EQUITY

Notes From the Trading Desk - Europe

February 12, 2018

Franklin Templeton's Notes from the Trading Desk offers a weekly overview of what our professional traders and analysts are watching in the markets. The European desk is manned by eight professionals based in Edinburgh, Scotland, with an average of 15 years of experience whose job it is to monitor the markets around the world. Their views are theirs alone and are not intended to be construed as investment advice.

Global equities were lower across the board last week. US indices saw their biggest falls since January 2016. It was a similar story in Asia and in Europe, where all indices ended the week lower, with all sectors in the red.

The Digest

The Return of Volatility Spurs on a Technical Correction

The selloff in equities dominated headlines throughout last week. Crucially, in our view, the pullback has now widely been considered as a *technical* correction rather than a fundamental one.

One of the aspects of this we'd like to point out is that the correction does not appear to reflect worsening economic or corporate fundamentals.

Macroeconomic data in both Europe and the United States, has been largely positive recently and that trend continued last week as eurozone purchasing manager index (PMI) data showed output hitting a 12-year high. We are also in the middle of one of the best corporate earnings season in years. Well over half of the companies on both sides of the Atlantic that have reported results so far have beaten earnings estimates.

With macro fundamentals looking solid, the selloff seems instead to have been driven by technical factors, including the unwinding of the "short-volatility" trades.

Heightened inflation expectations following the US January employment report release the previous week had led to a spike in volatility that we haven't seen since 2015. This in turn led those who had been betting against volatility (of which there had been many in recent times) to sell underlying equities.

No Classic "Risk-Off" Reaction

The reaction across asset classes was not your classic "risk-off" move. Despite the aggressive response in equities, we didn't see evidence of the usual flight to safety.

Moves in government bonds (the traditional safe-haven) were somewhat muted, and yields remained elevated.

The UK 10-year Gilt lost just seven basis points (bps), and the 10-year Bund lost 2.4bps on the week. The US 10-year Treasury was actually up by 1bps on the week.

There was also little sign of risk-off action in other traditional safe havens: the Swiss franc had its worst week in two months versus the US dollar and gold was lower for a second consecutive week.

To us this suggests, once again, that the pullback was driven by technical selling and quant fund deleveraging rather than a fundamental shift in sentiment.

Because the correction doesn't appear to be routed in fundamental issues, there is an argument that investors are finding it perhaps more unsettling.

The inability to point towards clear geopolitical, economic or corporate reasons may have left some market participants suspicious and lacking confidence in what will happen next.

This week investors will see whether the rising inflation fears that (at least in part) fuelled the market turmoil last week are justified when the latest data on US retail sales and inflation are released on Wednesday.

Bank of England Takes a Hawkish Tone

A more hawkish tone from the Bank of England Monetary Policy Committee (MPC) on Wednesday (February 7) did little to abate the inflationary concerns feeding into the moves.

The MPC voted unanimously to keep UK interest rates on hold, but commentary released immediately after the meeting noted that rates may need to rise earlier and faster than the committee members had previously thought as they lifted growth forecasts.

Expectations of a rate hike in May rose sharply and sterling spiked in response. That did not help the selloff in the exporter-heavy FTSE 100 Index.[1]

Consumer price index (CPI) data due out on Tuesday (February 13) will be watched closely following that BoE commentary.

Last Week

Europe

In German politics, Angela Merkel's Christian Democratic Union (CDU) party reached a coalition agreement with the Social Democrats (SPD), although this comes with some significant concessions.

LOOK OUT FOR... (FEB 13 – 19):

Tuesday February 13

- French Employment Data Link
- Swiss Producer and Import Price Index Link
- UK Inflation Data Link

Under the terms of the agreement, the SPD will take control of three major areas – finance, foreign affairs and labour. As a result an appointee from the SPD , which has a more left-wing stance on spending, will take over the role of finance minister from the CDU's pro-austerity Wolfgang Schäuble.

The new setup is likely to see an increase in public financing on infrastructure and services.

With Merkel handing over responsibility of these key governmental areas, it has raised questions of the longevity over her reign, with a number of commentators suggesting the agreement has been a "political mistake". The final deal will be voted on by SPD members on February 20. Markets showed little reaction to this news given the focus on the correction.

Uncertainty still surrounds the Brexit process with UK Prime Minister Theresa May coming under increased pressure to be clearer in negotiating a trade deal.

Wednesday February 14

- German Gross Domestic Product (GDP) Link
- Sweden Interest-Rate Decision Link
- Eurozone GDP Link
- Eurozone Industrial Production Link
- US Inflation Link
- US Core Retail Sales Link

Thursday February 15

- Australian Employment Data Link
- Japanese Industrial Production Link
- Spanish Inflation Link
- Eurozone Trade balance Link
- US PPI Link
- US Industrial Production Link

Friday February 16

- UK Retail Sales Link

In response, May claimed that her government would be looking for a clean break from the EU post-Brexit. This response triggered negative reactions and questioning from pro-Europe MPs who pointed to predictions of a significant gap in UK public finances if the government fail to secure an EU trade deal.

Americas

A number of US Federal Reserve speakers last week commented on the equity market volatility.

Federal Open Market Committee voter William Dudley claimed the Fed's base case for three rate hikes continues to look reasonable. However, he highlighted the possibility of four moves if the economy continued to gain momentum.

Chicago Fed Bank President Charles Evans (an FOMC non-voter) said that he could still support three or four hikes this year if warranted by the data, while San Francisco Fed chair John Williams (voter) said that the Fed would be steady and gradual with rate increases. He said, however, that he did not see signs of over-heating.

Asia

In Asia, Japanese equities ended the week down. The yen continued to rally despite Bank of Japan Governor Haruhiko Kuroda's attempts to talk down the currency. He said that it would be inappropriate to raise the 10-year Japanese government bond yield target now, "even by a small margin".

In China, trade balance figures came in much smaller than expected due to a surge in imports. Inflation data later in the week showed a large drop month-on-month in both the CPI and producer price index (PPI). That's generally not considered a great sign for the Chinese economy.

Week Ahead

The White House has indicated it intends to publish details of a new US infrastructure bill this week. We would be watching the construction names on the back off this.

Earnings season continues and we'll be watching to see if the current pace can be maintained, while also keeping an eye out for any comments on foreign exchange impacts.

Economic Data

- In Europe, UK CPI is scheduled for release on Tuesday; German and eurozone fourth-quarter GDP on Wednesday; and UK retail sales on Friday.
- In the United States, CPI data is due on Wednesday. This will be closely watched in the context of last week's moves). Housing starts figures are scheduled for release on Friday.
- In Asia and Pacific, Japan's fourth-quarter GDP should be out on Tuesday. Australian employment data is due out on Thursday.

Monetary Policy

- A Swedish Riksbank policy decision is expected on Wednesday.
- A number of European Central Bank governing council members are scheduled to speak this week. We'll be keen to hear their commentary on inflation and on the recent market moves.

Views You Can Use

Insight from Our Investment Professionals

Earnings Growth Underpins Our Solid Outlook for European Equities

Some investors seem to be questioning whether there's still room for additional growth in European equities, particularly if interest rates start to rise. The reaction of global equity markets in recent days suggests that the transition from a period of economic growth without inflation to one of growth with inflation is likely to cause market volatility. Still, Templeton Global Equity Group's Dylan Ball suggests labour reforms across Europe should give many firms the operating leverage they need to drive further earnings growth during 2018. Read More.

Seeing the Big Picture in Market Corrections

While we don't know when the equity market's recent volatility will settle down, it's important to consider the big-picture, fundamental backdrop for the market, and not get caught up in short-term sentiment swings, according to Franklin Templeton's head of equities, Stephen Dover. And, he believes the fundamental backdrop still looks solid. Read More.

Keeping Calm When Volatility Strikes

The recent declines in the global stock markets can lead to a lot of questions and concerns about what investors should do. Considering the market has been on a historic run to continuous record highs and double-digit gains over the past year, it's not entirely unexpected to experience a pullback.

At Franklin Templeton, we've been investing in global markets for more than 65 years, across bull and bear markets alike. We know that while volatility can be unnerving and confusing, it can also be a time of great opportunity for investors. Read More.

The Underappreciated Story: How Brexit Threatens to Shift the Balance of Power in the EU

For fixed income investors eyeing opportunities in Europe, 2018 should be the year economic fundamentals reassert their worth, according to David Zahn, Franklin Templeton's head of European Fixed Income. Nonetheless, he believes many investors are underappreciating the long-term implications for Europe of the biggest political uncertainty for the region—Brexit. Read More.

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1. The FTSE 100 Index is a capitalisation-weighted index of the 100 most highly capitalised companies traded on the London Stock Exchange. Indexes are unmanaged, and one cannot directly invest in an index. They do not include fees, expenses or sales charges. Past performance is not an indicator or a guarantee of future performance.