



MORNING BRIEFING

March 7, 2018

Eurozone Seems Unruly

See the [collection](#) of the individual charts linked below.

(1) Eurozone stocks remain as cheap as ever relative to US stocks. (2) It took six months to form a weak German coalition government. (3) There is actually an anti-bailout party in Germany. (4) Merkel's fourth term will be as a lame duck. (5) German liberals will have more power to spend money. (6) German IFO and M-PMI dip, but remain high. (7) Italy's latest election produced the usual political circus. (8) Euroskeptics are gaining power in Germany and Italy.

My Book. I am pleased to report that [Predicting the Markets: A Professional Autobiography](#) is currently #7 on [Amazon Hot New Releases: Investing](#). Not bad for a book that's available only for preorders until its March 15 release. Buy it now before the rush and push it closer to #1! On the book's Amazon [page](#), you can have a "Look inside" before you order it, and you'll find excerpts [here](#).

Eurozone: Cheap for a Reason? Last year, there was a lot of chatter about investors finding more value in the stocks of companies in the Eurozone than in the US. The forward P/E of the US MSCI index was mostly around 18.0 during 2017, while the forward P/E of the EMU MSCI hovered around 14.5 ([Fig. 1](#)). Yet even after the drop in valuation multiple during early February, the EMU remains relatively cheap. The fact is that the EMU's P/E has been well below the US multiple for quite some time ([Fig. 2](#)).

The ratio of the US MSCI stock price index (in dollars) to the EMU MSCI (in euros) fell sharply from mid-2016 through early 2017, but then rebounded, rising to new record highs so far this year ([Fig. 3](#)). The comparable ratio using the EMU priced in dollars also has rebounded since late last year, but remains below its early 2017 peak because the dollar has been weak relative to the euro ([Fig. 4](#)).

The persistent cheapness of the EMU MSCI relative to the US MSCI is partly attributable to the greater weighting of highly valued technology companies in the latter. The more recent bout of relative cheapness in the EMU, despite the surprisingly strong performance of the Eurozone's economy since late 2016, may be attributable to the weakening of governments in both Germany and Italy, as Sandra Ward and I discuss below.

Germany: A Reluctant Coalition. Germany is at long last on the verge of recognizing a new coalition government, nearly six months after a general election resulted in no clear majority for any party. As the largest economy in Europe, Germany's role will be critical in shaping the EU in the post-Brexit era and in responding to escalating trade tensions between the US and the European Union (EU). Chancellor Angela Merkel and the new coalition now also have to contend with domestic divisions. Alternative for Germany (AfD), the leading opposition party that won 13% of the vote in September, has promised to be fiercely outspoken, according to a 3/3 Reuters [report](#). I asked our contributing editor Sandra Ward to examine Germany's political situation and what it means for its economy; here's her report:

(1) *Some clarity.* Social Democrats (known as the "SPD" party) held their noses and voted Sunday to

forge a new alliance with Merkel's more conservative center-right Christian Democrats (the CDU), as detailed in a 3/4 [report](#) by the BBC. Merkel will be officially sworn in as chancellor by Parliament on March 14. "Now we have clarity," proclaimed Olaf Scholz, the interim head of the SPD who is expected to be named finance minister in the new government. Many SPD members, especially youth, blame their party's decline in the polls on its association with the CDU.

Forming a new coalition proved preferable to holding new elections in which the SPD feared losing more ground to the far-right, anti-immigration party AfD, the leading opposition party that gained popularity as a result of Merkel's former open-door policy for asylum seekers.

(2) *Less austerity.* The vote came after months of wheeling and dealing and significant concessions from the CDU in which three major government posts—foreign, finance, and labor—will now be filled by members of the more liberal SPD. The new coalition has also signaled it will adopt a less austere fiscal stance. The new government will spend €46 billion (\$57 billion), most of an expected budget surplus, on social welfare programs. It will also contribute more to the EU in the wake of Great Britain's departure.

(3) *The King's Committee.* According to tradition, the largest opposition party chairs the budgetary committee and, along with the finance ministry, oversees negotiations on all finance issues, explained the *Irish Times* in a 1/25 [report](#). The committee is known as "the King's Committee" because of the power it wields over the budgets of the ministries, according to a 1/31 Reuters [article](#).

AfD, the leading opposition party, was founded in 2013 as an anti-bailout party by fiscally conservative former CDU members who had become disillusioned after Merkel agreed to commit German taxpayer money to the EU's bailout of Greece. Despite repositioning itself along domestic security and anti-immigration lines, the party remains opposed to bailouts. Its choice for budgetary committee chief is Peter Boehringer, a corporate consultant and advocate for repatriating Germany's gold reserves held in overseas vaults; he has been critical of the ECB and the Eurozone, calling it the "illegal euro transfer union," according to a 1/24 *Financial Times* [piece](#), in addition to taking a hardline stance on illegal immigration.

(4) *The fourth will be last.* This will be Merkel's fourth, and likely last, term as chancellor. In the drawn-out coalition negotiations, Merkel heeded critics and flagged her choice of a likely successor by tapping a younger ally to be secretary general. Known as "AKK" and also dubbed "mini-Merkel," 55-year-old Annegret Kramp-Karrenbauer is the premier of the western state of Saarland and widely respected within the party as a policy wonk.

(5) *Safe haven.* After reaching a two-and-a-half-year high of 0.77% in early February, the German 10-year bond fell to 0.62% on Friday ahead of Sunday's vote, as investors were heartened that a coalition government would be approved. The 10-year yield fell further on Monday, to 0.60% ([Fig. 5](#)). Investors also turned to German bonds as a safe haven in response to President Trump's plan to slap tariffs of 25% on steel imports and 10% on aluminum imports. When the EU threatened to retaliate by raising tariffs on popular US imports, Trump suggested he would target European cars next. Germany is the world's second-largest car exporter after Japan.

(6) *Economic growth.* Germany's economy grew 2.5% (saar) during Q4, driven by a 2.0% rise in government spending and an 11.4% advance in exports ([Fig. 6](#), [Fig. 7](#), and [Fig. 8](#)). For full-year 2017, Germany's economy grew 2.2%, up from 1.9% the previous year, according to the federal statistics agency Destatis, with private and government consumption, fixed investment, and net exports all contributing positively.

(7) *Business confidence*. Optimism deteriorated among German businesses in February, falling to 115.4 points from 117.6 points a month earlier, according to the [ifo Business Climate Index](#) published by the CESifo Group in Munich. Business expectations for the next six months slumped from the previous month ([Fig. 9](#)). Still, the sentiment indicator remained well above the 100-point mark that separates optimism from pessimism and at its second-highest level since 1991, according to a 2/22 [report](#) in Focus Economics.

(8) *German M-PMI*. February's IHS Markit/BME Manufacturing PMI reading eased to 60.6 from January's 61.1, marking the second straight month of declines since reaching a record high at year-end 2017 and registering its lowest level since October, according to a 3/1 [report](#). Supply-chain pressures led to the greatest monthly increase in lead times ever recorded. Manufacturers are paying more for steel, plastics, and energy, and they are passing the costs onto consumers: The rate of output price inflation was the highest in seven years.

(9) *Valuation*. The Germany MSCI share price index (in euros) is down 6.1% ytd, compared with a loss of 3.3% for the EMU MSCI index. With a forward P/E of 14.1, down from 13.9 in late January and well below its historical mid-point of 15.4, the Germany MSCI valuation looks relatively attractive ([Fig. 10](#)). Projected earnings growth for this year has fallen to a 6.2% rate from the 10.7% expected in early January. For 2019, earnings growth is forecast at 8.9%. (See our [Performance Derby: MSCI Regions/Countries Earnings & Revenues Growth](#).)

Italy: Five-Star Circus. In elections Sunday, Italians embraced the anti-establishment populist Five Star Movement by a wide margin, delivering a blow to the governing center-left Democratic party that led the country through its latest economic revival.

"M5S," as it is known, garnered more than 30% of the vote compared with 19% for the center-left Democratic Party. The League (formerly the "Northern League")—a far-right, anti-immigration party led by former radio talk show host Matteo Salvini, known for his Italy-first stance and fascist rhetoric—emerged as a force to be reckoned with. Winning nearly 18% of the vote made it the third-largest party in Italy. Former Prime Minister Silvio Berlusconi's hoped-for comeback was thwarted, as his Forza Italia party came in fourth with only 14% of the vote. With no party winning a clear majority, the government will remain in disarray while coalition-building begins in earnest.

While this may be politics as usual in Italy, it spells trouble for the EU: The most popular political parties in its third-largest economy are proudly Euroskeptic. There is concern that EU budget restrictions will be ignored and nervousness that Italy's enormous public debt—which at €2.3 trillion represents 130% of GDP—poses huge risks to the banking system. That's especially true in a rising-rate environment, according to a 3/5 Reuters [article](#).

The impact of the election was immediately felt in the financial markets:

(1) *Italian 10-year bonds*. The yield on 10-year Italian government bonds jumped 10bps to 2.14% at the open Monday before settling at 2.09%, still up nearly 6bps on the day ([Fig. 11](#)). The closely watched spread between Italian and German yields was at 1.52bps at one point, its highest since Feb 24, according to a 3/5 USNews [report](#).

(2) *Banks*. The FTSE Italia All-Share Bank Index banking index dropped 2.6% Monday, as investors used the new uncertainty as an excuse to take profits, according to a 3/5 [article](#) in the *Financial Times*. The FTSE Italia All-Share Bank Index is up more than 20% over the past year, outperforming the broader market as represented by the MSCI EMU Share Price Index, which rose 19.8% y/y.

(3) *Valuation*. As we noted in the 2/14 [Morning Briefing](#), the Italy MSCI index's valuation appears attractive based on its P/E of 12.3 and a consensus earnings growth rate for 2018 of 18.9%, compared with 8.3% for the EMU ([Fig. 12](#)). It may stay attractive if investors become Italy-skeptic because of the rise of the Euroskeptics.

CALENDARS

US. Wed: ADP Employment 203k, Merchandise Trade Balance -\$55.1b, Productivity & Unit Labor Costs -0.1%/2.2%, Consumer Credit \$17.8b, MBA Mortgage Applications, EIA Petroleum Status Report, Beige Book, Dudley, Bostic. **Thurs:** Jobless Claims 220k, Weekly Consumer Comfort Index, Challenger Job-Cut Report, EIA Natural Gas Report. (*Wall Street Journal* estimates)

Global. Wed: Eurozone GDP 0.6%q/q/2.7%y/y, Japan GDP 0.2%q/q/0.0%y/y, Japan Leading & Coincident Indexes 106.1/115.3, Australia GDP 0.5%q/q/2.5%y/y, BOC Rate Decision 1.25%. **Thurs:** Germany Factory Orders -1.6%m/m/11.4%y/y, Canada Housing Starts 220k, Japan Household Spending -0.8%, China Foreign Direct Investment, China Trade Balance -\$8.45b, ECB Rate Decision 0.0%, ECB Marginal Lending Facility & Deposit Facility Rate 0.3%/-0.4%. (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—reached a new record high during the week of February 24, climbing six of the past seven weeks by a total of 10.3%. Our WLI is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI). Our BBB jumped 16.8% over the seven-week period, to a new record high as jobless claims, one of the components of our BBB, declined six of the last seven weeks—from 250,750 to 220,500 (4-wa)—the lowest since 1969. Meanwhile, the CRB raw industrial spot price index, another BBB component, is rebounding from its recent setback, though has moved sideways in recent sessions. The WCCI remains on a steep uptrend, reaching new cyclical highs.

US ECONOMIC INDICATORS

Manufacturing Orders & Shipments ([link](#)): Both core capital goods shipments and orders in January remained at high levels, though the latter posted its first back-to-back decline since early 2016. Nondefense capital goods orders ex aircraft (a proxy for future business investment) edged down a revised 0.3% last month—first reported as a 0.2% loss—after a 0.5% decline in December, which was slightly smaller than the 0.6% preliminary decline. Meanwhile, the comparable shipments measure (used in calculating GDP) edged down a revised 0.1% (rather than edging up 0.1%) in January after an 11-month jump of 8.8%. Core capital goods orders expanded 3.8% (saar) during the three months through January, based on the three-month average, slowing from double-digit gains the prior four months; the comparable shipments measured grew 8.0% (saar), slowing steadily from its recent peak of 14.1% in the three months through October. Headline manufacturing orders (-1.4%) recorded its first decline in six months, after a five-month surge of 7.0%, as transportation orders sank 10.0%—driven by a plunge in volatile commercial jet orders (-28.4%). Excluding transportation, orders rose for the eighth consecutive month, by 0.4% m/m and 6.1% over the period, to a new cyclical high.

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