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HERMES CHIEF ECONOMIST– IS EURO-ZONE MISERY REALLY LIFTING?

In his latest Ahead of the Curve, Neil Williams, Group Chief Economist at Hermes Investment Management, considers whether disparate euro-zone economies are finally converging back to health.

While our base case is Greece remains in the euro, restructuring risk should stay on the radar. With Greece needing to finance €10bn in official payments by September, some form of debt rescheduling looks likely, even if Greece does leave the euro.

Greece will have to restructure - in or outside the euro
More likely, Greece will slog it out inside the system to avoid the far harsher pitfalls of leaving. Outside, the excessively high market interest rates needed to prove the creditworthiness of the new, substantially weaker drachma would risk stagflation and escalate the funding costs that would then be on its foreign-currency (euro) debt. This would be unsupported by Greece's former peers.

Avoiding this scenario needs reform, restructuring, and risks further ripple-effects on euro-zone activity. To test whether the macro strains are still spreading from periphery to core, we update our 'Misery Indices' (MIs), which adjust for deflation. Off-the-wall methods for proxying economic hardship include an index adding together a country's unemployment and inflation rates.

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 and demand are surely as much a 'misery' to consumers as accelerating inflation.

Our Misery Indices look a more reasonable alternative
We thus offer a more reasonable alternative to previous MIs, and to conventional GDP estimates, which are produced with a lag and frequently revised. Our MIs are the sums of two parts:

- the absolute divergence of a country's CPI inflation from the 2% 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.

The method & sample data behind our Misery Indices (MIs)
The higher the 'Misery Index', the greater the economic hardship

	2015p[1]		Unemployment rates						Misery % point [2, 4]	
	U rate	CPI	2010	'11	'12	'13	'14	5-yr av	2015	2016
Greece	27.0	-3.0	12.6	17.7	24.3	27.4	27.0	21.8	10	5
Cyprus	16.5	-1.0	6.3	7.9	11.9	15.9	16.1	11.6	8	5
Italy	13.3	0.2	8.4	8.4	10.6	12.2	12.7	10.5	5	3
Portugal	15.4	0.0	10.8	12.7	15.6	16.2	13.9	13.8	4	2
Spain	23.7	-0.5	19.9	21.4	24.8	26.1	24.5	23.3	3	1
France	10.5	0.1	9.3	9.2	9.8	10.3	10.3	9.8	3	2
Belgium	8.5	0.2	8.3	7.2	7.6	8.4	8.5	8.0	2	1
Luxembourg	5.6	0.5	4.6	4.8	5.1	5.8	5.9	5.2	2	1
Finland	8.7	0.7	8.4	7.8	7.7	8.2	8.7	8.2	2	1
Netherlands	6.5	0.4	5.5	5.3	6.4	8.3	8.3	6.8	1	0
Austria	5.1	1.2	4.8	4.6	4.9	5.4	5.6	5.1	1	0
Ireland	12.4	0.2	13.6	14.3	14.7	13.1	11.3	13.4	1	0
Germany	4.9	0.4	7.0	5.9	5.4	5.2	5.0	5.7	1	1
Unweighted av	*12.2*	*0.0*							*3*	*2*
***Weighted av*[3]**	***11.1***	***0.1***							***3***	***1***

[1] *Standardised unemployment (%), & HICPs (%yoy)*
[3] *Using adjusted GDP weights.*
[2] *Absolute CPI deviation from 2% (+) 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)

The table shows our predictions for 2015 and 2016. Rising MIs would predict greater economic hardship, relative to that country's recent past. On this basis they suggest the following conclusions.

First, it's not surprising to again see as the 'most miserable' those members having to run austerity to cut fiscal deficits and debt. But, their positions are improving, and this should be sustained in 2016.

Second, the biggest economies, Germany, France and Italy, remain worse than their pre-crisis levels, as intra-regional trade remains subdued. This is important given the three account for two-thirds of euro-zone GDP, and are the biggest drivers of activity.

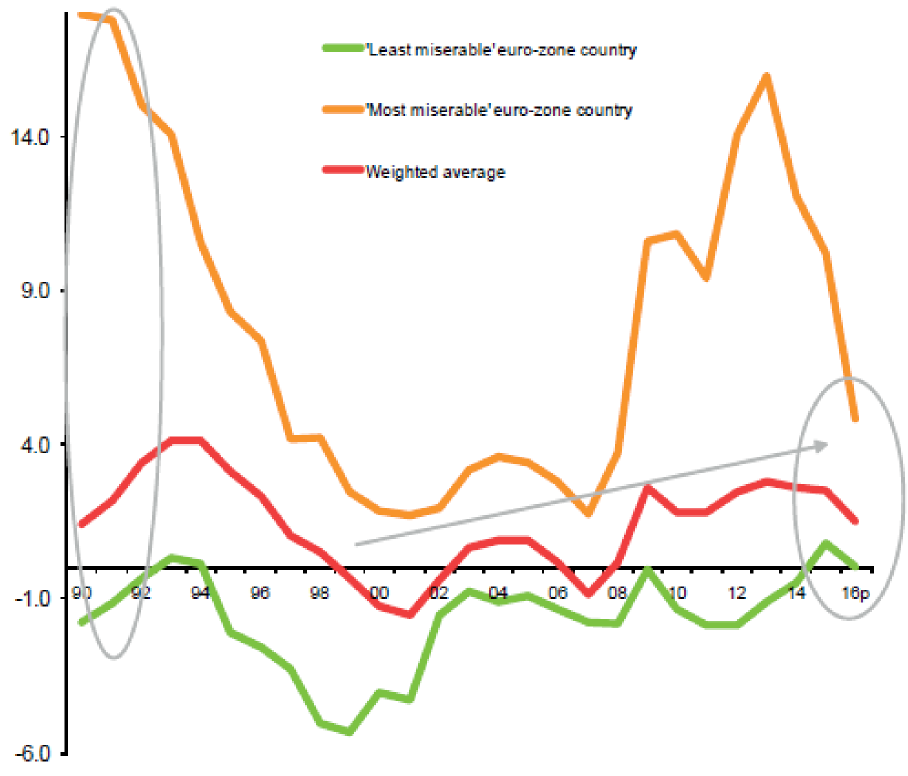
But, most revealing is what our MIs say about convergence. The chart below shows the two main stages thus far: the impressive convergence between the 1992 Maastricht agreement and the euro's birth; and, thereafter with the euro, a steady divergence as policy discipline waned.

Our MIs proxy euro-zone convergence by tracking the highest and lowest countries' MIs for each of the years shown. In 2015, Germany and Ireland are the 'happiest', with Greece still the 'most miserable'. Increased convergence is shown by the narrowing gap between the two extremes.

It suggests average euro-zone misery is still higher relative to when the euro became the single currency. This should be little surprise, given the aim was to converge on the low-inflation country, Germany. This has inevitably come at the expense of lost growth and jobs.

The divergence from the core is correcting

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



Source: Hermes Investment Management, based on Eurostat/Hermes projections (p)

Yet, the mix of reducing strains in the periphery without accompanying improvement in the core means the divergence since 2008 is starting to correct. This is not of course a *sufficient* condition for returning to economic health. This still rests on its core members, which account for over 80% of euro-zone GDP.

But it is a *necessary* one. The fact that the divergence since 2008 is finally starting to correct should offer a helpful counter-weight to the instability from Greece, reinforcing the impact of the European Central Bank's QE. In this way - though far from fixed - the zone's worst macro strains may be over.

Read May's issue of Ahead of the Curve **here**.

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Notes to Editors:

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We believe in **Excellence**, **Responsibility** and **Innovation**

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- **Real Estate**: Segregated, Unitised, Debt, UK, US Residential, European, UK PRS
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*Please note the total AuM figure includes £3.7bn of assets managed or under an advisory agreement by Hermes GPE LLP ("HGPE"), a joint venture between Hermes Fund Managers ("HFM") and GPE Partner Limited. HGPE is an independent entity and not part of the Hermes group. £0.4bn of total group AuM figure represents HFM mandates under advice. Source: Hermes as at 31 December 2014.