

Europe continues to reflate

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Key points

- > Europe has been getting its act together and the latest ECB stimulus measures add to confidence that its recovery will pick up pace. This is good for global growth.
- > The ECB's actions provide a reminder global monetary conditions remain very easy which is supportive of relatively high yield assets and growth assets generally.
- > One risk is that the boost to the search for yield will delay further falls in the value of the \$A.

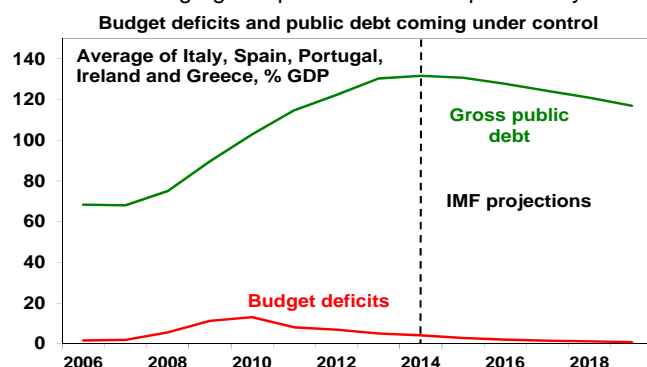
Introduction

Since the high point of the Eurozone crisis in 2012, Europe has been steadily fading from the headlines as the risk of a break up in the Euro diminished and troubled peripheral countries started to get their public finances under control. Quite clearly the combination of various bailouts, Eurozone leaders focusing on “more Europe, not less” and the efforts of the European Central Bank President Mario Draghi to “do whatever it takes to preserve the Euro” backed up by various monetary programs have been successful. This is all evident in a collapse in bond yields in peripheral countries and a return to economic growth across Europe. However, Europe has hit the headlines again with the ECB providing another significant round of monetary stimulus. This note looks at what it means for Europe, global growth and for investors.

Eurozone recovery

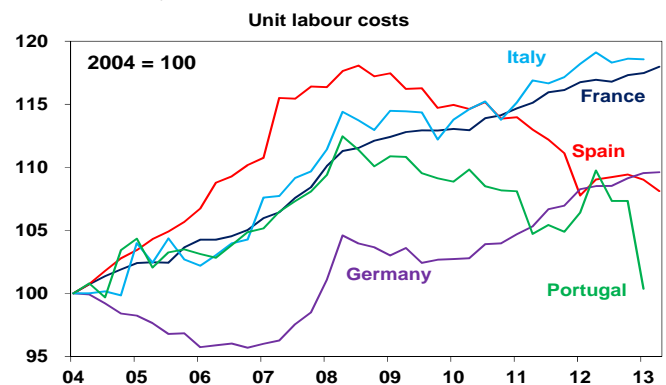
Signs abound that the Eurozone has left the crisis behind.

- Thanks to austerity programs and more recently a return to economic growth, budget deficits are coming under control in the main crisis countries, viz, Italy, Spain, Portugal, Ireland and Greece. Spain is a laggard, but the average Budget deficit in these countries will be around 4% of GDP this year, down from 10% plus a few years ago. Greece, Italy and Portugal are on track to run primary budget surpluses (ie the budget excluding interest payments) this year. See the next chart.
- The decline in budget deficits in the crisis countries is set to see average gross public debt levels peak this year.



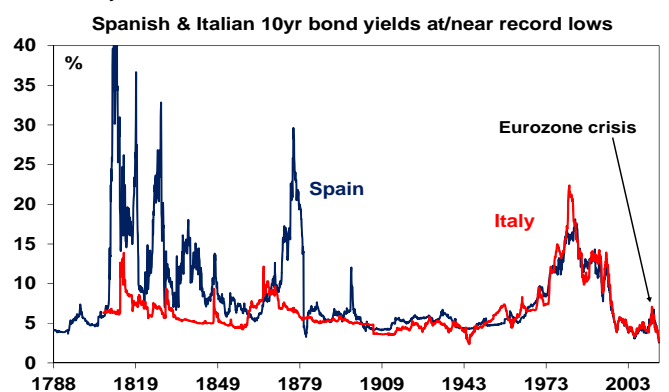
Source: IMF; AMP Capital

- Economic restructuring is starting to bear fruit. One guide is unit labour costs as it reflects both productivity growth and labour costs, so is a guide to competitiveness particularly across countries with a common currency as is the case in the Eurozone. Italy (and France) have been the laggards on the economic reform front with rising unit labour costs, but Spain and Portugal have made significant progress in reducing costs, particularly relative to Germany. See the next chart.



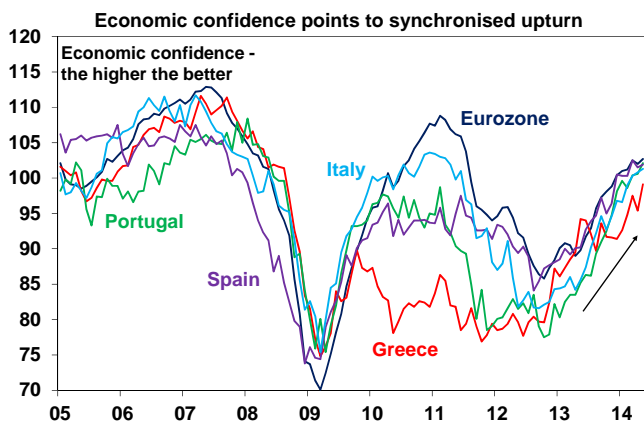
Source: OECD; AMP Capital

- Reflecting the return of investor confidence, particularly once it became clear the ECB was not going to allow a break up in the Euro (and so bond holders would get paid back in Euro's & not devalued new liras, pesos, etc), bond yields in the crisis countries have collapsed to pre-crisis levels or below. In fact Spanish and Italian 10 year bond yields have fallen to record or near record lows.



Source: Global Financial Data; AMP Capital

- Finally, confidence and business conditions have improved across the Eurozone and this has seen a return to growth. While the next chart has a lot of lines on it the key is that confidence is moving up across the Eurozone including in the crisis countries. In fact, the improvement in Greek confidence levels is quite astounding given where it was a couple of years ago.



Source: Bloomberg, AMP Capital

The ECB moves again

However, Europe is not completely out of the woods yet. While confidence and business conditions have picked up nicely, growth remains gradual (at just 0.9% over the year to the March quarter), unemployment has only fallen slightly from its peak of 12% to now 11.7%, inflation is just 0.5% year on year, money supply is growing at just 0.8% year on year and bank lending contracted 1.8% over the year to April. This has led to concerns that the Eurozone might be sliding into a Japanese type scenario of low growth and deflation.

To head off this risk the ECB has unveiled another round of monetary stimulus. While much anticipated, as the ECB had been foreshadowing a move for some time, it did not disappoint. The key measures deployed include cutting its key interest rate to just 0.15%, cutting the rate of interest banks receive on excess deposits at the ECB to -0.10%, an extension of guidance as to how long rates will remain low, an extension of the commitment to supply unlimited short term funds to banks at the 0.15% interest rate, a new long term lending program to banks (called Targeted Long Term Refinancing Operations or TLTRO), an end to the sterilisation of the bonds held in its existing bond buying program (which it calls SMP) and preparation for a program to purchase asset backed securities (which would amount to a US style quantitative easing program). The highlight was probably the TLTRO program which is effectively a “funding for lending” program that will allow banks to borrow to fund their non-mortgage lending at just 0.25% interest for four years.

The latest ECB move is not as momentous as its efforts in 2011 and 2012 (the first LTRO, “whatever it takes” and the Outright Monetary Transactions program that backed it up) that ended the Eurozone crisis. It would also have been better to see a US style quantitative easing program straight away and there are doubts about how successful each of the measures announced by the ECB will individually be.

But the ECB has more than met market expectations as reflected in the 2.3% rally in Eurozone shares and the collapse in bond yields in Spain, Italy and Greece since the announcement. What’s more the scatter gun approach of deploying virtually everything at once adds to confidence that the whole should be worth more than the sum of the parts in terms of its impact on the economy. The ECB’s broad based approach also adds to its own credibility and confidence that it is determined to get the economy on to a stronger path.

And the clear impression is that while interest rates have hit bottom it stands ready to do more if needed and this is likely to involve the purchase of private sector asset backed securities. Finally, there are signs that the wind down in bank

lending in Europe that has occurred in the run-up to this year’s review of the quality of the banks’ assets and stress tests of their capital, has run its course. If so the ECB’s measures aimed partly at boosting bank lending have a good chance of succeeding.

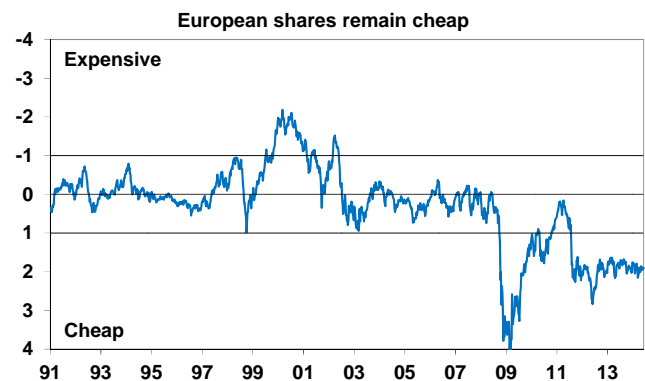
Implications for Eurozone & global recoveries

The bottom line is that the ECB’s measures – and commitment to do more if needed – add to confidence that the Eurozone economic recovery will pick up pace over the year ahead and that deflation will be avoided. This in turn is good for global growth and since Europe is China’s biggest single export destination, also good news for China, which in turn of course is good news for Australia.

What it means for investors

There are several implications for investors.

First, the determination of the ECB to put Europe on to a stronger growth footing and the easier monetary environment in Europe is positive for Eurozone equities, which remain relatively cheap. The chart below shows a composite valuation measure for European shares that indicates they are still about 2 standard deviations (or about 20%) undervalued.



Source: Bloomberg, AMP Capital

Second, ECB actions are likely to maintain downwards pressure on peripheral country bond yields, but given they are historically low, particularly so given the still high debt levels in such countries, this trade is becoming risky.

Third, the ECB’s actions provide further support for the global “carry trade” that involves borrowing cheaply in low yield countries like Europe and putting the proceeds into higher yielding countries and assets. As a result, the chase for yield looks like it has further to run. This is supportive of corporate debt and high dividend paying shares.

Fourth, and related to this, the reinvigoration of the carry trade risks delaying the next leg down in the value of the Australian dollar, as global demand for high yielding investments like those in Australia remains strong. Japanese interest in Australian bonds appears to be returning and Europe is likely to be a source of funding for carry trades. In the short term this could work against the downwards pressure on the \$A coming from the weaker terms of trade and the need to rebalance the Australian economy.

Finally, the ECB’s latest monetary easing also provides a reminder that the global monetary policy back drop remains very supportive for growth assets like shares generally.

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