March 2017 Investment Publications Highlights

Fiscal Politics in the Euro Area

Luc Eyraud, Vitor Gaspar, and Tigran Poghosyan, *IMF Working Paper*, International Monetary Fund, January 2017

The authors explore long-term governance issues related to euro area stability. First, policy biases are presented; then, empirical evidence is analyzed; and, finally, past and potential future reforms are discussed. The authors conclude that the euro area's incentive structure needs to evolve in order to address stability issues.

What exactly is the euro area (EA)? It is a federation of European countries, but it is unique from other federations in that the member countries retain significant fiscal autonomy. The system lies somewhere between that of the United States and the United Nations. Policies adopted by individual countries can have significant indirect impact on other member countries. The structure related to proposing legislation, voting on legislation, and enforcing rules can also impact member countries differently. These realities pose long-term challenges to the EA.

To better understand the risks, the authors analyze empirical evidence using data on the 19 EA countries from 1999 to 2015. Three categories of data are analyzed: macro-fiscal performance under the EU's Stability and Growth Pact (SGP), compliance with fiscal rules, and the relationship between a country's size and its fiscal outcomes. The authors argue that EA countries tend not to follow the agreed-upon rules, possibly for political reasons, regardless of a country's size. However, they note the conclusions drawn should be treated with caution because of the limitations of their analysis—the low number of observations and the potential for other contributing factors that were not included.

Other analyses of this topic have focused only on economic justifications for reforms. The authors agree this is important, but they focus their analysis on reforms that would also encourage member countries—through a proper incentive structure—to follow EA rules. In other words, both the correct reform must be chosen and it must be politically palatable. This can be done by creating tangible benefits for countries that comply with the rules, and by making sanctions more politically acceptable for countries that break the rules. In the long run, the authors argue any lasting solution must combine market forces and stronger fiscal governance, regardless of whether the EA moves toward fiscal union.

Brexit: Beyond "deal or no-deal"

Malcolm Barr, David Mackie, and Allan Monks, *Economic Research Note*, J.P. Morgan, January 20, 2017

Prime Minister Theresa May has stated the United Kingdom is willing to reject a trade deal with the EU if it is deemed bad for the country. The authors believe efforts to secure a barrier-free deal will likely fail. Instead, the authors argue, a deal creating tariff-free access for the majority of the goods sector and limited access for the service sector is more likely.

The United Kingdom's current trade agreements have evolved over its 43 years of EU membership. The current trade system between the United Kingdom and EU includes high-profile deals and more nuanced agreements that impact daily life. Currently, no developed country relies solely on the World Trade Organization (WTO) for trade with the EU. Those countries that use WTO rules are supported by additional trade agreements that have evolved over time.

The United Kingdom has suggested that its fallback plan, should no agreement be reached with the EU, would be to reduce tax and regulatory burdens to retain domestic businesses considering moves to the continent. However, the EU would be in a position to wait out the short-term volatility as trade shifts and businesses relocate, while the United Kingdom would be more vulnerable. A failure to reach an agreement while exiting the EU would also reflect an underlying divergence in the UK-EU values, with potential consequences for trade. UK goods could face delivery delays as items are tested as part of the quality assurance process that non-EU countries trading with the EU must follow. Since there is no storage system for holding items during this process, a backlog of products will likely accumulate. This will be magnified for components that cross borders multiple times during manufacturing. For the United Kingdom, trade agreements made with non-EU countries prior to Brexit will also be up for debate.

J.P. Morgan's base case for exit negotiations is that they will continue beyond the planned two-year period, into the second half of 2019. Given the number of players involved in EU deals, the two-year time frame laid out would be unprecedented. In addition, the main focus of this process is exit terms; a post-exit trade deal is a secondary concern. If no deal is agreed on, the United Kingdom will face imperfect choices, including extending negotiations, accepting an interim modified plan, accepting a more permanent narrow trade deal, or reverting to WTO rules. All of these options have downsides for Theresa May and the UK economy.

Far from the Madding Crowd: Five Observations on Europe Equity

Sharon Bell et al., *Portfolio Strategy Research*, Goldman Sachs, February 22, 2017

Investors' apprehension related to European geopolitics has surged of late. In light of this, the authors highlight five shifts impacting European equity markets that investors should also note: rising debt issuance, positive equity fund flows, factor performance changes, positive earnings revisions, and stubborn market valuations.

The low cost of debt, coupled with the European Central Bank's corporate bond buying program, has been fueling new debt issuance. The authors consider this a good sign because companies are refinancing expensive debt and improving interest coverage ratios. European corporates have begun raising more funds in the bond market, which offers more liquidity than bank financing. They also note debt-financed merger & acquisition activity has picked up, which could be a good channel to grow in a low-growth economic environment.

When the authors examine 2017 European equity fund flows, they appear neutral, in contrast to last year's outflows. To explain this shift, they point to this year's expected double-digit earnings growth, the highest since 2010. They also note the equity risk premium has increased and the relative value of European versus US equities, stemming from the former's sharp underperformance since November 2016.

The authors observe that higher political risks and uncertainty in Europe have recently reversed the course of value stocks, which outperformed growth stocks in the second half of 2016. During the sovereign crisis of 2010–12, when sovereign spreads widened, growth stocks outperformed. The authors argue that a similar relationship has held true since mid-November, with sovereign spreads widening and growth stocks outperforming. They suggest that value stocks would start to outperform later this year should political concerns dissipate.

While recent earnings revisions have been positive, a good sign, the authors note that the revisions are concentrated in European mining companies with emerging markets exposure. Still, they suggest that strong global economic growth could benefit European equities more than US equities. Lastly, they highlight that the impacts of economic and political shocks during the last three years on valuations have been minimal. Instead, weak earnings growth has been a primary determinant of European equity performance in recent years. ■

CAMBRIDGE C | A ASSOCIATES