The Eurozone Plots Its Long Road to Recovery

October 13, 2014

Growth in much of Europe is slow—some observers even say the economy is moving sideways. Lately, the eurozone seems to have more in common with Japan, whose economy has been idling for years, than it does with the UK or the United States. The European Central Bank (ECB) has recently launched programs to inject capital into the economy, and David Zahn, head of European fixed income and portfolio manager, says they're a good start. He urges a long-term approach driven by both the ECB and the governments of individual countries, which all have to do their part to get the European economic engine running on all cylinders.

We at the Franklin Templeton Fixed Income Group believe Europe in general will be in a slow-growth, low-inflationary environment for a considerable time. With that backdrop, we think a long-term, accommodative approach is needed to help spur the economy.

While the European Central Bank (ECB) has a role to play in the eurozone's economic recovery, we think the core economies should do a bit more to achieve necessary reform. We don't think the authorities are doing nearly enough in France, for example. Their deficit is quite high, and, in the latest draft budget, the French government has effectively said it can't meet the deficit target and will try to meet it at a later date. The country needs economic reform, in our view, and it doesn't appear to be working hard enough on it.

Germany, we believe, is meeting its fiscal requirements very well. Still, when most other countries in Europe are in fiscal austerity, maybe Germany can afford not to be so austere.

I think some of the eurozone's core countries could take a lesson from the so-called periphery economies. In many of the periphery countries, the authorities have enacted necessary reforms. They have put plans into place that successfully reduced their budget deficits. I'm not saying some of the periphery countries shouldn't do more, but many reforms have been passed, and we're starting to see them implemented.

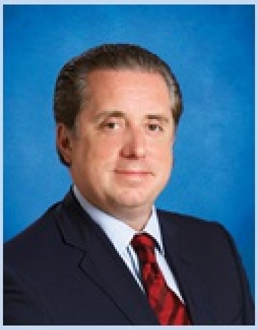
Still in Europe, but outside the eurozone, the UK economy is moving in a positive direction, in my opinion. Growth is good, inflation appears to be under control, and the country's central bank is in a very different place than the eurozone's. The central bank—the Bank of England—is considering raising interest rates, and we believe it's not a matter of if, but when it will raise rates. I think that's a good sign for the UK economy and, as a result, we don't believe UK Gilts offer a lot of value. For UK investors, there may be a case for looking at opportunities elsewhere in Europe because the economies appear to be moving in different directions.

Common Bonds

Looking globally, I believe the eurozone has more in common with Japan than with the United States or the UK at this point, and I think that trend will likely continue. Inflation in the eurozone is running at 0.4%, which is a far cry from the ECB's 2% target. My team and I expect inflation will likely rise a little next year, but it's likely not going anywhere near 2%. I think that's what ECB President Mario Draghi is primarily concerned about. He has said the ECB is fully behind undertaking whatever measures are necessary to combat low inflation.

I expect the Bank of Japan (BOJ) and the ECB should likely continue to be

David Zahn on the ECB's Ongoing Actions



So far, the prescriptive actions taken by the European Central Bank (ECB) have been helpful, in my view, even if their execution was a bit underwhelming. On the positive side, the ECB cut rates to levels that most central banks have never gone to—into negative territory. And its covered bond program is scheduled to start in mid-October, while its asset-backed plan should begin by the end of the year.

The ECB also has embarked on a targeted long-term refinancing operations (TLTRO) program. The plan allows banks to borrow money from the ECB for four years at an extremely low interest rate, 0.15%, to lend to borrowers. Most market watchers had predicted banks would borrow more than €100 billion during September's issuance, but the total reached only €82.6 billion,[1] which was slightly, but not dramatically, less than projected. Still, the result was disappointing, especially since ECB President Mario Draghi said he thought the TLTROs would have a sizable impact on the ECB's balance sheet. So far that doesn't seem to be the case, based on what we saw in September.

I think many banks may be waiting until after the ECB completes the banks' asset-quality reviews this month before they consider using TLTROs. If you were a bank, would you want to borrow a substantial amount of money right before you see the results of your stress test? Maybe the test will find that you need more capital; borrowing a lot of money is not going to help you meet you capital requirements.

The ECB is planning to offer another tranche of TLTROs in December, and more next year. I look forward to seeing the results of the upcoming releases—and everything else the ECB has up its sleeve to help generate growth in the eurozone. As we've said before, it's going to be a long ride.

1. Source: European Central Bank, 10/06/2014.

accommodative to combat deflation and low inflation in their respective countries. Much has been made about the amount of liquidity the US Federal Reserve Bank (Fed) has pumped into the US economy during its quantitative easing (QE) program. But, when you take into account what Japan and Europe combined are currently contributing to their QE programs, it probably more than matches what the United States was doing. So, on a global scale, we have probably just as much or more liquidity being created now than when the Fed was acting alone.

Divergent Paths

Meanwhile, the US economy has been performing relatively well. In the United States, the Fed has indicated it is going to stop its QE program this month, and its next focus will be on when to raise interest rates.

That's a strong differential to make, and it has ramifications for the currencies. I think the euro should probably weaken against the US dollar and, to a lesser extent, the British pound—it has already weakened quite a bit against the pound—because the economies are on different trajectories.

That might suggest to investors that European bonds may be a good place to look for potential opportunities. In the fund, we have taken a long-duration posture in Europe.[1]

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Franklin Global Government Bond Fund

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1. Duration is a measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates. It is expressed as a number of years.

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