EQUITY

Notes From the Trading Desk - Europe

December 3, 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 were broadly higher last week. European equities returned to the black after two weeks of losses. US markets were higher across the board, with hints of a potentially more dovish US Federal Reserve approach lending a boost. Hopes for an improved trading environment ahead of the G20 meeting also underpinned the performance of US equities. Equities in Asia also enjoyed a rally, paring three weeks of losses.

The Digest

G20 Summit Shows Signs of Truce

US/China Tensions Ease

Many commentators have cited the ongoing trade tensions between the United States and China as the biggest risk facing markets. So expectations were high ahead of the meeting of leaders of the G20 last week, and the outcome seems positive. Although the risk of a trade war has not been completely neutralised by events at the meeting, it has been dampened somewhat.

On the sidelines of the G20 meeting, the United States announced it was postponing an increase in the rate of tariffs payable on US$200 billion of Chinese goods. The tariffs had been due to increase to 25% from 10% on January 1, 2019, but the US authorities confirmed the rise would be delayed for 90 days.

Subsequently, China pledged to buy more from the United States, including an immediate increase in purchases of US agricultural products.

China is also said to have agreed to reduce and remove tariffs on cars coming into China from the United States. Currently the tariff is 40%. On Monday this week, China's foreign ministry stated that Presidents Donald Trump and Xi Jinping had instructed their economic teams to work towards removing all tariffs.

WTO Reform on the Cards

In other encouraging moves, the G20 leaders pledged to support reform of the World Trade Organization (WTO) to "improve its functioning".

Given Donald Trump's previous criticism of the WTO, this should be taken as positive, in our view. We believe an overhaul of the WTO has the potential to rein in US protectionism and improve global trade relations.

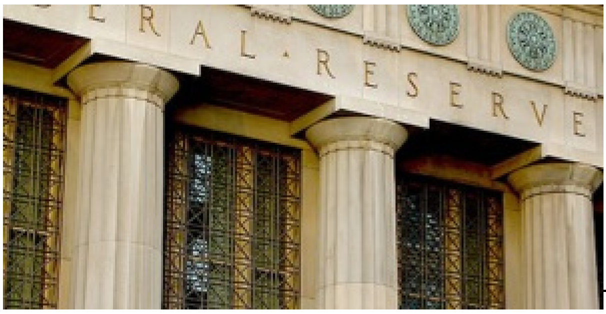
EU and US Back on the Same Page?

Finally, European Commission President Jean-Claude Juncker was quoted as saying: "The President of the US and I have come to a common understanding of how to develop our trade relationship… and we are working hard to fulfil our joint ambition of slashing costs and further easing trade."

We would caveat all of this positivity: In the past, President Trump has tended to offer a more conciliatory tone during such meetings, before back tracking and moving back towards a harsher stance.

Trump has also been uncharacteristically quiet on Twitter following the death of President George H. W. Bush, meaning we have less insight into his thinking than we might usually have. Only time will tell what happens here, but the headlines are being taken well by markets so far, with a strong rally in China in early trading on Monday this week setting the tone for European markets.

US Fed Boosts Markets With a Dovish Slant



The equity rally in Asia and Europe in early trading this week comes after a more dovish tone from the US Fed gave a boost to US markets last week. The S&P 500 Index posted its best week of the year.

Commentators interpreted a midweek speech from Fed Chair Jerome Powell as more dovish in tone than expected. In the speech, Powell described interest rates as "just below" the estimates of neutral. Only the previous month Powell had said: "We're a long way from neutral at this point, probably."

His latest comments reinforced the tone of minutes from the latest Federal Open Market Committee. These minutes, which were released last week, were also skewed to the dovish side, and noted that there had been discussion to remove the "further gradual increases" language.

The US dollar weakened following Powell's commentary, but did manage to retrace its losses by the end of the week. US Treasuries strengthened, with the 10-year Treasury yield slipping below 3% for the first time since September.

US data last week was mostly disappointing, lending support to the dovish tone.

The Fed is suggesting a greater emphasis on data dependency: if data comes in strong, the central bank intends to continue to proceed with interest-rate hikes.

This week, Fed Chair Powell is scheduled to deliver testimony to the Joint Economic Committee of Congress on Wednesday. Investors will look out for any further dovish slants, or any efforts to tone down the perceived level of dovishness.

Brexit Noise Continues…

The FTSE 100 Index underperformed broader markets last week, partly due to Brexit uncertainty. Weakness in the pound proved less effective than it has been in boosting the exporter-heavy index.

UK Prime Minister Theresa May will spend this week trying to sell her Brexit deal to members of parliament ahead of a vote in the House of Commons on December 11. She has already faced opposition from both inside and outside her own party.

Notwithstanding the positive news from the G20 summit, there was worrying news for Mrs May on trade last week.

US President Trump warned midweek that the Brexit deal favoured by May could curb the United Kingdom's ability to strike a trade deal with the United States. He urged May to reopen talks with Brussels, something she and European Union (EU) leaders have said won't happen.

The Bank of England's (BOE's) Brexit analysis, published last week, painted a gloomy picture in the event of a so-called "Disorderly Brexit". But the report suggested that the United Kingdom would likely be poorer under all exit scenarios modelled.

Despite its worrying forecasts, the BOE Governor Mark Carney said the bank was prepared for the worst-possible Brexit scenario.

These comments were supported by results from the BOE's latest stress test for banks, which said the banking system was "strong enough to continue to serve UK households and businesses" even in a no-deal divorce. The UK's seven largest lenders all passed the BOE's latest stress test.

Last Week

Europe

European markets were stronger overall last week. Changes to US Fed Chair Powell's rhetoric as well as renewed hopes that a compromise could be found on the Italian budget deficit buoyed equities.

Italian equities were among the outperformers last week amid optimism that the government may back down in its conflict with the EU over its proposed budget deficit for 2019. The Italian government and the EU have been on a collision course in recent months over the government's spending plans and its 2.4% deficit target.

Reports in the Italian press suggested the government was considering lowering its deficit target. Deputy Prime Minister Matteo Salvini said 2.4% was a moving target while Prime Minister Giuseppe Conte stated that the new deficit target would "almost certainly" be 2.2%.

LOOK OUT FOR... (DECEMBER 3 - 10):

Monday, December 3

- Australia October Building Approvals Link
- Eurogroup Meeting Link

Tuesday, December 4

- Canada Third-Quarter Labour Productivity Link

Wednesday, December 5

- Bank of Canada Interest Rate Decision Link
- Australia Third-Quarter Gross Domestic Product Link
- US Beige Book Published Link

Thursday, December 6

- German October Factory Orders Link
- Organization of the Petroleum Exporting

However, some reports suggested the government might aim even lower. It has been reported that the European Commission will meet to decide on any disciplinary action against Italy on December 19. Italian bond yields had softened as last week went on.

Investors will be carefully monitoring the situation this week for any sign of a budget compromise between the Italian government and EU officials and the impact on the evolving political landscape in the country.

In terms of macroeconomic data from Europe, it was a fairly poor week. Eurozone consumer confidence was lower but in line with estimates. Economic confidence slowed with the focus on the softness in Germany's reading. German consumer confidence fell, as trade-war concerns, Brexit, the Italian budget as well as rising fuel costs all weighed on the market.

Countries Meeting Link
- US October Factory Orders Link
- Australia October Trade Balance Link
- Canada October Trade Balance Link

Friday, December 7

- German October Industrial Production Link
- US Employment Report Link
- Canada November Unemployment Rate Link

Sunday, December 9

- China November Consumer Price Index Link
- China November Producer Price Index Link

Monday, December 10

- Japan Third-Quarter GDP Link
- German October Trade Balance Link
- UK October Manufacturing Production Link
- UK October Trade Balance Link

German flash consumer price index (CPI) also disappointed, rising just 0.1% on the month and missing estimates. German retail sales took a dip, down 0.3%, with a rise of 0.4% expected. German unemployment did beat however, falling to a record low of 5%.

Despite economic data disappointing of late in Europe, European Central Bank President Mario Draghi insisted that the bank's stimulus programme was still on course to end in December. Draghi said the decision to close out the asset purchasing programme remained subject to inflation beginning to show signs of rising. He also argued that recent weakness in economic data was relative to the outperformance seen in the eurozone in 2017 and suggested recent soft readings may be "temporary".

Americas

Last week saw US equity markets bounce back sharply from recent lows amid dovish commentary from the Fed and improving sentiment ahead of the G20 summit. The S&P 500 index rallied 4.8%, which represents the index's best weekly performance in 2018.[1] Note, the S&P 500 Index has now recovered back to its 200-day moving average,[2] an important psychological level for the index.

In terms of sector performers, we saw a reversal of recent form: the consumer discretionary and technology sectors recovered some ground after a torrid November.

Other events last week overshadowed US macro data. However, revised third-quarter gross domestic product data came in at 3.5%, in-line with expectations.

Asia

Asian markets also performed well last week as hopes grew for progress in US/China trade talks. The US Fed's apparently more dovish stance eased headwinds for Asian emerging markets.

Japanese equities led the way higher thanks to a weaker yen. A particularly strong Japanese October flash industrial production figure, representing its fastest pace in over three years, helped sentiment.

Chinese macro continued to disappoint as the trade conflict weighed on the market. November manufacturing purchasing manager index (PMI) data stalled for the first time in over two years. Industrial profits also slowed.

Meanwhile, South Korea's central bank, the Bank of Korea, raised interest rates for the first time this year as it looks to tackle high consumer debt and financial imbalances in the economy.

Week Ahead

We expect the main catalysts for this week likely yo be US Fed Chair Jerome Powell's testimony to Congress and Thursday's meeting of the Organization of the Petroleum Exporting Countries (OPEC).

The consensus view is that OPEC will cut output by at least 1 million barrels per day, although some recent comments from Saudi Arabia that it will not "act alone" to stabilise the oil market is causing some doubt.

Politics

- We have five days of debate on the Brexit deal to come, with Theresa May looking for support for the crucial parliamentary vote on December 11.

Economic Data

- Europe macro highlights: UK retail sales (Tuesday), German manufacturing orders (Thursday), Euro area final GDP (Friday), German industrial production (Friday – important given recent weakness from the European powerhouse).
- US macro highlights: Trade balance (Thursday), factory orders (Thursday), nonfarm payrolls (Friday).
- Asia macro highlights: A quieter week, but we get China foreign exchange reserves (Friday).

Fiscal Policy

- Fed Chair Jerome Powell will testify before Congress on Wednesday, alongside the release of the Fed's Beige Book.
- We hear from BOE Chief Economist Andy Haldane on Monday, and Governor Mark Carney and Monetary Policy Committee Member Gertjan Vlieghe on Tuesday.

Views You Can Use

Insight from Our Investment Professionals

An Integrated Approach to Managing ESG Risks and Opportunities

Over the years, as new information has emerged and evolved, investors have found innovative means to harness new insights to help inform their decisions. Today, some forward-looking investors are deepening their focus on environmental, social and governance (ESG) analysis to provide additional perspectives to complement existing research efforts. Julie Moret, Franklin Templeton's head of ESG, explains how ESG contributes to an evolved investment evaluation framework and serves as a tool to assess broader holistic risks. Read More.

Are We Nearly There Yet?: Revisiting the Politics and Processes of Brexit

In the summer, Sandy Nairn, Chairman of Templeton Global Equity Group and CEO of Edinburgh Partners, authored a paper entitled *The Politics and Processes of Brexit*. The paper explored a number of scenarios the United Kingdom faces on its path to Brexit. One of the questions Nairn posed was "Are markets underestimating the chances of the United Kingdom not leaving?" In this update, he examines the current situation and revisits that question. Read More.

Meet the Manager: Wendy Lam

After receiving a Ph.D. in biology, Wendy Lam found her calling in the science of *investing.* Now a portfolio manager and research analyst, Lam shares some anecdotes on why she chose a career in investment management instead of science. She also explains why data is always the critical driver in her decision making. Read More.

October Market Recap and Outlook: A Sea of Opportunities

Emerging markets continued to struggle in October amid an environment of heightened equity-market volatility globally. Manraj Sekhon, CIO of Franklin Templeton Emerging Markets Equity, and Chetan Sehgal, senior managing director and director of portfolio management, believe the pullback presents long-term investors with opportunities amid what they dub an overreaction. They present the team's overview of the emerging-markets universe in October. Read More.

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Important Legal Information

What Are the Risks?

Links to External Sites

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1. Indexes are unmanaged and one cannot invest directly in them. They do not include fees, expenses or sales charges.

2. The 200-day moving average is a technical analysis indicator which is used to analyze long-term price trends. It represents the average closing price of an individual security or index over a period of 200 days.