Cumberland Advisors Market Commentary – Investing in European Equities

Just days after US President Trump announced a ceasefire and resumption of trade negotiations with China, the US Trade Representative proposed new tariffs on 89 European Union (EU) goods worth $4 billion. These levies are in response to concerns about aircraft subsidies and would be added to the $21 billion list of potential tariffs the US threatened in April. Rising trade tensions with the US add to already substantial headwinds to Europe's economic growth, which include sluggish export growth, flagging business confidence regarding the US-China trade dispute, and the increasing threat of a disorderly exit of the UK from the EU.

Economic growth in the Eurozone has slowed markedly since mid-2018. Nevertheless, investors have not deserted European equity markets. Indeed, some of the national markets have outperformed thus far this year. This may reflect the market's looking through the current weakness and anticipating stronger growth in 2020, as is projected in the latest OECD Economic Outlook. There are, however, significant downside risks to this outlook.

According to the latest data included in the June Composite (manufacturing plus services) Purchasing Managers' Index (PMI), there has been an upturn in the pace of economic growth in the Eurozone at the end of the first half of the year, but that upturn still signals relatively weak current and future economic growth. Particularly concerning is a deterioration of business expectations for the year ahead. Ireland's service sector keeps that country's economy as the strongest performer, followed by France, which registered its best performance in seven months. Germany and Spain saw no change in their modest growth rates. Italy, despite a slight improvement in June, remains the weakest Eurozone economy.

Economic growth for the region looks on track to be only about 1.2% for the full year. This subdued growth is largely due to weaker external demand, particularly from emerging-market economies that have slowed because of the trade tensions, which have also depressed business confidence and investment decisions. A global slowdown in manufacturing has impacted the countries that rely heavily on manufacturing exports, namely Germany and Italy. Sources of strength have been private consumption, a robust labor market, and solid performance by the services sector. The fiscal stance is slightly positive, while monetary policy is very accommodative.

Looking forward, investors were surprised and pleased to learn that Christine Lagarde, currently the managing director of the International Monetary Fund and former French finance minister, will replace the highly regarded Mario Draghi as president of the European Central Bank ECB) on November 1. She is an excellent and unexpected choice and is expected to follow in Draghi's footsteps, willing to continue his pro-growth unconventional monetary policy and "do whatever it takes." Draghi has already begun to set the stage for the ECB to provide increased monetary stimulus to boost economic growth and raise core inflation towards the ECB target. Those actions led Trump to repeat his charge that the EU is engaging in unfair currency manipulation, a rather strange accusation from someone who is calling for the US central bank to lower interest rates for the same reasons.

There have been several other positive developments. The crisis between the Italian government and the European Commission over Italy's projected budget deficit, which is well above EU limits, has been eased by Italy's revising its budget to avoid likely fines. In France political demonstrations have eased and President Macron looks able to return to making some further progress with needed economic reforms. France is also leading European efforts to save the Iran nuclear deal and defuse that crisis. Another notable development is the European Banking Authority's announcement that European banks will be subject to a 23.4% increase in their minimum capital levels in order to meet the requirements of Basel IV global rules. This requirement will be challenging for the EU's large banks but will strengthen the banking system.

The main risks facing the Eurozone economy continue to be trade tensions, both those with the US and those between the US and China. If either of these disputes fails to be resolved and protectionism rises significantly, the global economy and that of the relatively open Eurozone economy will suffer further. However, it is interesting to note that while the US is threatening tariffs and moving towards increased protectionism, the EU has been concluding bilateral and regional trade agreements that extend the liberal trading system that has been the basis for the globe's economic growth since World War II. These agreements go beyond market opening and include EU standards in areas such as labor rights, the environment, rules of origin and dispute settlement. The EU has just concluded agreements with Vietnam and with Mercosur (Argentina, Brazil, Paraguay, and Uruguay). These follow agreements with Canada, Mexico, Japan, and Singapore.

Negotiations are well underway with India, Australia, New Zealand, and Chile. We regard these trade pacts as a big positive for the Eurozone economy.

Eurozone equity markets have shown considerable resilience thus far this year (year to date as of July 5) despite the challenging headlines and tepid economic growth. The iShares MSCI Eurozone ETF, EZU, is up 13.4% on a total return basis. That is similar to the 12.6% return for the aggregate iShares MSCI EAFE ETF, EFA, which includes all advanced-economy markets outside of the US and Canada.

There is considerable variation among the national equity markets. Spain's market underperformed. The iShares MSCI Spain Capped ETF, EWP, advanced 8.6%. The equity market of the largest Eurozone economy, Germany, also underperformed. The iShares MSCI Germany ETF, EWG, gained just 10.7%. Germany's manufacturing sector has been falling: May factory orders were down 8.6% over the previous year. Manufacturing international sales declined in June. Among the EU outperformers, France is notable. The iShares MSCI France ETF, EWQ, is up 15.6% despite the political turmoil that characterized the first half. Netherlands did even better. The iShares MSCI Netherlands ETF, EWN, gained 18.2%. The 16.3% gain by the iShares MSCI Italy Capped ETF, EWI, may look surprising in view of Italy's weak economic growth but can be explained by how far it fell last year. The 10.5% year-to-date gain in the iShares MSCI United Kingdom ETF, EWU, hides the 4.1 % drop in the second quarter as the prospect of a disorderly departure from the EU increased.

In Cumberland's International and Global Equity ETF portfolios we are maintaining our Eurozone positions while closely monitoring developments, particularly with respect to international trade.

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Sources: *Financial Times*, HIS Markit, OECD, Barclays Economic Research, CNBC