**COMMENTARY**

**October 26, 2018**

**Dear clients and colleagues,**

European markets have been quite volatile in the past few weeks. A complex political landscape combined with trade uncertainties has contributed to the recent sell–offs. The MSCI Europe Small Cap index has fallen by 15% since late April, and investors appear to be discounting further slowdowns ahead. We think the disconnect that exists between stock valuations and company fundamentals could end very soon.

This de-rating is not the result of any significant earnings downgrades, but rather due to fear over the late stage of the economic cycle and external factors such as Brexit, Italy's budget deficit and global growth. Current multiples suggest investors are already discounting weaker earnings for the next two years. Although economic growth expectations are pointing to a softer trajectory, fundamentals look resilient. Here are a few observations to support our view:

- Stock market weakness has brought price-earnings ratios to a 12% discount compared to their historical averages. Only during the sovereign debt crisis and the 2008 financial crisis have multiples been lower. As shown by the latest reports on ETF flows, investors' positioning seem to be excessively underweight European stocks.
- Corporate balance sheets are in a much better position than they were prior to the sovereign debt crisis or the 2008 financial crisis.
- Merger and acquisition activity could intensify. Many companies have indicated their intention to make strategic acquisitions. Now that equity valuations are depressed, CEOs could be more opportunistic on the M&A front. Two recent takeovers in our portfolio companies could support this view.
- Financing is available and lending conditions are still favourable. The latest European Central Bank (ECB) lending survey showed that banks expect strong loan demand from both companies and consumers in the fourth quarter.
- European companies will benefit from a weaker currency. A weakening euro and pound should provide some earnings protection for the next financial releases. The euro-USD rate has declined 9% since early 2018.
- The job market is vibrant and unemployment continues to decline. Fiscal policy is easing.
- Capacity utilization is at cycle highs in many industries.

Italy and Brexit remain an important risk, and the situation could stay gloomy a little longer. Until Italy implements its budget and more clarity emerges from the Brexit negotiations, investors could stay on the sidelines. In this context, financial markets should remain volatile.

It is worth mentioning that our investment philosophy prioritizes companies that offer above average industry growth with good free cash flow levels and strong balance sheets. Our approach has delivered good performance results in both up and down markets. We believe the current market environment creates interesting opportunities.

Have a good weekend.

The Global Alpha Team