2015 Investment Outlook: Europe—The Saga Continues

December 31, 2014

Like television fans deciphering a season-finale cliffhanger, investors have been left with unanswered questions about the eurozone as 2014 draws to a close. Will the European Central Bank unleash full quantitative easing? Will the eurozone fall into a recession? David Zahn, head of European Fixed Income and portfolio manager, Franklin Templeton Fixed Income Group®, gives his perspective on what he thinks may lie ahead as the eurozone's drama continues into 2015.

For the eurozone, 2015 offers the prospect of both significant change and continued inertia. Though the European Central Bank (ECB) refrained from announcing any further actions at its December 2014 meeting, a dovish speech by ECB President Mario Draghi a few weeks earlier did provide further backing for what markets have been signaling for many months, namely that the ECB might introduce full-blown quantitative easing (QE) at some point during the coming year. Should QE happen in 2015, we believe its onset could mark a step change in the ECB's role and the region's financing of debt, with potentially profound political implications for the monetary union.

And yet, regardless of whether QE is introduced or not, the secular stagnation that has gripped the eurozone seems unlikely to lift by the end of 2015. Although the region's overall third-quarter growth in 2014 was better than expected, the weakness of the German economy, which managed an expansion of just 0.1% over this period, dented any optimism.

On top of the existing internal problems of "lowflation," shorthand for ultra-low inflation, weak demand and anemic credit growth, the deterioration in the external backdrop over much of 2014—rising geopolitical tensions with Russia, and the slowdown of the Chinese economy and many other emerging markets—has made a rapid return to meaningful growth across the eurozone unlikely, in our view, despite some positive signs, including the stabilization of many peripheral economies and the boost in competitiveness from the weaker euro.

What Probably Will Change in the Eurozone in 2015?

Much has been made of the opposition of some German policymakers to QE, and politically its introduction, we think, could depend disproportionately on the course of future German economic data, rather than a more measured assessment of the overall course of the eurozone. If German industry's slowdown continues beyond the second half of 2014 into 2015, then the resolve of the country's officials to stick to their ideological knitting will likely be tested, and may create enough of a consensus for ECB President Draghi to move beyond the substantial raft of measures he has already announced.

In the event of a go-ahead for QE, its announcement might be of greater political than economic significance, potentially marking the first step on the road to closer fiscal integration of the eurozone. In terms of what QE could include, as well as purchases of member states' sovereign and corporate debt, other options might include supranational institutions such as the European Investment Bank. A regional approach to debt financing would be a critical threshold for policymakers to cross, potentially opening the way for further transfers to ease intraregional imbalances. We anticipate an announcement confirming QE's introduction could see further compression of spreads.[1] between peripheral and core eurozone bonds, though as has been the case in other countries that have used it, the actual implementation of QE may trigger a modest selloff, in our view.

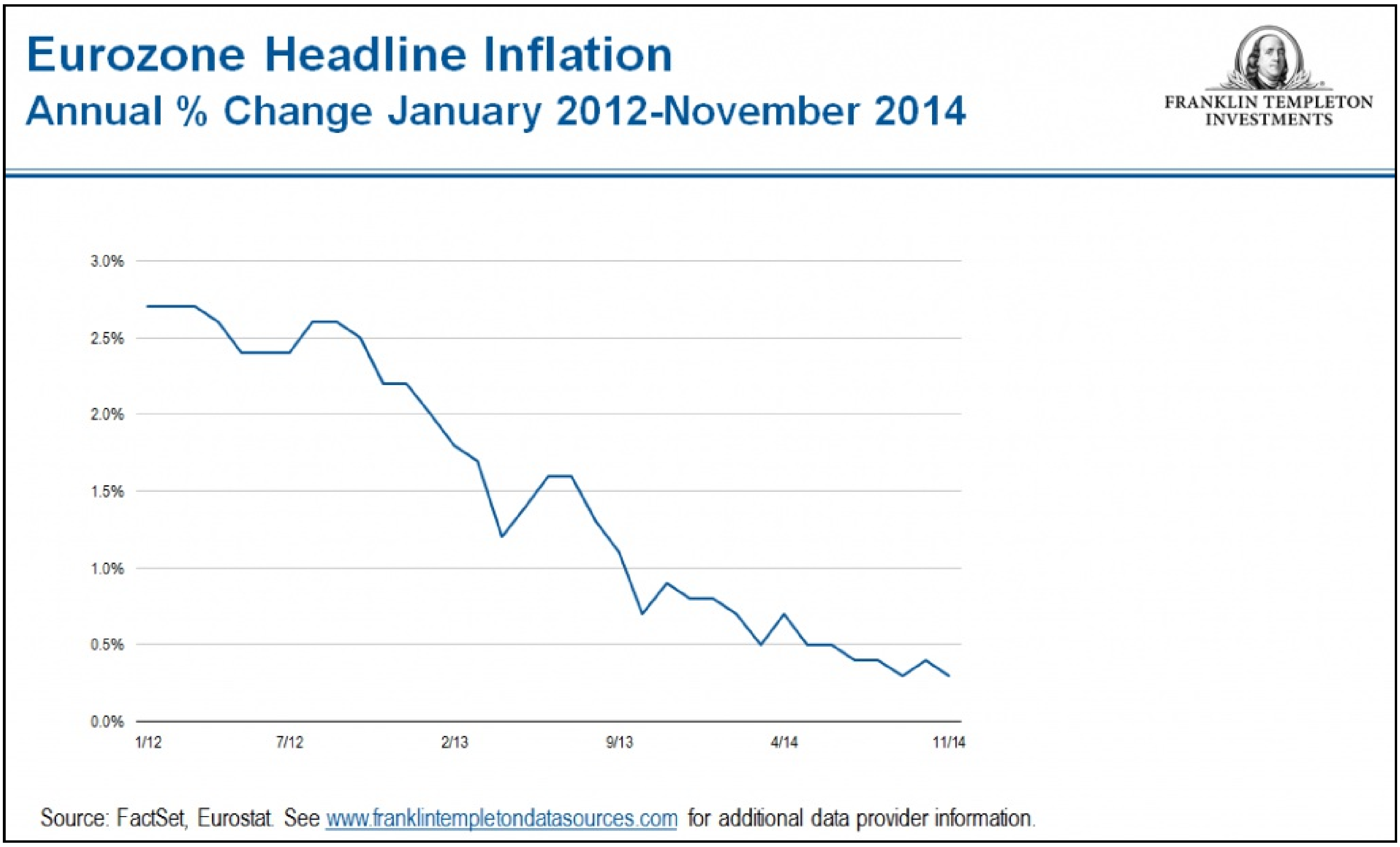
Ahead of any potential decision, we believe President Draghi will hope for signs that the ECB's existing measures are having some effect. While the remedies announced so far have lacked sufficient magnitude individually to have a noticeable impact, in aggregate they could help to dispel some of the deflationary pressures weighing on the region. Perhaps the most important goal is to reinvigorate credit growth, and here the cheap funds provided by the ECB's TLTRO (Targeted Longer-Term Refinancing Operation) program to the region's banks, designed to stimulate lending to businesses, might yet prove effective. The initial auction for the TLTRO loans in September 2014 proved disappointing, as banks opted instead to repay the previous round of loans from the ECB at the height of the eurozone crisis.

What Probably Will Not Change in the Eurozone in 2015?

One of the main criticisms of QE when used by other central banks has been its ineffectiveness in injecting money into the "real" economy. Though the ECB has acknowledged that one of the main factors underlying the eurozone's stagnation is a lack of credit growth, any potential use of QE seems unlikely to make much of an impact in this regard, even if an announcement of QE could drive yields down further, making it even less attractive for banks to hold government bonds.

Nor is there much prospect of relief for the eurozone economy from fiscal stimulus. We believe the precarious finances of the peripheral economies rule out such largesse, while core eurozone countries have only limited fiscal leeway, or in Germany's case, insufficient political interest in such expansion.

Though current and future region-wide initiatives to boost expenditure are sure to be talked up by officials, in reality their impact on growth is likely to be marginal, in our view, rather than meaningful. It is important to emphasize that, despite the current headwinds, we do not foresee a full-blown recession for the eurozone in 2015. Growth across the region may turn slightly negative at some point, indeed lowflation may even change to slight deflation, but these indicators are more likely to oscillate around zero than sharply deteriorate. Our base-case scenario for the end of 2015 sees the eurozone economy remaining more or less where it is now, not really growing much or shrinking much either. Even if growth in the region did show signs of picking up in 2015—and recent sharp falls in energy prices should support growth, though put further pressure on lowflation—given structural constraints, ultimately growth is likely to be limited to the region's trend rate, somewhere between 1% and 2%. So far, structural reforms that could lift this long-run average rate have been most evident in peripheral economies, with little sign in key core economies (such as France) of the necessary political will to grasp this nettle.



What Else Might Impact the Eurozone in 2015?

We see two other variables that could have a significant impact in 2015. If a worsening of the dispute over Ukraine caused a further deterioration in the European Union's (EU's) relationship with Russia, the dampening effect on growth in the eurozone (and even more so for the eastern EU member countries) would likely be negative while political relations remained strained. The other unknown is the UK general election in May 2015, in which a Conservative victory would raise the possibility of a referendum within a couple of years on the UK's membership in the EU. How European markets might react to the possibility of "Brexit," which is shorthand for "British exit from the European Union," both in the run-up to the UK election and its aftermath, remains unclear, although given that UK assets suffered as the result of the referendum on Scottish independence became less predictable such volatility could conceivably reoccur.

While Eastern European countries may experience a slowdown if the Ukrainian crisis worsens further, we believe that their fundamentals—generally higher growth than the eurozone countries, and significantly more manageable debt burdens—remain attractive. For the United Kingdom, we do not anticipate that its currently superior rate of growth will be affected by the coming election, though with the eurozone's weakness inhibiting UK inflation, the Bank of England might hold off raising interest rates for longer than many observers expect. The other key event that might occur in 2015 is a much-heralded increase in US interest rates, as the US economy continues to improve. While such a move would likely cause a spike in volatility in European markets, we would expect investors to quickly refocus on the eurozone's weak fundamentals. Such sentiment, along with the possibility of further monetary stimulus from the ECB, should also see the euro likely continue to fall over 2015.

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1. Spread is the percentage difference between the yields of different types of bonds.

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