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EUROPE: THE ROAD TO RECOVERY?

John Canally *Chief Economic Strategist, LPL Financial*

KEY TAKEAWAYS

Although it is too soon to gauge the effectiveness of QE in the Eurozone, key readings and data are beginning to show improvement, and consensus expectations are for continued growth in 2015.

However, market participants looking for an immediate and sustained response by the Eurozone economy to QE may be disappointed.

The renewed political and fiscal uncertainty in Greece will be watched closely by market participants in the coming weeks and months.

In the wake of the European Central Bank's (ECB) decision to embark on a bond buying program (quantitative easing or QE), policymakers and investors alike are looking for signs that the program is working. Although it is still too soon to tell—QE in Europe was only just announced on January 22, 2015, and the bond purchases themselves won't begin until next month—the economic data in Europe in recent weeks have begun to exceed lowered expectations, and market-based measures of inflation expectations have moved higher.

But, market participants looking for an immediate and sustained response by the Eurozone economy to QE may be disappointed. Recall that the Federal Reserve (Fed) began its first round of QE in late November 2008, and after three years (2011, 2012, and 2013) of real gross domestic product (GDP) growth near 2.0%, the economy finally found its footing in 2014, and we continue to expect that the U.S. economy may grow at 3%+ in 2015.*

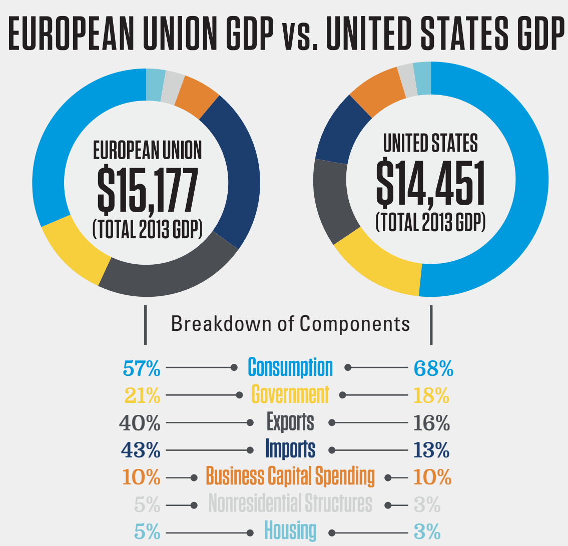
> Lower oil prices and a falling euro may also help to nudge Eurozone growth higher in the coming months and quarters.

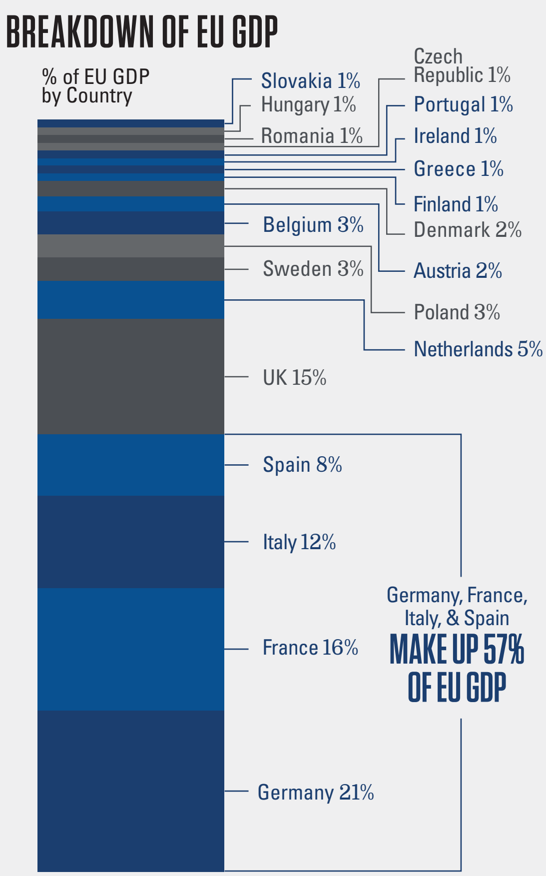
As was the case in the United States in 2008 and 2009, the Eurozone economy cannot start getting better until it stops getting worse. Even before the ECB's announcement on January 22, 2015, key readings on the economy and banking system had stabilized and had begun to turn higher, providing the Eurozone economy with a little momentum ahead of the QE. In recent weeks, several economic data reports (listed below) all suggest that the Eurozone economy had stopped getting worse in late 2014—after another year of subpar growth. In addition, lower oil prices (Europe is a big oil importer) and a falling euro (which makes European goods and services cheaper in the global marketplace) may also help to nudge Eurozone growth higher in the coming months and quarters.

- Investor and business confidence in Germany (Ifo and ZEW indexes for December 2014 and January 2015)
- Eurozone car registrations (December)
- Eurozone retail sales (December)
- Eurozone unemployment rate (December)
- Eurozone money supply growth (December)
- Bank lending to households and small and medium-sized businesses (December)
- Consumer confidence in France (January)
- Business sentiment in France (January)

*As noted in the *Outlook 2015: In Transit*, LPL Financial Research expects GDP to expand at a rate of 3% or higher, which matches the average growth rate of the past 50 years. This is based on contributions from consumer spending, business capital spending, and housing, which are poised to advance at historically average or better growth rates in 2015. Net exports and the government sector should trail behind.

1 U.S. ECONOMY MORE CONSUMER ORIENTED THAN EUROZONE ECONOMY, BUT TRADE A BIGGER PART OF EUROZONE ECONOMY





Source: LPL Financial Research, Haver Analytics 02/06/15

Total GDP amounts represented in billions of dollars.

Countries in shades of blue are part of the European Union. Countries in shades of gray are part of the Eurozone, but not the EU.

In fact, from the start of 2010 through the third quarter of 2014, the Eurozone economy, on average, has expanded at just 0.5% per year, far below the pace of growth seen in the United States during that time. The Eurozone will report its Q4 2014 GDP figures on Friday, February 13, 2015. The consensus of economists polled by Bloomberg expects that the Eurozone economy will post 0.8% growth in the four quarters ending in December 2014, a clear acceleration from the 0.5% pace of growth seen during the previous four years. As we noted in our recent *Weekly Economic Commentary*, "Gauging Global Growth," January 26, 2015, the consensus of economists expects the Eurozone economy—as measured by real GDP growth—to continue to accelerate in 2015, posting a 1.1% increase over 2014.

THE BIG PICTURE

Europe is defined as the 28 nations within the European Union. Nineteen of those nations currently use the euro as their currency, and the ECB serves as the central bank for these countries. These 19 nations are collectively known as the Eurozone nations. This group includes (in order of size of their respective economies): Germany, France, Italy, Spain, the Netherlands, Belgium, Austria, Greece, Finland, Portugal, Ireland, Slovakia, Slovenia, Luxembourg, Latvia, Cyprus, Estonia, Malta, and Lithuania.

The 19 nations that are part of the Eurozone, along with the other 9 European nations, comprise the European Union, a 28-member confederation of nations that share a single market, but not a single currency, government, central bank, etc. The 9 nations that are members of the European Union but do not use the euro or the ECB (again, arranged by the size of their economies) are: the United Kingdom, Sweden, Poland, Denmark, Czech Republic, Romania, Hungary, Croatia, and Bulgaria.

Although sharing some of the economic and trade linkages with the 19 nations that use the euro and the ECB, each of these 9 nations has its own currency and central bank. To make matters even more confusing, Turkey, Switzerland, Norway, and

Iceland are also European nations with sizable economies, but are not members of the Eurozone (19 nations) or the European Union (28 nations) and also have their own currencies and central banks.

ZOOMING IN ON EUROPEAN ECONOMIC POWER

European economic power is concentrated in a handful of nations, with Germany, the United Kingdom (a member of the European Union but not the Eurozone), France, Italy, and Spain accounting for 75% of economic output in Europe. By comparison, the top 20 states in the United States account for 75% of United States' economic output. The bad news is that both Italy and Spain, which together represent 20% of Europe's economic output, are heavily indebted nations, and budget cuts and tax increases in these nations will likely further slow economic output in the years ahead.

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The good news is that the nations facing the most turmoil in the coming quarters (and likely years), including Greece—which is currently facing renewed fiscal turmoil in the aftermath of last month's election—Portugal, and Ireland, together account for less than 5% of the Eurozone's economic output [Figure 1]. By comparison, Florida represents about 5% of United States GDP, as does the combined output of the 15 smallest states within the United States. The market's concern is that a European financial institution exposed to the sovereign debt of these nations (and economies) might be unable to meet its obligations and could potentially trigger a Lehman-like credit freeze-up in Europe, which would likely spread quickly to the United States and around the globe.

Though not detailed in Figure 1, there is a wide dispersion in the composition of GDP among the individual European Union members. For example, while Spain's economy is made up of close to the average of 57% consumer spending, the economies in Greece (75% consumer spending), Portugal (67% consumer spending), and, to a lesser extent, Italy (60% consumer spending) are heavily dependent on consumer spending. In turn, these nations face severe cuts to government spending (and government jobs) and social programs, which could make it difficult for these consumption-based economies to get back to "normal" anytime soon.

The composition of economic output in Europe (relative to the United States) reveals an economy that is much less dependent on the consumer, but much more dependent on trade, construction, and the government sector than the United States [Figure 1]. One other key difference is that the Eurozone runs a trade surplus, while the United States runs a persistently large trade deficit. The recent drop in the value of the euro may continue to boost Europe's exports and add to GDP growth in 2015.

A key to the consensus forecast (see our *Weekly Economic Commentary*, "Gauging Global Growth," January 26, 2015) of accelerating global GDP growth in 2015 is the performance of the Eurozone's economy. While structural, financial, and economic problems remain—especially in Greece—the recent drop in oil prices, the drop in the value of the euro, along with the ECB's long-delayed decision to enact QE keeps the Eurozone economy on track to accelerate in 2015 versus 2014. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential illiquidity of the investment in a falling market.

The ZEW Survey is a main indicator of investors' confidence. It is calculated on basis of 350 analysts' and institutional investors' polling. The indicator reflects the difference between analysts who are optimistic about forthcoming economic development of Germany within six months and those who are pessimistic. The survey is used for German economic prospects estimation. ZEW Survey growth causes the euro growth.

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