



Is Europe's GDP growth rate of +0.4% sustainable?

Consumption picking up (+0.5%). PMIs still on the fence. Long-term rates at historical low. Euro relatively stable. High risk premiums on European equities (27%).

Key points

- European growth stronger than expected so far this year
- GDP up +0.4% (+1.2% yoy)
- Household consumption up +0.5%
- Leading indicators may have turned a corner and seem to be improving
- Manufacturing still struggling
- Industrial output down -0.5% in April
- Slight improvement in confidence
- Euro relatively stable
- Complicated transition at the ECB
- Avoid another recession at all costs
- Euro yields continue to fall
- Ten-year rates at historical low (-0.26%)
- High risk premiums on European equities (27%)
- Faster growth is necessary for European share outperformance

European growth stronger than expected so far this year

Euro area GDP surprised on the upside with +0.4% growth in Q1 and +1.2% yoy. Nevertheless, this positive surprise does not denote a clear trend reversal, as the annualised growth rate was the same in March as in December (+1.2%).

All the same, it is a positive and rather reassuring sign, as the threat of recession in Germany was generating high levels of uncertainty with regard to economic momentum in Europe overall.

Thankfully, GDP growth thus accelerated in the Eurozone at the beginning of the year, somewhat contrary to expectations. Household consumption turned out to be much more resilient despite a challenging domestic and international environment, contributing to a large extent to the euro area's strong economic performance with an increase of +0.5% over the quarter (+1.1% yoy). Exports also rose by +0.6%, while public spending inched up a mere +0.1%.

GDP growth for the European Union (+0.5%) was slightly better than for the Eurozone (+0.4%) due to the strong performance of countries such as Poland (+1.5%), Hungary (+1.5%), and Romania (+1.3%).

In the euro area, while all countries posted positive results, the upturn in Germany (+0.4%) was key in terms of the region's overall performance. Among the Eurozone's heavyweights, growth in France and Belgium was somewhat slower (+0.3%), while in Italy it was barely positive (+0.1%). Spain (+0.7%) and the Netherlands (+0.5%) pulled the overall average up.

Growth thus thankfully strengthened at the beginning of the year, warding off the threat of recession.

In spite of these encouraging quarterly results, the German economy, which for a long time had been the driver of European growth, must contend with falling global industrial demand.

Leading indicators may have turned a corner and seem to be improving

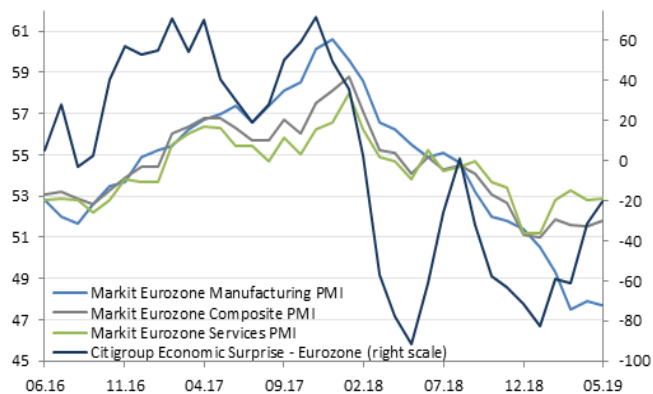
The leading indicator for the manufacturing sector ticked up very slightly over the past two months and is slightly higher in May (47.7) than it was in March (47.5). The stabilisation of this index is a first positive sign following

fifteen months of steady deterioration. Nevertheless, uncertainty persists given that the indicator stabilised below the growth threshold of 50.

The services PMI index performed better: following a slightly less lengthy period of decline (12 months), it rallied significantly in May (52.9) from its low in January (51.2).

The composite PMI has thus also improved since the beginning of the year, rising from 51 to 51.8 between January and May.

Eurozone – Leading indicators



Sources: Bloomberg, BearBull

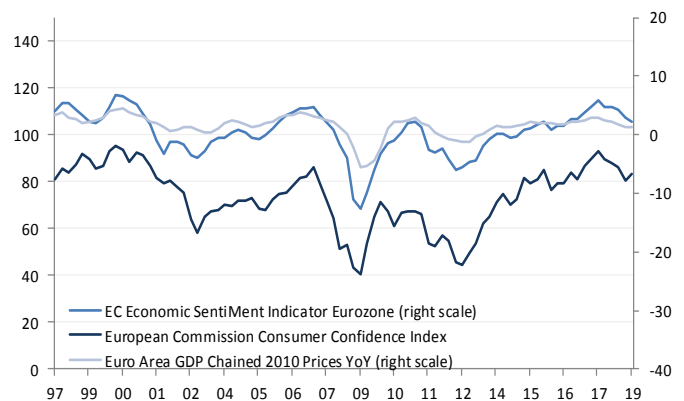
Manufacturing still struggling

Industrial output in the euro area slid a further -0.5% in April for the second month in a row (-0.3% in March), dragged down mainly by declining production in Germany. The performance of the manufacturing sector in France, Spain, and Ireland managed to partially offset the German decline. Moreover, economic conditions in the German industrial sector do not seem to be improving. Indeed, in April industrial output experienced its sharpest contraction in four years (-1.9%). This sector is thus causing no small amount of concern, driving the ECB to announce measures to stimulate growth, emphasising the risk that the downturn in manufacturing could spread to other sectors.

Slight improvement in confidence

Job market trends continued to improve in April and May. Unemployment in the Eurozone (7.6%) continued to decrease, dropping to levels last seen at the end of 2008, namely a 35% drop in unemployment from the high of 12% reached in 2013. Q1's strong economic performance was achieved in parallel with a rise in household confidence, which reached in May its highest level since the beginning of the year.

Eurozone GDP, economic sentiment and consumer confidence



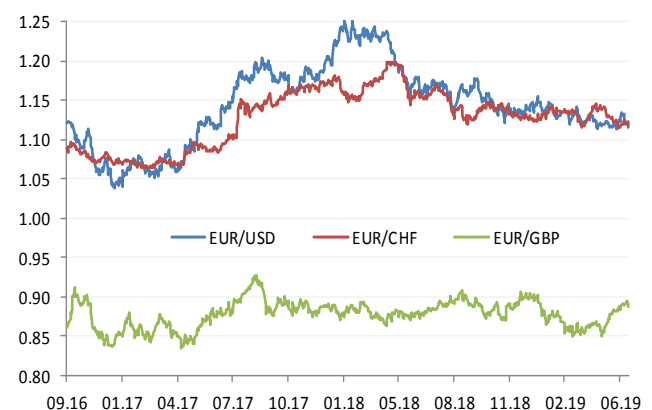
Sources: Bloomberg, BearBull

The European Commission Economic Sentiment indicator ticked up for the first time in May after declining for sixteen months. At this stage, it is of course too early to speak of a trend reversal, but most other sentiment indicators paint a similar picture.

Euro relatively stable

The economic upturn has not led to a revaluation of the euro over the past few months. The euro/USD exchange rate decreased slightly but remained relatively stable, fluctuating between 1.13 and 1.11 over the period. Indeed, the interest rate spread between the euro and the US dollar along with diverging economic results did not result in any significant movement. The current exchange rate of 1.13 USD to the euro likely already factors in the known risks of a slowdown in the Eurozone. The current stabilisation could lead to appreciation of the euro in 2019, if the growth outlook normalises, which seems difficult to predict for sure today in spite of several more positive signs in Q2. Otherwise, the euro is likely to weaken against the dollar given that there will be stronger downward pressure on long-term euro rates, while US dollar long-term rates are likely to stabilise.

Euro exchange rate (USD, CHF, GBP)



Sources: Bloomberg, BearBull

Complicated transition at the ECB

The ECB is looking for a new president. The Bank has not yet appointed a successor to Mario Draghi, and the candidate who will soon take over his responsibilities will not be inheriting a risk-free situation five months from now. Indeed, the economic context is less favourable than Draghi had hoped for with regard to handing over the reins. The contenders for the top job are trying to convey a reassuring message of working to prevent an economic slowdown. For instance, there is increasing mention of another rate cut, which could be accompanied by mitigating measures to soften the impact on banks.

The ECB had already changed its perception of economic conditions in Europe in light of the manufacturing downturn and the poor performance of the German economy. The growth forecast had been lowered to only +1.1%, and given the risk of a slowdown, the ECB had announced that it would delay an initial interest rate hike to 2020 and resume loans to the banking sector.

The ECB thus kept its rates steady and stated that they would remain unchanged at least through the first half of 2020, thus further delaying by six months the timeline mentioned during its previous meeting. More is now known about the programme to lend money to banks, which will launch in September for seven months. The chosen method aims to apply lower rates to banks who circulate a larger amount of credit out into the economy. The ECB also aimed to be reassuring with regard to its ongoing asset purchase programme, noting that it would reinvest for as long as necessary the maturing principal of the billions of euros in securities purchased since 2015.

Avoid another recession at all costs

Similarly to other central banks, the ECB noted the increasing risks of a global slowdown in 2019, while it had been hoping already to have reached its aim of sustainably boosting economic growth. The Bank, in turn, was about to normalise its monetary policy, but it must now remain focused and active to prevent the economy from going off the rails. Governments as well have witnessed the side effects of economic crisis on jobs, confidence, lending, the banking sector, and politics over the past ten years. It was difficult to come up with solutions to the last crisis and so challenging to implement them that it has become almost inconceivable for current governments to risk another crisis. Another recession would have political and economic consequences that no central bank would underestimate. Thus, we expect that the ECB will also undertake everything in its power to avoid one. The

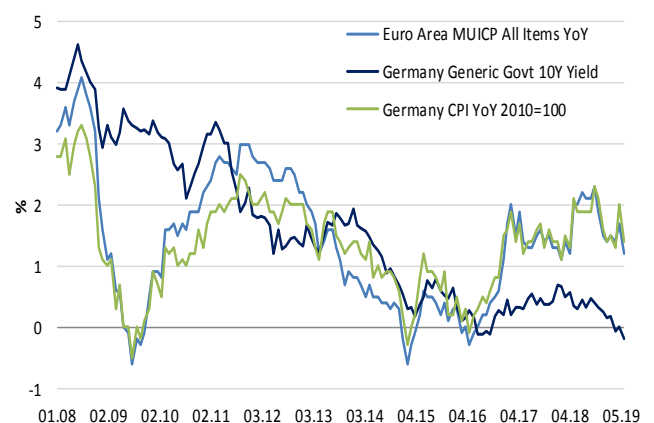
normalisation of monetary policy projected to be implemented in 2019 has already been called into question, and rates will thus likely stay low for longer than expected and remain lower than the growth rate. Governments will likely be tempted to adopt expansionary fiscal policies in the event of a downturn. Nevertheless, the decline in yields over the past weeks seems excessive given the current macroeconomic context.

Euro yields continue to fall

The escalation of tensions between China and the US in May once again depressed bond yields. The drop in ten-year government yields in euros had already wiped out positive returns at the end of March in an environment that was already considered challenging for the European economy. The decline in yields from 0% to -0.26% in May thus indicates a stronger resurgence of anxiety among investors than in 2016, when long-term rates had reached a low of -0.2%.

Inflation has indeed slipped from a high of +2.2% in October 2018 to only +1.2% in May. In comparison, in 2016 when rates had reached record lows, inflation in the Eurozone was negative (-0.3%), and the fear of deflation seemed more present than it is currently. Real yields are thus unambiguously negative at -1.26%, against only -0.1% in 2016. Excluding food and energy, core CPI stood at +0.8% in May.

Interest rates - inflation



Sources: Bloomberg, BearBull

Uncertainty in the euro area has pushed yields to extreme levels, even considering the unlikelihood of a rate change by the ECB.

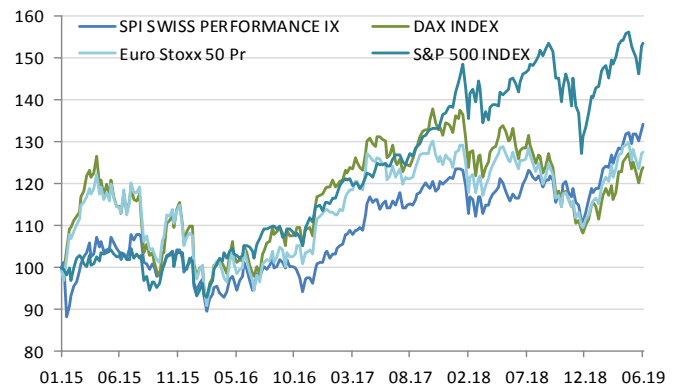
Given the macroeconomic context, the ECB's messaging can hardly be expected to be upbeat, but the Bank cannot convey pessimism either at the risk of having to explicitly announce swift rate cuts. In this environment, financial markets are pushing long-term rates ever lower and

squeezing the risk premium on various maturities along the yield curve. The yield spread between two-year and ten-year German Bund bonds has contracted down to only 40 basis points. We are thus seeing a flattening of the euro yield curve that is nothing short of extraordinary, with negative absolute and real yields on all maturities.

High risk premiums on European equities

The performance of European equities since the beginning of the year has been less impressive than that of the US or Swiss markets. The +11.9% increase is respectable, but below that of the S&P500 (+16.8%) and the SPI (+16.7%). Although the correlation of the European market remained high, the risk premium of close to 25% based on relative valuation levels has not really budged in spite of significant upward and downward shifts in various indices. Several months ago we noted that European equities would likely benefit at the beginning of 2019 from an expected decrease in global tensions and thus from favourable arbitrage on the part of investors due to their positive risk premium. However, this did not occur. The European market's PE (13.6x) remains well below that of the US market (17.3x). The valuation gap remained steady at around 27%, a relatively significant risk premium that does not seem to have shifted over the past several quarters. European shares still maintain a valuation and yield advantage (3.6% vs. 1.9%), while the earnings outlook for 2019 is converging with that of the US market. This valuation gap may be explained for now by the perception that European shares are more sensitive to external shocks such as a slowdown in China or in emerging markets. Investors are thus perhaps more convinced for now by the capacity of US vs. European businesses to weather such shocks. Improved economic conditions may thus represent to key to European equity outperformance.

European equities



Sources: Bloomberg, BearBull

BearBull Global Investments Group (Ltd) is regulated by the Dubai Financial Services Authority (DFSA) and offers the following services to UAE and International clients:

- Multi-Family Office
- Institutional Wealth Advisory
- Private Wealth Advisory
- Real Estate Investment Advisory
- Corporate Finance Advisory
- Financing Solutions

Disclaimer: This document and any attachments thereto are confidential and intended solely for the use of the addressee(s) and should not be transmitted to any person(s) other than the original addressee(s) without the prior written consent of BearBull Group. This document and any attachments thereto are provided for information purposes only and are not an offer or solicitation for any purchase, sale or subscription. BearBull Group shall not be liable for any decision taken based on the information disclosed herein and no advice, including any relating to financial services, is given herein by BearBull Group. This document and any attachments thereto are based on public information. Under no circumstances can this report be used or considered as a commitment by its authors. BearBull Group makes every effort to use reliable, comprehensive information and BearBull Group makes no representation that it is totally accurate or complete. In addition, the views, opinions and all other information provided herein are subject to change without notice. Prices and margins are indicative only and are subject to change at any time without notice depending on inter alia market conditions. Past performances and simulations are not representative of any future results. The opinion, views and forecasts expressed in this document and any attachments thereto reflect the personal views of the author(s) except for any specific mention, and do not reflect the views of any other person or that of BearBull Group. We do recommend that you seek professional advice before making any investments decision.

COPYRIGHT © BearBull Group Ltd (DIFC), 2019.
All Rights Reserved

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