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COOKIE May 24, 2017

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HOW TO PLAY EU OUTPERFORMANCE VS THE US: BETWEEN EQUITY, RATES AND CURRENCIES

Medium-to-long term, we maintain our view that equities are in a bubble (especially in the US), bonds are in a bubble (especially in Europe), and the EU is not a viable project unless deep reforms are implemented in short order, as it narrowly avoids one existential crisis after another. Complacent markets driven by ever larger passive flows (Central Banks, ETF, risk parity, trend-chasing algos) have an ability to survive steep over-valuation for lengthy periods, before non-linear re-pricing occurs (here attached our views.)

Meanwhile, there are non-directional plays worth looking into. One of which is Europe's outperformance vs the US. The relative value positioning has merit, on grounds such as follows:

› For starters, **GDP was higher in Europe than in the US in both full year 2016 and in Q1 2017.** The dreadful printing of 0.7% for US GDP in the first quarter (from the over 3% expected only few months back) came out in confirmation of several other hard data, and is now also reflected in soft data. S&P values did not bat an eyelash in response to such surprising economic weakness as the mighty power of economic narratives focused minds on a good earnings season and a tight labor market. Not even the prospect of impeachment for President Trump, however unlikely, managed to detach equities by more than 2% from all-time highs (if this one data does not convince of complacency in markets, I do not know what will.) Rates and the US Dollar responded some more than equities, but only mildly so.

› **In the short-term, not without irony, political stability looks better in Europe than in the US**. While President Trump faces domestic struggles with all Democrats and some Republicans, and a lengthy investigation process over his ties with Russia moves ahead, in Europe the biggest existential threat yet for the EU project was recently torpedoed with Macron winning the French elections. Italy will be the next crash test for the EU, but the likely timing of elections (early 2018) is such that markets can happily forget what's looming ahead. The timing is beyond what complacent markets – or any markets in this respect - can pin probabilities down to. We do not believe that populism is in recess in Europe (here our thoughts), but the risk of it forcing regime changes has certainly decreased in the near term. Meanwhile, a (last?) **chance is provided for the EU to implement the reforms that would make the project viable and sustainable**: banking and capital markets union, stronger EU institutions, anti-cyclical utilization of fiscal capacity/fiscal union/transfers replacing austerity overdrive, relaxation of bail-in rules at times of systemic risks, etc. **If Mr Macron succeeds at introducing some of it, the union will benefit greatly; when he fails, we won't know for months.** Again, markets' complacency will either enjoy his success or the benefit of the doubt, for the short-term. Similarly, over the last 5 months, US markets detached nothing much from all-time highs while enthusiasm for Trump's policies moved from hard reality to the benefit of the doubt.

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- **Monetary policy divergence between the US and Europe has peaked and is now slowly closing in.** Interest rates are negative on short tenors all across core Europe, while inflation resurrected. Take the case of Germany, for example, where short rates are still almost -1% while headline and PPI inflation is +2% to +3%: the real hit to German savers is now severe and, influential on policy as they are, unlikely to last. Now that the ECB's balance sheet exceeded the FED's (and BoJ's) at over $4.5trn, we may well be past peak policy divergence. The ECB is currently examining the safest exit strategy, and the diverging views of Constâncio, Praet and Coeuré are being debated. **While the policy mix matters much for what happens next to equities, the end result for the direction of rates is less uncertain: rates will move higher.** In our eyes, within normal market conditions, the ECB exit may see, in succession (i) a normalization of deposit facility rates from -0.40% to 0% already in 2017 (ii) progressive doses of QE offtakes (say, 15bn/20bn per quarter) in conjunction with moderate rates hikes, starting in 2018. We think the ECB will want to keep full flexibility to dose between the two, as time goes by. It follows that long rates can adjust upwards, from rock-bottom levels, while any policy dosing missteps may accelerate their lift-off.

Is the EU-US outperformance theme best played in equities, currency and bonds? **To us, equities may not be as attractive as bonds or FX for playing the theme.**

- We would not go long equities outright at current levels. We are conscious of valuations for US stocks and, differently than markets these days, we do not ignore/dismiss them. Most valuation metrics see a 20%+ overvaluation (BAML research). In a steep sell-off, US stocks would drag down global stocks, with most probability. It is a rare occasion, historically, one where US stocks go deep down and European equities rise.

- **However, relative value is also tricky** (going long Europe and hedging it with shorts on US equity), **as EU equity outperformance suffers from a downside beta which is way larger**. Which is to say that when global risk-off sentiment arises, for any or no reason, European equities find themselves running down faster than US stocks, historically. Even if the problem is US-centric, like in 2007. This has typically being justified by the larger exposure of European stocks to Emerging Markets, to commodities and energy, a lower level of economic dynamism and crisis resolution activism.

- In this vein, also, **the valuation gap between European and US equities is not above historical averages** (20% P/E discount, see our outlook on pag 13)**.**

- True, **the largest equity bubble is in the US, not Europe**: however, **being a bit cheaper than the most expensive US market in history (except for 1929 and 2000) can hardly give much comfort**.

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There may be a safer way to play Europe's outperformance.

› **Rates differentials on long duration bonds are narrowing down, beyond important levels.** The 30yr Treasury – 30 yr Bund spread moved from 2.20% earlier in the year to 1.70% now, and seems set to progress from here. Monetary policy recoupling between the US and Europe has its most direct implication on rates. **The largest bond bubble is in Europe, not the US**: there now lies the largest disconnect to the fundamentals of inflation, aggregate growth rates, surpluses and tight labor markets for northern Europe.

› In currencies, the EURUSD rallied hard this month in anticipation of ECB policies and following political headline from the US. **Absent punitive Border-Adjustment-Taxes in the US, and if ECB normalization is to continue, we expect more of the 2014-2015 EUR weakness to recover**, at least in the near term and before any renewed flare-up of crisis for the EUR-peg. **The strengthening of the EUR itself would be headwind for EU equities, in the eyes of local currency investors. It is worth reminding that the Euro benefits from real money flows, as the union has a [current account surplus of 360bn EUR](), for 3.4% of GDP** (270bn of which is just Germany, exceeding China).

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