Economic Research

WEEKLY ANALYSIS

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The Eurozone economy is gaining power and asserting itself

Eurozone growth is stepping up. The Euro has stabilised temporarily. A rise in long-term rates is on the cards for 2018. European assets will outperform in 2018.

Key points

- The ECB seems particularly optimistic and is sticking to its monetary policy
- Growth forecasts have increased to +2.3% (2018)
- Inflation will remain modest in 2018 (+1.4%)
- No immediate risks of a rise in rates
- There are grounds for the rise in the Euro, but it should now be limited for a time
- European growth is picking up the pace but will still be behind the United States
- Leading indicators are even more optimistic
- Strongest growth in employment for ten years
- Almost euphoric climate of confidence
- Growth in long-term rates still temporarily hampered by monetary policy
- However, a rise in long-term rates is on the cards for 2018
- 30% discount on European stocks
- 100% more yield

The ECB seems particularly optimistic and is sticking to its monetary policy

The ECB sent out a particularly optimistic message during its latest press conference on Thursday 14th December. In particular, it considerably increased its Eurozone growth forecasts for 2017, and even more so for the next two years. The ECB is now predicting +2.4% growth for 2017, +2.3% in 2018, and +1.9% in 2019.

After having long been cautious as to the quality of the Eurozone economic recovery, there seemed to be a clear change of tone just a few weeks before 2017 draws to a close. Indeed, Mario Draghi spoke of substantial progress in growth forecasts.

Our growth forecasts, both for the Eurozone and the Euro, were certainly amongst the most optimistic at the start of 2017. However, today we note with some satisfaction that this forecasting trend is gaining strength.

The ECB was therefore happy to underscore that Eurozone growth was robust and showed very clear signs of picking up the pace. However, prospects of an inflation recovery remained much more tentative and were not revised upwards to any considerable degree. Inflation forecasts for 2017 remain unchanged (+1.5%) and those for 2018 (+1.4%), and 2019 (+1.5%) have hardly risen. This pushes back the moment when inflation will hit its +2% target to beyond 2020.

As such, unsurprisingly, Mario Draghi announced that key rates policy would not change for now. As we had also expected, he confirmed that asset purchases would continue as announced until September 2018, and beyond then if necessary. The bank is confident in the success of its policy to revitalise growth and bolster the upward trajectory of inflation. Nonetheless, it will still undoubtedly be essential to keep a substantial degree of monetary accommodation given the lack of any real inflationary pressure.

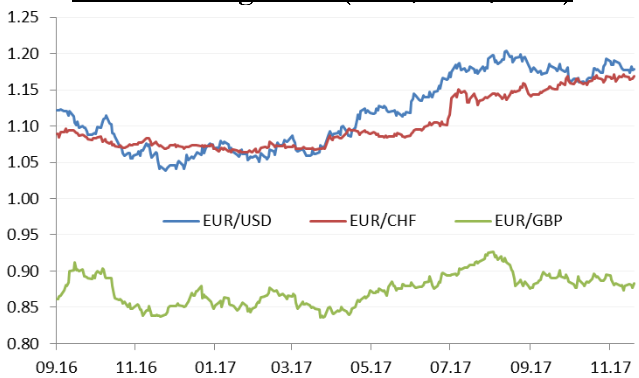
The Euro's recent rise against the US dollar could, however, be considered a source of uncertainty, and the reason for keeping in place quantitative policy with enough room for manoeuvre to exploit the programme's flexibility, retain the ability to take action, and let the interest rate differential grow with the ongoing normalisation process for US rates. It very much makes sense for the Euro to strengthen as the economy accelerates, but the ECB will remain prudent in not allowing this rise to endanger the quality of the current economy recovery. As such, in 2018, the ECB will very cautiously announce any potential tweaks to its programme, the breadth of which is still the only real question mark. We believe that it is likely that the programme will be reduced from 60 to 40, or even 30 billion Euros per month as of January 2018, due to "purchasable" financial assets drying up.

In this context, we still do not predict a rise in key rates for the next few quarters. It is only predicted that this will happen several months after the asset purchase programme is stopped.

There are grounds for the rise in the Euro but it should now be limited

The rise in the Euro may already be an issue for the ECB, which might start worrying about its undesired effects on inflation prospects and European industry's competitiveness.

Euro Exchange Rate (USD, CHF, GBP)



Sources: Bloomberg, BBGI Group SA

The changes in the Euro/US dollar exchange rate has been one of the major trends in 2017. The approximately +15% growth in the Euro was certainly partly down to the weakness of the dollar, but it is first and foremost thanks to the, for many surprising, improvement in economic conditions in the Eurozone, making the single currency more attractive again. As such, the Euro has appreciated against many currencies, particularly against the Swiss franc.

From the change in SNB monetary policy in 2015 onwards, we had forecast that the introduction of negative interest rates would in the long term lead to a gradual loss of interest in the Swiss franc, which could once again push the exchange rate towards 1.20. We are now getting ever closer. Despite the good results expected for the European economy in 2018, we believe that the phase of revaluation of the Euro is now strong enough to justify some profit-taking.

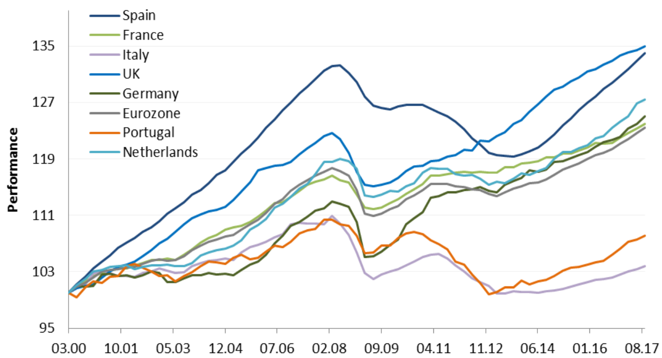
We believe that the rise in the Euro should become less intense at the start of 2018, particularly against the Swiss franc and the US dollar.

However, after a period of stabilisation, it is likely that the undeniable improvement in Eurozone economic fundamentals and the prospect of an about-turn in monetary policy will rekindle investors' interest in the single currency.

European growth is picking up the pace but will still remain behind the United States

Our forecasts at the start of the year that the European trend would improve in 2017 are still being confirmed at the end of the year. Aggregated Eurozone GDP now stands at +2.6% in November, and our 2018 forecasts predict still sustained growth of +2.5%. The two main European economies will surpass the +2% threshold (France +2.2%, Germany +2.4%), but the contributions of other economies which are seeing a strong recovery will boost growth considerably. Spain will certainly experience robust growth in 2018, in line with the higher than +3% growth that will undoubtedly be posted for 2017.

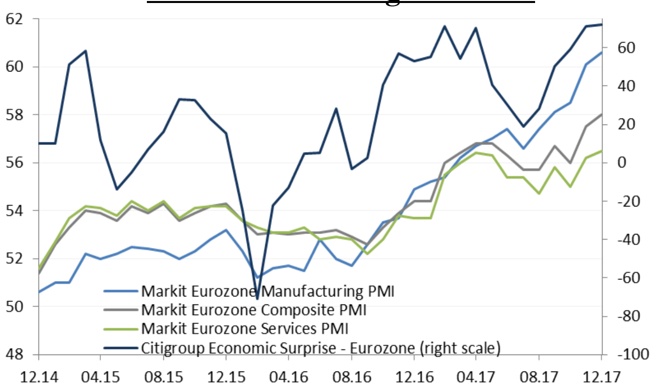
European GDP Growth



Sources: Bloomberg, BBGI Group SA

We were expecting a stronger second half of 2017, which seems to be being confirmed, and is still supported by leading indicators' higher levels. PMI indices for December confirm the still strong recovery of activity in Europe.

Eurozone – Leading Indicators



Sources: Bloomberg, BBGI Group SA

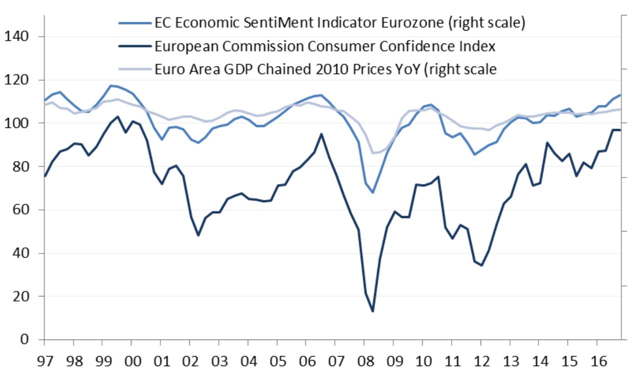
Composite PMI improved further in December (58), and is now at its highest level since 2011; similar movements have been seen on leading manufacturing indicators (60.6), underscoring the recovery of an industrial trend which should continue at the start of 2018. Services PMI is following the same trend, growing a little more to 56.2.

GDP is therefore showing a new phase of sustained growth, which should continue at the start of 2018

Almost euphoric climate of confidence

The European Commission's indicator for household confidence grew slightly again, hitting its highest levels for the last ten years. Sentiment has improved quite significantly, and the improvement is still buoyed up by job market conditions. Indeed, we have seen the greatest growth in employment since 2008, after long having seen negative growth until 2014. As such, this is the 4th consecutive year of employment growth. This has considerably reduced the overall unemployment rate from 12% in 2013 to less than 9% today. Beyond this, it is one of the main factors propping up consumer confidence, which is also at its highest point for ten years.

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 point since 2008. The consumer and business confidence survey is also showing renewed optimism, with it posting its highest levels since the start of the financial crisis. In most countries we are seeing a welcome return of increasingly assured optimism, which should then prop up consumption and GDP growth.

A rise in long-term rates is on the cards for 2018

For now, the rise in long-term rates is still entirely hampered by the ECB maintaining the status quo in terms of monetary policy.

The position set out by Mario Draghi of continuing the bond purchasing strategy until September 2018, and perhaps beyond that, is extinguishing even the vaguest hopes of long rates changing in step with the changes in fundamental and macroeconomic data.

Equally, as changes in inflation are not showing any clear signs of a surge, the need to change interest rates is not overwhelming. Indeed, for a few months inflation has stabilised at around +1.5%, after a clear recovery from 0% to 2% between June 2016 and February 2017. The rise in the Euro has undoubtedly been key in this recent development, as it was in stabilising energy prices before their latest increase from US $42 to US $58.

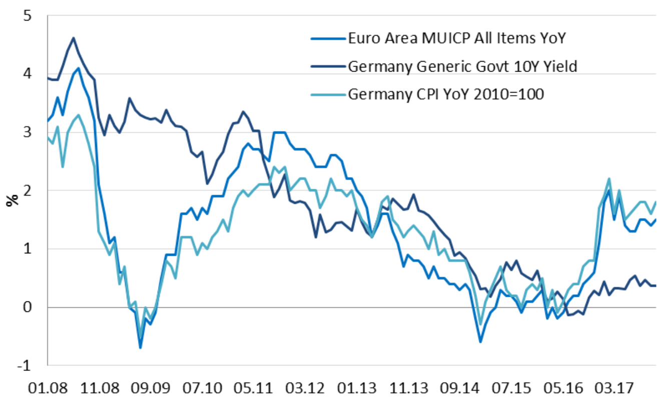
It is certainly too early to see a clear inflation recovery linked to the jobs market, which is still too far from is friction point for wage rises to lead to an increase in prices. The ECB's 2% inflation target will certainly be difficult to hit, even if the central bank continues with its expansionary monetary policy in 2018, and particularly if the Euro stays strong in the long term.

Salary costs are developing slowly, and despite the considerable fall in the Eurozone unemployment rate, it is still high in absolute terms.

Unless inflation picks up the pace and there are prospects of price rises, long rates will still be able to be influenced by ECB action.

Developments on long rates are now increasingly constrained to a narrow valuation band of less than 20 basis points for German government 10-year rates. They will close the year close to 0.3%.

Interest Rates - Inflation



Sources: Bloomberg, BBGI Group SA

We do not believe that bringing inflation back above +2% is essential in supporting a rise in long term interest rates in Euro.

European rates should certainly enjoy an upward trend, sparked by US monetary policy normalisation and a recovery of long rates in the United States. The

long rate differential seems increasingly less-well founded, given the way in which the European economy is catching up.

Although the first quarter should still be shaped by some stability on long rates, we believe that it is likely that we will then finally see a stark change in investors' perception of risk. We recommend not to wait before considerably reducing the bond risk in Euro.

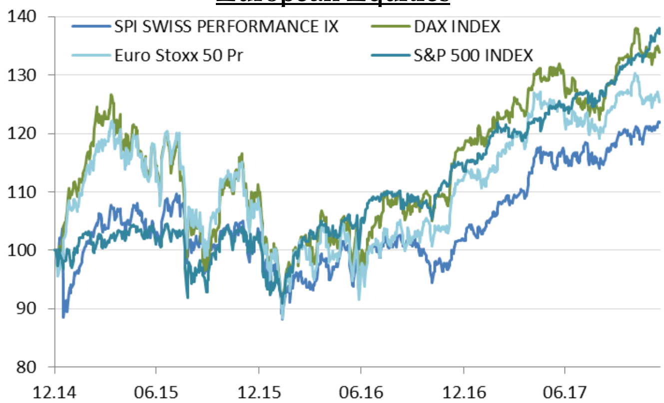
European equities have the advantage

The revaluation phase is not yet over for European equities. Abandoned due to political risks in 2016, European equities have enjoyed a period of revaluation, although this has not meant that they have outperformed US stocks in local currencies. The latter had been boosted by prospects of fiscal reform and by the trend on digital stocks, particularly in the 3rd quarter. However, the valuation of European equities is not particularly high when compared historically. Indeed, it is significantly lower than that of US equities. At 14x 2018 profits, the current valuation of European stocks offers a discount of 4 valuation points as compared to US equities (P/E 18x 2018).

We do not believe the 30% higher valuation of US equities as compared to European equities to be justified given the macroeconomic context for 2018, which is also favourable for European equities. In terms of dividend yield, European equities also seem much more attractive, offering 4.3% yield, which is twice the yield of US equities (2%). Profit growth consensus is now much more optimistic, and rightly so, we believe, as the improvement in the Eurozone's economic situation is increasingly tangible.

The recovery in growth and company profitability are key factors, which are then further helped by other favourable factors, such as a decline in major political and systemic uncertainty, and the improvement in banking sector conditions. These factors are making European equities more attractive; foreign investors should soon return, benefiting European equities. Profit growth per equity in the Eurozone is now increasingly close to that of US companies for 2018 (+10.5% versus +11.9%).

European Equities



Sources: Bloomberg, BBGI Group SA

We believe that the difference in valuation is far from justified. The current approximately 30% discount on European equities should at least halve in 2018.

As such, European equities should considerably outperform US equities in 2018 in local currencies.

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