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## INVESTMENT NOTE

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### **Piloting a fragile recovery: dilemmas facing the ECB**

European economic data provides a veritable pick 'n' mix for market pundits - there's something there for the most optimistic and the most pessimistic. The likely truth is somewhere in between, but central bankers are faced with some awkward choices.

A succession of positive consumer and business confidence survey data for January, especially from the peripheral countries of Europe, will have offered no immediate imperative for a change in monetary policy. However, continuing disinflationary pressures and weak German factory orders and retail sales will keep investors hoping for more stimulus at future meetings.

Relative to the US, where the gradual lessening of the pace of quantitative easing has begun, the Eurozone has more flexibility to provide new policy initiatives to support a still fragile recovery. Mario Draghi's comments at Davos on the potential for the ECB to buy bank loans suggest that monetary support will not end with the winding up of the latest LTRO programme. The strength of the euro last year effectively tightened monetary policy and remains a concern for the ECB.

While the still elevated level of the equity market in Europe suggests a robust economic recovery, the reality remains some distance from that hope. Politics too might be a factor in the thinking of the monetary authorities with a rash of right-wing populist parties throughout Europe calling for a withdrawal of their countries from the EU. Weaker economic growth in the core of Europe and another downward lurch in Eurozone inflation could well be the trigger for the ECB to act and possibly break new monetary ground. January provided no policy change, but that just keeps investors hoping for something in the future. Nominal interest rates remain low and the economic recovery has stuttered into life despite the shrinking of the ECB balance sheet as the LTRO II has been wound down.

The ECB is aware of the ongoing disinflationary forces at work in the Eurozone. A successor to the LTRO is likely as indebted peripheral governments continue to struggle with debt repayments as real interest rates have risen as the rate of inflation has declined. Outright deflation in parts of the periphery has led to improved terms of trade for companies manufacturing there, a necessary part of the rehabilitation process, but heavy sovereign (and private sector) debt burdens bring their own challenges: governments get tax receipts off nominal GDP and are quite happy if inflation is a significant part of any rise in GDP as bond coupons are fixed and rising prices erode the real value of their debts.

However, deflation is a real challenge unless accompanied by a boom in demand, as the value of those debts can expand alarmingly. Kingfisher, for example, is struggling with deflation in the UK DIY market where prices fell by 0.8% year-on-year in January to the detriment of gross margins. Deflationary booms can occur – it happened in the mid 1930s in the US and at times in the Industrial Revolution – but inflation is always seen as the easy option for eliminating excessive indebtedness by governments.

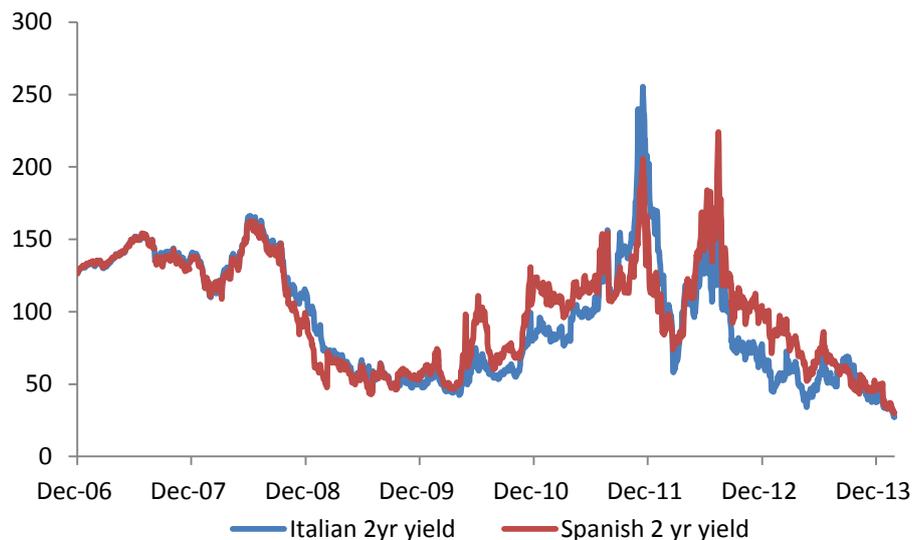
As the pace of disinflation increases, therefore, so it is likely that calls for reflation in Europe return. The rise in commodity prices so far this year, as equity markets have tumbled, may be a precursor to new reflationary policy announcements. The modest reversal in the

strength of the euro is another possible sign of change too, but how easy it will be to devalue the euro after the collapse of the Japanese yen is a different matter. The air of crisis building in the emerging markets will also add to pressure from authorities globally to act to stem an unravelling of confidence and to counter the return of exported deflation from the developing world, and Japan too.

There has been talk about the ECB buying banks loans – far easier than the difficulties surrounding buying sovereign bonds – and, if the right mechanism can be found to do this, such a plan would be a major boon to peripheral banks. The irony is that there is talk about the Bundesbank reversing its resistance to buying government bonds to stimulate growth just as the ECB is going the other way. What is certain is that the Eurozone now has more policy flexibility to revive growth through new initiatives than the other major developed economies, even if much of it is just the power of Mario Draghi's rhetoric.

Lower government bond yields (see chart below) are a blessing for the peripheral countries, as they allow Spanish and Italian banks, amongst others, to refinance the large amount of wholesale funding that needs to be rolled over in the course of 2014 at more advantageous rates than had been anticipated. Not all aspects of disinflation, therefore, are necessarily bad. In part, this shift in rates is why we have started to dip our toe back into peripheral banks with the purchase of Unicredit last month.

### Two Year Italian & Spanish Government Bond Yields - New Lows



Source: Bloomberg

We have always believed that the recovery in Europe will be relatively shallow, high government debt levels tend to hamper recoveries, and that is why we are reluctant to use normalised earnings to value the more cyclical and distressed areas of the market, we simply do not see the upsurge in demand that such a view implies.

**-ENDS-**

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