MAERKI BAUMANN & CO. AG

PRIVATE BANK

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The outlook for Europe

Europe has changed greatly over the last few decades. The fall of the Iron Curtain gave this divided continent a fresh perspective, lending the political "Project Europe" enormous impetus. Now, however, the United Kingdom has decided to leave the EU, while at the same time there are growing tensions evident within the Union that place a major question mark over the vision of an ever-closer political and economic community.
From an economic standpoint, Europe is very much on an upward trajectory, which is why this edition of the Investment Comment will also look at the question of whether the time has now come to gain greater investment exposure to this continent. Below we provide an overview of the macroeconomic situation in various European countries, take a look at the intentions of the ECB, and – last but not least – consider the political situation in specific countries.

The many uncertainties of Brexit
The investment community appears to have resigned itself to Brexit. The process of separation, which was initiated by the British Prime Minister's invocation of Article 50 of the Lisbon Treaty at the end of March, has made little progress so far. Indeed, there has actually been a rise in the risk of the UK leaving the EU without any agreement. The British economy is ailing, while inflation – essentially imported as a result of the weak pound – has risen sharply; this is not a comfortable situation for the Bank of England, which is currently holding monetary policy on a very loose leash. We do not see any attractions of an investment in the UK over the next few quarters, even though the pound is heavily undervalued against a backdrop of enormous uncertainty. Be it a hard, soft, or any other type of Brexit, we are currently abstaining from any recommendation in respect of new investments in the UK.

PIGS
The financial crisis of 2008/2009 sparked off a recession from which certain member states of the eurozone – notably Portugal, Italy, Greece and Spain (the so-called PIGS) – have yet to recover fully. In many places, gross domestic product remains below the levels last seen at the end of 2007, with the recession of 2011–13 having led to further problems. For example, youth unemployment remains very high: At the end of 2016, it amounted to a good 19% in the eurozone, or 17% in the EU as a whole. At the same time, governments have had to tighten their belts even more to meet the criteria of the Fiscal Compact. That said, the macroeconomic outlook has improved dramatically, with growth currently at its highest level since rebounding from the initial slump of 2008–9. For example, Portuguese GDP is set to grow by some 2.5% in 2017, while the equivalent figures for Italy, Greece, and Spain are 1.2%, 1% and 3% respectively.

Euro crisis in the rear-view mirror
So is the euro crisis a thing of the past? A glance at the EUR/USD exchange rate shows that this currency pair has risen by 15% recently – a significant movement, and one that clearly reflects the improved economic situation of the Eurozone, which is currently growing at a faster rate than the US economy. But despite all the "europhoria", we would observe that the US dollar has played its part in this

development. For now, Trump's major gambits in the form of tax cuts and infrastructure spending have yet to materialise.

One consequence of the improved situation is the fact that the European equity market – as measured by the DJ Euro Stoxx Index – has come to the end of an eight-year relative downward movement (as compared to the global equity index) and has now embarked on an upward trend, at least in US dollar terms. Contrary to the very mild correction that took place during the summer months in the US (-2.8% at most), significant price declines were evident in local currency: For example, the DAX fell by 8.4% from peak to trough, but as the euro appreciated during this period, the decline in Swiss francs worked out at less than 2%.

European stocks remain interesting from a valuation standpoint. When viewed on the basis of Shiller P/E ratios, there is still significant potential in Europe, particularly as corporate earnings are rising sharply. In contrast to the US, European earnings forecasts for the next few years have seen upward revisions, which suggests that the outperformance of European equities will continue.

Monetary support still in place

There is something ironic about a situation in which the President of the ECB continues to make a worried impression at the same time as economic growth is being revised upward with every quarter that passes. In the absence of any significant inflationary developments taking hold, the ECB can afford this "dolce far niente". However, given the time-lag that exists between the deployment of monetary instruments and their impact on the real economy, we believe the wait-and-see stance adopted by the ECB harbours latent dangers. The crux of the matter here is the securities purchase programme: We get the impression that the central bankers are concerned about a possible sharp rise in the financing costs of individual states in the absence of this support. The ECB's press conference on 26 October will certainly provide fascinating facets in this respect.

Political powder keg

The next six to nine months will certainly remain interesting. First up are the coalition negotiations in Germany, which could prove fraught. The conflict over Catalonian independence is also coming to a head, with the possibility of tangible consequences. Meanwhile, the upcoming elections in Austria – while hardly the focus of market interest – could deliver electoral gains for previously ostracised parties, and the next round of elections in Italy (May 2018 at the latest) is already casting its shadow. It is here that we discern one of the greatest obstacles for "Project Euro" going forward: with outstanding government debt of some EUR 2,300 billion, Italy is in a sense "too big to fail" for the eurozone. With tens of thousands of refugees having crossed the Mediterranean now being stranded in Italy, the political climate could become toxic to the point where a euro-sceptic government takes power in the spring. Admittedly, these are only fears at this juncture. But with every month that passes without Italy's European partners offering a helping hand, the risk of an electoral result that is detrimental to the (much-vaunted) notion of "European solidarity" grows. More clarity may come in December with publication of the Euro Barometer, a European Commission survey conducted in the member states in October. It would be an unhealthy sign if the proportion of Italians who believe the euro is a bad thing for their country (2016: 47%, 6% up on the previous year) were to rise. By way of comparison, only 26% of Germans (+4%) took the view that the euro was a bad thing for their country in the last survey.

Conclusion

It has been a very long time since Europe's economic outlook was this rosy, particularly from the perspective of an equity investor. On the one hand, valuations are relatively low. But on the other there is good reason to expect strong earnings growth. While there will no doubt be the odd political stumbling block in the road to the future, predictions of the demise of the EU or the eurozone look much less convincing now than they have for quite some while.

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