Europe Equity Market Outlook: Q3 2024

A brighter picture for the rest of 2024, albeit with some potential turbulence.

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Market Overview

Equities are fairly valued, but the macroeconomic backdrop is finally improving.

Europe Leads the Way With Interest-Rate Cuts

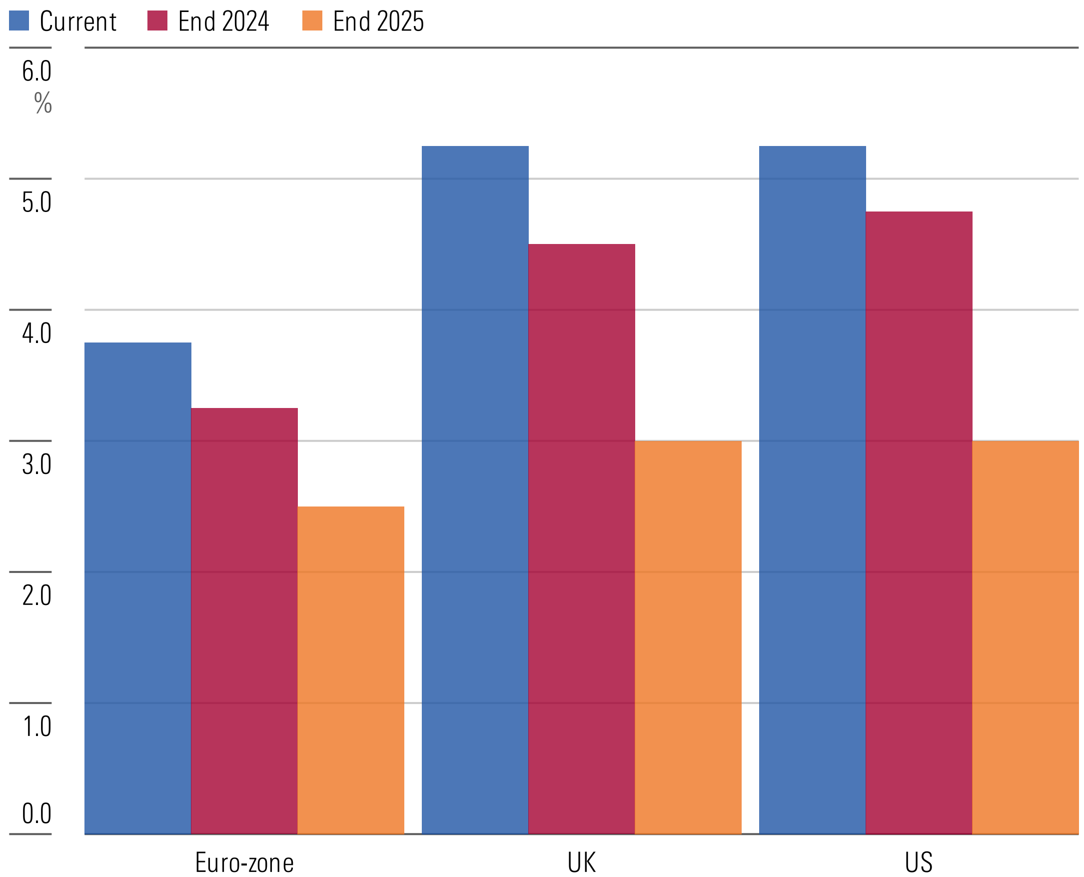
We wrote in previous quarters about the contrasting economic situations in the US and Europe. While the US saw its economy grow by 2.5% in 2023, Europe narrowly avoided a recession. The one benefit of a weak economy is that it has allowed the European Central Bank to pull the trigger more quickly on rate cuts than the US Federal Reserve.

The ECB cut rates by 25 basis points in June, with economists expecting two further cuts by year-end. Inflation in Europe has fallen considerably over the last two years and currently sits at 2.6%, just 60 basis points off the central bank's target rate.

Comparing economists' forecasts for the UK and Europe with our own internal forecasts for the US, it looks as if Europe will be operating with a lower interest rate than the two other regions until 2026.

European GDP expanded by 0.3% in the first quarter of 2024—a positive sign—and further interest-rate cuts should go some way toward stimulating the economy over the next couple of years.

Interest Rates in the Eurozone Likely to Remain Lower Than Elsewhere



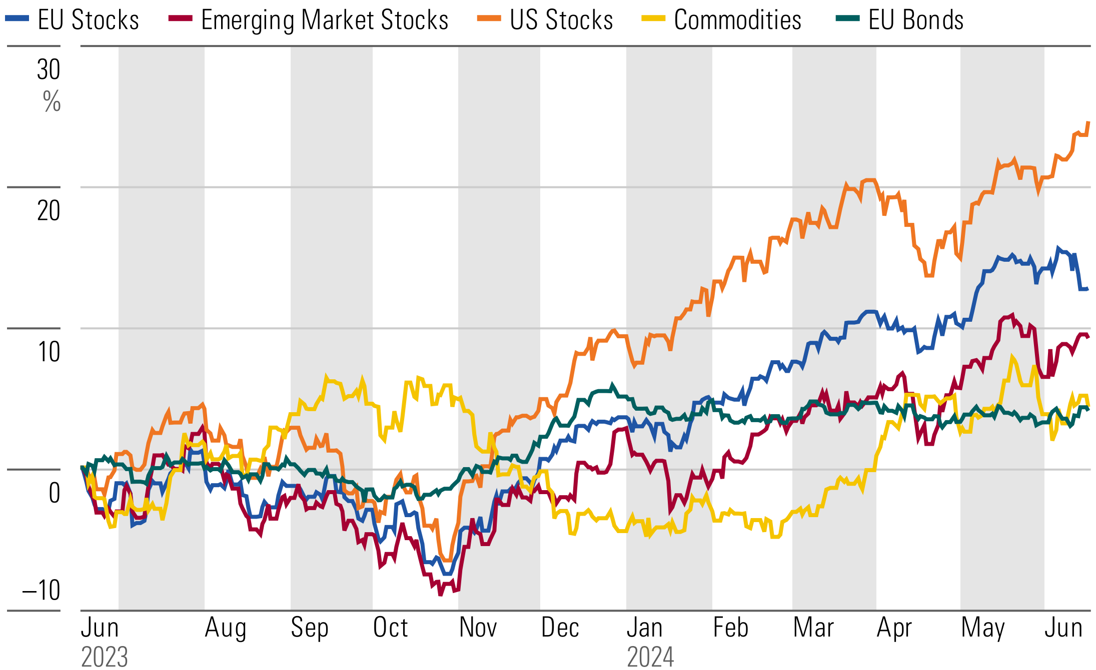
Source: Capital Economics, Morningstar forecasts as of June 2024.

European Equities Performing Strongly Into 2024

Although US stocks have been the star performers, European stocks have been a great place to be for the past 12 months when compared with other uses of cash.

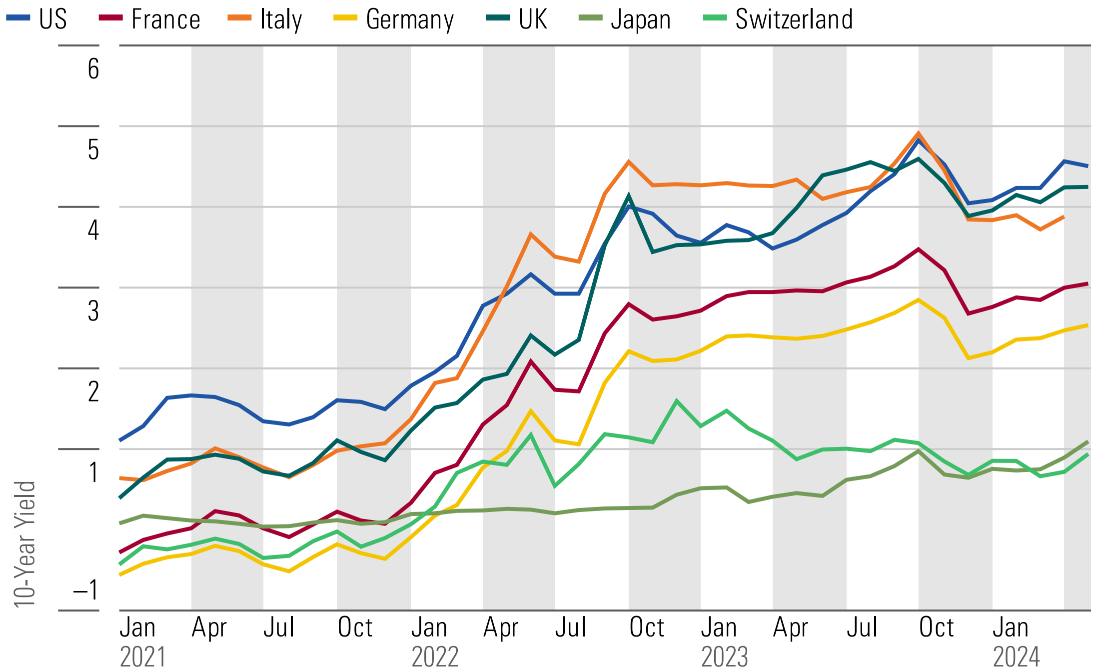
As interest rates start to fall, bond yields are following suit, but from a high base. Ten-year UK government bonds are now the only 10-year European bond offering a yield of more than 4%.

Trailing 12-Month Performance of Major Asset Classes



Source: Morningstar. Data as of June 17, 2024.

Global Sovereign Benchmark 10-Year Yields



Source: Morningstar. Data as of May 31, 2024.

European Equities Not Cheap but Not Expensive Either

Market Cap-Weighted Price/Fair Value Estimate for Morningstar Europe-Domiciled Coverage

Source: Morningstar. Data as of June 18, 2024.

Relative to the bargain territory of the past two years, valuations are not cheap, with the market now trading bang in line with our fair value estimate.

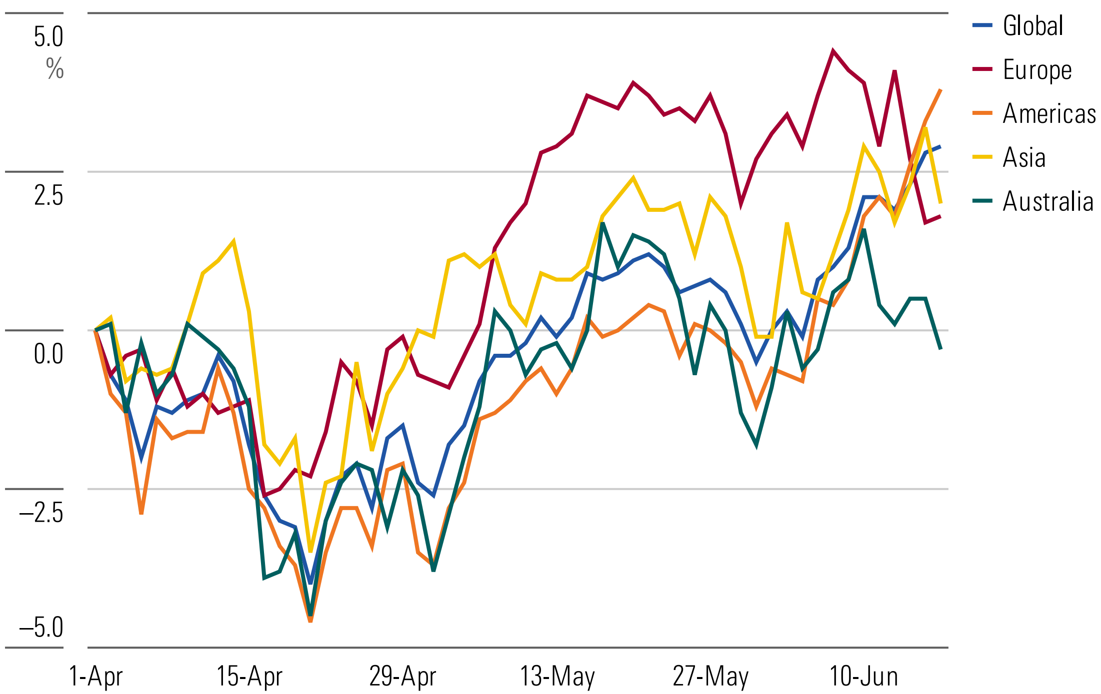
But saying that the bargain valuations of mid- to late 2022 are truly gone is different from saying that the market is overly expensive; it is not.

The macroeconomic environment is improving in Europe, which should be supportive of corporate profitability in the region. Whether this is enough to maintain profit margins above the long-term average for many of the region's firms is another question.

Equity Market Rallies Continue in Q2

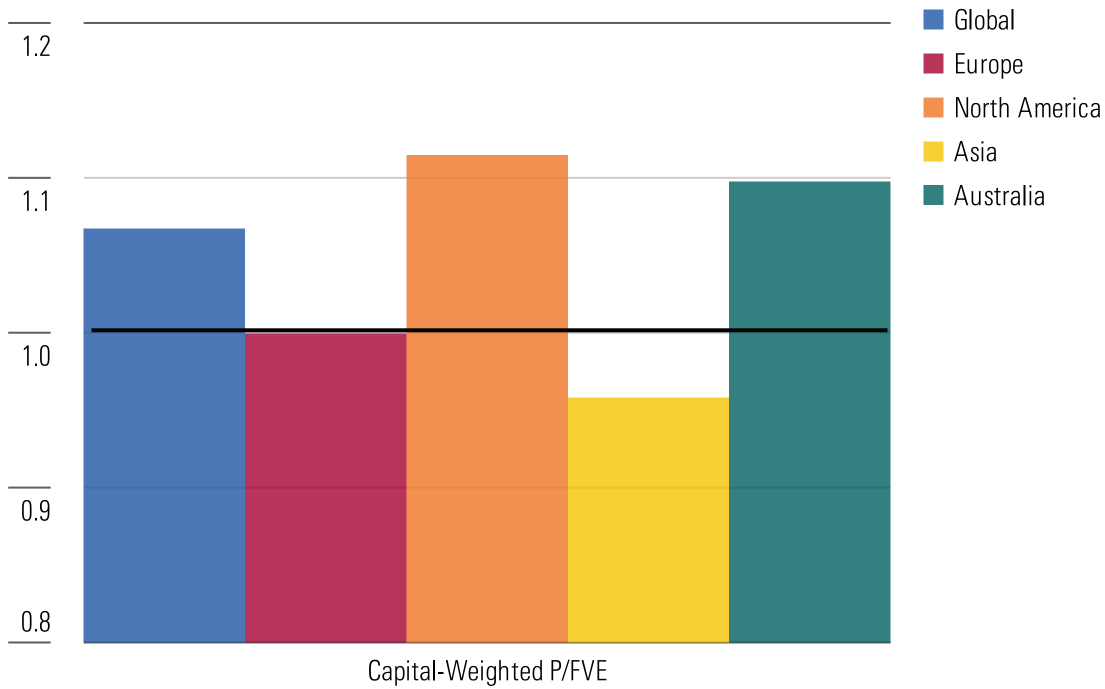
Equity market gains continued in the second quarter, albeit at a slower pace than previous quarters. The US once again led the way in terms of gains, rising around 4% over the period, followed by Europe with gains of around 2%. On a valuation basis, Europe is now one of the most attractive places to be, albeit marginally, with valuations trading below those of North America and Australia.

Regional Price Movements Over Q2



Source: Morningstar. Data as of June 18, 2024.

Capital-Weighted Price/Fair Value Estimate for the Regions



Source: Morningstar. Data as of June 18, 2024.

Value the Most Attractive Area Moving Through 2024

Value and growth stocks got slightly more expensive over the quarter, with the latter moving deeper into overvalued territory. This was a trend visible in both the US and Europe. Small- and mid-cap stocks remain materially cheaper than their large-cap equivalents in most cases.

Investors in Europe Currently Favor Large-Cap Stocks, With Growth More Highly Valued*

Europe Market Cap-Weighted Price/Fair Value Estimate

Size	All	Style: Value	Style: Core	Style: Growth
All	1.00	0.84	0.94	1.19
Large	1.01	0.84	0.94	1.20
Mid	0.93	0.80	0.94	1.00
Small	0.81	0.71	0.82	0.98

US Market Cap-Weighted Price/Fair Value Estimate

Size	All	Style: Value	Style: Core	Style: Growth
All	1.12	0.95	1.09	1.21
Large	1.15	0.97	1.13	1.23
Mid	1.00	0.91	0.99	1.07
Small	0.86	0.80	0.88	0.90

Overvalued
- ≥ 1.10
- 1.05 to 1.10

Fairly Valued
- 1.01 to 1.05
- 0.99 to 1.01
- 0.95 to 0.99

Undervalued
- 0.90 to 0.95
- ≤0.90

Source: Morningstar. Data as of June 18, 2024. *May not be fully representative of investment styles due to limited coverage in certain segments.

Sector Valuation Overview

Volatility in Q2 has created opportunities.

European Equity Markets Continue to Tick Up

Equity markets continued to grind upward in the second quarter, in line with optimism around an improving European economy. Over the last 12 months, investors have been rewarded with near 20% gains.

Gains in the first quarter were more spread out than in previous periods. Two sectors that had underperformed the market in the first quarter—healthcare and communication services—saw the biggest gains.

Consumer cyclical was the worst performer, falling almost 6% in the second quarter. Over the last 12 months, consumer has not been the place to be, with both the consumer cyclical and defensive segments seeing close to zero gains while the broader market was buoyant.

With just over 12 months since the banking crisis, it might be surprising to see that financial services was the best-performing sector over the past year, rising 28%, followed by technology and industrials.

Aggregated Stock Price Changes

Sector	TTM% Change	Trailing Quarter % Change
Aggregated European Market	18.7%	1.8%
Cyclical		
Basic Materials	11.2%	(0.0%)
Consumer Cyclical	1.0%	(5.9%)
Financial Services	27.9%	2.9%
Sensitive		
Communication Services	13.8%	4.5%
Energy	15.4%	(0.1%)
Industrials	19.0%	1.3%
Technology	21.6%	2.2%
Defensive		
Consumer Defensive	(0.1%)	3.2%
Healthcare	15.9%	6.0%
Utilities	(0.7%)	2.1%

Source: Morningstar. Data as of June 18, 2024.

While the Market Is Fairly Valued, Some Sector Opportunities Remain

Despite the European market being fairly valued as a whole, six of the eight sectors shown here are trading at discounts to their fair value estimates, showing the disparity across the sector universe.

Sector valuations have moved around markedly in the second quarter. The consumer sectors, which we had highlighted as attractive last quarter, have since seen their valuations rise. Consumer defensives, however, still have reasonable upside to their fair value estimate.

Healthcare and industrials are now trading at a premium to their fair value estimate, albeit marginally with the case of industrials. Utilities and communication services are the cheapest sectors in Europe. In the former, we believe patient investors could be rewarded, as falling interest rates and the shift to renewable power grids provide some medium-term tailwinds. The latter we believe is a real stock-pickers sector, but one with some clear areas of opportunity.

Morningstar European Coverage Average Price/Fair Value Estimate by Sector

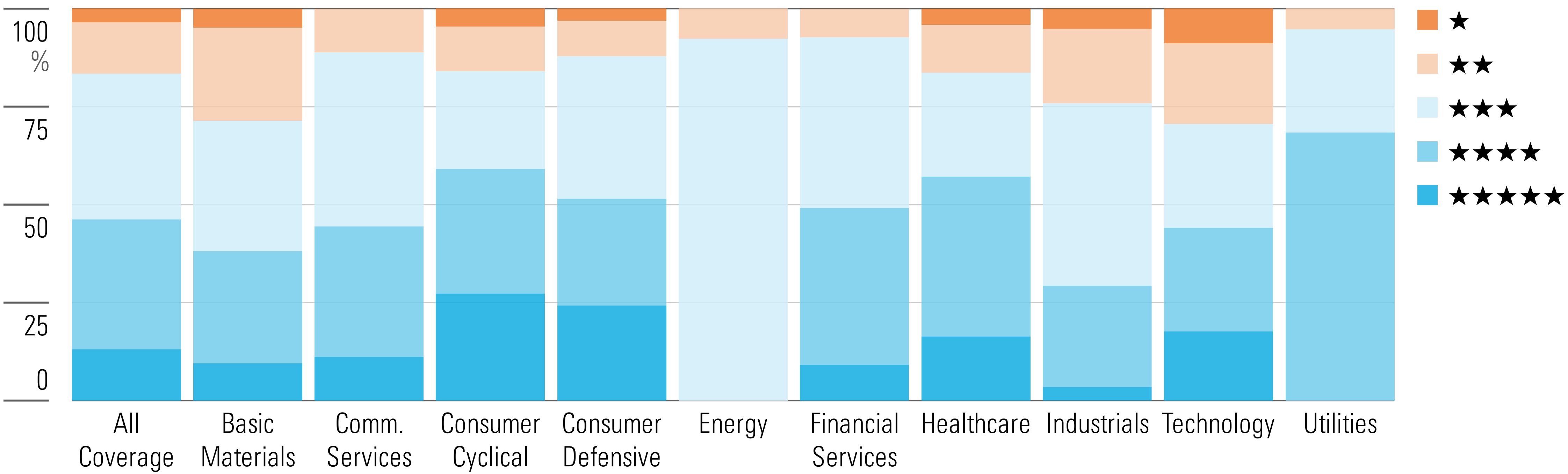
Cyclical Sectors	Average Price/Fair Value	Sensitive Sectors	Average Price/Fair Value	Defensive Sectors	Average Price/Fair Value
Consumer Cyclical	0.98	Comm. Services	0.89	Consumer Defensive	0.92
Financial Services	0.90	Energy	0.93	Healthcare	1.10
		Industrials	1.05	Utilities	0.88

Source: Morningstar. Data as of June 18, 2024.

4- and 5-Star Opportunities Remain, Despite a Fairly Valued Market

Almost half of the stocks under our coverage are rated either 4 or 5 stars currently, with only around 20% of stocks in overvalued territory. Five-star stocks are present in all but the energy and utilities sectors, highlighting the dispersion of opportunities.

Star Rating Distribution by Sector



Source: Morningstar. Data as of June 18, 2024.

Communication Services

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Sector Slightly Undervalued; Firms Will Have to Fight Back on Costs to Recover Margins

Higher Free Cash Flow and Cost Controls Have Sent Some Stocks Up

The Morningstar Developed Markets Europe Communication Services Index is in line with the Morningstar Europe Index year to date, up more than 10%. Firms like BT Group, Telefonica, Tele2, and Deutsche Telekom are performing well thanks to higher free cash flow guidance and cost controls. As inflation falls, telecoms should see less pressure in their cost bases, although we expect price increases to moderate too.

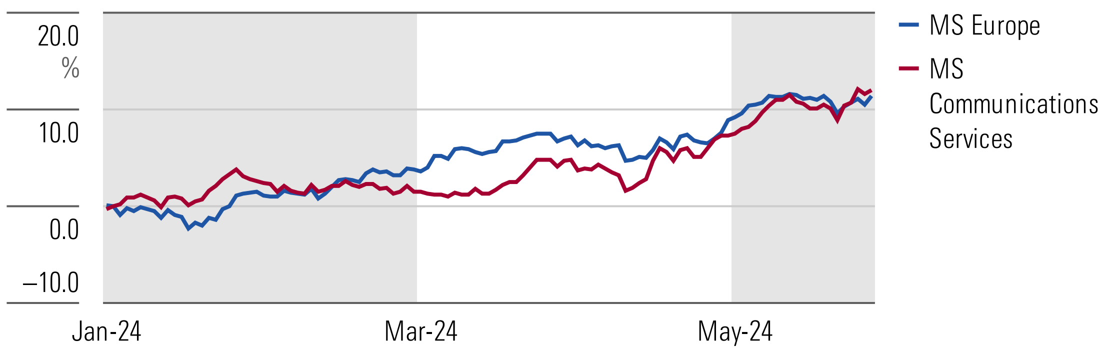
With Inflation Cooling, We Hope to See Continued Focus on Cost Controls

With EU inflation falling to 2.6% in May 2024 from 6.1% in May 2023, telecoms should see some relief in their cost bases. Inflation typically has a more immediate impact on operating expenses than revenue, since wage raises can be negotiated rapidly. The impact of energy prices is also immediate, although it depends on each firm's hedging policy. Telecoms try to offset this by executing price increases. The industry has low pricing power, however, and only in some selected markets are price increases effective. With inflation cooling, we see cost cuts as the most effective way to recover margins.

We Prefer Firms With Good Capital Allocation

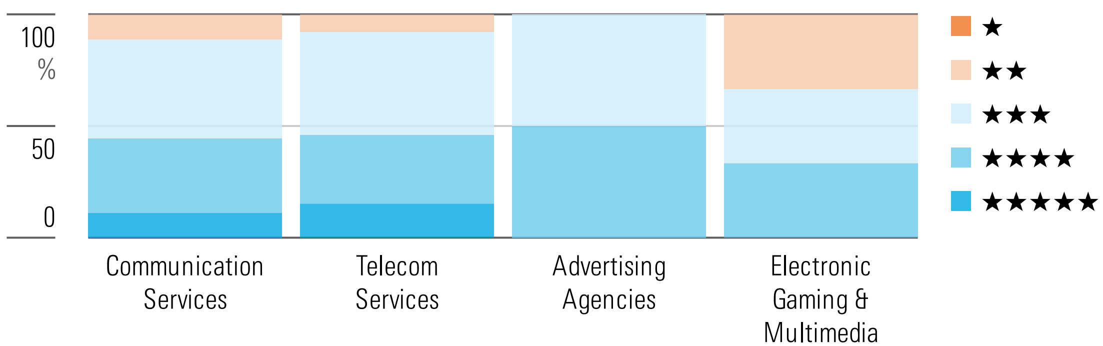
European telecoms are slightly undervalued, trading at an average 0.9 times price/fair value, with several in 4- and 5-star territory. Investors might need patience, though, as the sector moves at a slow pace and different countries experience different dynamics. At similar valuations, we tend to prefer streamlined firms due to their more straightforward narratives and better free cash flow visibility. Operators like KPN, Tele2, and Deutsche Telekom remain our favorites.

Communication Services vs. the Morningstar Europe Index



Source: Morningstar. Data as of June 18, 2024.

Communication Services Star Rating Distribution by Industry



Source: Morningstar. Data as of June 18, 2024.

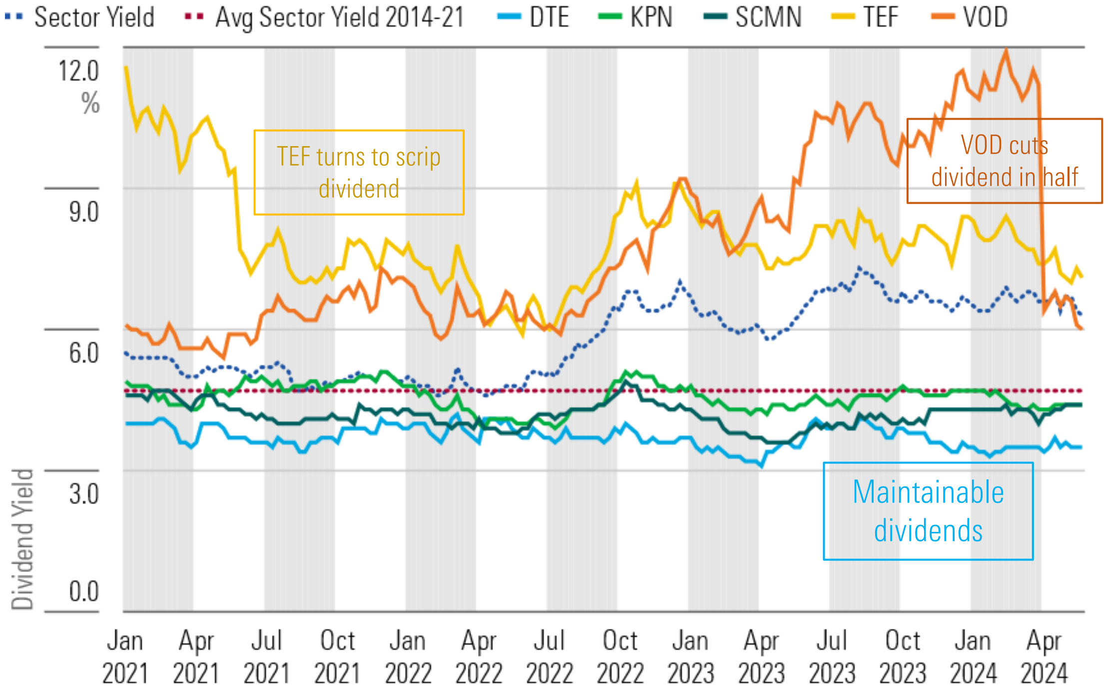
Inadequately Managed Firms Maintain Dividend Payments Even When Fundamentals Deteriorate

Many management teams wait until the last minute to cut dividend payments even when fundamentals deteriorate, increasing dividend risk. Most telecom firms have absolute dividend policies instead of payout ratio policies, anchoring investors to fixed payments that are sometimes not maintainable and end up being cut.

Vodafone and Proximus are two recent examples of unmaintainable dividends. During 2023 and 2024, both were offering yields of more than 10%, which ended up being cut in half as the dividends were not covered by organic cash flow generation.

High Yields Are More of a Warning Sign Than an Opportunity

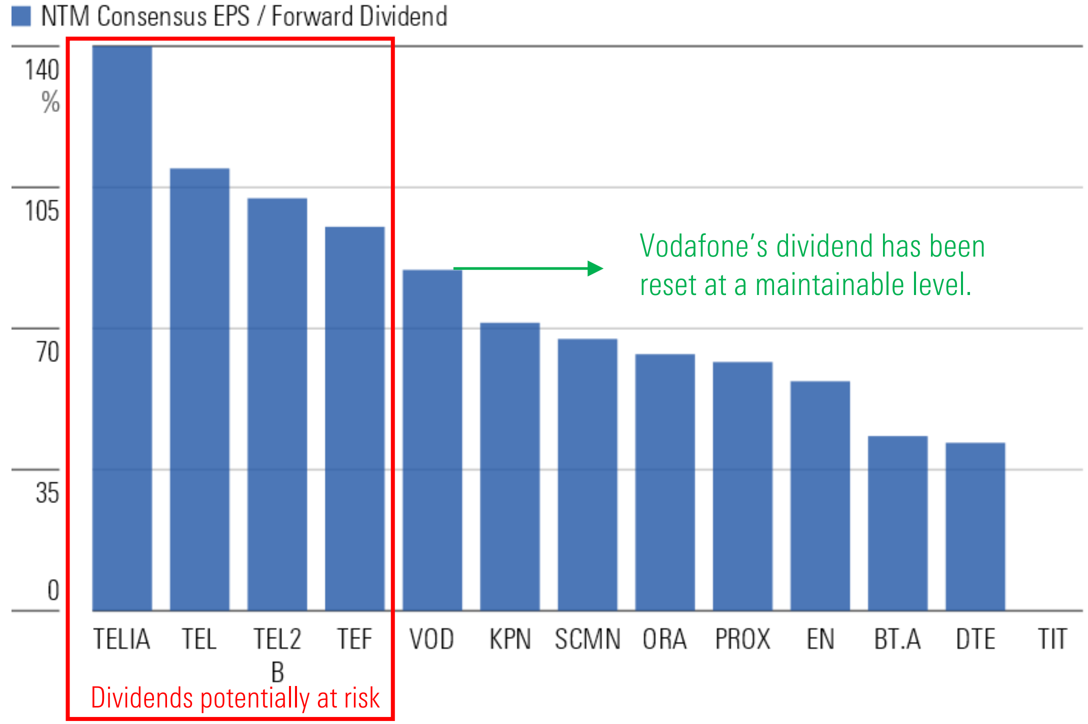
The average dividend yield is high vs. the historical average.



Source: Morningstar, PitchBook data.

Firms With Expected Payout Ratios Over 80% Are More at Risk of Dividend Cuts

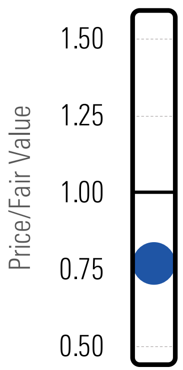
We prefer firms with maintainable dividend payout ratios.



Source: Morningstar, PitchBook data.

Communication Services | Top Picks

Infrastrutture Wireless Italiane INW



Market Cap
EUR 10 Bil

Moat
Narrow

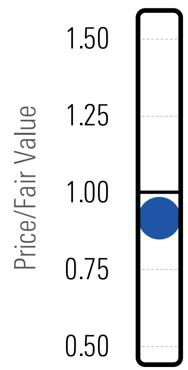
Rating
★★★★★

Yield
5.2%

P/FV
0.77

P/E
23.7x

Deutsche Telekom DTE



Market Cap
EUR 122 Bil

Moat
Narrow

Rating
★★★★

Yield
3.9%

P/FV
0.92

P/E
12.4x

Consumer Cyclical

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Luxury Segment Fairly Valued; Opportunities in Apparel and Food Delivery

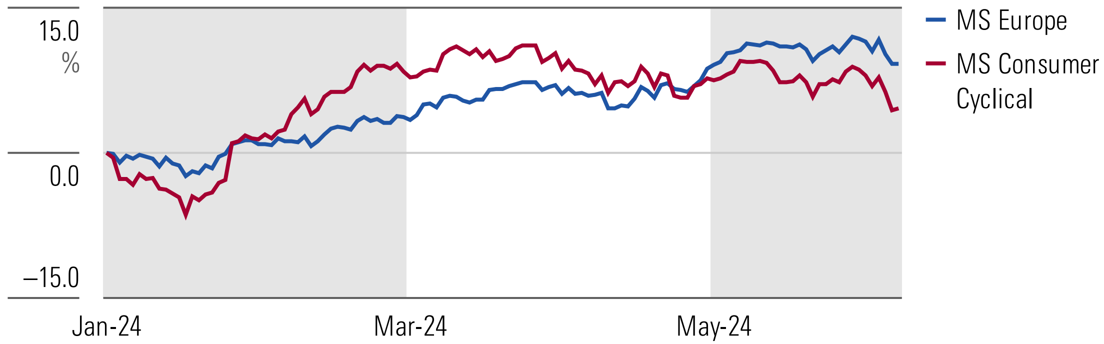
The Morningstar Developed Markets Europe Consumer Cyclical Index rallied in the beginning of the year thanks to a relatively solid earnings season but faded in the second quarter.

The sector is largely attractively valued; luxury goods trade close to fair values, but internet retail companies' valuations remain alluring. Within the diverse internet retail segment of our coverage, we see pockets of opportunities in food delivery. Zalando looks particularly attractive in apparel retail. Swatch and Kering look very attractive in the luxury sector.

Food delivery stocks are long-duration assets, meaning that a combination of high interest rates and cost of living pressures has weighed on stock performance. Despite the slowdown in orders, we remain constructive, but investors need to be selective. New EU labor rules for gig workers will likely increase costs for food delivery platforms in Europe but also expedite consolidation as well as increase barriers to entry.

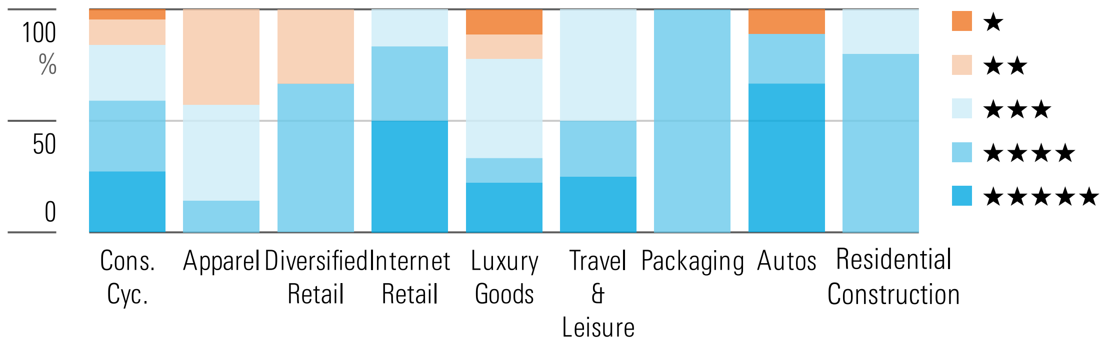
UK homebuilder stocks remain compelling as housing market conditions show signs of improvement in 2024. Indeed, leading indicators—such as house prices that are rising once more and a robust recovery in mortgage approvals—point to a housing market recovery that is likely nearing. The progressive loosening financial conditions in the UK throughout the remainder of 2024 should further inspire a return of homebuyer confidence. Our UK homebuilder coverage is well positioned to contribute significantly to the supply of new housing that a growing and aging UK population requires.

Consumer Cyclical vs. the Morningstar Europe Index



Source: Morningstar. Data as of June 18, 2024.

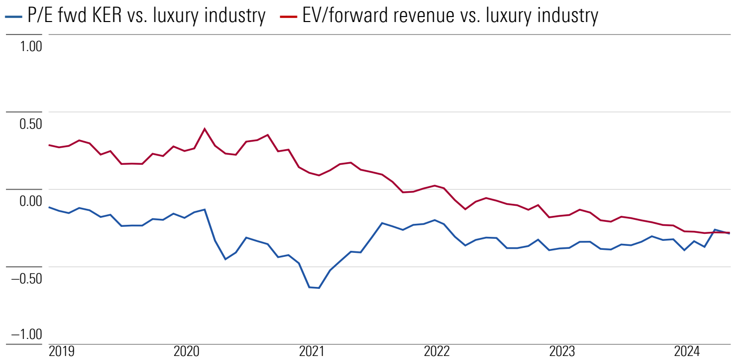
Consumer Cyclical Star Rating Distribution by Industry



Source: Morningstar. Data as of June 18, 2024.

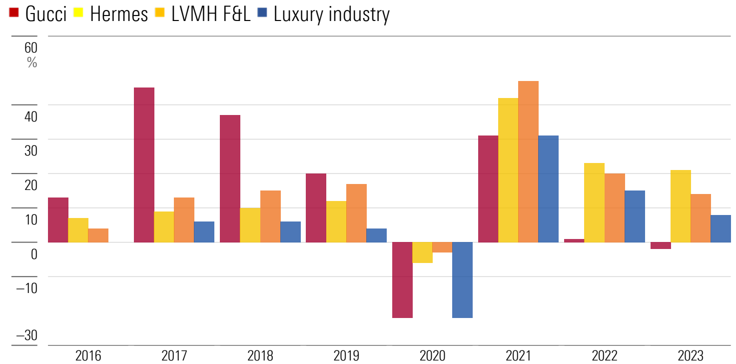
Kering Is a Top Pick in Luxury as Gucci Recovery Is Highly Likely

Kering Trades at an Increasing Discount to Peers



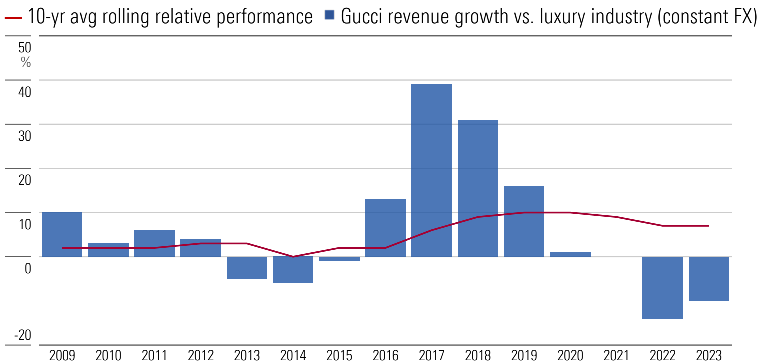
Source: PitchBook. Data as of May 2024.

Revenue Growth Has Cooled From Prior High Levels



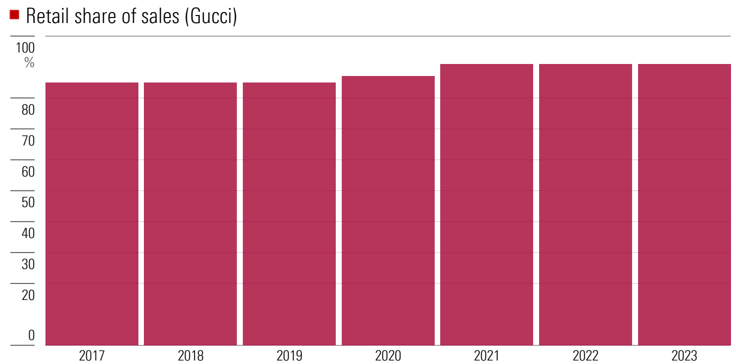
Source: Company data, Bain. Data as of Dec. 30, 2023.

Gucci Performance Is Cyclical but Stronger Than Peers



Source: Company data, Bain. Data as of Dec. 30, 2023.

Control Over Distribution Prevents Discounting



Source: Company data, Data as of Dec. 30, 2023.

Kering shares lost around 60% of their value from their 2021 peak, as revenue at top brand Gucci faltered more than peers. Gucci accounts for nearly 70% of Kering's operating profits, so its recovery is key to the investment thesis. We see Gucci's issues as cyclical rather than structural, driven by fatigue from the strong aesthetic of its prior creative director and higher-than-peer exposure to aspirational consumers (particularly in the US).

We've observed most luxury brands going through cycles of industry out- and under-performance over the last 15 years, and underperformance was in most cases not permanent. Gucci's moat-supporting pillars—pricing power on par with top peers such as Louis Vuitton, high brand awareness, more than 90% control over distribution (which limits the risk of discounting), and Kering's financial resources and access to talent—skew chances of a recovery upward.

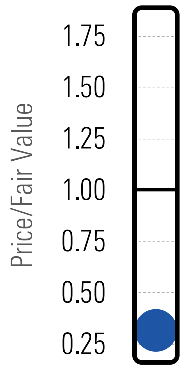
The current valuation implies low-single-digit cash flow growth and margins below historical levels for Gucci, which we see as too pessimistic. We forecast revenue to grow ahead of the industry over the next decade.

Consumer Cyclical | Top Picks

Persimmon LON: PSN

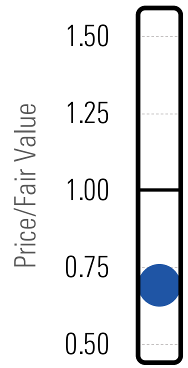
Market Cap	Moat
GBP 5 Bil	None
Rating	**Yield**
★★★★	4.6%
P/FV	**P/E**
0.59	16.7x

Just Eat Takeaway.com TKWY



Market Cap	Moat
EUR 3 Bil	Narrow
Rating	**Yield**
★★★★★	0.0%
P/FV	**P/E**
0.31	-7.0x

Kering KER



Market Cap	Moat
EUR 42 Bil	Narrow
Rating	**Yield**
★★★★★	3.2%
P/FV	**P/E**
0.69	18.6x

Consumer Defensive

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Volume Growth Lagging, but Marketing Investments Should Reverse Course This Year

Deep Underperformance in Q2

The Morningstar Developed Markets Consumer Defensive Index finished the second quarter of the year in deep underperformance territory relative to the broader index. Concerns that consumers are tapped out after such a long period of high inflation are top of investors' minds.

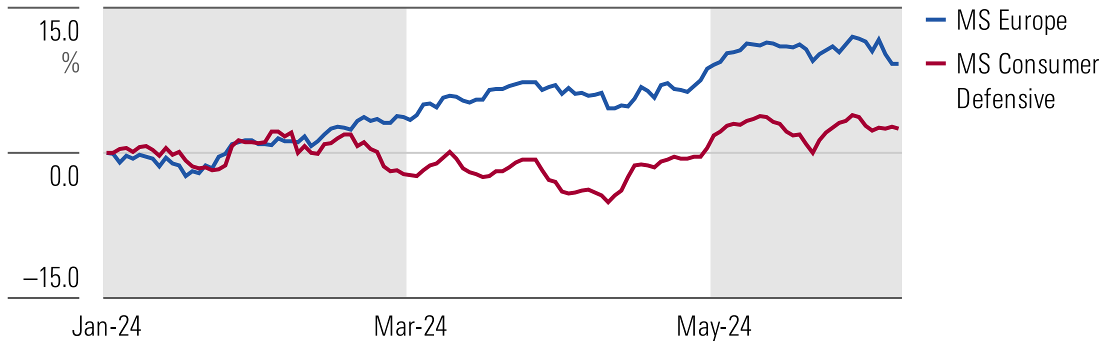
Relatively Weak Volume Performance Across the Sector

Reported volume growth for firms in the space has been mixed, with many Tier 1 companies in line with or slightly behind estimates so far this year. Spot prices have continued to slow across most commodities, and manufacturers are signaling lower levels of cost inflation for the rest of the year. At the same time, more companies have commented on downtrading and intensifying competition from private labels, especially in more-discretionary consumer categories with weak brand power and high elasticities. We expect companies in the space will maintain if not increase investments in marketing and promotional activity to boost volume growth as prices decline, with some initial signs of volume reversals evident in results.

Opportunities Are Plentiful Across the Sector

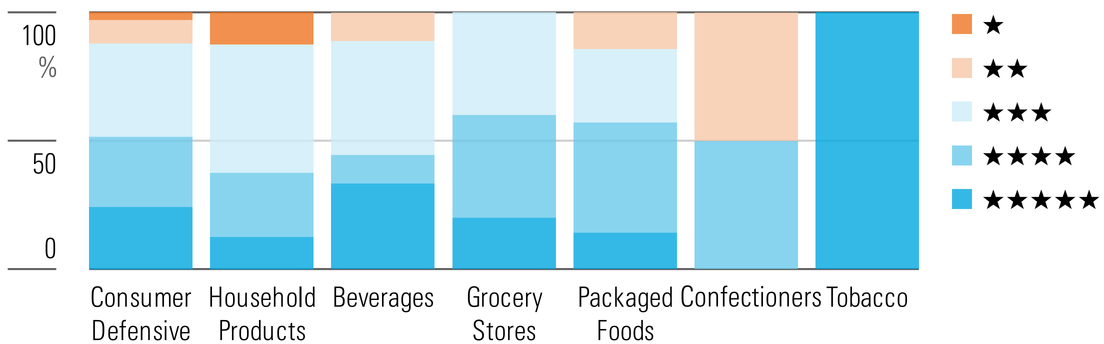
The sector is undervalued with plenty of opportunities among food and beverage and household product manufacturers. Tobacco stocks remain deeply undervalued.

Consumer Defensive vs. the Morningstar Europe Index



Source: Morningstar. Data as of June 18, 2024.

Consumer Defensive Star Rating Distribution by Industry



Source: Morningstar. Data as of June 18, 2024.

Private-Label Penetration Gains Represent a Return to Normal After Pandemic-Driven Slowdown

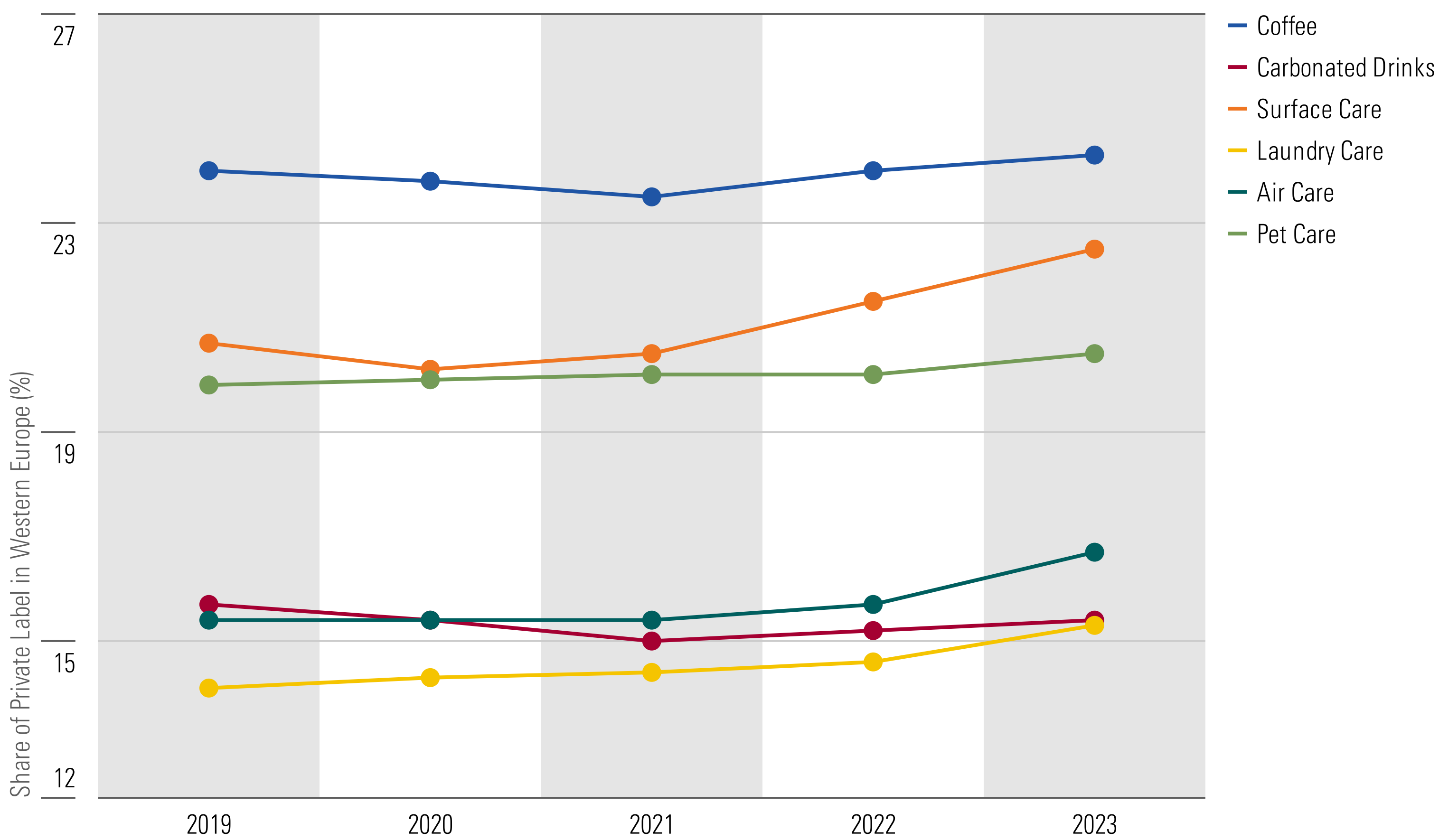
Share of Private Label Continues to Increase

The share of private-label goods has risen in the last two years in Europe in response to substantial pressure on disposable income after several rounds of price increases across the sector. Still, we believe that some of this growth represents a normalization after a period of stagnation during the covid-19 pandemic. The stagnation was driven by increased consumer risk aversion and a preference for well-known and tested brands.

Promotional and Advertising Increase to Boost Volume

Consumer downtrading has been weighing on volume growth for consumer packaged goods companies. With input cost inflation moderating, we have started to see an increase in promotional activity as companies look to rekindle volume growth, which we expect to continue in the second half of the year. At the same time, we expect companies to reprioritize innovation and brand investment to bolster their standing with retailers and consumers after two years where the emphasis has been on passing through cost inflation and product reformulation to secure cost savings.

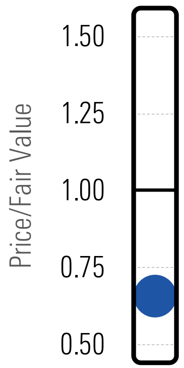
Private-Label Share Rebounded in 2022 and 2023 After a Slowdown in 2020 and 2021



Source: Euromonitor. Data as of June 2024.

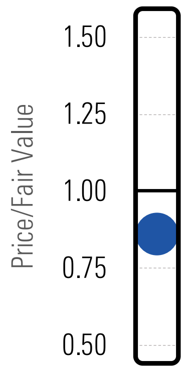
Consumer Defensive | Top Picks

Anheuser-Busch InBev BUD



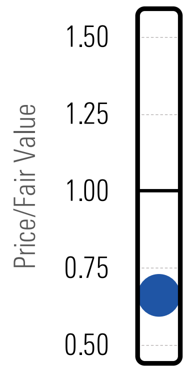
Market Cap	Moat
$116 Bil	Wide
Rating	**Yield**
★★★★★	1.8%
P/FV	**P/E**
0.66	17.5x

Nestlé NESN



Market Cap	Moat
CHF 275 Bil	Wide
Rating	**Yield**
★★★★	3.3%
P/FV	**P/E**
0.86	18.8x

Reckitt Benckiser Group LON: RKT



Market Cap	Moat
GBP 39 Bil	Wide
Rating	**Yield**
★★★★★	4.5%
P/FV	**P/E**
0.66	13.7x

Energy

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OPEC Struggles to Defend Prices, and Energy Underperforms Amid This Weakness

Oil Prices Look Weak, and We Expect More Weakness

On a quarterly basis, oil prices look weak and we expect that to continue, with West Texas Intermediate at $65-$70 a barrel—if not lower—still likely in 2024. We see the OPEC+ production cut extensions as a sign of weakness, not strength. Most of the extension deadlines were pushed back a year to the end of 2025. Further, Saudi Arabia just sold $11 billion in stock in state-run Aramco, indicating its need for cash to fund Vision 2030 efforts and its inability to defend oil prices.

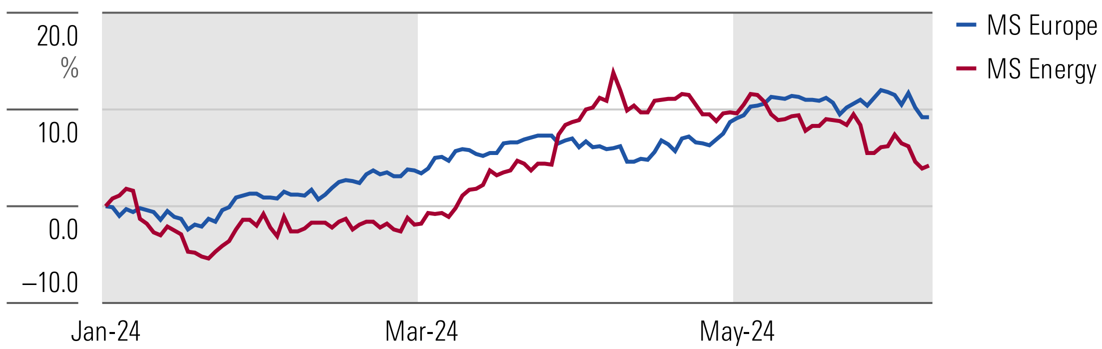
Gas Prices Spike Due to Production Cuts

We mainly attribute recent strength in gas prices to US producers cutting near-term gas production in response to weak prices. The production cuts were well timed. The market's attention has now shifted to growing 2025 gas demand from new US LNG terminals and potential US gas growth from artificial intelligence and data center demand by 2030. We estimate incremental gas growth of 7-16 billion cubic feet per day by 2030.

European Energy Stocks Underperform Market

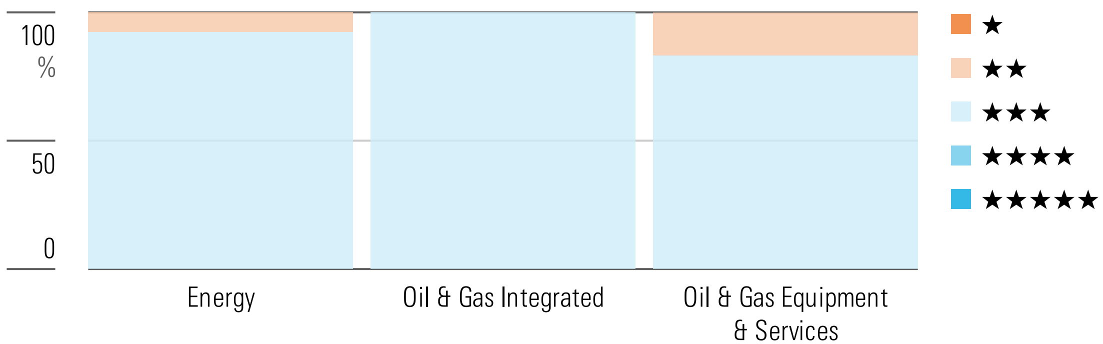
The slide in oil prices during the quarter on fears of oversupply later in the year, despite a renewal of OPEC cuts, weighed on energy stocks. While OPEC extended the current cuts, it signaled a reintroduction of volumes later in the year, which sent prices lower. Before that, weak economic data had already sent oil prices lower from their year-to-date peak in early April. Prices have already begun to recover in June, though.

Energy vs. the Morningstar Europe Index



Source: Morningstar. Data as of June 18, 2024.

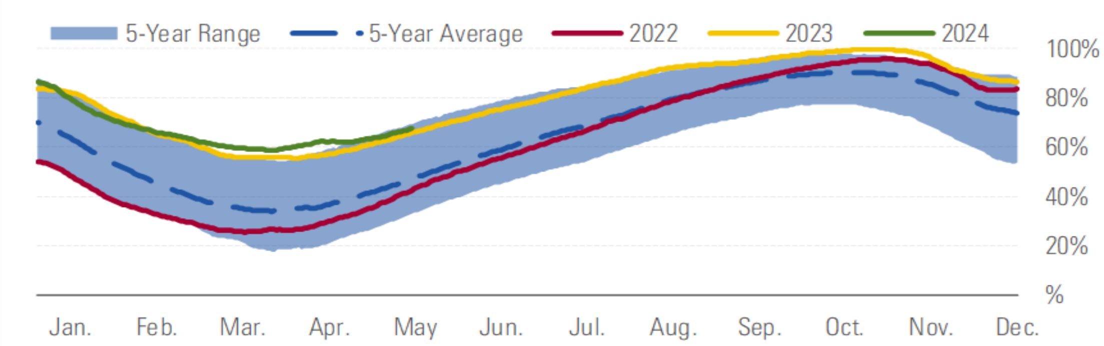
Energy Star Rating Distribution by Industry



Source: Morningstar. Data as of June 18, 2024.

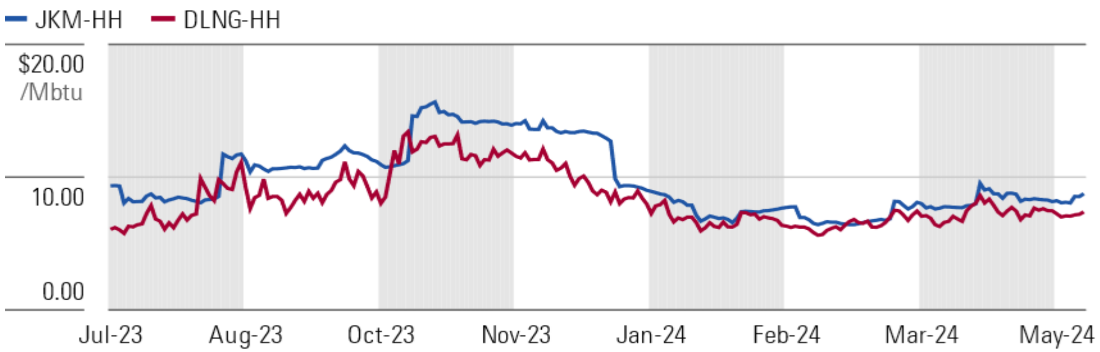
EU Gas Storage Looks Great; Gas Network Costs Now Need to Be Optimized

EU Gas Storage Levels Remain Excellent



Source: Gas Infrastructure Europe. Data as of May 29, 2024.

Asian and European LNG Spreads Are at Somewhat Healthy Levels



Source: CME Nymex. Data as of May 29, 2024.
JKM = Japan Korea Marker; DLNG = Dutch Title Transfer Facility; HH = Henry Hub.

We Expect US Gas Inventory Levels to Remain High Into 2025

The European storage and gas outlook continues to be excellent. European storage levels remain extremely healthy, while gas prices are near levels before the Russia-Ukraine conflict began. The challenge for the EU is maintaining the relatively healthy status quo. Much of the work by the EU is now focused on optimizing the cost structure for the EU gas pipeline system, including figuring out what to do with pipelines that formerly moved Russian gas.

Russian liquefied natural gas imports remain a source of risk, as they have increased substantially while piped gas flows have fallen. The EU has explored ways to eliminate this source of supply and now is discussing potential sanctions on Russian LNG supplies.

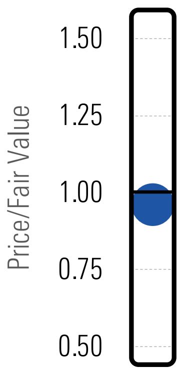
Optimization an Issue for Gas Networks

Another focus area has been Germany's levy, which was a EUR 1.86/megawatt-hour charge imposed on all gas touching its grid to recover the billions of euros in losses the government took buying gas when prices spiked to fill gas storage. The levy will increase to EUR 2.50/MWh in July but will end at the start of 2025.

The levy itself has been problematic. Additional costs were encouraging countries to adopt cheaper Russian gas and avoid German gas transit corridors. This was most notable in the Czech Republic, where Russian gas volumes increased 60% since 2022. The Czech Republic, Austria, and Slovakia are all planning to boost transit fees to recover lost Russian gas revenue.

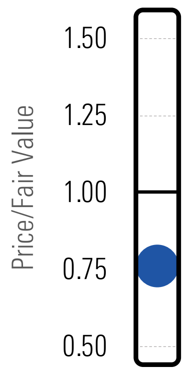
Energy | Top Picks

Shell SHEL



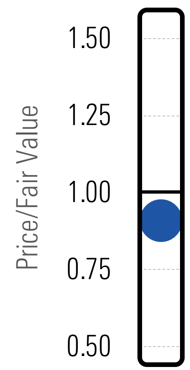
Market Cap	Moat
$221 Bil	None
Rating	**Yield**
★★★	5.0%
P/FV	**P/E**
0.96	6.6x

Schlumberger SLB



Market Cap	Moat
$65 Bil	Narrow
Rating	**Yield**
★★★★	2.4%
P/FV	**P/E**
0.76	13.0x

TotalEnergies TTE



Market Cap	Moat
$153 Bil	None
Rating	**Yield**
★★★	5.5%
P/FV	**P/E**
0.91	6.8x

Financial Services

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Financial Services Remain Attractive as Market Anticipates Rate Cuts

First Rate Cuts Mean We Prefer Businesses With Better Underwriting

The European Central Bank's cut in interest rates has led to a moderate decline in stock prices. We think financial services remain attractive where they have proved that their business models are supported by superior underwriting.

Payment Providers Remain Undervalued

Payment providers, in our view, remain one of the most undervalued parts of the European financial services sector. The firms under our coverage have gone through a volatile period, driven by interest-rate resetting of valuation multiples and idiosyncratic issues. We continue to see structural competitive advantages in this space, which brings opportunity to the long-term investor.

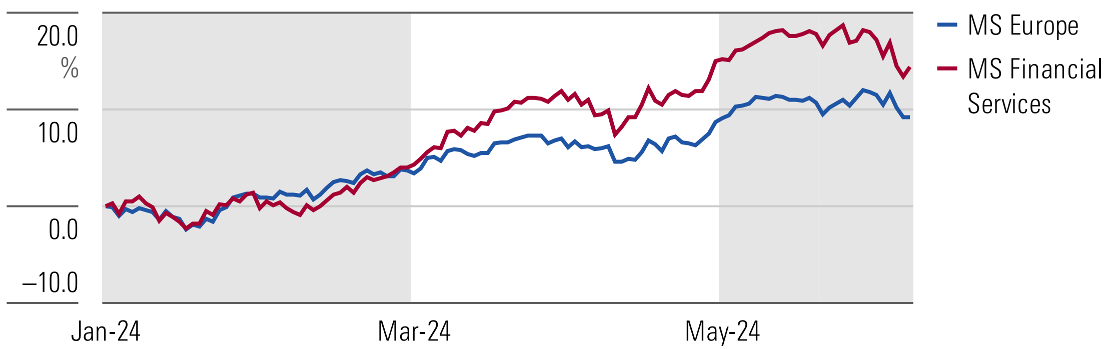
Banks With Low Funding Costs Are Winners in Normalized Rate Environment

Higher interest rates have been good for European banks. Declining rates will lead to some margin compression, but profitability should remain materially above levels seen over the last decade. We expect European banks with deposit-heavy funding to continue to outearn their cost of capital.

Timing and Steady Rate Rises Will Prove Crucial for Sound Underwriting

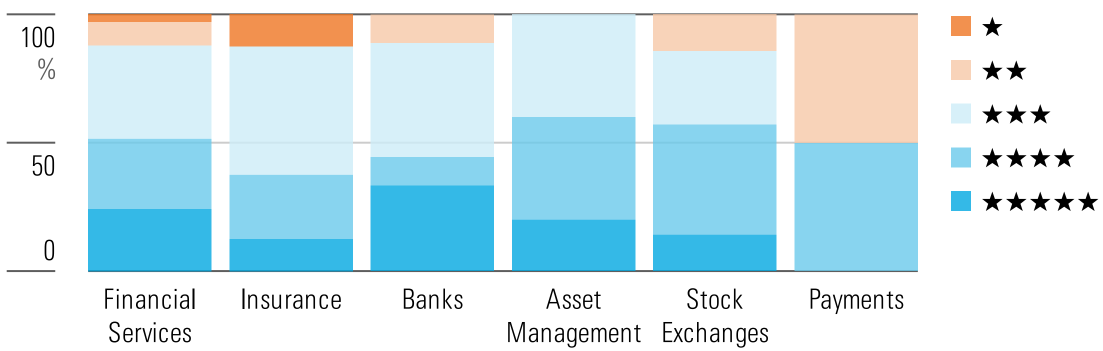
The last few years have been a roller coaster for most insurers writing personal lines. Rate rises typically lag claims inflation, leaving some insurers exposed. We think those that have steadily put through price increases will emerge as winners. In aggregate, pricing is up by half in 24 months.

Financial Services vs. the Morningstar Europe Index



Source: Morningstar. Data as of June 18, 2024.

Financial Services Star Rating Distribution by Industry



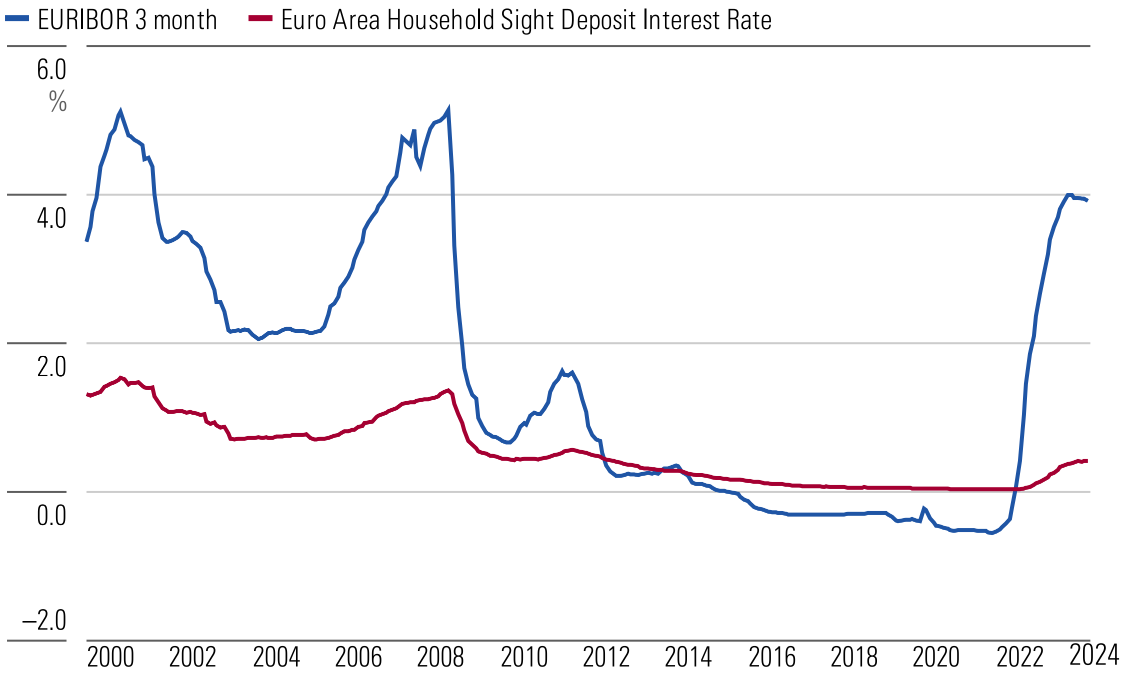
Source: Morningstar. Data as of June 18, 2024.

Still-High Interest Rates and Favorable Motor Insurance Pricing Support Profitability of Banks and Insurers

While we expect interest rates to decline further in the second half of 2024, we do not expect a return to the negative interest-rate environment of the previous decade. Profitability for European banks should remain above the depressed levels of the last decade.

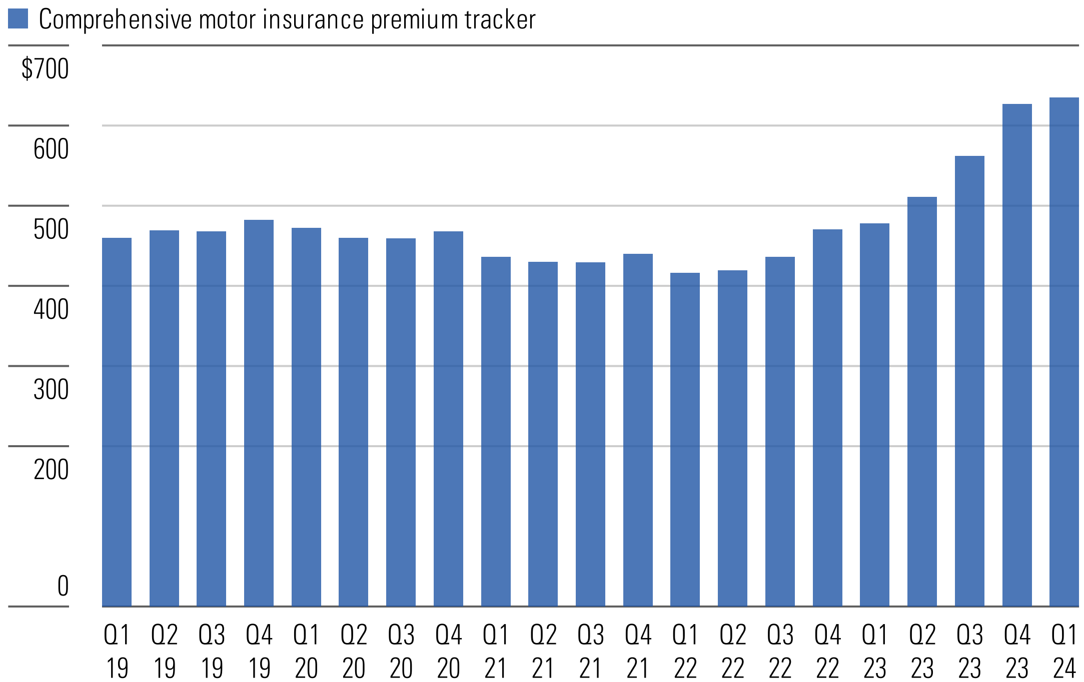
Motor insurance premiums in the UK have risen sharply over the last 18 months. Price rises implemented by motor insurers have had to contend with inflation in the cost of labor, parts, and the price of used cars. They have started to tentatively stabilize.

Deposit-Taking Finally Profitable Again for European Banks



Source: European Central Bank, Haver. Data as of April 2024.

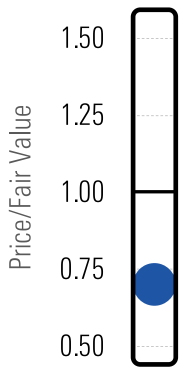
Motor Insurance Premium Tracker Shows Price Rises Starting to Flatten Out



Source: Association of British Insurers. Data as of March 2024.

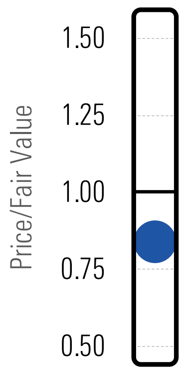
Financial Services | Top Picks

BNP Paribas BNP



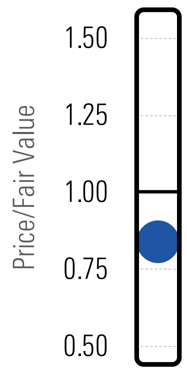
Market Cap	Moat
EUR 72 Bil	None
Rating	**Yield**
★★★★	7.9%
P/FV	**P/E**
0.70	6.4x

Allianz Group ETR: ALV



Market Cap	Moat
EUR 109 Bil	None
Rating	**Yield**
★★★★	5.7%
P/FV	**P/E**
0.84	10.4x

Admiral Group LON: ADM



Market Cap	Moat
GBP 10 Bil	Narrow
Rating	**Yield**
★★★★	5.5%
P/FV	**P/E**
0.84	17.0x

Healthcare

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Healthcare Valuations Look Attractive in Most Areas

Healthcare Has Slightly Outperformed the Market

Over the past 12 months, overall equity performance has underperformed the Morningstar Developed Markets Europe Healthcare Index. For much of this time however the performance of the sector has tracked the overall market closely. We expect the more defensive nature of the healthcare sector to support the group if concerns about recessionary pressures return.

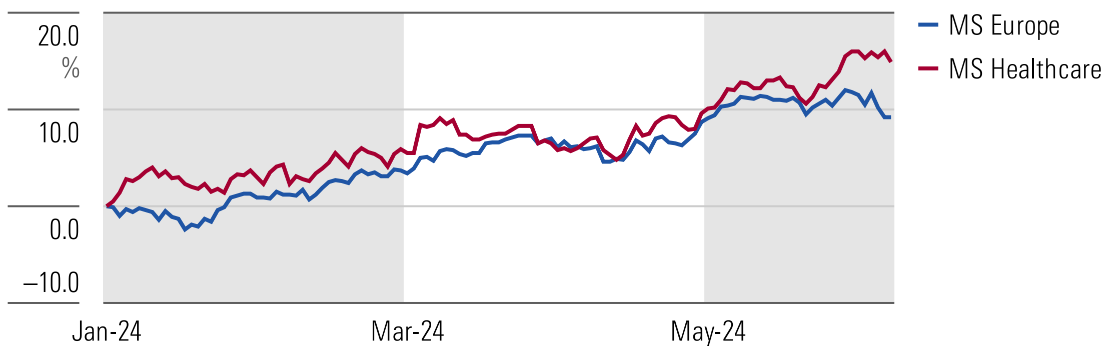
Valuations Look Still Appealing

We view the healthcare sector as undervalued, with just under 50% of the sector rated 4 or 5 stars and less than 20% rated 1 or 2 stars. In aggregate, our healthcare coverage trades below our overall estimate of intrinsic value. Besides medical distribution, the remaining healthcare industries look largely undervalued.

Short-Term Regulatory Headwinds Manageable

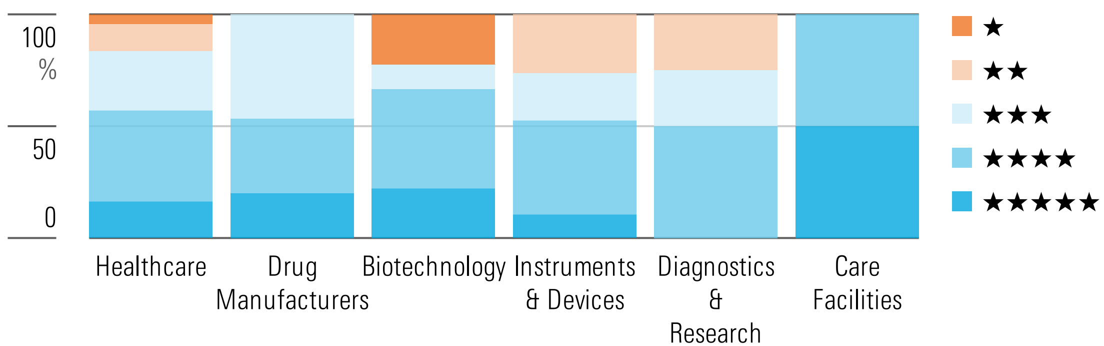
In biotech and drug manufacturing, the market is not fully appreciating the innovation in several therapeutic areas. In the healthcare plan industry, we believe the short-term headwinds of potential pharmacy benefit reforms, Medicaid redeterminations, and Medicare Advantage deceleration are creating undervalued opportunities. From a regional perspective, we believe the industry's largest market in the US will likely face some volatility during the 2024 election cycle and related political rhetoric, but we are not expecting major fundamental changes for most healthcare industries.

Healthcare vs. the Morningstar Europe Index



Source: Morningstar. Data as of June 18, 2024.

Healthcare Star Rating Distribution by Industry



Source: Morningstar. Data as of June 18, 2024.

Macro Factors Like Recessions and Inflation Generally Have Less Impact on Healthcare Firms

Macro Pressures Tend to Be Immaterial to Healthcare Demand

While the market appears more focused on faster-growing, more market-sensitive sectors, if any market disruptions occur, healthcare tends to hold up well regardless of macro pressures. In the most recent global recession of 2009, the drug and biotech industries posted steady results with limited impact to sales and profits (see upper right table). The need for healthcare stays relatively stable irrespective of the state of the economy.

Strong Pricing Power Offsets Inflationary Pressures

Further, most biopharma drugs carry high gross margins (see lower right table), reducing inflationary impacts. Beyond the solid pricing power that allows biopharma to transfer inflationary pressures to end users, biopharma ingredient and manufacturing costs are very low relative to revenue. While R&D and marketing costs represent larger portions of overall costs and will likely continue to experience some inflationary impacts, the core cost of goods sold expenses represent a very small portion of overall costs. The small costs are not apparent, as reported cost of goods sold typically includes items such as royalties to partners and other nonmanufacturing costs.

Biopharma Sales Were Largely Unaffected by Last Major Recession in 2008-09

			Recession			
	2006	2007	2008	2009	2010	2011
U.S. GDP growth (annual %)	2.90%	1.90%	**-0.10%**	**-2.50%**	2.60%	1.60%
World GDP growth (annual %)	4.40%	4.30%	**1.90%**	**-1.70%**	4.30%	3.10%
Big Biopharma Median Growth						
Global revenue	7%	8%	**7%**	**6%**	6%	4%
Operating income	8%	9%	**11%**	**11%**	5%	2%

Source: World Bank, company reports, Morningstar's April 2024 biopharma landscape report.

Estimated Underlying Cost of Goods Sold for Key Biopharma Drugs

Key Drug	Manufacturer	Typical Annual Dose (Grams)	Price Per Gram	Cost Per Gram Sold	Implied Gross Margin
Opdivo	Bristol	5.9	$19,000	$200	**99%**
Keytruda	Merck	3.5	$32,000	$200	**99%**
Tecentriq	Roche	20.8	$5,000	$200	**97%**
Cosentyx	Novartis	3.9	$5,000	$200	**97%**
Perjeta	Roche	7.3	$8,000	$200	**97%**
Ocrevus	Roche	1.2	$42,000	$300	**99%**
Eylea	Regeneron	0.01	$650,000	$20,000	**97%**

Source: World Bank, company reports, Morningstar's April 2024 biopharma landscape report.

Healthcare | Top Picks

Elekta EKTA B

Market Cap
SEK 2 Bil

Moat
Wide

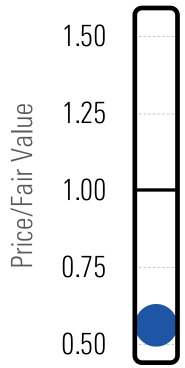
Rating
★★★★★

Yield
3.9%

P/FV
0.52

P/E
15.3x

Fresenius ETR: FRE



Market Cap
EUR 17 Bil

Moat
Narrow

Rating
★★★★★

Yield
3.4%

P/FV
0.56

P/E
9.6x

Roche SWX: ROG

Market Cap
CHF 229 Bil

Moat
Wide

Rating
★★★★★

Yield
3.9%

P/FV
0.67

P/E
14.2x

Industrials

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Low-Carbon Transition Opportunities Largely Priced In by Investors; Business Services, Defense Stocks Attractive

Q2 European Industrials Sector Performance Tracked in Line With Broader Market

The performance of European industrials stocks tracked largely in line with the broader European equity market in the second quarter, following the sector's significant first-quarter outperformance. Still, investor sentiment was reinforced by the sector's broadly resilient first-quarter earnings. A modest improvement in the near-term economic outlook for Europe also likely supported investor optimism, with the eurozone economy having returned to growth during the first quarter and the European Central Bank lowering interest rates at its June meeting.

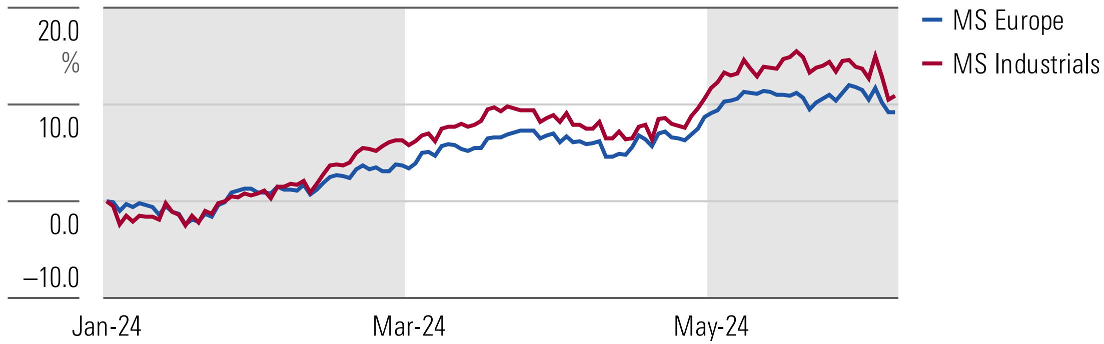
Low-Carbon Transition Remains a Boon for Capital Goods Suppliers

The ongoing transition toward a lower-carbon economy is a key secular trend supporting order intake for European capital goods suppliers in 2024. Indeed, buoyant order intake and robust order backlogs reflect an increasing demand for capital equipment and solutions that improve energy efficiency, embrace low-carbon fuel alternatives, and/or promote other forms of carbon emission reduction. Still, European capital goods stocks currently offer investors limited opportunity, with most trading in 2- or 3-star territory.

Business Services and Aerospace and Defense Stocks Are Attractive

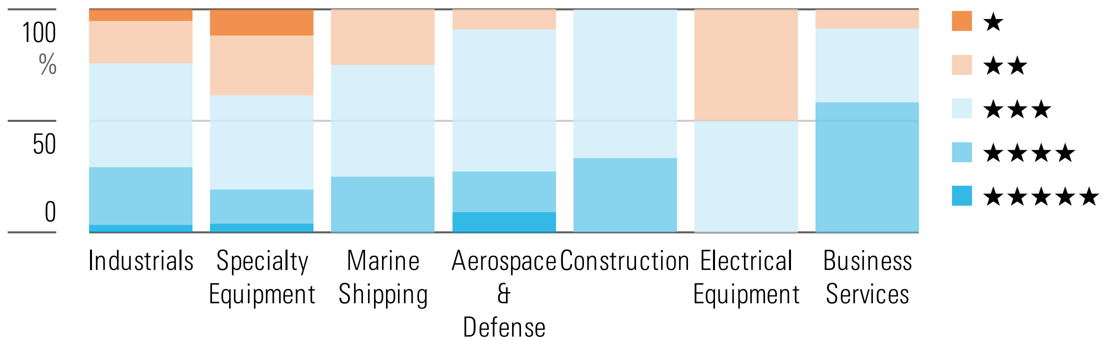
We view several industrials stocks in our coverage as undervalued despite the sector's strong year-to-date equity market performance. We see opportunities in business services, with testing, inspection, and certification companies screening as compelling. We also see opportunities in European aerospace and defense stocks, which are benefiting from a global increase in government defense spending.

Industrials vs. the Morningstar Europe Index



Source: Morningstar. Data as of June 18, 2024.

Industrials Star Rating Distribution by Industry



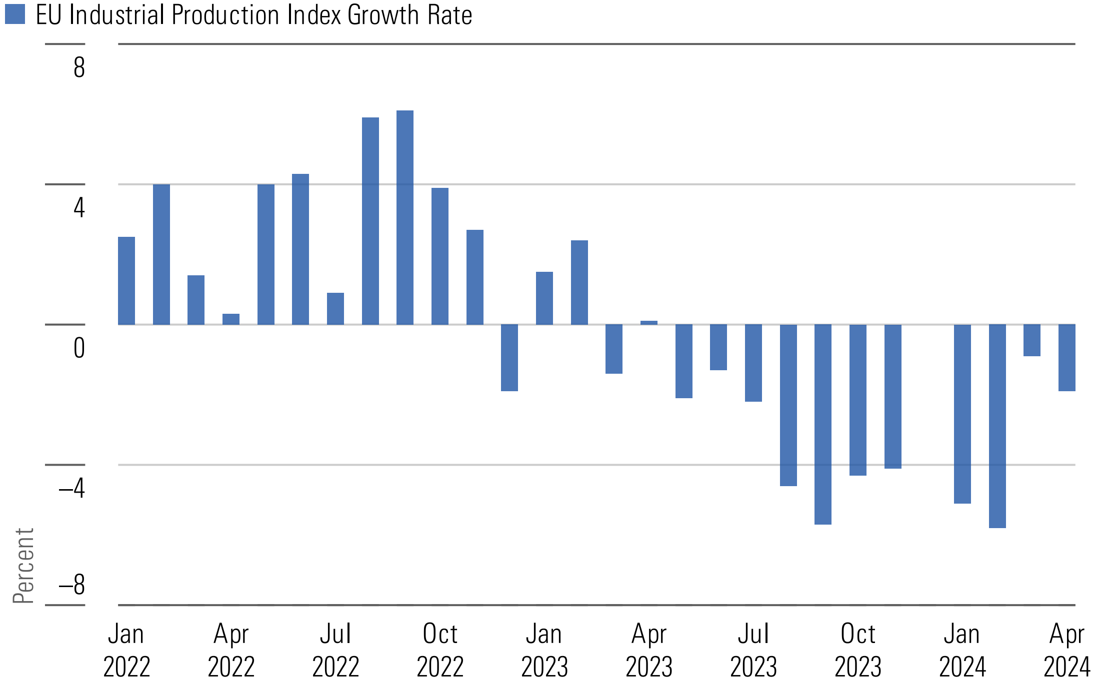
Source: Morningstar. Data as of June 18, 2024.

Secular Growth Opportunities Buoy Demand in Otherwise Weakened Demand Environment

Broadly speaking, economic conditions are on the up in Europe in mid-2024. Eurozone industrial output, however, remained soft in the second quarter, weighing cyclically on capital goods demand. Notwithstanding, renewable energy transition-related secular growth opportunities continue to promote strong order backlog growth for European capital goods manufacturers in 2024, providing earnings support despite ongoing industrial output weakness.

European Industrial Output Remains Under Pressure in 2024

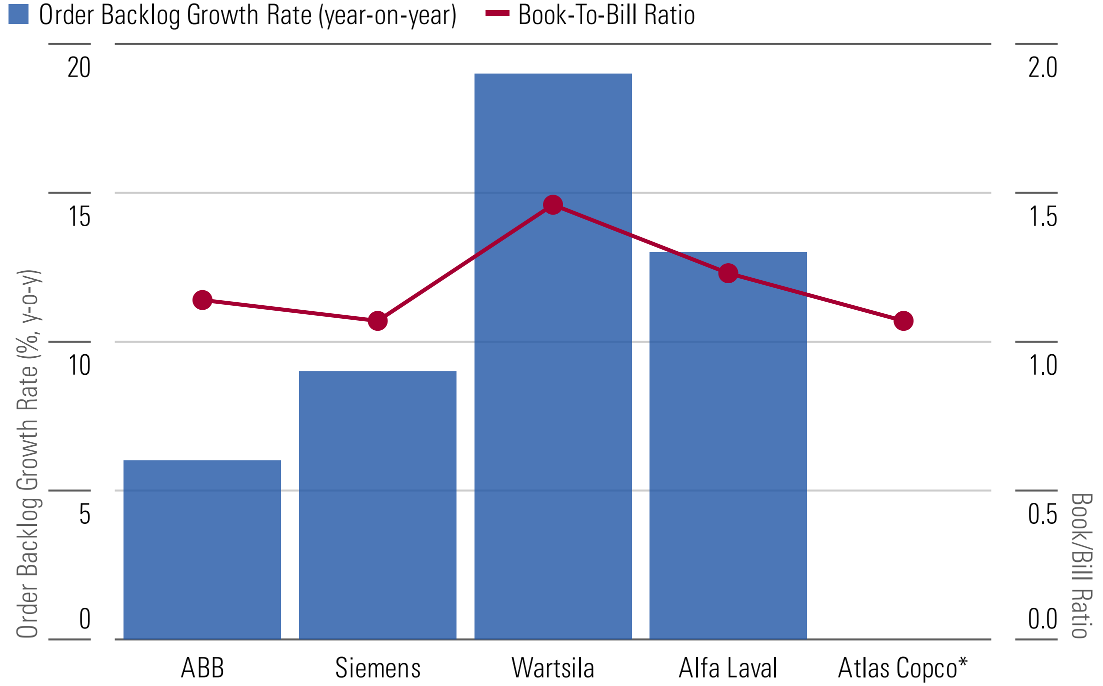
EU Industrial Production Index growth rate (year-on-year).



Source: Eurostat.

Robust Order Backlogs Support Capital Equipment Supplier Earnings

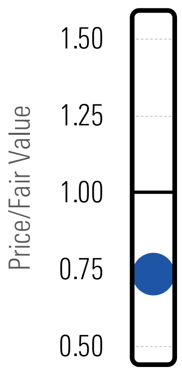
Order backlog growth rate and book/bill ratios.



Source: Company filings. *Order backlog metrics are not disclosed by Atlas Copco.

Industrials | Top Picks

Rentokil Initial LON: RTO



Market Cap
GBP 14 Bil

Moat
Wide

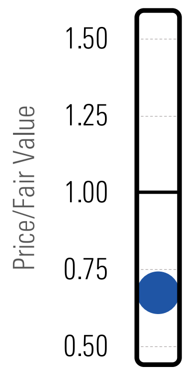
Rating
★★★★

Yield
2.0%

P/FV
0.73

P/E
19.3x

Rheinmetall RHM



Market Cap
EUR 23 Bil

Moat
Wide

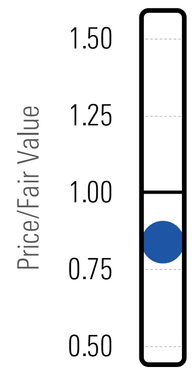
Rating
★★★★★

Yield
1.6%

P/FV
0.67

P/E
22.9x

Intertek ITRK



Market Cap
GBP 10 Bil

Moat
Narrow

Rating
★★★★

Yield
3.1%

P/FV
0.84

P/E
20.2x

Utilities

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European Utilities Edged Up on Soaring Power Prices, but High Interest Rates Still a Drag

Sector Edged Up in Q2 in Wake of Rising Power Prices and M&A

Utilities have reversed part of their first-quarter fall, thanks to a strong rebound in power prices. Moreover, the deep undervaluation of renewables developers has driven takeovers by big investment firms at very high multiples. Neoen's main shareholders accepted an offer at 18 times EBITDA. The sector is still significantly lagging the market in 2024 because of high interest rates.

Companies Pivot to Value Over Volume in Renewable Energy Investments

In May, EDP Renovaveis trimmed its targets for capacity additions, emulating most utilities involved in renewables. On the other hand, it raised its returns target. This reflects that renewable projects are still value-accretive as construction costs have stabilized, while purchase price agreement prices remain at healthy levels. The artificial intelligence-driven boost of data centers should support PPA prices.

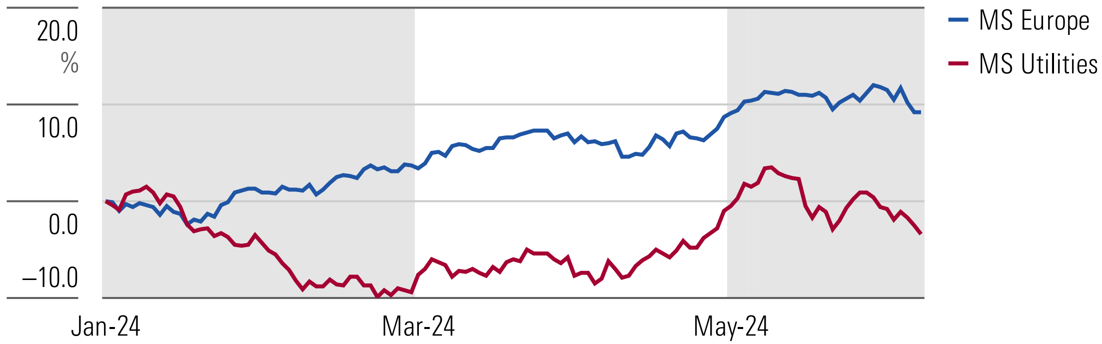
Companies Step Up Network Investments

The grid is the biggest bottleneck of the energy transition. All companies operating electricity networks have materially stepped up their investments over the last few months. The latest is National Grid, which had to resort to a highly dilutive rights issue. On the upside, high interest rates drive higher allowed returns.

Shares Are Attractive

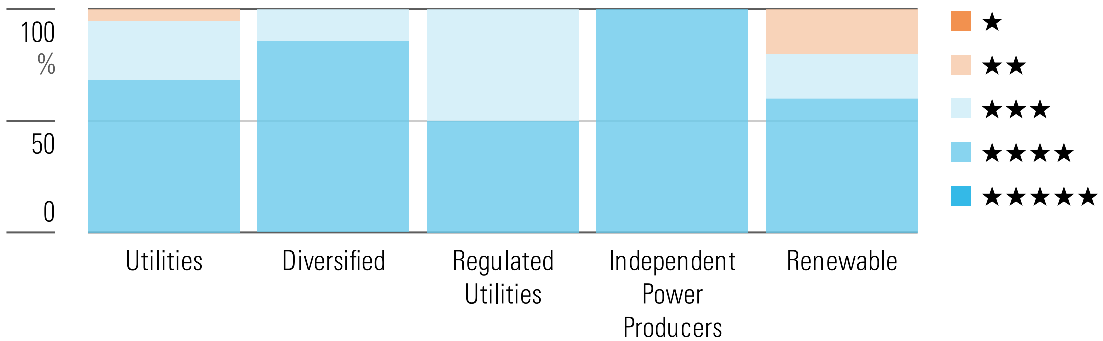
We view the sector as materially undervalued. The median trailing dividend yield of 4.8% is in line with the historical one, but its premium over government bond yields narrowed in the second quarter.

Utilities vs. the Morningstar Europe Index



Source: Morningstar. Data as of June 18, 2024.

Utilities Star Rating Distribution by Industry

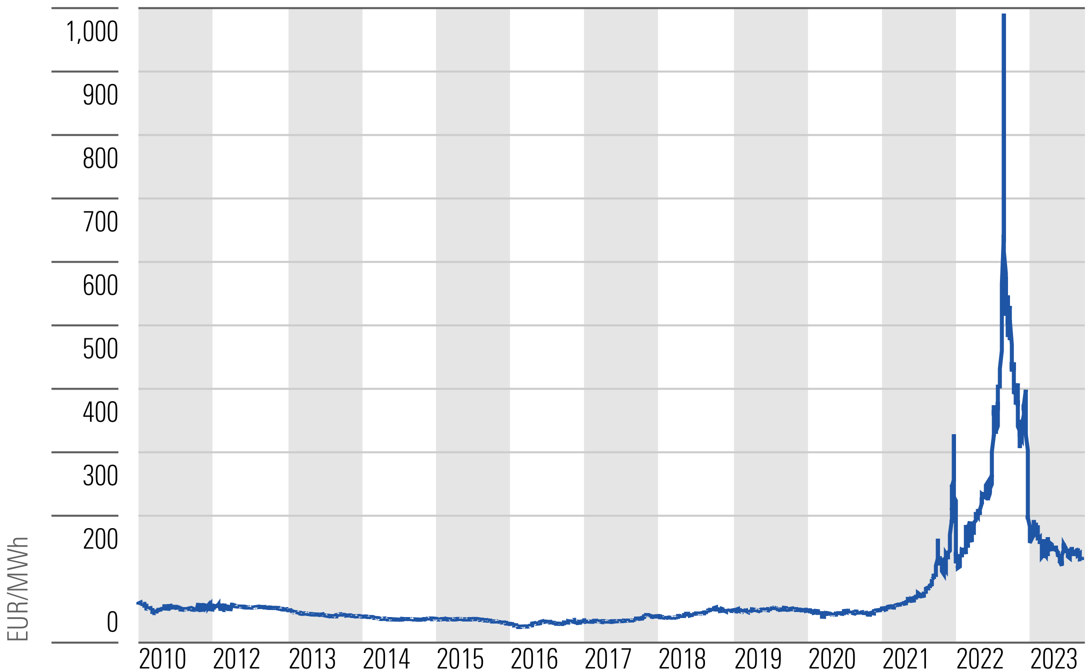


Source: Morningstar. Data as of June 18, 2024.

Wholesale Power Prices Rebounded in Q2 in Wake of Higher Gas and Carbon Dioxide Prices

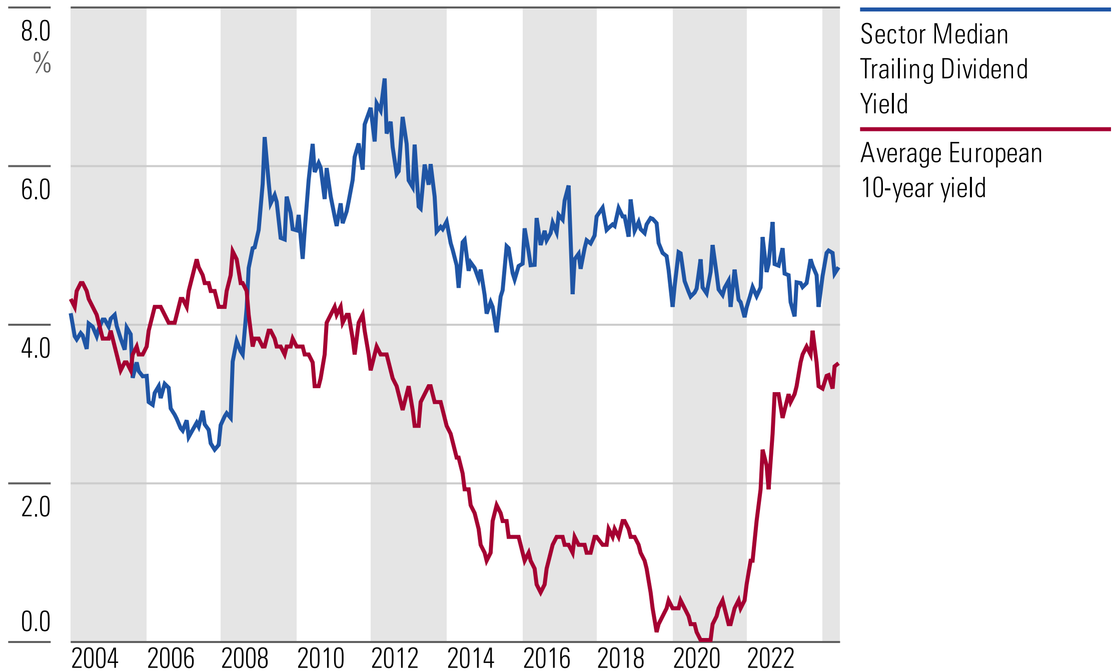
The European utilities' yield premium to European government bond yields decreased by 40 basis points since the end of March as the sector rose despite the increase in government bond yields. At 1.2%, the premium remains below the 2.1% historical average. On an absolute basis, the median trailing dividend yield of 4.8% is in line with the 4.6% historical median.

German Power Prices Have Rebounded in Q2



Source: Morningstar Commodity Data. Data as of May 31, 2024.

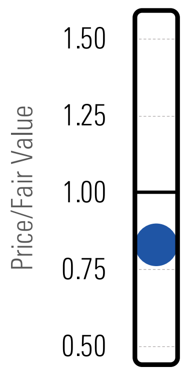
Utilities' Yield Premium to Government Bonds Narrowed in Q2



Source: Morningstar Commodity Data. Data as of May 31, 2024.

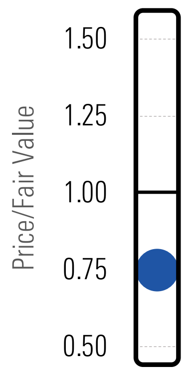
Utilities | Top Picks

SSE SSE



Market Cap	Moat
GBP 25 Bil	None
Rating	**Yield**
★★★★	3.6%
P/FV	**P/E**
0.83	11.1x

Veolia Environnement VIE



Market Cap	Moat
EUR 22 Bil	Narrow
Rating	**Yield**
★★★★	5.0%
P/FV	**P/E**
0.75	13.9x

RWE RWE

Market Cap	Moat
EUR 27 Bil	None
Rating	**Yield**
★★★★	3.3%
P/FV	**P/E**
0.70	12.2x

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