BBGI GROUP Global Investments

Economic Research

WEEKLY ANALYSIS

Alain Freymond – Partner - CIO

26th March 2018

New opportunities for Eurozone equities

Sustained growth in the Eurozone. Insufficient inflation. Risks of a strong Euro. Rise in long rates. Opportunities for Eurozone equities. Low PE and high yield.

Key Points

- The end of quantitative easing heralds upcoming key rate normalisation
- The ECB will wait until inflation heads above 2% before changing its interest rates
- The risks of a strong euro are rising and affecting the economic situation and inflation
- For the time being, Eurozone growth is keeping up a sustained pace (+0.7% forecast in the 1st quarter)
- GDP growth for 2018 estimated at +2.4%
- Confidence remains high and is propping up the trend that is currently taking shape
- Long rates are on the rise
- New opportunities for Eurozone equities after the market correction
- Attractive valuations at just 13.3x 2018 profits (16.6x in the United States)
- Attractive 3.5% yield (1.99% the United States)
- European assets out-perform

The end of quantitative easing heralds upcoming key rate normalisation

The ECB is showing increasingly self-assured confidence in the quality of the current economic recovery in the Eurozone. It is stating that the strength of growth could constitute a surprise over the coming months, and could even surpass forecasts. Indeed, everything seems to be looking up in the Eurozone; growth is able to post a faster pace thanks to good household spending, a more dynamic labour market, and rising exports, despite the euro's appreciation.

The ECB has increased its growth forecasts to +2.4% for 2018.

Economic indicators are suggesting that these positive trends will continue, backing up the ECB in its positive evaluation of 2018 and 2019 forecasts.

Confidence is definitely part of the ECB chief's analysis. However, he is keen to avoid giving too many hints to financial markets that a tightening up of monetary policy is on the cards.

As such, he is tempering the enthusiasm of those who would like to think that a reversal of monetary policy is imminent, pointing out that the adjustments made will be "predictable" and will be applied at a "moderate pace". There will therefore soon be a change in monetary policy, but undoubtedly not before inflation becomes much stronger. ECB monetary policy will continue to be "patient, persistent and prudent" in the words of its chief. The ECB's Governing Council has decided to change its stance, removing the reference to an "increase in QE if necessary" from its policy statement, whilst still keeping the option of extending the programme. Although the spectre of deflation seems to have been defeated, the inflation recovery remains too weak in past comparison to justify a move to raise key rates. However, it is more than enough to hope that quantitative easing will no longer have to be increased. The ECB is eager to underscore the importance of inflation as an element of its asset purchase programme. However, this should come to an end in 2018, as inflation is well on its way to its +2% target, although the rate of its growth could be momentarily disappointing. The difficulty lies in choosing the right moment to stop net bond purchases.

The US president's latest policy decisions regarding international trade also contain fresh risks for global growth and price growth, which is added to the risk that the recent strength of the euro poses; these are two key factors that will need to be taken into account over the coming months. The ECB chief clearly seems concerned by the emergence of new protectionist risks, and sufficiently irritated by Donald Trump's position to want to remind him that trade tensions would not necessarily be beneficial for the US dollar.

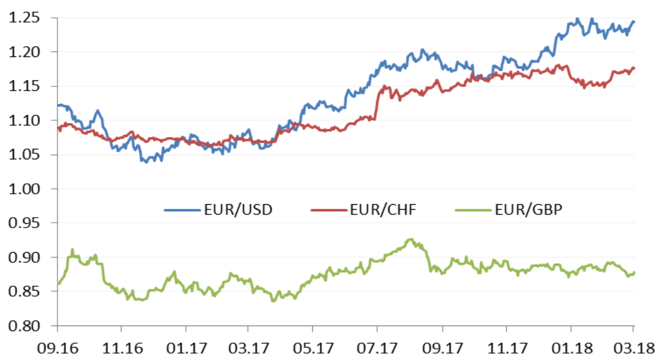
Consequently, we do not believe that the ECB will be particularly proactive in terms of wanting to hike key rates in the current context. We will certainly still need a few quarters of growth and improvement in employment for the ECB to risk changing its rates. Inflation will need to be "resilient" for the bank to feel comfortable enough to clearly change its stance without risking affecting the economic trend and financial conditions.

The ECB is sticking to its chosen monetary policy path, leaving its rates unchanged, whilst very slightly dropping its 2019 inflation forecasts from 1.5% to 1.4%.

The risk of a strong euro is rising

The ECB is not mistaken- the recent rise in the euro against the US dollar could represent a threat to the expected development of inflation over the coming months. The +15% rise in the single currency against the US dollar in 2017 has, in fact, continued in 2018, with nearly a further +3%. The overall rise of around +20% in barely a year does indeed constitute a risk for inflation prospects, as well as for the future development of the European economy.

Euro Exchange Rate (USD, CHF, GBP)



Sources: Bloomberg, BBGI Group SA

The euro's appreciation was the logical consequence of the relatively unexpected period of economic acceleration in 2017. However, in the current climate, the euro's strength is problematic for the ECB and could endanger the quality of the current recovery as well as the competitiveness of European industry.

The ECB will have to wait for weakness in the euro and an inflation recovery before increasing its key rates. This combination could take time to come about, which is why key rates have not been changed.

As regards the euro/CHF exchange rate, we can see that the strategy we implemented immediately after the SNB's change in policy is still proving effective. The euro rose nearly +10% against the Swiss franc in 2017, meaning that it has bounced back nearly +20% over the past three years. The exchange rate has nearly recovered to the level it was at on 14th January 2015 (1.20). A few months ago, we highlighted that the bounce back in the euro seemed to us to be broadly reflecting the improvement in fundamentals and heading into a new phase of relatively horizontal consolidation, which would be conducive to some profit-taking.

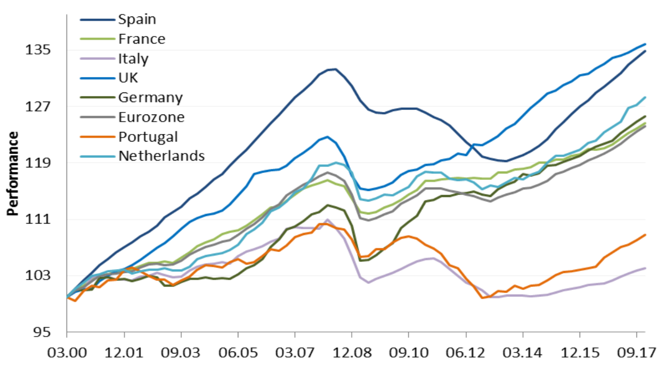
Today, after two quarters of stabilisation, we now believe that it is highly likely we will see the single currency head towards and beyond the 1.20 level. The euro should soon lose some ground against the US dollar, but become more attractive as compared to the Swiss franc.

For the time being, Eurozone growth is keeping up a sustained pace

Our forecasts of the European trend improving in 2017 were proven accurate, with the +2.7% rise in aggregate Eurozone GDP in the 4th quarter. In the end, the Eurozone posted higher growth than the US economy (+2.5%) due to a slight dip in activity in the United States. Growth forecasts for the current quarter stand at +0.6%, and +2.5% for 2018, which is slightly better than ECB forecasts. 2018 could still benefit from the improvement in the trend and a rise in demand, particularly for German products, caused by the global recovery. German GDP could hit +2.6% of growth and the OECD estimates that European GDP could grow +2.2%. In France, there have been surprises on the jobs market, in company investment, and in export developments, which should be in line with the +0.7% GDP growth seen in the 4th quarter 2017.

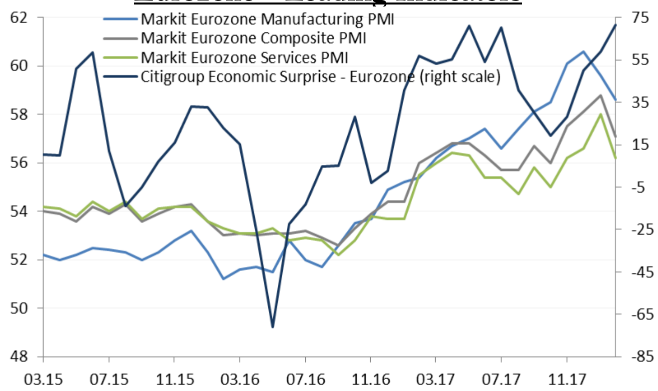
However, caution is still required in the current context of a strong euro and a rather stark slide in leading indicators. PMI indicators have done nothing but give ground since their peaks in December, giving a glimpse of a dip in activity in the 1st quarter 2018 too. The Markit Services Index slid from 58 (January) to 55 in March, confirming the trend first seen on the manufacturing index, which dropped from 60.6 in December to 56.6 in March.

European GDP Growth



Sources: Bloomberg, BBGI Group SA

Eurozone – Leading Indicators



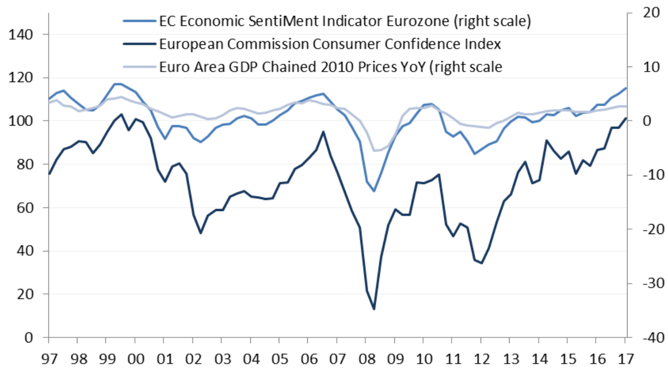
Sources: Bloomberg, BBGI Group SA

The start of 2018 should therefore be favourable, and confirm our positive growth forecasts for European GDP. Nonetheless, the risks posed by the rise in the euro are not trivial and could in the end weigh heavily on the forecast trend.

Confidence remains high

Brexit negotiations still do not seem to be affecting Eurozone confidence. The European Commission's economic confidence indicator has faltered slightly, but has remained close to its ten-year high. Sentiment has improved to quite a considerable degree, and this improvement is still being bolstered by the positive developments in job market conditions. Indeed, we have seen the strongest jobs growth since 2008, after having long seen negative growth until 2014. We have now seen the 4th consecutive year of growth in employment, which has led to a fall in the overall unemployment rate to 12% in 2013, and 8.6% today.

Eurozone GDP, Economic Confidence and Consumer Confidence



Sources: Bloomberg, BBGI Group SA

It is one of the factors propping up consumer confidence, which is also at a ten-year high. In most countries, we are seeing renewed optimism, which is very welcome, and should in turn prop up spending and GDP growth.

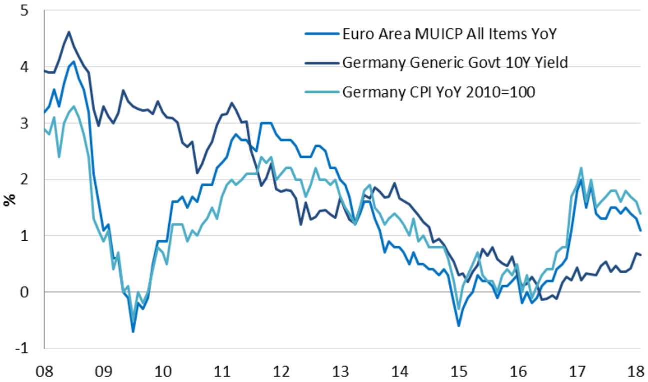
Long rates are on the rise

For the time being, the rise in long rates is still being held back by two essential factors- inflation and monetary policy. The ECB's decision not to change its monetary policy and to continue with its bond purchase strategy has put a dampener on any adjustments that should otherwise have taken place in the current context of robust economic growth. The second factor- inflation- is also preventing a rise in long rates due to its recent weakness. This is key, as in the absence of inflation, the need to adjust interest rates is far from pressing. Indeed, inflation has been gradually tailing off since its peak in the 1st quarter 2017 (2%), and now only stands at 1.1% year on year. The euro's weakness against the US dollar will certainly be the main factor enabling new, more robust inflationary forecasts, and a rise in long rates thereafter. It is certainly too early yet to see a clear inflation recovery linked to the jobs market; it is still too far from its friction point for wage rises to contribute to an increase in prices. The ECB's aim of bringing inflation up to 2% will certainly be difficult to achieve, even if the central bank continues with is expansionary monetary policy in 2018, and particularly if the euro remains stronger in the longer term. Salary costs are proving slow to budge and, despite its significant drop, the Eurozone unemployment rate remains high in absolute terms. However, inflation should gradually rise back towards 1.7% by the end of the year.

Nevertheless, Eurozone long rates should not be able to cut loose from the upward trend sparked by US policy normalisation and the recovery on long rates in the United States. The long rate differential seems to us to be less and less well founded given how well the European economy's growth rate has caught up.

After a 1st quarter still shaped by somewhat stable long rates, we believe that it is now likely that we will finally see a clear change in investors' perception of risk. We recommend considerably reducing the bond risk in euros without delay.

Interest Rates - Inflation



Sources: Bloomberg, BBGI Group SA

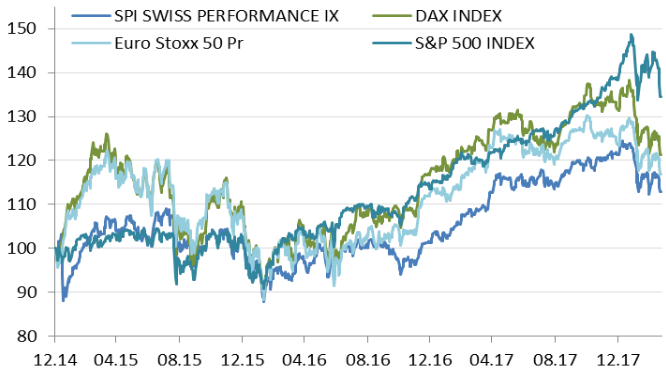
New opportunities for European equities

The correction to financial markets, starting in January 2018, was similar for Eurozone and US equities in the end. Fears linked mainly to the inflation recovery and faster rate rises in the United States plunged all equity markets into a general price correction of around -10%. European indices had a year's worth of growth wiped out, and are now at similar levels to the start of 2017. The price correction was not particularly intense, but it came at a point when the revaluation of European equities was far from over.

As such, the valuation of European equities has improved quite considerably over the past few weeks, both in past and international comparison. It is even significantly lower than the valuation of American assets. At just 13.2x 2018 profits, the valuation of European assets represents a 3.4 valuation point discount compared to US equities (PE 16.6x 2018). We do not believe the approximately 25% valuation differential between US and European assets to be justified in the current context, which is also favourable for European assets. In terms of dividend yield, European assets also seem much more attractive, offering 3.5% yield. This is nearly twice the yield of US assets (2%).

The recovery in growth and company profitability are key elements, which are then bolstered by other favourable factors, such as, inter alia, the fall in great political and systemic uncertainty, and the improvement in banking sector conditions. These factors make European assets more attractive; they should benefit from investors returning.

European Equities



Sources: Bloomberg, BBGI Group SA

We believe that there are really no grounds for the valuation differential. European equities should considerably outperform US equities in 2018 in local currencies.

BBGI Group SA
Rue Sigismond Thalberg no 2
1201 Geneva -Switzerland
T: +41225959611 F: +41225959612
info@bbgi.ch - www.bbgi.ch