EQUITY

Notes from the Trading Desk - Europe

March 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.

Global equities were weaker overall last week as markets struggled for any positive catalysts. Much of the focus was on the continued failure of the United States and China to strike a trade deal which would provide support to global markets. Weak Chinese economic data also weighed on global equities. Meanwhile, the outcome of the European Central Bank (ECB) governing council meeting failed to provide any real strength.

The Digest

ECB Takes a Dovish Stance

The ECB governing council met on Thursday (March 7). Ahead of the meeting, investor interest had centred on possible changes to rate forecasts as well as whether there would be any discussion of a fresh round of Targeted Long-Term Refinancing Operations (TLTROs).

As it turned out, the post-meeting communique was very dovish, with rate guidance pre-emptively pushed back to the end of 2019. Some commentators had expected that an explicit softening of guidance wouldn't happen until the ECB's April meeting, so this move hints at greater concerns over the eurozone economy among council members.

Confirmation of a new TLTRO programme, scheduled to start in September, also appeared more dovish than some observers had expected. There was plenty of speculation that such a move could be on the cards ahead of the meeting but expectations were generally geared towards a hint, rather than a full pre-announcement.

Pre-meeting speculation over the TLTROs had seen European government bond yields move lower, as TLTROs allow banks to use sovereign bonds as collateral. Italian yields were particularly impacted given funding concerns we saw towards the end of last year.

The ECB also reiterated plans to reinvest the proceeds of bonds maturing under its €2.6 trillion quantitative easing programme "in full" and for "an extended period of time", moving past the date when eurozone interest rates might begin to rise.

During his press conference, ECB President Mario Draghi revealed a larger-than-expected cut to economic forecasts. The 2019 euro-area growth forecast fell to 1.1% from 1.7%. Expectations had been for a less dramatic cut to 1.3%.

The euro dipped dramatically after the ECB announcement, hitting levels last seen in mid-February. This reaction suggests investors feel the ECB has been more dovish than had been priced in, despite all the speculation in recent weeks.

European banking stocks initially held steady before selling off, with the shine of the TLTRO programme apparently muted by the push back in rates.

Chinese Macro Data Weakens

With much of the focus in recent months on US/China trade relations, any impact this tension has upon Chinese economic data naturally garners interest.

In the last couple of weeks, hopes had been raised over the potential for a trade deal between the two countries, as the rhetoric took a turn for the better. However, as last week wore on, the lack of substantive progress towards a deal dragged on markets. The release of a change to Chinese growth targets as well as weak import and export data which emerged later in the week compounded the issue.

On Tuesday of last week, the National People’s Congress began in Beijing. The key takeaway for markets was that the government lowered its gross domestic product 2019 (GDP) growth target to a range of 6% – 6.5%. This had been amended down from 2018’s target of 6.5%.

The reason for the move was obvious—a clear softening in economic data. To counter the effects of this move, the Chinese government announced tax cuts worth US$298 billion for the year.

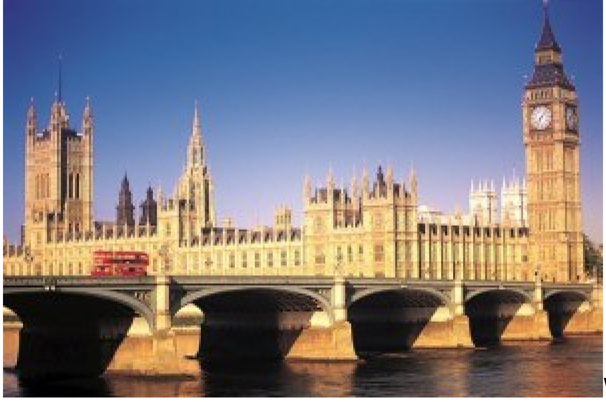
On Friday, we received the latest Chinese import and export data. The release showed exports were down nearly 21% on the year to February, while imports were down just over 5% in the same period. Naturally, this was taken poorly with mainland-listed Chinese equities experiencing one of the worst daily losses in years.

The data release was certainly an injection of realism into Chinese markets. As we continue in the hope of a trade deal being struck at some point, the question of the true impact of the tensions on the Chinese economy remains.

Not only that, if a trade deal is agreed, it almost certainly wouldn’t remove all the headwinds China faces. The impact of an economic downturn for this global powerhouse upon markets is clear; however, some feel that any meaningful long-term relief may not be too quick in coming—trade deal or not.

On the other hand, there have been some sign of progress over the weekend. The People’s Bank of China Governor claimed the United States and China had reached consensus on a number of “crucial issues”. This was complemented by commentary from the US Economic Advisor Larry Kudlow, who said he was “optimistic” that a trade deal could be struck.

A Big Week For Brexit Process

With just three weeks left until the Brexit deadline, this week sees a series of UK parliamentary votes that will determine the events leading up to the big day.

On Tuesday (March 12), members of parliament (MPs) will vote on Prime Minister's Theresa May's Brexit plan once again.

The last few weeks have seen the United Kingdom seeking concessions from the European Union (EU) over the Irish backstop. So far there's been little evidence of any success.

With May failing to get any meaningful movement from the EU, her plan will most likely be rejected in the House of Commons. If that happens, MPs will vote on Wednesday whether to accept the possibility of a "no-deal" Brexit. If MPs do reject "no deal" on Thursday, they will then vote on whether to request an extension to Article 50 pushing back the March 29 leave date.

It's worth noting that any extension beyond the end of June would meet difficulties around planned EU elections. This has encouraged Theresa May to talk of a "short and limited" extension to the end of June at the latest.

The potential for any surprises around these votes is fairly limited, in our opinion. However, we would note that markets remain at the mercy of the next headline.

This Week

Europe

European markets were mostly lower last week as growth concerns weighed on sentiment following the ECB's announcement.

The UK equity market was the outperformer, managing to remain flat on the week as weakness in the pound supported the exporter-heavy FTSE100.

Autos were the biggest losers on the week, with stock specific weakness driving the move. Banks also struggled on the back of the ECB communique, while real estate, telcommunications and food & beverage names outperformed given their defensive nature.

European cyclicals underperformed once again as bond yields fell with focus on the ECB and defensive rotation.

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

Monday, March 11

- German January Industrial Production Link
- German January Trade Balance Link

Tuesday, March 12

- UK Parliament Vote on Brexit Deal
- UK January Gross Domestic Product Link
- UK January Industrial Production Link
- UK January Manufacturing Production Link
- UK January Trade Balance Link
- French Fourth-Quarter Non-Farm Payrolls Link
- US February Consumer Price Index Link
- Australia January Home Loans Link

Wednesday, March 13

- UK Spring Statement
- Spanish February CPI Link
- Eurozone January Industrial Production Link
- US February Producer Price Index Link

While focus remains on Brexit, the political situation in Italy continues to bubble away. The two ruling coalition parties are in a spat over a proposed high-speed rail network to France. The issue has become a key point of tension between the Five Star Movement and The League as both aim to placate their existing supporters. Five Star has historically opposed the project, while the League's main support base is in the northern Italian regions which would reap the most benefit from such a link.

Last week Italian Premier Guiseppe Conte appeared to side with Five Star, telling reporters he was "not at all convinced that this is an infrastructure project Italy needs". However, over the weekend he hedged his position, allowing tenders to start, but asked for the French-Italian consortium in charge to abstain from any action that could bind Italy legally and economically.

Thursday, March 14

- China January Fixed Asset Investment Link
- China January Industrial Production Link
- German February CPI Link
- French February CPI Link
- US February Import and Export Price Indexes Link

Friday, March 15

- US January Job Openings and Labor Turnover Survey Published Link
- Bank of Japan Interest Rate Decision Link

Monday, March 18

- Eurozone January Trade Balance Link

Intervention from Conte came after the Five-Star controlled economic development ministry announced plans for Italy to endorse China's Belt and Road Initiative. This move appeared to drive a further wedge between Five Star and The League, which had called for "further reflection" from the government.

Market impact is limited so far, but these developments are a timely reminder of the fractious coalition ruling Italy and the potential upset to any stability. Speculation has risen that an escalation in tensions could see snap elections this year.

Recent polls show that Five Star has lost support to The League in recent months and so remaining firm on this significant issue becomes key in holding onto (and perhaps regaining) traditional supporters. Given this, it seems that tensions are only set to increase.

Americas

Last week saw a disappointing performance for US equities, with all major indices lower on the week.

Markets have had a good run year to date, and with a lack of fresh commentary around a US/China trade deal and the dovish stance from the US Federal Reserve (US Fed) now priced in, we saw profit taking and a risk-off tone to performance.

In addition, Friday's monthly employment data was weaker than market expectations. The defensive utilities and real estate investment trust (REITs) sectors outperformed, while the energy sector and healthcare underperformed.

Looking at the macro data in a little more detail, the monthly US nonfarm payrolls increased considerably less than expected. However, aside from the headline number, the rest of the employment data was broadly in line with expectations. Although the number of jobs added was undoubtedly disappointing, US weather in February was poor and there was also the hangover from the Federal Government shutdown. With that, some commentators suggested the weak number on Friday could have been a "one-off".

Asia

Asian markets were broadly lower last week, retreating from year-to-date highs after an impressive run and some incrementally negative headlines on trade.

A surge in the US dollar and the ECB-fuelled sell-off in bond yields also played into this dynamic.

Japan's equity market was the most notable underperformer in the region, with a stronger yen weighing on the market as investors looked for defensive plays. Cyclicals underperformed and losses in defensives sectors were muted, tying in with what we saw in Europe and the United States.

In China, exports for February were down 20.7% versus last year, while imports were down 5.2% year-on-year.

The one bright spot for the region was Australia. Australian equities managed to make small gains as the Reserve Bank of Australia (RBA) kept rates on hold for the 31st consecutive month.

The RBA's March policy statement noted that growth had slowed in the second half of 2018, but commentary was more positive and the central bank's central scenario remains for growth of around 3% in 2019.

Weak GDP data from Australia increased expectations for a rate cut this year, with markets now fully pricing this in, compared to a 60% chance last week.

Week Ahead

UK politics is likely to take centre stage as Theresa May puts her EU deal to parliamentary vote once again. Given her team is yet to negotiate any concessions from the EU, it seems likely we are set for another dramatic week.

Politics

- Brexit: All eyes will be on the UK parliamentary vote on May's Brexit deal on Tuesday. If it is rejected it will trigger votes on whether parliament want to proceed with a no-deal Brexit, or a delay to Article 50.
- US President Donald Trump's 2020 budget blueprint to be published on Monday. Focus will be on funding for his border wall with Mexican.
- On Wednesday, the UK Chancellor is due to publish his Spring Statement.

Macro

- Tuesday: US consumer price index (CPI) data; UK GDP and Industrial Production;
- Wednesday: Eurozone Industrial Production; US Durable Goods
- Thursday: Chinese Retail Sales and Industrial Production; German CPI. 'Quadruple Witching' sees a number of Index options rebalances and could bring increased volatility and volumes.
- Friday: US Industrial Production; University of Michigan Consumer Sentiment

Fiscal Policy

- It should be a quieter week for central banks. The Bank of Japan is scheduled to issue a policy decision on Friday.

Views You Can Use

Insight from Our Investment Professionals

Shifting Climate, Shifting Opportunities

Climate change—like any type of disruption—has disparate impacts on people, places and things. It can also have disparate impacts on corporations and investments. Krzysztof Musialik, senior vice president, Franklin Templeton Emerging Markets Equity, explores how climate change has impacted the global economy, and has created new potential investment opportunities in the realm of the emerging market landscape. Read More.

Meet the Manager: Sheila Amoroso

Some people seem to have a career path in place from an early age, while others just sort of stumble into one. Sheila Amoroso, director of Franklin Templeton Fixed Income Group's municipal bond department, is in the latter camp. You'd probably be hard-pressed to find many young women who aspire to be municipal bond managers—and Sheila was no exception. But, as she made her first foray into financial services, she found the work interesting, challenging and rewarding. And after more than 30 years with Franklin Templeton, that's still the case. Read More.

Tail Wagging the Dog? Some Thoughts on ETF Market Resilience

With volatility very much back in the headlines, some investors are questioning the role of exchange-traded funds in exacerbating market moves. Jason Xavier, head of EMEA ETF Capital Markets at Franklin Templeton Investments, puts those concerns into context and tries to allay some other fears about the resilience of the sector. Read More.

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