Spring in Europe

**Highlights**
- European risk assets have underperformed amid disappointing global growth, political headwinds and a series of idiosyncratic factors.
- With global growth healing and political issues manageable, we believe that there is room for Europe to surprise to the upside in coming months.
- Valuation and positioning surveys suggest peak pessimism is at hand. The bar is low for European risk assets to catch up to some of their global peers in 2019.

European equities have meaningfully underperformed their US counterparts for the last decade, a reflection of weaker growth and earnings, political uncertainty, and a global preference for growth over value stocks (European indices are heavily weighted towards value). The last 12 months have been no exception as the trade dependent eurozone economy suffered from sharply weakening global demand. Moreover, the region was plagued by a multitude of idiosyncratic events starting with the Italian election outcome, new emissions regulations in Germany, record low water levels in the Rhine, political upheaval in France and Brexit uncertainty. Together those factors contributed to the region’s equity and currency underperformance.

However, we sense peak pessimism in Europe at a time when the above headwinds are easing. First and foremost, the turn in China’s economy should boost exports while underlying domestic demand looks solid and will likely receive support from fiscal stimulus. Second, domestic political uncertainties are manageable, in our view. With valuations attractive on a historical and relative basis, we think there is a low bar for positive surprises in the eurozone.

**European economy**
Last year, eurozone GDP slowed to 1.9% from 2.4% in the year prior. Looking at individual growth components, most of the loss in momentum was associated with a decline in net trade which fell by 0.6% compared to 2017. We expect this trend to reverse and external demand to stabilize over the next two quarters supported by improving credit and manufacturing dynamics in China and other APAC economies.

The largest contributor to Eurozone domestic growth, household consumption, also dipped somewhat last year amid political uncertainty. However, the primary driver of consumption, household income growth, remains solid. Indeed last year’s softening in spending may have been just a temporary phenomenon as consumer sentiment started to tick up again in Q1 and while labor and wage dynamics remain supportive of consumption.

In the previous Macro Monthly, we illustrated the improved fiscal impulse for the Eurozone but it is worth reiterating the positive impact on government expenditures and economic growth for 2019. This month the IMF revised their fiscal effort estimate for the region and the primary structural deficit more than doubled from late 2018 estimates and resides at levels not seen for almost a decade. A primary structural deficit contributes positively to GDP growth.
Exhibit 1: Eurozone contributions to annual GDP growth

Consumption  Investment  Government expenditure  Net Trade  GDP

Source: Datastream as of 18 April 2019

Exhibit 2: Pick-up in China trade suggests a rebound in European manufacturing

EZ Manufacturing PMI (LHS)  China Export Orders y-y (t-3m, RHS)

Source: Macrobond as of 19 April 2019
Despite domestic and external uncertainties, we are encouraged that European business investment has been quite resilient. According to a recent survey conducted by our UBS Investment Bank colleagues, capex intentions remain elevated with cash layouts further increasing in 2019. This is an encouraging sign for productivity, wages and finally potential growth—ultimately extending the business cycle.

Lastly, the ECB will stay on hold for a prolonged period of time with eurozone harmonized index of consumer prices (HICP) inflation still muted. This in conjunction with further new measures such as a potentially more stimulative targeted longer-term refinancing operation (TLTRO) for banks or the introduction of a tiering system for excess reserves should help European banks and loan growth.

**Political risks**

*European parliamentary elections*

There is a confluence of local political overhangs in Europe but in our view these risks are manageable and well-reflected in market pricing. The 2019 European Parliament elections taking place in late May are in focus given expectations for a rise in anti-establishment parties' which are projected to win close to 30% of the seats (see Exhibit 4). Receiving less coverage is the growth of pro-EU integration parties such as the Alliance of Liberals and Democrats for Europe (ALDE). While parties forming the current coalition (European People’s Party (EPP) and Social Democrats) will lose out to these new alternative parties, they will remain a sizeable force and require a third group to build a coalition. This is much more likely to be a pro-integration party which

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**Exhibit 3: Eurozone primary structural balance (% of trend GDP)**

- Eurozone structural primary balance (% trend GDP) - Change in estimate over past 6m

Source: Datastream as of 19 April 2019. Note a primary structural deficit contributes positively to GDP growth

**Exhibit 4: Current coalition of EPP and Social Democrats will require a third group, most likely to be pro-integration**


1 ECR, ENF, GUE/NGL EFDD
could tilt the reform agenda into the direction of increased risk sharing and fiscal integration over the coming years. Indeed, it will prove difficult for the anti-establishment parties to build a coalition necessary to obstruct reform, given significant differences in ideology (right and left) on most issues.

**Italy**
The fragile Italian coalition between the far-right League and far-left five Star Movement could be tested after the EU parliamentary elections. A strong performance by the League may embolden its leader Salvini to call fresh Italian elections, sparking renewed uncertainty and volatility. But a new election could ultimately result in a rightwing coalition without the five Star Movement and ultimately proves more business friendly. Rating agencies have confirmed Italy’s credit rating two notches above non-investment grade, Italian bond yields have declined and the banking system is gradually healing. While Italy experienced a mild recession in H2 2018, the economy is showing early signs of recovery which should help stabilize the debt trajectory. While there are plenty of long-term structural concerns in Italy in the near term, we believe that the country’s problems do not pose a threat to the construct of the eurozone.

**Brexit**
With the UK and Europe kicking the can on Brexit to a new October 31 deadline, immediate pressure has eased. But the overall risk of a no-deal Brexit seems to have declined. The results of indicative votes in Parliament show a no-deal Brexit as the least desired of all potential options. Indeed, even a revocation of Article 50 (the trigger for Brexit) received a stronger backing than the no-deal option. In an emergency, the UK Parliament could – according to a ruling by the European Court of Justice – unilaterally revoke the exit procedure at the last minute. While uncertainty about the final deal remains, the tail risk of an economically damaging crash out looks remote.

**US-EU trade negotiations**
The key external risk to Europe is an escalation of trade tensions between the U.S. and EU. It is clear that as soon as the US and China come to a trade agreement, the Trump administration will turn its sights to Europe. Indeed, the Trump administration has until May 18th to decide if it would like to press ahead with tariffs on autos and auto parts under its Section 232 investigation into national security risks. We do expect volatility around this announcement and it is quite possible the administration will announce an ‘intention’ to tariff some form of autos or auto technologies. However, we suspect this is a tactic to create leverage in more comprehensive trade negotiations between the US and EU over coming months, and that actual tariff implementation will be watered down, delayed or not happen at all. As we approach the 2020 elections, President Trump is likely to be more careful in how he proceeds with trade policy given that he evidently sees economic and market performance as key to his political prospects. As trade uncertainty contributed to the market downturn in Q4, President Trump will likely have to tread carefully on this issue. Moreover, there is little business, public or congressional support for auto tariffs. In the end we suspect that amid scattered headlines and threats, the ultimate actions taken will pale in comparison to the US-China trade war which escalated last year. That said, we acknowledge that President Trump has generally followed through on tariff threats in the past and that it may take a negative financial market reaction for him to reverse course. In the end, we do not see sustained negative market or economic damage from auto tariffs.

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**Exhibit 5: Valuation discount vs. global equities (ex-Japan)**

Based on forward P/E and P/B multiples

Source: Datastream as of 19 April 2019.

Japanese equities are excluded because prior to the introduction of key market reforms around the turn of the century, Japanese accounting and auditing standards significantly deviated from other markets, which distorts relative valuations.
Valuations
Exhibit 5 shows that the EU valuation discount to global equities (ex-Japan, which is also cheap) is near 30-year lows. In April, the well-followed Bank of America fund manager survey noted short European equities as the most crowded trade for the second month in a row. We suspect that the bar is low for European risk assets, and as confirmation of growth stabilization in Europe materializes, EMU stocks can rebound quickly. Meanwhile, European bonds appear excessively priced even considering ongoing structural trend growth headwinds and negative rates. Markets have essentially priced in that the ECB will not be able to normalize rates this cycle. But if we are right on economic stabilization and with a new ECB President due to replace Draghi later this year, we think there is room for some healthy repricing of bunds. In FX, the EURUSD is somewhat cheap and we would expect the exchange rate to react positively to an improvement in the global growth picture.

The bottom line: Asset allocation
Manageable political risks and the improving trade environment creates room for a catch up in European stocks relative to some of their global peers. Across Investment Solutions portfolios, we are slightly overweight a diversified basket of European banks, small caps and Italian equities assuming a constructive stance on domestic Europe. Furthermore, we like the chances for European equities to perform well in the second half of 2019 supported by their higher cyclicity, greater exposure to international trade and steeper valuation discount. We remain of the view that European yields and the EUR are set to rise as the European economy rebounds over coming months.
Asset class attractiveness

The chart below shows the views of our Asset Allocation team on overall asset class attractiveness, as well as the relative attractiveness within equities, fixed income and currencies, as of 26 April 2019.

Overall signal Unattractive Neutral Attractive

Equities

Fixed Income

Currencies

Source: UBS Asset Management Investment Solutions Macro Asset Allocation Strategy team as at April 26, 2019. Views, provided on the basis of a 3-12 month investment horizon, are not necessarily reflective of actual portfolio positioning and are subject to change.
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<td>Global Equities</td>
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<td>– We see a China-led stabilization of ex-US growth and the pause in US monetary policy tightening as key to prolonging the business cycle, just as they were in early 2016. In particular, we view the probability of a recession in the coming year as low given the strength of labor markets and consumption across the developed world. We believe that the global economic growth is stabilizing around its trend rate.</td>
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<td>– After inconsistent Fed rhetoric prompted fears of a US monetary policy mistake in late 2018, a clearer and unequivocally more accommodative Fed narrative has emerged. In our view, the Fed is now likely to let the US economy ‘run hot’ in order to rebase inflation expectations. With scant evidence of significant momentum in US core inflation, the Fed has considerable breathing room.</td>
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<td>– The ability of China to cushion its slowdown continues to be key to the global economy and markets. The Chinese authorities have a broad range of policy tools at their disposal and have shown willingness to use the full breadth in achieving a difficult balancing act between de-risking a highly leveraged and capital inefficient Chinese economy and softening the slowdown prompted by those deleveraging initiatives.</td>
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<td>– In our view, risk assets discounted material concerns about factors including the potential impact of a protracted US/China trade war at the start of the year. The speed and scale of the rally in the face of disappointing macro data globally and downgrades to forward corporate earnings expectations suggest strongly that expectations for good news on US/China trade talks have now been largely priced in. We remain constructive on global equities, but the speed and scale of the rally in 2019 has tempered to a degree the conviction of that positive view. The likelihood of further material upside for risk assets in the short term is, in our view, now dependent on the ability of ex-US demand growth to accelerate from current weak levels to support earnings. In particular, the effectiveness of the broad array of measures progressed by the Chinese authorities to cushion their growth slowdown remains critical.</td>
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<td>Global Duration</td>
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<td>– We retain a negative view overall on developed world duration over the medium term. With global growth showing signs of stabilization, we think it is too soon for the market to be pricing material easing from the Fed, although the risks around this view have increased with apparent Fed determination to boost inflation and inflation expectations. Across the Atlantic, we are unconvinced that the ECB will be unable to tighten this cycle. In our view, yield curves are likely to steepen as global growth rebounds along with inflation expectations. While wage growth has yet to materially impact core inflation measures, developed world labor markets continue to tighten. We see nominal yields moving gradually higher as output gaps close, wage growth accelerates and the global economy stabilizes. However, upside to nominal yields is likely limited by structural factors including fast ageing populations in the developed world and technology-driven price pressures.</td>
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<td><strong>US Equities</strong></td>
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<td>– During the first few months of the year, US equities benefited from a resilient domestic economy and a lower exposure to global growth factors compared to other major indices. While we do expect US stocks to remain supported by easy to beat consensus earnings expectations and solid US consumer demand, the recent pickup in Chinese exports and manufacturing activity should support ex-US stocks to a larger degree as they exhibit higher cyclicality and trade reliance. US equities trade at a premium relative to other markets leaving less room for further rerating.</td>
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<td><strong>Global (Ex-US) Equities</strong></td>
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<td>– In Europe, growth has decelerated considerably, due to external and domestic factors. Externally, China’s slowdown and trade uncertainty negatively affected European exports. Domestically, political upheaval in Italy and France along with disruptive auto emissions regulations weighed on the economy. However, we expect those headwinds to fade over the coming months. European stocks remain supported by solid domestic demand dynamics, attractive valuations and by a likely stabilization of global economic conditions towards the second half of 2019. – We remain constructive on Japanese equities despite the recent headwinds from weak Chinese imports. Diminished political uncertainties and ongoing structural reforms are supportive of higher price multiples while a solid underlying domestic economy suggests the outlook for profits is stronger than markets are discounting.</td>
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<td><strong>Emerging Markets (EM) Equities</strong></td>
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<td>– Emerging market equities have this year underperformed developed market equities driven by a continued deterioration in earnings but the surge in Chinese social financing bodes well for EM growth over coming months. – We remain broadly positive on China in the expectation of further measures to cushion the domestic growth slowdown. Any broadening of the current trade stand-off with the US is likely to hamper Chinese growth, but a gradual economic slowdown is already priced in and the Chinese authorities have already shown themselves willing to provide monetary, fiscal and regulatory support to help smooth the ongoing economic transition. Chinese equities still trade at a PE discount to other markets and further market liberalization could prompt a rerating as international capital starts to flow into Chinese assets following the inclusion of onshore Chinese equities in MSCI’s widely followed EM equity indices.</td>
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<td><strong>Currency</strong></td>
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<td>– As signs of stimulus from China begin to take hold, we expect ex-US growth to stabilize. Over time, we anticipate capital will flow from the US into earlier-cycle economies and that the USD will weaken, especially as the USD remains somewhat expensive on a real trade-weighted basis. Elsewhere, we continue to see strong valuation support for the JPY and see short AUD as an effective hedge against on-going China weakness in an economy where domestic household leverage is likely to constrain growth.</td>
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<td><strong>US Bonds</strong></td>
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<td>– After the recent downward repricing of US rate expectations, 10yr nominal US Treasury yields appear reasonably value given our outlook. Nonetheless, US nominal yields look attractive relative to most other developed government bond markets on an unhedged basis. In the absence of a material pickup in inflation or term premium, yields are likely to remain range bound. Our overall assessment is neutral.</td>
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<td>Global (Ex-US) Bonds</td>
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<td>In aggregate, we see global sovereign bonds outside of the US as unattractive. The ECB has committed to low rates for some time, limiting attractiveness of core Euro area bonds. We find Italian BTPs attractive on diminishing political risks. Swiss bonds continue to look very overvalued and in our view they have an increasingly asymmetric risk profile. The Swiss economy is relatively strong and we see Swiss bonds as vulnerable to attempts to normalize monetary policy by a Swiss National Bank increasingly concerned by the strength of the housing market. Elsewhere we are more positive on Australian duration on a relative basis. We see the Reserve Bank of Australia taking a cautious approach to policy given elevated household leverage and slow inflation.</td>
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<td>Investment Grade (IG) Corporate Debt</td>
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<td>Although we do not believe that a sharp demand slowdown is imminent, we believe IG spreads troughed for the cycle in early 2018. Moreover, we are concerned about increased supply, reduced demand, and potentially large number of &quot;fallen angels&quot; when the economic growth takes slows down significantly and downgrades begin.</td>
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<td>US High Yield Bonds</td>
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<td>Current default rates in high yield are very low by historical standards. Given the still relatively positive economic backdrop, we do not expect a material pick-up in US defaults in the near term. However, after the significant recent rally, spreads have now tightened to a point where we see the balance of risks skewed towards more widening.</td>
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<tr>
<td>Emerging Markets Debt</td>
<td></td>
<td>Spreads on EM debt relative to US Treasuries widened substantially in 2018 in the face of higher geopolitical risks, a strengthening USD and higher USD funding rates. However, EM local currency bond yields have rallied both in absolute terms and relative to the US yields since September while EM hard currency bonds yields began a rally in late November. This reflects investor expectations for a less hawkish Fed, less aggressive US trade policy, and/or more China stimulus.</td>
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