Equity Research
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European Equity Strategy

2019 Outlook - Late Cycle Blues

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2019 Outlook – Late Cycle Blues

Our 2019 year-end target for the SXXP is 375 (+5%). Fundamentals call for caution as headwinds from softer growth, EPS downgrades, reducing excess liquidity and messy geopolitics are rising, but stocks are not priced for perfection anymore and sentiment is bearish. Our outlook for European equities assumes low-single-digit EPS growth and modest P/E upside to fair value, and is articulated around three key macro assumptions:

2019 year-end targets

DJStoxx 600	*375 (+5%)*
Eurostoxx	*370 (+6%)*
FTSE100	*7,350 (+5%)*

1) The US upcycle is becoming long in the tooth, but is not over yet

A recession is not Barclays' base case for 2019, but risks are rising and the growth/policy trade-off is worsening. Fiscal boost is fading, corporate margins are likely peaking, output gap is positive and the Fed is increasingly restrictive. Late cycles are not necessarily bad for equities but typically come with lower risk-adjusted returns. Stocks fell by 30% on average during past recessions, so the medium-term risk-reward looks asymmetric to the downside.

2) Global growth is slowing, but is expected to hold near trend

Barclays forecasts resilient, albeit softer, US growth, but looks for the negative momentum to continue in China. External demand is unlikely to boost the European economy, but growth should hold near trend as domestic activity drivers remain well-oriented and the oil price has moved lower. While the ECB is on course to end QE in December, a new TLTRO looks more likely than not. We forecast positive but well below-consensus EPS growth of 4% in the Eurozone and 2% in the UK, as weaker activity will constrain both top-line and profit margins.

3) Geopolitics are unhelpful, but may not get much worse

The long-term national security issues between the US and China are unlikely to be resolved quickly, but the G20 meeting could see some de-escalation of the trade tensions. The future relationship between the UK and EU is also complicated, and a 'no deal' is not impossible, but our base case remains for an orderly Brexit. Italy has turned confrontational with the EU, however tensions could ease ahead of the Parliament election in May. In short, uncertainty will not go away in 2019, but European equities have de-rated and had big outflows already. Assuming no significant worsening in politics, we see modest P/E upside to our fair value.

Regional Allocation

MW US vs. Europe: EPS growth differential between the two is likely to narrow; Europe is trading relatively cheap and is under owned but still faces structural and cyclical challenges.

OW Eurozone vs. UK: Potentially-stronger GBP and higher gilt yields under an orderly Brexit scenario could be headwinds for UK large caps. We favour France and Spain over Germany and Italy on the continent. Our targets are 370 for the SXXE and 7,350 for the FTSE100.

EM backdrop is still challenging but risks are more balanced: Headwinds from trade, China deleveraging, tighter Fed liquidity and a strong USD remain, but MSCI EM is in a bear market, EM/DM GDP growth differential is set to stabilise, lower oil is a positive and EM currencies have fallen a lot already. We close the short on our EM exposure basket (BCEUEREM).

Sector Allocation

Overweights:
Financials
Telecoms
Materials

Marketweights:
Energy
C Discretionary
Healthcare
C Staples

Underweights:
Utilities
Industrials
Technology

Sector Allocation

We hold a neutral beta allocation. Cyclicals have de-rated ytd but will see significant earnings downgrades and won't be helped by range-bound bond yields. We are **OW** Financials (Banks are cheap, under-owned and TLTRO3 could help), Telecoms, Materials; **MW** Energy, Discretionary, Healthcare, Staples; **UW** Utilities, Industrials, Tech.

Thematic Baskets for 2019

Corporate leverage: BCEUELDR/BCEUEHDR; **Wage inflation:** BCEUEWIN; **Trade war:** BCEUTRAD; **Oil price volatility**: BCEUEHCO/BCEUELCO; **Growth/Value**: BCEUGROW/ BCEUVALO; **UK exporters / domestic plays**: BCEUUKEX/BCEUUKDM.

Barclays Analysts' Key European Overweights for 2019

FIGURE 1

Key Overweights by sector for 2019, as recommended by Barclays' analysts

Security	BBC Ticker	Industry	Barclays Analyst	Rating	Price	Currency
BP*	BP/: LN	Integrated Oil & Refining	Lydia Rainforth	OW	512.6	£
Neste	NESTE:FH	Integrated Oil & Refining	Lydia Rainforth	OW	67.9	E
Subsea 7 *	SUBC NO	Oil Services & Drilling	Mick Pickup	OW	86.14	NK
Petrofac	PFC LN	Oil Services & Drilling	Mick Pickup	OW	483.8	£
Glencore*	GLEN LN	Mining	Ian Rossouw	OW	280.55	£
CRH*	CRH ID	Construction	Nabil Ahmed	OW	2165	£
HeidelbergCement	HEI GY	Construction	Nabil Ahmed	OW	58.82	E
BASF*	BAS GY	Chemicals	Sebastian Satz	OW	65.57	E
Assa Abloy*	ASSAB SS	Capital Goods	Lars Brorson	OW	167.25	SK
Experian	EXPN LN	Business Services	Paul Sullivan	OW	1849.5	£
Ferguson*	FERG LN	Business Services	Paul Checketts	OW	4853	£
Rentokil	RTO LN	Business Services	Jane Sparrow	OW	320.4	£
Volkswagen*	VOW3 GY	Autos & Parts	Dorothee Cresswell	OW	146.2	E
Schibsted	SCHA NO	Media & Internet	Andrew Ross	OW	294.9	NK
Accor	AC FP	Leisure	Vicki Stern	OW	39.29	E
Paddy Power Betfair	PPB L N	Leisure	Patrick Coffey	OW	7190	£
Taylor Wimpey	TW/ LN	UK House Building	Jon Bell	OW	152.6	£
Barratt Developments	BDEV LN	UK House Building	Jon Bell	OW	509	£
Tesco*	TSCO LN	Food Retail	James Anstead	OW	202.1	£
Sainsbury	SBRY LN	Food Retail	James Anstead	OW	310.3	£
AstraZeneca*	AZN LN	Pharmaceuticals	Emmanuel Papadakis	OW	6191	£
Genmab*	GEN DC	Pharmaceuticals	Emily Field	OW	987.2	DK
Lloyds*	LLOY LN	Banks	Chris Manners	OW	57.2	£
ABN AMRO	ABN NA	Banks	Omar Fall	OW	22.63	E
Allianz	ALV GY	Insurance	Claudia Gaspari	OW	184.12	E
Munich Re	MUV2 GY	Insurance	Ivan Bokhmat	OW	190.25	E
Prudential*	PRU LN	Insurance	Alan Devlin	OW	15.59	£
Nokia	NOKIA FH	Technology Hardware	Andrew Gardiner	OW	4.864	E
ASML*	ASML NA	Semiconductors	Andrew Gardiner	OW	144.5	E
KPN	KPN NA	Telecom Services	Daniel Morris	OW	2.383	E
Masmovil	MAS SM	Telecom Services	Simon Coles	OW	99.6	E

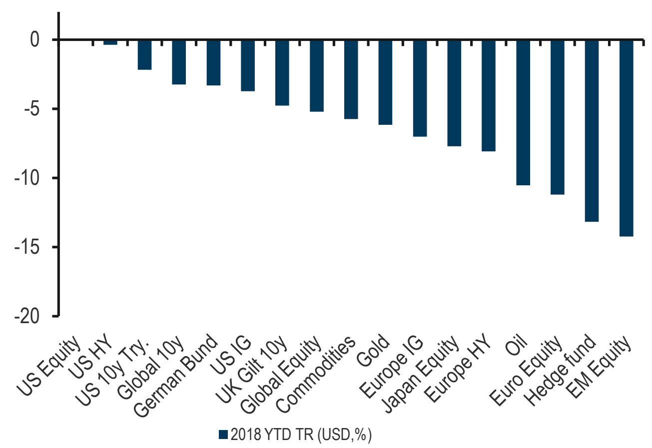
Note: * indicates official analyst Top Picks. See *European Top Picks*, 19 Nov 2018.
Share prices as at market close on 23 November 2018
Source: Bloomberg, Barclays Research

CONTENTS

2019 Outlook – Late-Cycle Blues

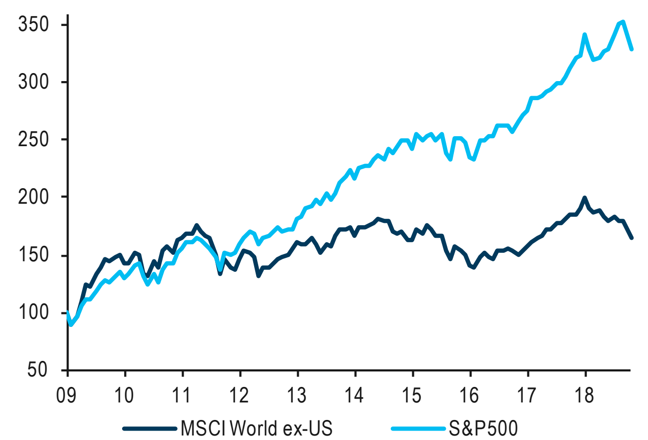
Stocks are not priced for perfection anymore, but fundamentals aren't great

FIGURE 2
Nowhere to hide – most asset classes are down on the year, barring US cash



Source: Datastream, Bloomberg

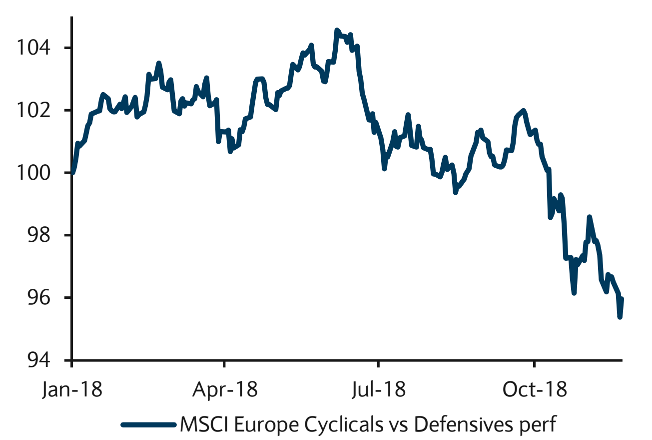
FIGURE 3
The gap between US and ROW equities increased further ytd



Source: Datastream

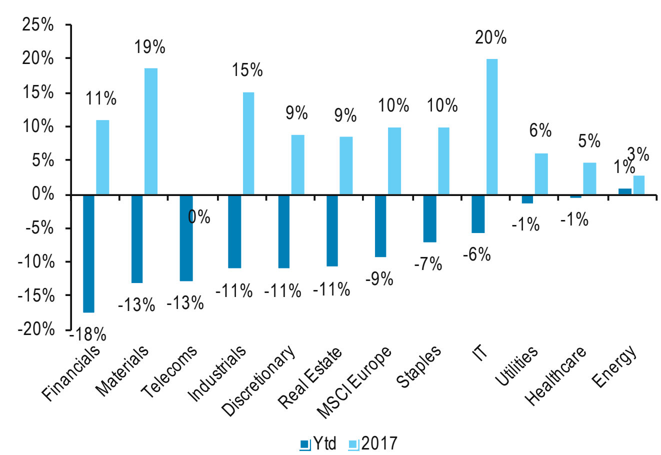
The reflation trade did not go according to plan in 2018. Many pundits had predicted another year of positive returns for equities and struggled to see what could go wrong at the start of 2018 when the global economy was running at full speed. This has not been the case, however – global equities are down ytd and are having their worst year since 2011. Growth disappointed and all the major asset classes are down on the year, barring US cash. High-beta equity markets struggled the most, with EM stocks in a bear market and European stocks down double-digits. US equities have been relatively more resilient than ROW, but have sold off aggressively most recently.

FIGURE 4
Cyclicals have rolled over sharply ytd



Source: Datastream

FIGURE 5
What went up in 2017, went down in 2018

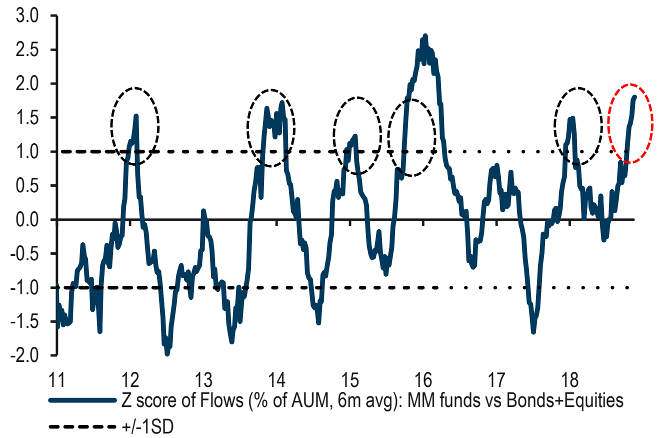


Source: Datastream

Beneath the surface, there has been a broad-based risk-off rotation within the market. Following their strong rally in 2016, 2017 and at the start of the year, Cyclicals and Financials have rolled over vs. Defensives in H2.

FIGURE 6

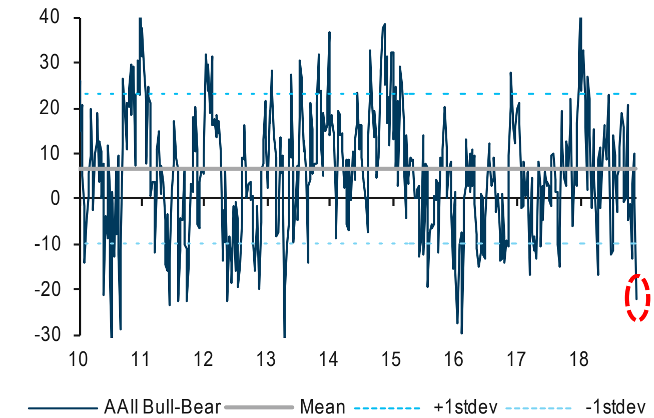
Capital preservation: Asset allocators have cut equity and bond exposure to add to cash



Source: EPFR, Barclays Research

FIGURE 7

Retail investors are bearish: AAII Bull-Bear sentiment index is the lowest since Feb'16

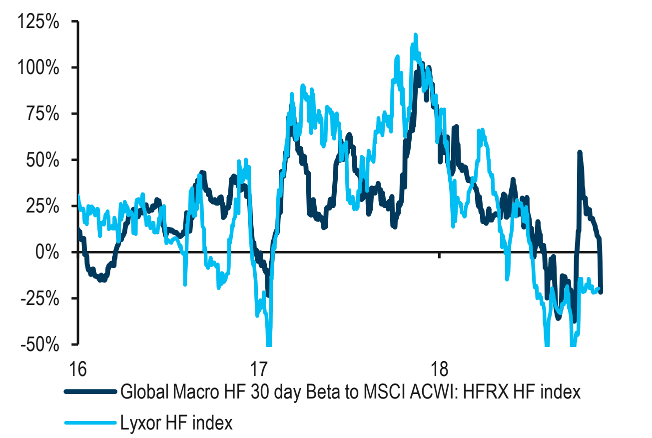


Source: Bloomberg

We may not have seen full capitulation yet, but there is evidence of investors de-leveraging and turning cautious. The reallocation from bonds & equities to cash is looking rather extreme and previous similar episodes were all followed by rising stock prices (see '*Capital Preservation & Value Rotation*' dated 25 October). Likewise, retail investors' sentiment is the most bearish since February 2016, which marked the bottom of the correction back then.

FIGURE 8

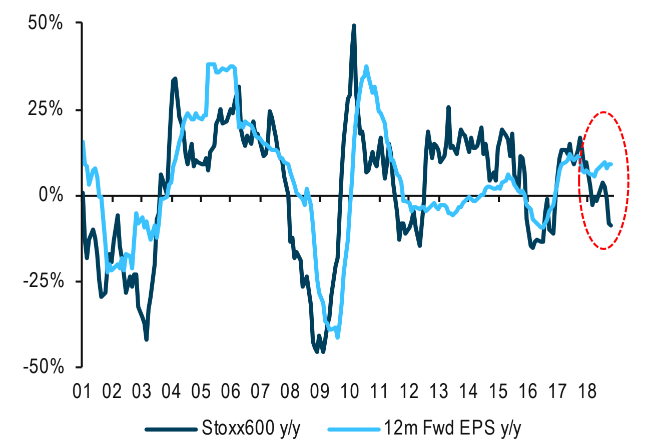
Hedge Funds have deleveraged



Source: Barclays Research

FIGURE 9

Equities are already pricing in a mini earnings recession

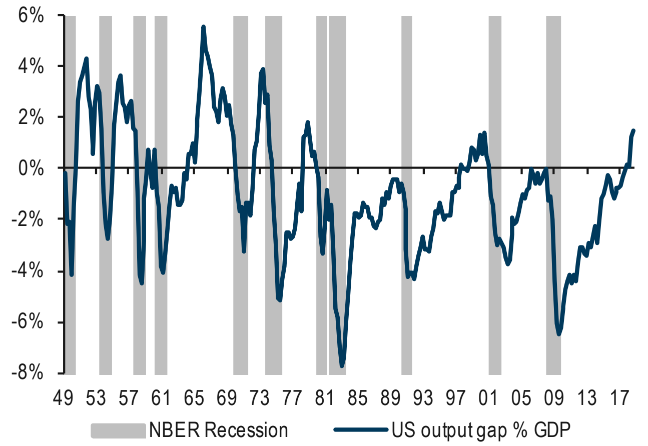


Source: Datastream, IBES

So what to do now? December and January are typically good months for stocks and the G20 meeting, as well as the never-ending Brexit negotiations, could bring some good news… or not. The correction has somewhat improved the near-term risk/reward for equities on this front, but we struggle to feel excited about fundamentals and a catalyst for a sustainable rally appears to be missing (aggressive China stimulus and/or more dovish Fed). Headwinds from slowing growth, reducing liquidity, earnings downgrades and messy geopolitics are rising, which suggests that equities may not be out of the woods yet. However, risks are better understood by investors now and equities are not priced for perfection anymore. We forecast mid-single-digit upside for European equities and articulate our view around three key macro assumptions: 1) US upcycle is at a late stage, but is not finished; 2) Global growth is decelerating, but holding near trend; and 3) Geopolitics are messy, but may not get much worse.

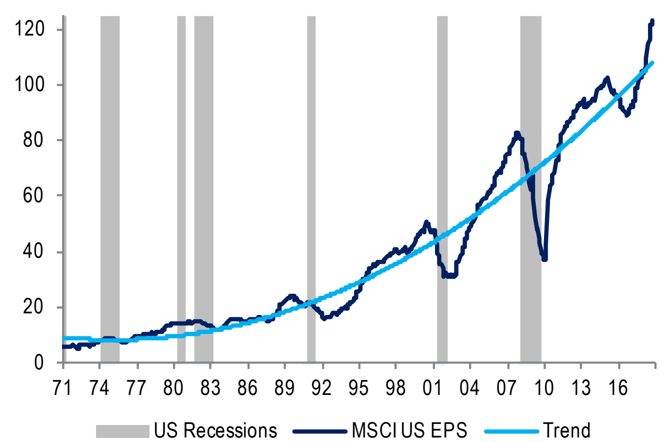
The US upcycle is at a late stage, but may not be over yet

FIGURE 10
US output gap is positive – for how long?



Source: CBOE, NBER

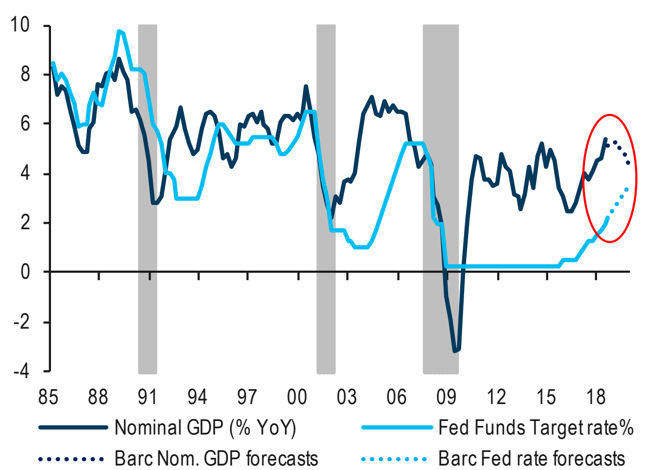
FIGURE 11
US corporate earnings have moved well above the trend following this year's 25% increase



Source: Datastream, NBER

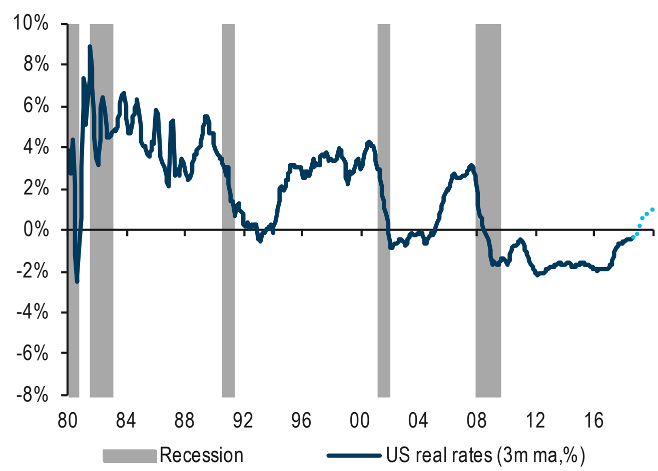
The US recovery started almost ten years ago and is looking rather lengthy by historical standards. Business cycles do not die of old age, but many activity indicators are well above their previous peak at present. Fiscal stimulus led to a strong rebound in US growth this year and the output gap is positive, which is typically a late-cycle phenomenon. Unemployment is at a record low, corporate earnings are well above the historical trend following this year's 25% increase and profit margins are at cycle highs. As good as it gets?

FIGURE 12
Fed funds are still well below nominal GDP growth, but Barclays economists expect the gap to narrow in 2019



Source: NBER, Bloomberg, Barclays Economic Research

FIGURE 13
Real rates are turning positive, but are still below the level seen ahead of past recessions

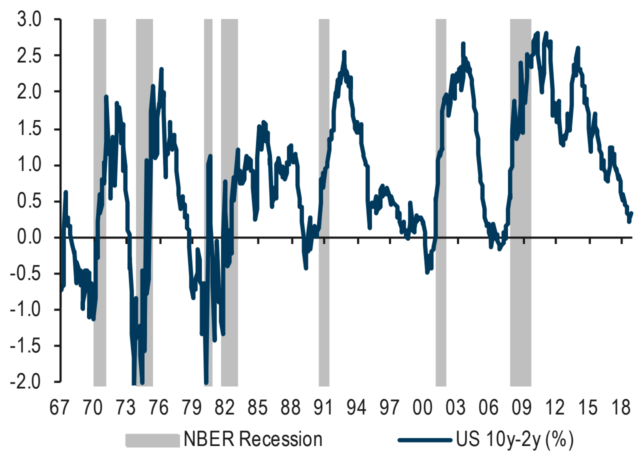


Source: NBER, Bloomberg, Barclays Economic Research

The concern is that while the US cycle is ageing, the Fed is turning more restrictive. Our US economists forecast the Fed to hike rates by 25bp again in December and then every quarter next year, which would leave the Fed Funds rate at 3.5% by the end of 2019. As a result, the gap between the level of rates and the level of nominal GDP growth is set to narrow materially. The obvious risk is that the Fed does too much and too late. We note however that while real rates are turning positive for the first time in a decade, they are still expected to end 2019 at a much lower level than the ones seen ahead of past recessions.

FIGURE 14

The US 10-2y yield curve always inverted ahead of past recessions – we are not there yet



Source: NBER, Datastream

FIGURE 15

Equities never peaked before the yield curve inverted though

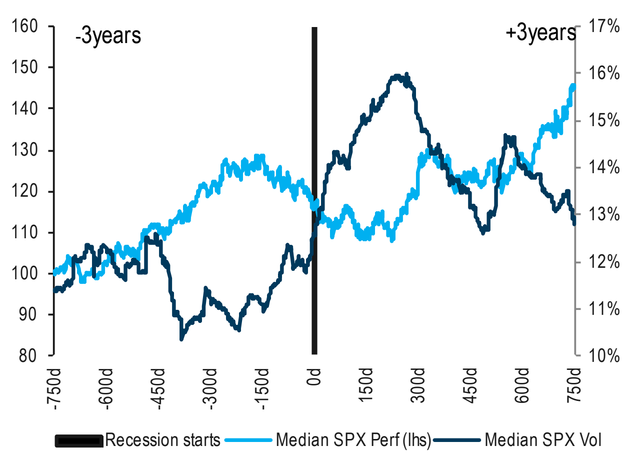
Start of US upcyle	Date of 10-2Y Curve Inversion	Date of S&P500 peak	Start of US Recession	# of months b/w curve inversion & SPX peak	# of months b/w SPX peak & recession	# of months b/w curve inversion & recession	% of cycle when curve inverts	% of cycle when SPX peaks
Mar-61	Dec-67	Nov-68	Dec-69	11	13	24	77%	88%
Dec-70	Mar-73	Sep-73	Nov-73	6	2	8	77%	94%
Apr-75	Aug-78	Jan-80	Jan-80	17	0	17	70%	100%
Jul-80	Sep-80	Nov-80	Jul-81	2	8	10	17%	33%
Dec-82	Dec-88	Jun-90	Jul-90	18	1	19	79%	99%
Apr-91	Feb-00	Aug-00	Mar-01	6	7	13	89%	94%
Dec-01	Aug-06	Oct-07	Dec-07	14	2	16	78%	97%
Average				**11**	**5**	**16**	**70%**	**86%**

Source: Barclays Research

The shape of the US yield curve is at the centre of the cycle debate. The current spread between two- and ten-year bond yields is not far from zero and our Fixed Income strategists believe that it will turn outright negative in Q1 2019. Many believe that an inverted yield curve is a key red flag for the US economy, as every time it happened in the last 50 years, a recession followed, without any false signals. As per the table above the curve typically inverted when the business cycle was 70-75% advanced, and thus it did not mark the end of the cycle. Late-stage doesn't mean end of the cycle and, based on these historical standards, the current expansion could still run for longer.

FIGURE 16

S&P500 performance and volatility around past recessions



Source: Barclays Research, Bloomberg

FIGURE 17

Peak to trough move in S&P500 price and EPS around past US recessions

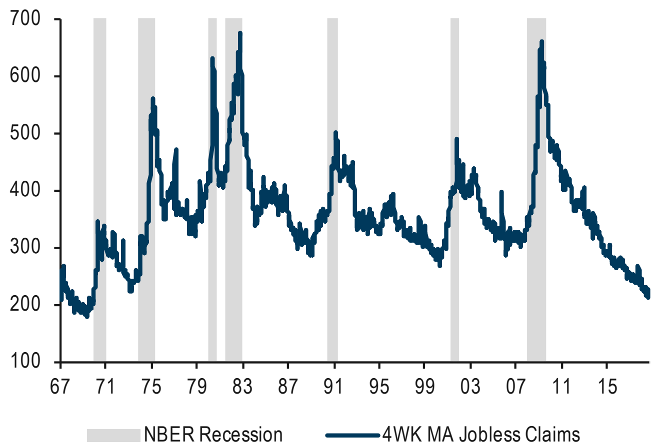
Recession start	Recession end	SPX peak	SPX trough	SPX Peak-trough (months)	Perf: SPX peak to trough	Trailing EPS peak to trough
Jul-53	Apr-54	Jan-53	Sep-53	8	-11%	-18%
Aug-57	Mar-58	Jul-56	Dec-57	17	-17%	-22%
Apr-60	Jan-61	Jul-59	Oct-60	15	-10%	-12%
Dec-69	Oct-70	Nov-68	May-70	18	-36%	-13%
Nov-73	Feb-75	Oct-73	Oct-74	12	-44%	-15%
Jan-80	Jun-80	Jan-80	Mar-80	2	-15%	-5%
Jul-81	Oct-82	Nov-80	Aug-82	21	-27%	-19%
Jul-90	Feb-91	Jul-90	Oct-90	3	-20%	-37%
Mar-01	Oct-01	Aug-00	Oct-02	26	-49%	-54%
Dec-07	May-09	Oct-07	Mar-09	17	-57%	-92%
Average				**14**	**-29%**	**-29%**
Median				**16**	**-24%**	**-18%**

Source: Barclays Research

Also, an inverted yield curve doesn't necessarily mean lower equity markets. The S&P500 peaked on average 11 months after the curve inverted and 5 months before a recession started. Assuming the curve inverts in Q1 next year, the equity bull market could still run into 2020. However, while stocks continued to rise for some time after the curve inverted, they typically produced lower risk-adjusted returns. We also note that equities fell sharply during recessions, by 30% on average. Risks are thus looking asymmetric to the downside, which could dissuade asset allocators from adding to equities at this stage of the cycle.

FIGURE 18

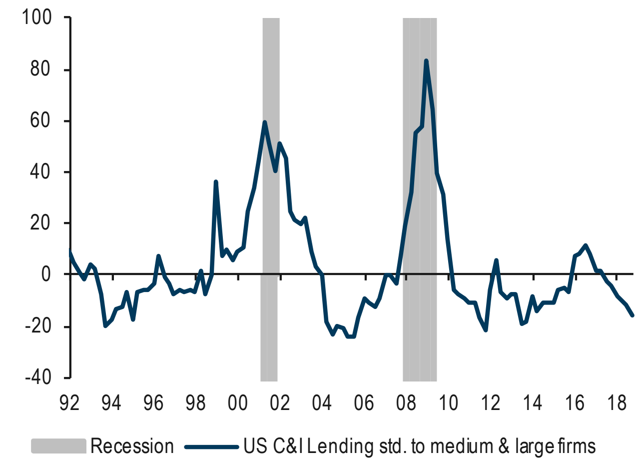
US jobless claims are not flashing red – they typically rose sharply ahead of recessions



Source: Bloomberg, NBER

FIGURE 19

US Banks lending standards remain well oriented

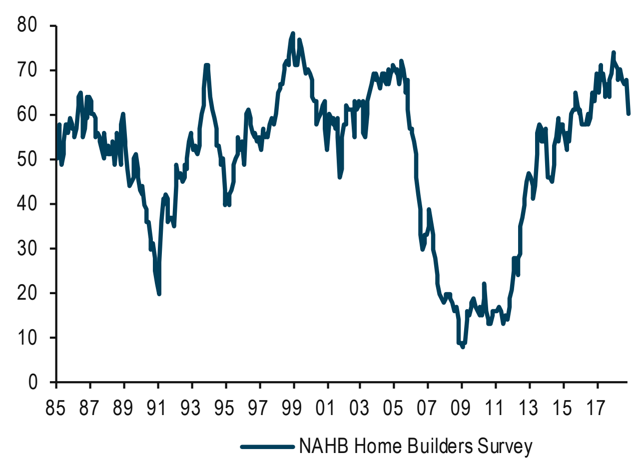


Source: Fed, NBER

While the US economy is undoubtedly in the late stages of the cycle, a trigger appears to be missing for the business cycle to end suddenly, in our view. The labour market is strong and jobless claims remain well-behaved. We note that they always peaked sharply ahead of past recessions. Likewise, bank lending conditions remain favourable, while they always tightened ahead of a downturn.

FIGURE 20

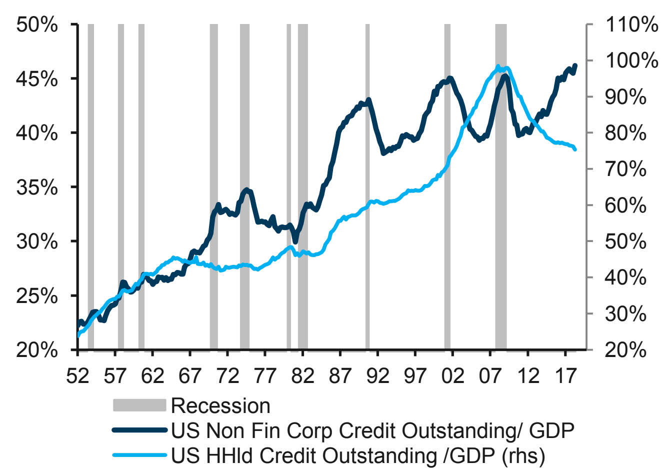
NAHB housing survey has declined sharply most recently



Source: Bloomberg

FIGURE 21

US corporate leverage is stretched, but household leverage is not

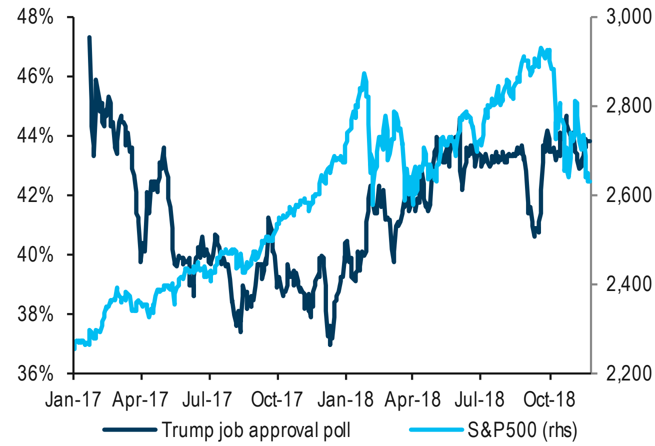


Source: Fed, NBER

It is worth noting, however, that some red flags are appearing and need to be monitored closely. This is mostly the case in rate-sensitive parts of the economy such as housing, where recent indicators have moderated. Elevated corporate leverage is another potential risk, even though household leverage is still well below the previous peak.

FIGURE 22

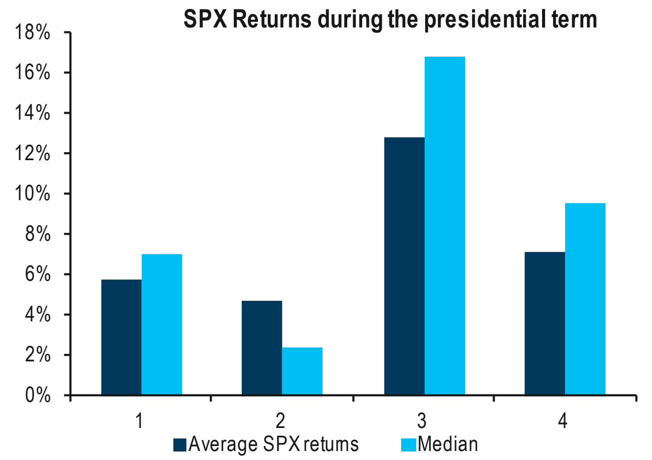
Trump approval ratings and S&P500



Source: Bloomberg

FIGURE 23

The third year of presidential terms is typically the strongest for S&P500 returns



Source: Barclays Research; Note: Year-4 is Presidential election year, since 1928

We note that the third year of the Presidential tenure was typically associated with strong equity returns. While we see little prospects for a bi-partisan agreement on further fiscal spending, we believe that President Trump will stick to his 'America First' agenda, with the aim to boost the economy and the equity market ahead of the 2020 election.

Global growth is softening, but is expected to hold near trend

FIGURE 24

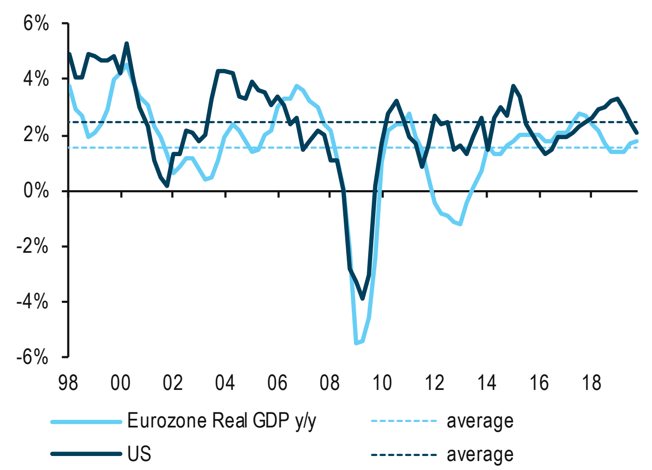
Barclays' economists forecast decelerating but still resilient global growth in 2019...

	Real GDP %y/y				
	2015	2016	2017	2018e	2019e
Global	3.7	3.6	3.9	3.9	3.7
US	2.9	1.6	2.2	2.9	2.7
UK	2.3	1.8	1.7	1.3	1.4
Euro Area	2.0	1.9	2.4	2.0	1.6
Germany	1.5	2.2	2.5	1.5	1.4
France	1.0	1.1	2.3	1.6	1.6
Italy	0.8	1.0	1.6	1.0	0.9
Spain	3.6	3.2	3.0	2.5	2.1
Japan	1.4	1.0	1.7	0.9	1.1
DM	2.3	1.7	2.2	2.3	2.0
EM	4.5	4.6	5.2	5.1	4.9
China	6.9	6.7	6.9	6.6	6.2
India	7.6	7.9	6.2	7.7	7.4
Brazil	-3.5	-3.5	1.0	1.4	2.0
Mexico	3.3	2.9	2.0	2.1	1.8
Russia	-3.7	-0.2	1.5	2.0	1.0

Source: Barclays Economic Research

FIGURE 25

...looking for near-trend growth in US and Eurozone

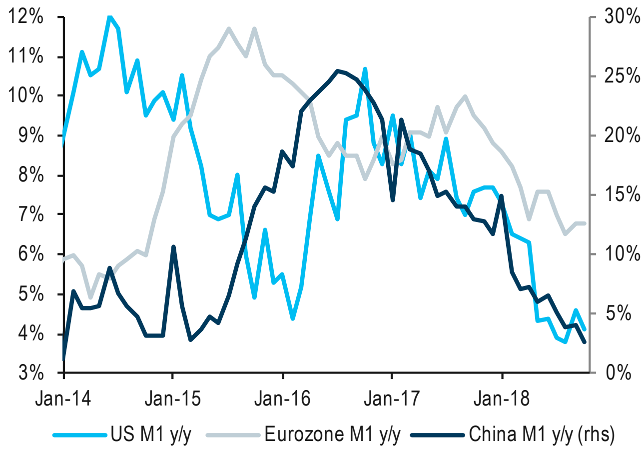


Source: Barclays Economic Research

As 2017 was the year of global synchronised recovery, 2018 was characterised by a de-synchronised slowdown. European and EM activity momentum rolled over sharply while the US accelerated, courtesy of the fiscal stimulus. For 2019, our economists expect slowing growth across all the main regions and look for weaker global GDP growth of 3.7%, down from 3.9% in 2018. US growth has likely peaked and should move back to trend in 2019. The tax cuts provided a significant boost to consumption and capex, but the fiscal impulse to domestic demand will likely be fading next year while the split Congress reduces the probability of further fiscal stimulus. Federal spending is set to remain elevated though and the private sector remains generally in a good shape.

FIGURE 26

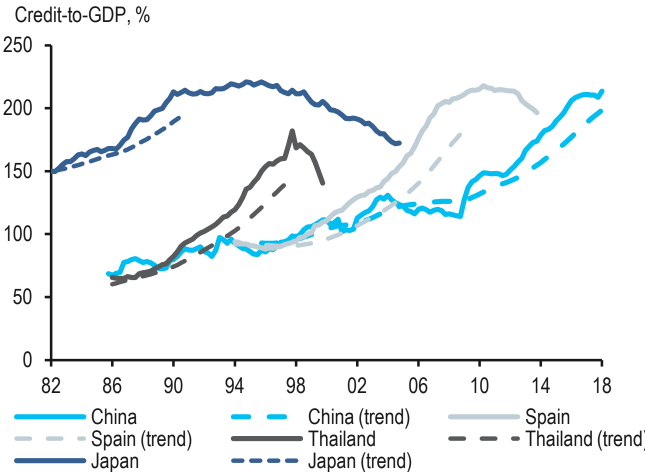
Money supply is on a downtrend in the US, Eurozone and China



Source: Bloomberg

FIGURE 27

China private leverage is elevated, which constrains the ability of policy makers to stimulate growth

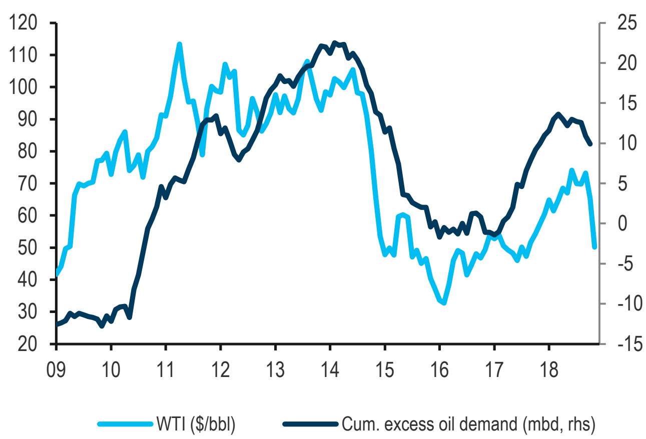


Source: BIS, Barclays Economics Research

In the meantime, measures of money supply keep rolling over in all the main regions as central banks unwind QE. In the case of China, credit and activity data have disappointed in 2018, which we believe was mostly self-induced and policy-driven. Domestic activity indicators remain soft across the board and we believe that the Chinese government will refrain from over stimulating the economy in 2019. On the contrary, our economists' view is that the government is willing to tolerate lower growth as it focuses on deleveraging the private sector, reducing structural imbalances and re-balancing the economy. Our economists forecast a small current account deficit next year, after decades of consistent surpluses, as services and energy trade balance have continued to deteriorate. Chinese exports have been surprisingly resilient ytd despite the negative headlines on trade. We believe this could be due to companies rushing to make shipments before the higher tariffs kick-in in January. There is thus a risk that exports materially slow in Q1.

FIGURE 28

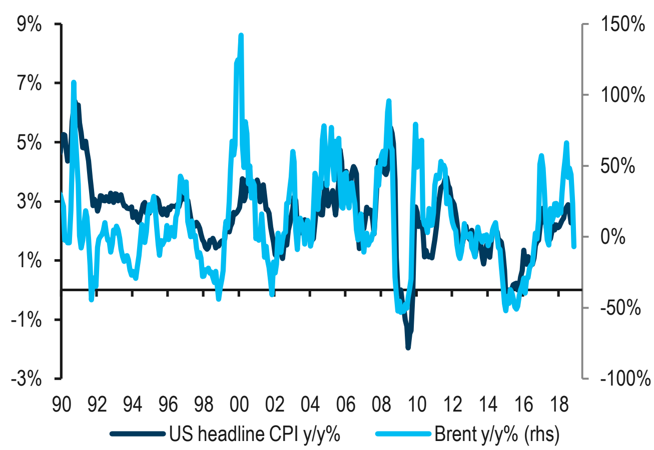
Oil price has followed the increase in demand in the last two years, but both are moving lower most recently



Source: Bloomberg

FIGURE 29

The fall in oil prices, if sustained, will result in lower inflation

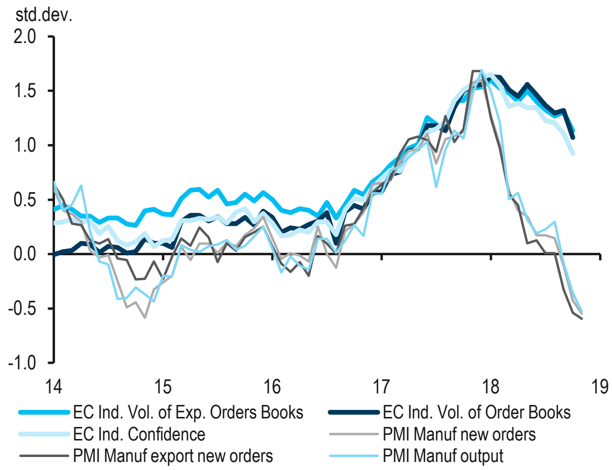


Source: Datastream

The strength in oil since mid-2016 accompanied the rebound in global activity and looked to be mostly driven by rising demand, even though tightening supply likely played a role too. The oil price has fallen sharply most recently, which we see as further evidence of softening activity. However, we think that lower oil, if sustained, could end up being a positive development for growth, as it eases the pressure on the consumer. This would be a relief for importers like Europe and many EM countries that were badly hurt by the mix of strong dollar and rising oil this year. As lower oil is deflationary, if could also provide some policy flexibility to central banks.

FIGURE 30

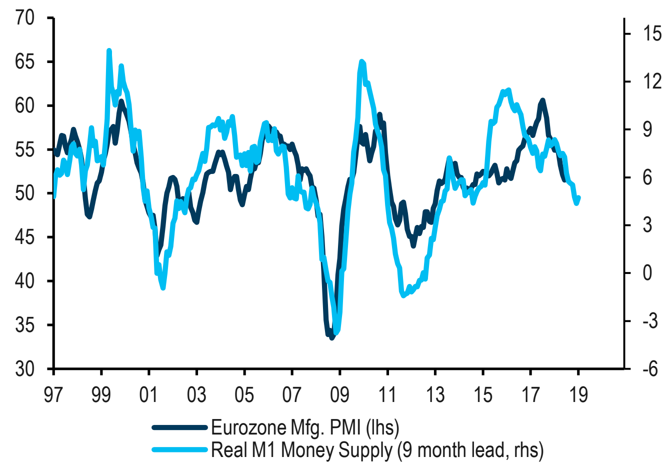
European surveys show a sharp loss of manufacturing momentum



Source: Haver Analytics, Markit, EC, Barclays Economic Research

FIGURE 31

The weaker PMI has been consistent with the roll-over in money supply

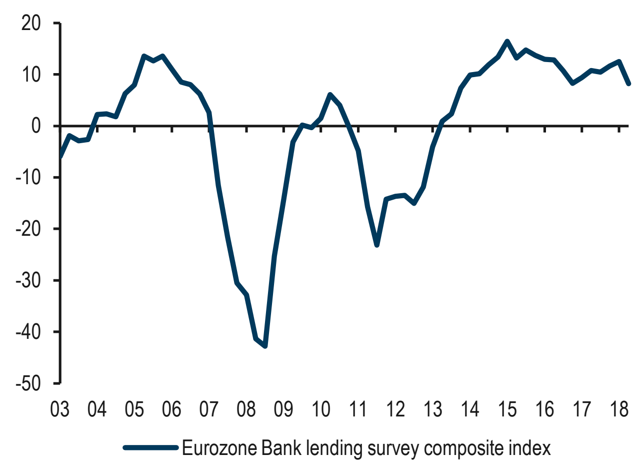


Source: Markit, ECB, Bloomberg, Datastream

In the Eurozone, following a strong 2017, activity momentum ran out of steam this year. Growth was particularly weak in Q3, which was mostly due to GDP contraction in Germany. We believe the weakness was driven largely by the collapse in auto sector output following the change in pollution emission standards (WLTP) and by weakening global trade. The drag from the auto sector is likely transitory from a GDP perspective, but with WLTP scheduled to be tightened further, the car market is likely to remain tough in 2019. Likewise, the uncertain trade outlook and our expectation of slowing Chinese activity point to external demand conditions remaining challenging next year.

FIGURE 32

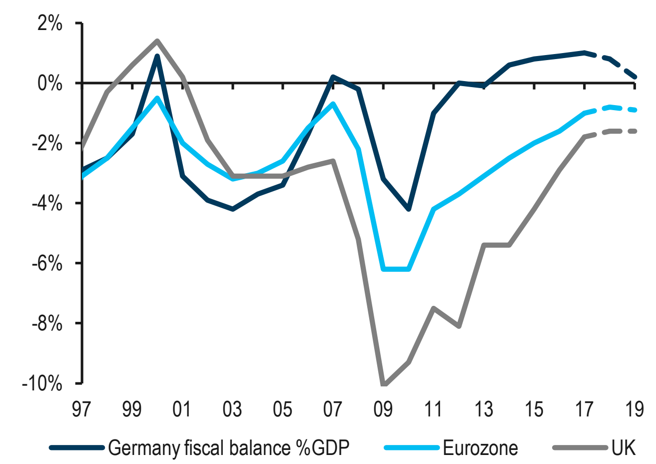
Eurozone bank lending survey remains well-oriented



Source: Bloomberg

FIGURE 33

Fiscal policy is turning less restrictive across Europe

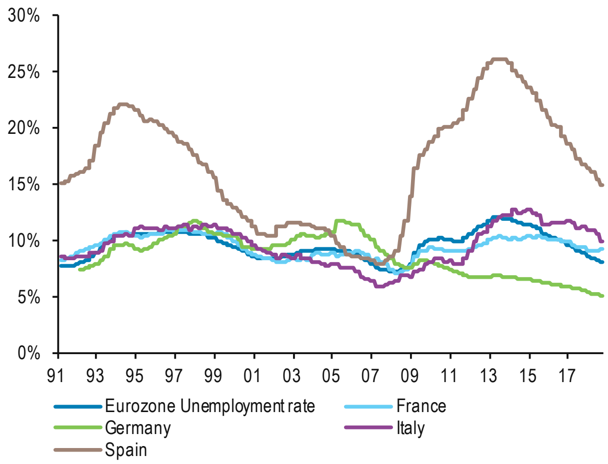


Source: Bloomberg, Barclays Research

Financing conditions remain favourable in the Eurozone and our economists expect the ECB to end QE in December. However, softer activity, political uncertainty in Italy and muted core inflation dynamics point to downside risks to the bank's current assessment of a "balanced risk profile". We thus believe that the first rate hike is unlikely to come before the end of 2019 at the earliest, while the likelihood of a new Targeted Longer Term Refinancing Operation (TLTRO) to be announced sooner-rather-than-later is rising. On the fiscal side, however, the pressure from austerity is easing following a decade of consolidation. Fiscal balances are moving lower as many countries, including Germany, turn more supportive of growth.

FIGURE 34

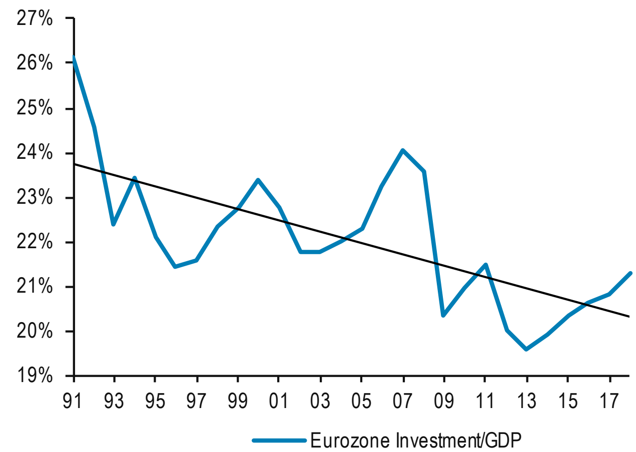
Unemployment rate is at cycle lows across the Eurozone...



Source: Eurostat

FIGURE 35

...and the capex share of GDP has rebounded

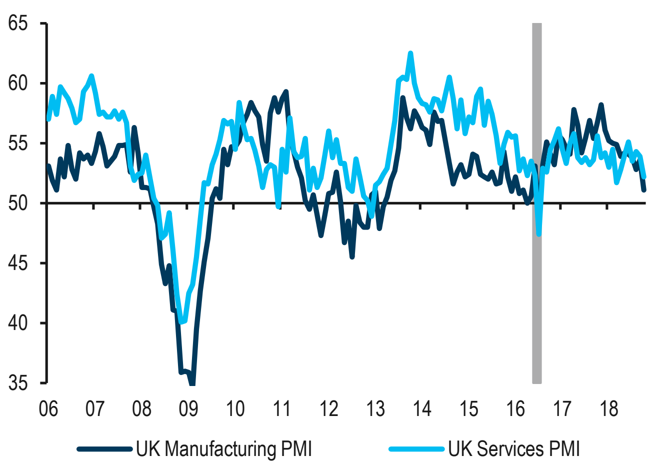


Source: IMF

Amid favourable financing and fiscal conditions, Eurozone private demand remains robust. Labour markets are strong and the unemployment rate is at the lowest level in a decade in most countries. Likewise, investment remains healthy and capex share of GDP is on an uptrend.

FIGURE 36

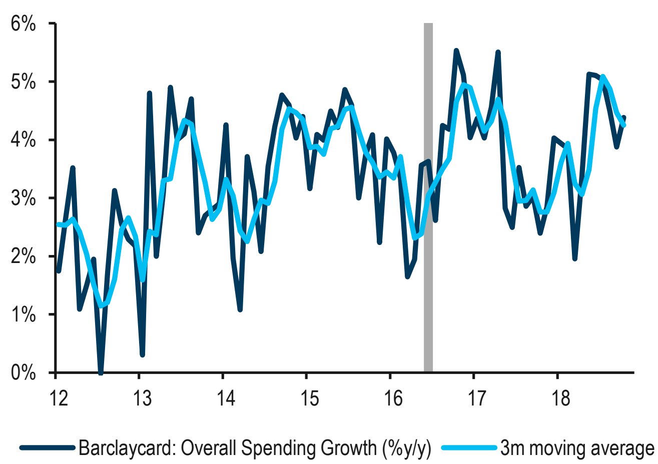
UK PMIs have rolled over sharply most recently



Source: Bloomberg, Markit

FIGURE 37

UK consumer surprised on the upside during the summer, but appears to be cooling most recently

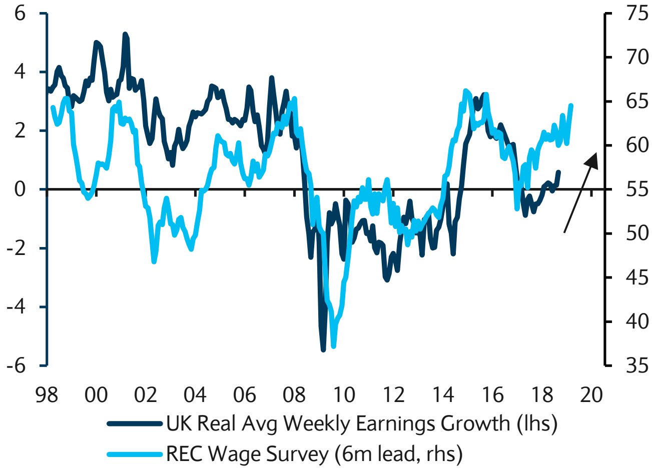


Source: Barclaycard

In the UK, our economists expect subdued and below-trend growth to persist in 2019. The latest surveys are indicative of a loss of momentum and are consistent with a reduced growth rate relative to historical standards. The composition of growth over the recent year suggests a somewhat stronger consumer-spending momentum than our economists previously expected, but conversely a weaker contribution of investment, possibly reflecting Brexit uncertainty.

FIGURE 38

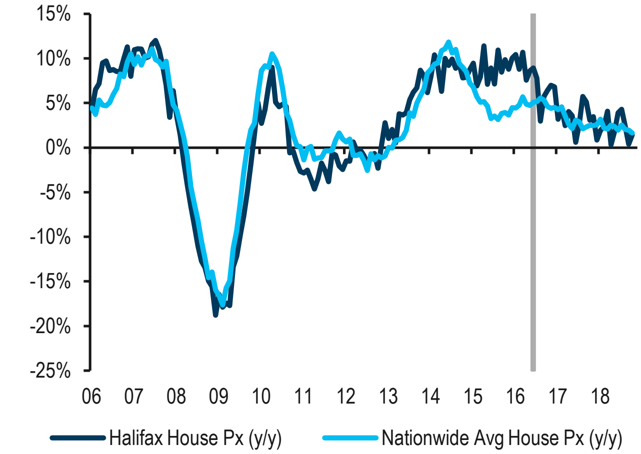
UK real wage growth is picking up...



Source: REC, Bloomberg

FIGURE 39

...but house prices are cooling down



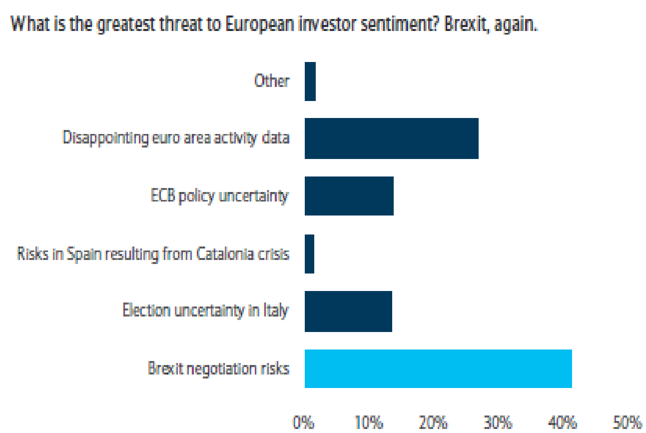
Source: NBS, Halifax, Datastream

Strong employment and rising wages are supportive of consumption, but households appear to have turned more cautious. Risks surrounding businesses have intensified, as the global manufacturing sector is slowing down, the auto market faltered across Europe, and Brexit uncertainty is not going away. While part of that slowdown appears temporary (new emission rules, tax changes), it seems unlikely that momentum will be restored quickly, given the lingering and persistent drag stemming from trade tensions. On the upside, the Budget statement suggested some short-term relaxation of fiscal consolidation that could support demand. We believe that an orderly Brexit would be a positive catalyst for domestic growth and would open the door to more BOE rate hikes, but we are not there yet.

Geopolitics are not a reason to cheer, but they may not get much worse

FIGURE 40

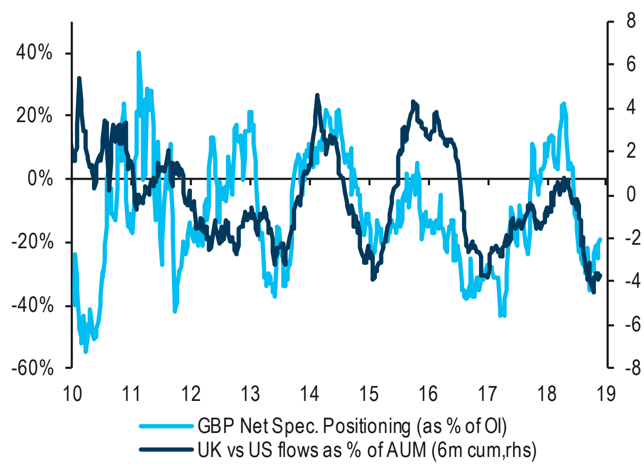
Global investors see Brexit as the biggest risk in Europe…



Source: Barclays Global Macro Survey, 28 September 2018

FIGURE 41

…and have significantly reduced exposure to UK assets

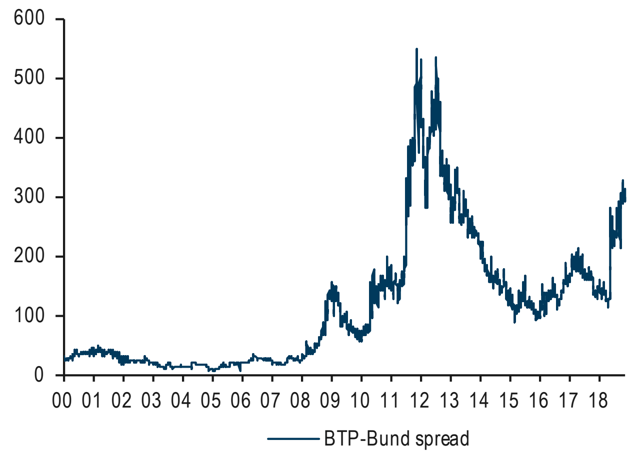


Source: EPFR, Datastream, Barclays Research

Geopolitics have not been kind to markets this year. Starting with Brexit, our base case is that a Withdrawal Agreement will be concluded, which should open the door to an orderly exit of the UK from the EU in March. But internal UK politics remain worrisome and a 'no deal' is not impossible. We note, however, that UK equities are consensus UW and had significant outflows since the EU referendum in June 2016. Likewise, net-shorts on GBP futures are near historical lows. No one appears to be positioned for good news anymore.

FIGURE 42

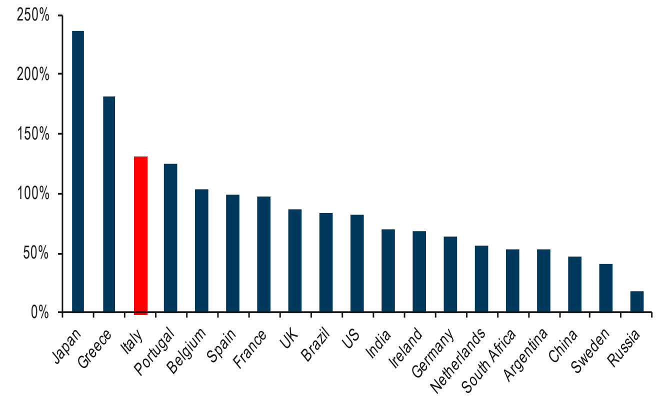
BTP-Bund spread is the highest since the debt crisis – the new normal?



Source: Datastream

FIGURE 43

Italy public-debt-to-GDP looks difficult to sustain at the current level

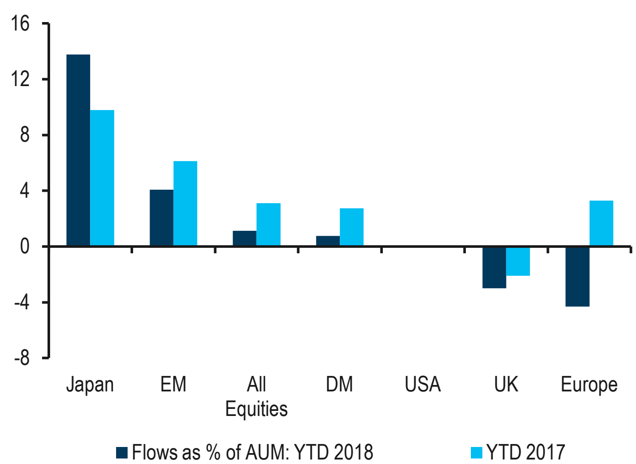


Source: Bloomberg, as of 2017

Elsewhere in Europe, Italy is likely to remain in the spotlight next year as the Italian government has turned confrontational with the EU on the budget deficit. Our economists believe that Italy is unlikely to comply with the European Commission's request to reduce the 2019 fiscal deficit target and see increasing risk that the EC recommends to the ECOFIN Council opening an Excessive Deficit Procedure (EDP) in violation of debt reduction benchmarks set by the Stability and Growth Pact, which could lead to sanctions. However, we do not expect the government to escalate fully-fledged anti-EU rhetoric, but rather to preserve a fine balance between the need to maintain an electorally-rewarding confrontational stance with the EU ahead of parliament elections, and avoiding outright confrontation with the EU that could lead to worsening bond-market pressures. On the other hand, from an EU perspective, an aggressive move towards fast-tracking sanctions against Italy could bolster the Italian government's anti-EU rhetoric ahead of the parliament elections. A thawing of tensions is thus possible, but the situation is fluid and somewhat unpredictable, so further escalation of verbal confrontation could still occur.

FIGURE 44

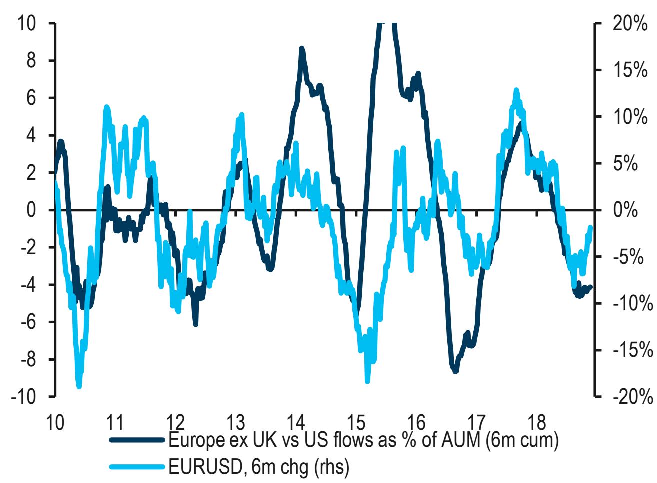
Ytd regional equity flows vs. 2017, as % of AUM



Source: EPFR, Barclays Research

FIGURE 45

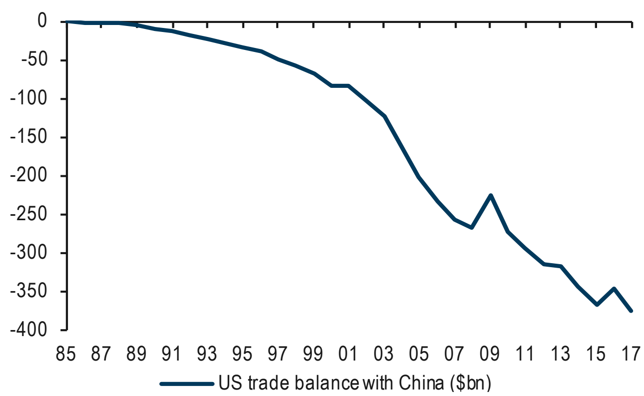
Europe equity outflows vs. US and EUR/USD



Source: EPFR, Barclays Research

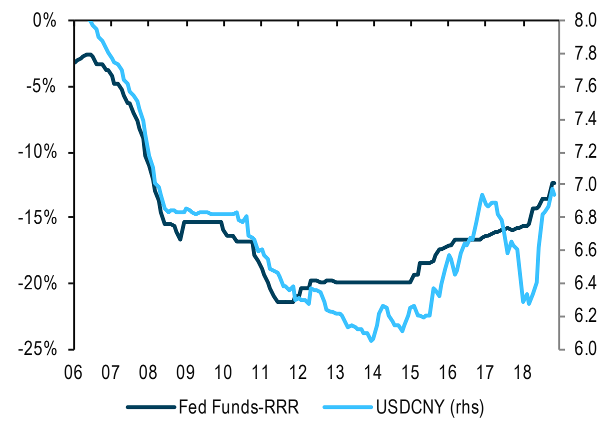
Beyond Brexit and Italy, the European political agenda will be busy in 2019. As Chancellor Merkel steps down as CDU party leader, succession plans are being activated and will have a material impact on the broader political direction of the EU. French President Macron is struggling at home and reliant on a revamped alliance with Germany to promote his ambitious EU reform plan and to counter populism. The EU parliament elections in May will be important in this regard and could reshape European politics. In short, we struggle to feel constructive on European politics for 2019, but no one does and a lot appears to be in the price already, as all the inflows into European equities from 2017 have been unwound ytd.

FIGURE 46
US trade balance with China



Source: Census

FIGURE 47
Further CNY weakness in 2019 is likely



Source: Bloomberg

On trade, our economists believe that softer growth in China and a desire to boost economic optimism after the mid-term elections in the US could bring the two sides together to reach a deal at the upcoming G20 meeting. A type of 'framework agreement', including Chinese purchases of US exports in exchange for tariff relief and improved market access seems most likely. The US is scheduled to raise the 10% tariff on $200bn worth of imports to a rate of 25% beginning 1 January 2019.

A G20 agreement could mean the higher tariff rate does not go into effect. However, Secretary Ross indicated the administration still plans to raise the tariff rate in January, suggesting that any tariff relief would begin from a higher starting level. Any agreement is likely to include benchmarks whereby each side can assess the other's progress. In other words, there may not be a discrete reversal of trade tensions, but a gradual dissipation over several quarters, should obligations be met. With these benchmarks comes the risk that any agreement goes off track at a later date.

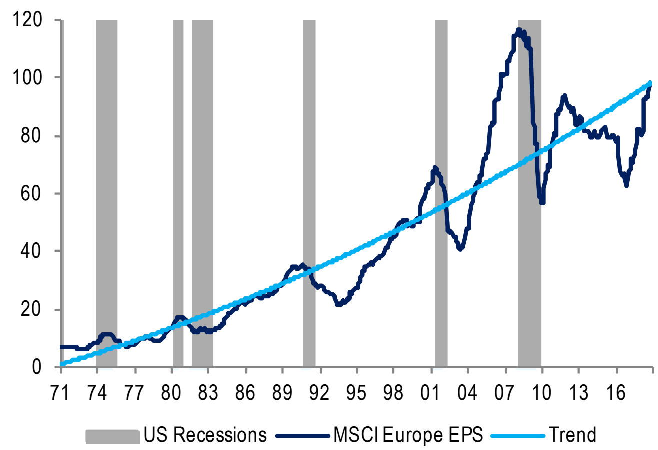
A potential agreement on trade would likely be a relief for investors, but the strategic issues about alleged intellectual property theft, forced transfer of technology and China's industrial policies are unlikely to be resolved quickly. See '*A potential framework agreement on trade at the G20*' dated 16 November for details.

Barclays does not expect FX to be used as a policy tool into year-end, as financial stability is the priority and there is still uncertainty on the next stages of the trade war. However, going into 2019, while a de-escalation of trade tensions would deliver a more persistent period of currency stability, further deterioration in growth could see CNY depreciation used as part of the policy response, despite its low efficacy. As result, our FX strategists recently revised their CNY forecast to 7.15 for Q2 2019. See '*Raising our 2019 USDCNY forecasts on slower China growth and likely tariff escalation*' dated 15 November.

Earnings – looking for low single-digit growth

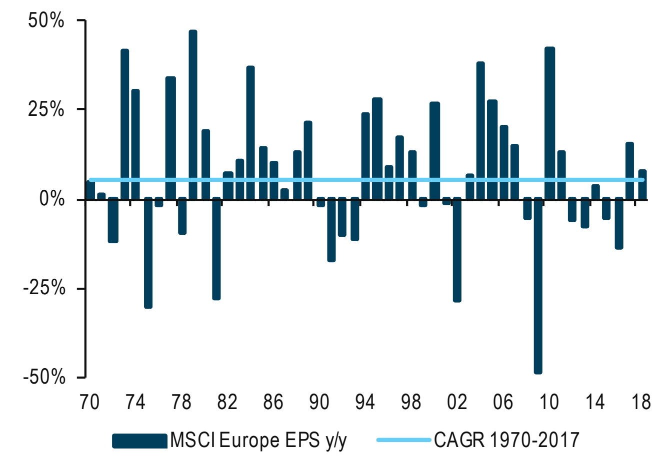
Weaker activity means weaker earnings

FIGURE 48
Earnings have also rebounded in Europe but are not as stretched as the US ones



Source: Datastream, NBER

FIGURE 49
Long-term annual EPS growth rate is 5% for MSCI Europe



Source: Datastream

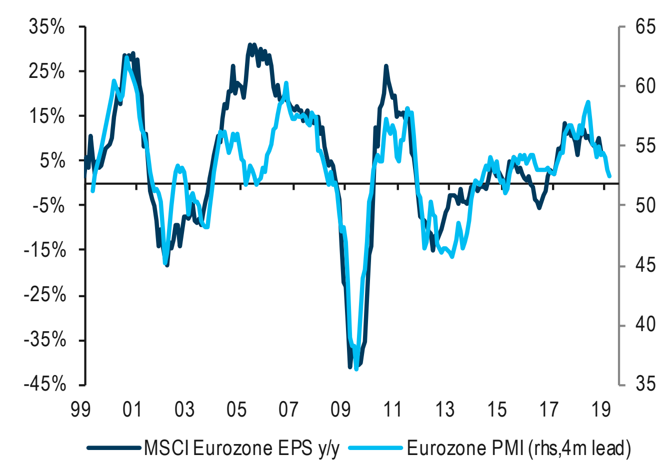
European earnings are not as stretched as the US, but still managed to rebound strongly and to grow above-trend in the last two years. Base effects are thus turning less favourable for 2019.

FIGURE 50
3% Global GDP growth is the threshold for positive EPS growth

Global Real GDP y/y	MSCI World EPS y/y	MSCI US EPS y/y	MSCI Europe EPS y/y
<2%	-6.6%	-4.7%	-1.4%
2-2.5%	-8.2%	-3.1%	-9.5%
2.5-3%	-4.4%	2.1%	-9.4%
3-3.5%	**1.7%**	**2.2%**	**3.6%**
3.5-4%	**12.8%**	**9.2%**	**13.3%**
4-5%	17.5%	13.7%	18.1%
>5%	14.5%	15.9%	10.3%

Source: Barclays Research, Note: median quarterly EPS growth y/y

FIGURE 51
At the current level, Eurozone PMI points to almost no EPS growth in 2019



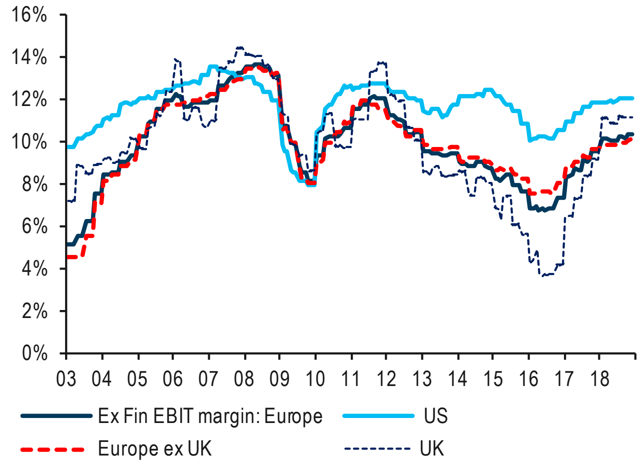
Source: Bloomberg, Markit, IBES

The strong rebound in earnings of the last two years coincided with the global synchronised recovery. It is thus likely that softer activity in 2019, coupled with less favourable base effects, will result in much lower EPS growth. Our economists forecast 3.7% global GDP growth next year, which is above the typical 3% threshold for positive EPS growth. However, Eurozone composite PMI has rolled over sharply ytd and its current level of 52.4 is consistent with almost zero growth in earnings.

Margins have likely peaked

FIGURE 52

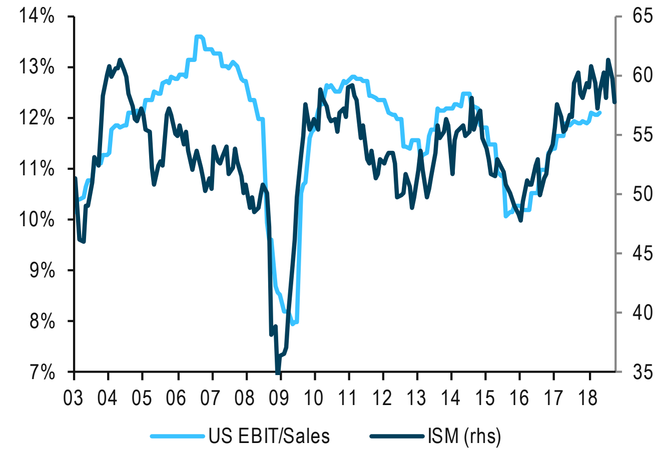
Operating margins are at/near cycle highs in US and Europe



Source: Datastream, Barclays Research

FIGURE 53

Profit margins are cyclical and move with activity indicators

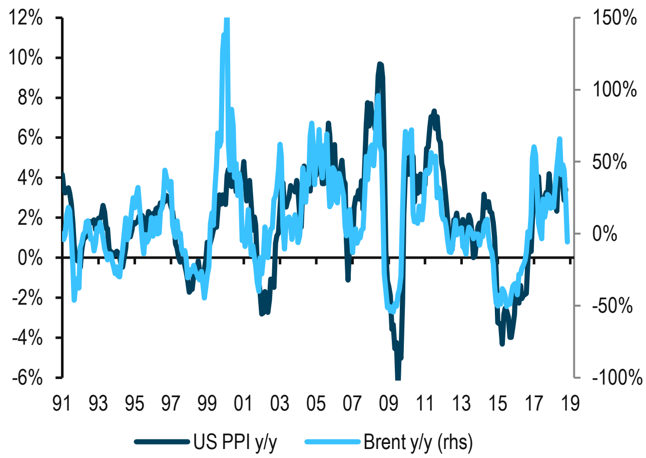


Source: Datastream, Barclays Research

Both top-line and profit margins have contributed to the strong rebound in earnings over the last two years. However, margins are near the cycle-highs in most regions at present and are unlikely to expand in 2019 if activity rolls over. Margins are indeed cyclical and follow the top-line direction.

FIGURE 54

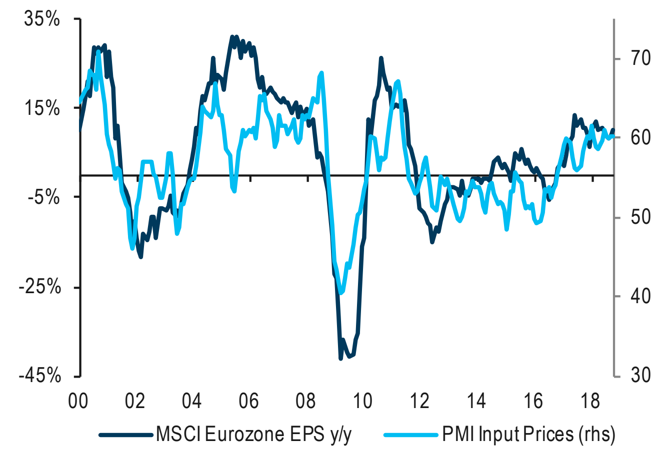
Corporate pricing indicators are closely tied to the direction of the oil price



Source: Datastream, Bloomberg

FIGURE 55

Eurozone earnings vs. PMI input costs

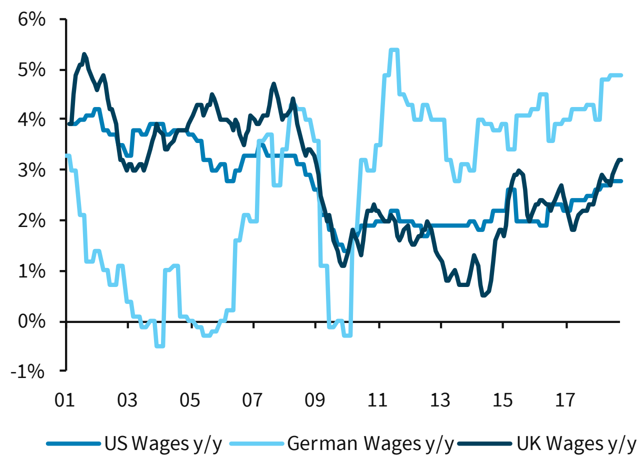


Source: Datastream, Bloomberg, Markit

Along with strong volume growth, pricing also contributed to top-line over the last two years, while cost inflation was contained. As a result, margins expanded. This is likely changing now as the recent drop in oil, if sustained, will likely reduce corporate pricing power.

FIGURE 56

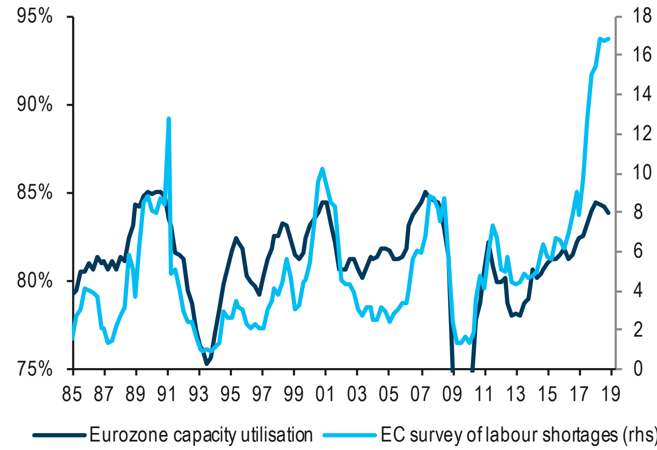
Wage growth is picking up in the US and Europe



Source: Bloomberg

FIGURE 57

Eurozone capacity utilisation and labour shortages are both at cycle highs

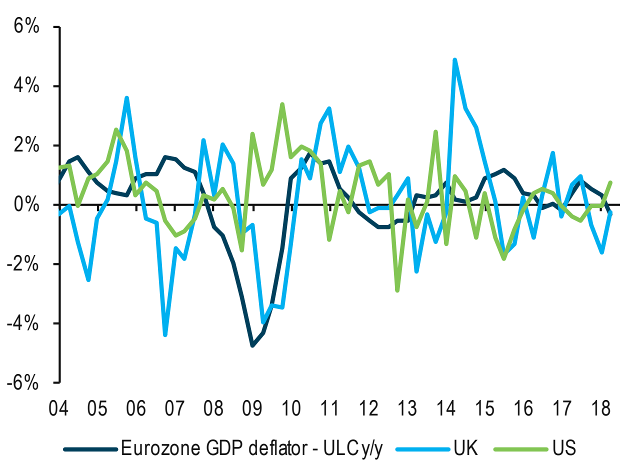


Source: Eurostat, Bloomberg

At the same time, late-cycle input-cost pressures are becoming more evident. As the unemployment rate is at cycle-lows in most developed markets currently, wage growth is firming up. This is not only the case in the US, but also in the UK and Germany, where labour market conditions are tightening, too. Eurozone capacity utilisation is at cycle-highs and the EC survey of labour shortage is the highest on record. Both are likely to reflect higher input costs for companies, in our view.

FIGURE 58

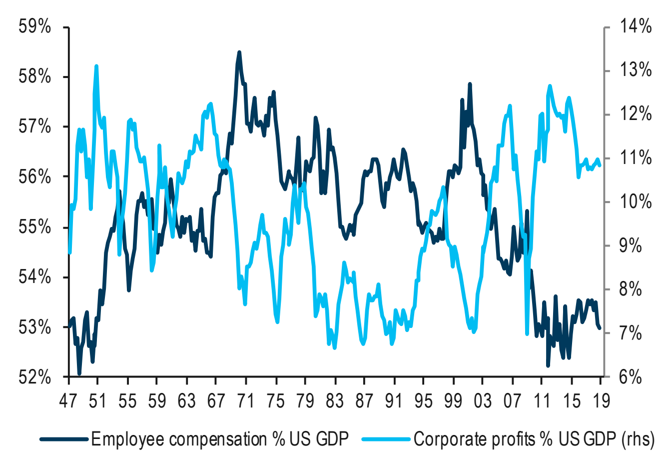
Unit Labour Costs are growing at about the same pace as GDP deflator



Source: Bloomberg

FIGURE 59

US corporate profits and wages shares of GDP keep moving in opposite directions



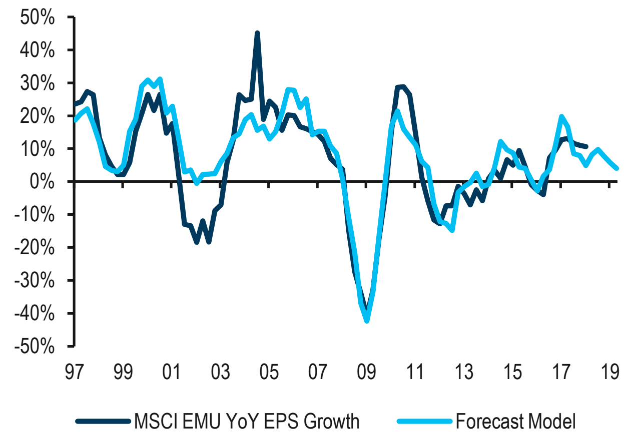
Source: BEA

Having said that, we note that the increase in Unit Labour Costs remains modest by historical standards and that it is still running at about the same level as overall inflation. In the case of the US, our economists believe that companies still have ammunition to absorb higher labour costs and continue to maintain high profitability.

Consensus estimates are too optimistic

FIGURE 60

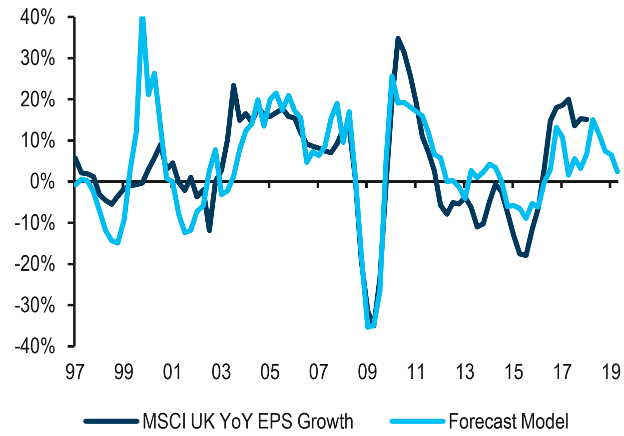
We forecast 4% EPS growth for the Eurozone in 2019



Source: Datastream, IBES, Bloomberg, Barclays Research

FIGURE 61

We forecast 2% EPS growth for the UK in 2019



Source: Datastream, IBES, Bloomberg, Barclays Research

Our earnings models forecast low single-digit growth in 2019 for both the Eurozone (4%) and UK (2%). This is mostly due to the lower GDP forecasts provided by our economists, but flat-to-lower commodity prices and slightly higher FX predictions also provide a headwind to earnings growth over the forecast horizon.

FIGURE 62

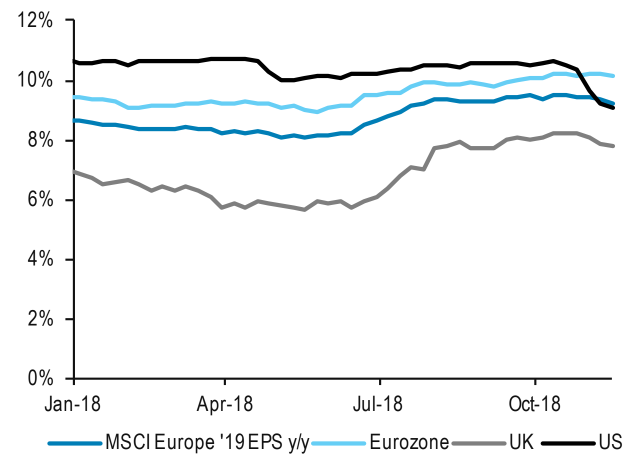
IBES is looking for another year of healthy EPS growth in 2019

EPS y/y	2020	2019	2018	2017
MSCI World	9.1%	8.5%	16.2%	16.3%
US	10.4%	9.1%	24.2%	11.8%
Europe	8.1%	9.3%	7.4%	15.5%
UK	6.5%	7.8%	10.3%	24.9%
Eurozone	8.9%	10.1%	4.8%	13.7%
Germany	9.3%	11.6%	-2.8%	15.6%
France	8.9%	9.8%	9.7%	8.7%
Italy	7.6%	11.0%	20.1%	27.0%
Spain	7.8%	8.0%	7.5%	10.7%
Japan	4.7%	3.5%	3.6%	38.7%
EM	10.9%	10.2%	13.2%	22.2%

Source: IBES

FIGURE 63

2019 IBES EPS growth estimates have barely moved ytd but are starting to be revised lower

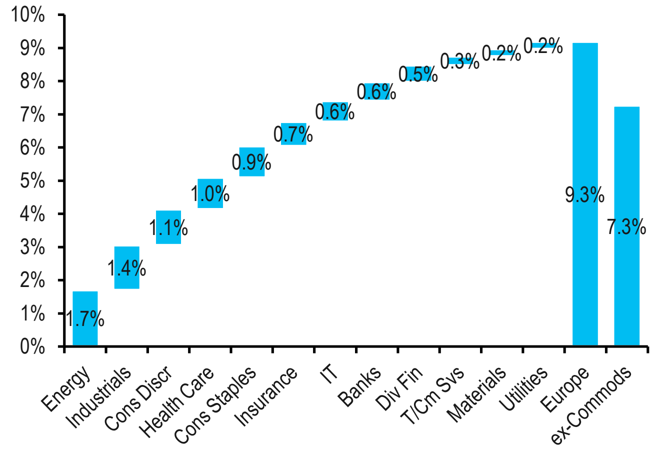


Source: IBES, Barclays Research

Our EPS growth estimates for 2019 are well-below consensus. IBES is looking for Eurozone earnings to grow 10.1% next year, up from 4.8% in 2018. For the UK, forecasts are for 7.8% growth in 2019, down from 10.3%. Overall for Europe, IBES estimates look for 9.3% growth in 2019 up from 7.4% in 2018. We note that consensus estimates for 2019 have barely moved ytd despite the roll-over in activity momentum, but are starting to be revised lower at present.

FIGURE 64

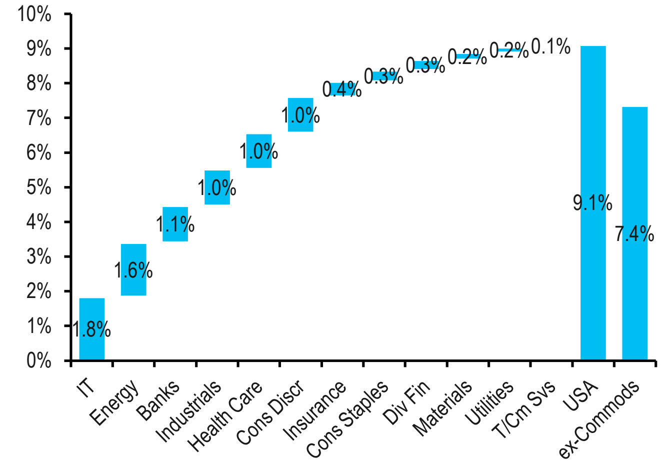
Sector contribution to IBES 2019 EPS growth estimates for MSCI Europe



Source: IBES

FIGURE 65

Sector contribution to IBES 2019 EPS growth estimates for MSCI US

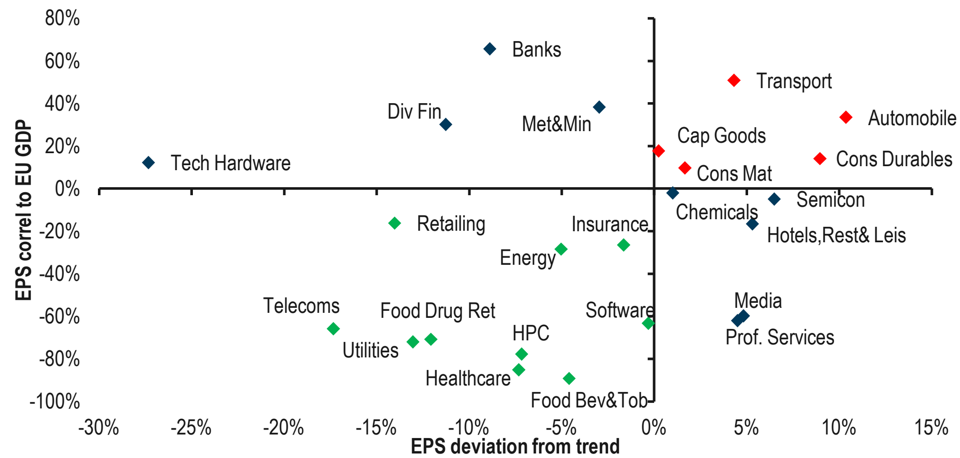


Source: IBES

About half of next year's EPS growth for Europe is expected to come from three sectors: Energy, Industrials and Consumer Discretionary. In the US, the bulk of the expected EPS growth for 2019 is forecast to come from Tech, Energy and Consumer Discretionary.

FIGURE 66

MSCI Europe sector EPS vs. trend and EPS correlation to GDP growth

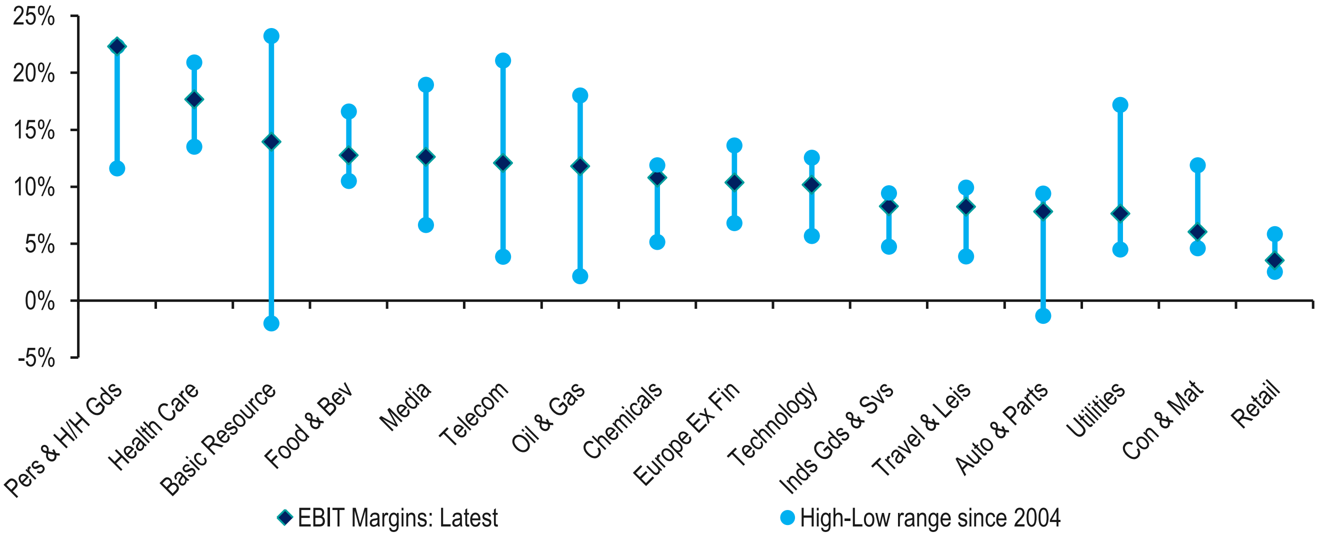


Source: Bloomberg, Datastream, IBES, Barclays Research

In the case of Europe, we doubt that consensus estimates for Industrials and Discretionary will be delivered if our cautious macro scenario materialises. The above scatter chart shows Level 2 sectors, comparing their current EPS vs. the historical trend to their sensitivity to activity. In other terms, the chart shows where earnings are most/least likely to be peaking, and where they are most/least at risk from softening growth momentum. Capital Goods, Transport, Autos, and Construction materials are the sectors that currently have earnings well-above trend while also being highly sensitive to growth, thus making them potentially vulnerable to earnings downgrades. On the other hand, Staples, Healthcare and Telecoms earnings are still well-below trend and relatively less sensitive to growth, making them less vulnerable to downgrades.

FIGURE 67

European sectors operating margins in the historical context

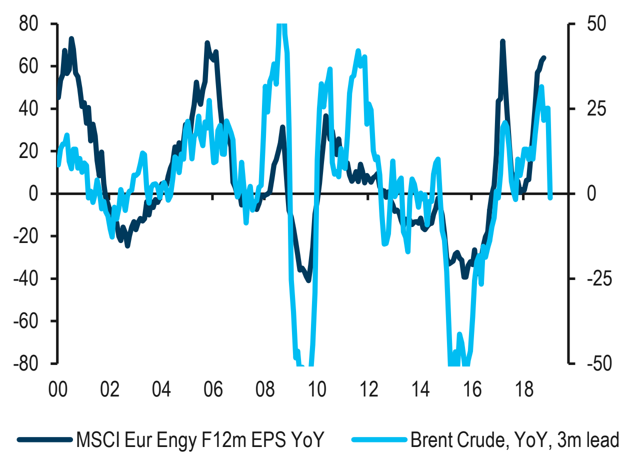


Source: Datastream, Barclays Research

We note that Capital Goods, HH & Personal Goods and Autos also have profit margins particularly elevated in an historical context.

FIGURE 68

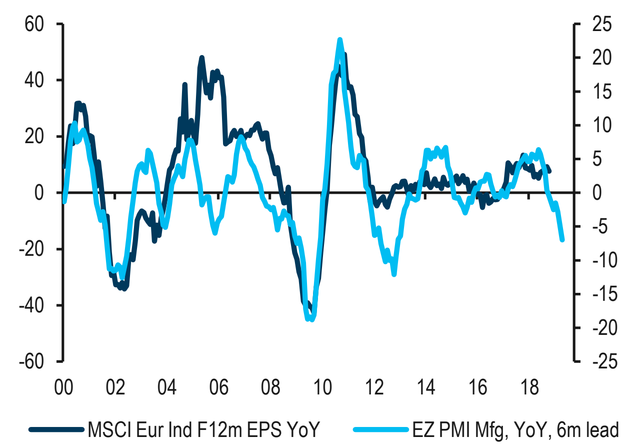
Positive contribution to MSCI Europe 2019 Earnings Growth from Energy will not materialise if oil keeps falling



Source: Datastream, IBES, Markit, Barclays Research

FIGURE 69

Positive contribution to MSCI Europe 2019 Earnings Growth from Industrials also looks challenging



Source: IBES, Markit

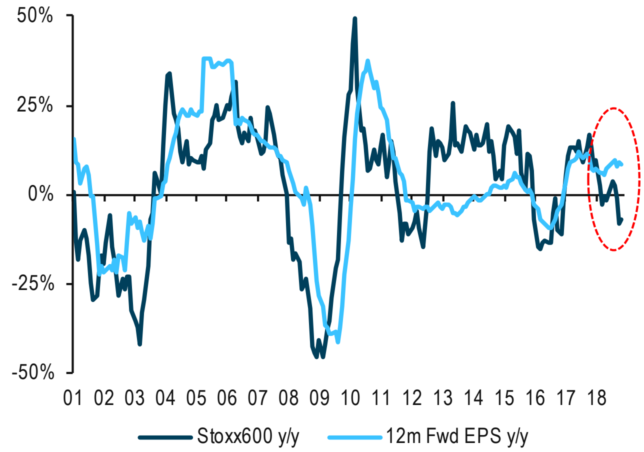
As discussed above, the two single largest contributors to consensus MSCI Europe EPS growth for 2019 are Energy and Industrials. The recent drop in oil puts the current consensus estimates for double-digit Energy EPS growth into question. We find the outlook for Industrials' earnings growth, and thus their positive contribution to overall European earnings growth, to be challenging as well. We have already seen a significant deceleration in industrial momentum, and struggle to find catalysts for a turnaround in the short term.

Valuation Outlook

P/E multiples have de-rated ytd and are below fair value

FIGURE 70

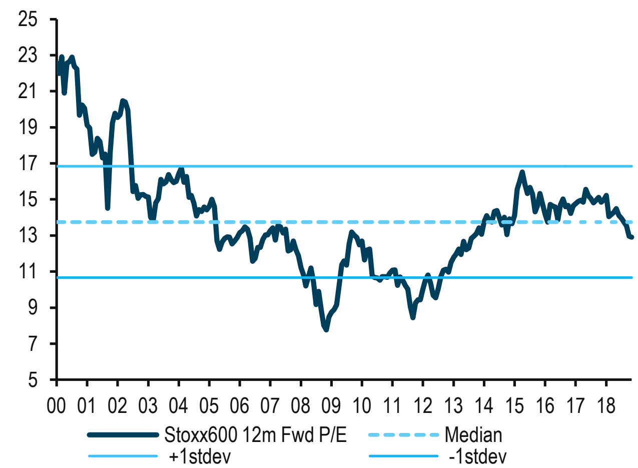
Equities have moved ahead of the upcoming EPS downgrades



Source: Datastream, IBES

FIGURE 71

P/E has de-rated to the cheap side of fair value, but on still-too-optimistic EPS growth estimates



Source: Datastream, IBES

The correction in stock prices suggests that investors already anticipate some deceleration in EPS momentum ahead. We believe that negative EPS revisions will constrain the potential for equity upside, at least at the beginning of the year. However, they may not be an impediment to higher stock prices for the full 2019 if newsflow around some other key sources of uncertainty, such as Brexit, Italy, Fed and trade, improves. The question is whether P/Es have already de-rated too far, or not, given our macro expectations for the coming year.

FIGURE 72

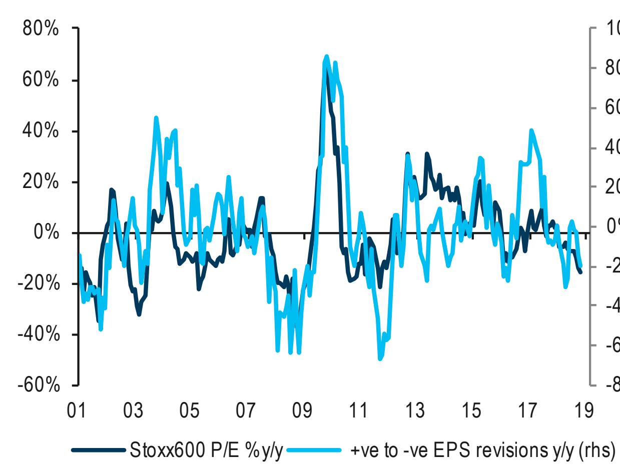
Regional P/E multiple and current level vs. historical median

	Current	10Y Median	20Y Median	Current vs 10Y Median	Current vs 20Y Median
MSCI World	**14.4**	**14.4**	**15.1**	**0%**	**-5%**
US	**15.6**	**15.0**	**15.8**	**4%**	**-1%**
Europe	**12.7**	**13.0**	**14.0**	**-2%**	**-9%**
UK	11.8	12.5	13.5	-5%	-13%
Eurozone	12.3	12.7	13.4	-3%	-8%
France	12.7	12.7	13.5	0%	-6%
Germany	11.7	12.2	12.8	-4%	-9%
Italy	9.8	11.6	13.0	-15%	-25%
Spain	11.0	11.5	13.0	-5%	-15%
Japan	**12.0**	**13.7**	**15.7**	**-12%**	**-23%**
EM	**10.4**	**11.1**	**11.0**	**-6%**	**-6%**
Brazil	10.8	10.5	9.4	3%	15%
Russia	4.8	5.3	6.4	-9%	-24%
India	17.4	16.2	15.1	8%	16%
China	10.2	10.5	11.4	-2%	-10%

Source: Datastream, IBES

FIGURE 73

P/E multiples move with EPS revisions

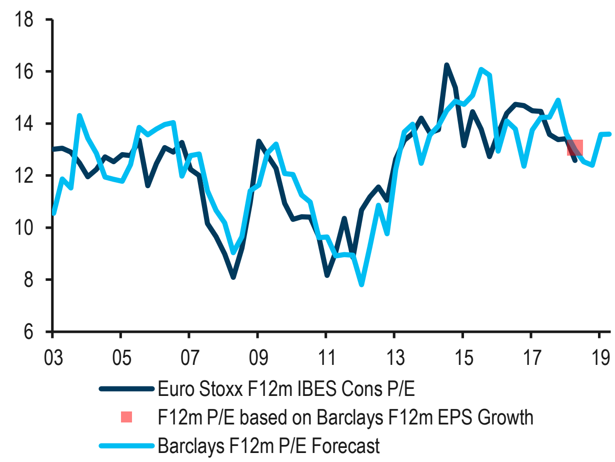


Source: Datastream, IBES, Barclays Research

We introduce our revised Forward P/E forecast models for Euro Stoxx and FTSE 100. The main components of these are a fast-moving economic local activity indicator (PMI New Orders), and local real yields, which capture the change in the discount factor that should be applied to earnings to arrive at a correct valuation. Ceteris paribus, higher real growth should lead to higher real rates, which helps the model control for changes in the discount rate. The UK model is well described by these two factors, but for Eurozone we add EURUSD, as the movement in the P/E measure seems sensitive to short-term FX movements. For the UK, the high degree of USD earners in market works as an automatic stabiliser to the valuation when currency shocks occur.

FIGURE 74

Euro Stoxx (SXXE) F12m P/E Forecast Model



Source: Datastream, IBES, Bloomberg, Barclays Research

FIGURE 75

Sensitivity of Euro Stoxx P/E forecasts to PMI New Order level & change in real bond yields

PMI New Orders Level	Real Yield Change YoY						
	-150	-100	-50	0	50	100	150
45	-12%	-9%	-6%	-3%	0%	4%	7%
50	-9%	-6%	-2%	1%	4%	7%	10%
55	-5%	-2%	1%	4%	8%	11%	14%
60	-1%	2%	5%	8%	11%	15%	18%

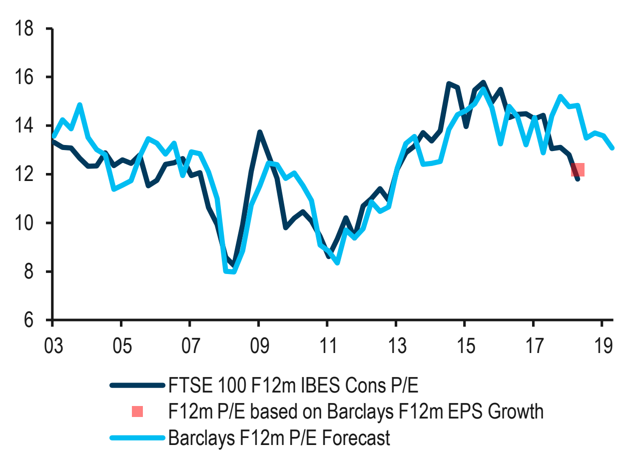
PMI New Orders Level	-150	-100	-50	0	50	100	150
45	11.0	11.4	11.8	12.2	12.6	13.0	13.4
50	11.5	11.9	12.3	12.7	13.1	13.5	13.9
55	11.9	12.3	12.7	13.1	13.5	13.9	14.3
60	12.4	12.8	13.2	13.6	14.0	14.4	14.8

Source: Datastream, IBES, Bloomberg, Barclays Research

The above chart shows that the current multiple has dropped below the fair value predicted by our model. Broadly speaking, our economists' GDP forecasts for the Eurozone and UK (1.6% and 1.4% respectively) imply a PMI level in the low 50s, which alone implies a small P/E expansion from current levels around ~12.6/11.8 respectively. Barclays forecasts real yields to expand >50bp in both regions (boosted by mildly-rising nominals & falling inflation), which combined with PMI stabilisation should allow P/E multiples to expand moderately from current depressed levels.

FIGURE 76

FTSE 100 F12m P/E Forecast Model



Source: Datastream, IBES, Bloomberg, Barclays Research

FIGURE 77

Sensitivity of FTSE 100 P/E forecasts to PMI New Order level & change in real bond yields

PMI New Orders Level	Real Yield Change YoY						
	-150	-100	-50	0	50	100	150
45	-13%	-10%	-7%	-4%	0%	3%	6%
50	-9%	-6%	-3%	0%	3%	7%	10%
55	-6%	-2%	1%	4%	7%	10%	14%
60	-2%	1%	5%	8%	11%	14%	17%

PMI New Orders Level	-150	-100	-50	0	50	100	150
45	10.2	10.6	11.0	11.4	11.8	12.1	12.5
50	10.7	11.1	11.4	11.8	12.2	12.6	13.0
55	11.1	11.5	11.9	12.3	12.6	13.0	13.4
60	11.6	12.0	12.3	12.7	13.1	13.5	13.8

Source: Datastream, IBES, Bloomberg, Barclays Research

Tightening central banks' liquidity will likely cap the upside for P/Es

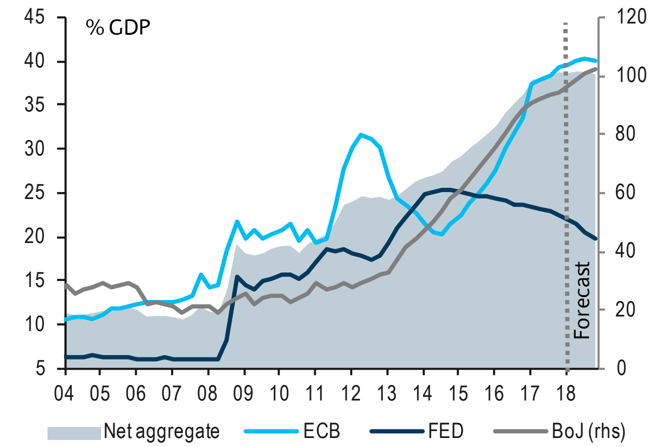
FIGURE 78

P/E compression from slowing excess monetary growth looks to have run its course

Source: Barclays Economics Research

FIGURE 79

The aggregate G4 central bank's balance sheet is not expanding anymore



Source: Barclays Economics Research

The reduction in central banks' liquidity is another threat to asset prices. Global excess liquidity (money supply growth minus industrial production) has held a strong relationship with changes in the global P/E ratio, and both have fallen in tandem ytd. While we expect the Fed to carry on with rate hikes and the ECB to end QE in December, the second derivative of the size of their balance sheet will likely stabilise in 2019 following the sharp rollover seen this year. This could reduce the pressure on equity valuations, even though P/E multiples are unlikely to expand materially if excess liquidity keeps tightening.

Equities still look attractively valued relative to bonds in Europe, less so in the US

FIGURE 80

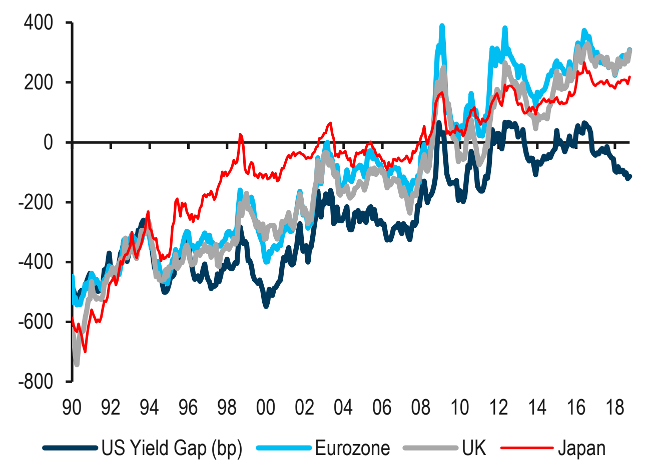
MSCI Europe forward P/E and realised earnings growth vs. real GDP growth bands

Real GDP Growth	F12m P/E	T12m EPS Growth
<-2%	11.2	-29%
-2- -1%	11.7	-5%
-1-0%	10.8	-2%
0-1%	13.0	-7%
1-2%	13.9	6%
2-3%	14.3	11%
3-4%	18.1	15%

Source: Datastream, IBES, Barclays Research

FIGURE 81

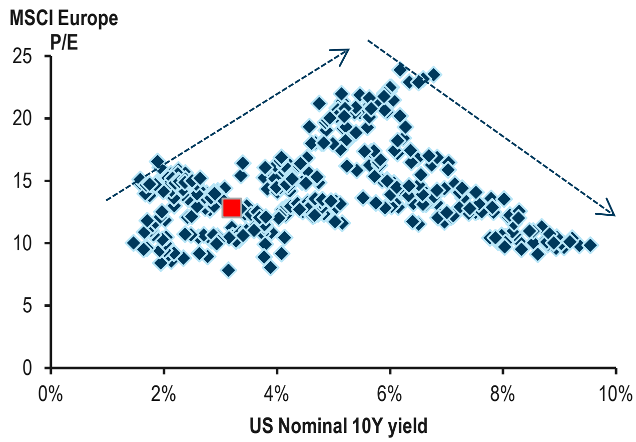
Simple dividend yield – bond yield gap by region



Source: Datastream, IBES, Barclays Research

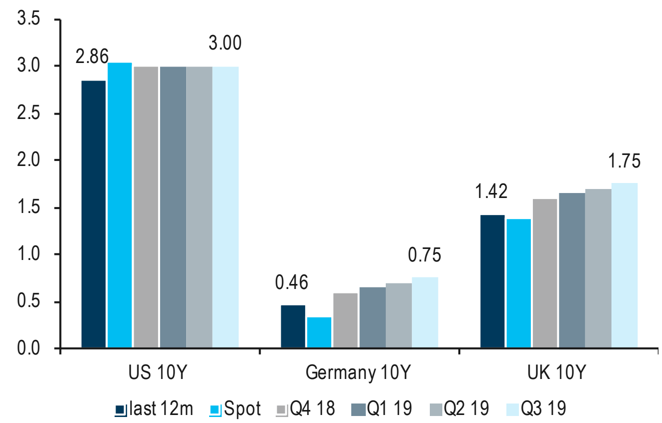
The current level of forward P/E (12.7 on MSCI Europe) already looks to be discounting a much lower growth environment than we forecast (0-1% real GDP growth, vs. our forecast of 1.6%). Furthermore, a simple dividend-yield minus bond-yield gap analysis shows equity valuation for all DM regions except the US to be attractive vs. local bond yields, offering uplift of around 300bp in both the UK and Europe. Rising front- and back-end 'risk free' bond yields combined with low dividend yields make US equities less attractive from an asset allocation point of view. However investors in the rest of DM are still offered a significant yield uplift from buying equities vs. their local risk free bonds.

FIGURE 82
MSCI Europe P/E vs. US nominal 10y yield



Source: Datastream, IBES, Barclays Research

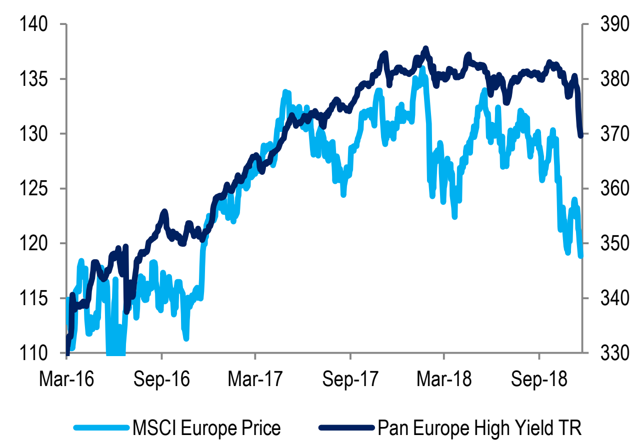
FIGURE 83
Barclays is looking for range-bound bond yields



Source: Barclays Research

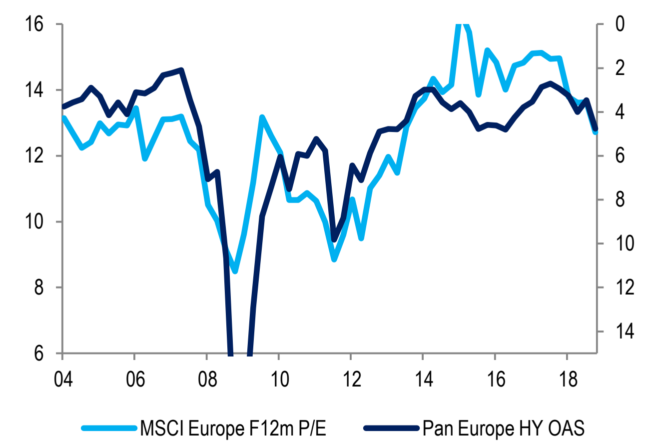
We don't believe the current level of bond yields represents a problem for equity valuations, as P/E is well within the normal range at present. Historically, equity valuations haven't started to suffer from higher rates until there is a much higher nominal yield of around 5%, which is far above where our rates strategists forecasts yields to get to next year.

FIGURE 84
Pan-Europe High Yield Total Return Index vs. MSCI Europe



Source: Bloomberg, Barclays Research

FIGURE 85
High Yield Spreads have recently followed P/E multiples



Source: Bloomberg, Barclays Research

One of the conundrums we have witnessed recently was equity markets have been selling off, but high yield and other credits had remained extremely resilient on both a price and spread basis. However in the last few weeks, credit has started to "catch down" with the equity market. Investment grade and high yield spreads in Europe may have been held artificially low due to the ECB corporate bond-buying programme. Our credit analysts had noted a widening basis between equity and related credits performance, and the move lower in credit may have been exacerbated by large new issuance into thin liquidity. Their base case assumes no recession in 2019 or 2020 which confirms we are in the late expansion phase of the credit cycle, but not the end.

Index Targets

We set our index targets using our earnings growth and P/E forecast models. These use as inputs the house views on growth, inflation, FX rates, bond yields, and commodity prices.

The single-digit upside to our price targets is a combination of low single-digit earnings growth, and a small amount of P/E expansion, as we believe P/Es have contracted too far given the slowing-but-still-resilient growth environment we expect over the coming year.

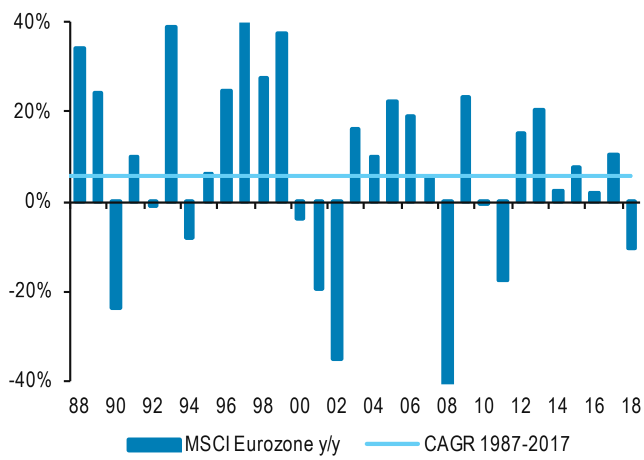
Any worsening of the economic outlook could lead to both earnings growth figures and P/E forecasts being cut. Equally, should we see a material upgrade to growth prospects as 2019 wears on, we could need to revise both earnings and P/E higher to reflect this.

FIGURE 86
Index Targets for year-end 2019

	FTSE 100	SXXE	SXXP
IBES 19e EPS Growth	7%	10%	9%
Barclays 19e EPS Growth	2%	4%	3%
Barclays Forecast 19e P/E	12.8	13.3	13.6
Current Price	7,011	349	357
Barclays Dec 19 Target	7,350	370	375
% Up/downside	5%	6%	5%

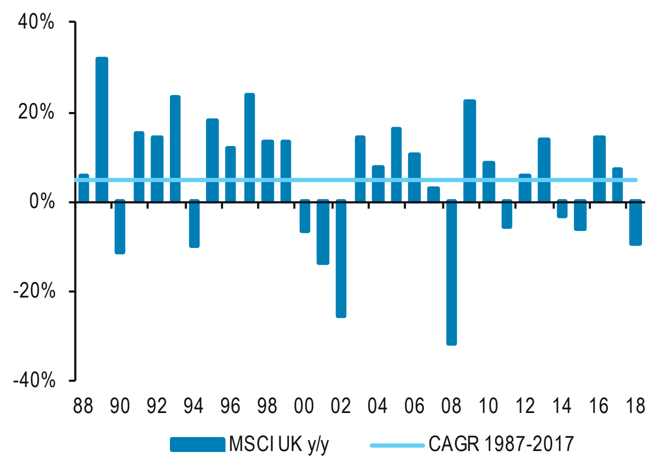
Note. Current price as at market close on 23 Nov 2018
Source: Datastream, IBES, Bloomberg, Barclays Research

FIGURE 87
MSCI Eurozone long-term CAGR is 6%



Source: Datastream

FIGURE 88
MSCI UK long-term CAGR is 5%

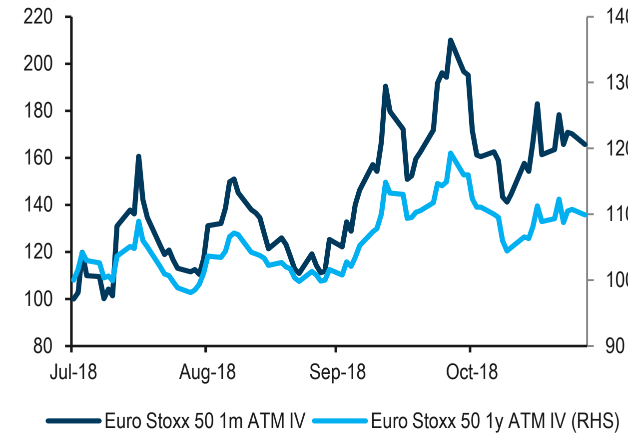


Source: Datastream

Our expected returns for Eurozone and UK equities in 2019 are about in line with their respective long-term CAGR.

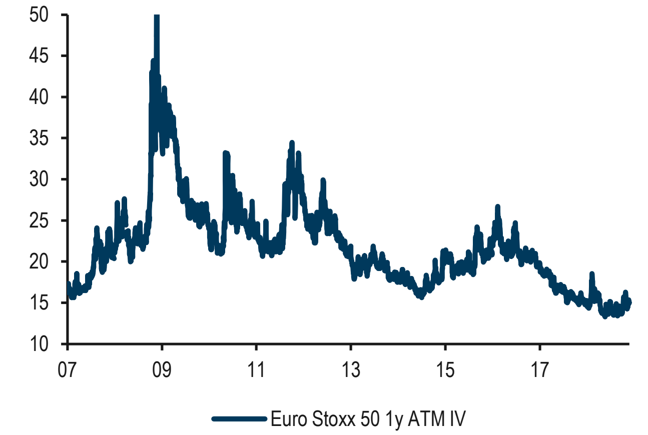
Derivatives Implementation

FIGURE 89
Euro Stoxx 50 1m & 1y at the money implied volatility, rebased to 100 at 31st August 2018



Source: Bloomberg, Barclays Research

FIGURE 90
Euro Stoxx 50 1y at the money implied volatility



Source: Bloomberg, Barclays Research

2019 could prove to be another tricky year and we see only mid single digit returns to our index target prices. One way to participate in the market but with lower risk could be to use options to get some exposure.

Option Implied Volatility has risen recently with the market sell-off, making options more expensive. However the increase in implied volatility has been concentrated in shorter tenors (1-3m) as investors have scrambled for short term hedges, while longer dated implied volatility remained well anchored at low levels. For instance, 1 year implied volatility on the Euro Stoxx 50 is still trading around the 10th percentile of its long term history, while shorter term implied volatility is trading closer to average. This makes using longer maturity options attractive both from a historical context, and when compared to shorter maturity options. A further benefit to longer dated options is they are less subject to time decay, making them easier to manage in a portfolio context for non specialists.

Post the 10% correction markets are no longer priced for perfection and a lot of bad news is likely discounted already. Recent performance and equity skew have made puts more expensive than calls, driving our preference of buying upside exposure rather than buying downside protection. Any positive newsflow on trade, Brexit, Italy or other current worries could cause investors to upgrade their growth expectations and/or lower the uncertainty discount they are applying, driving equities higher. This is not our central scenario, but given the sharp move lower and the relative cheapness of long term options, it could make sense have some long term (1y) upside optionality in a portfolio as an upside hedge. Please note the following are indicative pricing only, and were generated vs. spot ref: 3172 on 27/11.

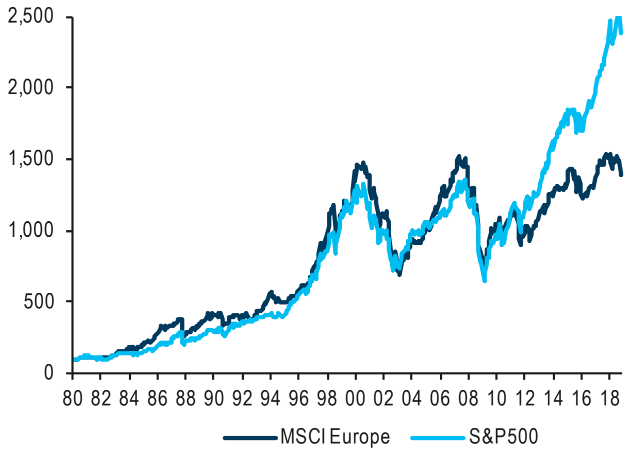
One way to get some upside exposure is simply to buy far out of the money call options (Dec 19 110% ATMF Call options on Euro Stoxx 50 costs around 2.26%, 14.2% IV, +28% Delta). For those who would prefer to have the strike closer to the money, a way to cheapen upside exposure could be to buy a call spread instead of outright calls. A Dec 19 105/110% ATMF Call Spread would be slightly cheaper to implement at inception, and allow capped participation in an upside move over the next 12m (The 1x1 Call Spread would cost around 1.70%, 12% Delta: the long 105% ATMF Call costs 3.96%, 15% IV, +40% Delta, the short 110% ATMF Call option price is above). For those who wish to consider downside protection, a Dec 19 95/90% ATMF put spread would be cheaper than buying outright puts (Put Spread cost 1.32%, -9% Delta, which is made up of long Dec 19 95% ATMF Put, costs 4.50%, 17.3% IV, -35% Delta, and short Dec 19 90% ATMF Put, costs 3.18%, 18.6% IV, -26% Delta).

Regional Allocation

Neutral US vs. Europe – looking for some of the gap to close

FIGURE 91

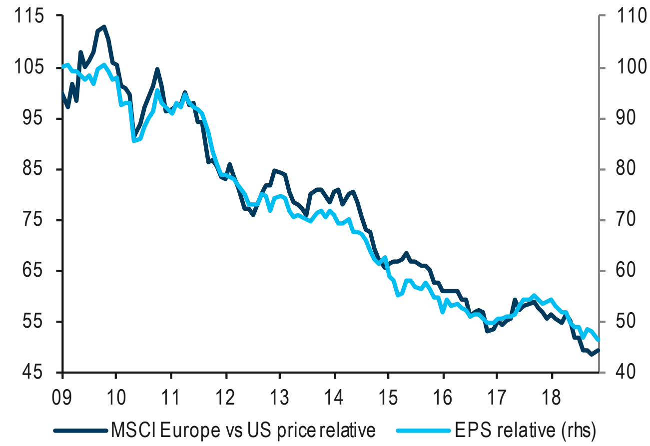
European and US equities have decoupled since 2011



Source: Datastream, re-based to 100 in Jan-80

FIGURE 92

Europe's underperformance has been largely due to weaker earnings

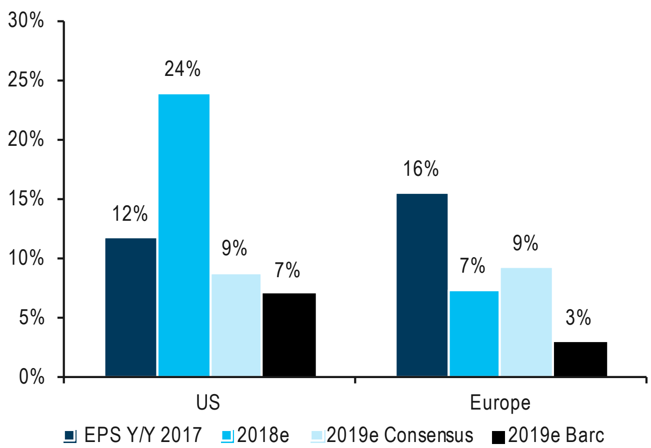


Source: Barclays Research

European equities have underperformed their US counterparts almost continuously since 2011. Yet again ytd, the Stoxx 600 is down about 10% while the S&P500 is broadly flat. We do not believe that the long-term underperformance of Europe will reverse sustainably, but see a potential for some of the current extreme gap between the two regions to narrow in 2019.

FIGURE 93

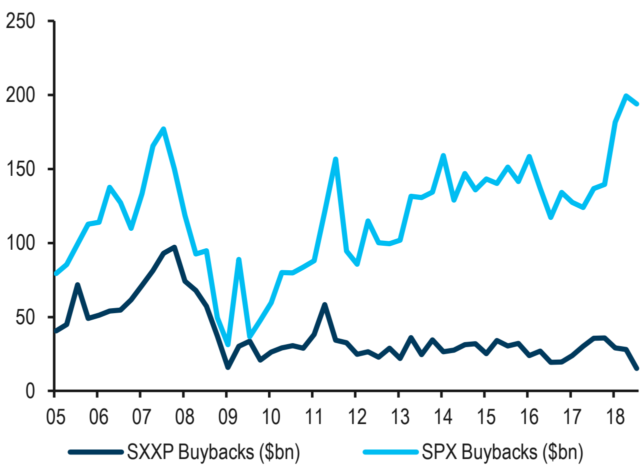
The EPS growth differential between the US and Europe is expected to narrow materially in 2019



Source: Bloomberg, Barclays Research

FIGURE 94

US buybacks were record high this year, but the tailwinds from cash repatriation and tax cuts will be fading in 2019

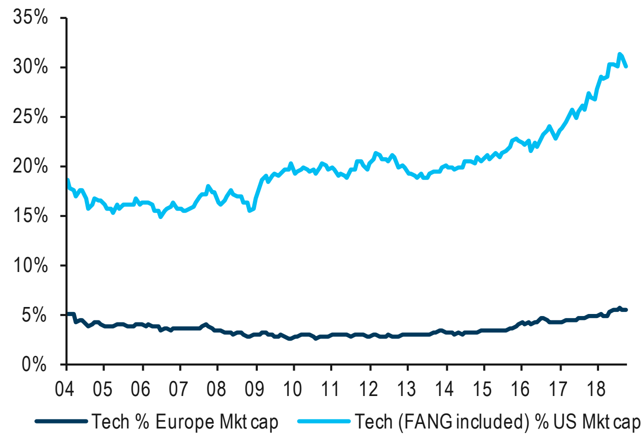


Source: Bloomberg, Barclays Research

The relative EPS growth of US vs. Europe is expected to be much lower next year. S&P500 EPS is on course to grow 24% in 2018, compared to 7% for Europe. For 2019, our US Equity strategist forecasts 7% EPS growth, which is still higher than our 3% growth forecast in Europe, but the spread is lower compared to 2018. US buybacks were particularly strong this year thanks to the boost from cash repatriation and corporate tax cuts, but should moderate next year. Europe might thus be less disadvantaged on this front. See '*US Equity Strategy 2019 Outlook: Reversion to the Mean*' dated 19 November for details.

FIGURE 95

Tech is 30% of US market cap… but only 6% of Europe



Source: Datastream

FIGURE 96

MSCI Europe and US sector composition and ROEs

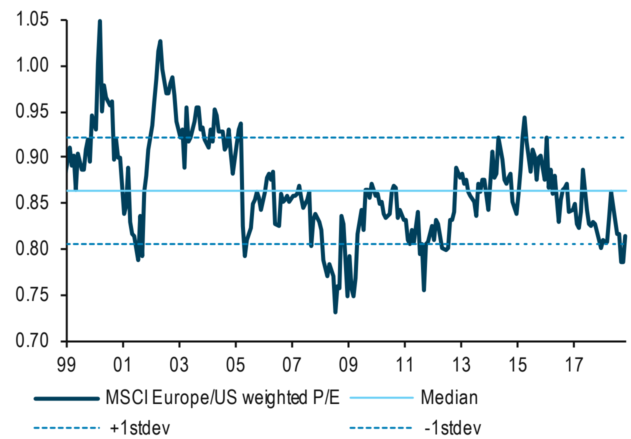
	Europe		US	
	Weight	ROE	Weight	ROE
Market	100.0%	11.2%	100.0%	15.5%
Energy	8.7%	9.8%	5.7%	6.5%
Materials	7.7%	14.2%	2.6%	12.1%
Industrials	12.8%	16.7%	9.2%	22.7%
Discretionary	10.2%	15.6%	13.0%	23.8%
Staples	13.9%	15.9%	7.2%	25.5%
Healthcare	13.6%	16.4%	14.6%	17.0%
Financials	19.0%	7.6%	13.4%	10.2%
IT	5.5%	9.7%	26.3%	27.1%
Telecoms	3.4%	8.8%	2.1%	10.8%
Utilities	3.7%	11.1%	3.0%	9.5%
Real Estate	1.4%	5.7%	2.8%	8.3%

Source: Datastream

Europe is somewhat of an "old economy" market dominated by Financials, Industrials, Materials and Staples, while Tech weights a mere 6% of the market cap, about the same as 15 years ago. In contrast, the weight of the Tech sector in the US index has doubled since 2004 to be at 30% now (including FAANG stocks). While US Tech has performed poorly recently, our US strategists remain constructive on the sector's outlook. However, their view is that the impact from disruptive innovation is beginning to moderate, as the disrupted start fighting back. This means that Europe may not be so penalised by its low Tech weighting anymore.

FIGURE 97

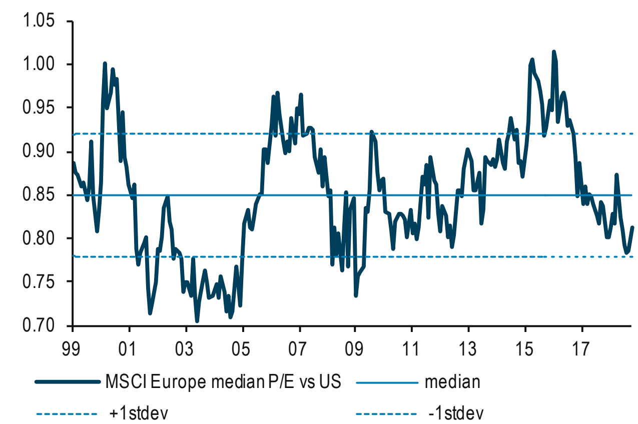
MSCI Europe weighted P/E relative to the US is near the bottom of the historical range



Source: IBES

FIGURE 98

MSCI Europe median P/E relative to the US is not demanding either

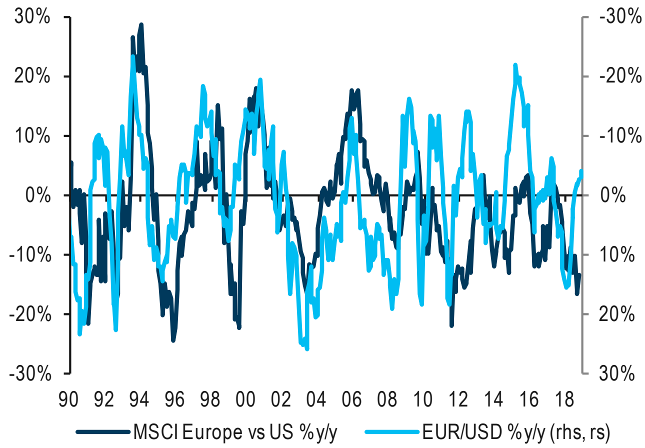


Source: IBES

As discussed earlier, European equities have seen significant outflows ytd and appear to be consensus UW. Their valuations have de-rated relative to US equities and are now looking attractive in the historical context. While a significant reversal looks unlikely given our cautious view on earnings and domestic politics for 2019, a lot appears to be in the price already.

FIGURE 99

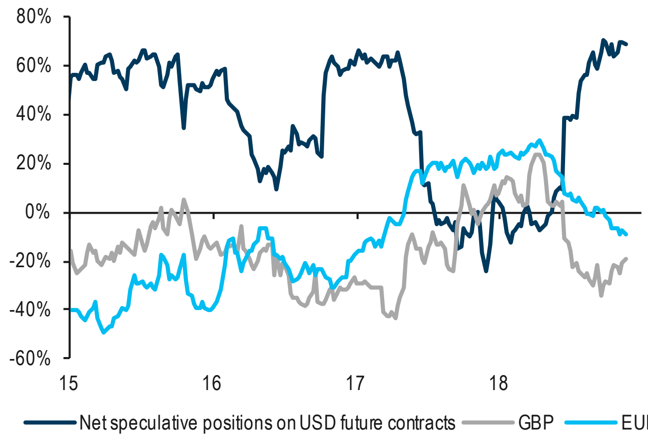
The weaker euro did not help the relative performance of Europe this year



Source: Datastream

FIGURE 100

USD appears to be a crowded long and speculators are short EUR and GBP

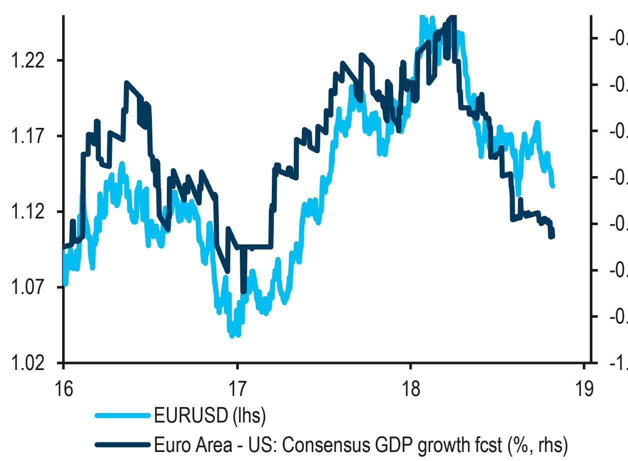


Source: CFTC, Bloomberg

A weaker euro is typically a tailwind for European equities, but that was not the case this year, as it did not have a meaningful impact on earnings. USD is undoubtedly a consensus long at present and is looking technically stretched. On the flipside, investors are short on both EUR and GBP, which we believe has a lot to do with political uncertainty.

FIGURE 101

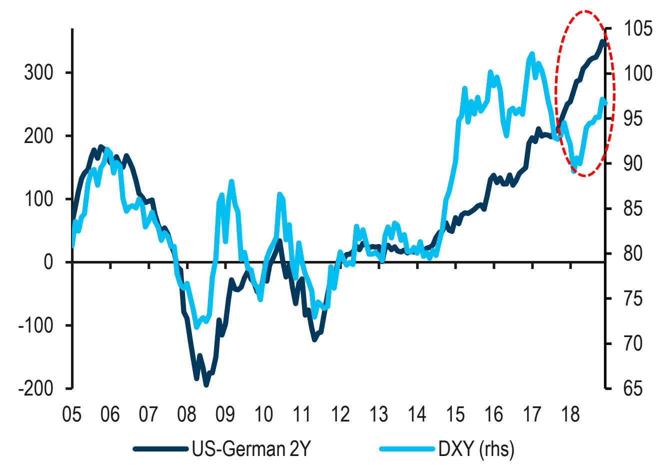
The GDP growth differential between US and Europe is still supportive of the USD though



Source: Bloomberg, Datastream

FIGURE 102

Likewise, Fed-ECB policy divergence is still a support for USD



Source: Bloomberg, Datastream

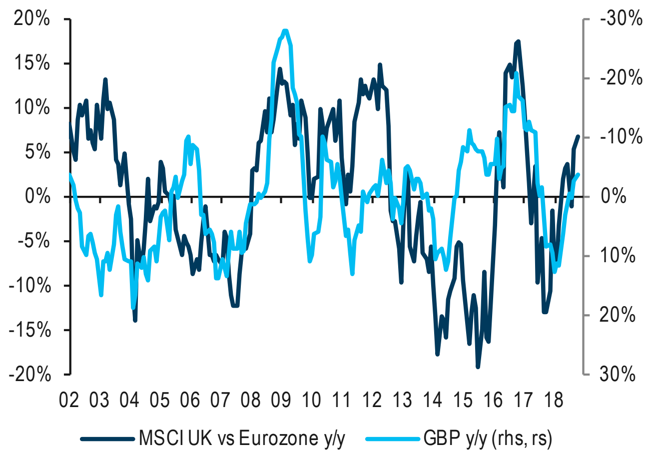
Fundamentally though, our FX strategists expect dollar to remain supported into 2019 as the GDP and rate differential between the US and ROW should remain elevated. However, a lot appears to be in the price already, in our view. We expect the weaker Euro to be a relative tailwind for European earnings in H1, but look for the boost to fade gradually as we move towards the second half of the year.

OW Eurozone vs. UK

The correlation between UK equities and GBP remains firmly negative

FIGURE 103

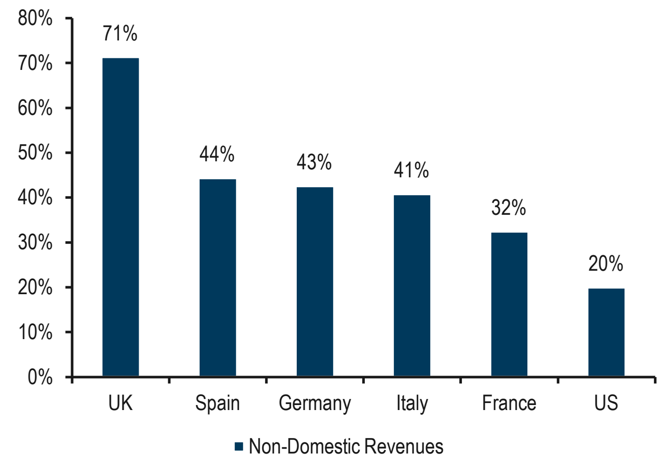
UK equities' relative performance to Eurozone is inversely correlated to GBP



Source: Barclays Research

FIGURE 104

The UK has more foreign revenue exposure than continental Europe

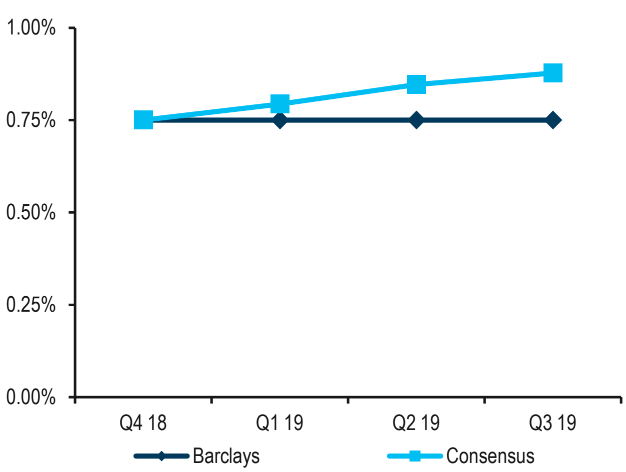


Source: Worldscope, Bloomberg, Barclays Research

We are OW Eurozone vs. UK equities. Political newsflow remains the key driver of investor sentiment on UK equities, but our base case is still for an orderly Brexit. If this materialises, it would likely avoid economic damage and materially reduce uncertainty; however, the range of potential outcomes is still wide at this stage. While a deal could boost investors' appetite for UK equities, it might not necessarily help their performance relative the rest of Europe, as GBP would likely strengthen too. The correlation between GBP and the relative performance of UK equities is indeed firmly negative. UK large-caps are much more exposed to foreign demand than their continental and US peers, which is why the correlation between EPS revisions and GBP is negative.

FIGURE 105

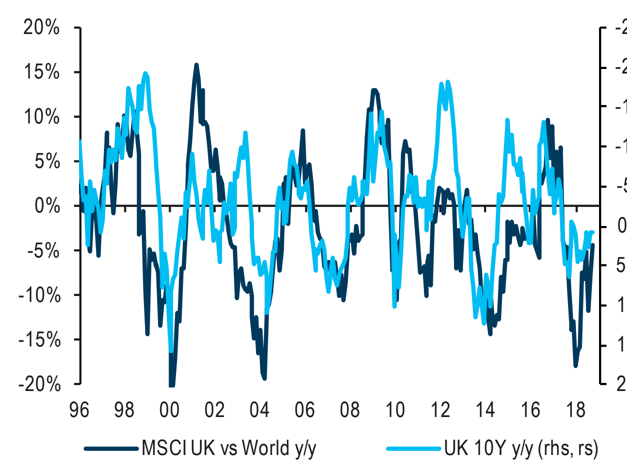
Market implies little chance for rate hikes by BOE in 2019



Source: Bloomberg, Barclays Research

FIGURE 106

UK equities are high DY and move in the opposite direction to bond yields

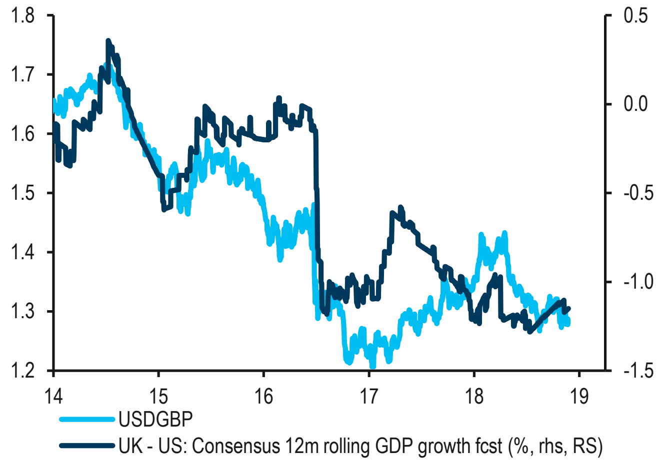


Source: Datastream

We note that the bond market is currently pricing in only 50% probability for a rate hike by the BOE until at least September 2019. Our economists also expect the BOE to stay on hold, although Carney's latest comments suggest that the BOE could increase the pace of policy normalisation if Brexit goes smoothly. As the UK is a defensive and high-dividend-yield equity index, it tends to behave as a bond proxy and to move opposite to bond yields. Our rate strategists believe that resolution of the Brexit impasse seems to be the only thing stopping an increasingly hawkish MPC from tightening. An agreement with the EU, coupled with fiscal impetus, could thus leave the front end forced to discount a more aggressive rate profile for 2019.

FIGURE 107

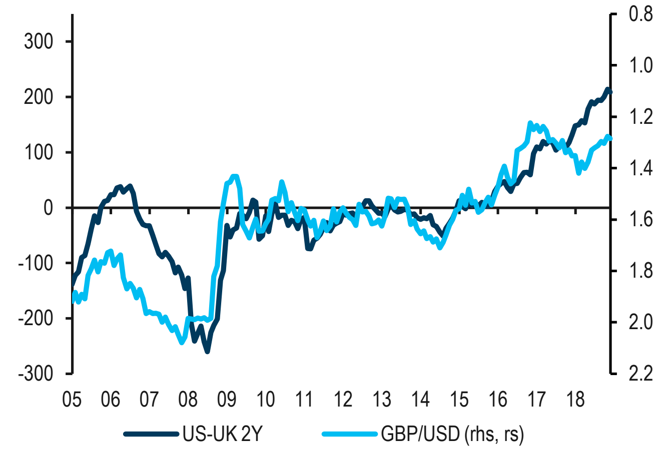
UK / US GDP growth differential is a good indicator of GBP



Source: Bloomberg, Datastream

FIGURE 108

The rate differential between UK and US is also important for GBP direction



Source: Bloomberg, Datastream

To be clear, Barclays' view is that any potential bounce in GBP due to reduced Brexit uncertainty will be contained. The key drivers of the currency remain the growth and rate differential between the UK and ROW. However, while our economists remain cautious on activity, we believe that UK growth and rate expectations could be revised up in the case of an orderly Brexit.

Our preference for UK domestic plays is contingent on an orderly Brexit

FIGURE 109

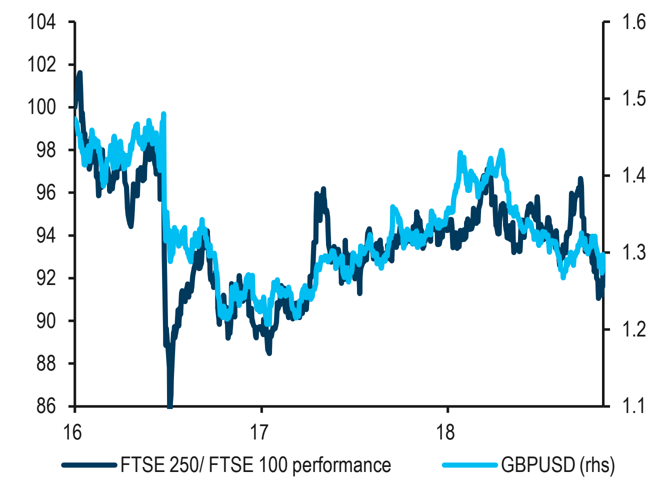
FTSE100, 250 and 350 foreign revenue exposure

Non-UK Revenues	FTSE 100	FTSE 250	FTSE 350
Market	72%	51%	69%
Cons. Discr.	61%	48%	56%
Cons. Staples	56%	57%	57%
Energy	91%	83%	91%
Financials	48%	31%	47%
Healthcare	96%	85%	94%
Industrials	74%	54%	67%
Materials	97%	86%	97%
Real Estate	4%	34%	26%
Tech	85%	64%	69%
Telecoms	61%	37%	60%
Utilities	32%	13%	30%

Source: Word scope, Bloomberg

FIGURE 110

FTSE250/100 relative performance moves with GBP



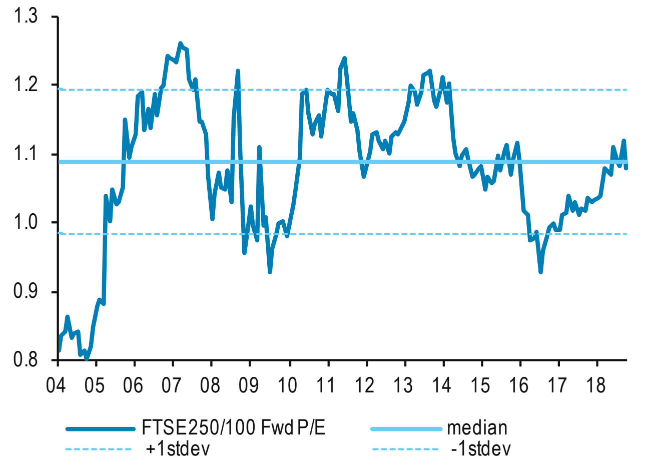
Source: Datastream, Barclays Research

We believe that if our base case of an orderly Brexit materialises, it will lead to internal rotation within the UK equity market, away from exporters and into domestic plays. FTSE250 derives a bigger share of revenues from the UK than FTSE100, and the relative performance between the two closely follows the direction of GBP. FTSE250 has lagged

FTSE100 in the last few months and also since the EU referendum two years ago, and could thus outperform going forward, in our view.

FIGURE 111

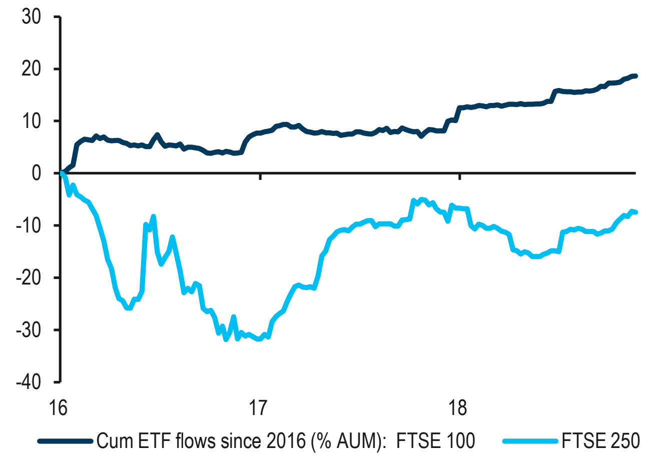
FTSE250 P/E is in line with the historical median vs. FTSE100



Source: IBES

FIGURE 112

FTSE100 ETFs have seen inflows in the last two years, but FTSE250 ETFs had outflows

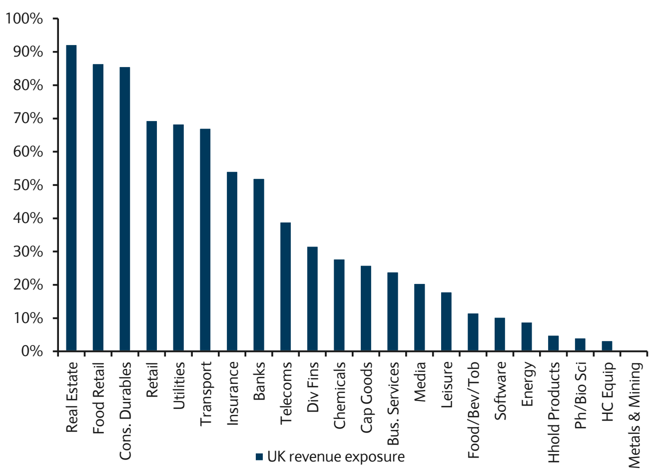


Source: EPFR, Barclays Research

FTSE250 valuations are back to their pre-EU referendum level relative to FTSE100, but are still not demanding in the historical context. Also, a lot of the FTSE100 de-rating has been driven by commodity sectors in recent months. In terms of positioning, we note that FTSE250 ETFs have seen significant outflows over the last two years, while FTSE100 ETFs had inflows. Likewise, our domestic basket has underperformed the exporters and de-rated since the EU referendum two years ago.

FIGURE 113

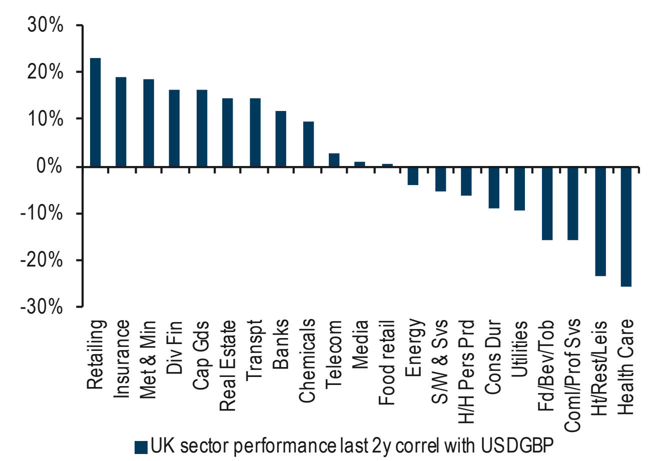
UK sectors' domestic revenue exposure



Source: Worldscope, Bloomberg, Barclays Research

FIGURE 114

UK sectors' correlation to GBP



Source: Datastream, Barclays Research

Real Estate, Retail, Housebuilders and Banks have the biggest domestic revenue exposure, while Commodities, Staples and Healthcare have the biggest share of sales coming from abroad.

FIGURE 115

UK domestic basket – BCEUUKDM

Ticker	Name	Sector	Mcap ($bn)	UK exposure
PSN LN	Persimmon	C Disc	9.9	100%
BDEV LN	Barratt Developments	C Disc	7.0	100%
BKG LN	Berkeley	C Disc	6.2	100%
TW/ LN	Taylor Wimpey	C Disc	7.2	98%
WTB LN	Whitbread	C Disc	9.3	96%
MKS LN	Marks & Spencer	C Disc	6.2	89%
ITV LN	ITV	C Disc	8.6	72%
PPB LN	Paddy Power Betfair	C Disc	7.5	61%
SBRY LN	Sainsbury J	C Staples	9.3	100%
MRW LN	Morrison (WM) Spmkts.	C Staples	7.9	100%
ABF LN	Associated Brit. Foods	C Staples	24.2	43%
LLOY LN	Lloyds Banking Group	Financials	56.1	100%
HL/ LN	Hargreaves Lansdown	Financials	12.9	100%
LGEN LN	Legal & General	Financials	20.2	98%
RBS LN	Royal Bank Of Sctl.Gp.	Financials	37.8	93%
AV/ LN	Aviva	Financials	25.1	55%
RMG LN	Royal Mail	Industrials	5.9	78%
EZJ LN	easyJet	Industrials	7.9	45%
RMV LN	Rightmove	IT	5.7	97%
BLND LN	British Land	Real Estate	7.9	100%
LAND LN	Land Securities Group	Real Estate	8.8	100%
BT/A LN	BT Group	Telecom	28.8	81%
UU/ LN	United Utilities Group	Utilities	6.4	100%
SSE LN	SSE	Utilities	16.4	97%
SVT LN	Severn Trent	Utilities	6.0	90%

Source: Bloomberg, IBES, Datastream, Barclays Research

Notes: This basket was first published in our report *European Equity Strategy: Navigating troubled waters - 'Crash out' unlikely but UK stocks still face challenges*, 12 September 2018

FIGURE 116

UK exporters basket – BCEUUKEX

Ticker	Name	Sector	Mcap ($bn)	Non-UK exposure
BRBY LN	Burberry Group	C Disc	11.7	89%
CCL LN	Carnival	C Disc	10.1	100%*
CPG LN	Compass Group	C Disc	33.4	91%
IHG LN	Ictl.Htls.Gp.	C Disc	11.7	96%
INF LN	Informa	C Disc	13.2	91%
PSON LN	Pearson	C Disc	9.5	91%
BATS LN	British American Tobacco	C Staples	126.0	99%
DGE LN	Diageo	C Staples	91.3	94%
IMB LN	Imperial Brands	C Staples	35.8	90%
RB/ LN	Reckitt Benckiser Group	C Staples	58.6	95%
RDSA LN	Royal Dutch Shell A	Energy	155.0	100%*
HSBA LN	HSBC Holdings	Financials	190.2	77%
OMU LN	Old Mutual Limited	Financials	10.9	100%*
PRU LN	Prudential	Financials	60.4	68%
III LN	3I Group	Financials	12.1	89%
AZN LN	AstraZeneca	Health Care	96.5	86%
GSK LN	GlaxoSmithKline	Health Care	100.2	97%
SHP LN	Shire	Health Care	52.5	100%*
SN/ LN	Smith & Nephew	Health Care	15.7	95%
AHT LN	Ashtead Group	Industrials	15.2	87%
ITRK LN	Intertek Group	Industrials	12.8	93%
MRO LN	Melrose Industries	Industrials	13.5	95%
REL LN	Relx	Industrials	23.6	93%
RR/ LN	Rolls-Royce Holdings	Industrials	24.5	88%
SGE LN	Sage Group	IT	9.2	80%
EVR LN	Evraz	Materials	10.4	100%
FRES LN	Fresnillo	Materials	9.7	100%
RIO LN	Rio Tinto	Materials	71.7	99%
VOD LN	Vodafone Group	Telecom	62.2	85%
NG/ LN	National Grid	Utilities	36.5	60%

Source: Bloomberg, IBES, Datastream, Barclays Research

Notes: * indicates company has some UK exposure but the split is not disclosed. This basket was first published in our report *European Equity Strategy: Hold your nerve, equities still have upside*, 30 July 2018

Our UK exporters basket includes the FTSE 100 stocks that derive the majority of their revenues from abroad. The basket is accessible on Bloomberg via ticker BCEUUKEX. Our UK domestic exposure basket includes the FTSE 100 stocks that derive the biggest proportion of their revenues from the UK. The basket is accessible on Bloomberg via ticker BCEUUKDM.

OW France and Spain vs. Germany and Italy within Eurozone

FIGURE 117

Eurozone countries performance, valuations and earnings forecasts

	Performance		EPS		Fwd P/E				
	Ytd	12m	'18e y/y	'19e y/y	Current	20Y	% Diff	DY	ROE
Eurozone	**-9.5%**	**-9.7%**	**4.8%**	**10.1%**	**12.3**	**13.4**	**-8%**	**3.5%**	**10.6%**
France	-5.3%	-5.3%	9.7%	9.8%	12.7	13.5	-6%	3.3%	10.5%
Germany	-14.3%	-14.4%	-2.8%	11.6%	11.7	12.8	-9%	3.2%	11.1%
Italy	-13.6%	-14.4%	20.1%	11.0%	9.8	13.0	-25%	4.4%	9.8%
Spain	-10.1%	-10.3%	7.5%	8.0%	11.0	13.0	-15%	4.5%	9.7%

Source: Datastream, IBES

We maintain our preference for France and Spain over Germany and Italy into 2019. France has performed the best this year and is now trading the most expensive, but we believe that macro and earnings fundamentals remain supportive. France has a diversified sector composition and fairly limited political risk. German equities have been badly hurt by Autos and the challenging trade environment. While some of these headwinds could alleviate in 2019, we expect the softening global growth backdrop to remain a problem for German equities given their cyclical nature, alongside uncertainty from political leadership change. Within the periphery, we believe that the risk-reward for Italian equities remains poor given the ongoing political situation and the sharp weakening in activity momentum. We thus keep a preference for Spain, where domestic growth is resilient and structural reforms have been implemented. Spanish equities could also benefit from improving investor sentiment towards Latam.

FIGURE 118

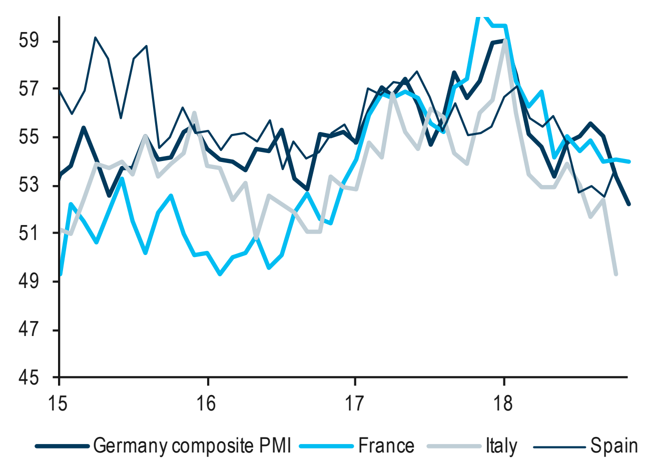
Eurozone countries macro snapshot

	GDP y/y		Unemployment Rate		Fiscal Balance %GDP		Public Debt %GDP		Current account %GDP	
	18e	19e	18e	19e	18e	19e	18e	19e	18e	19e
Eurozone	2.0	1.6	8.3	7.9	-0.8	-0.9	86.8	84.6	3.2	2.8
France	1.6	1.6	9.1	8.9	-2.6	-2.9	98.0	97.7	-1.0	-1.1
Germany	1.5	1.4	3.3	3.2	0.8	0.2	60.9	58.5	8.0	7.5
Italy	1.0	0.9	10.6	9.8	-2.0	-3.0	131.0	130.9	1.6	0.7
Spain	2.5	2.1	15.4	14	-2.7	-2.3	96.7	95.3	0.6	0.3

Source: Barclays Research

FIGURE 119

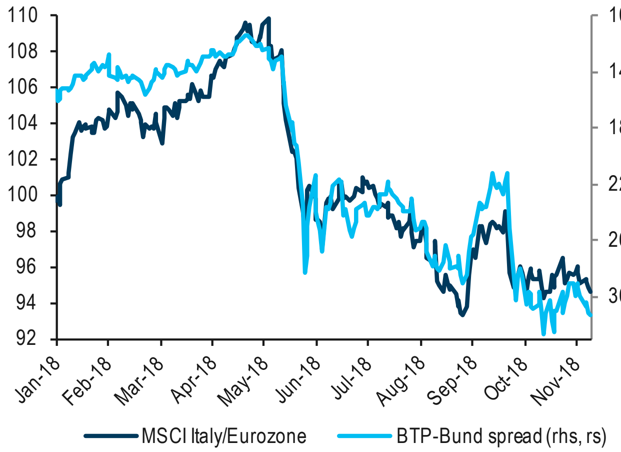
PMIs are rolling over across the board but Italy is particularly weak



Source: Markit, Bloomberg

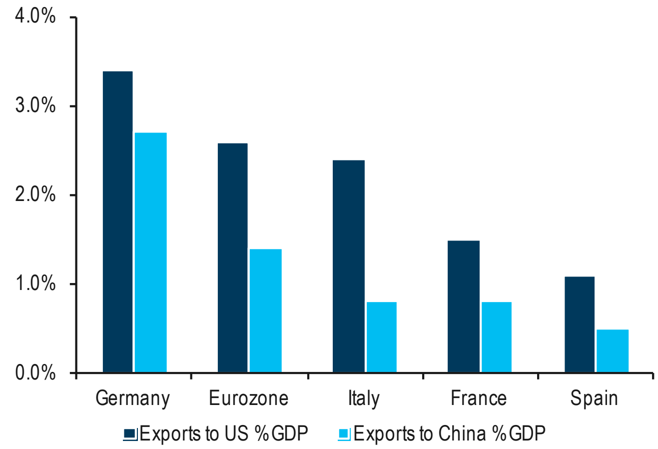
Macro fundamentals have stabilised across the Eurozone and, as we discussed earlier, domestic demand remains supported by an improving labour market, favourable financing conditions and easing fiscal austerity. However, growth surprised on the downside pretty much everywhere this year and the sharp loss of momentum in Italy is a particular concern given the ambitious fiscal targets set by the government.

FIGURE 120
Italian equities move with BTP spreads



Source: Datastream

FIGURE 121
Germany is the biggest play on global trade within Eurozone



Source: Bloomberg, Markit, IBES

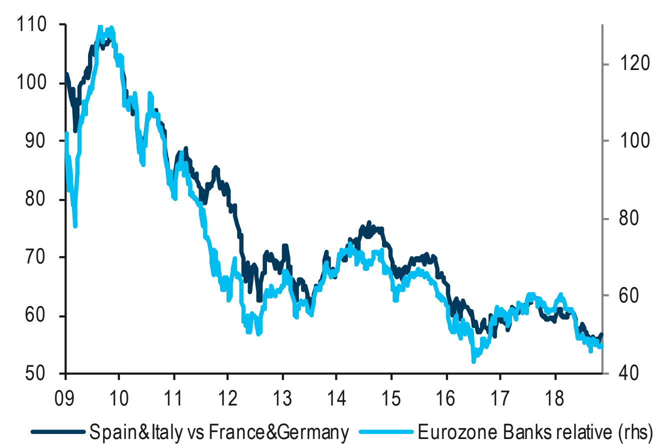
Italian equities are indeed somewhat hostage to the BTP spreads direction and the current political situation is highly uncertain. Consensus EPS growth estimates of 11% in 2019 look particularly optimistic given the weakening activity momentum. We worry that if our economists' forecasts of a further slowing in Chinese growth materialise next year, the German economy will remain under pressure. On the flipside, any de-escalation on trade tensions between the US and China would likely boost investors' sentiment towards German equities, at least in the near term.

FIGURE 122
Eurozone countries equity market cap composition

Market Cap %	Eurozone	France	Germany	Italy	Spain
Materials	8%	5%	11%	0%	0%
Industrials	15%	22%	14%	10%	9%
Discretionary	14%	18%	19%	17%	8%
IT	9%	4%	13%	0%	9%
Cyclicals	46%	49%	57%	27%	26%
Staples	10%	10%	4%	1%	0%
HealthCare	8%	10%	12%	1%	2%
Telecoms	4%	2%	5%	3%	10%
Utilities	5%	3%	4%	16%	17%
Real Estate	2%	3%	3%	0%	0%
Defensives	30%	29%	28%	22%	29%
Energy	6%	10%	0%	21%	8%
Financials	18%	12%	16%	31%	38%

Source: Datastream

FIGURE 123
Periphery vs. Core trade is a call on Banks

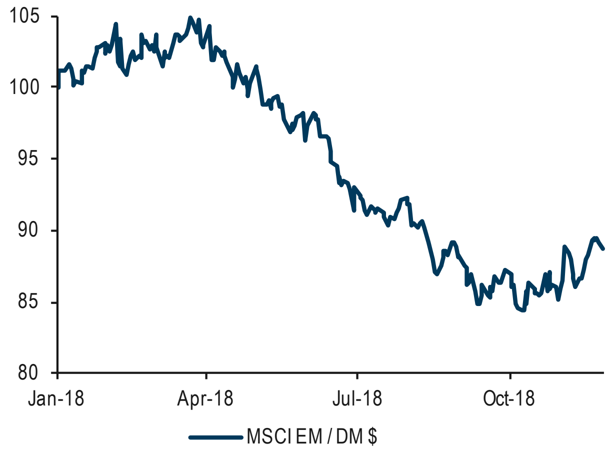


Source: Datastream

The French equity market is the most diversified within Eurozone in term of sector composition and is not overly dependent on Banks, contrary to Italy and Spain. Germany has by far the most cyclical sector composition and has no Energy exposure.

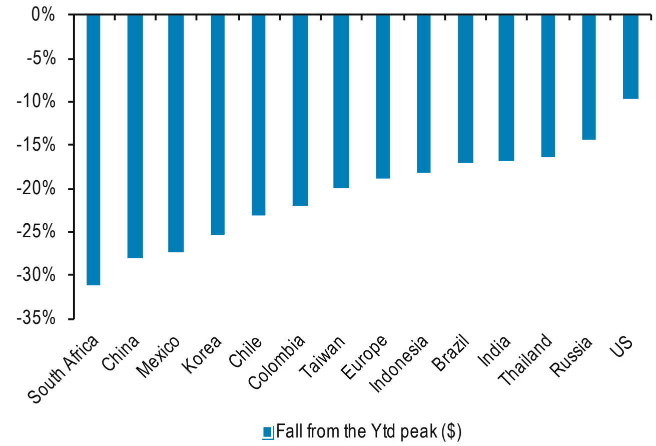
EM backdrop remains challenging, but the risks look more balanced now

FIGURE 124
EM equities have underperformed DM by 15% ytd



Source: Datastream

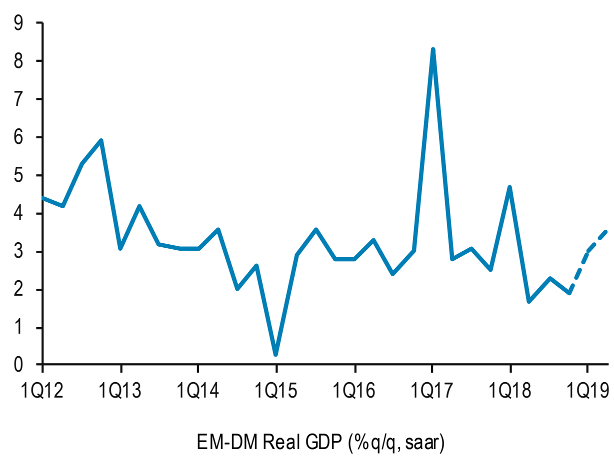
FIGURE 125
EM and DM equity markets performance from the ytd peak



Source: Datastream

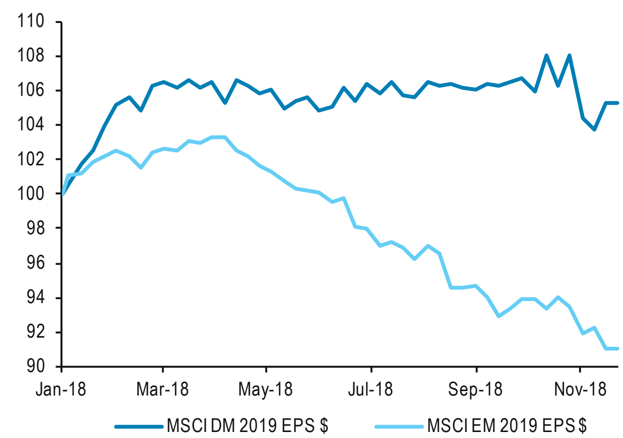
We have been cautious on EM exposure since our initiation last July and believe that the fundamental backdrop still calls for caution into 2019. The headwinds from trade, stronger dollar, tightening Fed liquidity and China deleveraging are not going away, but we think that they are more understood by investors following the correction in EM assets. MSCI EM is in a bear market, down nearly 25% from the ytd highs, and has underperformed MSCI DM by about15% ytd, in dollar terms. Chinese equities are down 30% ytd and many other regional EM markets have fallen sharply as well.

FIGURE 126
Barclays forecasts the EM-DM GDP growth differential to rebound in 2019



Source: Barclays Research

FIGURE 127
Consensus EPS estimates for 2019 have been lowered sharply in EM ytd, but not in DM

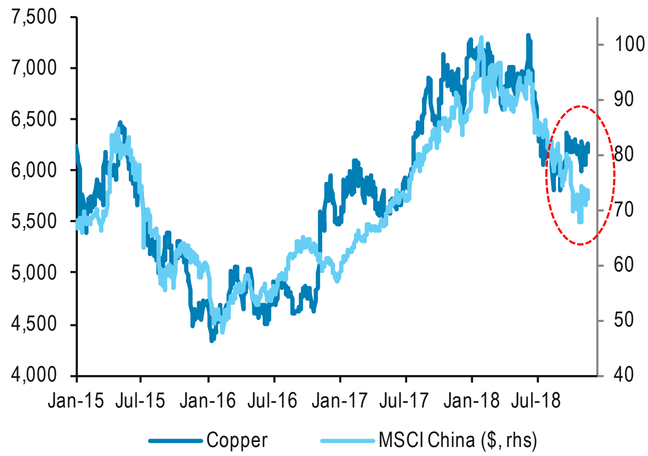


Source: IBES

Barclays' economists expect softer global GDP growth next year, but within this, are looking for the activity gap between EM and DM to stabilise. We believe that it could lead to a bottoming out in the relative EPS momentum of the former vs. the latter, which in turn could provide a floor to the relative performance of EM stocks. 2019 EPS estimates have been lowered by almost 10% for EM ytd, while they have barely moved for DM, which we find too optimistic.

FIGURE 128

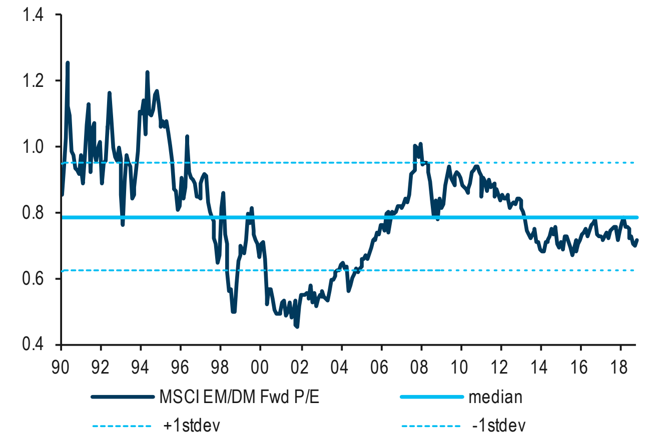
Chinese equities have undershot copper prices



Source: Bloomberg

FIGURE 129

EM relative valuations have de-rated and are not looking demanding

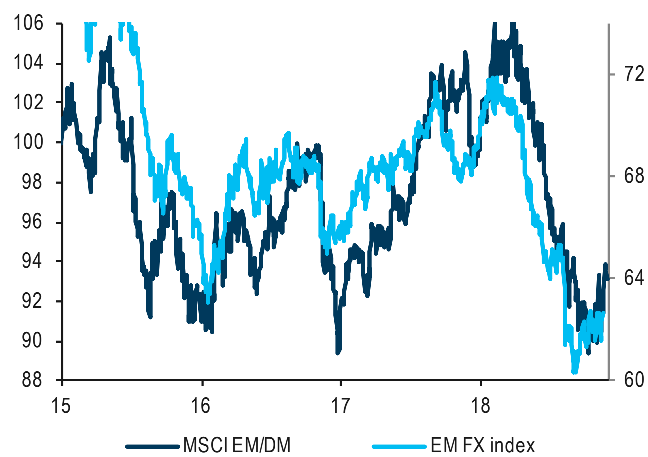


Source: IBES

Investor sentiment towards EM assets has turned negative amid weakening Chinese activity and tightening financing conditions. We note, however, that copper prices, which many see as a good indicator of activity in China, have been more resilient than the equity market. From a valuation standpoint, EM equities have de-rated and are back to trading near the bottom of the historical P/E range vs. DM.

FIGURE 130

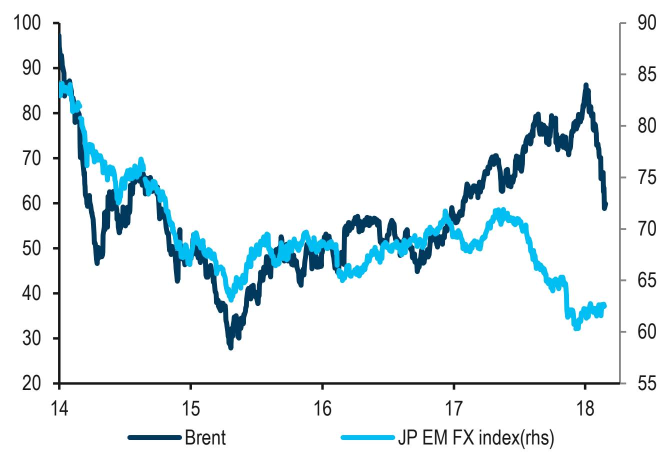
EM equity underperformance follows EM FX



Source: Datastream, Bloomberg

FIGURE 131

Rising oil prices and falling currencies have not helped EM this year, but this could improve in 2019

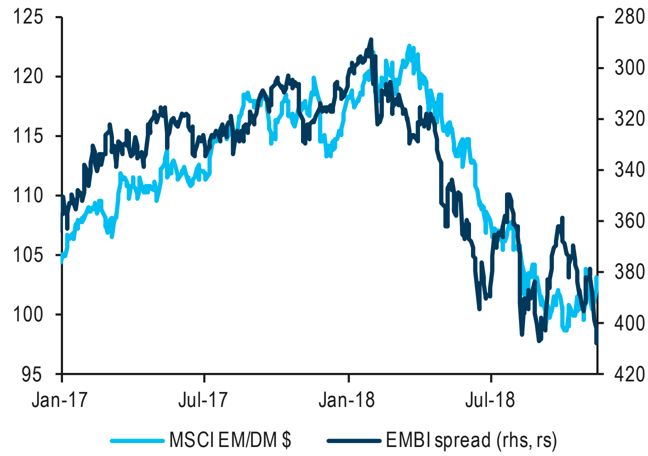


Source: Bloomberg, Barclays Research

The fate of EM equities is highly dependent on the dollar direction. The strong rally in EM equities coincided with the dollar sell-off in 2017 and the opposite happened ytd. Barclays expects the Fed to hike rates another five times by the end of 2019 and dollar to stay firm, which should keep EM FX under pressure. See '*USD: When the world is a downer*' dated 21 November. We note however that USD positioning is quite bullish already. On the positive side, the decoupling between oil price and EM FX was particularly painful for many EM economies this year, but the worst may be behind us. EM currencies have stabilised recently and oil price has rolled over.

FIGURE 132

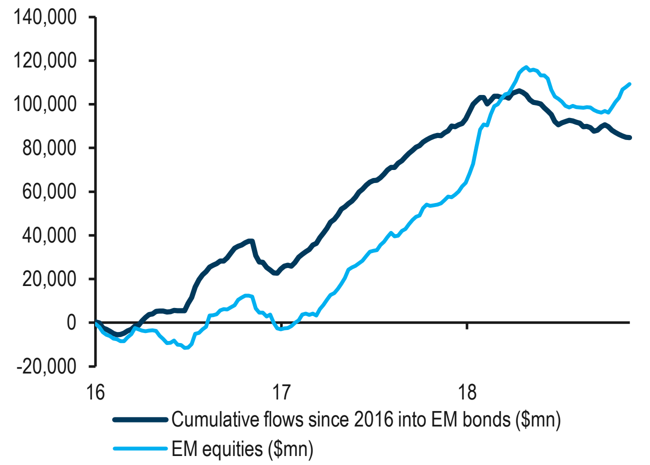
EMBI spreads has stabilised recently, which helps equities



Source: Bloomberg, Datastream

FIGURE 133

EM equities and bonds have only seen minor outflows ytd - they could be vulnerable to further negative news

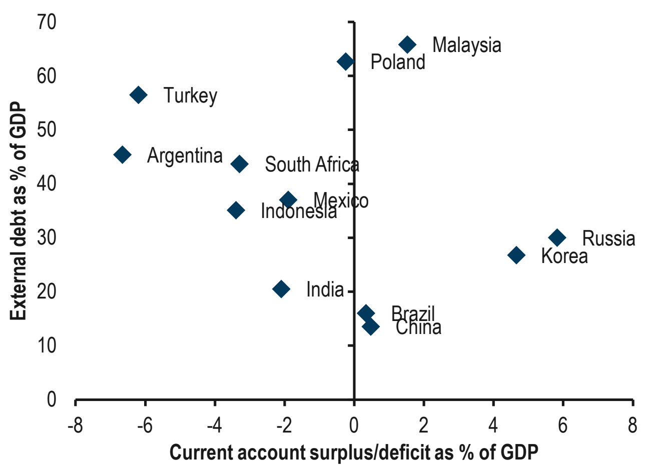


Source: EPFR, Barclays Research

We acknowledge that the tightening in Fed liquidity remains a key headwind for EM. The asset class was a key beneficiary of the search for yield over the last few years and saw massive inflows as carry trades were re-opened. However, outflows have been subdued ytd despite the repricing in the bond market, which suggests that investors still have room to reduce exposure. Our fixed income strategists forecast stable US bond yields next year, which could come with stable EMBI spreads, though.

FIGURE 134

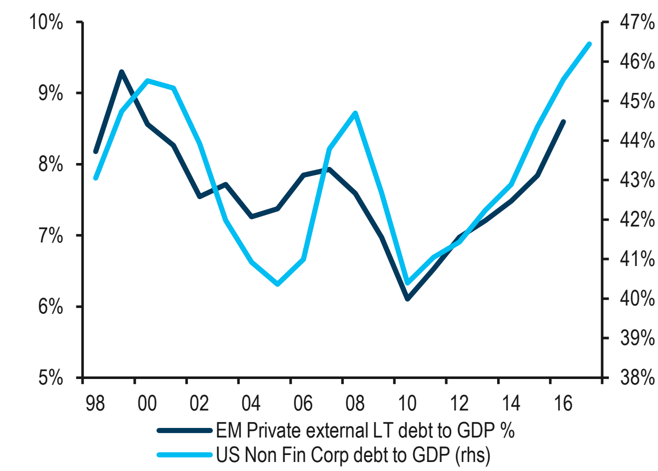
EM countries' external debt and current account balances



Source: Datastream, World Bank, Haver

FIGURE 135

Private debt to GDP has gone up a lot in EM, but also in the US

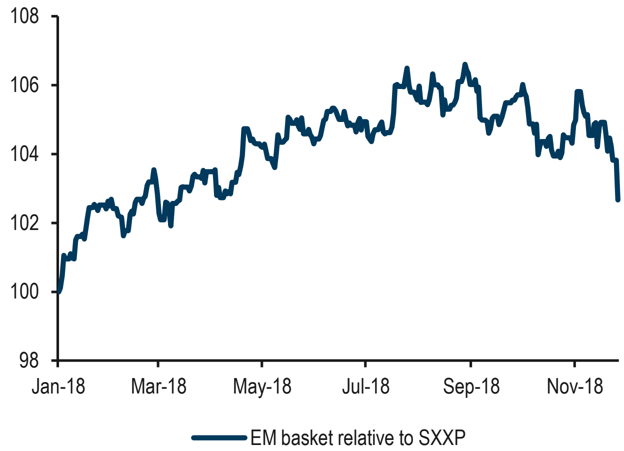


Source: Datastream, World Bank, Haver, Note: EM data only till 2016

EM structural imbalances remain plenty, with large current account deficits and excessive private leverage. This is likely to constrain the medium-term economic outlook of many EM countries, but may not worsen in the near-term as the weaker FX rate act as a stabilizer. We note that corporate debt is not only a risk for EM, but could also be a potential issue for the US.

FIGURE 136

Our EM exposure basket has underperformed recently



Source: Bloomberg

FIGURE 137

EM exposure basket - BCEUEREM

Ticker	Name	Sector	Country	Mcap ($bn)
ADS GY	Adidas	C Disc	Germany	46.1
KER FP	Kering	C Disc	France	68.3
CFR SE	Richemont N	C Disc	Switzerland	45.9
ULVR LN	Unilever (UK)	C Staples	UK	67.8
JMT PL	Jeronimo Martins	C Staples	Portugal	9.2
CCH LN	Coca-Cola Hbc (Cdi)	C Staples	UK	13.1
BN FP	Danone	C Staples	France	54.0
RDSA NA	Royal Dutch Shell A	Energy	Netherlands	156.9
BBVA SQ	BBV.Argentaria	Financials	Spain	48.2
SAN SQ	Banco Santander	Financials	Spain	90.6
MAP SQ	Mapfre	Financials	Spain	9.4
STAN LN	Standard Chartered	Financials	UK	30.5
NMC LN	NMC Health	Health Care	UK	10.5
SAN FP	Sanofi	Health Care	France	108.5
EI FP	Essilor Intl.Cmpg.D Optique	Health Care	France	32.2
BVI FP	Bureau Veritas Intl.	Industrials	France	11.5
ATCOA SS	Atlas Copco 'A'	Industrials	Sweden	24.0
ALFA SS	Alfa Laval	Industrials	Sweden	11.5
ABBN SE	ABB Ltd	Industrials	Switzerland	49.6
SIE GY	Siemens	Industrials	Germany	119.2
ASML NA	ASML Holding	IT	Netherlands	93.5
ERICB SS	Ericsson 'B'	IT	Sweden	24.6
DHER GY	Delivery Hero	IT	Germany	11.0
YAR NO	Yara International	Materials	Norway	12.2
DSM NA	DSM Koninklijke	Materials	Netherlands	19.3
BLT LN	BHP Billiton	Materials	UK	47.3
LHN SE	LafargeHolcim	Materials	Switzerland	30.6
AAL LN	Anglo American	Materials	UK	31.2
TEF SQ	Telefonica	Telecom	Spain	46.4
GAS SQ	Naturgy Energy	Utilities	Spain	27.0

Source: Bloomberg, IBES, DataStream, Barclays Research

Our EM exposure basket includes the European stocks that derive a significant share of revenues from Emerging markets and is accessible on Bloomberg via ticker BCEUEREM. We close the UW on our EM exposure basket after its underperformance versus the overall European equity market since July. However, we believe it is too early to add exposure and would wait for clearer evidence of dollar peaking to do so.

Thematic baskets for 2019

Corporate leverage

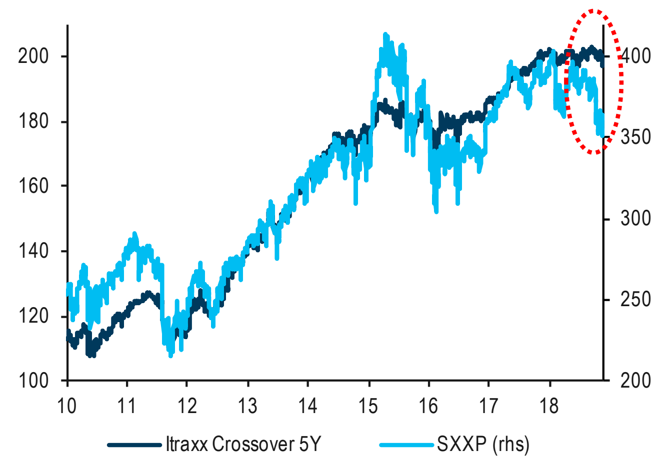
FIGURE 138

Eurozone corporate spreads have widened recently…

Source: Barclays Research

FIGURE 139

…but credit has behaved better than equities during the recent risk-off

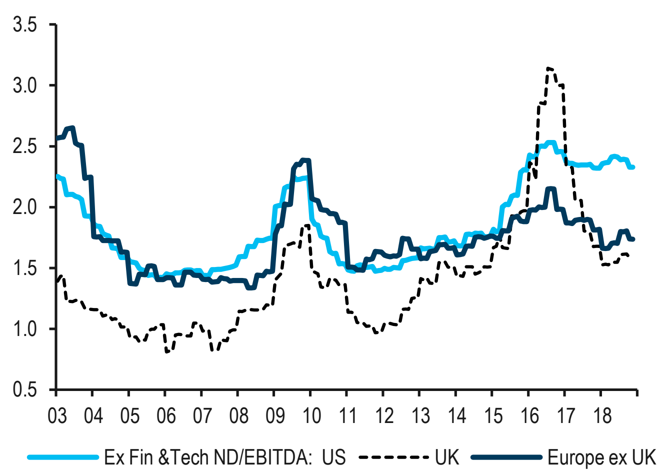


Source: Bloomberg

We are cautious on earnings for 2019 and expect G4 central banks' liquidity to tighten. Credit markets were mixed this year as spreads widened, but were still more resilient than equities. Our credit strategists expect lower ECB purchases due to the end of CSPP and equal level of supply to put moderate upward pressure on corporate spreads in 2019.

FIGURE 140

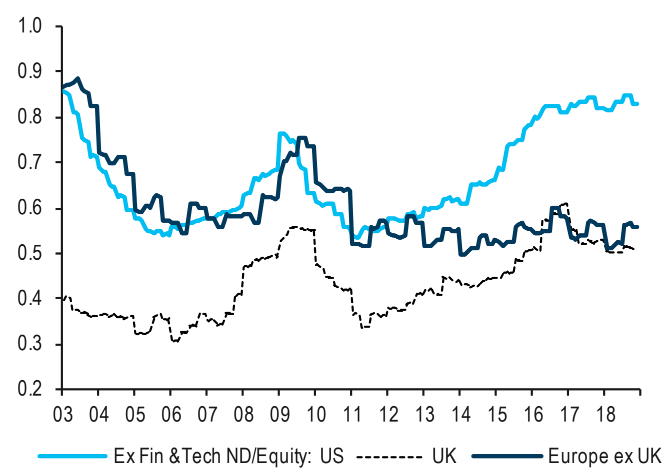
Net Debt/EBITDA is elevated in the US but not so much in Europe



Source: Datastream, Barclays Research

FIGURE 141

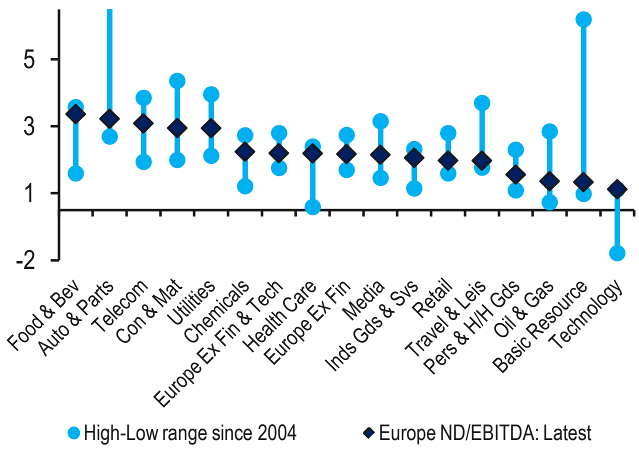
Net Debt/Equity is looking stretched in the US and also in the UK



Source: Datastream, Barclays Research

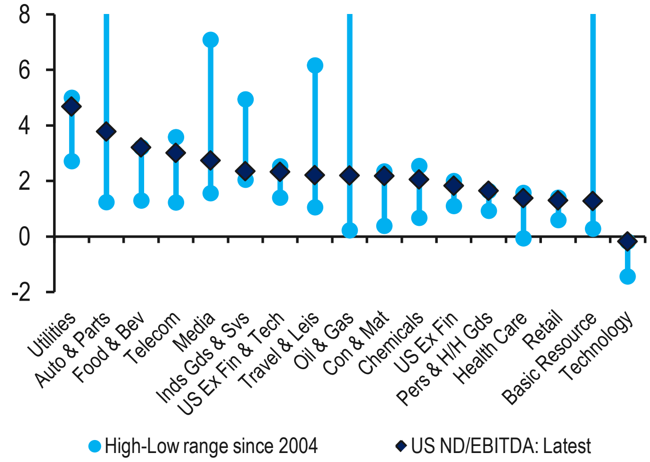
European corporate leverage is not particularly excessive at present, in particular on the continent, but it is much higher in the US. Excluding the cash-rich Tech sector, Net Debt/EBITDA and Net Debt/Equity are both above the last cycle-peak in the US. Of course, interest rates are still low in the historical context and coverage ratio is healthy, but funding costs are likely to increase if the Fed and other central banks keep normalizing policy.

FIGURE 142
European sectors ND/EBITDA



Source: Datastream, Barclays Research

FIGURE 143
US sectors ND/EBITDA



Source: Datastream, Barclays Research

Net Debt/EBITDA is currently at the top of the historical range for many US sectors, while it is less extreme in Europe.

FIGURE 144

Barclays Europe low leverage basket (BCEUELDR)

Ticker	Name	Sector	Debt Rating	ND/EBITDA 18e
EQNR NO	Equinor ASA	Energy	Aa2	0.4
RDSA NA	Royal Dutch Shell PLC-A	Energy	Aa2	1.0
FP FP	Total SA	Energy	Aa3	0.7
PROX BB	Proximus	Comm. Svs.	A1	1.1
BMW GY	BMW AG	C Disc	A1	(1.3)
ULVR LN	Unilever PLC	C Staples	A1	2.0
NOVN SE	Novartis AG-Reg	Health Care	A1	0.9
SAN FP	Sanofi	Health Care	A1	1.5
BAS GY	BASF SE	Materials	A1	1.7
SCMN SE	Swisscom AG	Comm. Svs.	A2	1.8
DAI GY	Daimler AG	C Disc	A2	(0.9)
HEN3 GY	Henkel AG	C Staples	A2	0.5
GSK LN	GlaxoSmithKline PLC	Health Care	A2	2.2
AIR FP	Airbus SE	Industrials	A2	(1.6)
ATCOA SS	Atlas Copco AB-A Shs	Industrials	A2	0.2
HO FP	Thales SA	Industrials	A2	(1.6)
BLT LN	BHP Billiton PLC	Materials	A2	0.4
ENGI FP	Engie	Utilities	A2	2.6
TEL NO	Telenor ASA	Comm. Svs.	A3	0.9
CCL LN	Carnival PLC	C Disc	A3	1.9
CPG LN	Compass Group PLC	C Disc	A3	1.5
ML FP	Michelin (CGDE)	C Disc	A3	0.7
VOW3 GY	Volkswagen AG-Pref	C Disc	A3	(0.7)
DGE LN	Diageo PLC	C Staples	A3	2.2
OMV AV	OMV AG	Energy	A3	0.5
AZN LN	AstraZeneca PLC	Health Care	A3	2.0
EN FP	Bouygues SA	Industrials	A3	1.3
DPW GY	Deutsche Post AG-Reg	Industrials	A3	1.9
MAN GY	MAN SE	Industrials	A3	2.9
DG FP	Vinci SA	Industrials	A3	2.1
AI FP	Air Liquide SA	Materials	A3	2.5
DSM NA	Koninklijke DSM NV	Materials	A3	0.4
EDF FP	EDF	Utilities	A3	2.5
SEV FP	Suez	Utilities	A3	3.1

Source: Bloomberg, IBES, Datastream, Moody's, Barclays Research
Notes: * Moody's debt rating for senior unsecured debt is considered

FIGURE 145

Barclays Europe high leverage basket (BCEUEHDR)

Ticker	Name	Sector	Debt Rating	ND/EBITDA 18e
TIT IM	Telecom Italia SpA	Comm. Svs.	Ba1	3.1
EO FP	Faurecia	C Disc	Ba1	0.1
UG FP	Peugeot SA	IT	Ba1	(1.0)
TSCO LN	Tesco PLC	C Staples	Ba1	0.7
CNHI IM	CNH Industrial NV	Industrials	Ba1	3.6
LDO IM	Leonardo SpA	Industrials	Ba1	1.7
NOKIA FH	Nokia OYJ	IT	Ba1	(1.3)
CLN SE	Clariant AG-Reg	Materials	Ba1	1.4
TUI LN	Tui AG-Di	C Disc	Ba2	0.2
ERICB SS	Ericsson Lm-B Shs	IT	Ba2	(1.1)
TKA GY	thyssenkrupp AG	Materials	Ba2	1.3
FCA IM	Fiat Chrysler	C Disc	Ba3	(0.2)
INF LN	Informa PLC	Comm. Svs.	Baa3	2.9
ITV LN	ITV PLC	Comm. Svs.	Baa3	1.1
KPN NA	Koninklijke KPN NV	Comm. Svs.	Baa3	2.8
TEF SQ	Telefonica SA	Comm. Svs.	Baa3	2.8
RNO FP	Renault SA	C Disc	Baa3	(0.6)
RCO FP	Remy Cointreau	C Staples	Baa3	1.0
FRE GY	Fresenius SE & Co KGaA	Health Care	Baa3	2.4
LHA GY	Deutsche Lufthansa-Reg	Industrials	Baa3	0.7
MTX GY	MTU Aero Engines AG	Industrials	Baa3	1.4
AAL LN	Anglo American PLC	Materials	Baa3	0.3
MT NA	ArcelorMittal	Materials	Baa3	0.8
HEI GY	HeidelbergCement AG	Materials	Baa3	2.8
STERV FH	Stora Enso OYJ	Materials	Baa3	1.1
EDP PL	EDP SA	Utilities	Baa3	4.4
RWE GY	RWE AG	Utilities	Baa3	4.3
ATL IM	Atlantia SpA	Industrials	Baa3*-	5.1

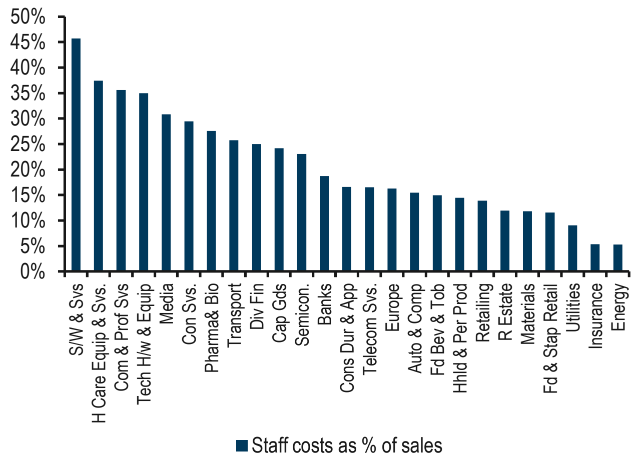
Source: Bloomberg, IBES, Datastream, Moody's, Barclays Research
Notes: * Moody's debt rating for senior unsecured debt is considered

We do not expect a credit crisis in 2019, but we believe that stocks that have relatively weak credit fundamentals will be under scrutiny. Our corporate leverage baskets screen for the SXXP stocks that have very good credit ratings (A3 and above) and those that have very poor credit ratings (Baa3 and below) according to Moody's. All stocks in the basket have filtered for liquidity criterion.

Wage inflation

FIGURE 146

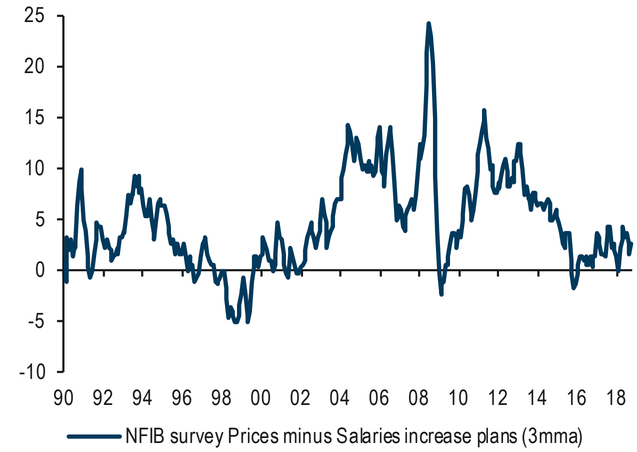
Labour costs as a share of revenues for European sectors



Source: Worldscope, Datastream, Barclays Research

FIGURE 147

The ability of US small companies to offset wage increases with higher prices appears to be limited



Source: Bloomberg, NFIB

Wage inflation is rebounding in Europe as labour markets are tightening. It is the most pronounced in the UK and Germany and could be problematic for those companies that are very labour-intensive and have limited pricing power. We created a basket of the stocks that have the biggest labour costs share of revenues across the SXXP sectors. All stocks have a market cap of at least c.$10bn.

FIGURE 148

Companies sensitive to rising wages (BCEUEWIN)

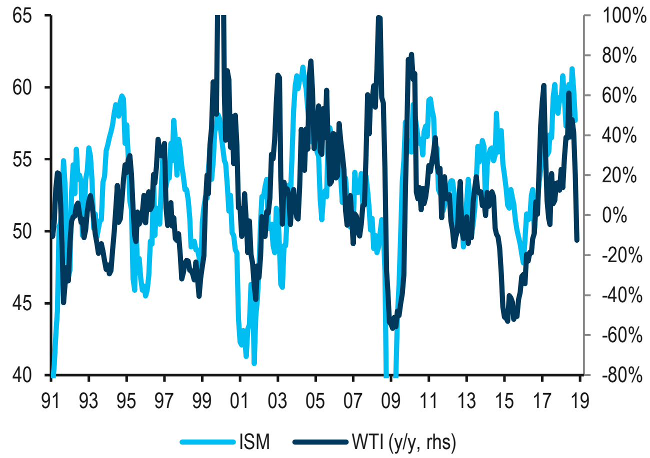
Ticker	Name	Sector	Staff costs as % of sales	Mkt cap ($bn)
SCMN SE	Swisscom 'R'	Comm Services	26%	27.6
PROX BB	Proximus	Comm Services	21%	11.1
PUB FP	Publicis Groupe	Consumer Discretionary	62%	15.7
WPP LN	WPP	Consumer Discretionary	54%	23.0
SW FP	Sodexo	Consumer Discretionary	48%	20.3
IHG LN	Ictl.Htls.Gp.	Consumer Discretionary	36%	12.1
UHR SE	The Swatch Group 'B'	Consumer Discretionary	29%	12.6
LISN SE	Choc.Lindt & Spruengli	Consumer Staples	22%	9.8
OR FP	L'Oreal	Consumer Staples	21%	124.1
AD NA	Koninklijke Ahold Delhaize	Consumer Staples	14%	27.4
ABF LN	Associated Brit.Foods	Consumer Staples	17%	30.2
TSCO LN	Tesco	Consumer Staples	13%	23.2
JMT PL	Jeronimo Martins	Consumer Staples	8%	12.2
HO FP	Thales	Industrials	40%	22.8
FER SQ	Ferrovial	Industrials	38%	16.6
SIE GY	Siemens (Xet)	Industrials	36%	118.5
KNEBV FH	Kone 'B'	Industrials	30%	24.2
SCHP SE	Schindler 'P'	Industrials	41%	9.4
CAP FP	Capgemini	Information Technology	63%	20.0
ERICB SS	Ericsson 'B'	Information Technology	38%	20.2
NZYMB DC	Novozymes	Materials	26%	14.4
GIVN SE	Givaudan 'N'	Materials	23%	21.3
EVK GY	Evonik Industries (Xet)	Materials	23%	17.6
AKZA NA	Akzo Nobel	Materials	19%	22.1
SRG IM	SNAM	Energy	7%	17.2
EDF FP	EDF	Utilities	18%	36.6
ENGI FP	Engie	Utilities	16%	41.9

Source: Worldscope, Datastream, Barclays Research

Oil price volatility

FIGURE 149

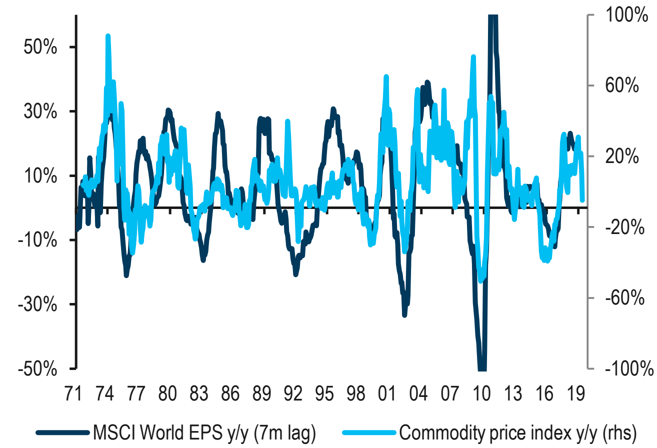
Oil price typically move with the US activity momentum…



Source: Bloomberg

FIGURE 150

…and is positively correlated with earnings



Source: Datastream

Oil went up a lot earlier this year, before falling by 30% most recently. Barclays expects the oil price to stabilise as demand stays resilient while supply disruptions in Iran, Nigeria, Venezuela and Iraq continue. However, speculative longs have been reduced and Saudi Arabia is increasing supply. Uncertainty about the direction of oil in 2019 is thus elevated, which will have key implications for growth, earnings and inflation. We created two baskets of the European stocks that have the most positive/negative correlation to oil price within each level 1 sector.

FIGURE 151

Barclays Europe positive sensitivity to oil basket (BCEUEHCO)

Ticker	Name	Sector	Mkt cap ($bn)	Correlation to Oil
EQNR NO	Equinor	Energy	79.6	45%
TEN IM	Tenaris	Energy	16.1	43%
BLT LN	BHP Billiton	Materials	43.2	39%
RDSA NA	Royal Dutch Shell	Energy	139.0	38%
ENI IM	ENI	Energy	60.6	37%
FP FP	Total	Energy	151.1	37%
REP SQ	Repsol Ypf	Energy	28.2	35%
BP/ LN	BP	Energy	136.0	33%
AAL LN	Anglo American	Materials	30.5	33%
MT NA	Arcelormittal	Materials	24.5	28%
ANTO LN	Antofagasta	Materials	10.4	27%
RIO LN	Rio Tinto	Materials	63.2	24%
SAND SS	Sandvik	Industrials	18.5	22%
AHT LN	Ashtead Group	Industrials	10.8	16%
RNO FP	Renault	C DIsc	19.9	15%
ATCOA SS	Atlas Copco A	Industrials	19.7	15%
FCA IM	Fiat Chrysler Autos.	C DIsc	25.0	12%
BMW GY	BMW (Xet)	C DIsc	51.1	12%
PSON LN	Pearson	C DIsc	9.5	12%
SU FP	Schneider Electric	Industrials	41.9	12%
BRBY LN	Burberry Group	C DIsc	9.2	11%
EDF FP	EDF	Utilities	49.7	7%
FORTUM FH	Fortum	Utilities	18.8	5%
TEL2B SS	Tele2 B	Comm. Svs.	7.6	4%
TEL NO	Telenor	Comm. Svs.	28.5	2%
CNA LN	Centrica	Utilities	10.5	0%
DRI GY	1&1 Drillisch	Comm. Svs.	8.8	0%

Source: Bloomberg, IBES, Datastream, Moody's, Barclays Research

FIGURE 152

Barclays Europe negative sensitivity to oil basket (BCEUELCO)

Ticker	Name	Sector	Mkt cap ($bn)	Correlation to Oil
SCMN SE	Swisscom 'R'	Comm. Svs.	24.1	-27%
TRN IM	Terna Rete Elettrica Naz	Utilities	11.0	-26%
BARN SE	Barry Callebaut	C Staples	9.5	-26%
NESN SE	Nestle 'R'	C Staples	258.7	-24%
LISN SE	Lindt & Spruengli	C Staples	10.8	-23%
RYA ID	Ryanair Holdings	Industrials	15.4	-23%
REE SQ	Red Electrica	Utilities	11.7	-22%
NOVN SE	Novartis 'R'	Health Care	226.0	-22%
GIVN SE	Givaudan 'N'	Materials	22.5	-22%
COLR BB	Colruyt	C Staples	9.7	-21%
MAN GY	Man (Xet)	Industrials	14.5	-21%
ADP FP	Adp	Industrials	19.3	-21%
ELE SQ	Endesa	Utilities	23.8	-20%
OR FP	L'Oreal	C Staples	131.8	-20%
DSY FP	Dassault Systemes	IT	30.7	-20%
EMSN SE	EMS-Chemie 'N'	Materials	12.7	-19%
LUX IM	Luxottica	C Disc	28.0	-19%
BEI GY	Beiersdorf (Xet)	C Staples	26.9	-19%
ELISA FH	Elisa	Comm. Svs.	7.2	-19%
PROX BB	Proximus	Comm. Svs.	8.9	-19%
AM FP	Dassault Aviation	Industrials	12.9	-19%
KNIN SE	Kuehne & Nagel Intl.	Industrials	16.0	-18%
SY1 GY	Symrise (Xet)	Materials	10.3	-18%
SW FP	Sodexo	C Disc	15.6	-17%
CPG LN	Compass Group	C Disc	34.3	-16%
ITX SQ	Inditex	C Disc	90.7	-15%
CCL LN	Carnival	C Disc	10.0	-13%
AKZA NA	Akzo Nobel	Materials	20.8	-10%

Source: Bloomberg, IBES, Datastream, Moody's, Barclays Research

We screened for the SXXP stocks that have the most positive/negative correlation to oil price in each sector since 2010. The two baskets are available on Bloomberg using the tickers BCEUEHCO and BCEUELCO.

Trade War

FIGURE 153

Our Trade basket has underperformed sharply

Source: Bloomberg

FIGURE 154

Barclays European Trade Basket - BCEUTRAD

Ticker	Name	Sector	Country	Mcap ($bn)
DAI GY	Daimler	C Disc	Germany	74.1
EO FP	Faurecia	C Disc	France	9.5
PHIA NA	Philips Eltn.	Health Care	Netherlands	41.9
ABBN SE	ABB Ltd N	Industrials	Switzerland	49.3
AIR FP	Airbus	Industrials	France	99.2
ALFA SS	Alfa Laval	Industrials	Sweden	11.6
ASSAB SS	Assa Abloy 'B'	Industrials	Sweden	21.0
ATCOA SS	Atlas Copco 'A'	Industrials	Sweden	23.9
EN FP	Bouygues	Industrials	France	15.8
CNHI IM	CNH Industrial	Industrials	Italy	15.8
SGO FP	Saint Gobain	Industrials	France	23.9
SAND SS	Sandvik	Industrials	Sweden	22.7
SU FP	Schneider Elec SE	Industrials	France	46.4
SIE GY	Siemens	Industrials	Germany	118.9
SKFB SS	SKF 'B'	Industrials	Sweden	8.5
WRT1V FH	Wartsila	Industrials	Finland	12.6
IFX GY	Infineon Tech	IT	Germany	30.1
STM IM	STMicro	IT	France	20.3
AI FP	Air Liquide	Materials	France	55.3
AKZA NA	Akzo Nobel	Materials	Netherlands	23.3
AKE FP	Arkema	Materials	France	9.4
BAS GY	BASF	Materials	Germany	90.7
1COV GY	Covestro	Materials	Germany	19.4
EVK GY	Evonik Industries	Materials	Germany	17.3
LHN SE	Lafargeholcim	Materials	Switzerland	29.8
SIKA SE	Sika	Materials	Switzerland	21.9
SOLB BB	Solvay	Materials	Belgium	13.7
TKA GY	thyssenkrupp	Materials	Germany	17.0
TEF SQ	Telefonica	Telecom	Spain	46.2

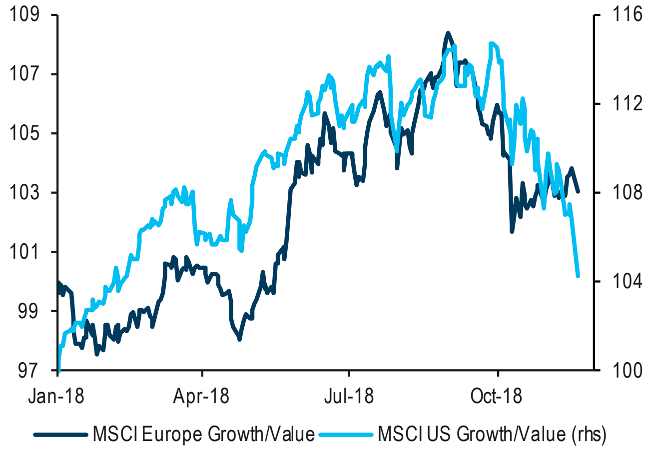
Source: Bloomberg, IBES, DataStream, Barclays Research

We created a basket of the European stocks that could be the most negatively impacted by the trade war between US and China/Europe. These stocks fell the most on the back of tariff headlines before our initiation and also derive a significant proportion of revenues from abroad. Our trade basket has underperformed the European equity market ytd and will likely remain in the spotlight for 2019. In the near term we believe that a potential cooling of trade tensions between the US and China at the upcoming G20 meeting could boost sentiment towards the space.

Value / Growth

FIGURE 155

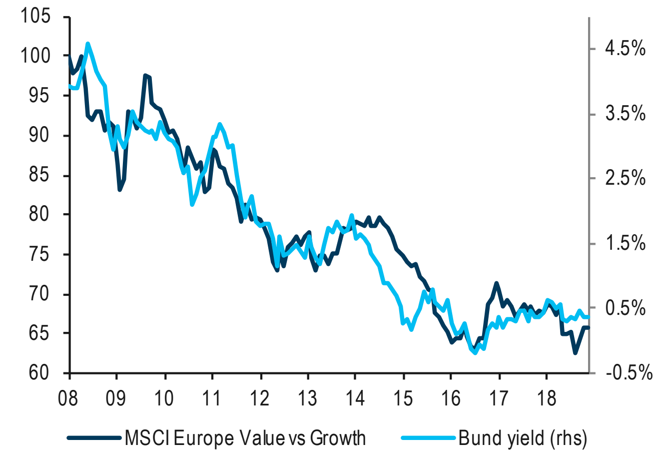
There was a significant style rotation away from Growth and into Value recently



Source: Datastream

FIGURE 156

In Europe, the Value/Growth trade is highly dependent on the direction of bond yields



Source: Datastream

We advised to add exposure to Value style in September and to reduce Growth bias. Growth and Quality had a strong run earlier in the year and look stretched. Also the Value/Growth trade is highly dependent on the direction of bond yields, which we expected would be higher. Looking ahead, Barclays forecast bond yields to stay range-bound.

FIGURE 157

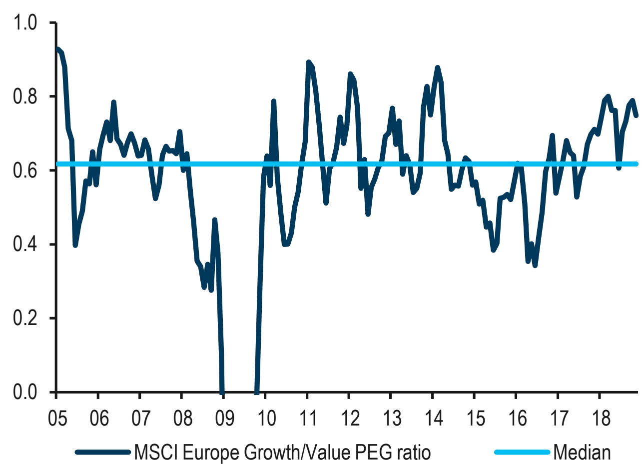
MSCI Value is biased to Financials and Growth is biased to Staples

	Sector	Value	Growth	Value-Growth
Value	Financials	31%	8%	23%
	Energy	17%	5%	12%
	Utilities	9%	0%	9%
	Telecoms	0%	0%	0%
	Real Estate	0%	0%	0%
Growth	Healthcare	9%	13%	-4%
	Materials	8%	11%	-3%
	IT	1%	5%	-3%
	C Discretion	5%	14%	-9%
	C Staples	2%	28%	-26%
	Industrials	8%	15%	-6%

Source: IBES, Datastream

FIGURE 158

Growth stocks valuation remain expensive compared to value



Source: IBES, Datastream

We have a small Value bias in our portfolio, mainly due to our sector preferences, which are discussed in the next section. We are OW on Financials, the biggest sector in MSCI Value, and UW Industrials and Tech, which are Growth. We note that while Growth stocks have underperformed recently, their valuations relative to Value do not look particularly depressed.

FIGURE 159

European Growth Basket - BCEUGROW

Ticker	Name	Sector	P/B	EPS CAGR 2017-20
ADS GY	Adidas	C Disc	6.5	26.8%
RMS FP	Hermes Intl.	C Disc	10.2	9.8%
MONC IM	Moncler	C Disc	8.1	15.4%
HEIA NA	Heineken	C Staples	3.5	6.9%
JMT PL	Jeronimo Martins	C Staples	3.7	9.0%
KYG ID	Kerry Group 'A'	C Staples	4.6	7.4%
RCO FP	Remy Cointreau	C Staples	3.8	11.3%
EQNR NO	Equinor	Energy	2.1	21.8%
GALP PL	Galp Energia Sgps	Energy	2.7	14.7%
CABK SQ	Caixabank	Financials	0.9	16.2%
DB1 GY	Deutsche Boerse	Financials	4.4	13.3%
HL/ LN	Hargreaves	Financials	21.4	14.1%
PGHN SE	Partners Group	Financials	9.2	6.0%
PRU LN	Prudential	Financials	2.6	7.8%
COLOB DC	Coloplast 'B'	Health Care	20.3	10.7%
NOVOB DC	Novo Nordisk 'B'	Health Care	14.2	6.2%
BVI FP	Bureau Veritas Intl.	Industrials	8.5	6.6%
GEBN SE	Geberit 'R'	Industrials	7.6	5.0%
ITRK LN	Intertek Group	Industrials	10.4	6.4%
KNIN SE	Kuehne+Nagel Intl.	Industrials	6.9	7.5%
REL LN	Relx	Industrials	13.8	6.4%
SGSN SE	SGS 'N'	Industrials	9.1	8.1%
TEMN SE	Temenos N	IT	22.6	18.5%
UBI FP	Ubisoft Entm.	IT	8.3	27.5%
CHR DC	CHR Hansen	Materials	13.9	12.9%
EMSN SE	EMS-Chemie 'N'	Materials	8.3	5.6%
NZYMB DC	Novozymes	Materials	8.1	6.7%
DWNI GY	Deutsche Wohnen	Real Estate	1.5	11.0%
KPN NA	KPN Kon	Comm. Svs	4.4	11.1%
EOAN GY	E On N	Utilities	5.0	3.5%

Source: Bloomberg, IBES, DataStream, Barclays Research

FIGURE 160

European Value Basket - BCEUVALO

Ticker	Name	Sector	P/B
BMW GY	BMW	C Disc	0.9
KGF LN	Kingfisher	C Disc	0.8
UHR SE	The Swatch Group 'R'	C Disc	0.3
VOW3 GY	Volkswagen Pref.	C Disc	0.8
CA FP	Carrefour	C Staples	1.3
CO FP	Casino Guichard-P	C Staples	0.6
AD NA	Koninklijke Ahold Delhaize	C Staples	1.8
SBRY LN	Sainsbury J	C Staples	1.0
ENI IM	ENI	Energy	1.1
REP SQ	Repsol YPF	Energy	0.8
ACA FP	Credit Agricole	Financials	0.6
DBK GY	Deutsche Bank	Financials	0.3
NN NA	NN Group	Financials	0.6
GLE FP	Societe Generale	Financials	0.4
STAN LN	Standard Chartered	Financials	0.5
SAN FP	Sanofi	Health Care	1.7
SN/ LN	Smith & Nephew	Health Care	1.4
MAERSKB DC	A P Moller - Maersk 'B'	Industrials	1.0
EN FP	Bouygues	Industrials	1.4
LHA GY	Deutsche Lufthansa	Industrials	1.0
SGO FP	Saint Gobain	Industrials	0.9
SGRE SQ	Siemens Gamesa Renewable	Industrials	1.3
ERICB SS	Ericsson 'B'	IT	2.5
NOKIA FH	Nokia	IT	1.7
AAL LN	Anglo American	Materials	0.9
GLEN LN	Glencore	Materials	0.7
HEI GY	Heidelbergcement	Materials	0.8
LAND LN	Land Securities Group	Real Estate	0.6
TIT IM	Telecom Italia	Telecom	0.5
EDF FP	EDF	Utilities	1.0

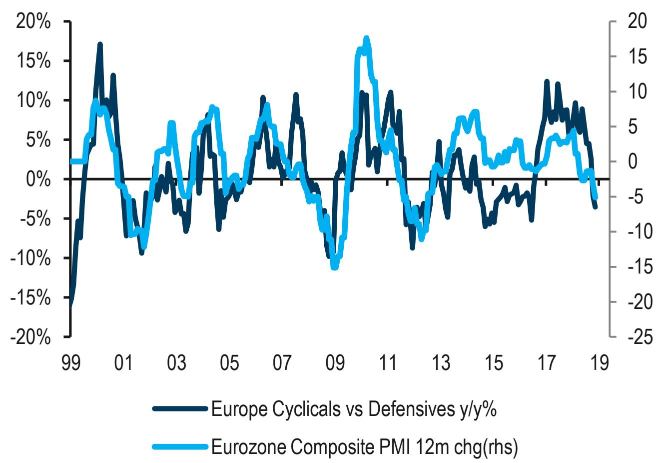
Source: Bloomberg, IBES, DataStream, Barclays Research

The Growth basket includes the stocks that trade on the highest P/B within each sector and which are expected by consensus to deliver strong EPS CAGR between 2017 and 2020. It is accessible on Bloomberg via ticker BCEUGROW. The Value basket includes the stocks that trade on the lowest P/B within each sector. It is accessible on Bloomberg via ticker BCEUVALO.

Sector Allocation

FIGURE 161

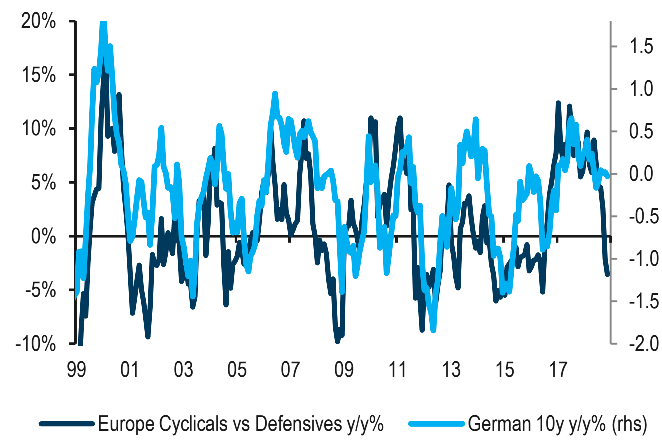
Cyclicals/Defensives move with PMI…



Source: Datastream, Bloomberg

FIGURE 162

…and with bond yields

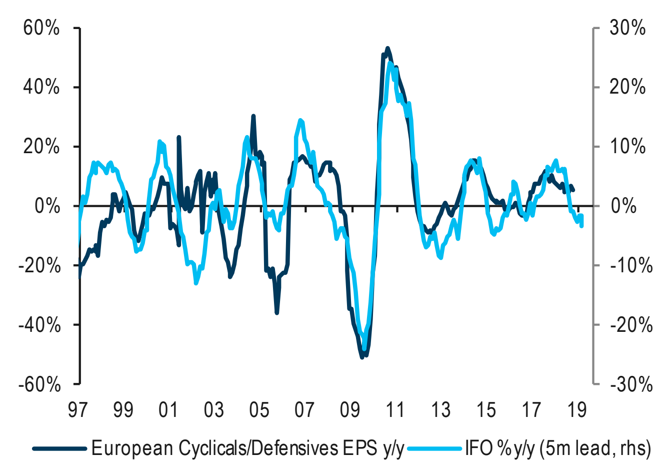


Source: Datastream

Cyclical sectors (Materials, Industrials, Discretionary and Tech) strongly outperformed Defensives (Staples, Healthcare, Telecoms, Utilities) in the last two years, by 18% in Europe and 27% in the US. Following a further rebound in H1, Cyclicals have recently rolled over sharply as activity momentum stalled and trade uncertainty increased. We recommend a neutral stance between Cyclicals and Defensives into 2019. Activity momentum is negative and we expect bond yields to stay range-bound, which is unlikely to help Cyclicals much.

FIGURE 163

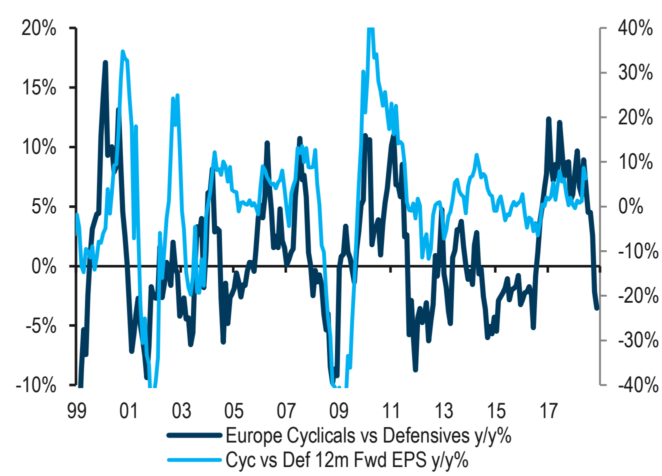
Cyclicals relative EPS momentum is set to turn negative…



Source: IBES, Datastream

FIGURE 164

…but Cyclicals have de-rated sharply already



Source: IBES

The rollover in leading indicators points to a weakening in the relative EPS momentum of Cyclicals vs. Defensives ahead. As discussed earlier, we find consensus estimates too optimistic for Cyclicals in 2019. Earnings momentum is thus likely to turn negative, but some of it must be already implied by the sharp recent de-rating of Cyclicals.

FIGURE 165

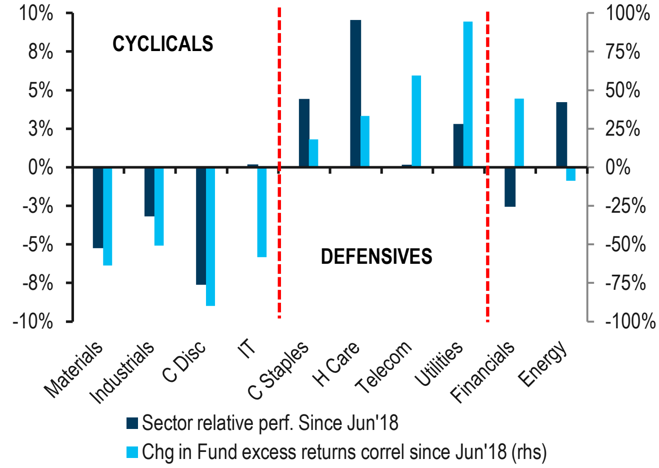
Cyclicals typically perform during the late stage of the cycle, but not during recessions

Median performance	From Yield Curve inversion to SPX peak 'late cycle'	SPX peak to trough 'recession'
US Market	13.0%	-34.0%
Financials	12.9%	-35.5%
Oil & Gas	30.1%	-29.5%
Materials	18.6%	-32.1%
Industrials	19.5%	-38.6%
C Svs	7.5%	-30.7%
Tech	9.8%	-41.7%
C Gds	1.9%	-31.2%
Healthcare	12.5%	-18.9%
Telecom	4.4%	-26.1%
Utilities	9.0%	-26.4%
Cyclicals	7.0%	-24.1%
Defensives	3.0%	-11.5%
Cyclicals vs Defensives	4.2%	-14.3%

Source: Barclays Research

FIGURE 166

European funds have been shifting exposure to Defensives in H2



Source: EPFR, Barclays Research

On the positive side, we note that Cyclicals typically outperform Defensives during the late stage of the cycle. Looking at the sectoral performance following past inversions of the US yield curve until the peaks of the S&P500, we found that Cyclicals delivered higher returns than Defensives. Materials and Industrials, along with Energy, performed particularly well, while Telecoms and Utilities were the weakest. Also, we note that there has already been a significant reallocation from Cyclicals to Defensives over the last few months, as mutual funds reduced their beta allocation. As a result, while fundamentals remain uninspiring for Cyclicals, we find their risk-reward well balanced vs. Defensives.

FIGURE 167

European sectors scorecard

	Overall rank	Price momentum (1,3 & 6 months)	P/Book vs 10Y median	Fwd P/E vs 10Y median	Fwd Div Yield	EPS y/y ('18e & '19e)	EPS Revisions (current, 1 & 3 months)	ROE
Food Bev&Tob	1	-3.2%	-18.7%	1.8%	3.1%	7.5%	-0.5%	15.4%
Energy	2	-8.2%	2.7%	-3.3%	5.4%	26.8%	43.8%	9.8%
Retailing	3	-0.7%	-12.1%	-4.7%	4.1%	4.7%	-48.6%	17.6%
Hotels,Rest&Leis	4	1.8%	0.0%	-4.4%	2.7%	8.1%	-51.0%	18.0%
Banks	5	-6.0%	-10.1%	-13.9%	5.4%	6.5%	-24.6%	7.3%
Semicon	5	-9.2%	-6.9%	-24.8%	1.1%	16.5%	20.0%	12.8%
Insurance	7	-2.2%	10.4%	2.6%	4.8%	13.2%	-4.3%	8.9%
Food Drug Ret	8	-0.2%	-12.6%	13.4%	2.7%	12.0%	2.0%	8.8%
Real Estate	8	-3.3%	-10.3%	-11.7%	4.8%	6.5%	-16.7%	5.7%
Automobile	10	-6.8%	-17.5%	-26.1%	4.5%	4.1%	-77.3%	14.7%
Healthcare	11	0.2%	-9.0%	5.0%	3.0%	5.4%	-17.4%	16.4%
Cap Goods	12	-6.6%	4.1%	-1.8%	2.8%	9.3%	-14.5%	16.0%
Cons Durables	12	-7.1%	22.9%	-0.7%	2.4%	13.6%	1.1%	18.9%
Media	14	-6.9%	-26.6%	-8.1%	3.9%	-0.1%	-30.5%	12.9%
Telecoms	15	1.8%	-12.9%	3.9%	5.6%	1.0%	-57.5%	8.8%
Met&Min	16	-8.1%	-1.2%	-18.3%	4.7%	3.5%	-41.7%	15.2%
Transport	17	-4.7%	2.3%	-2.4%	3.2%	7.6%	-48.0%	13.3%
Prof. Services	18	-0.9%	27.2%	4.9%	2.6%	6.9%	-6.4%	32.1%
Utilities	19	0.1%	3.4%	6.2%	5.1%	3.3%	-15.0%	11.1%
Tech Hardware	20	-1.7%	22.6%	10.5%	2.3%	20.3%	-5.0%	12.5%
Cons Mat	21	-6.0%	-2.2%	-16.4%	3.4%	7.3%	-100.0%	6.2%
Chemicals	22	-6.0%	2.4%	0.5%	3.0%	3.6%	-47.7%	16.2%
HPC	23	1.3%	34.1%	4.0%	2.6%	6.1%	-51.4%	24.6%
Software	24	-9.4%	9.5%	20.5%	1.5%	9.0%	4.6%	14.8%
Div Fin	25	-8.3%	-1.0%	4.9%	3.2%	8.4%	-36.6%	7.0%

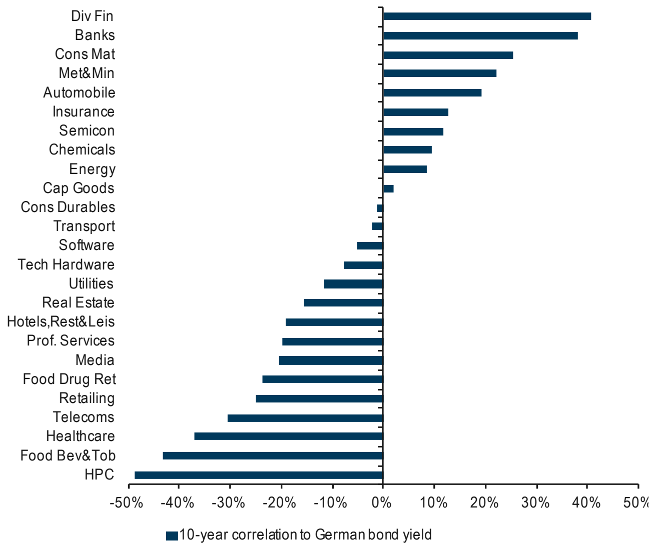
Source: Datastream, IBES, Barclays Research

Our methodology for sector allocation uses both quantitative and fundamental analysis.

We first use a scorecard to rank the MSCI Europe level 2 sectors according to seven variables: Price momentum, P/Book and P/E relative to their historical median, Dividend Yield, EPS growth, EPS revisions and ROE.

FIGURE 168

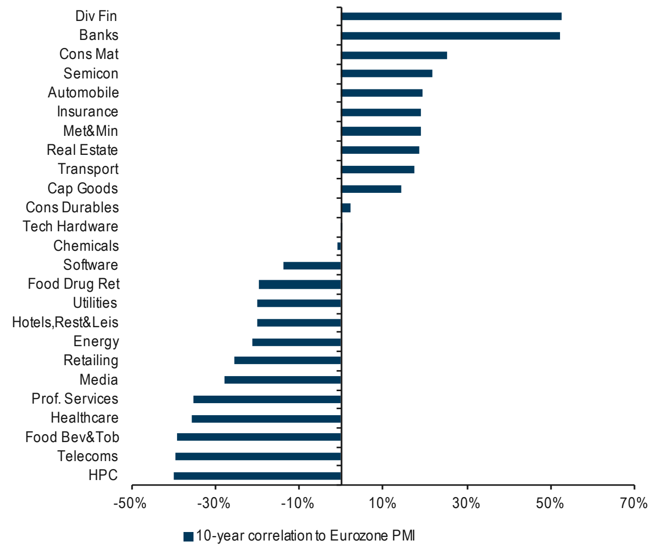
European sectors' correlation to bond yields



Source: Barclays Research

FIGURE 169

European sectors' correlation to PMI



Source: Barclays Research

We then apply a macro overlay to this quant analysis, for example how activity momentum, the direction of bond yields or FX would impact sector preferences. Finally, we take into account our sector analysts' views on sectors and stocks.

FIGURE 170

European Equity Strategy Sector Allocation

	Barclays Equity Strategy Recommendation	MSCI Europe Weight	Barclays Allocation	Barclays vs Benchmark
Energy	MW	8.1%	8.0%	-0.1%
Materials	OW	7.5%	10.0%	2.5%
Industrials	UW	12.7%	10.0%	-2.7%
Discretionary	MW	10.2%	10.0%	-0.2%
Staples	MW	14.2%	14.0%	-0.2%
Healthcare	MW	13.9%	13.5%	-0.4%
Financials	OW	19.1%	22.0%	2.9%
IT	UW	5.3%	3.0%	-2.3%
Telecoms	OW	3.6%	6.0%	2.4%
Utilities	UW	3.9%	2.0%	-1.9%
Real Estate	MW	1.4%	1.5%	0.1%
		100.0%	**100.0%**	**0.0%**

Source: Notes: Overweight (OW): The performance of the MSCI Europe sector is expected to outperform the MSCI Europe index in the next 3-6 months. Marketweight (MW): The performance of the MSCI Europe sector is expected to perform in line with the MSCI Europe index in the next 3-6 months. Underweight (UW): The performance of the MSCI Europe sector is expected to underperform the MSCI Europe index in the next 3-6 months
Source: Barclays, MSCI

We are **Overweight** Financials, Materials and Telecoms; **Marketweight** Energy, Healthcare, Staples, Real Estate and Discretionary; **Underweight** Utilities, Tech and Industrials.

ENERGY

Strategy Rating – Marketweight

FIGURE 171

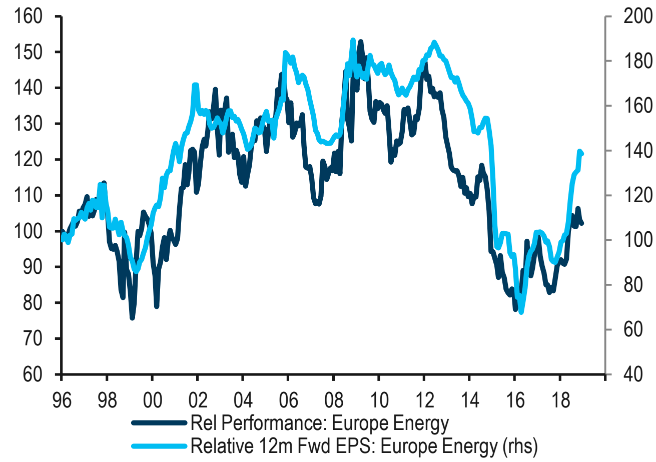
MSCI Europe Energy sector snapshot

	Absolute Perf.	EPS growth		Fwd PE	P/B	DY	Sector rating
	YTD	2018E	2019E	Latest	Latest	2019E	
Energy	**-2%**	**41.2%**	**17.2%**	**9.9**	**1.4**	**5.4%**	**MW**

Source: Barclays Research, IBES, Datastream

FIGURE 172

MSCI Europe Energy relative performance and earnings

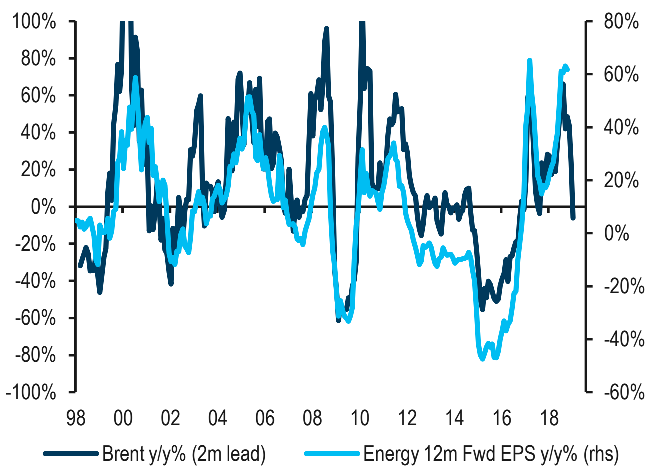


Source: MSCI, DataStream, IBES, Barclays Research

Energy is one of the best performerd ytd in Europe. The sector ranks well on our scorecard, but we see a potential for earnings cuts given the recent sharp fall in oil. We are downgrading it from OW to MW.

FIGURE 173

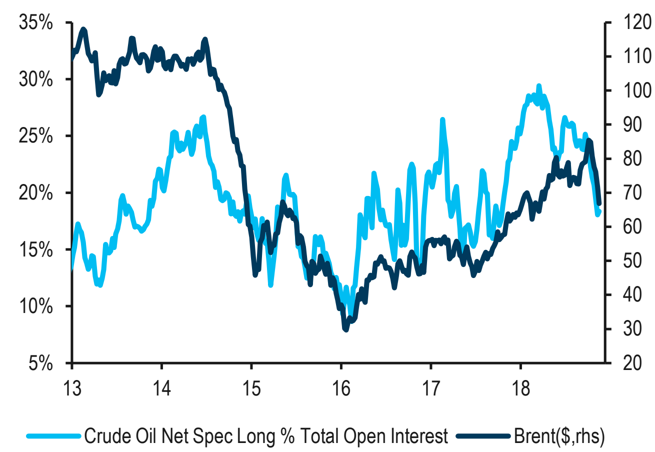
Oil price is the key driver of Energy earnings



Source: IBES, Bloomberg

FIGURE 174

Crude Oil speculative positioning has been trimmed down

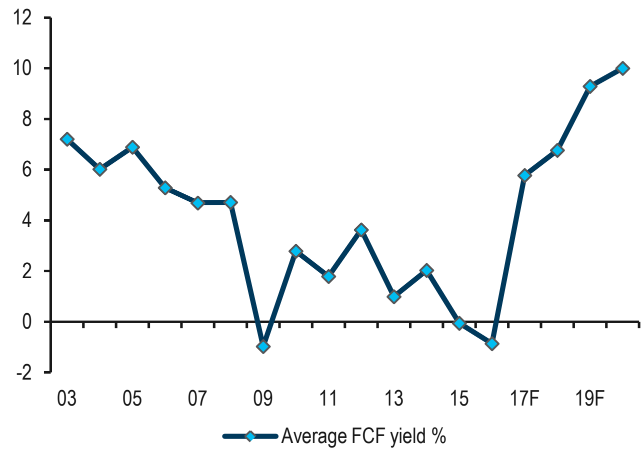


Source: CFTC, Bloomberg, Barclays Research

Oil price fell sharply most recently, which we believe was mainly due to speculative positions being trimmed, but also softening demand and increasing supply. Our sector analysts look for Brent prices to rebound through 2019, but recognise there is significant uncertainty ahead of the upcoming OPEC meeting. In their view, oil supply-demand balance remains tight and utilization rates are particularly elevated. They also forecast natural gas prices to move higher next year and see IMO as a bullish catalyst for higher diesel demand.

FIGURE 175

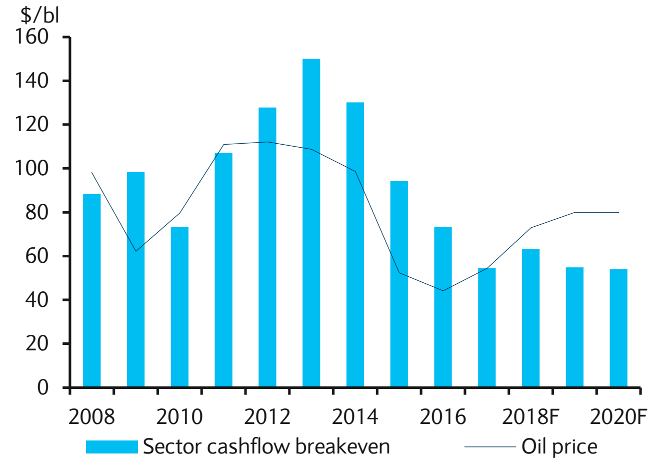
Energy cash flow is positive



Source: Barclays European Oil & Gas Research

FIGURE 176

Cash flow breakeven is below $60/bl

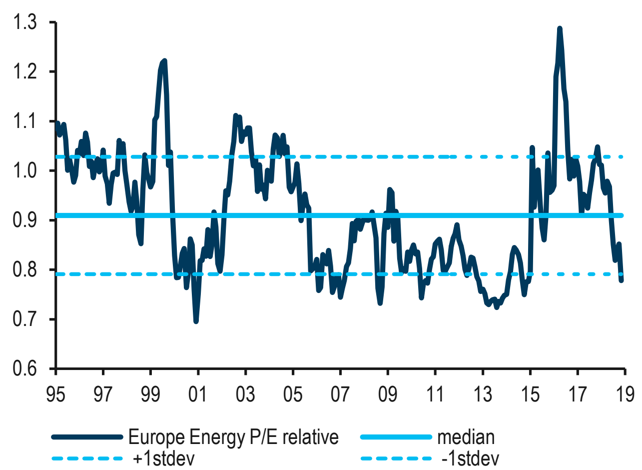


Source: Barclays European Oil & Gas Research

Fort most integrated companies cash breakevens are below $60/bl and we believe that the recent pullback in oil re-enforces the message of capital discipline. Higher gas prices in the near term dampen the earnings impact of a lower oil price, while the strength of refining margins suggests that any fears of a potential slow down of demand may be overdone.

FIGURE 177

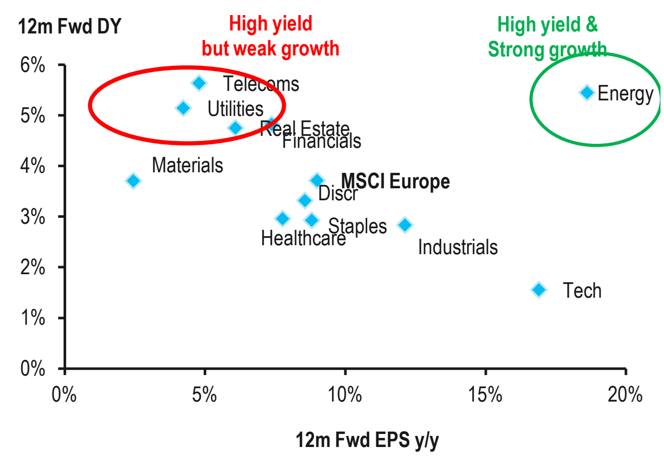
As earnings rebounded, Energy P/E has become cheaper



Source: IBES

FIGURE 178

Energy sector cash flow and oil price over time



Source: IBES, Datastream

Energy relative valuations are looking particularly attractive at present but could be questioned by investors if oil fails to rebound. The sector offers a 5% dividend yield, based on IBES estimates, almost the highest of all the European sectors. Our analysts do not see downside to current dividend projections. In comparison, Telecoms and Utilities dividend yields are about the same as Energy, but they are only expected to grow earnings low single-digit next year and we see downside risks to current dividend projections.

Integrated Oil & Refining – Analysts' view

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Sector outlook and key drivers for 2019

Tightened oil supply thesis unchanged - While in the near term we think the oil markets are set to be volatile with the direction for prices now determined by the 6th December OPEC meeting, our thesis that the market tightens in 2019 due to an impending supply shortage remains unchanged and as such, we see risks skewed to the upside in 2019 for oil price. At just 1.6mb/d in 2019E, the level of supply growth indicated by our project database is significantly below the 3mb/d that is needed to keep production flat. US shale will be able to fill some of this gap, but the situation becomes tighter when we consider demand growth of ~1mb/d and any potential supply cuts from OPEC.

Downstream an important source of cash flow - With previously delayed and idled refineries coming back on line, 2019E might see supply additions outstripping demand growth by an average 340kb/d post closures. This will put downward pressure on margins if this materialises. Despite this, we still expect downstream to remain an important source of cash flow and the IMO 2020 standards might provide additional upside to earnings.

Natural gas shouldn't be overlooked - The recent bull runs of US and European gas prices have surprised to the upside. Whist we do not expect a repeat of the extraordinary prices of the last month, we see EU and Asian gas prices as well supported with our analysis showing the LNG market as broadly balanced. We do note gas production makes up roughly half of sector volumes, and we see stronger gas prices as another helpful source of cash flow.

Lower prices reinforce discipline - The very sharp fall in oil price over the last six weeks has been unhelpful for sentiment and will likely lead to a number of downgrades to consensus estimates in the near-term. This may limit the near-term upside to share prices but also reinforces the message of capital discipline amongst the Integrateds, in our view. Sector cash breakevens are currently below $60/bl and hence, even at current prices, our thesis of growing free cash flow, returns and dividends is unchanged. Taking this together with our view that prices are risked to the upside in light of an impending supply gap in 2019 and we re-iterate our positive sector rating.

Bookshelf Reports

1. The Oil & Gas Benchmarks 2018: Rise of the Big Oils (11 September 2018)
2. Disruption ahead from IMO 2020 (27 July 2018)
3. Evidence of digital deployment (24 April 2018)
4. LNG – The need for projects (24 May 2018)

Earnings and valuation outlook

2018 has seen strong earnings growth across the group helped by oil price recovery and higher natural gas prices than a year ago. We forecast sector EPS will increase by another 34% in 2019E with Shell, Total and Repsol expected to report the highest growth. Our earnings forecasts assume that the Brent price will average some 10% higher in the coming 12 months than it has in 2018. A key differentiating factor for the companies is the growth of free cash flow. Supported by a more positive oil price outlook in 2019, new higher margin barrels coming on stream, and continued capital discipline, FCF should be boosted by a combined $15bn y/y, or 22%. In total we forecast organic FCF (pre dividends) of close to $86bn in 2019E and cash breakeven oil price of $55/bl. This should enable the companies to further bring down debt, increase shareholder returns or pursue growth opportunities if they need to. Our valuation implies sector 2019E EV/EBIDA of 5.1x and FCF yield of 11% versus 10-year average of 7x and 3%. On average we see 33% upside potential in our base case, c60% in our upside case and 11% downside potential in our downside case.

Positioning within the sector

Given the heightened volatility in the commodity market and expected slowdown of economic growth globally, we prefer stocks that are able to deliver stable FCF yield and shareholder returns and a track record of robust through-cycle returns. These stocks mainly include TOT (OW, PT EUR66), RDS (OW, PT 3,300p), BP (OW, PT 705p) and REP (OW, PT EUR19.5) among the Integrateds and Neste (OW, PT EUR85) in refiners.

Key stock recommendations

Lydia Rainforth, CFA

BP (BP/:LN, OW, PT 705p)

We believe BP offers a differentiated investment case in the European Oils sector. We expect free cash flow to meaningfully improve over the next 12 months driven by strong production growth, resilient downstream performance and steady operating progress. The growth in organic free cash flow is coming at the same time that payments for Macondo roll off, which together with disposals should see BP being able to reduce debt while increasing returns to shareholders. No portfolio is perfect though and BP is taking actions to strengthen and upgrade its asset base, with the acquisition of BHP assets and the $1bn increase in its 2021 Upstream FCF target a reflection of this. There is also clear evidence of the modernization of the business with delivery of projects ahead of schedule and below budget. Ultimately we see it leading to higher corporate and shareholder returns. We remain encouraged by the steps which BP is taking and see the actions eventually driving a re-rating of the shares. This improvement remains at odds with the valuation of the shares, with our estimated 2019F dividend yield at 5.2%. BP is our Top Pick in the European Oils space with 36% potential upside to our 705p/share price target.

Josh Stone

Neste (NESTE:FH, OW, PT EUR85)

Our investment case on Neste centres entirely on the growth in volumes of its renewable fuels business where we think consensus estimates are still too low. Management indicated a number of structural changes that have improved the profitability and visibility of earnings within that business. This includes a better pricing environment for products – especially in Sweden – but also a number of self help initiatives that have improved the availability of feedstock. It is becoming increasingly clear to us that renewable earnings will continue to grow from. In addition, we think the IMO standards present additional potential upside to its investment case with an impact of more than 60% to our 2020 earnings forecast. In Oil Products, the company has closed inefficient cracking capacity at Naantali refinery and increased distillate conversion capacity at Porvoo refinery. At the same time, by 2020, it has indicated that it expects to be able to convert its entire fuel oil pool to be IMO-compliant without additional investments. The Renewable Products division is also likely to benefit from the standards with renewable diesel sold at a diesel linked price and this, we think, is less well understood by the market. Overall, we remain of the view that demand growth for renewable fuels will justify more capacity additions than are priced into the shares and

Oil Services & Drilling - Analysts' view

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Sector outlook and key drivers for 2019

Work is beginning to drip feed back into the OFS sector following strength in oil prices. There are signals that the recovery has now taken hold, and while it is not a "back to the races" scenario immediately, the tone has turned more positive. There is more talking going on between the companies and their clients and, as we move into 2019, awards should start to come. In addition, the first looks at the 2019F trough earnings level should also be given and with that investors can move on and start to think about a more attractive future. Excepting an oil price crash, we find it hard not to believe that order books are set to rebound.

Although oil majors remain in "capital discipline" mode, akin to the returns focus they had in the early 2000s, our belief is that capital discipline and rising capex in moderation can co-exist. As capex rises moderately, activity levels jump at current pricing. This will drive utilisation and margins before pricing moves. This is the normal pattern of a recovery and why we believe the full impact of the current cycle will not be seen until 2022F+ and why multiples in 2020F will remain robust.

There are signals all around that imply to us that work is ticking up in all aspects of the oil service industry. The progress of the Oil Industry since 2015 has been significant and breakevens have come down sharply. At the corporate level, breakevens, which peaked in 2013 as US$135/bl, have fallen by 60% to US$54/bl, twice the typical 30% reduction in costs that we have noted is targeted by the industry in a downturn. Significantly, in 2018F, for the first time since 2011, breakeven costs, on Barclays estimates, will be below prevailing Brent oil prices. We have seen this inflection occur three times in the past 25 years, each time followed by a period of rising capex, with spending rising by an average of 48% in the next three years.

It's all very well us stating that increased workload will drive the sector, but we need to see the work coming. It is our belief, however, that there are enough signals to suggest that it is not a matter of "if," but a matter of "when". Across the different myriad of industries which comprise the OFS sector, we see signals that suggest to us that an inflection has occurred. We are at the birth of a new cycle. As with all newborns there will be days filled with joy, days of concern and days where panic may feel appropriate. But these become easier over time and ultimately the riskiest part of the growth phase is already past.

Bookshelf Reports
OFS: A 2020 Vision
(10 Oct 2018)

Earnings and valuation outlook

Over the past twenty one years the sector has averaged ca 9x EV:EBITDA and topped out on average at ca 10x. Early in an up-cycle it has averaged over 10x, with the peak coming two years later at over 12x. Today we see the sector averaging just 5x 2020F. Given that our sector thesis is that in 2020 we will just be seeing the first signs of a new cycle hitting the P&Ls and that utilisation across the sector will be returning to more acceptable levels, we feel that 10x 2020F EV:EBITDA is a good starting point for multiple based price targets and an appropriate high point from which we can make reductions depending upon risks with stocks and historical trading patterns.

Key stock recommendations

Mick Pickup

Subsea 7 (SUBC NO, OW, PT NOK185) – The one people want to own

The company has done exactly what we wanted it to in the downturn - take advantage of its strong balance sheet and come out of a trough stronger than it came in. With a series of operator alliances, a strong integrated partner, a new Middle East business, an enhanced Renewable offering and a new enabling asset in build, Subsea 7, to us, is the offshore player to own. Subsea 7's 3Q18 results which were in-line, were all about the guidance for 2019F and while disappointing, the company states this is the trough, and to be fair, the trough for oil activity has already occurred, it's the Renewables business that is ironically holding back the company. Our NOK185/share price target is set at 10x 2020F EV:EBITDA with the PLSVs separately accounted for by DCF (equivalent to 8.5x for the group) and offers 83% upside potential. This compares to the 9.5x that the company traded on over the 2005-13 period, which encompassed two up-cycles.

Mick Pickup

Petrofac (PFC LN, OW, PT GBP 10.00) – Reshaped and looking for returns

The transformation in Petrofac continues. The IES division is largely disposed of, 2019F will see the working capital position unwind and with it the company is heading back to a cash positive balance sheet. We see little to suggest that profitability will move significantly down from here and as such we see the stock trading under 5x 2019F EV:EBITDA and will have a ca 15% FCF yield in 2020F on our numbers. Our GBP10/share price target is based on just 7x 2020F EV:EBITDA, a lower multiple than for others to reflect concerns over the stock and the perceived riskier nature of Onshore construction related activities. It also continues to include a US$800mn potential liability from the SFO investigation. With ca86% upside potential and a pipeline that the company sees as encouraging, we remain Overweight.

Mick Pickup

Tenaris (TEN IM, OW, PT EUR19.00) – Building consistently, guide signals good start to 2019

Tenaris's shares have been weighed down over the past few months on increasing concerns that late 2018 and 2019 estimates would need to be revised down. After beating 3Q18 numbers, combined with guidance for the next few quarters, we're increasingly confident in our above-consensus numbers for next year, which are based largely on volume and mix changes. The company has sailed through additional tariff related costs and a US slow down, highlighting the potential it has when all its cylinders are firing. Unfortunately, Tenaris was unable to address the other major overhangs: how will Mexican import tariffs be treated under the new USMCA agreement and the impact from a full year of Section 232 implementation, both of which could be meaningful catalysts for the stock next year. Our EUR19/share price target is based on just 10x 2020F EV:EBITDA and in line with recent trading patterns and in-line with the long-run (1997- 2017) average of the sector at yearly highs. With ca54% upside potential and positive company guidance providing comfort to our estimates, we remain Overweight.

MATERIALS

Strategy Rating – Overweight

FIGURE 179

MSCI Europe Materials sector snapshot

	Absolute Perf.	EPS growth		Fwd PE	P/B	DY	Sector rating
	YTD	2018E	2019E	Latest	Latest	2019E	
Materials	**-14%**	**6.7%**	**2.6%**	**12.0**	**1.8**	**3.7%**	**OW**
Chemicals	-11%	-0.5%	6.4%	15.2	2.6	3.0%	MW
Con Mat	-23%	-4.3%	15.0%	11.9	1.1	3.4%	MW
Met & Min	-16%	12.9%	-2.8%	9.4	1.4	4.7%	OW

Source: Barclays Research, IBES, Datastream

FIGURE 180

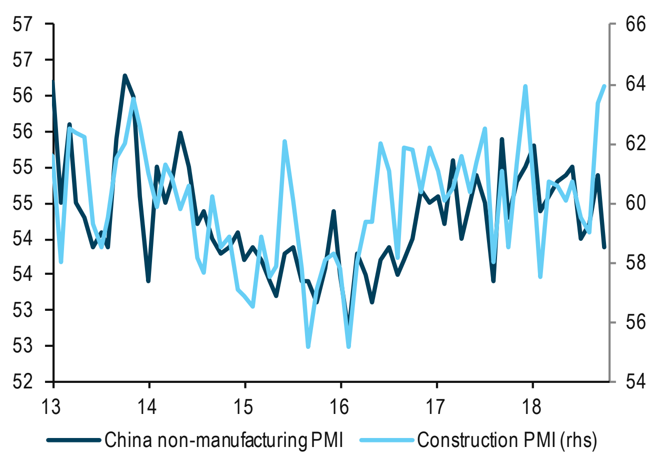
MSCI Europe Materials relative performance and earnings

Source: MSCI, DataStream, IBES, Barclays Research

We have been UW on Materials since our initiation and double upgrade the sector to a small OW for 2019. We are OW Mining, MW Chemicals and MW Construction Materials. Our concerns about the softening activity backdrop in China are not going away, but we see a potential for resilient infrastructure and construction spending ahead. The property market looks set to remain strong showing solid house price inflation and land sales. Materials' valuations are attractive and the sector offers self-help potential, so we believe it is a good hedge against a potentially improving EM backdrop.

FIGURE 181

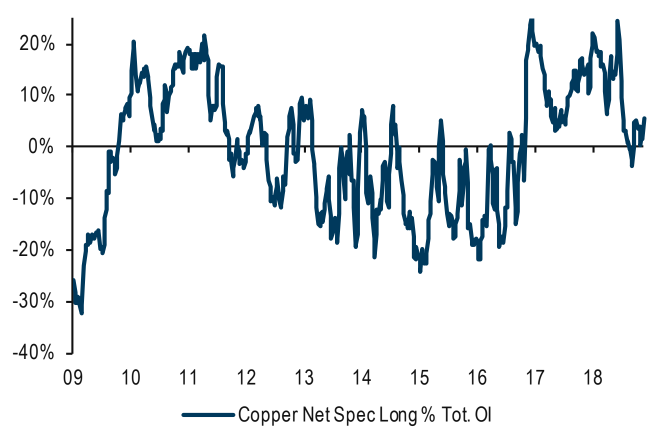
China construction PMI is elevated



Source: Markit, Bloomberg

FIGURE 182

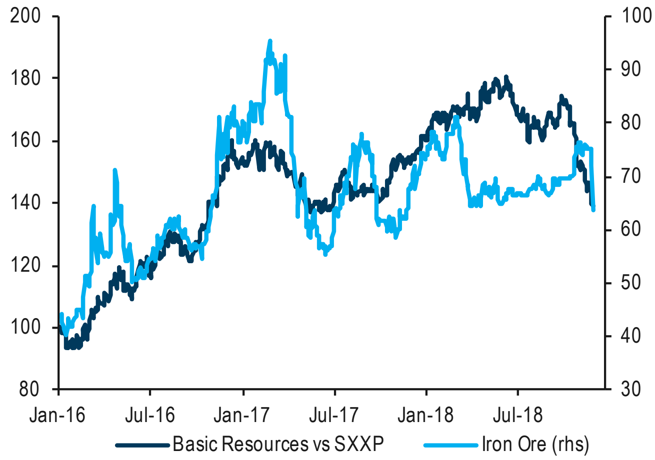
Speculative positions on copper have been trimmed



Source: Bloomberg, CFTC

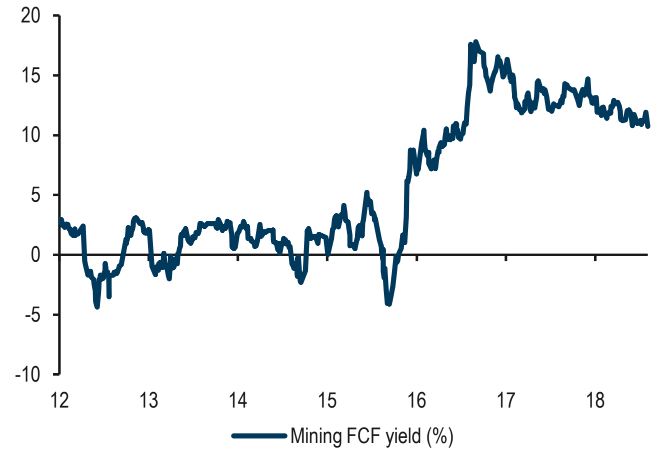
Our commodity strategists expect copper prices to average 6,263$/t in 2019, set to peak in the first half of the year, in line with a seasonal upturn in Chinese demand. However, they forecast copper to come under pressure in the second half, amid slowing global economic activity, ending the year at 5,900$/t. Sentiment on metal prices has been hurt by concerns about weakening Chinese growth and the trade war with the US, and both will remain key drivers in 2019. However, we note that speculative longs on copper contracts were closed recently, which points to a more balanced risk-reward for the space.

FIGURE 183
Mining has underperformed sharply in the last 6 months



Source: Datastream

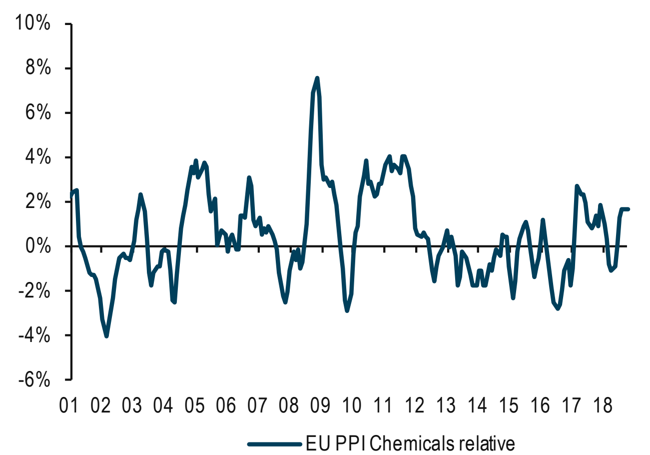
FIGURE 184
Mining FCF yield is attractive



Source: Barclays Metals & Mining Research

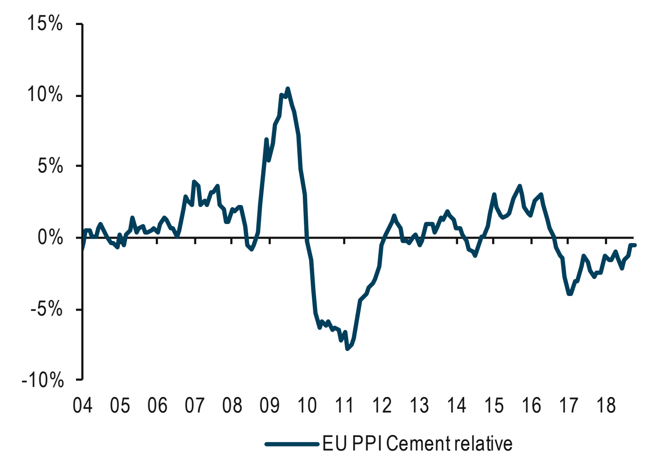
Miners' share prices have rolled over sharply in the last few months along with the weakening metal prices. While the sector's performance remains dependent on the direction of the underlying commodity prices, we believe that Miners offer attractive self-help potential, which somewhat reduces their macro sensitivity. Balance sheets were cleaned and overcapacity was reduced over the last few years, which led to a recovery in FCF.

FIGURE 185
Pricing matters – good for Chemicals...



Source: Bloomberg

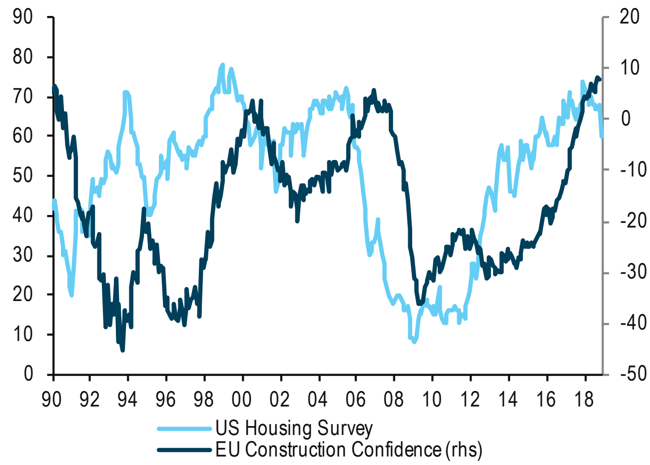
FIGURE 186
...not so good for Cement



Source: Bloomberg

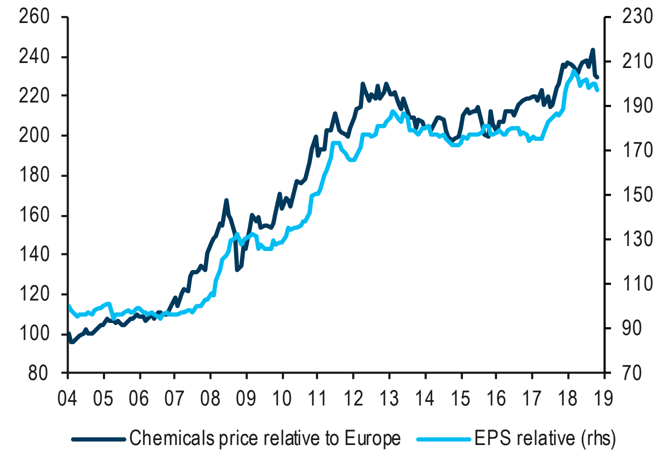
We are MW on Chemicals and Construction Materials. Both have underperformed this year due to concerns about the drag from higher oil prices on margins, Chinese slowdown and trade wars. While the higher oil price has indeed been a headwind for Chemicals' earnings, we note that pricing indicators remain relatively strong. On the flipside, cement prices remain constrained by overcapacity, market fragmentation and softening demand. But improving sentiment towards EM could help the space.

FIGURE 187
Construction and Housing surveys look toppish in Europe and US



Source: Bloomberg

FIGURE 188
Chemicals price and EPS relative are looking stretched



Source: Datastream, IBES

However, while an increase in Chinese stimulus would be a positive for Cement, we are concerned about the construction outlook in Europe and the US. Surveys in the two regions are looking particularly stretched at present and rising interest rates in the US could be a risk. As discussed earlier, Chemicals' earnings have been particularly strong and are at cycle highs. We believe that consensus estimates for EPS and margins are too elevated for 2019 and could see downgrades. While this is likely expected by the market already, it could constrain the relative performance of the sector.

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Mining – Analysts' views

Sector outlook and key drivers for 2019

The key drivers for the mining sector are commodity prices and capital allocation decisions by the companies. Our view is that the sector continues to offer attractive valuation support, with the diversified miners trading on double-digit FCF yields on average (11.3% spot 2019). Net debt is at or below the bottom of target ranges for almost all companies and boards are behaving in a shareholder-friendly manner, returning the vast majority of surplus cash to shareholders rather than increasing capex materially or acquiring assets. This is underpinned by a lack of tier 1 investment options following long-term under-spend on exploration and business development. Violent share price reactions to capital indiscipline (KAZ, Boliden) demonstrate the market is in no mood to let the sector 'off the leash'. Meanwhile the demand outlook remains solid (as explained below) and supply growth is limited by capital constraints. The sector remains under-owned/underweight in all surveys of institutional investors, as it has done for several years.

Macro: the backdrop has improved with the Chinese government transitioning from deleveraging at the start of 2018, to stability mid-year to now actively injecting stimulus. This is coming in a variety of forms – monetary, fiscal and infrastructure spend. Infrastructure spending growth inflected in September and accelerated in October, and we expect further acceleration through 2019. Meanwhile the Chinese property sector – the single most important driver of commodity demand – remains in rude health (starts +14% and land sales +15% YTD October). Land sales should underpin a decent year of starts in 2019: we expect +9% growth. The notable area of weakness continues to be auto and consumer-related white goods, which are likely to see some stimulus via lower purchase taxes and personal taxes. Finally China's supply side reform program – focused on eliminating low value added, pollutive surplus capacity in basic materials – could well herald a reversal of the last 20 years of exported deflation in certain commodities such as aluminium, steel, copper and zinc smelting.

Risks include further deterioration in the Chinese domestic economy; with onshore sentiment particularly bearish and the government struggling to incentivise private sector credit creation, this remains a material risk. Property sales have turned negative YoY for two consecutive months in Sept/Oct so there is some risk it signals a topping out in the property cycle which is already relatively extended vs. recent history though this would affect 2020 starts more in our view. There may be an "air pocket" in trade data in Q1 given front-running of new US tariffs in Q4. Acceleration in oil prices would be negative for opex inflation. A re-escalation of US/China trade rhetoric would pose further downside risk to the sector. Additional tightening by the Fed, a stronger dollar and EM equities underperforming would all likely put pressure on miners.

Earnings and valuation outlook

Our forecasts for the sector call for earnings to decline 5% on average for the diversifieds. This reflects our assumption of lower commodity prices: copper -5% YoY, iron ore -9%, thermal coal -9%, met coal -13%, zinc -9%. We assume only aluminium and oil go up in 2019, by 10% and 9% respectively. On spot prices however, earnings rise 15% YoY on average.

Bookshelf Reports

Metals & Mining: China shifts from stability to stimulus
(11 Oct 2018)

Glencore: Marketing for free
(25 Sept 2018)

Key stock recommendation

Analyst: Ian Rossouw

Glencore (GLEN LN, Overweight, PT 400p)

Following sharp underperformance vs. the sector YTD, pressure is building on management to translate significant cashflow generation into shareholder friendly actions. Valuation is notably cheap – putting Glencore's mining assets on the same PE as Anglo, Rio and BHP implies the market is putting the marketing business on zero equity value for 2019. The capital markets day on 3 December is an important date for management to begin rebooting the investment case, with numerous options at their disposal outlined in the note referenced. At heart we see no reason why all of the 16% spot FCF yield we project for the company in 2019 should not be returned to shareholders.

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Construction – Analysts' view

Sector outlook and key drivers for 2019

Construction has been the third worst performing sector behind Autos and Banks in 2018, underperforming large indexes (SXOP down 13% vs. STOXX 600 down 8% YTD) on a combination of earnings downgrades and multiples compression.

In **Building Materials**, two main drivers explain the segment's de-rating in our view, and we believe these two will again be key factors to watch in 2019:

- **Concerns on global macro**, with investors successively questioning the sustainability of emerging markets' growth, the strength of the European recovery and the duration of the US cycle. In Construction, this has not translated into weaker volumes yet (if we exclude the weather events that have penalised growth in Europe/US in Q1 and again the US in Q3). In fact, top-line growth has remained robust in most areas (with the exception of a few Latam markets).

- **Negative price-cost**, which has taken most participants by surprise, and led to a margin squeeze for most Materials manufacturers, resulting in muted earnings growth despite dynamic top-line growth.

Looking ahead, we believe pricing holds the key to a sector re-rating and is likely to remain the major differentiator between stocks. For this reason, we continue to favour exposure to US/Europe (rational market structure), where we expect prices to progressively catch up with cost inflation, reversing the margin trends. On the contrary, we remain concerned about emerging markets' fragmentation, new entrants and capacity additions outpacing demand growth, resulting in structural margin pressure.

The macro outlook remains the key risk to the sector in our view, given the high cyclicality of Building Materials consumption. Other potential catalysts / risks include Brexit (see *European Construction, Building Materials & Infrastructure: Updated UK and GBP exposure across the sector*, 14 November 2018 for more details on the sector exposure), a potential Federal infra package in the US (see *European Building Materials: US mid-term elections and local spend initiatives - implications for EU construction stocks*, 7 November 2018) and further M&A activity (we think largely asset disposals to reduce leverage).

The **infrastructure** sub-segment has fared much better (our stocks under coverage are all between -8%/+3% YTD) given their more resilient business model and strong FCF. Given their bond proxy features, the main risk remains the rising yield curve (see *European Construction, Building Materials & Infrastructure: Infrastructure: where's my bond proxy trade going?*, 12 February 2018 for details), but the hybrid concessions/construction groups like Eiffage and Vinci are not immune to the European activity slowdown.

In terms of catalysts, we expect 2019 to provide a number of final outcomes on some of the segments' special situations, namely for Vinci (government decision on ADP privatisation) and for Getlink (Brexit deal, clarification of main shareholder Atlantia's intentions).

Bookshelf Reports

European Construction, Building Materials & Infrastructure: French housing fatigue?, *11 June 2018*

Industrials: Construction insights: It's not just about rates, *13 April 2018*

European Construction, Building Materials & Infrastructure: Rather US than EM, *7 September 2017*

Earnings and valuation outlook

Our base case assumes moderating but still robust global growth in 2019 (our economists have 3.6% global GDP growth next year, after 3.9% in 2018), with none of the key regions (US, Europe, emerging world) entering into recession.

In this environment, and assuming cost inflation (energy in particular but also labour in some areas) does not accelerate further, we expect the Building Materials universe to post 14% EPS growth next year, thanks to better price-cost, modest volume growth and further deleveraging. The segment trades on 7.1x 2019E EBITDA, a c.15% discount to the 10-year median (8.4x), suggesting Building Materials are decent value if macro uncertainties vanish.

In Infrastructures, we expect traffic growth to normalize (i.e. c.1x GDP) after almost three years of strong outperformance, while expansion in contracting could slowdown, but remain well oriented. We forecast 11% median EPS growth in 2019 for the segment, on a combination of modest top line growth, operating leverage and refinancing benefits. Multiples are less relevant for infrastructure (highly reliant on concession length), but we note the segment trade on 11.7x 2019E EBITDA on average, a 6% discount to the 10-year median (12.4x).

Positioning within the sector

We tend to favour selectively Building Materials names over Infrastructures, as we believe valuations are particularly appealing in the first segment (again under the assumptions that global growth remains robust). Infrastructure offers attractive defensive FCF features but we believe growth is peaking and valuations offer less upside potential.

Key stock recommendations

Nabil Ahmed

CRH (CRH ID, OW, PT: EUR35)

We believe CRH ticks a number of boxes in this uncertain environment: reasonable leverage (c2x EBITDA), very limited exposure to EM (Philippines + Brazil c.1% of EBITDA) and wise capital allocation (disposal of US distribution on high multiples, several vertical integration deals with synergy potential, EUR1bn share back). Its strong positions in US/Europe provides superior pricing outlook in our view and this should contribute to restore margins, after the severe cost inflation seen in 2018. Despite peer de-rating, the stock trades at a significant discount to its SOTP.

Nabil Ahmed

HeidelbergCement (HEI GY, OW, PT: EUR73)

2018 has been a particularly difficult year for HeidelbergCement, which suffered from severe cost inflation, steep margin compression in EM and adverse weather / production issues in a number of key markets. Post profit warning, we believe expectations are reset to more reasonable levels, comps are easy, the US/European outlook should normalise, while pressure in key EM (Indonesia, sub-Saharan Africa) is significantly easing. Management's clear focus on squeezing cash has historically been associated with outperformance. Valuation is particularly attractive with P/E and FCF yields in the low teens.

Nabil Ahmed

LafargeHolcim (LHN SW, UW, PT: CHF42)

While management is working hard to put the group back on track (cost cutting, disposals), we believe LafargeHolcim is facing too many headwinds at the same time. The company has by far the largest exposure to emerging markets (55% of EBITDA), with many of them suffering significant pressure (Algeria, the Philippines, Malaysia, Iraq, Brazil, the UK), or becoming more uncertain (Egypt, Nigeria, most of Latam). The valuation is unappealing (7.3x 2019E EBITDA vs. 7.0x for cement majors) and does not discount the weaker geo-mix and Syria risk in our view.

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Chemicals – Analysts' view

Sector outlook and key drivers for 2019

The chemical sector can be divided into companies which produce basic petrochemicals where margins are a function of demand and supply (upstream) and those which produce specialty chemicals where margins are determined by the value of the product (downstream). Simplistically speaking, we expect earnings to decline for most upstream businesses next year. The corollary is that those basic petrochemicals are the single biggest cost for downstream companies which should alleviate raw material inflation. Some companies, like Arkema and BASF, are both upstream and downstream so the picture is more nuanced.

The primary challenge is understanding how multiples will react as fears of a potential recession mount. Most European chemical companies have meaningfully improved their portfolio compared to 2011-12 by selling low-margin upstream businesses and investing downstream. We're currently testing the lower bounds of historic valuation multiples but it remains to be seen whether those enhancements will attract higher trough multiples.

Earnings and valuation outlook

The primary drivers of earnings in the chemical industry are: volume growth, raw material cost inflation, fixed cost inflation and currencies. Our 2019 global GDP forecasts of 3.7% still imply volume expansion. We estimate that volume growth of 1-2% is probably sufficient to offset fixed cost inflation like wages. Raw materials should be a modest tailwind for most downstream companies and a headwind for those upstream. Companies which buy naphtha rather than gas-linked raw materials stand to benefit more owing to the decline in oil prices relative to gas. Downstream businesses tend to attract higher multiples so companies both upstream and downstream should, in theory, benefit from improved mix.

The wild card is always inventories. De-stocking along 3 steps in the supply chain, for example, can cause meaningful swings in demand. Judging the level of inventory at customers is difficult but any sign that prices are due to fall or underlying demand weaken often triggers de-stocking as customers wait to buy cheaper or prepare for lower demand.

Positioning within the sector

This year the relationship between earnings momentum and share prices has broken down as the market begins to discount recession. Instead, investors flocked to safety and the right trade has been to buy expensive defensive stocks and watch them get more expensive. The best compromise is probably 'cyclical' companies trading at sensible multiples with opportunities for structural growth.

Key stock recommendations

Sebastian Satz, CFA

BASF (BAS GY, OW, PT €92)

BASF is one of the best value opportunities in the European chemical sector. The market is excessively focused on declines in upstream earnings and giving little credit to the downstream business which stands to benefit in a deflationary raw material environment. With double-digit underlying operating profit growth projected for next year and the highest dividend yield relative to the wider market since 2009, we believe the shares are undervalued and offer material upside.

INDUSTRIALS

Strategy Rating – Underweight

FIGURE 189

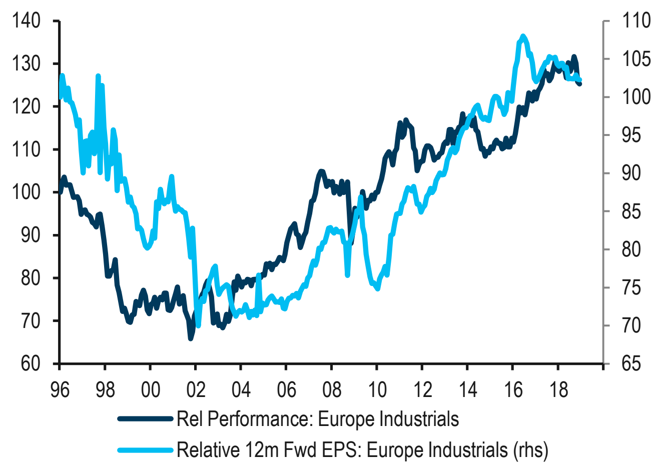
MSCI Europe Industrials sector snapshot

	Absolute Perf.	EPS growth		Fwd PE	P/B	DY	Sector rating
	YTD	2018E	2019E	Latest	Latest	2019E	
Industrials	**-11%**	**2.5%**	**12.8%**	**14.6**	**2.8**	**2.8%**	**UW**
Cap Gds	-10%	4.8%	12.3%	14.3	2.7	2.8%	UW
Coml/Prof Svs	-3%	3.7%	9.0%	17.0	6.3	2.6%	MW
Transpt	-19%	-10.9%	20.0%	13.8	2.0	3.2%	MW

Source: Barclays Research, IBES, Datastream

FIGURE 190

MSCI Europe Industrials relative performance and earnings

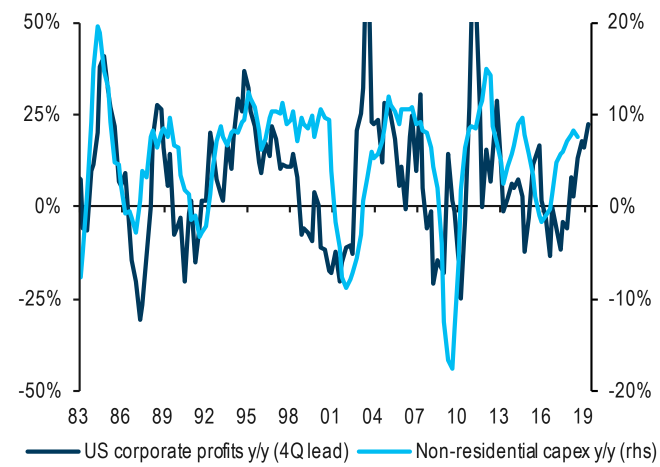


Source: MSCI, DataStream, Barclays Research

We are UW Industrials. The sector performed poorly in the last few months following its strong run over the last few years. Earnings are looking stretched and we believe consensus estimates for 2019 will be revised significantly lower. DM capex drivers stay well oriented, but may not get better as financing conditions tighten, corporate profits roll over and oil price has fallen sharply. The stall in manufacturing PMIs points to a softening in EPS momentum ahead, while Chinese activity outlook remains soft.

FIGURE 191

Corporate profits lead capex – as good as it gets?



Source: BEA

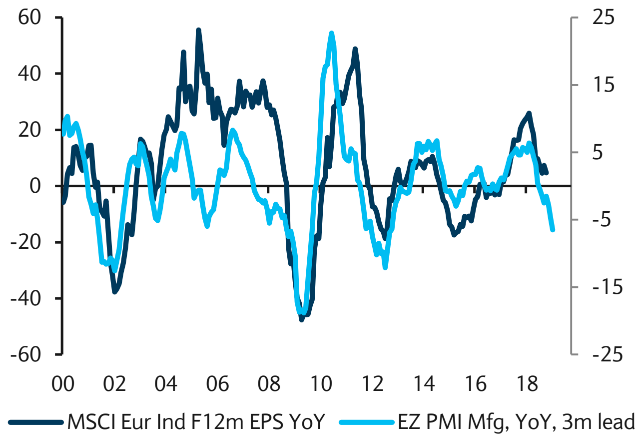
FIGURE 192

China FAI could be bottoming out, but significant stimulus looks unlikely

Source: Bloomberg

The strong rebound in US corporate earnings led to a pick-up in capex, but momentum is likely to normalise next year as EPS growth will slow. Capital Goods are particularly exposed to China and commodity capex, which we expect to remain under pressure. FAI has rolled over sharply ytd and tariffs uncertainty could result in delayed spending plans. Policy stimulus will likely lead to a bottoming out in FAI, while the G20 meeting could bring some good news on tariffs. However, we do not expect a significant rebound in industrial activity anytime soon.

FIGURE 193
The rollover in manufacturing PMI points to negative EPS growth for Industrials



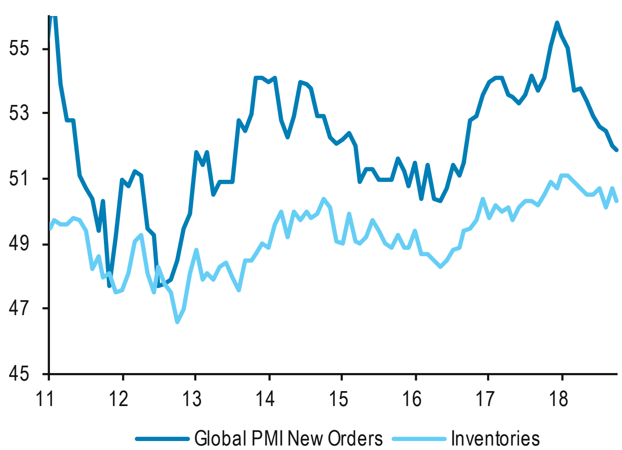
Source: Bloomberg, IBES

FIGURE 194
Industrials relative P/E is looking stretched

Source: IBES

The rollover in manufacturing PMI points to weaker earnings ahead, which suggests that current IBES estimates that look for double-digit EPS growth and further margin expansion in 2018 are too optimistic. True, the sector has de-rated ytd but its P/E relative remains elevated in the historical context.

FIGURE 195
The gap between new orders and inventories is narrowing but has not closed yet



Source: Markit, Bloomberg

FIGURE 196
Pricing has been resilient so far, but could be under pressure next year as final demand is slowing

Source: Eurostat

Leading indicators point to a challenging manufacturing outlook for 2019. New orders have fallen a lot already but inventories are still elevated. Pricing has been resilient so far but may not improve much next year while late cycle costs pressure from rising wages and commodity prices will likely be headwinds for margins.

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Bookshelf Reports

Global Industrial Dashboard - November 2018, 2 Nov 2018

European Capital Goods: Q3 earnings wrap - investor concerns shift from cycle to costs as tariff-induced inflation starts to hurt, 7 Nov 2018

Positioning for mid-cycle moderation: Sandvik and SKF Underweight; Assa Abloy stays Top Pick, 3 Oct 2018

Capital Goods – Analysts' view

We are getting increasingly concerned about the strength of the industrial cycle. While leading growth indicators point to an increasingly challenging demand outlook for short cycle in 2019, notably in China, step-up in tariffs (section 301 List 3) to 25% on 1 Jan'19 adds to the inflationary pressures (materials/ freight/ labour) for those in scope. Forward looking commentary/guidance from the companies point to a sector set to struggle with cost inflation at a time when demand (and pricing momentum) is starting to wane. Despite the correction since early October, we are in no rush to change our cautious view on the sector's short-cycle names, staying Underweight Sandvik, SKF and thyssenkrupp. Assa Abloy remains our Top Pick.

Demand outlook slowing in the short cycle: The reading on our Barclays Industrial Barometer continues to recede (26 in November from 29 in prior month; *Global Industrial Dashboard - November 2018, 2 Nov 2018*) led by broad based weakness in manufacturing data. Short cycle demand, notably in China, continues to slow down, as pointed to by Japan machine tool orders (down -1% with China down 37% y/y in October). The impact for the industrial short-cycle names can be exacerbated by the broader inventory destocking cycle - Timken saw destocking last quarter and expects Mobile destocking to persist through Q4 - reversing two years of channel restocking.

Cost inflation to worsen from Section 301 L3 tariffs; Pricing a challenge: As Section 301 List 3 tariffs come into effect from 1 Jan 2019, stepping up tariffs from 10% to 25%, it will add to the inflationary pressures (materials/ freight/ labour) in the sector. This we believe, at a time when demand outlook is more muted, will be difficult to pass on the customers through price increases. For SKF, we estimate cost inflation of SEK1bn hitting the bridge as tariffs become effective in the new year and believe consensus is still underestimating the impact of tariffs on price/cost (we are still 15% below the latest Infront consensus on 2019 operating profit).

Auto Cycle – weakening demand in China; some European production headwinds to subside: While WLTP-related issues in Europe will continue to have impact on the production schedules of the auto companies in the initial part of 2019, these headwinds should wane as the year progresses. However, what concerns us is the more pronounced decline in the auto sales in China (-8% y/y in October and is tracking substantially lower (-14% y/y) in November on a rolling 4-week basis, based on data from CPC Auto).

Key stock recommendations

Lars Brorson

Assa Abloy (ASSAB SS, OW, PT €200) – Top Pick

We raised Assa Abloy to Top Pick in European Capital Goods after the Jul'18 profit warning. We did so not just to reflect our preference for what we see as a relative 'safe-haven' at a time of deteriorating trends for the sector's industrial short-cycle names, but also because we saw signs of an improving growth profile starting to emerge, led by accelerating smart lock adoption. The trends seen since in the US smart lock market have reinforced that view. And it is not just Assa's organic growth profile that's improving; M&A is also picking up. The acquisition of Crossmatch that closed in Sep'18 is the largest in 5 years. Finally, we believe Entrance Systems (Assa's largest division) is entering an exciting period under new CEO Nico Devlaux, particularly industrial doors and services, an area which should be close to his heart after 25 years in Atlas Copco.

The adoption of smart locks is accelerating, particularly in the US market, and we believe Assa is uniquely positioned to benefit from that trend, not least due to its partnerships with e.g. Google, Amazon, and Apple. As we look into 2019, we are particularly positive about the company's partnership with Apple, whose decision to open up near-field communication (NFC) to third parties is likely to be a potential catalyst for broader mobile key adoption.

Lars Brorson

Sandvik (SAND SS, UW, SEK127)

Management has done a commendable job since 2015 and the group's cost structure is more flexible today than 3 years ago. But Sandvik remains the most operationally geared company in our sector. Machining Solutions (SMS) margins have recovered ~500bp since the new management team took over, but a big part of that has been cyclical, not structural. SMS margins today are just ~100bp shy of prior peak and – in light of the outlook – we see the risks to earnings in SMS skewed to the downside. Q3 margins were boosted – to our surprise – by yet more inventory restocking (+60bp). But that is set to turn in Q4 as the company starts to lower inventory levels and the tailwind from "overproduction" turns to a headwind (on our current estimates -50bp in Q4).

Add to that the structural headwinds facing the tooling industry – EVs, shift to round tools, and metal additive manufacturing most potent among them – and we think there's enough to support an UW rating.

Lars Brorson

SKF (SKFB SS, UW, SEK132)

The key debate on SKF is not just limited to the demand outlook but also the cost inflation coming through, partly from US tariffs. The company's "cost development" in its quarterly EBIT bridge has been cruising at SEK200-250m historically, i.e. the level of ordinary cost inflation hitting the bridge. But that stepped up to SEK300-350m during Q1-Q2, and jumped to ~SEK650m in Q3 (adjusted for one-offs). The company now guides to SEK750m in Q4. We estimate it will hit SEK1bn in Q1'19 assuming section 301 L3 tariffs are stepped up from 10% to 25% on 1 Jan'19. That's a level of cost inflation unlikely to be offset by pricing, in our view, not least as underlying demand starts to wane.

Add to that the bearings industry continues to commoditize, low-cost competition is rampant, Japanese OEMs are targeting higher-margin Western industrial markets and the emergence of EVs raises structural questions on the longer-term outlook for automotive bearings. The cyclical tailwinds are now starting to fade; the channel inventory cycle has run its course, SKF's own destocking means cost absorption is turning to a headwind. The self-help in automotive is largely behind us after the cost-out efforts since 2015, whilst investments required into automating/ digitalizing its manufacturing sites and supply chain will continue to weigh on capex.

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Business Services – Analysts' view

Sector outlook and key drivers for 2019

Structural growth / more defensive names should prevail in 2019 – the key question moves on from not 'if' the US & global economy slows but to 'by how much' and 'what's priced in?'. Given considerable economic and political uncertainty we prefer those names that offer differentiated growth, where structural drivers provide a buffer against cyclical headwinds. In a sector as broad as this, it is hard to pigeon hole stock selection into one category so once again we favour a stock specific approach, focusing on: 1) best in class operators (i.e. those gaining market share); 2) unique or stock specific growth drivers; 3) US over European exposure; and 4) defensive (or less cyclical) business models.

US cycle fears will create opportunities – the extent of a US economic slowdown is the main point of contention for the sector. As a sector we are heavily exposed to the US and this has been the main driver of outperformance over the last five years. Macroeconomic indicators are likely to be less positive than they were in 2018, and we expect US growth to be lower in 2019 than in 2018. But whether residential/commercial remodelling and construction activity (Ferguson), industrial activity for rental equipment (Ashtead, Aggreko) and the US credit cycle (Experian) enter near-recessionary conditions is still up for debate, in our view, and will create buying opportunities.

We are still cautious on UK exposure, but see upside in selective restructuring opportunities. A more rapid turnaround in prospects requires the UK outsourcing market to improve. Although Government budgets may be less squeezed in 2019 than they have been in prior years, ongoing Brexit and political uncertainty could see further delays to larger outsourcing projects. That said selective restructuring stories and depressed valuations cap downside risk and we could see a bounce in the event of a soft Brexit.

Trade war escalation (US/China tariffs) – Tariffs on $200bn of Chinese goods potentially steps up in January. The Testing & Inspection stocks are most exposed, but there are knock-on inflationary considerations for the wider sector.

Wage inflation – Economic growth and a shortage of suitable labour in many parts of the market have combined to squeeze up wages. The primary beneficiaries of this are Hays and Page as the vast majority of wage inflation drops through to their bottom line. But there are more examples of companies in the sector for who wage inflation poses a risk to their profitability. Generally speaking, low margin businesses with a high proportion of cost being employees are most at risk. It is being felt most acutely at G4S, is perplexingly absent so far at Securitas, and is also a feature at Bunzl, Ferguson and ISS who are all working hard to offset these higher operating costs.

Positioning within the sector

We remain Overweight those companies which we believe have solid structural growth stories with sustainable medium-term earnings power and strong management. Our preferred names include Experian: growing addressable markets; Rentokil and Bunzl: defensive growth; Edenred: corporate payments angle; SGS: quality growth and O&G recovery; HomeServe: significant profit opportunity in US membership with upside potential from the nascent Home Experts business; ISS: growth moving to top of peer group range but valued at a discount.

We still like US cyclical exposure and believe a step down in growth (albeit not a recession) is already priced in to **Ferguson** and **Ashtead** although near-term the shares remain highly susceptible to deteriorating macro indicators despite the likelihood of positive near term results. Similarly the European staffers (Adecco and Randstad) are pricing in a modest contraction in organic growth in our view and look fundamentally undervalued, in our view.

Bookshelf Reports

Experian: 'The beginning…not the end' 16th Nov 2018
Ferguson: 'Sustaining an advantage' 17th Apr 2018
Rentokil: '3Q update reports improving organic performance' 18th Oct 2018
ISS: 'Past the point of maximum pain' 9th Nov 2018

Amongst the TICS, we take a balanced approach with an O&G recovery balanced by international trade risk. We prefer OW-rated **SGS** and **Applus** over Bureau Veritas (UW) and Intertek (EW).

In the outsourcing space we prefer **ISS**, given an improving organic growth profile, margin improvement as well as proven defensiveness and **Rentokil** where we see an opportunity to supplement organic growth with M&A to build density and improve margins

Key stock recommendations

Paul Sullivan

Experian (EXPN LN; OW; 2,000p PT)

Experian offers an attractive combination of growth, resilience, high margins, high returns and strong cash flow driven by network effects which act as high natural barriers to entry. Experian is still at the beginning of an elevated growth cycle, driven by digitalisation and process automation across banking and health which expands their addressable markets. Data proliferation increases the need for intelligent use and decision making, which plays to Experian's strengths. Experian will also be a prime beneficiary of economic recovery in Brazil and the introduction of positive data (if and when this becomes a reality) is a material positive. A revamped consumer strategy is also starting to bear fruit. Though the shares have re-rated, we don't view 21x CY19e / c20x CY20e as expensive for 8% organic growth. On an EV/EBITA basis it is cheaper than TransUnion and Verisk and only modestly higher than RELX and Wolters Kluwer, similarly high quality Information Services peers.

Paul Checketts

Ferguson (FERG LN; OW; 6,700p PT)

Ferguson is our Top Pick in the sector due to its strong market position, good management, high growth and attractive valuation. We believe Ferguson's industry-leading US Plumbing & Heating merchant business (c90% of group profits) will continue to gain market share in its core and adjacent markets, which remain fragmented. End markets are currently strong across all verticals in the USA and while the comps toughen over 2019 and macroeconomic indicators are less positive than they were over 2018, we believe the recent share price moves reflect a more significant slowdown. If consensus expectations of 7% organic sales growth in the USA in 2019 are achieved, and we expect Q1 trading to support this, we see significant upside to the share price, with the shares trading on c12x FY19e PE.

Jane Sparrow

Rentokil (RTO LN; OW; 350p PT)

We see strong potential for organic growth, margin upside, and cash generation. Rentokil is a global leader in Pest Control with a platform established in c60 countries – different regions are at different stages of development with North America the most exciting in the short-term but longer-term, the rapidly growing businesses in Asia and LatAm have significant potential. We see upside to forecasts from M&A with the potential to spend up to £900m over the next three years, in fragmented markets; we also see potential upside from the Haniel JV that we don't believe is currently fully appreciated. CY2019e PE c24x.

ISS (ISS DC; OW; DKK260 PT)

Paul Checketts

We think ISS is one of the most interesting stocks in the sector for 2019. There are five reasons we like the shares: 1) margins will begin to improve from Q4; 2) we see potential for organic revenue growth to accelerate to around 5.5% in 2019 and 2020, which is ahead of consensus; 3) the company is structurally well positioned, leading the way in the market for large, cross-border, integrated contracts; 4) free cash flow generation should step up to around DKK2.7bn in 2020, a 33% year-on-year increase; and 5) the valuation – 14 x 2019e PE, 11x EV/EBITA, and 3.4% dividend yield - screens well for the growth we expect in 2019/20 and is at a discount to peers. We see upside potential to DKK260, 20% above the current share price.

Aerospace & Defence – Analysts' view

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The Civil OE 'cycle' debate is likely to rear its head again in 2019 given slowing order momentum, less than uniform air traffic across the regions of the world together with increasingly probable new product launch headlines. On this basis there's an argument to be made for modest multiple contraction, however we maintain the underlying fundamentals of Airbus are still overlooked and the powerful cash acceleration in 2019 and the removal of key overhangs (management changes, A400M and deferred prosecution resolution) should prevail and drive material outperformance. For those lower in the OE value chain, however, there's likely to be an increasing focus on the cash reinvestment profile which is a key item to watch. As for the other two A&D sub groups there are key sentiment shifts afoot in our view, which make us incrementally more positive on the Defence group and incrementally more cautious on the Civil AM names.

Defence

We foresee a sentiment shift underway for global defence, which has been of limited interest in 2018 but the progressive de-rating of the US group appears to be piquing great interest today. At these levels we see this subgroup as increasingly attractive but seemingly under-owned by the HF community. While the US defence names may get cheaper between now and the February 2019 budget request the highly visible revenue and EPS growth to the early 2020's should outweigh any risk of further multiple contraction and drive outperformance vs. wider industrials, in our view, especially so in the event of broader macro weakness. The setup into 2019 looks increasingly attractive on this basis, with investors clearly sharpening their pencils today, but notably on a more stock-specific and detailed basis than a few years ago when the rerating of the whole group was pretty indiscriminate. Stocks in specific focus in our recent investors meetings were LLL/HRS, NOC and GD, LMT to a lesser extent. Sadly this heightened US interest is to the detriment of the European names which if anything are currently seen as expensive vis-à-vis the relative growth prospects of the US defence group by investors we are speaking to, which is a notable change in sentiment given the European group has de-rated also (exc. Thales). However, if the US group outperforms from ~Q2'19 the European defence group should follow thereafter. Nearer-term, political uncertainty in the UK and Saudi in particular are cited as reasons not to own BAE (UW) on current weakness and, interestingly, LDO (EW) has dropped right off the radar with hedge funds who are seemingly tired of the bull thesis. If anything this makes us incrementally more positive on LDO given the company are doing many of the right things in terms of improving transparency and reinvesting in what is an attractive underlying product portfolio with the shares at compelling valuation levels. In the event we did see a solid Q4'18 at LDO (which may be a challenge) there's an argument for a legitimate rerating in 2019 noting the re-rating in prior years appears to have been on less legitimate guidance from prior management.

Commercial AM:

Without doubt Safran is the most crowded name in Global A&D, by some distance, which given the investment proposition is unsurprising and is arguably still attractive from a valuation perspective given the ~20 years of compounding growth outlook. However, consensus seems to assume Civil AM growth of ~9% for the next three to five years, which looks aggressive given the ~400-500bps of outgrowth vs. thru-cycle averages enjoyed over the past three years, which we will now be lapping. That's not to say that a number shy of 9% is unattractive, but 9% appears to be what is priced in. We feel it is increasingly challenging to argue for higher multiples and further outperformance at this point and the crowded nature in our view implies there is more downside risk than upside when we look to 2019. MTU (OW) appears to be piquing incremental interest given the SAF rerating, which at these levels we continue to prefer over SAF (EW) and RR (UW).

CONSUMER DISCRETIONARY

Strategy Rating – Marketweight

FIGURE 197

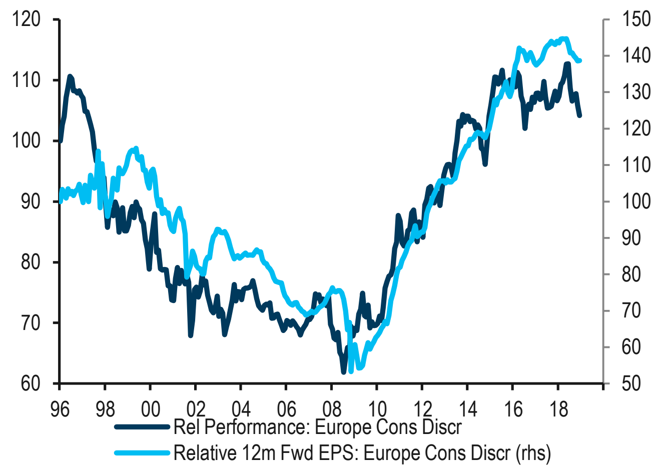
MSCI Europe Consumer Discretionary sector snapshot

	Absolute Perf.	EPS growth		Fwd PE	P/B	DY	Sector rating
	YTD	2018E	2019E	Latest	Latest	2019E	
Cons Discr	**-11%**	**1.3%**	**9.2%**	**10.9**	**1.9**	**3.3%**	**MW**
Auto & Compo	-21%	-4.6%	9.9%	6.2	1.0	4.5%	MW
Cons Dur/App	-5%	19.4%	9.7%	16.4	3.7	2.4%	OW
Media	-5%	-6.4%	4.2%	13.3	1.9	3.9%	MW
Retailing	-10%	-1.2%	8.6%	16.1	3.2	4.1%	UW
Hotels/Leis	-5%	5.0%	10.1%	16.1	3.4	2.7%	MW

Source: Barclays Research, IBES, Datastream

FIGURE 198

MSCI Europe Consumer Discretionary relative performance and earnings

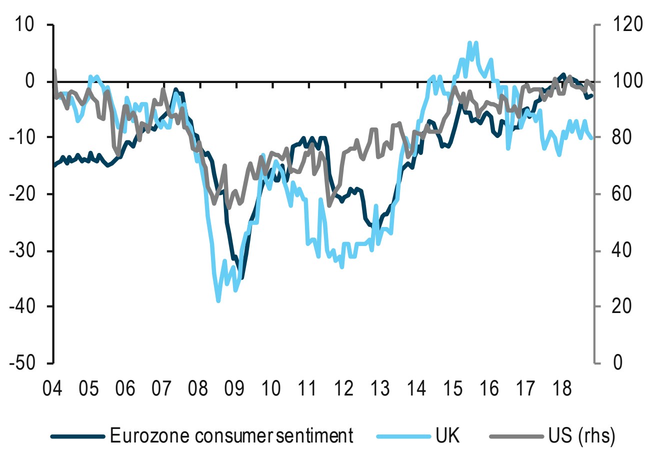


Source: MSCI, DataStream, Barclays Research

We are MW Consumer Discretionary, with a preference for Luxury Goods and Hotels & Leisure (OW) over Autos, Media and Retail (MW).

FIGURE 199

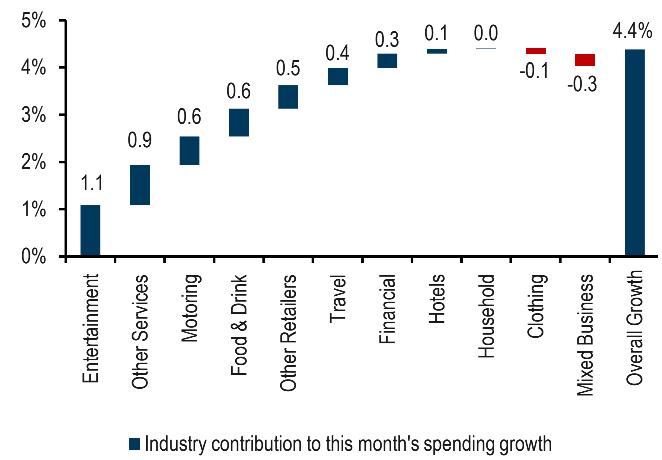
Consumer sentiment remains upbeat in the US, but is weakening in Eurozone and UK



Source: Bloomberg

FIGURE 200

Industry-level contributions to October consumer spending growth in the UK

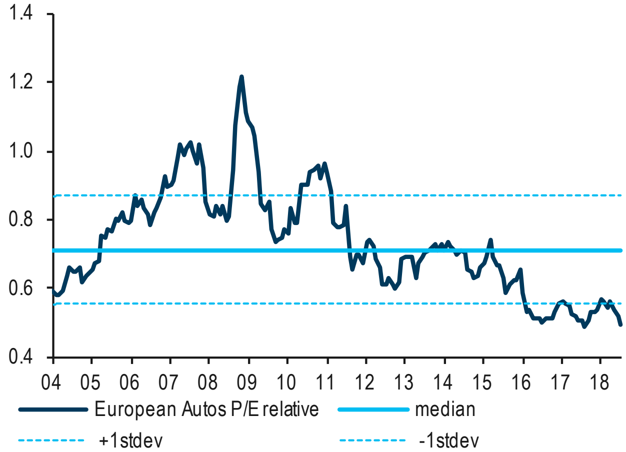


Source: Barclays Research, Barclaycard. Note: contributions are rounded

Consumer sentiment remains upbeat in the US but has turned more cautious in the Eurozone and UK. Strong labour markets and rising wages are positive, but the recent fall in oil could remove a key headwind to consumer spending. In the UK, Barclaycard data shows that spending growth on Essentials saw a slight uptick recently, pushed up by oil price inflation and FX. Discretionary spending remains healthy but is a tale of two halves. Retailer categories are being outpaced by Entertainment, which includes restaurants, pubs and attractions. The consistency of strong spending growth on experiences over our data history suggests that this area of discretionary spend is able to withstand a certain amount of pressure from economic and political uncertainty.

FIGURE 201

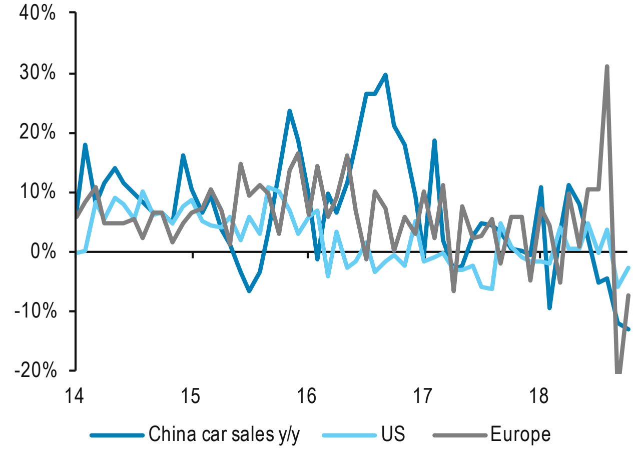
Autos valuations have de-rated sharply, but a catalyst for re-rating is missing



Source: IBES

FIGURE 202

Car sales have fallen sharply in China and Europe, but are still resilient in the US

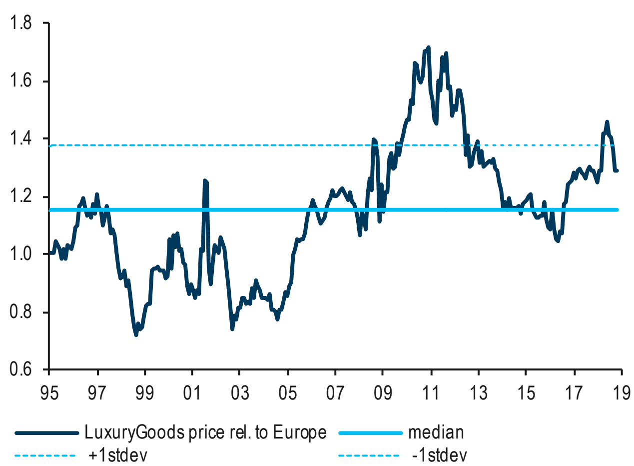


Source: Bloomberg

Autos have performed poorly this year and look attractively valued, but we acknowledge that the sector lacks positive catalysts. The structural shift towards EVs is gathering momentum, anti-pollution regulation is getting tougher and Chinese volumes are weakening. A potential cut in Chinese tax would be a strong positive, but overcapacity issues remain. The drag from WLTP should ease in 2019, but question regarding underlying demand remains. While an increase of US tariffs on European car is not our base case, it is likely to be a drag on investor sentiment again in 2019.

FIGURE 203

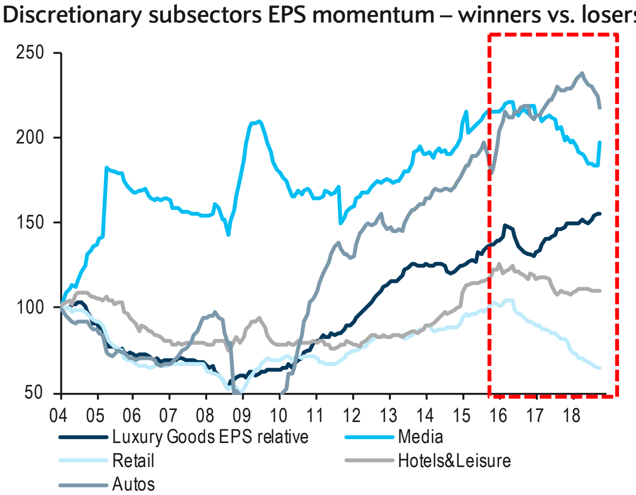
Luxury Goods' valuations have improved



Source: IBES

FIGURE 204

Discretionary subsectors EPS momentum – winners vs. losers



Source: IBES

We are OW Luxury Goods. The sector suffered from profit taking recently but valuations have improved and we expect earnings to be resilient in 2019. EM demand is robust, a weaker euro is a tailwind, the sector is immune to the tariffs threat and to structural online disruption, and should benefit from late cycle wage inflation. We are relatively more cautious on Media and Retail. Amid heterogeneous sector composition, we believe that their business models remain challenged by e-commerce and internet penetration, which is likely to keep pressuring profitability.

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Autos and Auto Parts – Analysts' view

Sector outlook and key drivers for 2019

2019 is a year with multiple macro risks for the Automotive sector.

The first is the risk of a continued slowdown in Chinese demand. Given the sharp decline in monthly car sales figures since the summer (-8% 3Q18, -13% Oct), the prospects for Chinese car demand remain a key concern for autos investors. We note that the current contraction in sales is largely limited to the volume market. In contrast, premium sales have held up well (+11% ytd). We believe this is because in addition to a gloomier economic outlook and fears over a global trade war, an important cause of the downturn is Beijing's crackdown on unregulated P2P financing in Tier 3-5 cities and near-record gas prices (up 50% since January 2016).

For 2019 our base case scenario remains cautiously optimistic for auto sales for 2019E, not just given relatively supportive GDP growth rates (BE +6.2%), but also in light of a potential government stimulus for car demand. This could take several forms including easing curbs on P2P lending, tax incentives or scrapping schemes. But without government stimulus, we note that Chinese auto sales may stall. Our base case for 2019E – auto growth of 4.7% – is predicated on government stimulus. With no stimulus, we present a bear case of -5% (assuming further declines in 1H19 but stabilisation in H2) and a worst case scenario of -15%. We assume premium car sales outperform the mass market in all scenarios by 3ppts.

The following table analyses the downside risk to OEM earnings from a contraction in China's market demand to our Bear case and our Worst case scenarios.

FIGURE 205

We would see the following EPS adjustments under our bear and worst case scenarios for Chinese car demand

	2018		Base case 2019E		Bear 2019E			Worst 2019E		
	China volumes (000's)	Total China NI (incl JV)	China volumes	China earnings	China volumes	China earnings	% change to EPS	China volumes	China earnings	% change to EPS
BMW	636	1,891	668	1886	623	1,754	-1.8%	560	1,565	-4.4%
DAI	696	3,063	731	2890	682	2,687	-2.2%	612	2,398	-5.4%
VW	4,081	5,491	4,318	5,786	3,918	5,218	-5.1%	3,510	4,764	-9.1%

Source: Barclays Research

The second macro risk for 2019 is a possible increase in US tariffs on European vehicle imports.

President Trump is known to be focused on the size of the US trade deficit with Europe and in particular what he regards as "unfair" German car exports. Currently US auto imports are being investigated under Section 232 of the Trade Expansion Act of 1962 but Commerce Secretary Wilbur Ross has until February to deliver his report to the president, who has a final say on the findings. President Trump last week said he would has decided to hold off imposing auto tariffs for now and a meeting with the CEOs of BMW, Daimler and VW is scheduled for next week. While some observers believe that Trump's criticism of vehicle imports and his desire to place a 25% tariff on auto imports is primarily part of a negotiating tactic and may help him to gain concessions in other areas of the trade negotiations, the risk of tariffs on European imports into the US continues to weigh heavily on the European autos sector.

We take this opportunity to remind investors of the risk to earnings that US tariffs present to BMW, Daimler and VW. If, as most recently threatened by President Trump, import tariffs on European cars rise from 2.5% to 25%, BMW and Daimler will potentially be most impacted as we expect US sedan imports to constitute 7% and 4%, respectively, of their global volumes in 2019. The number is much smaller for VW: we forecast a mere 1% of global sales volumes will be US sedan imports from Europe in 2019. However, our calculation also takes into account auto part imports from Europe upon which the tariff hike would also apply.

FIGURE 206

We would see the following EPS adjustments under a hike in US tariffs on sedan and car part imports to 25%

	Hit as a % of 2019 EPS if import tariffs rise to 25%				
% of tariff passed on	100%	75%	50%	25%	0%
BMW	0%	5%	10%	15%	19%
Daimler	0%	3%	6%	9%	11%
VW	0%	1%	2%	3%	4%

Source: Barclays Research

The third macro risk to the autos space is the risk of the cycle rolling over in the mature markets of North America and Western Europe.

Following the WLTP related distortion to European demand in 2018, we expect to see a normalisation of sales volumes in 2019. However, it is hard to ignore that underlying market demand is close to its peak given its position in the replacement cycle. As a result we expect to see a small contraction in 2019's European sales volumes (Barc -0.2%). A hard Brexit, further political uncertainty in Italy and the potential for a further slowdown in Europe's economic growth present additional downside risk to our forecasts. Our US counterparts currently see US SAAR on an eroding plateau. Going forward they believe that the auto sales environment will exhibit characteristics similar to that of 2002-2004, when monthly SAAR averaged ~16.8m with a standard deviation of 0.6m. In 2019 they expect a SAAR of 16.8, equivalent to a 1.5% yoy sales contraction. While the SAAR tends to increase in the initial year of rate tightening, thereafter restrictive monetary policy tends also to put pressure on auto sales. We note that several key emerging markets continue to see demand holding up well (Brazil, Russia, India), but see some downside risk here too, given the potential for further Fed tightening and dollar appreciation on top of continued trade turmoil.

These three macro risks come on top of the more structural challenges faced by the Autos sector from ever tightening CO2 regulation and the move towards electric driving in the near to mid term and the growing importance of autonomous vehicles, digitalisation and mobility services in the mid to long term.

Since the start of the year, the sector has de-rated 15% while earnings estimates have contracted 6%. Investors are clearly nervous about the future earnings potential for many of the companies under our coverage, given macro uncertainties and cycle worries. We do note however, that the share price response to recent profit warnings has been more muted than we would expect, implying that the market has already priced in a substantial portion of negative earnings risk. It is possible that we have reached trough valuation and that going forward the downside to valuation is limited. What is harder to identify at this point in time is a positive earnings catalyst that could lead valuations to recover. Valuations may be ~35% below 10-year historical average levels and look attractive even taking into account another 10% of earnings downside risk but we struggle to see positive share price drivers for now. Within the automotive sector we continue to prefer OEMs to suppliers as we think macro and future mobility disruption trends have been more fully factored into OEM valuations than their supplier peers.

Bookshelf Reports

Global Autos: VW and Ford: Extended Engagement; and Eventual Merger? (14th November *2018)*

European Autos & Auto Parts: China: a sleeping dragon? ***(29th October 2018)***

European Autos & Auto Parts: New EU CO2 regs to hit supplier jobs ***(15th October 2018)***

Volkswagen AG-PFD Preferred: A new chapter ***(10th September 2018)***

Key stock recommendations

Volkswagen AG-PFD (VOW3 GY, OW, PT206)

Like all OEMs, VW faces significant R&D, capex and mix headwinds given the auto industry's tech transition. But new CEO Dr. Diess' plans to hike efficiency should enable VW to meet these challenges head on. VW's efforts to cut costs in development, purchasing, production and distribution and to develop initiatives to generate greater synergies between the individual brands will provide an earnings tailwind in the face of structural headwinds. We expect the current production and sales distortion associated with WLTP to motivate the group to undertake a much-needed reduction in line-up complexity. At the same time, VW's new product momentum remains supportive and should benefit further from the rollout of an attractive pure electric offering from 2019. We believe VW's electric MEB and PPE platforms offer significant scale advantages, and this should allow the group to ramp BEV profitability faster than peers. A partial listing of the trucks business, planned for next summer, marks a step in the right structural direction in our view, and we believe the future of Ducati, MAN Power Engineering are also being considered with greater urgency. We would welcome any efforts by VW to expand its strategic alliance with Ford beyond LCVs (possibly into the areas of autonomous driving and pick up production in the US) and we see clear margin benefits from such an approach.

Media & Internet – Analysts' view

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Sector outlook and key drivers for 2019

This is a very diverse sector but, sitting here in November 2018, we see two big questions for 2019: 1) Can the advertising-driven names (TV and ad agencies) deliver more reliable progress than in the last two years and alter the widely-held view that they are structurally challenged?; and 2) After a weak end to 2018, can the growth names in Media (typically the internet stocks) resume the broad outperformance of the sector seen in the last few years?

On 1), macro is clearly critical to advertising-driven names, but the conclusions on structural pain have been drawn from their underperformance vs. macro trends. If that underperformance becomes less pronounced (and macro is not significantly weaker) then these names offer the most value in the sector (ad-driven names and value names are currently the same thing in the sector). We believe that: a) advertising agencies have more potential structural problems to come and are hardest to predict; and b) structural fears are actually overdone on the group of TV names (even if they remain highly cyclical).

On 2), recent underperformance is leaving some exciting growth names on affordable-looking multiples for the first time in a while. We highlight our preferences below.

Macro: overall the sector is defensive; it contains every flavour of cyclical exposure

In terms of macro exposure, European Media & Internet is, on a market cap-weighted basis, a defensive sector with names such as RELX, Wolters Kluwer and Vivendi much larger than, e.g. ITV, Pro7Sat1 and WPP. But there are a wide range of cyclical exposures in the sector and in the event of significant changes vs. expectations in GDP growth, it is obvious which names will perform better (satellites, publishers, Vivendi) and which will perform worse (TV, ad agencies, outdoor and some classifieds). As far as the UK is concerned, the sector contains a handful of UK cyclicals: ITV, Autotrader, Rightmove, DMGT (partly), and a number of sterling-denominated but dollar-exposed names (Informa, Pearson, WPP, RELX, Ascential, and DMGT). In aggregate, the sector would benefit from UK weakness.

Bookshelf Reports
1. MediaWatch XX: Growth can still win, *28 Sept 2018*
2. Ad Watch XIII: The media puzzle, *19 Oct 2018*
3. Music: The margins thin, *26 June 2018*
4. Ubisoft: Creed is good, *25 Apr 2018*
5. Lagardere: A change is coming, *17 May 2018*
6. Schibsted: Unlocking value, *19 Sept 2018*

Catalysts: these are, as always, quite stock-specific

We highlight the following potential catalysts in 2019 within the sector: 1) final impact of Lagardere's stated plans to dispose of key assets (and potentially reinvest in others) – *we think the process will be accretive and can drive a rerating*; 2) the spin-off of Schibsted's classified businesses outside Scandi should support the SOTP but also could present opportunities to participate in global consolidation – *we see this as a positive catalyst*; 3) the final piece of the C-band puzzle for SES will be revealed with the FCC's conclusions and then the prices that MNOs are willing to pay for the spectrum. *We feel that lots is already priced in but there could be upside if the market wants to put a value on the rest of the spectrum (that is not being put up for sale)*; 4) Vivendi is planning to attract bidders for a share of its UMG music business – *the market has high expectations but the true price remains a key uncertainty in the story*; 5) Pearson will have to start showing the market whether its earnings can realistically track towards the high or the low end of consensus in 2020 – *we think that the high end looks unachievable*.

Earnings and valuation outlook

On a market cap-weighted basis, we are modelling 10% EPS growth for the sector as a whole in 2019. With 9 of the 10 largest stocks in the sector by market cap having significant exposure to the US dollar (and denominated in either € or £), and with spot rates pointing to a modest positive effect to earnings in 2019 for dollar-exposed names (c.3-4%), the constant FX EPS growth for the sector would be slightly lower.

Within this, we have high single-digit EPS growth for professional publishers, flat for advertising agencies, mid single-digit for broadcasters, and mid-teens from internet names. In recent years the agencies and broadcasters have seen the most volatility on earnings.

On valuation, the advertising agencies and broadcasters are the cheapest they have been since 2008/9, with the average for both at c.10-11x P/E. The internet names have derated to a high-teens P/E in 2019e, while the professional publishers have held their rating at mid- to high-teens P/E. The key questions are whether the internet names can rerate back into the 20s and whether the advertising-driven names can bounce off these low levels.

Positioning within the sector:

We favour growth stocks with non earning-related catalysts

Key stock recommendations

Julien Roch

Lagardère (MMB FP, Overweight, PT €31.00)

This is a transformation story. Management stated their intention to sell most of their Active and Sports divisions indicating this would happen in the coming months. They intend to re-invest the proceeds in Publishing (cash cow) and Travel Retail (growth engine) with a preference for Publishing, even if the first acquisition was in Travel Retail. If they execute, this would significantly alter Lagardère's growth and cash flow generation profile. This is a story with many potential catalysts (possibility of several asset disposals through 2018E), rare these days in media. We have been here before. Over 2010-13, Lagardère sold assets, saw shareholder activism, and had periods of outperformance despite significant EPS downgrades. Historically, periods of transformation have been the time to buy this stock.

Andrew Ross

Schibsted (SCHA NO, Overweight,PT NOK350)

We expect value to be realised as Schibsted goes through the spin out of its non-Scandi classified assets into a new company (named MPI for now). As the split happens, we expect more disclosure on some of the less well understood assets (Brazil, Mexico, Spain, etc) and this to build more confidence on the outer year growth of the portfolio (the market doesn't appear to believe their mid-term revenue guidance of 15-20%). As the market builds confidence, we think the classified portfolio can rerate. Our PT implies c20% upside but a conservative value on Brazil, Shpock, Spain and Mexico (as well as France). We deliberately value the stub assets in the hold co conservatively (which is harsh given the materiality of Lendo to the stub, which remains a quality asset) and on that value the market is pricing MPI at c20x EV/EBITDA in 2020e – not cheap but the asset should grow EBITDA north of 20% beyond. Beyond the spin, we think further catalysts will materialize from industry consolidation in which Schibsted participates (a stated reason to do the spin) and an M&A premium should be attached to MPI.

Nick Dempsey

Ubisoft (UBI FP, Overweight, PT €98.50)

Ubisoft's shares have been hit hard recently with pressure coming from the derating of tech stocks and some points of uncertainty emerging for the large video games companies. The concerns are around: 1) whether the big franchise titles can continue to increase revenues each year, as well as generate significant in-game purchases; 2) the long delay to approvals for new games in China and question marks around the regulatory backdrop to that delay (focus on screen addiction and gambling); and 3) whether the arrival of Red Dead Redemption from Take Two has indeed hampered sales for the other key players in calendar Q4 (as feared throughout 2018). For Ubisoft, China is 5% of revenues and is one source of potential upside over time but not an important driver of short-term growth, while Assassin's Creed Odyssey is delivering ahead of their plan and they remain positive on The Division 2. We expect good delivery to reassure investors that the fundamentals remain very positive: as digital continue to increase, this should support revenues and margins, while there are future opportunities from eSports, streaming and China.

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Leisure – Analysts' view

Sector outlook and key drivers for 2019

- **Macro drivers** – consumer, business confidence and GDP growth are key drivers of top line growth for companies in the leisure sector.
- **Inflation risk** – wage and food inflation impact many companies in the sector and can be detrimental to margins if not mitigated.
- **Catalysts** – the Brexit outcome (29th March 2019), changes to UK, European and US consumer/business confidence, regulation, various CMDs, travel trends and FX.

As such, the overall outlook for UK exposed names in the Leisure sector is a little uncertain given the Brexit overhang (albeit companies such as Merlin have proved resilient during UK economic uncertainty in the past). The outlook for the US and globally exposed names will depend more on the economic cycle.

Earnings and valuation outlook

The average Leisure sector cal17-20E EPS (adj) CAGR is 15.7%. The average cal18-19E EPS growth in Attractions is +14%, Hotels +26% (underlying net income growth +17%), Caterers/Concession +7%, Tour ops +14%, Gaming +3%, Gyms +36%, Restaurants/Pizzas +9% (all Barclays forecasts).

Upside risks - include cost management, macro catalysts driving better top line growth, FX tailwinds.

Downside risks - include rising rate of inflation, ineffective cost-cutting actions and pricing, macro downturn, FX headwinds.

Multiples - with macro uncertainty we expect the majority of Leisure companies, which are mostly cyclical, to display an end of cycle valuation multiple. However, we note that gambling companies are usually late cycle sensitive while the caterers and Merlin have historically proven to be relatively defensive businesses in the past.

Positioning within the sector

There are many sub-sectors within the European Leisure space including Attractions, Hotels, Catering & Concessions, Gaming, Tour Operators, Gyms and Pizza/Restaurants. Overall we think that the gaming sector has the most upside and downside risk given gaming market growth (e.g. the US opportunity), regulation, consolidation and heavy news-flow.

We show our key stock recommendations by sub-sector below.

Key stock recommendations

Vicki Stern

Attractions: Merlin (MERL LN, OW, PT 415p)

We like Merlin within the attractions space and view it as an attractive compounding growth story. We view this as an attractive entry point for those with a longer-term horizon given 2018E/19E/20E forecast EPS growth of 1%/4%/11%. The key drivers for Merlin include improving consumer confidence levels, shifting structural trends towards more leisure spend on tourism and attractions, and the translational effect of FX.

Hotels: Accor (AC FP, OW, PT €48)

Accor remains our preferred hotel pick. We like it for the following reasons 1) increasingly asset light business model 2) a c80% European and Asian recovery play with an estimated 20% EBIT 2018-20E CAGR and, 3) trading at an attractive valuation to peers with an implied fee business multiple of 11.1x 2019E EV/EBITDA vs. IHG c12.3x. A key catalyst for Accor is the CMD on 27th November 2018 which may provide further light on a range of topics including strategy and capital allocation.

Catering: Compass (CPG LN, OW, PT 1770p)

We view Compass as a high-quality, long-term compounder offering attractive TSR potential. It is our preferred caterer, trading on an 18.8x cal19E P/E vs. Sodexo (UW, PT €77), our least preferred caterer (17.9x cal19E P/E) and Elior (EW, PT €14), albeit Elior also generates c36% of EBITDA from concessions. Compass recently delivered solid FY18 results in an industry highly exposed to rising inflation, illustrating that Compass remains the industry leader in mitigating cost increases while also driving top line growth.

Patrick Coffey

Concessions: SSP (SSPG LN, OW, PT 765p)

We remain constructive and view SSP as a rare stock delivering strong top-line growth and self-help measures to deliver consistent double-digit earnings growth. Momentum shows no signs of abating despite headwinds from US and UK labour inflation. Elior disposing of its concessions business is a potential short-term catalyst and will provide further clarity on how the concessions sector will shape out. With the sustained momentum and positive outlook going into 2019 we recently increased our PT from 730p to 765p (see *More upgrades, more cash returned*, 21 Nov 2018).

Gaming: Paddy Power Betfair (PPB LN, OW, PT £76)

Trading on an unlevered FCF Yield of 7.2%, PPB remains the least risky way to invest in the sector in our view. Longer-term, we continue to see scope for PPB to buy back 5-10% of its market cap per year whilst 1) maintaining low leverage, 2) growing the core business and 3) investing in the long term growth of the US sports betting industry (we think PPB is well positioned).

Tour Operators: TUI (TUI LN, OW, PT 1700p)

We continue to prefer TUI's diversified business model (Hotel and Cruise content as well as a Tour Operator) and TUI's stronger balance sheet. TUI is less of a trading business than Thomas Cook and thus has greater visibility of earnings, in our view. TUI's guidance has historically been more conservative than Thomas Cook and their yield management appears stronger.

James Rowland Clark

European Gyms: Basic-fit (BFIT NA, OW, PT €35)

We like BFIT for its low-cost gym rollout story into underpenetrated markets. The shares trade on 11.5x cal19E EV/EBITDA, which we continue to view as cheap relative to the growth (c30% EPS 2017-20E CAGR).We think the key risk is the rollout but we have conviction for the following reasons: 1) strong openings track record, (2) openings visibility; (3) effective site selection strategy; (4) clear runway of growth; (5) growing brand strength; (6) improving customer dynamics.

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UK house building – Analysts' view

Sector outlook and key drivers for 2019

New build housing will continue to be supported by the Help to Buy scheme (at price points below £600k), low mortgage rates, strong mortgage availability and low unemployment. However, we expect conditions to remain challenged at higher price points (more often than not in London and the south east) as buyers' confidence levels are impacted by Brexit.

The wider housing market is suffering from a lack of liquidity, with chains taking longer periods to complete, low levels of inventory on estate agents' books and weak transaction levels (we believe the 2018 outturn will be closer to 1.1m than 1.2m transactions, based on current trends). Those that rely more on the wider market will likely be more impacted by sluggish conditions.

House builders' balance sheets are in a strong position as we head into these more uncertain times, and dividend yields (sometimes double digit) are often very supportive.

Share prices will likely remain driven by Brexit progress/sentiment – expect much greater volatility than normal, in a sector already well known for its cyclicality.

Bookshelf Reports

1. UK housing market chart book, 20 Nov 2018
2. Back to neutral ground, *12 Sept 2018*
3. McCarthy & Stone: More light, less tunnel, *20 Nov 2018*

Earnings and valuation outlook

Earnings should be supported by forward order positions as we move into 2019, though any pressure on sales rates, house prices and build costs will have an inevitable impact on margins.

It is more difficult to operate in the South (where house prices are relatively high) than the North at this stage.

Positioning within the sector

We prefer stocks with: a) a key point of differentiation (e.g. Countryside Properties); b) attractive dividend yields (e.g. Taylor Wimpey); or c) late cycle characteristics (e.g. Barratt Developments).

Key stock recommendations

Jon Bell

Countryside Properties (CSP LN Equity, OW, PT 384p)

The company's Partnerships division continues to provide a key source of differentiation, although its margins will return to longer term norms after a strong period of outperformance. Its house building division is enjoying the benefits of operational efficiencies. Balance sheet remains strong, with net cash reported.

Jon Bell

Taylor Wimpey (TW/ LN Equity, OW, PT 200p)

The shares have been poor performers since the company's capital markets day (exacerbated by Brexit concerns). They offer a very attractive dividend yield (2019E 12.4%). Taylor Wimpey is in good financial health and achieves a top quartile return on capital among its peers.

Jon Bell

Barratt Developments (BDEV LN Equity, OW, PT 678p)

Barratt is the UK's largest house builder by volume. It has a strengthening balance sheet, and now reports net cash at period ends. It remains a late cycle play on the recovery of the new build segment, with significant scope for margins and return on capital to improve.

CONSUMER STAPLES

Strategy Rating – Marketweight

FIGURE 207

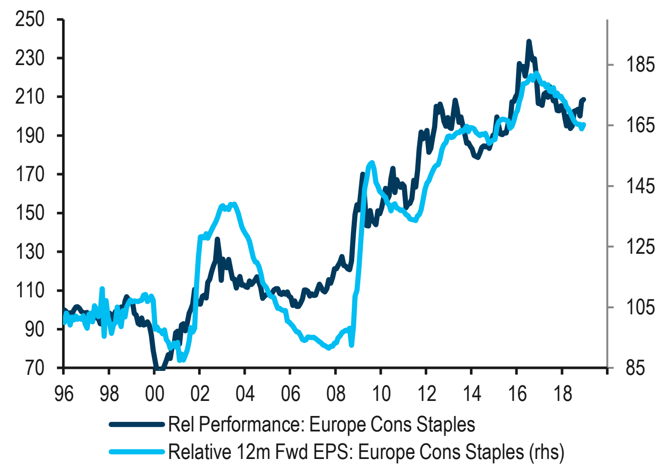
MSCI Europe Consumer Staples sector snapshot

	Absolute Perf.	EPS growth		Fwd PE	P/B	DY	Sector rating
	YTD	2018E	2019E	Latest	Latest	2019E	
Cons Staples	**-7%**	**5.6%**	**8.9%**	**17.8**	**3.1**	**2.9%**	**MW**
Fd/Staples Rtl	5%	12.0%	12.1%	14.6	1.6	2.7%	UW
Fd/Bev/Tob	-11%	5.5%	8.9%	17.6	3.0	3.1%	MW
H/H Pers Prods	2%	3.2%	7.9%	19.8	5.1	2.6%	UW

Source: Barclays Research, IBES, Datastream

FIGURE 208

MSCI Europe Consumer Staples relative performance and earnings

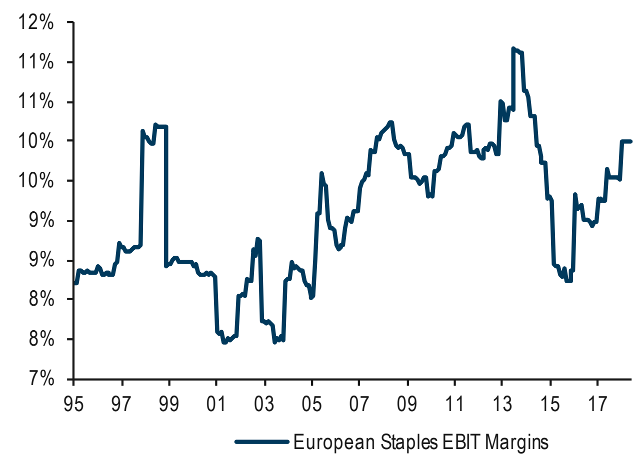


Source: MSCI, DataStream, Barclays Research

We remain MW on Staples. The sector is unlikely to underperform in the backdrop of range-bound bond yields and we expect its relative EPS momentum to hold up well in 2019, but find its valuations quite demanding.

FIGURE 209

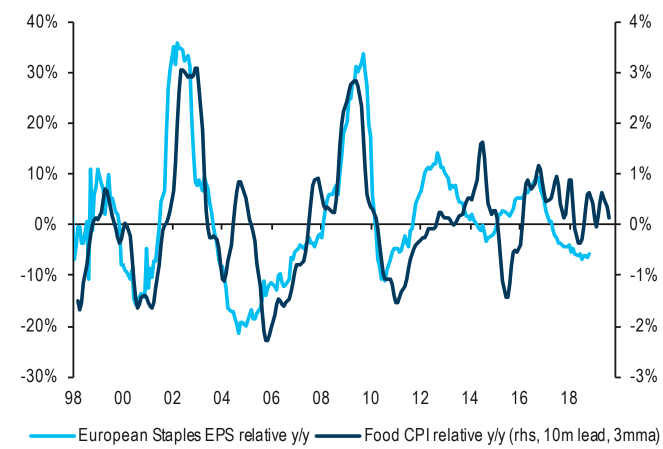
Margins have improved…



Source: Worldscope

FIGURE 210

…and food inflation is holding up

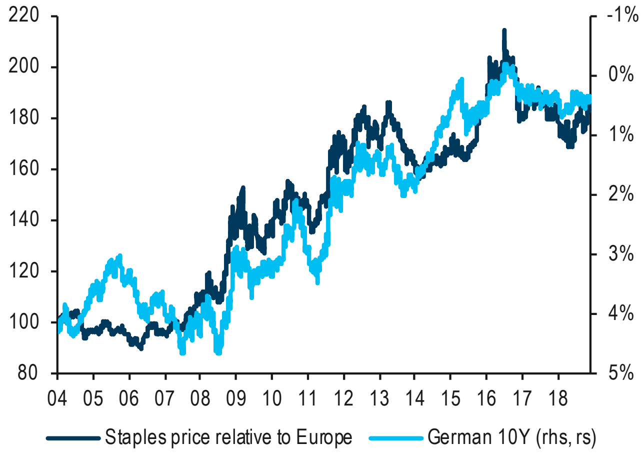


Source: IBES, Eurostat

The earnings outlook for Staples is not looking particularly exciting but IBES estimates of 9% EPS growth in 2019 are unlikely to be revised materially lower relative to the rest of the market. Margins have improved and rising food inflation is positive for pricing power. Staples' relative EPS momentum has softened in the last two years as Cyclicals and Financials earnings rebounded, but some reversal is likely next year. Food retailers remain structurally challenged and political uncertainty is a problem in the UK, though. We have a relative preference for food producers and late cycle names like spirits within the sector. We also believe that the drag from volatile EM FX could ease going forward.

FIGURE 211

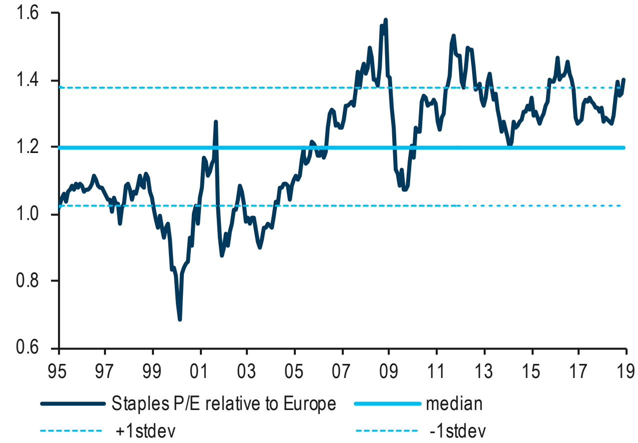
The correlation between Staples and bond yields is strongly negative



Source: Datastream

FIGURE 212

Staples P/E relative is near the top of the recent range



Source: Datastream, IBES

Staples have typically moved in the opposite direction to bond yields and the relationship between the two remains strongly inverse. If bond yields stay range-bound in 2019, as per Barclays' forecast, it should thus benefit the sector, but any potential rebound would be a negative. We find Staples' valuations particularly demanding and note that the sector has re-rated significantly ytd relative to the overall market, which damper our enthusiasm.

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Bookshelf Reports

Tesco – Thailand holds back 1H profit, 3 October 2018

Casino – Ambitious targets, 24 July 2018

Sainsbury – Accretion aplenty, 27 June 2018

Food Retail – Analysts' view

Sector outlook and key drivers for 2019

A significant proportion of the sector's market capitalisation is based in the UK – therefore the situation around Brexit is clearly a crucial driver of sentiment. The more turbulent the market perceives the UK's exit from the EU, the worse this is likely to be for consumer sentiment and for the value of sterling. The latter is important because a high proportion of UK food spending is on imported goods – weaker sterling means higher inflation. While higher food inflation can be helpful to some extent, it becomes unhelpful beyond a certain point as it encourages consumers to search for cheaper alternatives and may thereby tend to help the growth of the unlisted discounters (Aldi and Lidl). Tesco might be slightly better protected than the other UK players because c30% of its value lies outside the UK.

A new law regulating tariff negotiations between retailers and suppliers and limiting price competition will come into force in France early next year. The discount offered on promotions will not be allowed to exceed 34% of a product's price and the number of products under promotion will not be allowed to exceed 25% of the assortment for each product, while the Resale Below Cost threshold will rise by 10% on some food products. Although this new legal framework will likely help food retailers' performance in the short term and boost food inflation in France, we are wary of thinking that price competition will disappear and we expect French retailers will create new promotional tools or improve their loyalty programme in order to invest in prices, while complying with the new law.

Earnings and valuation outlook

The long-term earnings performance of the sector has not been admirable. There are reasons to perhaps be a little more optimistic in 2019 because several larger companies are in "turnaround mode" – notably Tesco and Carrefour. The sector is also steadily improving its cash generation – so earnings are being enhanced by cash returns to shareholders, notably at Ahold Delhaize, Morrison and Colruyt. The sector is trading at a P/E multiple of 14.2x for 2019e, which is not so remarkable compared with the longer-term average. However, we currently estimate the sector's FCF yield at 7.3% for 2019 – this is high versus long-term averages and is perhaps the most attractive aspect of the sector.

Positioning within the sector

In recent times we have tended to prefer the UK names because the market has not been especially price competitive – although clearly the ongoing growth of the discounters has not been helpful. As we describe above, it is possible that new legislation in France may act to reduce competition, but this remains to be seen. For now we continue to prefer the UK names – admittedly they suffer from nervousness around Brexit but we believe this is outweighed by the market stability and the fact that the three listed grocers all have potentially attractive investment case: Tesco is improving margins and generating synergies from Booker; Sainsbury is hoping to complete its ASDA merger and generate very material accretion; Morrison continues to generate and return cash to shareholders.

Key stock recommendations

James Anstead

Tesco (TSCO LN, OW, PT 280p)

Tesco is our Top Pick in the European Food Retail sector. The company has a margin target for the core business of 3.5-4.0% for the year ending February 2020, which implies growth of at least 25% over the two years running up to the target. It also bought Booker in early 2018 – that business continues to grow rapidly and Tesco expects to extract at least £200m of synergies in the three years to February 2021. The company is also reducing its interest charge, is growing its JV income and expects its tax rate to reduce. Even assuming the bottom end of the margin guidance range and the minimum synergy assumptions, we derive an EPS of c19.5p for the year to February 2021 – which implies a P/E of little more than 10x for "year three". Interestingly, 50% of management's most recent LTIP depends on achieving an EPS of 18.0-24.4p for the year to February 2021 – implying our forecast is well within the company's own expectations. Not only does Tesco look potentially cheap on a P/E basis, but it would likely be generating a good deal of cash by this point. We forecast a FCF yield of 10-11% for the years to February 2020 and 2021 respectively – the company should have the scope to make significant cash returns to shareholders.

Nicolas Champ

Casino (CO FP, Underweight, PT €30.0)

We expect real estate sale and leaseback transactions to represent the majority of the €1.5bn asset disposal programme announced by Casino in 2018. Even though these disposals will improve Casino's liquidity, they imply an increase in rental costs for the group that could weigh on its earnings growth and its already muted Free Cash Flow generation. Besides, we believe that competition is set to intensity in the Paris market following the recent entry of new operators and the growing online penetration. In this context, we consider that Casino's French EBIT growth and FCF generation targets between 2018 and 2020 are too ambitious. Overall, we struggle to justify Casino's generous earnings momentum given its higher risk profile, complex group structure, muted Free Cash Flow generation as well as the limited visibility on its earnings momentum. Casino is trading on a FY19E P/E of 16.1x vs. 14.2x for the European food retail sector average).

James Anstead

Sainsbury (SBRY LN, OW, PT 375p)

Sainsbury announced in April 2018 that it has agreed a potential merger with ASDA, Walmart's UK subsidiary. The merger is potentially very attractive for Sainsbury shareholders – primarily because the two companies expect £500m of net synergies but also because the terms appear favourable to Sainsbury (the implied EBITDA multiple is reasonable and Walmart will retain ASDA's pension liabilities). To our minds the question is not whether the proposed merger is attractive, it is merely whether the deal will be passed by the CMA with only a moderate number of store disposals being required. Neither Sainsbury nor ASDA has expressed an opinion regarding store divestment expectations, but we think that the deal would certainly remain highly accretive if the store disposals are below 100. The key question for the CMA is whether the discounters should be taken into account – and if so, to what extent. Given the huge changes catalysed by the discounters over recent years, we would find it difficult to imagine that their impact could be ignored – but the CMA has not set out its precise methodology and therefore it is difficult to have great confidence in how the proposed merger will pan out. It is possible that the CMA will publish its preliminary Phase Two findings in January. This will be a clear catalyst in one direction or the other – a merger with limited disposals would be very accretive, but a high number of disposals would render the deal economic and would potentially drive Sainsbury shares down given the arguably unattractive dynamics of its own core business.

HEALTHCARE

Strategy Rating – Marketweight

FIGURE 213

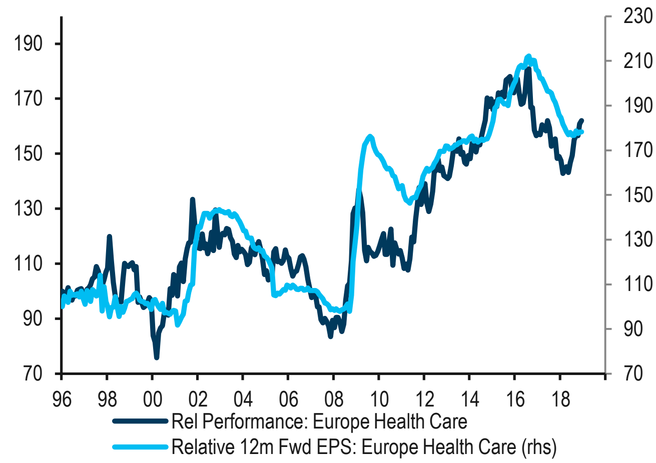
MSCI Europe Healthcare sector snaphot

	Absolute Perf.	EPS growth		Fwd PE	P/B	DY	Sector rating
	YTD	2018E	2019E	Latest	Latest	2019E	
Health Care	**1%**	**0.8%**	**8.4%**	**15.5**	**3.3**	**3.0%**	**MW**

Source: Barclays Research, IBES, Datastream

FIGURE 214

MSCI Europe Healthcare relative performance and earnings

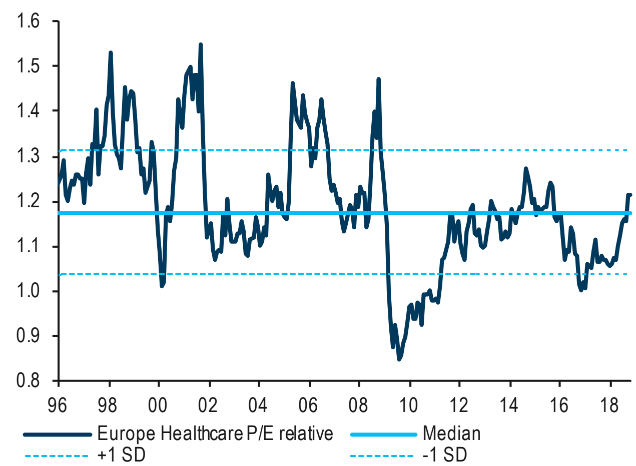


Source: MSCI, DataStream, Barclays Research

We are MW on Healthcare for 2019. The sector had a strong run ytd, which was mostly due to P/E expansion and falling bond yields, in our view. Fundamentals are supportive of earnings, but we struggle to see a catalyst for a strong re-rating of the sector.

FIGURE 215

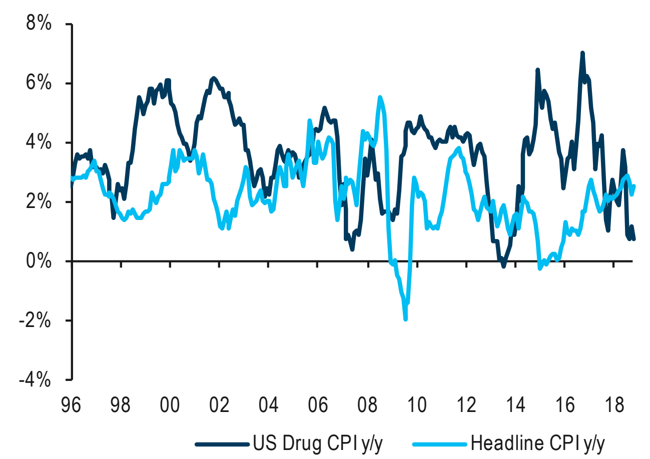
Healthcare valuations have re-rated to the expensive side of fair value



Source: IBES

FIGURE 216

US Drug pricing has rolled over in H2

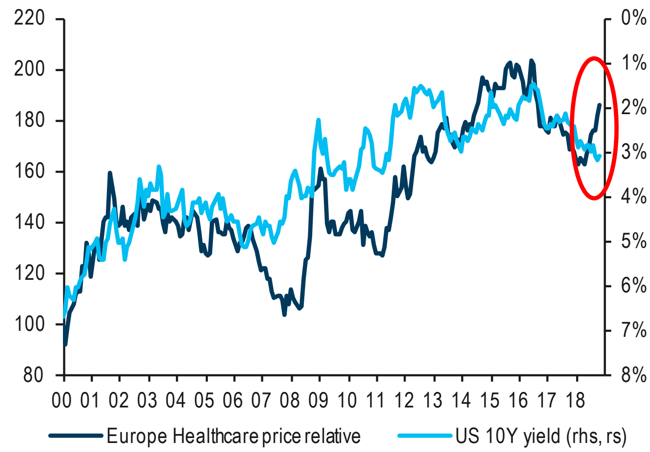


Source: Bloomberg

Following the rebound this year, Healthcare P/E relative has re-rated to the expensive side of fair value. We note that US drug pricing, which is an important driver of earnings, has rolled over sharply recently, which could be due to self-policing by the industry ahead of the mid-terms. Our sector analysts believe that the split-congress could agree on tougher pricing regulation while Democrats are likely to campaign on a 'Medicare for all' for the 2020 elections.

FIGURE 217

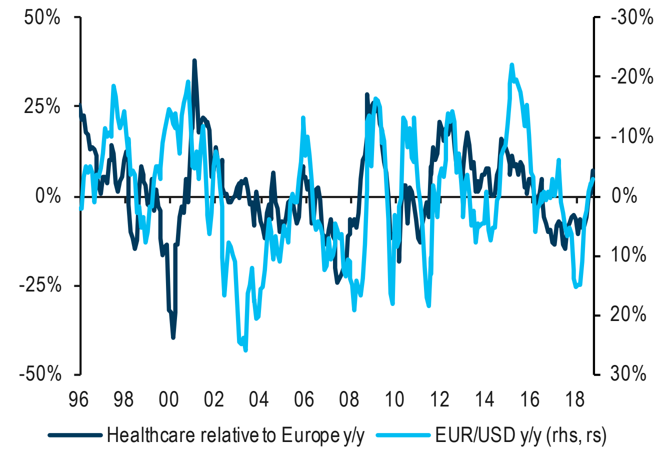
Healthcare behaves like a bond proxy, but the sector has decoupled from US yields recently



Source: Datastream

FIGURE 218

A weaker Euro is a positive for the sector, but the impact will likely fade in 2019



Source: Datastream

Healthcare's relative performance is typically strongly inversely correlated to bond yields, as the sector is seen as a bond proxy by investors. While we expect bond yields to stay range bound, we note that both have decoupled recently as the sector outperformed despite the rebound in yields. Finally, European Healthcare will continue to benefit from the weaker euro in H1, but the base effects could dissipate in H2.

Pharmaceuticals – Analysts' view

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Sector outlook and key drivers for 2019

Similarly to what we've seen thus far in 2018, we expect that investors will be focused on clinical catalysts (see below) and also on the performance of newly launched products. One area that has been historically a major driver for the sector that was for the most part absent in 2018 has been significant M&A (outside of the ongoing Takeda/Shire transaction).

Macro…

We believe the most prominent macro concern for the space continues to be the potential for changes in the drug pricing landscape in the US, particularly in light of the result of the recent midterm election. With the Democrats now in control of the House of Representatives, we do expect that rhetoric around drug pricing changes will increase, though we note that with the Republicans still in control of the Senate, we are unlikely to see any substantive legislation (see: *EU Pharmaceuticals: Brief thoughts into the midterms... (02/11/18)*). Other macro factors driving the space in 2019 are largely unchanged from 2018 including ageing demographics in the US and EU, continued penetration of pharma into the emerging markets and any developments on the biosimilar landscape in the US.

Catalysts…

For the large cap group key catalysts will include AZN's additional IO and roxadustat P3 readouts in H1, Bayer's glyphosate litigation newsflow through 2019, Novartis CRTh2 anatgonist and Entresto PARAGON results plus Roche's Alzheimer data.

For the mid cap names, major catalysts we expect to likely occur in the first half of 2019 include the FINCH 1 & 3 readouts of GLPG's filgotinib (1Q19), regulatory decisions for Merck's Mavenclad in the US (1H19), UCB's romosozumab in the US and EU (1H19). Catalysts that are likely to materialise in the latter months of 2019 include the readout of the CheckMate-9ER study of Ipsen's Cabometyx and the first phase 3 results of UCB's bimekizumab in psoriasis.

Earnings and valuation outlook

For the large cap names, we expect earnings growth for 2019 will accelerate to +9% y/y (+6% y/y ex-Bayer) vs. 2018's -1%. y/y This is driven primarily by the continued roll out of novel products such as Astra's Imfimzi, GSK's Shingrix and Roche's Ocrevus and Hemlibra. For the mid cap names, whilst earnings growth in 2019 will be less robust than that of this year (+32%), we still expect the group to average strong double digit growth (+13%), with Genmab and Ipsen leading the sector at +59% and +22% y/y, respectively.

We continue to find valuations in the space attractive, particularly among the large cap names, with the group trading at 14.2x our 2019E EPS, well below longer-term averages of mid-to-high teens. Whilst the mid-cap names are slightly more expensive (18.8x 2019E EPS), we still believe there will be room for multiple expansion for the group as a whole, given the strong EPS growth; we currently forecast '17-'22E EPS growth of +14.6%.

Bookshelf Reports

European Pharmaceuticals: The Hippocratic denouement *(30/04/18)*

Global Consumer Health: Heal thyself (online or at corner store) *(29/05/18)*

European Pharmaceuticals: Something a little harder to immunise against... innovation *(10/08/18)*

Key stock recommendations

Emmanuel Papadakis

AstraZeneca (AZN LN, Overweight, PT £68)

Astra continues to show strong performance from key assets and has an inflecting trajectory within oncology that frames a good risk-reward into additional upcoming datapoints (DECLARE, roxadustat, KESTREL, Lynparza POLO). With restructuring and capex on the decline, we expect the visible product inflection to be more duly reflected in 2019 CF

Emily Field

Genmab (GEN DC, Overweight, PT DKK 1300)

2018 has been a volatile year for Genmab, with the failure of Darzalex in solid tumours in May delivering a big hit to investor sentiment that has persisted throughout the broader selloff in growth names that we've seen in the back half of the year. That being said, we remain positive on the underlying growth story of Darzalex and expect that as the MAIA data is included in the label, we could see a further inflection in scripts, (see: *Genmab A/S: MAIA topline data hits - wall of worry now in the rearview mirror (14/11/18)*).

FINANCIALS

Strategy Rating – Overweight

FIGURE 219

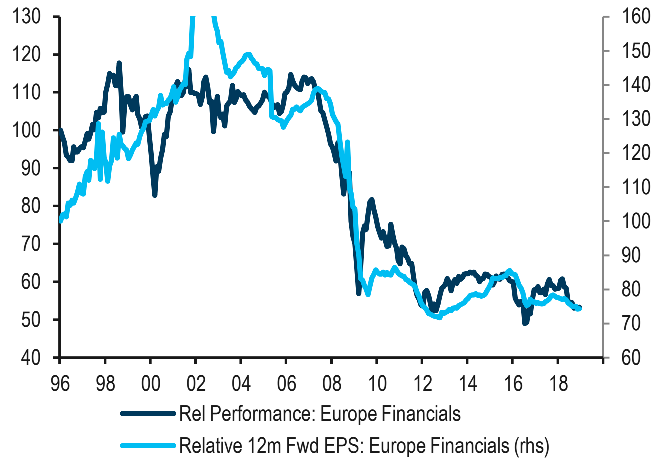
MSCI Europe Financials sector snapshot

	Absolute Perf.	EPS growth		Fwd PE	P/B	DY	Sector rating
	YTD	2018E	2019E	Latest	Latest	2019E	
Financials	**-17%**	**10.9%**	**7.1%**	**9.6**	**0.9**	**4.8%**	**OW**
Banks	-21%	10.3%	4.0%	8.9	0.7	5.4%	OW
Div Fin	-20%	-1.8%	15.3%	11.9	1.0	3.2%	UW
Insurance	-7%	18.7%	9.6%	9.9	1.2	4.8%	OW

Source: Barclays Research, IBES, Datastream

FIGURE 220

MSCI Europe Financials relative performance and earnings

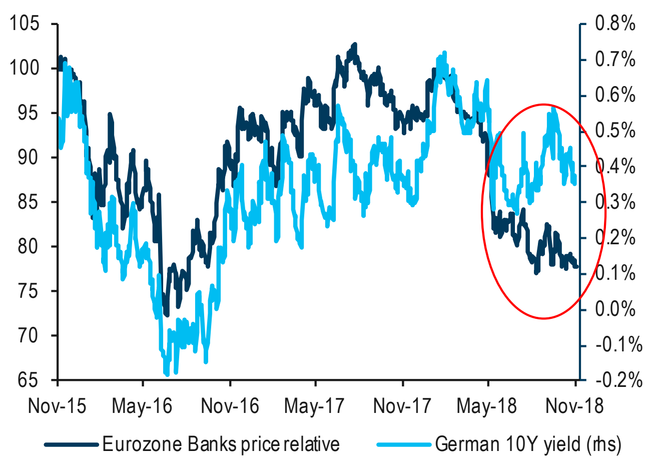


Source: MSCI, DataStream, Barclays Research

We are Overweight Financials, with a preference for Insurance (OW) and Banks (OW) over Diversified Financials (UW). Banks' performance has been lacklustre in 2018 and we think the sector offers a tactically attractive risk/reward into 2019.

FIGURE 221

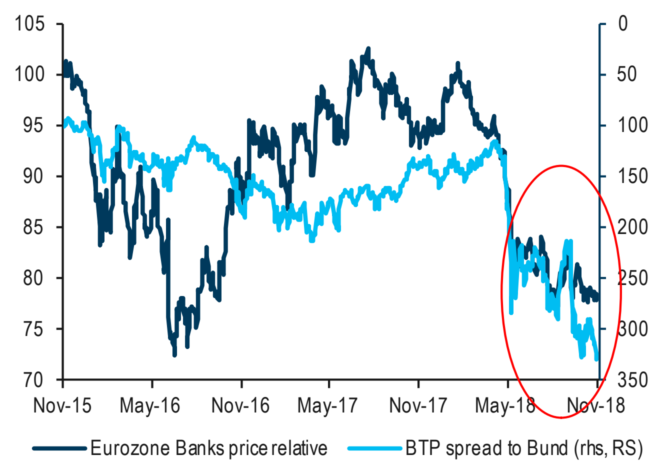
Bond yields matter for Banks…



Source: Datastream

FIGURE 222

…but BTP spreads too

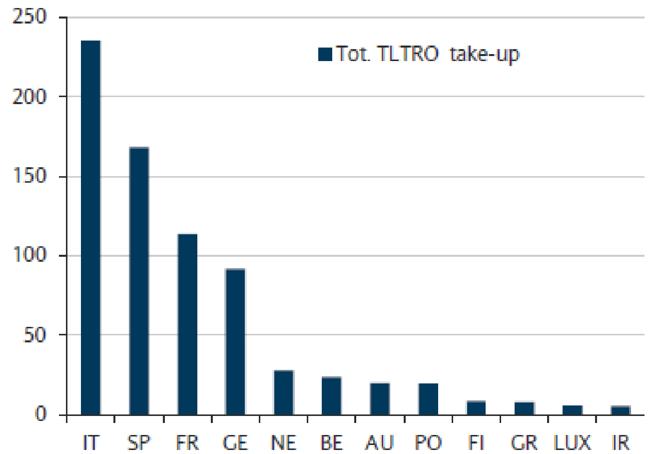


Source: Datastream

Banks are down 20% ytd and are consensus UW. European politics are not helpful and the sector remains hostage to BTP spreads and Brexit, but a lot appears to be in the price already and we see little risks to current EPS estimates for 2019 relative to other sectors. Our base case is that politics will not escalate, but risks remain elevated. The softening Eurozone activity added to the still low core inflation dynamics and the elevated political uncertainty are unlikely to push ECB to hike rates in hurry, but our base case remains that ECB will end QE in December.

FIGURE 223

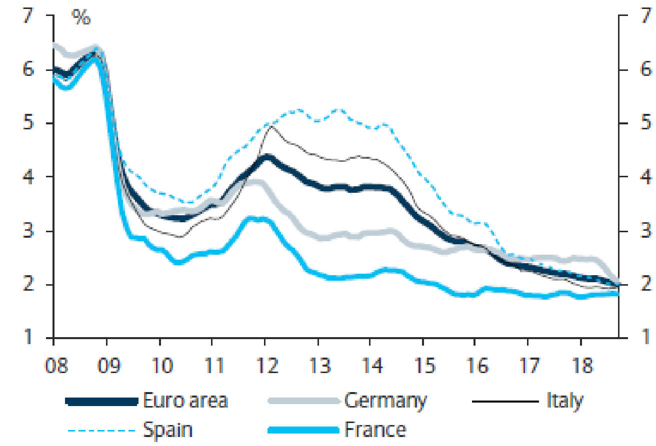
Peripheral countries are the larger TLTRO borrowers (€bn)



Source: ECB, Barclays Research

FIGURE 224

Bank lending rate to SMEs fell thanks to ECB action

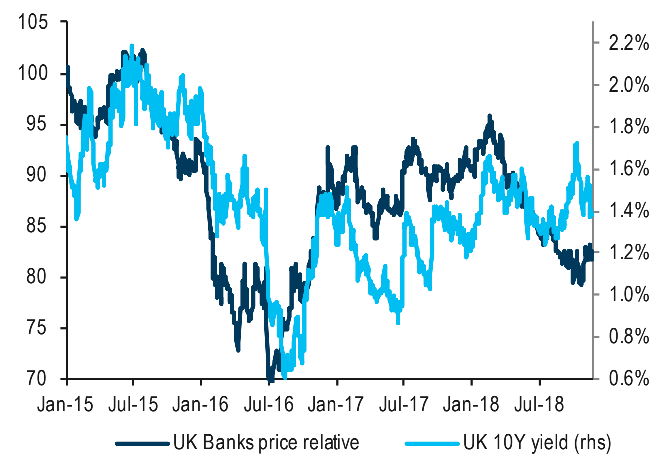


Source: ECB, Barclays Research

We believe however that ECB could announce another TLTRO in December or early 2019, which would be a welcome development for Eurozone Banks as it would ease their funding costs materially. Our economists believe that a new operation should be strictly targeted to deliver new loans to the private sector rather than to bond-investment or carry trades. Importantly, they also believe that a new TLTRO would not prevent the ECB from removing negative rates over the next two years, and could even create better conditions for this. See '*ECB Watching: The case for a new TLTRO*' dated 26 November.

FIGURE 225

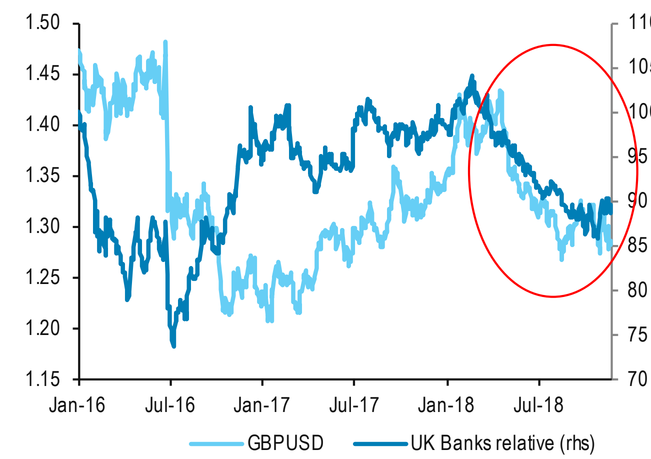
If Brexit is orderly, BOE could hike rates in 2019



Source: Datastream

FIGURE 226

UK Banks have rolled over in tandem with GBP



Source: Datastream

A more constructive view on Banks also looks compelling in the UK, but is highly dependent on an orderly Brexit. Political clarity is indeed needed as the sector could be badly hurt in the case of a no deal or a crash out. On the flipside, we believe that a smooth divorce between the UK and EU would open the door to BOE rate hikes, which would be a strong positive for Banks. We note that UK Banks have rolled over in tandem with GBP in the last few months and could thus rally materially if the Brexit uncertainty were to ease in 2019.

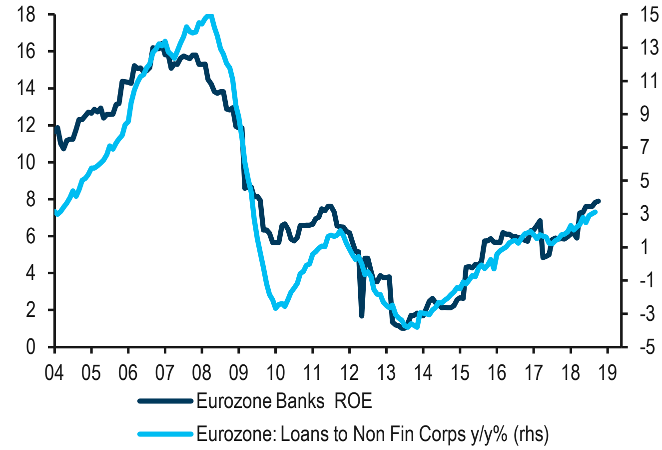
FIGURE 227

European Banks P/Book relative looks attractive…

Source: Datastream

FIGURE 228

…and lending growth keeps tracking which helps ROE

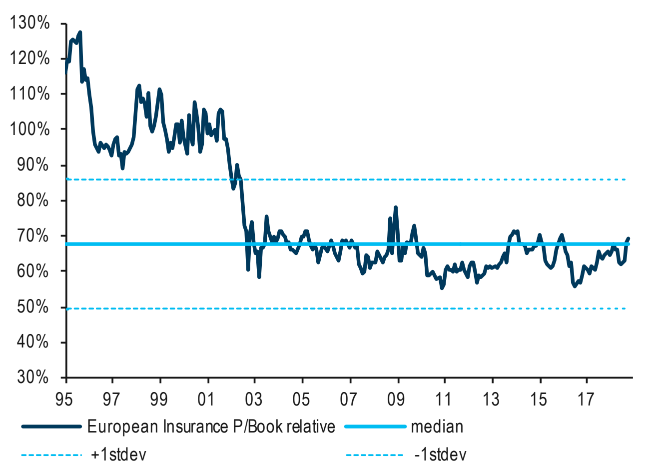


Source: Datastream, Eurostat

Beyond the politics, we find Banks' fundamentals relatively supportive. Our sector analysts believe that the bulk of the regulatory and capital pressure is behind us. We note that lending growth keeps trending higher across the Eurozone, which helps ROE. Valuations are attractive, with both P/B and P/E relative near the bottom of the historical range at present

FIGURE 229

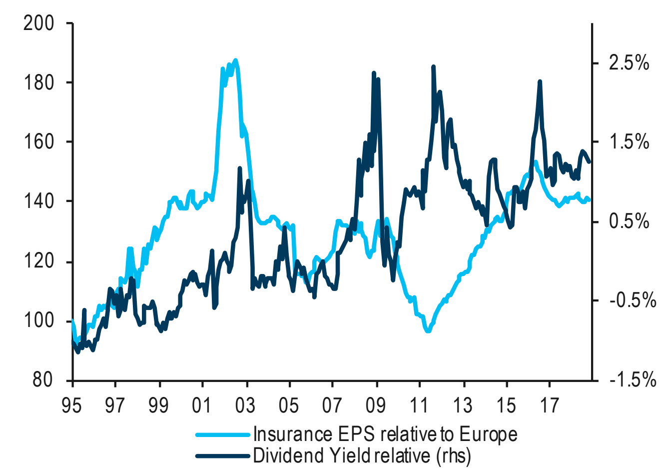
Insurance P/book relative is not demanding



Source: Datastream

FIGURE 230

Insurance dividend yield is backed by strong earnings

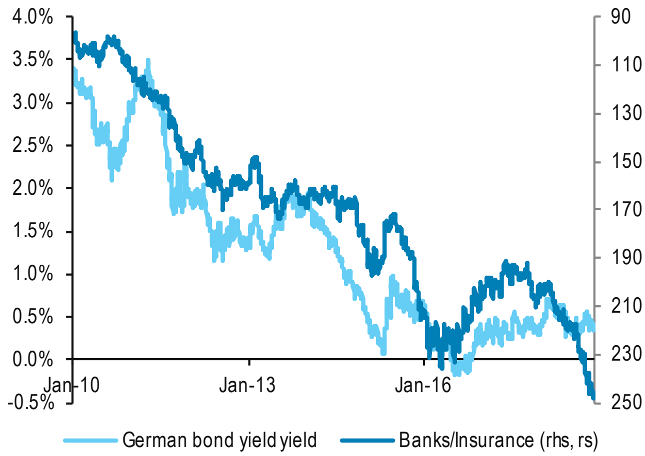


Source: IBES, Datastream

Insurance ranks well on our sector scorecard due to its high dividend yield, cheap valuations and strong EPS momentum. Our sector analysts believe that Insurers' capital position is strong, which gives them room to increase capital return to shareholders through dividends and buybacks.

FIGURE 231

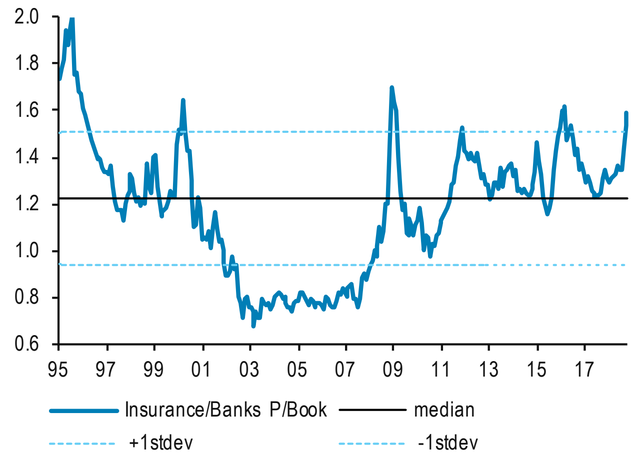
Insurance has benefitted from the flight to quality…



Source: Datastream

FIGURE 232

…and re-rated sharply vs Banks



Source: Datastream

We note however that Insurance has already outperformed Banks a lot as it benefitted from the flight to quality and safety. The relative P/Book between the two is looking stretched at present, but likely reflects the lower earnings and balance sheet risk of Insurance vs Banks.

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Banks – Analysts' view

Sector outlook and key drivers for 2019

Overall the sector faces several uncertainties going into 2019, with macro risks stemming from regional politics, geopolitical tensions and fluctuating rate expectations. We are also seeing more discussion about the role and impact of fintech/new entrants.

Brexit overhang – Political/macro risk is currently weighing on UK banks. And despite asset markets pricing in the increased risk of a no-deal scenario/change of government, we continue to see a central case of a deal being agreed as the most likely outcome (as per Barclays Economics Research). As such we expect a backdrop of slow growth, modest uptick in unemployment and a return to rate hikes, supporting a continuation of current operating conditions for UK banks. In this scenario, we see Lloyds and RBS as particularly cheap, expecting earnings upgrades and scope for significant capital return.

Rates – On our central case, we'd expect the UK to return to its rate hiking cycle in 2019, and see an underappreciated tailwind for domestic banks' net interest margins which we believe should help offset pressures from intense competition (mortgages). However, we note recent Brexit volatility has seen rate hike expectations pushed back.

The Norwegian central bank has started hiking rates and the Riksbank is expected to hike rates in either December 2018 or February 2019. We expect higher rates boost NII for the Swedish banks and for DNB. In Sweden in particular we think the key debate will be around how much of the rate hikes benefits will feed through into earnings and how much will be competed away.

Capital return – We expect the **Nordic banks** to remain high-yielding stocks in 2019, offering an average dividend yield of 7.6%, compared to the European banks sector dividend yield of 6.4%. High RoEs and solid capital positions allow for ongoing elevated payouts – we model total payout ratios of 75-100% in 2019 for the Swedish banks, Nordea and DNB.

We forecast a 10% yield at **ABN AMRO** in 2020 driven by a 90% payout, with our DPS some 16% ahead of consensus. This is aided by the group's rundown of its CIB loan book. Leverage constraints are being addressed by the legal merger of the group's holding company and bank as well as future regulatory forbearance on clearing exposures. With clarity on Basel 4, a bank with such high levels of CET1 (18.6%) should be paying out the majority of its earnings in our view, compared to the 50% payout last year.

We expect **Lloyds/RBS** to return 25-30% of market cap in 3 years. For **Lloyds,** given the slow growth of the bank and mid-teens return on tangible equity we expect to see substantial capital returns with anything over c.14% CET1 being returned to shareholders – for the period 2018-20 we model £7bn of dividends and £5bn of buybacks. For **RBS**, which is also a slow grower with a capital-generative business model, we expect the ordinary dividend to build to 10p by 2020; we also expect directed buybacks of c.£1.5bn/year to facilitate the government exit and for this to be supplemented by special dividends to get the CET1 ratio back towards target.

IB expectations – Within the IB space the key questions are; (i) whether the overall revenue pool will continue to shrink, (ii) will the banks be able to reduce costs and (iii) can the Swiss banks distribute more capital than anticipated.

Bookshelf Reports

ABN AMRO: Please Sir, could we have some more? Initiate at OW - 28% implied upside, 16 Oct 2018

UK Banks: Don't underestimate the rate hike benefit , 06 Sep 2018

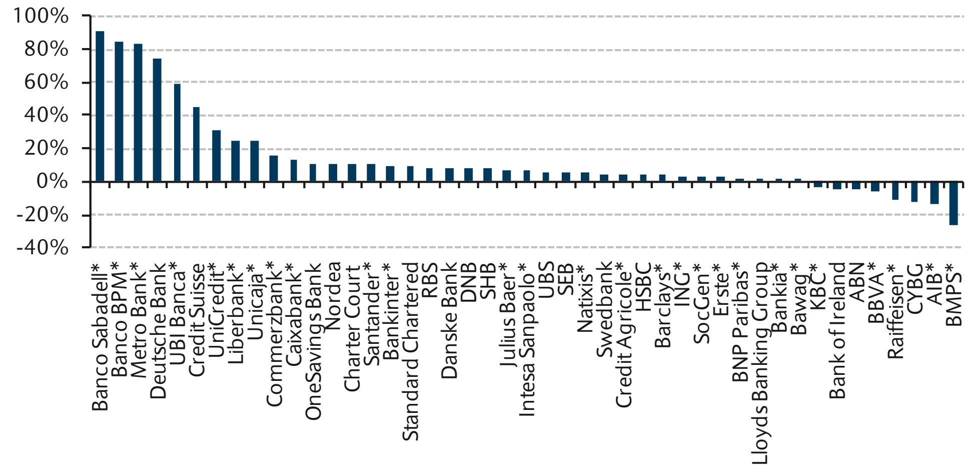
Deutsche Bank: Something Has to Change, But What?, 14 May 2018

Earnings and valuation outlook

The key question for 2019 is whether our and consensus expectations will be 'sticky'. In previous years we have seen earnings expectations downgraded over time, and the concern is that this could happen again. The market's pricing of the banks suggests that it is sceptical, and the key areas of focus for us are; (i) will benefits from higher rates be pushed out (again), (ii) can costs surprise on the positive side, and (iii) will asset quality remain benign.

FIGURE 233

European Banks 2019E EPS growth %

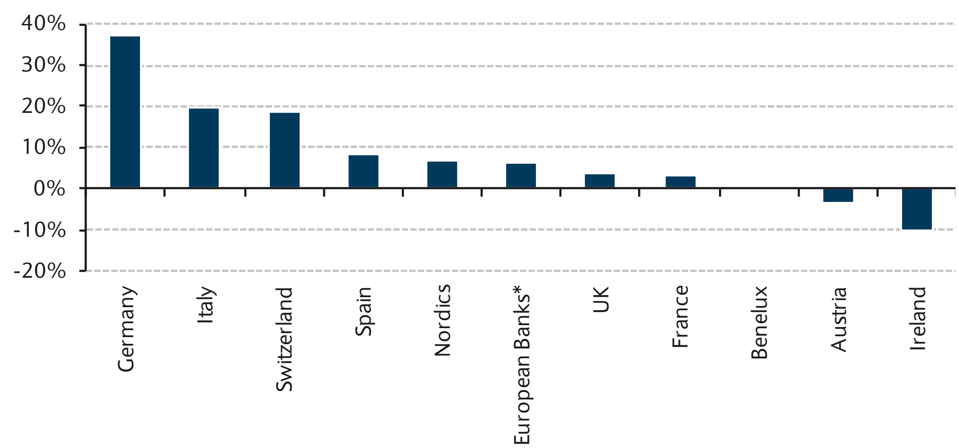


Source: Barclays Research, DataStream

* Not covered by Barclays Research. Data is either consensus or historical and in the public domain

FIGURE 234

European Banks subsectors 2019E EPS growth %



Source: Barclays Research, DataStream, * Figure 1 represents our European Bank universe Data is either consensus or historic or in the public domain

Valuation - Based on our latest valuation data (from 19/11/18) we model c.20% upside on average for each of the companies we cover. This is primarily because we are using lower CoE assumptions in our models than the current market implied CoE.

The market is applying an 11.5% implied CoE on a forward 12 month basis, which we think is relatively high versus historical averages. Typically we use assumptions of 9-10% in our estimates.

Key stock recommendations

Chris Manners

Lloyds (LLOY LN, OW, PT 90p)

We are positive on Lloyds' in the central case for a Brexit deal as we expect net interest margin (NIM) to beat consensus and Lloyds to sustain a c.16% statutory RoTE. This supports strong capital generation and c.30% of market cap being returned to shareholders via dividends and buybacks over 2018-2020. We believe the earnings and capital return outlook is undervalued at current multiples – at 1.1x 2018e TNAV for 16% RoTE, or 6.5x 2020e EPS, a 15% discount to the broader sector.

Our above-consensus call on NIM, is supported by our work suggesting that as UK rates normalise, Lloyds can expand its deposit margin (from lower 'deposit betas'/increasing structural hedge), offsetting pressure from SVR attrition/mortgage competition. We are modestly more positive than consensus on the impairment charge but factor in weak loan growth as Lloyds prioritises margin over volumes. Overall, our 2020 EPS estimates are c.5% ahead of Bloomberg consensus.

We expect a re-rating over time as upgrades provide conviction on the outlook for earnings and returns, and the market starts to pay up for capital distribution as we expect better delivery (and expect Lloyds to announce a £2bn buyback with FY18 results).

Omar Fall

ABN AMRO (ABN NA, OW, PT EUR28.9)

The market under-appreciates the restructuring of ABN's CIB, and the Global Sectors unit in particular (Trade finance, shipping, energy). The €5bn RwA reduction guidance is a good start, but our deep dive shows why ABN should wind it down entirely. It makes little sense that an otherwise domestically focused, simple bank making close to 20% RoE in its core business maintains a non-synergistic division that wipes 5%pts off group returns, particularly when these are mostly not long-tailed assets. Our product-by-product analysis of CIB shows how the short term, self liquidating, trade finance loan book is the main culprit in terms of profitability. We estimate Global Sectors as a whole consumes 16% of group RwA but generates just 5% of earnings, and only when normalized for loan losses.

We calculate close to €25bn RwA inflation under Basel 4 from the Group's corporate exposures, much of that is driven by Global Sectors. We show how under Basel 4, even if the unit doubled net profit, there are few realistic scenarios where it makes a 10% RoE. ABN has no material market share in these segments, while it is the main consumer of tighter USD funding at the group. With the vast majority of the loan book rolling off by 2022, the unit can be wound down relatively quickly at limited cost. We factor a full wind-down into our estimates and forecast a 90% dividend payout in 2020, which is a yield of 10% with DPS 16% ahead of consensus.

Amit Goel

Deutsche Bank (DBK GY, UW, PT EUR8)

Our adjusted PBT estimates are significantly (42%/50% for 2019/20e) below the last company-compiled consensus (from 20/11/2018). The consensus itself has management missing the 2019 profitability target of >4% RoTE, with a 3% adjusted RoTE expectation. The main reason for the difference in estimates is due to a lower revenue growth expectation. We think that the group will continue to lose market share within the CIB business, and we think that it may take longer to see benefits from rising European rates.

We view several of the problems facing Deutsche Bank as structural, and ultimately see the CIB operations being scaled back significantly from here. Please see our report (initiation link) for some scenario analysis.

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Bookshelf Reports

1. European Insurance: Forget Q3 - Investor day bonanza, *19 Oct 2018*
2. European Insurance: New game plan needed?, *7 Sept 2018*

Insurance – Analysts' view

Sector outlook and key drivers for 2019

Insurers have been one of the best performing sectors year-to-date holding flat against the market down 5%. Sector performance has been a function of high dividend yield (5.3%, 140bps premium to the market) and resilient earnings revisions – especially relative to other Financials sectors. We expect this picture of high yield and modestly positive earnings momentum to remain through 2019.

We see further support from robust capital positions with most companies sitting comfortably at the upper end, or even above, their Solvency 2 targets. While we question the extent of (temporary) market benefits to solvency, the sector appears well set to meet market expectations on dividends, as well as capitalise on organic growth opportunities. M&A has emerged as a sector theme and while we expect this to build, we also believe managements will be disciplined around valuations and fit, potentially offering support to the capital return story if opportunities to deploy fail to emerge.

While M&A presents some risk (or opportunity), operational risks are largely market-based given the levered nature of insurer balance sheets and asset-side exposures. Market risks are naturally elevated in more traditionally-focused life insurers, particularly in relation to interest rates and sovereign spread moves, and corporate spread (the latter especially in the UK).

Earnings and valuation outlook

Sector fundamentals are broadly supportive, with stable pricing in P&C and continued reserve releases supporting earnings. On the life side, while the ability to realise gains may continue to erode, headwinds of reinvestment rates are easing, and growth is in the early phase of surprising to the upside. Overall, we forecast modest (i.e. mid-single digit) EPS growth, helped in part by the stable/modestly positive operating picture described above, focus on the cost efficiencies, and capital management activities.

Positioning within the sector

Given recent political/macro movements, sector performance has been driven by more defensive sub-sectors, where strong capital, lower exposure to political risks, and arguably, more "operationally geared" earnings offer support – reinsurers, non-life focused composites, and Dutch life. In the mid term, we expect these trends to remain and continue to see positive trends in reinsurers, while the large composites (which dominate the market capitalisation of the sector) should also increasingly prove a "best of both worlds". UK life remains an attractively valued with overly discounted Brexit concerns. Overall, we maintain a strong quality bias in our Overweight ratings.

Key stock recommendations

Claudia Gaspari

Allianz (ALV GY, OW, PT €225)

Allianz shows, at this stage, a better operating performance than most of its peers. We have seen a clear acceleration in the operating momentum throughout the year: in P&C internal growth rates are accelerating and underlying margins improving; Life flows have stabilised at strong levels and reserves growth is accelerating; Asset management flows (PIMCO in particular) have stabilised after a tough couple of years, margins are under control and operating profit has returned to grow. Allianz also benefits from one of the strongest balance sheets in the European insurance sector making us comfortable that in a market stress scenario it would fare better than most peers. Most markets/LoBs across Europe remain stable and disciplined and we believe Allianz is well positioned to continue in its track record of over-delivering. We recently upgraded Allianz to Overweight with a revised price target of €225.

Ivan Bokhmat

Munich Re (MUV2 GY, OW, PT €214)

Munich Re has continued to deliver a better than expected operating performance despite recent heavy cat losses. Management remains confident there is no risk to the 2020 targets of €2.8bn net profit and we do too, particularly as both L&H Re and ERGO continue to perform ahead of expectations. We believe Munich Re is in a good position to deliver an increased dividend per share and at least a stable €1bn buy-back, offering an 8.3% capital return yield along with excellent visibility and room for improved capital repatriation. Above average large losses in 2018 create additional pressure for reinsurance prices to firm in 2018, percent especially on specialty side which is a growth priority for Munich Re. We have recently increased our 2020-21 EPS estimates by 1-2% to reflect management's confidence that targets will be met. We remain Overweight with a price target of €214.

Alan Devlin, CFA

Prudential (PRU LN, OW, PT GBp 2,163)

Similar to the majority of the other UK names, we believe the outlook for Prudential through the remainder of 2018 and early 2019 will continue to be highly correlated to political risks in Pru's three main geographical regions of the UK, US and Asia. Despite this, we still view Pru as the only large cap growth story due to its leading Asian franchise but note its poor performance so far year to date (down 16%) which now offers historical discounts with the company trading at a FY19 PE multiple of 9.5x versus 12x historically on our 8% CAGR earnings forecast out to 2022. We continue to believe the de-merger will unlock value for shareholders by increasing their exposure to the Asian franchise and as a such have a price target of GBp 2,163 which now sits modestly below our SOTP upside valuation due to currently depressed sector multiples.

INFORMATION TECHNOLOGY

Strategy Rating – Underweight

FIGURE 235

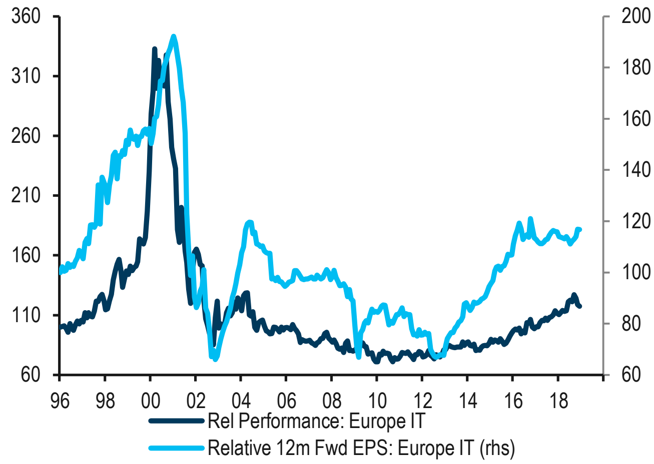
MSCI Europe Information Technology sector snapshot

	Absolute Perf.	EPS growth		Fwd PE	P/B	DY	Sector rating
	YTD	2018E	2019E	Latest	Latest	2019E	
Tech	**-5%**	**5.2%**	**17.9%**	**18.1**	**3.5**	**1.6%**	**UW**
S/W Services	-5%	3.9%	12.4%	19.7	4.3	1.5%	UW
Tech H/W	21%	-12.1%	41.9%	18.7	2.3	2.3%	MW
Semiconductors	-15%	16.7%	16.3%	15.5	3.3	1.1%	UW

Source: Barclays Research, IBES, Datastream

FIGURE 236

MSCI Europe Technology relative performance and earnings

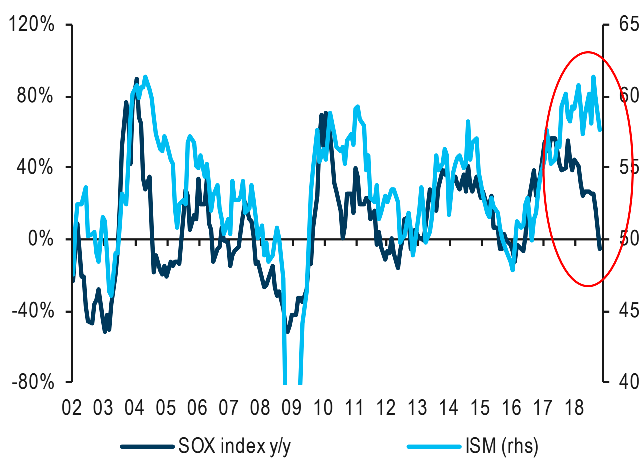


Source: MSCI, DataStream, Barclays Research

We have a small UW on Tech. We believe that its secular growth story remains intact but the sector had a very strong run in the last few years and held up relatively well ytd. Tariffs threat has been a drag on sentiment, but a potential deal at the G20 meeting could be a relief. However, the semis cycle has turned and we believe that businesses could become more cautious on tech spending next year as profits growth slows.

FIGURE 237

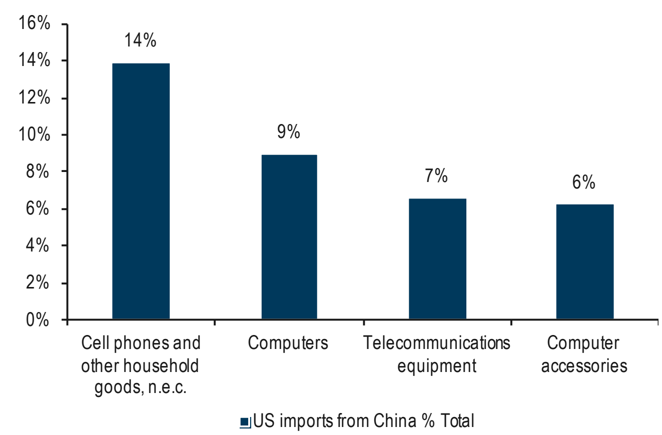
SOX has rolled-over despite the resilient ISM



Source: Bloomberg

FIGURE 238

The trade war between US and China is a risk for Tech – potential easing of tensions at the G20 could be a positive

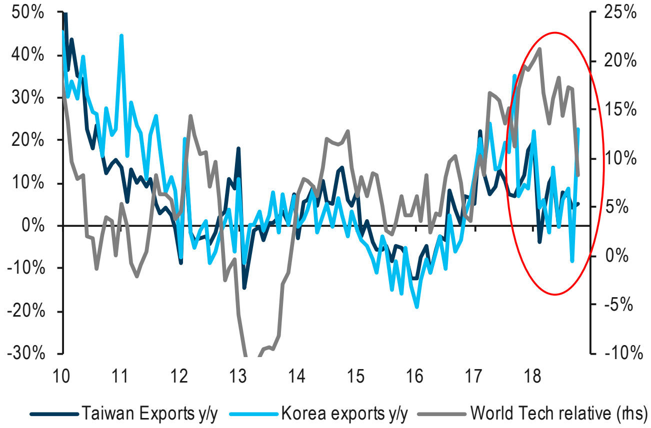


Source: Census

Semis have sold-off aggressively in the last few months even though US activity held up well. A potential resolution of the trade war between US and China would be a key positive for sentiment, but concerns about slowing growth in key end markets such as consumer devices, automotive and industrial are likely to continue in Q1.

FIGURE 239

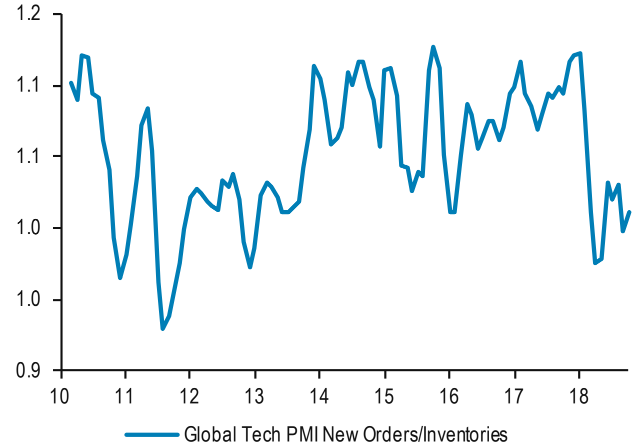
Taiwanese Tech exports remain soft, but Korean exports have rebounded most recently…



Source: Bloomberg

FIGURE 240

…but Tech PMI new orders to inventories ratio has fallen sharply

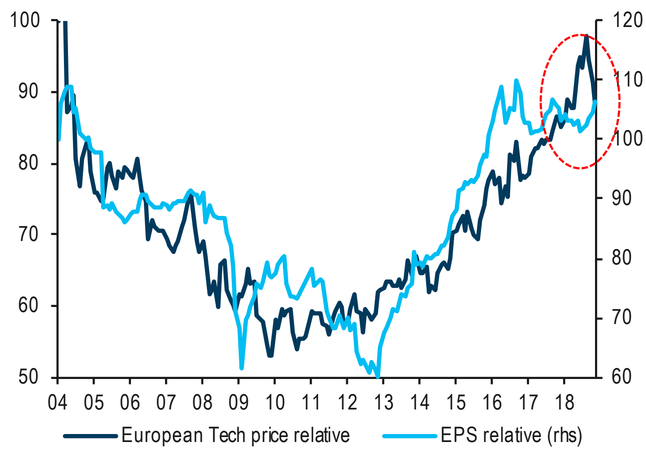


Source: Markit, Bloomberg

Asia Tech exports rolled over sharply in the last few months but appear to have stabilised most recently. We believe that it could be due to businesses front running the scheduled tariffs increase in January. However, the new orders to inventories ratio has fallen significantly ytd, which still calls for caution.

FIGURE 241

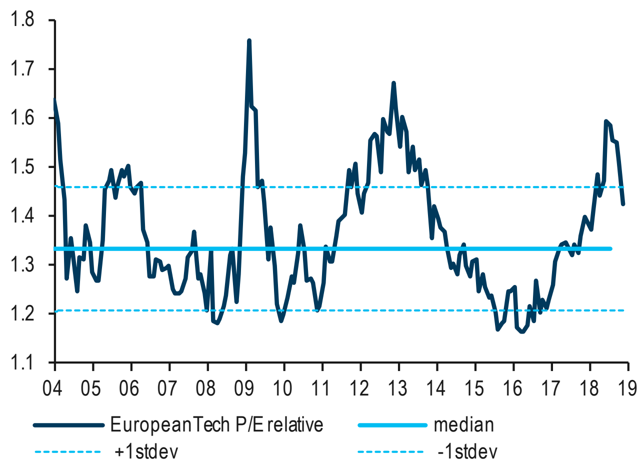
European Tech price momentum has closed the gap with EPS momentum



Source: Datastream, IBES

FIGURE 242

Tech valuations have improved but earnings estimates look too optimistic for 2019



Source: Datastream, IBES

Last July in our initiation report we flagged that the relative price and EPS momentum of the European Tech sector had decoupled, which we saw as a red flag. We note that following the recent sell-off in share prices, the gap between the two has closed. As a result, P/E de-rated, but it still remains stretched in the historical context. We find IBES estimates of 18% EPS growth rate for the sector in 2019 too optimistic and see potential for downgrades, which is unlikely to provide support to valuations.

Software, Services and Payments – Analysts' view

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Sector outlook and key drivers for 2019

2018 was a record year for IT growth and Gartner estimates that global IT spend increased 6.2% y/y to $3.8trn. This has been reflected by the companies under coverage and we calculate an organic 2018 revenue growth of 6.8% among software names and 6.4% for IT services. Based on this data, it would imply that IT is expanding at 1.4 times global GDP growth. This is higher than we experienced in prior years (1.1x in 2017) and this relates to the higher discretionary spend around the digital enterprise. Payments has continued to see strong secular growth with 7.3% organic in 2018.

With global and European GDP estimates being tempered for 2019-'20 it is likely that it will have some negative effect on IT spend. If we were to use the more traditional multiplier (1.1x), this would result in global IT growth slowing to a 4-5% range. This is still a very healthy level and most management teams should be able to match this with an OpEx moderation to limit EPS impact, as we discuss below, at least in 2019.

IT budgets are set during the November to January period and we suspect that digitalisation will remain top of the agenda. This should help the application software vendors and also the IT service companies which can act as change agents through this transition. This will require strong vertical and domain expertise and we suspect that IT services will need to continue to invest in IP and strategic/business consulting. However, with some tightening of the budget, companies will have to find ways to fund this innovation and thus need to reduce the total cost of ownership of the maintenance IT. This can be done by rationalising the technology stack with the transition to third-party applications and infrastructure (cloud).

Certain verticals, like government and financial services, have long resisted the above trend, but with competition from digital vendors and cost pressure, they will be forced to accelerate this adoption. Europe has been lagging the cloud trend, but the aforementioned factors mean that cloud is now increasingly being adopted and there has been a noticeable step-up of this during 2H18. During the transition there is a clear need for integration and orchestration between cloud and legacy (on-premise) solutions, but it is clear that over time the need for these services will be reduced.

Payments is a more visible and predictable sector and we expect the ongoing share gain of technology-led vendors, at the expense of the bank-led incumbents. There is an ongoing shift to digital channels, online commerce and integration of payments. Ultimately this will result in invisible consumer payments and only the leading technology vendors will be able to facilitate this. To the extent that consumer spending slows, the payment names will clearly be impacted; however, this is a proportionate impact and can be managed, very different from the potential licence volatility that can impact the traditional software model.

Bookshelf Reports

manufacturingTech primer vol:1: Age of hyperconnectivity and automation, 22/10/18

Fintech & Payments primer vol. 13: Sleepwalking into 3DS2.0 and PSD2, 12/11/18

Fintech & Payments primer vol.12: Invisible payments pressuring incumbents, 18/7/18

Earnings and valuation outlook

So far in 2018, our European software, services and payment stocks have seen negative earnings momentum (-5.4%). The software names, as one might expect, have seen significant variability, but at the median have seen modest improvement (+0.9%) to FY18E EPS. Services and payments have been softer, with negative revisions of -4.7% and -5.6% respectively. On the payment side especially, downgrades have typically been company-specific (but significant when they have happened), while the high-growth, online payment vendors continue to see upgrades.

The impact of upcoming tariffs is unclear on the sector, although large-cap tech has fully global exposure, including to emerging markets. So far vendors are not reporting slowing in key areas such as China, although there is clearly some risk here. While partly mitigated through USD pricing, these vendors will also not be immune to any weakening EM currency, as their products are becoming relatively more expensive locally. As we note above, while we are conscious of some global softening in data, we see this subsector as late cyclical and therefore expect any impact to be felt more in 2020. We therefore remain reasonably optimistic on software earnings for 2019, forecasting 12% growth. We see a similar level of earnings growth in payments, and perceive this to have a higher level of predictability.

In terms of valuation, the premium to the market for payments and software came down from the highs achieved earlier this year, 73% for SW and 102% for payments, to 38% and 64% respectively, but remain above the historical averages since 2013 of 37% and 51%. The valuation premium of services also declined this year from a high of 30% to a discount of -8% vs. an average discount historically of -2%. We have increasingly shifted our ratings towards favouring more value-focused investment ideas and expect the valuation differential between growth and value names to continue to reverse into next year.

Key stock recommendations

Temenos (TEMN SW, Underweight, CHF120 PT)

Temenos has a market-leading product and is exposed to an attractive longer-term secular theme in the form of the requirement of banks to update their age old legacy IT infrastructure. However, when we consider some of the above risks to the economic outlook, and pair this with a consideration of the most highly valued stocks in the sector, Temenos strikes us as considerably at risk. With increasingly tough comps, and some of the larger contracts rolling off in 2019, licence growth will become tougher. Further upside in the stock will have to come from success in the US and whilst it has won some deals this has been slower than anticipated. We therefore see limited room for the upgrades that we feel are needed to make the stock work. At the current valuation, Temenos appears priced for perfection, and whilst we like the team and upgrade cycle as banks are digitalising, we find the valuation too rich for a company with highly cyclical revenues – we therefore reiterate our UW and CHF120 price target.

Avast (AVST LN, Overweight, GBP3.50 PT)

We think Avast is an interesting midcap idea for those investors specifically looking for defensive, low-valuation stock ideas into 2019. Avast is the global leader in consumer security by users and, with its freemium model, has been a significant market disrupter; it has taken material share from industry incumbents in recent years. We forecast revenues to grow organically by ~7% to FY20, despite this being one of the cheapest stocks in our coverage. We see the stock as having limited exposure to macro risks, it has very high visibility and cash conversion, and has very broad geographic exposure. We therefore reiterate Overweight with our GBP3.50 PT based on 15x 2020E EV/NOPAT.

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Technology Hardware – Analysts' view

Sector outlook and key drivers for 2019

The European Technology Hardware sector's share performance in 2018 is quite clearly a case of two sub-sectors, the significant rebound in Telecom Equipment led by early 5G adoption in stark contrast to the collapse in confidence in Semiconductors. We expect these trends to sustain into at least 1H19, if not the year as a whole depending on the influence of macroeconomic factors.

The Telecom Equipment group of Ericsson, Nokia and Spirent have performed well in 2018, each up double digits. Revenue growth has returned for the first time in a number of years which combined with restructuring and cost discipline, leads to expectations of meaningful earnings growth in 2019 and 2020. The return to growth is driven by the early stage of 5G deployments, initially in 2H18 in the U.S. and, we expect, Japan and South Korea to start meaningful investment in 1H19, China and Nordics in 2H19, followed by developed Europe in 2020. While not dramatic, we do expect low-single digit revenue growth for this segment over the next few years, a clear contrast to the declines we have seen since 2014 when 4G investment peaked. Given the defensive nature of their telecom operator customers and the strategic imperative of 5G deployments, we see more limited macroeconomic impact to this half of our coverage. Even the trade war is of limited concern as we view Ericsson and Nokia as neutral, non-U.S., non-China parties who have already shifted most of their production to neutral sites.

Semiconductor shares, on the other hand, are facing significant macro fear. Structural growth in semiconductors, from the cloud to personal devices to cars and industry broadly, is a clear multi-year – even decade – trend. However, in the near term, we expect the issues of slowing global growth and a trade war to continue to affect the chip companies, to a lesser extent in terms of revenue and a greater extent share price. We are already seeing signs of slowing growth in consumer devices, (e.g. Android and Apple unit volumes under pressure), automotive (e.g. China units down, WLTP testing in Europe, U.S. low growth) and industrial (e.g. talk of slowing orders and inventory digestion). These issues have been key factors for investors during 2H18 and we expect will continue to be so in 1H19, resulting in a consistent near-term overhand. A key potential catalyst for the semiconductor names would be a resolution, partial or entire, of the trade war. The longer the fear of a trade war and increasing tariffs carries on, the longer the overhang on chip stocks.

Bookshelf Reports

Snow White's Apple – taking stock of the Apple supply chain

Compound Semiconductors – harder than it sounds

5G – A new dawn

Earnings and valuation outlook

As a result of the aforementioned drivers, we forecast faster earnings growth for the telecom equipment companies than we do for semiconductors, a number of which we have recently cut expectations to below the level guided to by company management. We forecast strong double-digit growth in earnings, over 30% p.a., for both Ericsson and Nokia in 2019 and 2020. By contrast, for the major semiconductor vendors of Infineon and STMicro, we now forecast high-single digit to low-double digit growth.

We think some of this disparity in outlook is already reflected in valuations, although continue to be selective within the sub-groups. Ericsson and Nokia trade on 12x/9x and 9x/7x 2019/20 EV/EBIT. Infineon and STMicro trade on 12x/10x and 8x/6x, respectively. In this way, we argue Ericsson trades at a material premium to Nokia and Infineon at a similar one to STMicro; in both cases, they are exposed to comparable sub-sector trends, hence our preference for the latter stocks in both pairings.

Key stock recommendations

Andrew M. Gardiner, CFA

ASML Holding NV (ASML NA, Overweight, EUR210 PT)

Visibility into ASML's 2020 outlook has increased materially over the past two years, with the market now looking beyond to 2025. Technical progress on EUV has continued, resulting in material commitments by lead customers to the new chip-making platform, which are likely to leave ASML capacity-constrained in the 2019/20 timeframe, with demand outstripping tool supply. Chipmakers are naturally thinking even further forward, with conversations shifting beyond their 7/5nm commitments to 3nm and below, which moves the discussion to EUV High NA, the next-generation tool. High NA has been on the map for c2025, but ASML's three lead customers have now committed to accelerating this timeline by placing orders and making deposits. These commitments help to bring the next stage of ASML's growth into view. With revenue likely to grow towards EUR22-25bn in 2025 on our estimates, we continue to see upside to Datastream consensus expectations, albeit now more beyond 2020 than in the next couple of years. While ASML may carry a premium multiple near-term, we argue that, on a 2020E P/E of 14x with double-digit growth continuing into the next decade, the shares remain very attractive.

Infineon Technologies AG (IFX GR, Underweight, EUR18.50 PT)

Infineon's outlook for the coming quarter and year demonstrate the strength of its positioning for long-term structural growth, while also highlighting the cost of such trends. It appears set to grow at double-digit rates in the coming year, while acknowledging slower global growth and softer orders in certain verticals. Despite consistently strong sales, however, Infineon is seeing limited operating leverage given high opex and capex investment to support such growth. We downgraded Infineon to Underweight in early July (see *Limited gearing exacerbated by autos*, 2 July 2018) given concern over the 1) near-term cycle and 2) long-term operating leverage. So far, Infineon is offsetting the cycle concerns, but the lack of margin expansion is stark given 11% growth guided for in FY19 but with flat margins. Infineon is investing heavily to deliver such growth (11-12% of sales in R&D, 20% in capex in FY19), which we think sensible for the long term, but it mathematically holds back margins in the near to medium term. We forecast 18-19% operating margins for FY19-21 and our operating income forecasts are unchanged. Infineon trades on 2.1x/1.9x 2019/20e EV/sales, 12x/10x EV/EBIT and 15x/14x P/E multiples that have compressed recently but that we think still call for margins of c20% and also remain at a premium to European peer STMicro on 8x/6x EBIT and 10x/9x P/E.

Nokia (NOKIA FH, Overweight, EUR5.50 PT)

Nokia's recent results and reiterated 2018/20 guidance demonstrate the company's execution and its confidence in steadily moving back to growth, to a limited extent at the top line and in a more meaningful way at the bottom line. We view its consistent 2018 guidance as a clear message of strong sequential trends in Networks sales and margins in 4Q, which we expect to provide a good starting point for next year given continued 5G deployments. We continue to find Nokia's 2020 guidance as credible, bolstered by the new cost cutting plan. Management's recent commentary demonstrates their focus and the efforts being made to drive such margin expansion in what remains a highly competitive industry. We argue current valuation of 14x/12x 2019/20 P/E for 34% EPS CAGR 18-20 is very attractive.

TELECOMS

Strategy Rating – Overweight

FIGURE 243

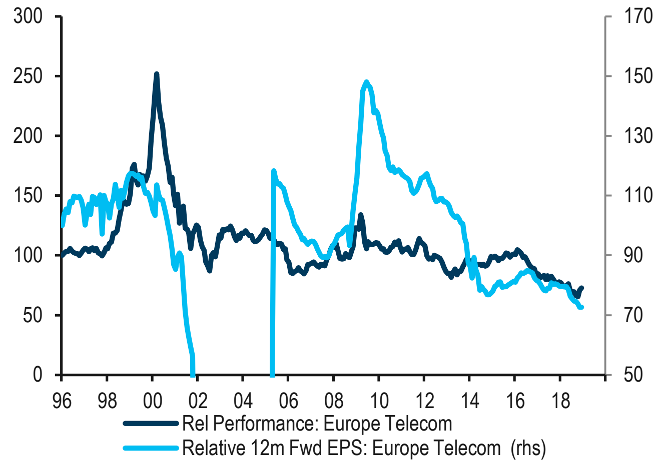
MSCI Europe Telecoms sector snapshot

	Absolute Perf.	EPS growth		Fwd PE	P/B	DY	Sector rating
	YTD	2018E	2019E	Latest	Latest	2019E	
T/Cm Svs	-12%	-9.5%	8.0%	13.2	1.4	5.6%	OW

Source: Barclays Research, IBES, Datastream

FIGURE 244

MSCI Europe Telecoms relative performance and earnings

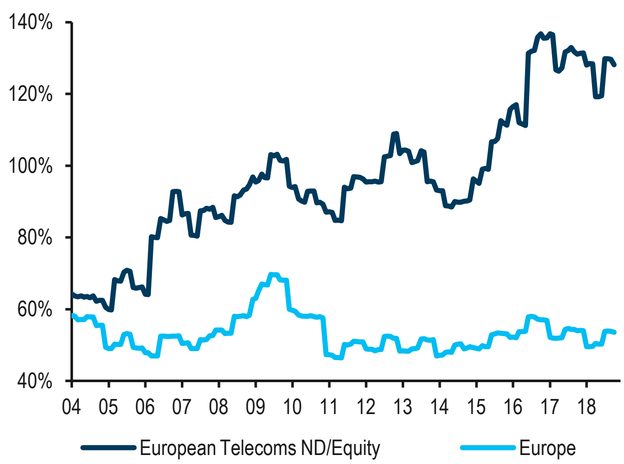


Source: MSCI, DataStream, Barclays Research

We initiated on European Equity Strategy with an UW stance on Telecom but are double upgrading it to OW for 2019, which makes it our preferred defensive play. The sector's fundamentals remain challenging, but a lot appears to be in the price already and recent newsflow on consolidation in Europe, if confirmed, could open the door to more restructuring and M&A within the sector, in our view.

FIGURE 245

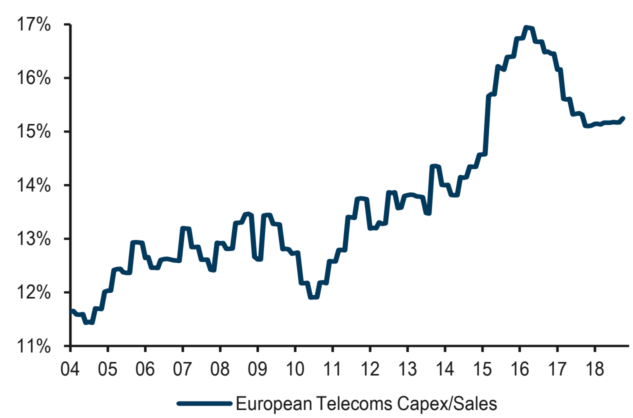
Telecoms balance sheet leverage has increased a lot...



Source: Worldscope

FIGURE 246

...as capex growth is not showing signs of abating

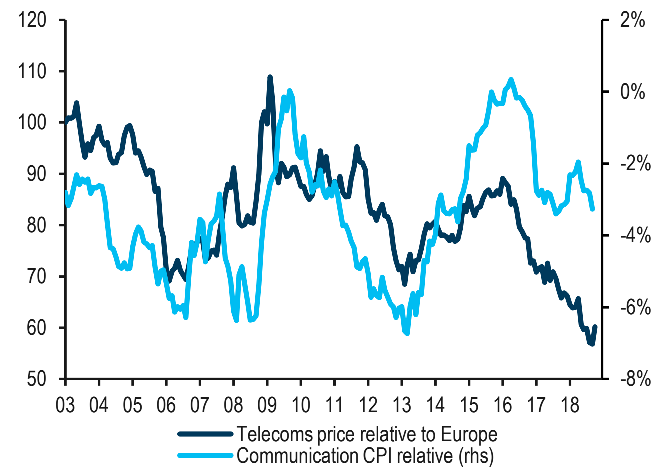


Source: Worldscope

We believe the mix of structural decline in mobile revenues and rising capex remains problematic for cash flows and dividends. The sector has significantly re-leveraged balance sheet over the last few years, not only to finance capex, but also to maintain dividends, which we think is not sustainable. This could be a problem if financing costs move higher and profitability remains under pressure. However, the recent news about the European Commission turning potentially more supportive of M&A could be a game changer and open the door to restructuring and consolidation within the sector. See '*EC reportedly clears T-Mobile/Tele2 NL merger*' dated 26 November.

FIGURE 247

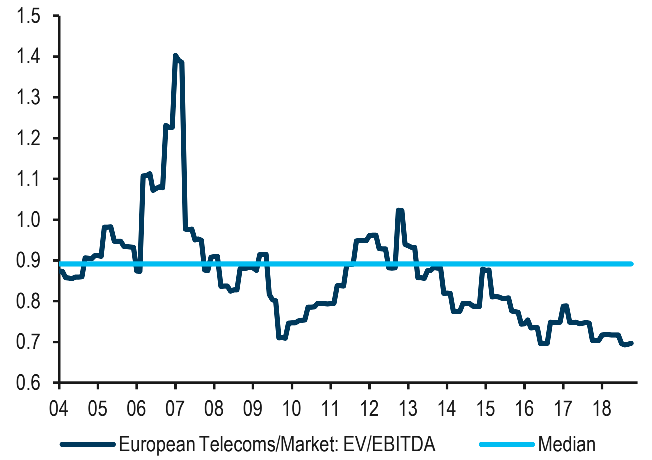
Pricing remains weak for Telecom sector



Source: Eurostat, Datastream

FIGURE 248

Valuations are depressed – consolidation could be a catalyst for a re-rating

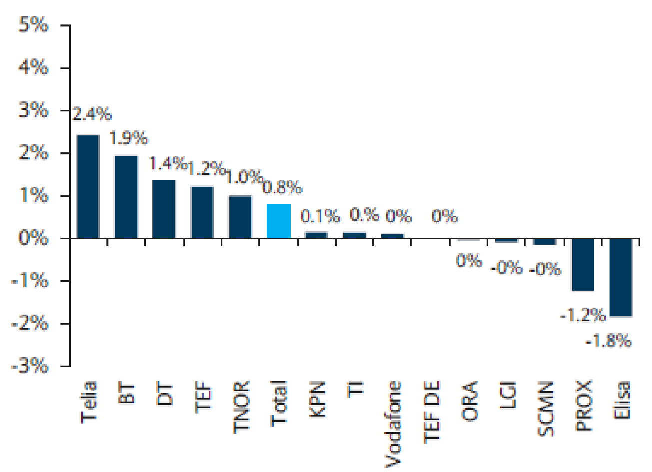


Source: Worldscope

Indeed, amid intense competition, Telecom pricing has been on a steady downtrend in Europe over the last few years, which has been a key drag on the sector's profitability. If the long awaited four to three consolidation were to become more likely, this could help improving the pricing trends within the sector. We note that Telecom's valuations are particularly depressed at the moment and appear to be pricing in little potential for good news.

FIGURE 249

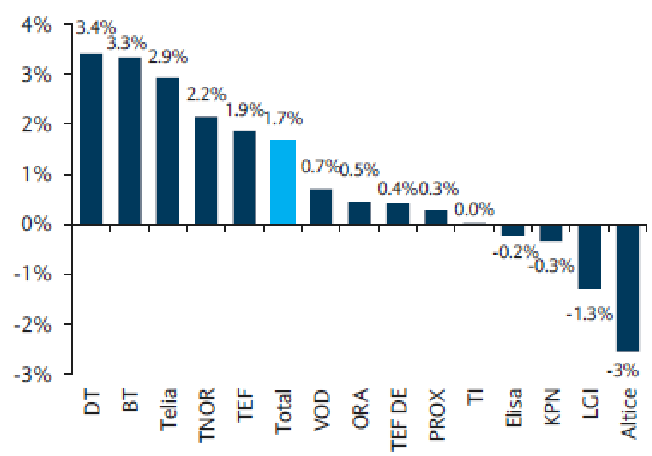
3Q18 total revenue % beat/miss vs. consensus*



Source: Source: Company data, Barclays Research, * Adjusted for one-offs. **All consensus data from companies

FIGURE 250

3Q18 total EBITDA*% beat/miss vs. consensus



Source: Company data, Barclays Research, * Adjusted for one-offs. **All consensus data from companies

Our Telecom analysts note that a majority of Q3 results came in ahead of consensus expectations and did not lead to downgrades to 2018 and 2019 estimates. Against this backdrop, we find current IBES estimates of mid-single digit EPS growth for the sector next year not particularly demanding and likely safer than for the overall market. See '*European Telecom Services – 3Q beat, guidance increases yet estimates unchanged*' dated 26 November.

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Telecom Services – Analysts' view

Sector outlook and key drivers for 2019

After a deterioration in operating trends in 2018 vs 2017, we expect no material recovery in 2019. In European mobile, competition at the low to mid point of the market should continue to offset 'more for more' data monetisation strategies at the higher end. In fixed, fibre upselling should remain supportive but legacy products in residential and B2B remain a drag. Also new entrants are investing in fixed infrastructure (Italy, UK) and should put pressure on the wholesale business of incumbents. We expect flattish revenues yoy in 2019. On the positive we expect continued digitalisation driven cost cutting initiatives to enable cost reduction and as a result low single digit growth in EBITDA. This should translate to mid single digit OpFCF growth as capex is already high (17% of sales) and should remain stable.

The sector operating trends remains largely insulated from the macro environment: volumes are growing strongly (+50% in mobile data). That is mostly offset by price reductions, driven by the competitive environment which is a function of market structure rather than macro economic trends. The sector is relatively geared (2.3x Net Debt to EBITDA) and given high expected spectrum expenses in 2019, important cash returns (50% pay out of FCF) and low EBITDA growth we see no deleveraging and risks of dividend cuts for a number of companies (BT, VOD, Telia). Potentially rising costs of debt would put additional stress on cash return policies and we note Telecoms tend to underperform in an environment of rising interest rates.

The main catalysts ahead are: **1/M&A:** We expect a decision on the VOD/Liberty Global deal in Germany (approval) and the TMUS/Sprint deal in the US (DTE exposed, uncertain). Other deals could materialise in France (long-awaited four-to-three consolidation) and Switzerland. **2/Change in regulator's priorities?** With European elections in May 2019, a new EC will be appointed. We could see a change in focus from a pro-consumer to a pro-investment bias, something we had hoped for under the current EC but that did not materialise. This could lead to a more constructive approach regarding four-to-three in market consolidation in Spain, UK or Italy. This remains entirely speculative at this juncture. **3/Spectrum auctions:** A number of important spectrum auctions will take place in 2019 notably in Germany, the UK and Spain and NL. Downside risks are a higher cost than forecasted and the entry of a new competitor that could disrupt market dynamics (Germany). **4/Further details on 5G roll-out plans** should be disclosed with a risk of potential capex upswing in future years (we expect flat capex).

Earnings and valuation outlook

We expect flattish revenues yoy in 2019, low single digit EBITDA growth and mid single digit OpFCF growth. This should lead to a high single digit Equity FCF although we note that over the past two years estimates for the year ahead have proved too optimistic. The sector trades on a 2019e EV/EBITDA of 6.1x for incumbents and 7.6x for challengers/cable, EV/OpFCF of respectively 12x and 14.6x, EFCF yield of respectively 8% and 6% and DY of respectively 5.8% and 4.8%. In our view this prices in expectations of flat revenue trends.

Positioning within the sector

Within incumbents we prefer OW-rated Orange (defensive nature and exposure to potential in-market consolidation in France), KPN (market repair in 2019, low leverage) and Telenor (high growth, attractive valuation). For challengers/cable we highlight Telefonica Deutschland (our expected recovery is not priced in by market), Masmovil (growth) and Drillisch – all rated OW.

Bookshelf Reports

European Telecoms : Addicted to Dividends (the return) – 17 Oct 2018

European Telecoms: Life after the 5G spectrum storm – 4 Oct 2018

European Telecoms: Make up or Break up – 23 Aug 2018

Key stock recommendations

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Telia (Telia SS, UW, SEK38 PT)

Telia is the incumbent operator in Sweden. It also has assets across Scandinavia and the Baltics as it seeks to become the leading Scandinavian and Baltic converged operator. It is currently in the process of exiting legacy markets in Eurasia (Kazakhstan, Uzbekistan, Moldova). Telia has recently acquired Get the Norwegian cable operator and is in the process of acquiring the Swedish broadcaster Bonnier to improve its competitive positioning further but this does bring execution risk with valuation, in our view, leaving little room for error. We also anticipate increasing competitive pressure in Telia's home market following the Tele2/Com Hem merger. Key catalysts are Q4 results (including 2019 guidance) and the final decision on the Bonnier acquisition.

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KPN (KPN NA, OW, €3.0 PT)

KPN is the incumbent operator in the Netherlands with leading positions in mobile and fixed. Unlike most peers, the company has no presence outside its home country. We believe KPN is currently unique among EU telecoms by virtue of its material upcoming supportive catalysts: 1) the CMD on 28 November should provide reassurance on mid-term capex despite a renewed FTTH build programme, 2) management is likely to reconfirm its shareholder returns priorities, and 3) the conclusion of the Tele2/T-Mobile EC merger process at the end of November should deliver long hoped-for market repair regardless of the deal outcome. KPN also screens as attractive vs. incumbent peers in terms of dividend risk. Even with cash tax normalization in 2021E only ORA and Nordic operators exhibit a lower dividend risk than KPN across the EU incumbents, in our view.

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Masmovil (MAS SM, OW, €150 PT)

Masmovil is the de facto fourth player in the converged Spanish market. It has gained scale through the acquisition of Yoigo (the fourth mobile operator) as well as fixed broadband remedies following the acquisition of Jazztel by Orange and its own fibre rollout. This has given it owner economics in both fixed and mobile allowing Masmovil to compete with the big three converged operators (TEF/VOD/ORA) by offering simple mobile, fixed and converged tariffs – typically at a discount to peers. We like Masmovil as we believe it can continue to take share in the fixed broadband market as it wins new customers and cross-sells to its significantly larger mobile base (Masmovil has ca900k broadband customers and ca6m mobile customers). Small bolt-on acquisitions such as the recent Lebara acquisition are another route to drive further growth. FY18 results will provide the next catalyst where we expect the company to unveil new improved mid-term guidance. Monthly portability data should show continued strong momentum in the Spanish market.

UTILITIES

Strategy Rating – Underweight

FIGURE 251

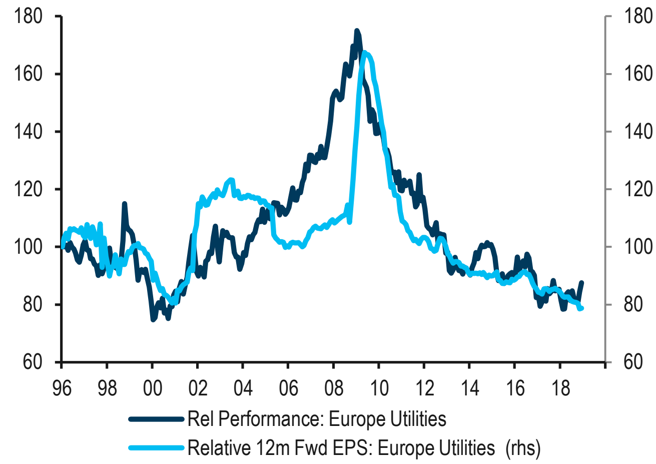
MSCI Europe Utilities sector snapshot

	Absolute Perf.	EPS growth		Fwd PE	P/B	DY	Sector rating
	YTD	2018E	2019E	Latest	Latest	2019E	
Utilities	**-1%**	**-0.2%**	**5.6%**	**13.3**	**1.5**	**5.1%**	**UW**

Source: Barclays Research, IBES, Datastream

FIGURE 252

MSCI Europe Utilities relative performance and earnings

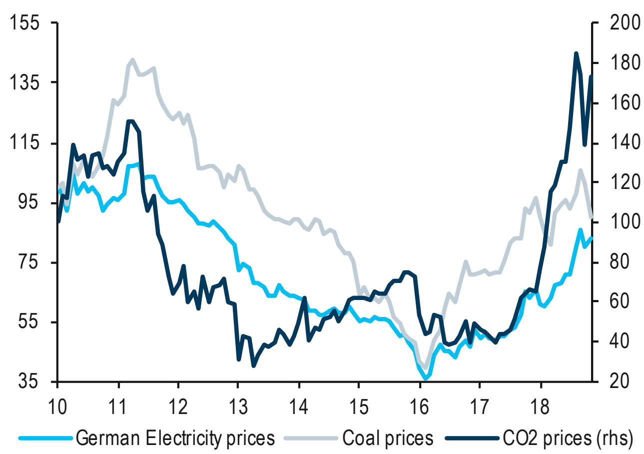


Source: MSCI, Datastream, Barclays Research

We are UW Utilities with a relative preference for non-regulated names, which benefit from rising power & CO2 prices, and offer restructuring as well as consolidation potential. We believe that the provisioning for nuclear clean-up is largely covered in Germany, which should help the earnings of the two major players to stabilise. However, we continue to find the overall sector structurally challenged by its heavy balance sheets, poor capital discipline and limited top-line growth opportunities.

FIGURE 253

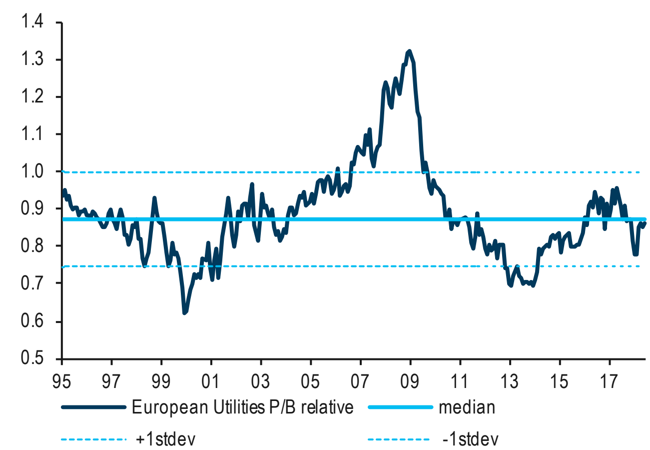
Power and CO2 prices are rebounding in Europe



Source: Bloomberg, re-based to 100 in Jan-10

FIGURE 254

Utilities P/E relative is in line with the long term median

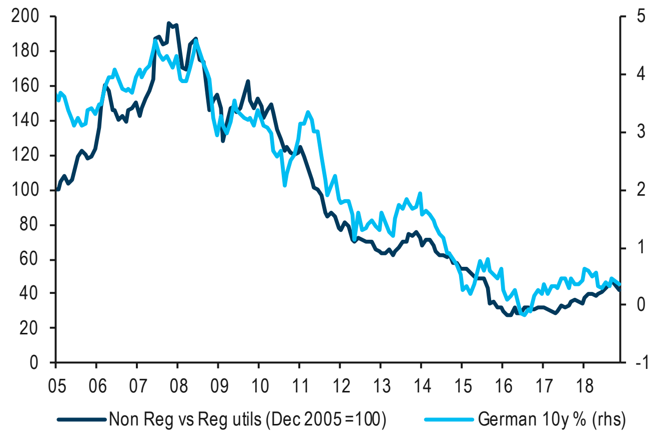


Source: Datastream, IBES

Our Energy analysts expect CO2 prices to keep rising due to reduced allocation quotas. On the flipside, coal prices could be vulnerable over the medium term due to the shift towards low-carbon and reliable energy. For the time being, we believe that current consensus estimates of 2% EPS growth for the sector in 2019 offer limited downside, in relative terms. However, Utilities' valuations are not depressed and the sector is trading back in line with its historical median on P/E and P/B relative metrics following ytd re-rating.

FIGURE 255

Regulated Utilities behave like bond proxies…



Source: Bloomberg, Barclays Research

FIGURE 256

…and remain more expensive than non-regulated ones

Source: Bloomberg, Barclays Research

Regulated Utilities, which are mainly UK-based, have outperformed non-regulated ones over the last few years as bond yields rolled-over. Most recently, political uncertainty in the UK and in Italy has hurt the sector though. For 2019, our fixed income strategists do not expect bond yields to rise much, which should be a relative positive for Utilities. However, if our base case of an orderly Brexit materialises, potentially higher BOE rates could be a negative for the UK names.

REAL ESTATE

Strategy Rating – Marketweight

FIGURE 257

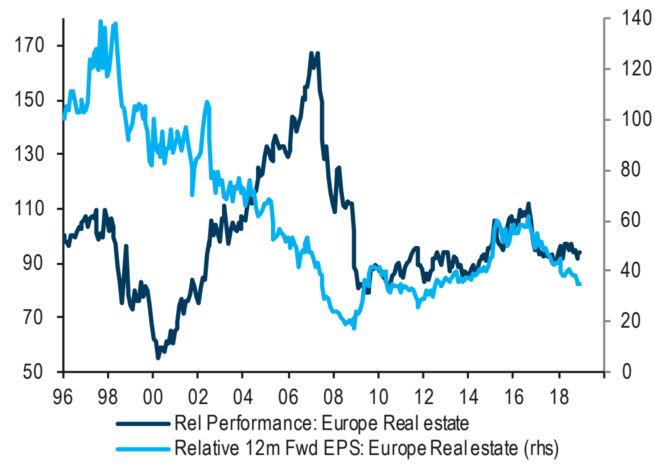
MSCI Europe Real Estate sector snaphot

	Absolute Perf.	EPS growth		Fwd PE	P/B	DY	Sector rating
	YTD	2018E	2019E	Latest	Latest	2019E	
Real Estate	**-10%**	**7.3%**	**6.0%**	**16.7**	**0.9**	**4.8%**	**MW**

Source: Barclays Research, IBES, Datastream

FIGURE 258

MSCI Europe Real Estate relative performance and earnings



Source: MSCI, DataStream, Barclays Research

We are MW on Real Estate. Stable bond yields should provide a floor to the sector in the near term, but fundamentals are not exciting. Asset and rental growth have been very strong in the last few years on the continent, but are now stabilising. The structural challenges faced by retailers are not going away and Brexit uncertainty remains a drag for the UK names, even though a lot appears to be in the price already.

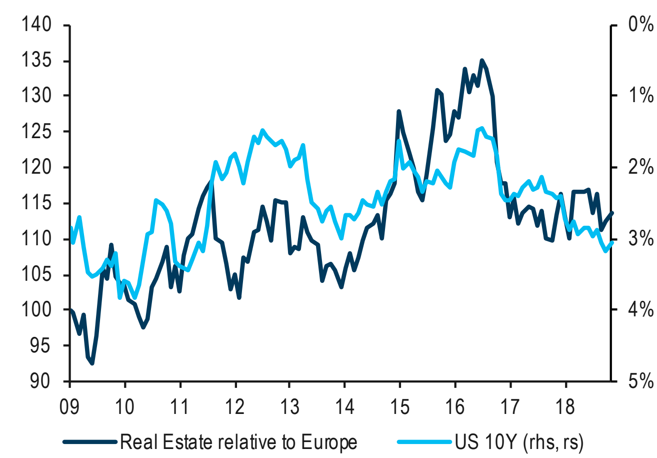
FIGURE 259

Real Estate valuations have improved

Source: Datastream

FIGURE 260

The sector behaves like a bond proxy



Source: Datastream

Real Estate valuations have improved recently, but still remain on the expensive side of fair value. The sector is a key play on the direction of bond yields, which we expect to be sideways over the coming months.

Real Estate – Analysts' view

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Macro

Going into 2019, we believe the macro background remains broadly neutral for the wider European Real Estate market. Debt costs are expected to remain low and should continue to support the broader real estate markets. While we expect Eurozone GDP growth to slow down compared to 2018, we believe it is unlikely that this will impact real estate markets in any material way. Office landlords will continue to see the benefit of reduction in unemployment (and hence; solid demand for office space). However, retail landlords are suffering from structural, rather than cyclical, shifts in consumer spend.

The outlook for the UK is more difficult to assess, given the political uncertainty. Unemployment in the UK is already at relatively low levels and is therefore unlikely to provide a major boost for office landlords, while Brexit could potentially provide (at least short term) headwinds. Regardless of a good or bad Brexit outcome, we believe that shopping centres will remain challenged due to structural changes in the retail landscape due to the rise of online spending. The main beneficiaries of this trend are expected to be logistics landlords, who continue to benefit from demand from traditional and online retailers.

Main risks

We believe that risks for the European real-estate market are sector-specific, and vary materially across the various asset classes. A brief summary of the main risks for the European real estate space in 2019:

- **London Office**: A hard Brexit is likely to have a negative impact on London office sentiment. While the longer-term impact is almost impossible to determine, capital values and tenant demand will likely suffer in the near term. The larger impact is the negative sentiment to share prices.
- **Retail Valuations**: Values for European shopping centres have generally held up well for the largest landlords in Continental Europe, but we believe that the slowdown in transactions observed across Europe is a risk to valuations. This process has already started in the UK in 2018, and we believe that this trend will continue into 2019. We expect the announcement of further tenant failures in 2019 will impact rental levels, especially in UK retail and lead to further valuation declines.
- **Rental growth headwinds for German residential**: Albeit marginal, we believe that German residential companies could see negative impacts on the like-for-like rental growth driven by both increases in regulation as well as increases in wage inflation (thereby making redevelopment costs more expensive)

Bookshelf Reports

1 UK Retail – Going Down the Rabbit Hole, *6 Nov 2018*
2 UK Logistics, 1 Oct 2018
3 French Offices, 3 Oct 2018

Earnings and valuation outlook

On a simple average basis, we expect UK earnings to grow by approximately 4%, while we expect nearly 10% earnings growth for Continental European companies. Earnings growth for Continental European companies is broad based and mainly driven by top-line growth through by like-for-like rental growth and the impact of developments. Earnings growth in the UK is more spread with Retail exposed landlords at the lower end compared to Office and Logistics landlords at the high end.

Valuations within real estate look to be, on average, fair at current pricing. The sector trades at a 10-15% discount to 1yr forward NAV and a 5% earnings yield. However, this masks a wide range of valuations which are determined by the outlook for total returns in each of the subsectors.

Positioning within the sector

We continue to favour structural growth sectors, namely logistics and German residential, despite these trading on optically less attractive valuations. Logistics is expected to continue to benefit from the shift to online retailing, while German residential will continue to benefit from in-place rents that are structurally below market levels due to the highly regulated nature of the German residential market. Our least preferred sector continues to be UK retail, as we continue to see ongoing structural challenges in the underlying market: both from an operational as well as an investment market point of view.

Equity Markets Snapshot

FIGURE 261

Equity Markets Performance, Earnings and Valuations

	Performance (local currency)				Performance (U$)				EPS y/y			Fwd P/E			P/Book			DY & ROE	
	-1m	-3m	-12m	Ytd	-1m	-3m	-12m	Ytd	17	18e	19e	Current	Median (10y)	Current vs Median	Current	Median (10y)	Current vs Median	Dividend Yield	ROE
MSCI AC World	**1%**	**-7%**	**-3%**	**-4%**	**1%**	**-7%**	**-4%**	**-6%**	**17%**	**16%**	**9%**	**13.8**	**14.0**	**-2%**	**2.2**	**1.9**	**13%**	**2.9%**	**13%**
Developed	**1%**	**-7%**	**-1%**	**-3%**	**1%**	**-8%**	**-3%**	**-5%**	**16%**	**16%**	**8%**	**14.4**	**14.4**	**0%**	**2.3**	**2.0**	**14%**	**2.9%**	**13%**
USA	**1%**	**-7%**	**3%**	**0%**	**1%**	**-7%**	**3%**	**0%**	**12%**	**24%**	**9%**	**15.6**	**15.0**	**4%**	**3.2**	**2.6**	**25%**	**2.5%**	**15%**
Japan	**2%**	**-4%**	**-8%**	**-9%**	**0%**	**-6%**	**-9%**	**-10%**	**39%**	**4%**	**4%**	**12.0**	**13.7**	**-12%**	**1.3**	**1.2**	**3%**	**2.3%**	**10%**
Europe	**2%**	**-7%**	**-7%**	**-8%**	**2%**	**-8%**	**-12%**	**-13%**	**16%**	**7%**	**9%**	**12.7**	**13.0**	**-2%**	**1.7**	**1.7**	**1%**	**3.7%**	**11%**
Energy	-3%	-9%	3%	0%	-3%	-10%	-2%	-5%	76%	41%	17%	9.9	10.3	-4%	1.4	1.4	3%	5.4%	10%
Materials	-1%	-10%	-11%	-13%	-2%	-12%	-15%	-18%	50%	7%	3%	12.0	13.6	-12%	1.8	1.7	4%	3.7%	14%
Industrials	1%	-10%	-9%	-9%	1%	-12%	-14%	-14%	13%	3%	13%	14.6	14.8	-1%	2.8	2.6	7%	2.8%	17%
C Discretionary	2%	-9%	-8%	-10%	2%	-10%	-13%	-15%	24%	1%	9%	10.9	12.8	-15%	1.9	2.1	-10%	3.3%	16%
C Staples	0%	-5%	-7%	-7%	0%	-7%	-11%	-11%	12%	6%	9%	17.8	16.9	6%	3.1	3.3	-5%	2.9%	16%
Healthcare	4%	-3%	1%	1%	4%	-4%	-3%	-4%	4%	1%	8%	15.5	14.7	5%	3.3	3.6	-9%	3.0%	16%
Financials	3%	-6%	-15%	-15%	3%	-8%	-18%	-20%	4%	11%	7%	9.6	10.6	-9%	0.9	0.9	-5%	4.8%	8%
Technology	0%	-15%	-7%	-4%	-1%	-16%	-12%	-9%	18%	5%	18%	18.1	17.9	1%	3.5	3.0	18%	1.6%	10%
Telecom	11%	3%	-8%	-9%	11%	2%	-13%	-14%	11%	-9%	8%	13.2	12.7	4%	1.4	1.6	-13%	5.6%	9%
Utilities	4%	0%	-2%	0%	4%	-2%	-7%	-6%	0%	0%	6%	13.3	12.5	6%	1.5	1.5	3%	5.1%	11%
Real Estate	2%	-8%	-6%	-9%	1%	-9%	-10%	-14%	8%	7%	6%	16.7	18.9	-12%	0.9	1.1	-10%	4.8%	6%
UK	**1%**	**-7%**	**-5%**	**-9%**	**1%**	**-7%**	**-9%**	**-13%**	**25%**	**10%**	**8%**	**11.8**	**12.5**	**-5%**	**1.6**	**1.8**	**-9%**	**4.5%**	**11%**
Eurozone	**1%**	**-8%**	**-10%**	**-9%**	**1%**	**-10%**	**-15%**	**-14%**	**14%**	**5%**	**10%**	**12.3**	**12.7**	**-3%**	**1.5**	**1.5**	**6%**	**3.5%**	**11%**
Germany	1%	-9%	-14%	-14%	1%	-11%	-19%	-18%	16%	-3%	12%	11.7	12.2	-4%	1.6	1.6	-1%	3.2%	11%
France	0%	-8%	-6%	-5%	0%	-10%	-11%	-10%	9%	10%	10%	12.7	12.7	0%	1.6	1.4	13%	3.3%	10%
Spain	4%	-5%	-10%	-9%	3%	-7%	-15%	-15%	11%	8%	8%	11.0	11.5	-5%	1.2	1.3	-9%	4.4%	10%
Italy	3%	-6%	-14%	-12%	2%	-9%	-18%	-17%	27%	20%	11%	9.8	11.6	-15%	1.1	0.9	14%	5.0%	10%
Netherlands	4%	-7%	-5%	-5%	4%	-9%	-10%	-10%	12%	4%	9%	14.6	13.6	7%	2.0	1.8	8%	2.9%	12%
Switzerland	3%	-2%	-4%	-5%	3%	-4%	-6%	-7%	5%	13%	11%	16.0	15.1	6%	2.6	2.5	4%	3.0%	13%
Sweden	0%	-9%	-7%	-5%	1%	-9%	-16%	-14%	6%	5%	4%	14.2	15.0	-5%	2.1	2.1	-2%	4.0%	13%
Denmark	8%	-6%	-5%	-8%	7%	-9%	-10%	-13%	5%	1%	5%	17.1	16.6	3%	3.5	2.6	34%	2.7%	19%
Norway	-1%	-5%	0%	-1%	-3%	-8%	-5%	-6%	46%	11%	16%	12.1	11.0	9%	2.0	1.5	31%	4.2%	11%
Canada	1%	-8%	-7%	-7%	0%	-10%	-11%	-12%	29%	14%	11%	12.6	14.3	-12%	1.7	1.9	-9%	3.0%	10%
Australia	0%	-9%	-5%	-6%	3%	-10%	-10%	-13%	7%	7%	5%	14.3	14.4	-1%	1.9	2.0	-4%	4.7%	13%
EM	**3%**	**-7%**	**-12%**	**-11%**	**4%**	**-7%**	**-15%**	**-16%**	**22%**	**13%**	**10%**	**10.4**	**11.1**	**-6%**	**1.5**	**1.6**	**-5%**	**3.2%**	**12%**
Brazil	0%	12%	13%	10%	-5%	17%	-6%	-6%	23%	21%	20%	10.8	10.5	3%	2.0	1.5	29%	3.0%	11%
Mexico	-13%	-20%	-19%	-21%	-18%	-27%	-27%	-25%	17%	5%	16%	12.8	16.4	-22%	2.1	2.7	-22%	2.8%	12%
Chile	0%	-3%	-2%	-10%	3%	-5%	-8%	-18%	15%	14%	16%	14.6	15.4	-5%	1.8	1.9	-4%	3.0%	11%
Russia	0%	1%	6%	8%	-2%	2%	-6%	-5%	13%	40%	0%	4.8	5.3	-9%	0.9	0.8	13%	6.4%	13%
India	7%	-9%	0%	-2%	10%	-11%	-9%	-12%	-1%	19%	24%	17.4	16.2	8%	2.8	3.1	-8%	1.4%	13%
China	6%	-8%	-19%	-17%	7%	-8%	-19%	-17%	25%	13%	15%	10.2	10.5	-2%	1.5	1.7	-9%	3.2%	13%
Taiwan	2%	-11%	-12%	-8%	2%	-11%	-14%	-12%	14%	5%	2%	12.6	13.5	-7%	1.8	1.9	-4%	4.4%	13%
Korea	2%	-9%	-19%	-17%	3%	-10%	-23%	-21%	48%	11%	2%	7.7	9.4	-18%	0.9	1.2	-19%	2.5%	12%
South Africa	7%	-11%	-16%	-15%	13%	-9%	-16%	-24%	9%	9%	20%	12.3	13.3	-8%	2.0	2.4	-19%	3.2%	10%
Turkey	5%	6%	-11%	-19%	12%	23%	-33%	-41%	42%	12%	10%	5.8	9.1	-36%	1.0	1.5	-34%	5.0%	16%

Source: DataStream, IBES, Barclays Research

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Materially Mentioned Stocks (Ticker, Date, Price)

ABN AMRO (ABN.AS, 26-Nov-2018, EUR 23.06), Overweight/Neutral, A/D/J/K/L/M/N

AccorHotels SA (ACCP.PA, 26-Nov-2018, EUR 39.50), Overweight/Negative, CD/D/E/J/K/L/M/N

Airbus Group NV (AIR.PA, 26-Nov-2018, EUR 93.58), Overweight/Positive, CD/D/J/K/L/M/N

Allianz SE (ALVG.DE, 26-Nov-2018, EUR 189.52), Overweight/Neutral, CD/D/E/J/K/L/M/N

Applus (APPS.MC, 26-Nov-2018, EUR 10.46), Overweight/Positive, D/J/K/L/M/N/T

Ashtead Group (AHT.L, 26-Nov-2018, GBp 1793), Overweight/Neutral, A/D/E/J/K/L/M/N/Q

ASML Holding NV (ASML.AS, 26-Nov-2018, EUR 146.66), Overweight/Neutral, CD/CE/J

Assa Abloy AB (ASSAb.ST, 26-Nov-2018, SEK 168.90), Overweight/Neutral, A/CD/D/E/J/K/L/M

AstraZeneca (AZN.L, 26-Nov-2018, GBP 61.38), Overweight/Positive, CD/CE/D/J/K/L/M/N

Avast (AVST.L, 26-Nov-2018, GBp 282), Overweight/Neutral, A/D/J/L

BAE Systems (BAES.L, 26-Nov-2018, GBp 512), Underweight/Positive, CD/D/J/K/L/M/N

Barratt Developments (BDEV.L, 26-Nov-2018, GBp 508), Overweight/Neutral, J/K/N

BASF (BASFn.DE, 26-Nov-2018, EUR 66.15), Overweight/Neutral, A/CD/D/E/J/K/L/M/N

Basic-Fit (BFIT.AS, 26-Nov-2018, EUR 26.25), Overweight/Negative, J

BP (BP.L, 26-Nov-2018, GBP 5.25), Overweight/Positive, CD/CE/D/E/GE/J/K/L/M/N

Other Material Conflicts: Barclays Bank PLC and/or affiliates is providing investment banking services to BHP Billiton Plc in relation to the sale of their US onshore shale oil & gas portfolio (excluding Fayetteville) to BP plc

Bunzl (BNZL.L, 26-Nov-2018, GBp 2356), Overweight/Positive, J/K/N

Bureau Veritas SA (BVI.PA, 26-Nov-2018, EUR 19.19), Underweight/Positive, A/CD/D/J/K/L/M/N

IMPORTANT DISCLOSURES CONTINUED

Casino (CASP.PA, 26-Nov-2018, EUR 39.50), Underweight/Neutral, CD/FA/J/K/M

Compass Group PLC (CPG.L, 26-Nov-2018, GBp 1694), Overweight/Negative, CD/D/J/K/L/M/N/Q

Other Material Conflicts: Barclays Bank PLC is providing investment banking services in connection with the share buy-back programme for Compass Group PLC.

Countryside Properties (CSPC.L, 26-Nov-2018, GBp 296), Overweight/Neutral, A/D/J/K/L/N/Q

CRH (CRH.I, 26-Nov-2018, EUR 24.60), Overweight/Neutral, CD/J/K/M/N

Deutsche Bank (DBKGn.DE, 26-Nov-2018, EUR 8.56), Underweight/Neutral, A/CD/CE/D/E/I/J/K/L/M/N/S

Drillisch (DRIG.DE, 26-Nov-2018, EUR 44.38), Overweight/Negative, CD/J

Edenred (EDEN.PA, 26-Nov-2018, EUR 31.96), Overweight/Positive, CD/D/J/K/L/M/N

Elior Group (ELIOR.PA, 26-Nov-2018, EUR 13.08), Equal Weight/Negative, D/J/K/L/N

Ericsson (ERICb.ST, 26-Nov-2018, SEK 76.42), Equal Weight/Neutral, CD/CE/D/J/K/L/M/N

Experian PLC (EXPN.L, 26-Nov-2018, GBp 1870), Overweight/Positive, A/D/J/K/L/M/N

Ferguson (FERG.L, 26-Nov-2018, GBp 4884), Overweight/Positive, A/D/J/K/L/M/N/Q

Genmab A/S (GEN.CO, 26-Nov-2018, DKK 1004.00), Overweight/Positive, J

Glencore (GLEN.L, 26-Nov-2018, GBp 287), Overweight/Positive, A/D/E/J/K/L/M/N

Other Material Conflicts: Barclays Bank Plc and/or an affiliate is providing equity sponsor services to Glencore.

HeidelbergCement (HEIG.DE, 26-Nov-2018, EUR 60.04), Overweight/Neutral, A/CD/D/J/K/L/M/N

Homeserve (HSV.L, 26-Nov-2018, GBp 941), Overweight/Neutral, A/D/E/J/K/L/N

Infineon Technologies AG (IFXGn.DE, 26-Nov-2018, EUR 18.15), Underweight/Neutral, CD/J/K/M

Intertek Group plc (ITRK.L, 26-Nov-2018, GBp 4646), Equal Weight/Positive, J/K/M/N

ISS (ISS.CO, 26-Nov-2018, DKK 229.00), Overweight/Positive, D/J/K/L/M/N

KPN (KPN.AS, 26-Nov-2018, EUR 2.52), Overweight/Negative, CD/J/K/M

LafargeHolcim (LHN.S, 26-Nov-2018, CHF 46.22), Underweight/Neutral, CD/E/J/K/L/N

Lagardere SCA (LAGA.PA, 26-Nov-2018, EUR 25.23), Overweight/Neutral, CD/D/FA/J/K/L/M/N

Legal & General (LGEN.L, 26-Nov-2018, GBp 245), Overweight/Neutral, CD/D/J/K/L/M/N/Q

Other Material Conflicts: Barclays Bank Plc and/or an affiliate is providing Investment Banking services to Legal & General Group PLC, in relation to the potential disposal of its Mature Savings business to Swiss Re. The ratings, price targets and estimates (as applicable) on Legal & General PLC as issued by the Firm's Research Department do not incorporate any such potential transaction.

Leonardo (LDOF.MI, 26-Nov-2018, EUR 8.56), Equal Weight/Positive, CD/D/E/J/K/L/M/N

Other Material Conflicts: Barclays and/or affiliates is acting as dealer manager on Leonardo US Holding Inc's securities guaranteed by Leonardo SpA, $300m 7.375% Notes due in 2039 (ISIN: USU58200AB97/US583491AB16, the 2039 Notes), and $500m 6.25% Notes due in 2040 (ISIN: US583491AC98/USU58190AA41, the 2040 Notes).

Lloyds Banking Group PLC (LLOY.L, 26-Nov-2018, GBp 57), Overweight/Neutral, A/CD/CE/D/E/I/J/K/L/M/N

Masmovil (MASM.MC, 26-Nov-2018, EUR 104.00), Overweight/Negative, A/CD/D/J/K/L/M

Merlin Entertainments Plc. (MERL.L, 26-Nov-2018, GBp 349), Overweight/Negative, A/CD/D/J/K/L/M/N/Q

MTU Aero Engines AG (MTXGn.DE, 26-Nov-2018, EUR 177.10), Overweight/Positive, CD/J

Munich RE (MUVGn.DE, 26-Nov-2018, EUR 193.85), Overweight/Neutral, A/CD/D/J/K/L/M/N

Neste (NESTE.HE, 26-Nov-2018, EUR 67.72), Overweight/Positive, CD/D/J/K/L/M

Nokia (NOKIA.HE, 26-Nov-2018, EUR 4.87), Overweight/Neutral, CD/CE/D/E/J/K/L/M/N

Orange (ORAN.PA, 26-Nov-2018, EUR 14.89), Overweight/Negative, A/CD/CE/D/FA/FB/J/K/L/M/N

Paddy Power Betfair (PPB.L, 26-Nov-2018, GBP 70.40), Overweight/Negative, D/J/K/L/M/N

Petrofac (PFC.L, 26-Nov-2018, GBP 5.11), Overweight/Positive, D/J/K/L/N

Other Material Conflicts: Barclays Bank Plc and/or an affiliate is providing investment banking services to Petrofac Limited in relation to their potential sale 49% of of operations in Mexico(1)(2), including Santuario, Magallanes and Arenque, to Perenco (Oil & Gas) International Limited ("Perenco").

Prudential Plc (PRU.L, 26-Nov-2018, GBp 1575), Overweight/Neutral, A/CD/CE/D/E/J/K/L/M/N

Rentokil Initial (RTO.L, 26-Nov-2018, GBp 324), Overweight/Neutral, CD/D/E/J/K/L/M/N/Q

Repsol (REP.MC, 26-Nov-2018, EUR 15.15), Overweight/Positive, D/J/K/L/M/N

Rolls-Royce PLC (RR.L, 26-Nov-2018, GBp 840), Underweight/Positive, D/FA/J/K/L/M/N

IMPORTANT DISCLOSURES CONTINUED

Royal Bank of Scotland Group PLC (RBS.L, 26-Nov-2018, GBp 225), Overweight/Neutral, CD/CE/D/I/J/K/L/M/N

Royal Dutch Shell A (RDSa.L, 26-Nov-2018, GBP 23.64), Overweight/Positive, A/CE/D/E/J/K/L/M/N

SAFRAN SA (SAF.PA, 26-Nov-2018, EUR 108.20), Equal Weight/Positive, CD/D/J/K/L/M/N

Sainsbury (J) plc (SBRY.L, 26-Nov-2018, GBP 3.14), Overweight/Neutral, CD/D/J/K/L/M/N

Sandvik AB (SAND.ST, 26-Nov-2018, SEK 133.65), Underweight/Neutral, CD/J/K/N

Schibsted ASA (SBST.OL, 26-Nov-2018, NOK 298.80), Overweight/Neutral, CD/J

SGS SA (SGSN.S, 26-Nov-2018, CHF 2342.00), Overweight/Positive, CD/J

SKF AB (SKFb.ST, 26-Nov-2018, SEK 141.30), Underweight/Neutral, CD/J

Sodexo SA (EXHO.PA, 26-Nov-2018, EUR 92.38), Underweight/Negative, CD/J/K/N

SSP (SSPG.L, 26-Nov-2018, GBp 648), Overweight/Negative, J/K/L/M/N/Q

STMicroelectronics NV (STM.PA, 26-Nov-2018, EUR 12.78), Overweight/Neutral, CD/CE/J/K/N

Subsea 7 SA (SUBC.OL, 26-Nov-2018, NOK 90.78), Overweight/Positive, D/J/K/L/M/N

Taylor Wimpey (TW.L, 26-Nov-2018, GBp 151), Overweight/Neutral, J/K/N

Telefonica Deutschland (O2Dn.DE, 26-Nov-2018, EUR 3.60), Overweight/Negative, D/E/J/K/L/M/N

Telenor ASA (TEL.OL, 26-Nov-2018, NOK 166.75), Overweight/Negative, CD/D/E/J/K/L/M

Other Material Conflicts: Barclays Bank PLC and/or an affiliate is providing investment banking services to Telenor ASA in relation to the sales of their CEE assets to PPF Group.

Telia Company AB (TELIA.ST, 26-Nov-2018, SEK 41.45), Underweight/Negative, CD/D/E/J/K/L/M

Temenos (TEMN.S, 26-Nov-2018, CHF 125.20), Underweight/Neutral, CD/D/J/K/L/M/N

Tenaris (TENR.MI, 26-Nov-2018, EUR 11.96), Overweight/Positive, CE/J/K/N

Tesco (TSCO.L, 26-Nov-2018, GBP 2.01), Overweight/Neutral, CD/D/J/K/L/M/N/Q

thyssenkrupp (TKAG.DE, 26-Nov-2018, EUR 16.60), Underweight/Neutral, CD/J/K/N

Total (TOTF.PA, 26-Nov-2018, EUR 48.30), Overweight/Positive, A/CD/CE/D/FA/J/K/L/M/N

Tui AG (TUIT.L, 26-Nov-2018, GBp 1250), Overweight/Negative, CD/D/E/J/K/L/M/N/Q

Ubisoft Entertainment SA (UBIP.PA, 26-Nov-2018, EUR 68.20), Overweight/Neutral, CD/FA/J

Volkswagen AG-PFD Preferred (VOWG_p.DE, 26-Nov-2018, EUR 154.18), Overweight/Positive, D/E/J/K/L/M/N

Prices are sourced from Thomson Reuters as of the last available closing price in the relevant trading market, unless another time and source is indicated.

Disclosure Legend:

A: Barclays Bank PLC and/or an affiliate has been lead manager or co-lead manager of a publicly disclosed offer of securities of the issuer in the previous 12 months.

B: An employee or non-executive director of Barclays Bank PLC and/or an affiliate is a director of this issuer.

CD: Barclays Bank PLC and/or an affiliate is a market-maker in debt securities issued by this issuer.

CE: Barclays Bank PLC and/or an affiliate is a market-maker in equity securities issued by this issuer.

D: Barclays Bank PLC and/or an affiliate has received compensation for investment banking services from this issuer in the past 12 months.

E: Barclays Bank PLC and/or an affiliate expects to receive or intends to seek compensation for investment banking services from this issuer within the next 3 months.

FA: Barclays Bank PLC and/or an affiliate beneficially owns 1% or more of a class of equity securities of this issuer, as calculated in accordance with US regulations.

FB: Barclays Bank PLC and/or an affiliate beneficially owns a long position of more than 0.5% of a class of equity securities of this issuer, as calculated in accordance with EU regulations.

FC: Barclays Bank PLC and/or an affiliate beneficially owns a short position of more than 0.5% of a class of equity securities of this issuer, as calculated in accordance with EU regulations.

GD: One of the analysts on the fundamental credit coverage team (or a member of his or her household) has a financial interest in the debt or equity securities of this issuer.

GE: One of the analysts on the fundamental equity coverage team (or a member of his or her household) has a financial interest in the debt or equity securities of this issuer.

H: This issuer beneficially owns more than 5% of any class of common equity securities of Barclays PLC.

I: Barclays Bank PLC and/or an affiliate is party to an agreement with this issuer for the provision of financial services to Barclays Bank PLC and/or an affiliate.

IMPORTANT DISCLOSURES CONTINUED

J: Barclays Bank PLC and/or an affiliate is a liquidity provider and/or trades regularly in the securities of this issuer and/or in any related derivatives.

K: Barclays Bank PLC and/or an affiliate has received non-investment banking related compensation (including compensation for brokerage services, if applicable) from this issuer within the past 12 months.

L: This issuer is, or during the past 12 months has been, an investment banking client of Barclays Bank PLC and/or an affiliate.

M: This issuer is, or during the past 12 months has been, a non-investment banking client (securities related services) of Barclays Bank PLC and/or an affiliate.

N: This issuer is, or during the past 12 months has been, a non-investment banking client (non-securities related services) of Barclays Bank PLC and/or an affiliate.

O: Not in use.

P: A partner, director or officer of Barclays Capital Canada Inc. has, during the preceding 12 months, provided services to the subject company for remuneration, other than normal course investment advisory or trade execution services.

Q: Barclays Bank PLC and/or an affiliate is a Corporate Broker to this issuer.

R: Barclays Capital Canada Inc. and/or an affiliate has received compensation for investment banking services from this issuer in the past 12 months.

S: This issuer is a Corporate Broker to Barclays PLC.

T: Barclays Bank PLC and/or an affiliate is providing equity advisory services to this issuer.

U: The equity securities of this Canadian issuer include subordinate voting restricted shares.

V: The equity securities of this Canadian issuer include non-voting restricted shares.

Risk Disclosure(s)

Options are not suitable for all investors. Please note that the trade ideas within this research report do not necessarily relate to, and may directly conflict with, the fundamental ratings applied to Barclays Equity Research. The risks of options trading should be weighed against the potential rewards.

Risks:

Call or put purchasing: The risk of purchasing a call/put is that investors will lose the entire premium paid.

Uncovered call writing: The risk of selling an uncovered call is unlimited and may result in losses significantly greater than the premium received.

Uncovered put writing: The risk of selling an uncovered put is significant and may result in losses significantly greater than the premium received.

Call or put vertical spread purchasing (same expiration month for both options): The basic risk of effecting a long spread transaction is limited to the premium paid when the position is established.

Call or put vertical spread writing/writing calls or puts (usually referred to as uncovered writing, combinations or straddles; same expiration month for both options): The basic risk of effecting a short spread transaction is limited to the difference between the strike prices less the amount received in premiums.

Call or put calendar spread purchasing (different expiration months; short must expire prior to the long): The basic risk of effecting a long calendar spread transaction is limited to the premium paid when the position is established.

Because of the importance of tax considerations to many options transactions, the investor considering options should consult with his/her tax advisor as to how taxes affect the outcome of contemplated options transactions.

Supporting documents that form the basis of our recommendations are available on request.

The Options Clearing Corporation's report, "Characteristics and Risks of Standardized Options", is available at http://www.theocc.com/about/publications/character-risks.jsp

Master limited partnerships (MLPs) are pass-through entities structured as publicly listed partnerships. For tax purposes, distributions to MLP unit holders may be treated as a return of principal. Investors should consult their own tax advisors before investing in MLP units.

Explanation of the European Equity Strategy sector rating system:

Overweight (OW): The performance of the MSCI Europe sector is expected to outperform the MSCI Europe index in the next 3-6 months.

Marketweight (MW): The performance of the MSCI Europe sector is expected to perform in line with the MSCI Europe index in the next 3-6 months.

Underweight (UW): The performance of the MSCI Europe sector is expected to underperform the MSCI Europe index in the next 3-6 months.

IMPORTANT DISCLOSURES CONTINUED

Guide to the Barclays Fundamental Equity Research Rating System:

Our coverage analysts use a relative rating system in which they rate stocks as Overweight, Equal Weight or Underweight (see definitions below) relative to other companies covered by the analyst or a team of analysts that are deemed to be in the same industry (the "industry coverage universe").

In addition to the stock rating, we provide industry views which rate the outlook for the industry coverage universe as Positive, Neutral or Negative (see definitions below). A rating system using terms such as buy, hold and sell is not the equivalent of our rating system. Investors should carefully read the entire research report including the definitions of all ratings and not infer its contents from ratings alone.

Stock Rating

Overweight - The stock is expected to outperform the unweighted expected total return of the industry coverage universe over a 12-month investment horizon.

Equal Weight - The stock is expected to perform in line with the unweighted expected total return of the industry coverage universe over a 12-month investment horizon.

Underweight - The stock is expected to underperform the unweighted expected total return of the industry coverage universe over a 12-month investment horizon.

Rating Suspended - The rating and target price have been suspended temporarily due to market events that made coverage impracticable or to comply with applicable regulations and/or firm policies in certain circumstances including where the Investment Bank of Barclays Bank PLC is acting in an advisory capacity in a merger or strategic transaction involving the company.

Industry View

Positive - industry coverage universe fundamentals/valuations are improving.

Neutral - industry coverage universe fundamentals/valuations are steady, neither improving nor deteriorating.

Negative - industry coverage universe fundamentals/valuations are deteriorating.

Below is the list of companies that constitute the "industry coverage universe":

European Aerospace & Defense		
Airbus Group NV (AIR.PA)	BAE Systems (BAES.L)	Chemring Group PLC (CHG.L)
Cobham PLC (COB.L)	Leonardo (LDOF.MI)	Meggitt PLC (MGGT.L)
Melrose Industries PLC (MRON.L)	MTU Aero Engines AG (MTXGn.DE)	Qinetiq Group PLC (QQ.L)
Rolls-Royce PLC (RR.L)	SAFRAN SA (SAF.PA)	Senior Plc. (SNR.L)
Thales SA (TCFP.PA)	Ultra Electronics Holdings PLC (ULE.L)	
European Autos & Auto Parts		
BMW (BMWG.DE)	Continental (CONG.DE)	Daimler AG (DAIGn.DE)
Fiat Chrysler Automobiles (FCHA.MI)	Porsche Automobil Holding SE (PSHG_p.DE)	Renault SA (RENA.PA)
Volkswagen AG-PFD Preferred (VOWG_p.DE)		
European Banks		
ABN AMRO (ABN.AS)	Bank of Ireland (BIRG.I)	Credit Suisse AG (CSGN.S)
CYBG PLC (CYBGC.L)	Danske Bank (DANSKE.CO)	Deutsche Bank (DBKGn.DE)
DNB (DNB.OL)	HSBC Holdings PLC (HSBA.L)	Lloyds Banking Group PLC (LLOY.L)
Nordea (NDAFI.HE)	Royal Bank of Scotland Group PLC (RBS.L)	SEB (SEBa.ST)
Standard Chartered PLC (STAN.L)	Svenska Handelsbanken (SHBa.ST)	Swedbank (SWEDa.ST)
UBS AG (UBSG.S)		
European Business Services		
AA Plc. (AAAA.L)	Adecco Group AG (ADEN.S)	Aggreko (AGGK.L)
Applus (APPS.MC)	Bunzl (BNZL.L)	Bureau Veritas SA (BVI.PA)
Capita Group Plc (CPI.L)	Edenred (EDEN.PA)	Equiniti (EQN.L)
Experian PLC (EXPN.L)	Ferguson (FERG.L)	G4S (GFS.L)
Hays (HAYS.L)	Intertek Group plc (ITRK.L)	ISS (ISS.CO)
PageGroup (PAGE.L)	Randstad Holding NV (RAND.AS)	Securitas (SECUb.ST)
Serco Group plc (SRP.L)	SGS SA (SGSN.S)	SIG Combibloc (SIGNC.S)
Spie (SPIE.PA)	Travis Perkins (TPK.L)	
European Capital Goods		

IMPORTANT DISCLOSURES CONTINUED

Alfa Laval AB (ALFA.ST)	Alfen (ALFEN.AS)	Assa Abloy AB (ASSAb.ST)
Atlas Copco AB (ATCOa.ST)	Epiroc AB (EPIRa.ST)	GEA Group AG (G1AG.DE)
Kone OYJ (KNEBV.HE)	Metso OYJ (METSO.HE)	RHI Magnesita (RHIM.L)
Sandvik AB (SAND.ST)	Schindler Holding (SCHP.S)	SKF AB (SKFb.ST)
thyssenkrupp (TKAG.DE)	Weir Group (WEIR.L)	
European Chemicals		
AkzoNobel (AKZO.AS)	Arkema (AKE.PA)	BASF (BASFn.DE)
Clariant (CLN.S)	Covestro (1COV.DE)	Croda (CRDA.L)
DSM (DSMN.AS)	Elementis (ELM.L)	Evonik (EVKn.DE)
Givaudan (GIVN.S)	Johnson Matthey (JMAT.L)	Lanxess (LXSG.DE)
Solvay (SOLB.BR)	Symrise (SY1G.DE)	Synthomer (SYNTS.L)
Umicore (UMI.BR)	Victrex (VCTX.L)	
European Construction, Building Materials & Infrastructure		
Balta (BALTA.BR)	Buzzi Unicem (BZU.MI)	CRH (CRH.I)
Eiffage (FOUG.PA)	Getlink (GETP.PA)	HeidelbergCement (HEIG.DE)
Ibstock (IBST.L)	LafargeHolcim (LHN.S)	Saint-Gobain (SGOB.PA)
Vicat (VCTP.PA)	Vinci (SGEF.PA)	
European Food Retail		
Ahold Delhaize (AD.AS)	Carrefour (CARR.PA)	Casino (CASP.PA)
Colruyt (COLR.BR)	DIA (DIDA.MC)	ICA GRUPPEN AB (ICAA.ST)
Jeronimo Martins (JMT.LS)	Metro AG (B4B.DE)	Morrison (MRW.L)
Ocado (OCDO.L)	Rallye (GENC.PA)	Sainsbury (J) plc (SBRY.L)
Sonae (YSO.LS)	Tesco (TSCO.L)	
European Insurance		
Admiral Group plc (ADML.L)	AEGON N.V. (AEGN.AS)	Allianz SE (ALVG.DE)
ASR Nederland NV (ASRNL.AS)	AVIVA (AV.L)	AXA (AXAF.PA)
Direct Line Insurance Group (DLGD.L)	esure (ESUR.L)	Generali (GASI.MI)
Gjensidige Forsikring ASA (GJFS.OL)	Hannover Re (HNRGn.DE)	Hastings Group Holdings Plc. (HSTG.L)
Hiscox Ltd. (HSX.L)	Jardine Lloyd Thompson Group (JLT.L)	Just Group (JUSTJ.L)
Lancashire Holdings (LRE.L)	Legal & General (LGEN.L)	Mapfre (MAP.MC)
Munich RE (MUVGn.DE)	NN (NN.AS)	Phoenix (PHNX.L)
Prudential Plc (PRU.L)	RSA Insurance Group plc (RSA.L)	Sabre Insurance Group Plc (SBRE.L)
Sampo (SAMAS.HE)	SCOR (SCOR.PA)	St. James's Place (SJP.L)
Swiss Re (SRENH.S)	Topdanmark (TOP.CO)	Tryg (TRYG.CO)
Unipol (UNPI.MI)	Zurich Insurance Group AG (ZURN.S)	
European Integrated Oil & Refining		
BP (BP.L)	Eni (ENI.MI)	Equinor (EQNR.OL)
Galp Energia (GALP.LS)	Neste (NESTE.HE)	OMV (OMVV.VI)
Repsol (REP.MC)	Royal Dutch Shell A (RDSa.L)	Royal Dutch Shell B (RDSb.L)
Saras (SRS.MI)	Total (TOTF.PA)	
European Leisure		
AccorHotels SA (ACCP.PA)	Basic-Fit (BFIT.AS)	Carnival PLC (CCL.L)
Compass Group PLC (CPG.L)	Elior Group (ELIOR.PA)	GVC Holdings Plc (GVC.L)
InterContinental Hotels Group Plc (IHG.L)	Merlin Entertainments Plc. (MERL.L)	Paddy Power Betfair (PPB.L)
Parques Reunidos SAU (PQR.MC)	Sodexo SA (EXHO.PA)	SSP (SSPG.L)
Telepizza Group SA (TPZ.MC)	Thomas Cook Group Plc (TCG.L)	Tui AG (TUIT.L)
Vapiano SE (VAO.DE)	Whitbread PLC (WTB.L)	William Hill PLC (WMH.L)

IMPORTANT DISCLOSURES CONTINUED

European Media		
Ascential plc (ASCL.L)	ATRESMEDIA (A3M.MC)	AutoTrader (AUTOA.L)
Axel Springer SE (SPRGn.DE)	Daily Mail & General Trust PLC (DMGOa.L)	Delivery Hero (DHER.DE)
Eutelsat Communications (ETL.PA)	Informa PLC (INF.L)	Intelsat S.A. (I)
ITV Plc (ITV.L)	JC Decaux SA (JCDX.PA)	Lagardere SCA (LAGA.PA)
M6-Metropole Television SA (MMTP.PA)	Mediaset Espana (TL5.MC)	Mediaset SpA (MS.MI)
MoneySupermarket (MONY.L)	Naspers (NPNJn.J)	Omnicom Group Inc. (OMC)
Pearson plc (PSON.L)	ProsiebenSat. 1 Media SE (PSMGn.DE)	Publicis Groupe SA (PUBP.PA)
Reach PLC (RCH.L)	RELX PLC (REL.L)	Rightmove Plc (RMV.L)
Rocket Internet (RKET.DE)	RTL Group SA (AUDKt.BR)	Schibsted ASA (SBST.OL)
Scout24 (G24n.DE)	SES SA (SESFd.PA)	Ströer SE & Co. KGaA (SAXG.DE)
Takeaway.com (TKWY.AS)	Television Francaise 1 SA (TFFP.PA)	Ubisoft Entertainment SA (UBIP.PA)
Vivendi SA (VIV.PA)	Wolters Kluwer NV (WLSNc.AS)	WPP (WPP.L)
European Mid Cap Pharmaceuticals		
Galapagos (GLPG.AS)	Genmab A/S (GEN.CO)	Grifols SA (GRLS.MC)
H Lundbeck A/S (LUN.CO)	Hikma Pharmaceuticals PLC (HIK.L)	Ipsen SA (IPN.PA)
Merck KGaA (MRCG.DE)	Osmotica Pharmaceuticals (OSMT)	UCB SA (UCB.BR)
Vifor Pharma AG (VIFN.S)		
European Mining		
Acacia (ACAA.L)	Anglo American plc (AAL.L)	Antofagasta (ANTO.L)
BHP (BHP.L)	Boliden (BOL.ST)	Ferrexpo Plc (FXPO.L)
Fresnillo (FRES.L)	Gem Diamonds Ltd. (GEMD.L)	Glencore (GLEN.L)
Hochschild Mining (HOCM.L)	KAZ Minerals PLC (KAZ.L)	Lonmin PLC (LMI.L)
Petra Diamonds Ltd. (PDL.L)	Randgold Resources (RRS.L)	Rio Tinto plc (RIO.L)
South32 Ltd. (S32.L)	Vale (VALE)	
European Oil Services & Drilling		
Aker Solutions (AKSOL.OL)	CGG (GEPH.PA)	Gulf Marine Services (GMS.L)
Hunting (HTG.L)	Maire Tecnimont (MTCM.MI)	Petrofac (PFC.L)
Petroleum Geo-Services (PGS.OL)	Saipem (SPMI.MI)	SBM Offshore (SBMO.AS)
Subsea 7 SA (SUBC.OL)	TechnipFMC Plc (FTI.PA)	Tecnicas Reunidas (TRE.MC)
Tenaris (TENR.MI)	TGS (TGS.OL)	Vallourec (VLLP.PA)
Wood (WG.L)		
European Pharmaceuticals		
AstraZeneca (AZN.L)	Bayer AG (BAYGn.DE)	GlaxoSmithKline (GSK.L)
Novartis (NOVN.S)	Novo Nordisk (NOVOb.CO)	Roche (ROG.S)
Sanofi (SASY.PA)	Shire (SHP.L)	
European Software & IT Services		
Adyen (ADYEN.AS)	Alfa (ALFAAL.L)	Amadeus (AMA.MC)
Atos (ATOS.PA)	Avast (AVST.L)	AVEVA (AVV.L)
Capgemini (CAPP.PA)	Cielo (CIEL3.SA)	Computacenter (CCC.L)
Dassault Systèmes (DAST.PA)	Evolution Gaming (EVOG.ST)	Hexagon AB (HEXAb.ST)
Ingenico (INGC.PA)	Just Eat (JE.L)	Micro Focus (MCRO.L)
NetEnt (NETb.ST)	PayPoint (PAYP.L)	Playtech (PTEC.L)
SafeCharge (SCHS.L)	Sage Group (SGE.L)	SAP SE (SAPG.DE)
Software AG (SOWG.DE)	Temenos (TEMN.S)	Wirecard (WDIG.DE)
Worldline (WLN.PA)	Worldpay (WPYa.L)	
European Technology Hardware		

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Aixtron (AIXGn.DE)	ams AG (AMS.S)	ASML Holding NV (ASML.AS)
Dialog Semiconductor (DLGS.DE)	Ericsson (ERICb.ST)	Gemalto (GTO.AS)
Infineon Technologies AG (IFXGn.DE)	IQE plc (IQE.L)	Nokia (NOKIA.HE)
Spirent (SPT.L)	STMicroelectronics NV (STM.PA)	TomTom NV (TOM2.AS)
European Telecom Services		
Altice NV (ATCA.AS)	Bezeq (BEZQ.TA)	Bouygues SA (BOUY.PA)
BT Group PLC (BT.L)	Cellcom Israel Ltd. (CEL.TA)	Cellnex Telecom (CLNX.MC)
Deutsche Telekom AG (DTEGn.DE)	DNA Oyj (DNAO.HE)	Drillisch (DRIG.DE)
Elisa Oyj (ELI1V.HE)	Euskaltel SA (EKTL.MC)	Freenet (FNTGn.DE)
Gamma Communications PLC (GAMA.L)	Iliad SA (ILD.PA)	Inmarsat plc (ISA.L)
INWIT (INWT.MI)	Iridium Communications Inc (IRDM)	KCOM (KCOM.L)
KPN (KPN.AS)	Liberty Global (LBTYA)	Manx Telecom (MANX.L)
Masmovil (MASM.MC)	NOS (NOS.LS)	Orange (ORAN.PA)
Orange Belgium (OBEL.BR)	OTE (OTEr.AT)	Partner Communications Company Ltd. (PTNR.TA)
Proximus (PROX.BR)	Sunrise (SRCG.S)	Swisscom (SCMN.S)
TalkTalk Telecom Group (TALK.L)	Tele Columbus AG (TC1n.DE)	Tele2 AB (TEL2b.ST)
Telecom Italia SpA (TLIT.MI)	Telecom Italia-RSP (TLITn.MI)	Telefonica Deutschland (O2Dn.DE)
Telefonica SA (TEF.MC)	Telekom Austria (TELA.VI)	Telenet Group Holding NV (TNET.BR)
Telenor ASA (TEL.OL)	Telia Company AB (TELIA.ST)	United Internet (UTDI.DE)
ViaSat (VSAT)	Vodafone Group Plc (VOD.L)	
UK Homebuilding		
Barratt Developments (BDEV.L)	Bellway (BWY.L)	Berkeley Group (BKGH.L)
Bovis Homes (BVS.L)	Countryside Properties (CSPC.L)	Countrywide PLC (CWD.L)
Crest Nicholson Holdings, plc. (CRST.L)	Foxtons Group PLC (FOXT.L)	Galliford Try (GFRD.L)
McCarthy & Stone (MCS.L)	Persimmon (PSN.L)	Redrow (RDW.L)
Taylor Wimpey (TW.L)	Telford Homes Plc. (TELF.L)	
UK Mid & Small Cap Services		
Ashtead Group (AHT.L)	DCC (DCC.L)	Diploma (DPLM.L)
Electrocomponents (ECM.L)	Homeserve (HSV.L)	MITIE Group (MTO.L)
Northgate (NTG.L)	Renewi (RWI.L)	Rentokil Initial (RTO.L)

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