EQUITY

Notes From the Trading Desk - Europe

September 24, 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.

Equity markets put in a resilient performance last week, by and large trading sharply higher despite the long-awaited confirmation of fresh US trade tariffs on China. Aside from that news, Brexit headlines dominated in Europe and a European Union summit in Salzburg set UK and EU leaders at loggerheads.

The Digest

Markets Shrug Off US-China Trade Tariff

Equity markets moved higher early last week on news that the next wave of US tariffs on China would not be as severe as expected. Retaliatory measures from China were also seen as restrained.

The White House announced it would be imposing tariffs on US$200 billion of Chinese goods, but revealed the rate would initially be 10%, below the previously speculated 25%. The rate will rise at year-end if no trade deal is reached.

In response, China announced tariffs on US$60 billion of US goods. Chinese authorities said they had no choice but to retaliate. The measures announced by China were also not as severe as some expected; it will now impose a 10% tariff on US goods it had previously earmarked for a 20% rate, while also bringing down US goods it initially earmarked for a 10% rate to 5%. So net-net, the measures from both sides were perhaps not as severe as they could have been.

On the back of last week's events, Chinese stock markets closed higher and European basic resources names also ended the week up.

However, we think it's important to keep the moves in context. Chinese equities are bouncing off multi-year lows after a tough 2018 so far. In addition to the measures being somewhat restrained, investors will likely appreciate having clarity on the tariff situation after months of speculation. Markets do not like uncertainty.

A further reason for the recovery in Chinese stocks is the hope China will increase new fiscal stimulus to counter the US tariffs.

All that said, we think there is still a long road ahead on the issues of US-China trade.

The tone at the beginning of this week is not positive: Over the weekend China declined the offer of further mid-level talks with the Unites States and cancelled the visit of the Chinese Vice Premier Liu He. China cited fresh US sanctions on a Chinese military figure as the reason.

Looking ahead, focus will likely be on any progress in talks ahead of the year end, which marks the deadline for tariffs increasing to 25%.

US President Donald Trump recently said taxes on another US$267 billion of goods were "ready to go on short notice," which would mean virtually all of China's exports to the United States would be subject to new duties. The rhetoric around China in the run-up to the US mid-term election will also drive sentiment.

Salzburg Summit Leaves EU and UK at Loggerheads

There had been some optimism going into last week's EU leaders' summit that the United Kingdom and European Union were making progress towards a Brexit deal. But the week ended in recrimination as the EU leaders publicly rebuked UK Prime Minister Theresa May's proposals.

After May pitched her "Chequers' Plan" to the EU leaders in Salzburg, the EU President Donald Tusk responded that the EU leaders agreed the plan would not work as it risked undermining the Single Market.

In addition, if there was no significant progress, Donald Tusk said there would be no special November summit to sign the divorce agreement.

The UK press reported that May had been caught off guard and had not anticipated such a firm rebuttal. She made a strongly worded statement on Friday, accusing the EU and Donald Tusk specifically of lacking respect.

She went onto highlight the lack of proposals from the EU on key issues such as the border between Northern Ireland and the Republic of Ireland.

Finally, she reiterated "no deal was better than a bad deal". This response was aimed at the EU leaders, but she will no doubt have had a domestic audience in mind as well as she gears up for the Conservative Party Conference next week.

On the back this, of the pound had is sharpest intraday decline against the US dollar in 15 months as the market took the view the likelihood of a deal was reduced.

This week, we'd expect the opposition Labour Party to try to capitalise on the Conservative Party turmoil over Brexit at its own party conference.

Last Week

Europe

LOOK OUT FOR... (SEPTEMBER 24 - OCTOBER 1):

Monday, September 24

- Holiday in South Africa, South Korea, Japan and China

Last week, European stocks saw their largest weekly gain since March as cyclical industries rebounded on an easing of trade-tariff concerns. Basic resources stocks saw a remarkable move—up nearly 8% on the week—amid some hope for easing of trade tensions and potential for stimulus in China.

The underlying commodities were also stronger. Other recent year-to-date laggards such as autos and banks also outperformed. Defensive stocks, including health care and media, lagged.

There was some respite for emerging markets globally. In Europe, Russian and Turkish equities were the star performers.

In developed Europe, Italy outperformed on hopes for a market-friendly budget from the Italian government. The falling pound spurred UK-listed large capitalisation stocks.

The Italian budget was again in focus throughout the week. Finance Minister Giovanni Tria and prime minister Giuseppe Conte tried to reassure markets, while the Five-Star and League leaders lobbied to increase Italy's deficit above 2%.

Importantly, Conte insisted Italy would produce a "credible" budget for 2019 to ensure investors retain their confidence in the country. Conte claimed next year's budget deficit would not exceed 2% of output and said it must be credible for markets.

The key date this week is Thursday, September 27, when the Italian government is supposed to set debt and deficit targets for next year. Then by October 15, a detailed 2019 budget plan is expected to be presented to the European Commission.

Tuesday, September 25

- Holiday in South Korea and Hong Kong
- World Leaders Gather at the United Nations' Annual General Debate Link
- Bank of Japan July Monetary Policy Meeting Minutes Published Link

Wednesday, September 26

- Holiday in South Korea
- New Zealand August Trade Balance Link
- US Federal Reserve Two-Day Monetary Policy Meeting (September 25-26) Link

Thursday, September 27

- European Central Bank Economic Bulletin Published Link
- German September Consumer Price Index Link
- US Second-Quarter Gross Domestic Product Link
- US August Goods Trade Balance Link

Friday, September 28

- Japan September CPI Link
- Eurozone September CPI Link
- French September CPI Link
- Spanish September CPI Link
- UK Second-Quarter GDP Link
- Canada July GDP Link
- German September Unemployment Rate Link

Sunday, September 30

- China September Manufacturing and Non-Manufacturing Purchasing Managers' Index Link

Monday, October 1

- Holiday in Hong Kong and China

Americas

It was a largely positive week for US equities during which the S&P 500 Index made fresh all-time highs. The materials sector outperformed, given the trade-tariff news discussed above.

Banks also had a strong week, as the yield backup for the 10-year US Treasury was a driver of rotation into cyclical stocks. Utilities were a laggard as widening bond yields took their toll.

Asia

It was an impressive week for Asian equities as Chinese stocks led the way higher on the trade- tariff news, albeit from low levels.

Japanese stocks also performed well as the US-China trade spat fears eased and Japanese Prime Minister Shinzo Abe was re-elected as leader of his Liberal Democratic Party. In addition, economic data, including inflation and manufacturing purchasing managers index (PMI), came in better than expected.

As expected, there was no change in monetary policy at the Bank of Japan meeting on Wednesday.

The two-day summit between the leaders of North and South Korea was a talking point last week, and South Korean stock markets closed largely higher thanks to some optimistic rhetoric.

Week Ahead

Economics

- On Wednesday, September 26, we'll be looking out for US new homes data and Chinese industrial profit figures.
- Thursday, September 27, is shaping up as a busy day for macro data in the United States, with durable goods orders, gross-domestic-product data, international trade in goods, jobless claims, and pending home sales index figures due out.

Monetary Policy

- A Federal Open Market Committee (FOMC) meeting takes place over two days, conclusing on Wednesday, September 26. The market is currently pricing in 100% odds of a rate hike of 25 basis points. This would take the Fed's benchmark short-term rate to a range of 2-2.25%.

Politics

- Trade tensions are in focus this week on the news China rejected the offer of new talks. With that, any news on the US-China spat will be a key focus for investors.
- Brexit talks will of course be front and centre in Europe following the fallout from the Salzburg summit. Watch for rhetoric out of the Labour Party conference.
- Italy: Italy must disclose its growth and budget targets for 2019 budget by Thursday September 27.

Views You Can Use

Insight from Our Investment Professionals

Global Investment Outlook: How Much Further Can Global Growth Fly?

A number of market headwinds—including trade tensions, rising interest rates and a general fear the long-running US economic expansion may be facing fatigue—have cast a shadow over the markets in the first half of the year. Nonetheless, US economic growth managed to hit a four-year high in the second quarter, and the US equity market marched along to what many regard as its longest bull run in post-WWII history. Read More.

Moving Up in Credit Quality for Better Durability

Some investment-grade bonds are riskier than their ratings imply, while high-yield bonds have seen some positive tailwinds. Meanwhile, a large number of bank loan agreements now favour borrowers over lenders. Franklin Templeton Fixed Income Group's Glenn Voyles, Marc Kremer, Matt Fey, Brian French and Reema Agarwal take a look at these areas of credit landscape today. They explain how credit research and long-term orientation helps them discern cash-flow durability in the companies they analyse and outline how they negotiate for better terms in credit agreements. Read More.

August Recap and Outlook: Finding Opportunities in Volatility

Market volatility marked the month of August, with sharp declines in the Turkish lira and Argentine peso souring investor sentiment for emerging markets overall. Manraj Sekhon, CIO of Franklin Templeton Emerging Markets Equity, and Chetan Sehgal, senior managing director and director of portfolio management, present the team's overview of the emerging-markets universe in August and why they don't see the asset class heading for a severe crisis. Read More.

Then and Now: Mortgage-Backed Securities Post-Financial Crisis

A little over 10 years ago, few people had heard of mortgage-backed securities (MBS). Yet that changed when MBS brought the global financial system to its knees. Today, they're still a pivotal part of the system, with the US Federal Reserve (Fed) the largest holder. Franklin Templeton Fixed Income Group's Paul Varunok explains how MBS fit into the Fed's future plans and gives his outlook for the asset class. Read More.

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