Lombard Street Research

LSR Daily Note

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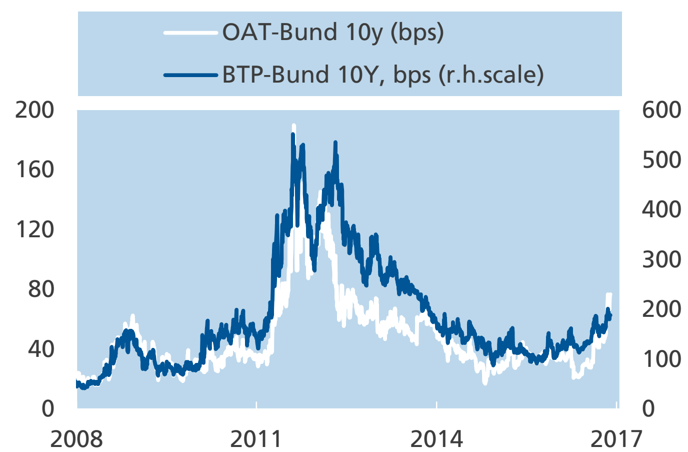
US investors are too bearish on the euro area

- **Our US clients view European politics as the key worry**
- **A potential Marine Le Pen victory is a recurring cause of concern**
- **There may be room for positive surprises in the euro area**

I was in the US last week visiting clients in New York and Boston. The Michael Flynn fiasco was grabbing the headlines. But the focus of the investors I met was mainly on European politics. Mario Draghi fought for second spot and Italy for third. While most investors are tactically long European equities, the outlook beyond the near term is binary. Most expect the political situation to get much worse while a handful think things will improve quickly. The biggest pushback was on our constructive view on EUR/USD towards the end of 2017. This was partly because investors expect more dollar strength and partly because they believe the euro will be weighed down by the vulnerable periphery countries.

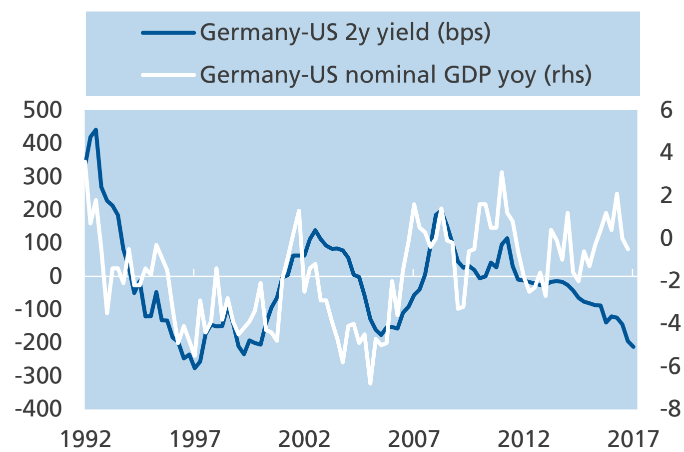
European political uncertainty has dominated investors' thinking since last spring. A glance at the 2017 calendar shows why they are preoccupied: general elections in the Netherlands (March 15), presidential elections in France (April-May) followed by legislative elections (June), general elections in Germany (September 24) and, potentially, general elections in Italy. Bond yield spreads in France and Italy are widening, reflecting concern about the outcome of the votes. Anecdotal evidence from our meetings was corroborated by the latest

Widening spreads on political uncertainty



Source: Bloomberg, TS Lombard

Rising pressure on EUR



Source: Bloomberg, TS Lombard

BAML Global Fund Manager Survey, which ranked 'European elections raising disintegration risks' as the biggest danger for markets.

The growing popularity of Marine Le Pen in France was the chief concern of our clients. While our TS Lombard colleagues accept there is a remote risk of Le Pen entering the Elysee Palace, they rate the chances of her far-right National Front party in the parliamentary elections as vanishingly small. So she would be an ineffective president in any case - albeit a hugely unsettling presence for markets.

In focusing on the string of looming elections, investors may be missing the EA's relatively healthy underlying economic momentum. Growth expectations for 2016 were revised up and have also been ratcheted higher for this year. There may be room for more upgrades. Low real FX rate is helping exports. Private consumption has been one of the main engines of growth as the collapse in oil prices last winter boosted real incomes in spite of lacklustre nominal wage increases. The fear has been that the recovery might peter out once the benefits of cheaper oil wanes. But, there are signs that the expansion is gradually broadening out to capex and we expect more improvement in business spending.

A still competitive currency and global manufacturing reflation bode well for the pricing power of euro zone producers. Businesses have strengthened their balance sheets, suggesting they are better placed to invest and create jobs. The ECB's policies have buoyed capital markets and compressed lending spreads for larger corporates as well as for small firms in the periphery. Monetary conditions have improved and bank credit has picked up. The ECB's bank lending survey forecasts improving credit demand and supply conditions. The worst of private sector deleveraging is likely behind us and fiscal policy has turned expansionary at the margin. The European Commission survey shows a healthy rise in industry's employment expectations.

The flip side is rising underlying inflation pressures. While firms have reported rising input prices and shrinking margins, they have so far not passed on their higher costs to consumers. Their restraint may not last for long. The labour market should improve further. And as the growth cycle matures, productivity will begin to show signs of fatigue, especially given our assumption that the euro zone has suffered a large shock to it supply-side potential. With deflationary risks from the second-round effect of lower oil prices disappearing, inflation expectations have already started to edge higher. Indeed, producers have raised their selling price expectations at the sharpest pace since the Global Financial Crisis.

How will Mr Draghi respond? Most investors accept that the benefits of ECB QE are diminishing, that its side-effects are increasing and that the central bank's asset purchases do not address the structural deficiencies of the euro area. At the same time, they are loathe to accept that the ECB will end QE anytime soon. All fingers point to the vulnerability of the Italian economy, which, it is assumed, will keep the ECB's taps flowing for longer.

We have regularly explained why we see Italy as the euro area's Achilles' heel, but an extended period of QE is no solution to the risk of economic stagnation. The situation shows what an incredibly tough task Mr Draghi faces to execute an exit without causing a severe tightening in financial conditions. We will be exploring his options in follow-up publications.

The European recovery still has legs. Seize the opportunity before it fizzles out.

Shweta Singh
shweta.singh@lombardstreetresearch.com