



NOVEMBER 15, 2022

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# European Equity market recovery?

## Key Takeaways

- Positive technical indicators and seasonality provide a tailwind for European equities in the near-term.
- But the jury is still out as to whether the recent rally in European equities marks the beginning of a sustained recovery.
- Watch industry breadth and investor demand for further confirmation.

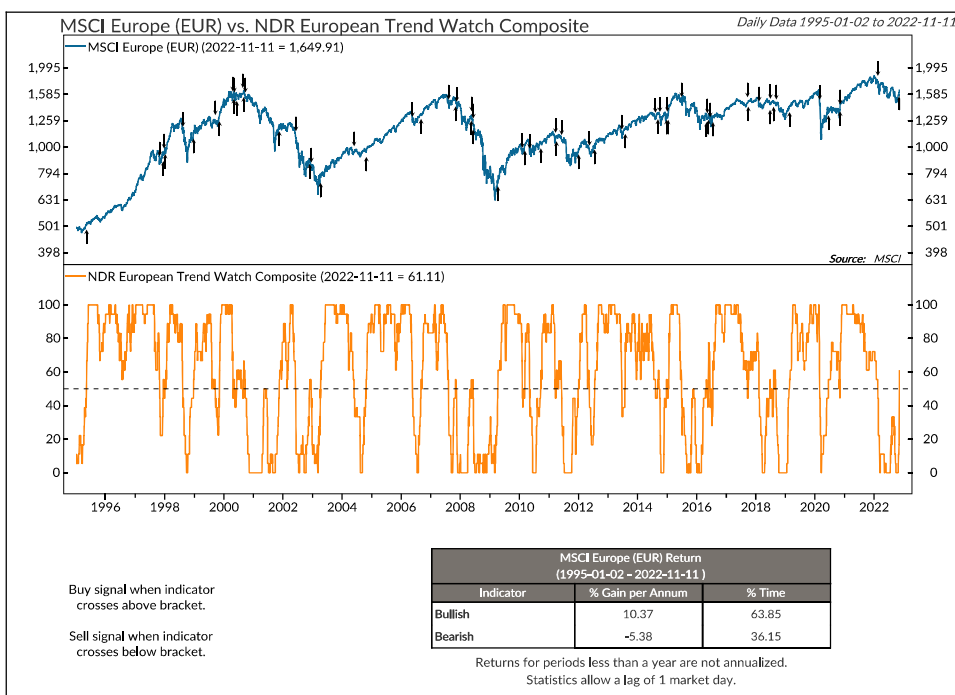
## Conflicting indicators

At NDR we approach investment with an objective data driven process. We update our views when the weight of the evidence derived from many different data sources changes, aiming to protect ourselves from becoming anchored to one narrative or dependent on one indicator.

When indicators are broadly aligned, they help us to make calls on the direction of markets with conviction, but when we receive conflicting signals from different indicators, we adjust our conviction level accordingly.

**The rally in European equities, bullish broad market participation and outperformance of higher beta equity strategies is now providing a**

## Trend watch turns bullish



EUR.TRW.RPT



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**counterbalance to analysis of leading economic indicators and the earnings cycle, which suggests a more cautious outlook.**

Last [month](#) we pointed out that the European survey sentiment had become extremely pessimistic and economic data was surprising to the upside. This together with the favourable seasonality factor provided potential for a rally into year end and early next year.

## Script change

If the overriding narrative driving global

equities up until October had been one of higher inflation, higher interest rates, and higher yields restricting the economy and earnings, this dramatically reversed last week as U.S. inflation expectations came in lower than expected.

There was also another narrative driving European markets, that of a Chinese reopening, confirmed by the official announcement from China on Friday of an easing in quarantine restrictions.

Add to this the optics of less antagonistic relations between the West and China – German Chancellor Scholtz meeting Xi Jinping at the start of November, and US president Joe Biden’s meeting with Xi Jinping before the G20 summit in Bali – and those European stocks with exposure to China have done particularly well. For example, [German](#), Consumer [Discretionary](#) and [Metals](#) and Mining equities have all outperformed so far this month.

However, one data point or a one-day price move doesn’t change our market view on its own. Indeed, while the 10-year German bond [yield](#) fell 17 bps to 2% on Thursday, the day the U.S. inflation data was announced, this almost entirely reversed on Friday rising 16 bps. And 10-year euro inflation [swaps](#) remained virtually unmoved all last week at around 2.7%, suggesting not much has changed as to the inflation and yield outlook for the eurozone.

On the one hand then, we need to see the recent recovery in equities in context of a reversal from extreme pessimism against the backdrop of an ECB still in tightening mode, a deteriorating economic outlook, and the potential for earnings downgrades, still posing downside risk.

But on the other, be alert to the possibility that technical developments are leading an inflexion point in the economic and earnings cycle. The key then is to distinguish between whether the recent rally represents a short-term relief rally, or something more sustained.

Below we review our key European technical indicators to assess the technical case for European equities.

## The trend is your friend

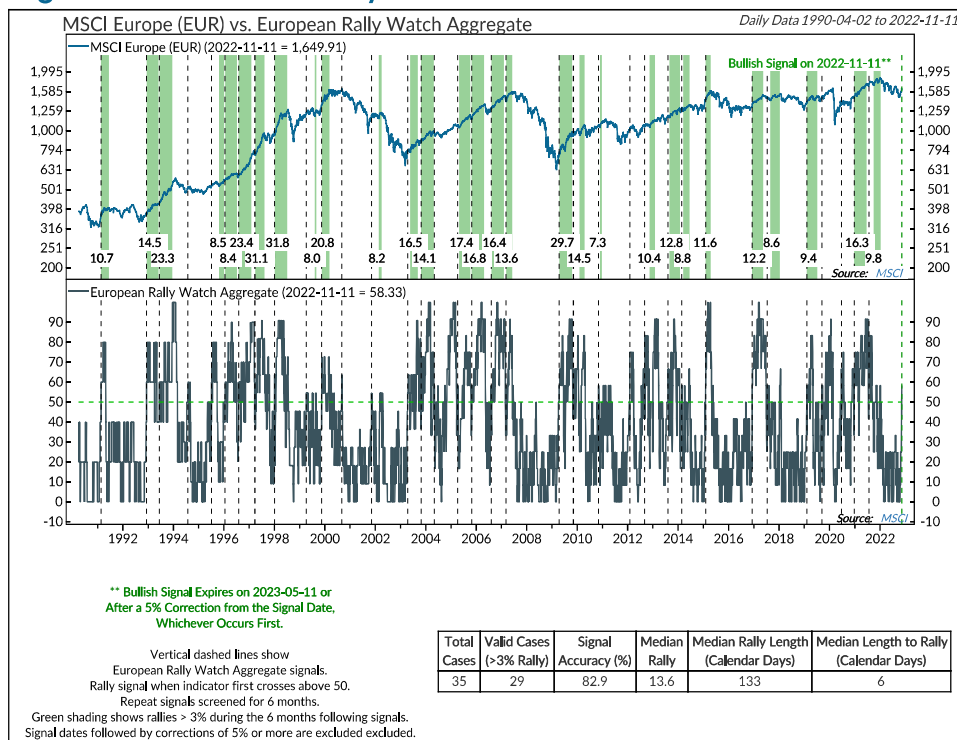
From a technical perspective our European trend [watch](#) composite provides a reading

of the overall health of the European market. The composite is comprised of nine short-intermediate- and long-term indicators and became bearish in mid-February when it fell below 50.

But last week the composite broke above 50 indicating a more bullish outlook for European equities, driven higher by a positive short-term trend, accelerating momentum, and rising short-term averages (chart on page 1).

We find a similar story from our rally [watch](#) indicators, which look at short-intermediate- and long-term breadth, in addition to risk indicators and European equity flows. Last week, **the number of indicators signalling a rally rose above 50%, a level historically followed by a sustained rally in European equities** (chart below).

## Signs of a sustained rally



EUR\_RYW.RPT\_RYWA



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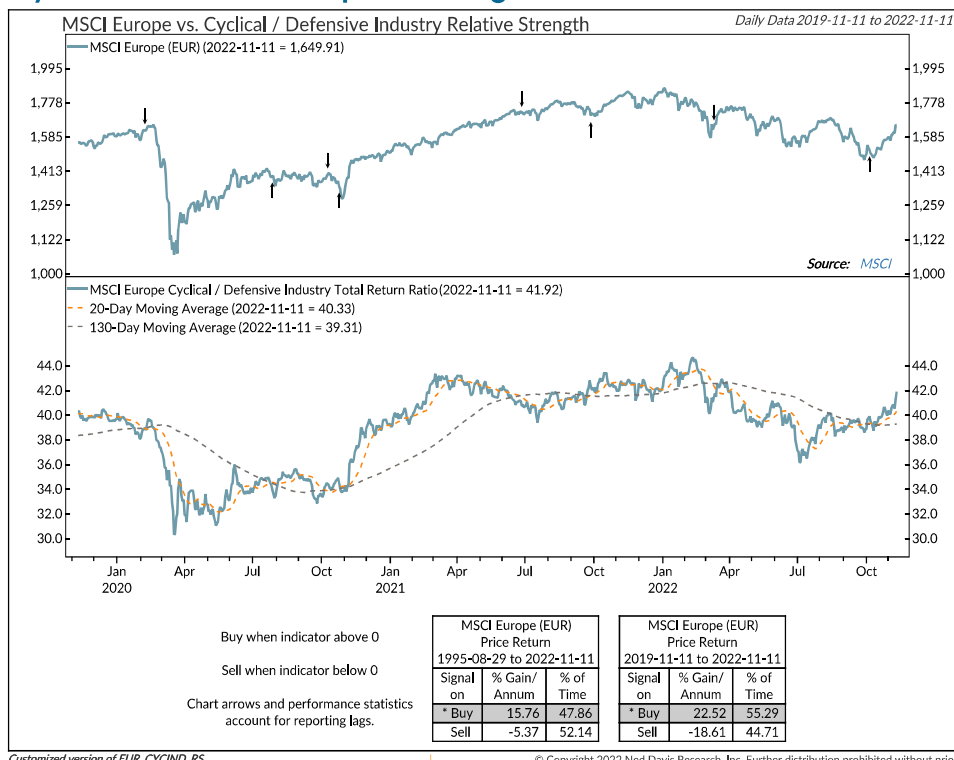
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Sectors and styles also indicate a broad reversal from risk-off to risk-on strategies. One indicator which we highlighted in [October](#) and last week was the cyclical industry relative strength line.

The intermediate trend has historically provided a good gauge as when to dial up and dial down equity exposure, and is currently bullish for European equities (chart right). It is also an indicator which we use to gauge whether to tilt toward cyclical or defensive sectors.

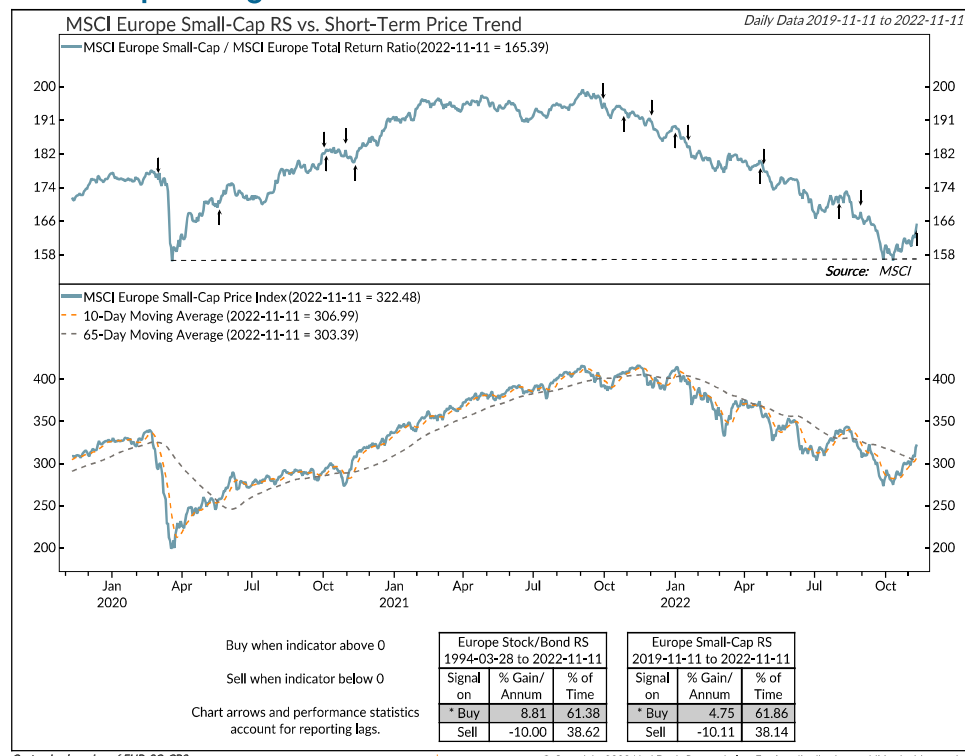
Our macro sector strategy [portfolio](#) tilted toward cyclical sectors at the end of last month due to bullish cyclical industry relative [strength](#) and positive euro economic [surprises](#).

## Cyclical industries outperforming



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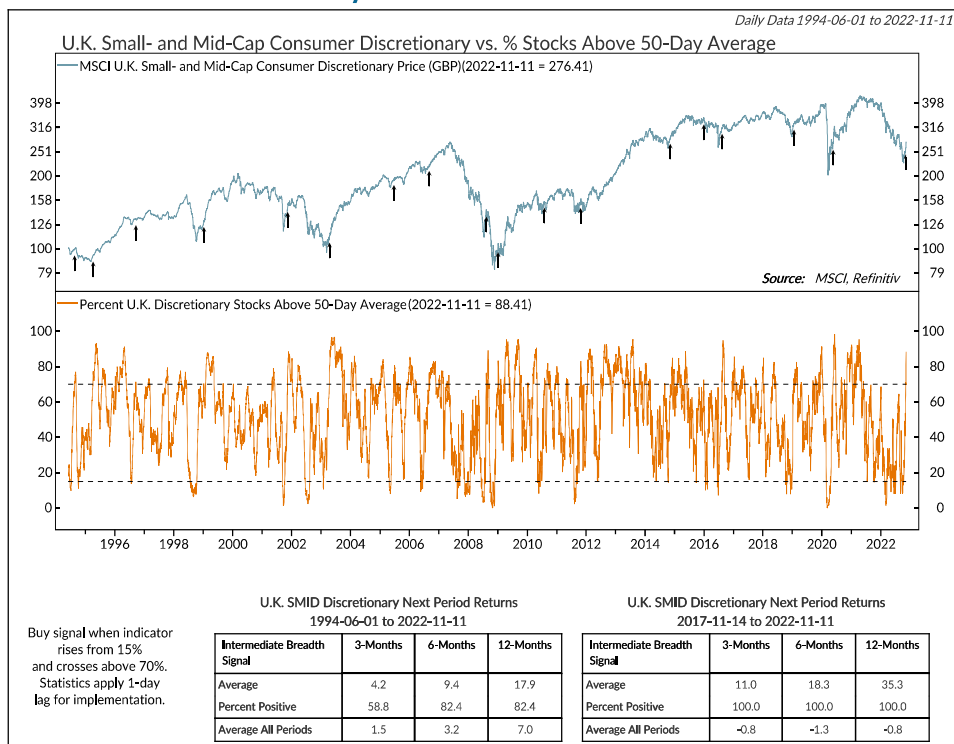
## Small-cap resurgence



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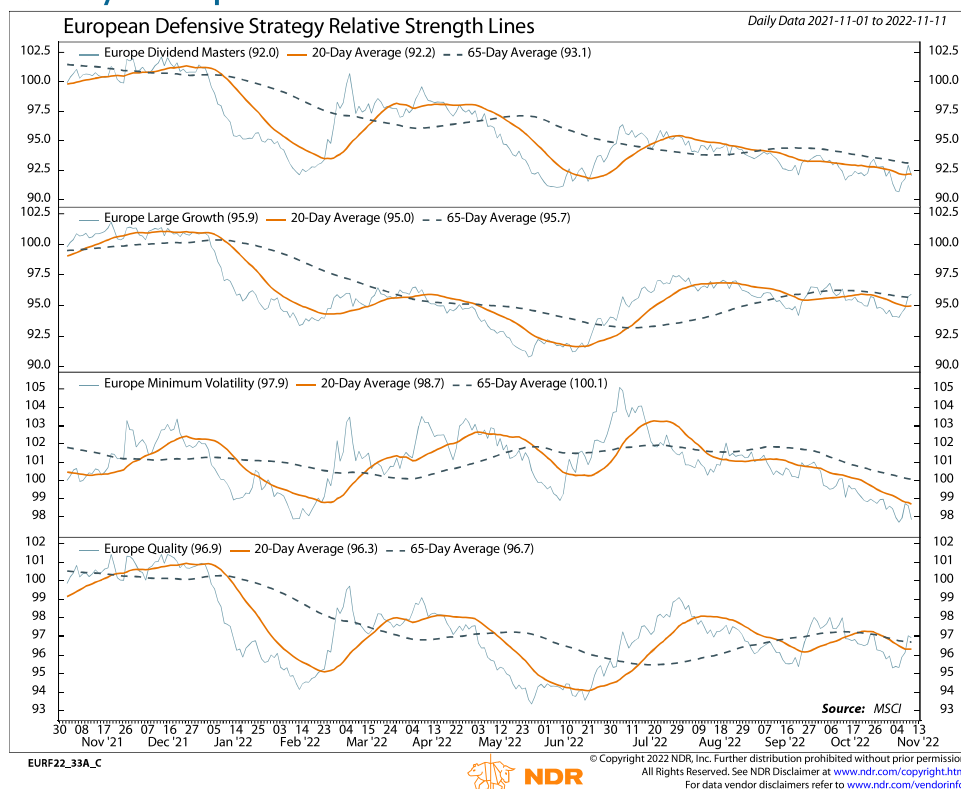
Other higher beta styles have also shown a resurgence. Relative performance of European Small-Caps has rebounded since testing the support at the March 2020 bottom at the end of September, then again on October 12. Both retests this year coming within basis points of the 2020 lows. Since then, the short-term trend has turned positive (chart left).

## U.K. SMID Discretionary rebound



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## Quality underperforms



Conversely in Europe, defensive quality stocks have been underperforming (chart left).

## Other bullish signals

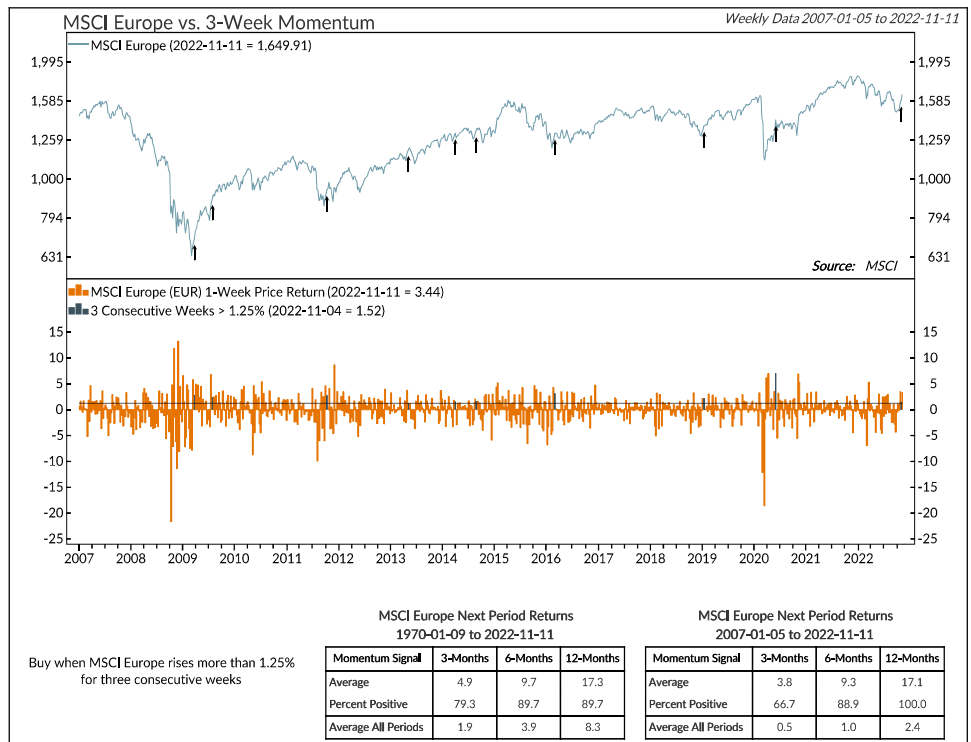
With our trend watch and rally watch indicators becoming bullish for the first time since early this year, we need to ask the question whether this represents the start of a sustained recovery in European equities.

The recent rally in equities is different from the previous two rallies this year. In the previous rallies, short-term indicators had been bullish but had failed to be [verified](#) by intermediate breadth indicators.

But **this time, we have seen intermediate breadth thrust indicators turn positive.**

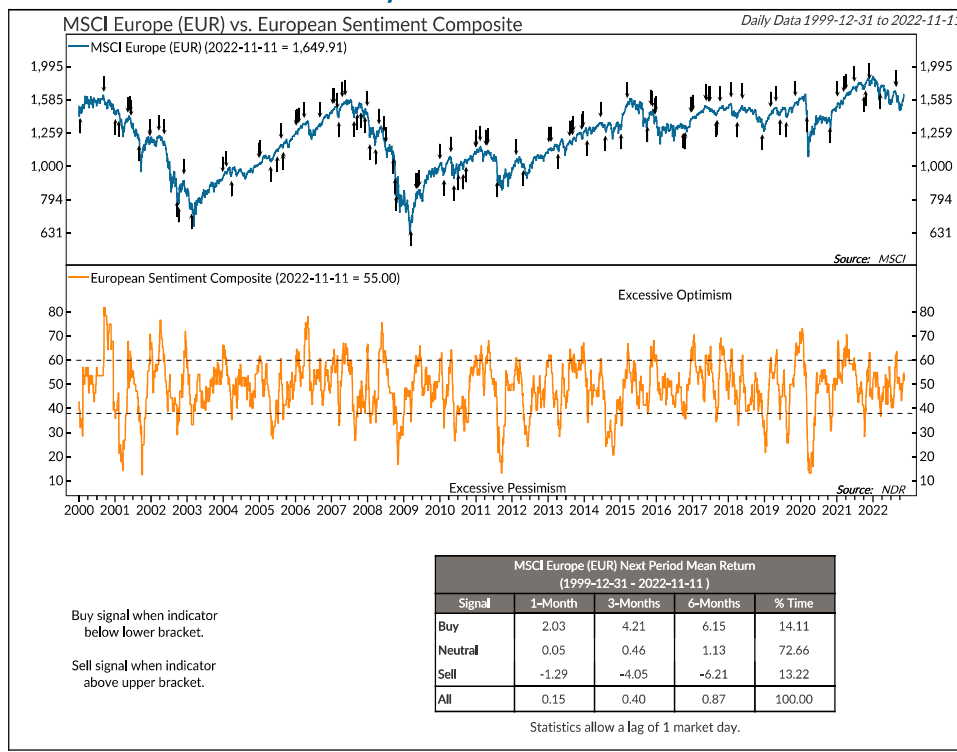
Most notably, the percent of stocks above their 50-day averages increased [above 85%](#) for the first time since May 2020, **providing weight to the case for a more sustained rally.**

## Three-week momentum



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## Sentiment not excessive yet



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Another bullish and infrequent signal triggered early in November. That is, **for the first time since May 2020, European equities posted three positive weekly returns of over 1.25%** (chart above).

## Sentiment

Further adding to the bullish case, at least in the short-term, is that even after a 12% rally in European equities from the September low, **sentiment as measured by our European sentiment composite still has not become excessive** (chart left).

A rise in the sentiment composite above 60 would signal excessive optimism and decreased likelihood of further near-term upside.



## Yet to confirm

Certainly, **the technical case for European equities has strengthened since October, indicators are now more bullish than bearish**. However, there are still some indicators which if not bearish, suggest a degree of ambiguity.

## Volatility adjusted rally

Firstly, we noted in [May](#) that a 10% rally tends to be positive for equities. Indeed, it is one indicator that we include in our trend watch composite and which produced a bullish signal last [week](#).

But there have been historical exceptions. Most notably, during the secular bear markets of the 1970's and 2000's there were several 10% rallies which turned out to be short-term bear market rallies. Prior to the signal last week, we had seen a bullish signal in late [March](#) only for the

market to fall again.

To some degree, we can avoid bear market rallies, by adjusting for a volatility factor. For example, the 10% rally in equities in October 2008 was less meaningful when the average daily price move was 4%, than other 10% rallies when daily price moves were less than 1%.

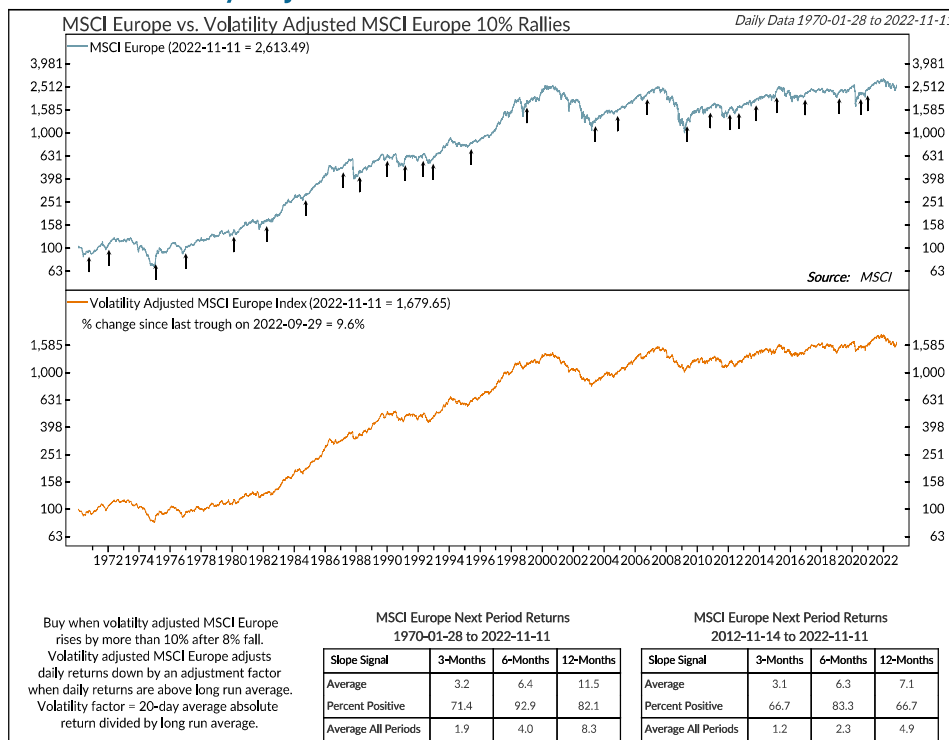
In the chart below we create a volatility adjusted index based on daily returns adjusted by a factor of the one-month average of absolute daily returns over the long-run average, when volatility is above average.

By applying this volatility adjustment factor, the bullish signals for the 10% bear-market rallies in the secular bear markets would have been avoided. The trade-off being that the bullish signals following the

1974, 2003 and 2009 bear market bottoms would have missed some of the early upside in the equity market recoveries that followed.

**Today, our volatility adjusted index, has not reached the 10% threshold to produce a bullish signal, although is very close at 9.6% above the recent low.**

## Watch volatility adjusted index



EUR\_SLPI



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an SMA or launch  
an ETF?

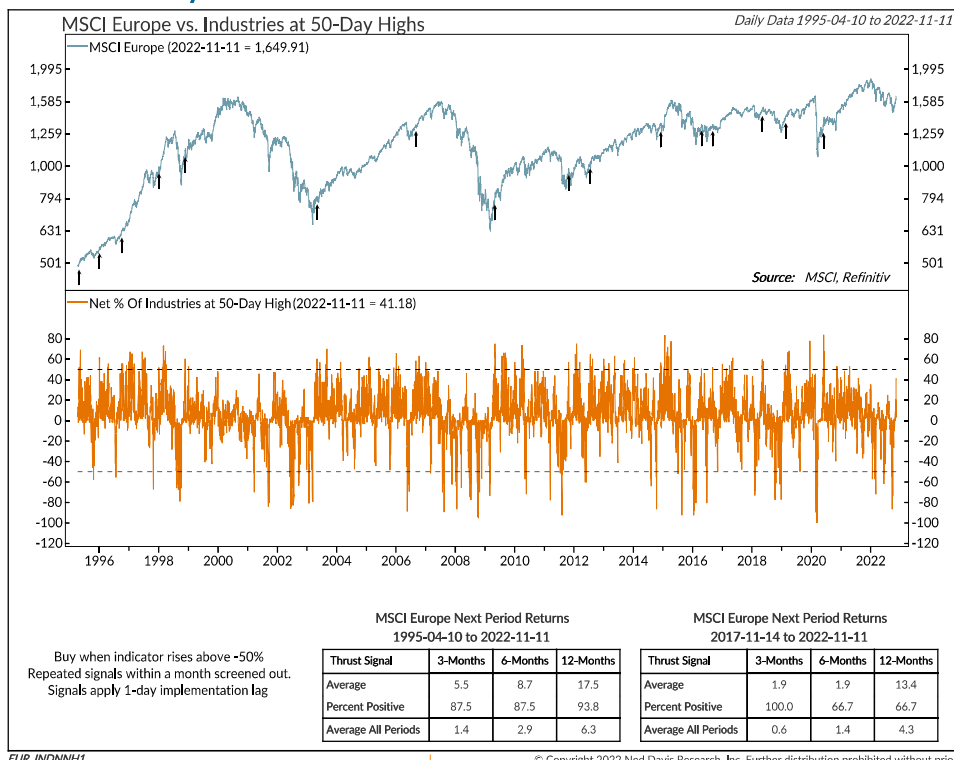
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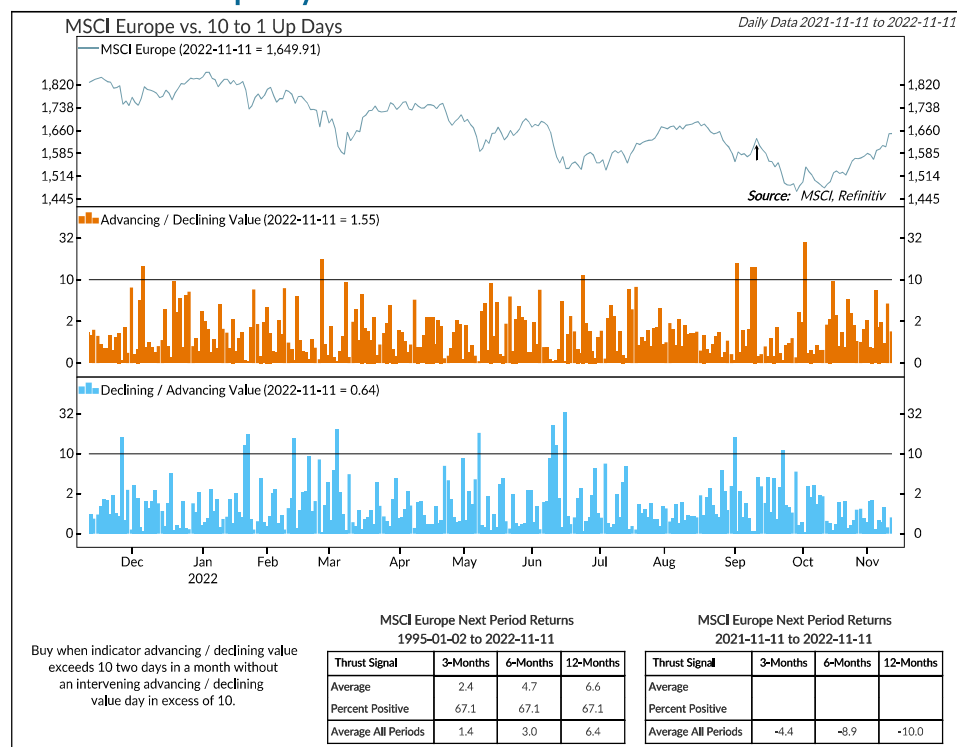
## And industry breadth

**Second, the net percent of industries reaching new highs has not risen above 50%, a level which followed all previous market bottoms (chart right).**



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## Watch 10 to 1 up days



Customized version of EUR\_10TO1A



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Third, **we haven't seen two 10 to 1 up days within a month since the market low in September.** This again was an indicator which produced a bullish signal following all previous market bottoms (chart left)..

Finally, the percentage of equity demand and supply value over the last six months remains ambiguous (chart below).

Historically, this indicator has helped to identify sustained rallies and drawdowns in equities. When equity demand rises above or falls below supply, this is bullish or bearish for European equities.

In the last week, **supply and demand value has been hovering around 50%,**

**suggesting bulls and bears are equally balanced.**

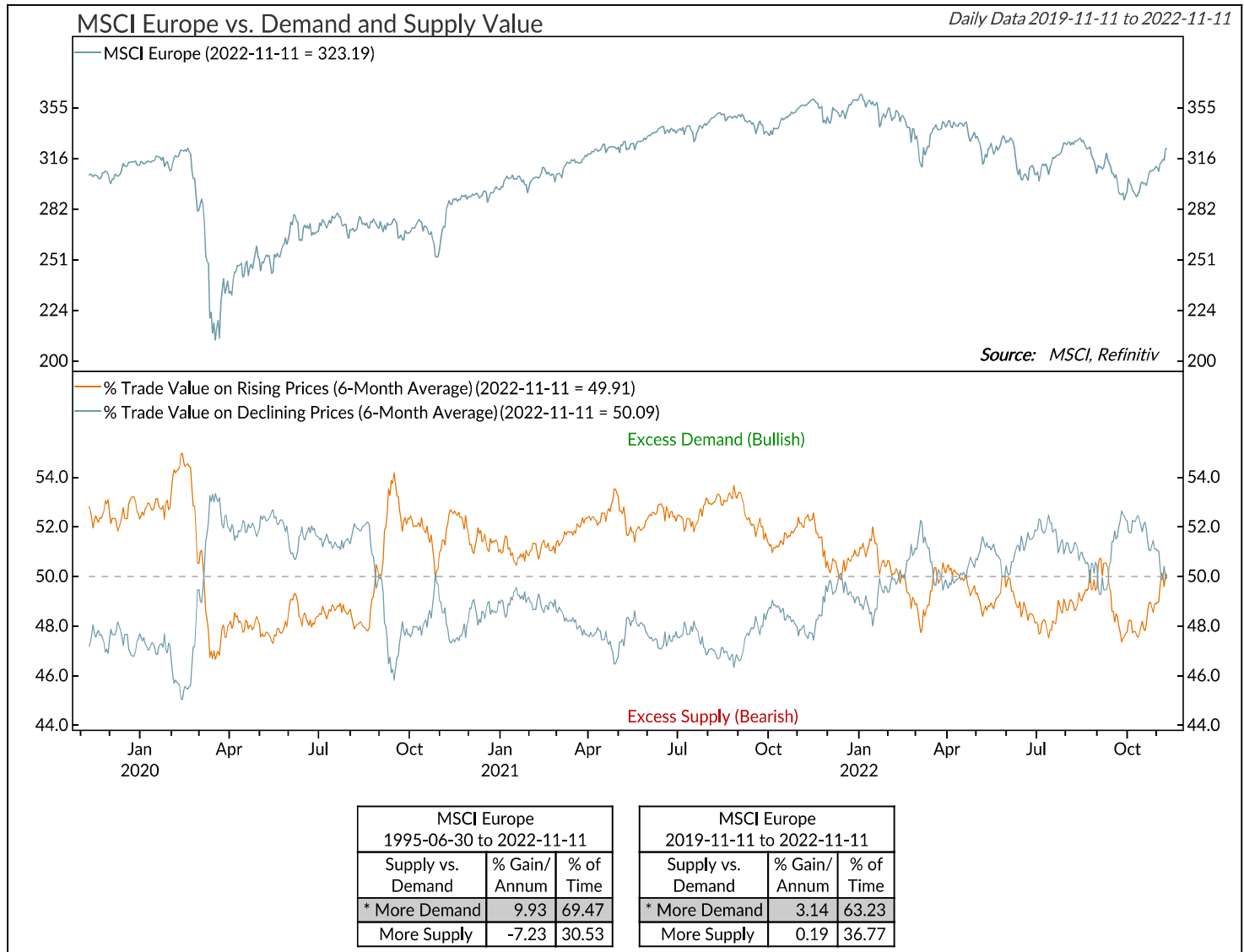
## The bottom line

The bottom line is that following excessively bearish survey sentiment at the end of September, we have seen European equities rally strongly. Technical indicators combined with the seasonality factor suggest that we could see equities rally further into the year-end and early next year.

But given our historical analysis of market downturns around [recessions](#), stock market [bottoms](#), and of the earnings [cycle](#), we still see downside risk.

**Over the short-term we recommend a neutral allocation to European equities but maintain an element of caution over the intermediate term.**

## And supply and demand



Customized version of EUR\_SPLDMD1



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EQUITIES

## NDR HOUSE VIEWS (Updated November 10, 2022)

For global asset allocation, NDR recommends underweight allocation to stocks, overweight allocation to cash and marketweight allocation to bonds. We are underweight stocks in response to new lows and bearish model readings.

### Equity Allocation

**U.S.** | We have a modest underweight to stocks in our asset allocation recommendation but are neutral on an absolute basis. The hawkish Fed has overwhelmed the positive tape development in the summer, but sentiment is extremely pessimistic. We favor small-caps over large-caps and Value over Growth.

**INTERNATIONAL** | We are overweight Europe ex. U.K. and marketweight on all other regions.

### Macro

**ECONOMY** | The global economy is in a sustained slowdown due to waning monetary and fiscal support, stubbornly high inflation, and rising geopolitical risk. While the slowdown remains moderate, the risk of severe recession increases in 2023. Global inflation pressures are easing but will remain historically elevated in the foreseeable future.

**FIXED INCOME** | We reduced our bond exposure to 95% of benchmark duration and expect the yield curve to flatten. We are overweight Treasuries, MBS, and CMBS and underweight high yield. We are marketweight everything else.

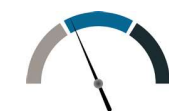
**GOLD** | Downtrend intact with relatively restrictive central bank policies. We are bearish.

**DOLLAR** | We are neutral while keeping an eye on our dollar composite readings.

### Economic Summary

November 14, 2022

Near term activity: ● Accelerating ● Neutral ● Decelerating



Global Economy  
(2.9%)



U.S. Economy  
(1.5%-2.0%)



U.S. Inflation  
(4.0%-4.5%)

Economic gauges reflect changes in near-term economic activity. Numbers in parenthesis refer to NDR 2022 forecasts.

### Global Asset Allocation

● Overweight ● Marketweight ● Underweight

- Cash (15%)
- Bonds (35%)
- Stocks (50%)

Benchmark: Stocks (55%), Bonds (35%), Cash (10%)

#### Equities — Regional Relative Allocation

- Europe ex. U.K. (14%)
- U.S. (61%) | Emerging Markets (11%) | Japan (5%) | U.K. (4%) | Pacific ex. Japan (2%) | Canada (3%)
- 

Benchmark – U.S. (61.5%), Europe ex. U.K. (12%), Emerging Markets (11.2%), Japan (5.5%), U.K. (3.8%), Pacific ex. Japan (3%), Canada (3.1%)

#### Global Bond Allocation

- Japan (19%)
- U.S. (55%) | Europe (25%)
- U.K. (1%)

Benchmark: U.S. (57%), Europe (25%), Japan (15%), U.K. (4%)

### U.S. Allocation

- Cash (15%) | Small-Cap | Value
- Bonds (35%) | Mid-Cap
- Stocks (50%) | Large-Cap | Growth

Benchmark: Stocks (55%), Bonds (35%), Cash (10%)

#### Sectors

- Health Care (17%) | Energy (5%) | Materials (4%)
- Consumer Discretionary (8%)

Benchmark: Technology (27.4%), Health Care (13.8%), Financials (10.7%), Communication Services (9.3%), Consumer Discretionary (12.1%), Consumer Staples (7.0%), Industrials (7.9%), Energy (4.0%), Utilities (2.7%), Real Estate (2.7%), Materials (2.5%)

#### U.S. Bonds — 95% of Benchmark Duration

## NED DAVIS RESEARCH

NDRsales@ndr.com  
www.ndr.com  
(800) 241-0621

### NOKOMIS

2520 North Tamiami Trail  
Nokomis, FL 34275  
(941) 412-2300

### NEW YORK

1120 Avenue of the Americas  
6<sup>th</sup> Floor  
New York, NY 10036  
(646) 810-7270

### MONTREAL

1001 de Maisonneuve West  
Suite 1510  
Montreal, QC, Canada H3A 1X8  
+1 800 724 2942, +1 514 499 9550

### LONDON

8 Bouverie Street  
Temple, London  
EC4Y 8AX  
+44 (0) 20 7779-8682

### HONG KONG

12/F, V-Point, 18 Tang Lung Street,  
Causeway Bay  
Hong Kong  
+852 3416 6676

### AUSTRALIA

19/1 O'Connell Street  
Sydney, Australia  
+61282491867

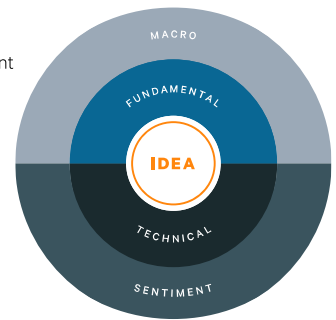


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