OCBC Treasury Research and Strategy

20 Feb 2014

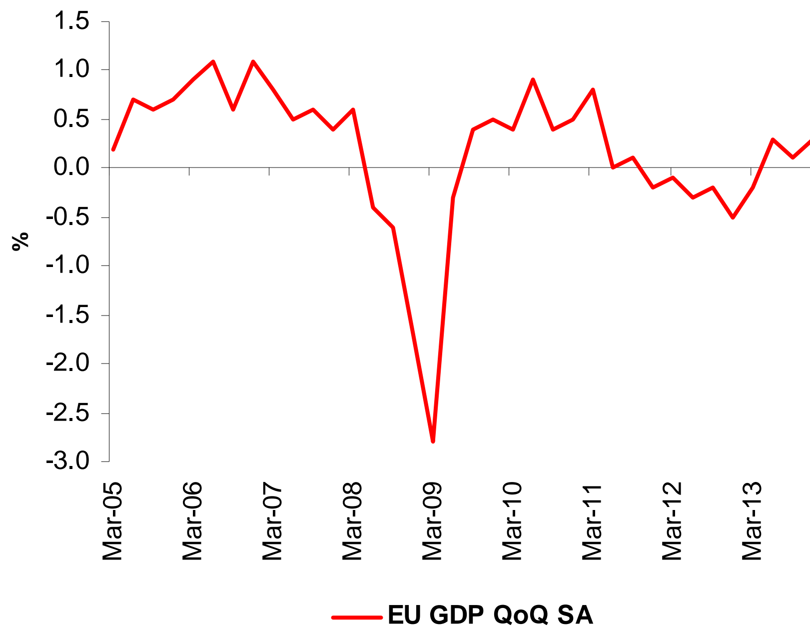
## Executive Summary

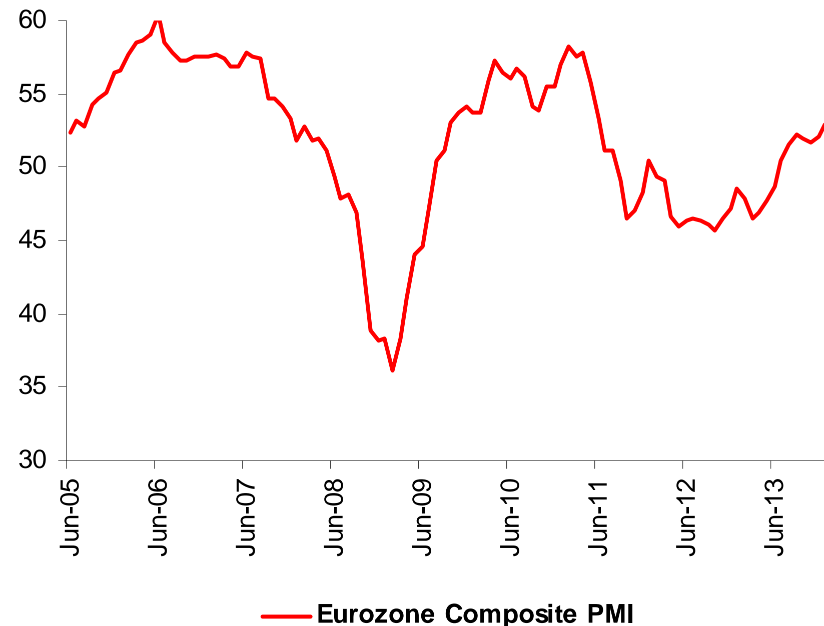
- The Euro Zone economy has emerged from recession in the second half of 2013, and growth is forecast to accelerate to 1.1% yoy in 2014.
- The unemployment rate, which peaked at 12.2% in September, has since stabilized at 12% in December 2013. This suggests that the worst may be over for the labor market.
- As financial conditions and investor confidence improve, peripheral Euro Zone countries are returning to tap international bond markets. Both Portugal and Ireland issued bonds recently and Moody's upgraded both Greece's and Ireland's credit rating to Caa3 and Baa3 (investment grade).
- Rebalancing efforts are also bearing fruit as the current account surplus improved 72% yoy to EUR221.3bn in 2013. This helped to impart some support to the Euro last year.
- The ECB has laid down two triggers for further action, namely deflation risks and an unwarranted rise in money market rates.
- The drying up of money supply and weak credit growth in December may be distorted by ECB's asset quality review, which is based on banks' static balance sheet as of end of 2013.
- Nevertheless, given the heightening disinflation risk and rising volatility in the money market, we expect the ECB to remain open to further monetary easing (eg. negative deposit rate or third LTRO) to protect the nascent recovery.

# Euro Zone: small upside surprise in Q4 GDP

• The Euro Zone economy expanded 0.3% qoq in Q4, beating maket expectation of 0.2% qoq. The upside surprise is largely due to stronger than expected growth in Germany and France.

• The composite manufacturing and service PMI in January rose further to 52.9 from 52.1 in December, the highest since June 2011, pointing to better growth momentum ahead. The Euro Area is expected to grow by 1.1% yoy in 2014 based on the latest forecast from the ECB, up from a contraction of 0.4% in 2013.

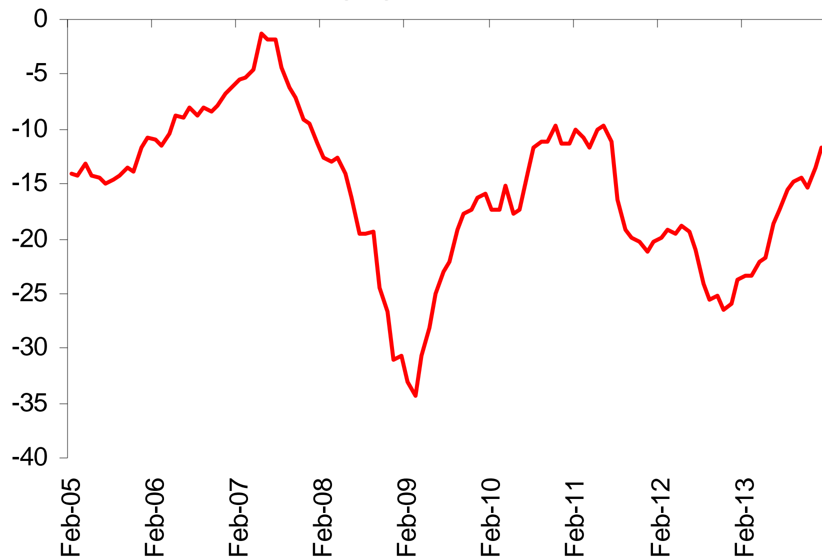


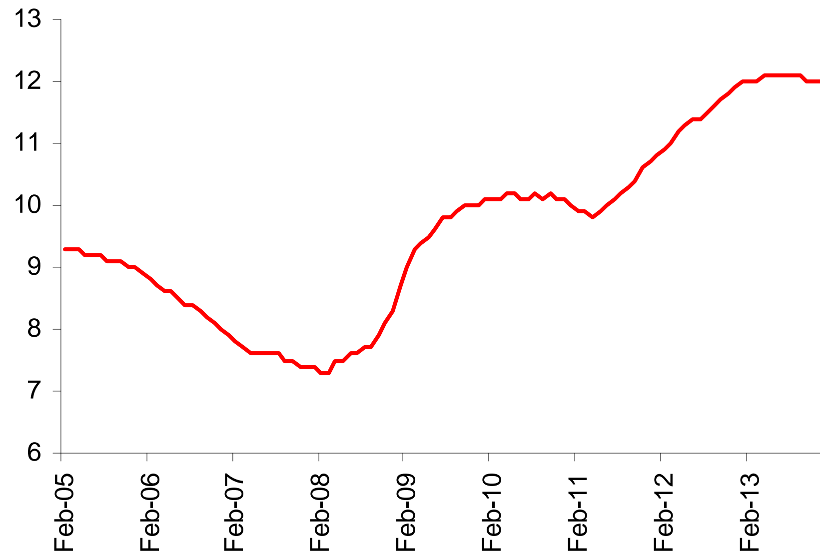



**Source:** Bloomberg, OCBC

# Euro Zone: unemployment has stabilized since 12.2% peak

- The consumer confidence in the Euro Zone improved markedly in January 2014, to a two and a half year high as fiscal austerity headwinds begins to fade.
- The unemployment rate eased from 12.2% peak in September 2013 to 12% in December 2013. The total number of unemployed people has fallen by 129K in December, the biggest monthly drop since April 2007. The falling jobless rate, albeit at a slow pace, suggest that the job market has stabilized in the region.
- The Eurozone's ZEW expectations survey hit a 7-year high of 73.3 in January 2014, before retreating to 55.7 in February amid concerns over EM volatility and China's slowing growth.

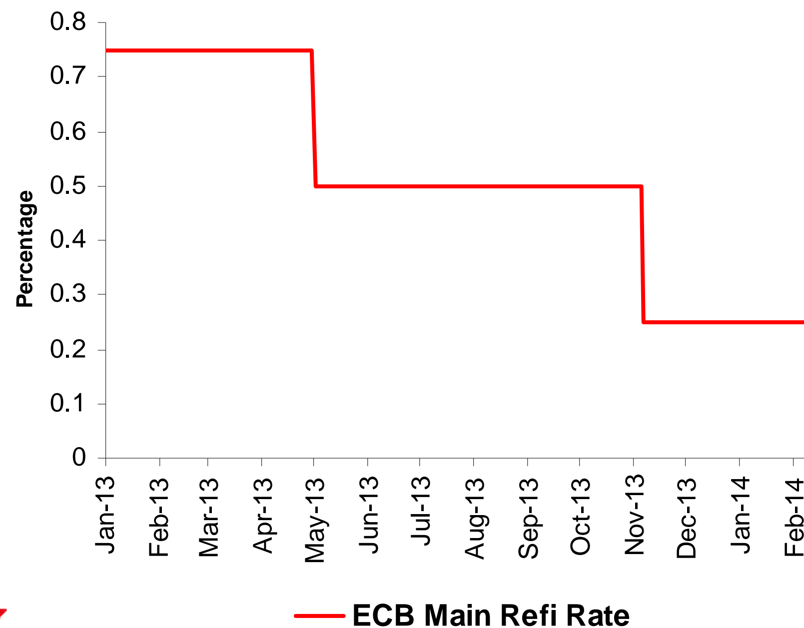


**Source:** Bloomberg, OCBC

# ECB: potentially more stimulus to support the recovery

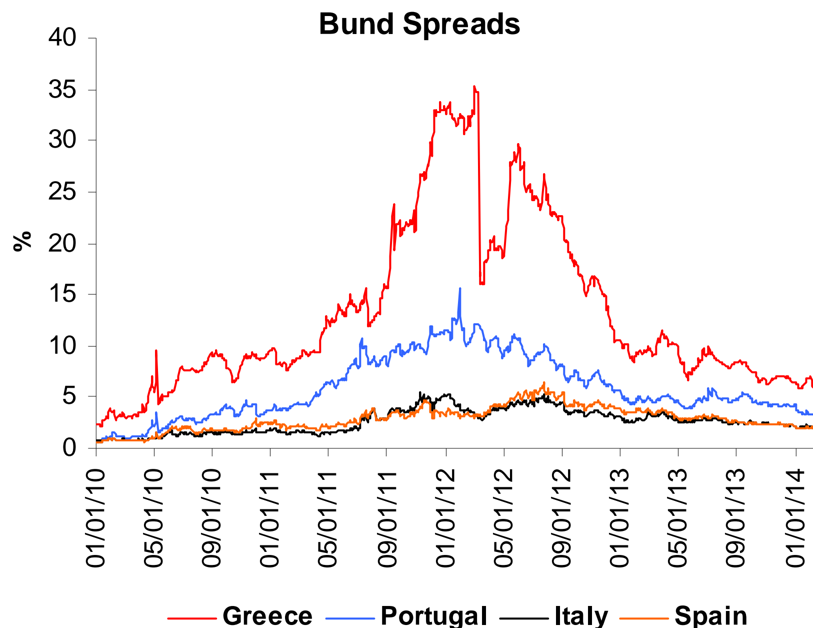
- In its July 2013 policy meeting, the ECB Governing Council took a pivotal step by providing explicit forward guidance, stating that "The Governing Council expects the key ECB rates to remain at present or lower levels for an extended period of time".
- In its November policy meeting, the ECB unexpectedly cut the main refinancing rate by 25bps to a record low of 0.25% but left the rate it pays to bank deposits unchanged at zero. The ECB President Draghi stressed that the central bank still had the room to act if needed. Inflation has slowed to 0.7% in January, matching the 4-year low in October that prompted the surprise November rate cut.

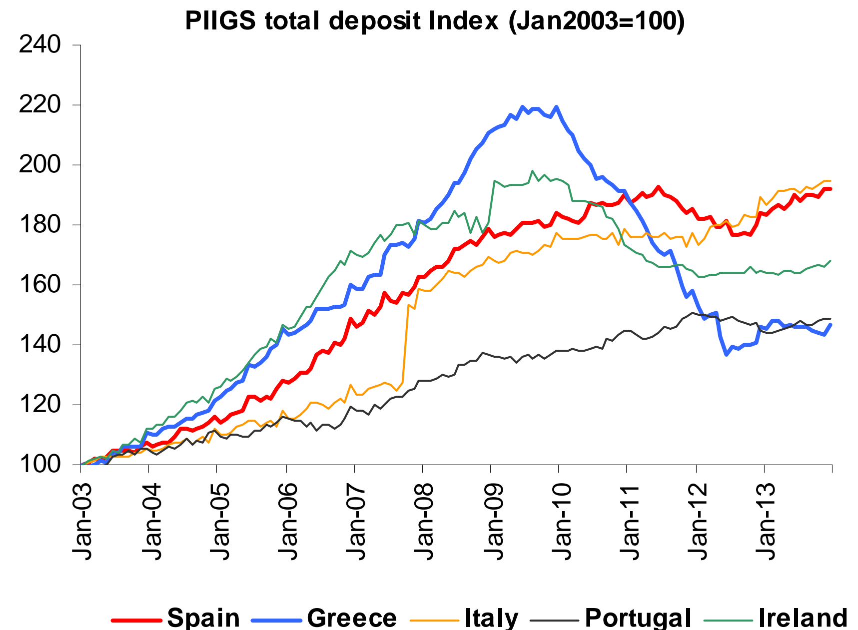


**Source:** Bloomberg, OCBC

# Peripherals: financial conditions improved further

- Financial conditions in the peripheral Euro Zone have improved significantly following the reassurance of policy support from the ECB and bund spreads and CDS continued to ease.
- Confidence in the peripheral Euro Zone's banking sector improved as evidenced by the return of deposits.
- Sovereign borrowing costs have fallen to record lows from Greece to Ireland while the Stoxx Europe 600 Index hit a 6-year high on 22 January.



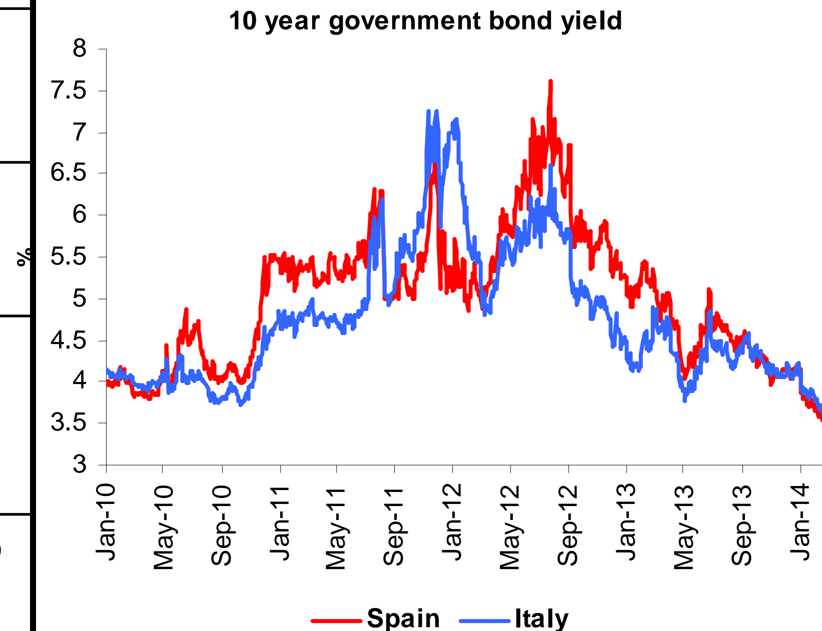



**Source:** Bloomberg, OCBC

# Peripherals: confidence vote by rating agency

- The rating agency Moody's has upgraded Greece's and Ireland's credit rating and lifted Italy's rating outlook to stable from negative since November 2013.
- Italian's 10-year government bond yield fell to an eight-year low of 3.62% as of 17 Feb 2014.

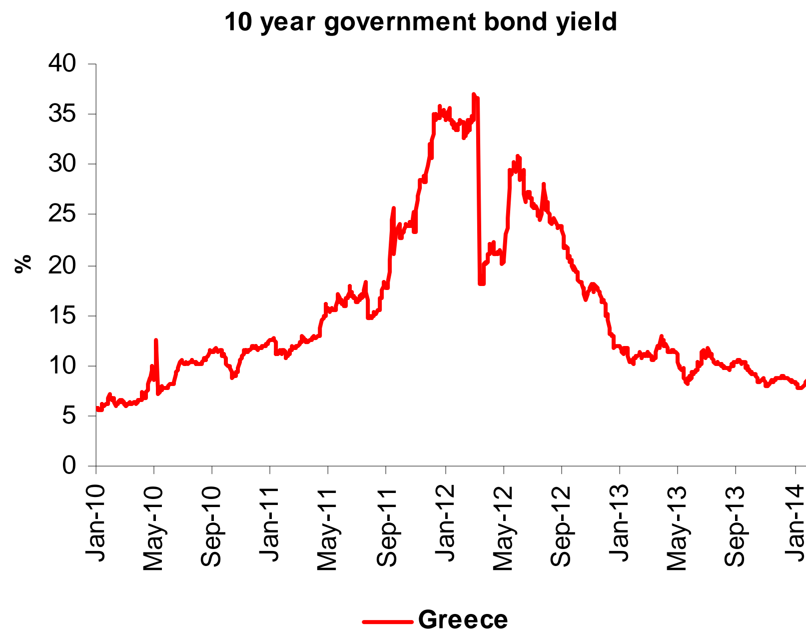
| Date | Rating Action |
| --- | --- |
| 29Nov13 | Moody's upgraded Greece by two notches to Caa3 from Single C to reflect good progress with fiscal consolidation |
| 29Nov13 | S&P raised Cyprus's long term debt rating to B- from CCC+, reflecting falling immediate risks to debt repayment. |
| 17Jan14 | Moody's upgraded Ireland's rating to Baa3 from Ba1 citing the growth potential and ongoing fiscal consolidation will bring down the debt to GDP ratio. |
| 14Feb14 | Moody's lifted Italy's credit rating outlook to stable from negative citing financial resilience. |



**Source:** Bloomberg, Various rating agencies, OCBC

# Peripherals: virtuous cycle of positive news

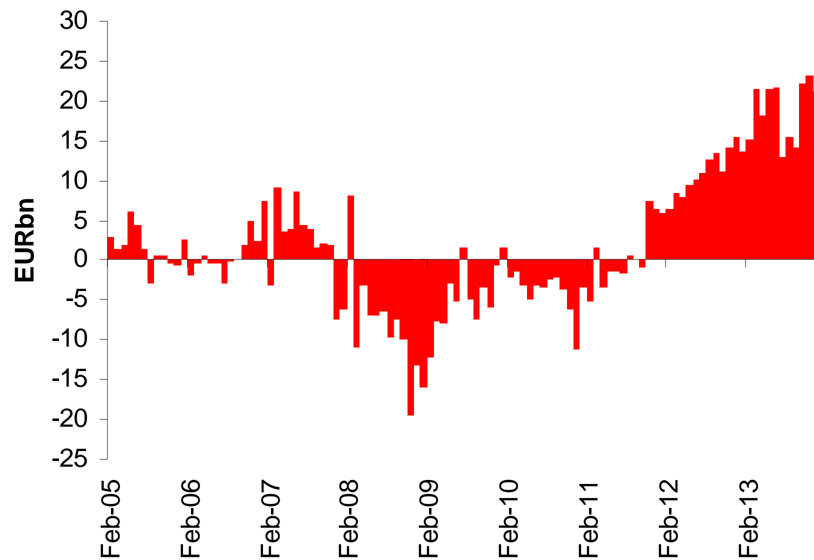
- **Portugal** first returned to international bond market in May 2013 after being shut out of bond markets for two years. Portugal managed to raise EUR3bn from a sale of 10-year bond in February 2014 at 5.11%, down from 5.67% in May. The country is trying to regain full access to international bond market once the bailout program ends in May.
- In addition, **Ireland** has become the first debt stricken EU country to exit the bailout program in December and returned to debt market in January with its first debt auction which drew huge demand.
- Meanwhile, **Greece** is also showing its interest to return to tap the bond market for EUR1.5-2bn, with the debt management office saying that its re-entry would boost confidence. Greece is trying to avoid taking a third aid package from the euro area.

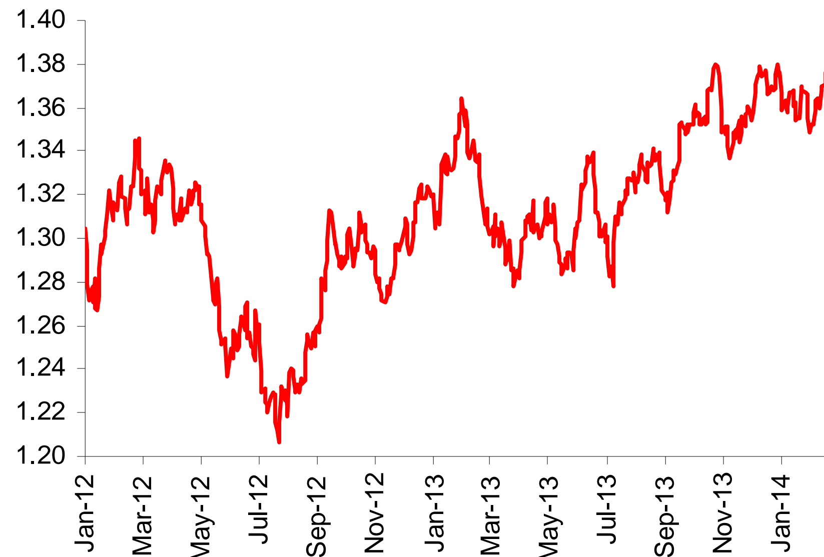


**Source:** Bloomberg, OCBC

# Euro Zone: rebalancing efforts to support Euro

- The current account surplus in the Euro Zone has increased at a rapid pace for the past two years. The adjusted current account surplus hit a high of EUR221.3bn in 2013, up significantly from EUR128.6bn in 2012, and in sharp contrast to the US$400bn deficit in the US.
- On hindsight, the strong current account surplus probably explained why Euro remained strong in 2013 despite the Euro being a popular short in 2013.

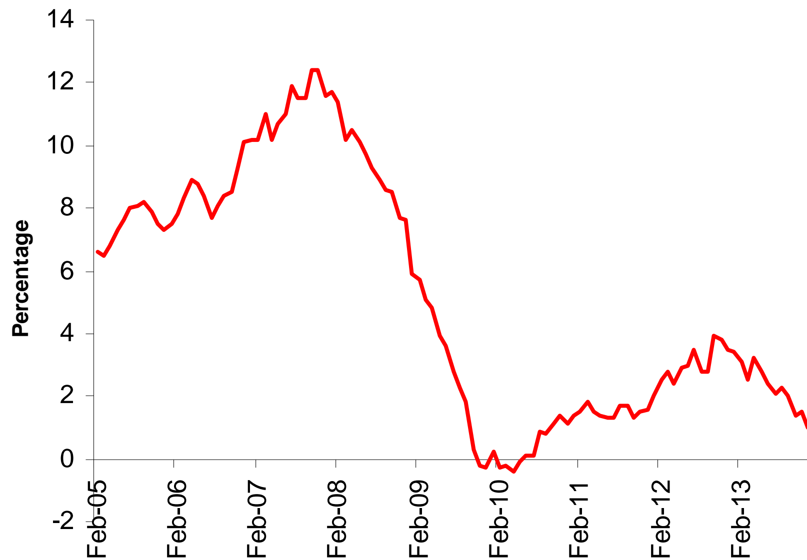


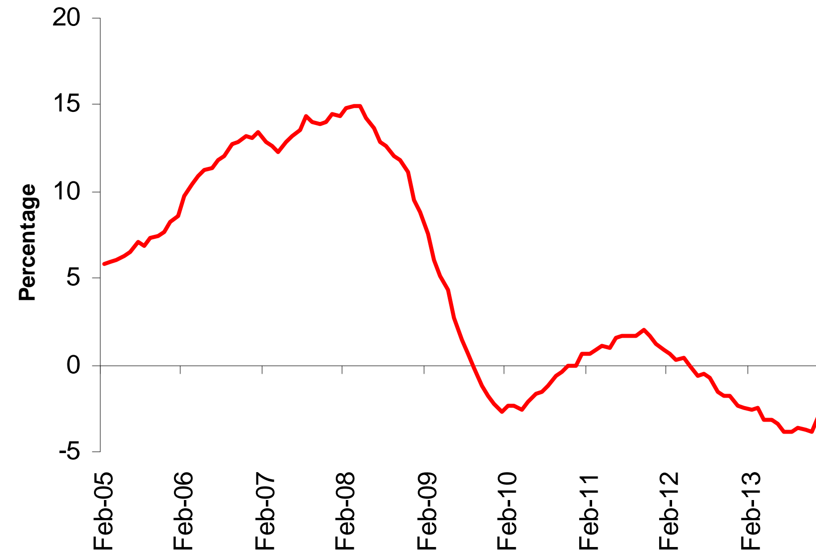



**Source:** Bloomberg, OCBC

# ECB: the drying up of money supply adds pressure on ECB

- Euro Zone's money supply M3 growth slowed to 1% in December, down from 1.5% in November and the slowest since September 2010. The sharp decline of money supply growth adds concerns on possible deflation risk.
- In addition, loans to non financial corporates continued to contract despite the ECB's main refinancing rate cut in November. The weak credit growth also posed a risk to the nascent recovery.
- There is some speculation that the ECB may act as soon as 6 March when it releases its 2016 forecasts which may show inflation undershooting its 2% target.



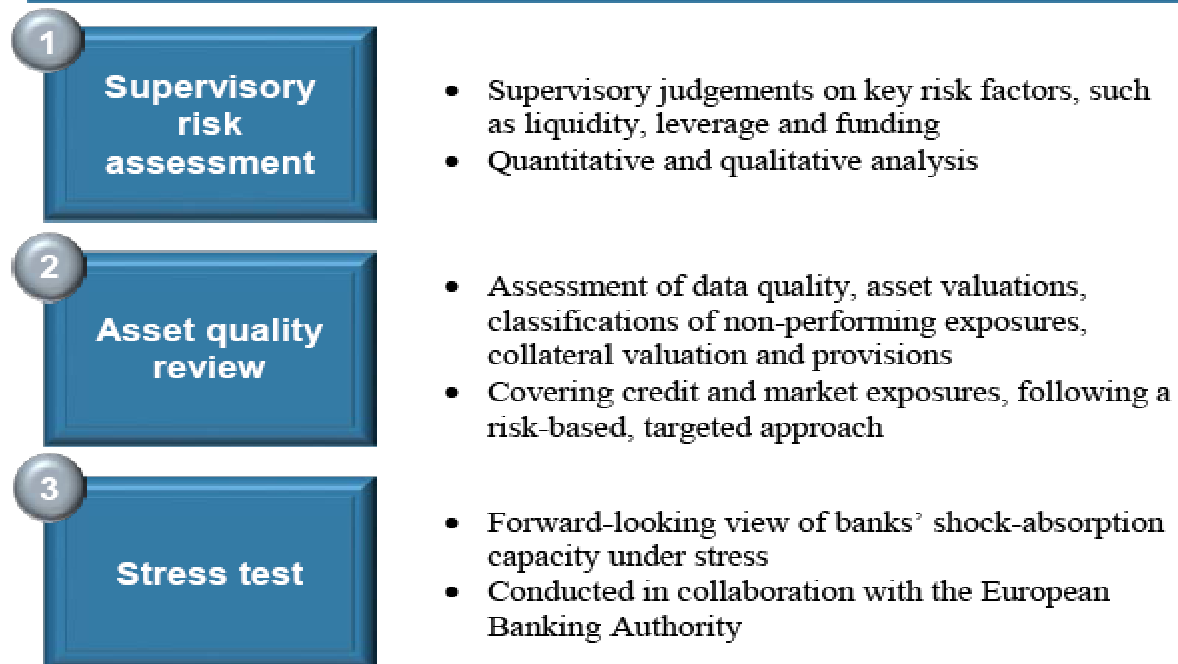



**Source:** Bloomberg, OCBC

# ECB: be prepared for the comprehensive assessment

- The ECB will carry out a comprehensive asset quality review for banks till October 2014 before it assume its new supervisory role in November 2014. The exercise will involve 130 credit institutions in 18 member states, covering approximately 85% of Euro Area bank assets. The comprehensive assessment comprises three complementary pillars including supervisory risk assessment, asset quality review and stress test.
- As the asset quality review is based on banks' balance sheet as of end-2013, banks' window dressing may have distorted recent loans data and money market rates.

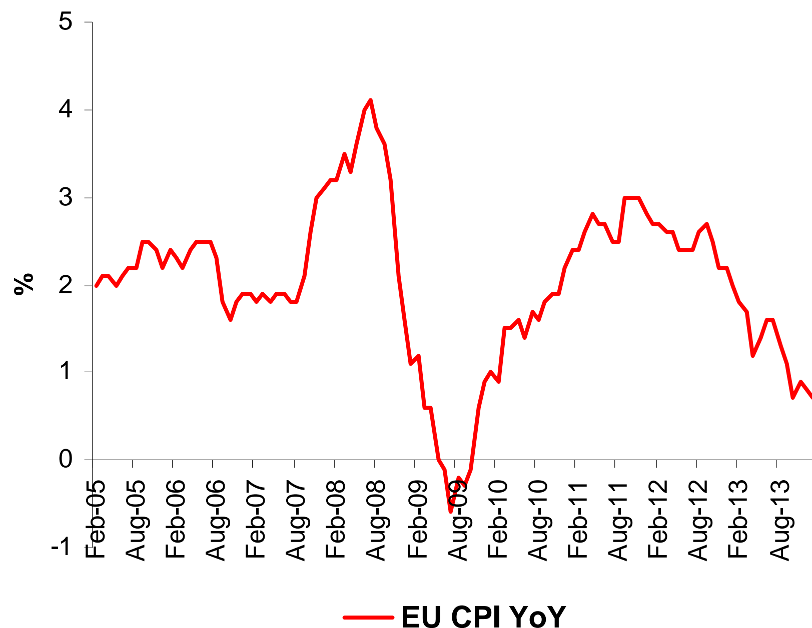
As of end-June 2013, European banks had EUR979.2b of impaired or non-performing loans (6.7% of total loans)

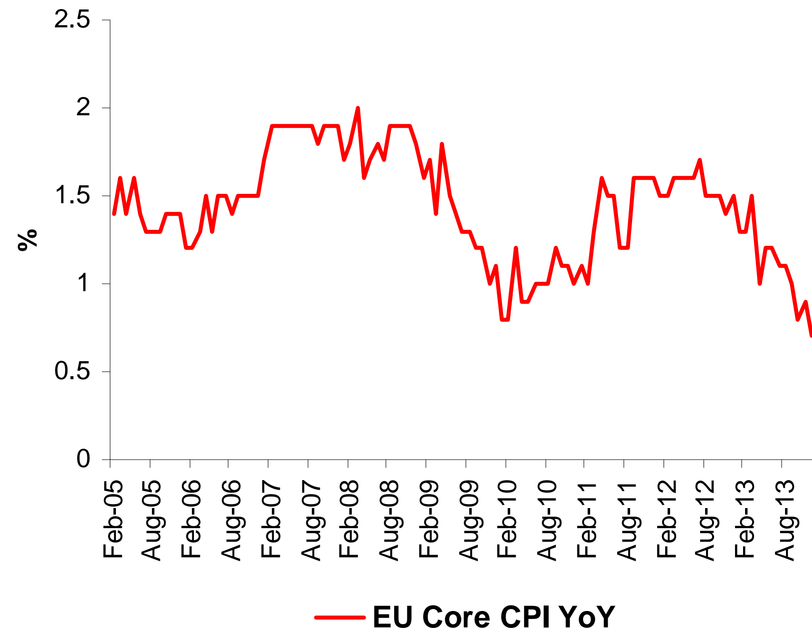


**Source:** ECB, OCBC

# ECB: disinflation remains the key concern

- The Euro area consumer prices fell again in January to 0.7% yoy from 0.8% in December, further below the ECB's 2% target. The soft CPI reading was mainly due to a 1.2% decline in energy costs. Deflation risk concerns have spurred hopes that ECB may have to ease more in the coming months.
- ECB President Draghi expects inflation to remain subdued for about two years, although he denied the Euro Zone will slip into deflation.
- European Parliament elections are due in late May.

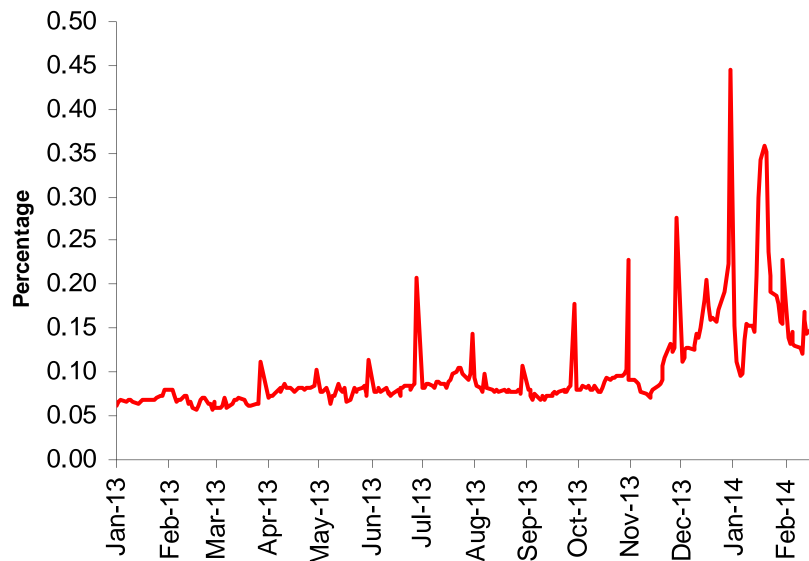


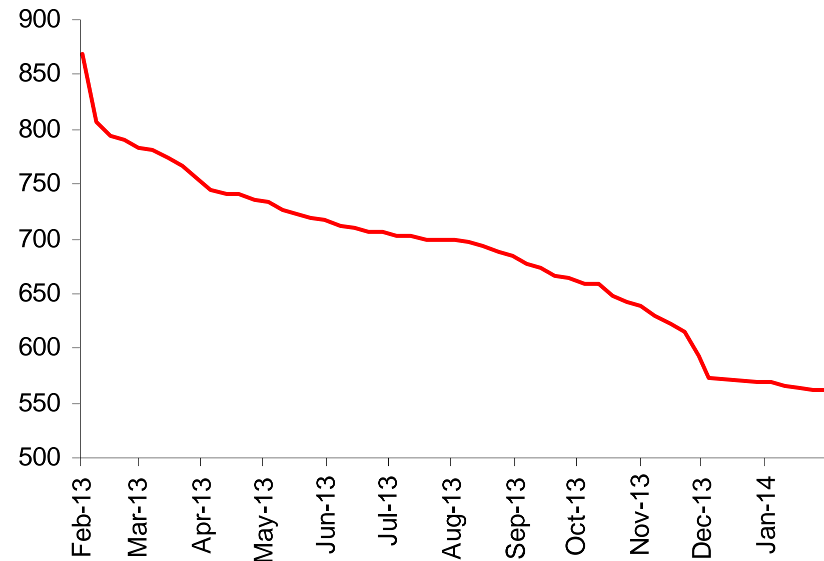



**Source:** Bloomberg, OCBC

# ECB: an unwelcome tightening in monetary conditions

- Although government bond yields in the Euro Area have been falling nicely, the benchmark overnight rate for Euro in the interbank market (EONIA) has spiked since November even though the ECB had cut its main refi rate again.
- The rising volatility in the money market was probably the result of shrinking excess liquidity after banks started to repay the first two tranches of LTRO.
- **The ECB has laid down two triggers for further action including falling inflation and an unwarranted rise in money market rates.** As such, the tightening monetary conditions will keep the pressure on ECB, and we see a good chance of more accommodative measures from the ECB.



**Source:** Bloomberg, OCBC

# Disclaimer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