EQUITY

Notes From the Trading Desk - Europe

November 05, 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 last few of days in October brought some welcome respite for equity markets thanks to month-end positioning, robust corporate earnings and better tone around US/China trade. Markets were in positive territory last week across the board.

The Digest

Markets recover their poise

After the alarming moves lower for equity markets in October, it was reassuring for investors to see markets steady up last week. But before looking at last week's bounce, it's worth reminding ourselves of the notable declines in global equity markets in October.

Red October

Equity-market declines were broad-based across the globe, although the US market didn't fare as bad as some others. Emerging markets—as measured by the MSCI Emerging Markets Index—fell more than 8%, while the MSCI Asia ex-Japan Index fell more than 10%.[1]

As one would expect, investors favoured defensive stocks in October. By sector, utilities stocks generally performed the best while consumer staples, telecommunications and health care also outperformed compared with other global sectors.

Why The Late-Month Bounce?

Our take is that a combination of oversold conditions, encouraging earnings and positive rhetoric on trade helped ease investor angst last week.

Oversold Conditions

With such extreme moves in October, many commentators were suggesting sentiment had been unduly negative and that markets had been oversold. In that context, we saw many investors appeared to be "bargain hunting" into month- end.

Earnings

Corporate earnings were for the large part reassuring last week. Facebook calmed investor nerves on Tuesday with a positive third-quarter earnings report; weak earnings from the tech giant in the second quarter had unsettled markets in July. With more than 50% of companies in the S&P 500 Index now having reported third-quarter earnings, we would expect corporate share buybacks to likely start once again. We think that could lend some support to markets.

Trade-War Rhetoric Improves

Through the course of last week, US President Donald Trump made a series of positive comments on the progress of trade negotiations with China.

Trump had a phone call with Chinese President Xi Jinping, which he described as "long and very good". Trump also claimed that discussions with China were "moving along nicely", and he expected "a great deal" with China on trade.

Regardless of the reasoning behind these comments (and some commentators have suggested a political motive), they appeared to influence investor sentiment last week.

Meanwhile, over the weekend we have seen fresh criticism from President Xi of what he called the "law of Jungle". Commentators are seeing this as a veiled swipe at Trump.

Xi added that China would continue to promote globalisation, pledging to cut import tariffs and boost domestic consumption.

All eyes now will be on the G20 summit in Argentina on December 1 where Presidents Trump and Xi are due to meet. There is added pressure on these talks as US import tariffs are due to increase to 25% from 10% on January 1 if no deal is reached.

US Midterm Election the Key Event This Week

We expect this week’s US midterm elections to be a driver of market sentiment this week. With the control of both the Senate and House at stake, the fate of the future of Trump’s administration could also be at stake.

Polls suggest that the Democrats are likely to take control of the House but will struggle to make the necessary gains in the Senate.

Markets seem to have largely priced Democrats winning the House, but Republicans controlling the Senate. However, if the Republicans win both the Senate and House, one might expect a boost for US equities as Trump’s administration will have a free reign to push on with his so-called “market friendly” agenda.

Should we get the surprising result of Democrats taking the Senate and House, we think there could be a negative knee-jerk reaction in US equities.

Last Week

Europe

European equities showed some relative strength last week, rebounding at the end of October after a sustained period of risk-off sentiment through the month.

In terms of sectors, basic resources outperformed other sectors, as hopes of positive progress in global trade disputes offered support. Food and beverage stocks lagged on the week, with investors moving out of defensive stocks as sentiment improved.

By the end of last week, over half of Eurostoxx 600 Index companies had reported earnings, with half of those companies beating expectations.

As we noted last week, Angela Merkel’s Christian Democratic Union (CDU) party suffered a disappointing result in the regional election in Hesse. Mrs. Merkel subsequently confirmed she would step down as party leader and would not run again for Chancellor in 2021 when her current tenure ends.

Speculation about who might succeed Mrs Merkel as party lead ensued, with Friedrich Merz emerging as an early front-runner. He had previously criticised Mrs Merkel for taking the party too far to the left.

LOOK OUT FOR... (NOVEMBER 5-12):

Monday, November 5

- Japan September Household Spending Link

Tuesday, November 6

- German September Factory Orders Link
- US September Job Openings and Labour Turnover Survey Published Link
- Reserve Bank of Australia Interest Rate Decision Link
- New Zealand Third-Quarter Unemployment Rate Link

Wednesday, November 7

- German September Industrial Production Link
- Reserve Bank of New Zealand Interest Rate Decision Link
- Japan September Current Account Link
- US Federal Reserve Interest Rate Decision (Two-Day Meeting) November 7-8 Link

Thursday, November 8

- German September Trade Balance Link
- French September Current Account Link

In Italy, Prime Minister Giuseppe Conte said the country's weak third-quarter gross domestic product data provided justification for his government's expansionary budget proposal.

Conte and Deputy PM Matteo Salvini reiterated that the controversial Italian budget would remain as the government endeavours to fight to address "social and economic emergencies in Italy".

The Italian Treasury confirmed it is to respond to the European Commission (EC) on its debt reduction proposals by November 13 after the EC said Italian debt levels were a concern for the entire eurozone.

- EU Economic Bulletin Published Link

Friday, November 9

- UK Third-Quarter Gross Domestic Product Link
- UK September Trade Balance Link
- China October Consumer Price Index Link
- China October Producer Price Index Link
- US Federal Reserve Vice Chairman for Supervision Randal Quarles Delivers Speech on Stress Testing, Washington D.C. Link
- US October PPI Link

Monday, November 12

- Italian September Industrial Production Link

In the United Kingdom, Chancellor of the Exchequer Philip Hammond presented his Budget, on Monday. He promised to increase spending, while warning of the risks of a potential "no-deal" Brexit. He advised that public spending would increase by 30% and borrowing would be cut.

Last week was a volatile one for the British pound. It dipped on Tuesday after a leading rating agency warned of risks around the UK leaving the European Union (EU) with no deal in place. The currency subsequently rallied on Wednesday after a report that UK Brexit Secretary Dominic Raab expects a deal to be agreed by November 21.

Further gains were made on Thursday when it was reported that the United Kingdom had struck a deal with the EU which would give UK-based financial services firms access to European markets. This was then played down by EU Negotiator Sabine Weyand, who said that there had been no change and that she didn't see a deal happening before the end of November.

The Bank of England released its interest-rate decision on Thursday. As expected, it kept rates on hold but monetary policy makers did hint that they were keeping their options open ahead of Brexit.

Last week, economic data releases in Europe were generally disappointing. Eurozone third-quarter GDP was lower, seeing its weakest quarterly increase in four years. On the year, the economy expanded 1.7% versus an expected 1.8% rise. Weaker growth from heavyweights Germany and Italy weighed on the euro area as a whole.

Americas

In the United States, equities managed to reverse at least some of October's losses as the month drew to a close. Commentators pointed to overselling throughout the month as one of the catalysts for last week's strength, with all the major indexes up at month end.

Materials outperformed as easing trade tensions provided some support. Utilities was the only sector to trade lower with investors moving into more risky assets.

Third-quarter earnings season continued with overall earnings outperforming market expectations. In terms of macro data, the focus was on the US October employment report, where non-farm payroll gains were better than expected. The October unemployment rate was held at 3.7% whilst average hourly earnings rose in line with expectations.

US consumer confidence rose more than expected, while present conditions and consumer expectations were at multi-year highs.

Consumer spending increased in line with expectations, while personal income slowed, meaning savings fell to it lowest level since 2013. The US dollar rose to a 16-month high. These data points and the releases were considered supportive of the US Federal Reserve's plans for gradual interest-rate rises.

Asia

Last week, Asian equities managed to snap five straight weeks of losses on the back of fresh optimism over trade and continued intervention from Chinese officials. Hong Kong's equity market was the clear outperformer in the region, but stocks in mainland China were also strong. The majority of those gains were made on Friday after a stronger yuan fixing from the Peoples Bank of China (PBoC), alongside hope from trade headlines.

Weakness in the Japanese yen (which was driven by risk-on sentiment) helped support equities there.

Australia didn't miss out on the rally though. Equities there enjoyed their biggest weekly gain since November 2016.[2]

China's appetite for continued market intervention was clear on Wednesday as the Chinese politburo stressed the need for "timely countermeasures" to support the Chinese economy.

China's Vice Finance Minister Zou Jiayi said China was planning more tax cuts to help spur domestic consumption. In addition to this, the country's securities regulator said it would encourage share buybacks and merger and acquisition activity by listed companies as well as reducing trade resistance and increasing market liquidity.

On the macro front, the argument for intervention gained further momentum as data continued to reflect the damage caused by the trade war.

In central bank news, the Bank of Japan (BOJ) voted to keep rates unchanged at its October meeting. The BOJ also trimmed its inflation forecasts for 2018 and 2019, but did reiterate that inflation was expected to continue to gradually rise towards 2%.

Macro data from Australia was mixed. The country achieved a trade surplus of A$3.02 billion, the largest since February 2017 and the third-largest on record. On the other hand, inflation fell short of expectations.

Week Ahead

It promises to be an interesting week ahead, with the US midterms likely to be the focus for many. The political situations around Italy and Brexit will likely continue to make waves, and it's another busy week in the corporate earnings season.

Outside of this, we have another meeting of the US Federal Open Market Committee (FOMC) and the release of German Industrial production data. Given recent data, a failure to see a production pickup will increase concerns that growth momentum has faded for the European powerhouse.

Politics

- US midterm elections on Tuesday will determine whether Republicans keep control of Congress, and set the stage for President Donald Trump's 2020 re-election bid.
- On Monday EU's Chief Negotiator Michel Barnier delivers a speech on Brexit.
- Monday also sees Chinese President Xi Jinping addresses the country's first International Import Expo in Shanghai. And Bank of Japan Governor Haruhiko Kuroda gives a speech and holds a news conference in Nagoya
- US Secretary of State Michael Pompeo is expected to accompany President Trump on a visit to Paris on Friday.
- Also on Friday, EU foreign affairs ministers meet in Brussels to discuss modernising the World Trade Organization, review the latest free-trade agreements, and discuss screening foreign direct investments.

Economic Data

- Corporate earnings season continues, with busy weeks expected in both the United States and Europe this week. Earnings also kick off in earnest in Asia.
- Europe Macro highlights: German Industrial Production (Wednesday), First estimate of UK Q3 GDP (Friday)

- US Macro highlights: Job Openings and Labor Turnover Survey (JOLTS) (Tuesday, likely to put payrolls into perspective), Producer price growth (Friday), University of Michigan sentiment (Friday)
- Asia Macro highlights: Japan Household spending (Tuesday), Japan machine orders (Thursday), China trade data (Thursday), China consumer price index (CPI) and producer price index (PPI) (Friday)

Monetary Policy

- On Thursday, the ECB Bulletin to be published and the European Commission will also release fresh economic forecasts.
- Thursday will see the FOMC likely keep the fed funds rate unchanged.
- On Tuesday, the Reserve Bank of Australia announces its interest-rate decision.
- On Thursday, the Bank of Japan releases a summary of opinions from its October 30-31 policy meeting.

Views You Can Use

Insight from Our Investment Professionals

The Race to Harness AI Technology in Asia

Artificial intelligence (AI) and automation present enormous investment opportunities, some in ways we don't even know yet. As the world adapts to technological advances, Franklin Templeton Emerging Markets Equity's Sukumar Rajah and Eric Mok think some promising developments in Asia could dictate the pace of change in the burgeoning AI market. Alongside this, they think infrastructure for new technology is likely to be just as significant if AI development is to truly thrive. They take a look at the implications for the region. Read More.

US Equity Market: Are Things as Good as They'll Get?

The US equity market's ascent paused in October as investors digested rising rates, slowing global growth and the persistent question: "Are things as good as they'll get?" As many observers expect further turbulence ahead, Franklin Equity Group's Grant Bowers shares his view on US equities, the economy, and how to stay focused on long-term investing in a volatile market. Read More.

How Angela Merkel's Future Could Influence European Markets

Markets have largely brushed off speculation about the future of German Chancellor Angela Merkel as she stood down as leader of the Christian Democratic Union party. However, Franklin Templeton's Head of European Fixed Income David Zahn believes her decision could have ramifications, both politically and economically, in the not-so-distant future. Read More.

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1. The MSCI Emerging Markets Index captures large- and mid-cap representation across 24 emerging-market countries. The MSCI AC Asia ex Japan Index captures large- and mid-cap representation across two of three developed markets countries (excluding Japan) and nine emerging-markets countries in Asia. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. MSCI makes no warranties and shall have no liability with respect to any MSCI data reproduced herein. No further redistribution or use is permitted. This report is not prepared or endorsed by MSCI. Important data provider notices and terms available at www.franklintempletondatasources.com. Past performance is not an indicator or guarantee of future performance.

2.. Based on the the S&P/ASX 200 Index, designed to measure the performance of the 200 largest index-eligible stocks listed on the Australian Stock Exchange by float-adjusted market capitalization. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. Past performance is not an indicator or guarantee of future performance.