NBAD

From West to East
Weekly Investment View
14th May, 2017

The positive tone in equities remains intact

The S&P 500 index continued to move in a narrow range last week, with the index closing 0.29% lower. US equity markets began the week concerned about continued fallout following the sacking of the FBI's chief, and ended it considering the achievement of a US/China trade deal covering specified sectors. The European STOXX 600 index once again did well, in the aftermath of Macron's win in the French presidential election, closing 0.49% higher. The UK's FTSE 100 closed at a new all-time high, up 2.08%, ahead of Theresa May's expected victory in next month's UK general election, and despite soft economic data. In the US, April retail sales grew by 0.4%, slightly below expectations, although there were upwards revisions to prior months, and the headline CPI rose 0.2% (reversing March's fall), with the 'core' CPI coming in below consensus. The Producer Price Index, increased by 0.5%, after falling in March. The US dollar closed 0.6% firmer over the week on its index (at 99.252), in a technical correction to the oversold condition of the previous week. The yield on the 10-year US Treasury bond closed a few basis points lower over the week, at 2.32%. The euro/dollar pair closed 70 pips lower over the week, at $1.0931, as traders continued to weigh up the factors impacting each side, with the current spot equating almost exactly to the (now flat) long-term moving average. Sterling at one stage looked as though it might firm to above $1.30, but was held back by poor data despite a hawkish tone from the Bank of England. **Crude oil prices firmed 3.5% over the week (to $47.84, basis WTI), helped by a larger than expected fall in US crude inventories.**

"Macron is a breath of fresh air; now the really hard work begins"

After his decisive victory in France's Presidential election, Mr Macron is attracting prospective candidates to his new party before the elections to the National Assembly next month, in which he must win a majority, or face having to form a coalition. Although Manuel Valls, interior and prime minister under President Hollande, was turned down upon applying to Mr Macron, Mr Valls was quoted as saying, "This Socialist Party is dead". This will have been music to the ears of global investors into France (and Europe) as they consider whether to increase weightings in European equities. Macron's En Marche! party has been re-named 'Republique en Marche', (Republic on the Move), and is seeking 577 candidates, with no alliances apart from that already concluded with Francois Bayrou's MoDem party. Macron campaigned on a platform of economic reform, despite the underlying mindset of France not being very accepting of it. France's socialist and republican parties will seek to recover, following an election in which neither made it into the second round of the recent elections. In the past the elected President's party has led the National Assembly, but this time the party is being formed after the event. Macron has pledged gender parity and that half of the candidates will not be career politicians, in order to shake things up and provide inspiration. Macron ran as a 'new populist', and 'positively disruptive' candidate, yet he believes in the European Union, wants to keep the euro, and is pro-NATO. He wants domestic reform to make the French economy more efficient, and to shed a malaise that has helped keep French growth low for many years. For instance, Macron wants French business to be able to hire and fire far more easily, and while this is good in theory, in practice he will have the

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trade unions up in arms against him, and possibly provoking industrial strife. So even if Mr Macron succeeds in forming a working majority, he and his party will indeed face some severe opposition. In 1958, after the Fourth Republic collapsed, General De Gaulle came out of retirement to take power with his Union for a New Republic. He had to cut deals with socialists and Christian Democrats, and although he would rather avoid it, Macron may well have to do so also. The socialists have said they would like an alliance with Macron, although he has so far refused, and in any case as he attempts to build the ranks of his government from the bottom-up. **Meanwhile, the Republicans are adamant they can still win an outright majority, and their campaign manager, Francois Baroin, has volunteered his services as PM.**

"Macron has a reasonable economic wind behind him"

Mr Macron intends to maintain sanctions against Russia until it complies with the 2014 Minsk agreement. German Chancellor Merkel has welcomed the election of Mr Macron, whose over-riding job will now be to unify France after an election that in many ways polarized the country. Rather like President Trump, he is having to finalize much of his agenda 'on the hoof'. Although he says he knows he has a huge task ahead of him, he was quoted in Le Depeche along the lines of: "I don't see why they would elect me and then weeks later vote against my project". Of course many votes cast in both rounds were against Marine Le Pen, rather than for Macron. Turning to EU economics, Macron has proposed a common eurozone budget, with infrastructure expenditures financed by Eurobonds. Eurozone fiscal hawks, especially the Germans, are unlikely to agree to a common eurozone budget, not wanting to leave themselves open to paying for the fiscal plans of others. Overall, however, subject to him and his party leading the next government, the Macron era does provide renewed hope for the eurozone project, which itself is in need of reform. The key point is that it is becoming apparent that populism doesn't always win, and that has emboldened international investors. Federal elections must be held in Germany before the 23rd October, while Italy's general elections must be held sometime before the 23rd May next year. It is possible that Italy might see the anti-euro Five Star Movement become the largest party in parliament, with investors hoping for a win by Matteo Renzi. Commentators have identified similarities between Macron and Italy's former Prime Minister, Mr Renzi – both are young, reform-minded, and pro-EU. Renzi recently won re-election as leader of the Democratic Party and at the next general election should be the party's candidate for PM. In economic hurdles still to be overcome, Greece still has to implement just under 100 measures to conclude its current bailout review, prior to a potential debt default in July. Having considered some of the remaining downside political risks above, we nonetheless find ourselves gravitating back to how eurozone growth is gradually being revised upwards, and how this makes it much easier for progress to be made in terms of reforms – potentially leading to beneficial multiplier effects down the road. **The European Commission forecasts that the 19-nation bloc will grow by 1.7% this year, followed by 1.8% in 2018.**

"Investors in Europe can now think a little less about politics"

Especially once France's legislative elections have been held on the 11th and 18th June – and in reality to an extent irrespective of the result – investors will be looking increasingly at corporate results, as we have begun to discuss in recent Weekly reports. Increasing evidence that economic growth has begun to stabilize is at the base of improving corporate results - and future expectations of them. The latest Citi Eurozone Economic Surprises index stands at a very healthy 69.50, the highest for several years. **With first-quarter results now in from about a third of European companies, Morgan Stanley has pointed out that the net 'beat rate' for earnings is better than for about ten years – and that for beating analysts' revenue estimates it's the best in at least 14 years.**

"We see opportunities for stock-pickers in Europe"

In last week's report we mentioned that the Asset Allocation Committee had the previous week added to its overweight position in European (ex-UK) equities, and it could be useful to update some of the statistics we gave at the time. Bloomberg suggests 2018 earnings on the STOXX 600 index should grow at 9.4%, resulting in a prospective P/E ratio of a very reasonable 14.7x. Further growth of 9.1% is assumed for 2019, equating to a P/E of 13.5x. For 2018, the market is trading on a yield of 3.58%, a Price/Book of 1.79x, and a Price/Sales of 1.25x, compared to 2.19%, 2.74x, and 1.88x respectively for the S&P500. The S&P500 P/E is 16.5x for 2018, with earnings slated to grow at 12.0%. As we have said, we are not suggesting that Europe is heading towards S&P-type valuations overnight. If European 2018 (and beyond) earnings estimates can continue to improve, stock selection opportunities will become more apparent. We reiterate our quote in last week's report: "Good stock-pickers should be able to do well in European equities". There has been good earnings recovery in the European Energy sector (which contains dividend yields of just over 5%), followed by Financials and also Basic Materials, and Consumer Discretionary should now do better. If unemployment can come down, even moderately, discretionary sectors should be more underpinned. Demand for European luxury goods is picking up from Asia Pacific. **Also, with just a slightly more constructive economic mood in Europe (and helped by interest rates that we believe should stay quite low), there are likely to be better possibilities for corporate restructuring/'status change' investment opportunities; so the 'value' thesis should work well in European equities.**

"Underlying oil demand is surprising to the upside"

Broadly speaking, the fundamentals of crude oil are continuing to reflect a rebalancing environment, in price terms consistent with a range of $45-60/barrel (basis WTI). Any break below the bottom of that range - should it occur - is in our opinion likely to be short-lived. Market observers now routinely accept the gradual upward march of US shale oil production, and the knowledge that – notwithstanding a price plunge below $40 – continued efficiency improvements in that sector will continue to bring break-even costs lower, more than negating the sharp decline rates inherent. It is also accepted/discounted that OPEC/NOPEC output restraint must be maintained into next year in order for the lower boundary of the trading range to remain intact. Early last week, Saudi Arabia made a 'whatever it takes' statement, while according to Bloomberg, OPEC sources indicated that they are indeed discussing both a nine-month extension of production restraint (into 2018), as well as the possibility of increasing the overall reduction in production. The IEA (International Energy Agency) said last week that the crude market is moving towards a supply deficit, assuming a further OPEC/NOPEC production deal for a further six months. Meanwhile, US crude stockpiles fell for the fifth week in a row, with EIA (US Energy Information Administration) data showing a 5.2 million barrel fall, vs. expectations for a 2 million barrel fall, apparently helped by a decline in crude imports. Also helpful was a reduction in US gasoline inventories, compared to expectations of an increase. Longer term, the IEA, OPEC and others predicate expectations of an oil shortage on the large reductions in 'Big Oil' capex since 2014, few discoveries, and production declines. In the meantime, supply outages are par for the course in the likes of Venezuela and Nigeria. At a conference in London last week, a Goldman Sachs executive was quoted as saying, "With demand continuing to surprise to the upside…the global supply deficit may be as wide as 2 million barrels a day by July". In reality, very few oil industry analysts are able to put together an accurate model of global oil demand and supply, with most of us following published data, as well as factors such as floating storage (which had grown to large inferred tonnages, but which is now being reduced).

We continue to expect that improving global GDP growth boosting crude demand going into 2018 should be instrumental in causing the $60-65/ barrel price level to be tested. We reiterate that in the event of a test of the lower $40s, global oil demand would be stimulated over and above shale oil additions, and therefore self-correcting.

"The ECB is not expected to remove its QE until the results from it are better"

INVESTMENT SUMMARY: Investment policy remains unchanged, with the Asset Allocation Committee meeting later this week. We continue to be bullish of European equities on a tactical basis, following Mr Macron's election win, and despite remaining uncertainties as the elections for the French National Assembly approach next month. We remain bullish of the US dollar, helped also by Mario Draghi's view expressed last week that the ECB won't rush to aggressively tighten its monetary policy. **In relation to the European economy, he said, "The economic recovery has evolved from being fragile and uneven into a firming, broad-based upswing"…"Nevertheless, it is too early to declare success".**

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