Europe. Growth, Value and Slightly More Stability (well, relatively)

Europe is in steady recovery mode, benefiting from the delayed effects of QE.

Eurozone Purchasing Manager Indices (PMIs) have been rising across manufacturing and service industries for the last 6 months. Industrial production is growing at a steady 1.9%. Inflation has risen to 1.9% headline and 1.2% core. GDP is forecast to rise at 1.70% and has been rising at 1.70% Q1 2017.

The banking system is almost fully recapitalized and functioning. With a few exceptions in peripheral Europe, banks are increasing loan growth and net interest margins. Euro area MFI loans to non-financial corporates rising at a steady 1.6%. Euro area MFI loans to households rising at a steady 2.6%. Consumer credit rising at 4.7%. Second year of growth.

Political risk is subsiding and changing.

So far, the anti-establishment plebiscite results (Brexit, Trump), have been in staunchly capitalist and Anglo-Saxon countries. The Socialist fabric of Europe has so far held together through Dutch and French elections.

Italy is a risk. The weakest economy in Europe, Italy breeds dissatisfaction with the euro, which could turn into a focal point for elections which have to happen eventually. There is the possibility of snap elections. Reformist former Prime Minister Renzi has recently regained leadership of the Democratic Party, but an election is likely to result in a hung parliament. There is little risk in Italy exiting the euro but the consequences would be serious given how entrenched the Italian financial system is within the single currency. The banking system is weak but has made progress in recapitalizing and loan growth is picking up. Unemployment, however, is a stubborn problem.

Spain’s coalition government remains unstable. An abstention by the Socialists have allowed incumbent Prime Minister Rajoy to retain power but Pedro Sanchez’s return to leadership of the Socialists could destabilize the arrangement. The Spanish economy has so far shrugged off the political uncertainties and staged a meaningful recovery.

European unity is likely to be strengthened by the turn in its relations with the US and UK. President Trump’s nationalist agenda and cosy relations with Moscow will lead Europe to feel that it needs to be more self-sufficient economically and militarily. The departure of UK from the EU reinforces the need for Europe to remain united evermore. Newly elected French President Macron is mostly regarded as a Europhile and federalist and will likely press for greater integration.

Unity and greater integration are likely to be the focus of Europe in the face of an uncooperative US and a recalcitrant UK. This should bolster the euro and cause further convergence of sovereign bond yields between peripheral and core members. Stable to rising German inflation will raise the floor on rates and the need to maintain lower rates across the zone will place a cap on peripheral rates. The ECB may taper QE but if peripheral bonds do not behave, they may have to reinstate unconditional LTROs to absorb peripheral issuance.

Brexit presents problems for both the UK and the EU.

The UK elections on June 8 are expected to see the Conservatives extend their slim majority, although recent experience has taught us that anything can happen. There is some debate over whether a strong mandate for Theresa May means a softer or harder negotiating stance. Given May’s track record at the Home Office, a hard stance is more likely. This is damaging to the UK economy in the short run. In the long run, it is difficult to say although the general consensus is poor. The impact on Europe is also negative. In most policy debates the UK has been the pro-business lobby against the statist French and the commercial leaning but less vocal Germans and with Brexit the EU loses its most liberal, pro-competition member. The risk is of a more insular, protectionist, EU.

ECB. Which way out?

The ECB was the last major central bank to move on QE. Given the influence of the Bundesbank and the reluctance of Germany to bailout the fiscally undisciplined it was a feat to implement QE. With the European economy in fine shape it is likely that QE will be tapered. Germany needs the ECB to end monetary accommodation, while Italy needs more support. The ECB is caught in between. The Germans will not be happy to let the ECB pick and choose which bonds it buys, and the ECB is not allowed to explicitly finance a sovereign nation. Yet the differing needs of different countries means that the ECB will have to find more specific and targeted policies to deliver stability. Fiddling with the asset purchase program will be difficult politically. The most flexible tool is repo. Even this could be complicated but if there was a strong signal from Brussels that the euro would be maintained at all cost, then sovereign yields should converge, and private commercial banks would have less reason to buy bunds and more to buy Italian bonds, thus animating that convergence, allowing the Germans to have higher rates while suppressing peripheral borrowing costs.