August 2015

Monthly Update

ETF Securities Research and Roubini Global Economics

Threats to Europe's Cyclical Recovery

- Our focus this month is on the threat to the European cyclical growth recovery, particularly the eurozone.
- The eurozone is in the middle of a weak cyclical rebound that began in Q2 2013 after a double-dip recession, but has gained pace (to 1.0% y/y) recently as a result of the lower interest rates, the weaker euro, the reduced fiscal "drag" for some countries (due to the increased "fiscal flexibility" that the EU authorities have allowed), lower oil prices and other idiosyncratic factors. Near-term threats abound, and longer-term problems remain as well.
- Most notably, if Greece fails to implement reforms, it could flunk its third successive "bailout". The UK's economy and politics are diverging from the EU, and other "anti-system" parties are gaining (in France, Hungary and Spain), while reform efforts are weak, indebtedness high and demographics negative.
- ***What to watch this month*:** Bank of England monetary policy committee meeting (August 6), for indications about when to expect a rate hike; Greek negotiations toward a European Stability Mechanism loan (mid-August)—further clues about whether the calm can be sustained.

Heatmap: Roubini's End-2016 GDP Growth Forecasts for Europe (%)

Source: Roubini Global Economics

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Key Theme: Greece and Other Threats to the European Cyclical Recovery

The eurozone is in the midst of a cyclical rebound thanks to lower interest rates, the weaker euro, reduced fiscal "drag" in some countries, lower oil prices and other factors, but threats abound.

Greece Rudely Interrupts

Until the Greece debt negotiations went into crisis territory, the eurozone was in the midst of a weak cyclical rebound that began two years ago, supported by domestic consumption, less self-immolating austerity and, to a lesser extent, net exports, as the region (especially core countries like Germany) gained from the weakness of the euro.

Even with the immediate threat of "Grexit" averted, downside risks remain and a broader structural recovery remains elusive. For the latter, the authorities would have to do much more to support aggregate demand.

As such, we expect the ECB will continue quantitative easing *beyond* 2016 and see the euro continuing its downward trajectory against the U.S. dollar at a moderate pace. We see two main scenarios ahead for Greece, which have differing effects on the rest of Europe.

Scenario 1: Spillovers Contained

In this scenario (the base case and where we seem to be at present), the impact of bank closures and capital controls would be contained and any spillover effects would be marginal on other periphery countries. Indeed, Germany and France, might perform slightly better because of the easing of financial conditions as a direct consequence of the lower yields boosting private-sector investment. In Spain and Italy, a weaker euro would offset slightly higher yields, limiting the impact on GDP.

The repercussions of austerity and mild bank/capital controls for Greece are negative and self-defeating, but, for the eurozone in aggregate, the impact would be contained, with no great difference in annual growth rates—it would continue on its cyclical rebound and moderation in 2016.

Scenario 2: Greece Defaults (but no Grexit)

This scenario of "limbo" for Greece is a longer extended version of Scenario 1, with all shocks lasting two quarters. However, here, Greece would also default on some of its debt and, as a result, there would be movements in yields for countries that are susceptible to either safe-haven or contagion flows. This scenario is most likely when Greek Bailout 3.0 falls apart.

In that case we would see larger and more significant spillover effects into the wider eurozone. The two countries outside Greece that would be significantly affected under this scenario, especially in 2016, are Italy and Spain, which would lose -0.5 pp and -0.3 pp of growth compared with our baseline view of those countries. Italy would be affected through a combination of a worsening trade balance and a decline in investment; Spain mostly through investment. The latter would be influenced by a rise in the real cost of capital as rates increase.

In Germany, the impact of a downturn in intra-eurozone trade would also be large, with a negative contribution to growth in 2016. However, the lower cost of capital would increase private-sector investment, leading to a net gain in 2016. France would be a similar story.

As a whole, the impact of this scenario would reduce eurozone growth from our baseline forecasts by as much as 0.1 pp and 0.4 pp in 2015 and 2016, respectively, assuming firewalls prevent spillovers from taking hold. But the rest of Europe would stand to benefit by somewhere in the realm of 0.2-0.3 pp in terms of 2016 growth, as a result of the positive spillovers from the flight-to-safety impact on yields.

Figure 2: Eurosystem's Exposure to Greece Stands at €130 billion (Greek intra-Eurosystem liabilities, €, billions)

Source: Bloomberg

*The Eurosystem consists of the ECB and the eurozone national central banks

Figure 3: Eurozone's Cyclical Rebound (GDP growth; %, y/y)

Source: Haver, Roubini Global Economics

What to Watch

- ***Greek negotiations and reform plans:*** Can the government keep the reform show on the road enough to get ESM funding? Slippage could quickly lead to Grexit.
- ***Spain's election(s):*** A Podemos surge would lead to market jitters and weigh on growth via reduced investment.

Past performance does not guarantee future results.

Asset-Class Implications: Fixed Income

Developed Markets

In developed-market fixed income, we have not altered our outlook for Treasurys or bunds, with year-end targets of 2.5% and 0.5%, respectively, fairly close to current levels.

Longer-term yields in the G4 continue to be restrained by the large-scale asset purchase programs operated by the European Central Bank and Bank of Japan, and there is little sign that underlying fundamentals are improving sufficiently to warrant an end to those programs.

We continue to expect another round of so-called "quantitative and qualitative" easing from the Bank of Japan later this year.

Upside risks to yields would include greater eurozone reflation, even if growth lags, or if the market reduces the odds of a "stop-and-go" Fed scenario to a steadier "normalization."

Emerging Markets

We think emerging markets will remain under pressure as Fed hikes approach.

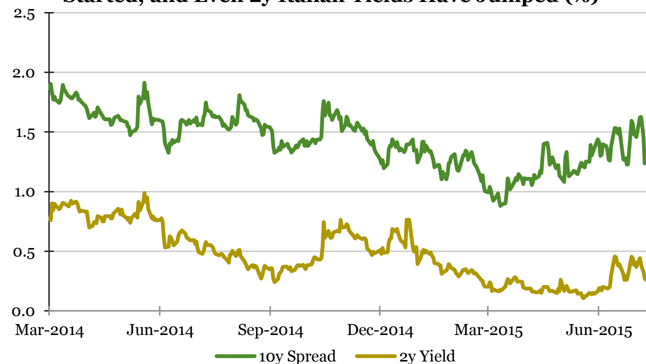
Currencies that are relative outperformers, such as the Chinese yuan, the Korean won and the Israeli shekel, will remain resilient due to current account surpluses.

Total return should be flat across the emerging-market currency universe, with higher yields offsetting spot weakness (for example, in Brazil, Russia and Turkey).

The bottoming out of oil prices should help the Mexican peso and the Russian ruble. This has been the case year-to-date.

Emerging-market external debt spreads will likely widen slightly, but slow Fed hikes argue against a sharp correction.

Figure 4: BTP Spreads (% vs. Bunds) Have Widened Since QE Started, and Even 2y Italian Yields Have Jumped (%)



Source: Bloomberg

Asset-Class Implications: Equities

Developed Markets

Stock-price action in late Q2 was largely driven by the rising risk of Grexit and jitters about China, but these shocks appear to have peaked, allowing the market to focus on micro factors (earnings).

However, soft U.S. retail sales for June and additional weakness in oil prices now pose downside risks to Q3 growth—tempering the improved market views on the U.S. outlook.

This suggests downside risk to growth-leveraged sectors (domestic and international cyclicals).

Growth-related risks to the aggregate, though, are offset by higher odds that the Fed will delay its initial rate hike (until December rather than September).

Within the S&P 500, the balance of risks appears more supportive of financial sectors than growth-sensitive sectors.

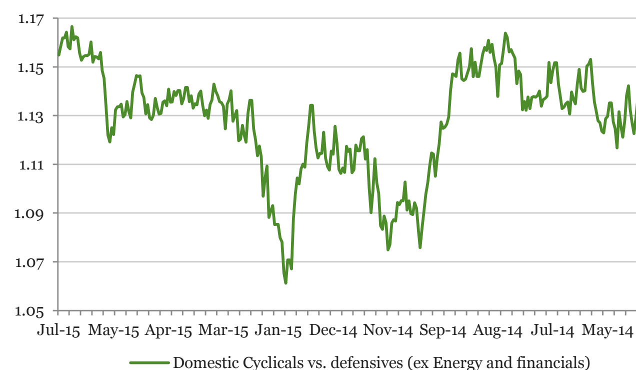
We see only moderate pressure on U.S. equities if the Federal Reserve begins to hike the Fed funds rate in September.

Emerging Markets

Our top emerging-market equity picks remain those with attractive equity risk premium, namely Mexico, Russia and South Korea.

We remain neutral on South African equities, which benefit from sizeable domestic institutional holdings, as well as investor concerns about Russia and Turkey, the other major EMEA equity markets.

Figure 5: Improved U.S. Domestic Stocks Performance

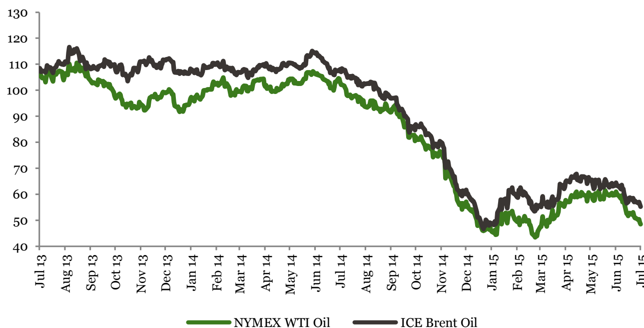


Source: Datastream

Asset Class Implications: Commodities

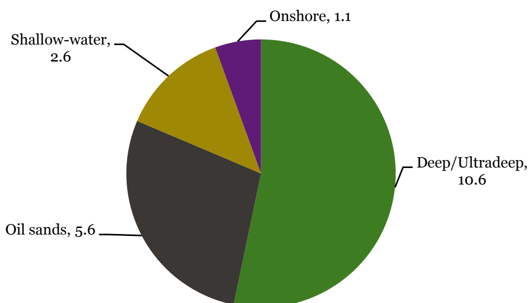
In “What happens when fundamentals reassert over sentiment?” (June 2015), we argued that the oil price rally between March and June had the potential to choke off the cuts in capex that the energy industry had planned. As we expected, excess supply has driven prices down further. We believe if prices remain at such levels for several months, high cost projects will get deferred or cancelled, helping to tighten the oil supply-demand balance.

Oil Price Decline to Drive Next Round of Capex Cuts



A recent study by Wood Mackenzie shows that 20 billion barrel oil equivalent (boe) of final investment decisions in upstream energy will be deferred as a result of the rout in prices this year. That equates to a US$200bn hole in the industry’s investment pipeline. Over 50% of those cuts come from deep water projects and nearly 30% from Canadian oil sands. The lead-times for these projects are long. Once deferred these projects will not come back on-stream quickly.

Deferred Project Reserves by Resource Theme (bn boe)



Source: Wood Mackenzie

We expect OPEC to continue to invest and increase supply. The potential lifting of sanctions in Iran will lead to higher supply once the county has made the necessary infrastructure upgrades. An antagonised Saudi Arabia will continue to produce at a break-neck pace to defend its market share. OPEC spare capacity is likely to remain wafer thin. Any shocks to the market could therefore quickly translate into price spikes.

The nimble shale/tight oil industry will likely remain the balancing agent. In event of a shock, shale production is likely to quickly ramp up production, in response to higher prices. As a result, investment in the US will likely remain undeterred.

Asset-Class Implications: Foreign Exchange

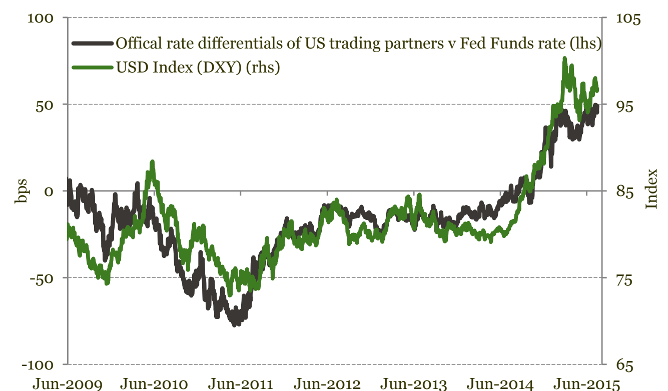
The divergence of growth between countries, and in turn monetary policy, will remain the key driver of G10 FX performance over in coming months.

The US Federal Reserve remains balanced in its rhetoric, highlighting the gains made on the jobs front. With full employment a goal of US Fed policy, alongside price stability, both need to be considered. The problem is that inflation tends to lag an improvement in economic activity, and thus the central bank must tailor its monetary policy 12-24 months in the future. After all, the economic impact of changes in monetary policy also occur with a lag.

We expect the Fed to maintain its intention to raise rates in 2015 and feel that the September meeting would be appropriate time to make its first and modest rate hike given the improvement in the underlying economy. Nonetheless, presently, there is an interesting divergence between market pricing and economic consensus on when the Fed will raise rates: the former is pricing a November hike (the FOMC meeting is held on the 27-28th October), while economists expect a September tightening. We feel that as the market begins to price in a September hike, the US Dollar will benefit.

A rate hike this year is likely to see a continuing divergence in rate differentials between the US and its major trade and investment partners. Such a widening of differentials is likely to see the USD test the highs seen earlier this year.

Rate Hike to Boost the Dollar



Source: Bloomberg, ETF Securities

Currently the options market is pricing strength for the US Dollar against all other G10 currencies, with the exception of the Japanese Yen over the coming month. The worst performing currencies are expected to be those linked to commodities, namely AUD, NZD, CAD and to a lesser extent, NOK. So-called commodity currencies are also expected to be some of the worst performers over the coming month against EUR and GBP.

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