Europe

*Fold, stick or twist?*

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## 1. Introduction

The state of the European economy seems to be the single biggest common risk factor in current market narrative. Although economic growth in the US is waning slightly while China seems to be stabilising, things in Europe have looked like they're all over the place.

The leading theory is that the region has been hit by a combination of idiosyncratic factors over the course of 2018:

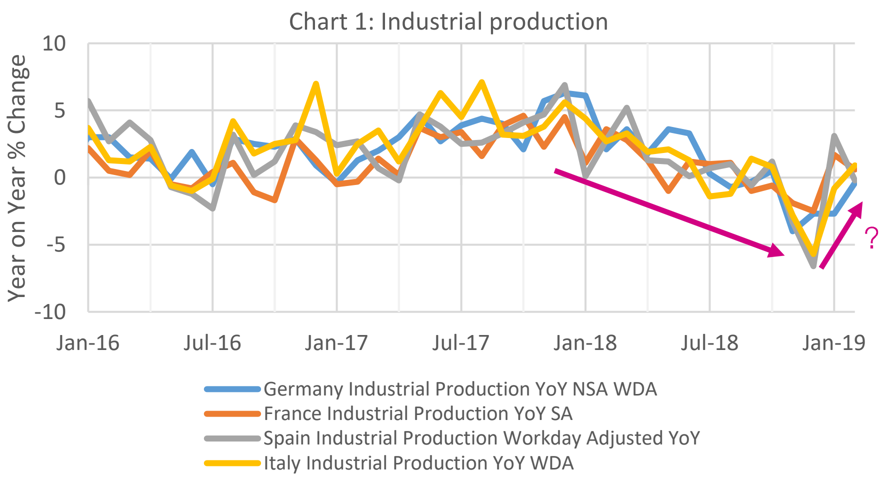
- US trade war concerns (Mar'18)
- Drag of slowdown in China on European exports generally and specifically on auto sales (Jul'18)
- A low water level in the Rhine slowing chemical exports (since Q3'18)
- New auto emissions standards (Sep'18)
- "Gilets jaunes" protests in France (Nov'18)
- Brexit uncertainty (heightened in Dec'18)

These factors are largely one-offs or they are factors where the risk is receding. This should mean there is scope for the region to recover. The alternative hypothesis is there is something more structural going on which would then pose a systemic risk to global growth. It is the objective of this paper to try and gain insight on which of these two hypotheses should be assigned a higher probability.

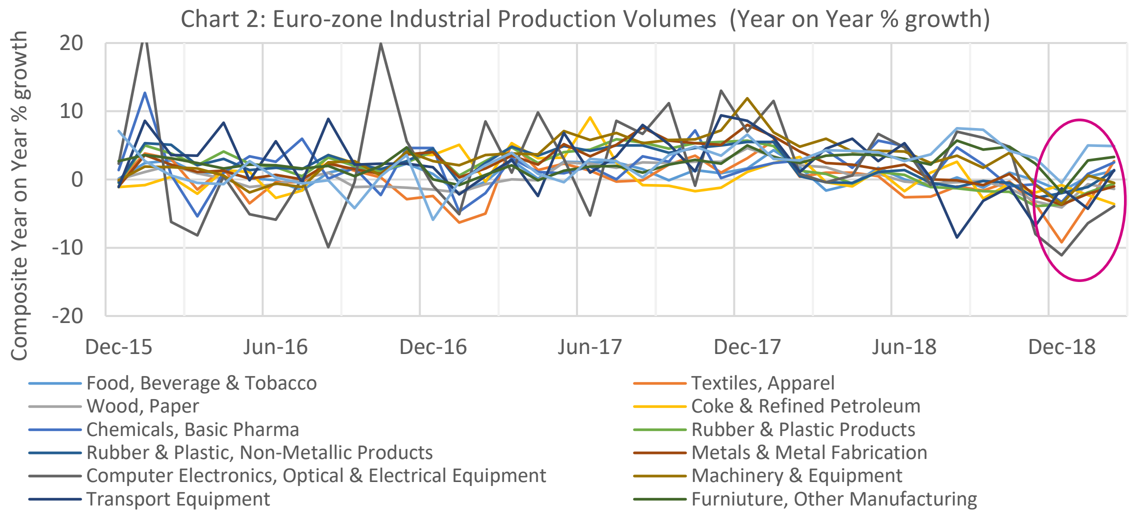
## 2. What are the signs of weakness and how bad are they?

### 2.1 Industrial activity

Slowing global growth has been a headwind to Europe which, when coupled with the idiosyncratic events mentioned above, led to a worrying drop in industrial activity, especially at the end of 2018, including in the economic powerhouse of Germany, as shown below. The smaller economies of France, Spain and Italy were also slowing down significantly during this time. In January, we saw a sharp rebound in the data for France, Italy and Spain, but Germany remained worryingly depressed.

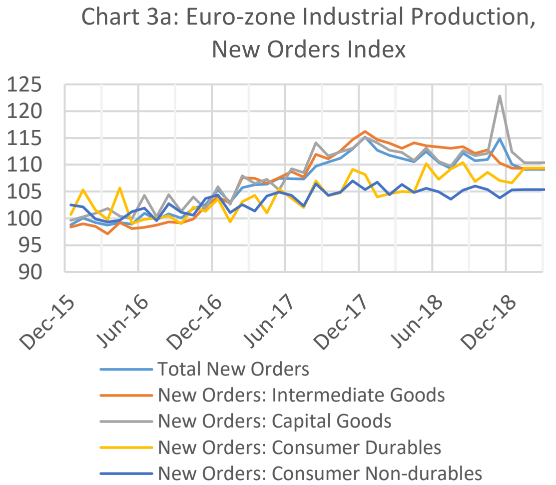


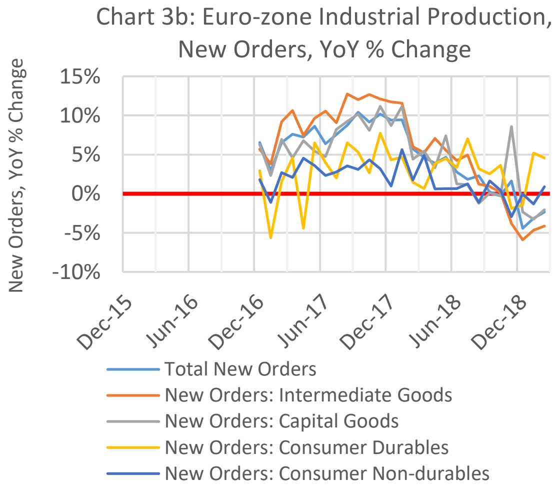

Even more worrying was the breadth of the slowdown in activity across industries (below) where by in December, every industrial sector in the Euro-zone had recorded a fall in activity versus the prior year.




The most recent industrial production data (chart 1, up to February 2019, released in April 2019) show a pleasingly steeper recovery in Germany's data although there is possible weakness showing up again in the data for France and Spain. Meanwhile, we are seeing recovery in production volumes (chart 2) across a number of industries.

Adding to the concern at the end of 2018 was the slowdown in new orders, i.e. it wasn't just current activity that had slowed, but the outlook was for slower growth to come. The charts below show that although the year on year numbers are improving, it is largely due to index base effects rather than an improvement in new orders.




## 2.2 <u>What is driving the industrial slowdown?</u>

Given the breadth of the slowdown in industrial activity, how it occurred coincidentally across several industries and how it deteriorated materially at the end of 2018, suggests there is some credibility to the hypothesis that the continent was hit by the series of idiosyncratic events (which were also concentrated in Q4'18) with the slowdown in China likely the most significant influence.

Indeed, four out of six of the "idiosyncratic" reasons relate to trade/ exports. Looking at the industrial production volumes in chart 2 again, we can see what looks like significant production volume growth towards the end of 2017/ beginning of 2018 when we were all cheering the globally synchronised economic expansion.

It was around this time that China "encouraged" the private sector to get corporate leverage under control (see chart below), the consequence of which was largely lost because around the same time, US-China trade rhetoric heated up dramatically. We can see a drop in production volumes (chart 2) and new orders (chart 3a/ 3b) early in 2018 albeit they were still registering positive year on year growth. Weakness, however, continued throughout the year.

The actual implementation of tariffs (which started in July 2018) marked the beginning of the negative export volume growth which then accelerated and broadened across industrial segments as the 10% tariffs were applied to a longer list of products (in September 2018).

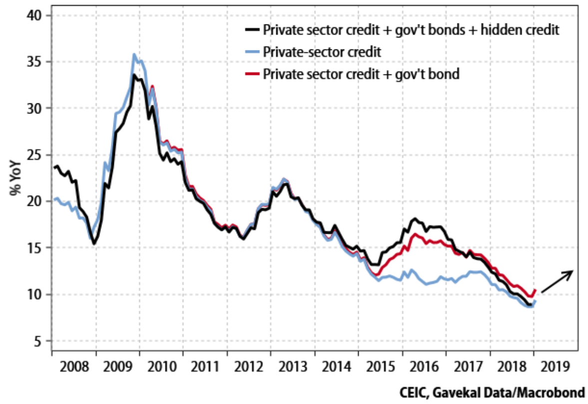
There were some tariffs applied on steel and aluminium for countries beyond China, but the bulk of tariffs were applied to China directly.

As such, Europe suffered a triple whammy due to the deleveraging induced slowdown in China, direct tariffs on certain industries and an additional slowdown from China's trade war induced export slow down, given Europe's export dependency.

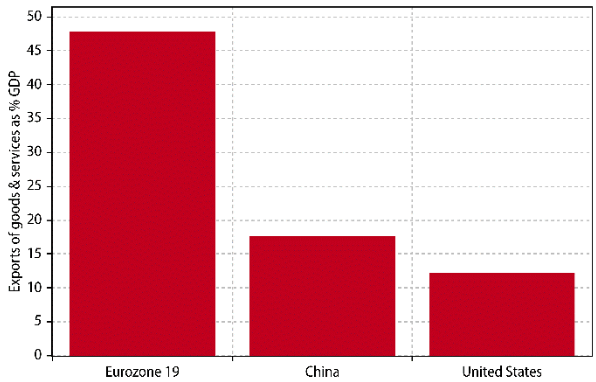
The high export exposure of the Euro-zone leaves the region especially vulnerable to trade shocks, even when it isn't the subject of the specific trade dispute, which the charts from Gavekal (right, top) and Absolute Strategy (right) serve to illustrate well. Export growth to China dropped to ZERO in 2018.

If the recent negotiations between the US & China serve to improve trade relations and if the deleveraging activity slows and fiscal stimulus improve growth prospects in China, it seems reasonable to infer that European export focused industrial activity should pick up. Yet, despite stability in industrial production volumes and new orders, the Purchasing Manager Indices indicate there is still considerable weakness to overcome with Germany leading the declines (chart 4 opposite).

**Credit growth has likely bottomed and is set to accelerate to 12-13%**




**The eurozone is especially vulnerable to dips in global growth**




Eurozone export volumes (3mma, 12m % change)

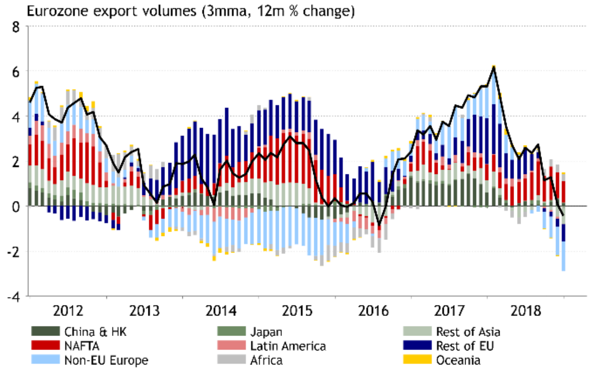
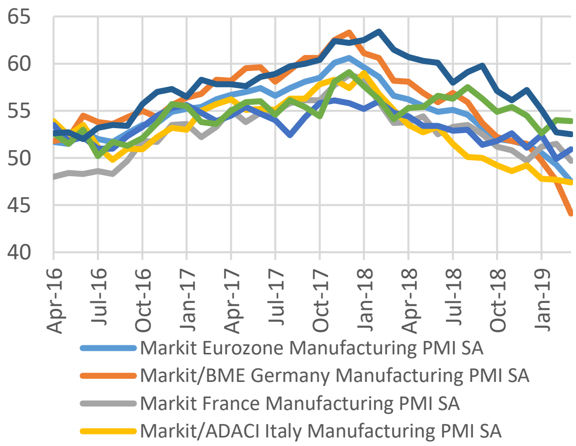
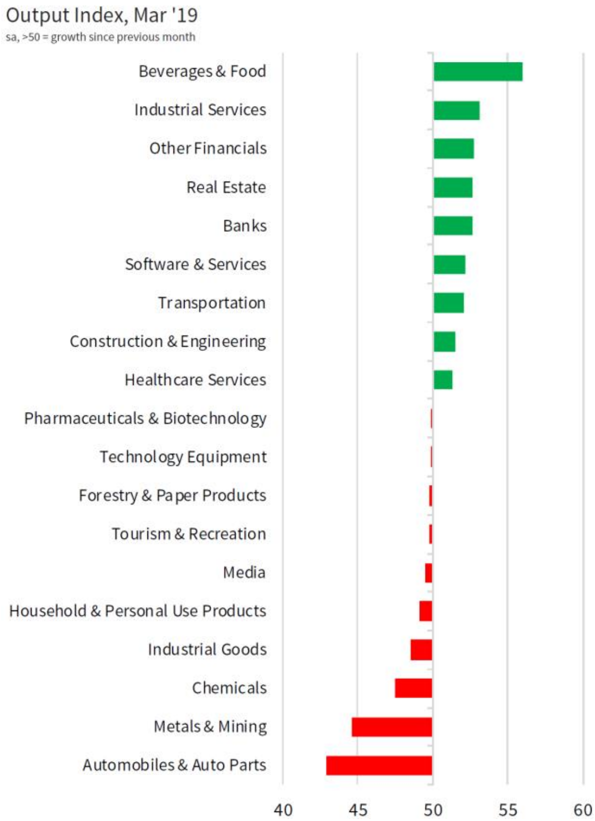



Chart 4: Purchasing Manager Indices

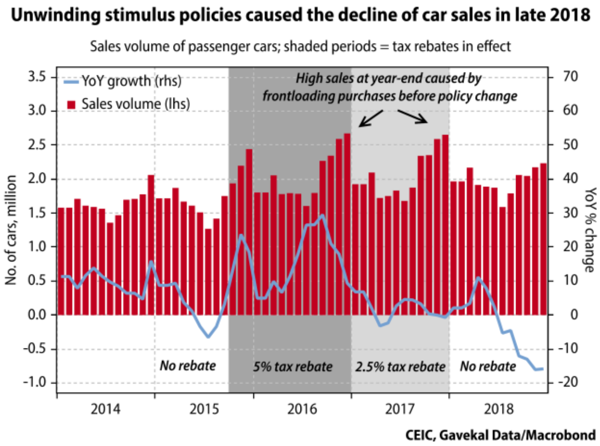


Helpfully, Markit (the PMI index calculation agent) also provides sector based PMIs for select regions and the chart opposite shows the result for Europe in March 2019. As we can see, it is in autos, mining, chemicals and industrials where there is considerable weakness, i.e. "Industrial" Europe, reflecting a lot of the comments above. But look at the other sectors; the more consumer facing services economy remains in expansion territory (above 50).




## 2.3 How important is the auto sector and Germany?

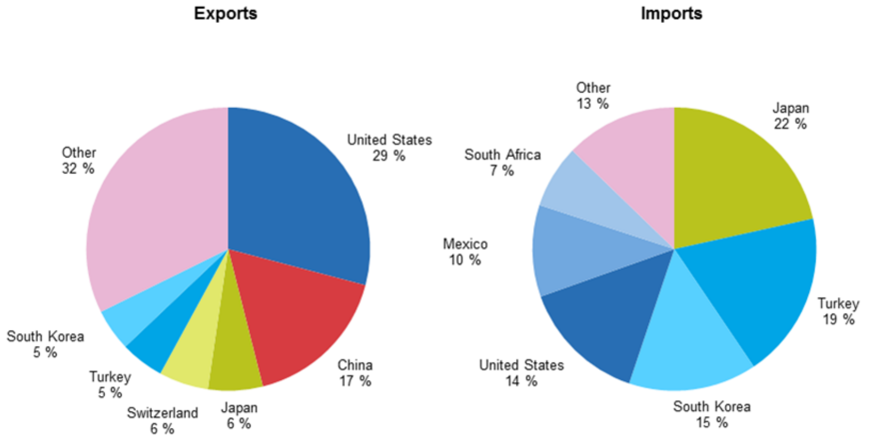
The auto sector has suffered not only due to costs associated with the emissions scandal, but also the gradual shift away from the internal combustion engine and a drop in exports to China due to a change in Chinese government support for electric cars. It is also in the cross-hairs for potential new tariffs by the US.


However, according to Eurostat, the export of cars represented 7% of Euro-zone exports in 2017 and of those, 17% went to China (i.e. 1% of total exports). 29% of Euro-zone car exports went to the US (2% of total exports)[1]. The value is significant, but it's hard to blame the whole of the Euro-zone slowdown on this.

[1]Eurostat: International trade in cars
https://ec.europa.eu/eurostat/statistics-explained/index.php?title=International_trade_in_cars#Germany_is_the_EU.27s_largest_exporter_of_cars

**Main extra EU-28 partners for exports and imports of motor cars, 2017**
(%)




*Source:* Eurostat (online data code: DS-018995)

Looking at it in more detail in the table below, we can see that Germany certainly dominates car exports from Europe with 55% of the total car exports. This is 13% of the country's total goods exports, which are a significant 39% of the country's GDP. That means autos are a hefty 5% of the German economy.

However, remember that GDP is the sum of consumption, investment, government spending and NET exports. Germany is also a heavy importer of goods (32% of GDP), so net exports are only 7% of GDP. Moreover, domestic demand makes up 94% of GDP (source: economic statistics from Bloomberg)!

The point here is there are several ways of slicing the data to build an argument both ways in terms of how important the auto sector is to Germany.

**Extra EU trade in motor cars by Member State, 2017**
(EUR million and %)

| | Extra EU trade (EUR million) | | | Share in total EU trade (%) | | Share for cars in total goods (%) | |
|---|---|---|---|---|---|---|---|
| | Export | Import | Balance | Export | Import | Export | Import |
| EU-28 | 131,728 | 45,090 | 86,638 | 100.0 | 100.0 | 7.0 | 2.4 |
| Belgium | 2,890 | 9,158 | -6,268 | 2.2 | 20.3 | 2.7 | 7.1 |
| Bulgaria | 74 | 129 | -55 | 0.1 | 0.3 | 0.8 | 1.2 |
| Czech Republic | 3,163 | 532 | 2,632 | 2.4 | 1.2 | 12.2 | 1.7 |
| Denmark | 107 | 211 | -104 | 0.1 | 0.5 | 0.3 | 0.9 |
| Germany | 72,541 | 13,203 | 59,338 | 55.1 | 29.3 | 13.6 | 3.8 |
| Estonia | 13 | 29 | -16 | 0.0 | 0.1 | 0.4 | 1.0 |
| Ireland | 4 | 169 | -165 | 0.0 | 0.4 | 0.0 | 0.6 |
| Greece | 5 | 131 | -126 | 0.0 | 0.3 | 0.0 | 0.5 |
| Spain | 4,936 | 3,854 | 1,082 | 3.7 | 8.5 | 5.2 | 3.1 |
| France | 3,199 | 3,845 | -645 | 2.4 | 8.5 | 1.6 | 2.3 |
| Croatia | 34 | 28 | 7 | 0.0 | 0.1 | 0.7 | 0.6 |
| Italy | 8,583 | 4,655 | 3,928 | 6.5 | 10.3 | 4.3 | 2.9 |
| Cyprus | 4 | 77 | -73 | 0.0 | 0.2 | 0.2 | 2.4 |
| Latvia | 12 | 9 | 3 | 0.0 | 0.0 | 0.3 | 0.3 |
| Lithuania | 100 | 103 | -3 | 0.1 | 0.2 | 0.9 | 1.2 |
| Luxembourg | 9 | 12 | -3 | 0.0 | 0.0 | 0.4 | 0.3 |
| Hungary | 1,188 | 163 | 1,024 | 0.9 | 0.4 | 6.3 | 0.7 |
| Malta | 2 | 30 | -28 | 0.0 | 0.1 | 0.2 | 1.5 |
| Netherlands | 663 | 905 | -241 | 0.5 | 2.0 | 0.5 | 0.3 |
| Austria | 1,078 | 303 | 775 | 0.8 | 0.7 | 2.5 | 0.9 |
| Poland | 1,110 | 364 | 747 | 0.8 | 0.8 | 2.7 | 0.6 |
| Portugal | 411 | 206 | 205 | 0.3 | 0.5 | 2.9 | 1.3 |
| Romania | 565 | 187 | 379 | 0.4 | 0.4 | 3.7 | 1.0 |
| Slovenia | 562 | 1,579 | -1,017 | 0.4 | 3.5 | 6.8 | 16.2 |
| Slovakia | 4,267 | 35 | 4,232 | 3.2 | 0.1 | 39.9 | 0.2 |
| Finland | 205 | 194 | 11 | 0.2 | 0.4 | 0.8 | 1.1 |
| Sweden | 4,000 | 610 | 3,389 | 3.0 | 1.4 | 7.2 | 1.5 |
| United Kingdom | 22,000 | 4,370 | 17,629 | 16.7 | 9.7 | 10.8 | 1.6 |

*Source:* Eurostat (online data code: DS-018995)

If we look at the composition of German (and European) industry by "gross value added" as a proportion of GDP, we see that "Industry" makes a lower but still significant 22% contribution to Germany while it is slightly lower at 18% for the Euro-zone overall. This number is closer to 10% in the US & UK.

Chart 5a: Germany Industry GVA as % of GDP

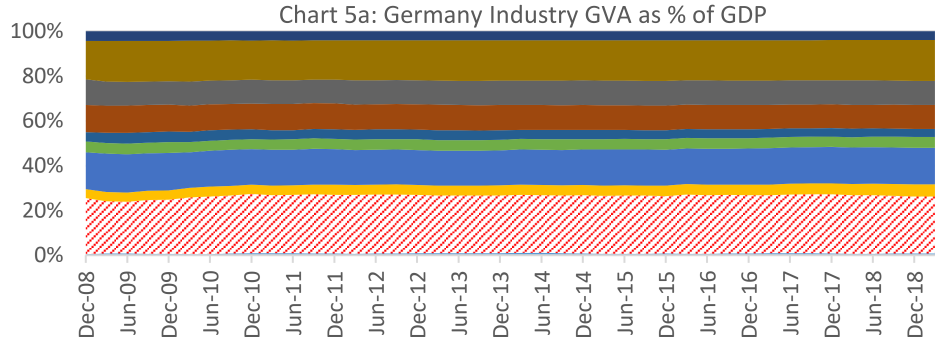
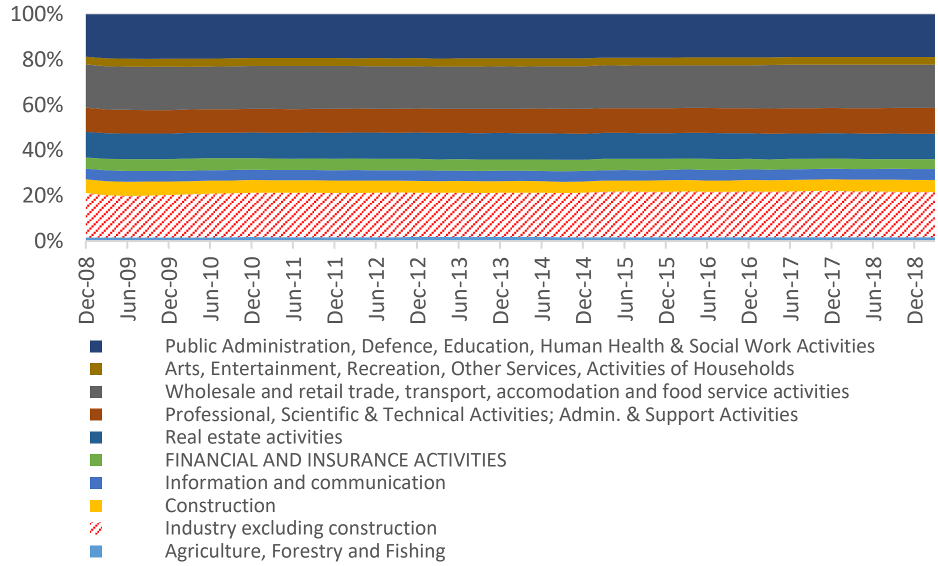



Chart 5b: Euro-zone Industry GVA as % of GDP




It should be noted that the auto sector has significant links to other sectors and so has an important multiplier effect in the economy. It is important for upstream industries such as steel, chemicals and textiles, as well as downstream industries such as ICT, repair, and mobility services. Overall the industry also employs around 12 million people.

So again, it certainly shouldn't be ignored but it is a smaller part of the economy than the consumer facing services sectors.

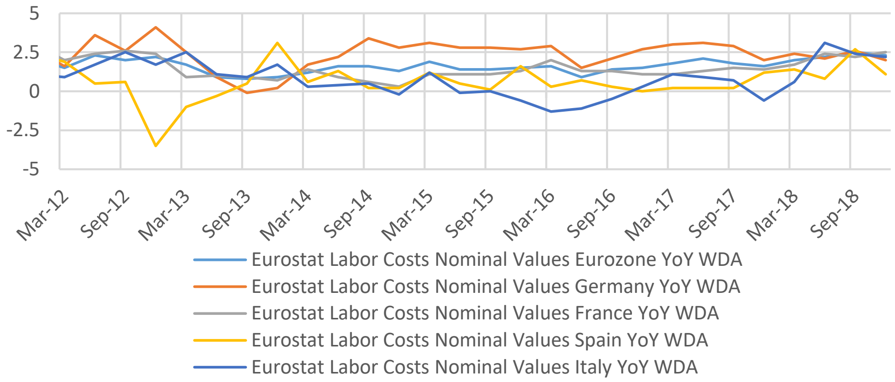
### 2.4 What is happening in other parts of the European economy?

Although there is significant weakness in certain industrial sectors, the weakness observed over 2018 was definitely broadly spread. If this was due to uncertainties regarding tariffs/ trade and the self-inflicted deleveraging based slowdown in China resulting in lower trade growth and a generally weaker external economy (the severity of each of which are receding), then can we get comfortable with the European domestic economy?

#### 2.4.1 Consumer

Indeed, although there was some weakness in retail sales towards the end of 2018, generally they have held up much better than the sharp declines in industrial activity seen earlier. In part, this will be driven by the continued fall in unemployment across the Euro-zone, together with the growth in wages.

Chart 6: Wages




The steep drop in retail sales in Germany does cause some concern, but considering how significantly industrial activity dropped, it's little surprise to see consumers show some restraint. Notably, retail activity has picked up again in 2019.

Chart 7a: Retail Sales (Germany, France)

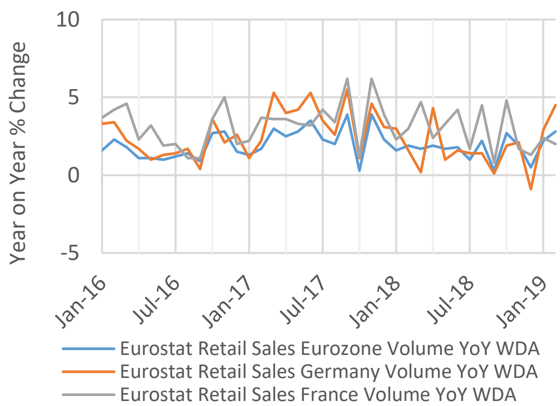
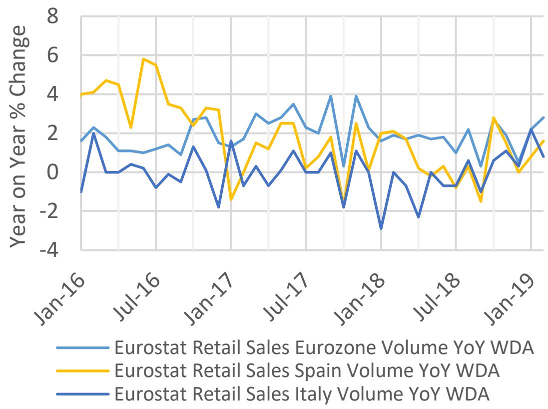
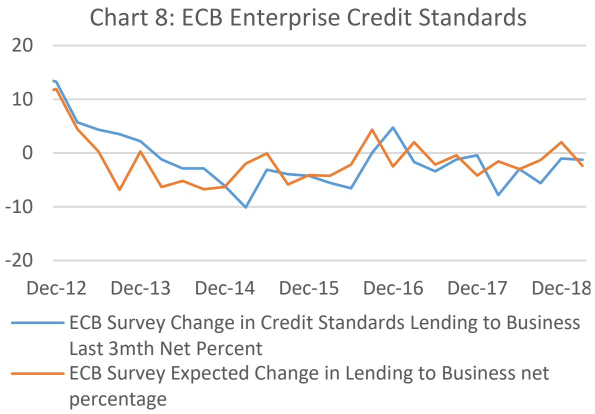


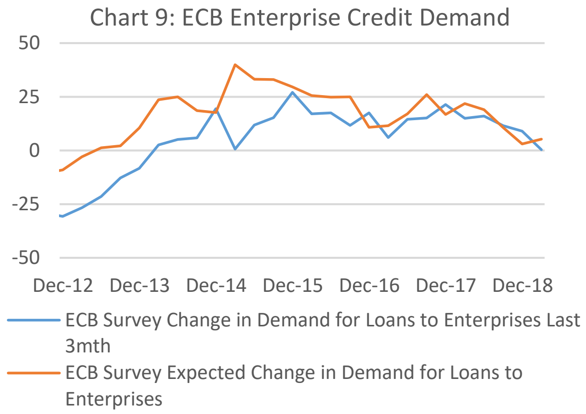

Chart 7b: Retail Sales (Spain, Italy)



### 2.4.2 Bank lending

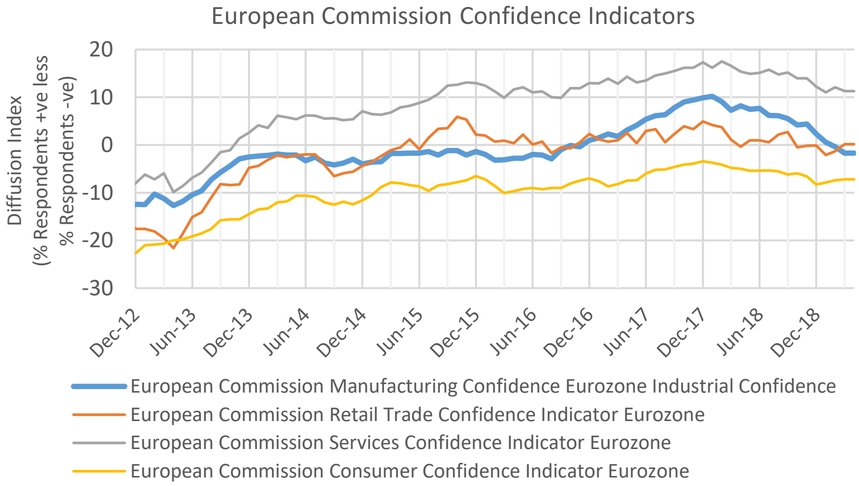
There has recently been some discussion in the market about tighter capital requreiments for the banks in Europe[2] and that this will somehow impede future growth. When we look at the ECB Senior Loan Officer Survey, we find that credit standards in Europe have generally had an easing bias for a number of years (chart 8 below left). However, when we look at the demand for credit (chart 9) we see a marked slowdown, again coinciding with the drop in industrial activity from around the beginning of 2018 – companies don't want to borrow or invest when there is a high degree of uncertainty, so the regulatory changes are not expected to add incremental pressure on growth.




## 3. Consumer & Business Confidence

The European Commission undertakes a wide variety of surveys across manufacturing, retail, services industries as well as surveying the consumer. It is clear to see a similar picture here, i.e. the weakness is concentrated in the industrial sector.




[2] TwentyFourAM – Have European Regulators Just Tightened Financial Conditions?
https://twentyfouram.com/2019/04/09/have-european-regulators-just-tightened-financal-conditions/

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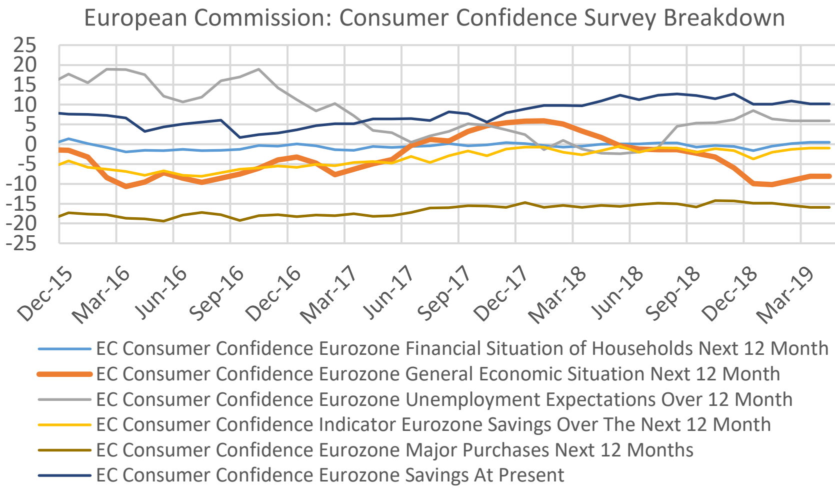
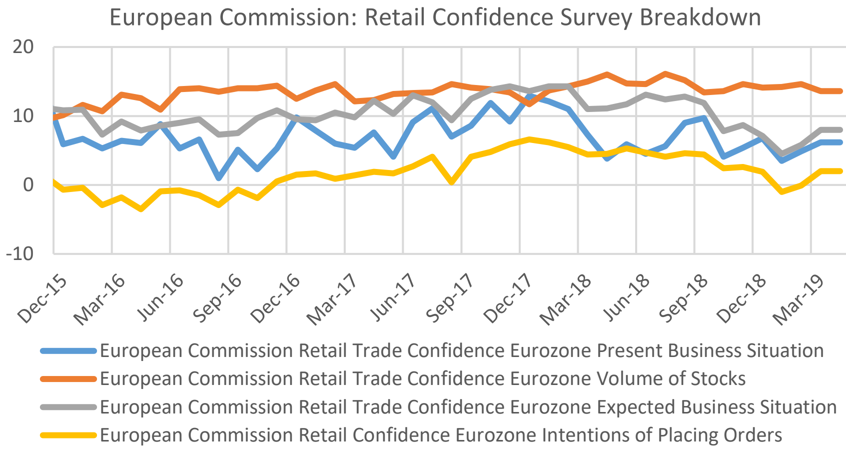
### 3.1 Consumer

Looking at the breakdown of the consumer confidence survey, we can see that not much has really changed in terms of expectations regarding financial situations, saving or making major purchases but what has deteriorated is simply confidence in the "General Economic Situation" which ties back to industrial weakness again.



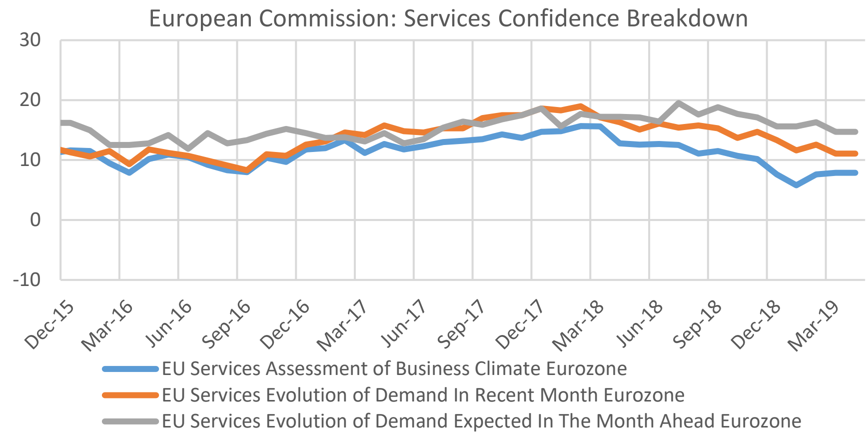

### 3.2 Retail

Retailers had been getting a little worried about the business outlook over the course of 2018, possibly reading across slowing business activity from other sectors. Pleasingly, the most recent data is showing signs of improvement.



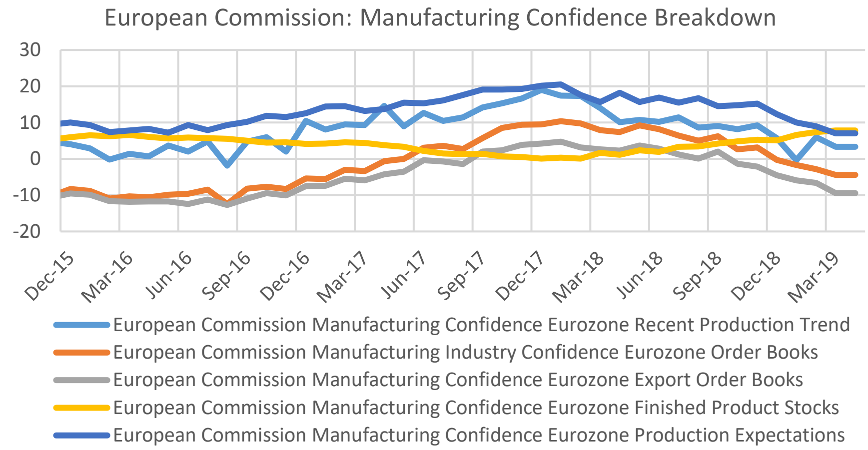
### 3.3 Services

Some slowdown has been witnessed in services but it is important to note these indices are well above the zero line.




### 3.4 Manufacturing

As with previous comments, the manufacturing sector is clearly weaker where we can see the greatest weakness in the export order books.



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## 4. Index Composition

The greater significance of the industrial sector in Europe by comparison to the US is reflected in the sector exposure of each region. Shown opposite are the sector exposures of the MSCI Europe ex UK index (iShares ETF) and S&P 500 (iShares Core ETF) where we see the Industrials & Materials sector (which are under pressure in Europe) are roughly double the size in the European index versus their equivalents in the US index. Add in worries about the impact on bank lending (financials) and the influence over market direction and significance of the market noise about the industrial slowdown is certainly more relevant in Europe.

| Sector Exposure | MSCI Europe ex UK | S&P 500 |
|---|---|---|
| Consumer Staples | 13.3% | 7.2% |
| Health Care | 13.9% | 13.3% |
| Utilities | 4.4% | 3.2% |
| Communications | 4.6% | 10.4% |
| Energy | 4.7% | 5.4% |
| Industrials | 14.8% | 9.6% |
| Information Technology | 7.2% | 21.7% |
| Consumer Discretionary | 10.6% | 10.4% |
| Financials | 17.9% | 13.2% |
| Materials | 7.0% | 2.7% |
| Real Estate | 1.6% | 2.9% |
| | | |
| Industrials + Materials | 21.7% | 12.3% |
| Financials | 17.9% | 13.2% |
| Ind + Mat + Fin Total: | 39.6% | 25.5% |

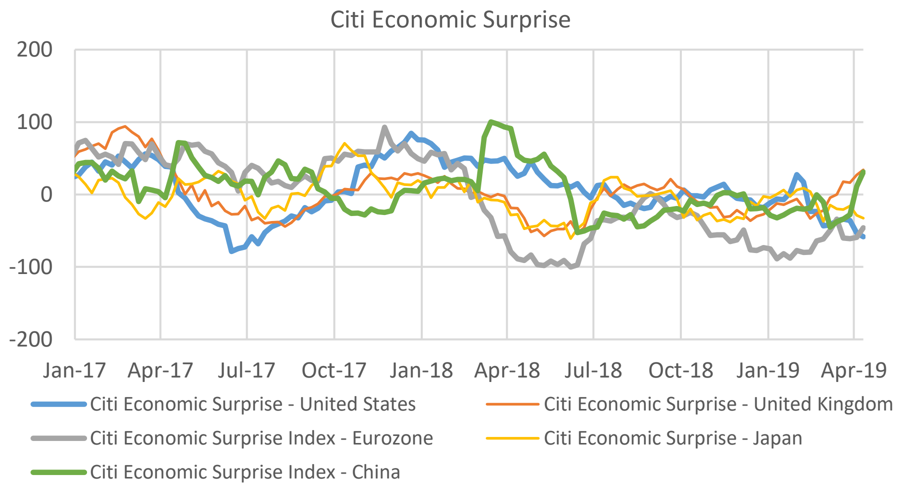
But, based on the resilience of the consumer/ services sector discussed above, it could be erroneous to extrapolate manufacturing weakness across the remainder of the economy or equity market.

## 5. Concluding remarks

After diving deep across a number of areas of the European economy, it seems to me that the biggest impact on the slowdown in industrial activity has been a weak export market, which is explained by a combination of the deleveraging efforts of China that started in early 2018 and reduced trade driven by the US-China trade war. Compounding the weakness in industrial activity in Q4 2018 in particular were a few Europe-centric or idiosyncratic events.

The consumer, on the other hand, remained relatively resilient given higher levels of employment, rising wages and a weak inflation background. However, given the magnitude of the industrial slowdown, it has had a negative impact on consumer sentiment, though seemingly more about the economic environment rather than materially impacting spending decisions.

Bringing all of the economic data together and comparing it versus market expectations, we can look at the Citi Economic Surprise Indices that measure the degree by which economic indicators beat or miss expectations for different regions. Here we see some weakness developing in the US while Europe and China appear to be on a strengthening trend in 2019.



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Finally, considering two additional very recent news items:

1. It looks as though Presidents Trump & Xi could be heading towards a meeting in May to sign off on a deal.
2. China's National Development and Reform Commission is circulating a proposal for auto and consumer goods stimulus. This follows a combination of stimulus measures late last year and early in 2019 that were designed to spur consumer spending while there were also 2 RRR rate cuts in January.

We were bullish on Europe back in January 2018 on the basis that the economy was growing strongly and being driven by domestic investment and household spending, NOT exports. We quickly reduced exposure (driven by the momentum indicator) while it was unclear why the European PMIs were falling, reducing further again when it became clearer the weakness was being caused by China's deleveraging efforts and concerns about trade tariffs.

Now it seems clear that China is no longer in a "forced" deleverage mode, in fact being more stimulative. The stimulus is far more domestically targeted than before, so we shouldn't expect to see a global growth rebound but it does seem fair that the negative headwinds that have faced the European industrial sector are abating, if not gone altogether.

As such, we should feel more comfortable taking a bullish (overweight) stance in European equities once more, especially considering valuation relative to the US.

Let's twist again, like we did last… oh, right, it was in January.