

## Europe in the limelight

From a European perspective, last week brought some relief for the continent as Trump, still locked in trade talks with China and diplomatic tensions with Iran, has delayed any decision with regard to auto import security which was originally due Saturday, by up to six months. This takes two allies [off of an imminent collision course](#), and is temporary good news for Germany's ailing economy which would be dealt a major blow if the US was to introduce tariffs on car imports.

With the continent having been flirting with the 'R' word, next week's consumer confidence readings and PMI releases will give a fresh assessment of the bloc's economic wellbeing and let us know if we are out of the woods: Have we reached a bottom or is there still some way to go? The German IFO survey will also be in the spotlight, however, it is worthwhile remembering that at the time when this was taken, trade tensions were high and Trump's decision to postpone the auto investigation was not yet known, so the reading may paint the reality worse than it currently is.

The European elections will take centre stage towards the end of the week, kicking off on Thursday. These elections may be more closely watched than they have been in the past because of growing political fragmentation. Italy's Salvini hopes to create a pan-European alliance of nationalist politicians which could have a collective voice in the European Parliament to challenge the traditional power brokers. For more about the elections, please see our latest article which will be uploaded on the blog today, following the publication of the original piece in Saturday's Luxemburger Wort.

Fredrik Skoglund, Group CIO

### Key focus for next week:

Monday	Japan 2019 Q1 GDP
Tuesday	EU Consumer Confidence OECD Economic Outlook
Wednesday	Publication of the latest FOMC meeting minutes France Insee Business Confidence Indicator European Parliament elections kick-off Japan Tankan Index UK Inflation
Thursday	Eurozone PMIs Germany IFO Business Climate
Friday	Japan Inflation US Durable Goods Orders

### Latest Publications:

- [On why a trade deal is in the US' best interests](#) – Despite the latest tariff impositions, we look at potential reasons why the US may still pursue a trade deal.
- [An unexpected Eurozone growth spurt](#) First quarter GDP growth topped estimates coming in at 0.4%.

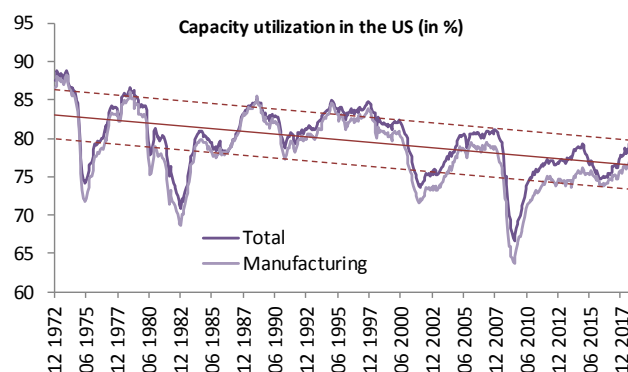
## Macro Focus

Last week was mixed in terms of macro publications in the US. While the small business confidence indicator showed ongoing strength and resilience, hard data revealed some challenges for manufacturing and consumption. We focus on the US this week: it is the strongest link in the world economy, and last week's data raises important questions.

The **Small business confidence index** compiled by the NFIB rose in April by 1.7 points to 103.5, but the survey data was collected before the resumption of the trade tensions. Expectations for better economic conditions increased, same as job creation plans, and business conditions. The labour market remains quite tense, 57% of firms reported hiring or trying to hire (-3%), 86% of which reporting few or no qualified applicants. An unchanged (and high) 34% report higher compensation and plans to raise compensation remained elevated as well. Over the past quarters, inventory build-up contributed positively to GDP growth, and the risk is that this becomes a drag for the coming quarters as companies wait for inventories to fall before resuming production. The NFIB survey is reassuring with this respect. Sales and inventories saw an improvement: 9% (up 4%) reported higher sales, and 20% (+1%) expect an improvement in sales. The answers on inventories indicate confidence in the economy's ability to absorb the inventory built-up, so there is less risk that inventories have a negative contribution to growth in the near future. However, less companies reported capital spending (54% vs a recent average of 60%), while the number of companies planning an increase remains unchanged: so it is early to expect a strong re-acceleration of investment short term, and the evolution of demand (investment and consumption) remains crucial to deal with the inventory question.

The hard data of last week underlines this cautious tone. **Industrial production** fell 0.5% in April, for the third time in 4 months. The decline was broad based, though led by weakness in machinery and motor vehicles (-2.6% each) which confirm the loss of momentum in the manufacturing sector. The latter is, to a large part, explained by the trade war and the uncertainties it brings: manufacturing fell 0.5% in April; it fell by a similar magnitude in January and February, and remained stable in March – then, April. Looking at the details of Industrial production (of which Machinery is a component), and adopting a market group view, all components fell: industrial supplies where business equipment fell 2.1%, non-industrial where construction fell 0.7%, except materials with a mild 0.2% rebound after 3 consecutive falls.

**Capacity utilization** fell for another month to 77.9%, after it peaked at 79.6% in November. It is now 1.9% below the long term average of 79.8%. In the manufacturing sector, capacity is of course (given what we said before) falling as well, to reach 75.7% (2.6% below the long term average). The chart below, with the regression lines, shows two things: 1. there are structural changes in the US economy explaining the long term downward trend for capacity utilization (among which investment abroad, for instance in China, by US corporates to reduce labour costs and increase profitability) and 2. we should analyse all activity indicators keeping in mind that November could have been the peak of this current cycle, and try to assess how low we can go.



Source: Bloomberg, BIL

It is important to say a few words about **China**. Retail sales, industrial production and investment pulled back more than expected after March's strong shoot-up. The main challenges are falling credit at home and slower demand abroad. Besides, we see that the public sector is driving fixed asset investment (+7.8% YoY vs when we saw a slowdown to +5.5% for the private sector), and the slowdown seen in investment production has been driven by the private sector. Along with uncertain perspectives for foreign demand, the private sector was hit by the sharp fall in corporate loans which is the main driver of the pull-back in new yuan loans.

All in all, the data published last week shed, *a posteriori*, more light on the importance of the trade war and the real cracks which it creates in the current cycle through the loss of momentum of the manufacturing sectors. Should it be prolonged, then we would start to reassess the strength of labour markets, which are the main pillars of private consumption, and ponder whether, after all, they have not become lagging indicators. We are not there yet, we keep our view that world growth will hold at comfortable levels, but from a macro point of view, we are happy with the underweight in equities we implemented recently.

## Equities

### Trade war takes the headlines

Next week should be quiet on the equity front – that is unless new trade war worries/tweets generate headlines. For weeks, investors have been focused on the earnings season on both side of the Atlantic, but now, as these draw to a close (having brought better results than had been feared), the trade war is back in the spotlight, and the risks we saw in Q4 18 have re-emerged.

So what does that mean for our view on equities? Well first of all, it has increased risk in a market that has already had a really good run this year. This means that some investors might be encouraged to protect a portion of their profits. The added risk can, to a large extent, be referred to as "President Trump risk" because of the unpredictability of his Twitter activity. Not that he is the sole catalyst, but the volatile signals in his messages are pushing markets in both directions. As a result, the volatility index (VIX) spiked back to levels unseen since the fourth quarter of last year, showing an increase in short-term risk/nervousness.

Looking back at the [earnings season](#), company results surprised on the upside in both Europe and the US, confirming our view that fundamentals point to a slowdown in growth this year but *not* an earnings recession. Going into the earnings season expectations were for an earnings recession in Q1 of 3.5%. Not only did we beat that number but also, at this stage where 90% of companies have reported, we have avoided an

earnings recession.

Throughout the earnings season, earnings revisions have turned. Although they are still in negative territory (meaning that there are more negative revisions than positive), the trend has changed direction. While this could be affected by risk factors going forward including the trade war, this is a positive sign that the worst could be over in terms of downgrades.

With regard to regions, the US has been stronger in terms of both earnings growth and earnings surprises versus expectations. We have seen a Q1 earnings season where the US has beaten Europe in every sector. So, from an allocation perspective, this, coupled with a stronger economic backdrop, provides support for our overweight stance on the US.

Looking more broadly at the markets, first quarter earnings figures, valuations that are neither expensive nor cheap, more manageable FY earnings growth expectations and our macro view, all still support equities. However, despite the fundamentals, after the strong rebound in Q1 and the added short-term risk from the trade war, we have been compelled to lock in some profits by going underweight equities. This risk-management-triggered-move, stems from fears of a potential correction if the trade war escalates further.

	S&P 500	Stoxx 600	Euro Stoxx	Japan
% beating EPS	76%	55%	54%	47%
EPS growth Y/Y	3%	2%	0%	1%
EPS surprise	6%	3%	0%	1%
% beating Sales	57%	58%	60%	44%
Sales growth Y/Y	5%	1%	3%	3%
Sales surprise	0%	1%	2%	1%

Source: JP Morgan, BIL

## Fixed Income

### The Tariff Man returns

Investors in the fixed income space had plenty of news items to digest last week, but the main driver of last week's performance was without a doubt the return of the trade war rhetoric. Mr Trump lived up to his self-given nickname of being a 'Tariff Man' and blew both hot and cold signals. Firstly, he increased tariffs on a number of Chinese goods (to which the Chinese retaliated very quickly) and later he "calmed" the market by saying there will be a great agreement and, fortunately for the European car industry, he also delayed auto tariffs by up to six months. They are not off the table and are bound to come back into investors' focus in the coming months.

All this led corporate spreads worldwide to continue their widening trend which started last week.

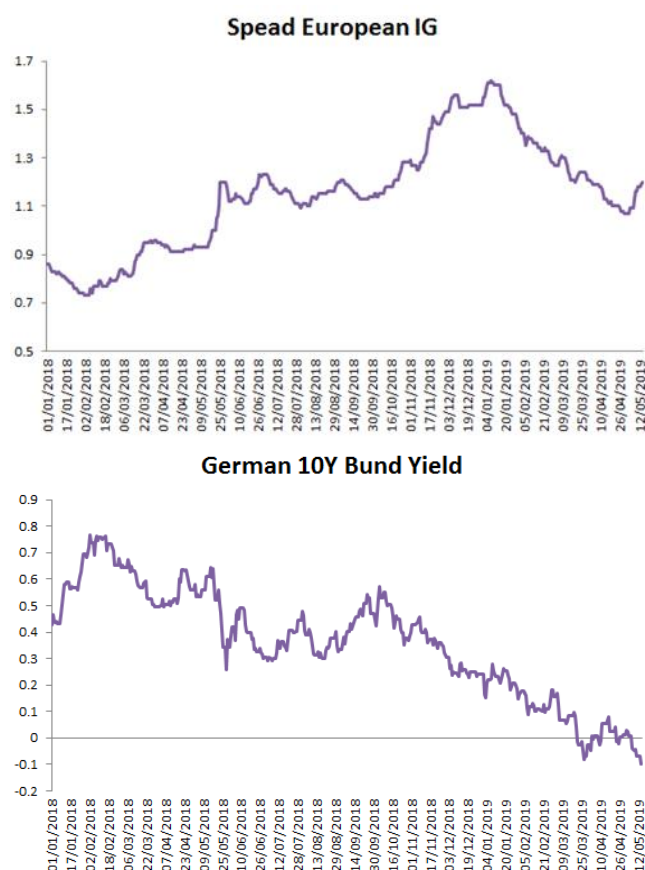
The general risk-off sentiment can also be felt on the government bond markets where the yields on the core government bonds continue to trend lower. German 10Y Bund yields now stand at -0.11% which brings us very close to the all-time low of -0.20% (reached in June 2016). The weaker economic data out of the US (disappointing retail sales) and China (lower industrial production numbers than expected) were the recent drivers behind this latest push lower.

One market that did not join the party of lower government bond yields was Italy. President Sergio Mattarella seems to be increasingly worried about how Italy will produce a budget for 2020 with the economy slowing and costly campaign promises that need to be funded. No one knows whether the government will continue or collapse after the European elections on May 26<sup>th</sup>. If it falls, elections could be held as soon as September, meaning the country would be without a government during the critical period when the budget is up for negotiation.

Looking to the US, traders continue to bet on a rate cut later this year, which is very far from the Fed's current projections. The Fed describes the economy as being in a very good place with both inflation and unemployment running low. Concerns about a deteriorating economic outlook have lessened since late last year.

However, renewed trade tensions could nudge the Fed in a more dovish direction. There is speculation that the tariffs could lead to a higher inflation and as such, could raise the odds of a rate hike. However, this inflation uptick should only be of a temporary nature. Consequently, the Fed should weigh economic weakness associated with the trade war more heavily than any upward pressure on inflation.

Still, considering the magnitude of the economic weakness needed to prompt the Fed to cut rates, we feel the market is running ahead of itself.



Source: Bloomberg, BIL

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