Europe: Open-Ended Stimulus a Positive…But Now We Need Reform

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- ***We are heartened by the ECB's decision to help restart a lousy economy.***
- ***European earnings need to increase for the recent rally to be more than a short-lived counter trend rally, in our view.***
- ***We think long-term value exists in the region, but recognize structural reform is needed to unlock this value.***

The last month or so has brought welcome news to any investors who count on central banks to wield influence over the value of stocks. Back in July it was the Fed who kicked things off by restarting rate cuts, a trend likely to continue this week with the upcoming FOMC (Federal Open Market Committee) meeting. Last week, another central bank got back into the 'easing' act: the European Central Bank (ECB).

In Mario Draghi's last act as ECB President, he announced a sweeping set of stimulus measures aimed at reigniting the moribund Eurozone economy. The measures included a 10bp cut of the deposit rate to -50bps (bps = 1/100th of 1%) and a restart of quantitative easing (QE) at 20B EUR per month, pledged until inflation gets closer to the ECB's target. In a nod to banks, a new program designed to incentivize lending into the real economy was introduced, along with a 'tiering' structure on bank deposit reserves to help minimize the effect of negative interest rates on the profitability of the banking system. After a volatile trading day on Thursday as markets digested the news, Euro stocks and the Euro eventually strengthened to end the week. Importantly, European bond yields also rose, reflecting some optimism around future growth and inflation in the region.

THE GOOD NEWS: OPEN-ENDED NATURE OF EURO QE IS A POWERFUL SIGNAL

We view last week's ECB decision as most impactful with regard to the open-ended nature of stimulus and interest rate guidance. In Draghi's own words, QE is likely to continue until "shortly before the first rate hike," which in turn is now directly linked to Eurozone inflation. This is a departure from prior ECB stimulus efforts, which were linked to a specific time-frame. This suggests to us that, despite political opposition from within and outside the ECB, QE is set to continue until growth and inflation improve meaningfully. Incoming ECB leader Christine Lagarde, a believer in proactive monetary policy, should provide continuity in this regard, in our view.

THE TOUGH NEWS: QE NECESSARY BUT NOT SUFFICIENT FOR GROWTH

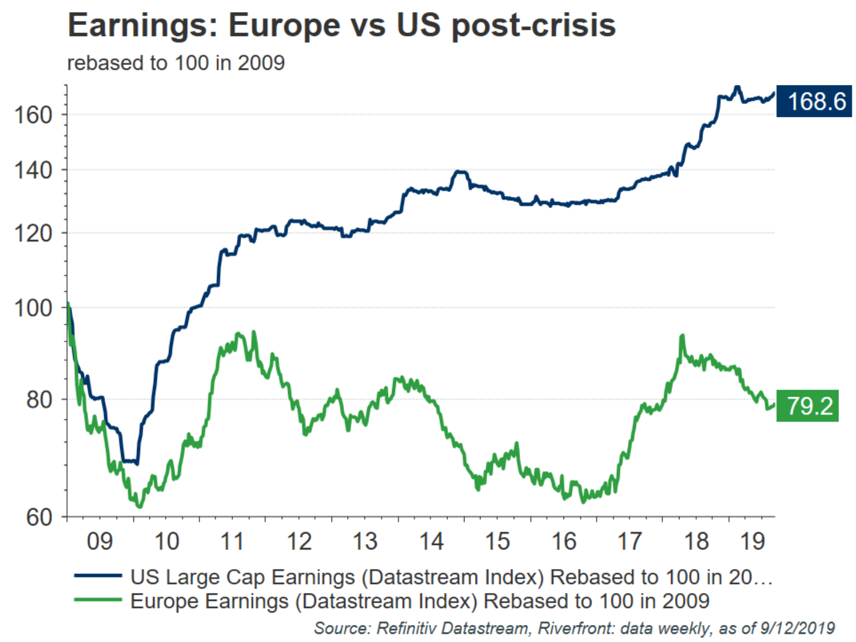
Now for the heavy lifting: we view easy monetary policy in the Eurozone as necessary, but not nearly sufficient in order to create a *lasting* economic rebound in the region. We believe open-ended monetary stimulus and negative interest rates can provide a 'floor' for Euro assets, but low/negative rates on the banking system also mean that monetary policy has a 'ceiling' unless combined with looser fiscal policy and other structural reforms. Lasting momentum can only come with European policymakers tackling structural issues like labor rigidity and high unit labor costs, high tax rates, and impediments to business creation and innovation, in our view. Draghi used his last appearance on the ECB stage to strongly reiterate this need for reform. However, with political instability in important Eurozone countries like Italy and Germany as well as in large Eurozone trading partners like the UK, it's hard for us to envision policymakers mustering the political will needed to tackle these unpopular reforms in the near-term. We are encouraged by French progress under President Macron but recognize that the most politically unpalatable part of his platform, pension reform, is still ahead.

EURO BANKS HOLD THE LONG-TERM KEY TO EURO STOCK MARKETS

QE has a mixed track record in the Eurozone. While Eurozone economic growth was decent in the first QE era (2015-2018) and unemployment dropped, joblessness remains structurally high in comparison to other advanced-age developed economies. Corporate earnings trends have collapsed in Europe since the beginning of 2018, and stock performance relative to the US has followed suit.

The impact of the European banking system on European economic growth and profitability is profound. Unlike the US, which benefits from efficient and robust capital markets, most lending into the real economy of the Eurozone is done directly through the banks.

Our chart to the right helps detail a number of 'false dawns' for corporate profitability since Draghi and the ECB first came to the rescue of Europe with his famous 'whatever it takes' speech in mid-2012. European bank earnings were severely compromised since the 2011 Euro crisis; and banks' willingness to lend has suffered. Although banks have done an admirable job cleaning up their balance sheets, their cost structures remain too high and their profitability remains compromised by low interest rates.



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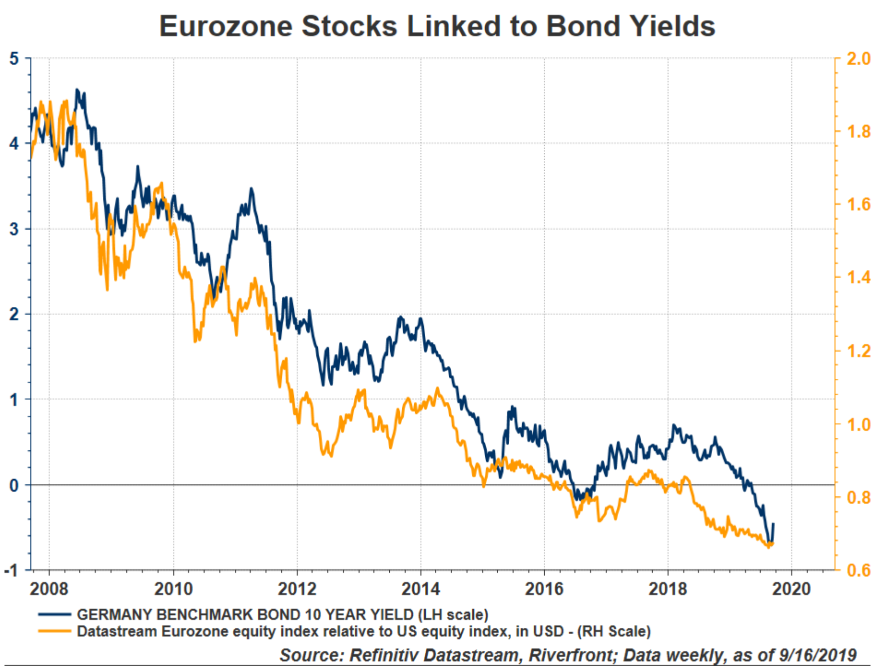
Not only are banks not lending enough, European stock indexes are also negatively impacted by the fact that the financial sector is the largest single sector, comprising almost one-fifth of the MSCI Europe Investable Market Index *(source: Factset)*. It's notable that during the ECB's last QE program, Euro bank stock prices were basically flat to down, underperforming both the region and the rest of the world index in the process.



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Banks' impact on the European stock market can perhaps most clearly be seen in the correlation between Euro interest rates and stock relative strength. The last decade has suggested a strong positive correlation between the direction of the German 10-year Bund (the Eurozone's Treasury-like benchmark bond) and the relative strength of European stocks versus US stocks (left chart). In our view, a sustained increase in bond yields is crucial for European stock performance, which means that growth and inflation expectations have to be positive enough to overwhelm the downward impact of QE on interest rates.

Simply put, it's hard to see European indices making a sustained advance without their banks leading the charge. We are encouraged by the strength in bank shares on Friday September 13, 2019 but want to see more concrete signs of either fundamental or technical momentum to get more optimistic.

RIVERFRONT'S BOTTOM LINE: NEED EVIDENCE OF REFORM IN EUROPE TO TURN MORE BULLISH

- We are heartened by the ECB's definitive decision to help restart a lousy economy. We are encouraged by early indications that stock, currency and bond yields all responded positively to the announcement, suggesting QE may help lift growth and inflation expectations in the region.
- European corporate earnings need to increase in response to ECB policy for this rebound to be more than just a short-lived counter trend rally. For this to happen, European banks have to get healthy, which requires higher interest rates over time in Europe, not lower.
- We remain believers in the long-term value that exists in the region but recognize that structural reform is needed before the bulk of this value can be unlocked.

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A basis point is a unit that is equal to 1/100th of 1%, and is used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indexes and the yield of a fixed-income security. (bps = 1/100th of 1%)

In a rising interest rate environment, the value of fixed-income securities generally declines.

It is not possible to invest directly in an index.

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The MSCI Europe Investable Market Index (IMI) captures large, mid and small cap representation across 15 Developed Markets countries in Europe. With 1,438 constituents, the index covers approximately 99% of the free float-adjusted market capitalization across the Developed Markets countries of Europe.

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