



EQUITY

# Notes From the Trading Desk - Europe

December 17, 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.*

European equities closed higher last week higher, but a tough Friday saw the markets in the United States end lower. Asian equities also came under pressure reflecting the impact of trade tensions on the Chinese economy.

## The Digest

### Markets Grind Higher, With a Defensive Tilt

Positive catalysts helped European equities edge higher throughout last week. These included the hopes of an easing in global trade- war tensions and political progress in Italy. Nevertheless, concerns over Brexit and some disappointing data from Europe and China continue to cast a dark shadow.

It's worth noting that even though equities in Europe posted gains last week, there was a defensive tilt to the move higher. Utilities stocks outperformed and basic resources ended the week up, helped by the easing of trade tensions.

On the other hand, the retail sector was the worst-performing sector, not helped by profit warnings and dividend cuts among UK retailers.

### Trade Wars Ease, But Data Disappoint



It was a slightly different story in the United States last week. Equities finished the week lower following a sharp move tied to worrying economic data from China on Friday as external pressures from trade tensions with the United States really start to materialise.

November trade data showed that Chinese exports fell almost 3% month-on-month and imports fell 9.2%. Consumer price index (CPI) figures show Chinese inflation also eased last month to 2.2%.

We expect the United States will now likely be encouraged to demand even greater concessions in trade negotiations, given that China cannot afford to keep being hit by new US tariffs. Ahead of Friday's data dump from China, trade tensions with the United States had eased somewhat, helping sentiment towards global equities and driving market moves.

Media reports suggest China is drafting a replacement for its “Made in China” 2025 plan in an effort to de-escalate trade tensions. The original plan had come under attack from the Trump administration for allegedly being too protectionist.

According to the media reports, China’s revised plan would include dropping Chinese companies’ numerical targets for market share. It would also set out policies aimed at introducing fairer competition among state-owned, private and foreign firms based on the concept of “competitive neutrality”.

In other signs of easing tensions between China and the United States, China cut a retaliatory duty on automobiles and the White House officially delayed a tariff hike on US\$200 billion of Chinese imports until March 1. The markets took these measures well.

China also completed a major purchase of soybeans, buying more than 1.5 million tons, worth in the region of US\$500 million.

It was not plain sailing, of course, as US national security officials told lawmakers in Senate hearings that Beijing continues to exploit US technology in a bid to develop its own economy. We can expect more headlines throughout the coming days.

## **US Yield Curve Steepens**

After several weeks in which concerns over a slowdown in the US economy and the US Federal Reserve (US Fed) rate-hike path have prompted discussion about a flattening yield curve, counterintuitively, the curve steepened last week. The move came despite the weakness in US equities and a solid US CPI reading that observers believe is supportive of an interest-rate hike later this week from the US Fed.

The 10-year US Treasury yield gained 5 basis points (bps) on the week, and the 10-2-year spread steepened 2bps. The move may be due to positioning given the aggressive flattening we saw recently, and we are likely also seeing some caution until the next expected Fed rate hike is confirmed on Wednesday.

Since the September Fed meeting, the US economic backdrop has weakened modestly. Financial conditions have tightened, and Fed rhetoric has turned more dovish. Given all of this, rate-hike expectations (as expressed in the so-called “dot plots”) for 2019 and beyond will be of interest. Market expectations are now for just one rate hike in 2019, while the Fed’s September dot plot had put the median projection at three rate hikes.

The increase in dovish expectations saw the US bank stocks underperform last week, although the US dollar still managed to strengthen as the policy differential of the Fed versus other major central banks in Europe and Japan continues to favour the US currency.

Concerns over Brexit and a weaker macro picture for Europe also helped this dynamic, with both the pound and euro lower on the week.

Alongside this, political developments in the US remained a market headwind. The prospect of a government shutdown is becoming more and more likely. Nonetheless, with 75% of the 2019 operating budget already funded, the effects of a government shutdown would be fairly limited.

## **European Political Update**

### **Italian Budget Hopes**



In Europe, we saw the spread between yields on Italian and German government bonds tighten.

German bond yields remained largely unchanged with positive trade headlines playing off against weaker economic data and a dovish leaning European Central Bank (ECB). Italian yields tightened significantly after Italian Prime Minister Giuseppe Conte submitted a revised budget to the European Commission.

The revised budget suggests a 2.04% deficit compared with the 2.4% envisaged in the earlier version. We would note that this is not yet a done deal. As the Italian government still plans to go ahead with its spending plans and it is not clear how the reduced deficit will be supported.

## Brexit Uncertainty Prevails

It was a big week for Brexit news. But in the end very little changed. Among the main developments:

- As we predicted, Theresa May deferred the parliamentary vote on the Withdrawal Agreement as she did not have enough parliamentary support. The pound hit 20-month lows on the back of the news.
- May declined to reveal when the vote will now be held, but reiterated that January 21 is deadline in Brexit legislation by which the government has to get a deal.
- Following her push back of the vote, the prime minister faced a leadership challenge, which she survived, although she conceded that she would step down before the next General Election.
- May then went to the European Union (EU) to secure a legally binding assurance that the Northern Ireland backstop would not be an inescapable “trap,” but the EU said it was not open for renegotiation, increasing the uncertainty over the future.
- A UK vote on the plan is now not likely until January and the continued uncertainty saw sterling close down 1.1% on the week.
- It’s also worth noting that the EU did offer a life line early in the week as the European Court of Justice (ECJ) confirmed that the United Kingdom could unilaterally revoke Brexit and remain in the EU under terms that are unchanged with regards to its status as a member state.

Data from the UK continued to be softer last week as the whole situation continues to weigh on the economy.

House-price data disappointed even on low expectations, and the trade balance was wider than expected for October. Industrial production also missed consensus estimates.

## Last Week

### Europe

European markets were higher overall last week reflecting optimism over easing US-China trade tensions and the apparent solution to the Italian budget saga. Peripherals including Finland, Hungary and Denmark led the way.

There was plenty of macroeconomic data out of Europe last week. But worryingly, eurozone flash Purchasing Manager Index (PMI) data were weak.

### LOOK OUT FOR... (DECEMBER 17-21):

#### Monday, December 17

- Eurozone November Consumer Price Index [Link](#)
- Eurozone October Trade Balance [Link](#)
- US November Housing Starts [Link](#)

#### Tuesday, December 18

- Reserve Bank of Australia Monetary Policy

The German October trade balance figures beat estimates; however, German economic sentiment was mixed.

There were a couple of bright spots as eurozone and Italian industrial production figures were better than expected and eurozone November CPI readings were broadly in line with provisional readings.

In central bank action, as expected, the ECB kept rates on hold at -0.4%. It confirmed it expected no change to rate guidance at least until next summer.

ECB President Mario Draghi said the eurozone is now facing downside risk as the ECB lowered growth forecasts for 2018 and 2019 and reduced expected 2019 inflation levels. He also confirmed that the quantitative easing programme would end in December (as expected). The ECB has altered its reinvestment plan so that existing purchased bonds coming to maturity will be reinvested.

## Americas

US markets finished last week down, with moves on Friday reversing the gains earlier in the week.

Markets had been stronger through the week after trade talks between the United States and China appeared to make some progress.

In terms of sectors, household products was the strongest, while the banks lagged ahead of the Federal Open Market Committee (FOMC) meeting this week.

In terms of US macro data, the US PMI composite also fell, with new orders at their lowest level since April 2017. November headline CPI slipped but was in line with expectations at 2.2%. November retail sales growth was better than expected but was still down to 0.2% from +0.8% in October.

## Asia

Asian markets drifted lower last week as nerves over US/China trade tensions and the impact on the Chinese economy remained front and centre.

There was also some disappointing macro data from Japan last week. The country's third-quarter gross domestic product was revised lower. October core machinery orders also missed estimates. With Japan's government planning to raise consumption tax next year from 8% to 10%, the government will be watching for signs of any slowdown. Last week, it announced a number of tax breaks for housing and cars to try lend further support for the economy.

## Week Ahead

With a number of holidays coming up, this week will represent the last meaningful trading volumes of the year. The most notable catalyst comes mid-week, with all eyes on the Fed meeting on Wednesday.

## Politics

- We expect the Brexit debate will continue to dominate headlines in the United Kingdom. Theresa May will deliver a statement to parliament, updating member of parliament (MPs) on the EU Summit. Parliament goes into recess on the December 20.

## Wednesday, December 19

- German November Producer Price Index [Link](#)
- UK November PPI [Link](#)
- Canada November CPI [Link](#)
- US Federal Reserve Monetary Policy Meeting [Link](#)
- New Zealand Third-Quarter Gross Domestic Product [Link](#)

## Thursday, December 20

- Bank of Japan Monetary Policy Meeting [Link](#)
- Bank of England Monetary Policy Meeting [Link](#)

## Friday, December 21

- French Third-Quarter GDP [Link](#)
- UK Third-Quarter GDP [Link](#)
- US Third-Quarter GDP [Link](#)
- Canada October GDP [Link](#)
- Japan November CPI [Link](#)

- The European Commission is expected to decide on any disciplinary action against Italy in relation to its proposed budget.
- French President Emmanuel Macron remains under pressure after another weekend of protests, albeit on a smaller scale.

## Monetary policy

- It is a big week for central banks with the Fed, Bank of Japan (BOJ) and Bank of England (BOE) all holding monetary policy meetings.
  - The Fed meeting and interest-rate decision is due on Wednesday, with the market currently pricing in a 74% chance of a rate rise.
  - The BOJ has a meeting rate decision on Thursday. No changes to interest rates are expected.
  - Thursday also brings the BOE meeting; again, no change to rates is expected.
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## Views You Can Use

### Insight from Our Investment Professionals

#### [Does a Brexit Resolution Require a New Referendum or a General Election?](#)

Political infighting abounds in the United Kingdom as the clock ticks relentlessly towards the March 29 Brexit date. Amid entrenched positions on all sides, Sandy Nairn, Chairman of Templeton Global Equity Group and CEO of Edinburgh Partners, argues that only a fresh referendum or a general election can break the Brexit deadlock and examines some of the implications for investors. [Read More](#).

#### [Theresa May Holds on, but What Does This Mean for Investors?](#)

Theresa May has survived a leadership challenge called by Eurosceptic members of her own party and will continue to lead the United Kingdom as it heads towards Brexit. But David Zahn, Franklin Templeton Fixed Income Group's head of European Fixed Income, warns May's troubles are not over yet. He predicts further volatility ahead for financial markets, but argues there may be opportunities for shrewd active managers. [Read More](#).

#### [Distortion, Divergence and Diversification: 2019 Global Investment Outlook](#)

Volatility has plagued equity markets globally in 2018—most notably emerging markets and US equity markets. As the US economic expansion officially crossed the nine-year mark in 2018, many investors started to wonder when the cycle would change—and what the catalyst might be. Our senior investment leaders see plenty of reasons to be optimistic about the year ahead, but recognise investment opportunities may be more divergent, with some previously overlooked countries or asset classes potentially taking the spotlight. [Read More](#).

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