EQUITY

# Notes from the Trading Desk - Europe

August 14, 2017

*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 was quiet until sleepy summer markets were woken by a war of words between North Korea and the United States, with both sides threatening military action. On the back of this we saw a de-risking across asset classes, and global equity markets declined across the board.

## The Digest

### Korean Tensions Flare Up Flight-to-Safety Theme

After fresh United Nations sanctions were passed in response to North Korea's missile tests, an unprecedented exchange of military threats flared up between Washington and Pyongyang last week.

As a result, we saw an overall de-risking across asset classes. Equity markets declined, with global indexes mostly weaker. Defensive sectors such as utilities outperformed, while cyclical stocks, particularly the banks, lagged. It was the same story in currency markets. Safe havens outperformed, with the Swiss franc strengthening after weeks of declines. This in turn saw the recent trend of Swiss equity strength reverse, and Swiss stocks became one of the week's laggards.

The Japanese yen also outperformed and moved below 109 against the US dollar for the first time in eight weeks. Foreign exchange traders still seem to view the Japanese yen as a safe-haven currency despite its geographic location off the Korean peninsula.

The flight-to-safety theme continued in bond markets, with core government bond yields tightening. The 10-year German bund yield hit a six week low. As expected, gold outperformed last week.

The CBOE Volatility Index (VIX Index) saw a huge move on Thursday (August 10), jumping 44% on the back of the new tensions.[1] Although this was a big move, the VIX is still at low levels compared to recent years. In our view, it's worth noting that trading volumes are lower than historical averages due to the typically slower summer season, so thinner trading volumes most likely exacerbated the move.

In addition, US equities had been trading at all-time highs amid benign market conditions for a number of weeks prior. So, to us it's not too surprising to see some profit taking at this point.

Tension appears to be easing at least as we begin this week; we have already seen a reversal of some of last week's declines in early trading on Monday (August 14). European equities made their way higher in the early hours of trading. Longer term, we would expect the sabre rattling to subside, but we think the key factor for the global economy will be how this crisis impacts the relationship between China and the United States.

**Last Week**

**EMEA**

Geopolitical concerns were the main drivers behind the lag in European stock markets last week. Declines were broad-based, and cyclical stocks led the move lower. The euro continued to perform well, so there was no respite for European exporters.

In South Africa, President Jacob Zuma narrowly survived another no-confidence vote. On Tuesday (August 8), ruling-party lawmakers rallied around Zuma to defeat the motion 198 to 177. It's the eighth vote the president has faced, the first with a secret ballot. South African equities largely shrugged this off. Looking ahead, the focus is now on December when the African National Congress decide on a new president.

**Americas**

After reaching fresh highs at the start of last week, US equities finished the week lower on the back of geopolitical concerns. By sector, financials and energy saw notable under-performance. The consumer staples sector was the only group to finish higher.

**LOOK OUT FOR... (AUGUST 14 TO AUGUST 18):**

**Monday, August 14**

- Eurozone Industrial Production Link
- Chinese Industrial Production Link

**Tuesday, August 15**

- Holiday in Greece, Italy, South Korea and India
- German GDP Link
- UK CPI Link
- Swedish CPI Link
- US Import and Export Price Indexes Link
- RBA Meeting Minutes Link

**Wednesday, August 16**

- UK Unemployment Rate Link
- Italian GDP Link
- Eurozone GDP Link
- US Building Permits Link
- US FOMC July Meeting Minutes Link
- Australia Unemployment Rate Link

**Thursday, August 17**

Second-quarter earnings season continued to wind down last week, with more than 90% of large-cap US companies having reported earnings. The growth rate remains strong, along with those reporting better-than-expected earnings results. However, the “sell-the-news” reaction remains prevalent among investors.

It was a relatively quiet week from a macro perspective in the United States. Inflation data came in at 0.1% month-on-month; inflation stats will likely be closely watched going forward amid much scrutiny on US Federal Reserve (Fed) policy.

ECB Monetary Policy Meeting Minutes Link

- Eurozone CPI Link
- Eurozone Trade Balance Link
- UK Manufacturing Production Link
- Japanese Trade Balance Link
- US Industrial Production Link

**Friday, August 18**

- Euro Area Monthly Balance of Payments Link
- German Producer Price Index Link
- Canadian CPI Link

**Asia**

As mentioned, rising geopolitical risk was last week’s main theme. However, much of the focus for Japan remained on the domestic political situation due to the recent cabinet reshuffle by Prime Minister Shinzo Abe to attempt to shore up falling support.

On the macro front, Japan’s second-quarter gross domestic product (GDP) came in stronger than expected on Monday (August 14). In China, the economic calendar was primarily focused on inflation. July’s consumer price index ticked lower to 1.4% year-on-year, down from 1.5% last month. Of course, the most-watched number this week was July’s trade balance, with a decrease in exports to 7.2% of GDP, year-on-year, from 11.3% in June , and imports down to 11% from 17.2%.

The export data also showed shipments to the United States rising only 8.9% (previously at 19.8% last month), which helped narrow the trade surplus with the world’s biggest economy.

Australian equities showed the best relative performance among the major Asia-Pacific players over the week. The main focus fell on Reserve Bank of Australia (RBA) Governor Philip Lowe’s remarks on Friday (August 11) that the interest rate would rise, but not too soon.

## Week Ahead

### Monetary Policy

- We expect to see minutes from the Fed’s July monetary policy meeting on Wednesday (August 16) and the ECB’s monetary policy minutes the following day.
- Looking ahead, focus will be on the Jackson Hole Economic Policy Symposium On August 24-26.

### Economics

- In Europe, we expect the following macro releases: eurozone industrial production; German, Italian and eurozone second-quarter GDP and UK and eurozone consumer price index (CPI).
- In the United States, the following are scheduled for release: import and export indexes, jobless claims, housing starts and industrial production.
- In Asia, we expect China’s industrial output to be published this week.

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## Views You Can Use

## Insight from Our Investment Professionals

### Navigating an Uncertain Second Half

Receding political anxiety and a gathering economic recovery in Europe helped global equity markets advance in the first half of 2017. Yet Templeton Global Equity Group's Cindy Sweeting and Tony Docal say investors should be somewhat cautious in the second half of the year. They believe rich stock valuations and shifting central bank policies could lead to bouts of volatility. Read More.

### India's Reform Movement Gains Momentum

India has embarked on a sweeping reform movement under Prime Minister Narendra Modi, which has attracted investors' attention. Templeton Global Macro CIO Michael Hasenstab recently visited India, and takes a look at some of the reforms he's most excited about as a global fixed-income investor. He believes India's future looks bright and that its growth trajectory should remain strong—despite some short-term adjustments. Read More.

### Mid-Year Outlook: The Resurgence of Emerging Markets

The first half of 2017 has been bright for emerging markets, generally speaking. Mark Mobius, Stephen Dover, chief investment officer of Templeton Emerging Markets Group, Chetan Sehgal, director of Global Emerging Markets/Small-Cap Strategies and Carlos Hardenberg, senior vice president, director of Frontier Markets Strategies, examine factors boosting sentiment this year and point to some themes and sectors we are excited about in this space going forward. Read More.

### Continued Euro Strength Draws A Long Road Ahead for the ECB

Markets responded enthusiastically to European Central Bank (ECB) President Mario Draghi's presumably upbeat comments last month, which prompted a surge in the euro that has continued into July. But Matthias Hoppe, senior vice president and portfolio manager, Franklin Templeton Multi-Asset Solutions, has interpreted more recent comments from Draghi as a warning to the market not to get ahead of itself. Read More.

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Past performance is not an indicator or guarantee of future performance.

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1. The Chicago Board Options Exchange (CBOE) Volatility Index is constructed from the implied volatilities of a wide range of S&P 500 Index options, and shows the market's expectation of 30-day volatility. It is widely used to measure market risk. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. Past performance is not a guarantee of future performance.