7 December 2016

EU GDP will have to wait to benefit from fiscal stimulus package

GDP growth of +0.3%. Expected acceleration in Q4. Growing confidence. ECB to resume its action. Watch out for long-term rates. Rise in equities, at last.

Key points

- European Commission's fiscal stimulus proposals stonewalled
- Fiscal stimulus will still reach Europe in due course
- Juncker Plan not up to the task
- European economy posts +0.3% growth in Q3 as expected
- Risks and level of political uncertainty gradually decreasing
- Confidence improving worldwide
- ECB to remain vigilant and expand its support for as long as required
- Rebound in long-term rates offers new opportunity for action for the ECB
- Few prospects for bonds
- Revaluation of European equities likely

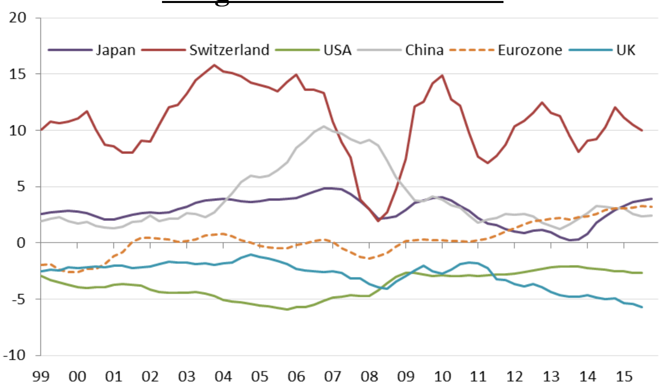
European Commission's fiscal stimulus proposals stonewalled

The Eurogroup has rejected the EU Commission's fiscal stimulus proposals. Finance ministers, led by Germany and the Netherlands, refused to set a fiscal expansion target for 2017.

Growth in the Eurozone will not benefit immediately from budget support that would probably have been welcome in the post-Brexit political context, at a time when the euro area needs to re-form its ranks around the European project. Germany and the Netherland's refusal runs counter to most other member states who would enjoy more flexibility in stimulating economic growth, which remains sluggish and has failed to accelerate despite unconventional and particularly expansive monetary policies and historically low interest rates.

In the wake of the OECD and IMF's change in policy, the EU Commission prepared some fiscal stimulus measures in the last few weeks to support growth in the euro area. Indeed, the IMF reversed its policy a few months ago, announcing that accommodative monetary policies had paved the way for fiscal stimulus measures to be adopted in the hope of more sharply boosting global economic growth. This reversal in policies somewhat eased the dialogue and gave more scope for actions that had been hampered until then by a school of thought strongly influenced by principles of austerity. At the initiative of European Commissioner for Economic and Financial Affairs Pierre Moscovici, countries that had some leeway to increase public spending were invited to do so in order to boost their own as well as the euro area's economy. Incidentally, the aim was mainly to try and urge Germany and the Netherlands to change their policies.

Budget deficit in % of GDP



Sources: Bloomberg, BBGI Group SA

The proposal was to involve all 19 member states and represented 50 billion in additional budget expenditure, i.e. approximately 0.5% of Europe's GDP. The request was rejected by the euro area's finance ministers, although the final report made provisions for countries that have some leeway to exploit it, should they wish to, in order to increase domestic demand and enhance their growth potential, according to their different national circumstances. In light of this decision, it appears that it is clearly a little too soon to hope for a fiscal stimulus package on a European level.

Fiscal stimulus will still reach Europe in due course

It took several years for unconventional monetary policies to be implemented in Europe following the example of the US. Therefore, it is probably only a matter of time before Europe begins considering fiscal stimulus measures too. Indeed, after the OECD and the IMF, the US is already clearly and openly talking about a sizeable fiscal package for 2017. President-elect Trump has openly put forward an amount of USD 1 trillion in additional public investments without concern for the resulting weakening of the public deficit to GDP ratio, which incidentally dropped by some -10% in 2008 before gradually climbing back up to reach approximately -2.5% of GDP in 2015. At the current level (-3.1%), the US public deficit ratio is well below the aggregate deficit of the euro area (-0.9%). Let us note that in China, the Prime Minister also reassured investors in March by agreeing to widen the budget deficit by -2 to -3% in relation to GDP.

In the euro area, the public deficit is up to -0.9%, thanks in particular to Germany's 0.7% surplus. The zeitgeist is gradually changing, and we believe it is likely that Europe too will see some fiscal stimulus measures in 2017. However, Germany will need a change of policy in order to support a plan to boost investment through an increase in public expenditure.

Juncker Plan not up to the task despite being agreed to by finance ministers

In September following Brexit, the Juncker Plan was strengthened, as we had expected. The aim was to double its capacity from 315 to 500 billion. Recovery through investment seemed to have gained unanimous support and was meant to convince populations of the interest of remaining within the European Union. The plan was designed to promote small- and medium-sized companies thanks to a fund for strategic investments, and to stimulate job creation by encouraging private investments. The aim is now to mobilise EUR 500 billion over five years.

The European Fund for Strategic Investments (EFSI) will support risk capital investments in innovative sectors such as alternative energies, energy efficiency, defence, infrastructure and digital services for example. To our eyes, this plan is rather disappointing and quite far from the fiscal stimulus package expected and required in the current situation. Driven by Germany, the budgetary stance in the euro area had stabilised at a relatively low level of global deficit, by international standards. Today, we need to persuade countries that have some real leeway, like Germany, to reverse their policies. We believe a targeted injection of 500 billion, as provided by the Juncker Plan, falls short of what is required. The plan is still far from the reorientation of the European project that some politicians advocate, by relaxing the 3% government deficit-to-GDP rule for example, which is deemed too restrictive to enable countercyclical action conducive to growth. This is undoubtedly a non-issue, since Europe does have some leeway, in particular in its largest regional economy.

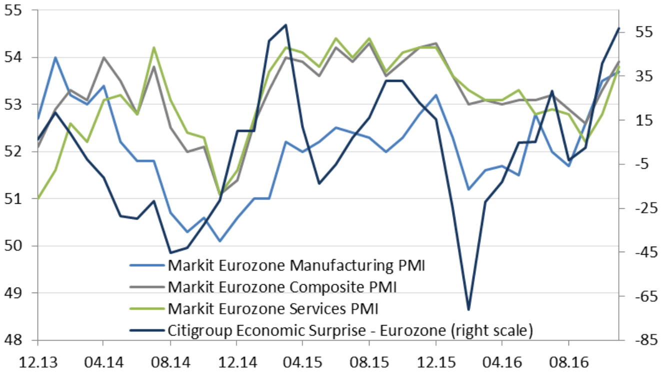
Germany does indeed have the most leeway for a global fiscal stimulus package, but for the moment a change in Germany's rigoristic philosophy remains unlikely.

European economy posts +0.3% growth in Q3 as expected

No acceleration in Q3 but no collapse either after the historic British vote. GDP growth in the euro area reached +0.3% in September, i.e. approximately +1.6% over a year. Once again, growth was supported by the positive contribution of household spending. This is the 14th quarter of consecutive growth, yet there is still no sign of any acceleration despite the alignment of supporting factors in 2016. Such a result will certainly be seen as disappointing, given the declining euro, dropping interest rates, and massive injections of liquidity by the ECB. Which gives even more incentive for the ECB to clearly pursue and intensify its support programme in 2017, knowing that the central bank is hoping for +1.6% growth in 2016 and +1.7% in 2017, i.e. a little more than the average of economic forecasts, which only anticipate a +1.3% increase.

Prospects for Q4 seem a little brighter however, if we are to believe the leading indicators and previously released statistics. Confidence indicators and in particular the EU Commission's economic sentiment index (106.5) are moving up. The composite PMI is stabilising at 53.9, while the services PMI shows positive results at 53.8, much like the manufacturing PMI, which remains at 53.7. Retail sales have improved (+1.1%) in October recording annual growth of +2.4%, while the sector's PMI remains slightly under 50 (48.6). In Germany, industrial orders posted their steepest monthly increase in two years (+4.9%), further indication that we may hope for an acceleration of economic growth in Q4. However, without such an acceleration, the EU's economic performance will be disappointing as the euro area will underperform compared to 2015 (+2%).

Eurozone – Leading indicators



Sources: Bloomberg, BBGI Group SA

Risks and level of political uncertainty gradually decreasing

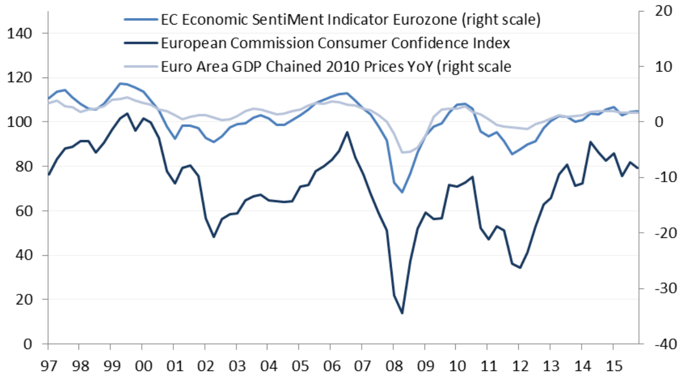
As of the beginning of December, the UK still has not triggered Article 50 in order to start the Brexit process. The latest political and legal developments mean that the fateful moment that Theresa May scheduled for March 2017 may be pushed back. The High Court in London found in favour of a parliamentary prerogative, and it is now up to the Supreme Court to uphold or overturn the decision contested by the British Prime Minister. The verdict is not expected before January, but if the High Court's decision is upheld, this will undoubtedly have an impact on the Brexit process.

Financial markets are comforted by the apparent lack of any significant short-term effect due to Brexit. As such, Europe has easily coped with the political and economic uncertainty caused by the British vote. Various votes and referendums held since June have not created any additional uncertainty either. The Austrian elections removed the threat of a return of the far-right to power, while the Italians' rejection of Matteo Renzi's referendum did not seem to have any adverse effect either. Serenity has not replaced uncertainty, but the latest economic news is rather positive and relatively encouraging, according to our analysis.

Confidence improving worldwide

Economic sentiment is improving worldwide. After a few worrying weeks following Brexit, confidence is back in the euro area. The comfort level of households is now above the historic average of the last 20 years. The consumer and business confidence survey shows increasing optimism in November (106.5). The business climate is stable (0.4 against 0.6 previously), while consumer confidence has gone up from -8 to -6. We are still far from a feeling of euphoria, but the trends are positive. The unemployment rate continues to improve slowly and has posted its lowest level in seven years (9.8%).

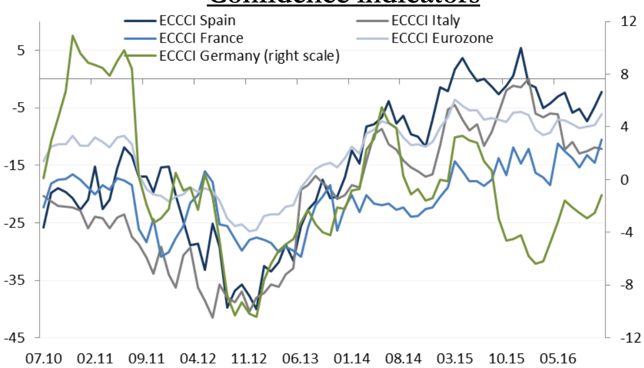
Eurozone GDP, economic sentiment and consumer confidence



Sources: Bloomberg, BBGI Group SA

These indicators also suggest that the last quarter will be stronger than the others. Consumer confidence in Europe had been improving steadily since 2012 before a temporary pause essentially related to Brexit. Ultimately, the elections and referendums held in various European countries in the last few months had no impact on the level of confidence. In most countries, we have witnessed a welcome return of cautious optimism.

Confidence indicators



Sources: Bloomberg, BBGI Group SA

ECB to remain vigilant and expand its support for as long as required

The European Central Bank remains focused and has reaffirmed, if need be, its commitment to supporting economic activity. Its programme will be maintained until March and extended by up to 60 billion per month until December, or a little more if required. Even if political uncertainty in the EU does not seem to affect current levels of confidence and economic trends, the European economy's best results are not exceptional yet. Recovery in industrial activity, decline in unemployment, and consumption growth are all positive signs, but inflation was still far from the ECB's target (+2%) in November (+0.6%), and growth rates are still not taking off.

The ECB will maintain its accommodative stance, whilst remaining vigilant with regard to the political risks that could affect Europe's ongoing recovery. Key rates will remain very low. The ECB is still looking to trigger inflation, but economic growth rates still seem insufficient to help it achieve its objectives. As for the financing of economic activity, the growth of loans to the private sector has reached +1.9% and remains a key factor for household confidence and consumption.

Rebound in long-term rates offers new opportunity for action for the ECB

Despite slow GDP growth, deflationary risks have been averted thanks to a +0.8% price increase in November (excluding food and energy). It is likely that the European CPI will shoot up in the next few months, driven by rising crude prices. However, the capacity utilisation rate and the high level of unemployment will not help inflation pick up. Rising prices and the quick rebound in long-term interest rates provide the ECB with a new opportunity to act on nominal rates by strengthening its purchase programme. Interest rates should then decline again in the euro area and lead to negative real rates, thereby creating a supporting factor for growth in 2017.

Revaluation of European equities

European equities have been neglected because of political risks, but growth is now strengthening and economic statistics are improving. At the moment, uncertainty still outweighs positive prospects and attractive valuation levels of 12.7x 2017 earnings. Moreover, Brexit will have no major impact on the business activity and profits of the largest European companies. In the absence of a household confidence shock, the euro area will maintain a GDP growth rate of above +1.6% in 2016 and 2017. European companies should benefit from an upcoming revaluation phase.

Conclusion

The euro area has regained a measure of confidence.

The economic outlook is improving despite a less-than-convincing Juncker Plan.

The ECB's monetary policy will be more expansive in 2017.

Inflation has climbed back above zero, pushing real rates into negative territory.

The GDP and European equities should benefit from the situation.

BBGI Group SA
Rue Sigismond Thalberg no 2
1201 Geneva -Switzerland
T: +41225959611 F: +41225959612
info@bbgi.ch - www.bbgi.ch