Euro Global Leaders Monthly Commentary, January 2017

After a favorable year-end for equities in 2016, 2017 began with the MSCI EMU Index down 0.99% in January and no clear sense of direction. **FOURPOINTS Euro Global Leaders**, which declined 0.58%, slightly outperformed its benchmark.

During the month, the energy sector corrected by 5.3% following a strong rebound in 2016, while real estate and utilities were negatively impacted due to their high sensitivity to rising interest rates. Apart from these three sectors, performance for most other index sectors was relatively flat. The portfolio benefitted from outperformance by its industrial holdings, which were up 1% thanks to a rebound by **Mersen** (+12%) and continued gains by **Spie** (+4.9%) and **Elis** (+2.9%). Our information technology positions, which increased 6.5% versus a gain of only 0.5% for comparable index constituents, also contributed significantly to performance on both an absolute and relative basis.

Meanwhile, stocks that performed particularly well in 2016, including **Sodexo** and **Thales**, fell victim to profit taking that contributed to declines of 6.3% and 5.8%, respectively.

We believe that accelerating global growth and rising inflation could be two important investment themes for financial markets in early 2017.

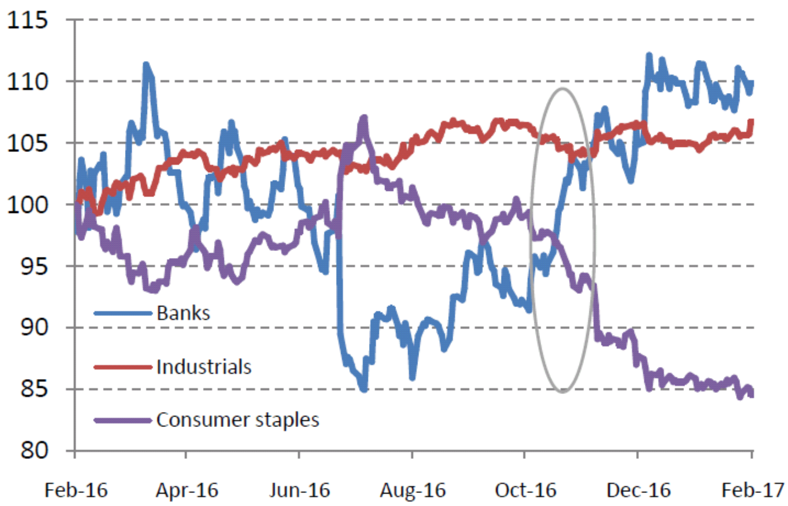
Indeed, all leading indicators signal an improvement in economic momentum. The Eurozone PMI, especially the manufacturing component, is at its highest level since 2013, which could lead to an upturn in industrial production. This trend is corroborated by business sentiment surveys, most notably Germany's IFO Index, which also reached a recent high. In the U.S., the economic environment appears healthy enough for the Federal Reserve to begin to normalize monetary policy. ISM's manufacturing PMI surprised positively in January, the pace of job creation remains healthy, and conditions for consumer spending continue to be favorable. Meanwhile, an early recovery in commodity-producing countries like Brazil and Russia and stabilization in China bode well for emerging markets.

After several years of deflationary fears, we appear to be entering a period of reflation aided by the rebound in commodity prices and an improved economic outlook in the U.S. as a result of President Trump's proposed fiscal stimulus initiatives. However, the dynamics are different on either side of the Atlantic. While rising inflation in the U.S. is fueled by a buoyant economic cycle and improving wages, reflation in Europe is primarily the result of higher raw material prices. In fact, "core" inflation in Europe is still anemic.

In our opinion, the current economic environment is favorable for equities, especially cyclicals.

The acceleration in global growth, improving inflation expectations, and rising interest rates favor value and cyclical sectors of the market. Indeed, in November 2016, the market witnessed a violent sectoral rotation towards value stocks/away from defensive sectors.

Sector Performance Relative to the MSCI EMU



Source: FactSet

While financials are the obvious beneficiaries of higher interest rates over the short-term, we believe that cyclicals, such as industrials, materials, and automotive suppliers, will be the lasting winners of the current economic environment thanks to a recovery in volumes, improved pricing power, and strong operating leverage.

Although they performed well in 2016, the diversified cyclicals held in **FOURPOINTS Euro Global Leaders** still have significant upside potential. In our opinion, three companies held in the portfolio, **CRH**, **Michelin**, and **Schneider Electric**, are poised to benefit significantly from the recent improvement in the business cycle.

CRH, a leading manufacturer and supplier of building materials, is benefitting from two growth engines: 1) the U.S. construction market is currently operating at full capacity, and 2) Europe is only in the early stages of its construction recovery, which has significant catch-up potential. The U.S., which represents approximately 40% of the company's profits, is poised to benefit from massive infrastructure investments over the next five years that have already been approved by Congress. While it is still uncertain, President Trump could propose additional infrastructure spending. Moreover, we expect margins to expand significantly thanks to greater operating leverage (in conjunction with cost reductions implemented during the crisis, capacity utilization in Europe will improve as volumes continue to recover), as well as synergies associated with the recent acquisition of assets from Lafarge Holcim.

We believe automotive supplier **Michelin** will benefit from several important catalysts in 2017 and beyond. While higher raw material prices negatively impact margins over the short-term, they ultimately create a more competitive environment in the long-run. Low-cost players may benefit in a deflationary environment, but industry leading companies like **Michelin** command significant pricing power that allows them to quickly pass on higher raw material costs to customers, as demonstrated by the increased pricing **Michelin** announced in the U.S. and Europe in the beginning of the year. We also expect rising inflation to contribute to a recovery in the mining industry, for which **Michelin** produces its most profitable tires (30% operating margin versus 20% for its entire specialty tire division). After three difficult years, the company's backlog rebounded strongly thanks to orders from major customers, such as Rio Tinto and Atlas Copco. **<u>Michelin</u>** expects mining-related volumes to improve by 8-10% in 2017. Through pricing power, volume recovery, operating leverage, and restructuring, we believe **<u>Michelin</u>** has the ability to significantly narrow the profitability gap with competitor **<u>Continental</u>**.

Finally, **<u>Schneider Electric</u>** is also well positioned to benefit from increased infrastructure investment. In recent years, the company has been penalized by tumbling raw material prices, a struggling Chinese industrial sector, and sluggish economic growth in Europe. Lower volume and deflation caused operating margin to fall below 14% from pre-crisis and 2010 levels of 15-16%. Despite margin erosion, **<u>Schneider</u>** was able to maintain pricing power and focused on productivity initiatives. At its investor day in October, management noted that it expected sales to increase by 3% per year going forward. Moreover, the company expects to be able to restore margins thanks to a combination of productivity gains (€1.7 billion, gross, between 2015 and 2017) and restructuring at its infrastructure division. **<u>Schneider</u>** is targeting 4-7% organic growth per year, and guided that margins could drop as low as 13% at the bottom of the cycle, but could reach 17% at the top of the cycle. At 15% operating margin in 2018, the consensus estimate is overly pessimistic in our opinion relative to guidance, which focuses solely on productivity and restructuring and does not take into account improving macroeconomic conditions. No doubt, **<u>Schneider</u>** will benefit from strong operating leverage from higher volumes and prices should investments resume in oil and gas, mining, and residential construction (more than half the company's profits come from low voltage products) and/or the automation of industrial processes. Over the coming months, we believe reflation could drive upward earnings revisions for the company, which would positively benefit **<u>Schneider</u>**'s share price.

The contents of this document represent the views of FOURPOINTS Investment Managers based on analysis of publicly available information. These views may change at any time, and may differ from the opinions of other analysts. The information contained herein does not constitute investment advice, nor is it a solicitation to purchase or sell any security. The above commentary references performance for the euro-denominated FCP (French mutual fund). Stocks held in the portfolio are bold and underlined. All stock and index performance is in local currency unless otherwise stated. Past performance is not indicative of future results. For more information, or to obtain a prospectus, please visit www.fourpointsim.com. FOURPOINTS IM – RCS Paris B 398027151 – 121, avenue des Champs Elysées, 75008 Paris – Tel: +33 (0)1 53 57 29 00 – Fax: +33 (0)1 53 57 29 12 – AMF No. GP94004