Ahead of the curve

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Europe's highly-charged year...

- **Europe's contagion this year is more likely to be political than financial. But, with the euro's solution set to take years, & the monetary engine overloaded, it's time to crank up the fiscal side.**
- **The avoidance of an extreme outcome in The Netherlands is reassuring markets. But, tensions with Turkey show where one country's referendum spills over into another's election. And the UK is opening the EU 'trapdoor' at one of the worst times politically.**
- **Tackling the *cause* of the euro's problems without stoking further social tension needs more than monetary expansion. To test whether the macro strains in the periphery are still holding back the core members, we update our 'Misery Indices' (MIs).**
- **The zone's MI should be its lowest since 2007. Also, reducing strains in the periphery & the relatively slower improvement in the core mean their unhelpful divergence since 2008 is correcting.**
- **So, while far from fixed, the worst of the euro-zone's macro strains looks behind us. Which is just as well, given the years it'll take to fix, & - critically in 2017 - Europe's highly-charged political year...**

Political rather than financial contagion...

"...monetary policy alone cannot lead to balanced growth. Fiscal policy should be used flexibly, and be growth friendly..." (G20 communiqué, 18 March 2017). *"...political risks have increased considerably in almost all euro area countries"* which threaten the fiscal and structural reforms needed for growth. This could *"contribute to contagion and refragmentation in the euro area"*. (ECB, 24 May 2016)

With 2017 being such a highly-charged political year in Europe *(see chart 1)* and signs from our own analysis that macro divergence between the peripheral and core euro members is correcting, any contagion - unlike 2008 - is more likely to be political than financial. But, with the solution likely to take years, and the zone's monetary engine overloaded, it looks time to crank up the fiscal side.

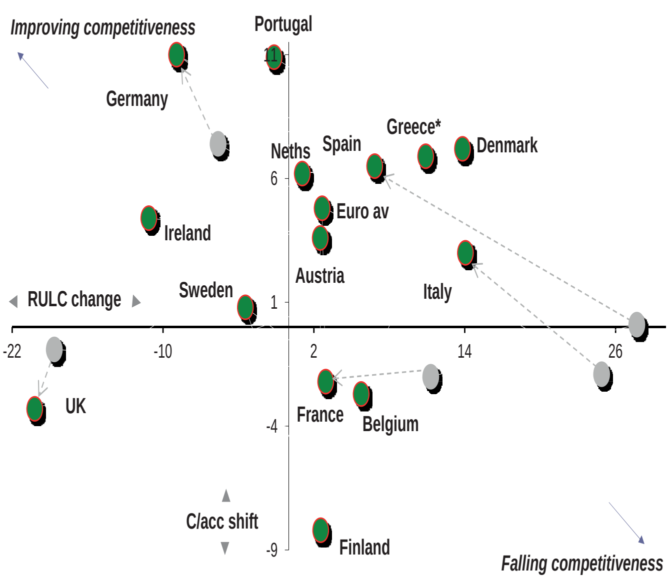
Mr Draghi's appeal to governments that have *"fiscal space"* to take back the baton from the ECB gives added urgency to administrations facing elections. While helpful in addressing the symptom, deflation, QE could never be expected to solve the underlying problem - a monetary union devoid of economic union. This will take years to sort out.

Chart 1. The EU's highly-charged political year...
Key scheduled & expected political events in 2017

22 Jan '17	France - 1st round of Socialist primaries - Hamon/Valls win
29 Jan	France - 2nd round of Socialist primaries - Hamon wins
12 Feb	Germany - Presidential election - Steinmeier selected
2 Mar	N. Ireland - Snap Assembly election - coalition
15 Mar	**Netherlands - General election - Rutte wins**
25 Mar	**60th Anniversary of Treaty of Rome**
26 Mar	Germany - regional election in Saarland
29 Mar	**UK triggers Article 50**
Apr/May	UK council elections
Apr	Hungary - Parliamentary elections
23 Apr	**France - 1st round of Presidential election**
7 May	**France - 2nd round of Presidential election**
7 May	Germany - regional election in Schleswig-Holstein
14 May	Germany - state election in North-Rhine Westphalia
June	France - Election of Lower House **Italy - likely General election**
Sept/Oct	**Germany - Federal election**
Oct	Czech Republic - Legislative/general election Luxembourg - Legislative/general election

Source: Hermes Investment Management

Chart 2. ...At a time when competitiveness is still too disparate
Change from 2000 in RULC, vs c/acc shift. Arrows denote shift since austerity in 2010



Source: Hermes Investment Management, based on OECD data (*Greece is from 2001)

The good news is that after seven years of austerity, Italy and Spain's economic performance-gap, in terms of their relative labour-cost competitiveness versus Germany, is now reducing ***(chart 2)***. But, while encouraging, it comes with significant economic and social costs, suggesting additional stimulus will be needed.

Without it, there's probably a limit to how far Spain and Italy can reform further, given male youth unemployment rates of 42% and 35%. Their real household spending are still 4-6% down on 2008, yet Germany's is 10% up. Then there's Greece, whose deflation improved competitiveness, but exacerbated its real-debt dynamics. Its €86bn package is only a 'sticking plaster', and after losing 30% of its real GDP since 2010, it too has reform fatigue.

We may be opening the EU 'trapdoor' at one of the worst times politically...

So, tackling the *cause* of the problem without stoking further social tension needs more than monetary expansion. And, despite an improving periphery, it will take years before the converging countries can reclaim their GDP lost. Italy and Greece's real GDP, on a net basis, has still yet to rise with the euro ***(chart 6)***. Linked to that, Italy's referendum last December rejected deeper governmental powers - setting the political tone for 2017. **The avoidance of an extreme outcome to Netherlands' election has since reassured markets. But, tensions with Turkey have thrown up a new risk - where one country's referendum issues spill over into another's election.**

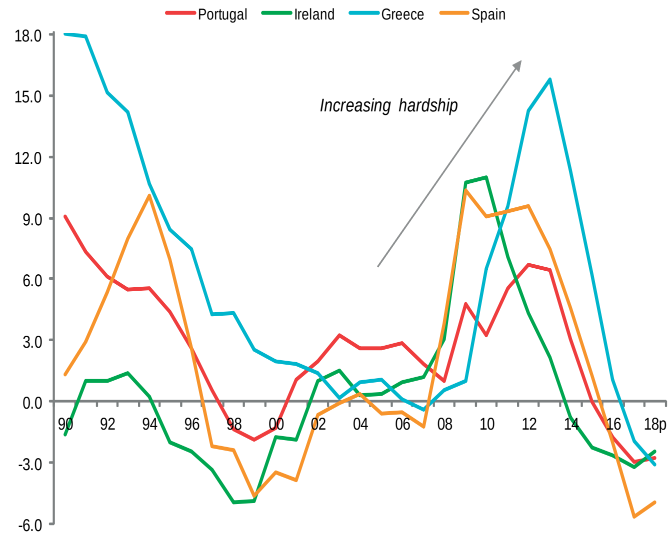
As for the UK, we could be inflaming the situation by opening the EU 'trapdoor' at such a politically sensitive time. Voters facing national elections in Germany, France and probably Italy may too want to approach it as a protest vote against austerity. With the 'peripheral' economies having bourne the brunt of the reform pain, it's little surprise that populist parties have been building. Which means our EU peers may be reluctant to condone an easy UK exit that puts its economy ahead of their own.

So, we could be choosing one of the worst times to negotiate an exit, given Europe's election calendar, and the anti-establishment feeling in the US. And the UK, and others reviewing their own European status (France?) will have to compromise if they want to maintain tariff-free trade. So, any new trade tie-ups in future – within Europe or beyond - will doubtless come with their own 'strings'. A hitch to growth is the euro-zone's absence of a region-wide fiscal agency. This probably precludes a unified fiscal giveaway, akin to the US's tax-rebates 'helicopter dropped' to consumers in 2001 and 2008. **But, with the euro-zone's 2%-of-GDP budget deficit now visibly below the 3% Maastricht 'criterion', it may now be easier to allow it unilaterally.**

To test whether the macro strains in the periphery are still holding back the core members, we update our 'Misery Indices' (MIs). Off-the-wall methods for proxying economic hardship include an index adding together a country's unemployment and inflation rates.

Chart 4: The macro strains from the periphery are easing...

The higher the 'Misery Index', the greater the economic hardship



Source: Hermes, based on Eurostat data. Includes Hermes projections (p)

Chart 3. The method & sample data behind our Misery Indices (MIs)

Sample of the data behind charts 4 & 5. The higher the 'Misery Index', the greater the economic hardship

	2017p[1]		Unemployment rates						Misery (p) % point [2, 4]	
	U rate	CPI	2012	'13	'14	'15	'16	5-yr av	2017	2018
Finland	8.5	1.2	7.7	8.2	8.7	9.4	8.8	8.6	**1**	**0**
Italy	11.7	1.2	10.7	12.1	12.6	11.9	11.6	11.8	**1**	**0**
Austria	6.0	1.8	4.9	5.3	5.6	5.8	6.0	5.5	**1**	**0**
Luxembourg	5.9	1.8	5.1	5.9	6.1	6.5	6.0	5.9	**0**	**0**
France	9.7	1.4	9.8	10.3	10.3	10.4	10.0	10.2	**0**	**0**
Belgium	7.9	2.1	7.6	8.4	8.5	8.5	8.0	8.2	**0**	**-1**
Netherlands	5.6	1.2	5.8	7.2	7.4	6.9	6.0	6.7	**0**	**-1**
Germany	4.3	1.8	5.4	5.2	5.0	4.6	4.4	4.9	**-1**	**0**
Greece	22.5	0.9	24.6	27.5	26.5	25.0	23.5	25.4	**-2**	**-3**
Cyprus	11.1	0.9	11.9	15.9	16.2	14.9	13.0	14.4	**-2**	**-3**
Portugal	10.3	1.3	15.6	16.2	13.9	12.4	11.1	13.8	**-3**	**-3**
Ireland	7.0	0.8	14.7	13.1	11.3	9.4	7.9	11.3	**-3**	**-2**
Spain	17.8	1.9	24.8	26.1	24.5	22.1	19.6	23.4	**-6**	**-5**
Unweighted av	*9.9*	*1.4*							*-1*	*-1*
***Weighted av*[3]**	***9.4***	***1.5***							***-1***	***-1***

[1] *Standardised unemployment (%), & HICPs (%yoy)*
[3] *Using adjusted GDP weights.*
[2] *Absolute CPI deviation from 1.9% (+) added to u rate deviation from 5-yr av (+/-)*
[4] *Orange shaded areas show 'above-average misery'*

Source: Hermes Investment Management MIs, based on Eurostat data, & Hermes projections (p)

Though hardly scientific, they become especially flawed in a low inflation world when the components may move in opposite directions. And, a country's nearness to deflation and what it means for wages/demand are as much a 'misery' to consumers as accelerating inflation. **We thus offer a more logical alternative to previous misery indices, and to conventional GDP estimates, for example, which are produced with a lag and frequently revised. Our MIs are the sum of two parts:**

- the *absolute* divergence of a country's CPI inflation from the 1.9%yoy synthetic average since convergence was kick-started by the Maastricht agreement, in February 1992; added to
- the divergence between that country's unemployment rate and, to gauge the economic cycle, its previous five-year rolling average.

We use Eurostat data up to February 2017, and our CPI and unemployment projections to the end of 2018 to: *(i)* highlight the disparities; *(ii)* quantify the degree/direction of convergence; and *(iii)* test whether the debtor countries are still an increasing drag on the core.

Convergence is necessary, but not sufficient

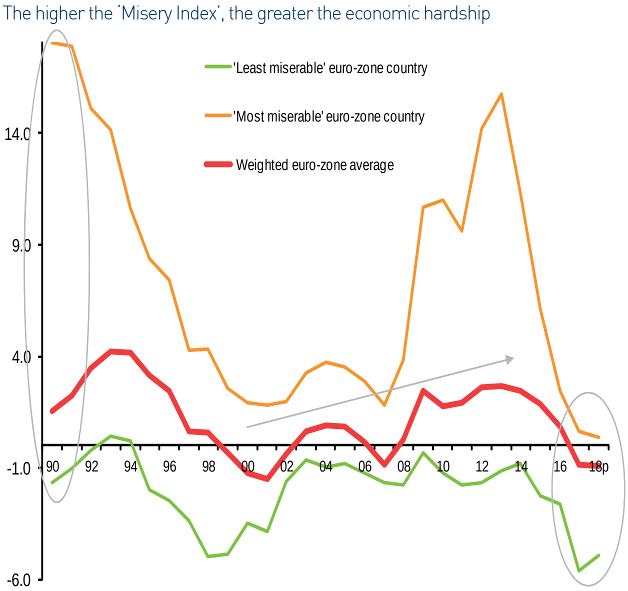
Chart 3 shows our predictions for 2017 and 2018. Rising MIs predict greater economic hardship, relative to that country's recent past. We use harmonised data, and to get the euro-zone average, adjust Eurostat's GDP weights to comprise only the established members shown. This adjustment thus excludes distortions from the newest joiners Malta, Slovenia, Slovakia, Estonia, Latvia and Lithuania.

On this basis, ***charts 3-5*** offer the following observations. First, after a marked deterioration in €-zone members' MIs during the global crisis, improvement since 2014 looks like being sustained in 2017. ***Chart 3*** shows the projected breakdown. **As a bloc, the euro-zone's (weighted) MI, at -1, this year should be its lowest since 2007.**

Second, it's not surprising to see as the 'most miserable' some of those members running austerity to cut deficits and debt. Although levels are lower, unemployment and deflationary pressures from the fiscal squeeze are dampening improvement in their *relative* positions. In 2017, Italy will for the eighth year running lie in the above-average-misery zone in ***chart 3***. **But, even these are much improved on 2010-14, and further gains look likely across the periphery *(chart 4)*.**

Chart 5: ...Meaning their divergence from the core is correcting...

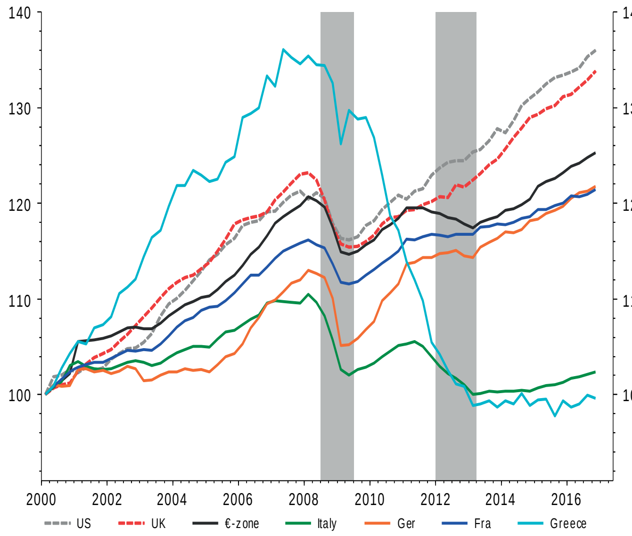
The higher the 'Misery Index', the greater the economic hardship



Source: Hermes, based on Eurostat data. Includes Hermes projections (p)

Chart 6. But, it'll be years before they reclaim GDP lost with the euro

Real GDP levels, re-based to Jan 2000 (= 100). Grey denotes euro-zone recession



Source: Thomson Reuters Datastream, based on national data

This is partly methodological of course given our five-year rolling average period is now dominated by the crisis years, but the stabilisation also fits with other data, such as GDP. Ireland's turnaround is particularly impressive, having ended in December 2013 its 2010 bail-out, then later returning to capital markets.

But, most revealing is what our MIs say about convergence *(chart 5)*. The dip in the euro-zone's MI from the mid 1990s (red line) reflects Germany's recovery after its 1992-93 unification-led recession, and the benefits as the converging countries tried to reduce inflation, bond yields, debt and deficits. ***Chart 5*** shows the two stages of convergence: from Maastricht in 1992 to the euro's birth; thereafter, with the euro, a steady re-widening as policy discipline waned.

Our MIs confirm that convergence after Maastricht was solid. They proxy convergence by tracking the highest and lowest MIs each year. In 2017, Spain looks the 'happiest' relative to its recent past (where GDP last year grew 3%yoy), with Finland/Italy the 'most miserable' (GDP +1%yoy). Greater convergence is shown by the narrowing gap between the two extremes. **It suggests misery is back down to when the euro became the single currency, with the gains driven by the periphery.**

This combination of reducing macro strains in the periphery with a relatively slower improvement in the core means the divergence since 2008 is correcting. **This is encouraging, though not of course sufficient for returning to economic health.** This still rests on the core members, which account for 80% of euro-zone GDP. Their MIs are also better. Yet, despite the relative improvement, it will take years before the converging countries can reclaim their GDP. The typical lags involved point to structural unemployment remaining high, while the reform needed for greater economic union unintentionally holds back growth. This defers the cluster in ***chart 2*** from becoming closer to a 'blob'.

So, while tacking the causes of the crisis needs more than just low rates and QE, without them, some of the benefits to Spain, Italy and others from their competitiveness gains would be offset by a stronger euro. QE could thus be with us for many years to come, including as a counter-weight to another probable Greece restructuring. **But, while far from fixed, the worst of the euro-zone's macro strains does at least look behind us. Which is just as well, given the years it'll take to reach the *"balanced growth"* sought by G20 governments, and - critically in 2017 - Europe's highly-charged political year.**

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