

Favorable Regional Economic Fundamentals

Europe is early in its credit cycle with positive momentum in economic drivers and underappreciated balance sheet strength, which should allow most European Banks to accelerate credit growth with improved profitability for at least the next few years. A reversal in interest rates from negative and falling to rising and positive should further push a reacceleration in bank earnings. With the benign conclusion of the French and Dutch elections, investors were relieved of these concerns and refocused on the surprising strength of bank balance sheets and the improved economic backdrop that has unfolded over the last year. Banks should remain a primary benefactor, as this category still has the biggest disconnect between reality and expectations.

European Financials P/B reached negative readings early this year. This substantial discount is unwarranted given fundamental developments. Political fears leading into the French elections allowed this disconnect to perpetuate until April and has since only modestly corrected. Nearly every aspect of European Union (EU) bank fundamentals suggest we are in the early stages of its credit cycle with big declines in non-performing loans (NPLs), an end to capital rebuilding, an improved appetite to lend, accelerating housing and economic growth with rising short rates and a widening yield curve. When combined with near record low relative valuations, it's hard to make the fundamental case against the category.

EU Falling Political Uncertainty

Moving into the latter half of 2017, we expect falling political uncertainty to continue contributing to European outperformance. In the beginning of 2017, European political pessimism was widespread causing unreasonably low expectations over populist takeovers in France and the Netherlands. Both elections proved benign, with centrist and status quo coalition governments emerging in both. As these elections unfolded, uncertainty gradually faded, with worst case scenario fears proving far overblown. European markets have begun aligning with the reality of improved economic fundamentals. With the year half done, two major elections have concluded and two remain in Germany and Austria. We expect continued falling uncertainty with a similar benign conclusion to both elections—although it is unlikely that we will see the same magnitude of relief post German elections as experienced in France. Expectations are for a Merkel victory, and polls consistently suggest that her lead is widening. EU disintegration risks remain, but fears have faded with recent elections and this trend likely continues.



Monetary Policy Uncertainty

The end of Quantitative Easing (QE) and reversal of negative rates within the next 12-18 months appears likely, and should provide the missing ingredient to an EU bank fundamental recovery—boosting net interest margins (NIMs) and return on equity (ROE). The category still has a very long runway ahead, despite recent short-term outperformance.

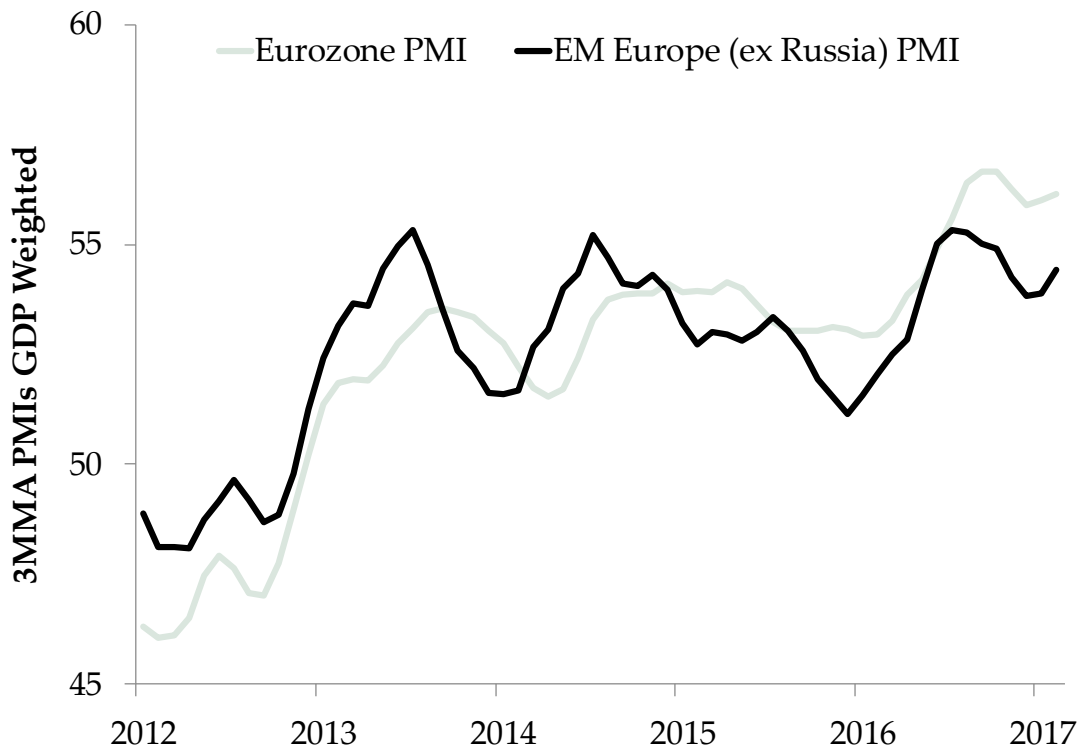
The biggest uncertainties right now are when Mario Draghi will announce QE tapering and its pace, and when Janet Yellen will announce the Fed's plans to unwind its balance sheet. Neither of these events are 'ifs' but rather 'whens'. And when they do occur, both are likely to put upward pressure on long rates, helping peel back another layer of uncertainty—which should be good for Financials globally. If either Yellen or Draghi decide to postpone these anticipated programs it will be a disappointment to investors and a headwind to Financials shares in the short term.



Eastern European Emerging Market (EM) Countries

Eastern Europe has very strong economic and market linkages with developed Europe, as much of the region's economic prospects are driven by exports to developed Europe. When European economics are improving, this translates into additional growth and demand for goods and services from the Eastern European periphery. The region has become an integral part of the European supply chain. We can see this impact in the economic data, as Eastern Europe typically sees its best growth when its developed neighbors are strengthening as illustrated by Eastern Europe's Purchasing Managers' Index (PMI) high correlation with developed Europe's PMI (Exhibit 1).

Exhibit 1: Eastern Europe PMI is Highly Correlated to Eurozone



Source: Factset, Eastern European countries cover Poland, Czech Republic and Hungary.



Opportunities in Europe

This periphery effect similarly translates into relative stock market returns. As Exhibit 2 indicates, when developed Europe outperforms the MSCI World, Eastern Europe typically outperforms Emerging Markets.

Exhibit 2: EM Europe Outperformance is Highly Correlated to DM Europe Leadership



Source: Factset as of 07/23/2017.



Opportunities in Europe

Free Trade

Being a part of the Schengen Area (i.e. the free trade and movement union) has led to reduced cost of doing business and encouraged additional trade within Eastern Europe. Yet, not being a part of the common currency has allowed for a localized pricing mechanism and encouraged international investment since the euro currency's creation. The marginal cost of doing business in Poland and Czech Rep vs Italy or Portugal has been in Eastern Europe's favor for many decades. But what's encouraged the accelerated shift in the past decade has been the removal of regulatory red-tape and tariff-free trade related to the EU trade union. Eastern Europe's integration into the German supply chain in particular has been a gradual phenomenon as shifting operations from Southern Europe and building out effective ecosystems to support this supply chain is something companies do not rush. As illustrated below, this is precisely what has occurred over the past decade - leading to record low unemployment across Emerging Europe (Exhibit 3).

Exhibit 3: Historical Unemployment Rates



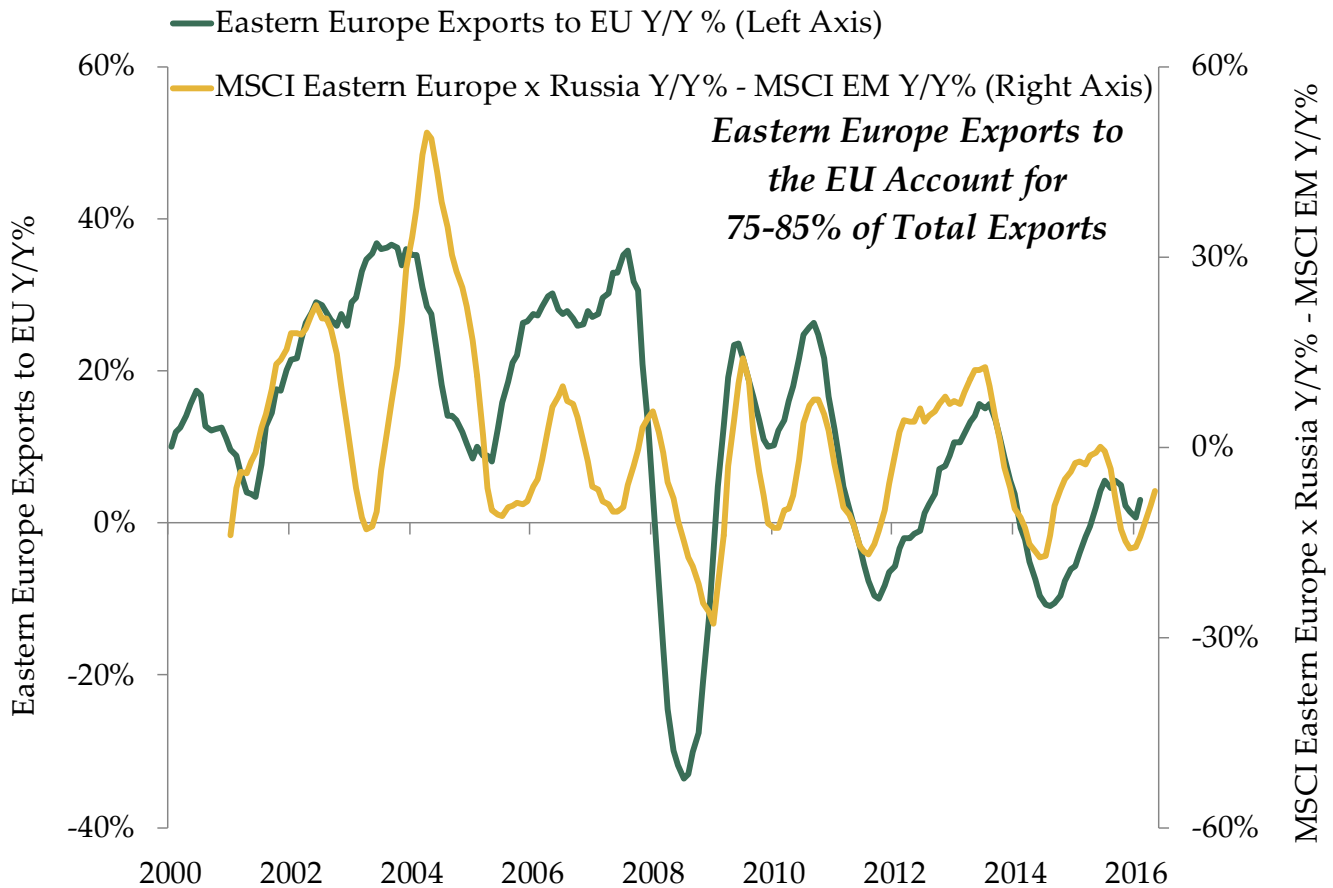
Source: Factset. Harmonised unemployment rate used.



Opportunities in Europe

Given how highly levered Eastern European exports are to developed Europe, as economic activity within the eurozone continues to improve, demand for Eastern European products should increase – leading to outperformance relative to the rest of EM (Exhibit 4).

Exhibit 4: Eastern European Exports within the EU



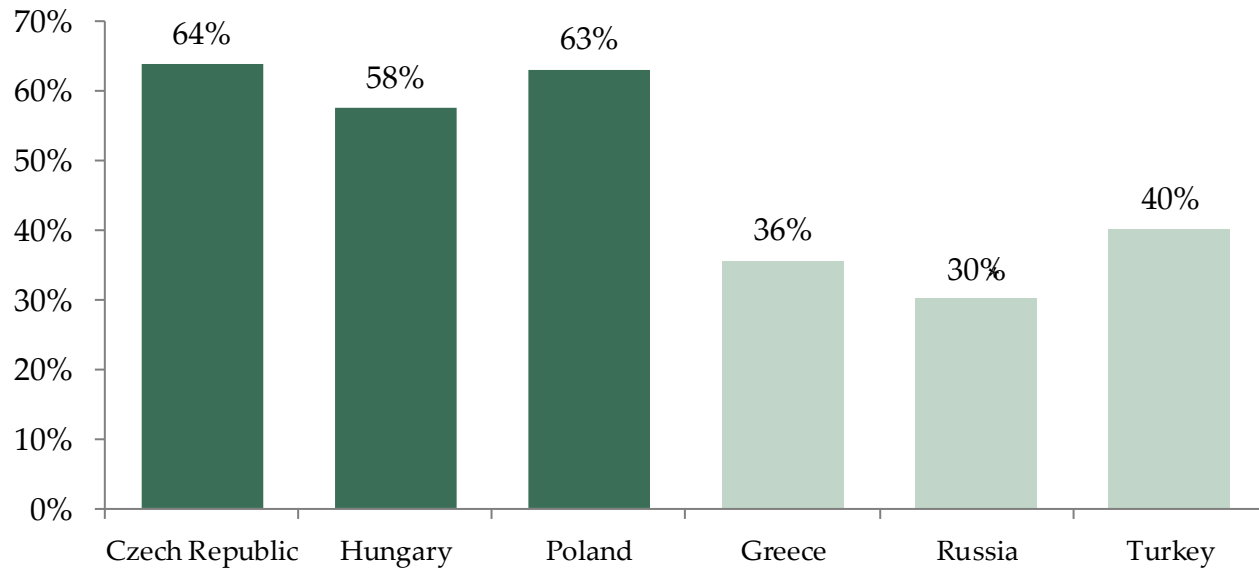
Source: Factset as of 05/25/2017. MSCI Eastern Europe Y/Y% - MSCI EM Y/Y% plots 6 month moving average.



Opportunities in Europe

Additionally, the Czech Republic, Hungary and Poland (all portfolio overweights) have stronger economic ties with developed Europe than the more peripheral EM European countries (Exhibit 5).

Exhibit 5: Exports to Developed Europe (% of Total Exports)



**The figure excludes 15.4% of total exports from Russia that are not allocated geographically.*

Sources: The World Bank. Exports data as of 2015. Developed Europe includes 15 European countries in the FTSE Developed Europe index.

In short, developed European companies have become more comfortable with their Eastern Europe operations to the point where economic inter-dependence is about as high as it's ever been — and unlikely to break down in the immediate future.



Opportunities in Europe

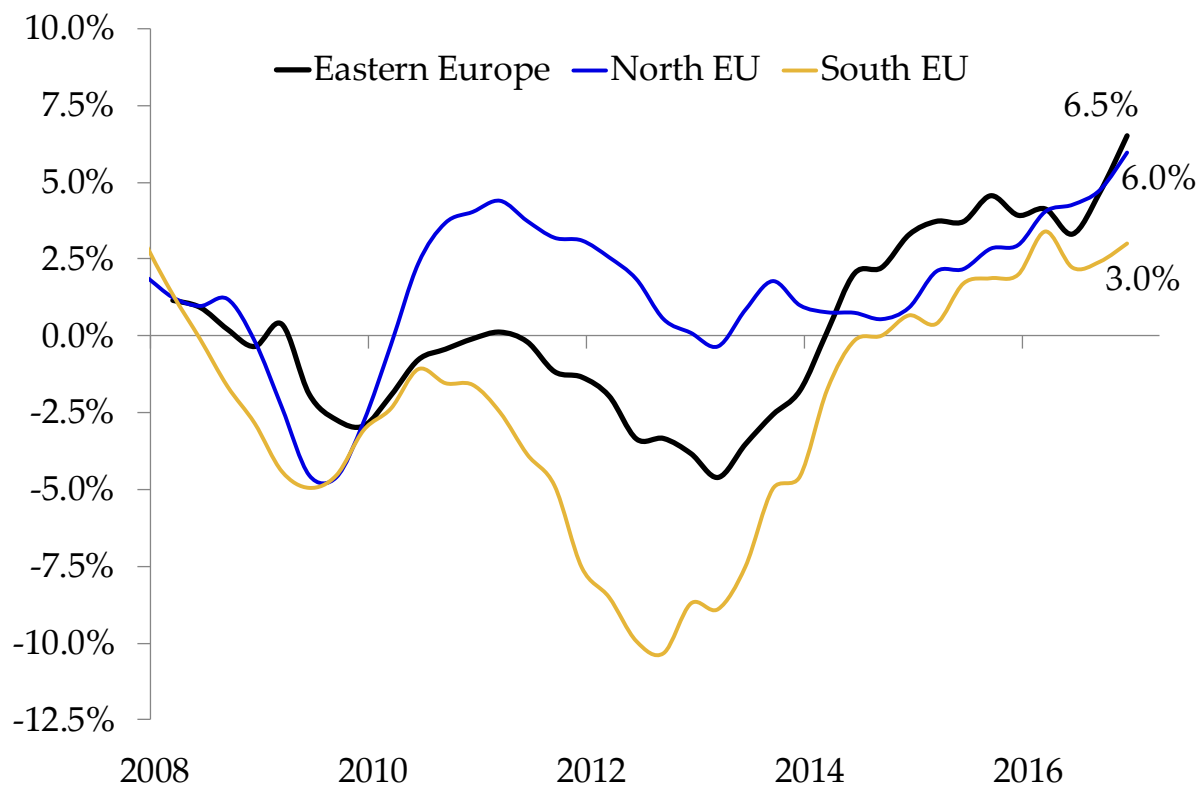
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Improving Backdrop for Banking

Fundamentals of the Eastern European banking sector are also quite supportive of continued outperformance with economic trends gaining momentum, housing prices growth accelerating, underpenetrated banking systems, asset quality improving, capital at or above regulatory hurdle rates, and early signs of reversal of extreme monetary policy. All of these factors continue to support profitable, balance sheet expansion.

Housing prices across the region have been accelerating as access to credit and economic growth is improving (Exhibit 6).

Exhibit 6: Housing Prices Y/Y Growth



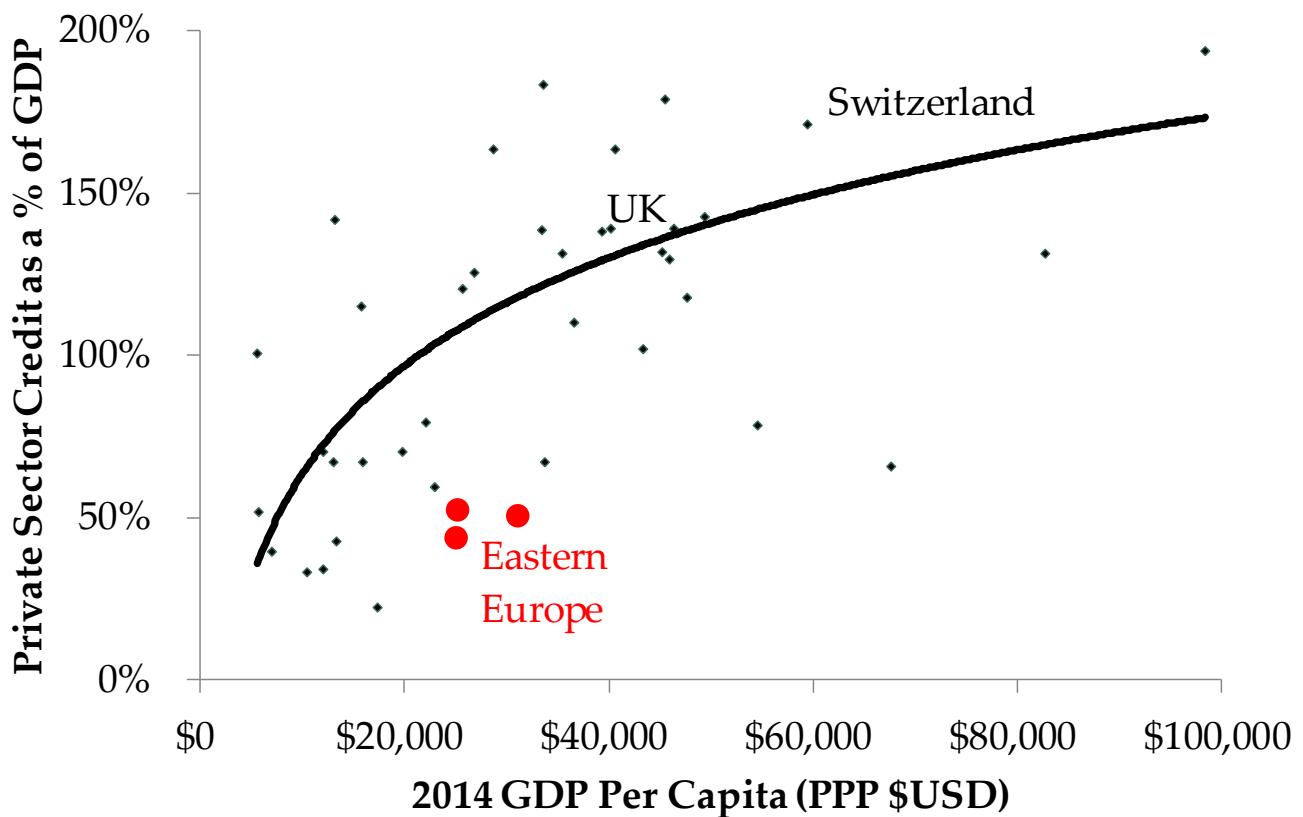
Source: Factset. North EU consists of Germany, France, Netherlands, Belgium and Austria. South EU consists of Italy, Spain, Greece, Ireland and Portugal.



Opportunities in Europe

Underpenetrated banking systems tend to outperform during economic expansions as previously underserved consumers and businesses gain access to credit for the first time. Additionally, new entrants' first loans tend to be highly profitable with low default rates. Eastern Europe remains in the bottom half of EM countries in terms of credit penetration, with a long runway for continued expansion (Exhibit 7).

Exhibit 7: GDP and Private Sector Credit



Source: Factset. Private Sector Credit as % of GDP and GDP per-capita.



Opportunities in Europe

Banks continue to improve their capital position, with falling levels of bad debts, and are increasingly more willing to make loans. For example, Polish NPLs have been declining since 2013 (Exhibit 8).

Exhibit 8: Polish Banks Have Continued to Improve Their Balance Sheets Since 2013



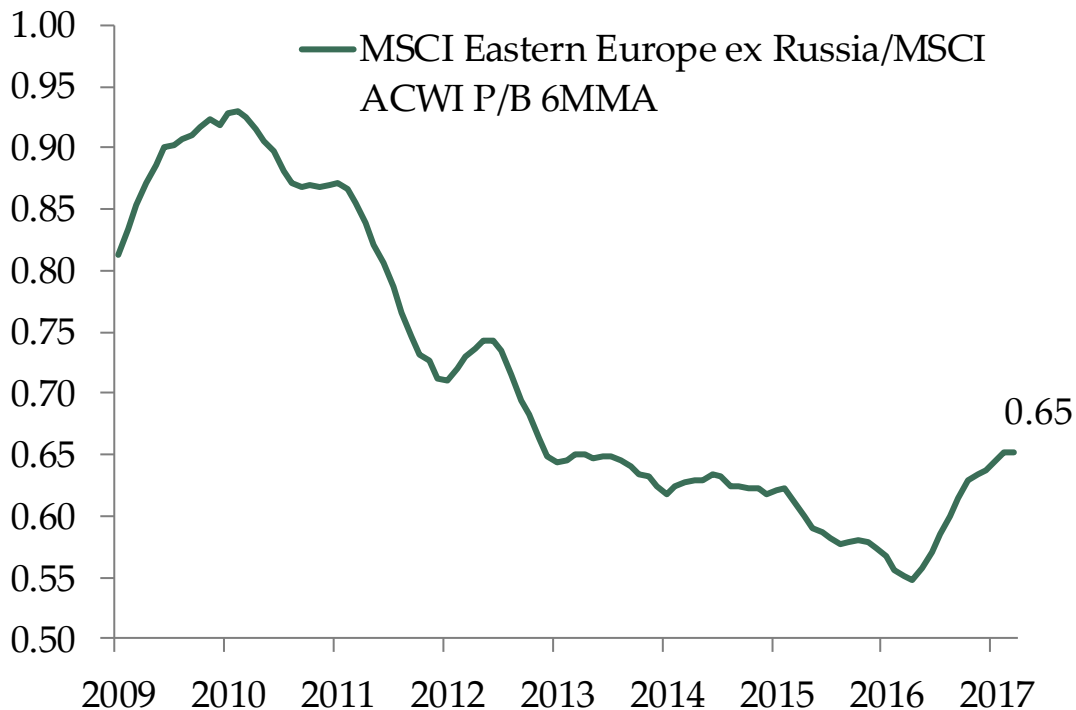
Source: Bloomberg, Polish Banks Non-Performing Loans Ratio, 03/31/2009 – 03/31/2017.



Sentiment on the Region Remains Cautious

The Eastern Europe Price to Book ratio relative to ACWI shows a sizeable discount to the rest of the market—particularly within Financials (Exhibit 9).

Exhibit 9: EM Europe Relative P/B Ratio Trades at a Substantial Discount to ACWI



Source: FactSet as of 06/30/2017. Based on monthly data points and 6 month moving averages.

We believe this discount is unwarranted, particularly given the improvement in the fundamental backdrop. As investors continue to realize their deep seeded political fears of the past 8 years are unlikely to come to fruition in the immediate future, investors should gradually reward Eastern European equities, with banks as the primary beneficiary.



Eastern Europe Political Risks

Eastern Europe has a long history of political upheaval. The hinterland between East and West is straddled by diverse, often-conflicting cultures, with competing ideologies applying pressure from both sides—so fears of political upheaval and concerns of populism are completely understandable. Indeed the political risk in Poland and Hungary is elevated, as the conservative governments clash ideals with the more centrist and liberal leaning governments across Western Europe. The Polish and Hungarian populous feel under attack from the EU and European Commission, taking the blame for the weak employment across mostly rural regions where job creation has yet to recover. Poland in particular has been doing a great deal more saber rattling with the EU than it has in the recent past as the majority PiS government is likely sending a message to Brussels regarding standing up for their own sovereignty. This has created ample headline risk, and remains a headwind for sentiment. But it's unlikely in the immediate term Poland or Hungary will make any drastic moves to disintegrate from the EU, in a Brexit type event—particularly when the economy is just starting to benefit from a regional economic tailwind which has been absent from the last 7 years.

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