We think the U.S. election outcome and a shift in global sentiment have created pockets of compelling investment ideas in Europe and Japan. We see a resumption of trends that began to play out over a year ago when U.S. monetary policy diverged, which is likely to persist for much of 2017.

The message has been loud and clear—global investors anticipate a reflationary market environment under President Trump's administration. While legislative bumps along the way are inevitable, the policy agenda of tax reform, deregulation and infrastructure spending is clearly pro-growth, providing the potential for a nice tailwind for the burgeoning recovery overseas.

WHAT DOES THIS MEAN FOR NON-U.S. DEVELOPED MARKETS?

We identify three themes that should spark attractive return potential in the coming months, illustrated below:
THEME ONE: POSITIVE MACRO TRENDS

The reflation theme, which has accelerated since Trump's election, has filtered into firming trends in the Eurozone and Japanese Purchasing Managers' Indices (PMIs). PMIs are considered leading economic indicators, and when activity is picking up in the manufacturing and services industries, consumer sentiment and spending also tend to rise. Encouragingly, recent PMI releases build upon a steady, sustained improvement in the two regions, shown below.

Exhibit 1: Eurozone and Japanese PMIs Trending Higher

![Graph showing Eurozone and Japanese PMIs]

Sources: Bloomberg, Markit, as of April 2017. Charts are provided for illustrative purposes only and are not indicative of the past or future performance of any Dreyfus products.

Notably, stronger macro data have translated into increased spending and activity. In Japan, the Abe administration has maintained a key focus on attracting more foreign tourism. A moderately weaker Japanese yen has contributed to the overall step change in the number of foreign visitors over the past few years, but so has a focus on ease of entry. Exhibit 2 details the expansion in tourism. Due to easier visa policies, close to 20 million tourists visited Japan in 2015, more than double the number of tourists in 2012. Exhibit 3 shows the associated increase in spending per visitor. These visitors continue to voraciously purchase goods and services; cosmetic and perfume products have seen notable increases.
Exhibit 2: Annual Number of Foreign Visitors to Japan

Sources: Credit Suisse, JNTO, JTA, April 2017.

Exhibit 3: Average Per Capita Spend on Shopping by Foreign Visitors to Japan

Sources: Credit Suisse, JNTO, JTA, April 2017.

After a steep decline in demand after the global financial crisis and again during the European sovereign credit crisis from 2011 to 2012, consumer confidence in the Eurozone has steadily improved. A sustained, broad-based recovery in demand for new car purchases has unfolded over the past few years, and trends have accelerated over the last 12 months. Years of pent-up demand have translated into an approximately 38% increase in the number of autos forecasted to sell in 2017 versus four years ago, as shown in Exhibit 4. The surge in demand not only benefits the auto manufacturers with dominant market share in the region, but it also provides a nice tailwind to a variety of other companies in the industry, including auto parts manufacturers and, increasingly, technology companies with growing content per vehicle.
THEME TWO: THE END OF FINANCIAL REPRESSION FOR EUROPEAN AND JAPANESE BANKS

In the first half of 2016, the unexpected move to a negative-interest-rate policy (NIRP) in Japan and a widening of NIRP in Europe marred EAFE (Europe, Australasia and Far East) financials. The market reaction was horrendous: bank stocks sold off sharply over concerns of weaker net interest margins, potential losses and pressure to raise fresh capital. The policy objective of fostering credit expansion hasn’t played out as well as central banks expected, with the unintended consequence of further depressing already low net interest margins. With higher bond yields globally since the U.S. election, the worst effects of these measures may be over.

Populism-Fueled Fiscal Stimulus and Infrastructure Spending

Widespread populist sentiment in the West has focused investors’ attention on the European election calendar this year. The markets breathed a sigh of relief with the French election outcome and center-left candidate Macron’s victory. In September, Germans will elect their next chancellor. Even mainstream candidates must address the rise in populism spurred by austerity, lackluster economic growth and the immigrant crisis. We think the likelihood of fiscal stimulus and higher domestic spending increases as we look out to 2018, particularly in areas such as infrastructure. Security and defense spending will also be higher, driven by elevated risks of terrorism and President Trump’s pressure on NATO allies to pay more for their defense. Countries that have “cheated,” spending below the NATO-mandated 2% GDP target, will look to close the gap—potentially adding upwards of 0.6% to European GDP.

1UBS & European Defence Agency.
Since the U.S. election, Japanese and European financials have outperformed the broader market in a magnitude similar to U.S. financials. While the Federal Reserve continues down the path of a tightening cycle, there are increasing signs that the European Central Bank may be nearing the end of its quantitative easing (QE) program, perhaps curtailing its bond-purchase initiative later this fall. Even the Bank of Japan has backed off expansion plans of its ongoing QE program, which is also supportive of slowly normalizing central bank policy and higher rates. This is a constructive backdrop for improving trends across non-U.S. developed market financials. Despite the challenging environment for banks over the past several years, we see clear signs that demand for and supply of credit in Japan and Europe have thawed and should be supportive of stronger economic activity, as shown in Exhibits 5 and 6.

Exhibit 5: Japanese Bank Lending

![Japanese Bank Lending Chart]

Source: Credit Suisse, Datastream, as of March 15, 2017.

Exhibit 6: European Bank Lending Survey

![European Bank Lending Survey Chart]

Source: Credit Suisse, as of March 2017, change over past three months.
THEME THREE: BETTER VALUATIONS AND EARNINGS POTENTIAL THAN THE U.S.

Economies tend to move in cycles, similar to stock markets. The U.S. was the first to start QE and exit the recession, which means the U.S. is six to seven years into a recovery and starting to see some signs of a slowdown. Importantly, Europe and Japan are two to three years behind the U.S. in this cycle. Consumption typically drives developed market economies, and we believe European and Japanese consumer spending is in the earlier stages of recovery. Labor markets are starting to tighten some, with Japan near an all-time low in unemployment. Consequently, a modest degree of wage inflation is beginning to materialize, which should provide an international recovery more room to run.

European and Japanese equity valuations remain steady, despite a sector rotation to financials and materials and away from defensive yield (consumer staples and utilities) over the last nine months. However, international developed markets remain more attractive than the U.S. on a price-to-earnings (P/E), price-to-book and dividend yield basis. Exhibit 7 details the P/E discount for the MSCI EAFE Index versus the S&P 500 Index.

Exhibit 7: MSCI EAFE Versus S&P 500 – 12-Month Forward P/E

Across the broader EAFE asset class, there is scope for company-specific self-help and return on equity (ROE) improvement, particularly compared to the more elevated corporate profitability levels in the U.S., as shown in Exhibit 8. Corporate Japan, in particular, has become acutely focused on ROE improvements. Japanese companies have been inefficient for years, with either high cash balances or cost structures—until recently. Increased investor attention on ROE with the advent of the JPX 400, or the “shame index,” has started to change corporate behavior. For example, productive mergers are rising as companies look to invest high cash balances. Furthermore, share buybacks and dividend payout ratios have seen a notable rise.
After a healthy period of sustained improvements in key economic indicators, we are now seeing follow-through to better consensus earnings revisions within the MSCI EAFE asset class compared to the S&P 500 Index, as shown in Exhibit 9.

Additionally, the MSCI EAFE asset class has far greater earnings leverage to an uptick in global PMI readings. The analysis in Exhibit 10 measures year-over-year growth in earnings for the U.S., Europe and Japan compared to the periodic change in global PMIs. Non-U.S. developed markets have clearly benefited from a burgeoning synchronized rise in global activity. The sector composition of the EAFE Index has more exposure to cyclically sensitive sectors like financials, energy, industrials and materials. These areas of the market have the most near-term earnings and margin recovery prospects. Conversely, the U.S. has a larger exposure to defensive and growth-oriented areas like health care and information technology.
Equities are subject to market, market sector, market liquidity, issuer, and investment style risks, to varying degrees. Investing in foreign denominated and/or domiciled securities involves special risks, including changes in currency exchange rates, political, economic, and social instability, limited company information, differing auditing and legal standards, and less market liquidity. These risks generally are greater with emerging market countries.

The MSCI EAFE Index (Europe, Australasia, and Far East) is a free float-adjusted market capitalization-weighted index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada. The S&P 500® Index is widely regarded as the best single gauge of large-cap U.S. equities. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization. The JPX-Nikkei Index 400 is composed of companies with high appeal for investors, which meet requirements of global investment standards, such as efficient use of capital and investor-focused management perspectives. It is composed of common stocks whose main market is the TSE 1st section, 2nd section, Mothers or JASDAQ market (in principle). The Tokyo Price Index (TOPIX) is a metric for stock prices on the Tokyo Stock Exchange (TSE). A capitalization-weighted index, TOPIX lists all firms that have been determined to be part of the “first section” of the TSE, a section that organizes all large firms on the exchange into one group. The second section pools all of the smaller remaining companies. The STOXX Europe 600 Index is derived from the STOXX Europe Total Market Index (TMI) and is a subset of the STOXX Global 1800 Index. With a fixed number of 600 components, the STOXX Europe 600 Index represents large-, mid-, and small-capitalization companies across 17 countries of the European region: Austria, Belgium, Czech Republic, Denmark, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and the United Kingdom. The Eurozone Manufacturing Purchasing Managers’ Index (PMI) is a weighted indicator calculated from indices of output, new orders, employment, suppliers’ delivery times and stocks of purchases. The Japanese Manufacturing Purchasing Managers’ Index is based on new orders, output, employment, suppliers’ delivery times, and stock of items purchased. A reading above 50 indicates expansion of manufacturing activity compared to the previous month; below 50 represents contraction; while 50 indicates no change. The J.P. Morgan Global Manufacturing PMI gives an overview of the global manufacturing sector. It is based on monthly surveys of over 10,000 purchasing executives from 32 of the world’s leading economies, including the U.S., Japan, Germany, France and China, which together account for an estimated 89% of global manufacturing output. It reflects changes in global output, employment, new orders and prices. The Global Manufacturing PMI is seasonally adjusted at the national level to control for varying seasonal patterns in each country and is produced by J.P. Morgan and Markit Economics in association with ISM and the International Federation of Purchasing and Supply Management (IFPSM). An investor cannot invest directly in any index.

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