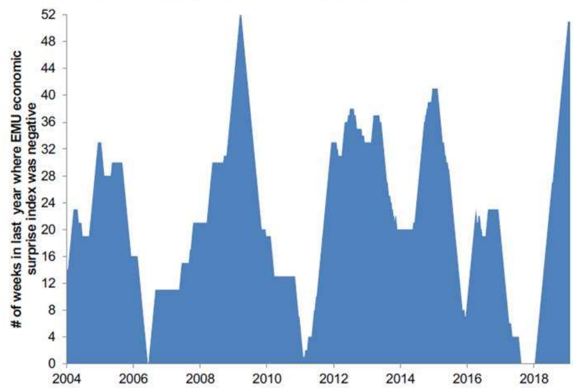
#1 A tough 12m for Europe

Europe has seen a record run of disappointing macro data… At the beginning of 2018, euro area GDP growth was close to 2.5% and 10-year Bund yields hit 70bps; today growth is c. 1% and Bund yields are just 5bps. The slowdown and disappointment in the data over the last 12 months have been extreme even against the euro area's own modest track record. The EMU economic surprise index has been negative for 51 of the last 52 weeks (last time we saw that was April 2009) and has been the lowest indicator of any major region for 47 of the last 52 weeks (previous worst was 33 weeks).

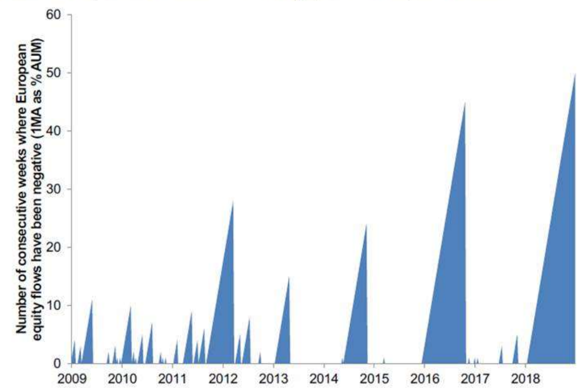
… and the longest run of persistent equity outflows in a decade. Early 2018 also marked a pivotal moment for European fund flows too, as the prior period of persistent inflows into equities and credit flipped over to persistent outflows, which has remained the case ever since. In fact, European equity funds have now seen 50 consecutive weeks of outflows, which is the longest run in a decade.

Exhibit 2: Eurozone economic surprise index has been negative for 51 of the last 52 weeks



Source: Bloomberg, Morgan Stanley Research

Exhibit 3: Europe has seen 50 weeks of continual equity outflows – longest for a decade



Source: MSCI, EPFR, Morgan Stanley Research. The EPFR data and charts displayed here must not be extracted and republished (whether internally or externally). Such use will violate the terms of Morgan Stanley's contract with EPFR which only covers named users.

#2 EMU macro data looks set to surprise on the upside

The 'idiosyncratic' drag on domestic growth is now fading… Despite the recent growth downgrade from the ECB, we think the macro news flow for the euro area is about to get better. From a domestic standpoint, the idiosyncratic issues that weighed on growth in 2H18 are now starting to fade – e.g. French consumer confidence is rising again and we are seeing signs of recovery in the German Auto sector, where both order intake and passenger car registrations are rebounding. Financial conditions across the euro area have also eased dramatically in the last three months.

… while Europe should also benefit from a China upturn. From an international perspective, European data should also get a lift from the rebound in the Chinese economy that our economists anticipate. We have previously shown how the IFO correlates more closely with China bond yields than German bond yields, and that China credit growth tends to lead our own lead indicator for European EPS; below, we show how the China PMI New Export Orders series leads the Euro Area PMI by about three months.

Exhibit 4: Survey data suggest the German Auto sector is seeing an improvement in order intakes

Source: Ifo, Morgan Stanley Research

Exhibit 5: A rebound in the Chinese economy should also be good news for Europe

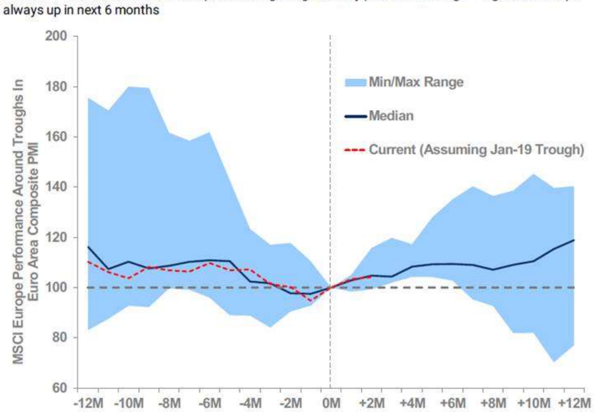
Source: Caixin, IHS Markit, Morgan Stanley Research

#3 PMI trough suggests better risk-reward for MSCI Europe

MSCI Europe has always been higher 6 months after a PMI trough. Any upturn in European economic data should also improve sentiment around the relative investment case for the region's equity market. Post better data in February, it looks like the euro area composite PMI troughed in January, and this suggests a better risk-reward for EU equities ahead. The median increase in MSCI Europe from prior PMI troughs has been 9.4% over the N6M, and there have been no negative readings – i.e. stocks have always been higher six months after the PMI bottoms.

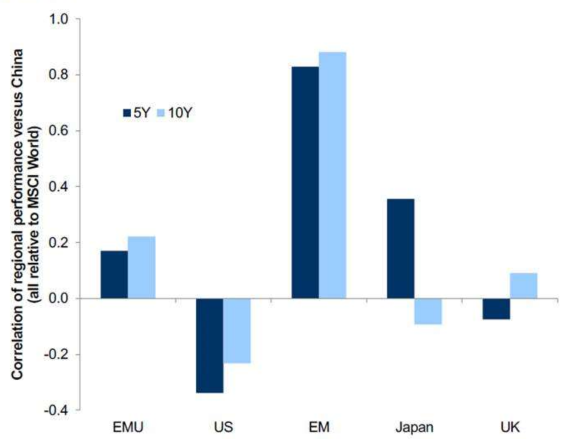
MSCI EMU is positively correlated with China equity performance. History suggests that our positive view on China equities should also be helpful for European stocks. While MSCI EM is (unsurprisingly) the most positively correlated region to MSCI China, we note that MSCI EMU is the only other region that has also correlated positively over both the last five and 10 years. In contrast, the US has historically been the big relative laggard when China is outperforming.

Exhibit 6: The risk-reward for EU equities changes significantly post a PMI trough – e.g. MSCI Europe always up in next 6 months



Source: MSCI, Haver Analytics, IHS Markit, Morgan Stanley Research

Exhibit 7: The relative performance of MSCI EMU correlates positively with the relative performance of MSCI China



Source: MSCI, Datastream, Morgan Stanley Research

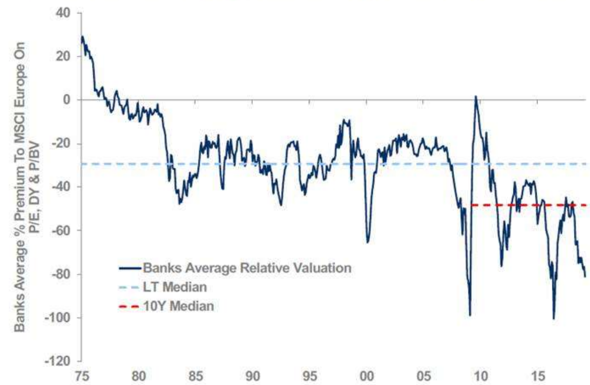
#4 Banks are pricing in a lot of bad news here…

Banks' relative valuations are close to historical lows. A more positive view on the European macro backdrop naturally leads to the question as to whether European banks can start to perform better going forward. While there is no getting away from the fact that monetary policy in the euro area is likely to remain a hindrance to the sector for some time to come, this is not new news and much is arguably already ‘in the price’. For example:

• Average relative valuations (a blend of P/E, P/B and DY) for European Banks are down at levels only previously seen at the end of 2008 and in mid-2016 (when Bund yields were negative).

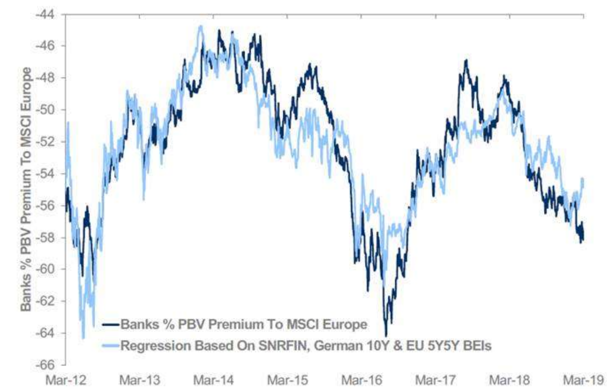
• Our regression analysis below shows that Banks are 7% cheaper than they should be for the current level of fixed income markets (which include Bund yields, inflation breakevens and Snrfin CDS). This 'discount' has only been wider 4% of the time since 2011.

Exhibit 8: MSCI Europe Banks' relative valuation discount has only been lower (briefly) in 2008 & 2016



Source: MSCI, IBES, Morgan Stanley Research

Exhibit 9: Banks currently trade at a 7% discount to fair value based on current fixed income inputs – this 'discount' has only been wider 4% of time since 2011



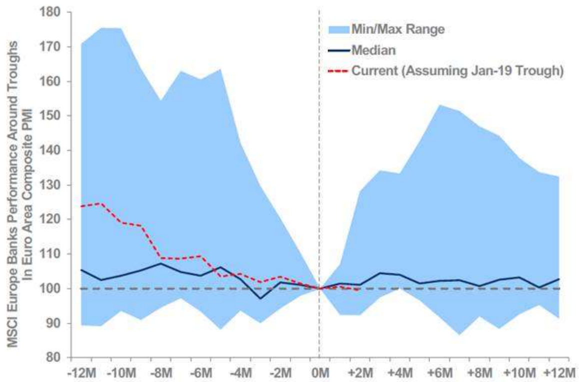
Source: MSCI, Bloomberg, Datastream, Morgan Stanley Research

#5 … and generally outperform after a PMI trough

A trough in PMI tends to signify a positive inflection in Banks' risk-reward profile. Given ongoing ECB monetary policy, it is easy to assume that European banks will continue to struggle to perform regardless of other macro trends. However, history does suggest that a trough in the euro area PMI is generally a positive signal for the sector, with Exhibit 10 illustrating quite a large reversal in the sector's relative risk-reward profile (i.e. pre the trough, relative performance tends to be flat-to-down; post the trough it tends to be flat-to-up).

Banks' underperformance versus Cyclicals looking extreme. Historically, a rise in the eurozone's economic surprise index relative to the global index has tended to favour Banks over Cyclicals, which would be a marked reversal on current trends. With the relative valuation of Cyclicals versus Banks close to a record high (its only been higher 3m in 40 years), it may not take much in the way of better news flow for the latter to start playing catch-up.

Exhibit 10: The 'median' return for Banks after a PMI trough tends to be somewhat muted; however, the overall risk-reward improves significantly



Source: MSCI, Haver Analytics, IHS Markit, Morgan Stanley Research

Exhibit 11: EMU Banks have badly lagged the rebound in Cyclicals

Source: MSCI, Bloomberg, Morgan Stanley Research