European equities: Analysis of macro data, monetary policy and the upcoming political calendar

Analysis Summary

European equities have outperformed their American counterpart since the U.S. election despite investor concerns over rising populism in the Eurozone area. In this analysis, we conclude that while we remain bullish on the asset class, we advise to proceed with caution considering the busy political calendar ahead and the possibility of the European Central Bank attempting to normalize their balance sheet and interest rates.

LINC MACRO STRATEGY

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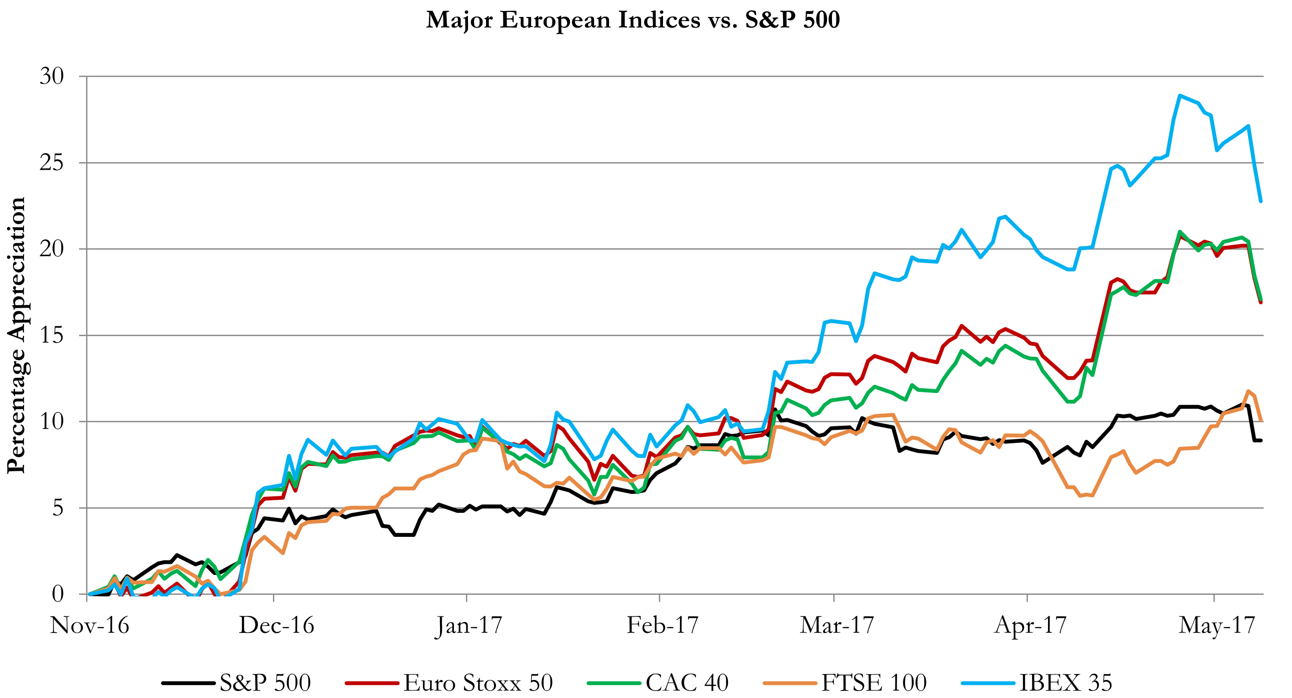

Exhibit 1: Major European indices versus the S&P 500 (percentage appreciation past 6 months)

Introduction

As Donald Trump assumed the role as President of the United States, one of the main themes that followed was the Trump trade, where the expectation of fiscal stimulus in the U.S. caused a major rotation from bonds to stocks, sending U.S equity market valuations to unprecedented levels. More recently however has been the chorus of investors and strategists rooting for European equities. While U.S. equities initially led the rally post-election, investors have now seeked sanctuary from lofty U.S. valuations in Europe (exhibit 10) as the Trump trade starts to mature. The current administration haven't done themselves any favors in this regard either as uncertainty looms over Trump's ability to provide pro-growth fiscal stimulus to the American economy. If that wasn't enough, the recent dismissal of FBI director James Comey and reports that the President shared classified information to Russian officials has only added fuel to the fire. One of the main beneficiaries of this has been European equities, as shown in the recent outperformance in exhibit 1.

This was definitely not the case at the end of last year as political risk in the Eurozone heavily affected investor sentiment. The worry over populist waves crushing the Eurozone has to some extent been exaggerated in our view as centrist candidate Emmanuel Macron emerged victorious from the French Presidential election, Geert Wilders' far right-wing party got trounced in the Dutch election and populism doesn't seem to be "en vogue" in Germany as the Social Democrats and Christian Democrats currently hold 36% and 27% of total votes respectively (Exhibit 8). Despite recent optimism and large inflows into European equity ETF's (34bn EUR YTD), there are some obstacles to climb. This includes a busy political calendar coupled with pressure on the ECB to normalize interest rates and their balance sheet. In this analysis, we attempt to provide a general outlook for the Eurozone economy followed by a look into ECB's monetary policy and some the upcoming political events.

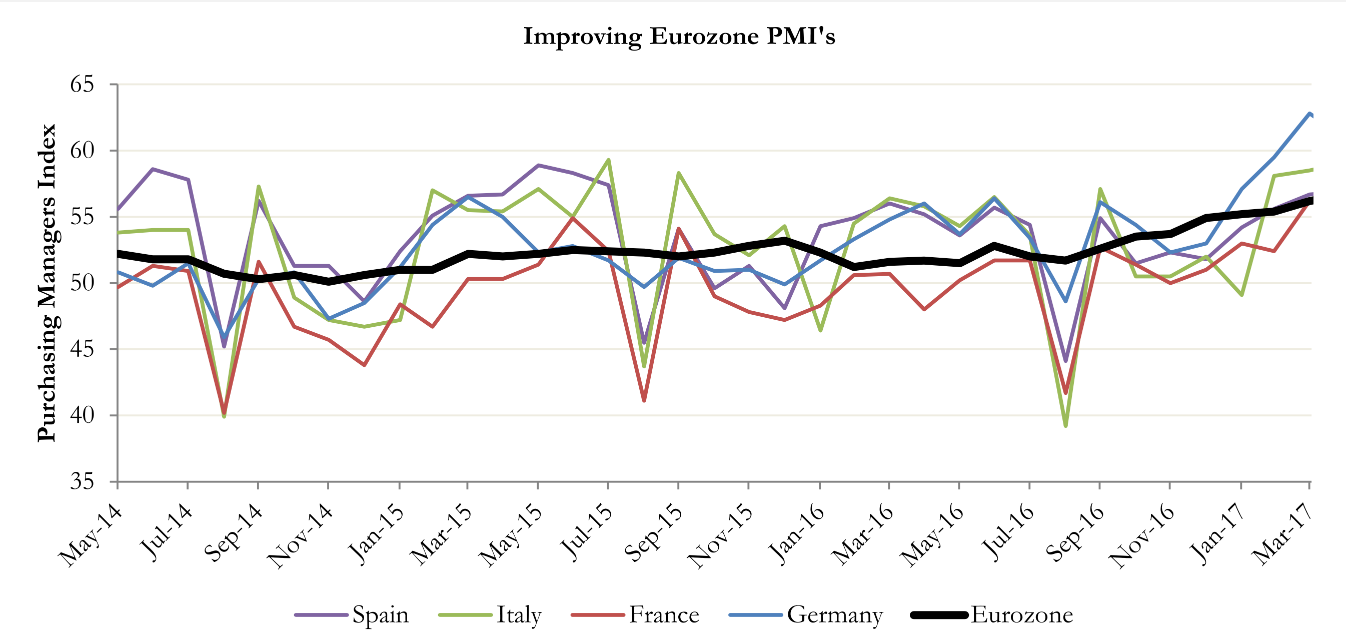

Exhibit 2: Eurozone PMI's

Eurozone economic data

Most baseline forecasts point to the Eurozone growing at a 1.5%-2% range, which reflects a pickup in momentum when taking into account the previous decade. The improvement in Unemployment, and inflation data as well as consumer confidence further strengthens the case for a structural Eurozone recovery. One of the most important leading indicators and sentiment readers, the Purchasing Managers Index (PMI), has been on an upward trend as of late for several of the major European economies (exhibit 2). This should provide investors with a clear bias to the upside with regards to future economic growth and business activity. The Citi Economic Surprise Index, which measures data surprises relative to market expectations, remains near a five year high for the Eurozone. In the U.S., this measurement has dipped into negative territory as shown in exhibit 3. Our view is that economic momentum clearly favors Europe versus the United States at the moment and the rotation into European equities is justified.

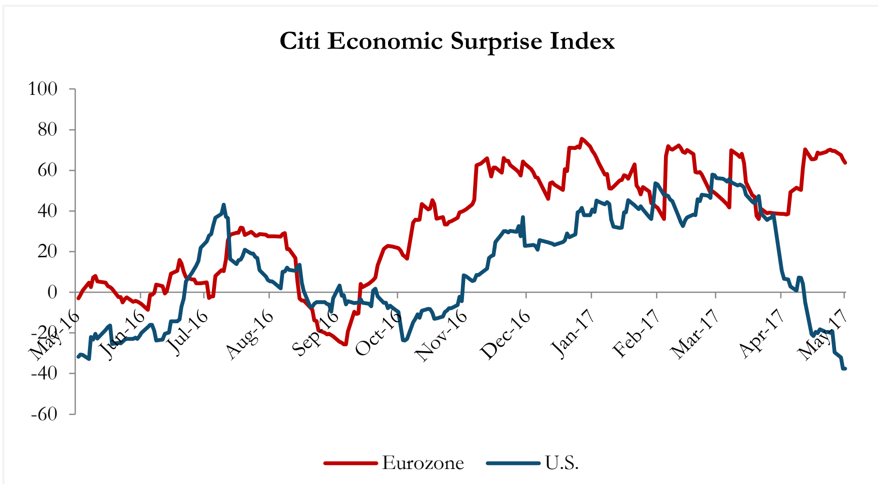

Exhibit 3: Citi Economic Surprise Index. Source: Bloomberg LP

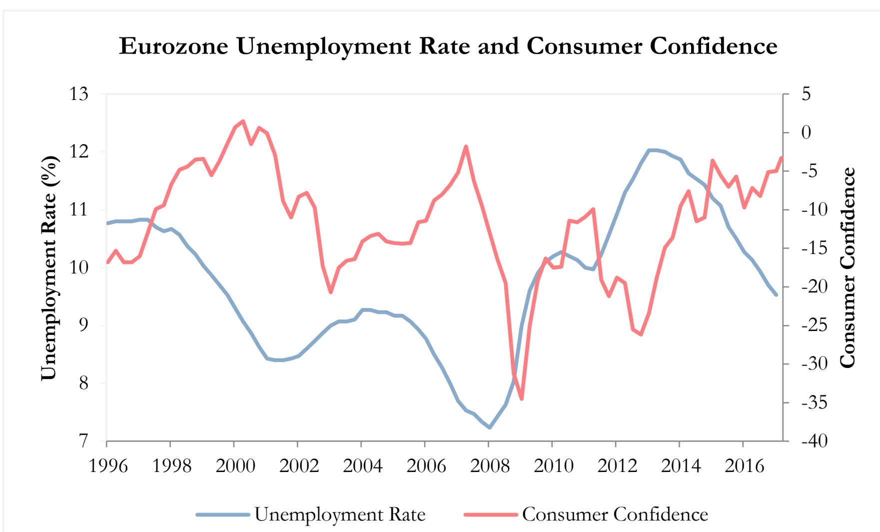

Exhibit 4: Eurozone unemployment rate and consumer confidence

Recovery in inflation, wage growth and unemployment positive signal for ECB

The ECB's inflation goal of 2% has proven elusive since 2012. After a number of years of unorthodox monetary policy, the goal was finally reached in February. However, this achievement was attained measured with headline inflation, which includes volatile factors such as food and energy. In March, the prices of these volatile components fell causing headline inflation to drop to 1,5%. The more robust part of the inflation figure, excluding the volatile components, is referred to as core inflation, where wage growth is an important component. Wage growth is in turn dependent on rising employment because this pushes up salaries. Unemployment in the Eurozone is, as of March, at its lowest since 2009 at 9,53%. If this recovery in wage growth and unemployment persists, it's likely that inflation will continue to rise as well. Exhibit 5 below depicts core and headline inflation for the Eurozone.

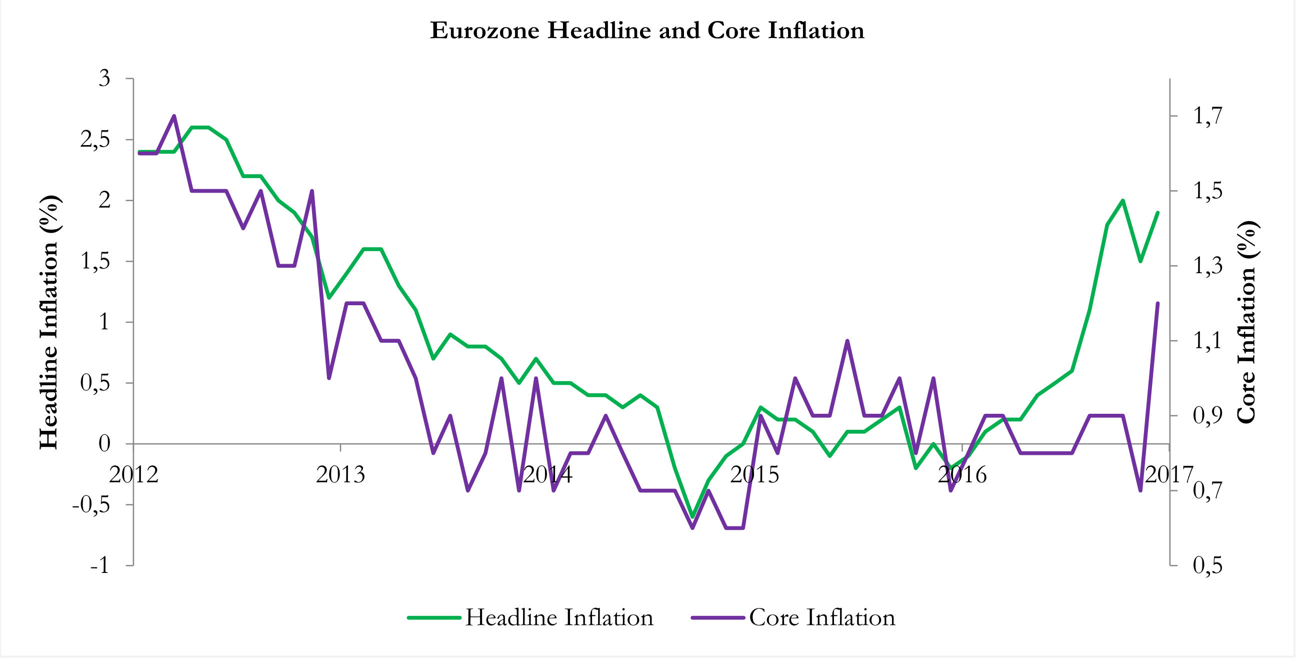

Exhibit 5: Eurozone headline and core inflation

The ECB's decision

Careful communication from the ECB has the European markets on edge for the coming central bank decision on June 8th. The head of the central bank, Mario Draghi, has held his position on that the current asset purchase program has been successful in its endeavor to create jobs and boost investment returns, but that further stimulus is required. The current program was recently downsized from €80 to €60 billion of monthly bond purchases, and is expected to remain on that pace for the rest of 2017. The asset purchase program affects asset prices in two ways. First, it provides the markets with liquidity, which finds its way into different assets, be it equities and bonds, which pushes up prices. Secondly, it drives down interest rates, which affects borrowing costs and the expected yield on assets. Lower rates translates to lower financing costs for companies, which in turn pushes up valuations. Moreover, the reality of exceptionally low rates means there's relentless hunt for yield given that comparably safe assets are yielding close to zero. This lack of alternatives has spurred investments in riskier assets like equities. Generally, accommodating monetary policy from the ECB is positive news for European equites.

While any sudden tapers in the asset purchase program is not to be expected to be announced June 8th, markets are expecting forward guidance on when the next taper will occur. The pace at which the asset purchase program will be tapered provides clues on how soon rate hikes will be up for discussion. More rapid tapering could indicate that a rate hike coming sooner than expected. Assuming the ECB follows in the footsteps of the FED, which stopped the bond buying completely before starting to raise rates, guidance on longer-than-expected asset purchases will provide some boost to equities, while shorter-than-expected will impact the stock market negatively. However, there is some relief in a shorter-than-expected scenario, seeing as the ECB would only pursue that kind of strategy if macroeconomic indicators allow it. Our view is that since economic data has gained momentum as of late, we expect the ECB to at least acknowledge a broad Eurozone recovery but are unlikely to begin tapering anytime soon. Exhibit 7 in the appendix shows the ECB's total balance sheet as a percentage of GDP.

Political calendar

On May 7th, the European stock markets breathed a sigh of relief as the French election went as expected when Emmanuel Macron won the French Presidential election. With Macron as president, EU has been given a second chance to unify Europe and develop the union. However, there are still uncertainties surrounding the European political landscape as both the UK and Germany have elections approaching within the near future. Our view is that this uncertainty will spill over on the stock markets resulting in increased volatility.

UK Prime Minister Theresa May has announced that she is calling for an early general election on June 8th, see appendix 6. The justification is a need for stability and to avoid a political stalemate when the Brexit talks continues. The announcement came as a surprise to many, as May has publicly announced that she does not need to be distracted by time-consuming campaigning. The markets reacted with a surge in the value of the pound and consequently the main British stock index, FTSE 100, fell to its lowest point in several weeks.

The current opinion polls give the Conservatives an almost 20 points lead and May's approval ratings dwarf those of her Labor counterpart Jeremy Corbyn. Looking at historical UK elections, the FTSE 100 index has had a tendency to surge when the outcome has been regarded as fairly certain. When elections have been a close run affair, however, markets have retreated.

Based on these facts, the election will probably be a good influence on the European stock markets in the short run. However, in the longer run, European markets may suffer as winning a general election would allow for Theresa May to claim popular backing for her hard approach to Brexit, which includes removing Britain from EU's single market. A hard Brexit has the potential to be very damaging for the European Union as it could reduce productivity, financial collaborations and trade possibilities. These events will most certainly affect the European stock markets negatively.

Federal elections will be held in Germany on 24 September 2017 to elect the members of the Bundestag, appendix 6 and 8. As the biggest economy in the EU, and the leading political force of the region, the election will have significant effect on the future of Europe.

The two sides who realistically can win the election are the conservative coalition consisting of Christian Democratic Union/Christian Social Union (CDU/CSU), led by Angela Merkel, and the Social Democratic Party (SPD) who in March 2017 elected the former President of the European Parliament Martin Schulz as their leader. Schulz has, since elected, improved SPD's ratings substantially. The ratings have in recent weeks fallen back following alleged irregularities involving cash and favors given to members of staff when he was president of the European Parliament. An investigation has not been officially opened, but the claims have nonetheless affected SPD's polling numbers (exhibit 8).

The German index DAX 30 hit an all-time high following the announcement of its strongest trade figures on record Tuesday, with exports up 0.4% in March to a record €118.2 billion. Imports climbed 2.4% to €92.9 billion. This was amplified by the predicted win of Macron. The market will most likely handle a win by either candidate without much reaction due to the strong underlying trends in the German economy. Both candidates share similar warm feelings towards the European Union as one would expect, with a heavy focus on allowing for free movement of goods and services between EU members. A factor to consider is if Great Britain does vouch for a *hard Brexit*, many predict that Germany might overtake Great Britain as the European hub for financial institutes. This could very well give Germany's already strong economy yet another leg to stand on, which would benefit Europe as a whole.

Additionally, there is risk of early elections in Italy. The election is first due in 2018 but several parties, including the anti-establishment Five Star Movement want to expedite the process. No decision has been made, but this is a potential upset for markets.

Summary

The combination of comparatively low valuations and strong economic data makes a compelling case for European equities. However, there are risks that could dampen down expectations. It will be important to follow the development in the European political landscape and the direction of the ECB.

Important upcoming elections

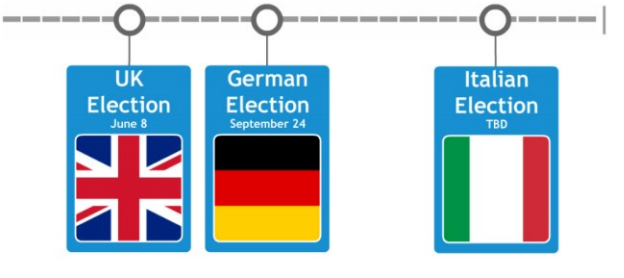

Exhibit 6: Timeline of upcoming elections

Appendix

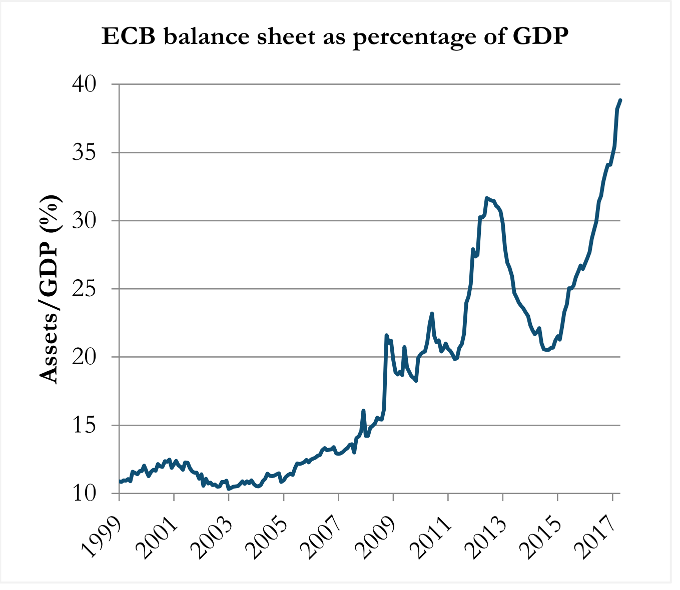

Exhibit 7: ECB balance sheet as percentage of GDP

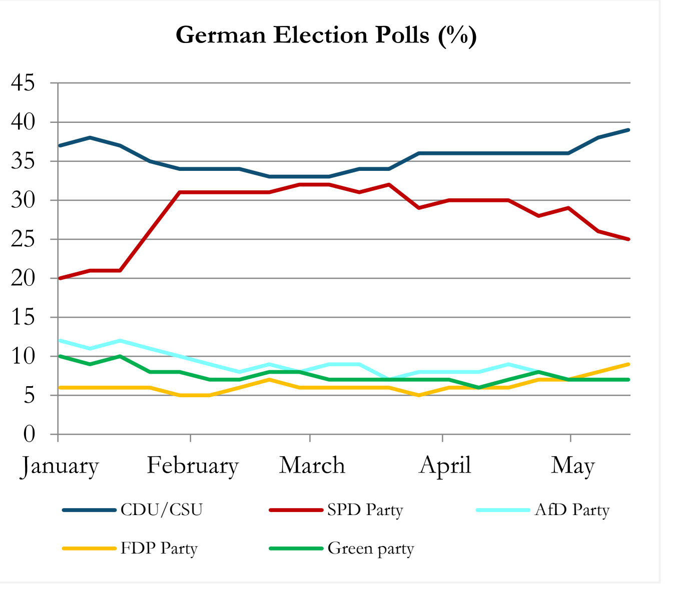

Exhibit 8: German election polls YTD

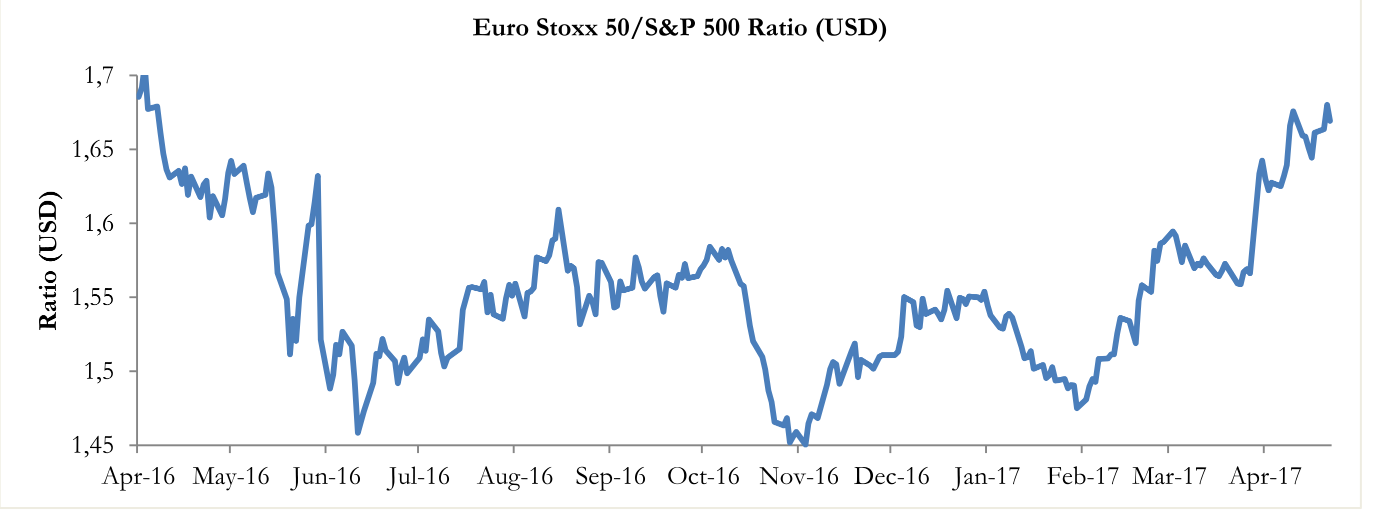

Exhibit 9: Euro Stoxx 50/S&P 500 Ratio

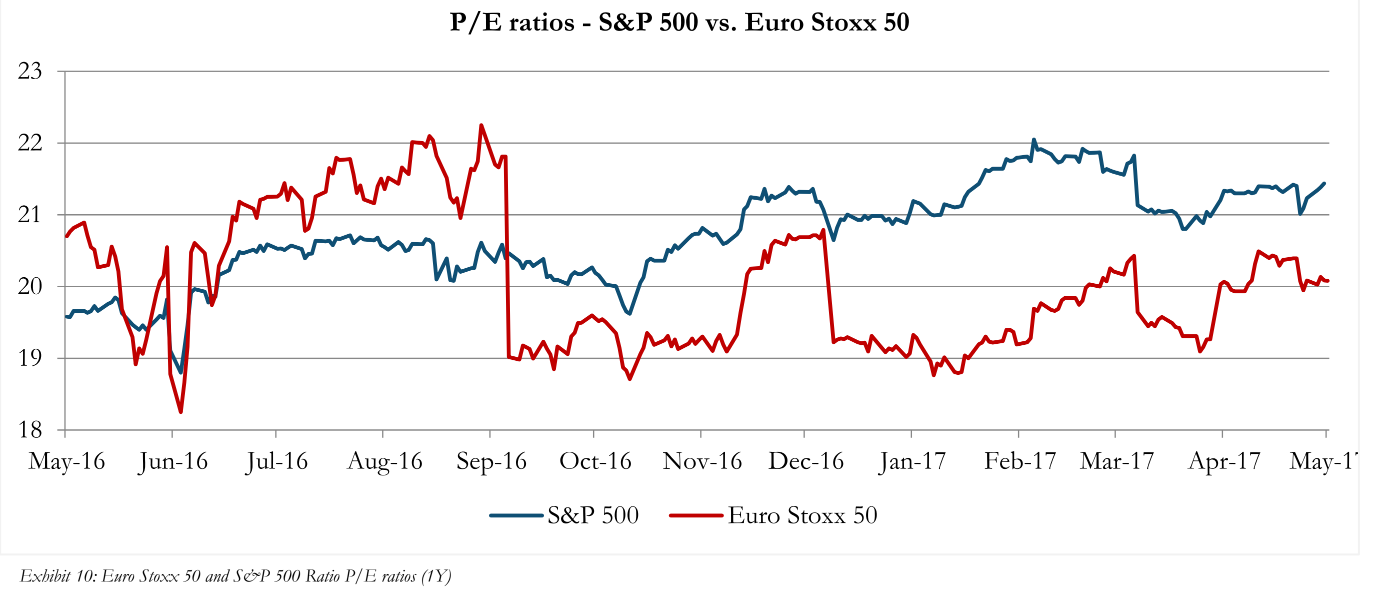

Exhibit 10: Euro Stoxx 50 and S&P 500 Ratio P/E ratios (1Y)