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OUR MOOD THIS FRIDAY

The global auto cycle has had it day. The sector is not immune from a call into question in Europe.

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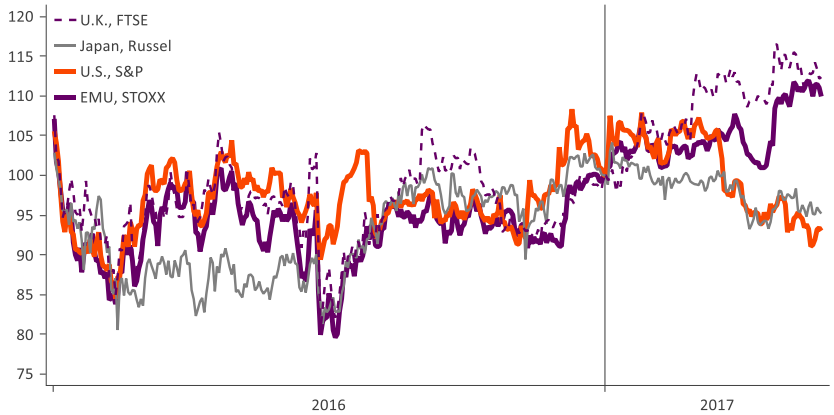
Since the beginning of the year, the European auto sector has been one of the weakest performers on the stock market. While economic growth prospects tend to be revised upwards in a context of lower deflationary pressures, we would have expected more encouraging signs from this sector. It seems that such a case is increasingly unlikely. Weighed down by weak domestic growth prospects after two years on the rebound, the sector finds itself dealing with the fallout of weak global prospects, the US administration's ill-advised moves with respect to reflation, the decline in the price of oil and now, the rising euro...

This is the view on a sector with characteristics that place it at the very heart of the challenges facing the financial markets in recent months.

Automobile sector performance - 01/01/17=100 (in dollars)

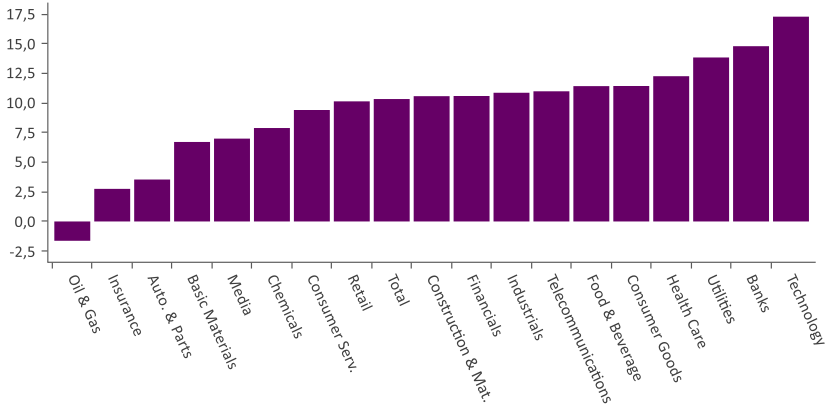


Sources: RichesFlores Research, Macrobond

The resistance of the European auto sector is fading

Up by over 10% since the beginning of the year, the dollar performance of the auto sector in the eurozone has fared rather well in comparison to its US or Japanese counterparts. However, this result is heavily distorted as half of it is attributable to foreign exchange effects. In euro terms, the sector has only registered growth of 3.5%, much lower than the entire industry, healthcare or even technology where growth exceed 10%, and for the main part thanks to the performance of auto parts manufacturers instead of constructors.

Euro Area STOXX performance by sector since January 2017, %



Sources: RichesFlores Research, Macrobond

Given that we are supposedly at the start of an economic cycle, this is a surprising finding for a sector with one of the weakest market valuations (with a multiple less than 10 times its earnings), in theory well-placed to benefit from low oil prices both in terms of costs and sales prospects.

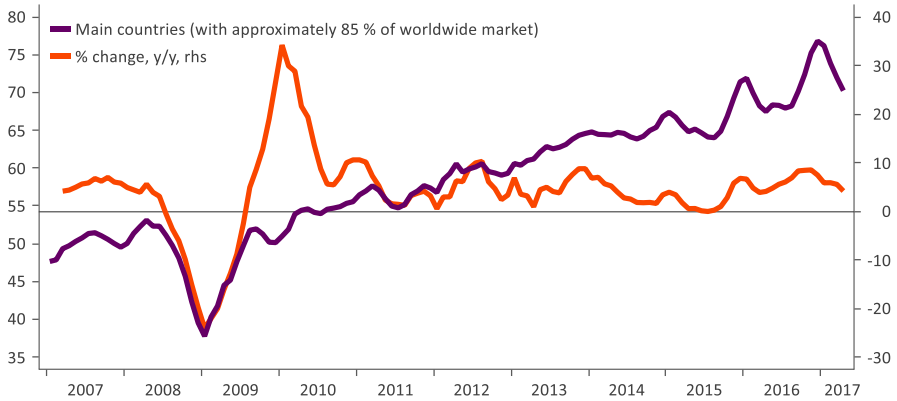
How can this situation be explained – is it a lag, that can be recovered if necessary, or on the other hand could it potentially get worse? Our prognosis leans towards the latter option.

The global auto industry cycle appears to be, for the most part, behind us

As the first industry to emerge from the 2009 crisis thanks to the very deliberate policies of governments around the world, the auto sector has already gone through a long growth cycle, during which sales in the world's strongest economies increased by about 35%, leading to more than 46% growth over 10 years.

Changes in automobile sector for the last 10 years

Million units at a y/y change and y/y rate in %



Sources: RichesFlores Research, Macrobond

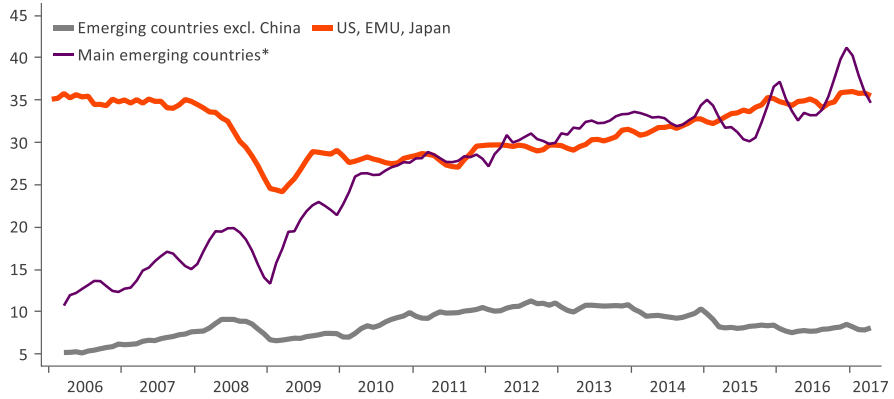
The tripling of the Chinese domestic market contributed to this growth, playing a key role at the beginning and end of the period. Since 2013, the US recovery has consolidated this trend, and it wasn't until 2014 that Europe made its contribution to the global movement, while emerging countries (excluding China) contributed very little to the global recovery, with sales constantly waning since 2013.

However, the likelihood of demand continuing to grow seems limited.

- The Chinese market is much less promising for European carmakers than it was in its early days, as the stimulation of credit coupled with the very favourable effects of collapsing oil prices and tax incentives, took sales level above the structural trends suggested by the country's economic characteristics, which we estimate at roughly 25 million units per year. While the government is trying to limit the rise in private debt levels within a less buoyant economy, sales are expected to have stabilized in the next two years, at best.

World automobile registrations (major world markets)

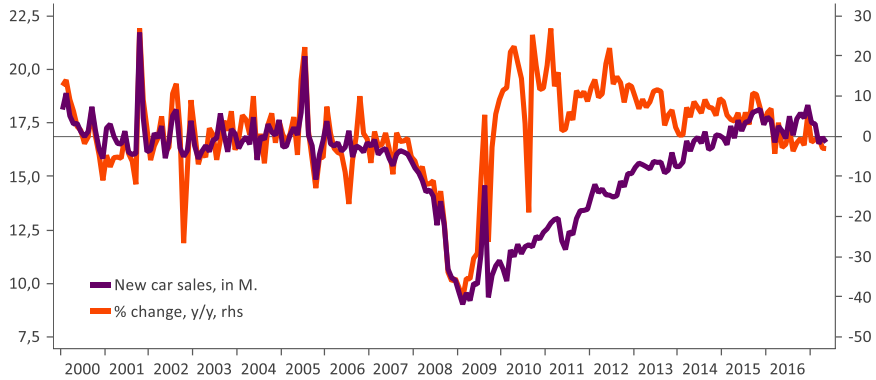
Million units, AR



Sources: RichesFlores Research, Macrobond *Chi, India, Bra, Arg, Mex, Indo, Rus, S.A.

- In the United States, car purchases have displayed signs of sluggishness in the past few months, which could well foreshadow the end of a cycle following several robust years during which the car stocks rose to levels higher than that seen before the 2008 crisis.

Automobile sales in the United States

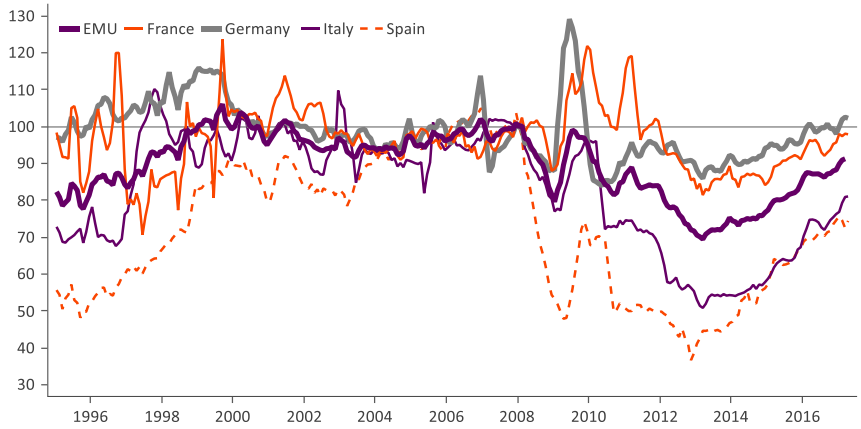


Sources: RichesFlores Research, Macrobond

Credit conditions have tightened in recent quarters and studies conducted by the Fed show the growing difficulties for less creditworthy borrowers to finance their car purchases, with the number of loan application rejection by banking institutions continuing to grow since the spring of last year, having risen to 28% in the first quarter of 2017. In the current environment, shrouded by uncertainty surrounding the direction the new administration will take, particularly in relation to healthcare, the risks that continue to plague the US auto market today seem relatively important.

- As the only large developed market with potential for additional growth relative to its recent historical performance, the eurozone has made up some ground over these past two years and its growth has clearly stagnated in the past few months. Although this slump appears to be temporary, linked to the erosion of purchasing power due to the rebound in inflation, significant gains seem difficult to expect with the number of German and French vehicle registrations already above their long-term average, that only exceptional economic conditions would allow to significantly exceed.

Automobile registrations 2007=100, MA3



Sources: RichesFlores Research, Macrobond

On the whole, the immediate outlook for the global auto market seems, if not highly concerning, at least bleak and clearly incapable of justifying any particular enthusiasm from investors.

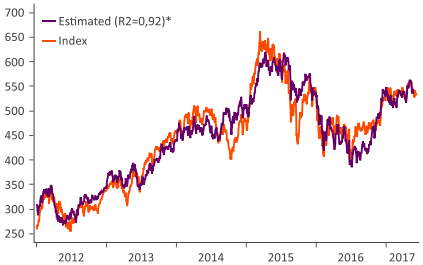
Indirect victim of the reflation scenario being called into question

Such business forecasts do not bode particularly well for the potential to improve margins in the coming months, despite continued low prices of inputs that are responsible for the widespread low prices of raw materials.

Recent experience has demonstrated the clear exposure of auto sector stocks within an environment of low oil prices, the effects of which have ultimately contributed to punishing the stock market value rather than doing the opposite in recent years. Despite the specificities of the oil market, the fall in stock market prices is primarily perceived as a global deflationary vector that can explain the many ways in which this phenomenon triggered the negative returns suffered by the auto industry, and by most cyclical segments of the market. However, the prospects for the oil market are not promising. There was marked disappointment at the agreement between OPEC countries to extend the restrictions on oil production by nine months rather than a year, indicating a significant risk of prices being persistently bogged down in the absence of a reduction in US oil production. Since the beginning of last year, the likelihood of oil prices continuing to slide towards $40 a barrel has never seemed as strong as it is today.

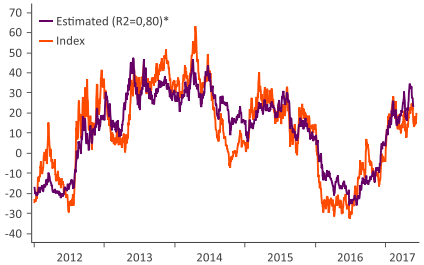
More fundamentally, it is the reflation scenario that is in fact at stake. As it is contingent on breakthroughs in the ongoing US budget negotiations, this scenario has barely had any wind in its sails over the past weeks as we explained last week (see here) and as has been demonstrated by the fall in long-term interest rates and, in turn, the fragility of stock market banking indices. It is worth noting the dominance of these indices in our valuation equation for the auto sector, as the Stoxx 600 banking index, along with the Euro-Dollar and Euro-Yen exchange rates have accounted for over 90% of the performance of eurozone auto stocks in the Stoxx 600 since 2011.

EMU automobile STOXX performance



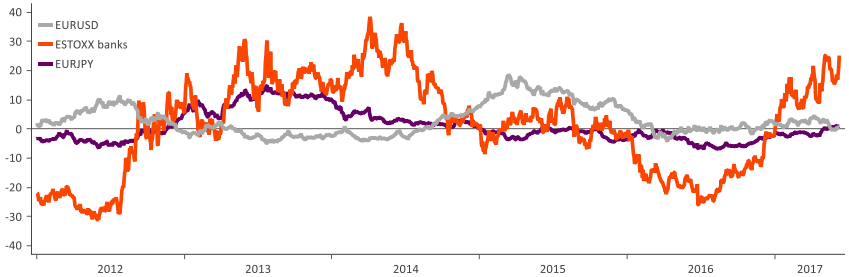
Sources: RichesFlores Research, Macrobond * Equation based on bank index of EURUSD and EURJPY over the period 2012 until today

EMU auto. STOXX performance (y/y in %)



Sources: RichesFlores Research, Macrobond Equation based on bank index of EURUSD and EURJPY over the period 2012 until today

Main component contributions of the equation, % change, y/y



Sources: RichesFlores Research, Macrobond

All in all, when considering the current trend, it is difficult to see what makes the auto sector attractive within an economic context where the euro is propped up by disappointing developments coming from the United States and the cautiousness of the Fed.

Should such a conclusion be interpreted as a warning for all cyclical stocks? We are inevitably tempted to do so as the chances of the reflation scenario coming to fruition, as mooted by the markets these past few months, appear unrealistic. As we wait to take a more decisive stand on this last point, the abundance of liquidity, persistently low interest rates and the cautiousness of central banks (primarily the Fed), still serve as a safeguard while growth prospects are still fledgling.

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