko represents a classic example of a company that increased investment – and then sustained a high capex-to-sales ratio into a declining ROIC profile. Investors who sold this stock in 2011 when this first became evident would have missed the implosion of the stock price later in the cycle. And even more recently – simply trading this stock short at the start of 2015 on the basis that ROIC was still falling and capex was moving higher again – would have avoided the 35% ytd decline.

Figure 145: Aggreko as an example of falling ROIC with increased Capex



Source: Factset, Datastream, Exane BNP Paribas estimates

In our quest to identify the big potential stock falls, we can materially improve results by incorporating this point on capital intensity. If the underlying returns of a company are deteriorating but management are fighting to keep profit growth up by retaining more earnings and increasing investment, this represents a major deterioration in the risk profile for shareholders. Investing into deteriorating returns, unless the Hail Mary pass comes off and the business turns around quickly, is likely to erode shareholder value.

In this respect an increasing capex-to-sales ratio and a declining ROIC profile is a major red flag. This is as clear a warning sign as we can find of management making inefficient capital allocation decisions. When increasing capital intensity is not protecting returns, but is instead associated with deteriorating ROIC, stock prices are ultimately likely to reflect the medium term pressure on the shareholder distribution profile this implies.

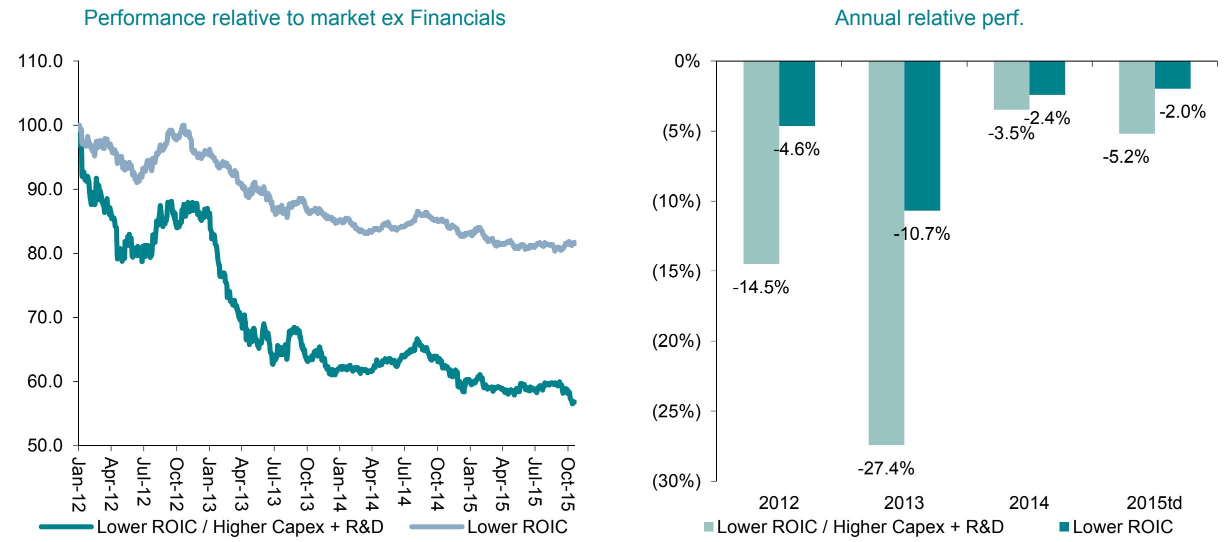
The final leg to our work simply involves a basic valuation overlay – if this deteriorating returns and capex profile has been fully recognised by investors then we should expect to see the stock de-rated on a straightforward earnings multiple. Where this has not happened it is likely investors have missed the underlying deterioration by overly focussing on earnings, or alternatively, giving the company an overly generous level of grace to turn things around.

We do not need to make heroic forecasts or put our faith in analysts' estimates to draw powerful conclusions about likely future share price performance using this approach. Using historic data our back testing suggests such characteristics have produced powerful results over the course of this cycle.

The charts below show the result of our work. Here, we rebalance our stock basket just once a year – on the 1st of January. We simply screen for companies displaying a falling ROIC (on a trailing basis) but increasing capital spending and R&D as a percentage of sales (also on a trailing basis). Finally we constrain results using a valuation overlay to select stocks trading rich relative to their 10y average. Here P/E has been isolated as the most appropriate metric compared to EV/EBIT or P/B.

Hopefully the results as outlined below are both self-explanatory and compelling. This strategy has produced material and consistent outperformance.

Figure 146: Performance of our deteriorating ROIC and higher Capex strategy



Source: Factset, Datastream, Exane BNP Paribas estimates

Looking forward to 2016, below we show two lists of names meeting these criteria of falling return on invested capital (we are using consensus forecast 2015, but given the proximity to year-end we feel comfortable this will not adversely impact results) and increased capex and R&D spending, while trading rich relative to their 10y average P/E.

Figure 147: Falling ROIC and increased Capex spending screen (Europe ex-UK)

Name	Sector	Exane rating	2014 ROIC	2015 ROIC	2014 Capex + R&D % sales	2015 Capex + R&D % sales	Current P/E vs 10y avg
TENARIS	Basic Resources	-	10.3%	4.4%	11.6%	14.9%	1.49
SYNGENTA	Chemicals	=	13.8%	11.9%	14.0%	14.9%	1.08
GEBERIT 'R'	Construct. & Material	NR	29.4%	22.1%	5.0%	6.8%	1.34
VINCI	Construct. & Material	+	7.9%	6.1%	3.9%	4.4%	1.31
ACTELION	Healthcare	+	30.7%	24.4%	23.8%	24.3%	1.11
COLOPLAST 'B'	Healthcare	=	36.6%	13.2%	7.3%	7.8%	1.32
ESSILOR INTL.	Healthcare	=	17.2%	11.0%	7.4%	8.0%	1.36
SONOVA N	Healthcare	=	20.0%	18.0%	10.8%	11.2%	1.01
STRAUMANN HLDG.	Healthcare	+	17.9%	10.6%	2.7%	8.3%	1.22
ABB LTD N	Ind. Goods & Services	NR	10.1%	8.6%	6.3%	6.9%	1.01
CNH INDUSTRIAL	Ind. Goods & Services	NR	3.4%	1.3%	6.5%	6.8%	1.29
POSTNL	Ind. Goods & Services	NR	52.4%	36.2%	2.2%	3.9%	1.12
SGS 'N'	Ind. Goods & Services	=	16.9%	14.1%	5.2%	5.2%	1.11
SES FDR (PAR)	Media	=	8.6%	6.9%	23.7%	27.9%	1.24
WOLTERS KLUWER	Media	=	12.1%	9.8%	4.2%	4.3%	1.37
TGS-NOPEC GEOPHS.	Oil & Gas	NR	15.2%	9.8%	50.7%	79.4%	1.24
BOSS (HUGO) (XET)	Pers & Househld Goods	+	35.6%	31.8%	7.4%	10.0%	1.08
UNITED INTERNET (XET)	Technology	NR	27.4%	12.7%	2.4%	3.7%	1.18
EDP ENERGIAS DE PORTUGAL	Utilities	-	4.2%	3.8%	10.7%	10.8%	1.17
	Constraints:			< 90% 2014		> 2014	> 1

Source: Factset, Exane BNP Paribas estimates

We run a similar screen on the UK market below.

Figure 148: Falling ROIC and increased Capex spending screen (UK)

Name	Sector	Exane rating	2014 ROIC	2015 ROIC	2014 Capex + R&D % sales	2015 Capex + R&D % sales	Current P/E vs 10y avg
AL NOOR HOSPITALS GP	Healthcare	NR	38.3%	30.6%	7.5%	11.8%	1.09
ANTOFAGASTA	Basic Resources	+	5.6%	3.1%	31.9%	34.7%	2.24
BURBERRY GROUP	Pers & Househld Goods	=	26.2%	20.4%	6.2%	6.8%	0.91
DIPLOMA	Ind. Goods & Services	NR	19.7%	17.7%	0.7%	1.3%	1.21
HUNTING	Oil & Gas	NR	4.2%	1.1%	7.2%	9.1%	1.11
INMARSAT	Telecommunications	NR	11.5%	7.2%	29.2%	37.0%	1.08
KIER GROUP	Construct. & Material	NR	2.4%	0.8%	1.9%	2.2%	1.19
KINGFISHER	Retail	+	8.8%	7.5%	2.5%	3.6%	1.10
MICRO FOCUS INTL.	Technology	NR	7.0%	5.9%	15.6%	19.3%	1.22
NOSTRUM OIL & GAS	Oil & Gas	NR	8.6%	1.6%	43.0%	65.4%	2.04
RESTAURANT GROUP	Travel & Leisure	NR	24.1%	21.3%	11.0%	12.2%	1.25
ROYAL DUTCH SHELL B	Oil & Gas	+	6.8%	4.0%	7.9%	10.4%	1.32
UDG HEALTHCARE PUBLIC	Healthcare	NR	13.2%	6.4%	1.8%	2.6%	1.46
WH SMITH	Retail	NR	90.6%	67.4%	2.8%	3.2%	1.53
	Constraints:			< 90% 2014		> 2014	> 1

Source: Factset, Exane BNP Paribas estimates

2. Turn-around candidates

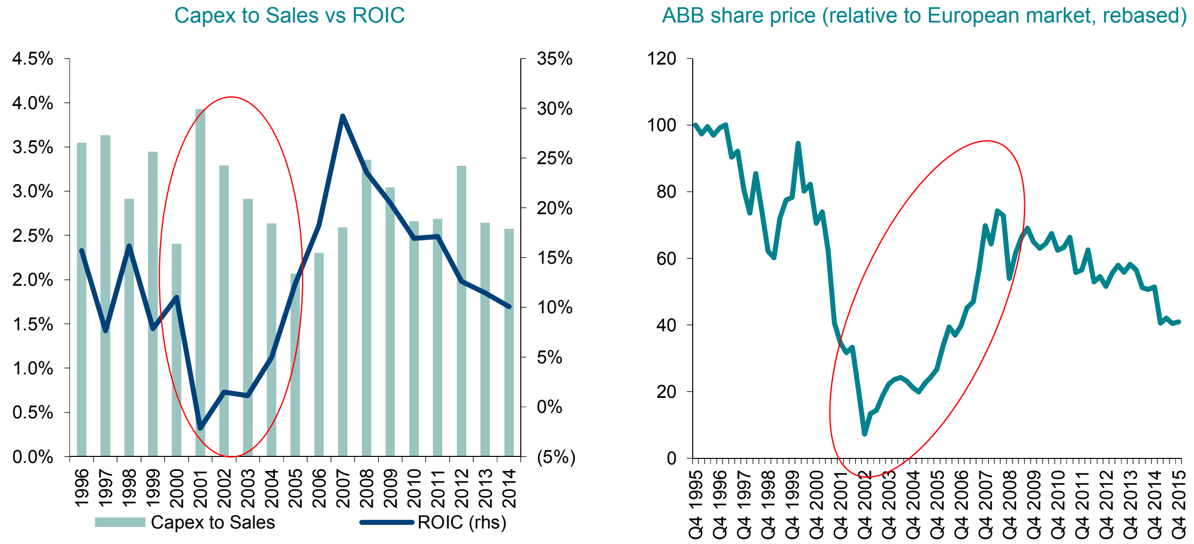
Most companies whose operating performance has deteriorated sharply would like investors to believe that things will turn around quickly. Some do, but alas some don't. And it often takes a lot longer than initially hoped. But we can utilise our capex work to identify stocks where the turnaround thesis looks to have an elevated chance of playing out and drive share prices higher.

The thinking behind our approach here is to take the falling ROIC / increasing capex approach to an extreme. We aim to identify companies where investment has not been rewarded in share price terms, as that investment has not generated returns. Put simply, we aim to look for companies that have spent heavily, have seen material share price weakness as the operational results have not played out the way the company hoped.

The next stage in this process is to believe that investors will force a change of strategy. Maybe the company is sold, maybe the management is changed, but at the very least the heavy investment days are over, and the company's focus is on repairing the damage and improving shareholder returns.

There have been countless examples of this over the years, resulting in some of the best stock price stories in the market. Investors will certainly remember ABB's woes back in 2001, when the company reported a net loss of USD691m amid an economic slowdown that followed a period of euphoric investment. The company restructured, cut capex aggressively, and this remedial management action set the foundation for a stock price move from a low of CHF1.5 in 2002 to CHF35 in 2007.

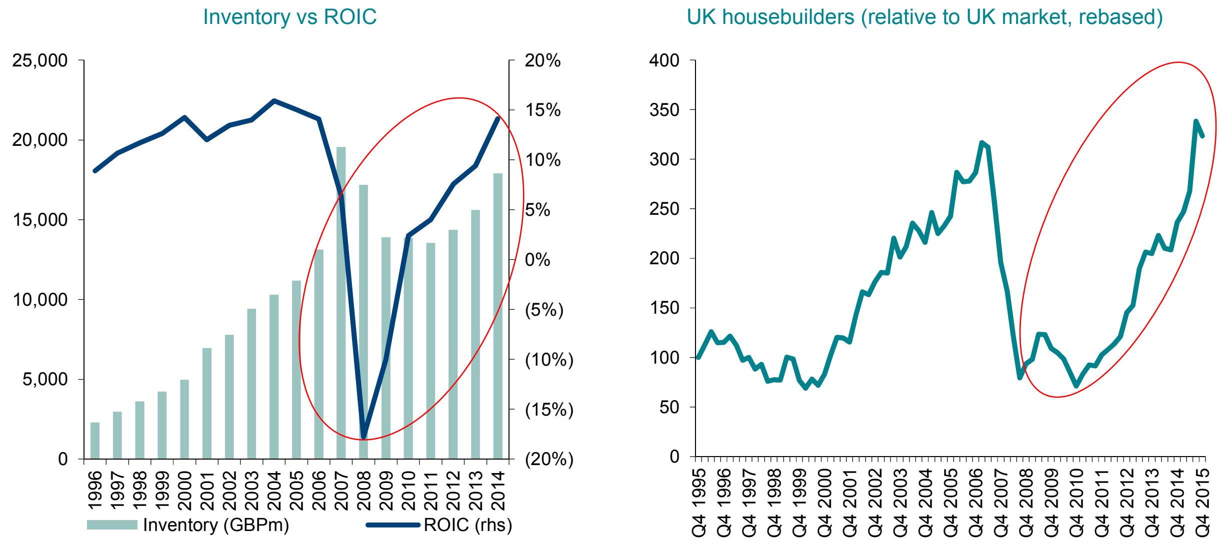
Figure 149: ABB as an example of a successful turn-around



Source: Factset, Datastream, Exane BNP Paribas estimates

Similarly, in the UK, the housebuilders have arguably been the story of the cycle. Having collapsed during the financial crisis after a period of major growth, they were left holding huge inventory into the recession. After re-capitalising, managing inventory and working capital very conservatively, share prices have hugely outperformed the market over the last 5-years.

Figure 150: UK housebuilders as an example of a successful turn-around



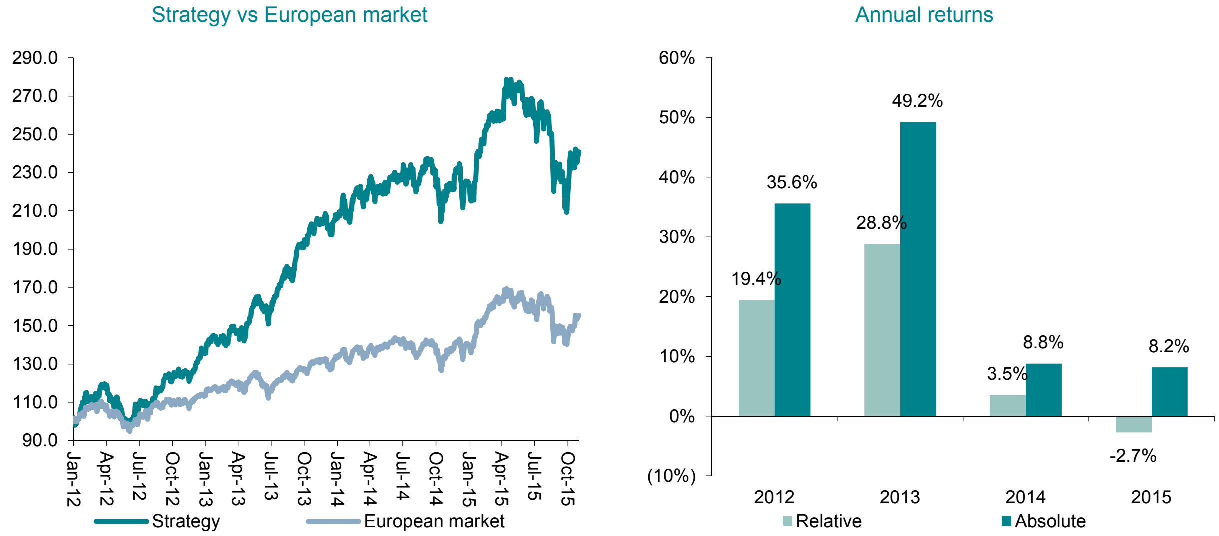
Source: Factset, Datastream, Exane BNP Paribas estimates

So our question is, how do we identify the quantitative criteria that can give us the best chance of identifying the actual turnaround plays from the hopefuls that never make it? Our first screening criteria here is to identify the biggest 'over-investors' or mis-allocators. To do this we sum the capex and R&D spend of the previous 2 years and express this as a percentage of the Enterprise Value. The companies with the highest legacy capex to EV are examples of potential over-investors.

Once we have identified the short list, we think look for evidence that management action is addressing the problem. To achieve this we need to see that current year capex / R&D is falling and that the ROIC trend has turned and the current financial year will see an improvement. This may miss the very early stage of share price recovery – the hope trade – but significantly de-risks the results.

Specifically, our strategy selects companies that have spent more than 20% of their current EV on Capex & R&D in the last 2 years, combined with the current year seeing absolute Capex and R&D reductions along with an improving ROIC. The strategy is rebalanced at the beginning of every year and constituents are equally-weighted. The results are shown in the following chart.

Figure 151: Performance of our change recovery strategy



Source: Exane BNP Paribas estimates

Historical returns, in relative and absolute terms, are robust. The strategy has delivered outperformance in 3 of the last 4 years, and while the summer sell-off in European shares has curbed 2015 performance, the recent performance trends are again encouraging.

We now apply this methodology to selecting stocks for the 2016 basket. We use consensus data for capex and R&D for 2015/16. We calculate ROIC for 2015/16 based on consensus net income and payout ratio. The results of this analysis – our list of potential turn-around stories for 2016 – is shown below for Europe ex UK. And the following table shows the UK names.

A word of warning. Many of these names will be on investors' sell list – they are generally disliked stocks. But that is the point of this approach – to search through the stock price sinners for companies that can recover. By focussing on a set of quantitative criteria the emotion is removed. And as we see above, the approach has a successful history.

Figure 152: Potential Europe ex-UK turn-around stories for 2016

Name	Sector	Exane rating	Share price vs 5y peak	2015 ROIC	2016 ROIC	2015/14 Capex + R&D as % of EV	2016 change in Capex + R&D
RHEINMETALL	Automobiles & Parts	=	-9%	7.6%	8.8%	22%	-6%
LANXESS	Chemicals	+	-27%	4.2%	6.5%	23%	-4%
BOUYGUES	Construct. & Material	=	-11%	2.3%	4.0%	20%	-1%
LEONI	Ind. Goods & Services	=	-42%	7.4%	9.9%	39%	0%
ENI	Oil & Gas	-	-28%	1.5%	3.1%	34%	-3%
STATOIL	Oil & Gas	+	-27%	3.7%	4.2%	43%	-6%
CASINO GUICHARD-P	Retail	-	-43%	2.6%	2.9%	24%	-6%
ALCATEL-LUCENT	Technology	+	-15%	3.2%	9.5%	55%	-1%
ERICSSON 'B'	Technology	+	-25%	7.6%	10.0%	33%	-3%
STMICROELECTRONICS	Technology	+	-33%	2.0%	4.4%	65%	-2%
HELLENIC TELECOM.ORG.	Telecommunications	NR	-32%	6.1%	7.2%	24%	-9%
	Constraints:				**> 2015**	**> 20%**	**< 0**

Source: Factset, Exane BNP Paribas estimates

Figure 153: Potential UK turn-around stories for 2016

Name	Sector	Exane rating	Share price vs 5y peak	2015 ROIC	2016 ROIC	2015/14 Capex + R&D as % of EV	2016 change in Capex + R&D
BHP BILLITON	Basic Resources	=	-59%	2.9%	3.1%	26%	-34%
ENTERTAINMENT ONE (DI)	Media	NR	-33%	10.4%	11.3%	24%	-29%
FIDESSA GROUP	Technology	NR	-24%	19.2%	20.9%	19%	-1%
FIRST GROUP	Travel & Leisure	NR	-70%	3.3%	3.9%	31%	-3%
GKN	Automobiles & Parts	+	-30%	13.8%	14.0%	16%	-5%
GLENCORE	Basic Resources	+	-77%	1.2%	2.0%	19%	-17%
HOME RETAIL GROUP	Retail	-	-54%	2.8%	3.1%	56%	-10%
MORRISON(WM)SPMKTS.	Retail	-	-49%	3.5%	4.3%	16%	-3%
NOSTRUM OIL & GAS	Oil & Gas	NR	-45%	1.7%	3.1%	31%	-26%
PETROFAC	Oil & Gas	=	-56%	3.6%	11.4%	21%	-8%
THOMAS COOK GROUP	Travel & Leisure	-	-39%	6.1%	13.8%	18%	-5%
TUI (LON)	Travel & Leisure	=	-9%	9.8%	12.1%	15%	-12%
	Constraints:				**> 2015**	**> 15%**	**< 0**

Source: Factset, Exane BNP Paribas estimates

3. Efficient investors

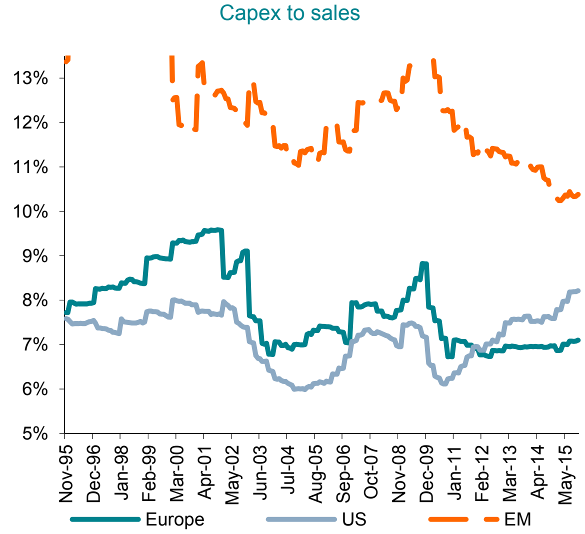
It is no secret that capex has remained very subdued over this cycle in Europe. A lack of perceived growth opportunities, low capacity utilisation, funding difficulties and political risk are all explanations that have been put forward to explain the lack of business spending.

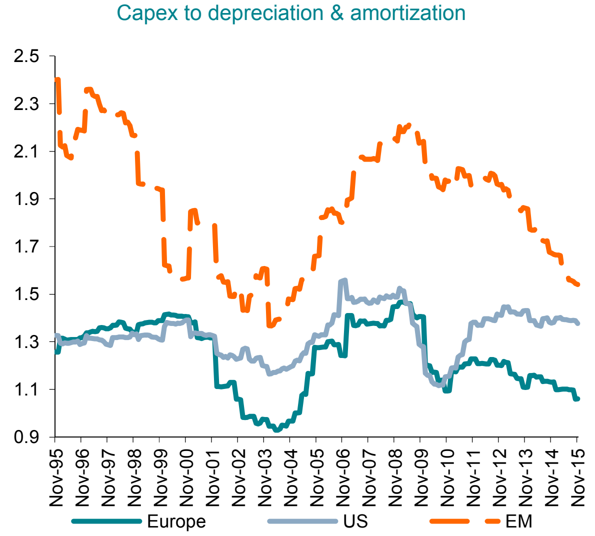
While investors may feel this has been a rational and prudent response from the corporate sector in response to the macro backdrop, this capex ‘discipline’ raises its own risks. In aggregate, listed European companies are flirting with a Capex to Depreciation & Amortization ratio of 1.

This implies the corporate sector risks not investing sufficiently to maintain a stable asset base. Ultimately there are potentially negative long- term implications in terms of innovation, and Europe’s competitiveness in global markets.

This risk is all the more relevant as the US corporate sector has increased the pace of capex over the last 12-months, while EM corporates continue to invest a greater share of sales.

Figure 154: European firms have been underinvesting

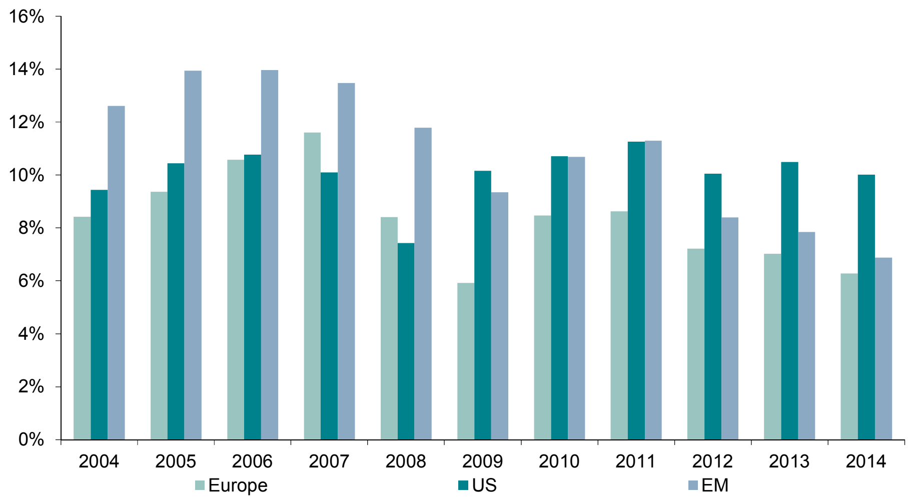




Source: Datastream, Exane BNP Paribas estimates

Whether its cause or effect Europe's lower level of investment has coincided with a period of declining market Return on Invested Capital. And the relative gap with the US corporate sector has widened.

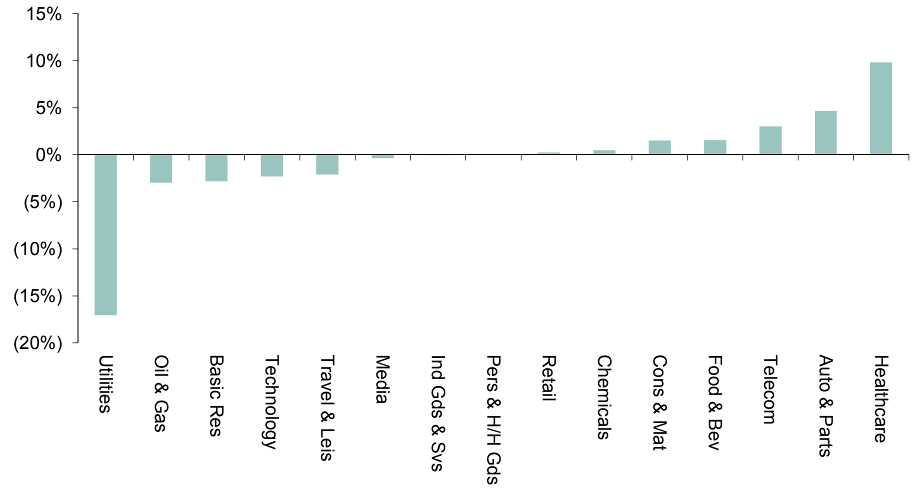
Figure 155: Return on Invested Capital



Source: Factset, Exane BNP Paribas estimates

In some sectors the gap between European and US investment trends looks pronounced. It would seem reasonable to conclude that if this were to persist, then over time, at least in the more globally orientated sectors, European companies would start to lose ground to their US peers. Below we rank sectors according to the gap in capex and R&D to sales.

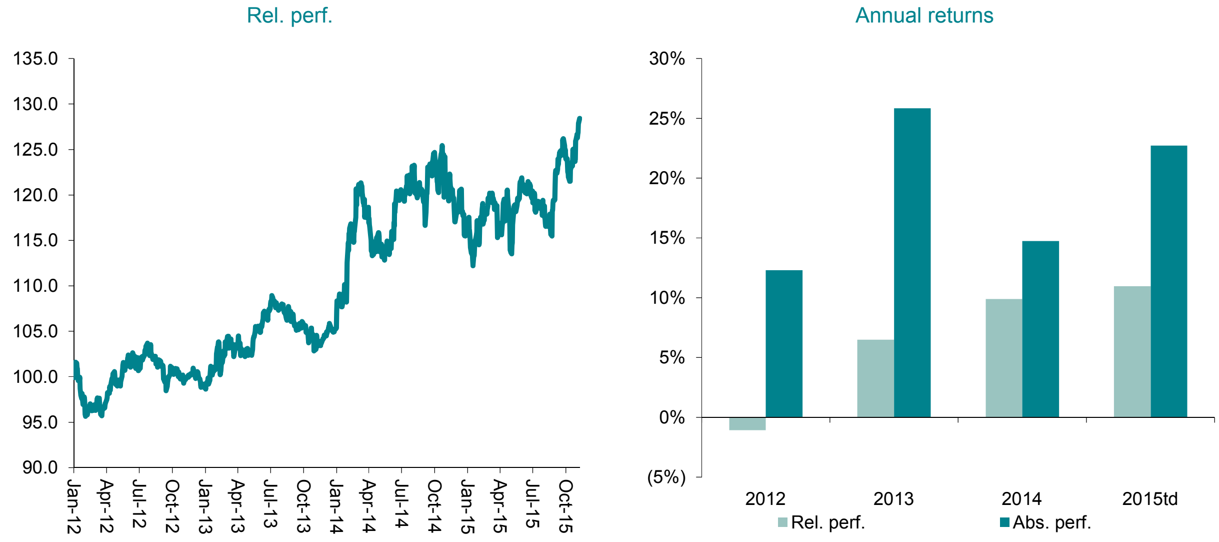
Figure 156: Europe less US sectors, 2016 Capex + R&D to Sales



Source: Factset, Exane BNP Paribas estimates

Against this backdrop of low investment, with European companies arguably losing competitive ground to their international peers, it would seem a reasonable proposition that companies that are investing materially, and profitably would likely outperform. This combination of attributes – increasing ROIC with capex and R&D outpacing depreciation by at least 20% should be rewarded by shareholders. Again the backtesting work suggests this has worked historically.

Figure 157: Efficient investors produce consistent outperformance



Source: Datastream, Exane BNP Paribas estimates

The following table shows the current results of this screening exercise. We also add a valuation constraint as a final cross-check – ensuring the 12M forward forecast EV/EBIT is below the 5-year average.

Figure 158: Efficient investors for 2016

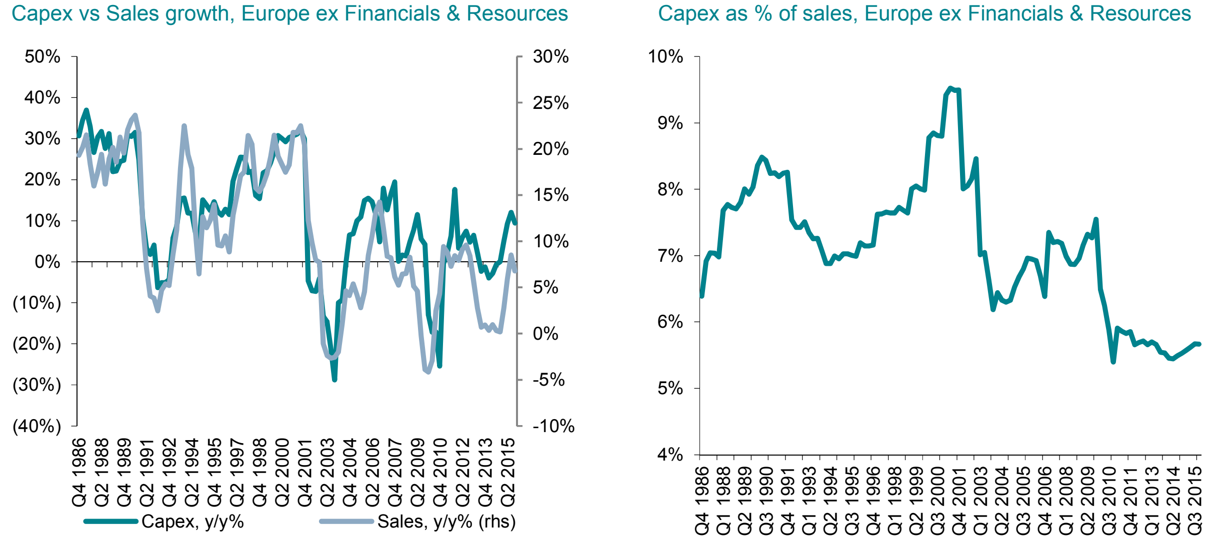
Name	Sector	Exane rating	2014 ROIC	2015 ROIC	2016 Capex + R&D to D&A	+12m EV/EBIT	5y avg +12m EV/EBIT	+12m EV/EBIT vs 5y avg
FAURECIA	Automobiles & Parts	+	6.0%	12.7%	1.8	5.8	6.2	0.9
EVONIK INDUSTRIES	Chemicals	=	8.0%	14.6%	2.0	9.6	10.0	1.0
K + S	Chemicals	=	7.3%	9.2%	3.0	9.5	9.7	1.0
MEDIASET ESPANA	Media	-	4.6%	14.2%	15.5	14.7	20.3	0.7
NESTE	Oil & Gas	NR	1.4%	13.5%	1.2	9.6	10.8	0.9
VESTAS WINDSYSTEMS	Oil & Gas	+	17.4%	22.4%	1.4	12.1	14.4	0.8
HERMES INTL.	Pers & Househld Goods	=	27.2%	29.1%	1.5	20.8	21.1	1.0
TAYLOR WIMPEY	Pers & Househld Goods	NR	15.0%	16.7%	3.6	8.1	8.2	1.0
B&M EUROPEAN VAL.RET.	Retail	NR	5.0%	10.3%	1.7	17.9	18.4	1.0
DIXONS CARPHONE	Retail	+	9.0%	9.8%	1.3	11.4	44.5	0.3
ARM HOLDINGS	Technology	+	18.0%	23.8%	7.8	25.2	29.9	0.8
DIALOG SEMICON.	Technology	+	17.4%	23.8%	6.4	7.6	10.3	0.7
GEMALTO	Technology	-	8.9%	10.2%	2.2	11.0	13.4	0.8
ILIAD	Technology	+	9.0%	10.4%	1.3	16.3	17.1	1.0
INTL.CONS.AIRL.GP.	Travel & Leisure	NR	11.1%	13.7%	1.7	6.4	9.7	0.7
DEUTSCHE LUFTHANSA	Travel & Leisure	NR	0.5%	15.5%	1.5	5.1	8.0	0.6
	Constraints:			**> 2014 & > 8.5%**	**> 1.2**			**< 1**

Source: Factset, Exane BNP Paribas estimates

Stock selection…Juncker winners (again!!!)

Private investment is an important driver of revenue growth and hence earnings growth. European companies (even excluding Resources) have restrained Capex spending since the financial crisis. A lack of confidence in the European economy and poor return expectations – even in a very low interest rate environment – are probably limiting corporate investment.

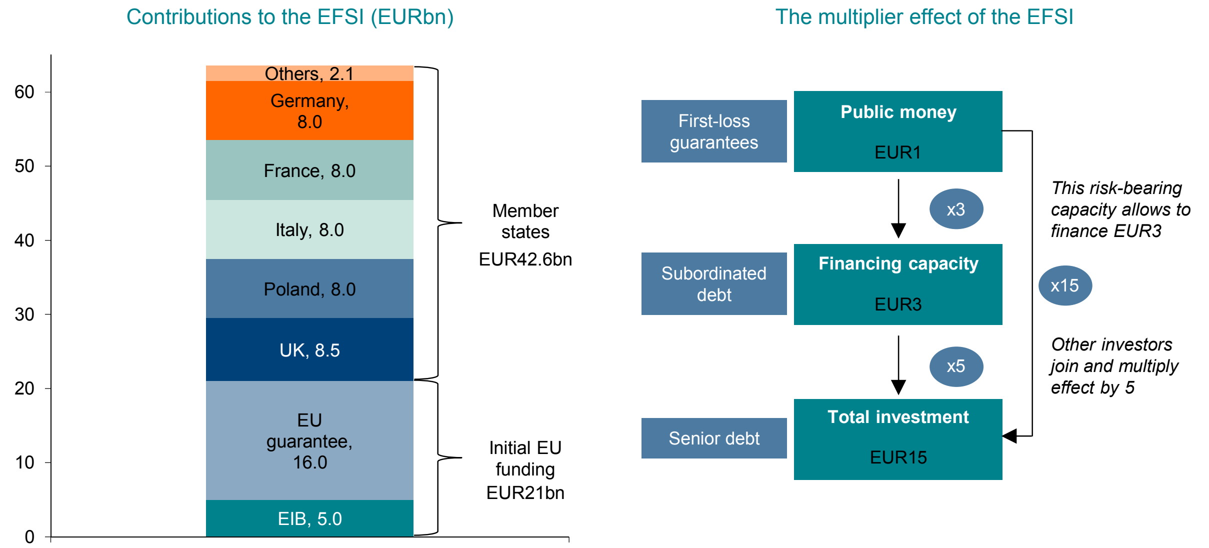
Figure 159: Capex spending as a key driver of sales growth



Source: Datastream, Exane BNP Paribas estimates

The EU has tried to address the latter when they announced the Juncker plan (now called EFSI) last year. The plan was then welcomed with a fair degree of scepticism given the low initial funding (EUR21bn), the implied multiplier (15x) and the necessary private sector buy-in. While pretty much absent of the headlines this year, there have actually been a few positive developments.

Figure 160: Public money financial engineering



Source: European Commission, Exane BNP Paribas estimates

EU member states have indeed been encouraged to top up the initial pot as any capital contributions they make sit outside of the official budget deficit calculations, effectively creating a backdoor to reduce the pace of fiscal consolidation in Europe. And their contribution has far exceeded market expectations with EUR40bn+ in capital commitments to the fund in less than 12m.

In theory, the 'first loss' guarantee, equivalent to 6.7% of final investment (1/15), could significantly improve private investors' expected returns and attract them to riskier projects. In our view, even if the target multiple looks ambitious, the plan could clearly lift investment spending in some focus areas. We take a look at recent projects and seek sectors and stocks set to benefit the most from the plan.

Examples of funded projects

There has been very little disclosure around which projects will be selected for financing under the EFSI beyond the focus areas of energy, transport, broadband, education, research and innovation. Mostly because the institutions are still being created. In the interim, the EIB has taken on the role of allocating some the capital until the EFSI's structure becomes fully operational. So far, most funded projects have been with a lower multiplier than the official target. The table below summarises some projects announced as being part of the EFSI and funded by the EIB.

Figure 161: EFSI projects selected and approved by the EIB

Country	Name	Description	Sector	EIB finance	Project size
Denmark	Copenhagen Infrastructure II	*Infrastructure fund investing in large energy-related projects, with a focus on offshore wind, biomass and transmission.*	Energy	DKK560m (~EUR75m)	DKK15,000m (~EUR2,000m)
Spain	Abengoa RDI II	*Selected investments in the areas of biotechnology / chemical process development for advanced bio refineries, water treatment, advance power systems and renewable energy.*	Energy / Water & sewerage / Industry	EUR170m	EUR340m
France	Energy efficiency in residential buildings	*Programme-loan to support energy efficiency investments in private residential buildings in France.*	Energy / Industry	EUR400m	EUR800m
Spain	Grifols Bioscience R&D Spain	*Research activities in the fields of plasma-derived therapies, diagnostics and medical solutions for hospitals.*	Industry	EUR100m	N/A
Finland	Äänekoski Bio-Product Mill	*Construction of a new 1.3m tonnes per annum bio-product mill in Äänekoski, Finland.*	Industry	EUR275m	N/A
Spain	Redexis Gas Transmission & Distribution	*Extend the gas distribution networks in Spain for the period 2015-2018. The investments include mainly the construction of new pipelines to reach unserved Spanish customers who currently rely on fuel oil and propane for heating and cooking purposes.*	Energy	EUR125m	EUR250m
Italy	Arvedi modernisation programme	*Financing of part of the modernisation programme (steel plant)*	Industry	EUR100m	EUR227m
Ireland	Primary Care Centres PPP	*Development of up to 14 primary care centres including accommodation for the primary care team and general practitioner services.*	Health	EUR70m	EUR142m
Austria	Vienna Hospital programme	*Construction and refurbishment of 3 hospitals, replacing the existing outdated facilities under a comprehensive integrated healthcare plan for the served population.*	Health	N/A	N/A

Source: European Investment Bank, Exane BNP Paribas estimates

Sector analysis

We list below the areas of focus of the EFSI and the related equity market sectors that are exposed at their top line and investment levels:

– **Construction:** Building materials/fixtures and Heavy construction;

– **Energy efficiency:** Renewable energy equipment and Electronic/electrical equipment;

– **Public infrastructure:** Telecom equipment, Healthcare equipment & services and Industrial transport.

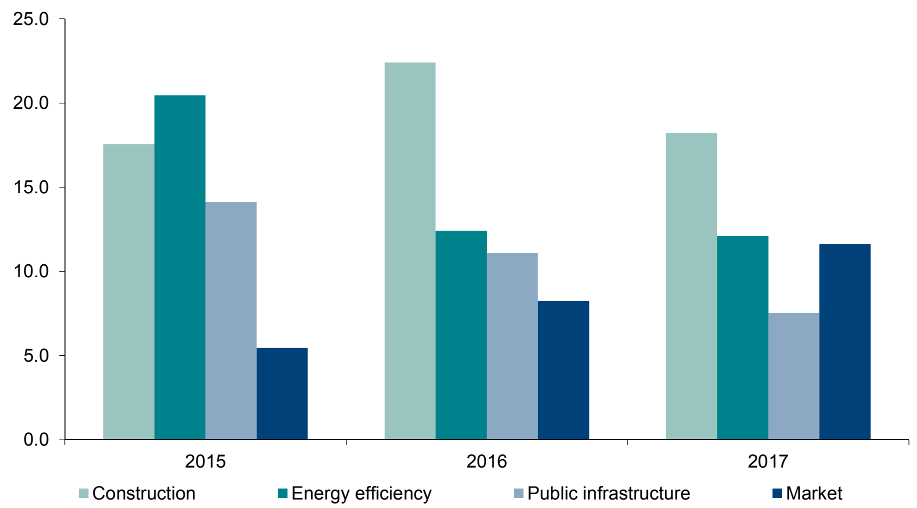
Figure 162: Large cap stocks (> EUR5bn) with European exposure (> 30%) from selected sectors

Name	Sector	Exane rating	Market cap (EURm)	+12m P/E	2016 sales growth	Sales to Europe (%)
HEIDELBERGCEMENT	Building materials/fixtures	+	12,788	12.8	5%	32%
SAINT GOBAIN	Building materials/fixtures	+	22,273	14.4	3%	72%
ASSA ABLOY 'B'	Building materials/fixtures	=	19,326	22.7	6%	37%
GEBERIT 'R'	Building materials/fixtures	NR	10,954	21.8	7%	92%
SIKA 'B'	Building materials/fixtures	NR	6,319	16.0	6%	49%
CRH	Building materials/fixtures	=	20,502	15.9	18%	41%
FERROVIAL	Heavy construction	-	17,074	36.0	4%	67%
BOUYGUES	Heavy construction	=	11,796	21.7	1%	79%
EIFFAGE	Heavy construction	+	5,402	14.3	0%	96%
VINCI	Heavy construction	+	36,307	16.1	0%	81%
BOSKALIS WESTMINSTER	Heavy construction	=	5,432	13.9	-3%	39%
SKANSKA 'B'	Heavy construction	NR	6,928	14.7	1%	69%
VESTAS WINDSYSTEMS	Renewable energy equipment	+	11,841	19.9	5%	51%
LEGRAND	Electronic/electrical equipment	+	13,391	20.8	4%	46%
NOKIA	Telecom equipment	+	22,348	20.4	1%	31%
FRESENIUS	Healthcare equipment & services	+	28,637	22.8	7%	41%
COLOPLAST 'B'	Healthcare equipment & services	=	13,236	26.5	8%	66%
GETINGE	Healthcare equipment & services	NR	5,069	19.5	2%	37%
SMITH & NEPHEW	Healthcare equipment & services	+	14,248	18.2	5%	38%
FRAPORT	Industrial transport	=	5,536	17.6	5%	88%
DSV 'B'	Industrial transport	NR	6,608	20.9	7%	84%
ABERTIS INFRAESTRUCTURAS	Industrial transport	=	14,111	18.1	4%	72%
ADP	Industrial transport	+	11,232	23.2	3%	98%
GROUPE EUROTUNNEL	Industrial transport	+	7,059	45.2	2%	100%
ATLANTIA	Industrial transport	+	20,901	19.9	5%	88%
KUEHNE+NAGEL INTL.	Industrial transport	NR	15,005	22.7	5%	61%

Source: Factset, Bloomberg, Exane BNP Paribas estimates

Consensus expects strong earnings growth in Construction. Future earnings growth expectations are broadly in line with the rest of the market for the Energy efficiency and Public infrastructure sectors. The EU's target of executing most projects in the next 3 years means these sectors could see some positive earnings support.

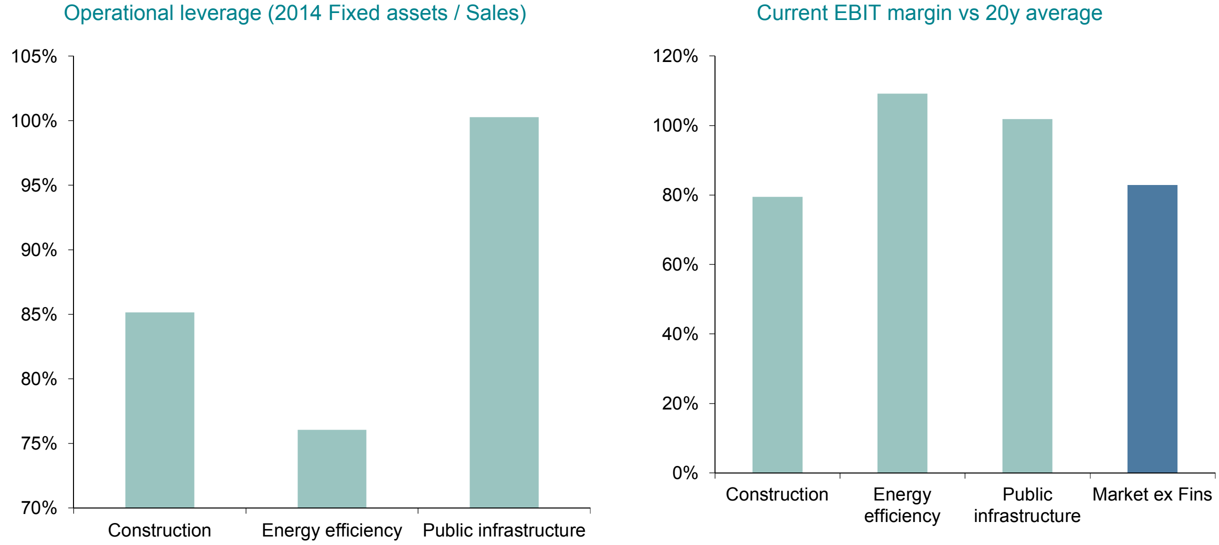
Figure 163: Consensus EPS growth



Source: Factset, Exane BNP Paribas estimates

The potential for higher earnings growth is real given the superior operational leverage of Construction and Public infrastructure and their close to normalised margin levels. Increase sales by a notch and it will disproportionately be felt at the earnings level.

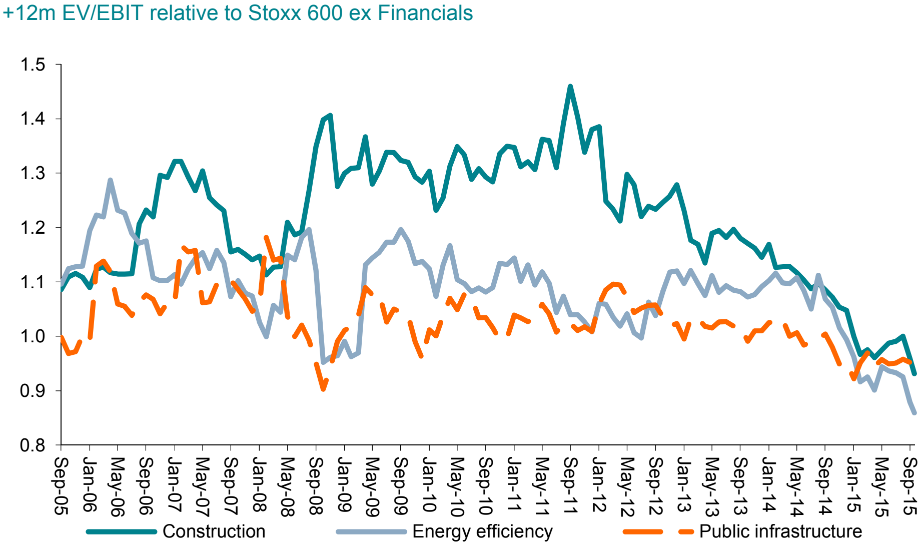
Figure 164: Operational leverage and margin



Source: Datastream, Exane BNP Paribas estimates

Against this positive backdrop of moderate earnings growth expectations, below or close to normalised margins and elevated operational leverage, valuations relative to the market (ex Financials) are closed to an all-time low as shown below.

Figure 165: Attractive relative valuations



Source: Factset, Exane BNP Paribas estimates

From a sector perspective, Energy efficiency (i.e. Renewable energy equipment and Electronic/electrical equipment) and Public infrastructure (i.e. Telecom equipment, Healthcare equipment & services and Industrial transport) combine the most powerful mix of attractive relative valuations, operational leverage and moderate earnings growth expectations.

Earnings growth expectations in Construction (i.e. Building materials/fixtures and Heavy construction) are already elevated but margins are still significantly below normalised levels and operational leverage high. The sector is also naturally exposed to most of these projects.

Stock selection

Our sector analysts have shortlisted companies most exposed to the thematic of higher investment spending in the focus areas of the EFSI.

Figure 166: EFSI exposed names

Company name	Exane rating	Sector	Juncker plan exposure
Fresenius SE	+	Medtech & Services	As Helios gets partial refunding from public bodies of its Capex investments. This helps bring patients to state-of-the art hospitals (thereby boosting organic growth) and further improves efficiencies.
Grifols	+	Medtech & Services	The company already negotiated a EUR 100m loan from the EFSI to finance its R&D activities, which are the basis of future growth.
Danieli	+	Italian Mid-Caps	Steel plant-maker with world leadership in the most energy efficient/less pollutant technologies like DRI and EAF.
Salini Impregilo	+	Italian Mid-Caps	Specialises in construction of large infrastructure projects (dams, tunnels and transport infrastructures). Exposure to Europe is significant: 35% of 2014 backlog in Italy and 11% in the rest of Europe.
Gamesa	+	Italian Mid-Caps	Having access to new financing, especially working capital lines, can be an advantage for the company in its dual capacity as a developer of wind farms + wind turbine manufacturer. Gamesa applies this dual role in geographies such as Mexico and India, two of the most vibrant wind power markets at present.
Vestas	+	Spanish Mid-Caps	The investment case on the shares will firm up by year-end when/if the US government will extend the PTCs (Production Tax Credits) for wind. If this happens, then Vestas' volume visibility in its manufacturing business will rise substantially (2-3 year visibility). This, coupled with its very solid Service business, should raise the appeal of this stock to investors.
Nokia & Alcatel Lucent	+	IT Hardware	The key beneficiary of increased broadband spending (FTTx) in the EU as part of the Juncker Investment Plan for Europe is Alcatel-Lucent (targeted by an ongoing offer by Nokia). ALU is the market leader in European fixed broadband infrastructure with a 40-50% market share (FTTx, VDSL etc) within its Fixed Access infrastructure segment (10% of ALU revenue / 5% of Nokia revenue post ALU acquisition; 10-15% EBIT margin).
HeidelbergCement	+	Building Materials	The group has a high exposure to infrastructure spending in the UK, Germany, Benelux and some Eastern EU markets; and margins in their European business are depressed. US pricing momentum should also help offset any exposure to EM pressures.
CRH Plc	=	Building Materials	The acquisition of assets from LafargeHolcim has increased the group’s leverage to infrastructure in the UK, France, Germany and Eastern Europe. The stock is mostly a US play, but a surprise recovery in Europe would add a new driver for earnings growth.

Source: Exane BNP Paribas

DISCLOSURE APPENDIX

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We, James Bushnell, Valentin Fily, Ian Richards, (authors of or contributors to the report) hereby certify that all of the views expressed in this report accurately reflect our personal view(s) about the company or companies and securities discussed in this report. No part of our compensation was, is, or will be, directly, or indirectly, related to the specific recommendations or views expressed in this research report.

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