Europe Insights

Monthly update on European markets

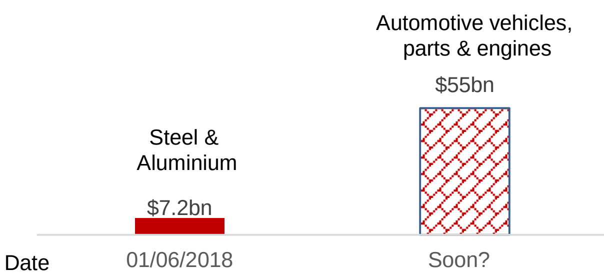
July 2018

In the spotlight: Europe, lost in trade tensions?

Recent policy developments

- On June 1, the United States imposed tariffs of 25% on steel imports and 10% on aluminum imports representing about $7 billion.
- The European Commission has so far responded with a 25% duty on $3.2 billion of European Union (EU) imports for a range of U.S. products including motorcycles, jeans and drinks, various types of corn, rice, orange juice, cigarettes, cigars, t-shirts, cosmetics, boats and steel.
- At this stage, the scope of EU products subject to U.S. tariffs is negligible - around 0.4% of extra-EU goods exports.
- But the risk of an escalation of anti-trade measures is rising: the European Commission is exploring the possibility of retaliation tariffs on more U.S. products, in order to match the $7 billion value of EU aluminum and steel subject to U.S. tariffs.
- Meanwhile the US is threatening a 20% (or 25%) tariff on imports of cars and car parts from the EU.
- On aggregate for the EU, this would be manageable, hitting an equivalent of 2.5% of total extra-EU exports, or 0.3% of EU GDP (*see graphs 1 below*).

Graph 1a: US imports from the EU



Graph 1b: EU imports from the US

Source: European Commission Directorate-General for Trade 18/04/2018. http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc_113465.pdf

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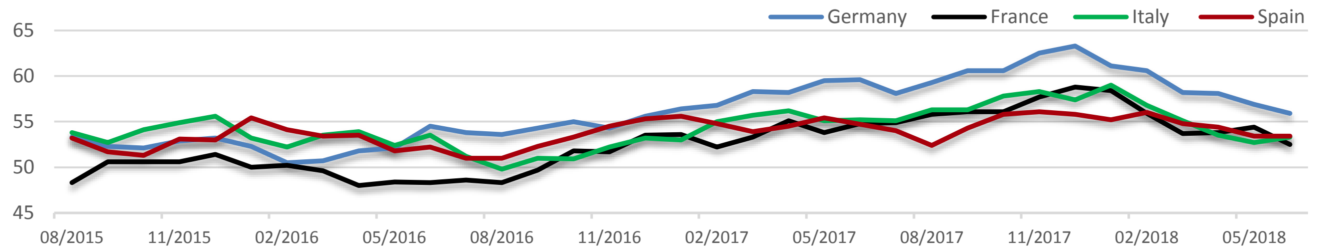
Europe, lost in trade tensions? (contd.)

How is this situation affecting the economy?

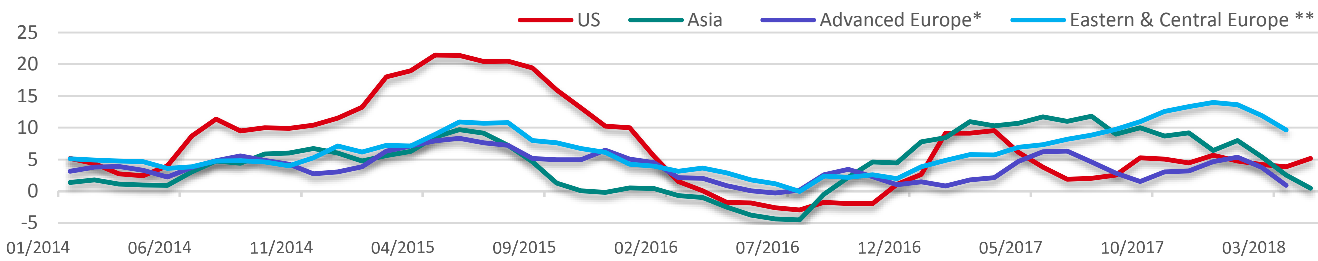
Loss of momentum of major Eurozone export markets, except to the US...

- In the short term, as politics are involved with concerns over potential retaliatory actions, risk-off sentiment dominates. If the situation remained unclear for some time, uncertainties would delay or stop investment and hiring plans, adding market concerns, and resulting to a tightening in financial conditions and loss of economic momentum. Business surveys in Europe have already signaled a shift in sentiment, while trade has slowed down more significantly over the past three months (*see graphs 2*). Still, the current levels remain above trends. Meanwhile, balancing effects are at work: the euro has already depreciated against the US dollar (-5% since early March) which, ultimately, supports all European exports.

Graph 2a: Business surveys across the major EU economies signal a loss of momentum in the manufacturing sector



Graph 2b: Destination of Eurozone goods exports 3-Month Sum % yoy



Sources: Bloomberg, Eurostat, end of June 2018

* includes the UK, Switzerland, Sweden, Norway and Denmark, ** includes Turkey, Poland, Czech Republic, Bulgaria, and Romania

A political issue with many potential outcomes

If implemented, a rise in U.S. tariffs from 2.5% to 25% on car imports would not significantly weigh on European growth, on aggregate

- If implemented, a rise in US tariffs from 2.5% to 25% on car imports would not significantly weigh on European growth, on aggregate. Still the automotive industry represents more than 4% of gross value added (GVA) for countries like Germany and Slovakia. Between 20-25% of the value added in the German and UK total car exports are integrated in supply chains processes across various EU countries (OECD estimates). Estimating the impact of a rise in tariffs supposes many assumptions, such as assuming a full pass-through of the rise in tariffs into import and final selling prices, stable exchange rates, and supposing a price elasticity of car demand. In a worst case scenario supposing retaliation measures everywhere with a 10% rise in import tariffs, the IMF estimates that the global output would be hit by almost 1¾% after five years and 2% in the long term versus no-tariffs scenario (1). The implications of trade restrictive measures are broader in the long term, as it undermines the incentive to innovate, and to increase productivity, leading to higher costs for the consumer.
- If trade barriers escalate more globally, and if recent measures begin to show signs of adversely affecting the economy, and particularly the U.S., it is not impossible that the Trump administration will tone down its protectionist stance. The EU is clearly not in favor of retaliation measures (2). Furthermore, the EU policy response to U.S. tariffs may take time as it requires finding a consensus across EU member states. The European Commission recently proposed a "plurilateral" tariff reduction on car imports involving the U.S., South Korea and Japan. Opportunities may arise, via more bilateral trade agreements, for instance with China, India or other emerging economies offering better access to European goods, services or investments.

(1) International Monetary Fund World Economic Outlook - October 2016 (Scenario Box 1. Tariff Scenarios – page 37)

(2) EU comments on US section 232 Cars investigation http://trade.ec.europa.eu/doclib/docs/2018/july/tradoc_157068.pdf

European Equity market: ramifications of the trade war

The countries that underperformed in the last 3 months were clearly those that had significant exposure to Autos, Transportation and Machinery

- When Trump tweeted on March 2nd that "*Trade wars are good and easy to win*", it sparked a war of words, that led to the imposition of tariffs on European aluminum & steel imports as of June 1st. This was followed by threats of tariffs on European car imports on June 22nd. As a result, European sectors targeted by the tariffs, namely Auto components (-14.9%), Automobiles (-14.7%) and Metals and Mining (-5.2%) suffered; however, the indirect effects on some other sectors have been just such as consequential. Machinery declined by (-8.2%) due to their high metal content; Electrical components were down (-16%) due to tariff threats on input costs (steel) and currency weakness in emerging markets; the Materials, Construction and Building Product sectors all suffered as tariff threats loomed large. Sectors directly involved in transportation, such as Air Freight & Logistics (-17.5%), Airlines (-8.7%) and Marine transport (-12.8%) were all buffeted by potential disruptions to global trade and higher fuel costs.
- The countries that underperformed in the last 3 months were clearly those that had significant exposure to Autos, Transportation and Machinery. Countries with a high exposure to Energy and little exposure to the tariff targeted sectors such as Ireland (+7%), Norway (+8.5%), Portugal (+7.2%) and Finland (7.2%) outperformed. The only exception was Austria whose high Energy exposure (24%) was countered by an even higher exposure to underperforming Financials (49%). Italy, likewise, has a high exposure to Energy (19%) but was penalized by its high exposure to Autos (11.8%) and Financials (32%).
- Here below are the countries most adversely impacted by adverse sector exposure.

		Sector exposure			
Best / Worst sectors	**Returns**	**Denmark**	**Italy**	**Germany**	**Sweden**
Energy	+17.4%	-	19.20	-	-
Autos	-10,50%	-	11.83	12.30	-
Transportation	-5,90%	11%	1.12	3.00	-
Machinery	-8,20%	-	-	-	26.30

Source: Factset as of 12 July 2018

- The only real relative safe havens from an escalating trade war would be domestic focused companies and sectors. On aggregate, a wide choice in domestically exposed businesses can be found in small cap companies and sectors such as Real Estate, Retailing, Utilities and Telecoms.

Sector Views

Sector	Weighting*	Sector focus
Telecoms	Overweight	◆ The overweight is a predicated on highly attractive valued companies following the recent correction
Commercial Services & Supplies	Overweight	◆ Many companies in the sector offer sustainable growth and attractive valuations
Healthcare & Equipment	Overweight	◆ Our position is a result of stock choices and offsets our underweighting in Pharmaceuticals
Materials	Overweight	◆ Valuations are low and underlying global growth still supportive
Transportation	Overweight	◆ Overweight is predicated on three holdings with attractive valuation and dividend profiles
Consumer Durables & Apparel	Underweight	◆ The sector is composed of very expensive luxury good companies
Food, Beverage & Tobacco	Underweight	◆ The sector is relatively expensive, defensives companies with low growth profiles
Semi-conductors	Underweight	◆ After strong outperformance, this cyclical sector has become too expensive.
Utilities	Underweight	◆ Very few companies presenting attractive fundamentals in the sector
Real Estate	Underweight	◆ Rising bond yields and relative valuations are unattractive

* Position of European investment strategy in terms of key Overweight (OW) and Underweight (UW) versus MSCI Europe

Sources: HSBC Global Asset Management/Factset/MSCI as of 12 July 2018

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Euro fixed income: yield and credit positioning update

Corporate fundamentals are robust, refinancing conditions remain accommodative and valuation indicators improved after the recent material spreads widening

- After some signs of a tentative recovery at the beginning of the month, risk aversion came back with rising concerns about the extent of a possible trade war and European difficulties with migration flows. In that context, the 10Y German bund yield decreased to 0.30% in June.
- **Yield exposure**: We have entered a rate normalization environment with a gradual (but very moderate) cyclical inflation coming through. Given the economic growth rate deceleration year-to-date, we revised our target down from 1% to roughly 0.7-0.8% for the end of the year and we actively trade the market volatility, reducing our short as yields increase (close to 0.60% and above) and conversely increasing it as yields decrease (close to 0.40% and below). We are still cautious on Italy across the board.
- **Credit Exposure**: We are still cautious on credit and maintain our credit beta at 1: corporate fundamentals are robust, refinancing conditions remain accommodative and valuation indicators improved after the recent material spreads widening. We are now far from the historical lows reached at beginning 2018 and the end of the Corporate sector purchase programme (CSPP) is partly priced in.

Data watch as of 12 July 2018

F: Final, **A**: Advanced, **P**: Preliminary estimate

Indicator	Data as of	Latest data	Consensus	Previous data	Analysis
PMI Composite	June F	54.9	53.9	54.1	The composite PMI recovered part of the loss observed since January, mainly thanks to Services. The June release is consistent with above-trend quarterly GDP growth, and eases concerns over a sharp slowdown in the region.
GDP Growth QoQ	1Q F	0.4%	0.4%	0.7%	GDP growth slowed down in 1Q, despite the acceleration in private consumption which was offset by a moderation in fixed investment and a negative contribution from net trade. Some of this is likely related to temporary factors, such as strikes (France and Germany) and an unusual bad weather. Country-wise, GDP growth slowed down in most economies, except in Spain (where the sequential quarterly pace remained unchanged at 0.7% qoq).
Industrial production (% YoY)	May	2.4%	2.4%	1.7%	Eurozone industrial production stabilized, with the 3-month averaging 2.4% yoy, above the 2011-2018 trend (at 1% yoy).
Unemployment rate	May	8.4%	8.5%	8.4%	The unemployment rate has decreased at a swift pace, from 8.7% last December (9.2% in May 2017), driven by broad-based progress in the region.
Trade balance (goods, ex EMU) € billion (12Mth cumulative)	April	239.8	241.0	239.5	Over a 12-month period, the eurozone goods trade surplus has been stabilizing at elevated levels. Despite ongoing trade policy concerns, the momentum in both exports and imports has been rather unchanged (yoy for a 12-month period), with the lower euro probably supporting the region's competitiveness.
Retail sales % YoY	April	1.4%	1.6%	1.6%	Retail sales for June leaves the 3-month average growth stabilizing close to 1.7% yoy, a pace observed since the start of the year. Given elevated consumer confidence, continued job creation and strengthening wage growth, the outlook for private consumption remains fairly solid.
Inflation (% YoY) - Headline CPI - CPI core*	May A	 2.0% 1.0%	 2.0% 1.0%	 1.9% 1.1%	Both headline and core inflation surprised to the upside. Core inflation has remained in the 0.7%-1.2% range since early 2015. Looking ahead, the recent surge in oil prices and a lower euro should keep headline inflation close to 2% in the coming months.
ECB Refinancing rate Deposit rate Asset Purchase Target - € bn/Mth	14 June	0.00% -0.40% 30	0.00% -0.40% 30	0.00% -0.40% 30	The European Central Bank (ECB) announced its intention to reduce the monthly pace of its asset purchases in 4Q 2018, from €30 to €15 billion, setting an end in Dec. 2018. However, the ECB stressed that the bond buying program could be restarted if economic conditions warrant it. Also, the ECB will continue to reinvest maturing assets it currently holds for "*an extended period of time*" in order to "*maintain favourable liquidity conditions and an ample degree of monetary accommodation*". Lastly, the ECB expects "*interest rates to remain at their present levels at least through the summer of 2019 and in any case for as long as necessary*."

Indicates improved or better-than-expected data on month-on-month/quarter-on-quarter basis

Indicates worsened or below-expectations data on month-on-month/quarter-on-quarter basis

Indicates unchanged or or in line with expectations on month-on-month/quarter-on-quarter basis

* Eurozone CPI Core is CPI excluding energy, food, alcohol & tobacco

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