AdviceIQ Trusted. Financial. Guidance.

Guidance
Find opportunities. Avoid traps.

Europe: Misplaced Optimism

Submitted by Walid L Petiri on Wed, 03/19/2014 - 9:00am

Is Europe finally looking up? Not much. While the continent has posted improvements, they are weak. Stock market rallies in Europe are based on little other than excessive hope, and lately fizzled. The MSCI stock index of nations in Europe's monetary union is up 0.2% this year, a full percentage point less than in the U.S.

Worrisome signs exist that deflation in Europe may become real. In the 18-nation group that uses the euro, Januaryinflation dipped to just 0.7%, a dismally low reading that hampers the ability of interest rate policy makers to spur economic growth. And then there's the European Central Bank's inaction in the face of this threat: It has not lowered short-term rates further or embarked on large-scale bond buying, as the U.S. Federal Reserve did. That rekindles fears that, once again, European bureaucrats are compromising global stability by doing nothing.

Muddling the picture is that the latest readings of European gross domestic product paint a picture of recovery that is not consistent with impending deflation. GDP rose 0.3% in 2013's final quarter, beating analysts' expectations. That is tepid growth, but at least it is moving upward.

With the installation of Janet Yellen as the new and first female to chair the Federal Reserve, most of Wall Street and the global investment community are pleased. Thanks to the Fed's stimulus, there is indeed reason for muted optimism on this side of the Atlantic. The U.S recently revised fourth quarter GDP annual growth to 2.4, from 3.2%, which while disappointing is better than Europe's showing. Slow, if choppy, improvement seems to dovetail with the Fed's move to gradually wind down its bond-buying program.

Meanwhile, the euro zone, the world's largest marketplace, projected its recent depression-level GDP to produce sustained growth, after two years of contraction. In late February, Olli Rehn, the European Union's commissioner for economics and monetary affairs, forecast growth of 1.2% for 2014 and 1.8% in 2015. While most economists agree that the EU will have positive, albeit sluggish, growth for 2014, the forecasts for specific countries are not very optimistic.

Spain, a country of nearly 47 million people with an overall unemployment rate of 27%, and youth joblessness (ages 16-24) at 57%, might see better days ahead. That is a big if. The European Union increased its forecast for Spanish 2014 economic growth to 1% from 0.5%. While technically this would affirm the end of the Spanish recession, this paltry level of growth along with continuing austerity policies is likely to continue if not see an increase in domestic unrest. That is not a good environment.

Worse for the European Union: If this is the outlook for its fifth largest economy (Spain is No. 13 in the world, according to the CIA's *World Factbook*) one wonders how likely it will be for the EU to meet its growth targets.

Many economists expect France's GDP to grow slightly at less than 1% for 2014, and that French unemploymentwill be slightly higher than initially expected, 11.2% for this year. If these forecast for Europe's' second largest economy (No. 5 in the world) pan out, they are going to foster significant doubt amongst European Union leaders, on French President Francois Hollande's ability to guide France to a robust recovery.

If France and Spain are still wobbling, how strong can a recovery in Europe be? "The forecasts are particularly damning for France and will significantly increase pressure on Hollande at a time the president is already vulnerable," said Mujtaba Rahman, the director for Europe of the Eurasia Group consulting firm.

Economists see as emerging from its two-year recession with expected positive 2014 GDP growth of 0.5%. Relatively speaking, this looks favorable, in light of where Italy was recently. Recall the riots and violence in Italy in 2012 as its government instituted austerity plans. While things have calmed down quite a bit, unemployment is still high, with its government statistics agency forecasting an expected rise to 12.4% for this year, from 12.1% in 2013.

This persistent unemployment remains despite a return to growth, supported by exports, which are projected to gain further momentum in the next two years as foreign demand accelerates. Italian unemployment is set to remain high as the impact of rising demand for goods and services is likely to initially increase average working hours of persons already employed. (Sounds just like the U.S.)

So while none of these reports even remotely resembles strong growing economies of either a nation or European Union as a whole, we must put it in context. Just a couple years ago, many speculated that the EU would expel some countries because of their budget deficits and other weaknesses.

Worries stirred that the common currency and the EU itself might dissolve. Would the recessions in Spain and Italy, with austerity as a remedy, lead to political instability, anarchy or civil war? But none of these extreme circumstances occurred (yet) and the euro, while taking its knocks, stopped falling in value.

Europe is still not in the clear. With inflation expected to stay below 1% – the euro zone's 2014 target is 2% –*deflation* is a very real possibility during the second half of this year. Unlike the Bank of Japan, Britain's Bank of England or the U.S.'s Federal Reserve. There's opposition in Europe to the European Central Bank's buying government bonds to stimulate the economy, a problem that its counterparts in the U.S., U.K. and Japan do not have.

ECB rules forbid it from financing governments. To maneuver around those restrictions, the ECB would likely buy bonds across all euro zone countries from Germany to Spain to tiny Estonia. That way it would not prop up any one country yet seeks to buoy them all. The program's future, though, is uncertain just like the predictions of a stable 2014 EU recovery.

Follow AdviceIQ on Twitter at @adviceiq.

Walid L. Petiri, AAMS, RFC, is chief strategist at Financial Management Strategies LLC in Baltimore.

AdviceIQ delivers quality personal finance articles by both financial advisors and AdviceIQ editors. It ranks advisors in your area by specialty, including small businesses, doctors and clients of modest means, for example. Those with the biggest number of clients in a given specialty rank the highest. AdviceIQ also vets ranked advisors so only those with pristine regulatory histories can participate. AdviceIQ was launched Jan. 9, 2012, by veteran Wall Street executives, editors and technologists. Right now, investors may see many advisor rankings, although in some areas only a few are ranked. Check back often as thousands of advisors are undergoing AdviceIQ screening. New advisors appear in rankings daily.

Topic:
Economy
Investing
Stocks