EQUITY

Notes From the Trading Desk - Europe

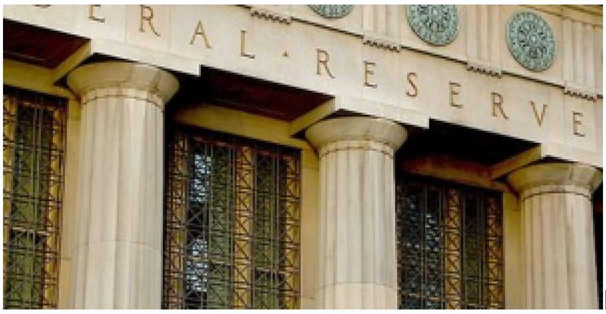
October 8, 2018

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.

The first week of the new quarter continued the disappointing performance of the previous week, with most global equity markets drifting lower. A widening in US Treasury bond yields weighed on equity performance in the United States, while concerns over the Italian budget weighed on sentiment in Europe.

The Digest

Hawkish Fed Comments And Stronger US Macro Drives Yields



Following a series of positive comments from US Federal Reserve (US Fed) Chair Jerome Powell and some stronger macro data, US Treasury yields widened sharply midweek, which weighed heavily on equity markets.

Speaking at a few events during the week, Powell took what we view as a fairly hawkish tone. He spoke in glowing terms about the US economy, describing it as "remarkably positive," "extraordinary," and "particularly bright".

Powell added: "There is no reason to think that this cycle can't continue for quite some time". He also suggested that interest rates "may go past neutral rate".

The combination of Powell's comments and some stronger Purchasing Manager Index (PMI) data saw the 10-year US Treasury yield widen to reach its highest level since 2011. The yield on the 30-year US Treasury climbed to its highest level in over four years.

News reports suggested several technical factors exacerbated the move in yields last week. According to the reports, a US tax break expired in September which led to a decline in demand for long-duration bonds.

In addition, a sudden jump in the cost of hedging US dollar exposure meant US debt may have become less attractive to overseas buyers.

The impact of all this was a sharp move lower in equity markets midweek. Cyclical stocks were particularly weak.

High-profile technology stocks suffered, as crowded equity trades saw some profit taking. Emerging markets also suffered on higher yields and a stronger US dollar.

Italian Assets Remain Under Pressure

Italian assets remained under pressure last week as the Italian government remained defiant about its controversial spending plans. At times it appeared almost hostile towards the European Union (EU), in our view.

Earlier in the week, it was reported that the Italian government was planning to a compromise on its budget deficit plans. Its original plan was to run a deficit of 2.4% in each of the years from 2019 to 2021. The reported compromise suggested lowering the public deficit to 2.2% in 2020 and 2% in 2021.

However, in other aspects the Italian government remained unbending. Deputy Premier Matteo Salvini accused certain European Commissioners of hostility towards Italy because of its tough stance on immigration.

Separately, Lega politician Claudio Borghi, who heads the budget committee of Italy’s lower house, suggested Italy could solve most of its problems if it had its own currency. He did later row back on that, saying there was no plan to leave euro.

From an EU perspective, Jean Claude Juncker did little to placate the situation, in our view, by comparing the situation in Italy to that of Greece, and suggesting Italy could potentially go the same way as its near-neighbour.

Brexit Update: Signs of Progress At Last?

It was a mixed start to the week for Brexit rhetoric, however, comments did improve to the upside as last week went on.

On Monday, British newspaper headlines indicated the UK government might be willing to compromise on Irish border negotiations to allow a deal to proceed. That proved to be positive news for sterling.

However on Tuesday, Arlene Foster, the leader of Northern Ireland’s Democratic Unionist Party (DUP) seemed to pour cold water on the idea as she insisted that Northern Ireland must leave the EU on the same terms as the rest of the UK.

The Conservative Party conference last week proved fairly uneventful and Prime Minister Theresa May avoided dwelling too much on the subject of Brexit. As expected, what she did say was positive, insisting that Brexit presented the UK with an “opportunity for growth”.

Through the rest of the week, rhetoric from political leaders on both sides was largely positive. UK Brexit Secretary Dominic Raab, EU President Donald Tusk, and Irish Prime Minister Leo Varadkar all suggested there was hope of a deal in November.

This positive sentiment was compounded on Friday amid reports that EU diplomats saw a deal with the UK as "very close". Sterling moved sharply higher as a result.

There are a number of interesting meetings coming up in Brussels this week. The EU's Chief Negotiator Michel Barnier is meeting Arlene Foster on Tuesday (October 9). On Wednesday, Barnier will present a draft of the political declaration to a meeting of European commissioners.

Later in the month, all eyes will be on the EU summit, which takes place on October 17.

Crude Oil Continues To Push Higher

Oil prices reached their highest levels since late-2014 last week despite US crude oil inventory data showing decent-sized builds for the week.

The strength centered around US sanctions on Iran, expected to come into force on November 4, and the suspected inability of nations in the Organization of the Petroleum Exporting Countries (OPEC) to cover the supply gap left by the sanctions. This is despite speculation that Russia and Saudi Arabia had struck a private deal in September to raise crude oil output.

The United States had been putting pressure on other countries to cut oil imports from Iran, with allies such as South Korea and Japan appearing to fall in line. There still remains an air of uncertainty around the impact of these sanctions with the US talking about granting waivers on sanctions to countries which had shown efforts to reduce Iranian oil imports.

Last Week

Europe

Last week, European equities declined throughout the week, while European bond yields spiked as Italian and British politics dominated headlines.

From a sector perspective, Retail, Travel & Leisure and Real Estate names all struggled. Industrial names also came under pressure. The Retail space was hit by some stock-specific issues. In addition, concerns over tighter controls from Chinese customs dragged on some luxury stocks.

Airlines weighed on the travel & leisure space as crude oil prices continued the recent rally. Insurance was the only sector to finish in the green last week, benefitting from higher yields and steeper curves, which in turn weighed on the real estate names.

LOOK OUT FOR... (OCTOBER 8 - 15):

Monday, October 8

- Holiday in Canada and Japan
- German August Industrial Production Link

Tuesday, October 9

- Holiday in South Korea
- Japan August Current Account Link
- German August Trade Balance Link

Wednesday, October 10

- UK August Industrial and Manufacturing Production Link
- UK August Trade Balance Link
- US September Producer Price Index Link

On the central-bank front, the European Central Bank (ECB) last week halved its bond buying. Meanwhile, last week's macroeconomic data for the region was mostly strong.

Americas

All three major US stock market indices ended last week lower. The retail sector struggled and banks outperformed as investors focused on the backup in yields. Telecommunications companies and energy names were also strong, with the latter helped by strength in crude-oil prices.

The key data point in the United States last week was Friday's employment report. The latest nonfarm payrolls print disappointed, coming in below estimates, but a revision to the prior number helped to ease the pain. Elsewhere, US unemployment hit a new low at just 3.7%. Hourly earnings were in line with expectations.

Trade rhetoric continues to bubble away and there was an upbeat start to the week as Canada joined the United States and Mexico in a trade deal.

Thursday, October 11

- French September Consumer Price Index Link
- Spanish September CPI Link
- Swedish September CPI Link
- US September CPI Link
- ECB Publishes September Monetary Policy Meeting Minutes Link

Friday, October 12

- Holiday in Brazil
- International Monetary Fund Annual Meeting in Bali, Indonesia (October 12-14) Link
- German September CPI Link
- US Import and Export Price Indexes Link
- Eurozone August Industrial Production Link

Monday, October 15

- New Zealand Third-Quarter CPI Link

Asia

Mainland Chinese markets were closed all of last week for Golden week. However, Hong Kong's stock market was open, and ended the week down amid fears that the new US/Mexico/Canada trade deal could allow US President Donald Trump to ratchet up the pressure on China.

The technology sector also dragged thanks to allegations of a Chinese infiltration of US companies via a hardware hack.

Japanese equities closed last week lower. Japanese macroeconomic data was soft as the third quarter Tankan sentiment survey showed manufacturers' outlook has been dented by concerns over US/China trade tensions.

Official and private manufacturing surveys from China also disappointed as the impact of the trade spat starts to hit. Along with global yields, Japan's 10-year bond yield touched a 20-month high.

In Australia, the Reserve Bank of Australia (RBA) kept interest rates on hold at the record low of 1.5%, as expected, maintaining the status quo in place since August 2016.

Week Ahead

Politics

- Brexit: EU chief Brexit Negotiator Michel Barnier is due to meet DUP Leader Arlene Foster, , on Tuesday. On Wednesday, Barnier is scheduled to present a draft of the political declaration—which he is currently writing—to a meeting of commissioners on Wednesday.

Economic Data

- From Europe, Industrial Production data is scheduled from France, Italy and the UK on Wednesday. The Euro area figure is expected on Friday.
- UK gross domestic product data is due from the UK on Wednesday.
- The third-quarter US earnings season kicks off this week with many of the major banks reporting on Friday.

- On the US macro front, business optimism survey results are scheduled for Tuesday, inflation data on Thursday and import prices on Friday.
- On Friday we expect to see China Trade Balance data for September.

Fiscal Policy

- Given Fed Chair Powell's comments last week, Fed speakers will be particularly in focus this week.
- The minutes from the most recent ECB meeting will be released on Thursday, with focus likely to fall on the level of concern of the deceleration of growth in the region.
- Also on Thursday, the Bank of England's third-quarter credit condition survey results are due.

Views You Can Use

Insight from Our Investment Professionals

Four Reasons Why We Think Emerging-Market Fears Are Overblown

A confluence of factors has caused investor sentiment to sour on emerging markets recently, including global trade tensions, a rising US dollar and idiosyncratic issues in Turkey and Argentina. While some of the headlines may seem disconcerting, they don't tell the whole story, according to our Franklin Templeton Emerging Markets Equity team. They believe it's important to point out emerging markets are not homogeneous, and the countries dominating the dire headlines represent a very small part of the emerging-market universe. Read More.

EM Index Inclusion Could Spell A New Chapter for GCC Bonds

GCC bonds are planned to be part of the J.P. Morgan Emerging Market Bond Index. Dino Kronfol, CIO of Franklin Templeton Global Sukuk and MENA Fixed Income Strategies, explains why he and his team think the inclusion could be an exciting milestone for the region. Read More.

Active ETFs: For Fixed Income Investors Who Don't Want to Follow the Pack

In this connected world of 24-hour news and social media, many factors continue to vie for the market's attention, keeping volatility at the forefront of many investors' minds. Jason Xavier, head of EMEA ETF Capital Markets at Franklin Templeton Investments, explains volatility can present tactical investment opportunities, but not for those who are stuck following the crowd. Read More.

Lifting the Lid on Social Infrastructure

Raymond Jacobs, Managing Director, Franklin Real Asset Advisors, offers an introduction to social infrastructure investing and explains what it can do not just for investors' portfolios but for society as a whole. Read More.

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