BBGI GROUP Global Investments

Economic Research

WEEKLY ANALYSIS

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4 October 2018

Trade tensions weighing on European GDP

Slowdown in growth. Ambiguous leading indicators. End of quantitative easing. Paradigm shift with regard to long-term rates. Attractive European equity risk premium.

Key points

- Slower GDP growth in Q2 (+0.4%), +2.1% yoy
- GDP growth hampered by decline in foreign trade
- Trade surplus down 45% in July
- Leading indicators losing momentum
- German economy is resilient, but risks are rising
- Trump is the main cause of uncertainty
- Confidence put to the test
- Euro remains stable
- ECB remains confident but postpones rate hike
- Quantitative easing to end on 1 January 2019
- Pressure expected on long-term rates
- Why are European equities underperforming US shares?
- 25% Eurozone equity risk premium

GDP growth hampered by decline in foreign trade

European GDP was further impacted in Q2 by various factors that curbed the exceptional momentum seen in 2017. Indeed, in Q4 2017 the European economy was for a short time performing better (+2.7%) that the US economy (+2.5%). However, since the beginning of the year, quarterly growth has stabilised at +0.4%, or +2.1% yoy, which is rather disappointing and well below US performance. The main contributors to GDP growth are still household consumption, corporate investment, public spending and inventory changes. Capital investment was the largest contributor in Q2 (+0.3%) with an increase of +1.2%. The other three contributed +0.1% each.

In contrast, foreign trade penalised GDP growth, as exports (+0.6%) grew less than imports (+1.1%). The strength of the euro was likely a key factor in the deterioration of the balance of trade that took place over the past few months. In July, the trade surplus declined to 12.8 billion euros, posting a drop of -45% compared to the end of December (22.7 billion).

Nevertheless, it is conceivable that, despite the rising trade tensions between the EU and the US over the summer, the -10% correction of the euro from 1.24 to 1.14 against the dollar may have a positive impact on European exports going forward. However, in the short term it would seem that uncertainty continues to prevail, negatively affecting foreign demand. German growth remains a key component in terms of the positive performance of the European economy overall. Indeed, with a growth rate of +0.5%, the Eurozone's leading economy posted better results than any of the other 19 member states. The relatively poor performances of France (+0.2%), Italy (+0.2%), and Ireland (-0.6%) weighed on the Eurozone's overall results. Their lacklustre contributions could not be offset by the positive performances of smaller, more dynamic countries such as Luxembourg (+2%), Malta (+1.9%), Estonia (+1.4%) or Slovakia (+1.1%). Several months ago, we noted that caution was advised with regard to economic forecasts for the Eurozone, given the significant deterioration of leading indicators and the emergence of new political risks. Over the past few months, the European economy has had to contend with intensifying trade tensions with the US, the indirect effects of the Turkish crisis, as well as the Italian issue, which continues to be a concern.

Leading indicators losing momentum

While leading indicators fortunately remain positive, they have continued to decline. They are thus providing no indication of a potential economic upturn or pick-up in the pace of growth. Indeed, the Markit composite PMI fell again in September, from 54.5 to 54.1, thus indicating a decelerating trend, confirmed by the new orders component, which also slid from 54.3 to 53.9. The outlook is somewhat more positive for services, whose leading indicator ticked up from 54.4 to 54.7. The economic performance of the Eurozone as a whole is closely tied to that of Germany. The steady fall in the German manufacturing PMI, which dropped sharply from 63.3 in December 2017 to 53.7, is thus concerning.

Eurozone – Leading indicators

Sources: Bloomberg, BBGI Group SA

This negative trend is occurring in the context of increasing trade tensions, contracting industrial production, and decreasing orders. The trend is similar in the Netherlands and in Spain. The growth outlook for the Eurozone is thus significantly more uncertain today.

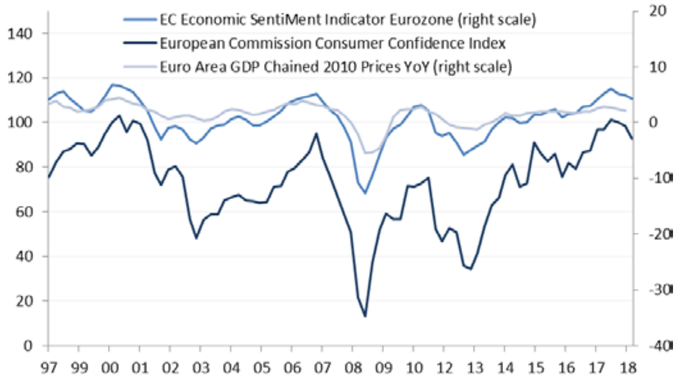
Trump is the main cause of uncertainty

Brexit is no longer a major source of concern for the Eurozone, having been overtaken by worries stemming from the Italian crisis and more particularly by the rising tensions between Washington and Brussels regarding the trade deficit, which is now clearly the main issue impacting the business climate and consumer sentiment. And yet, the president of the European Commission had made concessions to Trump in an attempt to deescalate the trade war instigated by the US president. The EU had thus agreed to import more American soy and liquefied natural gas and to reduce customs duties on certain imported products. However, these measures did not completely mitigate the risk of new tariffs on imports of European vehicles. Europe wants to avoid new tensions at all costs and is even willing to revisit the issue of US beef import quotas, settled over 30 years ago. The pressure exerted by Trump is considerable. Uncertainty thus persists, in spite of the concessions made, due to Trump's relentless insistence on considering the German trade surplus as almost on par with China's, leading to fears of further coercive measures.

Confidence put to the test

The European Commission's indicator measuring economic sentiment declined for the ninth consecutive month. Both households and manufacturers seem more and more concerned with regard to the trade dispute between the major economic powers. The decline in the industrial sentiment index was steepest in Germany and France, whose auto industries would likely bear the brunt of a trade war. Ultimately we have to look to the service sector to find any improvement in leading indicators, as consumer confidence also stalled, even though the unemployment rate continued to decrease. The emerging markets crisis and the situation in Turkey also weighed on overall sentiment. Indeed, Europe is likely more directly affected by a deterioration in emerging market fundamentals due to more significant economic ties.

Eurozone GDP, economic sentiment and consumer confidence



Sources: Bloomberg, BBGI Group SA

Euro remains stable

In the short term, the euro has been negatively impacted by the Italian crisis. However, it is mostly the increase in the interest rate spread against the US dollar and diverging economic performances that are weighing on the currency. Given the ECB was worried about the strength of the euro in the first part of the year, it must now be reassured by its recent weakness.

Euro exchange rates (USD, CHF, GBP)

Sources: Bloomberg, BBGI Group SA

The euro will likely continue to stabilise against the dollar, while appreciating against the franc and once again approaching the CHF 1.20 level. The long-term interest rate spread should, in our view, increase at the beginning of 2019 in favour of the euro.

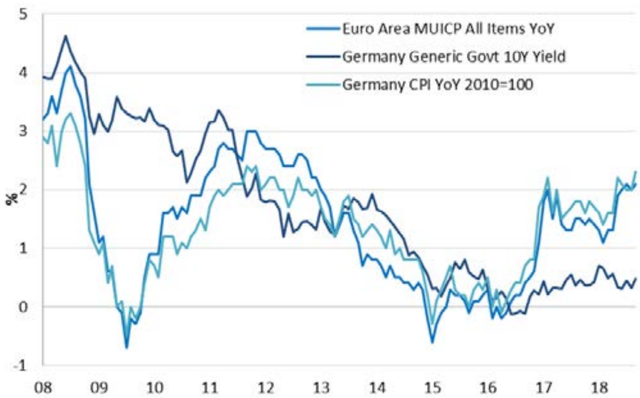
ECB remains confident but postpones rate hike

At its last meeting, the ECB announced that it was revising its GDP growth outlook for 2018. The revision is minor, as the forecast decreased from +2.1% to +2%, or just 0.1% less growth than initially projected. The bank justified its decision based on the risks of a decrease in foreign demand, while noting that the risks affecting growth prospects could still be deemed balanced overall. Moreover, the bank also confirmed that the risks tied to protectionism and the vulnerability of emerging markets have become more significant. At its September meeting, the ECB thus unsurprisingly kept its key rates unchanged at -0.4% on its deposit facility (banks' excess reserves) and 0.25% on its marginal lending facility, while confirming that it would likely not be raising its rates before summer 2019. However, the current economic slowdown could delay the next rate hike further, particularly if the global economy also experiences slower growth in the second half of 2019. As for quantitative easing, the current pace of 30 billion euros per month will be reduced to 15 billion per month until December, and then to 0 as of 2019. The ECB will then undertake, for a prolonged period of time, to reinvest the debt maturing after the termination of net purchases, in order to maintain favourable liquidity conditions and provide a high level of monetary support for as long as necessary. We expect that the ECB will not risk normalising its key rates before Q4 2019. A few more quarters of stronger economic growth and improvements in the job market are necessary before the ECB will take action. Moreover, inflation will have to be resilient in order to reassure the bank that modifying its position will not adversely affect economic growth and financial conditions. In addition, the ECB will likely wait for the euro to weaken and inflation to accelerate before raising its rates.

Pressure expected on long-term rates

The ECB is pointing to vigorous inflation in the Eurozone. President Draghi seems convinced that the job market will show increasing signs of upward pressure on wages, which will lead to an increase in underlying inflation over the next few months. It is indeed true that trends are positive and that wages have increased somewhat faster in Q2 (+2.2%). Unemployment has reached a 10-year low (8.3%), while the employment rate (67%) is at an all-time high. Inflation reached +2.1% in September, which seems to confirm the ECB president's view, although its core component slowed down to +0.9% over the same period. We think this latest development somewhat contradicts the ECB's assessment and could contribute to delaying the next rate hike to year-end 2019. This development also affects the perception of long-term rates' normal levels, which is tied to inflationary expectations, the growth rate, and the ECB's quantitative policy. The change announced by the ECB will alter supply and demand dynamics going foward.

Interest rates - inflation



Sources: Bloomberg, BBGI Group SA

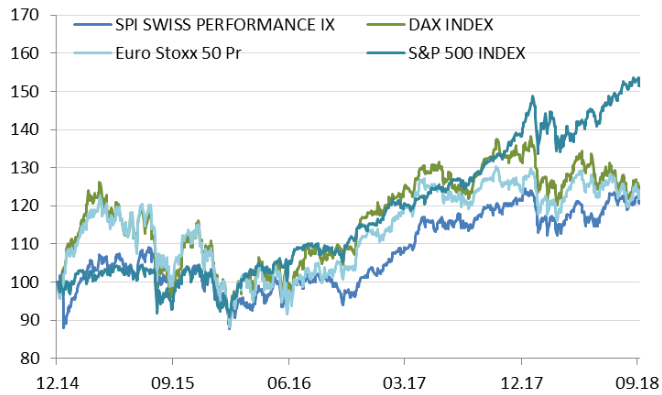
ECB asset purchases had been absorbing almost all net new issuance of sovereign bonds in the Eurozone; the termination of these purchases will boost yields. Given the favourable economic context, the fall in demand will undoubtedly result in an increase in long-term rates at the beginning of 2019. The 10-year German Bund yield has exceeded 0.55% and will thus now react more sharply to any inflation news. After a long phase of consolidation around 0.5% for 10 year terms, German government bond yields will likely tighten once again and rise back up to 0.75%-1% at the beginning of 2019. The Italian crisis remains a factor, likely temporary, that could hamper or interrupt this trend. The depreciation of the euro against the dollar is also an important variable with regard to evaluating the appreciation potential of long-term rates. We now think that this factor is no longer an impediment to the logical adjustment of the yield curve in the Eurozone. Even though the ECB's decision is not a surprise, we believe that its true impact will only be felt over the next several months. Only then will investors fully take into account the risk of price corrections. We recommend not waiting to further reduce exposure to euro bond risk.

Why are European equities underperforming US shares?

The valuation of European equities has remained persistently lower than that of US equities, without resulting in arbitrage or share price revaluations. Still today, the European market's overall PE (13.8x 2018 earnings) remains very attractive compared to the US's (18x 2018 earnings). This 25% valuation differential is considerable, and we are thus trying to determine how much longer the US market may benefit from this premium, having posted an outperformance of around +17% to date in 2018. European shares retain a valuation and yield (3.6% against 1.9%) advantage; while investors should thus be returning, Euro shares also present several drawbacks. US corporate earnings growth is benefiting from supportive fiscal policies, whose impact is being felt mainly in 2018, and which doubled growth prospects (+23%) compared with 2017 (+12%). Eurozone earnings growth had been higher in 2017 (+15%) without resulting in net arbitrage. The growth differential is clear in 2018 (Eurozone growth below +10%) but should even out in 2019 and 2020, as forecasts for both markets are similar (+10%). This factor likely worked in favour of US equities. The prospects for emerging markets and the latter's sometimes chaotic stock market performance have been stronger sources of uncertainty and risk in Europe.

Indeed, the relative exposure of US and European shares to this risk indicates that European firms are more invested and exposed than their American counterparts. Overall, Eurozone firms could be more affected by a slowing global economic cycle. The risk of contagion from emerging market crises to peripheral Eurozone countries and to the European banking sector as well as the risks related to the Italian crisis are also factors that have weighed on the risk outlook. However, the most crucial factor remains, in our view, the uncertainty related to the US's protectionist threats, which is probably the largest contributor to the widening of the European equity risk premium.

European equities



Sources: Bloomberg, BBGI Group SA

European equities will likely benefit from a decrease in international tensions and from investor arbitrage related to their risk premium.

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