European equities stuck between a rock and a hard place…or between elections and Wall Street

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The victory of pro-European parties at the March 15 legislative elections in the Netherlands is a key factor in stabilizing and even improving perception of European risk in the minds of international investors, ahead of the forthcoming elections in France. In this respect, Emmanuel Macron's current position in the polls is even prompting some international investors to forge ahead and start bolstering their positions on Europe. This play is tempting but risky. Especially if Wall Street gets involved...

Watershed scenario: what would the impacts be?

Polls over recent days still suggest that the Eurosceptics who have rallied behind the National Front candidate Marine Le Pen will be represented in the second round of voting in the French presidential elections, but that the chances for Le Pen's rival, whether Emmanuel Macron or François Fillon, will be much higher in this final round (although intended votes for these two candidates are much more unsteady). In the event that Marine Le Pen wins the election, we would see a twofold market impact straight away:

1) a significant widening in the OAT/Bund spreads (widening in bond yield spreads between France and Germany) along with a sharp surge in volatility for equity indices. In this respect, it is important to note that the equity market and the bond market recently took to different paths, as equities benefited from a drop in the risk premium driven by purchases from international investors, while the sluggish bond market remains stuck on a France-Germany spread wider than the figure witnessed a few months ago (65bp/70bp vs. 30bp/40bp), and especially,

2) a severe depreciation in the euro against the main currencies (EURO–US Dollar at least at parity for example). In this scenario, investors would have to steer clear of French equities for a while, particularly if the market continues the pre-electoral rally trend that kicked off over recent days.

From a sector standpoint, this scenario would severely weaken companies exposed to interest rate fluctuations. So **banks, real estate, concessions**, and more broadly speaking **companies with high debt levels** would be highly affected. Furthermore, **companies that are very exposed to domestic activity** and imports would also be dented.

Conversely, exporting companies or those that are not very exposed to France (luxury goods and spirits in particular), defense, the oil sector and healthcare would act as safe haven stocks on the equity markets.

And what if the good-news scenario comes off?

Of course there is a possibility of a positive conclusion to the markets' situation after this election (the legislative elections on June 11 and 18 will also be a key moment, but it is still too difficult to analyze this event as it will depend heavily on the results of the presidential election). This scenario is deemed to be likely in the event of the election of Emmanuel Macron or François Fillon, particularly from the standpoint of non-domestic commentators, and it goes alongside substantial reforms i.e. more flexible labor market, better tax conditions, reduction in state spending, reform in relationships with social partners, pension reform, pro-business and pro-European economic policy. In view of favorable demographic trends in France, particularly compared to the other main OECD countries, structural reforms that lead to better productivity could foster more favorable growth prospects for the country. Of course a degree of national consensus would be required beforehand, along with a stable political majority and a government that is truly serious about its aim of implementing these reforms as promised this time. The equity markets have perhaps already started to price in this scenario, when we look at their resilience as April gets off to a start. But beware of disappointment. In this scenario, **financial stocks and sectors** (primarily banks) would be the key winners, **along with companies with high debt**, which are exposed to interest rate fluctuations. More broadly speaking, shares with a high beta (average reactivity higher than the market) would outperform. So **"lower quality" cyclical stocks** would be the victors. From a geographical standpoint, **equities in peripheral markets (Spain, Portugal and especially Italy)**, that still carry very low absolute profits compared to the previous cyclical high (2007/2008), would display the best showings.

Are we heading for a correction on the US markets?

What with expectations of favorable scenarios on the equity markets, post-election closure, risk of disappointment, and watershed scenario, the near future for European equities could turn out to be very volatile, and quite a roller-coaster ride. However, as we noted, there are a number of reasons to remain hopeful despite these uncertainties. The improvement in economic conditions in the Eurozone, including France, and the outlook for profit growth for listed companies (slightly more credible for 2017 while figures are still on average close to 25% below previous cycle peak levels) are gradually blowing away the thick layer of clouds that has been obscuring our economic and financial horizon for almost ten years.

Ahead of all this, there is one necessary, albeit insufficient, condition that should also help ward off an unfavorable scenario for the months to come: a (minimum) degree of stability on the financial markets' outlook in the US. Against all expectations, Donald Trump's election to the White House acted as a pretext for a fresh rally on US equities' valuations in a surge in confidence ('reflation trade') which has not yet been confirmed by facts. Companies in the S&P500 are trading on valuations of close to 3.2x book value and 18x expected earnings for 2017 (more than 27x 'de-cyclicalized' profits), figures that are close to or even exceed historical highs displayed in periods before market bubbles have burst (1987,1999-2000 for example). These levels are well ahead of European equity valuations (where companies are trading at half these price-to-book value levels, with forward P/E at 15x). Admittedly, earnings growth for US companies has traditionally been higher than for their European counterparts, but earnings revision momentum has turned around and now points in favor of Europe. US stock markets players are still hoping for a strong natural impact from share buyback programs (which destroy value in the long term) and they hold particularly high hopes for the effects of tax cuts promised by Trump during his electoral campaign. Against this backdrop and after a very long period of accommodative monetary policy, the Fed seems prepared to step up its rate hike pace in order to rein in the markets' complacency. The central bank has less than a year left with Janet Yellen at the helm, and the chair must be sorely tempted to accelerate normalization of policy. So there is a real threat of a combination of a potential return to more realistic valuations for financial assets and a more aggressive central bank. These two factors combine to make the perfect recipe for a correction on the US markets.

In this report, we have outlined some very specific dimensions of the European political landscape in 2017. If we single out and set aside these aspects, and also factor in the areas for opportunities on the European context and the risk factors on the US markets, this broader analysis bears out our idea of a **positive relative play on Europe vs. the US**. Even if the European markets decline in the wake of Wall Street, their correction should be smaller, and this justifies our buy stance on European equities and our sell stance on US equities.

Let's hope that the old saying "When Wall Street sneezes, the rest of the world catches a cold" does not turn out to be true this time.

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