

Three steps forward, two steps back – but Eurozone risks are receding

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Key points

- > The risk of a break-up in the Eurozone peaked in May, and has been declining since as European leaders have opted for “more Europe” and the European Central Bank (ECB) has committed to do whatever it takes to ensure the euro is irreversible.
- > The Eurozone debt crisis is a long way from over, and it will be a long hard slog for Greece, Portugal, Ireland, Spain and Italy but I suspect that we may have passed the worst of the financial panic associated with it. With the exception of Greece, which may yet leave one day, ultimately I see the Eurozone hanging together and becoming stronger, not weaker.
- > With economic rationalist reforms being imposed across Europe, depressed European shares and assets are likely to be great value on a ten-year horizon.

Introduction

Back in May it seemed that the risk of a broad-based break-up of the Eurozone was high. Greece looked like it was electing a radical left wing anti-bailout party into government, driving fears it was heading to a messy exit from the euro. This then further intensified fears that other countries would follow, ultimately taking out Spain and Italy. The fear of a euro exit was seeing Spanish and Italian bond yields surge anew and their citizens withdrawing their euro-denominated deposits from their banks. And it was well known that the Eurozone bailout funds were not big enough to bail out both Spain and Italy and the ECB was back on the sidelines. Since then the risk of a break-up triggering a financial crisis and global recession has receded significantly.

On the path to irreversibility

To be sure the euro was flawed from the start. Having a monetary union without a fiscal union (i.e. common budgetary policy) is not sustainable and differences in competitiveness, work ethics and savings are immense across Europe.

But at every flare-up of the crisis since 2010 Europe has been faced with a choice: either settle for ‘less Europe’ and an inevitable break-up or push down the path of ‘more Europe’. And Eurozone leaders have consistently chosen the latter. This is evidenced by the advent of various bailout funds, the fiscal convergence starting to occur via the fiscal compact (the ultimate end game of which may be the issuance of common eurobonds several years ahead), the spreading of rational economic reforms into peripheral countries, moves towards centralised bank supervision, an extraordinary degree of patience shown towards Greece and the recognition by the ECB that preserving the euro is within its mandate.

At its heart the euro is the culmination of a grand political vision of a more united Europe that has been underway for more than sixty years, which European politicians do not want to give up on. So given all the political capital tied up in the euro they will continue to find a way to make the economics work. Even if progress looks less urgent than those outside Europe would like to see and seems

to trace out a ‘three steps forward, no steps back’ pattern.

Several things have happened to pull Europe back from the brink since May. Firstly, the Greeks supported parties (namely New Democracy and Pasok) that were able to form a coalition government willing to work with the rest of Europe.

Secondly, Eurozone leaders followed their commitment to the June G20 leaders summit to “take all necessary measures” to safeguard the Eurozone with a leaders summit at which they agreed to move to the centralised supervision of banks and more flexible use of bailout funds enabling them to recapitalise banks directly. Again ‘more Europe’, not less.

Thirdly and most importantly, in late July ECB president Mario Draghi put the ECB and Europe on the brink of a major game changer. Draghi said “the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough.” He specifically tied this to high yields on some European bonds, which reflected fears of a Eurozone break-up and indicated that they were hampering the transmission of easy monetary policy across Europe. What’s more he quickly backed this up with plans to intervene in bond markets in troubled countries in concert with the Eurozone bailout funds. So at last the institution with the power to settle the Eurozone debt crisis has indicated that it will aggressively swing into action. What’s more the plan has the support of the German Government, and while the Bundesbank is opposed it looks to be isolated.

Super Mario

The key aspects of the ECB’s bond-buying plan (known as Outright Monetary Transactions) are as follows:

- > Firstly, troubled countries like Spain and/or Italy will have to apply for assistance to the Eurozone bailout funds (most likely the soon to start European Stability Mechanism, or ESM) and sign up to key economic reforms. This gives the ECB comfort that it is not providing money for nothing.
- > Secondly, once this occurs the bailout fund will provide assistance in the country’s primary bond market, i.e. when bonds are first issued, the ECB will then act in concert to buy the country’s bonds in the secondary market in order to reduce borrowing costs to more sustainable levels.
- > Thirdly, the ECB’s bond buying will be unlimited which has the effect of leveraging up the limited firepower of the ESM (with around €400 billion left), removing concerns that the bailout funds lack sufficient resources and removing the need for them to become a bank.
- > Also, while the ECB will focus on buying short-term bonds (out to three-year maturities) as it’s consistent with the realm of monetary policy and provide added incentives for countries to reform, portfolio effects will see the impact transmitted out to longer-dated bonds.
- > Finally, the ECB has indicated it will not rank senior to other investors, encouraging them to stay invested.

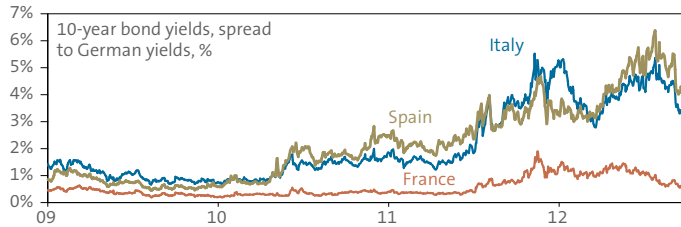
While the ECB is often viewed sceptically by non-Europeans, it would be wrong to underestimate the ECB’s commitment to preserving the euro, with Draghi saying “it’s pointless to bet against the euro... because it will stay and it’s going to be irreversible”. Draghi has already proven he is very different to Trichet, his predecessor at the ECB. In particular he has a track record of delivering despite initial scepticism as was seen last year with the provision of cheap funding for banks.

The important point is that Europe finally seems to have a credible and well-articulated plan to bring bond yields back under control in troubled countries. The ECB's actions once they commence should have the effect of repairing the transmission of easy money across Europe which should take pressure off the Spanish and Italian economies.

Positive reaction

The reaction to this has been positive. Eurozone shares are up more than 20% from their June low. The euro is up 8% from its July low against the US dollar. Spanish and Italian bond yields have fallen from their highs of several months ago.

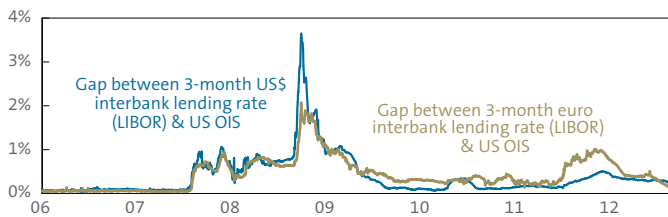
Spanish and Italian bond yields have fallen, but have more to go



Source: Bloomberg, AMP Capital

And interbank lending spreads have collapsed in Europe suggesting little problem with banks being able to fund themselves, thanks to the earlier provision of cheap three-year funding by the ECB, again highlighting a key difference with the global financial crisis where interbank lending spreads exploded and late last year where the same looked to be starting occur.

Interbank lending spreads have collapsed in Europe



Source: Bloomberg, AMP Capital

Problems remain immense, but...

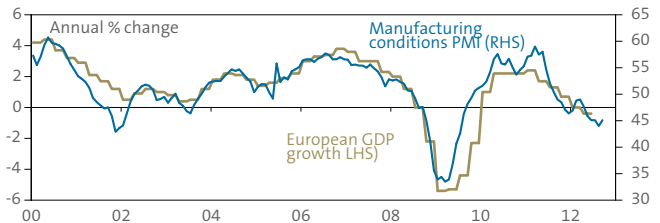
To be sure problems remain immense in Europe. Progress will likely remain gradual. The move towards centralised ECB supervision of banks looks like it will take longer than year-end to implement. Uncertainty remains as to whether and when Spain will seek assistance. A decision has yet to be made regarding ongoing assistance for Greece. And Europe still has to deal with a recession. Looking at Spain, Greece and the recession in turn:

- > Quite clearly Spain would rather not have to sign up to a bailout package – given the blow to national pride and the fear that it will be pushed down the same path as Greece. Rather it seems to be hoping the announcement of more structural reforms and the threat of ECB action will be enough to calm markets. This is possible but not probable. Given the depth of Spain's recession and the resultant pressure on its budget, the more likely outcome is that it will have to seek assistance. The likelihood is that we may have to go through another bout of market worries and upwards pressure in yields to force it

to seek help. However, whether Spain does it proactively or reactively the end result is likely to be the same in triggering ECB bond buying.

- > Greece remains a problem not least because the move to reduce its public debt to gross domestic product (GDP) ratio to 120% by 2020 as a result of private investor write-downs announced earlier this year is unlikely to be enough (even if it is achieved) to put Greece on to a fiscal sustainable path. It now looks like the latest troika (the International Monetary Fund, the ECB and the European Commission) review won't be released until mid-October. However, it does look as if Greece will be given more time to meet its commitments (as Portugal recently was) with Germany and European Union policy makers generally looking like they are unlikely to want to take the risks a Greek exit would pose for the rest of the Eurozone. At least not now.
- > Finally, while the ECB is on track to deliver on its commitment to keep the euro together and to ensure the benefits of its easy money are more equally spread across the Eurozone, it won't put a quick end to the recession. But it should help put an end to the panic in various bond markets thus allowing the benefit of low interest rates to flow through and preventing the recession this year from turning into a deep recession as was seen in 2008-09 and allowing a return to modest growth next year. The ECB may still have to provide more quantitative easing though.

Eurozone business indicators point to a 'mild' recession



Source: Bloomberg, AMP Capital

...the worst of the panic may well be over

Numerous problems remain, but our assessment is that with an immense political commitment to the euro being backed up by a progressive move to 'more Europe' and not less, and importantly the ECB with its potentially unlimited firepower now starting to swing into action, we may have seen the worst of the panic associated with the Eurozone debt crisis. With the exception of Greece, which may yet leave one day, I see the Eurozone hanging together. With economic rationalist reforms being imposed across troubled Europe, depressed European shares (e.g. German shares are trading on a forward price-to-earnings ratio of 9.8 times) and assets generally are likely to prove to be great value on a ten-year horizon.

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