EQUITY

Notes From the Trading Desk - Europe

January 7, 2019

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.

Last week brought a volatile start to the year. A number of catalysts saw risk-on sentiment in full force by the end of the week. US equities got a boost from a strong US employment report on Friday following a dovish address from US Federal Reserve (Fed) Chair Jerome Powell the previous day. Markets had already received a boost from easing monetary policy in China in the form of a 1% reserve requirement ratio (RRR) cut. Together these developments allowed markets to wipe out losses made in the first two days of 2019 and close the week higher.

The Digest

What Did The First Trading Days Of 2019 Bring?

A number of catalysts contributed to a positive end to the first week of 2019:

- Amid concern over the direction of US monetary policy, Powell attempted to reassure markets last week. Speaking on Thursday, he said the Fed could afford to be patient, given that inflation risk remains contained. He also insisted that US monetary policymakers were listening to the market.
- Friday's monthly employment report was positive, with nonfarm payrolls well ahead of expectations. Prior months were revised upwards and average hourly earnings also surprised to the upside, providing a boost to US equity markets.
- Also helping markets was some positivity on the trade front: US President Donald Trump expressed optimism following a phone conversation with China President Xi Jinping, although of course we remain at the mercy of the next headline.

Last week's news wasn't all positive, however. The United Kingdom's first data releases of 2019 were lacklustre and showed a stagnating economy. House price growth slowed, and businesses and consumers delayed purchases. Brexit concerns clearly were weighing on people's minds.

Eurozone services purchasing managers index (PMI) data also showed the slowest growth in over four years in December, and eurozone inflation came in at the lowest rate in eight months.

Review of The Year And What To Watch In 2019

After a bright start to 2018, which saw US equity indices make new all-time highs, all major global stock market indices closed the year in negative territory, with some even entering bear markets.

Trade wars between the United States and China, and political concerns in the United Kingdom and throughout mainland Europe weighed on investor sentiment. Alongside this, worries about a slowdown in global growth also played a part in dampening sentiment.

Equities: Regions and Sectors

Europe

- Germany proved to be the worst-performing equity market in Europe in 2018. It entered a bear market in early December, weighed upon heavily by its autos exposure. The European autos space came under heavy pressure because of uncertainty over trade tariffs.
- A [perceived stalling of economic growth also was not helping Germany.
- Bank stocks were only marginally better than the autos, and construction and materials was the next-worst sector.
- The United Kingdom fared slightly better, albeit still closing the year firmly in negative territory. Weakness in the pound given the mess of Brexit and the exporter-heavy nature of the country's large-capitalisation stocks should be taken into account here.

United States

- All three major US indices closed lower for the year for the first time since 2015, although they clearly outperformed their European counterparts.
- Looking at sectors, defensive rotation saw health care and utilities outperform—the only sectors to end the year in the green.
- The underperformers were energy (impacted by falling crude oil prices), materials and commercial services.
- US Fed policy was also a notable overhang for equities last year and we saw dramatic moves in Treasury yields.

Asia

- China was the big underperformer globally. Trade tensions with the United States were clearly an overhang, but the softening of the Chinese economy (even without the inevitable impact of trade tensions) and weakening yuan also contributed to equity weakness.
- The Japanese stock market surged to a 27-year high in October, with a weaker yen adding a boost. However, concerns over the US/China trade war saw a massive selloff in the fourth quarter, which caused a move into bear market territory on December 24 and ended with a negative close to the year.

Bond Yields

- Last year was an interesting one for bonds, with an the uncertain macro picture and tightening from some global central banks driving volatility in the asset class.
- In October, the 10-year US Treasury yield rose to its highest level since 2011 on the back of more hawkish rhetoric from the Federal Open Market Committee (FOMC). It did fall back to more reasonable levels, however, as expectations for further future rate hikes were dampened towards the end of the year.
- Causing further concern was a flattening of the US Treasury yield curve and worries about a potential inversion of the curve.
- The spread between yield on the two-year and 10-year US Treasuries tightened to less than 0.11% at one point, and there was some inversion at the front end of the curve. Historically, this kind of inversion has indicated potential recession on the horizon. This will be a concern to continue to watch through 2019.
- Should the yield curve continue to flatten in the United States, it could potentially weigh on US financial stocks. On the other hand, European banks have the potential to benefit from rising European Government Bond (EGB) yields. The end of the European Central Bank's (ECB's) purchasing programme is likely to be a key factor here.

Brexit

Brexit remained a theme throughout 2018, so let's quickly run through the important points we think investors should be aware of in the year ahead.

- Uncertainty about the terms of Brexit is likely to impact consumer spending and business investment into 2019, but the extent to which it will is up for debate. The first macro releases of 2019 have not been encouraging.

- UK Parliament returns from its recess this week, so we can expect headlines and debate to intensify once again. Over this past weekend, UK Prime Minister Theresa May said she would stick to her plan.
- A meaningful vote on her proposed deal is expected to go ahead at some point in the coming days, with parliament still looking likely to reject the proposal. But with no majority in parliament for the other two options (no deal or no Brexit), this would leave the process at an impasse and heading for a second parliamentary vote. Over the weekend, more than 200 cross-party members of parliament have written a letter to the prime minister asking her to remove the option of a no-deal Brexit.

China: Trade wars and Economic Slowdown

- China was one of the many concerns that plagued markets into the end of 2018, not only in terms of the direct impact of the trade tensions with the United States, but also fears that its economy was slowing.
- Friday's RRR cut showed that the Peoples Bank of China is concerned, but is also willing to intervene. We would note that the so- called "trade truce" between China and the United States, during which the United States has postponed an increase in tariffs, ends on March 1. So, we would anticipate headlines and the potential for further tariffs then.

European Slowdown

- It wasn't just China's economy that was cause for concern last year. A significant theme was the sharp slowdown in European growth from a strong second half of 2017. Stagnation in Germany caused particular concern.
- Eurozone growth slowed and was at its lowest level in four years in the third quarter of 2018.
- In 2019 we will be watching for any signs of stabilisation. Data from Germany this week wasn't a great start, showing that factory orders fell for the first time in four months.

Central Bank Policy and Economic Growth

- We think central bank policy will be in focus throughout 2019, as the ECB ended its bond buying programme last year and the Fed shifted towards neutral monetary policy. Worries over the pace of the Fed's tightening has the potential to spark volatility in both the equity and bond markets, as we saw last year.
- As we saw last week following Powell's address, markets are extremely sensitive to rhetoric from the Fed and this will be a key area to watch in 2019.
- Alongside all of this, global growth is key. If we continue to see growth stall and slow globally, tightening of fiscal policy could lead to a return of risk-off sentiment.

Last Week

Europe

European equity markets saw a positive end to last week as news of Chinese stimulus and dovish Fed commentary buoyed markets globally. Sectorwise, oil and gas stocks outperformed, thanks to a bounce in crude oil prices.

It was still a fairly quiet week in terms of newsflow in Europe. There was some disappointing eurozone macro data, with the eurozone services PMI showing the slowest growth in four years.

LOOK OUT FOR... (JANUARY 7-14):

Monday, January 7

- German November Factory Orders Link

Tuesday, January 8

- German November Industrial Production Link
- French November Trade Balance Link
- US November Trade Balance Link
- US November Job Openings and Labor Turnover Survey Link

Wednesday, January 9

A large part of this slowdown was attributed to the ongoing protests in France. If these protests continue to drag on, this will be a dynamic to watch in Europe in 2019, as pressure mounts on both the economy and the government.

Newsflow on Brexit was still limited, with UK politicians only returning from recess this week. Press reports suggest Theresa May will hold a parliamentary vote on her deal on January 15.

Americas

The first week of the year brought remarkable volatility for US equities, as the market slumped on the news of Apple's profit warning on Wednesday, only to snap back sharply on Friday thanks to Powell's dovish comments and strong macro data.

At the end of a breathless week, energy and bank stocks helped push US equities overall higher. Technology hardware was the worst- performing sector. Given the huge weightings for the tech sector in US equity indices, the impact of the tariffs on the tech sector is something we highlighted as a key risk throughout 2018.

If this pain continues, it could put real pressure on President Trump to make progress in the trade talks with China. Last week, Trump put volatility in financial markets down to the Democrats taking control of the House of Representatives.

The partial US Federal government shutdown continues in the United States as the Democrats and Trump administration remain at loggerheads over funding for a wall along the United States/Mexico border.

Asia

Focus was on China last week. Mainland Chinese equities closed higher in response to positive services data. In addition, US-China trade talks resume today, and there was some optimism of progress. The news of stimulus from the PBOC came after Asian markets had closed on Friday.

- German November Trade Balance Link
- Eurozone November Unemployment Rate Link
- Bank of Canada Interest Rate Decision Link
- Canada December Housing Starts Link
- US Federal Reserve Meeting Minutes Published Link

Thursday, January 10

- China December Consumer Price Index Link
- China December Producer Price Index Link
- European Central Bank Monetary Policy Meeting Link
- US Fed Vice Chairman Richard Clarida Delivers Speech on Economic Outlook and Monetary Policy at Money Marketeers of New York University Link

Friday, January 11

- UK Gross Domestic Product Estimate Link
- UK November Industrial Production Link
- UK November Trade Balance Link
- US December CPI Link

Monday, January 14

- Holiday in Japan

Week Ahead

Economic Data

- Europe: German industrial production figures are due on Tuesday; and UK gross domestic product data on Friday.
- Asia and Pacific: Japanese labour cash earnings growth on Tuesday; Chinese inflation and aggregate social financing data on Thursday; and Japan's household spending and current account surplus on Friday.

Politics

- US trade representatives were due in Beijing on Monday as talks resume with their Chinese counterparts on trade.
- UK parliament resumes debate on the Brexit withdrawal bill on Wednesday.

Monetary Policy

- ECB minutes are due on Thursday where focus will be on any hints over the timing of the next interest-rate rise.
- FOMC minutes are to be released on Wednesday.
- US Fed Chair Jerome Powell is due to speak on Thursday in Washington, DC.

Views You Can Use

Insight from Our Investment Professionals

Emerging Markets Equity Investing: Never Waste a Crisis

Emerging-market equity investors are likely happy to bid goodbye to 2018—a year filled with challenges and uncertainties. Chetan Sehgal, Franklin Templeton Emerging Markets Equity's director of portfolio management, examines some of these challenges and uncertainties, and makes the case that investors may have been overreacting. He says many emerging markets were unjustifiably priced for crisis-type situations. Read More.

Is it Time for Small-Cap Stocks to Shine?

As global markets increasingly ponder how long US economic growth can continue, Franklin Equity Group's Ed Lugo says he's looking for potential investment opportunities outside the United States. He explains why he sees opportunities in Europe and Asia, despite concerns about Brexit negotiations and a slowing Chinese economy. Read More.

What Will a US Government Shutdown Mean for Investors?

US members of Congress are finding themselves at a stand-off over the creation of a border wall between the United States and Mexico. President Trump's threats to shut down the government if the bill is not passed raise questions and uncertainty that will contribute to increased political risks for investors to consider. Stephen Dover, Head of Equities for Franklin Templeton Investments, shares his perspective about the potential impacts. Read More.

Who's Who in the ETF Ecosystem

Understanding the functions of all participants in a trade is a vital part of exchange-traded fund (ETF) investing. Two roles that are often confused, even by experienced investors, are Market Maker and Authorised Participant. Jason Xavier, head of EMEA ETF Capital Markets at Franklin Templeton Investments, offers a simple explanation of what each role plays in ETF trading. Read More.

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