LOMBARD ODIER
INVESTMENT MANAGERS

Global Perspective

Europe enters a sweet spot (for a change!)

Asset Management

May 2017

Salman Ahmed
Chief Investment Strategist

The performance of the European economy, especially relative to that of the US, is fast becoming a tangible reality. And rightly so: the recovery is not only high-quality and broad-based; we believe it is likely to be supported by continued dovishness from the European Central Bank (ECB) and, thanks to the political uncertainty of recent months, risk-asset markets are a long way from pricing this in. There is a strong case that Europe has entered a summer sweet spot for investors.

In the hours after Emmanuel Macron's convincing victory in the French Presidential election I wrote that investors could now **focus their attention back on Europe's fast-improving fundamentals**. With the votes counted and the dust settling, we can turn to the detail of those fundamentals, and they are compelling.

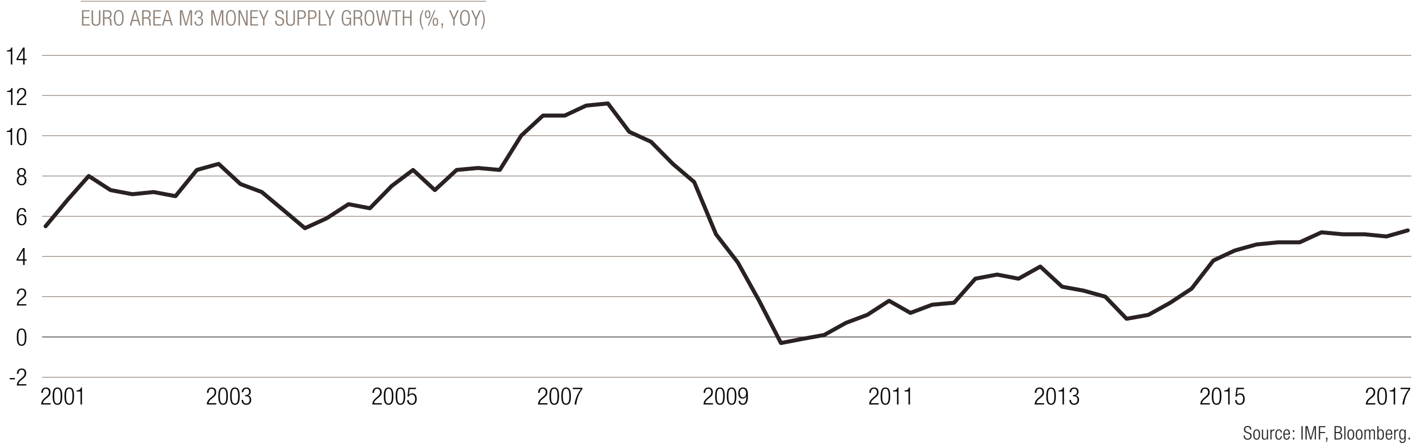
Recovery is strong and broad based

Even before the vote in France we were keen to highlight **Europe's "quiet" recovery**, pointing to robust real GDP growth, optimistic business climate and purchasing managers' indices (PMI), credit growth, and falling unemployment. The latest estimate puts seasonally-adjusted annualised Eurozone GDP growth in the first quarter at 2.0%, up from an already impressive first estimate of 1.8%.

This is not all about Germany pulling up the average. It is broad-based. Italy has been growing at close to 1% annualised for two years, now. Portugal's economy grew by an impressive 4% annualised in the first quarter. Most Eurozone countries are now registering PMIs above 55, a very strong level consistent with annualised GDP growth at around 3%. That is significantly above where we estimate potential growth to be, at around 1% per annum, and twice the rate of growth the US reported in the first quarter of 2017.

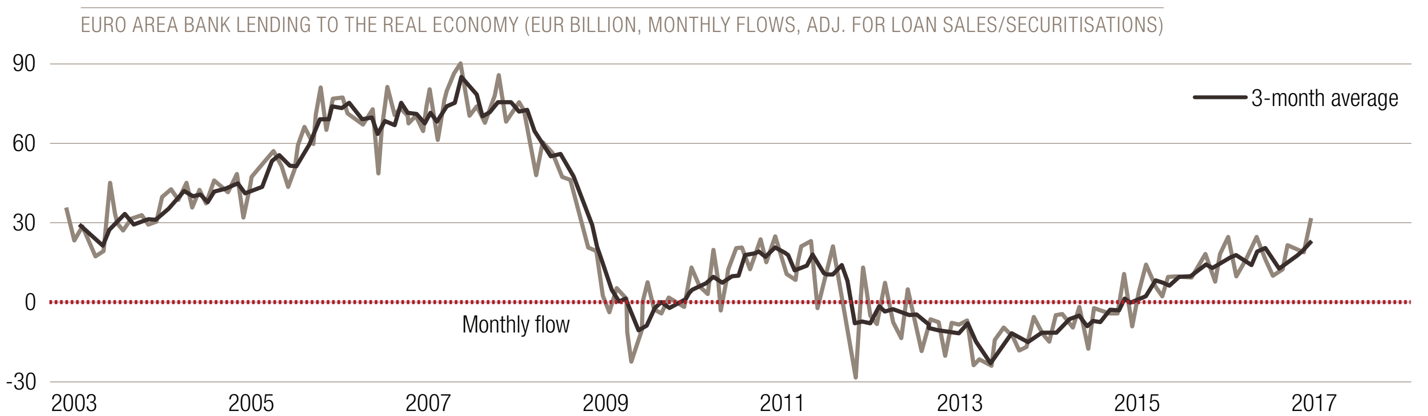
FIG. 1 EUROPE'S BANKS ARE LENDING AGAIN

EURO AREA M3 MONEY SUPPLY GROWTH (%, YOY)

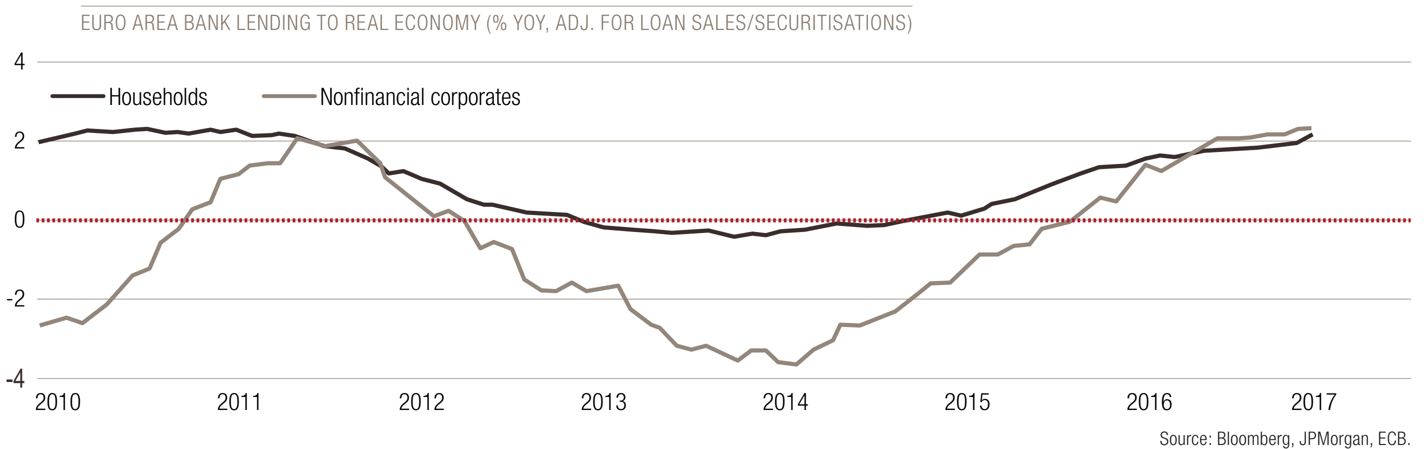


Source: IMF, Bloomberg.

EURO AREA BANK LENDING TO THE REAL ECONOMY (EUR BILLION, MONTHLY FLOWS, ADJ. FOR LOAN SALES/SECURITISATIONS)

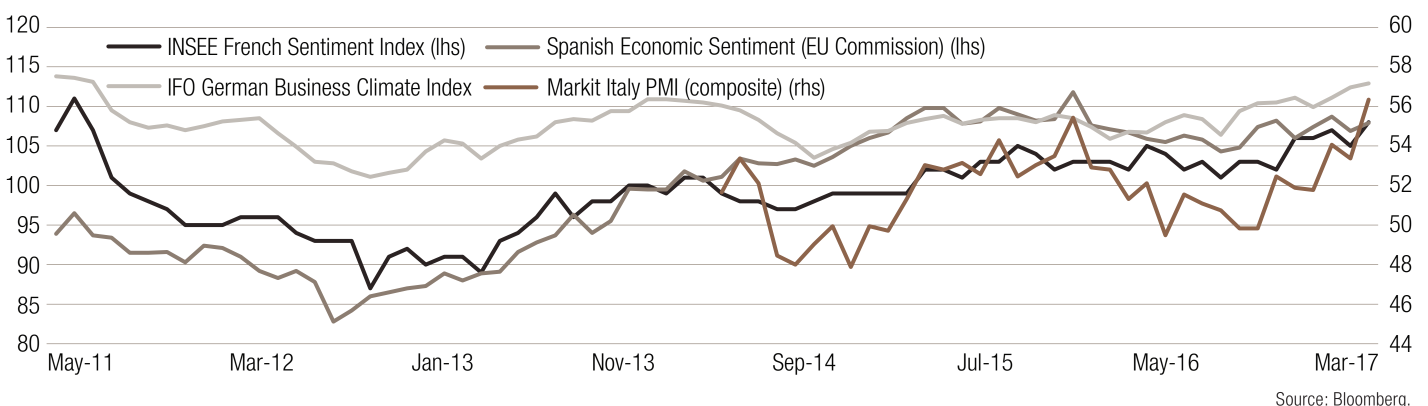


EURO AREA BANK LENDING TO REAL ECONOMY (% YOY, ADJ. FOR LOAN SALES/SECURITISATIONS)



Source: Bloomberg, JPMorgan, ECB.

FIG. 2 BUSINESS CONFIDENCE IS GROWING… AND NOT ONLY IN GERMANY



Source: Bloomberg.

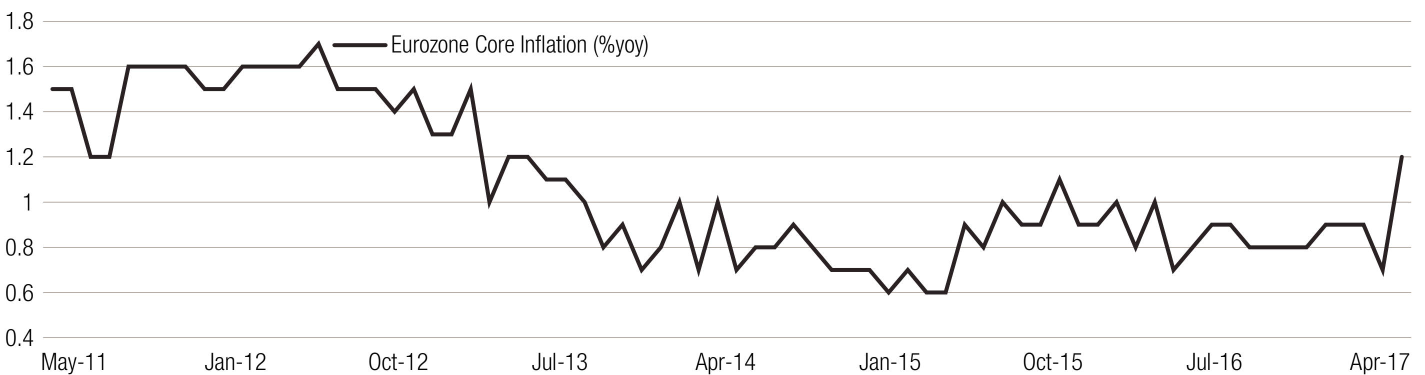
A dovish ECB provides support

This is a cyclical recovery, but it has also been supported for several quarters by the ECB's negative interest rates, asset purchases, and generally dovish stance. With such a narrow scope for fiscal stimulus in Europe, monetary policy carries a lot of weight on its shoulders. Until recently, Eurozone inflation data made accommodative policy an easy choice: while headline inflation had started to move with the recovery in oil prices since the beginning of 2016, core inflation remained anchored below 1%.

Core inflation broke through that threshold in April, however, possibly because of a sharp rise in items such as package holidays (Figure 3). That bears watching as a risk to the ECB's accommodative stance, but we believe this spike will be temporary.

Note that Peter Praet, the ECB's Chief Economist and a Member of its Executive Board, used a speech on 4 May to observe that, "despite the cyclical recovery, underlying price pressures remain subdued." That supports our view that signs of Eurozone inflation remain tentative, and also that the ECB will stay committed to its forward guidance on not raising rates until its asset-purchase programme has run its course, and prioritising solvency risks in the Eurozone periphery in its considerations.

FIG. 3 EUROZONE CORE INFLATION HAS SPIKED, BUT WE THINK IT IS TEMPORARY



Source: Bloomberg.

The case for Japan-style yield-curve control

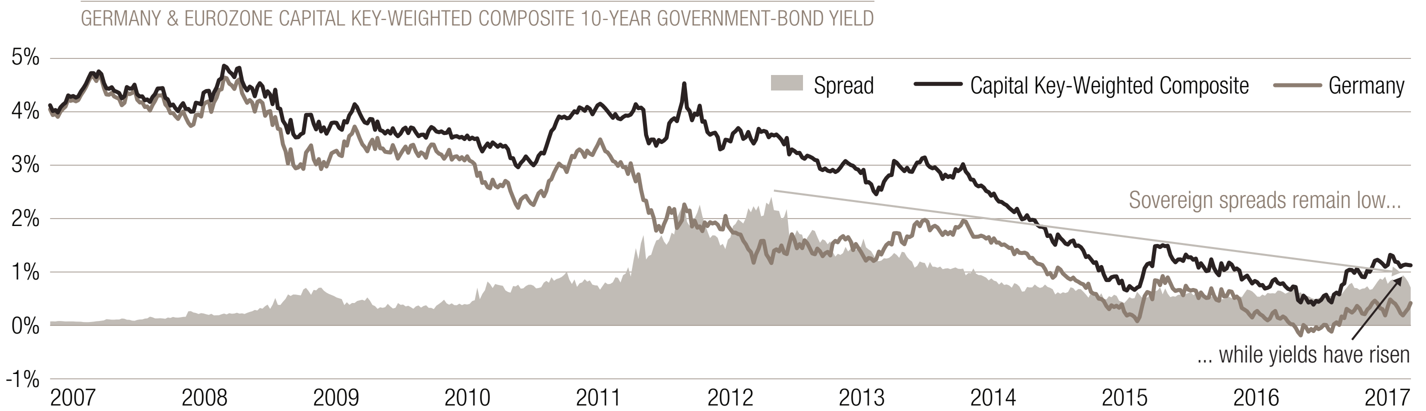
All of this does raise the question of what the ECB's exit plan might be. It is an important question. We know from the ECB's mistimed hikes in 2011, and the miscommunication out of the Federal Reserve that set off the 2013 "taper tantrum", that both markets and the economy are currently very sensitive to central bank actions. Eurozone monetary policy is further complicated by political risk and questions about the sustainability of public debt burdens as interest rates rise.

Overall, we think there is a strong case for the ECB to consider a Japan-style yield-curve control framework, whereby rates at the long end of the curve are fixed by the force of central-bank credibility. Eurozone curves have steepened over the last 12 months and that has helped alleviate the pressure on bank profitability from negative rates and the curve flattening of 2014-16 (Figure 4). We believe it is now safe to lock-in rates at the long end of the curve. As it has in Japan, using the central bank's credibility to hold down rates will enable the ECB to slow the pace of its asset purchase programme without a consequent drift upwards in rates. This will keep monetary conditions accommodative as the economic recovery strengthens, and help keep the risks of the larger sovereign debt burdens in check – giving them more time to implement necessary structural reforms.

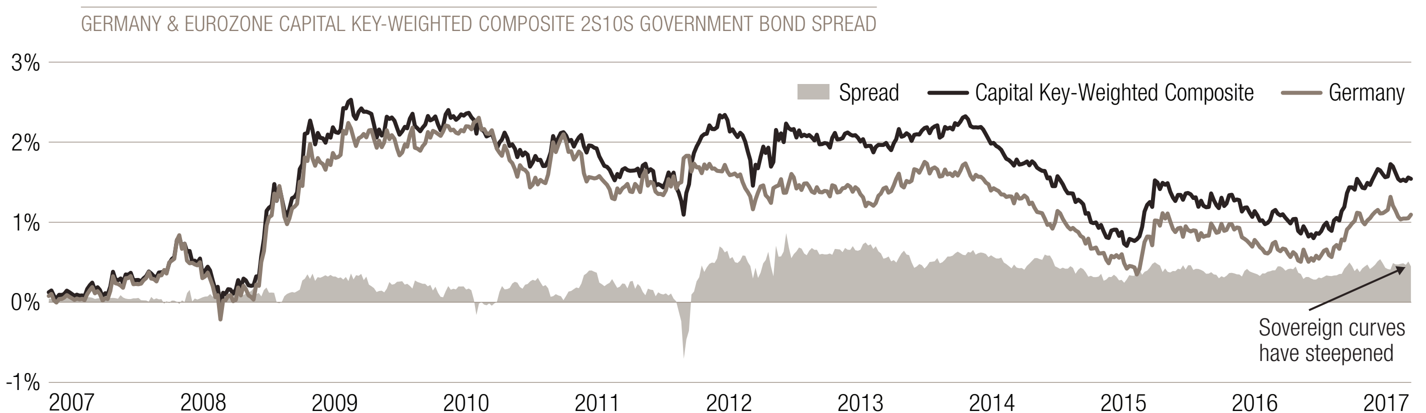
Unlike in Japan, we think the ECB should consider targeting a composite interest rate, made up by blending the interest rates of all Eurozone members, weighted by the amount of paid-up capital their central banks provide to the ECB (the "capital key"). Targeting a composite capital key-weighted interest rate would side-step the problem of targeting either the German curve alone or all the individual Eurozone sovereign yield curves – and by doing so, creating the new problem of credit spreads being fixed at current levels. Indeed, targeting the capital key-weighted interest rate would mean that the resulting intra-EU sovereign credit spreads would be an outcome of the policy, rather than a target of the policy, just as it is with the ECB's capital key-weighted quantitative easing programme.

FIG. 4 RECOVERY IN LONG END YIELDS MAKES YIELD-CURVE CONTROL FEASIBLE FOR THE ECB

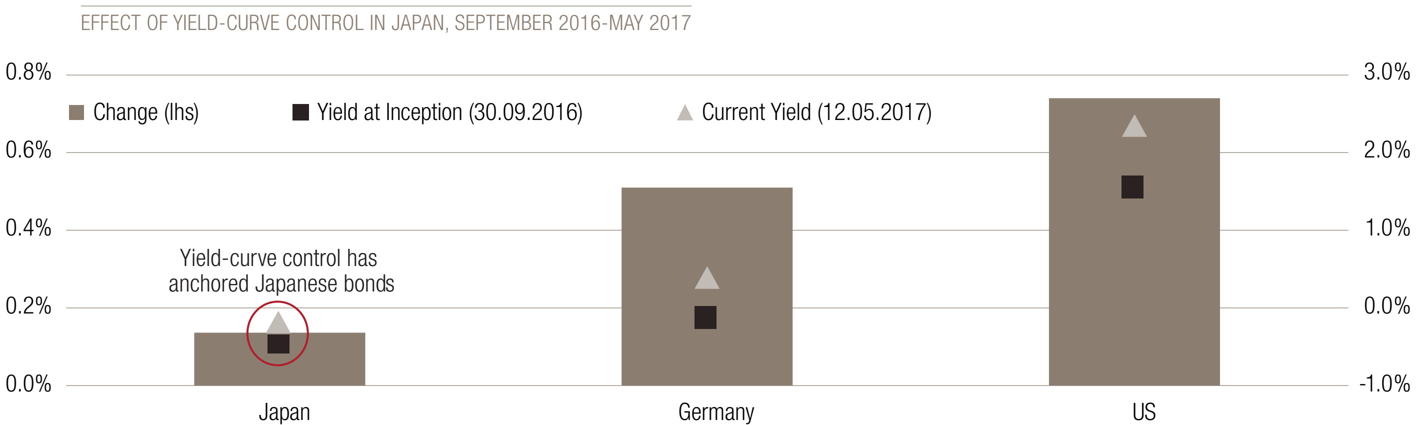
GERMANY & EUROZONE CAPITAL KEY-WEIGHTED COMPOSITE 10-YEAR GOVERNMENT-BOND YIELD



GERMANY & EUROZONE CAPITAL KEY-WEIGHTED COMPOSITE 2S10S GOVERNMENT BOND SPREAD



EFFECT OF YIELD-CURVE CONTROL IN JAPAN, SEPTEMBER 2016-MAY 2017



Source: Bloomberg.

European equities are historically cheap relative to US equities

Put the broad-based cyclical recovery together with accommodative monetary policy and you have a mix likely to be very positive for European risk assets. Moreover, the prospect of a stronger euro stifling that recovery appears remote.

Markets never priced in a severe risk of break-up of the single currency, and therefore a substantial relief rally after the French election was always unlikely. Real interest rate differentials – and therefore US dynamics – will be more important determinants of euro strength than European politics. Given the hawkish tone of Federal Reserve committee members and another strong set of US employment numbers on 5 May, we expect US real rates to rise more rapidly than the Eurozone's, effectively capping the any meaningful EUR/USD rate upside.

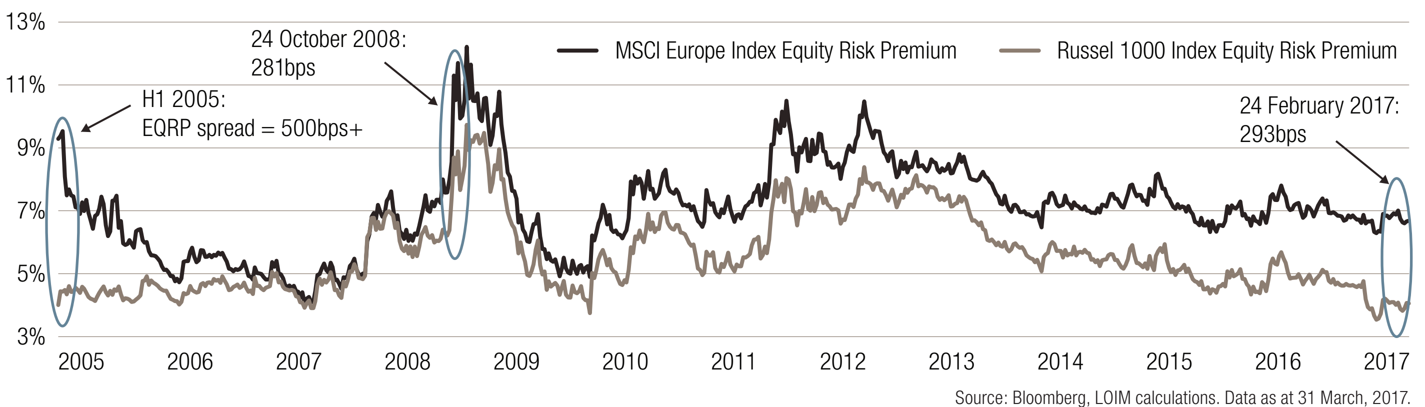
At the same time, there has been a meaningful deterioration in hard economic data out of the US. In addition, the legislative difficulties of the first 100 days of President Donald Trump's administration make us firmer in **our belief that there will be no meaningful fiscal stimulus before mid-2018**, at the earliest. After pulling the first version of his healthcare bill from the House of Representatives over concern that the necessary votes were unavailable, Trump succeeded with a more radical bill in April

– but one more likely to hit opposition in the Senate. Treasury Secretary Steve Mnuchin has warned that one casualty of the healthcare debacle will be tax reform, apparently postponed until after the summer. Add this to the ongoing lack of senior appointments and the seemingly endless stream of controversies besetting this administration, and it is clear that controlling the White House and the two legislative chambers has not made law-making any easier for the Republicans. Revelations this week regarding the dismissal of FBI Director James Comey, and allegations that sensitive intelligence may have been shared inappropriately with Russia's Ambassador and Foreign Minister, have only added to the sense of disarray - and led to the first real signs of serious concern in financial markets.

Risk-asset pricing does not reflect this picture of a US recovery losing momentum as financial conditions tighten, while a European recovery gains momentum underpinned by loose financial conditions. The equity risk premium – the excess annualised return one can expect from investing in equities rather than government bonds, given current valuations – is higher in Europe relative to the US than it has been for over a decade. European equities are notably cheap relative to US equities, despite the underlying economic fundamentals, and the fact that European companies enjoy much more exposure to the strengthening recovery in the emerging world.

We believe that valuation gap is largely attributable to high expectations for US corporates following the election of Donald Trump, and to the political uncertainty in Europe, which has dissipated considerably with the recent blow to Marine Le Pen's ambitions in France and the resurgence of Angela Merkel's Christian Democratic Union in local elections in Germany.

FIG. 5 THE VALUATION GAP BETWEEN EUROPEAN AND US EQUITIES IS AT ITS WIDEST FOR OVER A DECADE



Source: Bloomberg, LOIM calculations. Data as at 31 March, 2017.

Risks ahead, but a sweet spot in Europe for now

The immediate risks to this scenario of a subdued-euro and strong European equities are clear: a policy mistake or miscommunication from the ECB, or simply a drift towards more "Bundesbank" thinking in response to more persistent core inflation. We rate the likelihood of that as low.

In the medium term, it is important to remember that political risk has not evaporated. Germany's national elections in September look set to be reassuringly ordinary after the thrills and spills in France, but the Five Star Movement continues to poll strongly in Italy, where elections must be held before May 2018. Italy's banking sector is still fragile, the biggest source of non-performing loans in the Eurozone and a major political football as long as that issue remains unresolved. The combination of vulnerable banks and success for an anti-EU party could be very disruptive. Even if that disruption is contained for now, the longer-term threat of a return to populism should the centrist establishment fail to address Europe's structural problems is real.

In the meantime, however, markets should be able to take a break from political punditry and refocus on fundamentals. Right now, as we have seen, Europe's fundamentals are improving, well-supported by the ECB, and woefully undervalued – a genuine sweet spot for investors. As a result, we believe that European equities, in particular, represent one of the most attractive investment opportunities currently available.

Salman Ahmed
Chief Investment Strategist
Lombard Odier Investment Managers

Important information: Please see important information at the end of this document.

For professional investor use only. This material does not constitute an offer or solicitation in any jurisdiction where or to any person to whom it would be unauthorised or unlawful to do so.

This document is provided for information purposes only and does not constitute an offer or a recommendation to purchase or sell any security or service. It is not intended for distribution, publication, or use in any jurisdiction where such distribution, publication, or use would be unlawful. This document does not contain personalized recommendations or advice and is not intended to substitute any professional advice on investment in financial products. Before entering into any transaction, an investor should consider carefully the suitability of a transaction to his/her particular circumstances and, where necessary, obtain independent professional advice in respect of risks, as well as any legal, regulatory, credit, tax, and accounting consequences. This document is the property of LOIM and is addressed to its recipient exclusively for their personal use. It may not be reproduced (in whole or in part), transmitted, modified, or used for any other purpose without the prior written permission of LOIM. This document contains the opinions of LOIM, as at the date of issue.

Past performance does not guarantee future results

Issued by Lombard Odier Asset Management (Europe) Limited, authorised and regulated by the Financial Conduct Authority (the “FCA”), and entered on the FCA register with registration number 515393

©2017 LOIM. All rights reserved.