European Equity Strategy
Outlook 2017: No More Excuses…

Equity Strategy

Europe including UK

Nick Nelson
Strategist
nick.nelson@ubs.com
+44-20-756 81960

Karen Olney, CFA
Strategist
karen.olney@ubs.com
+44-20-7568 8944

Joao Toniato
Strategist
joao.toniato@ubs.com
+44-20-756 74657

Andras Nagy, CFA
Associate Strategist
andras-a.nagy@ubs.com
+44-20-7568 3577

2017: A Window of Opportunity for European Equities…

We believe 2017 is a window of opportunity, but a narrowing one: by 2018 we see the Eurozone slowing to 1.2% GDP growth and the UK 0.7%. We forecast 8% EPS growth in 2017 as 3 drags fade: commodities, zero inflation and EM. What evidence do we have? A decent Q3 reporting season and revenue momentum has just turned positive for the first time in 16 months – it leads sales growth by 6 months (Figure 1). We target 360 (Stoxx 600) end-2017 - combined with a 3.8% dividend yield: a c.10% total return. We see less upside in the FTSE 100 and target 7,100 end-2017.

What do higher Bond yields mean for European Equities?

3 factors matter: why are yields rising, at what speed and from what level. So far, the move has been about inflation rather than real yields (Eurozone 5yr 5yr inflation swaps are up 30bps from lows) and equities are currently positively correlated to rising inflation (Figure 2).

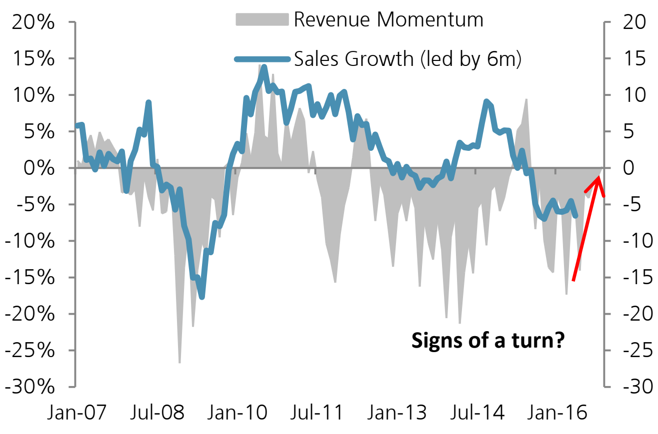
Upside risks: fiscal, releveraging, re-rating. Downside risks: rising yields, politics

Upside risks: as monetary policy runs out of road, a switch to fiscal boost (Fiscal Fitness – Is Global Spending "Bulking Up"?), companies relever, equities re-rate to bond-like multiples, US investors come back. Downside risks: real yields rise sharply; the ECB tapers too early, capital concerns over Banks and a busy European political calendar.

Upgrade the Energy sector to Overweight - Downgrade Transport

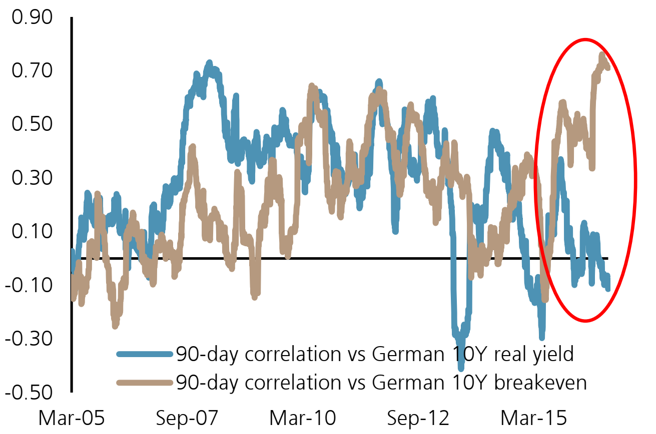
We upgrade Energy to Overweight from Neutral as the oil price drag on EPS is turning into a boost and the sector offers the highest dividend yield in Europe. While Energy has outperformed the market YTD it has underperformed the Mining sector by over 50% and earnings growth is yet to turn positive – something we believe will happen soon. Hence, we think there is plenty more upside from here. We downgrade Transport to Underweight as a supply-side shock to oil prices puts pressure on margins and EPS downgrades are now on par with the sharpest since the data began.

Figure 1: Revenue Momentum leads Sales Growth by 6 months and points to a turn…



Source: Datastream, IBES, UBS European Equity Strategy

Figure 2: Correlation of European Equity returns with real yields and break-evens



Source: Datastream, UBS European Equity Strategy

UBS Research THESIS MAP **2017 Outlook: c.10% total return for Stoxx 600. Window of opportunity for Europe**

PIVOTAL QUESTIONS

Q: A window of opportunity…Can Europe deliver first EPS growth for 6 years?

Europe is running out of time. European growth is set to slow heading into 2018. We think consensus estimates of 13% EPS growth for 2017 are too high, but still expect 8% - the first growth for 6 years. This would be a big deal for European equities and allow some rehabilitation amongst investors.

Q: Will higher Bond yields de-rail the Equity market recovery?

We think it matters *why* bond yields are rising, how fast and from what level? The current move since July has been inflation, not real yields. Currently equities are positively correlated to the move in inflation break-evens: i.e. from this ultra-low level, *higher* inflation is good news for equities (this fits with the evidence on earnings below).

Q: What are the biggest risks?

Upside Risks (p.38): Fiscal boost bigger than expected, Equities re-rate to bond-like multiples, European companies follow the lead of the US and re-gear balance sheets through buybacks and M&A, US Investors return to Europe.

Downside risks (p.44): An aggressive sell-off in bonds with rising real yields (our House view is no, but what if we're wrong?), Banks (latent concerns from investors over capital), European politics – a very busy political calendar ahead of us. Potential volatility from the unexpected US Elections results.

WHAT'S PRICED IN?

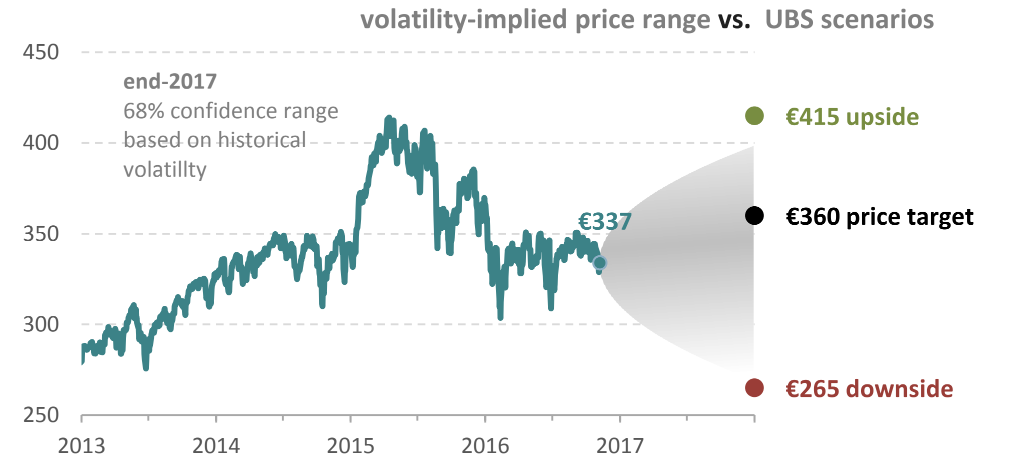
Equities trading at a 20% discount to the average cyclically adjusted P/E: We look at 8 different valuation measures: fwd P/Es are in line with long run average – but this is on super-depressed EPS. Cyclically-adjusted measures show c20% upside suggesting market not pricing a profit recovery (p.28).

UBS VIEW

2017: a "Window of Opportunity" for Europe: The macro backdrop is fair and the 3 main drags for profit growth have reversed (Inflation, Commodities and EM). This should allow c.10% total return.

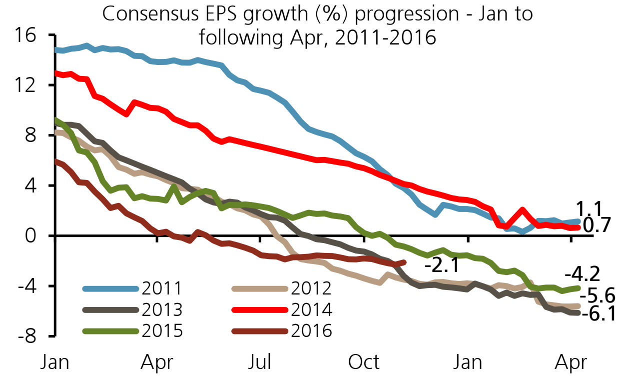
EVIDENCE

Revenues have been revised up for first time in 16 months and Q3 saw best revenue beats for 5 quarters. What has changed since last year? Eurozone Inflation has turned, Commodity prices are no longer a drag – at some point in Q1 the oil price will likely be up close to 100% YoY - and Emerging markets, having caused downgrades for European stocks for 32 months in a row, are now recovering.

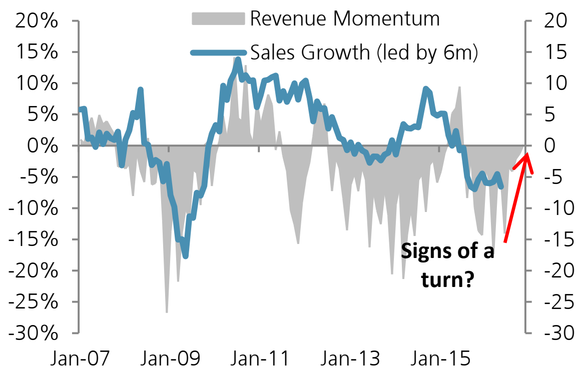


Source: Thomson Datastream, UBS European Equity Strategy

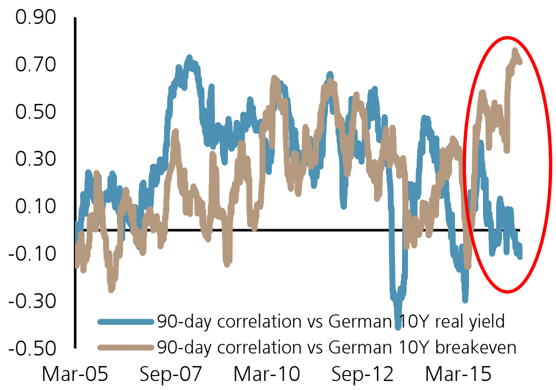
OUR THESIS IN PICTURES



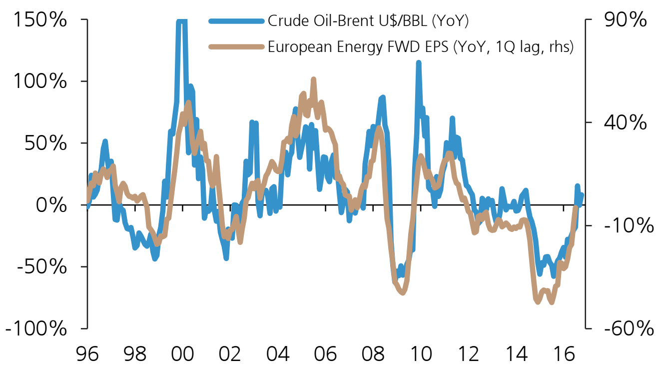
After 6 years in a row of no growth, 2017 is a window of opportunity as key drags disappear…



What evidence? Revenue momentum has turned positive for the first time in 16 months and tends to lead sales growth by 6 months…



What impact of rising bond yields? So far it has been inflation-driven - equities are positively correlated to inflation break-evens



After c5 years of negative EPS growth the Energy sector appears to be on the brink of growing again.

Sources: Datastream, UBS European Equity Strategy

What worked and what didn't work…

Operational Leverage: One of the themes that we looked at in our 2016 Outlook was the potential for a pick-up in operational leverage. But this didn't materialise this year as there was no growth at the top-line given the oil price and commodities collapsed in to Q1, inflation surprised on the downside and Financials again, missed estimates. But we think that this is now changing given the turn in revenues (we saw upgrades in October for the first time in 16 months and the beats in Q3 so far have been the best for 5 quarters), inflation turning and Emerging markets recovering.

What didn't work: no operational leverage as no top-line growth

EM Exposure: We highlighted back in May that Emerging market exposed stocks were starting to see a turn in relative earnings momentum for the first time in 5 years and this was a trend likely to continue, driven by FX and an improvement in the PMIs *(see* European Earnings Watch - Q1: Miss on Revenues, Earnings Beat 13 May 2016*)*.

What worked: European stocks with EM exposure outperformed

After outperformance in recent months by European stocks with high EM exposure, outperformance by Emerging Markets themselves, and given a world potentially moving away from globalisation, we now shift focus away from this theme.

Where next?

Looking forward to end 2017, some 13½ months away, is always a tricky task. But to do so at this point in the rate cycle and political backdrop is even trickier than usual. Before we can look to end-2017 we still have to get to the end of 2016: in the next 4 weeks markets must navigate the Italian referendum (Dec 4) as well as the often forgotten re-run of Austrian presidential elections on the same day; the ECB meeting with likely decision on QE (Dec 8) and the FOMC meeting with the chance of the second hike of this cycle (Dec 14). And this is all against the backdrop of potentially higher volatility after the surprise US elections result.

Where next? Tricky to look to end 2016, let alone end 2017…

Figure 3: Catalyst Calendar

Month	FOMC meetings	BoE MPC meetings	ECB MPC meetings	Parliamentary/Presidential Elections
Dec	13-14	15	8	Switzerland* Italy's constitutional referendum – 4 Austria's presidential elections – 4
Jan'17	31-1	-	19	Singapore (parliament)
Feb	-	2	-	Germany*
Mar	14-15	16	9	Netherlands (parliament)
Apr	-	-	27	
May	2-3	11	-	France (president round 1) - 7
Jun	13-14	15	8	France (parliament round 2) - 18
Jul	25-26	-	20	India*
Aug	-	3	-	Singapore (president)
Sep	19-20	14	7	France (senate) - 24
Oct	31-1	-	26	Germany (parliament)
Nov	-	2	-	Slovenia (president)
Dec	12-13	14	14	South Korea (president)

Source: UBS European Equity Strategy, BBC, FT, Google News - *President (by Parliament)

…given a busy political and Central Bank calendar

Sector Comments and Changes

Some of the key macro views we focus on for 2017 are:

Macro views include: fiscal stimulus, higher commodity prices and Dividend Yield

(1) Commodity prices continue to increase moderately from here.

(2) Governments implement fiscal stimulus.

(3) Operating leverage kicks in and margins expand

(4) Companies lock-in debt at current low rates and refinance/ releverage

(5) Investors continue to be drawn to high and safe dividend yield stocks

Looking forward into 2017 **we upgrade the Energy sector to overweight** as a key beneficiary of most of these views, especially the commodity cycle and dividend yield. **We also downgrade the Transport sector to underweight** as a potential laggard under these views, especially the commodity cycle.

Figure 4: Matrix of sectors and macro views

		Macro view 1: Commodity cycle	Macro view 2: Fiscal Stimulus	Macro view 3: Oper leverage	Macro view 4: Refinancing	Macro view 5: Dividend Yield	Macro view 6: Value + Quality
Overweight	Energy	+++		++		+++	++
	Pharma			++	+	++	++
	Telecom				+++	+++	+++
	Utilities	+++	+	-	+++	+	+++
	Auto	-		+++	+	++	++
	Software		++	+		+	
	Comm Svs		+				
	Food Retail						++
	Tech hard			+++		+	+++
	Construction	-	+++	+++	+++		
Neutral	Cap Gds		++	+			
	Banks			-		+++	+++
	Insurance			-		++	+++
	Chemicals	+++		++			++
	Cons Dur	-	+	++			
	Div Fin					++	+++
	Media			--		+	
	Met & Min	+++	++	++	+		+
	H/C Equip			--		---	
	Real Estate			+	++	+	
	Retail					-	
	Semis						
Underweight	Food Prd	-		---		-	---
	HHold Prd	-				-	--
	Beverages					-	---
	Tobacco			-		---	--
	Transport	--	+				
	Cons Svs	-		+		--	

Source: UBS European Equity Strategy

We also look to the impact of those macro views on bottom up stock picking in conjunction with our analysts and highlight some of the key ideas across sectors that fit the views we focus on in our outlook for 2017.

What stocks fit the macro and sector views?

Figure 5: Key macro views vs stock recommendations matrix

	Macro view 1: Commodity cycle	Macro view 2: Fiscal Stimulus	Macro view 3: Oper leverage	Macro view 4: Refinance/Releverage	Macro view 5: Dividend Yield	Macro view 6: Value
Financials			• *Generali* • *ING* • *Intesa SP*	• *Hufvudstaden*	• *Generali* • *ING*	
Technology	• *Hexagon*	• *Hexagon*	• *Capgemini* • *Worldpay*			
Telecom			• *Vodafone* • *Deutsche Telekom*	• *Vodafone* • *Deutsche Telekom*	• *Vodafone* • *Deutsche Telekom*	• *Vodafone*
Utilities	• *Enel*	• *Enel*	• *EDP*	• *Enel*	• *EDP*	• *Enel*
Energy	• *RD Shell* • *ENI* • *Petrofac*		• *ENI*		• *RD Shell* • *ENI*	• *RD Shell* • *ENI*
Materials	• *BASF* • *Rangold* • *Glencore*	• *CRH* • *Rio* • *Glencore*	• *BASF* • *Lanxess*		• *BASF* • *Rio*	
Industrials		• *Alstom* • *Vinci* • *BAE Systems* • *Legrand*	• *Vinci* • *G4S*	• *Legrand*	• *Legrand*	• *Vinci*
Cons Discretionary			• *Daimler* • *Renault* • *Valeo*		• *Daimler* • *Sky*	• *Renault*
Cons Staples			• *Tesco*		• *Imperial*	
Healthcare			• *Roche*	• *Roche*	• *Roche*	

Source: UBS European Equity Strategy

For more on the Fiscal Stimulus theme please see: UBS Tactical Q-Trades - Europe: Stock beneficiaries of Increased Fiscal & Infrastructure Spending, 3 Nov 2016

For more on the Refinancing and Releveraging theme, see: European Equity Strategy: What Boost to Earnings from Cheaper Refinancing?19 May 2016 or Q-Series® - To Buy or Not to Buy… What is Behind the Current M&A Version of a Shakespearean Encore? 21 Jul 2015

For more on the Dividend Yield theme please see: UBS Tactical Q-Trades - European dividends: 35 top picks across sectors to optimise yield, growth & safety, 7 Nov 2016

For more on the Value theme please see: Europe thematic outlook "Europe differs to World = 4 unique buy ideas" Olney

(1) Macro Backdrop

The global macro backdrop is relatively benign. Our economists expect global GDP growth to accelerate modestly in 2017 to 3.5% and see 2017 as the first year of an acceleration in *nominal* GDP growth in 7 years.

The global macro backdrop is relatively benign…

But by 2018 they see the Eurozone and the UK slowing to sub-trend growth of 1.2% and 0.7% respectively. That is why we think that 2017 is the window of opportunity for European equities: they have the base effects of commodities, financials and higher inflation to support before heading into slower regional growth in 2018.

For more details please see our Global Economic Outlook for 2017: Global Economic Outlook 2017-2018 Nov 14, 2016.

And for some of the themes looking into 2017, please see our accompanying Thematic report:

…but the Eurozone and the UK are set to slow to 1.2% and 0.7% growth in 2018

Figure 6: UBS Global Economics: Growth & Inflation forecasts

	Real GDP			CPI (% year average)		
	2016F	2017F	2018F	2016F	2017F	2018F
US	1.5	2.4	2.5	1.3	2.3	2.3
Japan	0.5	0.8	0.9	-0.3	0.5	0.6
Canada	1.1	2.3	2.7	1.5	1.8	2.0
UK	2.0	1.0	0.7	0.7	2.8	2.8
Switzerland	1.5	1.3	1.6	-0.4	0.4	0.9
Eurozone	1.6	1.3	1.2	0.2	1.4	1.8
Germany	1.8	1.3	1.3	0.4	1.3	1.8
France	1.3	1.3	1.4	0.3	1.4	1.6
Italy	0.7	0.8	0.8	-0.1	1.1	1.8
Spain	3.2	2.3	1.9	-0.4	1.6	1.7
Asia (ex Japan, inc.Aus & NZ)	6.0	5.8	5.8	2.5	2.7	2.7
China	6.7	6.4	6.0	1.9	2.1	1.8
Latin America	-1.0	1.6	2.3	8.9	6.8	5.6
G7	1.4	1.8	1.8	0.8	1.8	2.0
Advanced economies	1.6	1.8	1.9	0.7	1.8	1.9
Emerging & Developing Economies	4.4	4.9	5.1	4.2	3.8	3.5
World	3.1	3.5	3.6	2.6	2.9	2.8

Source: UBS Global Economics Team

Global Macro Momentum Heatmap

One of the positive surprises over 2016 has been the resilience of the Eurozone to external shocks. Back in Q1 there were concerns that the US was going to roll over into recession, hard-landing and bank debt fears in China and commodity prices in freefall. There has also been the shock of the UK vote to leave the EU. Despite all this, the PMIs have been "steady Eddie" for the Eurozone: indeed for 7 months in a row there were the same level – small positive. The US and the UK have been far more volatile.

Macro momentum in the Eurozone has held up relatively well to date…

Another point of note has been the improvement in Emerging markets – or getting "less bad".

Figure 7: Composite PMI Heatmap

	2014												2015												2016									
US	0.1	-0.2	0.1	0.4	0.6	0.7	0.9	1.1	1.0	0.7	1.4	0.8	0.7	0.7	0.7	0.8	0.5	0.0	1.3	0.9	0.6	0.9	0.5	0.3	-0.2	-0.2	0.1	0.4	-0.2	0.6	0.4	-0.6	0.7	0.2
Japan	1.1	0.7	0.9	-0.4	0.1	0.3	0.4	0.5	0.9	0.2	0.6	0.7	0.6	0.3	0.2	0.5	0.6	0.6	0.6	0.9	0.5	0.8	0.8	0.7	0.8	0.5	0.3	0.1	0.1	0.1	0.3	0.3	0.1	0.6
Eurozone	0.2	0.2	0.2	0.4	0.3	0.1	0.3	0.1	0.0	0.0	-0.2	-0.2	0.1	0.2	0.4	0.4	0.3	0.4	0.4	0.5	0.3	0.4	0.4	0.5	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.1	0.2
UK	1.0	0.9	0.7	1.1	1.1	0.8	1.0	1.2	0.8	0.3	0.8	0.2	0.6	0.6	1.0	1.0	0.4	0.7	0.6	0.2	-0.2	0.2	0.3	0.2	0.5	-0.4	-0.2	-0.6	-0.3	-0.4	-1.6	-0.2	-0.1	0.1
Germany	0.4	0.6	0.2	0.6	0.5	0.1	0.5	0.1	0.1	0.1	-0.4	-0.3	0.0	0.1	0.4	0.1	-0.2	0.1	0.0	0.3	0.1	0.2	0.4	0.4	0.2	0.1	0.1	0.0	0.2	0.2	0.4	0.0	-0.2	0.4
France	-0.6	-0.8	-0.1	-0.3	-0.5	-0.7	-0.5	-0.5	-0.7	-0.7	-0.8	-0.5	-0.5	0.0	-0.1	-0.3	0.0	0.2	-0.1	-0.4	-0.1	0.1	-0.2	-0.4	-0.4	-0.5	-0.4	-0.4	-0.2	-0.5	-0.4	-0.1	0.1	-0.1
Spain	0.7	0.6	0.7	1.0	0.9	0.8	0.9	1.0	0.8	0.8	0.6	0.7	1.0	0.9	1.0	1.3	1.2	0.9	1.2	1.3	0.7	0.8	0.9	0.8	0.8	0.7	0.8	0.8	0.7	0.9	0.6	0.7	0.6	0.7
Italy	0.1	0.6	0.1	0.4	0.4	0.7	0.5	-0.1	-0.2	0.0	0.1	-0.2	0.1	0.1	0.4	0.7	0.6	0.7	0.6	0.9	0.6	0.7	0.7	1.1	0.6	0.6	0.4	0.5	0.1	0.4	0.3	0.3	0.1	0.1
China	-0.7	-1.0	-1.1	-1.1	-0.8	-0.2	-0.4	0.0	-0.2	-0.4	-0.6	-0.5	-0.6	-0.3	-0.4	-0.5	-0.5	-0.7	-0.9	-1.3	-1.5	-0.9	-0.7	-1.1	-0.9	-1.1	-0.5	-0.7	-0.8	-0.8	-0.3	-0.3	-0.5	0.0
India	-1.1	-1.0	-1.2	-1.1	-0.9	-0.3	-0.5	-0.7	-0.7	-0.9	-0.4	-0.5	-0.4	-0.4	-0.4	-0.6	-0.8	-1.2	-0.7	-0.6	-0.8	-0.5	-1.0	-0.7	-0.4	-0.8	-0.2	-0.5	-0.9	-0.8	-0.6	-0.2	-0.6	0.0
Brazil	-0.1	0.1	0.1	-0.1	-0.1	-0.1	-0.2	-0.2	0.0	-0.4	-0.5	-0.3	-0.2	0.2	-0.6	-1.2	-1.4	-1.8	-1.9	-1.1	-1.5	-1.5	-1.1	-1.3	-1.0	-2.2	-1.9	-2.2	-2.4	-1.6	-0.8	-1.2	-0.8	-1.1
Russia	-0.7	-0.6	-1.1	-1.1	-1.2	-0.6	-0.4	-0.4	-0.4	-0.8	-1.1	-1.2	-1.5	-1.7	-1.3	-0.5	-0.3	-0.7	-0.4	-0.8	-0.5	-0.8	-0.5	-1.1	-1.0	-0.5	-0.5	-0.4	-0.4	0.1	0.1	0.0	0.0	0.1
South Africa	0.1	0.4	-0.3	-0.5	-0.4	-0.7	-3.4	0.1	0.9	1.2	0.1	-0.2	-0.1	0.4	1.0	0.6	-0.3	-0.8	-1.0	-0.5	-1.5	-1.4	-0.7	-1.4	-0.2	-0.6	-2.1	-0.9	-0.1	-0.5	-0.1	0.1	0.2	0.6
Emerging Mkts	-0.5	-0.6	-0.9	-0.9	-0.7	-0.3	-0.5	-0.2	-0.3	-0.5	-0.6	-0.4	-0.6	-0.4	-0.4	-0.6	-0.8	-1.1	-0.9	-1.1	-1.3	-1.0	-0.9	-1.1	-0.9	-1.2	-0.7	-0.9	-1.0	-0.9	-0.4	-0.5	-0.6	-0.4
Developed Market	0.4	0.2	0.4	0.2	0.6	0.8	0.9	0.7	0.6	0.3	0.2	0.0	0.2	0.4	0.7	0.5	0.4	0.3	0.4	0.5	0.2	0.3	0.4	0.2	0.1	-0.3	-0.3	-0.2	-0.3	-0.3	-0.3	-0.3	-0.2	0.2
GLOBAL	0.2	0.0	0.1	-0.1	0.3	0.6	0.6	0.5	0.4	0.1	0.0	-0.2	0.0	0.2	0.5	0.3	0.1	0.0	0.1	0.2	-0.1	0.0	0.1	-0.1	-0.1	-0.6	-0.4	-0.4	-0.5	-0.5	-0.4	-0.4	-0.3	0.1

Source: Haver, Markit, UBS European Equity Strategy. Z-scores since 2005

The gap between Europe and the rest of the World is closing and developed markets have had worst PMIs than the eurozone

Additionally, the EM growth premium (or bubble) over DM has deflated and for the first time in 15 years is now back in the range that it was in the 1980s and 1990s. The last couple of data points have seen a tick up in EM relative to DM.

The EM "excess" growth premium has receded

What about Europe?

Our economists expect Eurozone GDP growth of 1.3% in 2017 and 1.2% in 2018…

Following GDP growth of 1.6% in 2016, our European Economics team expect a deceleration to 1.3% in 2017 and 1.2% in 2018. While they maintain a constructive growth outlook for the coming months, they believe that the exceptionally strong support that Eurozone domestic demand has enjoyed in 2015/16 is likely to soften going forward; particularly as higher oil prices and inflation are likely to slow down the growth in household real incomes. Somewhat stronger exports and moderately supportive fiscal policy are unlikely to compensate for this.

…downside risks: China shocks, aggressive Fed tightening, disruptive ECB tapering and politics…

Downside / upside risks:

…upside risks: fiscal easing, increased credit growth, reform

Key downside risks to the forecasts could stem from new China growth shocks, disruptive Fed tightening or a US growth slowdown, a sharp rise in oil prices, uncertainty around the UK's EU exit, disruptive ECB tapering, or new Eurozone shocks. Positive deviations from their base case forecasts could result from acceleration in Eurozone structural reforms, a big European fiscal initiative, or simply by a swift reduction in uncertainty, which could result in faster investment and credit growth.

For more details please see the European section of our Global Economics Outlook: *Global Economic Outlook 2017-2018* November 14, 2016.

What do rising Bond Yields mean for European Equities?

The biggest incoming question in recent weeks has been what is the impact on the market, sectors and styles from higher bond yields?

What do rising bond yields mean for Equities?

We think there are 3 factors to look at: (1) why are yields rising (is it because of higher growth, higher inflation or simply policy?), (2) how quickly are yields rising? and, (3) what *level* are yields at?

It matters: (1) why yields are rising, (2) how fast and (3) what *level* are yields starting from

What's the UBS House View?

Our macro team see the rise in yields as a reversal from extreme low levels rather than the beginning of a sharp normalisation of yields. Our macro team expect yields to rise only very modestly from here: US 10yr yields at 2.3% by end 2017 and 2.5% by end 2018.

Our macro team see only a modest rise in US yields from here…

We examine the risk to our House view that the rise may be sharper and more rapid in the risks section – see p.36.

…we examine the risk of a sharper rise in our Downside Risks (p.44)

Big Macro 04: Secular stagnation and equities; the new normal 12 September 2016

Global FX Atlas: Where are we heading and when will we get there? 6 November 2016

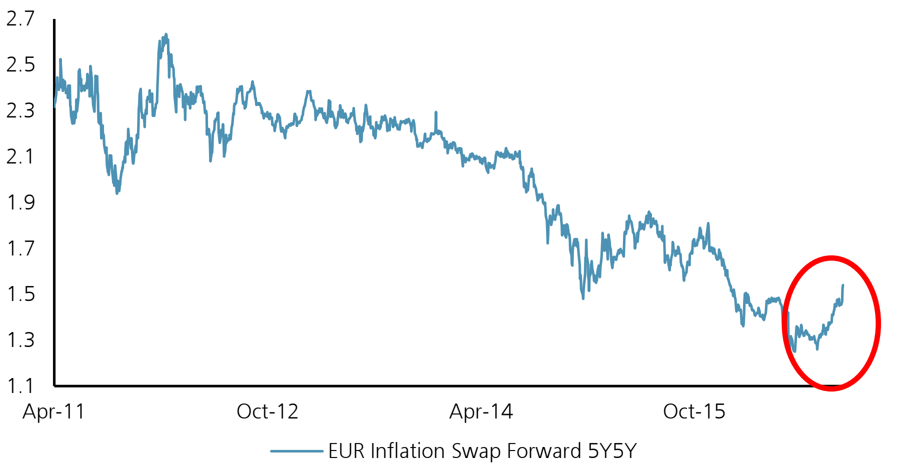
(1) Why are yields rising?

One of the key factors for equity markets is whether it is real yields or inflation that is rising. Currently the bulk of the move is coming primarily from inflation expectations rather than rising real yields. Eurozone 5yr 5yr implied inflation expectations have risen from 1.25% to 1.54%.

Yields are rising because of inflation expectations…

…5-year 5-year inflation swaps have risen from 1.25% to 1.54%

Figure 8: EUR inflation swap 5-year 5-year forward



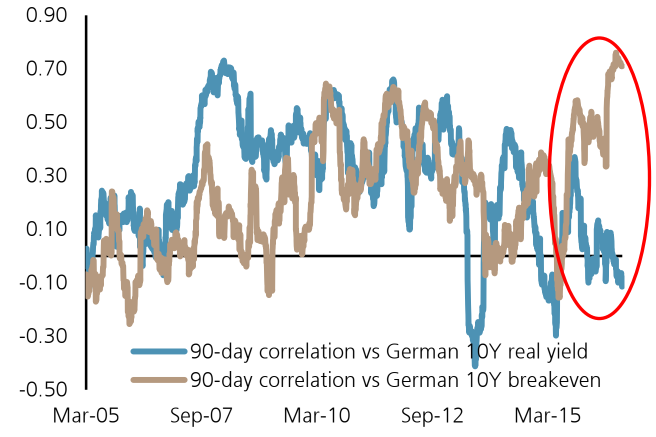
Source: Datastream, UBS European Equity Strategy

Over time, the correlations for equities to real yields and inflation break-evens have tended to move together (Figure 9). But this has broken down in the last 12 months: the correlations between equities and break evens right now are strongly positive, but the correlations to real yields are negative.

Currently equites are *positively* correlated to inflation break-evens…

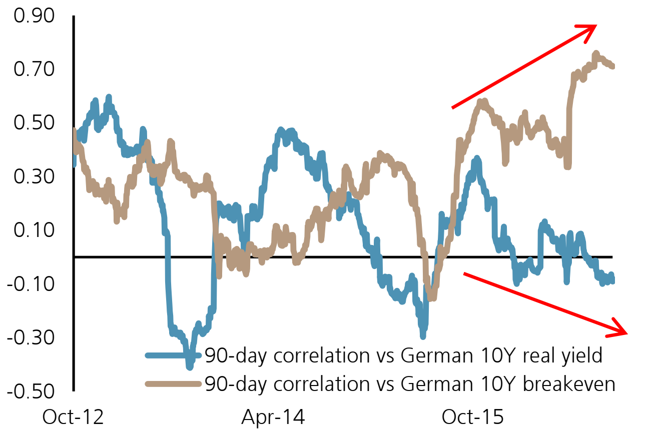
That is to say, higher inflation from this low level is a positive. This fits with our theory that low inflation has been a drag on companies' top-line growth, and in turn, a drag on earnings (*see page 21*).

Figure 9: LONG RUN: Correlation of European Equity returns with real yields and break-evens



Source: Datastream, UBS European Equity Strategy

Figure 10: SHORT RUN: Correlation of European equity returns with real yields and break-evens



Source: Datastream, UBS European Equity Strategy

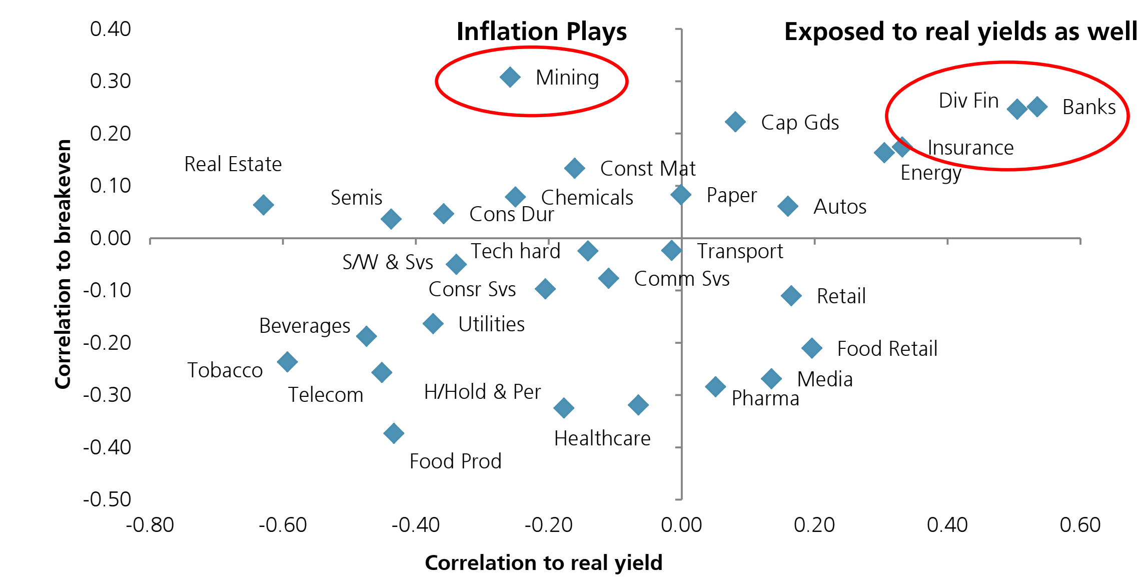
When we drill down to a sector level to look at what is going on "under the hood", it shows a wide spread of sensitivity. Some sectors are pure "inflation plays", such as Mining, whilst the Financials have been driven by *both* rising inflation and rising real yields.

Some sectors are pure "inflation plays" (Mining)…

The Consumer Staples have been the sector most negatively correlated to rising inflation and real yields. Additionally, poor earnings momentum in that sector is now leading to underperformance: it had the biggest misses in Q3 earnings season so far and more downgrades than the market for 2 months in a row.

…Financials exposed to real yields as well

Figure 11: European Sectors: Correlation to Real Yields and Break-Evens (last 90 days)



Source: Datastream, UBS European Equity Strategy

(2) How quickly are yields rising?

How quickly are yields rising…

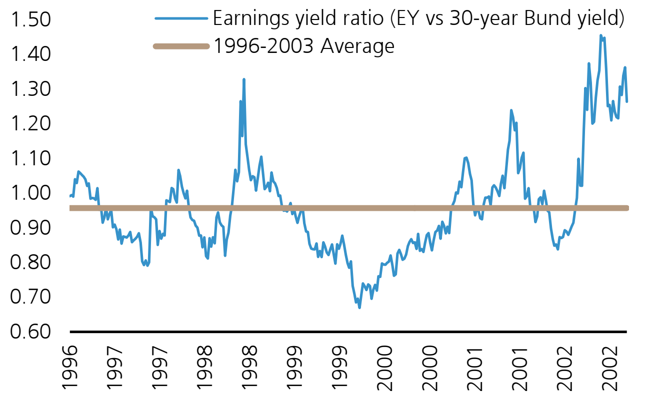
Secondly, we think the speed of the rise in yields matter: a gradual rise of 30 bps over the year is a very different backdrop to 30bps over 3 weeks. Previously we have had periods where yields have crept up and this may have less effect on equities than the short sharp shock of a rapid rise.

(3) What absolute *level* are yields?

…and from what level

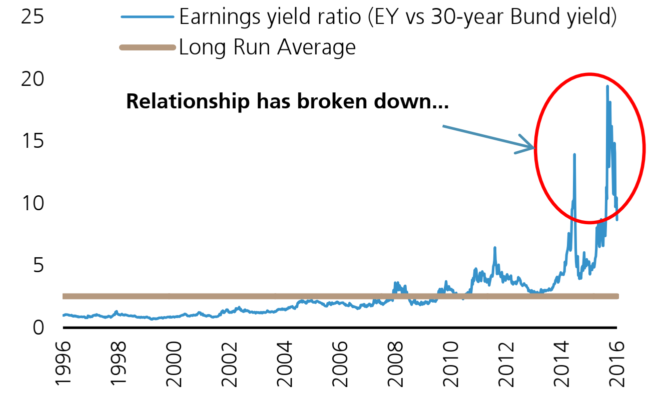
Finally, what is the absolute level of yields? Surely it is different if we look at yields rising from 1 to 2% than 5 to 6%? Back in the 1990s, equity investors used the so-called "Fed model" to value equites (the ratio of the earnings yield over the bond yield). But this relationship broke down around about 2003 as we shifted to a lower yield environment.

Figure 12: Europe: Earnings Yield Ratio (1996-2003)



Source: Datastream, UBS European Equity Strategy

Figure 13: Europe: Earnings Yield Ratio (1996- current)

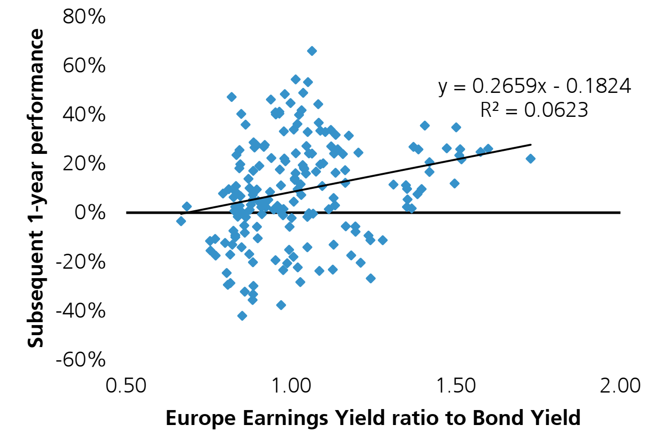


Source: Datastream, UBS European Equity Strategy

Previously, in the 1990s the ratio may have worked. But more recently it has been a poor predicator of returns, with at times an inverse relationship. We plot the level of the earnings yield ratio vs the 12m forward equity returns.

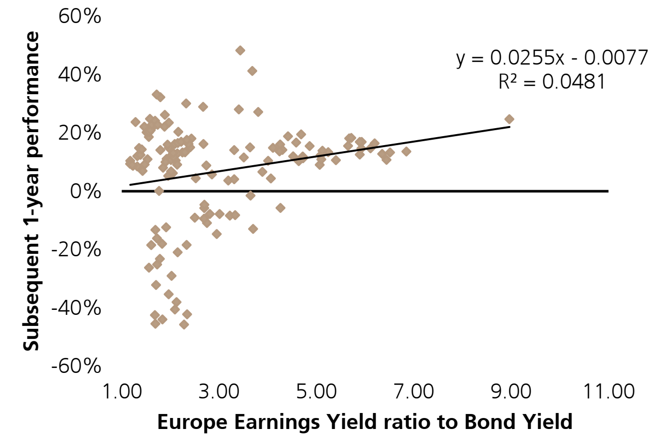
The earnings yield ratio has broken down as an indicator

Figure 14: European Earnings Yield ratio vs EU equity returns over next 12m (1988 – 2002)



Source: Datastream, UBS European Equity Strategy

Figure 15: European Earnings Yield ratio vs EU equity returns over next 12m (2003 – 2014)

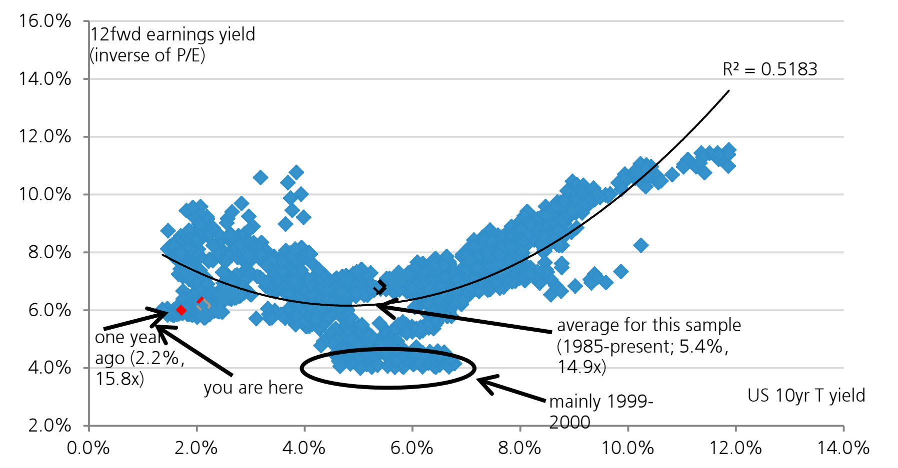


Source: Datastream, UBS European Equity Strategy

Previously, we have highlighted the Earnings yield "smile"- this picks up on the fact the relationship is not linear and higher rates at different levels of yields imply different things for equities. From the current low yields we see today, rising yields has in the past been associated with re-rating of equities and higher valuations – at least until yields reach the c4-5% level.

It matters what *level* bond yields are rising from – the relationship is not linear…

Figure 16: Earnings yield "smile": US Earnings Yield vs. 10yr Treasury yield



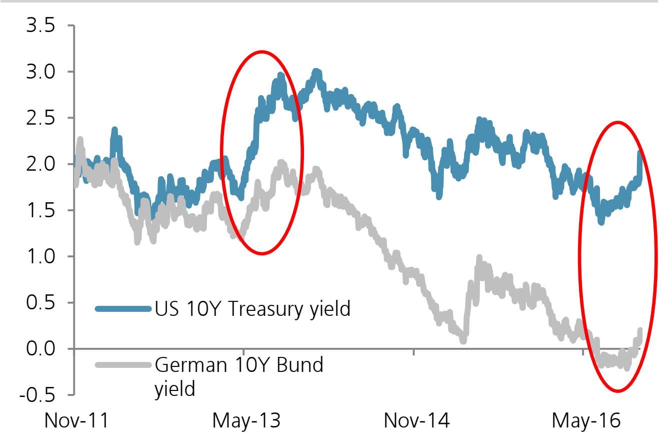
Source: Datastream, UBS European Equity Strategy

How did the US 2013 Taper tantrum play out for European equities?

Back in the Q2 / Q3 2013 US Treasury yields rose sharply in the "taper tantrum" and European yields followed to a degree. What was the impact on equities?

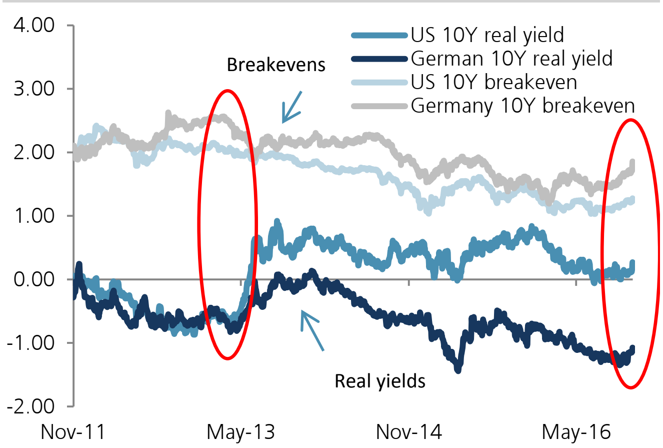
Back in the "taper tantrum" both US and European yields rose…

Figure 17: 2013 US "Taper Tantrum": US 10y yields rise over 120bps…



Source: Datastream, UBS European Equity Strategy

Figure 18: …but it was real yields rather than inflation…



Source: Datastream, UBS European Equity Strategy

At a headline level, there was little impact on the market - European equities were up 1.2% over the period. But there was brutal sector rotation within the market: cyclicals outperformed defensives by 7.6%.

Figure 19: Performance during US taper tantrum (May – Sep 2013)

US 10Y Treasury yield (bp)	122
German 10Y Bund yield (bp)	80
# of days	125
S&P 500	2.5%
Stoxx 600	1.2%
Cyclical vs Defensives	7.6%

Source: Datastream, UBS European Equity Strategy

…but equities were slightly up…with brutal sector rotation

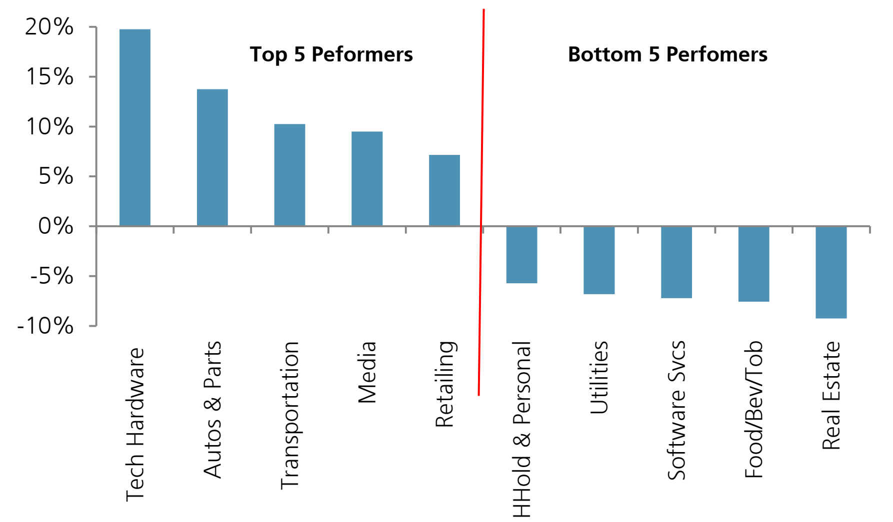
Sectors: Winners & Losers…

The top 5 performing sectors were all cyclicals, led by Tech, Autos and Transport. Underperformers include bond proxies such as Real Estate and Utilities, but also Consumer Staples.

Figure 20: Best and worst performing sectors (relative) during US taper tantrum (May – Sep 2013)

Tech, Autos outperformed…

Consumer Staples and Real Estate underperformed



Source: Datastream, UBS European Equity Strategy

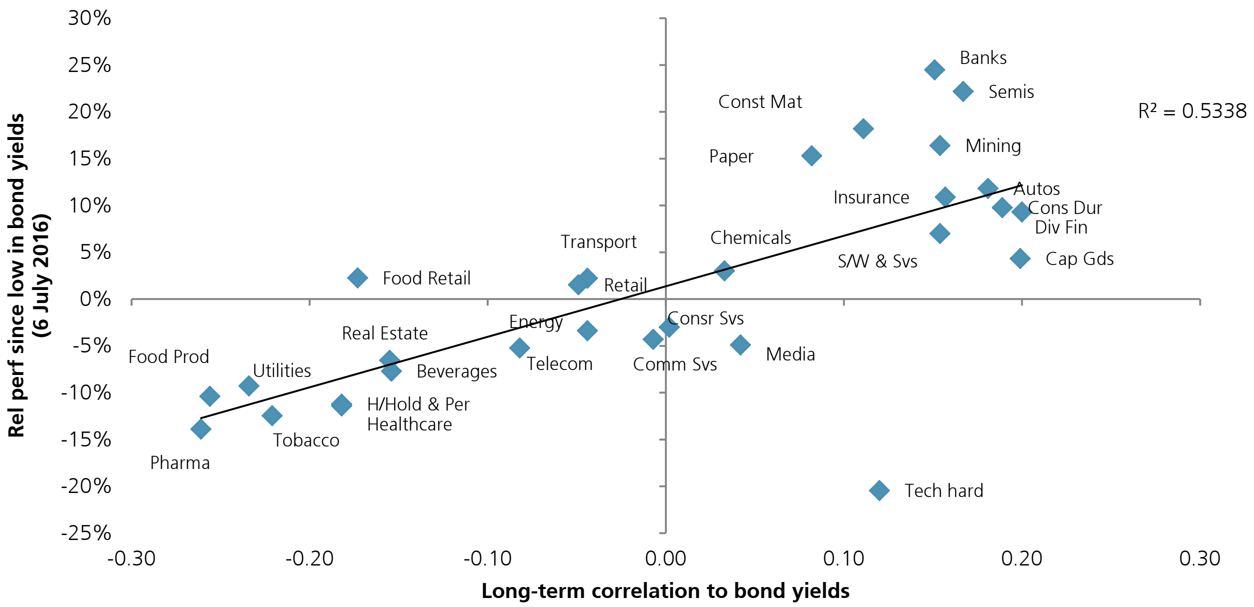
And what has happened so far this time..?

The sectors have broadly performed in line with their long run relationship to bond yields since the turn in yields back in July. The only outliers are tech hardware to the downside, which has been largely driven by stock specific drivers, and the Banks performing better than their beta suggests, maybe driven by investor positioning and the Q3 earnings season where they beat estimates, partly on costs and better Fixed Income trading.

Sectors have broadly performed with their beta to bonds….

Banks stand out on the upside, Tech on the downside

Figure 21: Sector performance since low in bond yields and long-term correlation to bond yields



Source: Datastream, UBS European Equity Strategy

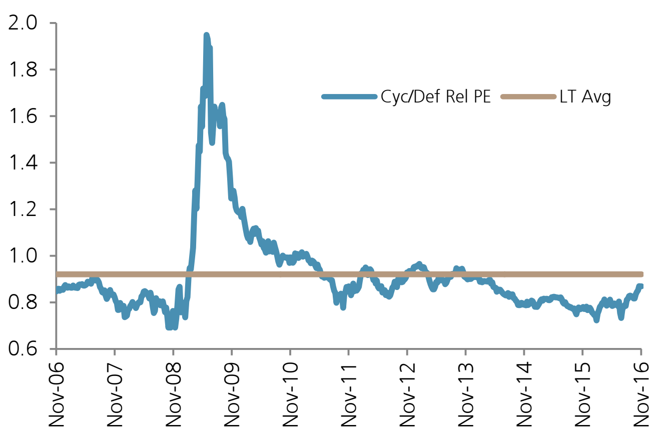
What does this mean for cyclicals vs defensives?

The starting point is that valuations of cyclicals relative to defensives have normalised somewhat.

The P/E relative is below the long run average – however, this is clearly impacted by the spike in 2008/09 as cyclical earnings collapsed and some made losses. Nonetheless, we would not expect the cyclicals to appear obviously cheap on this particular measure, given the earnings are more depressed than the defensives – so would be a "double discount". At times of depressed earnings, the dividend yield relative may be more useful – this has come down recently to close to average, partly due to some cuts in some of the cyclicals, but also given the recent outperformance of the cyclicals.

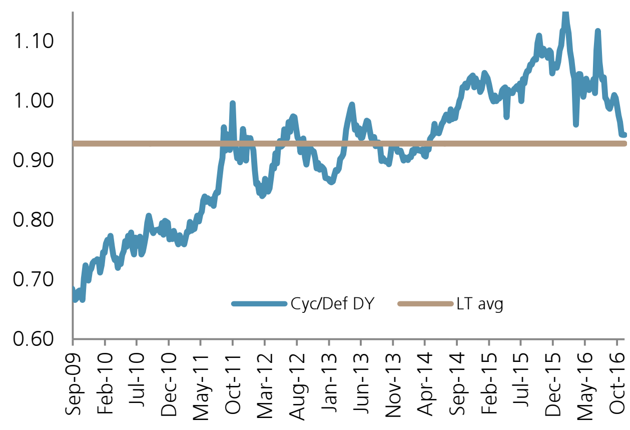
Cyclical valuations relative to defensives have normalised somewhat

Figure 22: P/E of Cyclicals vs Defensives



Source: Datastream, UBS European Equity Strategy

Figure 23: Div Yield of Cyclicals vs Defensives



Source: Datastream, UBS European Equity Strategy

The problem is for cyclicals to continue to outperform from here we likely need bond yields to continue rising at a fairly rapid pace. Indeed, even including the sharp rise post the US elections with US 10yr Treasuries at 2.25% at time of writing, the relative performance of cyclicals vs defensives has already moved somewhat.

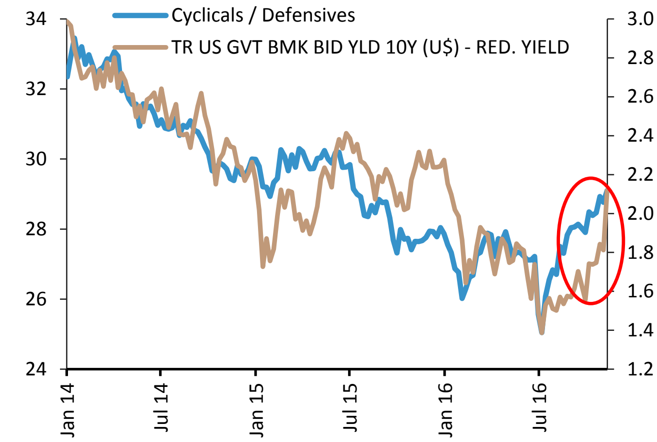
As bond yields have risen…

All of this suggests to us it is correct to pursue a "barbell" strategy within the sectors – we are only slightly overweight cyclicals in aggregate. We overweight the cyclicals where we think there is an interesting theme (such as Energy, Autos, Construction and the fiscal expenditure plays). We also cherry pick some cheap defensives (such as Pharma and Telcos) but underweight the Consumer Staples and Household Products.

We stick with a small overweight on cyclicals, but also cherry pick cheap defensives

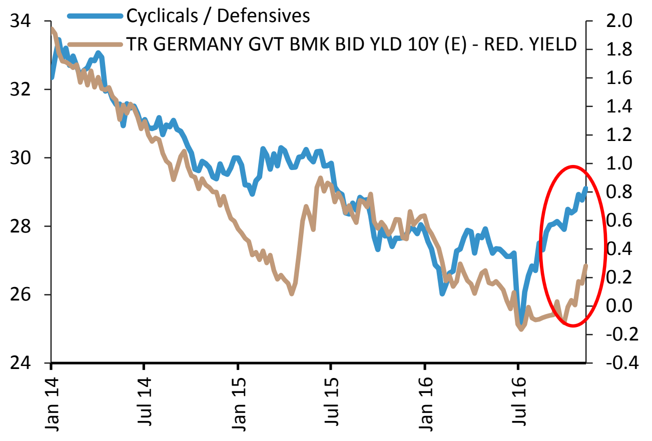
For more details please see our sector strategy section p.48.

Figure 24: Cyclicals vs Defensives and US 10yr yields



Source: Datastream, UBS European Equity Strategy

Figure 25: Cyclicals vs Defensives and German 10yr yields



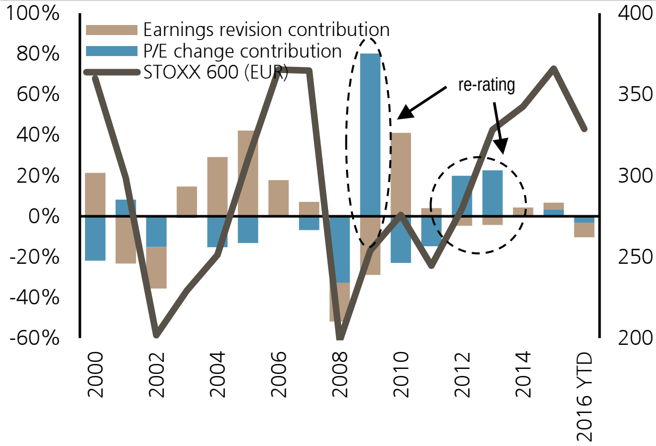
Source: Datastream, UBS European Equity Strategy

(2) Market Outlook for 2017

The Outlook for 2017 is driven by one factor – earnings

We think the outlook for European equities for 2017 is driven by one simple factor – earnings. The P/E multiple expansion that has driven European equities so far has stalled. We outline downside (and upside) scenarios for the P/E multiple in our risk section, but our central view is that the P/E is likely to remain range bound - just as it has done for the last 3 years. Indeed we have been in a range of 13.0x-16.7x over the last 3 years (or 13x –16x if we exclude the spike in Q1 2015).

Figure 26: European Equity returns have been driven by multiple expansion



Source: Datastream, UBS European Equity Stratetgy

Figure 27: Europe 12m fwd P/E broadly in line with long term average

Source: Datastream, UBS European Equity Stratetgy

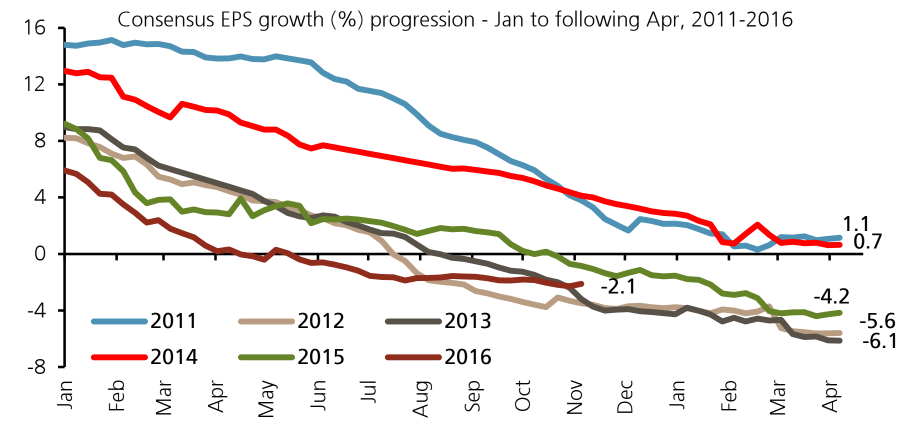
When Will Earnings Turn?

When will earnings turn?

This is the million dollar question (or maybe the million euro question). Since the crisis, we have now had 6 years of effectively no earnings growth whatsoever. It is hard to make a case for an equity or region if the trend rate of growth over 6 years has been zero.

For more details on the Profit Black Holes in Europe please see: [Europe thematic outlook "Europe differs to World = 4 unique buy ideas" Olney]

Figure 28: Consensus EPS growth forecasts…year after year of downgrades…



Source: Datastream, UBS European Equity Strategy

After 6 years of no growth post-crisis…

So what went wrong in 2016?

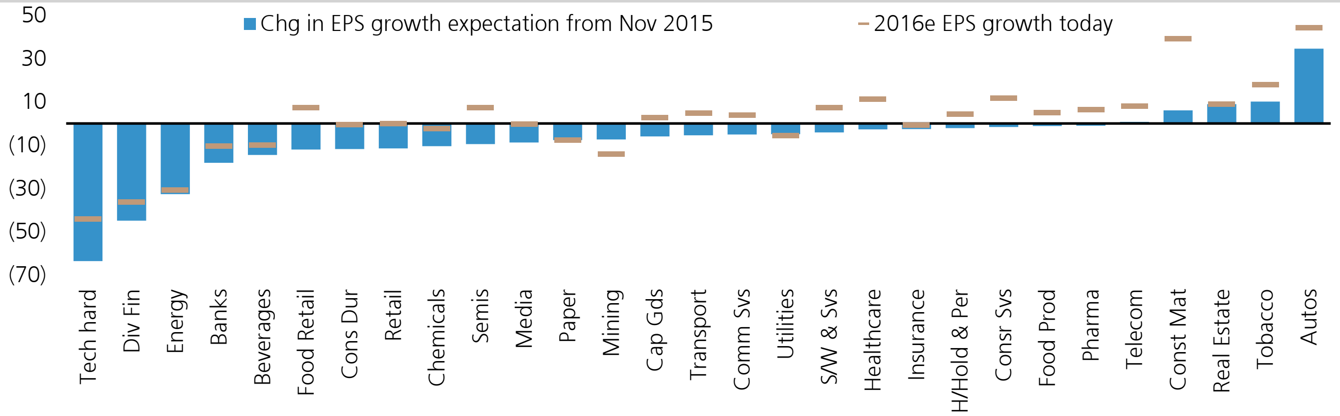
What went wrong in 2016?

Simply put, there was no top-line growth and without any top-line growth, it is tough for companies to generate earnings growth. Part of the reason for this was the fall in inflation and commodities. But this is changing (*see below*).

Commodities and Financials

Year to date, all the *net* downgrades can be explained by the cuts to the Div Fins, Energy, Banks, Chemicals, Mining and Utilities (but some sectors have had upgrades, so this does not account for the whole gross downgrade).

Figure 29: SECTORS: Upgrades and Downgrades to Consensus EPS estimates for 2016 (from November 2015 to now)



Source: UBS European Equity Strategy, Thomson Datastream

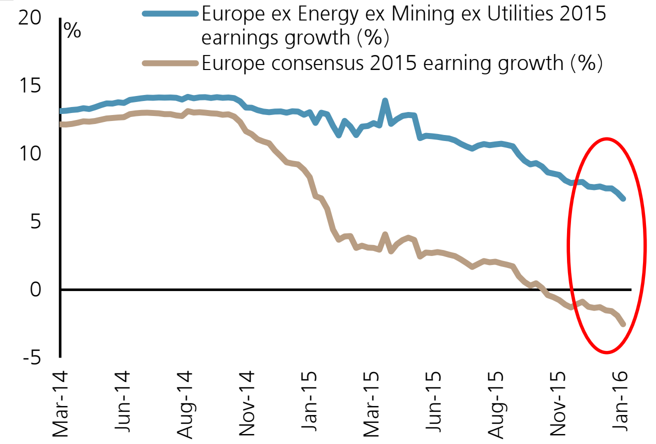
What are the catalysts going forward?

(1) The turn in commodity prices…

In 2015 Energy took c.10% off the market earnings, but after the collapse at the turn of the year, oil prices have risen sharply from the January low. Consensus earnings estimates have tended to lag the oil price by several months (see *Figure 31*).

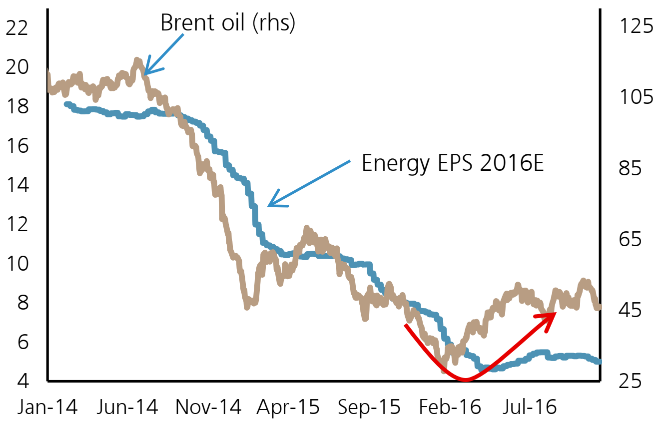
Catalyst (1) Turn in commodity prices

Figure 30: 2015: Commodities took c.10% off EPS growth



Source: Thomson Datastream, UBS European Equity Strategy

Figure 31: Oil price and 2016 Energy EPS



Source: Thomson Datastream, UBS European Equity Strategy

And it's not just oil. We are also seeing an improvement in the other commodity related sectors: Mining, Utilities (given power prices) and Chemicals have all seen absolute earnings upgrades over the last 3 months.

Not just Oil, also Mining, Utilities and Chemicals

(2) Inflation and Top-Line growth is turning….

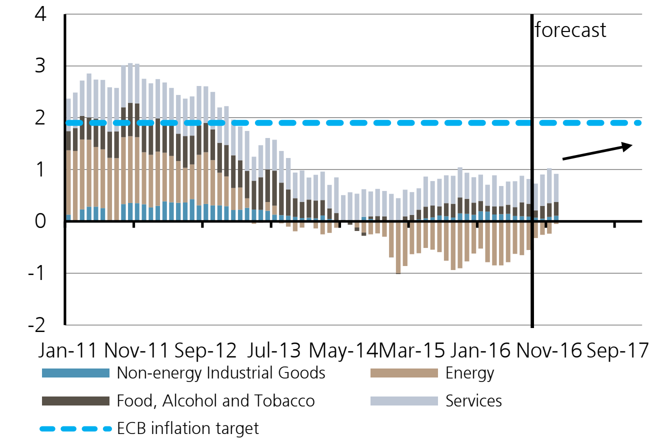
Over the last 2-3yrs headline inflation in the Eurozone has been hovering around zero. This is important for the top line of companies – given they live in the *nominal* world not an artificial "real" one that strips out inflation. This is part of the explanation why the top-line for corporates (and indeed earnings) hasn't tracked the pickup in real GDP growth actors the Eurozone in the last 2 years.

Catalyst (2) Inflation picking up…hitting a 4yr high…

But this is now turning. The most recent "flash" HICP estimate is 0.5% for September and we expect close to 1% by year end as the energy drag annualises out (*see Figure 32*). Going forward into 2017, by the end of the year our economists expect Eurozone inflation to hit 1.7% - the highest in over 4 years.

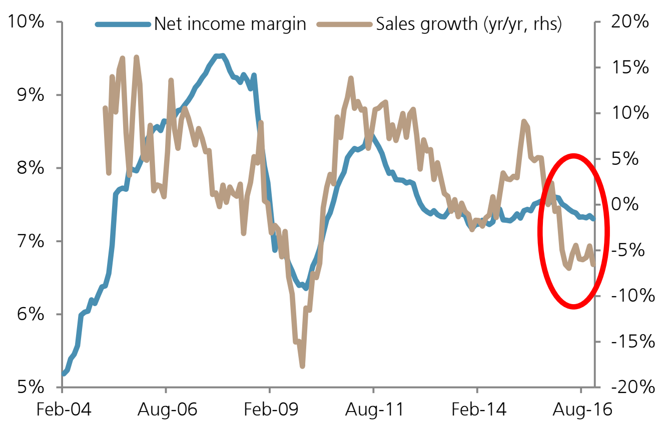
Important for top-line growth and margins

Figure 32: Eurozone Inflation (HICP) set to rise…



Source: Haver, UBS European Economics team

Figure 33: Europe net income margin and sales growth



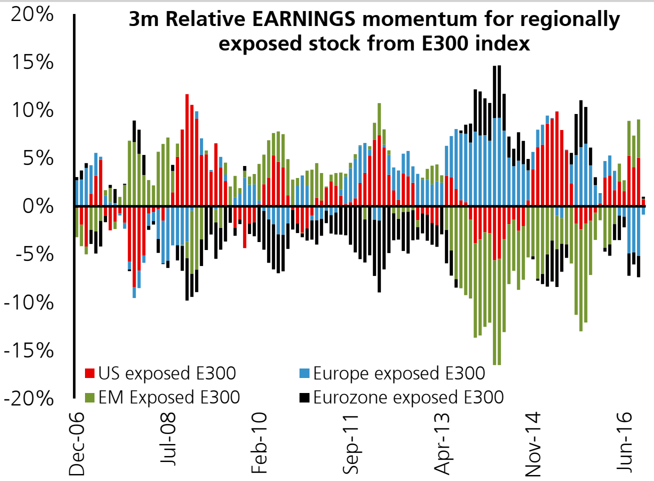
Source: Thomson datastream, UBS European Equity Strategy

(3) Emerging Markets: Switched from headwind to tailwind…

Emerging markets have switched from being a large drag to a boost to earnings. For Europe, emerging markets are a large area of exposure.

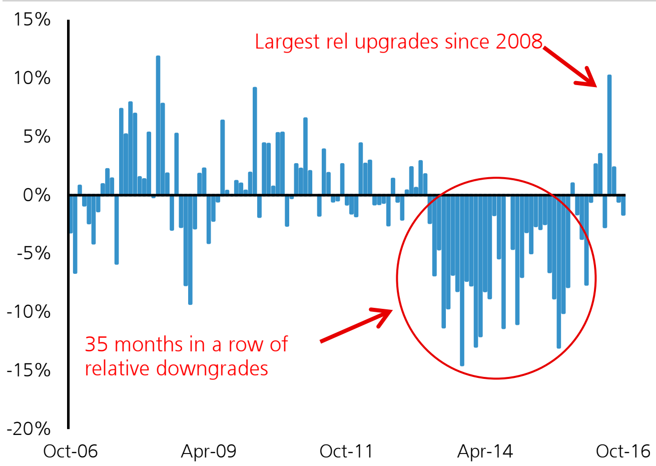
Catalyst (3) EM switched from headwind to tailwind

Figure 34: Relative Earnings Momentum for regionally exposed stocks (3m ave)



Source: Datastream, UBS European Equity Strategy

Figure 35: Relative Earnings Momentum for EM exposed stocks (1m ave)

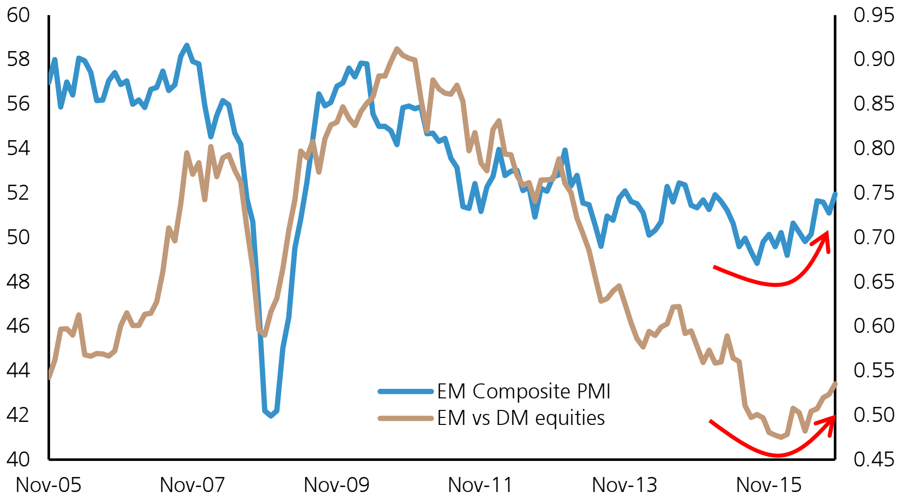


Source: Datastream, UBS European Equity Strategy

The PMIs have turned – or at least stopped falling. This is in part because some of the larger economies, such as Brazil and Russia, are coming out of recession – the composite PMI in Russia is back up to its long run average for the first time since 2013.

Figure 36: EM PMIs vs DM PMIs and relative performance

Some stabilisation in EM PMIs



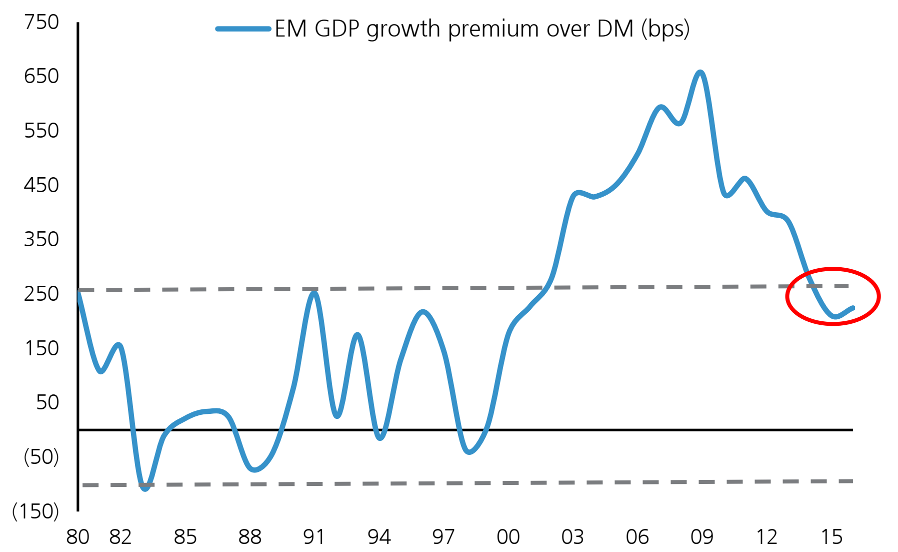
Source: Datastream, UBS European Equity Strategy

Taking a step back, the multi-decade view suggests that the EM excess growth "bubble" has now been deflated and for the first time in 15 years we are back down in the range of the 1980s and 1990s. The last couple of data points have shown better momentum in EM than DM.

However, having highlighted the turn in the EM exposed stocks earnings momentum back in May (European Earnings Watch - Q1: Miss on Revenues, Earnings Beat 13 May 2016*)* we believe that for the time being this theme may have played out: the stocks have outperformed (sector neutral) and our macro team are concerned about the impact of de-globalisation on Emerging markets – please see The What, Why and So-What of Globalisation - III. Asset Implications 31 October 2016.

Figure 37: The "excess" GDP growth premium of EM over DM has come back to the pre-2000 range

Longer term, "excess" growth has come out



Source: Datastream, UBS European Equity Strategy

Which quarter does earnings growth turn positive?

We feel fairly convinced that Q1 2017 earnings will be positive year on year, if simply because of the large base effect in commodities (Oil will likely be up c.100% YoY at some point in Q1). But might year on year EPS growth turn before that?

Q1 2017 is likely to be strongly positive YoY given base effects

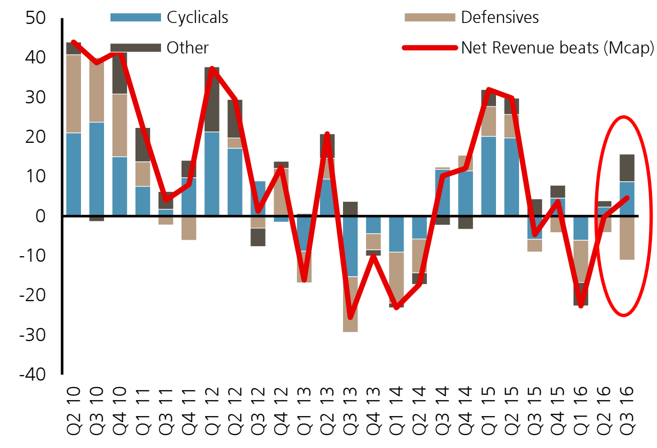
As of time of writing, we are in the midst of the Q3 reporting season, which so far has been reasonably supportive. In particular the net beats at the top-line, although small, were the best for 5 quarters and suggest some turn in the trend (Figure 38). *For more details please see:* Macro Keys - European Q3 Earnings: Revenue Recovery… 7 November 2016.

The context ahead of the reporting season is important. There have been persistent downgrades over the last 6 years, but particularly in Q1 this year (the downgrades peaked at the market low in February). So any "beats" should be taken with this as the backdrop.

Q3 results have beaten on both EPS *and* revenues

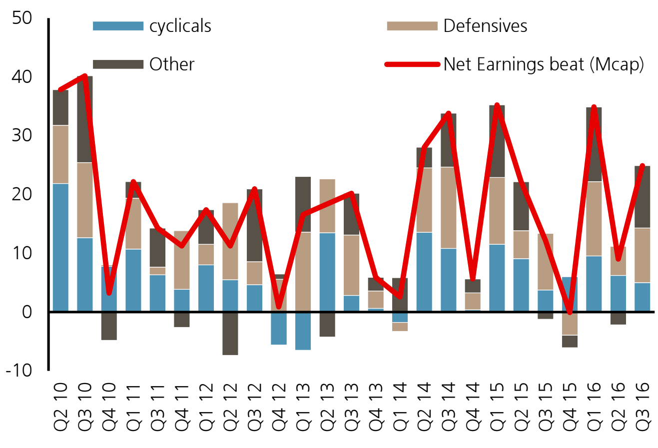
However, we noted that back in August; European corporates saw upgrades for the first time in 15 months. Since then we have seen basically flat earnings momentum in September and October. Earnings estimates were not slashed in the quarter in the immediate run up to this reporting season. This maybe gives a modicum of credibility to the "beats" this time round.

Figure 38: Net REVENUE Beats (Weighted by Market Cap) and Breakdown



Source: Bloomberg, UBS European Equity Strategy

Figure 39: Net EARNINGS Beats (Weighted by Market Cap) and Breakdown

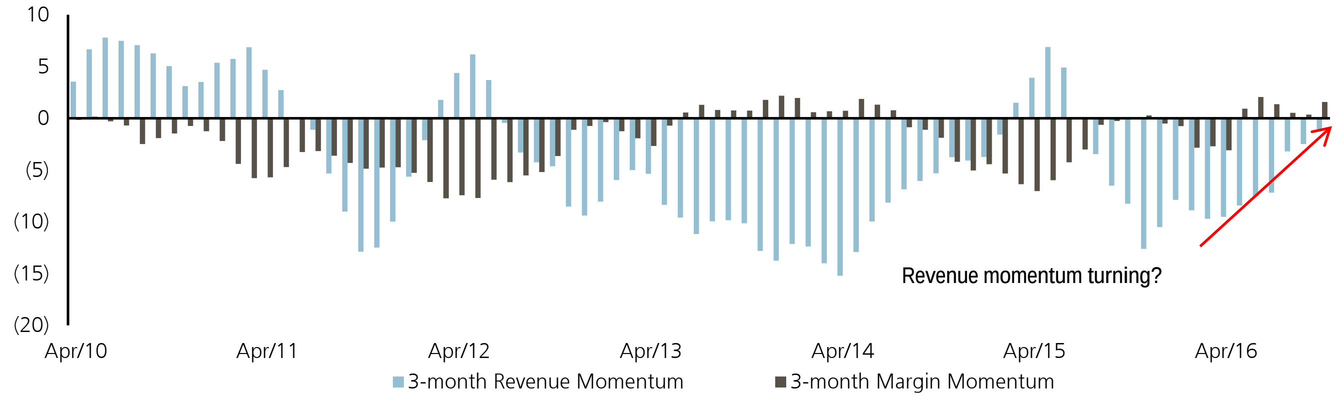


Source: Bloomberg, UBS European Equity Strategy

Supporting evidence from revenue revisions: we split the earnings revisions data into revenue momentum and margin momentum. Revenue downgrades troughed this year in March and since then the 3m average has now improved for 7 months in a row. This is important given margin improvements from cost cuts can only get us so far: for a sustainable turn we need top-line growth.

Revenue momentum has turned positive for the first time in 16 months

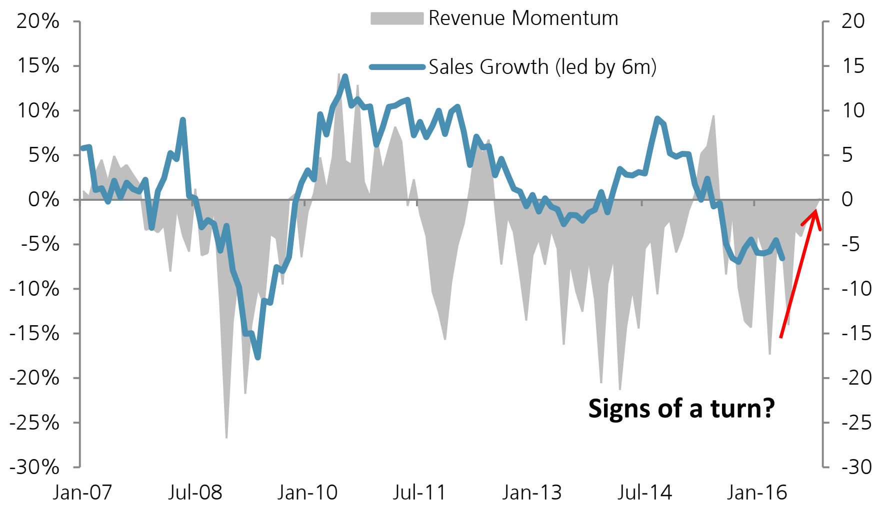
Figure 40: Europe: Revenue Momentum vs Margin Momentum (3m ave)



Source: UBS European Equity Strategy, Thomson datastream

The last month for revenues momentum was positive for the first time in 16 months. And revenue upgrades tend to lead actual sales growth by 6 months – Figure 41.

Figure 41: Revenue Momentum leads Sales Growth by 6 months and points to a turn…



Source: UBS European Equity Strategy, Thomson Datastream

…and this tends to lead actual sales growth by 6 months

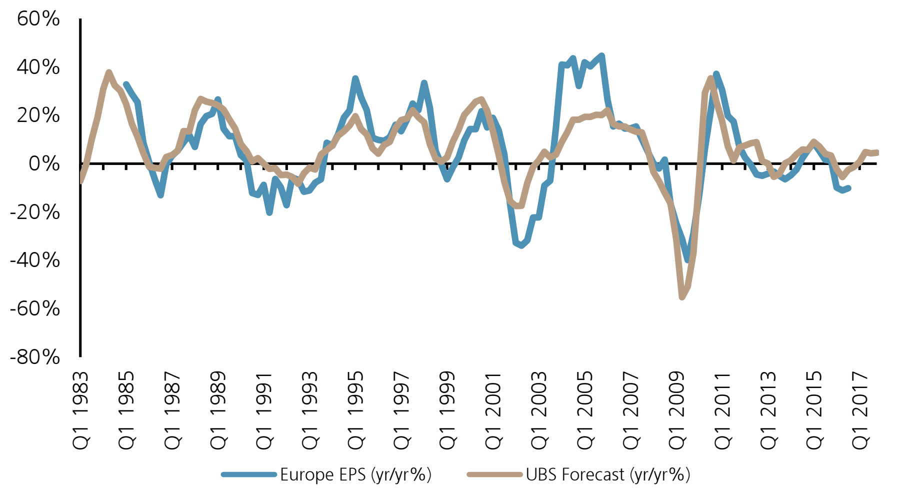
What does our earnings model suggest?

We update our top-down 4-factor model based on: Global Industrial production growth, nominal Eurozone GDP growth, nominal US GDP growth and EUR/USD (a negative factor).

Inputting our global economists' forecasts into the top-down model, points to earnings growth of c.5% in 2017 and 2018 (Figure 42).

Figure 42: Top-down earnings model

Our top-down model points to modest earnings growth…



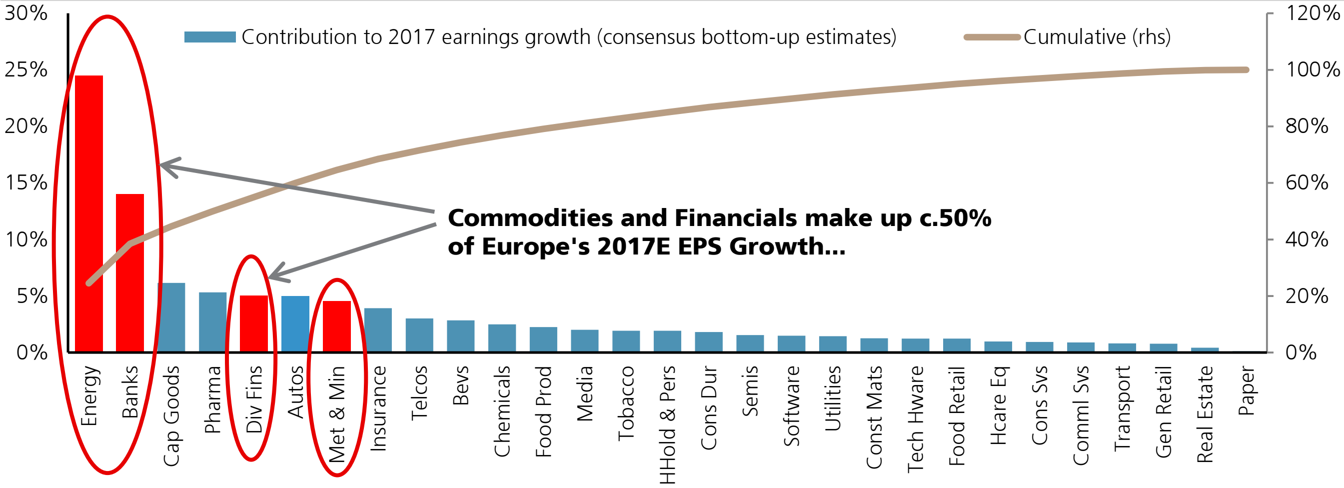
Source: UBS European Equity Strategy, Thomson Datastream

But we think that the 2017 numbers underestimate the likely bounce back in the commodities and financials - neither of which are inputs in our model.

…but it makes no allowance for the massive base effect in Commodities and Financials

Bottom-up consensus estimates are for 13.3% EPS growth in 2017 – we suspect this is too high for the 7th year in a row. But we would argue: (1) the headline number is somewhat misleading, almost half of the expected growth comes from base effects in Energy and Financials (the oil price will likely be up c.100% at some point in Q1). (2) Given 6 years in a row of misses to the downside, the consensus forecast and what the markets are expecting are now two different things.

Figure 43: Contribution to 2017 earnings growth



Source: Datastream, UBS European Equity Strategy

Adjusting for these base effects points to c.8% EPS growth in 2017 and 5% in 2018

As mentioned above, we believe that our 4-factor top down model misses this significant base effect as there is no account for commodity prices or financials. On the consensus estimates the "base effect" boost from Energy and Financials is c.50% of the 13.3% growth rate or close to 7 ppts. If we compare this boost to the "normal" contribution from these parts of the market (simply by looking at mkt cap weight), then that points to an excess 4 ppts boost.

If we add back in the boost from energy and banks to our model estimate than that suggests c.8% EPS growth.

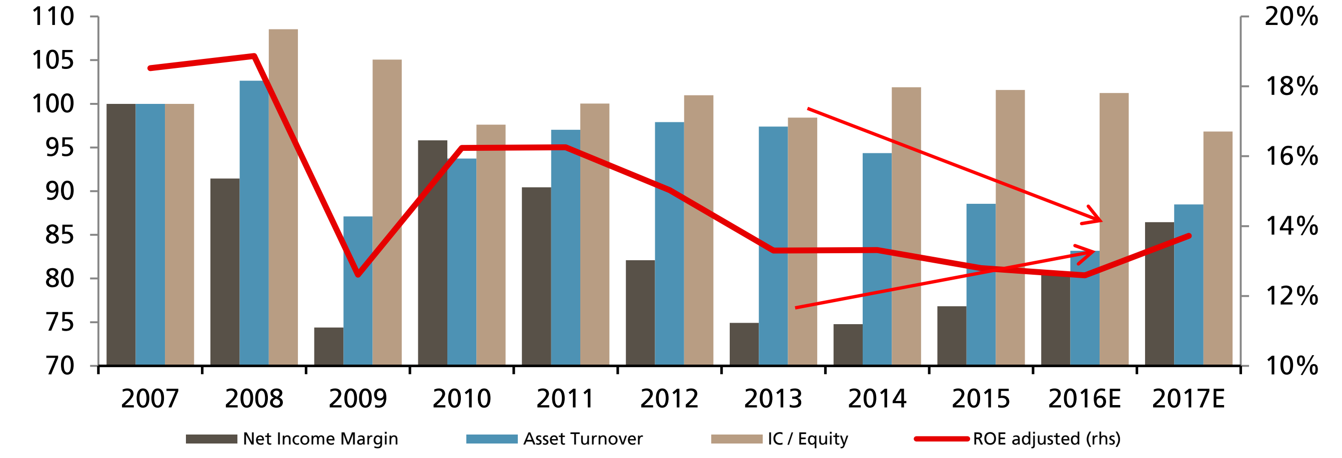
DuPont analysis on RoE

We use DuPont analysis to break down the factors behind the change in RoE - what components have been driving it…? The clear recent weakness has been the fall in asset turns on the back of no inflation and no top line, but this may be stabilising into 2017. In addition, there has been no re-leveraging on the Invested Capital / Equity measure and this could be about to change. At the same time, margins are showing first signs of picking up.

Margins appear to be stabilising… supporting RoE

Weakness in asset turns could reverse in 2017 as inflation rises

Figure 44: European Du Pont Analysis (Based on UBS Market Map data)



Source: UBS European Equity Strategy

Where are valuations now?

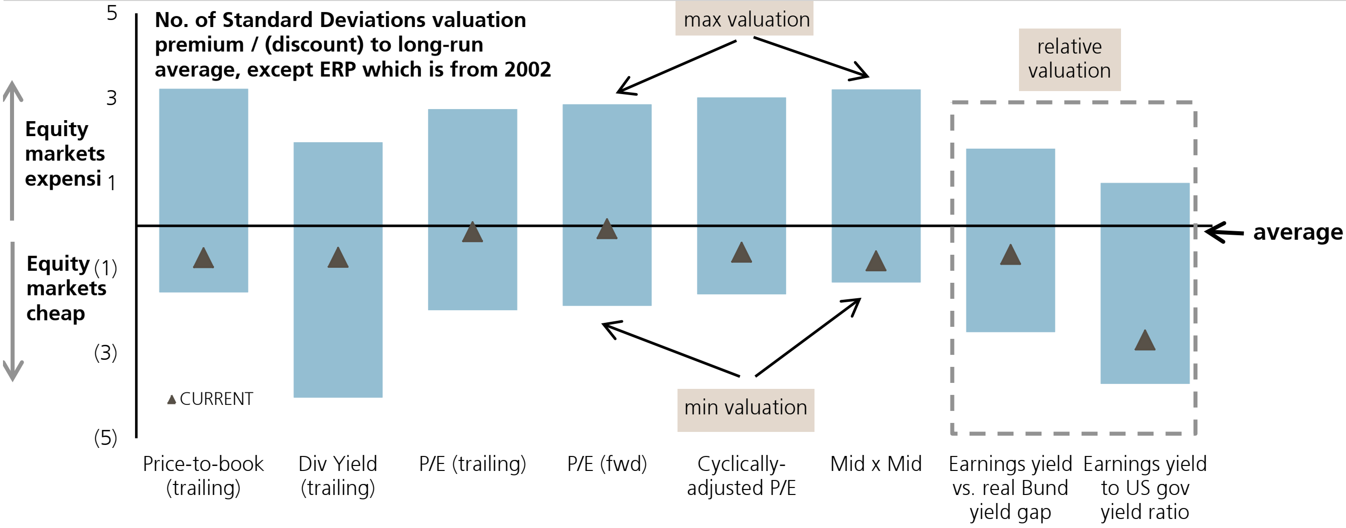
We update our snapshot of valuations looking at 4 different methodologies: (1) trailing, (2) forward P/E, (3) cyclically adjusted and (4) relative to bonds. The trailing P/E is bang in line with long run averages, but on both P/BV and DY the market is reasonably cheap (23% and 18% upside). The 12m fwd P/E only suggest 2% upside to fair value, but when we look at cyclically adjusted measures we see clear upside.

We update our Valuation Snapshot…

… a large spread depending on approach

Relative to bonds is where the real explosive upside comes (for the earnings yield ratio we use US Treasury yields given core European yields are so close to zero). But as discussed previously, whilst we see this as one of the upside risks to the equity market, we do not hold it as a central scenario simply because of the significant levels of intervention in bonds markets.

Figure 45: European Valuation Snapshot: Standard Deviations from long run average



Source: Datastream, UBS European Equity Strategy

Below we show the upside and downside scenarios under various different valuation measures.

Plenty of potential upside: but only if investors believe in the earnings cycle

We think at some point the market will switch to the cyclically adjusted measures. We look at two: (1) CAPE – the cyclically adjusted P/E – today's price divided by the average of the last 10yrs trailing earnings and (2) "mid x mid" – this is the long run trend earnings (taken from a best fit line since 1988) and then multiplied by the long run average P/E – a form of trend earnings.

The difficulty is that for investors to "trust" the cyclically-adjusted earnings they need to see actual earnings turn first – 6 years of no growth has left them understandably sceptical.

Figure 46: Upside / Downside based on different valuation measure

	Price-to-book (trailing)	Div Yield (trailing)	P/E (trailing)	PE (fwd)	Cyclically-adjusted PE	Mid x Mid	Earnings yield vs. real bund yield gap	Earnings yield to US gov yield ratio
Current	1.65	3.7%	16.0	14.3	16.2	-28.4%	6.3	5.1
Average	2.14	3.2%	16.6	14.5	20.7	0.0%	4.4	1.8
Upside / downside	23.1%	17.7%	3.6%	1.7%	21.5%	28.4%	41.8%	183.5%

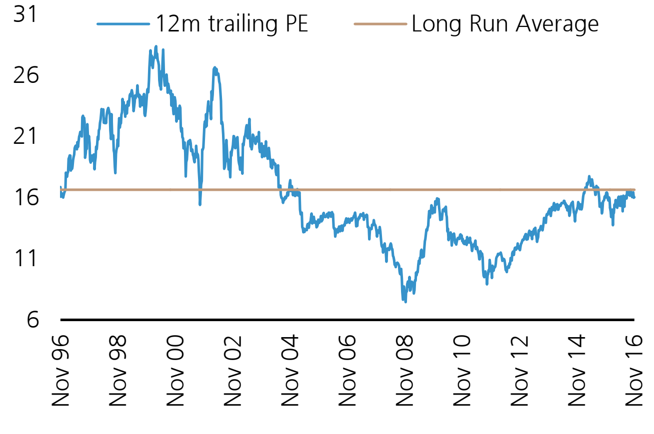
Source: Datastream, UBS European Equity Strategy

(1) Trailing Valuations: Neutral to Cheap

Trailing valuations: Neutral to Cheap

The trailing P/E multiple at 16.0x is close to the long run average of 16.6x. P/BV is at a 23% discount.

Figure 47: European 12m trailing PE



Source: Thomson Datastream, UBS European Equity strategy

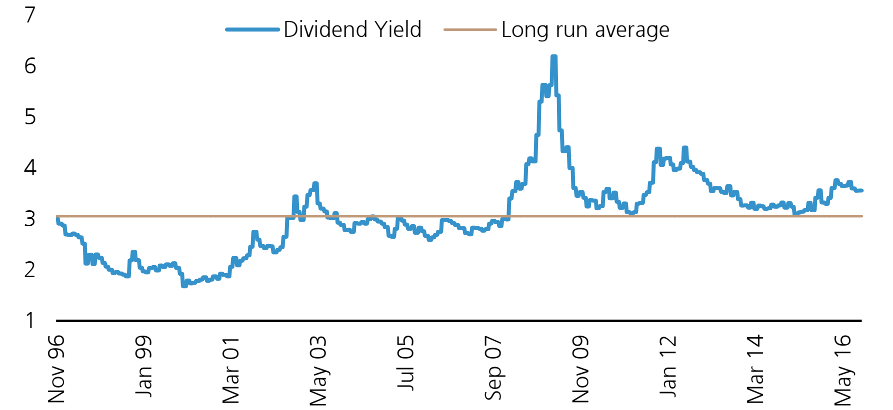
Figure 48: European Price to Book (trailing)

Source: Thomson Datastream, UBS European Equity strategy

The trailing DY is 17% above the long run average, and this is including the artificial spike at the market low in March 2009. In addition, this is despite far lower bond yields. The forward DY is 4.3%

The trailing DY is above the long run average – even if we include the '09 spike

Figure 49: European Dividend Yield (trailing)



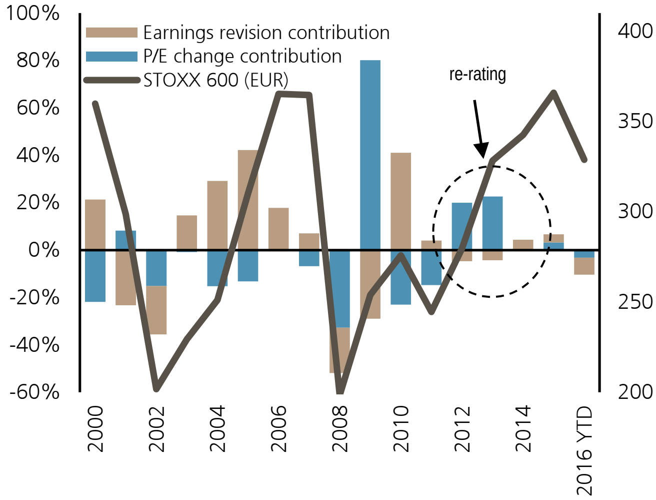
Source: Thomson Datastream, UBS European Equity strategy

(2) Forward P/E: Slightly Expensive

Forward P/E: in line with history…

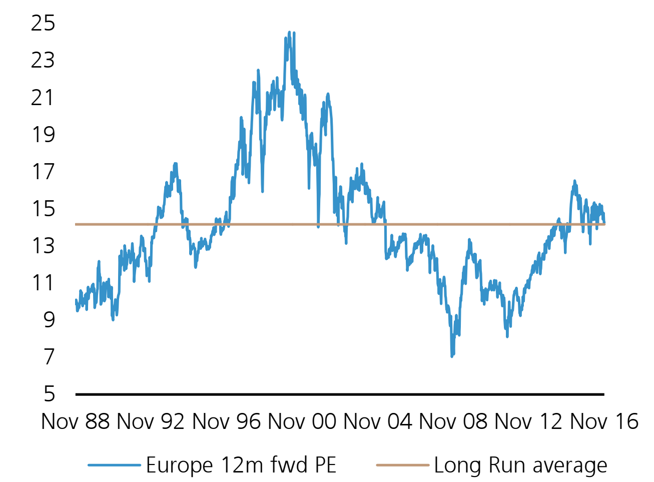
Much of the recovery has been driven by multiple expansion. But in the last 2 years the market has been trading in a range from 13x to 16.5x (at the peak in April 2015). Currently the market is only 2% below the long run average but, as we show below, this is on a particularly depressed "E".

Figure 50: European Equity Returns split between: Change in Multiple and change in Earnings



Source: UBS European Equity strategy, Thomson Datastream

Figure 51: European 12m fwd P/E ratio – just above long run averages…



Source: UBS European Equity strategy, Thomson Datastream

(3) Cyclically-adjusted valuations: Large upside to fair value

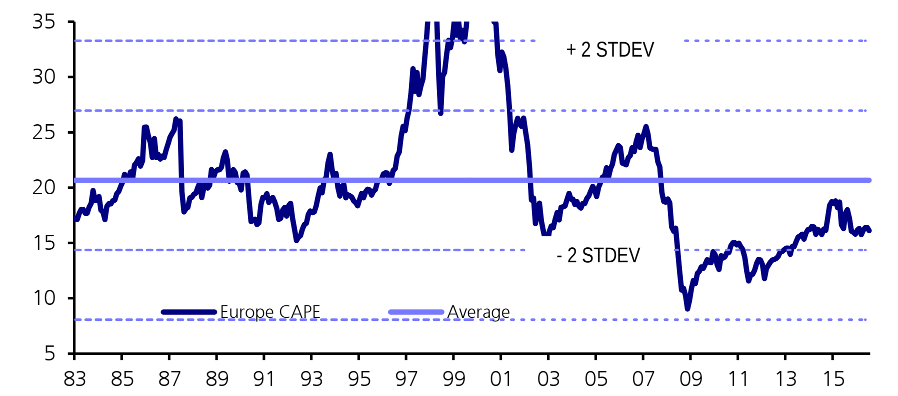
Cyclically-adjusted measures: large upside, if the cycle returns…

Given the extremity of the profit cycle in Europe (with no earnings growth over nearly 6 years and earnings that are c.25% below their 2007 peak), we think it makes sense to adjust for the cycle. After all, at the end of the great 2003-2007 Bull market (Stoxx 600 up 115% trough to peak) the market peaked on an optically reasonable 13.6x P/E multiple – in line with long run averages. The problem was that earnings had doubled in c.4 years. It seems to us unlikely that the market was "cheaper" at the peak of the last cycle than at the recent low in February this year.

For more on the "profit black holes in Europe" please see our accompanying Thematic note: and European Profit Black Holes - how BIG & where? 25 August 2016

Cyclically-adjusted P/E (CAPE) is c.20% cheap

Figure 52: CAPE (Cyclically-adjusted P/E)



Source: Datastream, UBS European Equity Strategy

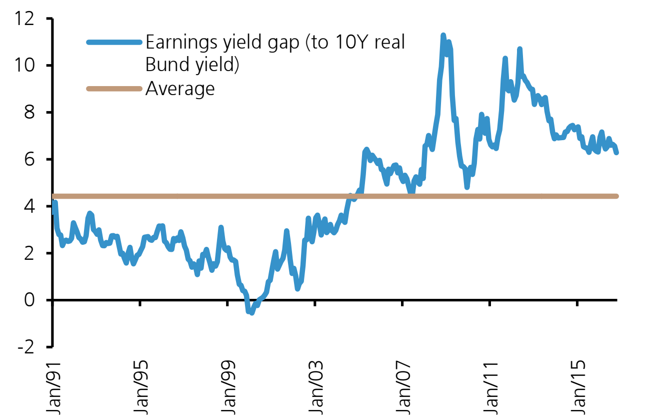
(4) Relative Valuations to Bonds: Dramatic upside

The dramatic upside to valuations comes when comparing with bond yields. Whilst we certainly see this as one of the upside risks for equities (*please see our upside risk section – p.38*), we do not hold it as our core scenario. The bond markets are significantly intervened in and we do not think it realistic to use the current levels. Having said that there is clearly a "real world" effect at work here: companies can borrow in the market for close to zero (or even negative yields in some cases) and can utilise that cash in many ways that are likely to boost returns. In addition, the risk of yields rising going forward might add some sense of urgency for corporates to "lock-in" the current low rates before they change.

Dramatic upside when compared to bonds…

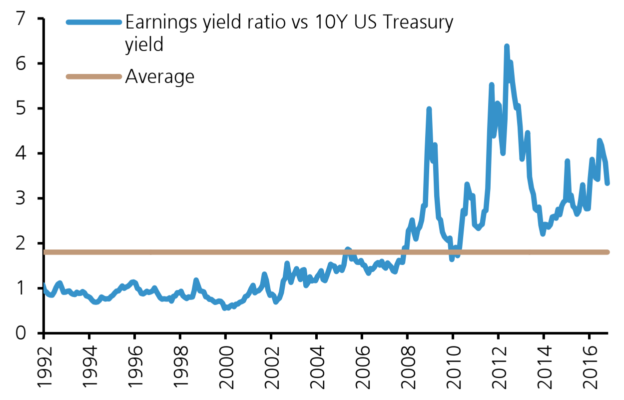
… but these relationships have broken down

Figure 53: Earnings yield minus real 10Y Bund yield



Source: Datastream, UBS European Equity Strategy

Figure 54: Earnings yields vs 10Y US Treasury yield (ratio)



Source: Datastream, UBS European Equity Strategy

(3) Index Target

Stoxx 600 target: 360 end-2017 (c. +7%)

We target 360 Stoxx 600 for end-2017. Combined with a forward dividend yield of 3.8%, this points to a total return of c.10%. In a low return world and with the current volatility in bonds, we believe this is enough to make the asset class attractive.

Target: 360 Stoxx 600 end-2017

But as discussed, we see risks to both the downsides and the upside. Indeed there are several "risk events" even before the end of the year.

Upside Scenario: 415 end-2017 (c. +24%)

Upside: 415 end-2017

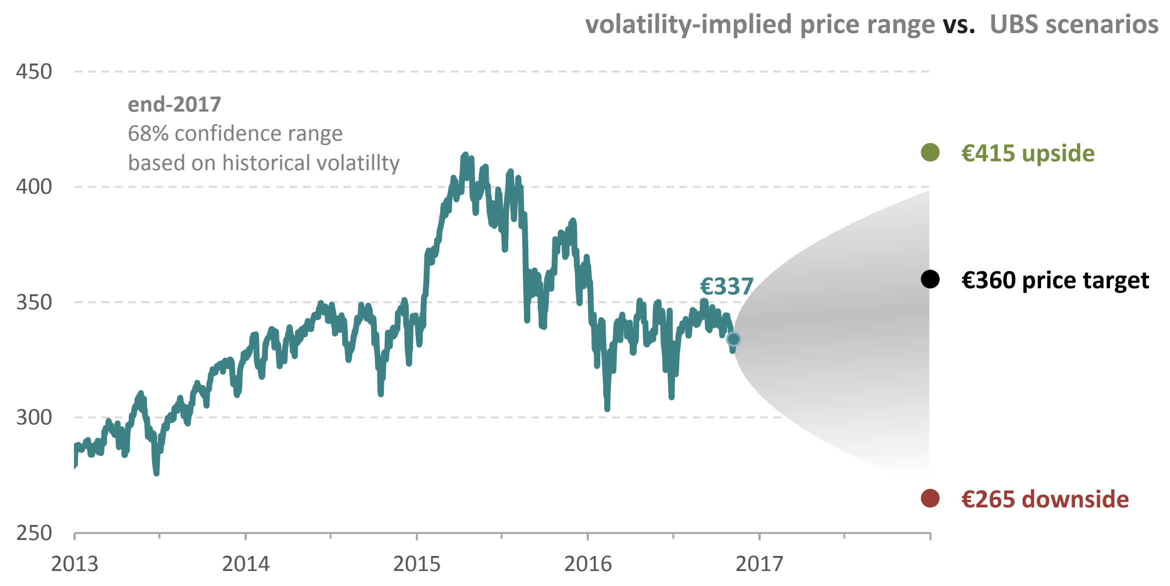
Our upside scenario is a world where US and European nominal GDP growth 1 – 1.5ppts higher, Euro weakens against the USD, boosting earnings. This points to 15% EPS growth in 2017 and 12% in 2018. We apply a slightly higher P/E multiple of 15.5x and this points to fair value of 415 Stoxx 600.

Downside Scenario: 265 end-2017 (c. -21%)

Downside: 265 end-2017

In contrast, in our downside scenario Eurozone nominal GDP growth halves and the Euro strengthens significantly - a painful combination. This then suggests earnings down 6% in 2017 and no recovery in 2018. We apply a below trend P/E of 13.5x = 265 Stoxx 600 end-2017.

Figure 55: Stoxx 600: Volatility Implied Price Range vs. UBS Scenarios for end-2017



Source: Datastream, UBS European Equity Strategy

Below we show the macro inputs we use to get to our central, upside and downside scenarios and the P/E multiples we apply:

Figure 56: Scenario assumptions for Earnings Growth

	US nominal GDP growth	EURUSD	Europe nominal GDP growth	Global IP	Model - Europe EPS growth	UBS Top-Down EPS growth	12m fwd P/E multiple	Index Target
2017								
Top-down base case	4.3%	1.8%	3.0%	3.2%	4.5%	8%	15.0x	360
Upside scenario	5.5%	-5.0%	4.5%	4.5%	14.7%	15%	15.5x	415
Downside scenario	2.5%	7.0%	1.5%	2.0%	-5.7%	-6%	13.5x	265
2018								
Top-down base case	4.4%	4.3%	3.0%	3.5%	4.9%	5%		
Upside scenario	5.0%	-5.0%	4.0%	4.0%	11.6%	12%		
Downside scenario	3.5%	7.0%	2.3%	2.7%	-0.8%	-1%		

Source: Datastream, UBS European Equity Strategy

What should the fair value P/E be?

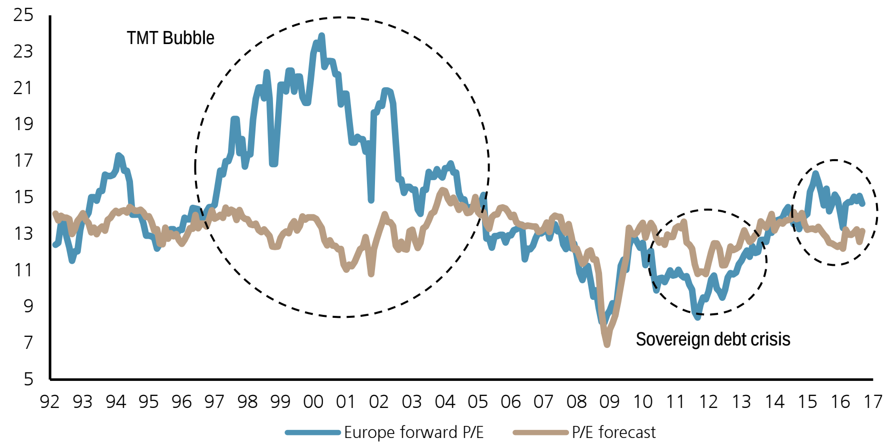
What is the fair value P/E?

We update our top-down model based on two factors: (1) the ISM Manufacturing New Orders and (2) the BBB corporate credit spread in Eurozone. The ISM we use as a proxy for the cycle and the BBB credit spread as a proxy for risk appetite.

The indicator repeatedly pointed to a higher P/E than the actual outcome during the sovereign debt crisis. But this has persistently been above the actual P/E over the last 2 years – on average by 2 P/E pts. If we add that back to the current forecast 13.1x goes to 15.1x.

Our model suggests c.13x, but it has underestimated by 2 PE pts in last 2 years

Figure 57: European P/E 12m fwd and model (based on ISM New Orders and BBB corporate credit spreads)



Source: Datastream, UBS European Equity Strategy

We have created an interactive model of our Stoxx 600 model that allows investors to input their own assumptions.

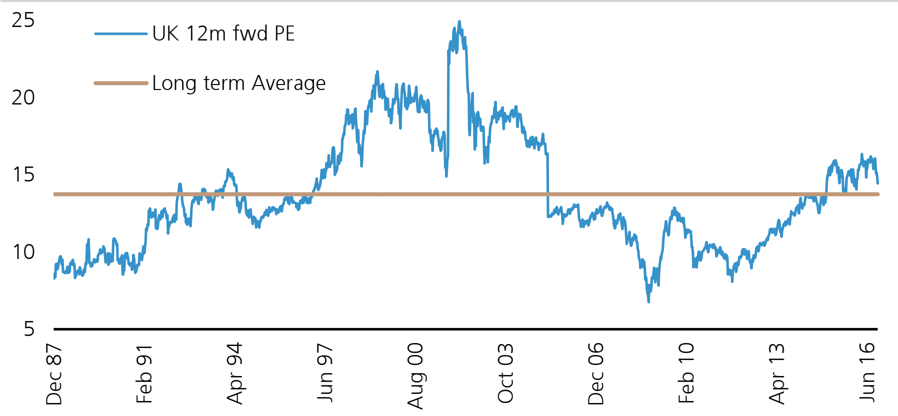
FTSE 100 target: 7,100 end 2017

FTSE 100: target 7,100 end-2017

We struggle somewhat with the valuations on the UK market. The 12m forward P/E has fallen slightly in recent weeks – but we are still towards the top of the historical range since the data began c.30yrs ago (ex-TMT bubble).

FSTE 100 P/E multiple – up with events

Figure 58: UK 12m fwd P/E and long run average



Source: Thomson datastream, UBS European Equity Strategy

And consensus EPS growth of 18% prices in GBP and oil move

Clearly there is a benefit from overseas sale exposure with c.75% of the FTSE revenues coming from outside the UK. But even allowing for further weakness in Sterling and higher oil prices, our top-down earnings model suggests that much of that is now already in the price on the consensus EPS estimates of 18% growth in 2017. If we isolate the two other factors in our top-down model (US nominal GDP growth and US EPS growth) then we can shock the model for different magnitude changes in the currency and the oil price – *see Figure 60.*

Figure 59: FTSE 100 Earnings Sensitivity Matrix (2017E EPS g): Change in the currency and change in the oil price

2017 chg in GBP \ 2017 chg in oil price	-50%	-40%	-30%	-20%	-10%	0%	10%	20%	30%	40%	50%
20%	-11%	-11%	-10%	-9%	-8%	-7%	-6%	-6%	-5%	-4%	-3%
15%	-8%	-8%	-7%	-6%	-5%	-4%	-3%	-3%	-2%	-1%	0%
10%	-5%	-4%	-4%	-3%	-2%	-1%	0%	1%	1%	2%	3%
5%	-2%	-1%	-1%	0%	1%	2%	3%	4%	4%	5%	6%
0%	1%	2%	2%	3%	4%	5%	6%	7%	7%	8%	9%
-5%	4%	5%	6%	6%	7%	8%	9%	10%	11%	11%	12%
-10%	7%	8%	9%	9%	10%	11%	12%	13%	14%	14%	15%
-15%	10%	11%	12%	12%	13%	14%	15%	16%	17%	17%	18%
-20%	13%	14%	15%	16%	16%	17%	18%	19%	20%	21%	21%

Source: Datastream, UBS European Equity Strategy

Weak GBP = higher FTSE 100? Becoming more volatile…

In EUR or USD terms the FTSE 100 is actually down 4% and 8% since the vote to leave the EU. At some point overseas investors are going to be more concerned about the losses from Sterling weakness than the gains in local currency for the FTSE. Maybe we are close to that tipping point now. Indeed, the correlation between Sterling and Gilt prices has turned positive the 30-day trailing correlation of the FTSE 100 and GBP/USD has flipped from being strongly negative to something close to zero and then back again.

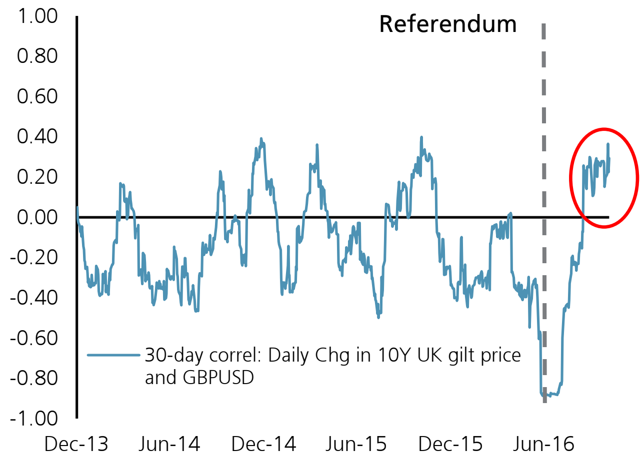
If Sterling falls rapidly…

Additionally, we would argue that 25% of the revenues are domestically exposed, where we have yet to see the economic slowdown hit and have only had the "front-loaded" good news from policy etc. Our economists expect the UK to slow to just 1.0% growth in 2017 and 0.7% in 2018.

…the inverse correlation with the FSTE 100 breaks down

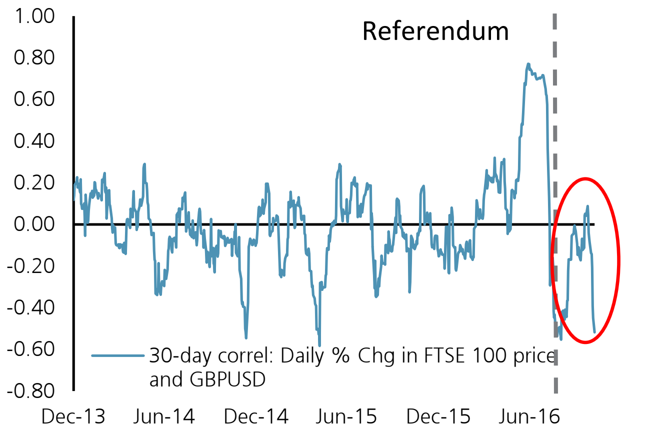
For more details please see our most recent report on UK leave: European Equity Strategy "UK Leave is coming - market & stocks exposed" 7 October 2016

Figure 60: GBP/USD correl to 10Y Gilt prices



Source: Datastream, UBS European Equity Strategy

Figure 61: GBP/USD correlation to FTSE 100 prices



Source: Datastream, UBS European Equity Strategy

(4) What are the Risk Scenarios?

What are the risks?

So where are the risks to our central view? As highlighted above, we see even more risks than usual given the political calendar. Indeed, it is hard to see into the end of 2016, let alone the end of 2017.

Upside risks: more fiscal easing

Upside Risks: As monetary policy runs out of "road", we think there is a risk that governments switch to fiscal: *see our Global report from the other week:* Macro-Strategy Key Issue: Fiscal Fitness – Is Global Spending "Bulking Up"? 3 November 2016. Since the surprise US elections result, we think the risks here have risen sharply.

Companies re-leverage

Elsewhere, this may finally be the time when European companies utilise the ultra-low bond yields and re-leverage. What's the catalyst? The risk of rising yields suggests the window of opportunity for them to take advantage of this is closing and forcing companies to act.

Equities re-rate to bond-like multiples

It hasn't happened yet, and certainly isn't our core scenario, but maybe European P/E multiples re-rate to "bond-like" levels as the last trade in the "stretch for yield" with an Equity market on a 3.8% dividend yield.

US investors come back

Finally, there is the risk US investors, the key swing investors for European equities come back in 2017 after 10 months in row of selling European equities.

Downside risks: Real yields rise sharply

Downside Risks: Bond yields, particularly real yields rise more sharply than our House view expects. For the time being bonds are selling off and equities are rallying hand in hand. But how long can this last? So far, it has been in the main a rise in inflation expectations rather than real yields and, as we show above, equities have been positively correlated to a rise in inflation. This could change.

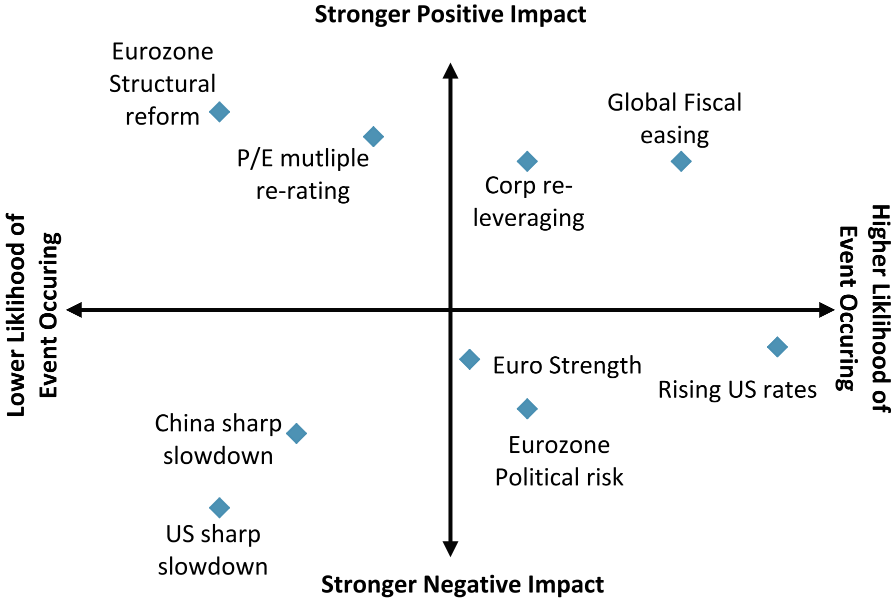
Concerns on Banks, Politics

Elsewhere we think the market still sees signs of some capital concerns in parts of the European Banking sector and clearly the busy political calendar also has potential to through up surprises and shocks that may limit investors' appetite for European equities in 2017.

Below we attempt to show a schematic of how we see some of the risks to European equities in the year ahead. We map out some of the upside and downside risks, the potential impact and the relative likelihood of them occurring.

Figure 62: Positive & Negative Risks: Likelihood of Event occurring vs. Potential Impact on European Equities

Upside & Downside risks, likelihood and relative impact



Source: Datastream, UBS European Equity Strategy

Upside Risks

(1) Fiscal Policy Boost as focus switches away from monetary policy…

Switch from Monetary to Fiscal boost…

Investors are questioning if monetary policy is starting to reach the limits of its effectiveness. Certainly the strategy of lower and lower policy rates is having some negative side-effects in Europe.

Less of a drag in Eurozone and UK reversing fiscal austerity

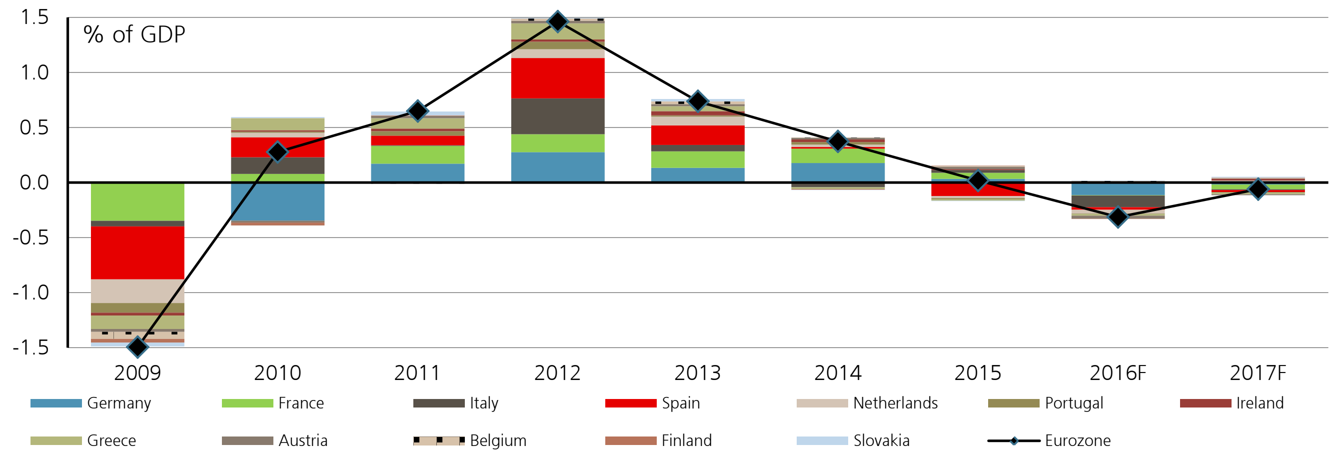
2016 is the first time in 7 years that fiscal policy in the Eurozone was a net boost to growth rather than a drag. Whilst our economists in aggregate expect 2017 to see only a modest boost – in part because of a slowdown in the rate of immigration into Germany - there are still potential beneficiaries of this plan and political pressure may mean the end numbers are higher.

In the UK there has already been a shift in this direction. Post the vote to leave the EU, the previous strategy of balancing the budget by 2020 has been abandoned. We will hear more from the Chancellor in his autumn statement on November 23, but expectations are that there may be more spending on infrastructure – in particular roads, railways and housebuilding.

Additionally, the impact of QE and the macro backdrop have allowed Government borrowing costs across the region to come down. Even with the recent back up in yields, the current range for the major European countries of 0.2%–1.7%, is sharply down from the 4-5% at the end of the last cycle or the wide spread we saw at the peak of the Eurozone debt crisis in 2012. This should enable Governments to borrow more cheaply.

For more details please see our European section in our Global Economic Outlook report: Global Economic Outlook 2017-2018 14 Nov 2016

Figure 63: "Fiscal effort" (reduction in structural budget deficit) in the Eurozone (% of Eurozone GDP)*



Source: UBS European Economics Team, European Commission * Contribution from individual countries is GDP-weighted

And this is not just a European phenomenon: it has come into closer relief post the US elections. Higher infrastructure spending was one of the few major policies that President–Elect Trump name-checked in his acceptance speech. So even if there are limits within the Republican Party as to the scope and magnitude for fiscal stimulus, it is likely that markets will entertain this as a key driver over coming months.

Additionally, in Asia there is $2.6trn worth of infrastructure projects in the pipeline over the next few years. European stocks may be exposed to some of this as well.

$2.6trn of infrastructure projects in Asia…

Our Global Macro team have run sensitivity analysis to estimate what the potential fiscal boost in the US might mean for the economy and asset markets. Although, it is far too early to tell what the magnitude and scope of any fiscal easing in the US might be and, crucially, what the fiscal multipliers could be, it is worth running some scenarios. On their analysis each additional $1trn of fiscal easing with fiscal multipliers would boost US equities by 10%, but in the low multipliers scenario be a drag of 5%.

US elections raise potential for large fiscal boost

For more details please see: Fiscal easing: How much hope is in the price? 10 November 2016

Even if the impulse at a macro level only moves the needle slightly on GDP – at a micro level, for the market and some stocks there may be a more significant impact.

Construction and capital goods are some sectors that may benefit – particularly heavy construction of railways, roads bridges etc. and following on from this, parts of machinery and building materials. Some of the potential beneficiaries include: CRH, Alstom, Ferrovial and BAE.

Construction, cap goods benefit

For more details please see: Macro-Strategy Key Issue: Fiscal Fitness – Is Global Spending "Bulking Up"? 3 November 2016

Figure 64: Potential beneficiaries of Increased Fiscal & Infrastructure Spending

Ticker	Name	Sector	Price	M Cap EUR bn	Rating	Abs perf % (12m)	PE 2016E	PE 2017E	PB 2016E	PB 2017E	DY 2016E	DY 2017E
BA/ LN	BAE Systems	Capital Goods	535.0	19.0	Buy	19.5	13.9	12.8	4.5	4.2	4.0	4.1
FER SM	Ferrovial	Capital Goods	17.4	12.7	Buy	-22.0	n/a	n/a	n/a	n/a	4.2	4.3
DG FP	Vinci	Capital Goods	65.0	35.9	Buy	6.1	15.3	14.1	2.4	2.2	3.3	3.5
ALO FP	Alstom	Capital Goods	24.4	5.3	Buy	-18.2	113.3	15.1	1.7	1.4	0.0	0.0
LR FP	Legrand	Capital Goods	51.1	13.5	Buy	2.1	22.8	20.3	3.1	2.9	2.3	2.3
CRH LN	CRH	Construction Materials	2606.0	23.9	Buy	45.6	20.8	15.5	1.8	1.6	2.0	2.3
FORN SW	Forbo	Consumer Durables	1254.0	2.1	Buy	11.7	17.2	16.0	3.2	2.8	1.5	1.6
HEXAB SS	Hexagon	Technology Hardware	309.5	11.1	Buy	-1.0	20.2	17.5	2.6	2.3	1.3	1.7
ENEL IM	Enel	Utilities	3.9	36.6	Buy	-7.0	12.5	12.4	1.2	1.2	4.6	4.9

Source: UBS European Equity Strategy

(2) Ability to Refinance / Re-leverage, M&A

Re-leveraging or re-financing

Another upside risk is the ability of companies to refinance at incredibly cheap levels, or even re-leverage. US investors often make a comparison between the US in 2010-2015 and the potential for European corporates currently. Whilst we are not convinced that European companies will go on a buy-back "bonanza" to the degree the US did, in part because of culture, increased difficulty and lack of confidence – there is still clear opportunities for specific companies.

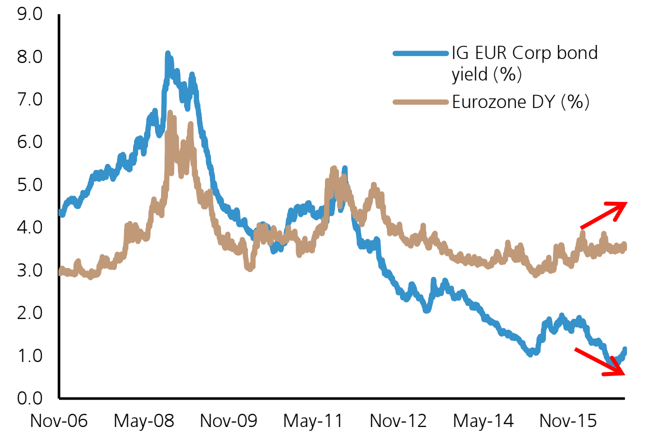
Even if the European companies do not have the confidence to re-leverage their balance sheets, they will gain from lower refinancing costs: the current gap between what companies are paying on their debt to what they could issue at is at 156bps.

Catalyst? Rising bond yields

What's the catalyst? The recent back up in bond yields may be the catalyst to lock in low rates before companies lose these opportunities.

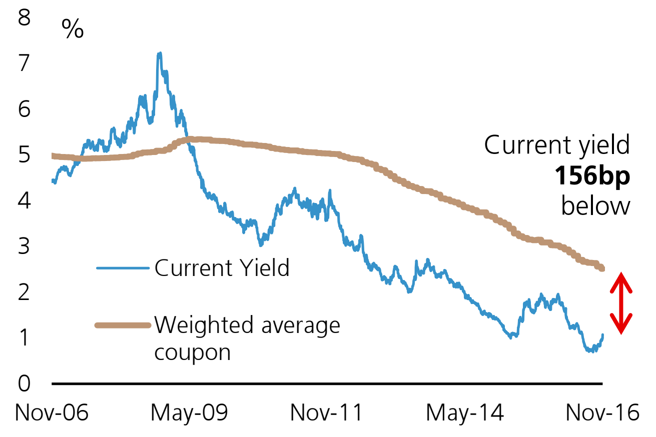
For more details please see: Macro Keys - Negative Yields in Europe: Impact on Equities 20 June 2016 *and* What Boost to Earnings from Cheaper Refinancing? 19 May 2016

Figure 65: Eurozone Corporate yield vs DY



Source: Thomson Datastream, UBS European Equity Strategy

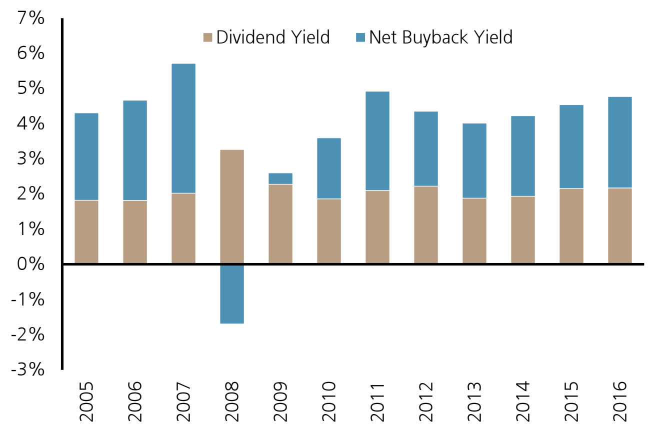
Figure 66: Europe Corporates Current Yield vs average Coupon



Source: Thomson Datastream, UBS European Equity Strategy

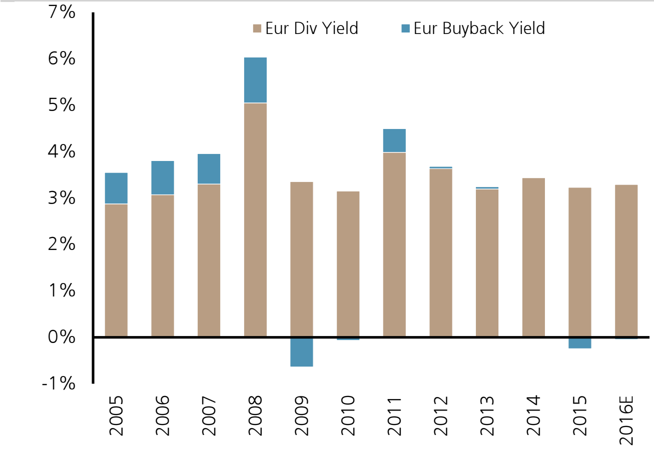
Although not a really fair comparison of like with like (as one is seen as an annuity another as a "one-off"), the *combined* yield and net buyback yield in the US is similar to that in Europe, but we have seen precious few net buybacks in Europe in recent years.

Figure 67: US: Dividend Yield and Net Buyback Yield



Source: UBS European Equity Strategy

Figure 68: Europe: Dividend Yield and Net Buyback Yield



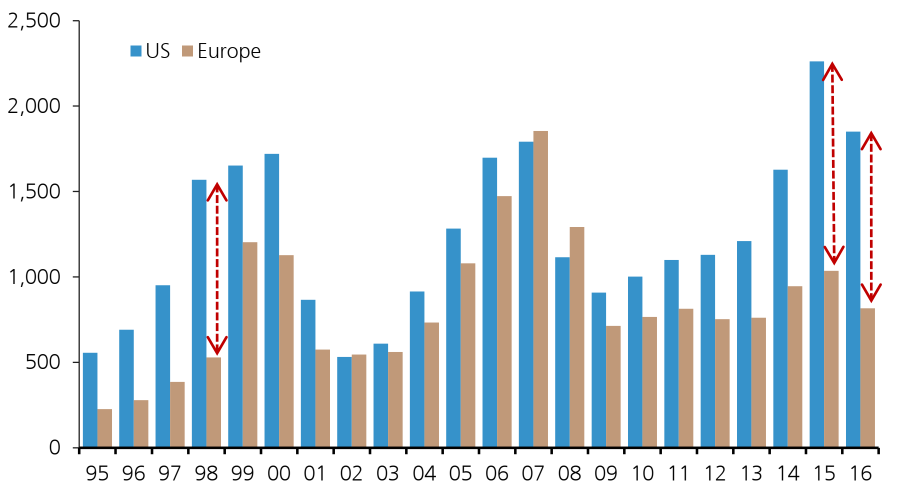
Source: UBS European Equity Strategy

Could European M&A finally pick up?

To date European M&A has been several steps behind the US in this cycle. Often the uncertainty of the cycle is blamed but if the earnings cycle in Europe finally picks up CEOs could get the confidence to be more proactive. So far the gap between M&A activity in Europe and in the US is close over the last 2 years is close to a 16-year high.

M&A in Europe continues to lag the US by a large margin

Figure 69: The gap between European and US M&A remains at historical highs



Source: Dealogic, UBS European Equity Strategy. NB - 2016 YTD value annualised.

Figure 70: Stock Screen: Refinancing & re-leveraging potential winners

Name	Sector	Mkt Cap (EUR bn)	Price (p)	UBS rating	P/E 2016	DY 2016	12m relative perf (%, EUR)	Potential long term chg in Net interest expense	Net interest expense as % of Revenues	Potential long term boost to Net profit margin	Average maturity
Abertis	Industrials	12.6	12.7	Buy	16.1	5.5	11.9	-61%	19.3%	8.3%	6.4
Eurotunnel	Industrials	4.6	8.3	Buy	41.4	2.9	-26.4	-61%	14.5%	6.2%	20.6
Telenet	Media	5.6	48.5	Buy	24.8	0.0	-1.1	-57%	13.4%	5.3%	7.8
Atlantia	Industrials	16.9	20.5	Buy	17.0	4.8	8.9	-61%	11.0%	4.7%	8.5
Telecom Italia	Telecommunications	12.9	0.7	Neutral	8.2	0.0	-19.8	-54%	9.1%	3.4%	8.4
Vopak	Industrials	5.5	42.9	Buy	15.6	2.7	17.2	-61%	6.3%	2.7%	8.9
SES	Media	8.2	20.5	Neutral	21.6	7.0	-16.1	-57%	5.9%	2.4%	9.1
Edenred	Industrials	4.3	19.0	Neutral	20.6	3.4	29.2	-61%	3.9%	1.7%	6.0
Anheuser-Busch InBev	Food & Beverage	157.8	97.6	Buy	29.0	3.7	-2.2	-70%	3.4%	1.7%	12.3
Telefonica	Telecommunications	38.1	8.4	Buy	12.6	8.7	-14.9	-54%	4.3%	1.6%	6.1
Orange	Telecommunications	36.0	13.6	Neutral	11.9	4.4	-8.4	-54%	4.2%	1.6%	9.1
OTE	Telecommunications	4.0	8.1	Neutral	11.3	3.5	2.4	-54%	4.0%	1.5%	3.4
Deutsche Telekom	Telecommunications	66.4	14.4	Buy	18.4	4.2	-8.1	-54%	3.4%	1.3%	8.2
HeidelbergCement	Construction & Materials	17.3	87.4	Neutral	18.8	1.5	37.9	-62%	2.9%	1.3%	4.1
Linde	Chemicals	28.4	153.1	Neutral	20.7	2.3	-2.2	-70%	2.3%	1.1%	5.8
ProSiebenSat.	Media	7.3	33.9	Neutral	14.0	5.5	-25.8	-57%	2.8%	1.1%	5.2
EDP	Utilities	9.8	2.7	Buy	10.6	7.0	-11.4	-31%	5.1%	1.1%	5.4
Leonardo	Industrials	6.9	12.0	Buy	10.9	0.0	18.0	-61%	2.1%	0.9%	8.3
FCA	Automobiles & Parts	8.7	7.1	Neutral	7.5	0.0	-39.4	-66%	2.0%	0.9%	3.8
ArcelorMittal	Basic Resources	19.6	6.4	Buy (CBE)	-65.6	0.0	77.4	-62%	2.0%	0.9%	7.3
Evonik	Chemicals	12.1	25.9	Neutral	13.2	4.4	-13.9	-70%	1.7%	0.8%	6.8

Source: UBS European Equity Strategy

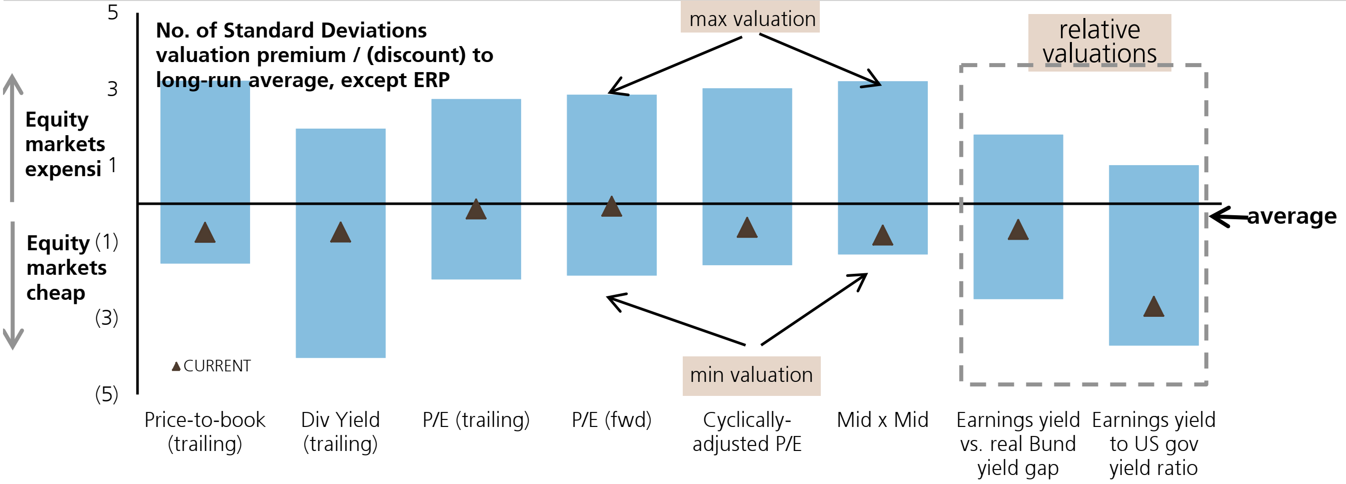
(3) European Equities re-rate to "bond-like" multiples….

Equities re-rate to "bond-like" multiples

Throughout the rally post 2009, we have resisted valuing Eurozone Equities against bonds. This has been because we see the bond market as massively intervened and not a genuine "risk free" rate. But what if the TINA ("there is no alternative") argument goes into overdrive and equites gain inflows as the last outpost in the reach for yield? In our valuation matrix, the relative valuations to bonds have the largest upside.

For more details in the yield attraction for European equities please see: Optimal dividends across sectors: 35 top picks November 1, 2016

Figure 71: European Valuation Snapshot: Standard Deviations from long run average



Source: Datastream, UBS European Equity Strategy

(4) US investors come back…

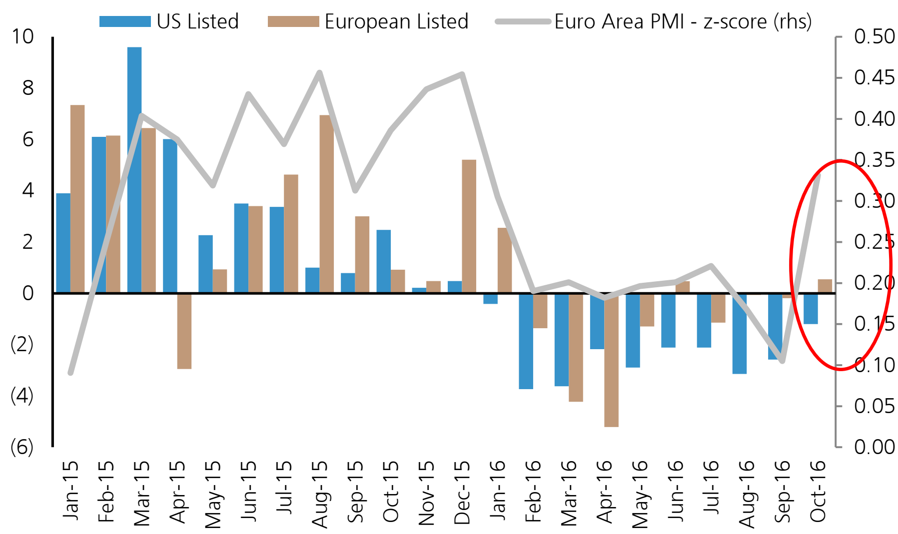
After 10 months in a row of selling…

We see US investors as the key swing investors for Europe. They have been selling for 10 months in a row. But the conditions have to be right: some clarity on two of the biggest perceived risks – Banks and Politics at the same time as genuine delivery of earnings growth for the first time in 6 years may prove the turning point.

Could we see the return of the US investor?

If they buy, it can be large: in the first 4 months of 2015 they bought more than domestic investors through ETFs when European equities were up 20% YTD to the peak in April 2015 – *see figure 72.*

Figure 72: US & European listed ETFs net buying vs Eurozone PMIs



Source: UBS Global Equity Finance, UBS European Equity Strategy

Downside Risks

(1) US rates rising sharply, Global bond sell-off

Sharp and continued sell off in real yields

At the beginning of the report we highlighted that the biggest investor concern currently appears to be the impact of rising bond yields on equites. Our house view is that yields will only rise gradually from here. But what if we're wrong? At what point does the rise in bond yields crimp equity valuations and start to force negative returns in equities as well as bonds.

ECB tapering too early…

ECB tapering too early? A connected concern would be if the ECB were to start shutting off monetary stimulus too early. Our European economics team's central scenario is for the ECB to announce an extension of QE at the current run rate of €80bn per month for another 6 months, taking them to September 2017. But if this was not to be the case then this may well cause a sharper sell off in yields.

As argued earlier, it depends on why bond yield are rising – is it inflation or real yields, what speed are yields moving at (the last 2 months have been rapid) and finally, what are the absolute levels?

So far, given the move up in bond yields, the overall European equity market has been relatively stable. Instead there has been some fairly brutal sector rotation underneath the headline indices. For certain sectors this is a risk, particularly the "expensive bond proxies" such as Consumer Staples.

The good news is that the equity market in aggregate has not been valued off bond yields, so whilst this hasn't given us upside it potentially limits some of the downside in a bond sell-off.

Big Macro 01: Are Low US Yields Here to Stay? 8 September 2015

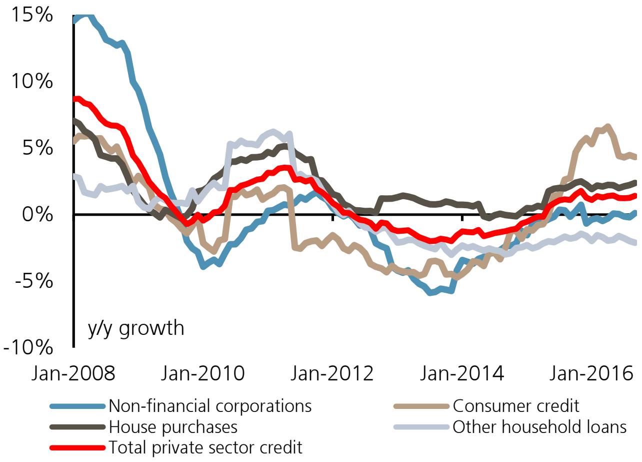
Big Macro 04: Secular stagnation and equities; the new normal 12 September 2016

(2) Banks…still…

Renewed concerns on Bank capital

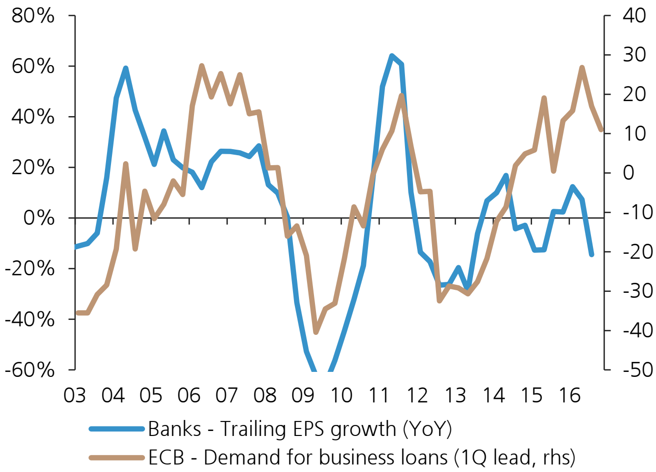
Although Bank share prices have rallied in recent months, there are still investor concerns – in particular if connected to risk #3, European politics. Loan growth to the corporate sector in the Eurozone is lacklustre – hovering around zero. In addition, Banks' profits have decoupled from loan demand and recent numbers show loan growth decelerating.

Figure 73: Bank lending in the Eurozone to corporates has been weak…



Source: Haver, UBS European Economics

Figure 74: …and Banks profits have decoupled from loan demand…

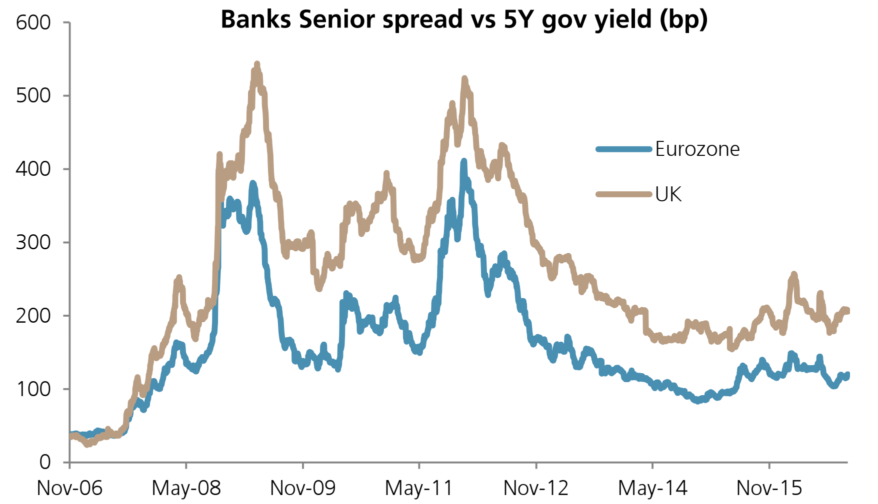


Source: Haver, UBS European Equity Strategy

But we would argue that the capital positions have improved since the crisis, which is why most CDS spreads remain well-behaved.

But CDS remain well-behaved

Figure 75: Banks credit spreads

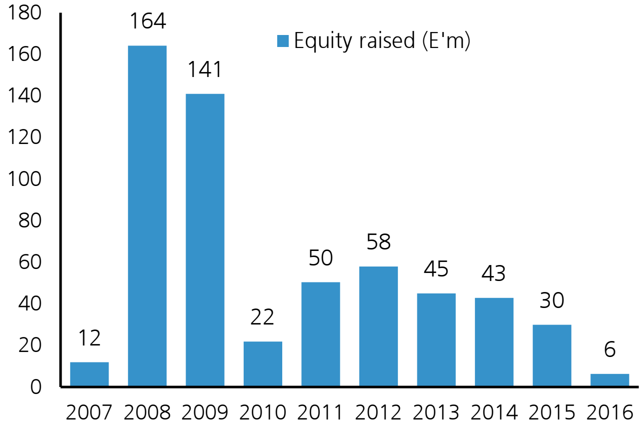


Source: Datastream, UBS European Equity Strategy

Our Banks team track €570bn in capital raised by deleveraging or equity issuance since the crisis began across Europe and the UK (*see below*). Within the sector they continue to advocate that investors hold the better capitalised, higher return banks, particularly in markets in which there is volume growth and decent capacity to reprice loans and deposits: the Netherlands, UK and Sweden.

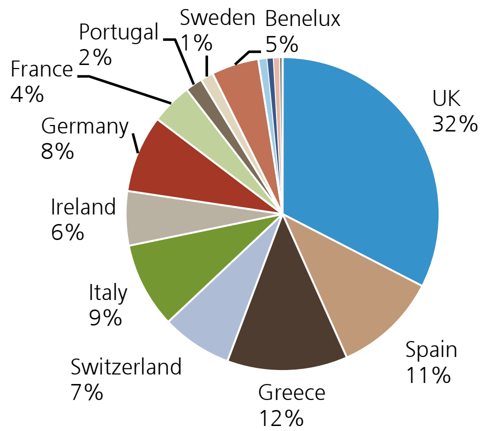
And a large amount of capital has already been raised

Figure 76: €570bn in equity raised, more to come



Source: UBS estimates, Company Data

Figure 77: Distribution of equity raises since 2007



Source: UBS estimates, Company Data

(3) Politics…again

Politics…as ever a concern for Europe

Having navigated the US Elections, focus now turns to Europe. Unfortunately given the large number of countries across Europe there is almost always likely to be an election, referendum or key vote going on somewhere at some time. But even by these standards the next 12 months are quite remarkably busy - *below we update our catalyst calendar:*

The next major European political event is likely to be the Italian referendum. Whilst the current polls are close with many still undecided, Prime Minister Renzi has backed away somewhat from initial comments that he would resign if he were to lose the referendum. This may mitigate the risk somewhat. *For more details please see our macro team's recent note:* Macro Keys - Italian referendum: What you need to know 27 September 2016.

Figure 78: Catalyst Calendar

Month	FOMC meetings	BoE MPC meetings	ECB MPC meetings	Parliamentary/Presidential Elections
Dec	13-14	15	8	Switzerland* Italy's constitutional referendum – 4 Austria's presidential elections – 4
Jan'17	31-1	-	19	Singapore (parliament)
Feb	-	2	-	Germany*
Mar	14-15	16	9	Netherlands (parliament)
Apr	-	-	27	
May	2-3	11	-	France (president round 1) - 7
Jun	13-14	15	8	France (parliament round 2) - 18
Jul	25-26	-	20	India*
Aug	-	3	-	Singapore (president)
Sep	19-20	14	7	France (senate) - 24
Oct	31-1	-	26	Germany (parliament)
Nov	-	2	-	Slovenia (president)
Dec	12-13	14	14	South Korea (president)

Source: UBS European Equity Strategy, BBC, FT, Google News - *President (by Parliament)

..but this time with a busy political calendar

What is the likely impact of the surprise US Election result?

So far, European equity markets have rallied since the surprise victory by President-Elect Trump. Whilst there is still the chance of near-term volatility as the results are absorbed and markets move to contemplate what a Trump presidency looks like, we would argue that, in the near-term at least, it is not an obvious negative for equites.

What to do within the market…?

We would focus on the infrastructure-exposed themes highlighted above and also the Healthcare sector as a relative winner.

For more details please see:

Impact of US Elections on European Equities 9 November 2016

US Equity and Derivatives Comment - US Election 2016: A Republican Sweep 9 November 2016

US Economic Comment - Trump victory, what now? 9 November 2016

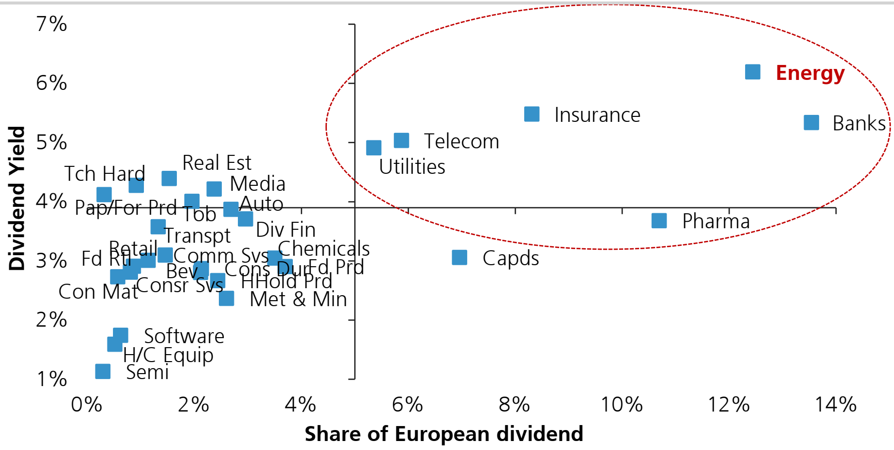
Sector Strategy

Upgrade Energy to Overweight from Neutral

Profit boost from higher oil prices and the highest dividend yield in Europe

We upgrade the Energy sector to Overweight from Neutral as the commodity price drag on profits is moving out of the picture as discussed above and the sector offers the highest dividend yield in Europe by a significant margin (Energy offers c6% yield followed by the Banks, Insurance, Utilities and Telecoms on c5%).

Figure 79: Energy offers the largest Div Yield and is the second largest component of the European dividend

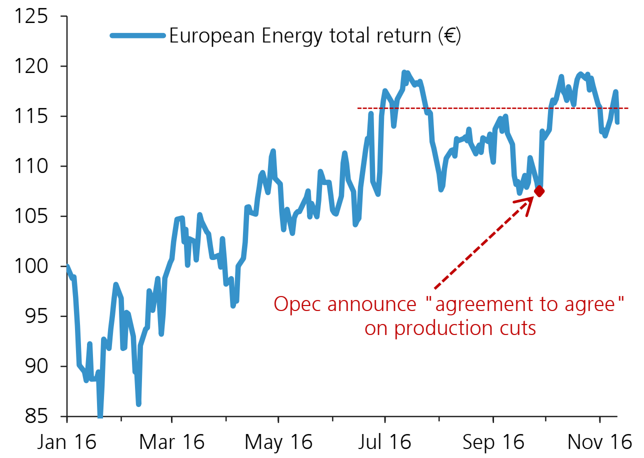


Source: UBS European Equity Strategy, DataStream

Energy has underperformed Mining by circa 55% YTD

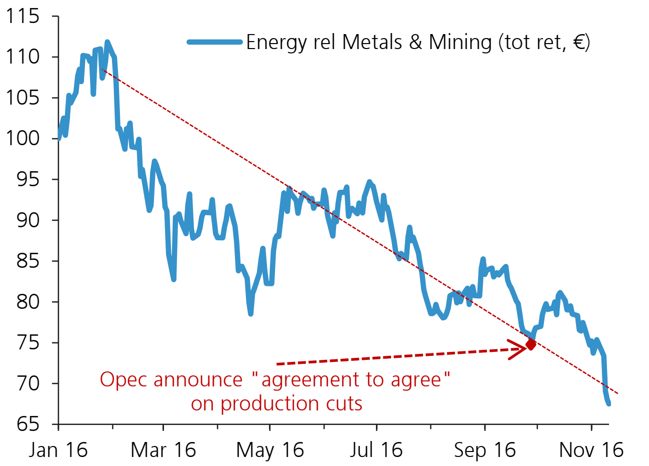
While one possible pushback on moving into Energy now is the question of "is it too late?" In our opinion it is not. The European market as a whole has shown poor performance this year and most sectors are showing negative returns year to date (Miners, Energy and Construction are the only exceptions). In that environment it is easy to see Energy's c8% price returns and c14% total returns since January as extraordinary. We beg to differ. A closer look shows a sector which mainly moved sideways since June and has significantly underperformed its main peer in the commodities universe; Miners have outperformed Energy by c55% YTD in total returns (Figure 81). Hence, as we start lapping the lows in oil prices of late 2015 and early 2016 we adopt a preference for Energy over Miners.

Figure 80: Energy moving sideways since June



Source: UBS European Equity Strategy, DataStream

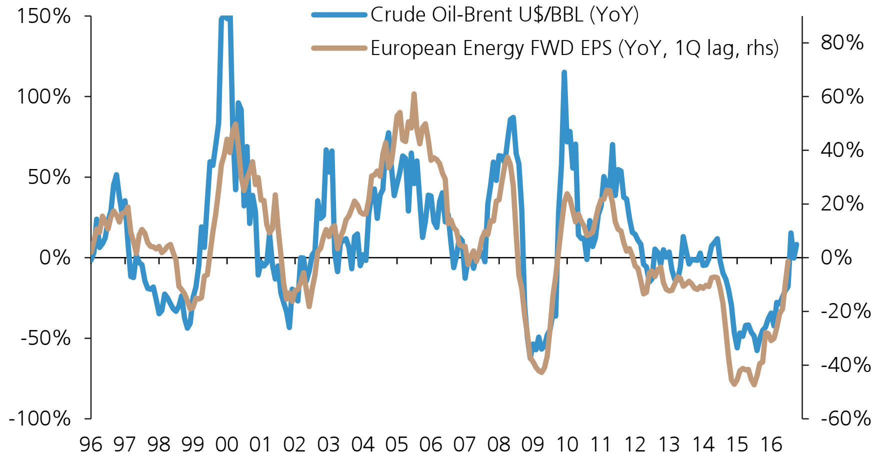
Figure 81: Energy lag Miners by c555 since oil price turn



Source: UBS European Equity Strategy, DataStream

As we stated above, we believe EPS growth is key to drive performance of European stocks in 2017. Few areas of the market appear to have much room for rerating (Pharma being one of the exceptions). Looking at earnings for the Energy sector we appear to be at the brink of a return to growth after nearly 5 years of negative growth. Crude prices, which have just started lapping lower comps from late 2015, are likely to hit close to 100% growth YoY by Q1 2017 and this could translate into a period of robust EPS growth for Energy stocks as growth in oil prices tend to be a strong indicator of growth in Energy stock EPS circa 1 quarter later (Figure 82).

Figure 82: Oil prices point to earnings returning to growth soon and likely remaining there

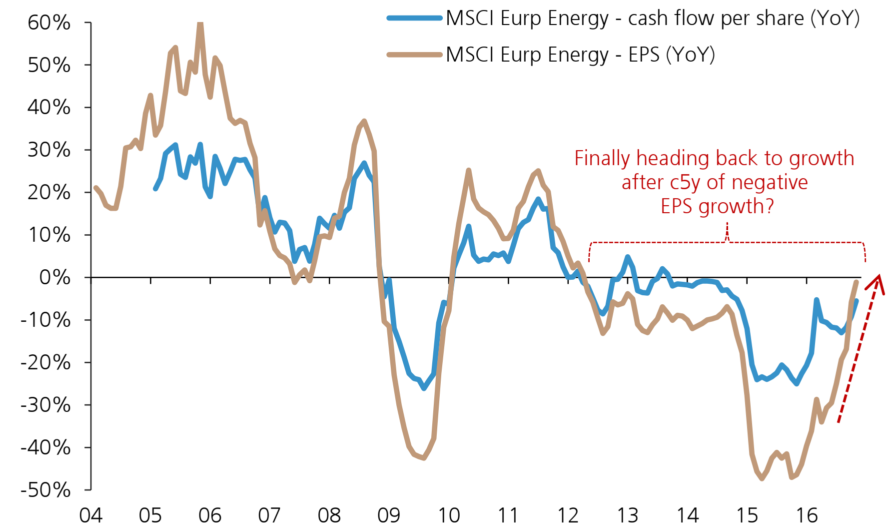


Source: UBS European Equity Strategy, DataStream

Energy EPS could be returning to growth for the first time since late 2011

Moreover, the period of negative EPS growth Energy corporates have gone through over the past few years was one in which cash flows were much more resilient than earnings (Figure 83). This leads us to another key argument in favour of Energy: the sector offers the highest dividend yield in Europe.

Figure 83: Cash flow has been more resilient than EPS – if the sector returns to profit growth as we believe the yield is likely to materialise

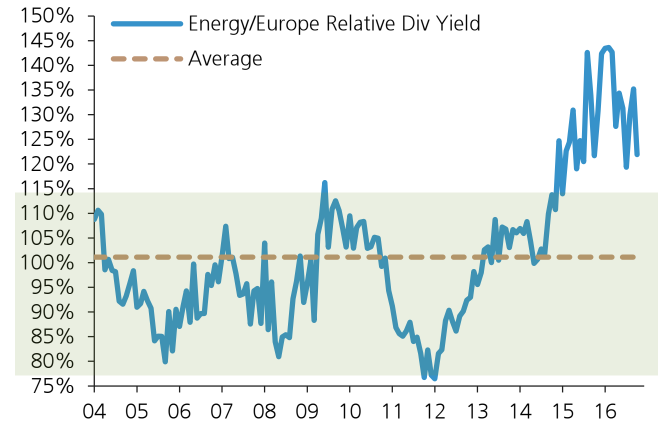


Source: UBS European Equity Strategy, DataStream

Resilient cash flows could support dividends

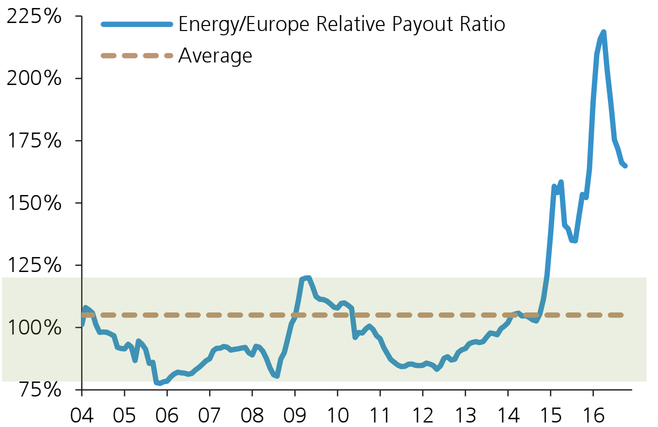
Relative to the wider market Energy stocks offer a c25% yield premium and although the payout is stretched, our analysts do not foresee significant dividend cuts ahead. As cash flows have been resilient and the sector appears to be about to enter a period of profit growth Energy stocks could be in a stronger position to sustain dividend levels than the payouts might suggest. Hence, we could see payouts shrink via profit growth rather than dividend cuts.

Figure 84: Energy offers the highest dividend yields in the European markets across sectors



Source: UBS European Equity Strategy, DataStream

Figure 85: Payouts do look stretched but cashflows are resilient and profit prospects are positive

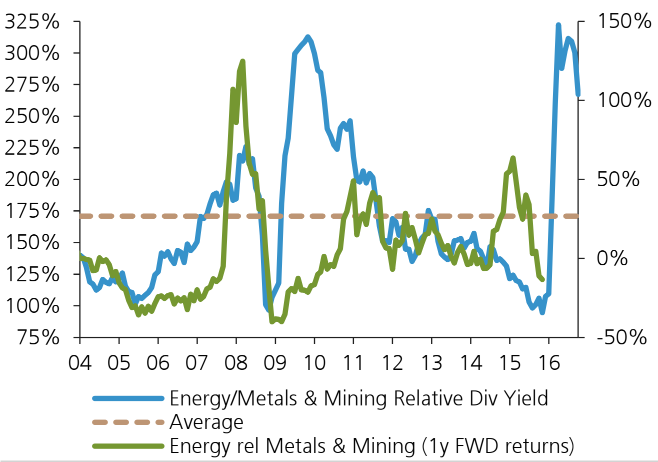


Source: UBS European Equity Strategy, DataStream

Energy offers c3x the dividend yield of Miners

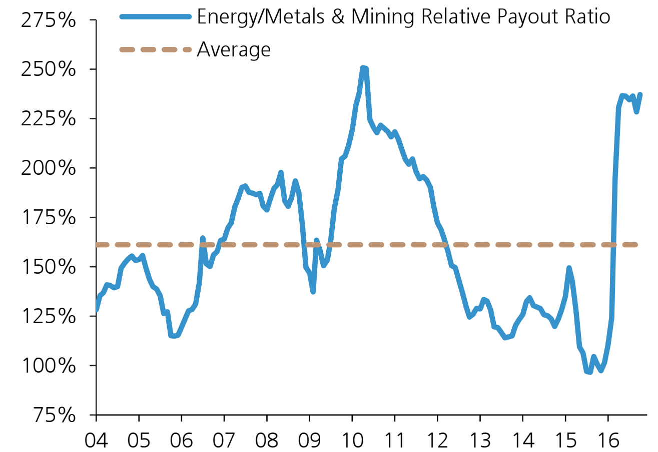
In relative terms to Metals & Mining the Energy sector offers close to 300% the dividend yield of Miners. Periods when Energy offered a premium yield to Miners in the past have generally translated into good entry points for Energy relative to Miners (Figure 86).

Figure 86: The dividend yield in Energy is c 2.5x that of Miners, after hitting over 3x during summer



Source: UBS European Equity Strategy, DataStream

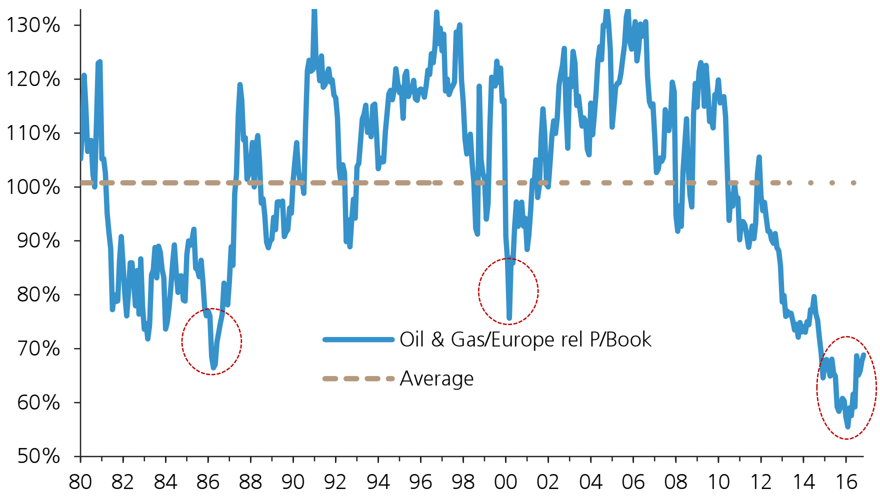
Figure 87: Relative payout ratios are also stretched but we believe any cuts in Energy dividends should be limited



Source: UBS European Equity Strategy, DataStream

In terms of valuations, the relative performance of the sector year to date has done little to change the picture of how cheap the sector trades at. For instance, relative to the wider European market the sector trades at a c 30% discount on P/Book. This is a larger discount than at the through valuations of the mid-80s and late 1999 and 2000 when Brent Crude hit c$10 a barrel (Figure 88).

Figure 88: European Oil & Gas stocks trade at a lower P/Book than in the previous troughs in the mid-80s and 1999/2000.



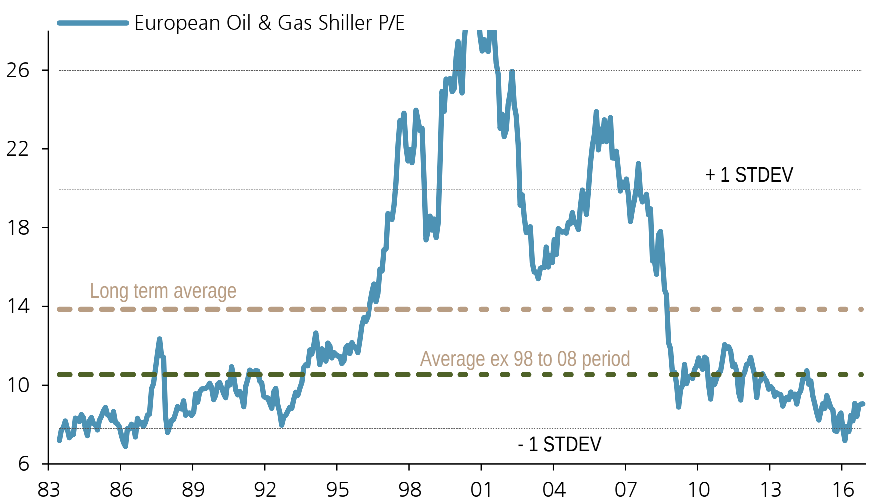
Source: UBS European Equity Strategy, DataStream

The sector is cheaper on relative P/Book today than in 1999 when Brent reached $10

If we take the cycle into account, which as we stated should enter a period of profit growth for Energy stocks soon, the sector looks equally undervalued.

The Shiller P/E for the Oil & Gas sector is now at c8x. This is vastly lower than the long term average of c14x. However, it can be argued that the decade between 1998 and 2008 was abnormal and should not be considered in the long term average. However, even if we exclude this period, the average valuation is still c10.5x and hence significantly greater than current levels (Figure 89).

Figure 89: The current Shiller P/E for the sector is significantly below historical average – even if we exclude the period between 1998 and 2008

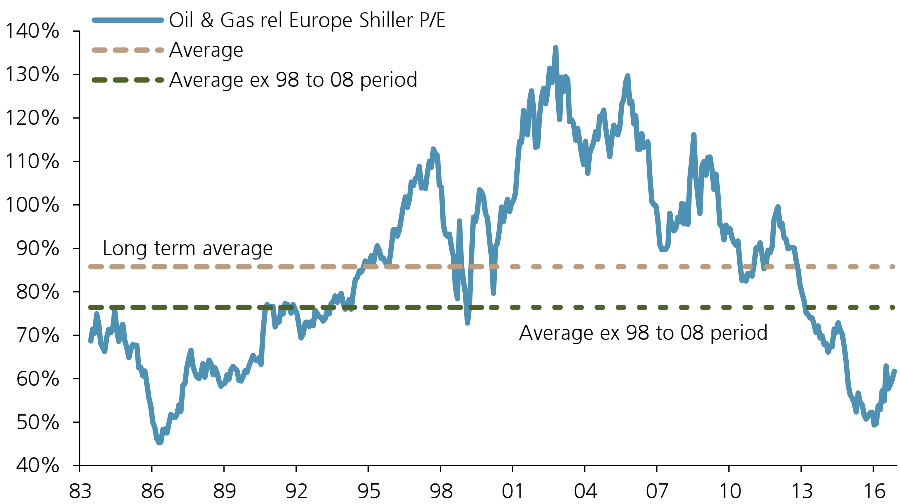


Source: UBS European Equity Strategy, DataStream

Oil trades at the cheapest cycle adjusted valuations since the early 90s

It could be argued that the Shiller P/E looks low for all of the European market but even in relative terms Oil & Gas stocks trade at a large discount – c60% of the European market Shiller P/E (Figure 90). This compares to a long term average of c87% and an average of c76% if we exclude the 98 to 08 period.

Figure 90: The Shiller P/E relative is at the lowest levels since the late 80s



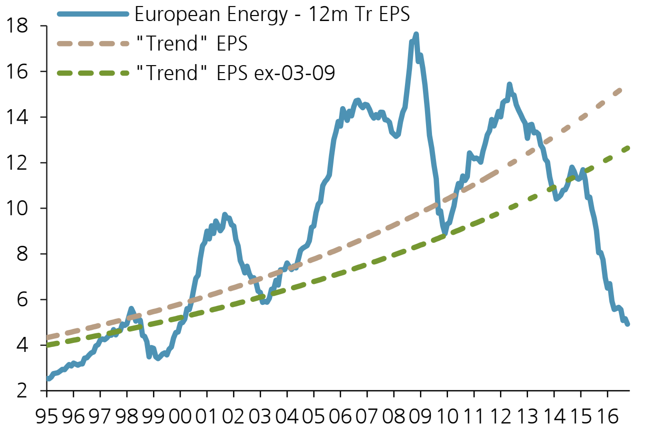
Source: UBS European Equity Strategy, DataStream

In relative terms the sector is still the cheapest in nearly 30 years

Of course, believing in the Shiller PE cheapness means also believing in the earnings cycle changing for the sector. This is something we do see support for. The recent profit down cycle for Energy stocks has been the steepest and most prolonged since our data begins and seems ripe for change. As mentioned above, the oil price changes point to a long overdue period of profit growth ahead. The current profit level for the sector is largely below even the trend in profits excluding the 2003-2009 commodity supercycle (let alone the long term trend if we include all the data) (Figure 91). Using those 2 earnings trends and the mid-cycle P/E to look at our Mid x Mid valuation[1] also point to a largely undervalued sector (Figure 92).

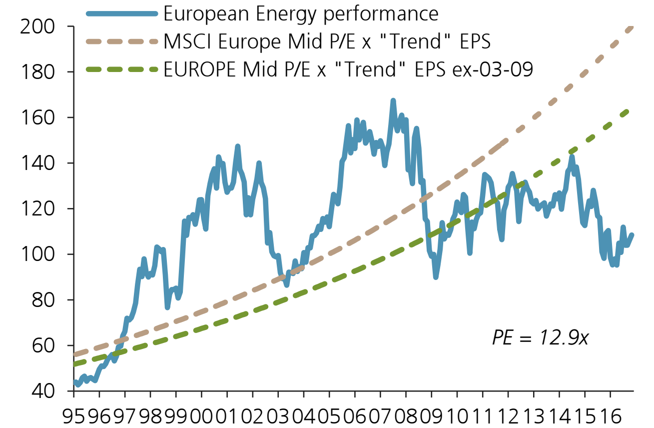
Energy profits are vastly below trend and with the movements in oil this could be about to change

Figure 91: Energy EPS trend weakest since mid-90s



Source: UBS European Equity Strategy, DataStream

Figure 92: Mid x Mid valuation points to strong upside

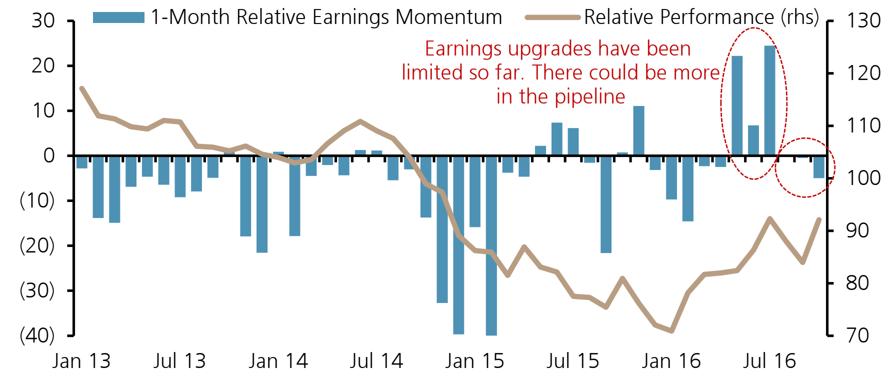


Source: UBS European Equity Strategy, DataStream

[1] Earnings trend multiplied by the mid-cycle P/E

Finally, the EPS momentum for the sector shows no significant pick-up yet. Year to date only 3 months (May, June and July) showed positive revisions in earnings; the remainder of the year saw analysts continuing to take their numbers down (Figure 93). We believe this could change as we move into 2017, oil prices start lapping significantly lower comps and inflation picks up.

Figure 93: Earnings momentum is yet to show a significant pick-up



Source: UBS European Equity Strategy, DataStream

*Our analysts highlight **RD Shell, ENI** and **Petrofac** as top picks.*

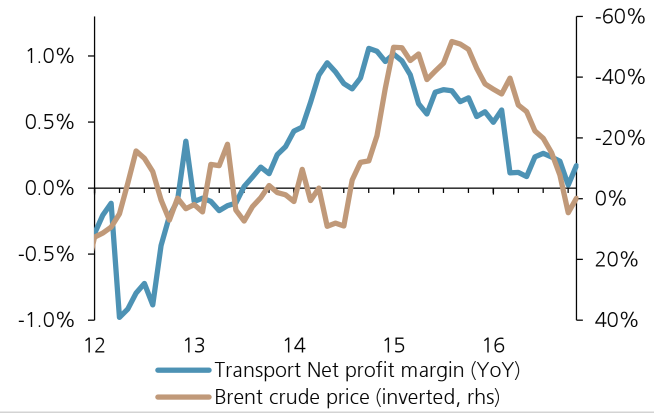
Downgrade transport to Underweight from Neutral

The recovery in oil prices weakens the support for margins for Transport

We downgrade the Transport sector to Underweight from Neutral. As Energy benefits from the commodity price environment, that same environment is a challenge for margins in Transport stocks. We first downgraded the sector (to a Neutral) in July as oil prices started putting pressure on margins. We see continued pressure going into 2017. The recent EPS downgrades have been on par with the worst since our data begins.

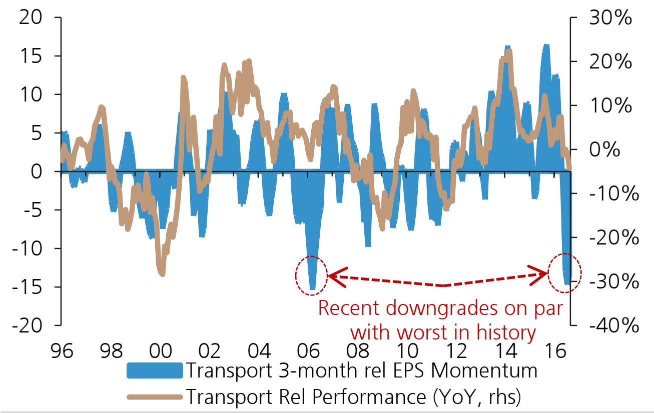
The sector benefited from the low oil prices over the last few years, this helped margins expand and supported strong earnings momentum between 2012 and early 2016 (Figure 94 and Figure 95). The rise in oil prices now removes the support for margins and we can already see significant compression in profit margins since 2015. This is also translating into the poor earnings momentum as the downgrades on the sector over the past 3 months have been on par with the historic lows for the sector in 2006 (Figure 95).

Figure 94: Oil prices no longer provide support for continued margin expansion



Source: UBS European Equity Strategy, DataStream

Figure 95: Earnings downgrades are on par with the strongest since our data begins

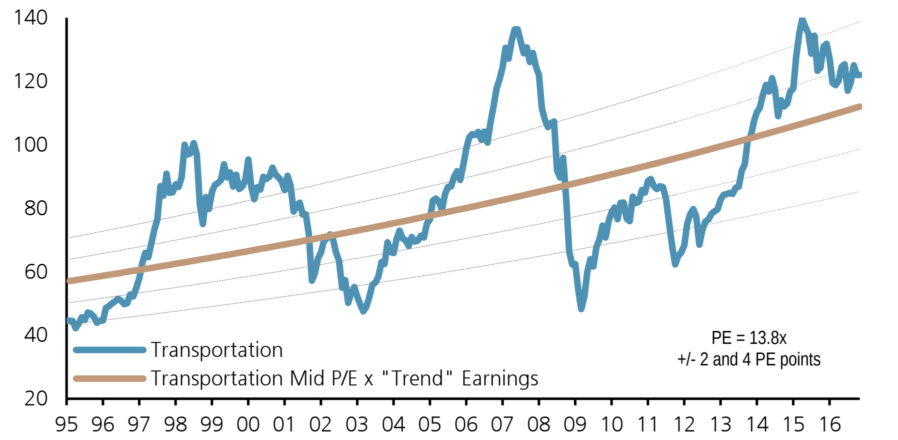


Source: UBS European Equity Strategy, DataStream

In addition, cycle adjusted valuations for the sector look stretched as earnings have jumped significantly above trend and despite the recent underperformance Transport still shows Mid x Mid valuations significantly above trend (Figure 96).

Transport EPS momentum is at historical lows but performance response is still subdued

Figure 96: Transport looks expensive on cyclically adjusted valuations



Source: UBS European Equity Strategy, DataStream

*Our analysts highlight **Air France** and **DSV** as their least preferred names.*

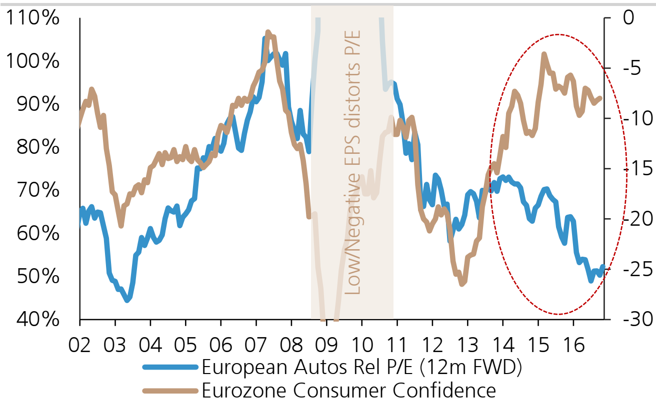
Autos Overweight

We hold the Autos sector Overweight as it could benefit from its exposure to EM given movements in EM currencies over the last year and key EM markets getting out of recessions. In addition, valuations look very attractive (lowest rel P/E in over a decade) and EPS momentum is showing signs of strength. But it is not only exposure to EM that benefits the Autos; the domestic European market might finally become a boost to the sector.

Autos could benefit from its exposure to EM and from a recovery in their home market

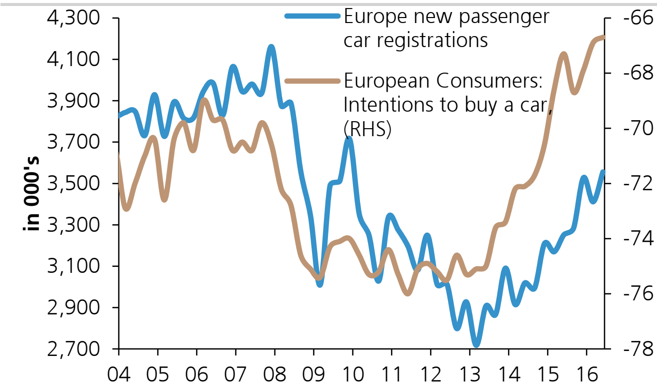
For years now a slow home market has been a drag for European Autos but this now appears ripe for change. The gap between consumer confidence in Europe and Autos valuations has now stretched to historical highs (Figure 97). In addition, intentions to buy a car in Europe are now higher than at the peak of the previous cycle while car registration numbers are just starting to catch up (Figure 98).

Figure 97: Autos relative PE lowest in over a decade has decoupled from consumer confidence



Source: UBS European Equity Strategy, DataStream

Figure 98: Intentions to buy a car at historical highs and car registration numbers starting to catch up



Source: UBS European Equity Strategy, DataStream

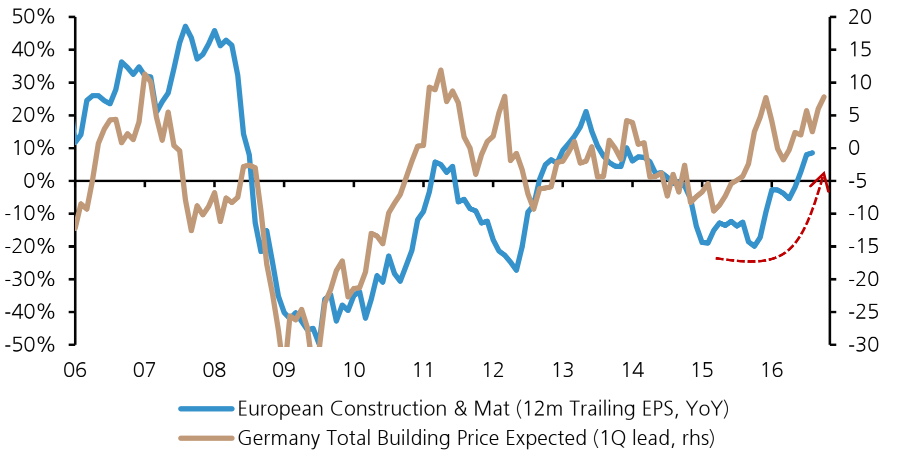
*Our analysts highlight **Daimler, Volkswagen, Renault, Valeo** and **Michelin** as top picks.*

Construction Overweight

We remain Overweight the Construction sector. The background of fiscal stimulus discussed above is supportive of the construction industry. In addition, property prices already show strong trends in key European countries (Germany stands out as a prime example) yet the impact of that on earnings is still only starting to feed through as the sector showed a return to growth in September (Figure 99). This could lead to continued EPS growth for construction going forward.

Fiscal stimulus could be a key boost for construction stocks

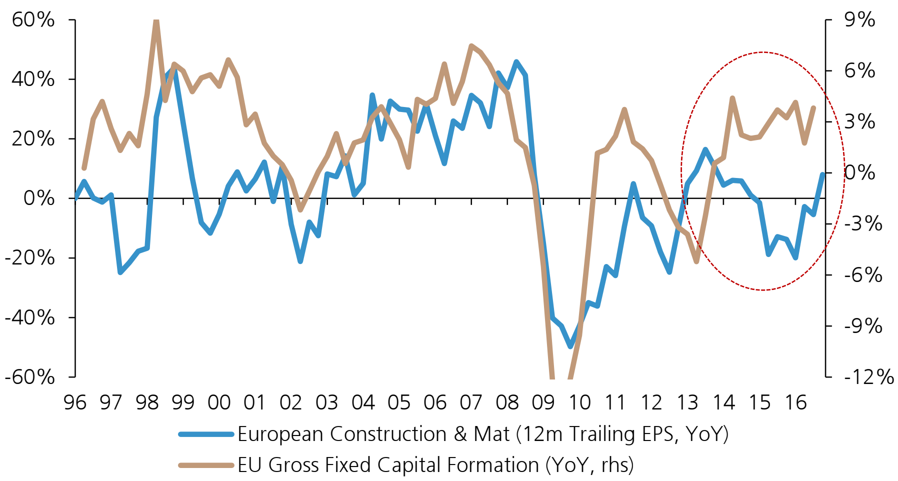
Figure 99: Building and property prices point to EPS growth going forward



Source: UBS European Equity Strategy, DataStream.

Another positive trend for the sector is a potential recovery in CAPEX. While a strong capex recovery in Europe still seems elusive we have seen signs of a modest pick-up (for more see: UBS Evidence Lab: Is Eurozone investment gaining strength? 24 Aug 2016). This could support a continued pick-up in profits (Figure 100).

Figure 100: The impact of a modest recovery in CAPEX we see in recent data does not appear to be reflected in EPS yet



Source: UBS European Equity Strategy, DataStream.

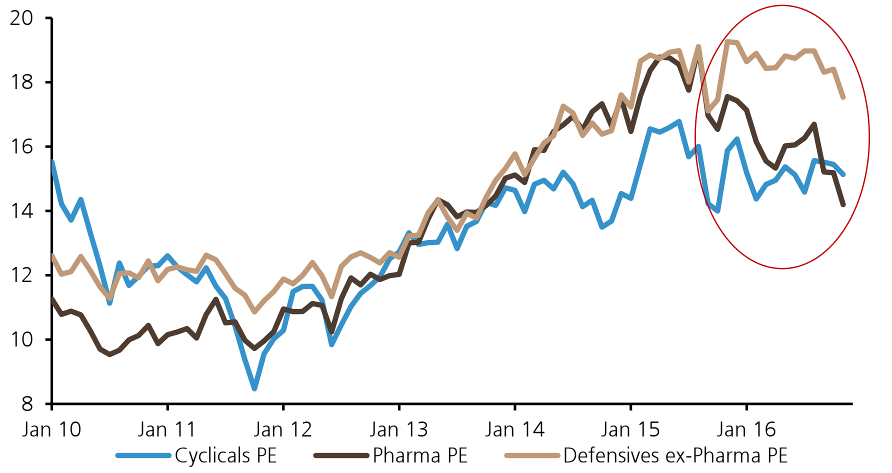
If the positive trend in CAPEX continues the sector could see continued EPS growth

Our analysts highlight **CRH**, **Vinci** and **Redrow** as key Buy recommendations in the sector.

Pharma Overweight

We are Overweight the Pharma sector as a defensive trading at valuations which are now visibly below the average cyclical sector in Europe (Figure 101).

Figure 101: Defensives ex-Pharma vs Cyclicals vs Pharma PE



Source: UBS European Equity Strategy, Datastream

Pharma now trades at a lower PE than cyclicals in Europe

The key pushback on the Pharma investment case was pricing pressure in the US market. This was partially driven by some of the proposals by Hilary Clinton to curb drug prices. Although there is still pricing pressure from the private side, given the election result we believe it is likely valuations and earnings expectations will recover partially as the pressure on prices from the public side subsides.

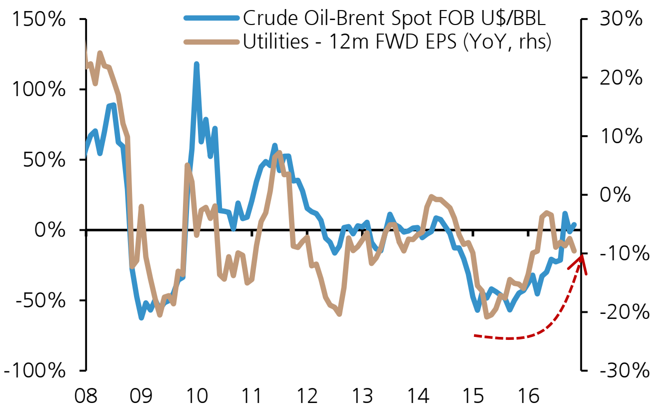
Key buy recommendations by our sector analysts are **Roche**, **Shire** and **Astrazeneca**.

Utilities Overweight

Commodity prices support EPS growth in Utilities

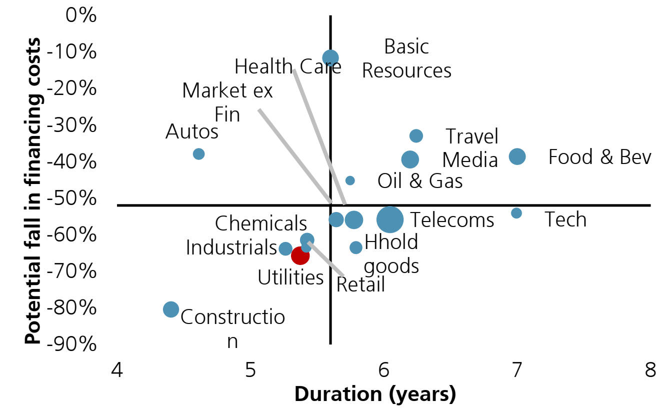
We are Overweight the Utilities sector as it is another key beneficiary of the environment of higher commodity prices discussed above (Figure 102). In addition, the sector is currently benefiting from cheaper refinancing costs given current coupon on debt is significantly higher than current yields and the ECB corporate bond buying program provides further support. This can have a strong impact on the earnings for the sector as they are highly leveraged and pay a large portion of their income to refinance debt (Figure 103). For more see: European Equity Strategy - What Boost to Earnings from Cheaper Refinancing?, 19 May 2016

Figure 102: Commodity prices support a recovery in Utilities EPS



Source: UBS European Equity Strategy, DataStream

Figure 103: Utilities (as well as Construction and Telecoms) could receive a boost from cheaper refinance



Source: UBS European Equity Strategy, DataStream

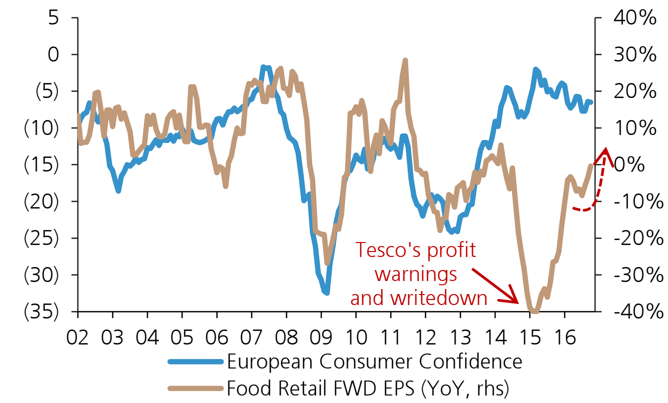
Key Buy recommended stocks highlighted by our analysts are: Enel, EDP and Gas Natural.

Food Retail Overweight

Resilient consumer confidence points to significant upside to earnings

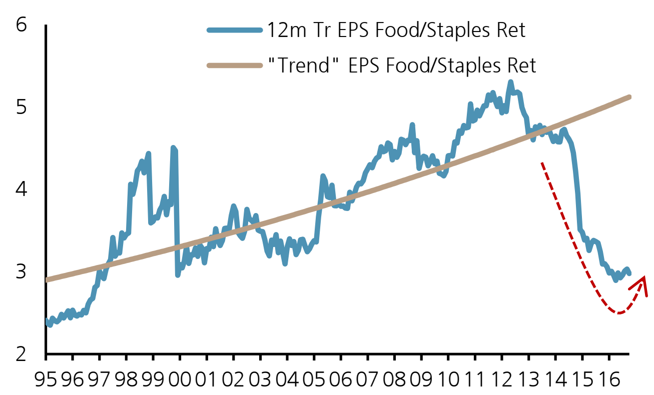
We are Overweight the Food Retail sector. The gap between consumer confidence and earnings for Food Retail remains at historical highs since 2014 but EPS now seems to finally be showing early signs of recovering (Figure 104). On top of that if we see a pick-up in inflation the sector could benefit.

Figure 104: Consumer confidence points to further recovery in EPS



Source: UBS European Equity Strategy, DataStream

Figure 105: Profits collapsed back to 2003/04 levels but are now showing signs of picking up



Source: UBS European Equity Strategy, DataStream

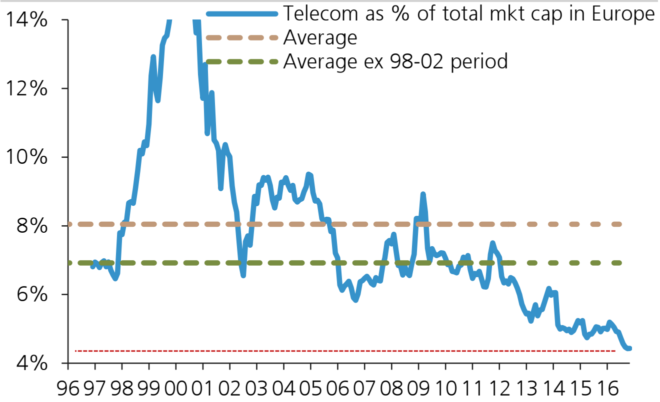
In addition, if we take the earnings cycle into account then the Food Retail sector trades at very attractive valuations. Looking at the earnings trend in Food Retail we are still back to profit levels seen in 2003/04 (Figure 105) and the sector is only now showing some initial signs of a pick-up in profits.

Telecom Overweight

We are Overweight the Telecom sector as we see profit recovery potential and depressed valuations. Average spent on mobile phones in the US is vastly higher than in Europe. This means earnings in the European Telco sector are still c41% below their pre-crisis peak levels while US peers are already above pre-crisis peaks. The result of all this is that the sector now accounts for circa 4.5% of market cap in Europe – the lowest level since our data begins (Figure 106).

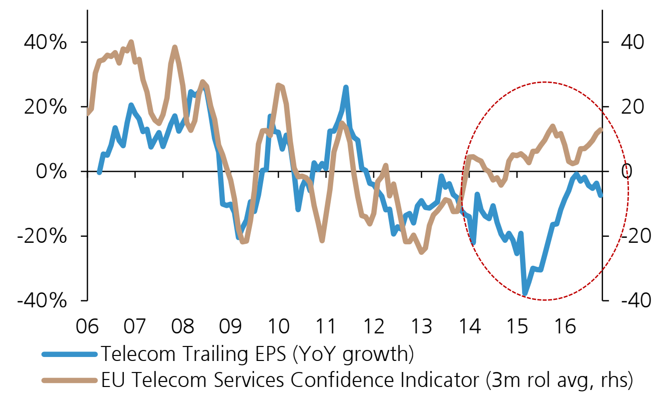
Going forward, however, the view from within the industry is positive with lead surveys pointing to confidence in the Telecom sector. In the past such confidence showed a strong correlation to earnings growth (Figure 107).

Figure 106: Telcos capitalization at historical lows



Source: UBS European Equity Strategy, DataStream, MSCI.

Figure 107: EPS and lead indicators gap decoupled again



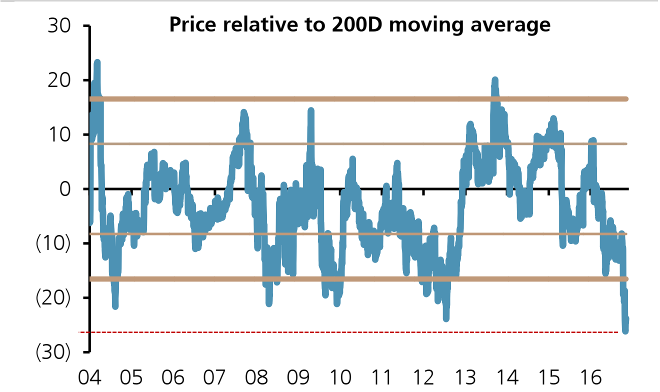
Source: UBS European Equity Strategy, DataStream, MSCI

Key buy recommendations by our sector analysts are **Vodafone**, **Telefonica** and **Sky**.

Technology Overweight

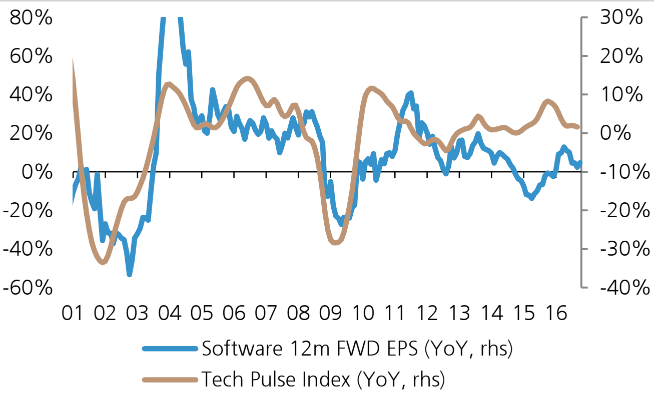
We are overweight the Software and Tech Hardware sectors. PE relatives are back to some of the lowest levels in a decade for both sectors and cycle adjusted valuations point to significant upside (Especially for the Tech Hardware sector which looks oversold on technical indicators – Figure 108).

Figure 108: Tech Hardware – most oversold position since the dot.com bubble burst



Source: UBS European Equity Strategy, DataStream.

Figure 109: Software – Industry surveys suggest economic activity in the sector remains strong



Source: UBS European Equity Strategy, DataStream, Federal Reserve Bank.

In addition, key drivers of performance for the sectors are looking better than the market appears to be pricing in lately. For example, industry surveys such as the Tech Pulse Index point to resilient economic activity in Software (Figure 109).

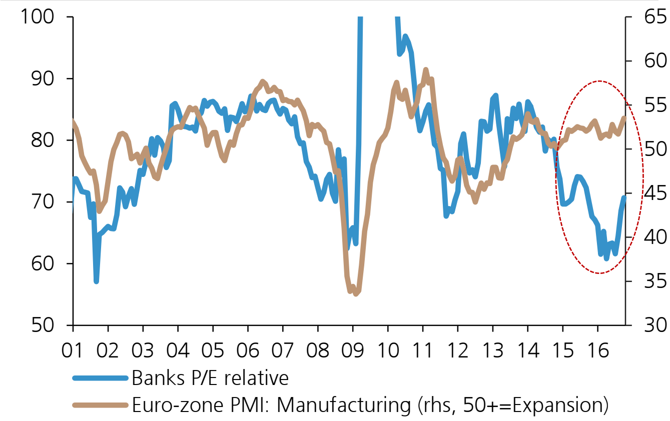
Software and Tech Hardware trades at some of the lowest relative valuations in a decade

Key stocks highlighted by our sector specialists are **SAP**, **Hexagon**, **Atos**, **Software AG** and **Temenos**.

Neutral Financials

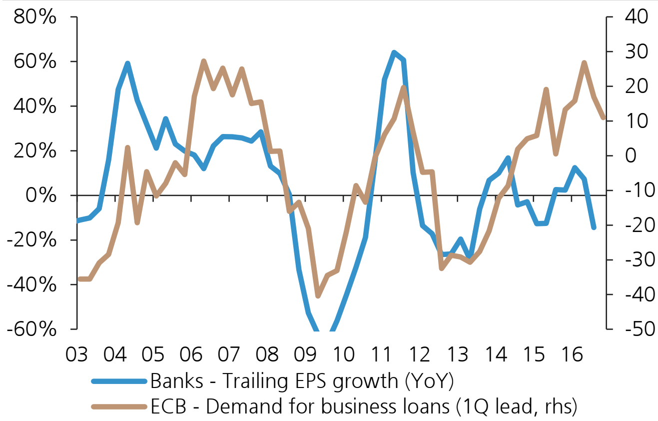
We hold the Financial sectors Neutral. On one hand, very cheap valuations and extreme gaps to underlying numbers (Figure 110) could lead to short term rallies. On the other hand, a deceleration in domestic European growth and many stock specific issues pose challenges to a sustained recovery in the sector. Looking at the loan demand from corporates in the most recent ECB bank lending survey the number was softer than what we had earlier in the year and with that the small signs of a pick-up in profits we were seeing largely disappeared (Figure 111).

Figure 110: PMIs point to a potential continued recovery for depressed valuations



Source: UBS European Equity Strategy, DataStream

Figure 111: But net interest margins are an ongoing challenge and the earnings picture still poor



Source: UBS European Equity Strategy, DataStream

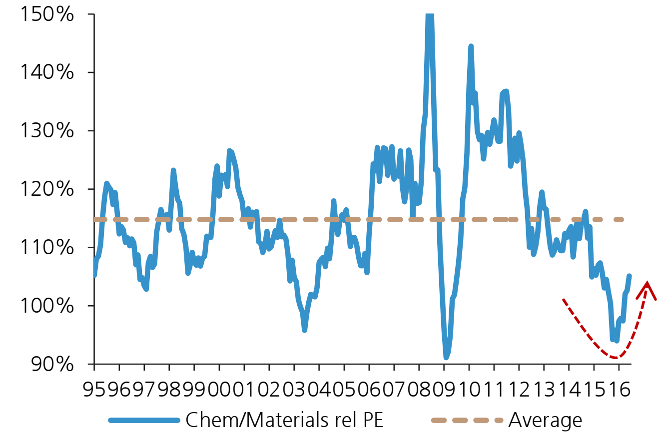
Key Buys highlighted by our analysts are: **Lloyds, ING, SEB**

Neutral Chemicals

We hold the Chemicals sector Neutral but highlight it as in a strong position within the Materials universe as valuations relative to other Materials seem attractive and are starting to recover (Figure 112).

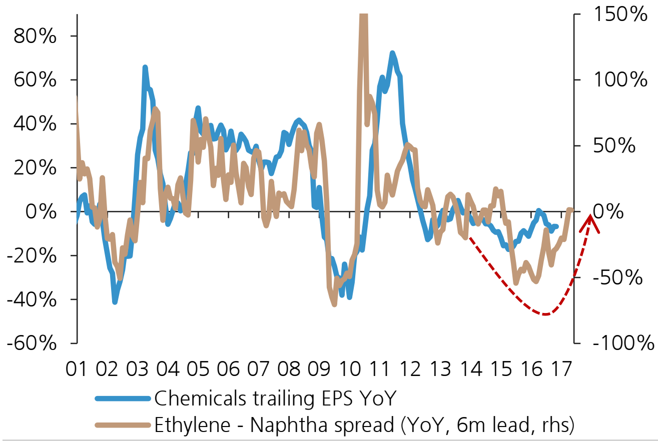
Cheap valuations relative to other materials and commodity spreads point to a recovery for Chemicals

Figure 112: Chemicals rel Materials PE in recovery



Source: UBS European Equity Strategy, DataStream

Figure 113: Commodity prices support a pick-up in EPS



Source: UBS European Equity Strategy, DataStream

In addition, with the recovery in commodity prices, the gap between earnings for Chemicals and the spread between the key commodity inputs and outputs for the sector (Ethylene and Naphtha) in now pointing to a recovery in profits (Figure 113).

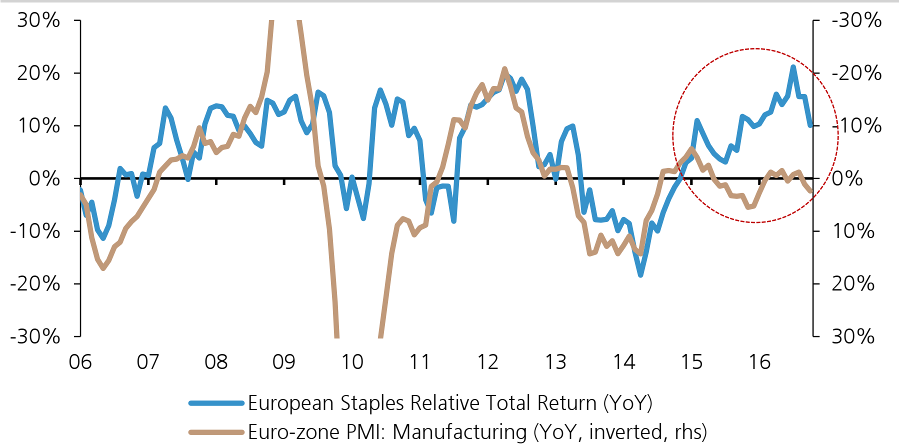
*Key Buys – **BASF, Lanxess, Symrise, Elementis** and **Arkema***

Underweight Staples

Rich valuations and resilient PMIs paint a negative picture for Staples

We hold an Underweight position on the Staples sectors (except for Food Retail where we are OW). We see the Staples as a hard investment case to justify when other defensives such as Pharma offer much more attractive valuations as highlighted above. PMIs tend to have an inverse correlation with Staples performance and the current resilience in lead indicators in Europe has led to the largest gaps between Staples performance and PMIs in over a decade (Figure 114).

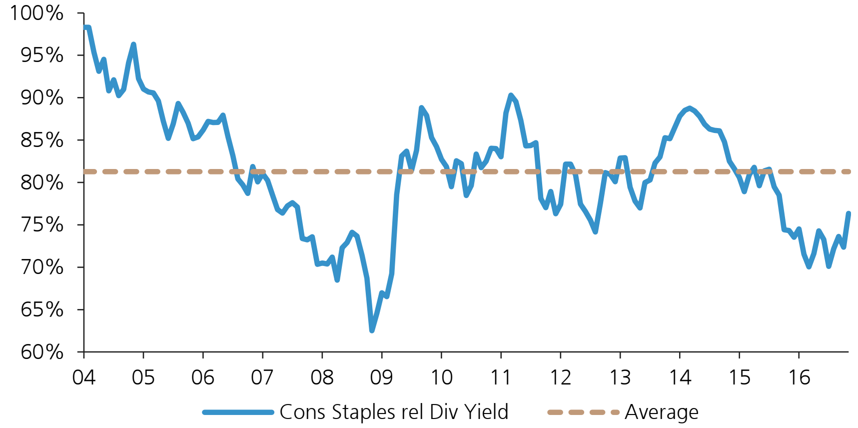
Figure 114: European PMIs continue to show resilience – The gap between PMIs and Staples performance is at historical highs but showing signs of closing



Source: UBS European Equity Strategy, DataStream, MSCI.

In addition, the sector looks fairly expensive in terms of valuations. Staples relative dividend yield is now significantly below long term averages and still at some of the lowest levels since 2008 (Figure 115).

Figure 115: Staples relative dividend yield at 75% below long term average



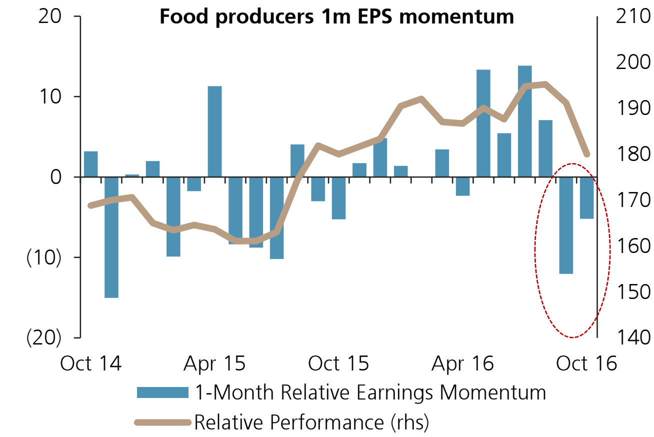
Source: UBS European Equity Strategy, DataStream.

Staples are offering relatively unattractive dividend yields

In addition, EPS momentum for the Staples has been showing signs of weakness. Since August, most staples have shown negative or flat earnings momentum.

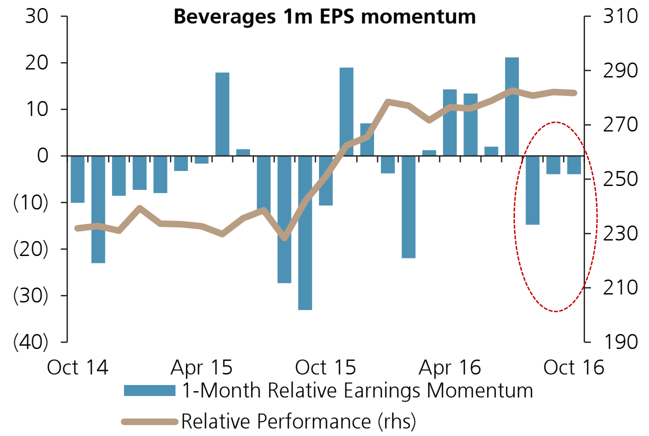
Staples EPS momentum has been weakening

Figure 116: EPS momentum fell sharply for food producers…



Source: UBS European Equity Strategy, DataStream

Figure 117: … as well as for Beverages



Source: UBS European Equity Strategy, DataStream

Our analysts highlight **Carlsberg** and **Campari** as key sell recommendations.

Matching our themes and analysts' stock recommendations

We try to put together what we see as the key macro issues for 2017 and our analysts top picks to give investors a view on how to apply the macro views discussed here to stock picking. The matrix below illustrates that (Figure 118).

Figure 118: Key macro views vs stock recommendations matrix

	Macro view 1: Commodity cycle	Macro view 2: Fiscal Stimulus	Macro view 3: Oper leverage	Macro view 4: Refinance/Releverage	Macro view 5: Dividend Yield	Macro view 6: Value
Financials			• *Generali* • *ING* • *Intesa SP*	• *Hufvudstaden*	• *Generali* • *ING*	
Technology	• *Hexagon*	• *Hexagon*	• *Capgemini* • *Worldpay*			
Telecom			• *Vodafone* • *Deutsche Telekom*	• *Vodafone* • *Deutsche Telekom*	• *Vodafone* • *Deutsche Telekom*	• *Vodafone*
Utilities	• *Enel*	• *Enel*	• *EDP*	• *Enel*	• *EDP*	• *Enel*
Energy	• *RD Shell* • *ENI* • *Petrofac*		• *ENI*		• *RD Shell* • *ENI*	• *RD Shell* • *ENI*
Materials	• *BASF* • *Rangold* • *Glencore*	• *CRH* • *Rio* • *Glencore*	• *BASF* • *Lanxess*		• *BASF* • *Rio*	
Industrials		• *Alstom* • *Vinci* • *BAE Systems* • *Legrand*	• *Vinci* • *G4S*	• *Legrand*	• *Legrand*	• *Vinci*
Cons Discretionary			• *Daimler* • *Renault* • *Valeo*		• *Daimler* • *Sky*	• *Renault*
Cons Staples			• *Tesco*		• *Imperial*	
Healthcare			• *Roche*	• *Roche*	• *Roche*	

Source: UBS European Equity Strategy

European Sector Snapshot

Below we show European sector valuations; all based on consensus estimates.

Figure 119: European Sector Valuations (consensus bottom-up estimates)

	Mcap (Bn, EUR)	% of Mcap	2016 earnings growth	2017 earnings growth	2018 earnings growth	2016 sales growth	2017 sales growth	2016 PE	2017 PE	+12m P/E	2016 DY	2016 PB	2016 RoE
MSCI	6840.5	100.0%	-2.1%	13.7%	10.9%	-1.6%	5.3%	16.1	14.1	14.3	3.7%	1.6	10.2%
Energy	496.2	7.3%	-30.8%	69.5%	27.0%	-14.1%	19.8%	23.7	14.0	14.5	6.3%	1.1	4.7%
Materials	580.0	8.5%	-3.1%	17.2%	11.3%	-6.8%	5.2%	20.1	17.2	17.3	2.4%	1.7	8.6%
Cap Gds	653.4	9.6%	2.6%	9.8%	10.9%	0.4%	3.3%	17.7	16.1	16.2	2.8%	2.7	15.1%
Comm Prof	122.4	1.8%	3.8%	7.1%	7.0%	4.4%	3.9%	16.4	15.3	15.4	3.1%	5.1	30.9%
Transpt	106.5	1.6%	4.9%	6.4%	9.4%	-0.1%	3.3%	14.5	13.6	13.7	3.5%	2.0	13.5%
Auto G	213.6	3.1%	44.1%	10.9%	5.8%	2.1%	3.5%	8.0	7.2	7.2	3.7%	1.1	13.5%
Cons	206.9	3.0%	-0.6%	9.4%	9.8%	5.5%	5.4%	19.0	17.4	17.5	2.7%	2.6	13.5%
Consr Svs	83.4	1.2%	11.6%	12.5%	10.9%	4.1%	5.9%	19.0	16.9	16.8	2.6%	3.8	20.0%
Media	123.4	1.8%	-0.3%	17.6%	15.4%	11.5%	5.7%	18.0	15.3	15.4	4.6%	2.2	12.2%
Retailing	92.3	1.3%	-0.2%	9.6%	10.6%	7.1%	5.6%	19.3	17.6	17.8	3.0%	3.7	19.0%
Fd/Drug Rt	85.6	1.3%	7.3%	14.7%	14.2%	8.1%	4.3%	17.3	15.1	15.4	2.6%	1.7	10.0%
Fd/Bev/Tob	627.7	9.2%	3.5%	12.5%	8.5%	1.8%	7.7%	20.6	18.3	18.4	3.1%	3.7	17.9%
H/H Pers Prd	248.7	3.6%	4.3%	9.6%	7.8%	-0.5%	6.0%	21.2	19.3	19.5	2.6%	4.7	22.0%
H/C Eq/Svs	97.4	1.4%	11.2%	12.7%	10.5%	5.7%	9.2%	21.4	18.9	19.2	1.4%	2.9	13.5%
Pharm/Biote	811.3	11.9%	6.3%	5.9%	9.9%	6.5%	4.3%	15.3	14.4	14.5	3.4%	3.4	22.4%
Banks	751.6	11.0%	-10.3%	13.5%	9.6%	-6.9%	0.8%	12.2	10.8	10.9	5.0%	0.8	6.4%
Div Fin	206.3	3.0%	-36.3%	24.7%	21.3%	3.6%	2.4%	17.2	13.8	14.0	3.2%	0.9	5.5%
Insurance	427.6	6.3%	-0.7%	5.9%	5.3%	6.2%	1.9%	11.0	10.4	10.5	5.0%	1.0	9.5%
REALEG	93.6	1.4%	8.9%	5.2%	6.1%	3.3%	3.0%	20.0	19.0	19.1	4.2%	1.0	5.0%
S/W & SVS	149.9	2.2%	7.3%	11.2%	8.7%	7.0%	5.4%	19.3	17.3	17.5	1.6%	3.6	18.9%
Tch H/W/Eq	50.6	0.7%	-44.1%	27.8%	21.1%	18.2%	-1.0%	19.3	15.1	15.4	4.3%	1.4	7.3%
Semis	83.1	1.2%	7.4%	24.1%	17.8%	18.3%	6.6%	22.0	17.7	17.9	1.0%	3.3	15.0%
T/Cm Svs	289.3	4.2%	8.0%	10.2%	12.3%	6.5%	1.5%	16.5	15.0	15.2	5.4%	1.5	9.1%
Utilities	239.6	3.5%	-5.7%	4.6%	5.1%	-18.1%	1.5%	13.6	13.0	13.0	5.3%	1.4	10.5%

Source: Thomson Datastream, UBS European Equity Strategy.

Appendix

Economic forecasts

Figure 120: GDP Growth

%y/y	Weight*	2015	2016F	2017F	2018F
US	0.19	2.6	1.5	2.4	2.5
Canada	0.02	1.1	1.1	2.3	2.7
Japan	0.05	0.5	0.5	0.8	0.9
European Union	0.16	1.8	1.8	1.5	1.4
of which:					
Eurozone	0.11	1.9	1.6	1.3	1.2
UK	0.03	2.2	2.0	1.0	0.7
Switzerland	0.01	0.8	1.5	1.3	1.6
Asia **	0.41	6.1	6.0	5.8	5.8
of which:					
China	0.21	6.9	6.7	6.4	6.0
India	0.09	7.6	7.4	7.6	7.8
Latin America	0.09	-0.4	-1.0	1.6	2.3
of which:					
Brazil	0.03	-3.8	-3.6	1.3	2.6
Emerging EMEA	0.09	0.2	1.1	2.1	2.4
of which:					
Russia	0.04	-3.7	-0.6	1.3	1.7
Advanced economies	0.47	1.9	1.6	1.8	1.9
Developing economies	0.53	4.4	4.4	4.9	5.1
WORLD	1	3.3	3.1	3.5	3.6

Source: UBS estimates. *Based on purchasing-power-parity adjusted GDP levels. ** Includes Australia and Newzeland

Figure 121: Inflation

%y/y	Weight*	2015	2016F	2017F	2018F
US	0.19	0.1	1.3	2.3	2.3
Canada	0.02	1.1	1.5	1.8	2.0
Japan	0.05	0.8	-0.3	0.5	0.6
European Union	0.16	-0.1	0.2	1.6	2.0
of which:					
Eurozone	0.11	0.0	0.2	1.4	1.8
UK	0.03	0.0	0.7	2.8	2.8
Switzerland	0.01	-1.1	-0.4	0.4	0.9
Asia **	0.41	2.4	2.5	2.7	2.7
of which:					
China	0.21	1.4	1.9	2.1	1.8
India	0.09	4.9	4.8	4.5	4.9
Latin America	0.09	8.2	8.9	6.8	5.6
of which:					
Brazil	0.03	9.0	8.8	4.8	4.6
Emerging EMEA	0.09	9.0	5.7	4.6	4.5
of which:					
Russia	0.04	15.5	7.1	5.0	4.2

Source: UBS estimates. *Based on purchasing-power-parity adjusted GDP levels. ** Includes Australia and Newzeland

Figure 122: Interest Rate forecast

%	Latest	Dec-17	Dec-18
US			
Fed Funds Rate	0.38	1.13	1.63
10 year yield	2.09	2.25	2.50
Canada			
Bank of Canada Rate	0.50	0.75	1.00
10 year yield	1.35	-	-
Japan			
Call Rate	-0.05	-0.10	-0.10
10 year yield	-0.04	0.00	0.05
Germany			
Repo Rate	0	0	0
10 year yield	0.19	0.50	0.90
UK			
Repo Rate	0.25	0.10	0.10
10 year yield	1.34	1.4	1.65
Switzerland			
3 month rate	-0.74	-0.75	-0.5
10 year yield	-0.32	-0.05	0.15
Australia			
Cash Rate	1.50	1.50	1.75
10 year yield	2.57	2.6	2.9
New Zealand			
Cash Rate	1.75	1.75	2.25
10 year yield	2.94	3.10	3.55

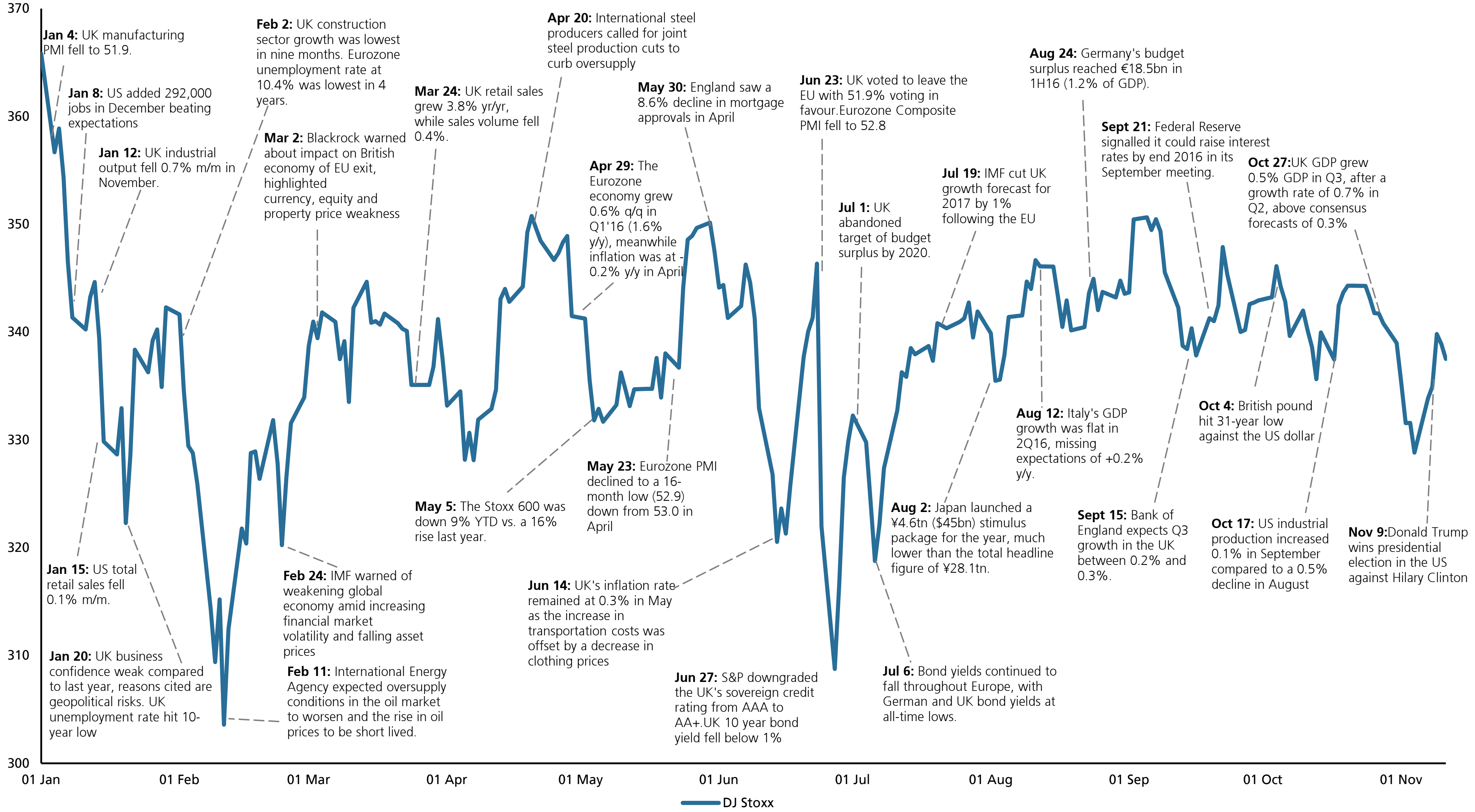
Source: UBS estimates

Figure 123: Foreign Exchange rates

	Latest	Dec-17	Dec-18
EUR/USD	1.09	1.13	1.17
USD/JPY	107.00	110.00	110.00
EUR/JPY	116	124	129
USD/RMB	6.81	7.20	7.50
GBP/USD	1.26	1.13	1.17
EUR/GBP	0.86	1.00	1.00
USD/CHF	0.99	0.98	0.97
EUR/CHF	1.07	1.11	1.13
USD/CAD	1.35	1.38	1.34
AUD/USD	0.75	0.78	0.80
NZD/USD	0.72	0.75	0.76
EUR/SEK	9.86	10.20	10.20
EUR/DKK	7.44	7.46	8.46
EUR/NOK	9.13	8.90	8.70

Source: UBS extimates

Figure 124: Europe: Year in review (Stoxx 600 index)



Source: Thomson datastream, FT.com,BBC.com,UBS European Equity Strategy

Valuation Method and Risk Statement

Risks include macroeconomic variables (such as GDP growth rates and inflation), economic slowdown, a weakening currency, global economic events, and government policy changes.

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Neutral	FSR is between -6% and 6% of the MRA.	39%	25%
Sell	FSR is > 6% below the MRA.	15%	17%
Short-Term Rating	**Definition**	**Coverage[3]**	**IB Services[4]**
Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%

Source: UBS. Rating allocations are as of 30 September 2016.
1:Percentage of companies under coverage globally within the 12-month rating category.
2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.
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UBS Limited: Nick Nelson; Karen Olney, CFA; Joao Toniato; Andras Nagy, CFA.

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Abertis[2, 22]	ABE.MC	Buy	N/A	€12.44	14 Nov 2016
Air France - KLM[3a, 13]	AIRF.PA	Sell	N/A	€5.29	14 Nov 2016
Alstom[7]	ALSO.PA	Buy	N/A	€26.70	14 Nov 2016
Anheuser-Busch InBev[4, 16]	ABI.BR	Buy	N/A	€97.19	14 Nov 2016
ArcelorMittal[16, 20]	ISPA.AS	Buy (CBE)	N/A	€6.69	14 Nov 2016
Arkema[13]	AKE.PA	Buy	N/A	€87.00	14 Nov 2016
AstraZeneca[7, 16]	AZN.L	Buy	N/A	4,366p	14 Nov 2016
Atlantia	ATL.MI	Buy	N/A	€19.89	14 Nov 2016
Atos	ATOS.PA	Buy	N/A	€91.97	14 Nov 2016
BAE SYSTEMS[7]	BAES.L	Buy	N/A	594p	14 Nov 2016
BASF SE[5, 7, 14]	BASFn.F	Buy	N/A	€81.60	14 Nov 2016
Capgemini	CAPP.PA	Buy	N/A	€71.59	14 Nov 2016
Carlsberg A/S	CARLb.CO	Sell	N/A	DKr576.00	14 Nov 2016
CRH[2, 4, 5, 7, 14, 16]	CRH.L	Buy	N/A	2,804p	14 Nov 2016
Daimler	DAIGn.DE	Buy	N/A	€64.88	14 Nov 2016
Deutsche Telekom[3b, 7]	DTEGn.F	Buy	N/A	€14.35	14 Nov 2016
DSV	DSV.CO	Sell	N/A	DKr285.50	14 Nov 2016
Edenred[12]	EDEN.PA	Neutral	N/A	€18.56	14 Nov 2016
Elementis PLC[4, 13, 14]	ELM.L	Buy	N/A	252p	14 Nov 2016
Enel[4, 7]	ENEI.MI	Buy	N/A	€3.61	14 Nov 2016
Energias de Portugal[7]	EDP.LS	Buy	N/A	€2.64	14 Nov 2016
Eni[7, 16]	ENI.MI	Buy	N/A	€12.26	14 Nov 2016
Evonik Industries	EVKn.DE	Neutral	N/A	€25.71	14 Nov 2016
FCA[5, 7, 16]	FCHA.MI	Neutral	N/A	€6.94	14 Nov 2016
Ferrovial[2, 4]	FER.MC	Buy	N/A	€16.04	14 Nov 2016
Forbo[5, 7, 13, 59]	FORN.S	Buy	N/A	CHF1,272.00	14 Nov 2016
G4S	GFS.L	Buy	N/A	248p	14 Nov 2016
Gas Natural Fenosa	GAS.MC	Buy	N/A	€16.10	14 Nov 2016
Generali[2, 4, 5, 7]	GASI.MI	Buy	N/A	€11.85	14 Nov 2016
Glencore Plc[2, 4, 5, 7]	GLEN.L	Buy	N/A	283p	14 Nov 2016
Groupe Eurotunnel SA	GETP.PA	Buy	N/A	€8.23	14 Nov 2016
HeidelbergCement[13]	HEIG.DE	Neutral	N/A	€86.95	14 Nov 2016
Hexagon AB	HEXAb.ST	Buy	N/A	SKr306.80	14 Nov 2016
Hufvudstaden AB	HUFVa.ST	Buy	N/A	SKr128.20	14 Nov 2016
Imperial Brands	IMB.L	Buy	N/A	3,423p	14 Nov 2016
ING[2, 4, 6a, 7, 16]	INGA.AS	Buy	N/A	€13.15	14 Nov 2016
Intesa SanPaolo[2, 3c, 4, 5, 7]	ISP.MI	Buy	N/A	€2.20	14 Nov 2016
Lanxess AG[13]	LXSG.DE	Buy	N/A	€58.37	14 Nov 2016
Legrand	LEGD.PA	Buy	N/A	€52.86	14 Nov 2016
Leonardo Finmeccanica[4, 14]	LDOF.MI	Buy	N/A	€12.35	14 Nov 2016
Linde	LING.DE	Neutral	N/A	€153.00	14 Nov 2016

Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
Lloyds Banking Group[2, 4, 7, 14, 16, 18, 20]	LLOY.L	Buy (CBE)	N/A	61p	14 Nov 2016
Michelin[5]	MICP.PA	Buy	N/A	€95.00	14 Nov 2016
Orange[16]	ORAN.PA	Neutral	N/A	€13.43	14 Nov 2016
OTE	OTEr.AT	Neutral	N/A	€8.10	14 Nov 2016
Petrofac[2]	PFC.L	Buy	N/A	764p	14 Nov 2016
ProSiebenSat.1 Media SE	PSMGn.DE	Neutral	N/A	€33.30	14 Nov 2016
Randgold Resources[16]	RRS.L	Buy	N/A	5,815p	14 Nov 2016
Redrow Group	RDW.L	Buy	N/A	417p	14 Nov 2016
Renault[7]	RENA.PA	Buy	N/A	€73.25	14 Nov 2016
Rio Tinto Plc[7, 16]	RIO.L	Buy	N/A	3,146p	14 Nov 2016
Roche[2, 4, 5, 6a, 6b, 6c, 7, 22]	ROG.S	Buy	N/A	CHF233.50	14 Nov 2016
Royal Dutch Shell[7, 16]	RDSa.L	Buy	N/A	1,928p	14 Nov 2016
SAP[7, 16]	SAPG.DE	Buy	N/A	€75.84	14 Nov 2016
SEB	SEBF.PA	Buy	N/A	€127.50	14 Nov 2016
SES	SESFd.PA	Neutral	N/A	€20.43	14 Nov 2016
Shire Pharmaceuticals[7, 16]	SHP.L	Buy	N/A	4,942p	14 Nov 2016
Sky Plc	SKYB.L	Buy	N/A	770p	14 Nov 2016
Software AG	SOWG.DE	Neutral	N/A	€31.99	14 Nov 2016
Symrise	SY1G.DE	Buy	N/A	€54.05	14 Nov 2016
Telecom Italia[2, 4, 5, 7, 16]	TLIT.MI	Neutral	N/A	€0.70	14 Nov 2016
Telefonica[5, 7, 16]	TEF.MC	Buy	N/A	€8.36	14 Nov 2016
Telenet Group	TNET.BR	Buy	N/A	€48.75	14 Nov 2016
Temenos[5]	TEMN.S	Sell	N/A	CHF61.45	14 Nov 2016
Tesco PLC[7]	TSCO.L	Buy	N/A	206p	14 Nov 2016
Valeo[13]	VLOF.PA	Buy	N/A	€49.50	14 Nov 2016
Vinci	SGEF.PA	Buy	N/A	€60.03	14 Nov 2016
Vodafone Group[2, 3b, 3d, 4, 5, 7, 14, 16]	VOD.L	Buy	N/A	205p	14 Nov 2016
Volkswagen[7, 22]	VOWG_p.DE	Buy	N/A	€117.00	14 Nov 2016
Vopak	VOPA.AS	Buy	N/A	€41.92	14 Nov 2016
Worldpay Group PLC[4, 13]	WPG.L	Buy	N/A	266p	14 Nov 2016

Source: UBS. All prices as of local market close.
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