THE DRIVE YOU DEMAND

SPOTLIGHT: FRENCH ELECTIONS

Market-friendly results allow markets to re-focus on earnings

The apparent victories by Emmanuel Macron and Marine Le Pen in the first round of the French presidential elections should bring relief to markets and allow them to focus on the ongoing strength in the underlying European economy. With markets opening strongly following the result, we believe a strong earnings season will be key to a sustained rally in Eurozone equities. Eurozone banks appear well positioned to gain further, having most aggressively priced increased risks of Eurozone fragmentation.

April 2017 | Global Investment Committee

UBP

UNION BANCAIRE PRIVÉE

Key points

- *As pre-election polls had suggested, Emmanuel Macron and Marine Le Pen appear to have qualified for the second round of French presidential elections on May 7*
- *Following the June National Assembly elections, risks are rising that the ECB will begin to pivot towards a more neutral policy stance*
- *This market friendly result should allow markets to focus on the impressive growth trajectory of Eurozone economies year-to-date*
- *Valuations in Eurozone equities appear fair relative to their US counterparts though Eurozone banks should continue to benefit from attractive valuations, economic recovery and the prospect of a steepening Eurozone yield curve*
- *The recent strength in EURUSD may prove only transitory as interest rate differentials and positioning are unsupportive*

Eurozone economies show continued strength moving into 2Q2017

The first round of the French presidential elections delivered an outcome close to both pre-election polls and market expectations, reversing the trends seen during the BREXIT referendum and the US presidential election in 2016.

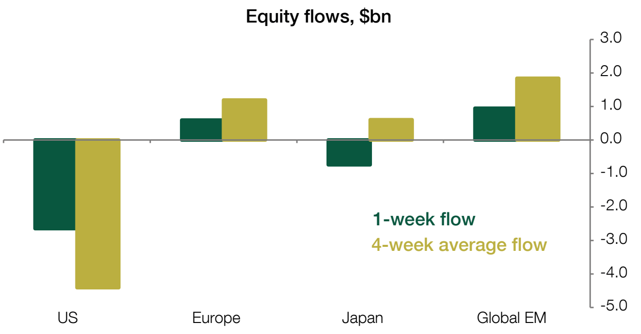
This, combined with polls for the second round suggesting a wide lead for market-friendly Emmanuel Macron, should allow markets to focus on the ongoing economic strength seen across the single-currency area in 2017.

Indeed, while US and UK economic data has shown signs of stabilising in recent weeks, data across the Eurozone suggests an economy that continues to accelerate. April purchasing manager surveys indicate little impact from electoral 'uncertainty' surrounding French elections among the continent's corporates. Instead, the Eurozone economy is showing signs of ongoing acceleration in both the manufacturing and services sectors.

Inflows into European equities were rising going into the French elections

It has been this economic strength that has reversed the caution that many investors (including ourselves) began 2017 with. This was reflected in strong inflows seen into European equities in recent weeks, even ahead of the results of the first round of French elections.

Inflows into European equities were rising going into the French elections



Sources: BoA ML, EPFR, UBP ETR

Although we believe that further flows into European equities are likely in the weeks ahead, investor surveys indicate that overweight positions in European equities are already nearing multi-year highs. In contrast, investors are holding the largest underweight positions in US equities since 2007.

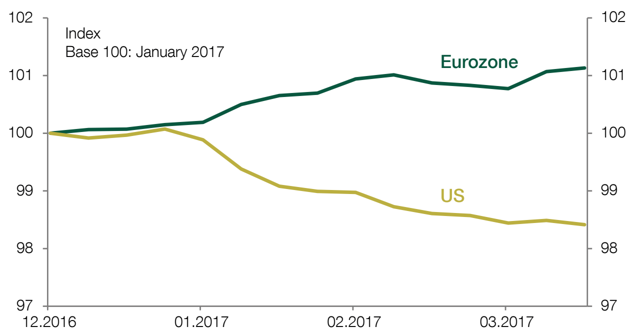
Therefore, from a flow and positioning perspective, some caution may be warranted especially given the relief rally following the French election.

Earnings upgrades are the necessary follow through to sustain the post-election rally in Eurozone equities

However, as with post-election markets in the United States following the presidential elections, we encourage investors to focus on the economic growth backdrop and the outlook for earnings on the continent looking forward.

Over the year-to-date, Eurozone equities have seen a consistent rise in earnings expectations in contrast to the weakening of expectations in the US. However, given the 6% rise in equities in the single currency area even before the post-election rally, the sustainability of the YTD rally will increasingly rely on further upgrades to current earnings expectations.

Rising Eurozone earnings expectations need to accelerate further



Sources: UBP and Thomson Financial

Given the strong economic growth that has continued into the 2nd quarter, we expect the upcoming earnings season to deliver some surprises. Despite comparatively weaker growth trends in the United States, the US earnings season has already shown 75% of reporting companies beating expectations by an average of 6%, ahead of the 71% and 4% averages seen in earlier quarters.

Moreover, with Eurozone banks having lagged behind going into the French elections, we added positions in March given the attractive valuations on offer and the prospect of earnings upgrades, especially as the ECB pivots towards more neutral policies looking ahead.

Waning political uncertainty and ongoing economic strength may result in a change in ECB policy

With uncertainty surrounding the French elections beginning to dissipate and in light of the ongoing strength in the Eurozone economy, we believe that the risk is rising of the European Central Bank beginning to pivot its accommodative policy stance to a more neutral position.

This may begin as early as the summer via a shift in its communications strategy followed by communication of a 'tapering' of its quantitative easing programme later in 2017.

Although such a move should be supportive for the single-currency, we believe the year-to-date strength, especially against the US dollar appears likely to overprice the pace of tapering on the part of the ECB whilst underpricing the potential for further tightening from the US Federal Reserve in the months ahead.

As a result, we fear the post-election strength in EURUSD may prove to be only transitory. Indeed, with wide interest rate differentials between German and US rates and with previous short positions in EURUSD already substantially closed, we believe headwinds are now growing against further sustained strength in EURUSD.

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