MACKENZIE
Investments

Europe's macro struggles point to a more divergent world

Todd Mattina, PhD
Senior Vice President, Chief Economist, Portfolio Manager, Team Co-Lead
Mackenzie Multi-Asset Strategies Team

Jules Boudreau, MA
Economist
Mackenzie Multi-Asset Strategies Team

Highlights

- Europe's economy is caught in a perfect storm of soaring energy prices, slowing demand for exports and populist policy making.
- The European Central Bank (ECB) and the Bank of England (BoE) will have their hands full trying to set policy in a volatile and uncertain macro environment.
- In 2022, the return of divergent global macro trends has unlocked tactical opportunities for investors. Europe's complex situation has been fertile ground for macro trades.

The pandemic-era markets of 2020 and 2021 were globally convergent. Asset price fluctuations were driven by global COVID waves and concerted liquidity impulses as central banks around the world reacted in tandem. The result was synchronized swings in global stock and bond prices. In 2020-2021, the average return correlation between different stock markets and the S&P 500 was the highest it's been in any two-year period.[1] In addition, volatility in G10 currencies was at its lowest since the 1980s. High return correlations and low FX volatility reflected common macro drivers across countries and were symptoms of the lack of divergence in global macro trends.

But regional divergence in macro trends has made a noted comeback in recent quarters. The reversal from convergence to divergence in global markets had three main causes:

1. **COVID flipped from a force of convergence to one of divergence.** COVID is now far down the list of market drivers in most advanced economies. However, it remains a major cause of fluctuations in China's economy, leading to macro divergences between China and the rest of the world.
2. **The invasion of Ukraine had varying economic effects.** The disruption of food and energy exports from Russia and Ukraine was a disaster for some economies (eurozone, UK and unstable frontier markets), but a boon to others (Canada and commodity-exporting emerging markets).
3. **Central banks are not on the same page anymore.** Synchronized stimulus in 2020 and 2021 gave way to "all-hands-on-deck" tightening in some countries, including the US, and continued easing in others, like Japan and China. Fiscal policy is also diverging across countries.

Europe's economy has been caught flat-footed amid these shocks. While economic momentum was positive across Europe at the end of 2021, long-lasting COVID lockdowns and a botched vaccine rollout in many countries had left Europe's post-COVID recovery incomplete. When Eurozone countries were forcibly weaned from Russian gas in 2022, policymakers had to juggle a surge in inflation and a still-depressed economy, an unsavoury combo for central banks trying to balance supply and demand. Contrast this situation to the US, where GDP was back to trend in late-2021 and energy markets are more insulated from Russia's supply shock than those of Europe. If the Fed's current position is tricky, the ECB and BoE are facing no-win situations by comparison.

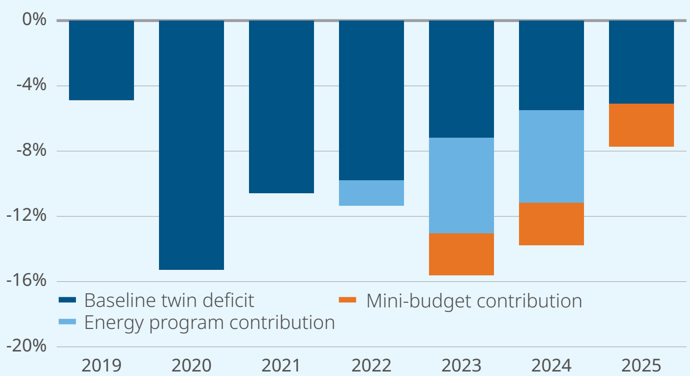
Bond yields have surged across Europe and will likely continue to climb in the months ahead. In the UK, the government's plan to cap energy costs for households and businesses, combined with the largest tax cuts since 1972, put in doubt the sustainability of the UK's twin deficit — the sum of budget and external borrowing. Yields on 10-year gilts were below those on equivalent US

1 We restrict the universe to those equity markets with a market cap above US $25 billion as of December 31, 2021. Full sample begins in 2000.

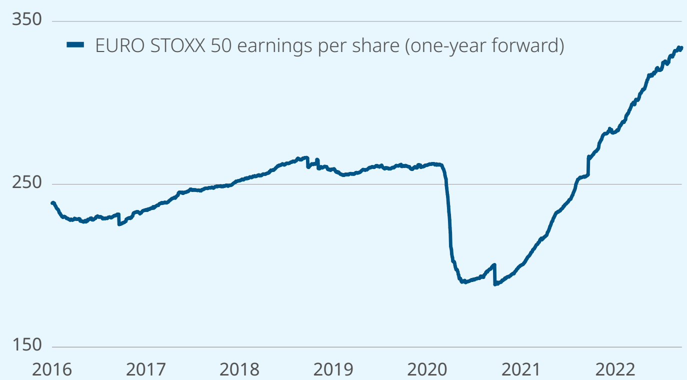
Treasuries a few weeks ago, an oddity, in our view, considering the amount of capital the government will have to borrow externally to fund its new expenses. Figure 1 shows that according to our forecast of the UK government and current account balances, in 2023 the UK twin deficit could exceed its pandemic highs. The government's plan to cap energy costs is especially risky. It puts the government on the hook for any further increases in energy costs and disincentivizes British households to conserve electricity and gas. The Bank of England's recent intervention to buy gilts helps contain volatility in the market but does nothing to improve long-term fiscal sustainability. Across the channel, 10-year German bunds yields are exceeding 2% for the first time in almost 10 years. Given eurozone governments could possibly follow the UK in subsidizing electricity, we see further upside in eurozone yields. Italian bonds are on even shakier ground, as the election of a populist right-wing coalition government could lead to a clash with other eurozone countries. Italian borrowing costs are being kept in check by an implicit guarantee from the European Central Bank, but that guarantee hinges on good behaviour, more in line with the opposition's "Draghi agenda".

Figure 1. Both European bonds and equities are risky propositions in the current environment

The eurozone's external position could follow the UK's if it also elects to cap energy costs



Consensus estimates for European earnings are optimistic



Notes: Government and external balance baseline forecasts from the IMF April World Economic Outlook. Additional forecasts by the Multi-Asset Strategies Team assuming 75% external borrowing. One-year blended forward earnings estimates for EURO STOXX 50 from Bloomberg as of September 26, 2022.

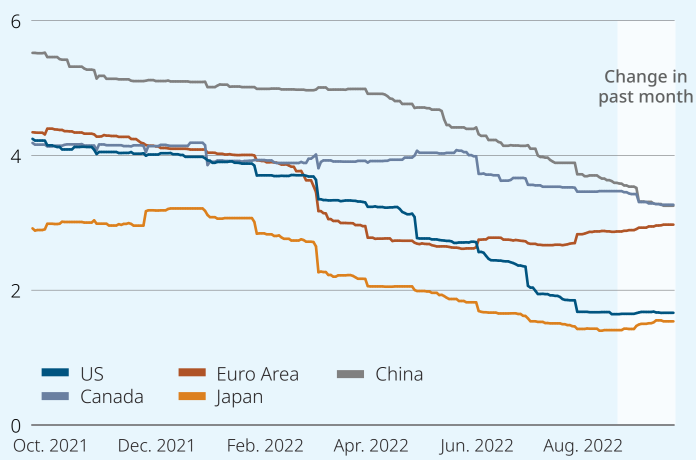
Euro area firms could also struggle going forward. Figure 1 shows that analysts' earnings forecasts for the companies listed in the EURO STOXX 50 index are probably too optimistic. European companies have a tough road ahead. The sharp slowdown in Chinese consumer spending should be a drag on revenue growth over the coming quarters, given that the share of EURO STOXX company sales to China is about double that of S&P 500 companies. At the same time, the compression in profit margins that began in Q1 will likely continue as energy prices keep production costs elevated. This could be especially an issue for those large industrial firms with manufacturing bases in Germany, Italy, France and the Netherlands. Higher margins for banks from rising interest rates should compensate somewhat, but the upcoming eurozone recession could also generate losses on bank liabilities.

There are scenarios in which European assets end up faring better than we expect. A ceasefire in Ukraine would ease the pressure on European energy markets, even if a suspension of hostilities if unlikely to lead to an immediate blanket removal of sanctions on Russia. A phasing out of zero-COVID policies in China would generate a rebound in Chinese consumer demand, supporting European company revenues and boosting national exports to China. An easing of inflation in the US would allow the Fed to pause rate hikes, easing the depreciation pressure on the euro and pound. But in this year of cascading shocks, it would be risky to bet on a reversal to normality in the short term. Instead, this trend of regional macro divergences should persist into 2023 and, with it, the relative value opportunities available to global macro investors.

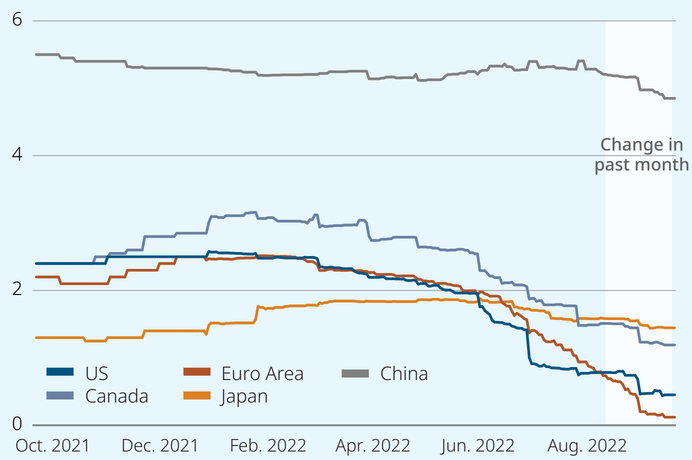
Global macro update

- Consensus forecast for **2023 Eurozone GDP** growth have tumbled to 0 in recent months, with energy scarcity almost certainly leading to a recession this upcoming winter. Europe's generating capacity will recover from the hot summer that throttled nuclear and hydro power, and gas storages are full. That should prevent the worst-case scenario of households being unable to heat their homes. Industrial firms across Europe have already made plans to cut production this winter, which should lower overall electricity demand. But lower industrial production implies a drop in GDP. Job losses are also likely if governments don't step in with furlough schemes similar to those implemented in 2020.
- **US inflation** for July came in above expectations (0.1% vs. -0.1% expected, month-on-month). More worryingly, core inflation was dangerously high, with CPI excluding food and energy growing at a pace of 6.9% annualized. High housing inflation was behind the unexpectedly hot print. Since the methodology for rent CPI generates persistence in prints, we expect housing inflation to stay well above target for the rest of the year.

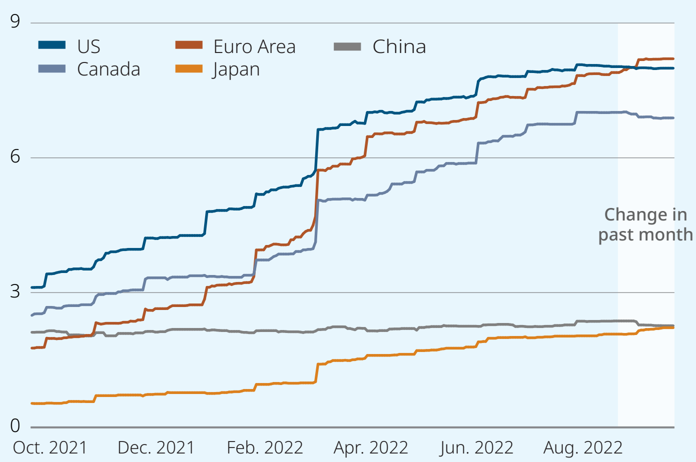
2022 real GDP growth forecast (%, consensus)



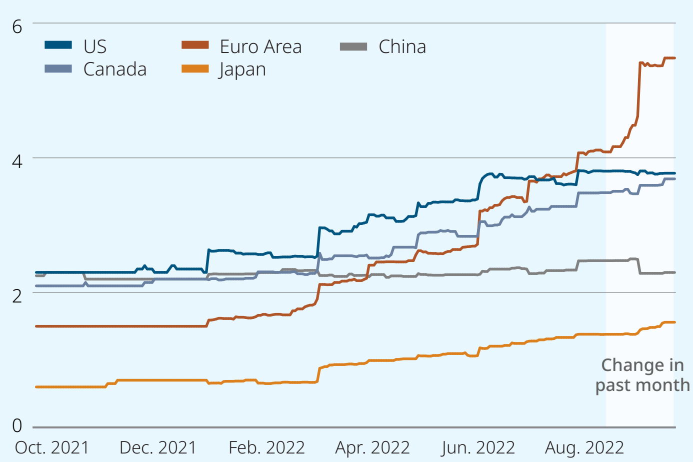
2023 real GDP growth forecast (%, consensus)



2022 inflation forecast (%, consensus)



2023 inflation forecast (%, consensus)



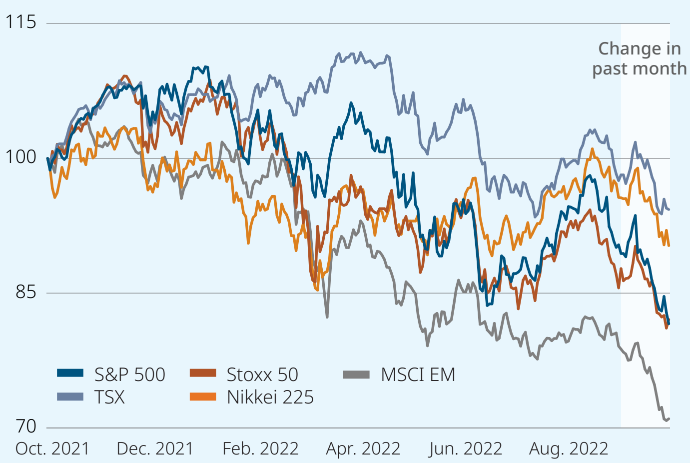
Notes: Average growth and inflation forecasts from Consensus Economics as of September 30, 2022.

MACKENZIE
Investments

Capital markets update

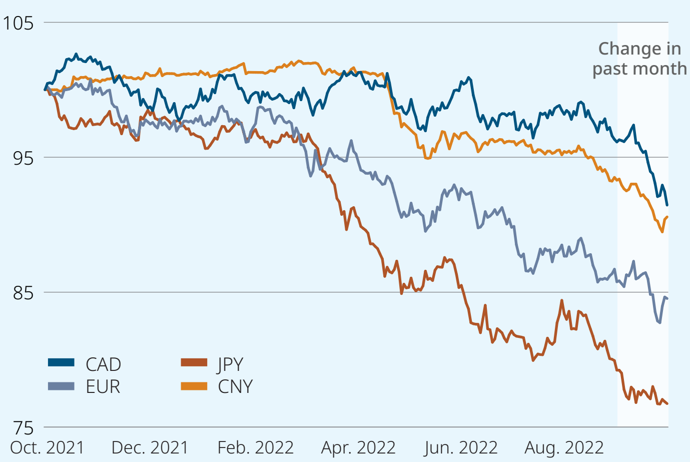
- The **S&P 500 d**eclined below its June lows in September as a hawkish Fed, a creaky Treasury market and a handful of global macro shocks damaged investor sentiment. A positive earnings season could reassure markets, as it did back in Q2. Earnings expectations have inched down in past months, but analysts still expect solid growth.
- **US Treasury yields** spiked in September, as Fed Chair Powell reiterated the Fed's willingness to keep tightening until inflation is back at 2%. Poor liquidity in the Treasury market probably exacerbated the sell-off towards the end of the month. It is possible that Japan and China sold US bonds in their attempts to prop up their currencies vs. the USD in past weeks, which could explain the deterioration in liquidity.
- **The British pound** sold off hard on the release of the UK government's "mini-budget", which includes deficit-financed tax cuts. The pound overtook the Japanese yen as 2022's worst performing G10 currency. Yields on UK gilts also surged on the announcement, with the plan raising concerns about the sustainability of the UK's fiscal and external positions.

Equity indices (one year ago=100)

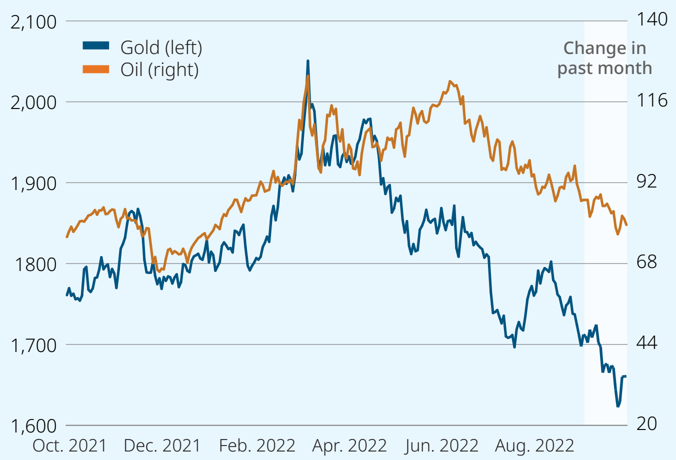


US Treasury yields (%)

Currencies (relative to USD, one year ago=100)



Commodity prices (in USD)



Notes: Financial data from Bloomberg as of September 30, 2022. Total return equity indices are in local currencies, except MSCI EM, which is denominated in USD.

What we'll be watching in October

October 7: US nonfarm payrolls for September

- The US economy has created an average of 378k jobs per month over the last three months, almost double the typical pre-pandemic number. This is hard to square with talks of a recession. As the economy slows down, we expect to see job growth slow and the unemployment rate inch up.

October 16: Final release from the Strategic Petroleum Reserve

- Back in March, President Biden announced a plan to release 1 million barrels of oil per day from the US Strategic Petroleum Reserve (SPR). The final delivery of oil from the SPR will take place later this month.
- With oil prices down 36% from their peak in June, the US government could decide to replenish the SPR in Q4 to ensure that domestic producers do not ramp down production as oil prices decline. Maintaining this productive capacity would help soften the blow of any future disruptions in oil markets, such as an interruption of Russian exports or a rebound in Chinese imports. On the other hand, it would probably lead to higher prices in the short term.

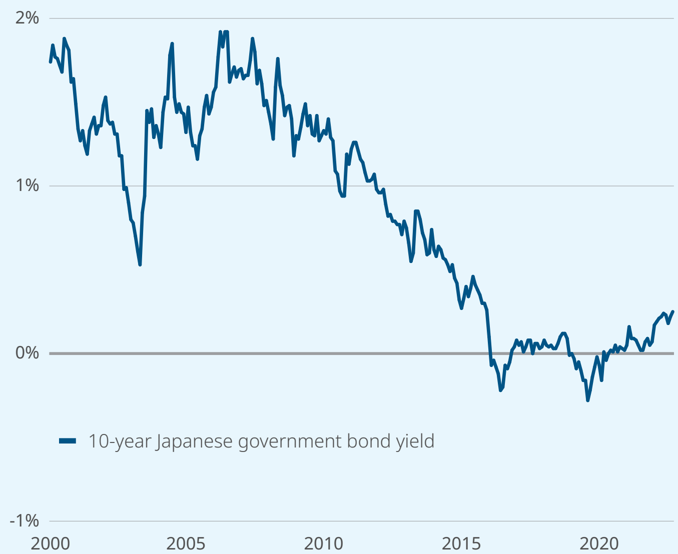
October 19: Canada CPI for August

- Canadian inflation decreased from 7.6% to 7.0% in August. Notably, month-on-month core inflation was only 2.5%, compared to 6.9% in the US. Much of the discrepancy is due to the difference in how Statistics Canada and the Bureau of Labor Statistics compute rental prices. So while measured inflation may be slightly lower in Canada going forward due to this statistical quirk, the Canadian economy remains at least as hot as the US economy.

Emerging theme

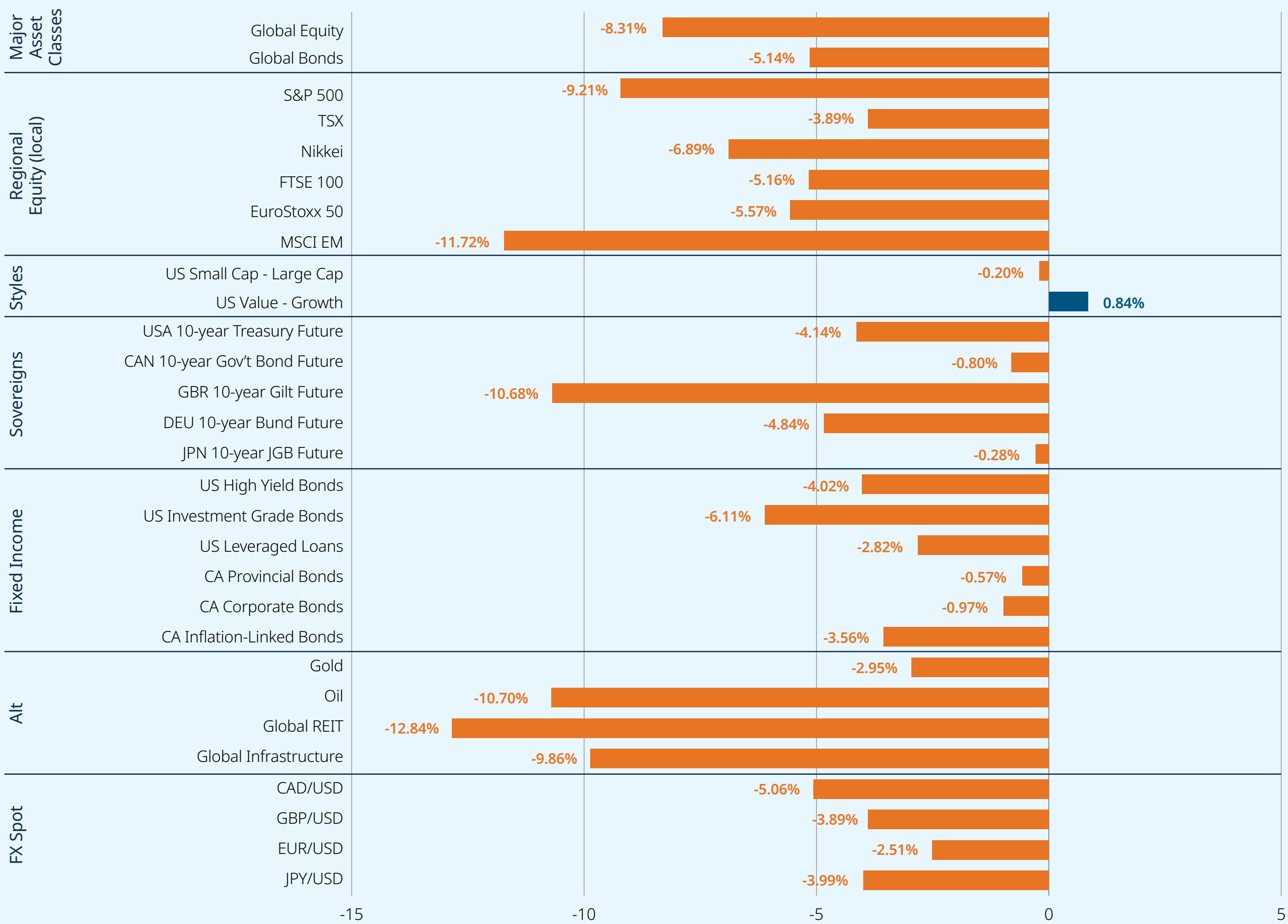
- While other central banks are tightening their monetary policy, the Bank of Japan is in effect loosening theirs by maintaining a 0.25% cap on 10-year government bonds as inflation climbs. This policy differential explains the weak performance of the yen this year.
- The odds of the BoJ lifting the binding cap in 2022 are low, but not zero, especially with the yen depreciating. On September 27, Japan's Ministry of Finance openly intervened to support the yen's value for the first time since 1998. But as long as the Bank of Japan is committing to buying an unlimited number of Japanese bonds to protect the 0.25% yield cap, it is very unlikely that a currency intervention would have any lasting effect on the yen's value. Suppose the Ministry of Finance decides to buy yen and sell dollars, with the goal of propping up the yen's value. Doing so would decrease yen liquidity in Japan's financial sector, putting upward pressure on interest rates. But any increase in rates from the intervention would cause the Bank of Japan to buy more government bonds to protect its 0.25% cap. Monetary policy will not tighten, and the yen will remain depressed. If Japan wants a stronger currency, it will need to lift its yield cap.

Yen interventions won't work as long as BoJ caps yields



Notes: Data from Bloomberg as of September 27, 2022.

Capital market returns in September



Notes: Market data from Bloomberg as of September 30, 2022. Index returns are for the period: 2022-09-01 to 2022-09-30. In order, the indices are: MSCI World (lcl), BBG Barclays Multiverse, S&P 500 (USD), TSX Composite 60 (CAD), Nikkei 225 (JPY), FTSE 100 (GBP), EURO STOXX 50 (EUR), MSCI EM (lcl), Russell 2000 - Russell 1000, Russell 1000 Value - Russell 1000 Growth, USA 10-year Treasury Future, CAN 10-year Gov't Bond Future, GBR 10-year Gilt Future, DEU 10-year Bund Future, JPN 10-year JGB Future, BAML HY Master II, iBoxx US Liquid IG, Leveraged Loans BBG (USD), Provincial Bonds (FTSE/TMX Universe), BAML Canada Corp, BAML Canada IL, BBG Gold, BBG WTI, REIT (MSCI Local), Infrastructure (MSCI Local), BBG CADUSD, BBG GBPUSD, BBG EURUSD, BBG JPYUSD.

2386000 10/22