Centre for Asset Management Research & Investments
NUS Business School

# CAMRI Global Perspectives

**Monthly digest of market research & views** **Issue 47, November 2017**

# The EU Playing It Safe

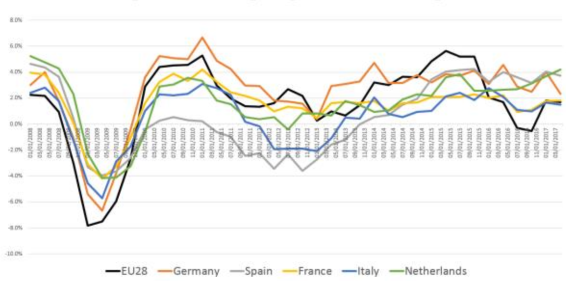
**By [Brian Fabbri]**

**Visiting Senior Research Fellow, CAMRI & President, FABBRI Global Economics**

**EU countries have overcome considerable troubles**

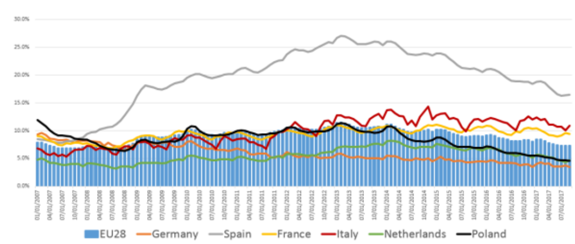
The European Union (EU) leaders relaxed their harsh economic programs, the European Central Bank (ECB) filled its Treasury with EU bonds and kept basic interest rates uncommonly low, and the economy finally responded after a prolonged slumber and began to grow.

**GDP Y/Y GROWTH IN EU**




Annual EU GDP has averaged 1.7% over the past several quarters. Moreover, even the painfully high unemployment rates have tumbled in the past year to a region average of 7.3%. These welcome economic achievements have arrived just in time to moderate the widespread, strident, anti-immigration protests.

**UNEMPLOYMENT RATE IN THE EU**




**The people played it safe**

This was a year of consternation, testing and turnaround; 2017 was filled with protests, anti-immigration demonstrations, and terrorist acts. It set the southern most countries, which were receiving the heaviest proportion of immigrants, against countries further north that received only a trickle. The inflow of unemployed and socially diverse peoples from Africa and Asia created an uproar in political debates throughout the year that raised extremist political parties into prominence. In the end the people decided to pursue a continuation of the same, relatively safe course that they have been on for the past decade or so, as seen through the results of several key national elections.

**The big disruption: independence**

The bigger disruption in the EU was the vote for independence in the Barcelona region of Spain. The success of the Catalonians has yet to play out politically and economically. Although their desire for independence has been long simmering, their vote was no doubt inspired by the English decision to opt out of the EU. Ironically, the leadership in Barcelona wants to remain in the EU, but it is not known how the EU leadership will treat this fledgling independent region. Without doubt it is highly unlikely that the EU leadership will treat them generously, lest it lead to a parade of followers within other EU countries.

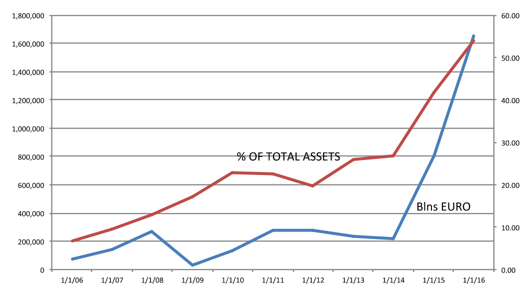
**Maintaining present economic momentum is vital for stability**

Had the economy not begun to improve weeks before key national elections took place in the EU's founding countries – France, Germany and the Netherlands, the outcome could have been quite different. Now the pivotal challenge these new leaders face is to maintain the present economic momentum. The critical test will come when economic leaders begin to remove the massive monetary and fiscal support that has boosted economic activity.

**Massive monetary stimulus**

Monetary stimulus has been extremely sizeable. Official interest rates have been at or near zero for years, whilst ECB purchases of sovereign EU securities have climbed from 143 billion euro in 2007, or 9% of total ECB assets, to 2 trillion euro in 2016 and now comprise 54% of the ECB balance sheet. Moreover, the chairman of the ECB has stated that the ECB will do everything that it takes to promote economic growth and at least 2% inflation.

ECB holdings of EU securities

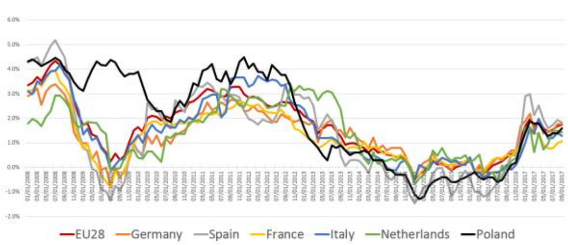



One conspicuous result of the ECB's massive securities purchase program was the flattening of the EU sovereign yield curve by lowering of long term sovereign bond yields. Sovereign bond yields have dropped to the lowest levels in their history. Now yields on 10-year notes issued by most of the original countries that formed the EU have dropped below 10-year Treasury yields. Consequently, they have pulled down with them corporate borrowing rates. Private finance is now historically cheap throughout the EU.

## Unprecedented low inflation

Ironically, EU inflation has been stubbornly below the ECB's stated target of 2% since early 2013. Presently the harmonized inflation rate in the EU is 1.7%. Relatively low rates of inflation have been widespread throughout nearly all EU countries, as seen in the following chart. Low rates of inflation have been prevalent in nearly all of the economically developed countries of the world, and have persisted even in countries with estimated full employment such as the US.

**Inflation is below 2% everywhere in the EU**



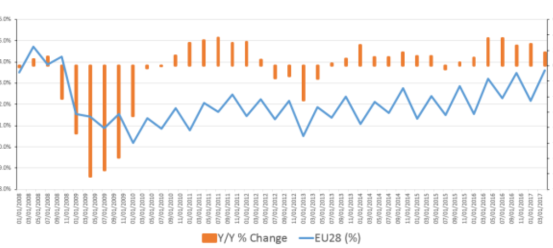

## The glacial pace back to normal

Consequently, the ECB is likely to maintain its relatively benign policies well into the future. Nevertheless, the ECB, like the US Federal Reserve, will soon have to search for some prolonged path back toward normalizing monetary policy by reducing and eventually ending asset purchases as well as gradually raising official interest rates. Normalization is likely to be glacial.

## Private investment is key to future growth

Both private and public investment will be crucial. It is very unlikely that EU economic growth will continue to benefit from recent public investment. Therefore, private investment will have to pick up its pace and take the lead in stimulating new growth. Business investment in the EU has not recovered back to the levels that existed prior to the 'great recession'. Annual growth rates have been feeble at 1% to less than 2% in most recent years.

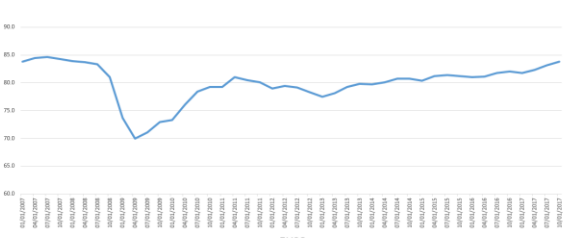
**Business Investment in EU**




## High utilization rates inspire new investment

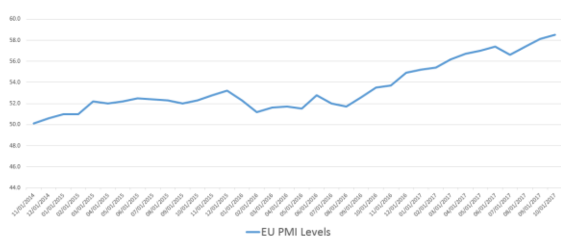
Fortunately, capacity utilization rates throughout the EU are close to their historic peaks. This is probably the result of years of meager business investment. Business had little incentive towards investment during the protracted period of languished economic growth. Business confidence in the strength of the economy sank to low levels during this era and the desire to enlarge capacity slowly turned insipid.

**High Capacity Utilization in EU (%)**



Recently business confidence has improved in concert with the acceleration of economic growth. The high rates of capacity utilization, which typically drive productivity, should therefore motivate EU businessmen to invest to enlarge their production facilities. Of course, minimal interest rate costs will also support a more favorable business climate. Nevertheless, new investment requires vision and confidence in the socio-political environment to engage in new business investment. Cheap financing will be available to facilitate execution of business ideas.

**EU Purchasing Managers' Index**




**Rebound in global trade also a positive**

Coincidentally, the improvement in global trade should also add to the improved outlook for EU economic growth. Although the trade weighted Euro has appreciated by more than 10% in the past year – reflecting the EU's improved economic performance and the success of the incumbent politicians in national elections this year, the Euro is 12% below its previous high before the extended EU economic malaise. The present value of the Euro is therefore making EU trade more competitive. Exports from the EU to the rest of the world form a very large proportion of the harmonized EU GDP.

**Conclusion: The outlook for the EU is much brighter than it has been in the recent past**

The hostile rhetoric and massive public protests that scared the EU region for the past year have been toned down of late following the national elections conservative results. Nevertheless, resentment and anger continue to simmer beneath the surface throughout the region. Maintaining the present economic momentum will be the critical solution to keeping a lid on the smoldering social pressures within the EU.

The outlook for stronger economic growth in the EU has improved considerably in the past 6 months. It looks as though EU GDP growth in 2018 could exceed 2% for the following reasons.

First, the ECB announced in October that it will continue to insulate the economy by acquiring public and private-sector debt for most of the next year and will not raise interest rates for a long time thereafter. Thus, they are guaranteeing an expansionary monetary policy.

Second, global economic growth has picked up significantly in all corners of the world, which should contribute to the EU's export oriented economies. The slightly depreciated Euro should also add to the global competitiveness of their products.

Third, the business community's economic outlook has improved recently, implying that they will increase their private investment in the EU, especially since capacity utilization rates are near their peak levels.

Fourth, the EU region has a significantly large number of unemployed workers, both domestic and foreign. While labor shortages have been a drag on natural rates of economic growth in other key developed economies, they are not in the new EU. Moreover, because capacity utilization rates are at high levels, business productivity should also be rising. Thus, both factors will add to long-term economic growth estimates.

Finally, the EU leadership's insistence upon strict adherence to their budget standards has also been quietly suspended. The current leadership understands that their hold on power rests upon the shoulder of economic growth, and not artificial budget mandates. They also know that without economic growth politics would turn nasty.

*For more information, please contact*
*camri@nus.edu.sg*

| | KEY INDICATORS TABLE (AS OF 31 OCTOBER 2017) | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **INDEX** | **LEVEL (LC)** | **%1MO (LC)** | **%1MO (USD)** | **%1YR (LC)** | **%1YR (USD)** | **INDEX** | **LEVEL** | **%1YR** |
| S&P500 | 2575.26 | 2.33% | 2.33% | 23.62% | 23.62% | 3MO LIBOR | 1.38 | 56.20 |
| FTSE | 7493.08 | 1.82% | 0.89% | 12.07% | 21.65% | 10YR UST | 2.38 | 30.34 |
| NIKKEI | 22011.61 | 8.13% | 7.12% | 28.64% | 18.81% | 10YR BUND | 0.36 | 122.65 |
| HANG SENG | 28245.54 | 2.64% | 2.77% | 28.00% | 27.24% | 10YR SPG | 1.46 | 21.82 |
| STI | 3374.08 | 4.82% | 4.36% | 23.90% | 26.55% | 10YR SGS | 2.15 | 14.19 |
| EUR | 1.16 | -1.42% | | 6.06% | | US ISM | 58.70 | 12.88 |
| YEN | 113.64 | 1.00% | | 8.41% | | EU PMI | 58.60 | 9.53 |
| CMCI | 1226.02 | 3.44% | | 11.91% | | JP TANKAN | 15.00 | 200.00 |
| Oil | 54.38 | 5.24% | | 16.05% | | CHINA IP | 6.60 | 8.20 |

*Source: Bloomberg*

## APPENDIX

**GLOSSARY OF KEY TERMS (Source: Bloomberg, with tickers in parenthesis. In US$ where applicable)**
**S&P500:** capitalization-weighted index of the prices of 500 US large-cap stocks (SPX)
**FTSE:** capitalization-weighted index of the prices of the 100 largest LSE-listed stocks (UKX)
**NIKKEI:** capitalization-weighted index of the largest 225 stocks of the Tokyo Stock Exchange (NKY)
**HANG SENG:** capitalization-weighted index of companies from the Hong Kong Stock Exchange (HSI)
**STI:** cap-weighted index of the top 30 companies listed on the Singapore Exchange (FSSTI)
**EUR:** USD/EUR exchange rate: 1 EUR = xx USD (EUR)
**YEN:** YEN/USD exchange rate: 1 USD = xx YEN (JPY)
**CMCI:** Constant Maturity Commodity Index (CMCIPI)
**Oil**: West Texas Intermediate prices, $ per barrel (CLK1)
**3MO LIBOR:** interbank lending rate for 3-month US dollar loans (US0003M)
**10YR UST:** 10-year US Treasury yield (IYC8 – Sovereigns)
**10YR BUND:** 10-year German government bond yield (IYC8 – Sovereigns)
**10YR SPG:** 10-year Spanish government bond yield, proxy for EU funding problems (IYC8 – Sovereigns)
**10YR SGS:** 10-year Singapore government bond yield (IYC8 – Sovereigns)
**US ISM:** US business survey of more than 300 manufacturing firms by the Institute of Supply Management that monitors employment, production inventories, new orders, etc. (NAPMPMI)
**EU PMI**: Purchasing Managers' index for the 17 country EU region (PMITMEZ)
**JP TANKAN:** Bank of Japan business survey on the outlook of Japanese capital expenditures, employment and the overall economy, quarterly index (JNTGALLI)
**CHINA IP**: China's Industrial Production index, with 1-month lag (CHVAIOY)
**LC:** Local Currency