

On the Minds of Investors

February 2019

Europe at a crossroads: Recession or turnaround?

There was a lot of promise and expectation for European growth at the start of 2018. Fuelled by easy financial conditions and falling unemployment, the European recovery looked to be finally finding its feet.

However, since then, economic data for the region has deteriorated significantly. As this weakness has persisted, investors have become tired of the seemingly perpetual excuses for weak data, and sentiment towards European assets has worsened. With few domestic catalysts for a turnaround, it may take a rebound in demand from the emerging world to improve prospects for the region.

What has gone wrong for the European recovery?

Looking at the detail of the slowdown, it appears that much of the weakness can be attributed to net exports. Net exports contributed 1.4 percentage points to the annual real GDP growth rate in the fourth quarter of 2017, but in the third quarter of 2018 their contribution was negative. Both sides of the equation—imports and exports—contributed to the deterioration, as the rising oil price in the first three quarters of 2018 led to a sharp increase in imports, while at the same time export growth stalled.

Given that exports make up approximately half of GDP in the eurozone, a slowdown in global growth was always going to prove a strong headwind. In particular, demand from emerging markets has softened. In November, exports to Turkey contracted by one-third year on year due to the confidence crisis that led to a slowdown in growth and the devaluation in the currency, while export growth to Asia slowed because of a slowing Chinese economy.

But external factors aren't the only ones to blame: domestic factors have played their part too.

In Italy, the new coalition government's dispute with the European Commission over its proposed budget sent borrowing costs to multi-year highs and tightened credit conditions. The prolonged period of political uncertainty has taken its toll on the Italian economy, with the country technically falling into recession.

In France, the protests of the "gilets jaunes" (a movement focused on social inequality) have caused significant disruption, sending the French composite purchasing managers' index into contractionary territory at the end of 2018. Impetus in the protests now seems to be waning and growth data for the fourth quarter of 2018 held up surprisingly well. But populism remains a risk across Europe, with the European Parliament elections in May likely to show that Eurosceptic parties still garner significant support.

In Germany, the autos industry has struggled to get to grips with the new emissions testing regulations, hampering industrial production and dragging significantly on growth. After a difficult fourth quarter of 2018, German auto production now looks to be picking back up (**Exhibit 1**), which could be a near-term boost to growth.

AUTHORS

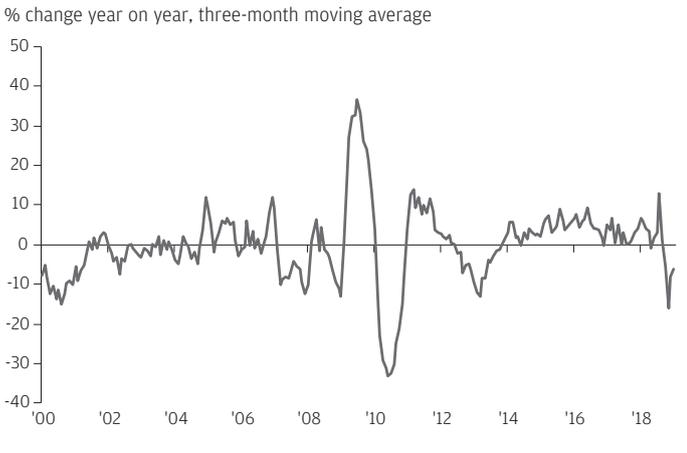


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EXHIBIT 1: GERMANY NEW CAR REGISTRATIONS



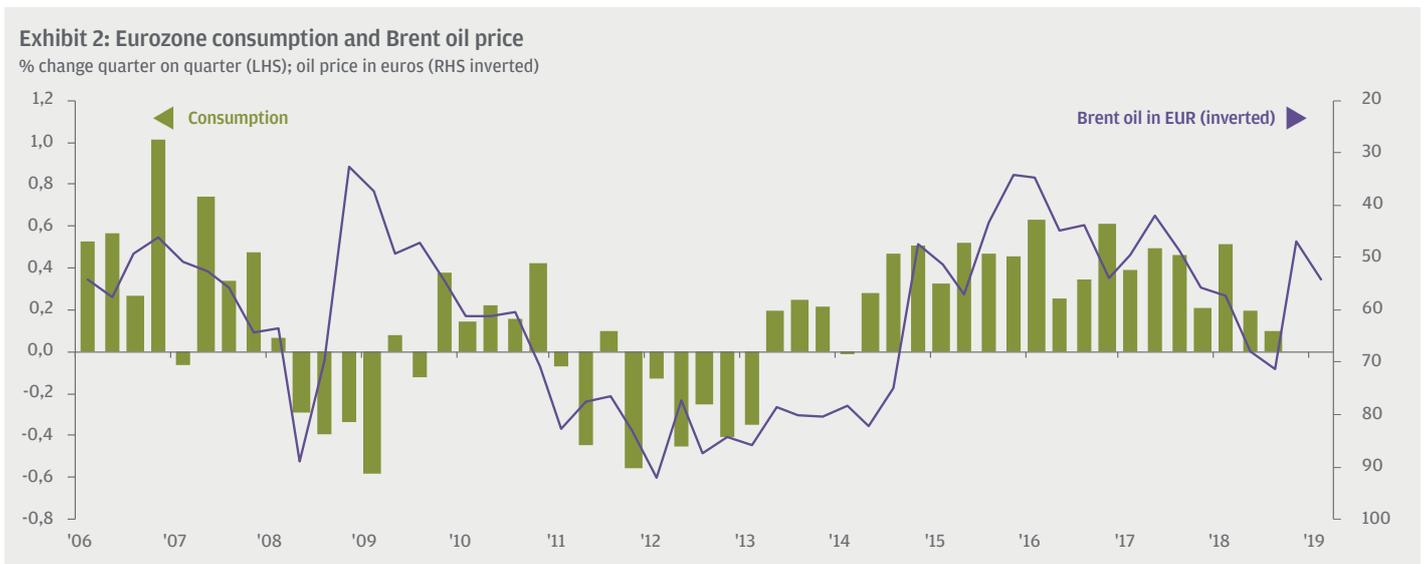
Source: KBA, Refinitiv Datastream, J.P. Morgan Asset Management. Past performance is not a reliable indicator of current and future results. Data as of 31 January 2019.

What could be the catalysts for a turnaround?

The European consumer is still fundamentally well supported as the unemployment rate continues to fall and wages pick up. In addition, the oil price has fallen significantly since October last year, serving in effect as a significant tax cut for European households. Historically, there has been a close inverse relationship between the oil price and consumption in the region, suggesting that the recent move in oil can help to boost consumption (see **Exhibit 2**). The fall in the oil price will also help European businesses by easing cost pressures.

EXHIBIT 2: EUROZONE CONSUMPTION AND BRENT OIL PRICE

% change quarter on quarter (LHS); oil price in euros (RHS inverted)



Source: Bloomberg, Eurostat, Refinitiv Datastream, J.P. Morgan Asset Management. Past performance is not a reliable indicator of current and future results. *Guide to the Markets - Europe*. Data as of 31 January 2019.

Monetary policy looks set to remain accommodative in 2019, which will keep lending rates at a very supportive level. The European Central Bank (ECB) reiterated its forward guidance on interest rates in January, and also acknowledged that the risks to the outlook had moved to the downside.

Attention is quickly turning to what the ECB could do to provide further stimulus. In the near term, this may involve further liquidity assistance through its Targeted Long Term Refinancing Operation II initiative (TLTRO II) – a EUR 700 billion programme launched by the ECB to incentivise eurozone banks to lend to non-financial corporations and households, by lowering the banks’ marginal borrowing costs. Italian and Spanish banks currently hold the largest chunk of the loans (60% of total volume). This policy measure is starting to come into focus again as these loans will begin to mature in June 2020. At a minimum, we would expect the ECB to announce an extension of the initiative to continue to provide support to the banking sector and economy.

Beyond this liquidity provision, the ECB’s ability to stimulate the economy further is limited. Key interest rates are already in negative territory. The ECB will struggle to expand quantitative easing as it is nearing the upper limit of the amount of German Bunds it is permitted to buy. Parameters would have to shift to allow it either to buy a larger proportion of the German market, or more debt from other countries—a politically contentious issue.

On the fiscal side, we are seeing governments move to incrementally looser policies—notably in Italy and France. But these countries will ultimately be constrained by their already high public debt-to-GDP ratios, which sit at 132% and 99%, respectively (vs. the 60% limit set out in the EU's Stability and Growth Pact). Germany has fiscal capacity for significant stimulus, but the political appetite appears limited.

With limited help available to the eurozone economy from within, an improvement in external factors might prove the key for a turnaround in sentiment among both manufacturers and consumers. The necessary catalyst for a change in economic momentum could also come from the avoidance of a hard Brexit, a de-escalation in trade tensions or a soft landing in China. While the first two carry the imponderabilia of politics, we have a larger degree of confidence in the latter as China continues to ease monetary and fiscal policy to stimulate its economy. In January, the People's Bank of China cut its Reserve Requirement Ratio by a further 100 basis points, injecting a net figure of RMB 800 billion (0,8% of nominal GDP) into the Chinese economy. New infrastructure projects have also boosted investment growth, and Beijing continues to implement tax cuts for corporates and consumers alike.

Eurozone stocks may perform better than the economy

The multitude of elements that have contributed to a slowdown in Europe, coupled with the absence of a clear catalyst for a turnaround, has left investors cautious of investing in the region. But it is worth remembering that approximately 50% of European corporate revenues come from outside the region. In 2018, the European macroeconomic environment continued to deteriorate, but companies were still able to achieve a respectable 5% earnings growth. An uncertain economic outlook for the region suggests investors should remain cautious in the near term. But the international nature of European companies and the broader eurozone economy means that the direction of the global growth environment will have a large bearing on future performance. Investors will likely stay on the sidelines in Europe until we get the promise of a lasting recovery in growth. But were the macro data to improve we could see a change in fortunes for European stocks given a lot of bad news is in the price.

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LV-JPM51852 | 02/19 | EU | 0903c02a824ee878