ECONOMIC OUTLOOK

REGIONS

February 2013

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The Euro Zone: Will "Whatever It Takes" Be Enough?

There is no denying that when Mario Draghi, President of the European Central Bank (ECB), pledged last summer to do "whatever it takes" to preserve the euro, the bruised and battered currency suddenly found new life. At the time, though perhaps not likely, there was considerable speculation that individual countries might exit the euro, and the worst case scenario of a disorderly breakup of the euro could not be entirely ruled out. After President Draghi's remarks the euro began to strengthen while yields on government bonds in many Euro Zone nations began to fall. What is not clear, however, is whether this reaction reflected a new found sense of confidence about the outlook of the Euro Zone or whether it was simply a case of hedge funds and others who had been betting on a breakup of the euro covering their short positions, not to mention their backsides.

Were it merely the latter, the euro and yields on government bonds would have at some point leveled off. Instead, these moves have been sustained which is widely seen as a sign of improving sentiment over the prospects for the Euro Zone despite some of the larger member nations having yet to emerge from recession. Indeed, with the dollar/euro exchange rate having crossed 1.35 on January 30 for the first time since late 2011 – when it was most hurriedly moving in the opposite direction – there are now those concerned that the euro is too strong, thus blunting the effects of falling relative wages in many countries and acting as a drag on Euro Zone exports.

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The Euro: Thriving, Or Merely Surviving?

Source: Bloomberg

On the surface it may seem as though the run-up of the euro and corresponding declines in yields on Spanish and Italian government debt are somewhat overdone. While President Draghi may have mitigated the tail risk, or at least the perception of that risk, the underlying structural issues that got many Euro Zone economies where they are today have yet to be addressed in a meaningful way. As such, it could be argued there is more downside risk in the Euro Zone than is at present being priced into the euro.

We agree with that premise. To be sure, we're not joining the chorus of those who continue to proclaim, albeit in a much quieter tone than was the case last summer, the euro's days are numbered. Nonetheless, we find it hard to overlook unemployment rates that remain exceptionally elevated in many Euro Zone nations, banks faced with mountains of bad loans yet to be worked through, household balance sheets weighed down by debt, and many Euro Zone governments not only unable to provide a buffer in the form of fiscal stimulus but instead embarking on austerity programs of varying degrees. That said, it is worth paraphrasing Keynes to note that, as with beauty contests, when it comes to currencies, winners are determined on a relative basis, not an absolute basis.

In other words, in accounting for the euro's sustained rise since the summer of 2012, one should be careful to distinguish between those factors specific to economic trends and the evolution of policy within the Euro Zone, or, endogenous factors, and those factors out of the control of Euro Zone policy makers and independent of economic trends within the Euro Zone, or, exogenous factors. We would argue that while endogenous factors, particularly President Draghi's line in the sand defense of the euro, have no doubt contributed to the euro's rise, exogenous factors have also played a significant role. This is especially the case given the extent to which the initial gains seen in the aftermath of President Draghi's remarks have been steadily built on.

First and foremost, the ECB has yet to join what has become a trend towards more aggressive and, for lack of a better term, creative forms of monetary policy accommodation. In contrast, the Federal Reserve has not only laid out economic thresholds to guide the timing of a hike in the Fed funds rate, but they have also signaled a tolerance for inflation slightly ahead of the 2.0 percent rate widely viewed as their target rate. This was followed up by the announcement of "QE-4," under which Operation Twist – which did not expand the size of the Fed's balance sheet, only the composition – was replaced with purchases of long-term securities that will add to the size of the balance sheet. In Japan, the arrival of the new Abe administration saw the Bank of Japan adopt a higher inflation target, with a depreciating yen now viewed as one means through which the Japanese economy can be brought back to life and the higher inflation target met. Meanwhile, the Bank of England is welcoming a new leader in July – Mark Carney, imported from Canada – who has stated a

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willingness to tolerate above-target inflation in return for generating faster economic growth. Mr. Carney is also seen as being willing to engage in "unconventional" policy tools to meet these ends.

Admittedly, as we hear of central bankers welcoming higher than targeted inflation, our first reaction is "be careful what you wish for." We cannot speak for ECB President Draghi, but as a practical matter, by simply standing their ground as other central banks actively expand their balance sheets and look for faster inflation, the ECB is watching their policy effectively become tighter in a relative sense. Moreover, as European banks begin to repay the emergency loans made under the ECB's longer-term refinancing operation (LTRO), the ECB's monetary policy becomes less accommodative which likely added upward pressure on the euro over recent days. The broader point, however, is that the actions of other central banks fall into the category of exogenous factors that have helped sustain the euro's upward run over recent months.

As a side point, the term "currency wars" has become popular of late as a description of central bank behavior, but we do not consider this an appropriate characterization. Consider the successive rounds of competitive devaluations seen in the run up to the Great Depression – now those were currency wars. The point, after all, was for each country to depreciate their own currency in order to make their exports more attractive in global markets, with retaliations by trading partners leading to successive rounds. What we are seeing now, with perhaps the exception of the Bank of Japan, are successive rounds of policy accommodation explicitly aimed at lowering longer term borrowing costs. Here, home currencies are innocent bystanders and depreciating currency values are a byproduct, not the direct target, of policy actions. These depreciating currencies will, at least in principal, contribute to growth in exports, though this effect is diminished to the extent that other countries are running similar policies, but will also bring added inflation pressures in those economies.

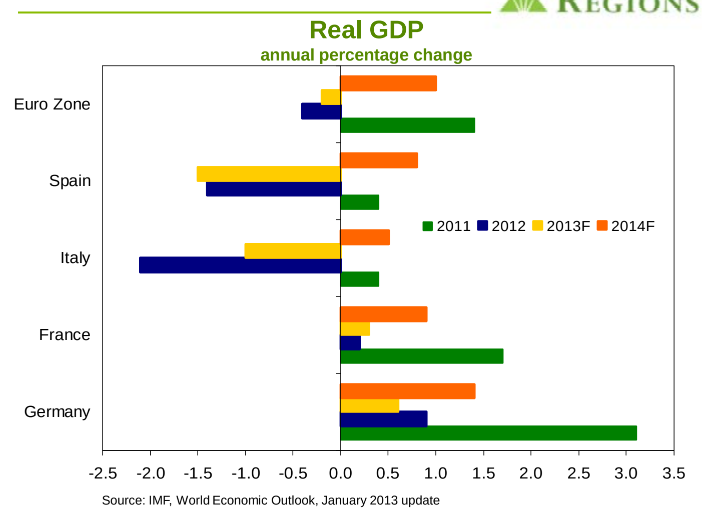
Our quarrel with the use of the term "currency wars" may be a mere matter of semantics but, either way, consider where the actions of foreign central banks leave the ECB. As the euro appreciates against the U.S. dollar, the Japanese yen, and the British pound, the effects of painful and ongoing internal efforts to lower costs can be negated, making exports from the Euro Zone become less competitive, which only adds to the economic headwinds facing those Euro Zone nations still struggling with slow growth or trying to emerge from recession. There has been much discussion as to how long the ECB will sit by idly and watch an appreciating euro eat into export growth before opting to cut their policy rate, which has been anchored at 0.75 percent since July 2012.

The ECB made no such move at their February 2013 meeting, and it isn't clear to us the ECB will actually move to lower the policy rate during 2013. It is possible a cut in the policy rate would take some of the edge off of the euro, but the reality is that in a world in which other major central banks continue with aggressive accommodation, a cut in the ECB's policy rate would not likely have much of an impact on the value of the euro relative to the currencies of these nations. Moreover, President Draghi has gone out of his way to stress the exchange rate is not an ECB policy target and, as such, the bank is not inclined to alter policy in response to movements in the euro.

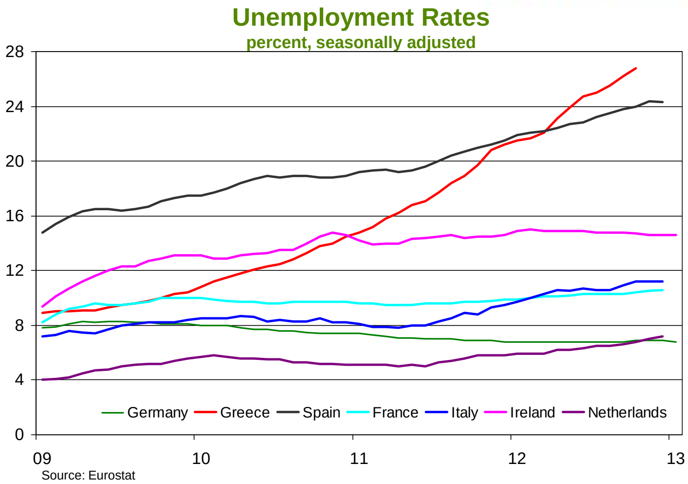
There is, however, one factor that does hold out the possibility of a cut in the ECB's policy rate at some point. Keep in mind the ECB has a single mandate – price stability – as opposed to a dual mandate which also includes full employment. With a stronger euro dampening inflation pressures in an already weak Euro Zone, the ECB would at least have the latitude to cut the policy rate as a means of fending off downward pressure on prices. Again, though, short of the euro/dollar exchange rate parking above the 1.375 level, we do not expect to see the ECB cut its policy rate in the near term, but instead ECB officials are likely to attempt to "talk down" the euro as President Draghi succeeded in doing, at least temporarily, after the February ECB meeting.

Euro Zone Economic Outlook Remains Uninspiring

The sustained rise in the euro over recent months comes amidst an economic outlook that remains somewhat less than inspiring. Even with the bar of expectations being set fairly low, as seen in the chart below, the near term risks seem tilted to the downside. The International Monetary Fund (IMF) recently issued an updated forecast projecting Euro Zone real GDP will contract by 0.2 percent for 2013 as a whole following an anticipated 0.4 percent contraction during 2012 (final 2012 data are not yet available). The IMF expects Germany's real GDP to post a paltry 0.6 percent increase in 2013, and Germany will be vulnerable to a euro that remains strong relative to the U.S. dollar and Japanese yen. Both Italy and Spain are expected to see further contractions in real GDP in 2013 of 1.0 percent and 1.5 percent, respectively.



With expectations ranging from only modest growth to further contractions in real GDP during 2013, there is likely to be little progress made in paring down persistently elevated unemployment rates across much of the Euro Zone. Even more worrisome than elevated headline unemployment rates is the fact that unemployment amongst those 25 years-old and younger is even more severe and not likely to improve in a meaningful way any time soon.



A weak growth environment and the effects of austerity programs, which are contributing to job losses in the public sector, are factors behind our view that 2013 will bring little, if any, progress on paring down unemployment rates across the Euro Zone. Another factor is what, across much of the Euro Zone, are structural rigidities that make labor markets far less flexible than we here in the states are used to. This includes statutory restraints on dismissing workers and what in many European nations are two-tiered labor markets with permanent jobs that are typically held by older (35 and over) workers and temporary jobs typically held by younger workers, with these temporary jobs lacking the protection afforded permanent jobs.

As if a stronger euro, moribund labor markets, and fiscal austerity weren't enough to contend with, many Euro Zone economies face additional headwinds in the form of household deleveraging, housing market imbalances, and somewhat dysfunctional credit markets. The U.S., after all, did not corner the market on unsustainable increases in house prices accompanied by rapid growth in household debt, and the adjustment process in Europe will be longer and more painful for households given that it is far more difficult for individuals to walk away from bad debt than is the case in the U.S. While some nations, such as Ireland, have made personal bankruptcy laws a bit less stringent, for the most part, bad debt will follow European consumers for years to come in the form of wage garnishments and restrictions on taking on new debt.

Of course, the merits of forcing the borrowers to bear the pain, as opposed to the banks or the governments (i.e., taxpayers) can be debated to no end, but the point here is that household debt levels and debt service burdens in the U.S. have fallen sharply relative to their cyclical peaks, while in Europe they are little changed. These still heavy debt burdens will act as a drag on growth in consumer spending, and in turn overall economic growth, for years to come in many Euro Zone nations. At the same time, banks continue to tighten credit standards, on net, to business and household borrowers while loan demand continues to contract.

Thus, while the initial repayments of the LTRO loans to the ECB suggest conditions in the Euro Zone interbank market are improving, it is far too soon to get too comfortable with that notion. The banking system must still contend with lingering bad debt while demand for new loans remains tepid, at best. In this environment, it is not so much the price of credit that is the issue, but instead what remains a broken transmission mechanism that results in policy actions on the part of the ECB having little tangible impact on the broader economy. In our view, this will continue to pose a downside risk to the Euro Zone economy for some time to come.

Oh By The Way, About That Government Debt Crisis . . .

One offshoot of the stronger euro over recent months has been a significant decline in the cost of borrowing for governments across the Euro Zone. For instance, having peaked at 7.62 percent in July 2012, yields on 10-year Spanish government bonds fell below 5.0 percent in January 2013. Meanwhile, yields on 10-year Italian government bonds touched a low of 4.13 percent in January 2013. Of course, recent weeks have seen yields rise on both Spanish and Italian government debt due to rising political risk. In Spain, the issue is the current leader, Prime Minister Rajoy, may be swept from office over an alleged bribery scandal, while in Italy the issue is a former leader previously swept from office and no stranger to scandal, Silvio Berlusconi, may actually come back.

Now, neither one of these matters threatens to send yields on government bonds back to their previous peaks, but they do serve as a useful reminder that what are at present relatively calm conditions do not mean the Euro Zone is entirely clear of the sovereign debt storm. Lower borrowing costs have clearly helped; after all, borrowing costs are both a reflection of and a determinant of the fiscal health of the issuing governments. The pressing issue remains whether or not Euro Zone nations such as Greece, Ireland, Italy, Portugal, and Spain will be able to stabilize their debt-to-GDP ratios without further intervention and assistance programs in a manner which will not roil the credit markets.

The debt-to-GDP ratio is the most convenient way to frame the issue. Clearly, with (nominal) GPD still contracting or posting only modest growth, lowering or even stabilizing the ratio means debt will have to be pared down. As such, what we have seen is a wave of austerity sweep across much of the Euro Zone despite weakness in the broader economy as governments strive to pare down their primary budget deficits. By contrast, in the U.S. we saw the federal government budget deficit widen sharply during the Great Recession and its aftermath thanks to fiscal stimulus intended to mitigate weakness in private sector demand. Whether fiscal stimulus was large enough (probably not) and effectively targeted (clearly not) is a matter of debate here in the U.S., but in the Euro Zone they do not even have the luxury of engaging in such a debate.

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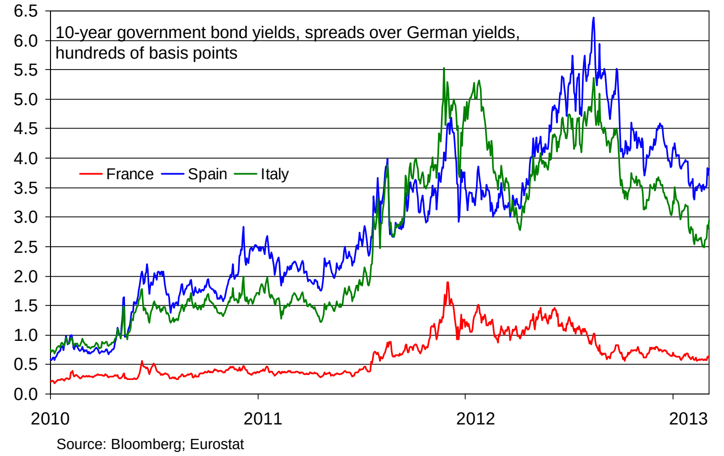
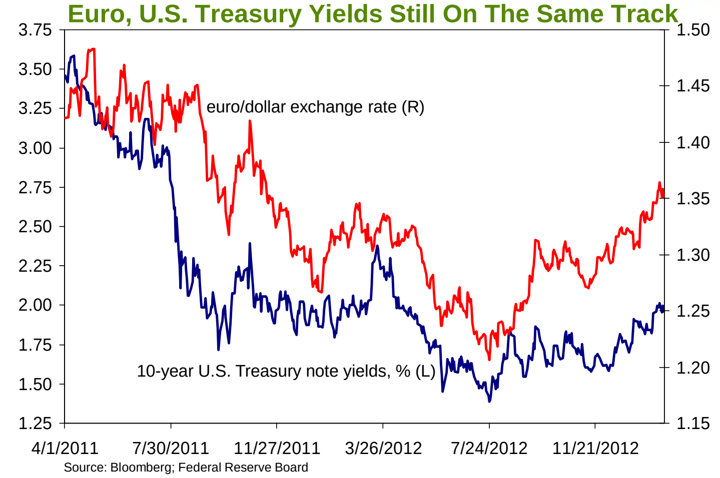
Risk Premia Have Narrowed But Remain Elevated



Source: Bloomberg; Eurostat

Euro, U.S. Treasury Yields Still On The Same Track



Source: Bloomberg; Federal Reserve Board

Instead, for many Euro Zone nations, it is somewhat of a vicious circle – a weak economy acts as a drag on revenue growth which leads to further restraint on the spending side of the ledger which leads to weaker economic conditions. Still, as the above chart shows, the perceived risk of government debt has lessened considerably since last summer – even Greece is enjoying sharply lower borrowing costs. In addition to the ECB taking a firm stand on preserving the euro, the European Stabilization Mechanism (ESM) should be fully capitalized in 2014 and the prospects of a permanent program has helped soothe the financial markets, as has the ECB's Outright Monetary Transmission (OMT) program, which involves secondary market purchases of government debt.

The reality, however, remains that these programs have yet to be put to the test – the OMT will not be utilized until an individual Euro Zone government asks for assistance – and we do not know how they will function if it comes to that. Even should the Euro Zone emerge from recession at some point during 2013 as expected, the outlook for growth in subsequent years is somewhat subdued. Given the weak economic outlook that suggests any stabilization, let alone reduction, in debt-to-GDP ratios will have to be primarily driven by austerity rather than growth, we think it premature to assume we've seen the last of the Euro Zone sovereign debt crisis.

Should the current calm give way to renewed concerns about the ability of Euro Zone governments to service their debt, yields on government debt will head higher and the euro will take a tumble. This would also have effects here in the U.S. as well, in the form of downward pressure on yields on U.S. Treasury securities. While some refer to this as a flight to quality, we prefer to think of it as a flight to relative quality. Either way, the euro/dollar exchange rate and yields on 10-year U.S. Treasury notes have tended to move together for some time now (though of late the exchange rate has moved more rapidly). At times, heightened concerns over the financial footing of Euro Zone governments and the fate of the euro have been reflected in a falling euro/dollar exchange rate and lower yields on U.S. Treasury securities. When risk aversion has diminished, we have seen the opposite effects and would see them in play again should the current sanguine view on the Euro Zone deteriorate.

We think this will be the case at some point during 2013, with the downside risks still inherent in the Euro Zone economy being repriced. This will be reflected in a weaker euro, at least relative to the U.S. dollar, and higher yields on government debt, though yields may not match their highs of July 2012.

The downside risks in the Euro Zone have to include political risks – aside from the political risks stemming from potential changes in leadership in Italy and Spain. More specifically, the longer the Euro Zone goes with elevated unemployment rates, particularly youth unemployment rates, and fiscal austerity, the more restless citizens of those affected nations will become. This could result in changes in governments, and such changes would not likely be viewed favorably by the financial markets, while new leaders would likely have an equally dim view of the financial markets. In short, this is perhaps an underappreciated source of downside risk over coming quarters.

The consensus view is that the Euro Zone will "muddle through" with the economy emerging from recession during the second half of 2013 and then settle into a pattern of moderate growth, with of course Germany outperforming the Euro Zone as a whole. We don't necessarily disagree with this view, but that is precisely what makes us nervous. We simply are not convinced that countries such as Spain, Italy, and Greece will be able to muster up sufficiently fast rates of economic growth to stabilize, let alone pare down, debt relative to GDP.

This simply highlights the point that if the Euro Zone and the euro are to survive, further structural changes will have to be made. This includes a fiscal integration to go along with the monetary integration. We have made this point many times in reference to the Federal Reserve but it applies to the European Central Bank as well – central banks can mitigate the pain, but they cannot cure the underlying structural disease. It is an open question as to whether there is sufficient political will across the Euro Zone for an adequate degree of fiscal integration to be agreed on much less implemented. We think it only a matter of time until the debt crisis comes back to the surface, and it will be at that time the Euro Zone nations will have to decide just how badly they want the euro to survive.