At the start of 2015, we had a positive view on European equities, driven by our expectation that we would see an improvement in economic growth and further loosening of monetary policy. The cheaper oil price and depreciating euro provided additional tailwinds. During the year, our confidence was rewarded as eurozone economic indicators generally ticked higher and the recovery appeared to be on track. Despite the wobbles associated with the Greek debt crisis and the global sell-off in risk assets in the latter part of the year, European equities ended 2015 in positive territory.

At the end of the year our view on Europe turned slightly less positive as the European Central Bank’s (ECB’s) actions became harder to read. As concerns over slowing Chinese growth and its impact on global growth intensified in the final months of 2015, the ECB had widely flagged that it would increase stimulus further. In the event, the measures announced in December fell short of expectations in terms of both interest rate cuts and expansion of the asset-buying program. This surprised market participants, particularly as the impact of the Chinese slowdown was already being seen in lower European export figures.

While the ECB adopted more dovish rhetoric in January, suggesting that further moves would be made in March, it became clear that additional stimulus measures were likely to be focused on taking interest rates further into negative territory. We were not convinced that this would necessarily be positively received. The Bank of Japan’s move to negative rates in January has so far had the opposite effect than policymakers had hoped for—the yen is one of the strongest performing currencies so far in 2016.

We have looked for ways to express our modified stance on Europe in the portfolio. As we are still broadly positive, we looked for the opportunity to sell outperformers rather than adopt an outright bearish stance. Over 2015, the Italian market was the star performer in Europe, with the FTSE MIB returning 12.7% in local currency terms, making it one of the best performing equity markets globally over the year. The rally was partly playing catch-up but, more importantly, it reflected Italy’s economy returning to growth after three years of recession, the country’s longest period of retrenchment since World War II.

Reform Agenda

The recovery owed a great deal to the ECB’s efforts to kick-start the economy, but investors were also encouraged by Italian Prime Minister Matteo Renzi’s reforming agenda, which has promised to return the country to growth and boost its competitiveness. Renzi has focused on stimulating domestic consumption, which had been a major drag on the economy, with policies such as tax cuts for lower-paid workers. In addition, in an attempt to tackle one of the highest unemployment rates in the EU, labor market reform has been a priority, and a series of measures has been introduced, with varying success so far.

These efforts were rewarded with estimated growth of 1% in GDP over 2015, and forecasts of 1.6% for 2016. Lackluster although this might appear, it was a vast improvement on previous years and investors chose to focus on this new story of domestic economic revival. In the equity market sell-off of the second half of the year, Italy held up better than other European markets because of its lower dependence on exports to China. As a
As well as the potential for mean reversion, Italy was facing the considerable headwinds of its worsening banking crisis. The prospect of more deeply negative interest rates from the ECB and its potential impact on bank profitability would not help matters.

Given the outperformance of the Italian market, we considered it was likely to mean-revert and took the opportunity to sell a winner by instigating a downside trade in January. As well as the potential for mean reversion, Italy was facing the considerable headwinds of its worsening banking crisis. The prospect of more deeply negative interest rates from the ECB and its potential impact on bank profitability would not help matters.

The Italian financial system is weighed down with €330bn in non-performing loans and is still looking for an effective measure for dealing with them. In addition to years of weak economic growth and low profitability, Italian regulators are tackling the legacy of a banking system composed of dozens of small regional banks. A series of reforms has been instigated, but these have been unsuccessful so far in restoring confidence. The beginning of 2016 saw negative news flow intensify for Italian banks, as the EU's new bail-in reforms were criticized, hitting already fragile sentiment.

A new bill to reform the country’s tiny provincial co-operative banks was not enough to soothe the markets. As a result of this spate of negative news flow, our downside target on the MIB was met and exceeded early in the year. Although there is the possibility of a short-term bounce, we prefer to maintain a modest negative tilt against Italian equities over the medium term.

Figure 1: Italian equities – the rise and fall of the FTSE MIB index

Source: Bloomberg as of February 19, 2016.

Please note the value of investments and any income from them will fluctuate and is not guaranteed (this may be partly due to exchange rate fluctuations). Investors may not get back the full amount invested.
Views expressed are those of the manager stated and do not reflect views of other managers or the firm overall. Views are current as of the date of this publication and subject to change. This information should not be construed as investment advice or recommendations for any particular investment.

Insight Investment is the corporate brand for the group of companies managed or administered by Insight Investment Management Limited which includes Insight Investment Management (Global) Limited, Pareto Investment Management Limited, Insight Investment Funds Management Limited, Cutwater Investor Services Corporation (CISC) and Cutwater Asset Management Corporation (CAMC). CISC and CAMC are owned by BNY Mellon and operated by Insight.

BNY Mellon Investment Management is one of the world’s leading investment management organizations and one of the top U.S. wealth managers, with $1.6 trillion in assets under management. It encompasses BNY Mellon’s affiliated investment management firms, wealth management services and global distribution companies, including The Dreyfus Corporation, Insight Investment and MBSC Securities Corporation. Dreyfus and Insight are affiliates. BNY Mellon is the corporate brand of The Bank of New York Mellon Corporation. MBSC Securities Corporation is a registered broker-dealer, a member of FINRA and a wholly owned subsidiary of BNY Mellon.

For Use with Financial Professionals Only. Not for Use with the General Public.