GERMAN EQUITIES OUTLOOK

Highlights

- Despite recent market volatility, we believe that German companies are poised for strong earnings growth in an environment that sees global economic activity accelerating to its strongest pace in 10 years
- In our view, valuations remain compelling given the earnings growth on offer and relative to the wider European equity market
- We continue to find many reasonably priced investment opportunities with the potential to deliver attractive returns in the medium term

A supportive environment

The German equity market posted strong gains during 2017, with total returns in euros of 12.5% for the large-cap DAX Index and 14.8% for the mid-cap HDAX Index.[1] Notwithstanding the recent market volatility, we believe the favorable conditions that underpinned German companies' positive performance last year will continue throughout 2018. Our outlook is based on our on-the-ground company research and expectations that earnings growth will remain strong amid an environment of buoyant business activity. In our view, the fundamentals are solid, with the world currently enjoying its strongest wave of economic growth in 10 years.

In Germany, business confidence and the pace of economic activity have remained robust, despite the ensuing political gridlock in the Bundestag following the September 2017 elections. Nowhere is this more apparent than in the leading indicators for the economy. In January, the German ifo Business Climate Index hit a record high of 117.6,[2] while the German Manufacturing PMI edged down to 61.1 after its record high of 63.3 in December.[3] The data are consistent with the strong sales and orders figures we are seeing in our company-focused research and in the optimism we have heard expressed by corporate management teams.

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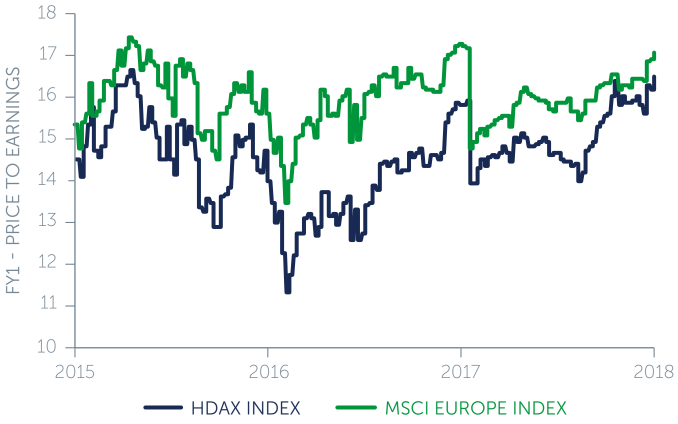
With the acceleration in growth, companies are investing to ease capacity constraints. Hiring is on the rise—unemployment is low at 5.8%[4]—and we expect capital investment to increase as well. That paints a bright picture for domestic demand, but strengthening global activity should also provide a spur for exporters. Germany is the world's third largest exporting country—after China and the U.S.—and we expect sales to rise to its largest foreign markets, where activity is also strong.

Across Europe, the acceleration in business activity has been broad-based and appears sustainable, while strong growth and tax cuts in the U.S. should combine to boost profits for German companies with exposure to the market. If some form of the Trump administration's infrastructure spending package is passed, this could paint an even rosier picture for external demand.

1. Thomson Reuters. As of December 31, 2017.
2. ifo Institute. As of January 2018.
3. IHS Markit. As of February 1, 2018.
4. Bundesagentur für Arbeit. As of January 31, 2018.

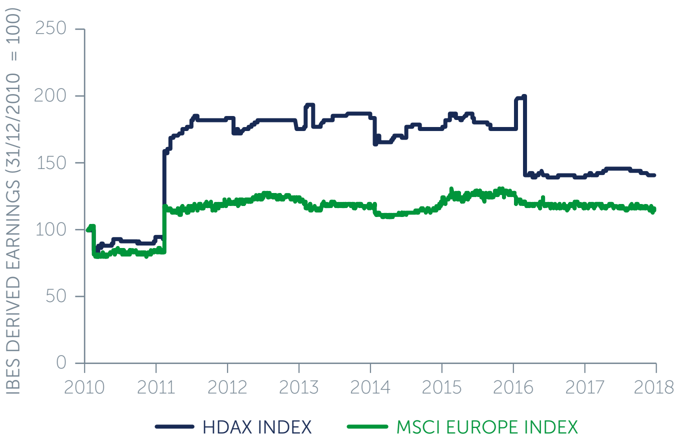
FIGURE 1: GERMANY TRADES AT A DISCOUNT TO EUROPE



SOURCE: *THOMSON REUTERS, IBES. AS OF JANUARY 28, 2018.*

"Specifically, we seek to invest in companies with credible management, healthy financials and strong earnings growth potential on a five-year horizon."

FIGURE 2: EARNINGS GROWTH FORECASTS



SOURCE: *THOMSON REUTERS, IBES. AS OF JANUARY 28, 2018.*

Identifying opportunities

While valuations edged up during 2017, German equities remain less expensive than the wider European market and continue to offer stronger growth potential (see FIGURE 1 and FIGURE 2). As ever, our focus remains on seeking high quality companies that are reasonably valued, where we continue to find opportunities that meet our investment criteria. Specifically, we seek to invest in companies with credible management, healthy financials and strong earnings growth potential on a five-year horizon.

We have the flexibility to invest in companies across all market capitalizations, but we are generally biased towards small and mid-cap companies, as we believe they offer higher growth potential. In our experience, we have found more 'hidden champions' clustered around the small and mid-cap end of the market. These are often global industry leaders in their specific niche sectors which tend to be overlooked by analysts. We believe these companies can represent a compelling investment opportunity, as we expect they will continue to drive Germany's economy in the long run.

An optimistic outlook

While political wrangling may persist in Berlin, the country's economic conditions appear sufficiently durable to withstand the uncertainty. We see potential for other pockets of political volatility to emerge—related, for instance, to Brexit uncertainty or further volatility in global equity markets—but we believe the underlying economic conditions for investors in German equities will remain supportive in the year ahead. The strong growth environment has pushed the euro higher, but exchange rate risks are reduced, given the widespread use of currency hedging by German exporters. Overall, we expect earnings growth to remain a key driver of the equity market performance and believe earnings upgrades by sell-side analysts will exceed downgrades.

While we believe the current environment is favorable and marks a good entry point for investors today, we focus on companies that have excellent long-term growth prospects. Positively, the German equity market offers a rich source of companies operating in sectors that stand to benefit from cyclical as well as structural growth over the short and longer term.

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**As of December 31, 2017*