COMMENTARY

January 26, 2018

Dear clients and colleagues,

We recently had a chance to meet with over 60 European and Scandinavian companies at various conferences. Here are some of our observations from these meetings:

- We noted a positive tone from management teams across the board. Companies expect profit improvement due to the synchronized global growth recovery in a modest inflation environment. Management sounded very optimistic, especially within Capital Goods, Property & Construction, IT Services and Health Care. The tourism industry should also recover after a difficult 2016 and 2017.

- In some sub-industries within the Technology and Industrials sectors, capacity utilization has improved considerably. New capital spending is now expected, which would have a positive impact on the business cycle.

- France should continue to benefit from favourable market conditions and ongoing reforms. In general, we noted that there is a growing focus on cash conversion and free cash flow.

- On the negative side, the unexpected strengthening of the euro was a major topic of discussion with the companies we met. Several firms have a natural hedge in place, where revenues and costs are somewhat matched in the same local currencies. Nonetheless, euro-reporting companies could suffer from a translation impact in the short term. Many firms also commented on the potential impact an increase in raw materials prices could have on items such as IT components, oil-derivative products and material prices.

- We also observed a growing concern regarding labour shortages across many industries and countries. The lack of qualified staff within transportation, industrial, retail, hospitality and service sectors could eventually impact GDP. As such, we expect the automation trend should intensify in the coming years.

- Political risk, which was a big concern in the past years, is now fading. Italy's general election is set for March 4, and the chance of seeing a populist party lead the government is currently very low. A large coalition government will likely have a better outcome and a greater chance of succeeding.

In general, healthy balance sheets and strong business sentiment across Europe bodes well for 2018. European companies we met remain committed to returning cash to their shareholders mainly through a dividend or special dividend if the M&A capital deployment is weak. Thanks to strong corporate confidence and appealing financing conditions, the willingness of companies to pursue M&A opportunities continues to be high. In some cases, high valuations seem to be the only barrier to M&A activities.

In our view, European stocks still offer better margin expansion and thus more re-rating potential than most other regions. Europe, which remains under-owned in many portfolios, could be benefiting from a gradual capital inflow to the region.

Have a good weekend.

The Global Alpha Team