MORNING BRIEFING
April 4, 2017

Europe: Good Fundamentals, Bad Politics

See the collection of the individual charts linked below.

(1) Brexit overdose in London. (2) UK is between the Rock and a hard place. (3) Brexit negotiations will be nasty. (4) Fundamentally, Europe is looking upbeat, according to PMI and ESI. (5) Forward revenues and earnings are also improving. (6) Investors seem to believe that populism is a passing fad in Europe. (7) Dutch treat. (8) French fried. (9) Will there be a Frexit referendum after presidential election? (10) Germans preferring the status quo voted for Mini-Merkel. (11) Italy is still Italy politically, but Italian banking crisis may be getting worse.

Europe I: War Talk. Greetings from London! I am visiting our accounts in Europe this week. During my meetings yesterday, I found that London's institutional investors are sick and tired of talking and reading about Brexit. They reckon no one knows for sure how it will all play out. In any event, they were happy to discuss the investment implications of the Trump administration for a change. Of course, in the US we have all had enough of all the cacophony from Washington since Election Day, though we can't complain about the stock market rally since then, with the S&P 500 up 10.2% through yesterday's close. Meanwhile, American investors in general aren't particularly concerned about Brexit.

According to my informed sources in London, I am reasonably confident that a war between the United Kingdom and Spain over Gibraltar is very unlikely. On Sunday, the former Tory leader Michael Howard, citing Margaret Thatcher's war with Argentina over the Falkland Islands, said he was "absolutely certain that our current prime minister will show the same resolve in standing by the people of Gibraltar." The rocky 2.6-square-mile (or 6.7-square-kilometer) enclave at the tip of the Iberian peninsula has been a British territory—and cause of friction between the UK and Spain—since 1713. The latest spat was sparked by draft Brexit negotiating guidelines drawn up by the European Union (EU), which said no future agreement between Britain and the bloc would apply to Gibraltar unless both the UK and Spain agreed.

Fabian Picardo, the chief minister of Gibraltar, accused the EU of behaving like a "cuckolded husband who is taking it out on the children" by appearing to hand Spain a veto over the Rock's future in Brexit negotiations. He said: "Gibraltar is not a bargaining chip in these negotiations. Gibraltar belongs to the Gibraltarians, and we want to stay British." He made the comments after Spain accused Britain of "losing its temper" over Gibraltar. Downing Street dismissed suggestions that Britain could send a task force to Gibraltar. "It isn't going to happen," a spokesman said. Brexit negotiations are likely to be rancorous.

Europe II: Good Fundamentals. Political uncertainty in Europe has weighed on European equity valuations, especially with the Netherlands, France, and Germany all holding critical elections this year. Lately, the cheapness of Eurozone relative to US equities has attracted the attention of investors and gotten lots of financial press. Eurozone stocks have been performing well so far this year, yet valuations remain relatively attractive. In addition, the latest economic data out of the region show upward momentum. In other words, the fundamentals are looking better for the Eurozone, while politics remain unsettled if not unsettling. Let's start with the former before moving on to the latter:

(1) *Performance & valuation*. During Q1, the performance derby among the MSCI stock price indexes for the major developed countries is as follows (in dollars, and local currencies): EMU (8.3%, 6.8%), US (5.7, 5.7), UK (3.9, 2.7), Japan (3.7, -1.0) (*Fig. 1* and *Fig. 2*). The forward P/E of the EMU MSCI index is 14.5, which is well below the US at 17.9 (*Fig. 3*).

(2) *Factory activity & prices*. The Eurozone's M-PMI (56.2) and NM-PMI (55.5) jumped to cyclical highs during March and February, respectively, according to Markit (*Fig. 4*). Chris Williamson, chief business economist at IHS Markit, observed that the six-year highs were evident across all key business activity gauges—output, new order inflows, exports, backlogs of work, and employment. The upturn was broad-based, with Greece being the exception to the strength. Business is so good elsewhere in Europe that suppliers are having trouble keeping up with demand.

Europe's M-PMI performance derby shows Germany leading the way: Germany (58.3), Italy (55.7), UK (54.2), Spain (53.9), France (53.3). March data for the NM-PMI will be available on Wednesday. February's performance derby for the NM-PMI showed Spain leading the way: Spain (57.7), France (56.4), Germany (54.4), Italy (54.1), and UK (53.3) (*Fig. 5* and *Fig. 6*).

(3) *Economic sentiment*. Europe's economic sentiment indicator (ESI) is also upbeat. During March, the European Union and Eurozone ESIs were at cyclical highs (*Fig. 7*). The latter is highly correlated with the y/y growth rate of real GDP in the Eurozone, which was 1.7% during Q4 (*Fig. 8*).

(4) *Forward revenues and earnings.* Industry analysts have turned more optimistic on the outlook for both revenues and earnings of the EMU MSCI stock index (*Fig. 9* and *Fig. 10*). Both have turned up on a 52-week forward basis. Revenues are expected to increase 4.9% this year and 3.5% next year, while earnings are expected to rise 13.3% this year and 10.5% next year.

Europe III: Bad Politics. Since the Brexit decision last summer, populist movements have been gaining strength in Europe, threatening the viability of both the European Union and the Eurozone. Investors received a momentary reprieve when the populist party was defeated in the latest Dutch election on March 15. In France's upcoming presidential election, the populist candidate has a decent shot at winning. Germany's national election will be held this fall, with the likely result skewed toward the establishment given the outcome of recent regional elections. In Spain also, the establishment has managed to outmaneuver the populists. The most unstable political situation of all might be in Italy. That's hardly a new development. Neither is the Italian banking crisis, which has fueled the political unease.

To buy into Europe, investors must buy into the this-too-shall-pass belief. Melissa and I aren't believers, so we aren't ready to overweight European equities. Even if the election outcome in France, for example, turns toward the establishment, anti-EU sentiment probably won't just disappear. Neither will Italy's debt woes, although officials are trying to force Italian banks to clean up the mess before it gets messier. The bottom line is that Europe has good fundamentals right now, but the political situation isn't pretty. Neither are Italy's zombie banks. See our 3/1 and 2/14 *Morning Briefings* for prior coverage of the European drama. Below, we recap the latest episodes:

(1) *Wilders loses and wins.* On 3/15, Geert Wilders, the Dutch platinum-blonde version of Donald Trump, lost the presidential election in the Netherlands. Some say it was a small victory for the anti-EU Party for Freedom, which gained five seats in Parliament while the People's Party for Freedom and Democracy lost 8 seats. However, Wilders' party failed to get a majority. It won 20 seats to the 33 seats that Dutch Prime Minister Mark Rutte's establishment party held onto. (See Bloomberg's helpful chart on "How the Dutch Voted" from a 3/16 article.) Even if Wilders had won, his party was unlikely to have

been able to form a government, according to a British analyst quoted in *Barron's*. Rutte's party has a better chance of forming a majority coalition, although that's still not guaranteed, and could take months to finalize, according to *The Guardian*.

(2) *Mudslinging in France.* The French presidential election begins on April 23 (the first round) and ends on May 7 (the second round). French presidential candidate Marine Le Pen, who staunchly opposes the EU and wants to take France out of the euro, leads the opinion polls, reported *Barron's*. However, Le Pen is expected ultimately to be defeated in the second-round vote. But it's all up in the air, especially with the mudslinging increasing as the days of reckoning approach. Center-right Francois Fillion is knee-deep in the mud after a formal investigation was opened on him in mid-March for a case involving nepotism. However, centrist Emmanuel Macron and far-right-winger Marine Le Pen have not been immune to accusations of wrongdoing themselves.

But what would a Le Pen win look like? France wouldn't just up and leave the EU immediately if Le Pen takes office. First, she would need the support of a parliamentary majority to push her program forward, according to a 3/23 *WSJ* article. Also, a "Frexit" referendum vote would need to be held.

Europe's already sensitive recovery could take a turn for the worse if Le Pen were to get that far and further succeed with her agenda of dismantling France's involvement with the euro. Research house Autonomous recently suggested that France leaving the euro could trigger a Lehman-style event for European banks and markets, according to the 3/20 *FT*. On the other hand, the bearish analysts attached a 27% probability to a Le Pen victory and only a 12% probability to her "securing a 'leave-the-euro' referendum vote later this year."

(3) *Merkel's mini-win.* At the end of March, Germany's establishment scored when German Chancellor Angela Merkel's Christian Democratic Union (CDU) party won the governor's seat in Saarland state, reported *The Washington Post*. Incumbent Minister-President Annegret Kramp-Karrenbauer, dubbed "Mini-Merkel," overcame her center-left opponent. In May, two more state elections will be held, followed by Merkel's run for chancellor in the 9/24 national parliamentary election. Merkel is campaigning against Martin Schulz, the candidate of the center-left Social Democratic Party (SPD), who remains confident that his party still has a chance on a national level.

As for the populists, the title of a 3/27 local German news article says it all: "How Saarland could show that the far-right AfD are finished." An "equally intriguing story" as the Merkel-vs-Schulz contest has been "the miserable result scored by the AfD." The populist party won just 6.2% of the Saarland vote, which is just a touch above the 5% "threshold for making it into German parliaments." The article noted that the "drab score is in sharp contrast to a string of double-digit results in five state elections throughout 2016." Several political analysts were quoted in the article as saying that the Saarland vote could signal that the Afd will "disappear." But the AfD party's co-leader said of the result that not too much should be read into it given special conditions in the small state.

(4) *In-fighting in Spain.* During a radio interview in January, Spain's Prime Minister Mariano Rajoy was asked about the possibility of populists coming into power in European countries like France and Germany. According to Breitbart, Rajoy responded: "I don't even want to think about it, that would be a disaster. It would simply mean the destruction of Europe." Rajoy was reelected as Spain's prime minister during February, and Spain's anti-austerity party suffered some major setbacks.

A 2/12 Politico article reported that Rajoy's reelection was the "surprise development of Spanish politics." It noted: "Just a year ago, pundits were writing Rajoy's political obit. But the conservative leader, who took over the party in 2004 and survived two electoral defeats before winning government, has defied his doubters once again." Now "back from the dead" politically speaking, the Prime Minister and his party are expected to remain "unchallenged for some time." That's especially true given the "disarray" of the other political parties.

For example, Podemos, the anti-austerity party, has been plagued by in-fighting. According to a 2/10 Politico article: "On January 31, journalists and politicians in Spain's Congress watched as the party's leader, Pablo Iglesias, became locked in what seemed to be a bitter argument with his deputy, Íñigo Errejón, seated next to him. In photos subsequently published in the media, the ponytailed Iglesias looks haggard and tired, sometimes fiercely making a point to his colleague, at others frowning as he listens. The usually fresh-faced Errejón appears much older than his 33 years, at one point wearily removing his glasses to remonstrate with the party leader."

Comparing the outward display of the party's internal power struggle to a train wreck, an important member of the party's governing committee resigned the next day. Others in the party were not shy to chime in with distaste for the episode. Spain's populist party might very well "self-destruct" given all of this. So the establishment can safely celebrate their victory, and investors can take solace in the apparent stability, at least for now.

(5) *Italy in purgatory*. Italy's banks are in crisis, while the country's government is unstable. These are the two major reasons why investors are betting against Italy, as discussed a 3/9 *Forbes* article. Not much is new on either situation since we last discussed them in our 3/1 and 7/6/16 *Morning Briefings*.

On 3/10, MarketWatch observed that some are still clinging to the hope that Prime Minister Renzi could make a comeback in a new election. Renzi had stepped down after failing to reform the Italian Senate by a referendum vote held on December 5, 2016. While not impossible, the latest developments might have made that more difficult.

Upon Renzi's defeat, rebels within Renzi's party broke off to form a new party, the Democratic and Progressive Movement (MDP), which is further to the left. "They took enough lawmakers with them that they could now potentially bring down the government," according to MarketWatch. The "current disarray" means that elections now are more likely to be held earlier than next year. Meanwhile, the anti-EU, anti-austerity Five Star Movement party led by Beppe Grillo has "emerged as the most popular party at about 30% and continues to build support," according to *Forbes*.

(6) *Running on empty*. The 3/30 *Economist* explored the deep roots of Italy's bad-debt problems. It wrote: "Bad loans have quadrupled in value since 2008 ... But no bank has quadrupled their staff to manage them. Lenders have been [reluctant] to sell their loans. Many have them in their books at around 40% of their face value, whereas investors are prepared to pay around half that. Banks' capital ratios are already thin; disposals would stretch them further. Government efforts to boost the market have flopped." On the other hand, last year was "the first since 2008 in which Italy's total NPL exposure fell." Additionally, the ECB has been pressuring banks to clean up their balance sheets. That development has forced the banks to come up with detailed plans, which some investors are optimistic about.

CALENDARS

US. Tues: Merchandise Trade Balance -$44.5b, Motor Vehicle Sales 17.4mu, Factory Orders 1.0%, Tarullo. **Wed:** ADP Employment 170k, ISM NM-PMI 57.0, MBA Mortgage Applications, EIA Petroleum Status, FOMC Minutes. (Bloomberg estimates)

Global. Tues: Eurozone Retail Sales 0.5%m/m/1.0%y/y, RBA Rate Decision 1.50%, Draghi. **Wed:** Eurozone, Germany, France, and Italy Composite PMIs 56.7/57.0/57.6/54.7, Eurozone, Germany, France, and Italy NM-PMIs 56.5/55.6/58.5/54.3, UK Composite & NM-PMIs 53.8/53.5, Japan NM-PMI. (DailyFX estimates)

STRATEGY INDICATORS

YRI Weekly Leading Index (*link*): Our Weekly Leading Index (WLI)—a good coincident indicator that can confirm or raise doubts about stock market swings—retreated for the third time in four weeks during the week of March 25, by a total of 3.1%. The weakness followed a ten-week surge, totaling 10.1%, to a new record high. Our WLI is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI). Our BBB also fell for the third time in four weeks, by a total of 5.3%, after rising eight of the prior ten weeks by 15.8% to a new record high. The recent weakness reflects a rise in jobless claims for the fourth week to 254,250 (4-wa) after sinking to 239,750 four weeks ago—which was the lowest since 1973. The CRB raw industrials spot price index—another BBB component—is moving higher. Meanwhile, the WCCI slumped 3.1%, after surging seven of the prior eight weeks by a total of 13.5%, to a new record high.

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose last week to record highs for LargeCap and MidCap. SmallCap's was up for the third time in seven weeks to 0.6% below its early February record. The yearly change in forward earnings is up from six-year lows in early 2016 for all three indexes as y/y comparisons have eased. In the latest week, LargeCap's forward earnings rose to a 30-month high of 8.7% y/y from 8.4%, which compares to a six-year low of -1.8% in October 2015; MidCap's jumped to a 30-month high of 11.5% from 10.6%, which compares to a six-year low of -1.3% in December 2015; and SmallCap's edged down to 12.6% from a 34-month high of 12.8%, which compares to a six-year low of 0.3% in December 2015. Growth rates now expected for 2017 and 2018 before the impact of tax-rate changes: LargeCap 10.9% and 12.2%, MidCap 9.4% and 13.3%, and SmallCap 9.5% and 20.1%.

S&P 500/400/600 Forward Valuation (*link*): Valuations rose across the board last week, but remain slightly below recent multi-year highs. P/Es have been melting up recently and beginning to reflect the impact of lower tax rates on corporate earnings, but the 'E' still remains low as analysts await legislative changes to the tax rate. LargeCap's forward P/E rose to 17.5 from a six-week low of 17.4, and remains near the 13-year high of 17.8 in early March. That's up from a 15-month low of 14.9 in January 2016 and the post-Lehman-meltdown P/E of 9.3 in October 2008, but remains well below the record high of 25.7 in July 1999. MidCap's forward P/E edged up to 18.5 from an 18-week low of 18.4; that compares to a 15-year high of 19.2 in late February and the record high of 20.6 in January 2002, but is up from a three-year low of 15.0 in January 2016. SmallCap's rose to 19.7 from an 18-week low of 19.4; that's up from a three-year low of 15.5 in February 2016 and compares to a 15-year high of 20.5 in early December, when Energy's earnings were depressed, and a record high of 20.9 in April 2002. Looking at their forward price/sales ratios since data became available in 2004, valuations are similarly elevated for the three indexes: LargeCap's P/S of 1.90 and MidCap's 1.29 are close to their recent record highs of 1.94 and 1.37, while SmallCap's 1.00 is down from 1.15 in July 2015 and a record high of 1.17 in November 2013.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): Q1 earnings estimate revision activity picked up last week for the S&P 500 sectors as analysts made slight adjustments ahead of the upcoming quarterly earnings season. The Q1 consensus rose w/w for one of the 11 S&P 500 sectors, was steady for five, and fell for five. Consumer Discretionary rose 0.1% w/w, and these three sectors had the biggest w/w percentage declines in their Q1 forecasts: Energy (-3.5%), Real Estate (-0.9), and Telecom (-0.3). The S&P 500's Q1-2017 EPS forecast fell 8 cents w/w to $29.43, and is down 3.8% from $30.53 at the end of Q4. That represents a forecasted pro forma earnings gain of 10.1% y/y, the strongest growth since Q3-2011, with the forecast down from 10.4% a week earlier and down from 13.8% at the end of Q4. Since the end of Q4, Q1 estimates are lower for 10/11 sectors and unchanged for Real Estate. The Q1 forecast for Tech has edged down only 0.4%. Industrials is down the most (-7.6), followed by Consumer Discretionary (-7.1), Energy (-5.8), Materials (-5.7), Consumer Staples (-4.1), and Health Care (-4.0). The S&P 500's Q1-2017 forecasted earnings gain of 10.1% y/y would be its third straight gain after four declines and the highest since Q3-2011. All 11 sectors are expected to record positive y/y earnings growth in Q1-2017, and four are expected to beat the S&P 500's y/y earnings gain of 10.1%. That's an improvement from the 9/11 sectors rising y/y during Q4-2016 and Q3-2016, and compares to 6/10 rising during the quarters from Q4-2015 to Q2-2016. Analysts expect Energy to report a profit relative to a year-ago loss and no longer think Industrials and Telecom will record y/y earnings declines as they had expected at the end of January. The latest forecasted Q1-2017 earnings growth rates vs. their blended Q4-2016 growth rates: Energy (returning to a profit in Q1 from a year-ago loss vs. 5.3% in Q4), Financials (15.8% vs. 11.6%), Tech (15.0, 12.7), Materials (12.4, 7.1), S&P 500 (10.1, 8.0), Industrials (5.6, -0.9), Health Care (2.6, 7.1), Telecom (2.4, -0.2), Consumer Staples (2.5, 7.2), Real Estate (1.6, 8.7), Consumer Discretionary (1.4, 5.3), and Utilities (0.8, 10.1).

S&P 500 Q1 Earnings Trend vs. Past Quarters (*link*): With the March-quarter books closed at the end of last week, the current Q1-2017 EPS forecast of $29.51 has dropped 3.8% over the 14 weeks since the quarter's start. That marks the 24th straight quarter that forecasts have fallen, but is well above the average 4.3% decline in the quarter's estimate since 1994. Analysts expect EPS for Q1-2017 to be up 9.2% y/y on a frozen actual basis, better than the 6.0% gain for Q4-2016 and the third straight quarter of higher EPS on a y/y basis. However, we think that Q1's EPS will be $29.75 and that earnings will rise 10.3% y/y for the first double-digit growth quarter since Q3-2011. Since 1994, the Q1 earnings surprise has been positive in 22/23 years (all but 2008). We think Q1 will mark the S&P 500's 33rd straight quarter of positive surprises—a streak dating back to Q1-2009 and longer than the prior 10-quarter positive surprise streak (Q1-2003 to Q2-2005).

GLOBAL ECONOMIC INDICATORS

Global Manufacturing PMIs (*link*): Global manufacturing activity in March held steady at February's 69-month high. The JP Morgan M-PMI was unchanged at 53.0 last month, as rates of increases in production (to 54.2 from 54.3) and new orders (unchanged at 54.2) were either at or close to February's recent highs. Growth in emerging markets (to 51.6 from 51.3) expanded at the fastest rate since July 2014, while the pace in developed markets (53.9 from 54.1) held around recent highs. The Eurozone M-PMI remained a "bright spot" within the global manufacturing sector, according to Markit, accelerating to a 71-month high of 56.2, with growth improving in the Big Three economies, Germany (58.3, 71-month high), Italy (55.7, 72-month high), and France (53.3, 2-month high). Growth in the Netherlands (57.8, 2-month low) and Austria (56.8, 3-month low) slowed a bit, but were number two and three on the leader board behind Germany. Meanwhile, growth slowed in the UK (54.2 from 54.5), US (53.3 from 54.2), Japan (52.4 from 53.3), Russia (52.4 from 52.5), and China (51.2 from 51.7). Manufacturing activity continued to contract in South Korea (48.4 from 49.2) and Brazil (49.6 from 46.9), though the rate of decline eased sharply in the latter.

US Manufacturing PMI (*link*): Manufacturing activity in March slowed to a six-month low according to Markit's survey, but was stalled around its cyclical high according to ISM's. The ISM M-PMI dipped to 57.2 after rising steadily from 49.4 in August to 57.7 in February, which was the highest since August 2014. The employment index (to 58.9 from 54.2) was in expansionary territory for the sixth month in March, jumping to its best reading in six years; it contracted seven of the first eight months of last year. Also contributing positively to March's index was the supplier deliveries' gauge (55.9 from 54.8), which was the highest since the end of 2014. The new orders measure (64.5 from 65.1) was little changed from February's 38-month high, while the production gauge (57.6 to 62.9) dropped below 60 after two months above. Inventories (49.0 from 51.5) contracted again after expanding in February for the first time in 20 months. Markit's M-PMI eased for the second month since reaching a 22-month high of 55.0 at the start of this year, falling to 54.2 in February and 53.3 last month. The loss of momentum reflects softer rates of growth in both output and new orders, alongside a slower pace of hirings.

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