Euro Global Leaders Monthly Commentary, November 2016

While U.S. indices continued to climb following the election of Donald Trump, the MSCI EMU Index recorded a slight decline of 0.3% in November despite sharp improvements in many Eurozone macroeconomic indicators.

Indeed, data released during the month signaled accelerating economic momentum in the region. The Eurozone PMI reached its highest level of the year, driven by rebounds in both the manufacturing and services sectors. Meanwhile, retail sales grew 2.4% year-over-over in October versus an increase of just 1.0% in September. The improvement in household consumption is particularly reassuring in light of rising gas prices, which reduce consumer purchasing power.

Citigroup's Economic Surprise Index for the Eurozone, which surged to a new high for the year, confirms that recent economic data has far exceeded expectations. Germany continues to be the growth engine of the European economy thanks to strong domestic dynamics and an improving global economic cycle, particularly in emerging markets.

Moreover, the euro's significant depreciation against the dollar also supports European economic growth, especially in Germany. The dollar's rise has been fueled by higher inflation expectations in the U.S., which in turn are expected to speed up interest rates hikes, which could push the dollar even higher.

Despite positive data and economic tailwinds, European equities are trading at a 25% discount to U.S. equities based on 2017 price-to-earnings estimates. On an absolute and relative basis, European equities offer extremely attractive valuations.

The Eurozone market rotation from low volatility to value/cyclical stocks that began in October due to the sharp rise in long-term interest rates in the U.S. and in Europe continued in November. Utilities (-8.5%), telecom (-5.2%), and real estate (-4.4%), which are inversely correlated with interest rates, were the worst performing sectors during the month. In addition, consumer staples, a defensive sector that has been popular with investors since the end of the financial crisis, suffered a decline of 4.4%.

By contrast, sectors more correlated with global reflation and rising interest rates outperformed. Energy, industrial raw materials, financials, and industrials were each up about 2% in November. The only outlier was health care, a defensive sector, which was also up 2% as Hillary Clinton's failed presidential bid reduced the overhang from drug pricing pressure.

FOURPOINTS Euro Global Leaders was up 1.1% in November, and outperformed its benchmark by 1.4 percentage points. Health care holdings **Qiagen** and **Grifols**, and information technology holding **Criteo** were up 17%, 13%, and 18%, respectively, on better than expected quarterly earnings. The ambitious medium-term outlook that **Qiagen** provided at its investor day, as well as **Criteo**'s new "search" product also helped prop up both stocks. Meanwhile, a more favorable environment for defense companies following Trump's election as well as the stronger dollar benefitted **Airbus** and **Thales**, which were up 11% and 7%, respectively. Finally, the two exploration and production companies held in the portfolio, **Ophir** and **Tullow**, surged 21% and 19%, respectively, thanks to OPEC's agreement to reduce oil production.

This month's focus: Philips, refocusing to create value

In November, we initiated a position in **Philips**. The Dutch technology company is refocusing its efforts on health and personal care. **Philips** expects to sell Lumileds by year-end, and is planning to divest its 71% stake in the lighting business.

With a combined addressable market of €150 billion that is growing 5% per year, the company is now focused on three businesses:

- Personal care (42% of sales) is growing 6-8% per year thanks to **Philips**' leading positions in the most dynamic product families, including oral hygiene (especially electric toothbrushes), electric shavers, and child care. These operations are also very profitable, with a combined operating margin of approximately 14%. During its investor day in November, **Philips** noted that it expects the segment's margin to increase to more than 15% by 2019.

- Medical diagnostics (39% of sales) are growing 4-5% per year. **Philips** is the world's leading manufacturer of ultrasound equipment and X-ray machines. However, the company significantly lags **General Electric** and **Siemens** in other medical imaging, particularly MRI scanners, following production problems at a Cleveland plant that tarnished its reputation and cost **Philips** 5-10% of market share.

Management is focused not only on regaining lost market share, but also on restoring profitability. Excluding ultrasound, **Philips**' medical imaging margins are below 10% compared with 15-20% margins for **Siemens** and **General Electric**. **Philips** hopes to bridge the margin gap with its competitors by streamlining production and resolving issues at the Cleveland plant.

- "Connected care" (19% of sales), which is growing 6-7%, provides patient monitoring solutions, a market in which **Philips** is the world leader with 40% share. The company is at the end of the investment cycle for its new telehealth solution. As such, margins are expected to improve to nearly 15% by 2019 from 10% in 2016.

The health and personal care portion of **Philips**' business offer an attractive growth profile: organic sales are expected to grow 4-6% until 2019, and operating margin should increase by 100 basis points per year over the same time period. For the company as a whole, earnings per share are expected to increase 12% annually until 2019. Valuations are also attractive (2017 and 2018 price-to-earnings of 15x and 13x, respectively). Our base case target price is €31 (15% upside), but we think the stock could go as high as €40 if management hits all of its 2019 objectives.