Eurozone at 20: Reasons for optimism

The eurozone has defied the odds and critics to reach its 20th birthday. Andrew Cole says the region could deliver some positive economic surprises over the coming months, to the benefit of its equity markets

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Milton Friedman was famously not a fan. Neither is fellow Nobel Laureate Joseph Stiglitz. Yet the eurozone has somehow defied the odds and its critics, surviving a problematic infancy and turbulent adolescence to make it through to its 20th birthday.

We believe the eurozone still has the capacity to deliver positive surprises in terms of economic growth and financial market performance. The fact that most investors are pessimistic on the region will likely magnify the impact of any such surprises on asset prices.

One reason for optimism is that reforms are generally heading in the right direction. That's especially the case for the labour market. Thanks to a loosening of employment regulations, Europe's labour force participation rate has increased steadily over the past several years. What is more, one of the eurozone's most persistent weak spots, the gap in competitiveness between Southern European economies and Germany, has shrunk by 15 to 20 per cent since 2010. The World Bank noted this progress by sharply upgrading the region's 'ease of doing business' scores in recent years, both in absolute terms and relative to the US.

There are also signs that the eurozone is willing to cast off its fiscal straight jacket. The fact that Germany is in a technical recession may prove a boon if, as seems increasingly likely, it prompts the government to increase spending. Finance minister Olaf Scholz has already said that the country is ready to deploy "many, many billions" of euros if needed to stave off an economic crisis. That would be in addition to existing plans to boost infrastructure spending.

Such self-help measures are particularly important given that German consumers have proven to be even more cautious than their policy makers, steadily pushing up savings rates and pumping ever fewer euros into the economy.

Economic boost for stocks

On a eurozone-wide level, the International Monetary Fund (IMF) estimates that fiscal easing in 2019 should provide a 0.5 percentage point boost to gross domestic product (GDP) – a level of stimulus last seen 10 years ago.

That's encouraging, given the region's economy is already on an upward path – Germany excepted. France and Spain in particular are seeing improving momentum, and our European leading indicators have turned positive. Construction spending is rising, and even the autos market is showing early signs of improvement (German car sales in August were the highest in a decade, according to Dataforce).

There is also stimulus coming from the European Central Bank, which in September approved a new, open-ended round of bond purchases, cut interest rates and eased conditions on long-term loans to banks.

On paper that all bodes well for European equity markets, particularly considering that corporate earnings have stabilised and stocks now offer very attractive risk premiums, with Germany's posting their biggest ever excess return over the risk free rate at over 9 percentage points.

The crucial question is whether it will be enough to persuade European savers to stop favouring bonds over equities. They have done so for the past two generations, enjoying equity-like returns without the risk thanks to capital appreciation. That no longer seems possible, with significant parts of the European fixed income market now delivering negative real returns.

It would make sense for consumers to start changing their habits. If they do, the boost for equity markets would be very significant.

But even without such a radical shift in investor preferences, a modest upward surprise in economic growth should be enough to justify our cautious optimism and to support market performance.

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