Economic Research

WEEKLY ANALYSIS

Alain Freymond
Partner & CIO

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European trend picks up the pace in the second half of the year

Eurozone and US growth is level pegging. Fundamentals justify the rise in the Euro. The gap between valuation and profits is benefiting European companies.

Key points

- The German elections have dampened prospects of European reconstruction
- The ECB is confident, but concerned by the rise in the Euro
- Monetary policy will remain expansionary in 2018, despite an expected overhaul to QE
- The rise in the Euro mainly reflects the improvement in Eurozone fundamentals
- The single currency has temporarily stabilised
- European growth proved a surprise, level pegging with US growth
- GDP will likely pick up the pace in the second half of the year
- The investment climate is increasingly confident
- Inflation will not head back above 2% before 2018
- The Eurozone no longer inspires fear, Credit Default Swaps are at their lowest levels
- Interest is growing in European equities

The German elections have dampened prospects of European reconstruction

Unsurprisingly, the German elections have granted Angela Merkel a fourth term, though with disappointing results (33%) for her party. Despite her win, the inroads made by the far-right have shocked, worried and unsettled the parties involved in the process.

The Chancellor will need to forge a coalition around her party in order to govern. This seems to be a difficult undertaking given the Social Democratic Party's decision not to join, instead choosing to be an opposition party. An alliance with the FDP (Free Democratic Party) is still possible, but would have political consequences. As such, the Chancellor is starting this term in office in a complex, and more uncertain context.

In the medium-term, the French president's ideas for reform, as well as prospects of European reconstruction could turn out to be collateral damage in the coalition-forming process should it lead to an agreement with the FDP, which is rather hostile to the idea of a European revival.

The Euro has already reacted to this fresh uncertainty by dropping 3 cents against the US dollar in the days following the election. This reaction interrupted the eight month long upward trend.

We believe that in the short-term this new political landscape could dampen investors' enthusiasm for the single currency.

The ECB is confident, though nonetheless concerned by the rise in the Euro

At its latest meeting in September, the ECB decided not to change its policy. More recently, the latest statements by the ECB's chief before the European Parliament's Economic and Monetary Affairs Committee have once again demonstrated its confidence in the success of its policy to revitalise growth and bolster the upward inflation trend. However, Mario Draghi did point out that it would still probably be essential to maintain expansionary monetary policy to a considerable degree. The European economy seems to be on the right path, but the recent rise in the Euro represents a new source of concern. This came just as risks, particularly political risks, had very much fizzled out after the French elections, before bubbling back up again after the German elections last weekend. We will likely see greater strength of language before the next ECB Governing Council meeting on the 26th October, suggesting that the change of tack expected of the ECB in terms of its monetary policy will be gradual, measured and pragmatic. As such, the asset purchase programme, which was to be kept until at least the start of 2018, will undoubtedly be tweaked, but retained beyond this date in order to make the most of the programme's flexibility and ensure the Central Bank can take action if required to do so. The ECB will remain prudent in its approach and should refrain from any policy which could threaten the economic recovery and the improvement in economic operators' confidence, given that the macro-economic context may already have been shaken by the single currency's appreciation. The ECB will announce an overhaul of its programme, though the scope of this is still an unknown element. We believe it likely that the programme will be cut from 60 to 40, or even 30, billion per month as of January 2018 due to the drying up of "buyable" assets.

In this context, we cannot see key rates being increased in the coming quarters; this should only come a few months after the asset purchase programme has finished.

The rise in the Euro mainly reflects improved fundamentals

Should it continue, the rise in the Euro could hinder inflation heading towards the ECB's target as hoped, and foil Mario Draghi's plans. In the medium-term, however, we believe that the Euro could recover some stability.

Euro Exchange Rate (USD, CHF, GBP)

Sources: Bloomberg, BBGI Group SA

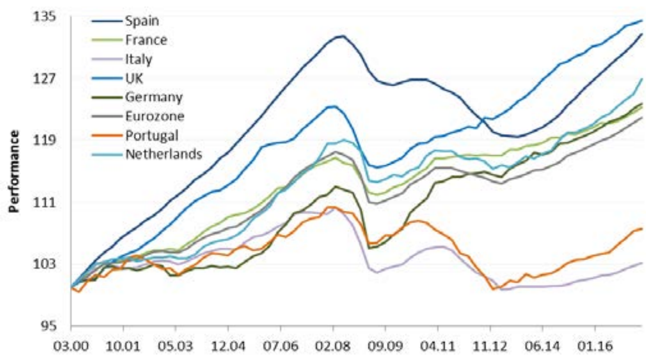
The Euro was expected to rise against the Swiss franc, bringing the single currency to a 1.15 exchange rate in 2017. The bulk of this has taken place over the last two quarters. As regards the Euro/US dollar exchange rate, the Euro started appreciating in the first few days of 2017, giving rise to the theory that its strength was only a side effect of the US dollar's weakness. However, one should not forget that the Euro appreciated against a broad array of currencies, underlining the improvement in the economic and political situation in the Eurozone as the key factor driving the trend change.

We therefore believe that the rise in the Euro has undoubtedly hit a ceiling in the short-term. The undeniable improvement in economic fundamentals and the prospect of an about-turn in monetary policy will bolster investors' interest in the single currency further down the road.

European and US growth are level pegging

Our forecasts of the European trend stepping up are being borne out in the 3rd quarter. The OECD is also revising its forecasts for 2017 upwards, whilst aggregated Eurozone GDP moved above +2% in June (+2.3%). German growth should gain in strength and breadth, propped up in particular by domestic spending, which will pick up some of the slack from exports. In France, GDP will certainly exceed +1.7%, whilst in Spain the trend remains robust, and could push GDP above +3%.

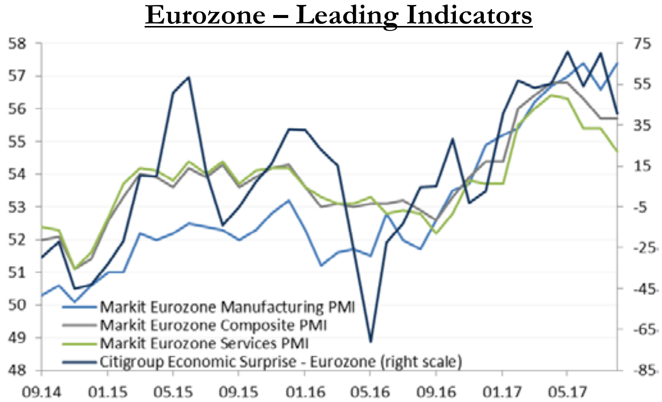
Evolution of European GDP



Sources: Bloomberg, BBGI Group SA

The end of the year could bring even better news if leading indicators are to be believed. Indeed, PMI indices for September confirm a clear recovery in activity in Europe.

Eurozone – Leading Indicators



Sources: Bloomberg, BBGI Group SA

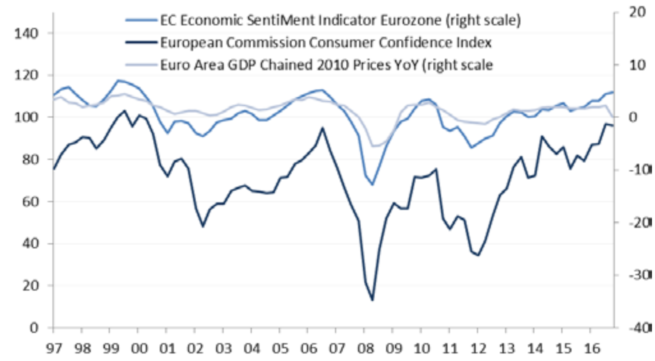
Composite PMI improved further in September (56.7), and now sits at its highest level since 2011; similar movements can be seen on manufacturing leading indices (58.2). The sub-index for production even hit 59.5, and underscores an industrial recovery which could well accelerate at the end of the year. The private sector is doing better, and does not seem to have been penalised by the Euro's appreciation.

This means that GDP has posted its seventeenth consecutive quarter of growth, and we believe that it could pick up the pace in the second half of 2017.

The investment climate is increasingly confident

The European Commission's household confidence indicator rose slightly again in the 2nd quarter. Sentiment has improved rather significantly, propped up by the improvement to conditions on the labour market.

Eurozone GDP, Economic Sentiment and Consumer Confidence



Sources: Bloomberg, BBGI Group SA

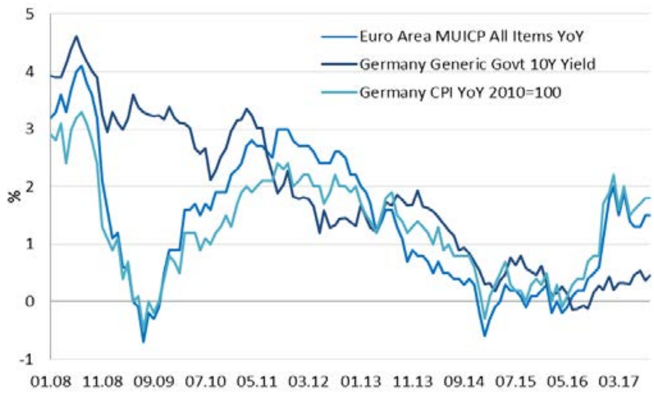
Household confidence is now higher than the average of the last twenty years, and at its highest since 2008. The consumer and business confidence survey also shows renewed optimism, posting its highest score since the start of the financial crisis. Whilst perhaps not yet euphoric, this positive trend is propping up consumption, which increased +2.6% year on year. In most countries, we are seeing a welcome return to cautious optimism, which should in turn prop up consumption and GDP growth.

Inflation will not head back above 2% before 2018

After the expected rise in inflation in the 1st quarter to its highest levels since 2012, price indices have shown some signs of running out of steam, as expected. As forecast, the increase in crude oil prices tailed off, and the Euro's appreciation is holding back imported inflation. Equally, it is too soon to see a solid inflation recovery linked to the labour market, the latter still being too far from its point of friction for wage rises to contribute to a price increase. The ECB's target of 2% inflation will certainly be difficult to achieve, even if the central bank continues with expansionary monetary policy in 2018, and particularly if the Euro remains stronger in the long-term. Development of salary costs is slow and the Eurozone unemployment rate is only falling very gradually. At current rates, although the drop seen between 2013 (12%) and today (9%) is continuing, it will take until 2020 to reach the 7.5% of the previous cycle seen before the financial crisis of 2008. Naturally, Eurozone inflation therefore slid from 1.9% to 1.3% in the 2nd quarter; it should get back on the right track in the second half of the year, though it will not quickly hit the ECB's target. With no inflation acceleration, and with prospects of price rises, long rates can still be influenced by ECB action a while longer. The evolution of long rates is now increasingly contained within a narrow valuation band of less than 50 basis points below zero for the Euro Bund Future issued by the German Government with an average maturity of almost 10 years. Long rates have risen slightly over the year as a whole, and are trading at their highest levels, though still slightly below zero.

We believe that it is not essential for inflation to head back above +2% in order for it to prop up a rise in long-term interest rates in Euros.

Interest Rates - Inflation

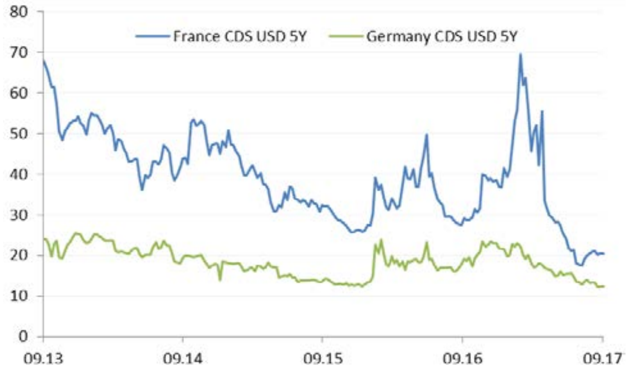


Sources: Bloomberg, BBGI Group SA

The Eurozone no longer inspires fear

Relatively speaking, and in light of forecasts, we believe that the Eurozone's economic, political, and financial situation shows clearer improvement than that of the United States. Growth rates for the two economies are neck and neck, suggesting that the Eurozone is doing a better job of catching up. More surprisingly still, European companies are now more profitable than US companies when calculated as a percentage of GDP. Politcal and economic risks in the Eurozone have beaten a considerable retreat, as is also shown by CDS (Credit Default Swap) levels for the Eurozone, which have dropped considerably since the start of the year. This is very important in supporting the single currency.

CDS Premia - Europe



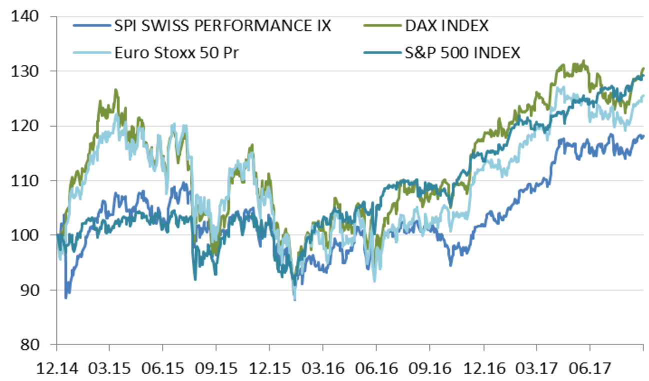
Sources: Bloomberg, BBGI Group SA

Growing interest in European equities

Having been abandoned due to political risks in 2016, European equities have since enjoyed a revaluation phase as announced in first half of the year. After having suggested in May that a consolidation phase seemed increasingly probable, we now believe that Eurozone equities could outperform US equities at the end of the year. They had easily surpassed the performance of US equities, but then saw some profit-taking with the rise in the Euro, despite rather robust company results. At 15x profits, the valuation of European equities was no longer as attractive, though not excessive. Profit growth consensus is now much more optimistic, and rightly so, we believe, given that the improvement in the Eurozone's economic situation is increasingly clear. The recovery of growth and company profitability are key factors, to which are added other favourable factors, including the fall in major political and systemic uncertainty, and improved conditions in the banking sector, among others.

These factors have in fact made European assets more attractive, drawing back in foreign investors (increase in purchases by non-residents at the start of the year) whose asset purchases have also propped up demand for the Euro. Growth of EPS (Earnings per Share) in the Eurozone is now ever closer to that of US companies, for 2017 (+12.8% vs +11.8%) as well as 2018 (+10.5% vs +11.9%), after having been higher in 2015 (+11.2% vs +0.3%).

European Equities



Sources: Bloomberg, BBGI Group SA

In theory, this could be grounds for a similar valuation of these two large markets, but the impact of the exchange rate is undoubtedly another factor to consider; in 2017, it is perhaps once again working in favour of international US equities, the profits of which could be boosted by a favourable currency effect. In the current US political context, of greater importance are hopes for a revamp of the tax conditions applicable to US companies, as promised by Donald Trump. This hope is undoubtedly contributing to the strength of demand for equities, which is propping up the relative performance of US stocks.

BearBull Group
Gate Village 3, Level 1
Dubai International Financial Centre
PO. Box. 127676, Dubai
United Arab Emirates
T +971 4 4019160
F +971 4 4019992
M info@bearbull.ae

www.bearbull.ae