From West to East

Weekly Investment View

7th May, 2017

Positive things could be stirring in Europe

The S&P 500 edged to a new all-time closing high of 2,399.29 last week, up 0.6%, after a few months when it kept investors guessing, initially not following the NASDAQ Composite higher. The NASDAQ also closed at a new all-time high, at 6,100.758, after what has been an excellent period for technology stocks, led by the 'FANGS' (Facebook, Amazon, Netflix and Google - the parent of the latter is Alphabet), whose results have exceeded expectations and confounded critics who have said they are expensive in valuation terms. On the other side of the Atlantic, the STOXX Europe 600 had a very good week, closing 1.9% higher, on the face of it facilitated by Mr Macron's performance in the polls (putting him about 20 percentage points ahead of Ms Le Pen), and underlined by his robust participation in the televised debate between the two of them mid-week. As we write, the French electorate is going to the polls for the second round of their Presidential election, with Macron the firm favourite. In this report we observe that rather than European equity markets simply getting through some political milestones (with more to come, of course), it looks increasingly as though there could be some fundamental (and quite bullish) changes taking place in the minds of global investors as regards this asset sub-class. France's CAC 40 index closed 3.1% higher over the week - at a nine-year high rather than a record; by comparison, Germany's DAX index was 2.2% higher, and at a new all-time closing record. The euro closed just under 1% firmer against the US dollar. Turning to the US, the Federal Reserve meeting passed quietly, with – as very much anticipated – no change in the Fed funds rate, although with a supportive comment to the effect that recent US economic weakness was expected to be 'transitory'. In line with this assumption the US Non-Farm Payrolls for April duly came in above expectations, at 211,000 jobs added (the consensus estimate had been 190,000). **The relevant Bloomberg model is now suggesting just under a 93% probability of a 25 basis point increase in Fed funds at the 14th June FOMC meeting, and although a few other calculations are not as high, the almost full tilt of expectations is clear.**

"Trump still has to get his amended health bill through the Senate – while the UK local elections looked very good for Mrs May"

President Trump managed to get his Administration's amended healthcare bill through the House of Representatives towards the end of the week, although some detail is still lacking and the proposals still have to get through the Senate. Geopolitically it was a relatively quiet week. In the UK, the Conservative Party, led by Theresa May, achieved some excellent results in local government elections, viewed by many as a test of the voters' mood on the ground as a prelude to next month's General Election. The US 10-year Treasury yield closed at 2.3487%, just under seven basis points higher over the week, broadly in line with the tendency to 'risk-on' in other markets, and consistent with economic data and the reassurances received. The German 10-year Bund yield was a notable ten basis points higher, closing the week at 0.429%. Oil prices closed about three dollars lower over the week (to $46.22, basis WTI), as near-term supply bear factors got the better of medium-term demand bull factors. Lastly, consistent with the sum total of the above developments, gold fell $40 (or 3.2%), to $1,228.01/oz. **The dollar was quite resilient, closing 0.4% lower, at 98.648 on its index, and we continue to believe it to be good value.**

"US economic data is leaning towards a better second quarter performance"

Claude-Henri Chavanon

Head of Products & Services
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It was encouraging for the US economy that the level of job creation was seen to recover last month, following the relatively weak performance of March, with the US Non-farm payrolls adding 211,000 jobs in April, vs. expectations of 190,000, and supportive of the Fed's comment mentioned above that the economic weakness seen in first quarter statistics should be short-lived. We argued this in our last report. It should be mentioned that payrolls for March were revised lower, to a gain of 79,000, down from the initially published 98,000. The unemployment rate edged lower, to 4.4%, from 4.5%, whereas analysts had been expecting 4.6%. There is no exact number for 'full employment', although we think 4.4% to be almost exactly or very close to it. The labour participation rate fell slightly, to 62.9%, from 63.0%. Commentators have once again expressed some disappointment with hourly earnings, the year-on-year growth rate of which came in slightly lower than the previous month, at 2.5%, from 2.6% in March. In other US data, the Institute for Supply Management (ISM) said its index of manufacturing activity came in at 54.8 in April, down from 57.2 in March, and below expectations of 56.5, according to Reuters.

The ISM non-manufacturing (services) index rose to 57.5 in April, from 55.2, beating expectations, and demonstrated health in the services sector. For the 12 months to March, Fed's preferred inflation measure, the 'core' PCE price deflator was at 1.6%, down from 1.8% in Feb, with this being the first month-on-month fall since September, 2001. US consumer spending was flat for a second month in March, with personal consumption being unchanged, vs. +0.2% expected, so underlining the weak period of consumer spending. So we can conclude that in recent months increased spending on services has been offset by a reduction in purchases of big-ticket items, especially autos. Elsewhere, the PCE (Personal Consumption Expenditure), the 'core' version of which is the Fed's preferred inflation measure, fell 0.2% month-on-month in line with expectations; the core PCE edged down 0.1% as expected, this being the first fall since late 2001. **Lastly, at a speech given last Monday, Treasury Secretary Mnuchin repeated his view that US GDP growth of 3% is possible during the next two years on the back of the Trump Administration's sweeping tax reforms.**

"In Europe as elsewhere investors are ultimately guided by whether economic news is improving – and it is"

Turning to eurozone economic data, the eurozone grew manufacturing output at the fastest rate since 2011. IHS Markit published their eurozone manufacturing PMI index last week, which rose to 56.7 in April, from 56.2 in March, in line with expectations. They said that companies have benefitted from the historically weak euro, improved export growth in key markets, rising domestic demand and ongoing central bank stimulus with record-low interest rates, and that, "Optimism about the year ahead, meanwhile, appears unaffected by political worries." Their survey covers the eight most important markets, with Greece being the only one in which export orders fell sharply. The overall labour market remains in poor shape, however, prolonging its restraint on growth, with unemployment unchanged at 9.5%. Last week also saw the publication by Eurostat of eurozone economic growth data for the first quarter, showing that it held steady at 0.5%, quarter-on-quarter, despite various political uncertainties, and in line with expectations. There was also some potentially good news on Greece, in that its government agreed a deal with creditors on the reforms required for the country to receive the next disbursement from the €86 billion rescue package. Eurozone members and the IMF had asked for pension cuts and a lower tax-free threshold. **This still leaves the difficult question of debt relief/forgiveness, a degree of which is necessary to make the debt repayments manageable in the face of maintained austerity.**

"There is also a 'Wall of Worry' being climbed in European equities, not just the US"

European stocks have been out-performing in recent months, and we believe this should continue in the absence of any serious political shocks, thinking initially of the results from today's voting in France's Presidential elections. The Asset Allocation Committee remains overweight in European equities (ex-UK), on a currently tactical basis – yet we are aware that deeper fundamental improvements could be getting closer, which if realized could bring about a more lasting and structural improvement in investment view. Starting with the evidence so far from first quarter European earnings announced to date, it looks as though these could on average be about 20% higher, year-on-year. More telling is the trend in estimate revisions for the asset class as a whole for 2017, and into 2018. In recent years these had tended to begin the calendar year at optimistic levels, only to gradually collapse through the rest of the year. However, for the year to date (for both 2017, and 2018 earnings estimates on the index – in this case the STOXX 600) that hasn't yet been the case. If we look beyond the very favourable statistical comparison of estimated earnings for 2017 vs. a very bombed-out 2016 (+61.3%), Bloomberg suggests 2018 earnings should grow at 9.5%, resulting in a prospective P/E ratio of a very reasonable 14.7x. Further growth of 9.0% is assumed for 2019, equating to a P/E of 13.5x. For 2018, the market is trading on a yield of 3.58%, Price/Book of 1.79x, and Price/Sales of 1.25, compared to 2.18%, 2.75x, and 1.89x respectively for the S&P500. The S&P500 P/E is 16.5x for 2018, with earnings slated to grow at 8.4%. We are not suggesting that Europe is heading towards S&P-type valuations overnight, but rather that if European 2018 earnings estimates can continue to improve, stock selection opportunities will become more apparent. Yes, there is Greece, and there are elections due in Germany and Italy, but average earnings improvements in Europe would be off a low historic base. Turning to short-term French politics, Mr Macron is thought to have won the important televised debate convincingly last week, and is more than 20 percentage points ahead of Ms. Le Pen in the polls. Once in power, Macron would have to rapidly unify France. He would also have to gather support from other parties to get a majority in the 11th and 18th June parliamentary elections, when 577 members of the French parliament will be selected. **Certainly polls can be wrong, although it would seem that the likely extent of tactical voting (socialists and centre-Right voting to keep Le Pen out) should indeed keep Le Pen out.**

"Good stock-pickers should be able to do well in European equities"

As far as we can see, the strengthening cashflows into European equities recently seen should continue – and even increase. The broad valuation and estimate revision metrics look supportive, yet without much at all being demanded in the way of earnings growth. Top-line revenue growth (not just from exporters) could accelerate, and fall in a moderately leveraged way to the bottom line. European stocks were subject to outflows for most of last year as investors continually worried about eurozone structural, political and debt issues.

To repeat: we are not saying those issues have gone away. In its 'heart of hearts', the ECB would probably love to definitively taper its QE, but they are aware that to win the game of competitive devaluation, that will almost certainly have to wait. For many, many, years, the growth rate of European corporate profits has been behind those elsewhere, especially the US, hence the lower rating. To complete the 'big picture' we only have to look at the under-performance of European economic growth vs. other developed market regions, set against what have often been market-unfriendly politics. Our European colleagues suspect that some interesting (and profitable) things are changing in this sub-asset class, and that there is growing appetite for European stock ideas. Significantly, it's not just all about taking the export advantage from the low euro. In the markets, the major earnings bounce in the energy sector off the early 2016 bottom has helped, as have some improvements in banks, again from very bombed-out levels. In recent weeks we have noticed how consumer discretionary stocks (including internationally-sold luxury goods) have also driven stock prices. **As economic growth for Europe as a whole moves from 'very low', to 'low', the international aspect of earnings growth should be helped by the more favourable backdrop described by the IMF a few weeks ago. Investors may still be being too cautious on Europe; there will be bumps along the way, although good stock-pickers should do very well.**

"Oil had a bad week – global demand factors should ultimately turn these markets"

In oil markets, bearish factors got the upper hand last week, with the lower boundary of our forecast $45-55 range looking as though it could be tested. There has been a recovery in Libyan output (now up to 760,000 barrels/day), the highest since late 2014, as well as other supply problems reversing in Nigeria and Canada. Meanwhile, US shale production has continued to make small but steady gains. In other news, Saudi Arabia confirmed its intention to increase oil export capacity to 15 million barrels/day (MBD) by sometime in 2018, from 11.5 MBD currently, with the necessary upstream expansion to feed it. In pricing news, it became clear that Saudi Aramco had reduced its crude price quotes into Asia, in an attempt to restore market share recently lost to Iran, Russia (and probably also the US). Commentators who had recently been talking about the necessity for OPEC/NOPEC production restraint being extended beyond the 25th May meeting also began to consider whether this would also be needed going into next year. Having said all this, it is understood that Russia has now fully complied with its agreement to cut production by 300,000 barrels/day, to 11 MBD. Last week was one in which the American Petroleum Institute (API) reported that US crude stocks fell by 4.16 million barrels in the previous week, whereas the Energy Information Administration (EIA) reported a fall of only 930,000 barrels (vs. the consensus estimate for a drawdown of 2.3 million barrels. **Gasoline inventories in the US were also building again, although ahead of the all-important driving season.**

"The Asset Allocation Committee still has a marked 'risk-on' stance"

INVESTMENT SUMMARY: The Asset Allocation Committee met late last week, and decided to leave investment policy unchanged, therefore maintaining its essentially 'risk-on' stance of being overweight in Global Equities, underweight in Fixed Income (via 'Governments'), and underweight in Commodities (non-Precious Metals) and Hedge Funds. However, the Committee did agree to meet early in the week to review the results of the French elections, with a possible view to putting the original full overweight position in European equities back on.

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