MORNING BRIEFING
March 1, 2017

Populism Popping Up in Europe Too

See the collection of the individual charts linked below.

(1) A bunch of small countries. (2) US election widened yield spreads in Eurozone. (3) Madame Frexit is likely to win first round, but second round maybe not. (4) Lots of fake news in Europe too. (5) Old news: Italy may be a bigger problem than France. (6) Blonde Geert is Netherlands' Orange Don. (7) Robots taking over Rotterdam. (8) Signs of life in Eurozone economy. (9) EMU MSCI is relatively cheap, but populist politics may be more troublesome in Eurozone than in US.

Europe I: Populists Gaining. ECB officials recently warned that the European Union could be dissolved into "small countries" without much geopolitical weight. Their concern is that populist parties with nationalist tendencies could be on the verge of overtaking more traditional political parties across European nations. Political polls show that is unlikely. However, the credit markets don't trust the polls anymore following the widely unexpected results of the Brexit vote and US election.

Causing further angst for Eurozone bond markets, the ECB is reducing its amount of monthly bond purchases, which had been supporting European bond prices. Meantime, inflation in the broader Eurozone has rebounded with the economy on a positive trajectory (*Fig. 1*). Latest GDP figures show that the region's economy grew at a moderate 1.7% y/y during Q4 (*Fig. 2*). This series is highly correlated with the region's economic sentiment index, which continues to improve. However, political uncertainty is what's driving markets rather than better economic performance. Let's review the latest developments:

(1) *Bond spreads widening.* Melissa and I wrote on 2/14 that the yield spread between the French and German 10-year government bonds has been widening on concerns that populists are gaining in France. That spread had widened from 38bps to 72bps from the US election until mid-February (*Fig. 3* and *Fig. 4*). Since then, the spread widened further to 80bps, the most since November 8, 2012, narrowing slightly during the final days of the month. Trading volume has exploded too, double the average recorded last year by data service provider Trax, reported the 2/16 *FT*. As we discussed previously, redenomination risk under the anti-euro Marine Le Pen is of particular concern for bondholders. Italian and Spanish yield spreads have also widened since the US election.

(2) *Madame Frexit ascending.* Fresh French polls conducted 2/20 on the first round of voting (to be held on 4/23) put far-right anti-European candidate Le Pen comfortably ahead of centrists Francois Fillon and Emmanual Macron, who tied for second place according to several media reports. On the news, the spread jumped to 80bps. None of this is quite new news, as Le Pen has been expected to win in the first round and lose in the second to Macron. Fillon, involved in a scandal, has become increasingly expected to be defeated. (By the way, a helpful Capital Economics table included at the bottom of a 2/17 Business Insider article outlined Le Pen's more extremist views as compared to Macron.)

(3) *Political spinning*. Bloomberg reported on 2/19 that two French socialist party candidates were discussing combining forces. The article noted: "That boosts the chance that the anti-euro Marine Le Pen may not face a centrist candidate in the final round." Peter Chatwell of Mizuho International told Bloomberg that could mean a "choice of two market-unfriendly candidates" for the second round.

Reuters reported a day later that such a possibility had fizzled over tensions between the socialist candidates expected to team up. "I have no intention of going and hitching myself to a hearse," one socialist reportedly said about the other.

(4) *More faking.* It could be a French bond-buying opportunity for those willing to bet that Le Pen will lose the second round of the French presidential election on May 7. There's been no shortage of possibly fake news that could impact election results either way. On the same day that the polls were released, "France's far-right National Front accused authorities of staging a media stunt on Monday to influence the presidential election after police searched its headquarters in an investigation into 'fake jobs,'" according to Reuters.

Fake news, especially of the social media variety, has become a political challenge in contrast with the typically "sedate" media landscape in Germany too, as a 2/14 *FT* article discussed. The 2/20 *NYT* wrote: "One of the biggest problems policy makers across Europe say they face is a lack of tech specialists"—that is, in the context of defeating cyber-attacks and the proliferation of fake news.

(5) *Italy splitting.* Deutsche Bank economists wrote in a note that Italian political uncertainty is more of a risk to European markets than French uncertainty is, reported CNBC. The Italian Democratic Party (PD) is poised for a split following Prime Minister Matteo Renzi's failure to reform the Italian Senate by a referendum vote. The Italian election to replace Renzi, who resigned on the "no" vote, could be held before 2018. Eurosceptic 5 Star party leaders are waiting in the wings for the PD to unravel, as the *WSJ* recently discussed. Since the referendum vote, Italian-German spreads have widened 41bps.

(6) *Netherlands wilding.* Dutch elections haven't typically received as much press as other nations'. But more global headlines than usual will cover the March 15 parliamentary elections in the Netherlands. They could set the tone for other "key elections across Europe this year," observed a 2/25 article in *The Guardian*. It cited a story in *The Economist* that recently argued that "developments in the Netherlands tend to be followed in other European countries a few years later."

The Netherlands has "seen a sharp decline in electoral support for established parties," noted *The Guardian*. It explained: "In the 1980s populist parties barely got more than a few seats in parliament." In 2002, the left populist and right populist parties garnered more than 20% taken together. The latest polls show that the right-wing Party for Freedom led by Geert Wilders is "running neck-and-neck" with the center-right establishment.

Wilders, "the firebrand [member of parliament] with the peroxide-blond hair," has been compared to the orange-maned leader of the free world, President Donald Trump. Both are a "one-man show," dominating politics. Both men have an affinity for outlandish tweets. Wilders wants to get out of the euro and the EU and to ban Muslim immigration. Does this nationalist sentiment sound familiar?

There's a link between the rise in Dutch populism and robots too. Bloomberg wrote that "Wilders has tapped into deep fears among many low-skilled workers over their jobs in a world of rapid technological change …" Rather than manned cranes at two terminals at the port in Rotterdam, cargo is automatically maneuvered around by orange robots that bear resemblance to Amazon's Kiva systems.

Europe II: Animal Spirits? Besides widening credit spreads, bond investors are starting to see an upward trend in European yields because inflation is rising and economic growth is improving. Is the US exporting Donald Trump's animal spirits, which have been so strong here since Election Day, over there? That's not very likely since antipathy for our President is much higher in Europe than in the US, according to meetings and phone calls I've had with a few of our European accounts over the past couple of months. More likely is that the rebound in the price of oil price since the start of last year is reviving Europe's energy industry, much as it has in the US. In addition, the euro is down 2.4% y/y and 5.5% from two years ago, which is a plus for the Eurozone's manufacturing exporters. In addition, consider the following developments:

(1) *CPI.* The headline CPI inflation rate, which drives the ECB's monetary policy, jumped from roughly zero on a y/y basis during April of last year to 1.8% through January (*Fig. 5*). That's awfully close to the ECB's 2.0% inflation target.

(2) *Business surveys.* As noted above, the Eurozone's Economic Sentiment Index (ESSI) has risen to a cyclical high of 108.0 during February, up from 103.9 a year ago, which augurs well for real GDP growth. The production expectations component of the ESSI was little changed at 13.0 in February, near January's 13.9, which was the highest since April 2011 (*Fig. 6*). This component is highly correlated with the Eurozone M-PMI, which has also been strong in recent months.

(3) *Germany's business confidence.* Germany's IFO business confidence index edged up in February, led by a sharp increase in the current situation component, which is up 5.4 points over the past six months to 118.4, the highest reading since August 2011 (*Fig. 7*). This big increase coincides with Trump's victory in the US, but it's hard to imagine that's why it happened. The IFO's diffusion index is highly correlated with Germany's M-PMI (*Fig. 8*). Both have been quite strong lately. Particularly strong IFO diffusion indexes were recently reported by Germany's fabricated metals, electric equipment, and other machinery and equipment industries (*Fig. 9*). This confirms our view that the global economy may be improving more than widely expected.

(4) *Stock prices.* Since last year's 6/23 Brexit vote, the EMU MSCI stock price index (in euros) increased 9.7%, lagging behind the US MSCI with a gain of 12.2% (*Fig. 10*). Germany's MSCI has led the way with a gain of 14.3% over this period (*Fig. 11*). As Joe discusses below, the rally has been fairly widespread among the 11 sectors of the EMU MSCI (*Fig. 12*).

(5) *Forward earnings.* Our Blue Angels analysis shows that the forward earnings of the EMU MSCI (in euros) has been turning up since the middle of last year, though it isn't higher than it was in 2011 (*Fig. 13*). Below, Joe also details the valuation story for the EMU and its sectors. The forward P/E at 14.2 is relatively cheap compared to the US MSCI's at 18.0 (*Fig. 14*). However, there are probably more potentially negative political uncertainties hanging over the EMU than the US.

CALENDARS

US. Wed: Personal Income & Consumption 0.3%/0.3%, Headline & Core PCED 0.4%/0.3%, Motor Vehicle Sales 17.7mu, Construction Spending 0.5%, ISM M-PMI 56.1, MBA Mortgage Applications, EIA Petroleum Status Report, Beige Book, Kaplan. **Thurs:** Jobless Claims 245k, Weekly Consumer Comfort Index, EIA Natural Gas Report. (Bloomberg estimates)

Global. Wed: Eurozone, Germany, France, and Italy M-PMIs 55.5/57.0/52.3/53.5, Germany CPI 0.6%m/m/2.1%y/y, Germany Unemployment Change & Unemployment Rate -10k/5.9%, UK M-PMI 55.7, BOC Rate Decision 0.50%. **Thurs:** Eurozone Headline & Core CPI Flash Estimate 1.9%/0.9% y/y, Eurozone Unemployment Rate 9.6%, Canada GDP 2.0%q/q/1.7%y/y, Japan Headline, Core, and Core-Core CPI 0.4%/0.0%/0.2% y/y, Japan Jobless Rate 3.0%. (DailyFX estimates)

STRATEGY INDICATORS

EMU MSCI (*link*): The EMU's MSCI price index has gained 1.9% ytd in dollar terms after falling 1.2% in 2016. In euro terms, the price index is up a lower 1.2% ytd following a 1.8% gain for all of 2016. Euro-based forward revenues has improved 2.1% from its six-year low in May 2016, but remains 2.1% below its cyclical high (August 2015) and 8.7% from its record high (September 2008). Euro-based forward earnings had stalled since 2011--but is now 0.4% above its prior cyclical high in September 2015. It remains 27.6% below its record high (January 2008), but has improved 7.3% from its 23-month low in June 2016. Analysts expect revenues to rise 4.6% and 3.5% in 2017 and 2018, respectively, after falling 1.2% in 2016, but think earnings will rise 14.4% in 2017 and 10.7% in 2018 following a 0.7% decline in 2016. Forecasted STRG of 4.4% is down from a 64-month high of 4.6% in January. Forecasted STEG of 13.6% is at a 21-month high, which compares to a seven-year low of 5.6% in April 2016. STEG has been higher than LTEG (9.7%) since July after trailing it since late 2015. The forward profit margin has improved 0.8ppt to 7.0% from a cyclical bottom of 6.2% in May 2013. The implied profit margin is expected to improve to 7.0% in 2017 from 6.4% in 2016 before rising another 0.4ppt to 7.4% in 2018. NERI was positive for a third straight month in February, as it improved 1.2ppts m/m to a 21-month high of 3.8% from 2.6% in January. NERI is up from a 24-month low of -13.2% in April 2016, but down from a 56-month high of 4.0% in May 2015. The P/E of 14.2 is down from a 13-year high of 16.4 in April 2015, but up from a 30-month low of 12.2 in February 2016. That represents an 11% discount to the World MSCI's P/E now, up from a record-low 25% discount during 2011. But the current reading is still well below the 1% premium during April 2015--the post-euro-inception record high.

EMU MSCI Sectors Net Earnings Revisions (*link*): The EMU's NERI was positive for a third month in February, as it improved to a 21-month high of 3.8% from 2.6% in January. NERI was positive for an impressive 10/11 sectors and improved m/m for seven (compared to eight positive and nine improving in January). Energy topped all sectors in February, and Industrials was at a six-year high. Real Estate has the longest positive NERI streak of nine months, followed by Materials (8) and Health Care (7). Industrials' NERI turned positive for the first time in 22 months and Tech in 18. Here are the sectors' February NERIs compared with their January readings, ranked in descending order: Energy (9.2% in February, up from 5.9% in January), Consumer Discretionary (6.4 [20-month high], 5.6), Materials (6.1, 8.3 [5-year high]), Financials (5.1 [18-month high], 4.6), Real Estate (4.4, 3.5), Industrials (4.0, -1.1), Health Care (2.7, 8.0 [19-month high]), Telecom (0.3 [16-month high], 0.1), Tech (0.3 [18-month high], -2.6), Consumer Staples (0.1, -2.6), Utilities (-0.8, 0.4).

EMU MSCI Sectors Earnings, Revenues & Valuation (*link*): Forward revenues and earnings are at or around record highs for just 3/11 sectors: Consumer Discretionary, Consumer Staples, and Health Care. Among those three sectors, only Consumer Staples has a record-high forward profit margin. Financials' forward revenues is at a cyclical high, but forward earnings remains near a record low and the profit margin is at a cyclical low. Industrials, Materials, and Tech have revenues at a cyclical low, but their earnings and margins are at a cyclical or record highs. P/Es are down for all 11 sectors from their 2015-2016 highs, but these are rising now from their late-2016 lows: Financials (10.7), Health Care (15.8), Industrials (16.1), Materials (16.3), and Tech (19.4). P/Es for these four sectors remain near two-year lows: Consumer Staples (18.9), Real Estate (18.9), Telecom (14.9), and Utilities (13.1).

US ECONOMIC INDICATORS

GDP (*link*): Real GDP expanded at an unrevised 1.9% (saar) last quarter, slowing from Q2's 3.5% rate, though there were notable revisions to some major components. Growth in real personal consumption expenditures (revised to 3.0% from 2.5%, saar) was stronger than first thought, with durable goods (11.5 from 10.9), nondurable goods (2.8 from 2.3), and services (1.8 from 1.3) consumption all revised higher. Growth in nonresidential fixed investment (1.3 from 2.4), on the other hand, was 1.1ppt lower than the initial estimate, reflecting slower growth on spending on intellectual property products (4.5 from 6.4) and equipment (1.9 from 3.1); structures (-4.5 from -5.0) spending fell, but at a slower rate. Real residential investment (9.6 from 10.2) was also slower than first thought, though still robust. Real government spending (0.4 from 1.2) was near a standstill last quarter, as revisions cut growth in state &

local (1.3 from 2.6) spending in half; federal spending fell an unrevised 1.2%. Despite all the revisions, growth in real final sales (3.5%, saar), like real GDP, was unrevised from initial estimates.

Contributions to GDP Growth (*link*): Real consumer spending last quarter once again was the number-one contributor to GDP growth; real trade was the only drag. Some details: (1) Real consumer spending accounted for 2.05ppts of real GDP growth, as goods consumption added 1.23ppt--durable (0.83ppt) and nondurable (0.40)--while services consumption contributed 0.81ppt. (2) Inventory investment (0.94) added positively to growth for the second quarter—all nonfarm (1.06)—after a five-quarter string of negative contributions. (3) Residential investment (0.35) contributed to GDP growth for the first time in three quarters. (4) Nonresidential fixed investment (0.17) contributed to GDP growth for the third quarter as positive contributions from intellectual property products (0.18) and equipment (0.11) more than offset a decline in structures (-0.12); it was the first positive contribution for equipment since Q3-2015. (5) Real government expenditures (0.06) added to GDP growth--entirely state & local government spending (0.14), which had contributed negatively the previous two quarters; federal government spending (-0.08) detracted from growth for the third time in four quarters. (6) Trade (-1.70) subtracted from growth for the first time in a year, as both imports (-1.20) and exports (-0.50) were a drag on growth.

Consumer Confidence (*link*): Consumer confidence in February unexpectedly rose to a new 15-year high, surpassing December's high following the election. The Consumer Confidence Index rebounded to 114.8 last month—the most since July 2001—after falling to 111.6 in January, following a 12.5-point jump the previous two months to 113.3. The present situation component jumped 3.4 points last month to 133.4—the highest since July 2007; the expectations component was 3.1 points higher at 102.4, moving back toward December's cyclical high of 106.4. The current job outlook was mixed, with both jobs plentiful (to 26.2% from 27.1%) and jobs hard to get (20.3 from 21.1) moving down, the latter to a new cyclical low. The consumers' six-month job outlook has dramatically improved since the election, with those expecting more jobs (20.4 from 19.7) continuing to exceed those expecting fewer jobs (13.6 from 14.4). That result follows a long string of declines, with February's spread (6.8ppts from 5.3ppts) holding near December's reading of 7.6ppts, which was the largest margin since spring 2002.

Contact us by email or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor & Webmaster, 570-775-6823