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Europe turns a corner

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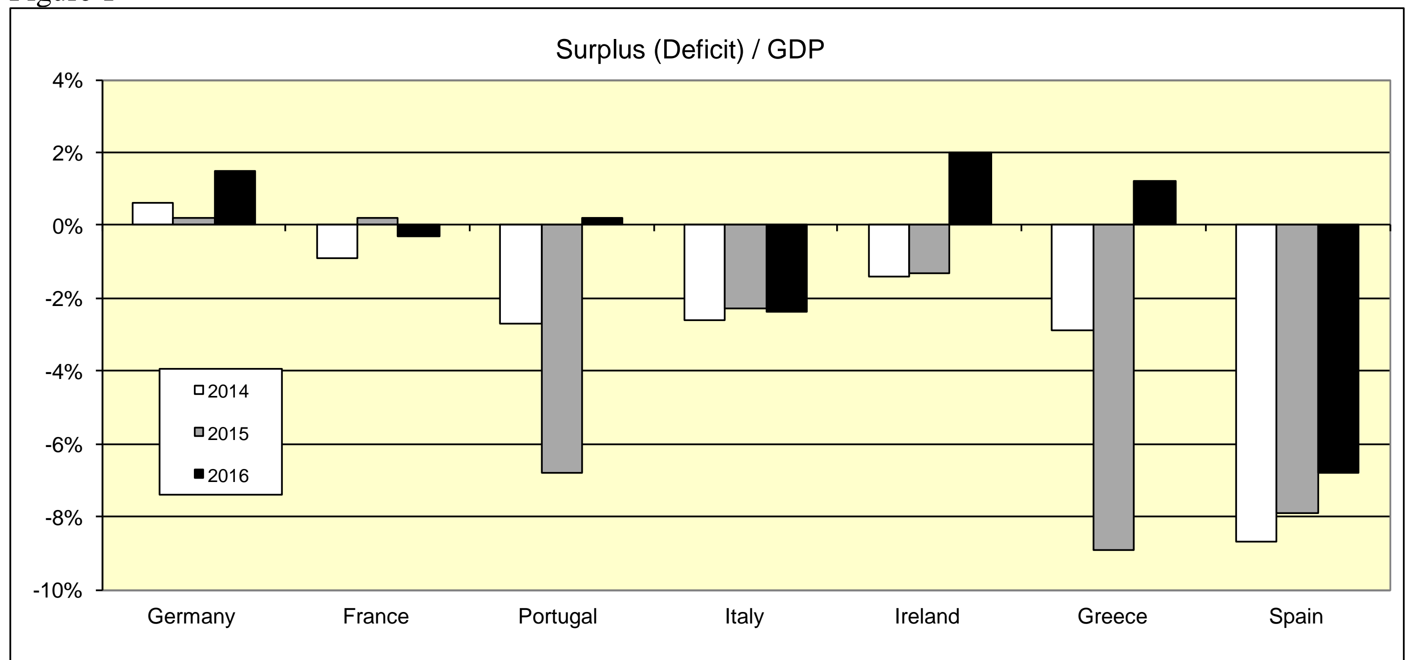
During the early aftermath of the global financial crisis in 2008-09, Europe's sovereign debt situation made regular headlines. Concern over the survival of the Eurozone proved to be one of the primary drivers of volatility. More recently, early negotiations around Brexit and resultant uncertainties with respect to trade and politics have provided additional rationale for avoiding the region. However, the continued low interest rate environment coupled with efforts to control government debts and deficits are now being accompanied by a move away from isolationist political views. These developments have formed the basis for an improved outlook for the region, both economically and from an investor's perspective.

The PIIGS

Figure 1

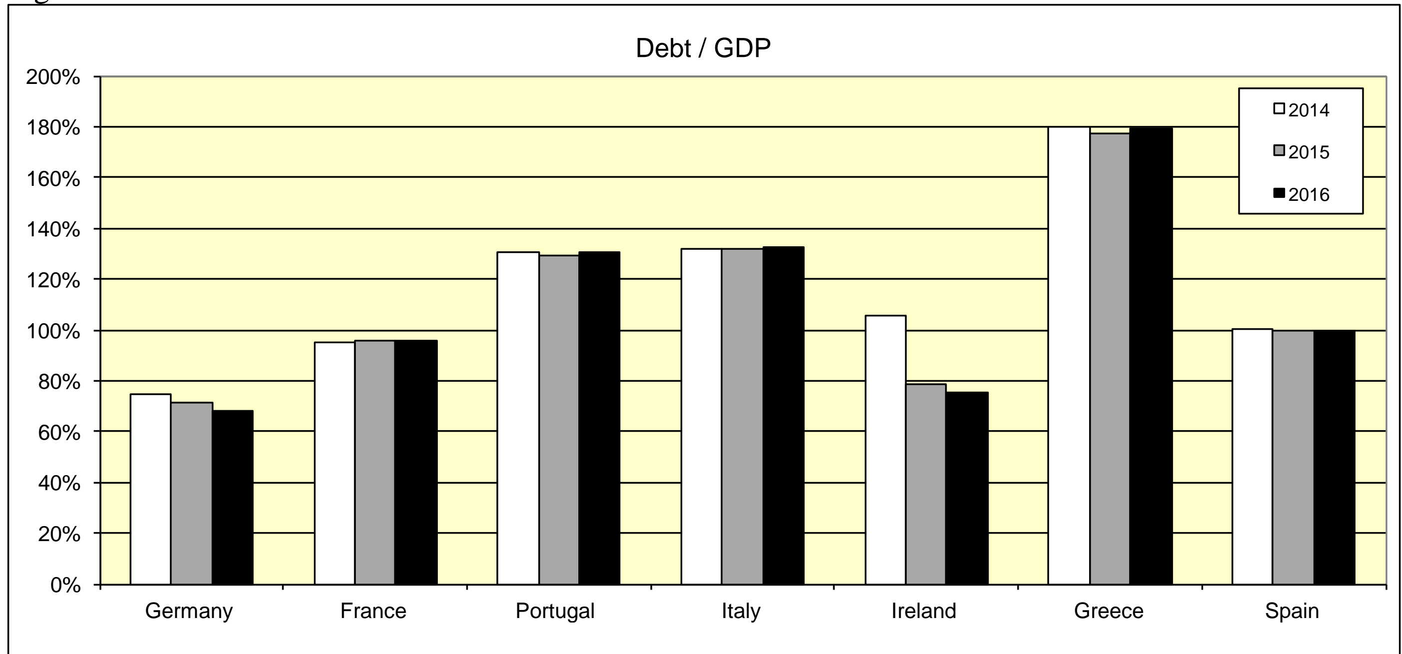


Source: EuroStat

Canadian investors can be forgiven if their first thoughts of investing in Europe return to the so-called PIIGS nations (Portugal, Ireland, Italy, Greece and Spain) as they recall the media's focus on precarious debt positions and the "pending collapse" of the euro, which has yet to occur. As can be seen in Figure 1, the swings in the size of deficits in these countries, when compared to the larger economies of Germany and France, have been substantial. All five countries reported deficits in 2015. Greece was the worst offender at

8.9% of GDP. Nevertheless, the beleaguered nation posted a surplus of 1.2% of GDP in 2016. Portugal and Ireland also recorded surpluses that year. Although Spain and Italy remained in deficit positions, both countries showed signs of improvement or, at least, stability.

Figure 2



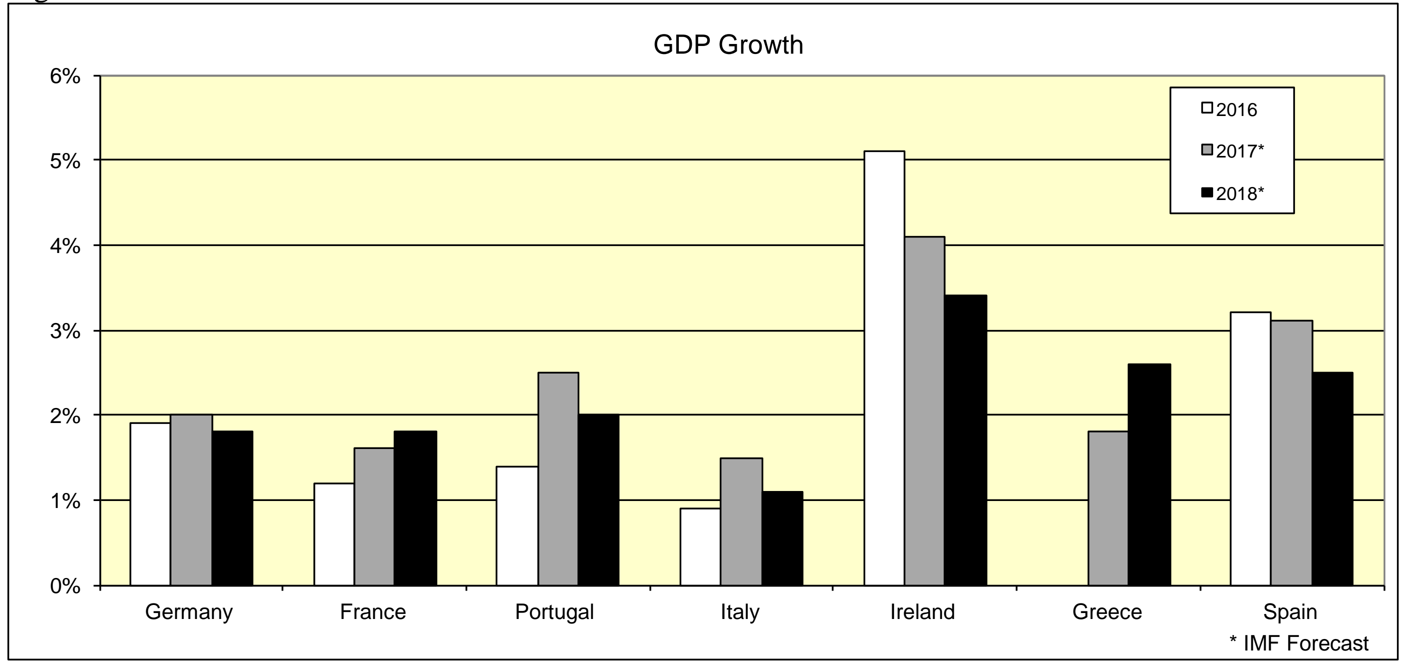
Source: EuroStat

As the deficit positions improve, the results are reflected in each country's debt. As can be seen in Figure 2, the improvements have not been as dramatic. Greece continued with a debt-to-GDP ratio of 179.0% in 2016 while Italy's debt stood at 132.6% of GDP. Ireland had the greatest improvement as its debt-to-GDP ratio tumbled to 75.4% in 2016 from 105.3% in 2014. Even Spain's debt-to-GDP ratio edged below 100% (99.4%) in 2016, aided by underlying growth in both its economy and greater regional stability. As has been the case with all major central banks, the European Central Bank (ECB) has maintained easy monetary policy. Against this stable backdrop, heightened efforts to reduce government debt burdens and an increased willingness to negotiate agreeable terms has allowed the region to turn this corner. As well, the election of French President Emmanuel Macron has signalled a step away from the more isolationist sentiment that previously appeared to suggest an imminent breakdown of the European Union.

As these fears diminish, the economic picture looks brighter. In Figure 3, the latest International Monetary Fund (IMF) outlook revealed upgrades for GDP forecasts for the region's two largest economies plus the formerly troubled PIIGS nations[1]. These upgrades come even as recent data on economic growth have been stronger than expected.

[1] IMF, World Economic Outlook. October 2017

Figure 3

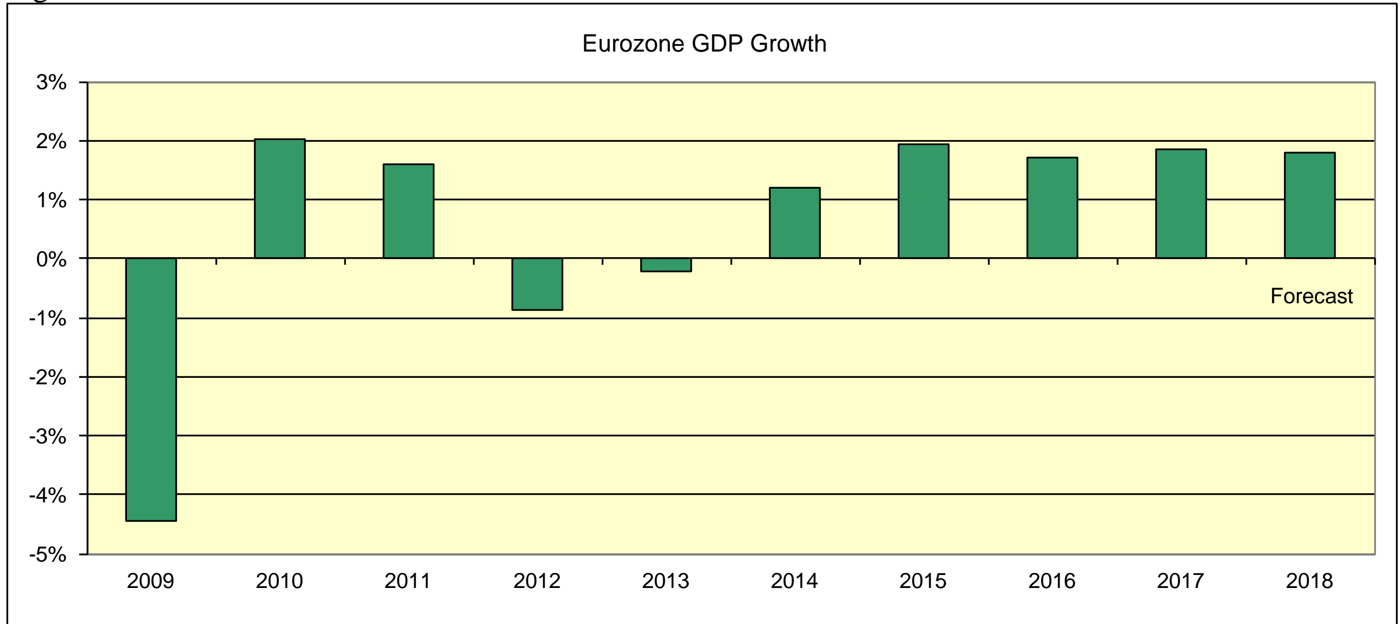


Source: International Monetary Fund

The Eurozone

Industrial production in the Eurozone jumped 1.4% in August, pushing annual growth to 3.8%. This is a dramatic improvement as an annual decline in output was reported as recently as July 2016. Labour conditions have also improved. The unemployment rate in the region was 9.1% in August 2017, the same as in the previous two months. Although this appears relatively high by North American standards, it is the lowest jobless rate since February 2009. Additionally, it is down from the 9.9% level that prevailed in August 2016 or the 12.0% level seen in 2013. As can be seen in Figure 4, the Eurozone is expected to continue its economic expansion into 2018.

Figure 4



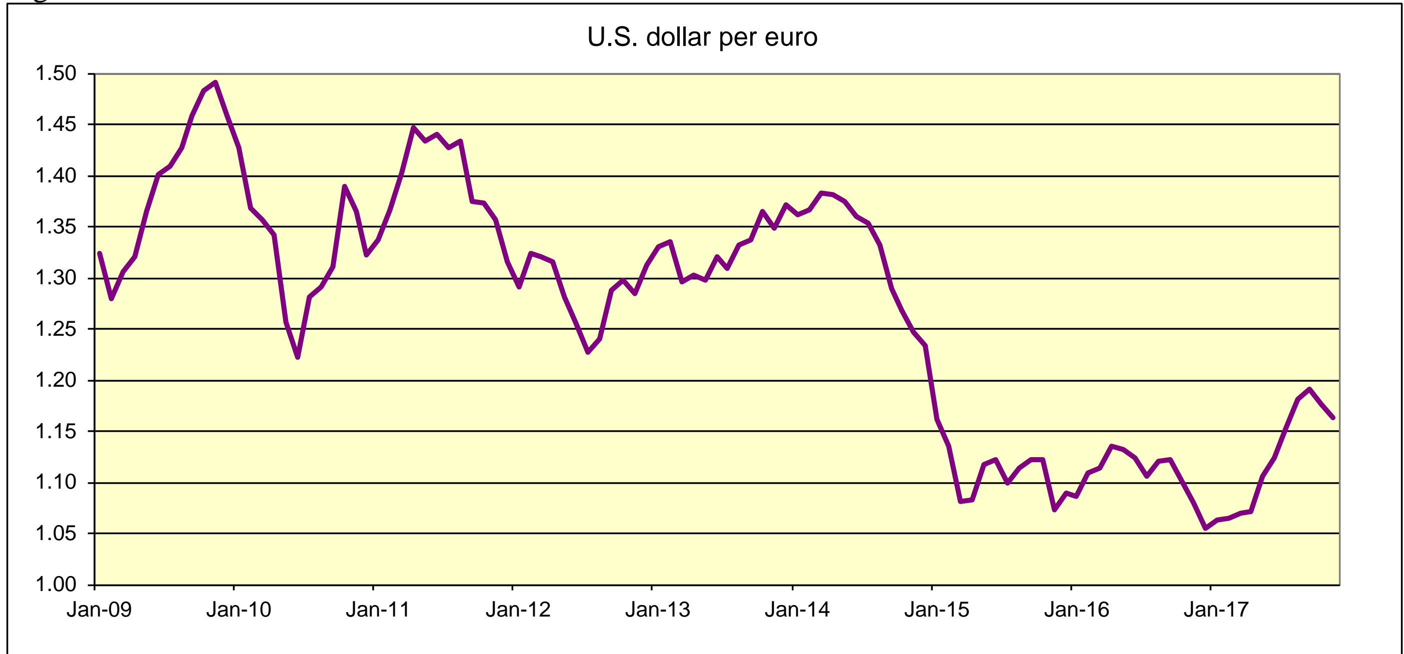
Source: Organization for Economic Cooperation and Development

While unusual from a historic perspective, deflationary fears have been part of the economic discussions in most European regions for some time. As recently as April 2016, consumer prices in the Eurozone were in negative territory on a year-over-year basis. Consumer prices increased by 1.5% (year-over-year) in September 2017, the same pace as the previous month. Annual core inflation, which excludes the volatile prices of energy, food, alcohol and tobacco, was also confirmed at 1.1% in September, compared with 1.2% in August. As the ECB considers annual core inflation in its policy decisions, a return to more traditional monetary policy can be expected to follow these signs of stable, if still low, inflation.

The currency

While the ECB continues to hold its benchmark refinancing rate at 0%, where it had first been set in March 2016, it confirmed that net asset purchases are intended to continue at the current monthly pace of €60 billion until the end of 2017. A gradual reduction in purchases is anticipated for the beginning of 2018. The need for the additional monetary stimulus provided by this quantitative easing (QE) program is expected to steadily diminish afterward. An end to the ECB's QE program will likely follow the pattern set by the U.S. Federal Reserve as it too winds up its QE program. Additionally, one of the outcomes from ECB policy has been its influence on the euro itself. The weakness in the currency relative to the U.S. dollar has provided an economic boost. As can be seen in Figure 5, the euro is now off the lows (of near par with the U.S. dollar) following U.S. President Donald Trump's election win in 2016. Still, it remains at levels that are supportive for trade and this continues to be reflected in the GDP data.

Figure 5



Source: U.S. Federal Reserve

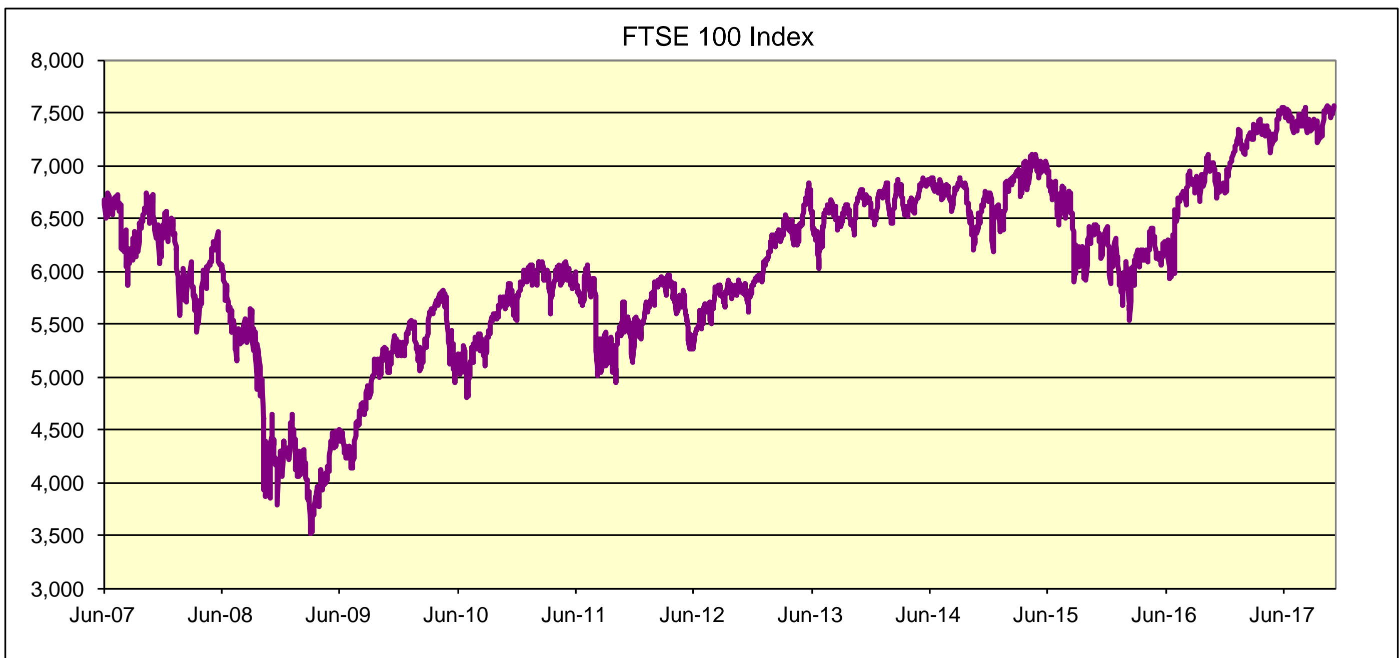
The markets

As Figures 6, 7, and 8 show, Europe, let alone the Eurozone, is not represented by a single equity market. Germany's DAX has been performing much like the U.S. equity market. By comparison, the benchmark S&P 500 Index has advanced 283.5% from the peak of the financial crisis in March 2009. Like its U.S. counterpart, the DAX has also seen new highs and was up 267.6% (over the same period) to November 3, 2017. Although the U.K. is not part of the Eurozone and is decoupling from the European Union through the Brexit process, it is worth noting that its equity market performance has been more like that of Canada. With its early November high, it stood with a cumulative 115.3% advance from its March 2009 low. The Canadian market posted a similar 113.2% gain on November 7, 2017 from its March 2009 bottom. The French CAC 40 possesses some similarities, but is also different. The French equity index stood with a cumulative 119.0% advance on November 3, 2017 from its financial crisis low. However, this has been insufficient to recover to the pre-crisis high seen in June 2007. Concerns over investing in Europe over the past several years have been based on a number of uncertainties. Not all of these uncertainties have disappeared. Brexit negotiations will leave trade questions on many fronts, at least for the medium term, and the Catalan independence referendum has created new uncertainties. However, the region's wider fundamentals have improved. Taking advantage of professional advice can help ensure an individual's investment portfolio is well diversified and will be able to benefit from underlying improvements – wherever they materialize.

Figure 6

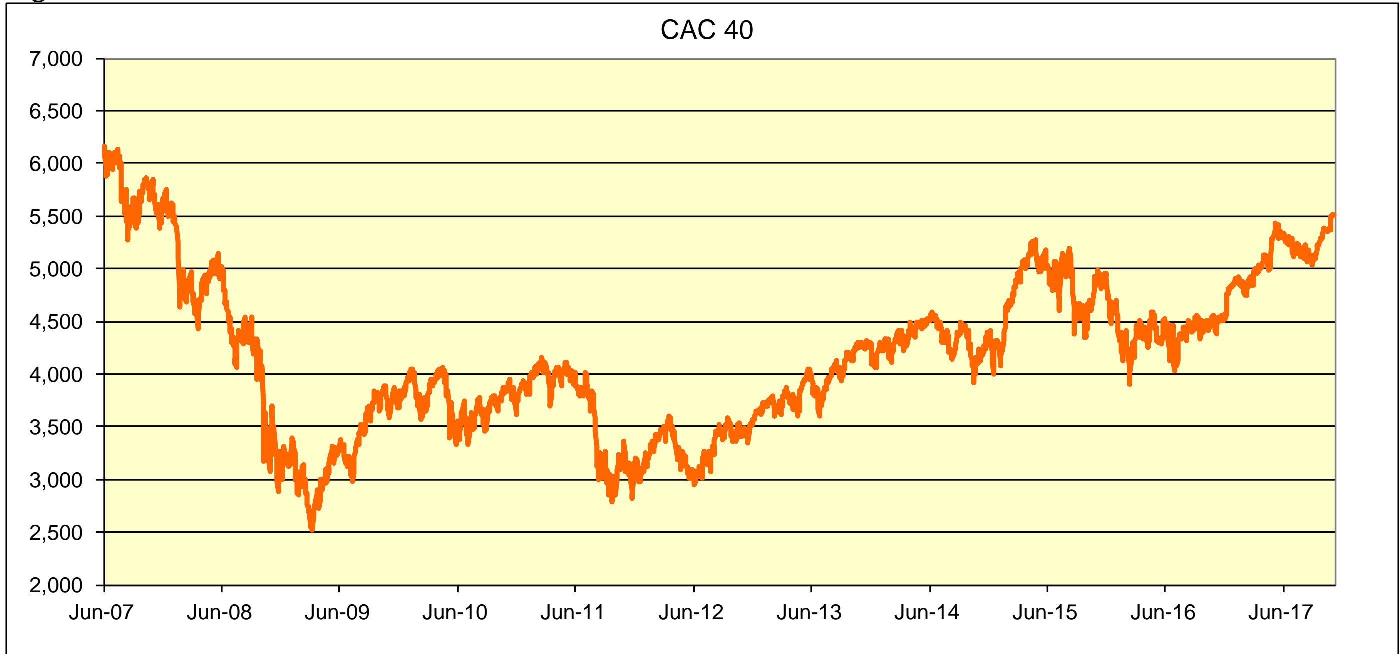
Source: Bloomberg

Figure 7



Source: Bloomberg

Figure 8



Source: Bloomberg

Conclusions

- While worries over sovereign debt issues may arise unexpectedly from any region, the systematic risks that previously plagued the Eurozone appear to have diminished significantly. Efforts made by governments within the region have provided the basis for improved stability.
- Improving underlying economic conditions for the so-called PIIGS nations, and for other European countries, have provided the basis for stronger corporate profitability and improving market conditions.
- The absence of headlines, even negative ones, sometimes means that market participants may begin to overlook investment opportunities. Taking advantage of professional advice ensures that an investor avoids emotional ups and downs and maintains a well-diversified investment portfolio.

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