Income & Fixed Interest Newsletter

Vimal Gor

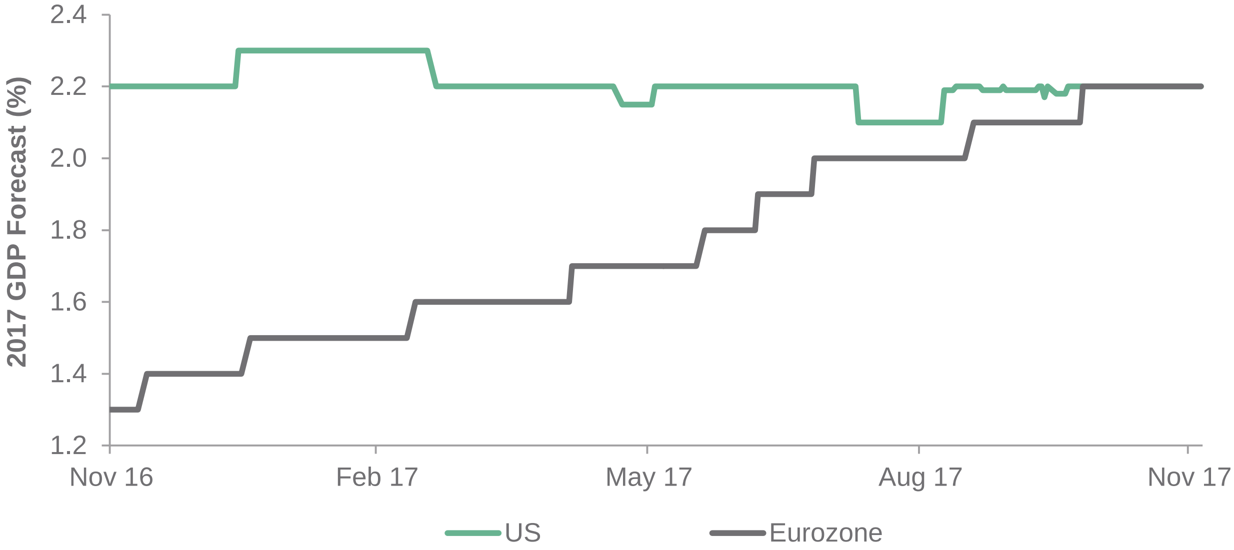
We two have run about the slopes,
and picked the daisies fine;
But we've wandered many a weary foot,
since auld lang syne

2017 will go down as the year that that markets climbed a wall of worry. With all the potential pitfalls ignored, asset returns across the board were stellar and testament to the amount of money sloshing around the financial system. I hope this year was a good year for you all, both personally and professionally. As the year draws to a close there is little left for me to do but wish you a very happy festive period and I look forward to engaging with you again in the New Year.

In this final newsletter of the year I want to broaden out our analysis of the global reflation theme. In analysing this theme over the last few newsletters we've established that it begins and finishes with China. That said, the recent US tax plans may well give it a boost in the near term, but the role of Europe has been grossly overlooked as the most impressive growth story. In this newsletter I want to take a comprehensive look at Europe to identify the growth drivers and investigate how structural in nature they are. While the absolute levels of growth may not be headline grabbing material, especially against the eye-watering recovery in global emerging markets, the European path of recovery has surprised us and many others in the face of very depressed expectations at the start of this year.

Exhibit 1 highlights how disparate the views for US and European growth prospects were on US election day last November. Whilst US growth forecasts were already at 2.2%, European forecasts were a paltry 1.3%. Now GDP forecasts for the two regions have converged to the same 2.2% level with the near 1% upgrading of European growth prospects impressive to say the least. This year's award for "Most Improved Economy" should go to Europe, and we think they are not done surprising us just yet.

Exhibit 1: The tortoise stole the show



Source: Bloomberg

Escape velocity

Expectations for European growth at the start of this year were low for good reasons. Not only have growth outcomes in the region consistently disappointed over the last five years, potential growth has also fallen since the GFC and the Eurozone sovereign crisis. Potential growth is what economists refer to as the level of real GDP growth that countries can hope to achieve on a consistent basis. The level of potential growth in an economy is driven by the growth in the working age population and the change in the productivity of this workforce.

The table below shows the estimated potential growth for developed large economies. Whilst there are differences between countries in Europe, the Eurozone as a whole will generate more than double its potential GDP growth this year.

Exhibit 2: Pumped

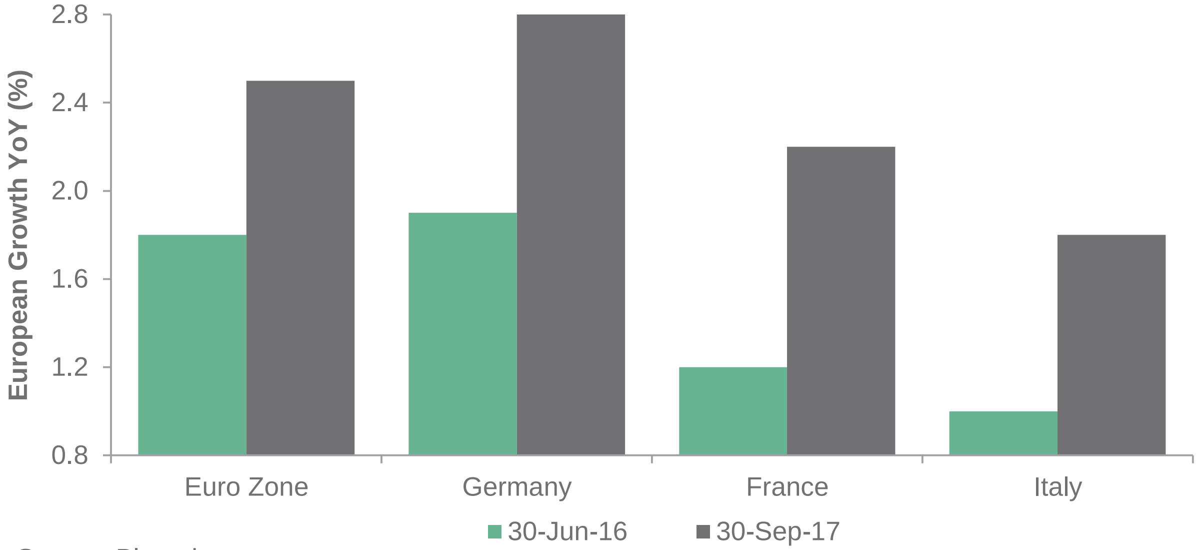
Country	Potential GDP	2017 GDP Forecast	Forecast versus potential
Eurozone	1.0%	2.2%	2.2x
US	1.4%	2.2%	1.6x
Japan	0.6%	1.5%	2.5x
Australia	2.4%	2.3%	1x

Growing above potential is a very very desirable outcome for Europe, as it is an area which has a massive output gap and strong growth should lead to the shrinking of excess capacity in the economy. If businesses expect the momentum to continue, this will eventually encourage new investment, increase productivity and raise the level of future potential growth. Ever since the GFC, we've all been waiting for Europe to shake off its funk and 2017 represents the first credible chance for the region to finally achieve that much needed escape velocity.

Broad-based recovery

Perhaps the most heartening aspect of the story is the breadth of the growth recovery across the Eurozone countries. Germany has been the economic powerhouse of Europe since its inception and has increased its weight to total Eurozone GDP over the last ten years as a result of outperforming most other European economies over this time. This year, however, it has been the smaller countries that have outperformed to bump up the Eurozone average, and even the slower growing larger economies have wildly exceeded market expectations. The big underperformers, Italy and France, may not have changed their relative underperformance against the rest of the region, but this doesn't make their recoveries any less notable.

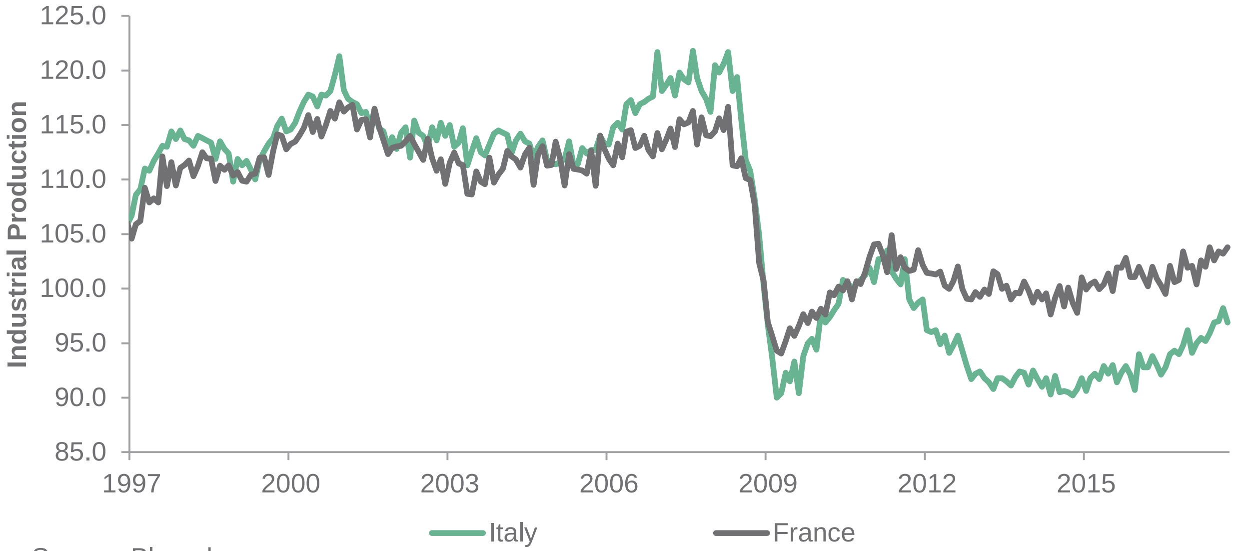
Exhibit 3: Look, even Italy



Source: Bloomberg

The recent uptick in industrial production has been key to the improvement in Europe's growth and this is largely a result of the global trade cycle, and correlates well with the improvement in Eurozone GDP. This improvement is a big deal because apart from Germany, industrial production in Europe has been stunted since the GFC. As a result, total production in Europe still falls considerably short of levels seen since prior to the GFC, and for notable laggards such as Italy, recent gains in industrial production have not been strong enough to return production levels to even where they were prior to the European crisis.

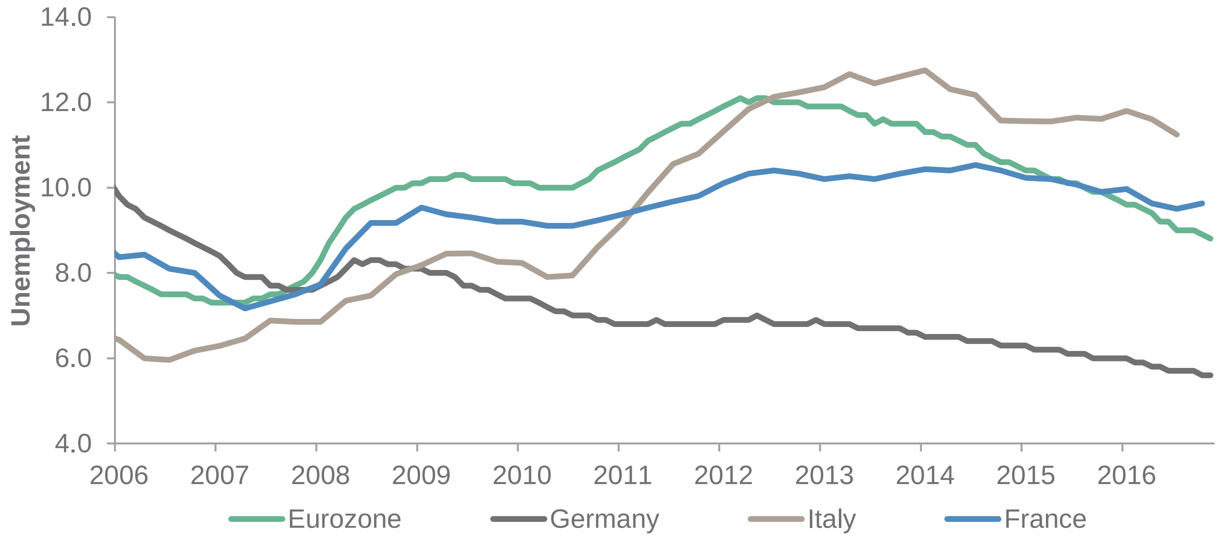
Exhibit 4: Finally showing some life



Source: Bloomberg

Nevertheless, the turnaround in industrial production may be responsible for the improving employment picture across Europe. Like industrial production, it's important to keep the recovery in employment rates in perspective. Germany suffered the least during the GFC and unemployment there is hitting fresh lows. But unemployment rates in France and Spain were climbing since the sovereign crisis and only started to improve in late 2015/early 2016. The improvement has even spilled over to Italy in 2017, although there is still much ground to catch up on against the rest of the Eurozone.

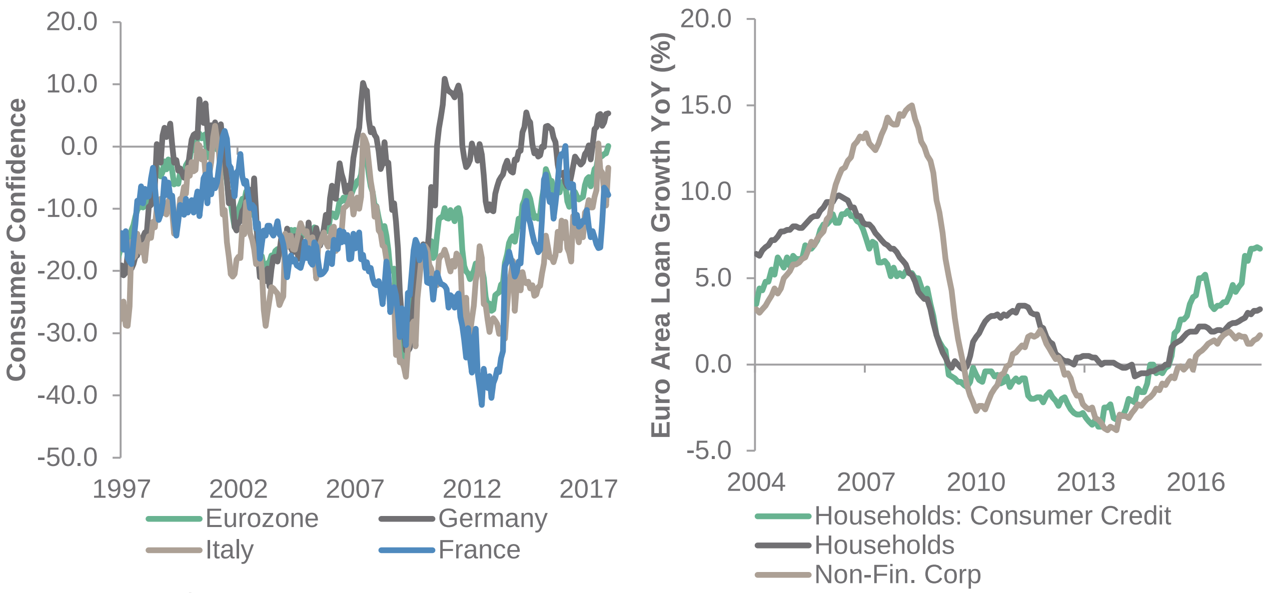
Exhibit 5: No longer a jobless recovery



Source: Bloomberg

Just as high and climbing levels of unemployment are very damaging for an economy, lower unemployment rates have unlocked new demand within the Eurozone. Firstly, consumer sentiment across the Eurozone has reached new highs. This trend began in 2012, and has been fairly broad-based across the region, most recently being reflected in the Italian labour and consumer markets.

Exhibit 6: Getting their swagger back



Source: Bloomberg

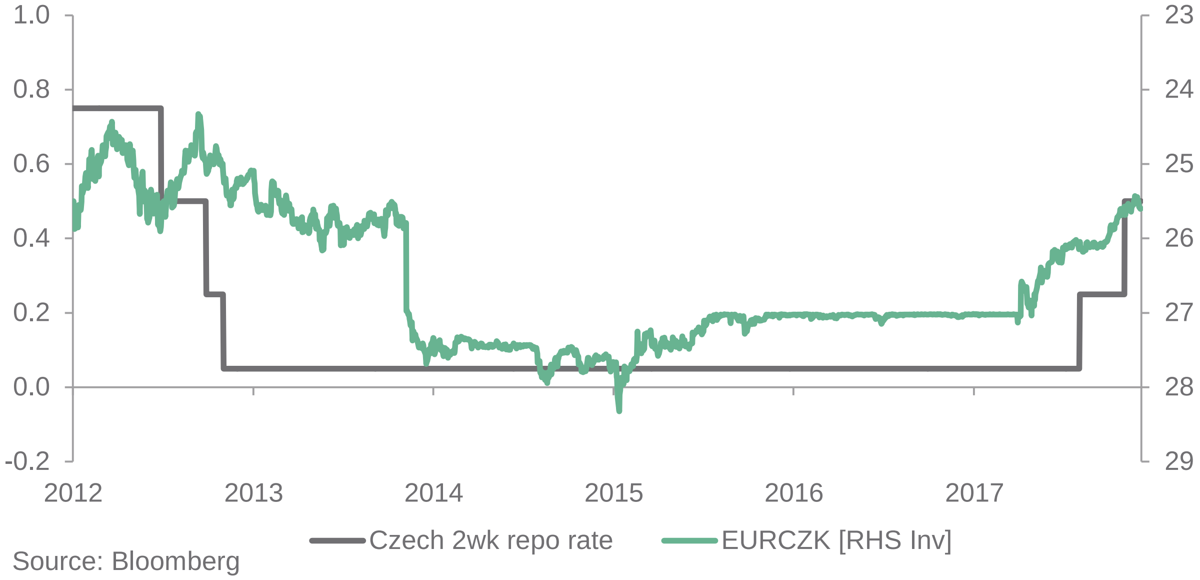
When consumers feel more confident, they are likely to borrow and spend more. Along with improving consumer confidence, credit growth to households has jumped and consumer lending has been outpacing the growth in mortgages and loans to corporates.

A tale of two central banks

The spill-over effect to countries outside the jurisdiction of the ECB has been even more impressive. For the emerging countries to the east, more favourable demographics have allowed them to harvest more of the benefits of the broader Eurozone recovery. And for the Scandinavian countries in the north, perhaps independence over their own monetary policy has provided an advantage over Europe's "one size fits all" model. Two examples stand out in particular - the Czech Republic and Sweden. Both are experiencing similar dynamics of good growth and accelerating inflation, yet the central bank responses could not be more diametrically opposed.

Growth in the Czech Republic has accelerated from below 2% earlier this year to 5% now, significantly ahead of potential growth at 2.5%. Meanwhile, both headline and core inflation have recovered from roughly 0% to currently above 2%. Exports have jumped and wages growth has accelerated to above 5%. This has all happened in synchronicity with the upturn in the global economy. In response to accelerating inflation, the Czech central bank (CNB) has dropped the floor on the Koruna to the Euro and has lifted interest rates from 0% to 0.5%.

Exhibit 7: A Prague-matic response



Source: Bloomberg

The Swedish economic story looks very similar. Growth has averaged 4% over the last 2 quarters, and underlying inflation has been at or above the Riksbank target of 2% since June (only recently dipping below this target). Services inflation, a more appropriate measure of domestic price pressures, has been running at an incredible 4%, to the envy of central banks like the Fed.

While the CNB has used the opportunity to tighten policy, the Riksbank has been focused on maintaining a stance that is even more dovish than the ECB, hinting that it is extremely likely to extend its own quantitative easing in December, in line with the intentions of the ECB.

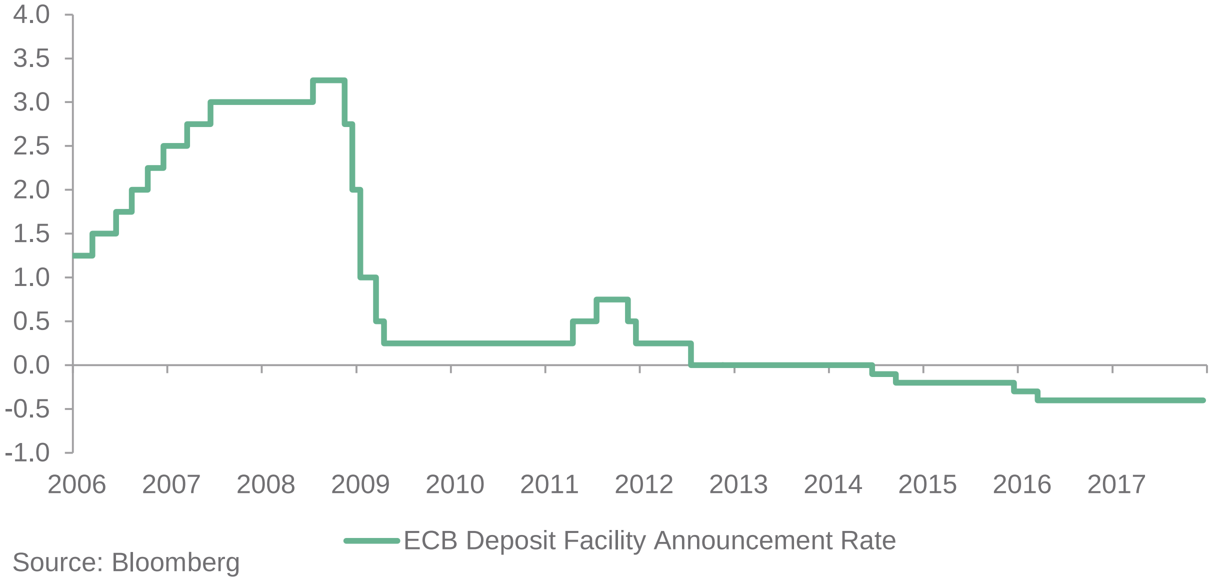
The Czechs have been willing to accept an appreciating currency against the Euro as a result of tightening policy, but the Swedes are terrified of allowing the same to occur in the face of endless ECB easing. They say currency appreciation will dump "Euro-lowflation" on the doorstep of Stockholm, and are therefore willing to accept an unaffordable housing market instead. Not surprising, then, that Sweden has the most negative real interest rates and its citizens suffer one of the most expensive housing markets.

Whether or not these peripheral central banks are choosing to normalise monetary policy in the face of improving economic fundamentals, they share a common reason for having delivered extraordinary policy in the first place, which highlights their position at the feet of an 800-pound gorilla.

Understanding ECB QE

It all started in 2011, when Greece was shut out from funding markets. Not only did this put the brakes on any post-GFC recovery in the Eurozone, the European sovereign crisis slowed economic growth the world over. Easy monetary policy was needed, but having only just started hiking again in 2011, the ECB was reluctant to deliver at first. Even after entering a new cutting cycle, each phase of new extraordinary monetary policy has been preceded with significant hesitation and disagreement among EU member states. The long pause at 0% facilitated a period of debate around whether to allow negative rates. The most recent cuts in 2016 left us with an ECB deposit rate of -0.40%.

Exhibit 8: Zero ain't nuthin' but a number



Source: Bloomberg

Negative rates alone were a necessary, but not sufficient, condition to end the violent death spiral of the EU sovereign crisis. Draghi had promised "whatever it takes" and what it took was bond buying across government, supranational and corporate issuers across Europe. Yet, the deeply political and bureaucratic nature of Europe affects the ECB greatly, and if allowing negative rates had been contentious, an official ECB QE programme was downright illegal in the eyes of the European treaties. Perhaps this is why Draghi decided to act first, ask permission later. His speech had convinced the markets that QE would be there to save the day, and the EU had no choice but to deliver on the promise lest it wanted a fresh round of doubt on the viability of Italian and Spanish debt and renewed attack on the cohesion of the single currency.

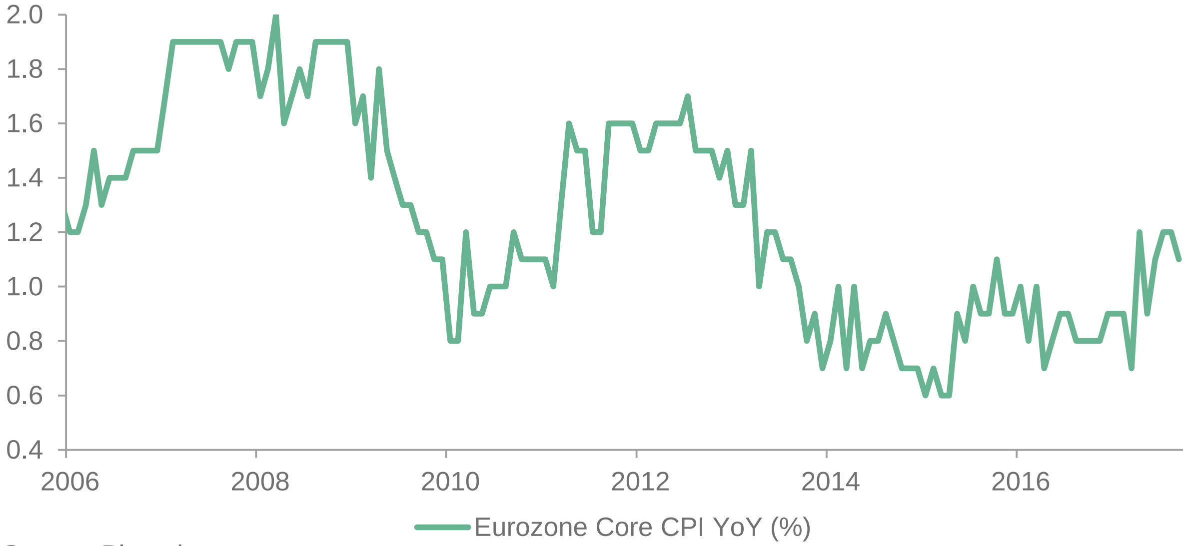
In line with the aforementioned hesitation and doubt, European QE started in a soft form via TLTROs. These were bond buying programmes aimed at peripheral European sovereign debt, implemented in the form of bank liquidity injections. It was not until March 2015 that we saw the first true quantitative easing conducted by the ECB and its national central banks, which has since expanded until March 2016 to reach the rate of €80bn per month. This was ultimately needed to contain Eurozone risks, forcing out remaining market disbelievers, and closing the door on any idea of exit risks for the periphery.

QE delivered on its implicit goal

Since QE was implemented by the ECB, European credit spreads have been tightening and catching up to the global credit picture. Any Euro break-up speculation was extinguished by the results of the French election in May. The stated aim of bond buying was to lift inflation back to the ECB's target, yet despite good growth, the inflation goal has not been achieved. Core inflation since the start of QE has remained unchanged, and still well below the ECB's target.

Regular readers will know that we are sceptical of QE as an effective tool to lift inflation. However, in the European example, if the implicit goal of QE was to avoid a break-up of the currency union, which would no doubt have been severely deflationary in its aftermath, then at the very least QE helped Europe avoid a much more dangerous situation.

Exhibit 9: When low ain't so bad



Source: Bloomberg

The success of QE in its implicit goal should not be a reason to move towards tapering the bond buying programme, especially with inflation nowhere near target. Whilst the uplift in growth unlocks the door to the end of extraordinary monetary accommodation, as we've seen with various indicators of the current recovery there is still much room for improvement. Output gaps are only now nearing the point of being closed, and the lack of inflation thus far should alleviate concerns about a sudden overheating.

The rinky-dink

Alas, the reasons for taper are more technical and it is first important to know how the ECB was allowed to conduct government bond buying in the first place. The European treaties establish laws that prevent the ECB from directly funding governments, hence our mention previously of the perceived illegalities of ECB bond buying. However, by buying bonds in the secondary market a few days after they had been issued rather than buying directly from governments, the ECB was able to keep within the letter of the law, whilst disregarding the spirit in which it was written. The wool couldn't be pulled over the eyes of the more fiscally conservative members of the EU however, who stopped the ECB from buying too many bonds of more questionable countries by imposing the "capital key". This limits ECB buying of governments' bonds to the percentage that each country has contributed to the capital of the ECB.

Germany is the largest member of the Eurozone and has contributed the most capital. But Germany also has fewer bonds on issue due to their level of fiscal responsibility relative to the rest of the Eurozone. So while there may be far more French and Italian bonds to buy, once the ECB has bought all the German bonds on offer, no more bond buying can happen. This scenario is exactly what is happening now. If the ECB wants to continue to ease policy then it will have to break the capital key willingly. If it doesn't want to break the key then QE has to stop. The capital key has broadly been adhered to, meaning that the market will have to believe another Mario Draghi promise without a clear path on how it will be delivered, just like 2012.

Draghi has managed to simultaneously taper purchases in Europe and send bond yields lower. He did this by lowering the pace of purchases until the end of September next year but by still promising not to end purchases at that time. Unless he pulls a rabbit out of a hat (or in other words break the capital key without the Germans noticing), he won't be able to deliver on his promises.

Whilst ECB tapering has technically started, given the still significant room for the market to be disappointed with reduced bond buying, the effects of tapering haven't really hit Europe yet. Unlike the US, where the Treasury will adjust its issue to the changing composition of demand as the Fed reduces its buying, no such coordination can occur in Europe. Each

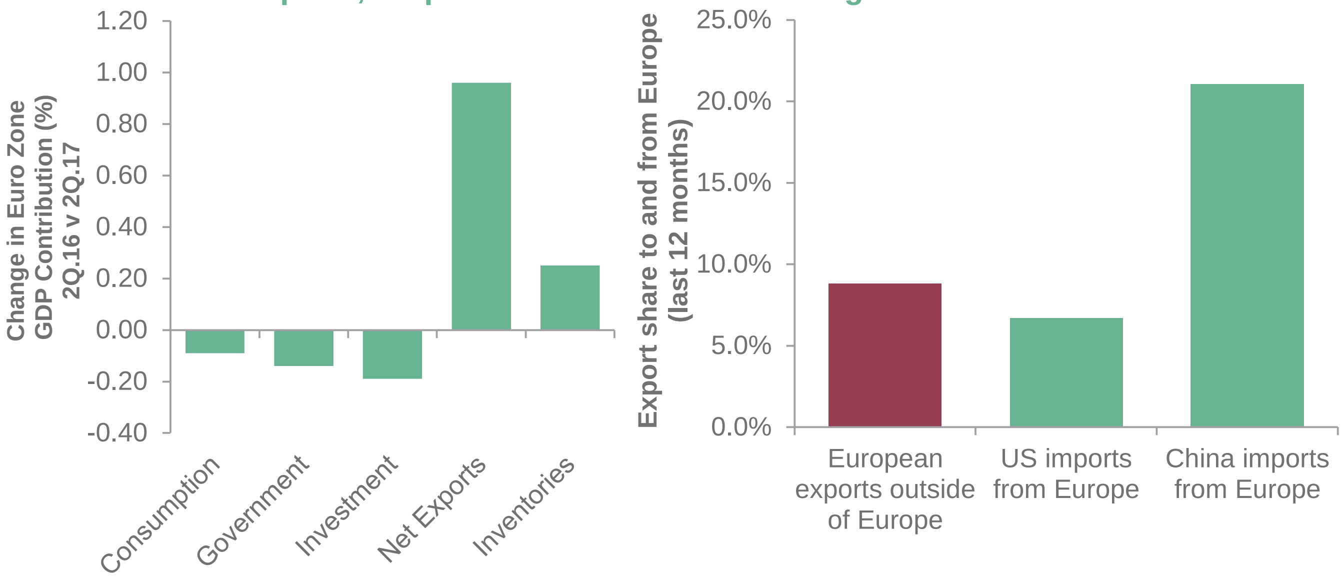
European member's sovereign issuance programme has no direct link to the ECB's buying programme. As I argued in the September newsletter, US tapering is unlikely to lead to rising yields, and recent plans announced by the US Treasury to reduce long dated issuance in favour of T-bills is already supporting this notion. However, ECB tapering will likely exert an upward pressure on European yields once it becomes apparent that the ECB will no longer hold down the German yield curve.

Does this thing have legs?

A gradual taper is desirable when combined with a self-sustaining economic recovery for the Eurozone, and positive changes to growth and employment forecasts point to a reason for hope. Inflation remains the caveat, but this story is being echoed around most of the developed world. Yet simply because growth has been good and unemployment has been falling, these indicators are not sufficient to tell us whether the recovery in the Eurozone has legs. To assess whether European growth is self-sustaining, we need to look into the quality and composition of growth.

As mentioned earlier, more consumption and investment should lead to a more sustainable recovery, whereas growth powered by exports and inventories is more likely to be transitory, given a reliance on short term or offshore demand. From this view, the composition of growth in Europe isn't great. Over the period where total growth climbed the most, consumption, government spending and investment actually fell, while nearly all of the increase outside of this has been due to net exports. The recovery in the Eurozone has been broad based by country, but very narrow in its origin.

Exhibit 10: Surprise, surprise it's all about China…again



Source: Bloomberg, BTIM

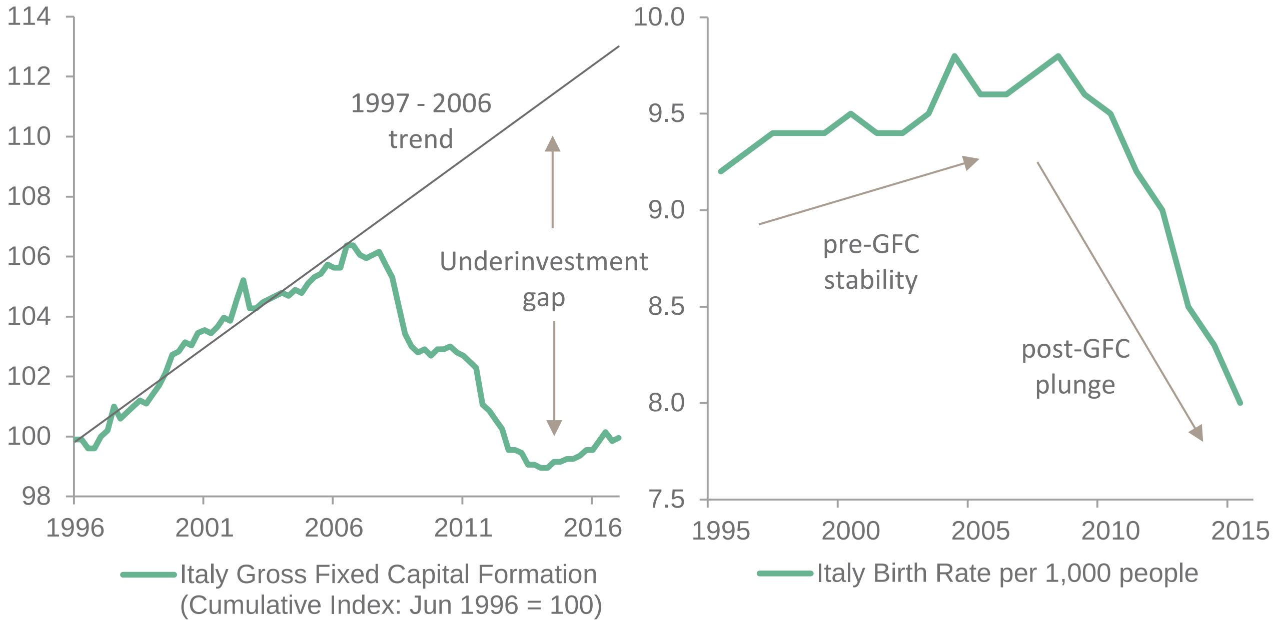
To make matters worse a single country has dominated the growth in these exports. European exports with destinations outside of Europe grew by nearly 10% over this period, with the overwhelming amount of this growth from China. If China's growth recovery isn't sustainable and the export performance doesn't convert into investment or consumption, European growth will once more drift back down to its lower potential.

Manufacturing indices, the best leading indicators of the economic cycle we have, are nonetheless still pointing to good times for the next few quarters. A number of these indicators are still at decade highs (and in the case of the German IFO index, an all-time high since 1960), and are fairly reliable in guiding to growth outcomes up to two quarters ahead. On this measure, we should see the Eurozone hit a 3% or higher growth outcome, something we haven't seen since 2011. Slow growth in Europe will be a late 2018 story if a more favourable composition to growth doesn't emerge in the meantime.

The lost decade

A self-sustaining recovery in Europe is not only highly desirable for the shape of the global economy, but for the quality of life of the people within the remit of the ECB. We've spoken about Italy improving with the rest of the Eurozone, but still being the laggard on a number of measures. The first measure is inflation. Low inflation isn't such a problem in an economy, unless that economy is carrying a lot of debt. Italy is one of these economies, with government debt to GDP ratio at 120%. An economy like this needs a high amount of nominal growth (or growth in Euro terms), which is a combination of real GDP growth and inflation. Italian real GDP growth may be the best we've seen in 15 years, but low nominal GDP growth as a result of falling inflation means that nominal growth is still far below the 4% pre-GFC average, currently travelling at 2.4%. Debt will continue to be a noose until inflation can re-emerge, and this should be a strong enough story for the ECB to limit the further pace of tapering until an upturn in inflation re-emerges.

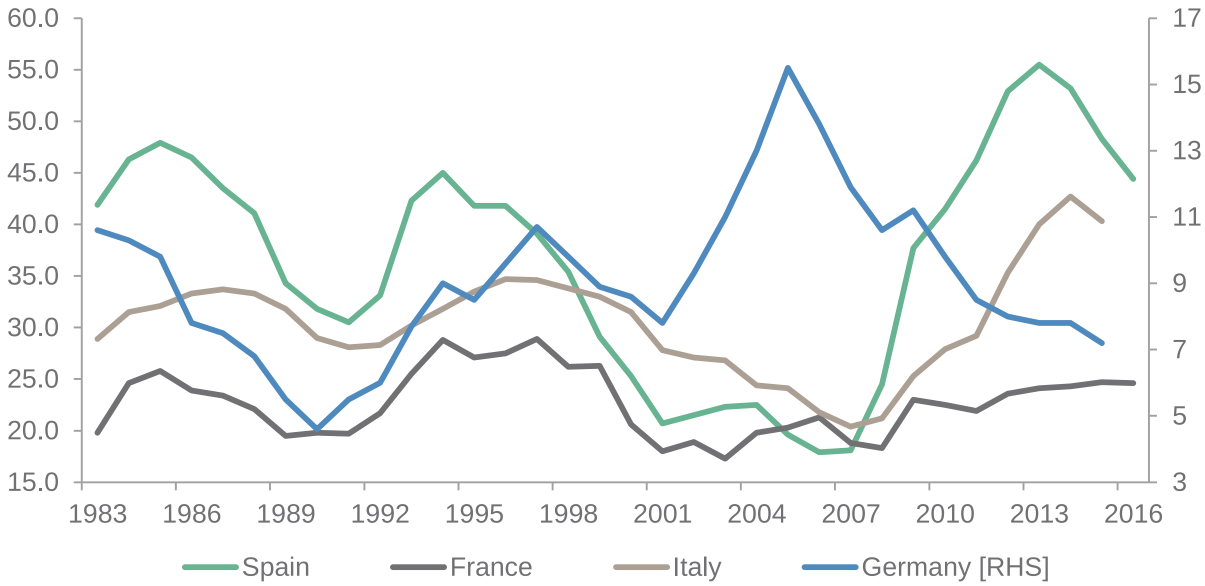
Exhibit 11: The lost decade will cost more than a generation



Source: Bloomberg, World Bank

As for the improved employment picture, youth unemployment remains at incredibly high levels not just in Italy but across the Eurozone. Youth unemployment has only just started to fall in Italy and Spain (from 42% and 55% respectively), but is still rising in France. Unemployed youth represents underinvestment in human capital. These people are not learning the necessary skills to drive growth in the future, ensuring a quality of life that will be far below the two generations before them.

Exhibit 12: Youth unemployment, thankfully falling at last



Source: Bloomberg

Is austerity the right means to an end?

The drag in investment and the social cost of high youth unemployment are just a few of the longer term structural issues plaguing the Eurozone. The short term boost to growth that we have seen this year has helped to revive corporate Europe but has yet to translate into wage growth and better work opportunities for the disenfranchised. The market seems to have been placated post the French elections and successful Italian election reform, but the threat of a shift to populist governments still lingers at the edges. Quantitative easing may have something to answer for in widening the gap, but there is a bigger need to address why potential growth remains so low. Time and again, when EU policies have been tabled to tackle the underlying structural issues such as youth unemployment, they are overturned in favour of fiscal austerity. This damaging austerity will likely reduce potential growth in Europe even further in the future, rendering somewhat irrelevant the question of how much longer the current expansion can go on. Of course, a longer expansion will help matters, but only when done in conjunction with good policy can real improvements be made.

Note: There will be no December Newsletter as we take our customary Xmas break. Regular service will resume in January.

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About BTIM's Income & Fixed Interest Boutique

BT Investment Management's Income & Fixed Interest team of thirteen dedicated professionals, led by Vimal Gor, manage the #1 performing Australian composite bond fund of 2014 and 2011.

For the latest Market Insights from Vimal Gor and his team visit btim.com.au/education-and-resources/

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