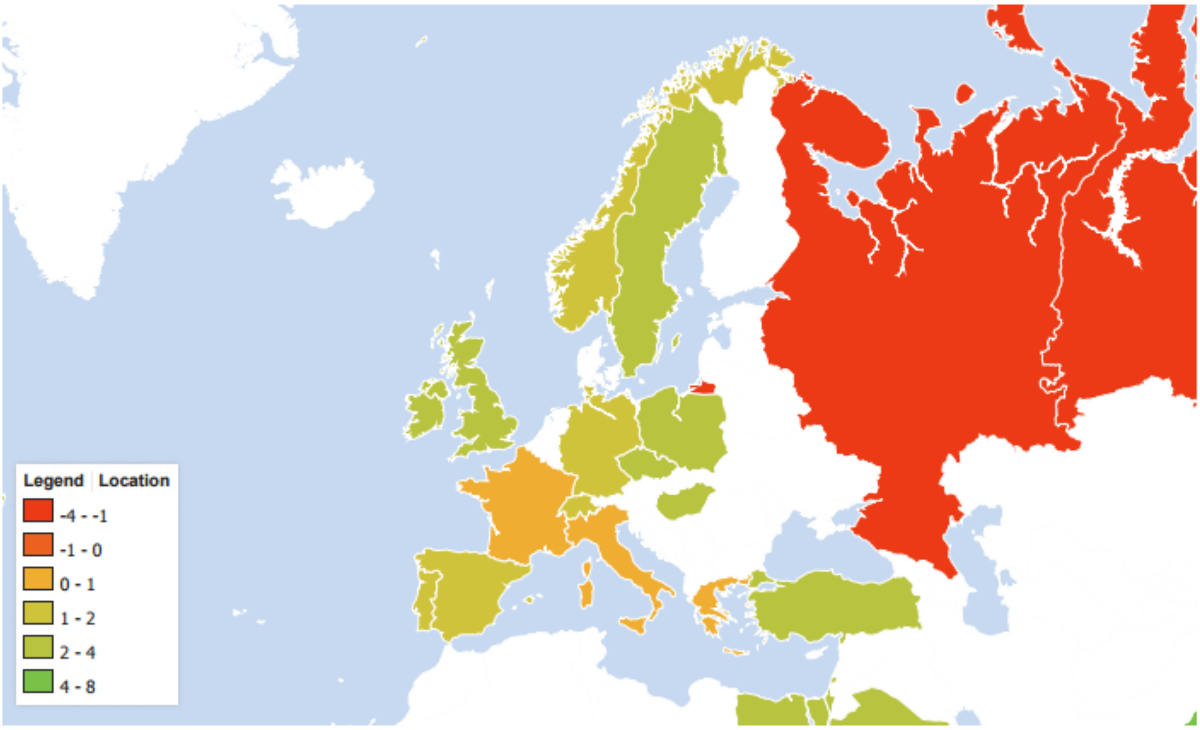
Monthly Update

ETF Securities Research and Roubini Global Economics

Europe's Political Hurdles

- Our focus this month is on Europe's fractious politics and the implications for our key theme of European growth.
- We are seeing a growth improvement throughout most of Europe on low interest rates and low oil prices, but fiscal support and structural reforms are needed to make the recovery substantial and persistent. And a heavy political calendar could spoil the party.
- Key risks coming up this year, and weighing on business sentiment and investment, include the UK general election in May, with a likely hung parliament, continuing Greek negotiations, the Catalan election in Spain (a proxy referendum on independence) and the Spanish general election later in 2015/early 2016. The future of the membership of the EU itself remains in focus, with the potential for an EU referendum in the UK and continuing Greek negotiations.
- ***What to watch this month*:** UK general election (May 7); Bank of England monetary policy committee (May 11) for indications of the timing of the first hike; major debt payments due from Greece to its official-sector creditors (May 8-15); Spanish regional elections (May 24) for indications about how the general election might progress.

Heatmap: Roubini's 2015 Growth Forecasts (%)



Source: Roubini Global Economics

Key Macro Theme: Europe's Fractious Politics Weigh on Cyclical Rebound

We are seeing a cyclical improvement in Europe on low rates and low oil prices, but fiscal and structural reforms are needed to make the recovery more substantial. Moreover, the region's tricky politics and busy electoral cycle raise the risk of "accidents."

Complex Geopolitics

As we discussed in our Quarterly Outlook, Europe is undergoing a cyclical upswing, but finds itself facing a number of political problems with which its imperfect institutions are ill-equipped to cope.

Externally, the EU will face even more instability on its Middle East and North Africa borders (ISIS in Libya, war in Syria and Iraq) and a protracted showdown on its eastern flank (associated with the Ukraine conflict), which will mean sanctions on Russia will stay in place. These tensions exacerbate the economic pressure on Europe.

Internally, domestic political issues abound, including resurgent nationalism, the growth of separatist movements and the rise of anti-system parties.

Challenging Election Cycle

This is a year of European elections, with Greece and the UK at the forefront of attention.

In the former, a series of risks lie on the horizon. Prime Minister Tsipras is trying to strike a difficult balance between presenting a list of reforms the Eurogroup would find acceptable and maintaining some degree of bargaining power. The creditor institutions will provide just enough cash to prevent Greece from taking radical measures to avoid a deeper crisis, and the government will only make incremental concessions in exchange. The risk of an "accident" in the negotiations is high.

In the UK, the May 7 election is too close to call. On the basis of current polls, neither party is likely to have an overall majority in parliament, and it seems probable the government will be weaker than in the past, further undermining confidence.

Elsewhere in Europe, Italy's new president, Sergio Mattarella, took office without a hitch, but the switch dissolved the implicit alliance between Prime Minister Matteo Renzi and the opposition Forza Italia, which could make it more difficult for the government to implement reforms.

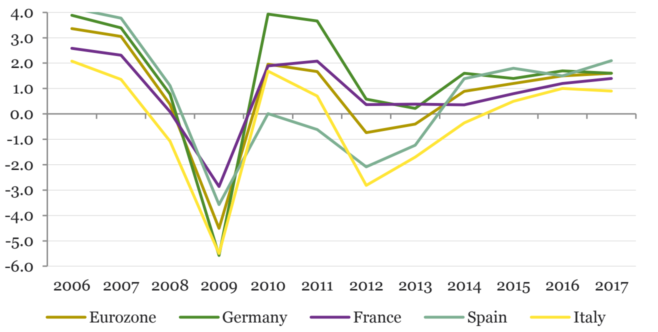
September will bring elections in Portugal and a series of regional Spanish elections, with voting in Catalonia seen as a proxy for a referendum on independence.

Later, Spain's general election will reveal whether Europe's tough stance on Syriza has weakened support for Podemos.

In Emerging Europe, June parliamentary elections will determine whether Turkey's ruling AKP has the capacity to transform the country from a parliamentary republic into a presidential one, which would confirm its authoritarian bent and herald further meddling in monetary policy.

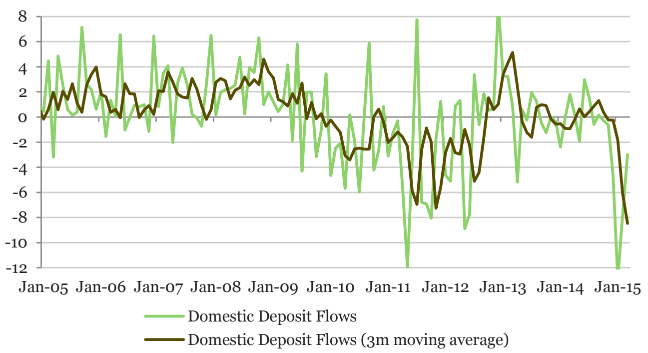
And October's parliamentary elections in Poland will see a very close race between the market-friendly Civic Platform and the more populist Law and Justice, which is likely to be positive for consumption, although not investment.

Figure 2: Eurozone Economies Head for Cyclical Rebound (GDP growth; %, y/y)



Source: Roubini Global Economics, Haver

Figure 3: Greek Deposit Withdrawals Similar to Those Seen in 2012 Crisis (€, billions)



Source: Haver

What to Watch

- ***Greek debt repayments:*** Can Syriza keep the show on the road? Treasury bills need to be rolled over in May and payments to the IMF made.
- ***UK election:*** A Tory win on May 7 would generate plenty of volatility in equity and FX markets on EU referendum fears. A Labour win might lead to increased corporate debt yields, with firms potentially less likely to invest due to tax hikes.

Asset-Class Implications: Fixed Income

Developed Markets

Central banks have used the policy space granted by lower price pressures to cut rates, particularly in Asia. And *negative* rates have become prevalent in Europe. Recent cuts have been a mix of easing (making savings unattractive, lowering yields further out on the curve) and tactical maneuvers in the so-called "currency wars."

Monetary policy divergence—the first macro theme in our Q2 Quarterly Outlook—is still front and center. The Federal Reserve is on track to begin raising rates in the second half of the year, but the risk that its first move will be delayed beyond September has increased. The U.S. 10-year should head to 2.5% by end-2015.

UK yields will likely rise, but lag their U.S. counterparts, especially at the short end of the curve, as we expect the Bank of England to let the Federal Reserve lead the hiking cycle.

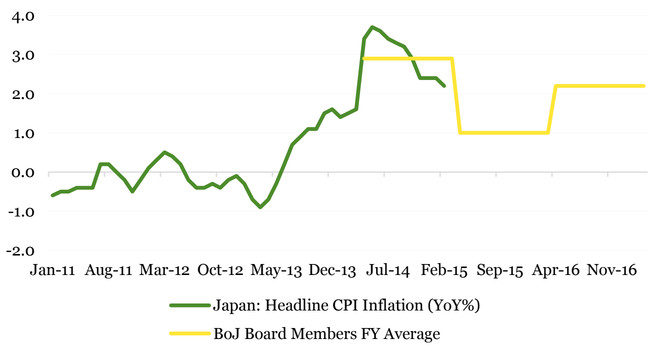
Quantitative easing from the European Central Bank and "quantitative and qualitative easing" from the Bank of Japan (of which we expect more later this year) will keep German bund and Japanese government bond yields very low across the curve.

Emerging Markets

Emerging-market local debt curves look well prepared for a gradual rate "normalization" from the Federal Reserve. Fiscal adjustment in Brazil should support the long end of the curve. Meanwhile, Ukrainian and Venezuelan U.S. dollar bond spreads already price in "credit events," although we think Venezuela may well manage to cover its 2015 payments, which are concentrated in Q4.

And we think downgrades from the major credit rating agencies could lie ahead for Brazil, and oil-exposed Malaysia and Thailand, while Hungary could receive an upgrade. We see value in Hungarian local debt given our view of the easing to come.

Figure 4: Bank of Japan Inflation Expectations Are Subdued, Implying More Easing (%)



Source: Haver Analytics

Asset-Class Implications: Equities

Developed Markets

We are neutral on global equities and expect volatility spikes. In the U.S., S&P 500 earnings expectations have been marked down sharply; large caps are exposed to weaker currencies and oil majors are over-represented. But low inflation should continue to boost consumer sectors, utilities, non-energy industrials and transport stocks, which have lifted the S&P to new highs.

In Europe, the eurozone's minor rebound should continue to help stock-market performance, especially in Germany and Spain. Russia is in recession, but its beaten-up equities make a compelling investment case.

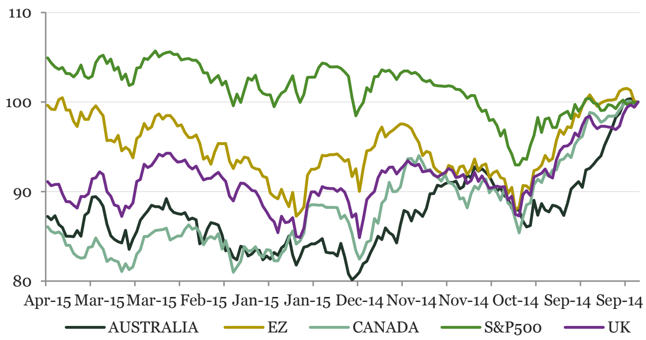
In the UK, notwithstanding decent economic activity and a cyclical rebound in the eurozone, equity indexes have underperformed their developed-market peers (not including the U.S.) this year, in both local currency and dollar terms (by 5% and 4.7%, respectively), amid oil-price concerns, election uncertainty and a stronger pound. This negative dynamic remains intact.

We thus remain cautious on the UK given the index's high exposure to commodities and financials and structural tilt toward defensive rather than cyclical sectors. Indeed, 82% of the earnings of the non-financial index come from commodities and defensive sectors (staples, health care), while 60% of revenue is generated overseas. Both factors help explain the tepid performance, despite the relatively strong domestic growth. In addition, election-related uncertainty is weighing on sentiment and increasing business investment risk.

Emerging Markets

Emerging-market equities look fairly valued versus developed-market equities. We prefer countries exposed to developed-market demand, with attractive valuations. We expect solid performance in South Korea, Russia, Poland and Mexico, with Thailand and South Africa lagging.

Figure 5: UK Equity Market Performing in Line With Other Commodity-Intensive DMs



Source: Datastream

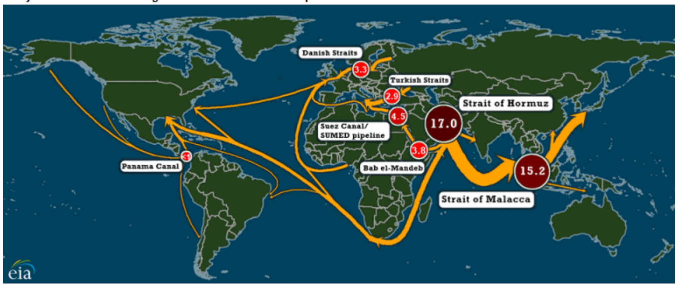
Asset-Class Implications: Commodities

Oil

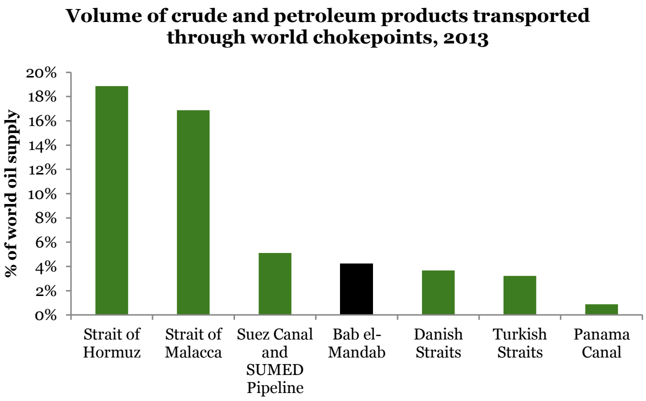
After falling by almost 60% between the peak in June 2014 to the trough in March 2015, WTI has gained close to 16% in the past month. Lower oil inventory builds in the US have helped remove some of the excessive negative sentiment toward the commodity.

Furthermore, Saudi Arabia's attacks on Yemen have raised the threat of oil getting stuck at one of the major transit chokepoints. 4% of the world's oil supply transits through the Bab el-Mandab located near Yemen, threatening tighter global supply if conditions worsen.

Daily transit volumes through world maritime oil chokepoints



Source: EIA, Estimates are in million barrels per day, 2013



Source: EIA, ETF Securities

Highlighting just how sentiment has changed, net speculative longs in the WTI futures market have risen by 54% in the past month. With Brent gaining a more modest 10% in the past month, the Brent-WTI spread has narrowed to around US$5/bbl, a level comparable to the average in 2014, after a period in which the two oil benchmarks were more than US$10/bbl apart.

Over the short-term we believe there will be a pull-back in both oil benchmarks because global supply has not yet tightened. In fact, OPEC output surged by 810,000 barrels per day in March. Storage capacity constraints in the US could also see more of the oil produced in the US hit the market which would weigh on price. All eyes will remain on the OPEC cartel for cues of production cuts coming at its June meeting.

Asset-Class Implications: Foreign Exchange

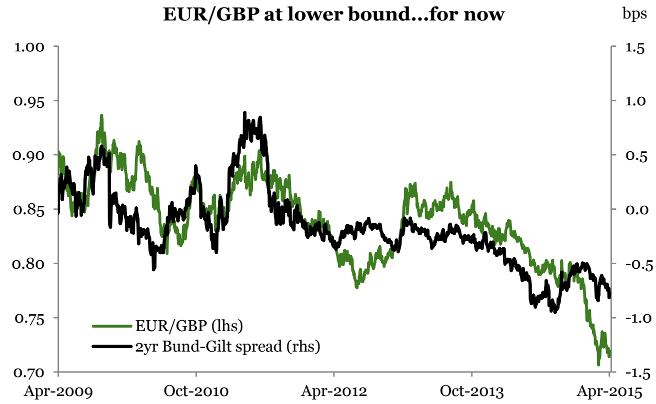
Uncertainty in the run-up to the UK General Election is the key focus for Sterling in the coming weeks. Two things are critical for the UK election result:

The first being whether or not there is a decisive result. Odds indicate little chance of either the Conservative or Labour party winning the 326 seats required for a majority. Uncertainty is no friend of the British Pound with rising volatility historically leading to depreciation. Hence, the further coalition negotiations stretch on, the weaker the GBP could become.

The second hinges on the policy stance of the final winner. There is a substantial difference between the fiscal policy stance of the major parties. The softer the stance on fiscal austerity, the less accommodative that the Bank of England must be to offset the impact of spending reductions. Fiscal loosening could lead to GBP consolidation in the near term. However, if it appears that the victor is spending recklessly and that debt to GDP ratios are widening as a result, then there is greater potential for a decline in GBP as risk premiums rise.

The other key policy consideration is the stance on Britain's EU membership. GBP will suffer and bond yields will likely rise as the chance of a British exit from the EU increases, as it will be bad for business and in turn UK growth.

The run-up and the ensuing coalition discussions surrounding the 2010 election saw GBP/USD decline by over 6%. With a similarly uncertain outcome appearing the most likely occurrence, there is a significant downside risk for GBP/USD.



Source: Bloomberg, ETF Securities

The GBP rally also looks stretched on a valuation basis against the Euro. The decline in EUR/GBP has now moved out of line with underlying rate differentials. GBP has strengthened significantly more against the Euro than would be expected looking at the difference between UK Gilt and German Bund yields. As a result, we expect that the Euro will strengthen, as election uncertainty begins to become more of a concern for businesses.

Important Information

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