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OUR MOOD THIS FRIDAY

Stay the course or wait for a deeper correction before repositioning on European indices?

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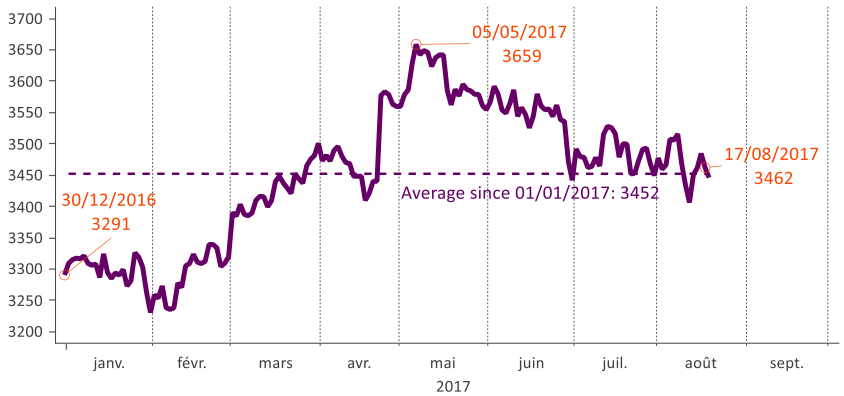
We might ultimately be vindicated; only time will tell. But one thing is certain: we were mistaken in predicting since the beginning of June that European markets would continue to rise. We can take some comfort in the Eurostoxx index's performance in dollar terms, a positive 1.7 % between May 31 and August 17, with nearly identical trends in indices on both sides of the Atlantic. This is not much consolation, however, given that we had been anticipating an appreciation in the euro, and this is exactly what has happened. The euro now stands at USD 1.18.

The European economy is picking up, and its outlook is improving. The risk of political extremes has been eliminated, and monetary policy is particularly accommodative. So how can we explain the underperformance of European markets, and what is in store for the coming months?

Eurostoxx 50 Index since the start of the year



Sources: RichesFlores Research, Macrobond

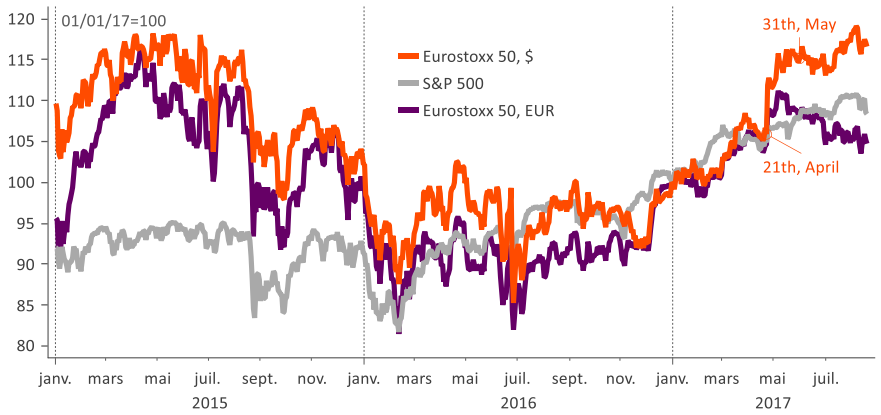
What went wrong

Since the beginning of June, the Eurostoxx 50 has lost 5.4 % of its value. After peaking with a gain of more than 11 % on May 5, the flagship European index's YTD performance was whittled down to 5.2 % by August 17. This is not at all what we expected, and it's tempting to say that we just got the timing wrong, that our prediction has simply been shifted a few months forward. The favorable economic news these last few weeks and the upward revision in the economists' consensus that should follow would seem to point in this direction. But the behavior of indices over the past several days belies this view, making us wonder if something else is afoot and requiring, at the very least, a more in-depth analysis.

The role of exchange rates

As we said at the outset, the Eurostoxx performance is less mediocre in dollar terms. The euro has appreciated by 4.4 % against the dollar since the beginning of June, more or less equivalent to the decline in the index. Expressed in dollars, the market's performance is more consistent with the economic environment. The improvement in European economic conditions is visible in the Eurostoxx, whose performance has outstripped that of the S&P 500 by 7.9 % since the beginning of the year. It has been especially visible since April 21, the day before the first round of the French presidential election, which marked the start of this period of outperformance.

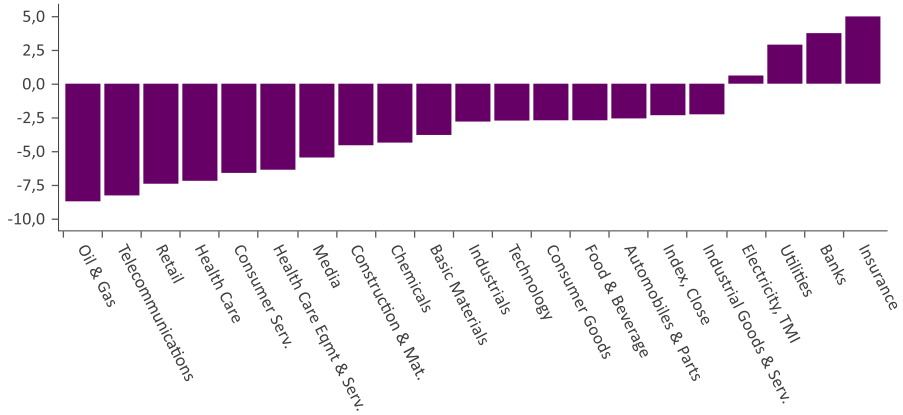
Eurostoxx has outperformed the S&P 500 by 8% since January



Sources: RichesFlores Research, Macrobond

That said, the trends in individual sectors do not confirm the view that exchange rates have been the only cause. Since the beginning of June, most sectors, including those least sensitive to exchange rates (telecoms, healthcare, media, consumer services, construction), have taken the market correction on the chin, while sectors traditionally more exposed to an appreciation in the euro have fared better, as investors showed renewed appetite for cyclicals.

Performance of eurozone stocks in the Stoxx 600 since May 31, in %

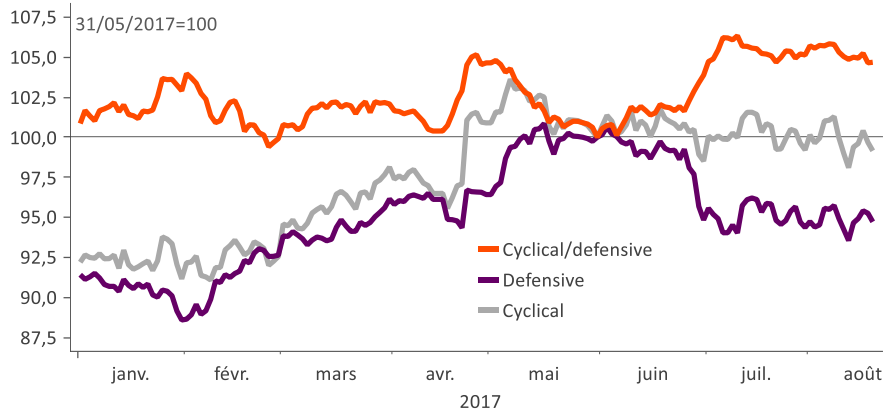


Sources: RichesFlores Research, Macrobond

Profit-taking on defensives and a shift to high-dividend equities

Another characteristic of the period under review: defensive stocks have underperformed. This is because investors are confident in the eurozone's economic outlook again and because the deflationary pressures that plagued the market for two years have now abated. European defensive stocks, whose valuations were relatively stretched, have suffered significant profit-taking since the end of May, declining by 4.6% over the period and underperforming cyclicals to the same extent.

Relative performance of cyclical and defensive stocks in the eurozone

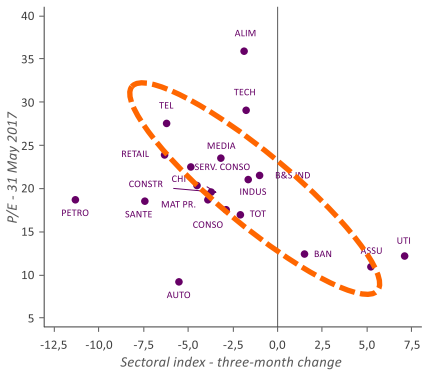


Sources : RichesFlores Research, Macrobond

With a few exceptions (materials and automotive in particular), the graph on the next page clearly shows that investors have pulled their support for the European market's high-priced sectors (in P/E terms) after favoring them for two years. Telecoms, retailing, services and, to a lesser extent, healthcare were the sectors that suffered the most.

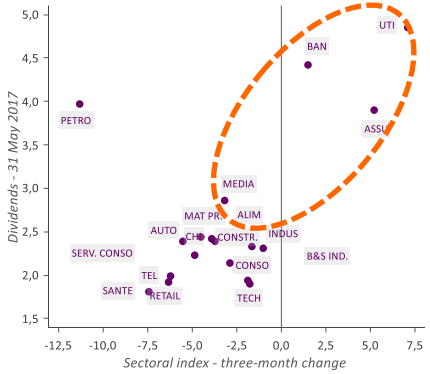
Investors remained conscious of risk throughout the period, so the last few months have also reflected an increased preference for stocks paying high dividends, i.e. financials and utilities; only they increased in price during the period.

Sectoral Eurostoxx and P/E (eurozone)



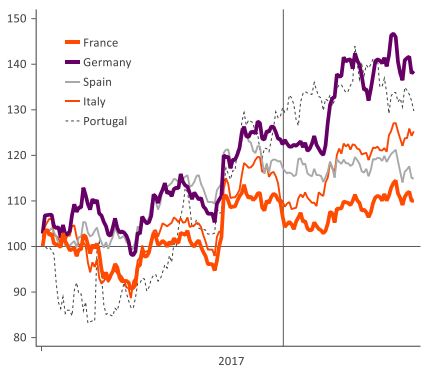
Sources: RichesFlores Research, Macrobond

Sectoral Eurostoxx and dividends (eurozone)



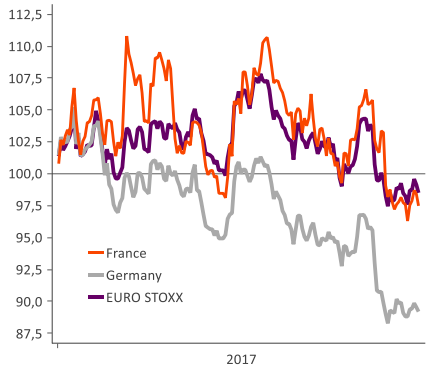
Sources: RichesFlores Research, Macrobond

European banking indices, 01/01/17=100



Sources: RichesFlores Research, Macrobond

Automotive sector indices, 01/01/17=100



Sources: RichesFlores Research, Macrobond

Cyclicals out of step with each other

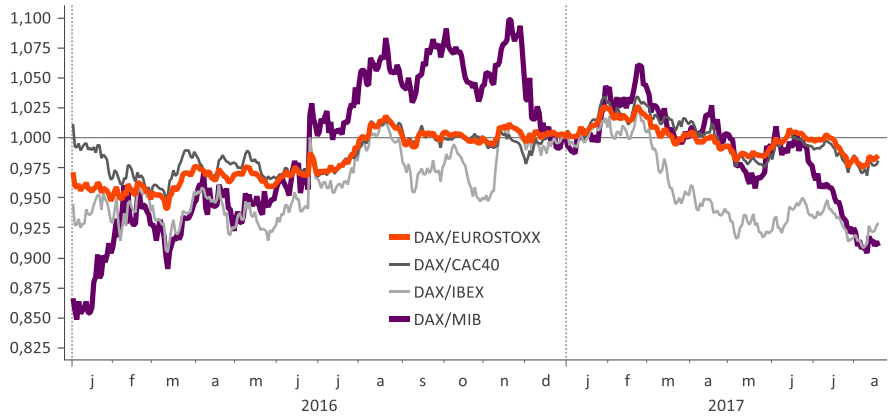
Two of the sectors that traditionally drive a renewed appetite for cyclicals have been notably absent this time round: energy/materials and the automotive sector.

- Oil prices have hardly benefited from the more optimistic outlook for the world economy. Excess supply and increasing doubts about the oil market's structural outlook continued to put pressure on prices throughout the summer. This hurt cyclicals as a whole.
- Financials, whose fortunes had been tied to those of the energy sector for the past two years, have managed to free themselves, thanks to expectations of inflation and the higher interest rates that followed Mario Draghi's speech at the Sintra meeting at the end of June. Following an already exceptional performance since January, however, they did not sustain their early-July momentum.
- The automotive sector has missed out on the favorable conditions for cyclicals, significantly underperforming throughout the period. Although predictable, this trend infected the rest of the market.

Underperformance in Germany

Putting sectors to one side, underperformance in the German economy has been another factor driving equity markets in the last few months. In fact, it is arguably the most fundamental in as much as renewed interest in cyclicals should ordinarily be a boon to the German market compared with others in the region.

DAX 30 relative performance, 01/01/17=100

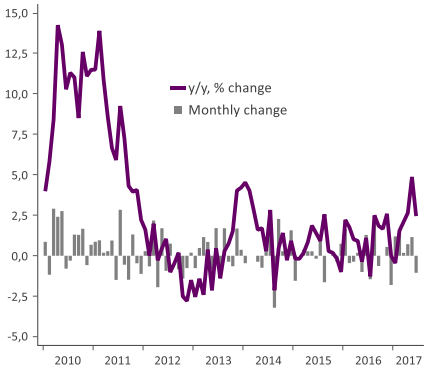


Sources: RichesFlores Research, Macrobond

This situation can be partly explained by renewed interest in the markets of southern Europe, where the risk of extreme events that existed until last winter has gradually subsided. But it is also tied to certain recent information coming from Germany. In particular, there has been no clear indication that the improved global momentum has had an effect on German statistics.

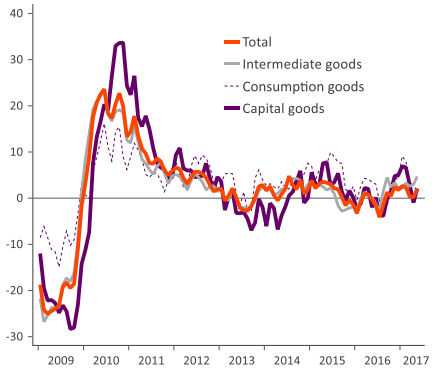
German growth has recently been robust, but lacks what usually characterizes the economy of the world's second-largest exporter of manufactured goods during periods of international recovery: a clear improvement in manufacturing and exports. In the past, these would have been among the leading indicators of an improvement in overall conditions. Instead, German industrial production has been struggling to get traction on a healthy, long-lasting market upswing. Growth in exports is just barely positive, including exports of capital goods, traditionally Germany's flagship industrial sector.

German industrial production



Sources: RichesFlores Research, Macrobond

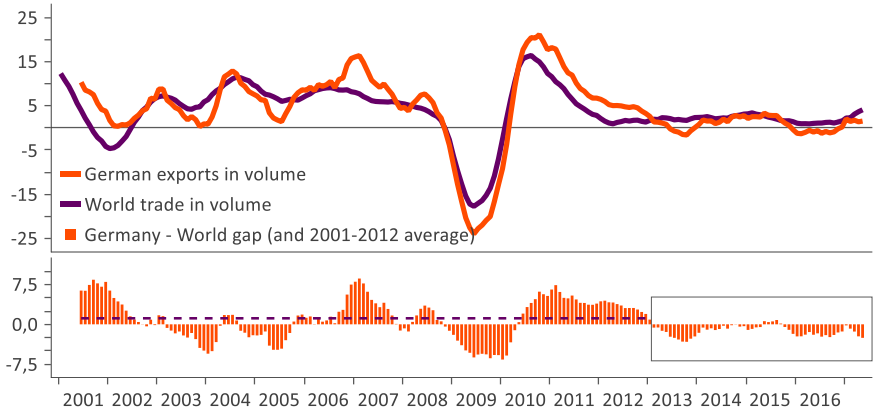
German exports, in volume, y-o-y in %



Sources: RichesFlores Research, Macrobond

These observations suggest a number of possibilities, including that the German economy is changing gears. In the last few years, German exports have grown more slowly than global trade, whereas the opposite was generally true until 2012. Since then, the manufacturing sector's contribution to German growth has steadily shrunk, and by the beginning of this year, it was virtually nil.

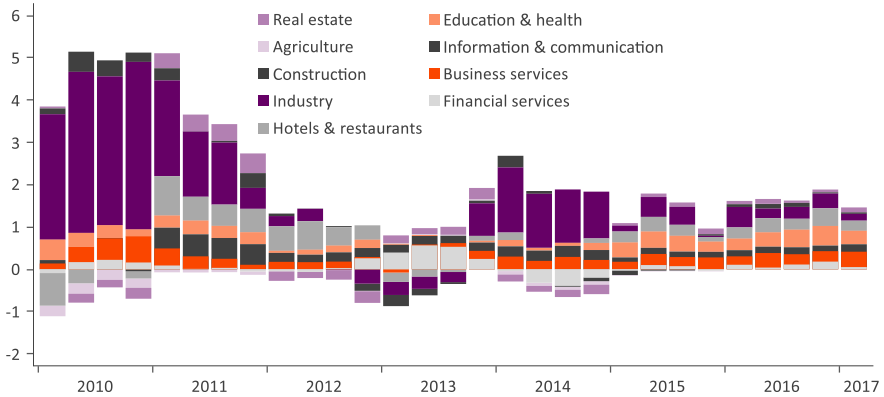
World trade and German exports in volume, 6-mo. MA, %



Sources: RichesFlores Research, Macrobond * CPB data

Contribution to annual German growth

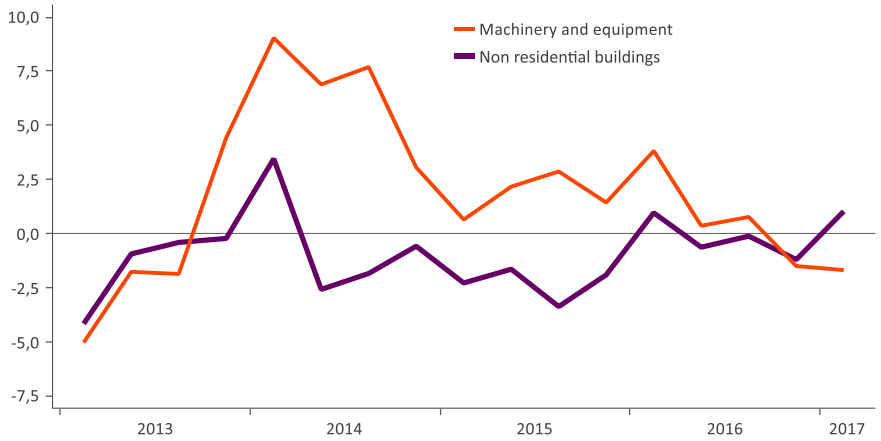
Year on year change - constant prices



Sources: RichesFlores Research, Macrobond

This lag might yet be temporary and without any long-term consequences once growth in global trade becomes more robust, a scenario that still needs to be confirmed. Nevertheless, the sluggishness of new capital formation in Germany gives us pause.

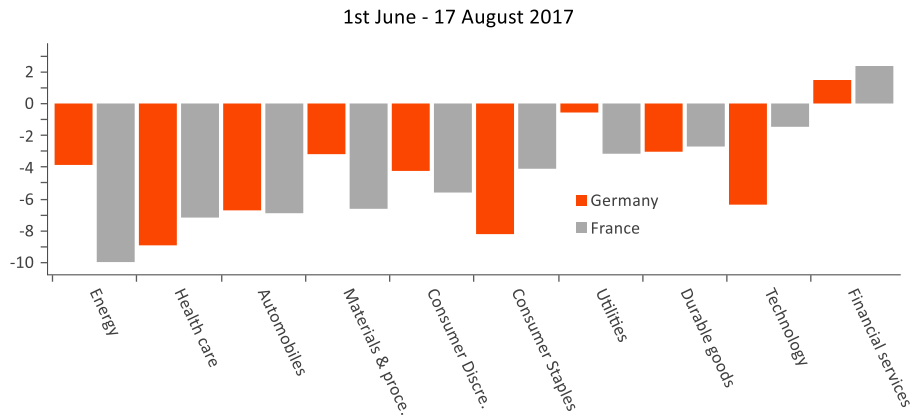
Private capital expenditure in Germany, at constant prices



Sources: RichesFlores Research, Macrobond

This disappointing development could potentially harm the performance of the German market, which has already been hurt by its beleaguered automotive industry.

Perfomance of French and German equity market sectors



Sources: RichesFlores Research, Macrobond

In conclusion, there are many factors that could penalize European markets for some time to come, unless the worldwide economy starts to see more explosive growth. In addition, expectations that fiscal policy will vigorously support economic growth are waning fast, in Europe and even more so in the United States where Donald Trump clearly has his hands tied. The summer is ending on a complicated note, and it is probably better to wait for a deeper correction before considering a repositioning on European indices.

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