2nd July 2018

The European economy is holding its course despite uncertainty

GDP is expected to recover. Inflation hits 2% target. The Euro is weakening. Nothing to report from the ECB until 2019. Long rate rise held hostage. 25% "discount" on European equities.

Key Points

- Euro Summit in June rings hollow
- Compromise on the migratory crises
- Brexit negotiations flounder
- The migrant crisis eclipses Eurozone reform
- The EU will not give in to Donald Trump's threats
- ECB- nothing to report until 2019?
- No change in key rates until September 2019
- The Euro should weaken against the US dollar and appreciate against the Swiss franc
- Growth will likely recover after a small, temporary dip in GDP
- Uncertainty has yet to make a dent in confidence
- Long rate rise still held hostage
- The risk of a trade war is weighing heavily on equity markets
- European equities are benefiting from a 25% "discount" in their valuation

Euro Summit in June rings hollow

The Euro Summit on the 28th and 29th June was set to be both critical and decisive. In the end, they found a way to hammer out a compromise on approaching the migratory crisis from a new angle. Italy is satisfied; they will no longer deal with the crisis single-handedly. Solidarity has won the day.

The European Union finally seems to have found a compromise on the difficult issue of the migratory crisis at the latest Eurozone Summit. The agreement is brittle, and above all hazy as regards implementation, but European cooperation has won out, and there will now be greater solidarity with receiving countries. The welcome centres that are being built on European soil could eventually give way to landing "platforms" and control centres outside of the European Union.

As regards Brexit, hopes have dwindled even further as the negotiations with the United Kingdom are stumbling and floundering due to the lack of clear position on the part of Theresa May's government. Nine months from the deadline, there is still no credible proposal. On a different front, a few days before the Summit at the end of June, France and Germany had reached an agreement to float the idea of a European budget, but had to bow to the fact that the migrant crisis had monopolised the debate. European leaders put off substantive discussions on the topic, by postponing Eurozone reform, whilst accepting the idea of finalising the banking union and putting in place a crisis budget. Luckily, Europe showed more solidarity and engagement in setting out their position for the current negotiations with the United States on tariff barriers.

The EU will not give in to Trump's threats

The trade war started by Donald Trump could spread; it now also includes a 20% increase in customs duties on European vehicle imports. Europe seems to have no intention of giving in to threats, and is showing a united front in the face of an American attack that it considers unacceptable. The European Union seems prepared to introduce retaliatory measures which could amount to several hundred billion US dollars' worth of American products if the United States go ahead with their threat to tax car imports. This type of escalation in trade tensions is not desirable, and as Mario Draghi stated, the risks hanging over the European economy due to these threats could affect the current trend. The ECB chief clearly seems concerned by the emergence of new protectionist threats, and seems sufficiently irritated by Donald Trump's stance to remind him that trade tensions would not necessarily be beneficial for the US dollar. Nor is it certain that the US economy would immediately come out of this wave of protectionism Donald Trump has set in motion swinging.

European leaders did agree on proposals to change the WTO (World Trade Organization). The aim is to ease tensions by making certain changes, particularly to the dispute settlement process.

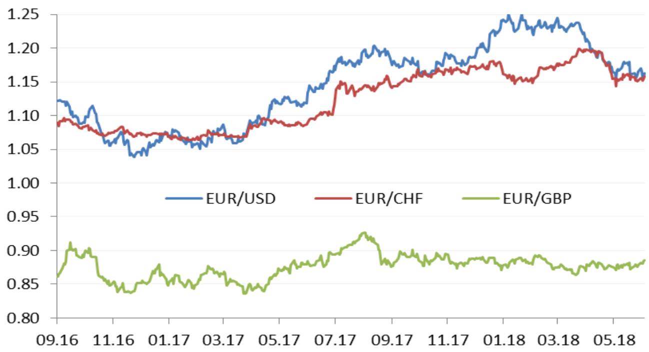
ECB: nothing to report until 2019?

At its latest meeting, the ECB announced that providing there are no unexpected shocks, it will stop quantitative easing at the end of 2018. It also underscored that the Governing Council now planned to maintain its key rates until summer 2019, at the earliest. Now that the end of QE has been announced, it could put an end to the calm that seemed to be reigning on rate markets. The end of ECB bond purchases does not currently seem to be considered a likely and imminent risk by investors, who for the time being seem to be more preoccupied with the economic downturn in the 1st quarter and risks of a trade war. However, we believe that once this decision is taken more seriously, it could significantly change long rates, as was the case in May 2015 when German rates leapt from 0.05% to 1.05% in just six weeks. As regards key rates, the ECB will not be particularly proactive in wanting to act before the last quarter 2019. A few more quarters of growth and improvement in employment are needed before the ECB will risk taking any action. Inflation should be "robust", enabling the bank to clearly change its position without risking affecting the economic trend and financial conditions. The ECB should certainly wait for the Euro to weaken and inflation to recover before raising its key rates.

The Euro should weaken against the US dollar and appreciate against the Swiss franc

The single currency remains almost surprisingly highly sought after in a context which is rather uncertain. Indeed, the Euro is still not feeling the effects of the threats of a trade war that the US president is holding over the European Union, of the slight economic slowdown at the start of the year, or the political migrant crisis which once again threatened Eurozone cohesion. Nothing currently seems able to shake the Euro, but its appreciation since the start of 2017 is nonetheless threating the Eurozone's trade development prospects and inflation forecasts. At its current level, the strength of the Euro is certainly problematic for the ECB and is endangering the quality of the recovery and the competitiveness of European industry. We can see that to date, our euro/CHF exchange rate strategy, put in place folllowing the SNB's policy change, is still proving effective.

Euro Exchange Rate (USD, CHF, GBP)



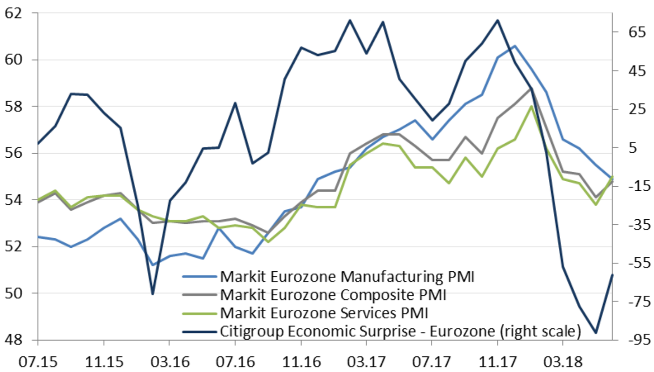
Sources: Bloomberg, BBGI Group SA

The exchange rate has almost recovered to where it was on 14th January 2015 (1.20). However, a few months ago we had pointed out that the bounce back in the Euro already seemed to broadly reflect the improvement in fundamentals, and that a new phase of relatively horizontal consolidation should get underway, sparking some profit taking. Today, after two quarters of stabilisation, we believe that the chance of the single currency hitting 1.20CHF and surpassing it is once again higher, particularly given the upcoming end of ECB bond purchases and rises in long rates, which will make themselves felt in the second half of the year.

Growth will likely recover after a slight, temporary dip in GDP

The European economy improved as expected in the 4th quarter 2017 (+2.7%), and in the end posted a better result than the US economy (+2.5%) due to a slight drop in activity in the United States. However, unfortunately this bright spell could not continue, and the European economy took its turn treading water at the start of the year. Growth forecasts for the 1st quarter 2018 (+0.6%) were not achieved, with growth probably having been held back by the strength of the Euro. As such, GDP only grew +0.4%, or +2.5% year on year. A few months ago, we stated that caution was the watchword for economic forecasting for the Eurozone, in a context in which leading indicators were clearly weakening. Our forecasts of temporary weakness in Eurozone activity proved accurate, but they have now once again given way to appreciation, which will be slightly more favourable in the current quarter and over the coming months. PMI indices seem to be picking themselves up after their decline over the past few months, suggesting a recovery in activity. The Markit services index is posting an encouraging recovery, having bounced back from 53.8 to 55 in June, but it remains well below its recent high in January (58). The manufacturing index has stuck to its downward trend (54.9) and remains a source of concern.

Eurozone – Leading Indicators



Sources: Bloomberg, BBGI Group SA

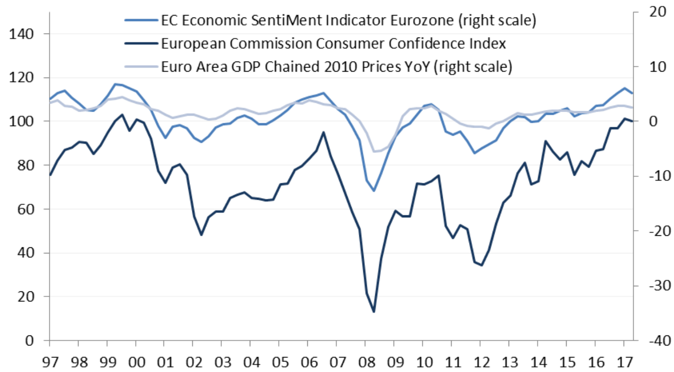
We are maintaining our positive European GDP growth forecasts, but the risks caused by the rise in the Euro are not insignificant and could hold back forecasts of the economy picking up the pace in the end.

Uncertainty has yet to make a dent in confidence

On the institutional front, Brexit does not seem to be having any major impact on economic confidence. The migrant crisis, and particularly the difficulty in finding a response to Italy's resolute requests for support, do not seem to be making a difference either. President Trump's statements and comments raised fears that a second front in the trade war he is waging against the whole world would be opened in the Eurozone, likely having an increasing effect on investor and household sentiment. The European Commission's indicator of economic confidence had already dipped in the 1st quarter, but has now slid a little further, driven by the "economic prospects" component, which is dropping faster than the consumer confidence indicator.

Data regarding the business climate and industrial confidence have also dipped slightly, but like consumer confidence indices, they are still close to their ten-year high. Whilst not disguising this slight downturn in global confidence, at the start of the 3rd quarter the evaluation of the situation remains rather positive. Sentiment has improved overall and is still propped up by the favourable developments in employment market conditions. Indeed, we are seeing ongoing improvement in employment and the unemployment rate. The latter fell to 8.4% in May, and has further dropped away from the peak seen in summer 2013 (12.1%).

Eurozone GDP, Economic Confidence, and Consumer Confidence



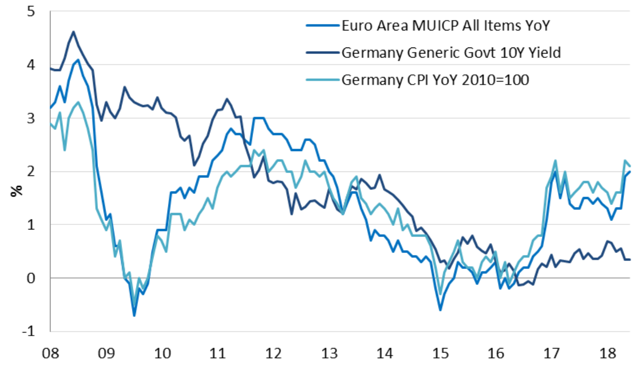
Sources: Bloomberg, BBGI Group SA

Long rate rise still held hostage

The rise in long rates is still held hostage by the evaluation of how inflationary risks and ECB monetary policy are developing. As regards the central bank's position, its decision to pursue its bond purchase strategy, even at a lesser pace, is still slowing the adjustments that investors should normally make in the current context of +2.5% GDP growth year on year. Higher yield should certainly be demanded in the current economic situation due to the gradual inflation recovery. However, upward pressures on long rates are still very modest, particularly as the rise in inflation is not caused by wage rises, but by crude oil prices. The result is an unwanted real-terms wage contraction. Despite everything, we are seeing a relative surprise in June, with the CPI index increasing to +2% in a year, bringing it up to the same level as in February 2017, and rekindling forecasts of price increases. Although we have just started to see this, for the time being these forecasts mainly depend on external factors, such as the rise in crude oil prices. Inflation excluding food and energy remains contained and relatively stable at +1%, approximately the average of the past few years. It is likely that for the time being the ECB will not give any more thought to this figure, which says nothing of any importance about the potential tensions forming in the economy other than those caused by the rise in crude oil and the Euro. As such, it is not urgent to take action and adjust expected yield on ten-year state bonds in order to incorporate the fact that the CPI has hit the ECB's target.

We still need to wait for a trend reversal that works against the Euro/US dollar, as well as tensions on the job market in order for inflationary forecasts to be pushed upwards and subsequently foreshadow a rise in long rates. Despite unemployment dropping to 8.4%, it is still too early to predict a clear inflation recovery sparked by wage rises.

Interest Rates - Inflation



Sources: Bloomberg, BBGI Group SA

In this context, Eurozone long rates should not be able to carry on completely disconnected from the recovery in long rates in the US for much longer. We believe that the grounds for the yield differential are increasingly flimsy, given how the European economy has caught up with US growth.

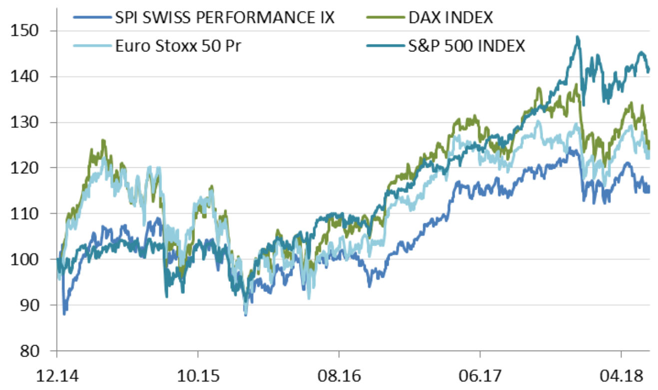
After a first half of the year still shaped by stability, we should now see a change in investors' risk perception. We recommend further reducing the bond risk in Euros without delay.

The risk of a trade war is weighing heavily on European equity markets

The valuation of European equities has improved considerably over the past few months, both compared to historical measures and when compared internationally. At just 13.6x 2018 profits, the valuation of European equities is currently offering a 3.4 valuation point "discount" compared to US equities (PE17x 2018 profits).

We do not believe there to be any good reason for the roughly 25% difference in valuation between US and European equities. European equities also seem much more attractive in terms of dividend yield, offering 3.6%. This is nearly twice that offered by US equities (1.9%). European equities have kept their valuation advantage. They should see investors return, but for now they are being punished, undoubtedly excessively so, by the uncertainty sparked by the US President's threats of a trade war.

European Equities



Sources: Bloomberg, BBGI Group SA

We believe that the valuation differential is entirely unjustified. As such, European equities should considerably outperform US assets in local currencies in 2018.

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