EQUITY

Notes From the Trading Desk - Europe

February 11, 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.

Las week, European equities saw their first weekly decline in six weeks, with much of the selloff coming on Thursday after a good run for markets. A marked slowdown in European earnings weighed on stock prices, but positioning was also in play. In the United States, major indices took a pause for breath, managing to just eke out small gains. Solid US macro and the US Federal Reserve's (Fed's) dovish tone were both supportive of equities. Trade-war rhetoric and earnings season were also in focus. It was a quiet week for the Asia Pacific (APAC) region with many markets closed for the Lunar New Year. Australia was the standout performer for the week.

The Digest

Trade Wars Return to the Spotlight

Last week began positively with US President Donald Trump commenting that trade talks with China were "doing very well".

However, as we've grown accustomed to, the more upbeat sentiment did not last. On Thursday, Trump poured cold water on the possibility of an agreement on tariffs ahead of a key March 1, 2019 deadline. If there's no deal by then, the United States will increase its tariffs from 10% to 25% on around US$200 billion of Chinese imports.

Trump's fresh pessimism and the lack of a planned meeting between the presidents of the United States and China contributed to a selloff in US and European equities.

However, there is still some hope that a deal can be reached this month. US Treasury Secretary Steve Mnuchin and US Trade Representative Robert Lighthizer are set to travel to Beijing next week for more trade talks. The evidence suggests, however, there remains a sizable gap between the two sides' expectations.

The autos sector is one of those most impacted by these concern, an autos stocks struggled in both the United States and Europe last week.

Brexit Returns to the House of Commons

The Brexit debacle continues: there were many headlines last week, but little significant progress.

European Council President Donald Tusk provoked some anger when he said there would be a "special place in hell" for those who campaigned for Brexit without planning the finer details. His comments generated many dramatic headlines (many of which misquoted Tusk), but did nothing to advance the debate.

In other developments, UK Labour Party Leader Jeremy Corbyn wrote to Prime Minister Theresa May to lay out the circumstances in which he would support her deal. He called for a customs union, which was said to be well received by Tusk, but is highly unlikely to be taken into consideration by the UK government because it would alienate Brexiteers in May's own party.

May has, however, engaged with Corbyn on other ideas, including protecting workers' rights post Brexit, in a move to placate the opposition.

Writing in a Sunday newspaper, May suggested she would seek either an alternative to the controversial backstop, or a time limit or unilateral exit mechanism to prevent the United Kingdom from being trapped in European Union's (EU) structures indefinitely.

Of course, both of these suggestions have already been publicly rejected by Brussels, and so it is hard to see what this declaration could achieve.

In addition to his more dramatic commentary, Tusk also reiterated that the EU would not make a new offer to the United Kingdom on the withdrawal agreement. European Commission President Jean-Claude Juncker agreed, saying that he could not accept reopening the Brexit divorce deal. All of this seems to increase the risk of a no-deal Brexit.

So what happens next?

If Theresa May doesn't manage to get a new Brexit deal with the EU this week—as we've discussed is unlikely—she will then make a statement and put forward an amendable motion in parliament on Wednesday, February 13. Members of parliament (MPs) will debate, and possibly amend, the motion on Thursday.

During this debate, amendments could be passed with the aim of avoiding a no-deal situation, alongside others to give Parliament more say in the Brexit process.

There are also reports that MPs are likely to be willing to give Theresa May more time to renegotiate a deal.

May is now promising MPs that they'll have another chance to rule out no deal in another new amendable motion by February 27.

Pro-EU Tories who don't wish to rebel may be inclined to give May some breathing space and see what concessions she drags out of Brussels by then. So there remain a number of important dates to watch, but nothing concrete to report.

The impact of Brexit concerns on the UK economy is becoming clearer: The Bank of England cut its 2019 gross domestic product (GDP) growth forecast to 1.2% versus 1.7% previously, while the forecast for 2020 was cut to 1.5% versus 1.7%.

On Monday this week (February 11), there was further disappointing data as UK growth cooled sharply, ending 2018 on a downbeat note as industrial production contracted and consumer spending declined. The pound lost 1.03% versus the US dollar last week as concerns bubbled away.

European Macro Under the Microscope

It wasn't just the United Kingdom that disappointed on the macro front last week.

The worrying macro picture in the eurozone continued as the European Commission's Investor Confidence index hit a four-year low.

German December Factory Orders fell 7% year-on-year, reflecting the worst drop since summer 2012, and the industrial production figure from the European powerhouse wasn't much better.

Spanish December industrial production was extremely poor, down more than 6%.

And towards the end of the week, the European Commission revised its euro-area growth forecast to 1.3% from 1.9%.

The impact of the worsening macro picture is clear as we look at German bund yields, which have plummeted alongside risk sentiment. The euro also remains subdued, hitting new year-to-date lows versus the US dollar last week.

This Week

Europe

Last week, European equities suffered their first weekly decline of 2019 as data on the continent continued to disappoint. It was Europe's peripheral markets which outperformed last week while its core markets were particularly weak. Germany, Italy and France all ended the week in the red. The United Kingdom outperformed other core markets mainly thanks to sterling weakness.

Sector moves were mainly earnings-driven with health care and technology stocks generally up. Autos were the week's clear laggard amid disappointing earnings in the space and continuing trade-tariff concerns. Media and financials stocks were also weak.

As we progress through the fourth-quarter earnings season, the numbers indicate European names are on course for their worst quarter since 2014.

LOOK OUT FOR... (FEBRUARY 11-18):

Monday, February 11

- Holiday in Japan
- Eurogroup Meeting
- UK Fourth-Quarter Gross Domestic Product Link
- UK December Industrial Production Link
- UK December Trade Balance Link

Tuesday, February 12

- Monthly OPEC Report Published Link
- US Federal Reserve Chair Jerome Powell Delivers Speech on Economic Development in High Poverty Rural Economies Link
- New Zealand Central Bank Interest Rate Decision Link

Wednesday, February 13

- UK January Consumer Price Index Link
- US January CPI Link

In terms of central bank commentary, the Bank of England kept rates unchanged on Thursday after a unanimous vote. Rate guidance also remains unchanged; however, the GDP growth forecast was revised lower for 2019 from 1.7% to 1.2%.

Elsewhere, European markets took a dip on Thursday after the European Commission released its winter economic forecast. German, French and Italian GDP were all cut with Italy receiving the largest revision, down to 0.2% growth from 1.2% previously.

UK consumer spending growth came in stronger in January; however, this may have more to do with weak Christmas sales in 2018.

Thursday, February 14

Japan Fourth-Quarter GDP Link

- Germany Fourth-Quarter GDP Link
- Eurozone Fourth-Quarter GDP Link
- US January Producer Price Index Link

Friday, February 15

- Spain January CPI Link
- China January CPI Link
- China January PPI Link

Monday, February 18

- Holiday in the United States and Canada

Americas

Last week saw US markets pause for breath, as investors took stock of a glut of corporate warnings and digested the recent change of tack by the Federal Reserve.

Looking at sector performance, the utilities and software names outperformed, while the energy sector fell sharply as the price of crude oil slumped.

The US dollar continued its move higher, as US macro data continued to outperform the rest of the world.

In terms of big picture events, it was quieter last week although President Trump did make his delayed State of the Union address. There wasn't much in the address that directly impacted market action last week. He called on Congress to reach an agreement on border security and referred to the "economic miracle" taking place in the United States.

Talks between the Democrats and Republicans on avoiding another federal government shutdown are said to be deadlocked at the moment. The parties have been talking for two weeks and have a deadline of this Friday (February 15) to agree a deal on border security or face another shutdown.

Trump has threatened a further shutdown if the two sides cannot put forward a deal he supports. The previous 35-day shutdown reduced first-quarter GDP by 0.2%, according to the Congressional Budget Office. We expect the run-up to Friday's deadline will dominate headlines in the US this week.

Elsewhere, it is worth noting Fed speakers last week generally stuck to the new script. St Louis Fed President James Bullard said the Fed needed to tread carefully going forward.

Fed Chair Jerome Powell had dinner with Trump during the week and reiterated Fed policy would be based "solely on careful, objective and non-political analysis".

Asia

It was a quiet week for Asian markets amid the Chinese New Year holidays.

Australian equities enjoyed a strong week, with Australian banks rallying after the release of a Royal Commission Report which was not as severe as many anticipated.

In addition, the Reserve Bank of Australia (RBA) kept interest rates on hold at 1.5%, and the central bank lowered its forecast for growth in 2019 to "around 3%" from 3.5%.

Japanese markets lagged, as manufacturing purchasing manager index (PMI) data fell, showing the pace of activity hitting the lowest level since August 2016.

In addition, December household spending for Japan came in weaker than expected.

Week Ahead

Earnings season remains the focus in Europe this week. In addition, we expect US-China trade talks as well as Brexit negotiations to continue to hold attention.

Economic Data

- Europe: UK consumer price index (CPI) data is due on Wednesday; eurozone GDP and employment, German GDP and French unemployment on Thursday; UK retail sales, eurozone trade balance and car registrations on Friday.
- US: US CPI on Wednesday; US retail sales and import prices on Friday.
- Asia and Pacific: China foreign exchange reserves data on Monday; Japan GDP on Thursday; Chinese CPI on Friday.

Politics

- UK Prime Minister Theresa May is due to put forward an amendable motion on Wednesday. New voting on Brexit amendments on Thursday.
- Another round of US-China trade talks due through the week ahead of the meeting between Presidents Trump and Xi Jinping at the end of the month.

Monetary Policy

- US Fed speak with Loretta Mester and Esther George on Tuesday and Raphael Bostic on Wednesday.

Views You Can Use

Insight from Our Investment Professionals

The Real Risk in Today's Global Markets

While some observers might worry that the current global economic cycle is ending, Templeton Global Macro CIO Michael Hasenstab characterises the slowing growth we are experiencing as a cyclical slowdown, not the end of the cycle. He is more concerned with the political vulnerabilities he's seeing in the global economy today, and says the world's increasing fragmentation due to populist policies is a major concern. Read More.

K2 Advisors: It's the End of the Fed's World as We Know It

Market volatility returned with a vengeance towards the end of 2018, invoking memories of the Great Recession. K2 Advisors' Robert Christian and Brooks Ritchey believe the most recent turmoil has been a function of some asset-price distortions stemming from central bank actions. They explain what it all means for investors—and for hedge-fund vehicles in particular. Read More.

Liquidity Bump Underlines MENA Stocks' Appeal in 2019

Salah Shamma, Franklin Templeton Emerging Markets Equity's Head of Investment, MENA, sees an upcoming wave of liquidity that could create a splash for stocks in the MENA region in 2019. He explains what's behind this potential liquidity wave—and why Saudi Arabia in particular is capturing investors' attention. Read More.

Three Reasons to Embrace Emerging Market Corporate Credit

Robert Nelson, a portfolio manager with Franklin Templeton Fixed Income Group, believes emerging market corporate debt presents a compelling but under-appreciated investment story. Here he sets out three reasons why investors might consider an allocation to the asset class. Read More.

Chinese New Year: Symbolism in the Year of the Pig

On 5 February 2019, the Chinese New Year ushers in the Year of the Pig. Traditionally, the pig is the last animal represented in the 12-year Chinese astrological cycle.

Franklin Templeton Emerging Market Equity's Chetan Sehgal and Andrew Ness consider how the characteristics of the Chinese zodiac's pig might relate to some of the themes on emerging-market investors' minds in 2019. Read More.

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