Weekly Strategy

Wake Me Up Before You Go-Go Wham!, 1984

This past week, the ECB confirmed the concerns we have been raising for some time, namely that the Eurozone is in the midst of a significant slowdown and a lack of inflation pressures calls for a more accommodative monetary policy stance. While the ECB significantly revised down their forecasts for growth and inflation in 2019, we remain concerned about the health of the European economy and, more importantly, the ability of policymakers to reverse the trend if it continues unabated. While policymakers are waking up before growth go-goes, it looks to us like its hanging on like a yo-yo.

WHAT'S NEXT?

Policymakers are waking up but haven't opened their eyes fully

Last Thursday, the ECB downgraded their forecasts for growth in the Eurozone to 1.1% from 1.7%, as well as their inflation forecast to 1.2% from 1.6% (all figures year-over-year). They also communicated that rate hikes were unlikely until 2020, pushing back their first post-sovereign debt crisis rate hike previously planned for later this year. Yields on 10-year German Bunds fell to 0.05%, before recovering a bit to 0.07%, while the euro fell broadly and is currently trading below 1.125 against the US dollar.

Despite these significant downgrades, we believe policymakers are still not appreciating (or, at the very least, not communicating) how tenuous the European economy is. Growth has fallen consistently since hitting a post-GFC peak of 2.8% in Q3 2017 and stood at 1.1% at the end of last year. Our proprietary Growth Nowcaster, which gives a real-time reading on current economic conditions, points to further deterioration in Q1 2019. In other words, there has been a clear, entrenched trend of declining growth for over a year that has, thus far, shown no signs of stabilising, let alone reversing. If the trend continues at its current pace, the Eurozone will be in recession within a couple of quarters.

Monetary and fiscal policy look unlikely to reverse the trend

So what can policymakers do to turn things around? In our view, not much. In terms of monetary policy, the effectiveness of the ECB's tools is much lower than the last time they had to stimulate the economy. Short-term rates remain negative, though not as low as some of their peers. Net asset purchases (i.e. quantitative easing) could resume, but the size of the ECB balance sheet is quite large and they have already moved out on the risk curve to corporate bonds in order to provide additional stimulation in the economy. The new targeted long-term refinancing operation (TLTRO-III) will help to ensure credit conditions remain favourable for demand, but according to its own Bank Lending Survey, credit is not the issue. Conditions for both firms and households have been easing for some time and standards do not show any signs of tightening. Rather, as we will discuss below, demand is the issue and the TLTRO-III is not designed to address that. Another option for the ECB is to purchase equities, but if the experience of the Bank of Japan is any guide, the ECB could soon find itself pushing on a string.

On the fiscal side, governments also look to be constrained from doing massive stimulation. Across the Eurozone, general government gross debt now stands at 86% of GDP versus 69% in 2008. While German debt levels are back around their pre-crisis levels of 61% of GDP, the next three largest countries (by GDP) are in a much worse situation: France is at 100% vs 69% in 2008, Italy is at 133% vs 102% and Spain is at 98% vs 40%. These levels will constrain the size of any fiscal stimulation.

Demand is critically lacking

In our view, the critical issue for the Eurozone economy is the lack of domestic demand. The synchronised global growth experienced in 2017 and into early 2018 helped to obfuscate this problem, but the de-coupling of global growth has now laid this issue bare. Digging into the underlying data of our Growth Nowcaster, we can see that household consumption, in both durable and non-durable goods, has slowed down significantly since the beginning of 2018. While wage growth has picked up, savings rates have declined over the last few years and were at 12.3% in Q3 2018, at the bottom of their historical levels going back to 2000. Debt-to-income levels (gross) for households were at 94% in the Eurozone at the end of 2017. This paints a picture of a significantly indebted household sector that is already spending most of its income. Consumers were not able to push growth higher in 2018 and it seems unlikely stimulation targeted at them would be sufficient to reverse the current course.

Non-financial corporations also seem unlikely to provide much support. Investment rates have remained steady at around 21% since 2016, an improvement over levels of 2010-2011 but still at the bottom end of pre-crisis rates going back to 2000. Our Growth Nowcaster has seen investment perspectives and production expectations decline over the last year, with the latter falling to levels last seen during the worst years of the sovereign debt crisis. The fact is that firms invest in response to demand, and their disinterest in ramping up investments for the last few years, in spite of peaking growth, does not bode well going forward. Importantly, they also do not look to be in a position to stimulate domestic demand by increasing wages further: while the profit margins of EuroStoxx 50 and Stoxx 600 firms closely tracked (and even sometimes exceeded) firms in the S&P 500 before the GFC, a meaningful gap has opened between them since 2011 (7.4% vs 10.4%). Adjusting for sector bias or taking an equal-weighted average across all firms in the index still shows that European firms' profit margins trail their American counterparts. Moreover, European firms' margins stabilised in 2018 and are now showing signs of falling, which will certainly push pressure on them to reduce costs.

External demand pivots most directly on China, one of the Eurozone's major trading partners and export destinations. Chinese policymakers' response to their own slowdown will have important ramifications for the Eurozone. Given their desire to be somewhat restrained in their easing measures, so as not to add further fuel to their highly indebted private sector, it seems unlikely that a pickup in Chinese growth will be a panacea for Europe's ills.

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