GLOBAL MACRO DEPARTMENT
EUROZONE REGIONAL MARKET REPORT

NUS INVESTMENT SOCIETY

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Abstract

Europe is home to more than 731 million people living in 48 different countries. Like other continents, the wealth of Europe's states varies, although the poorest are well above the poorest states of other continents in terms of GDP and living standards. Whilst most European states have GDP per capita higher than the world's average and are very highly developed, some European economies, despite their position over the world's average in the Human Development Index are still catching up with European leading countries.

The European Union (EU) is an economic and political union of 27 member states which are located primarily in Europe. The economy of the European Union (EU) generates a GDP (nominal) of about €14.303 trillion (US$18.451 trillion in 2014) and a GDP (PPP) of about €12.710 trillion (US$16.773 trillion in 2014) according to International Monetary Fund, which makes it the largest and second largest economy in the world respectively if treated as the economy of a single country.

This section aims to explore and analyse the regional market outlook of the European economy. Analysis was conducted using macroeconomic theories and technical analysis with reference to recent news and events. The aim is to enhance the critical combination of various analyses to find confluence of indications in enhancement of forecasting convictions.

Eurozone

Economy in Brief

The European economy gradually recovered in 2015, underpinned by high domestic demand, continuing to brush off global economic concerns. Although not spectacular, the recovery of the Eurozone economy continued. A cocktail of low oil prices, a weak euro and an ultra-loose monetary policy seem to be working to sustain economic growth, despite headwinds coming from the Greek crisis, global financial volatility and a slowdown in China and other emerging economies.

Heading into 2016, a challenging political landscape looms on the horizon for the Eurozone. The influence of populist parties, both from the right and the left, is gaining momentum in Europe and their national political agendas represent a risk to Eurozone policies, such as calls to open borders and migration, austerity measures as well as crisis management. While the Eurozone will continue to face the challenge of very low inflation, high unemployment, fiscal and public debt adjustment, and the impact from slower economic growth in key emerging economies, the recovery in the Eurozone will continue in 2016 and the economy is expected to expand 1.7%.

Interest rates analysis and expectations

History Table

Date	Actual	Consensus	Previous
12-03-2015 (Dec 3)	0.05%	0.05%	0.05%
10-22-2015 (Oct 22)	0.05%	0.05%	0.05%
09-03-2015 (Sep 3)	0.05%	0.05%	0.05%
07-16-2015 (Jul 16)	0.05%	0.05%	0.05%
06-03-2015 (Jun 3)	0.05%		0.05%
04-15-2015 (Apr 15)	0.05%	0.05%	0.05%
03-05-2015 (Mar 5)	0.05%	0.05%	0.05%
01-22-2015 (Jan 22)	0.05%		0.05%
12-04-2014 (Dec 4)	0.05%	0.05%	0.05%

Figure 1: interest rate analysis and expectations

The European Central Bank's (ECB) decision to boost its stimulus programs may send ripples across the rest of the continent, prompting policy easing by other central banks to avoid fresh declines in already low inflation rates. The ECB announced it would extend its bond purchase through March 2017, having previously targeted an end date of September 2016. It also cut its deposit rate to -0.3% from -0.2%, thereby charging banks more to look after their spare cash.

These moves present challenges and opportunities for the Eurozone's neighboring economies. While the additional stimulus could spur fresh demand in the currency area for goods from other European countries, the creation of euros to buy the bonds, combined with a lower deposit rate, is likely to weaken the euros against other European currencies, although the currency strengthened on foreign exchange markets because investors had expected more aggressive measures.

A weaker euro could have an impact on other central banks through two related channels. Firstly, it would directly lower the prices of goods and services imported by other European countries from the other members of the Eurozone, pushing down inflation rates that are already viewed by central banks as too low. Secondly, it could also lower exports from other European countries by making their goods and services more expensive for Eurozone households and businesses.

In the event that the euros weaken further in the near future, other central banks may seek to weaken their own currencies by cutting key interest rates, increasing their own bond purchases, or intervening directly on the foreign exchange markets.

For some other central banks, the ECB’s move may delay planned action rather than prompt fresh easing. The Bank of England expects its next change in policy to be a rise in its key interest rate, but the timing is still unknown. As elsewhere, a weaker euro would also weaken inflationary pressures, but the domestic economy is growing at a faster pace than most of the rest of the Europe, and unemployment is low. The policy makers expect rising wages to eventually lead to higher consumer prices.

Monetary policy

In September, the European Central Bank (ECB) weakened the euro and bond yields with an aggressive downgrade of 2015-2017 forecasts for GDP and CPI, while announcing an increase in the issue share limit of bonds included in Quantitative Easing (QE) purchases to 33% from 25%. The increased limit means the ECB can buy a higher share of an individual nation's bond issue, giving it more freedom of concentration in particular issues. CPI forecast for 2015 was downgraded to 0.1% from a previous 0.3% reading, while 2016 CPI was revised to 1.1% from 1.5%. GDP forecasts for 2015 and 2016 were also downgraded to 1.4% from 1.5% and 1.7% from 1.9% respectively. The ECB's decision to deepen the purchase of individual issues does not imply an increase in the size of QE but allows it more flexibility in producing result. In providing more stimulus, the ECB hopes to raise the annual rate of inflation to its target of just under 2% (in November) within the next two to three years. But most of the Eurozone’s neighbors face a similar predicament. In October, United Kingdom consumer prices were flat on the same month a year earlier, while prices in Switzerland were 1.2% lower, and prices in Poland were down 0.6%. The Czech Republic and Hungary had inflation rates of just 0.2%.

Prior to December, the Eurozone is continuing to experience weak growth, low inflation and high unemployment. These economic woes led investors to believe that the ECB would step in with decisive, new measures aimed at boosting Eurozone economic activity. The speculation was that a cut in interest rates was possible, but they are already virtually at zero, and that further QE was in the offing. It was imagined that the QE could be extended to other asset groups and that the absolute amount of asset purchases would be increased, but in the end, these expectations were dashed.

On 3rd December 2015, the ECB president, Mario Draghi, did deliver was a further "discount" in what the bank paid to financial institutions for leaving their funds with the ECB. The overnight deposit rate was reduced from -0.2% to -0.3%, meaning that the costs to commercial banks for parking money with the ECB have risen. The idea behind this move is that it ought to prompt the commercial banks to lend money to businesses and private individuals since the ECB's move makes this slightly more appealing. The ECB announced it would extend its bond purchase through March 2017, having previously targeted an end date of September 2016.

The reaction to the move was for all of the major European stock markets to fall sharply. While on the Forex markets, a stronger reaction was seen with the euros making strong gains against other major currencies. The reason for this was that the Forex markets had been pricing a more bullish monetary approach into the euros price over the period before the announcement. However, this was overdone and resulted in the leap in the euros value.

Economic growth and outlook

Figure 2: Euro Stoxx 50 daily chart

As the EU economy enters the third year of recovery, economic growth is expected to be slow. Low oil prices, a weak euro, a loose monetary and fiscal policy as well as consumer spending were the main factors that accelerated EU's recovery.

GDP growth below expectations to 0.3% on quarter in the three months to September 2015, slowing from 0.4% increase in the previous period and below market forecasts. Countries including Germany growth slowed to 0.3% from 0.4% from Q2 while Italy grew at 0.2%, the slowest pace in a year. Belgium, Spain, Latvia and Austria (0.2 percent, 0.8 percent, 0.4 percent, and 0.1 percent respectively) while Portugal showed no growth at all. Economies namely, Estonia and Greece shrank by 0.5% each while Finland contracted at 0.6%.

On the other hand, France expanded at a faster rate of 0.3% and Lithuania advanced by 0.5% while GDP growth in Cyprus, the Netherlands and Slovakia remained unchanged at 0.5%, 0.1% and 0.9% respectively.

The EU economy expanded by 0.4% percent, same as the previous quarter and expanded by 1.6%, on a yearly basis.

A positive outlook for the economy would bring more job creations and help to lower unemployment in the EU. However, political risks are of paramount importance to domestic threats that could affect economic growth in the Euro Area.

Capital Flows

Capital Flows in the Eurozone grew a surplus of €12.47 billion in September 2015 from €6.47 billion in August 2015 with an average of €2.23 billon from 1999 till 2015 and an all-time high of €125.15 billon in November 2012 and an all-time low of negative €109.89 billon in November 2010.

Strong inflows from domestic and international investors, mainly REITs and retail funds, were raised through bonds issuance in 2015 and are likely to continue to experience high levels of investment in 2016.

However, North American and Asian capital dominates the European Investments for large lot sizes and portfolios. Fresh capital from Chinese & Taiwanese Insurance Companies, Thai Private Investors and Indian PropCos/Developers were invested into Europe stems, mainly focusing on UK/London market and acquisition of retail/office assets in Europe.

The strength of the UK economy and London as a real estate market continued to a global appeal to Asian investors whereas Asian investments in other European Tier 1 cities were generally weaker due to economic conditions and property fundamentals compared to the UK.

Mid-Term Entrants such as the Malaysian and Korean Pension Funds and the Chinese Sovereign Wealth Funds invested in the European market from 2009 to 2013 in property and private equity. Long-Term Players including Singaporean, Hong Kong and Japanese Capitals were still the major sources of Asian capital into Europe, specifically represented by Japanese property companies, Singaporean sovereign wealth capital and High-Net-Worth Individual (HNWIs) and private equity from Hong Kong.

Trade Balance - Eurozone Trade Surplus Hits Record High

The weaker euro plays a major role in helping Eurozone to achieve an all-time high of €31.4 billion in July 2015, up from €21.2 billion in July 2014 due to a 7% increase in exports and 1% import increase due to the much cheaper energy. Furthermore, Eurostat claimed it to be the largest surplus since January 1999.

The increase of 1% was mainly due to the imported energy from Russia, the main energy provider for Europe. Between January-July 2015, the value of imported energy such as gas and oil was €201.3 billion, while a year earlier, the imports totaled €268.7 billion due to the higher prices, which however, plunged by 26% in the January-July period of 2015.

Comparing the period from January to August 2015, exports of goods such as machinery, vehicles and manufactured goods increased by 6% over the same period a year earlier to €1519.2 billion, while imports rose by 2% to €1342.3 billion.

Despite the regular trade surpluses in the Eurozone, the widening of the trade surplus indicates modest economic recovery.

News & Events

The Greek bailout as it is

In August this year, Greece gets the green light for a third bailout deal and received its first funds under a third bailout, worth €86bn. For that, the country was put to face with the possibility of a fresh Greek elections and the non-participation of the International Monetary Fund (IMF). With the funds, Greece was able to meet repayments due to the International Monetary Fund (IMF) and European Central Bank (ECB), including €3.2bn due to the latter. These institutions have lent Greece the least out of the €240bn from previous bailouts, with the EU's European Financial Stability Facility being the biggest lender.

The rescue loan comes with a host of conditions attached that amount to a radical overhaul of the Greek economy, stipulating major reforms of health, welfare, pensions and taxation systems, alongside more ambitious privatisation schemes. It also gives the troika - the European commission, ECB and IMF - decisive influence over reforms of the country's struggling banking sector. The total on its way to Athens is €86bn but not all at once. In the first tranche, Athens will get €10bn immediately to recapitalise its banks and a further €13bn in financial aid, which includes the funds to make the ECB payment. The remaining €3bn of the first disbursement (total to €26bn) will be made in the autumn if Greece carries out sufficient reforms.

The IMF has voiced concerns over the deal, saying Athens needs more debt relief and that bailouts alone will not solve the country's financial crisis. Sceptics argue that Greece has sunk so low it needs significant structural reforms, further cuts in public spending and a hefty debt write-off. They point to the collapse in industrial production, the high unemployment, the corruption that affects so many business transactions and public sector life, the lack of investment in basic infrastructure and the loss of so many highly educated youth to overseas jobs as a hindrance to progress. The inability of the government to use its budget to pay for anything more than basic pensions, public sector salaries, welfare and the interest on its massive pile of debts is another reason to be doubtful.

In November, Greece has been formally cleared to receive its next bailout loan, worth €2bn, after it agreed to implement new austerity measures. The Eurozone bailout fund, the European Stability Mechanism (ESM) said it had agreed to release the next instalment of the country's bailout programme, following a €13bn payout in late August. The approval was expected after

Greece's parliament approved new austerity measures, which include higher taxes on wine and road use as well as increased limits on protections for distressed mortgage holders. Opposition to the latest measures, however, cut the leftwing government's majority in parliament from five seats to three. The government is racing to complete a bailout-supported recapitalisation of its troubled banks before the end of 2015 and still faces a long list of more painful measures that include an overhaul of the national pension system. The Greek economy is expected to slip back into a recession next year, according to the 2016 budget submitted to parliament, while the national debt is set to climb higher.

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