

Exchanges at Goldman Sachs
The European Recovery: Here to Stay?
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Allison Nathan: This is Exchanges at Goldman Sachs and I'm Allison Nathan, a Senior Strategist in Goldman Sachs Research.

In this episode, we'll be looking at the accelerating recovery in Europe. To do that, I'm joined by Jari Stehn, Chief European Economist for Goldman Sachs Research, and Rich Privorotsky who manages European cash equities trading in our Global Markets Division. We'll first turn to Jari to discuss the economy and where fiscal and monetary policy stand for the region and are likely headed.

Jari, welcome to the program.

Jari Stehn: Hi, Allison.

Allison Nathan: Jari, the economic outlook for Europe has brightened in recent months. We've seen a significant step up in the vaccine rollout that has facilitated that. But this isn't the first time that growth has started to look better in Europe but then ended up disappointing. Why is this time different?

Jari Stehn: Well, we think it's different because we're getting very encouraging information across a range of metrics in Europe. So, first, I would highlight that we have seen pretty sharp improvements now on the medical side. COVID cases and hospitalizations are now down pretty sharply, really across the Euro area. Vaccinations are up. We think we're on track to reach 50 percent of the population later in June. And I think even though concerns around the new variants persist, and particularly, you know, the Delta variant here in the UK, we ultimately think that the evidence suggests that it's a manageable risk as long as the vaccine rollout continues.

You know, second, we have already seen significant reopening steps. Plans are for that to continue into the summer. And that's, of course, highly relevant for services activity, which is very depressed. But as these restrictions lift, we should

see, you know, an unlocking of pent-up demand as we go into the summer months.

And third, the incoming activity data, I think, is consistent with a very strong pick up in activity, particularly services, in May and in June. Now so far, we only have preliminary service. It's sort of high frequency data for June. But it does look like the economy is accelerating and the forward-looking indicators, whether you look at business expectations or you look at new orders suggest that there is more room to run.

So, when you take that together, we see strong momentum into the summer. We are significantly above consensus for growth, both for Q2 and for Q3. And we also think there's room for that to run. There's fiscal support coming from the Recovery Fund. And our global growth views are constructive. And that's, of course, important for Europe which is a very open economy. And so, bottom line for us is 5.4 percent growth in 2021 for the Euro area and 8.1 percent for the UK. And both of those are pretty sharply above consensus.

Allison Nathan: But are you seeing differentiation across sectors in the economy? So, are there some sectors that are really benefiting from the acceleration you talked about? And are there some that are still lagging?

Jari Stehn: Yes, sure. So, you know, manufacturing activity has already been quite firm. So, industrial production levels, for example, already normalized earlier in the year. And I think that's partly because growth momentum in parts of the world, you know, in China and the US have been firm. And so, that has lifted global trade. And, of course, manufacturing was not affected by the COVID restrictions during the third wave. So, it's quite natural for manufacturing activity to have shown more resilience.

But services activity is still very depressed, which of course is true particularly in the contact intensive parts where the restrictions are specifically targeted at those sectors. And those are responsible, really, for the large remaining shortfall in GDP across Europe. And so, as these restrictions are lifted, we think services activity should accelerate sharply. And that's what we are seeing in the early data.

So far, survey data, because the services hard data is released with a lag, but I think that does look very encouraging.

Allison Nathan: You mentioned the increased fiscal support in the EU to help repair and recover from the pandemic. How do you see that playing out? And do you think that we're sort of in a new era where we generally will see more supportive fiscal policy? Or is this really just a one-time shift in policy just to address the crisis and Europe could move back in a fiscally tighter situation going forward?

Jari Stehn: I think we have seen pretty remarkable shifts in fiscal policy across Europe. And I think it's helpful here in Europe to distinguish between national policies and then EU-wide policies.

So, on the national basis, this is really where the COVID response initially took place. And I think European governments really focused on bridging measures, rather than outright stimulus measures initially. And this, of course, includes short-term work schemes and also the corporate support schemes that are very expensive, but also very effective in shielding workers and in shielding firms. And so, for example, we saw a much more limited increase in unemployment in Europe than in the US. But, of course, it came with a large increase in deficits across Europe.

I think on the national side, we think that deficits will start to shrink as we go into '22 as the economy recovers. But we think the turn towards consolidation is going to be a much more gradual one than in the past. And I do think that's one of the key lessons that was learned after the crisis, that Europe turned towards consolidation too quickly.

Now, the second aspect of the fiscal response, and in some ways the much more innovative one, was, of course, the EU-wide fiscal response with the creation of the Recovery Fund, which has now been ratified and has now issued debt and will disperse those funds across countries. And this is hugely important for southern Europe because the allocations there are very large. So, Italy, for example, and Spain will get around 12 percent of GDP from grants and loans over the next few years. And we think the money will be spent on things that tend to have high multipliers. So, basically, public investment projects. And they're paired also with some structural reforms.

And so, we do think the overall fiscal stance, so, if you sum together the national level and EU-wide level, will remain expansionary across the Euro area. So, we estimate this year it adds around 1.5 percentage points to growth. Next year, probably

half that. So, that is modest compared to what we've seen in the US. I think that's clear. But I also think it's a huge improvement relative to what we saw after the crisis. And I would also note that the fiscal support is very persistent. So, the Recovery Fund money will stretch all the way to 2026. And that's, of course, where it gets its name from. It's supposed to really support the recovery over multiple years.

Allison Nathan: Of course, monetary policy has also played a key role in the recovery. And the European Central Bank just met. They maintained the pace of their bond purchases, even though we've seen improvement in growth as you've discussed and inflation. What was the key takeaway from that meeting? And did anything surprise you about it?

Jari Stehn: Yeah, I would highlight three things. You know, as you say, the governing council decided to pledge a steady hand, as President Lagarde called it, with regard to the bond purchases. So, they maintained this pledge to buy at a significantly higher pace with its PEPP program and demotivated that by the recent increase in interest rates that we've seen since the March meeting to say that there is still a risk that this will feed through into borrowing costs that households and firms face.

But at the same time, they did guide towards a slight reduction in the pace on the back of seasonal issue during the summer. So, they typically buy less during August because there's less issuance. And that's also our expectation this time around.

I would say the second takeaway and the most surprising one is how much more optimistic the ECB turned on the growth outlook. And so, you saw that in the growth projections. Those came up much more than expected. And also in the risk assessment, because the governing council now sees the risks as balanced, which has not been the case since December 2018. So, as we just discussed, I mean, we very much agree with this. And our own growth numbers are actually still higher than their new numbers. But nonetheless, I think this is a big upgrade for the ECB.

And then the third takeaway, and I think in some ways the most forward-looking takeaway, was that they remain very cautious on inflation, despite that upgrade to growth. So, you saw a small upgrade to the core inflation profile. But they kept the end point for headline inflation unchanged. So, that's in many ways the key number is the 2023 headline inflation number. They kept that at 1.4 percent, which is still well below that aim of 2

percent that they're following. And as a result of that, Lagarde said that any exit discussion at this point is premature and also unnecessary.

And so, bottom line for us is that we think they will keep policy highly accommodative well into the recovery because it will take time for inflation to move up. And we don't have a hike from the ECB until 2025.

Allison Nathan: And the ECB not changing their inflation forecast was, perhaps, particularly surprising just because inflation has jumped recently in the Euro area. It's reached the central bank's target for the first time in more than two years. So, what gives them confidence that this is a temporary versus a longer-term move? And do you agree with that?

Jari Stehn: Yeah, I think it's really the structure of the inflation increase. And, of course, that's similar also in other countries such as the US. And that one factor is commodity prices. That's clearly pushing up headline inflation. Another one is base effects. So, you know, we had drops in some prices last year. And so, the comparison one year later points to a big increase. And then there are also a number of technical factors, some of them specific to Europe, such as tax changes that we think are likely to push up inflation more in the next few months.

And we think inflation will peak in November. And I think the most eye-catching number here is that we think German headline inflation will reach 4 percent in November. Which, of course, for European standards is quite a lot.

At the same time though, I think it's pretty compelling that this increase is not going to be sustainable. First of all, a lot of these temporary factors that I talked about will drop out as you go into '22. So, there's going to be a mechanical decline in the inflation numbers. And at the same time, we think the underlying inflation trend is still very subdued. So, when you cut through the noise in the inflation data, what we see is that the inflation trend is only about 1 percent and hasn't changed very much. And we think that's because there's a lot of slack in the Euro area. And that is going to take a long time for that underlying inflation trend to firm.

And so, when you look ahead, we think core inflation will go up. But will only go up relatively gradually. And we have core inflation reach 1.5 percent on a sustainable basis, so not just

on a one-off basis, at the end of 2024. And so, you know, that's still clearly below 2 percent. Hence a dovish view on the ECB. But I would also say that 1.5 percent inflation on a sustainable basis is quite a bit better for Europe than what we've seen over the last ten to 20 years.

Allison Nathan: Thanks so much for joining us on the program, Jari.

Jari Stehn: Thank you.

Allison Nathan: We'll now turn to Rich Privorotsky to discuss how the markets are pricing in the European recovery. Rich, welcome to the program.

Rich Privorotsky: Thanks for having me.

Allison Nathan: Rich, we just spoke with Jari Stehn who was quite optimistic about Europe's economic recovery. From your seat in Global Markets, is the market pricing in this optimism?

Rich Privorotsky: I think we're really starting to see some European outperformance for the first time in a number of years. I think if we look at year to date it's pretty clear the SX5E has actually outperformed both the S&P and NASDAQ. That doesn't happen very often. If you look at the decomposition of what's been leading the rally, it's been banks, autos, which are up nearly 30 percent each. The defensive parts of the market like utilities are unchanged. It's been entirely a value-decomposed rally. It's been driven by consumption, domestics, Italian domestics, EU inflation. I mean I would say we're definitely starting to see some signs of optimism. And it's been a while since investors have really warmed up to the geography.

Allison Nathan: And how are investors positioning for the recovery?

Rich Privorotsky: I would say that, in general, our flows indicate quite substantial appetite for banks, construction, broad cyclical value. We've seen a notable uptick in demand for southern Europe, specifically Italy. It does feel that there is a bit of a domestic tilt towards the flow. There are probably some really good reasons for that in terms of the scope of the Recovery Fund and the direction of travel in terms of some of the structural reforms that have come out of the pandemic.

But in general, investors position themselves with more cyclical tilt. And given the overall, I would say, tendency towards value in the European geographies certainly relative to the US, it's been expressed in those parts that I've mentioned, like the banks, where it's always been a bit of a love/hate relationship amongst the investor base.

Allison Nathan: You mentioned investor flows. Can you dig in a little bit more in terms of what you're seeing in Europe versus the US, for example?

Rich Privorotsky: So, it's been about kind of ten out of 11 weeks of inflows into Europe. It's been a while since I've been able to say anything like that. In general, most portfolios have been structured for a long time towards growth. They hold specifically a large overweight within the US. And within Europe, I would say there have been episodes where macro funds have come in, chased the geography, have had bad experiences, and this kind of kept the allocation relatively low.

If we look back, it was really the last French election. We had an overwhelming sense of positive feedback and kind of euphoria. And if I kind of benchmark positioning at that level, we were probably ten out of ten then. I would say if we look at where implied funding has come just in things like broad Euro stocks, we're seeing investors moderately long. Maybe call it one to three. But I would say relative to a baseline of negative four, that's a rapid improvement. So, we have seen positioning tick up.

I think if you look at our PB, which is our prime brokerage measure of all of the client hedge fund positioning we have across our book, it's clear that Europe remains a relative underweight geography versus most other geographies in the book. And I think all indications suggest that there is still a lot of room to go if investors really feel that this is the geography that they need to be exposed to.

Allison Nathan: But I mean, ultimately, a lot of the optimism we heard from Jari was just coming from declining COVID cases, vaccine rollouts. What extent is the market comfortable with the region's longer-term growth prospects, which as you just mentioned, have ended up disappointing at points in the past? So, in other words, are people increasing buying into a narrative that the outperformance can last? Or does this feel more temporary to you?

Rich Privorotsky: To be honest, I do feel a lot of feedback is slightly more temporary in nature. I think certainly for the macro community, the view has been that the relative pace of recovery for Europe just makes it a much more appetizing investment. And I do think that's predicated on the vaccination path having very rapidly improved, particularly for continental Europe. And versus the US where a large portion of the reopening trade has already occurred.

So, on a relative basis, there is lots of room to be very excited in terms of the slope of recovery, the slope of GDP improvement coming out of pandemic. And there are some structural arguments that are worth discussing. But the arguments that are being put forward for Europe are the same arguments that we're now hearing for Japan. Look at where vaccinations are. Look at how they're progressing. And it's very clear that there is a sharp pick up in PMIs recovery that's yet to come.

That is, perhaps by nature, slightly more short termism. There are structural arguments that I'm very sympathetic to. And you know, I think we should address them. One, if you look at the last decade of returns, it's been predicated on kind of a disinflationary narrative. This idea that growth is scarce and hard to come by post GFC. And hence, investors have been allocating very aggressively to secular growth and parts of the market where multiple expansion is greatly rewarded. And that tends to favor the US. That tends to favor tech. And it tends not to favor Europe or Japan, for that matter.

So, I do think that there is, perhaps, a slight correlation, and perhaps part of it is causation as well, but I think rising interest rates, there's a hole in the structural view on rising rates to certainly benefit Europe as a geography. And that has a lot to do with the banking sector and the relative rate and the relative underperformance of European banks, I would say, and how investors think about making investment into Europe.

There are other important structural arguments. I think that the pandemic has tightened the bond amongst European countries. It's forced big reforms, particularly in southern Europe. And those reforms are bearing fruit in terms of large fiscal expansions that are predicated on structural reforms. So, the Italian flows that I was referring to, I would say, are more long term in nature relative to short term. And with the view that the Draghi put, if you will, will carry forward much bigger impactful and longer-term changes.

So, you know, I guess it's not fair for me to say it's purely short term in nature. But there are structural earnings that I'm sympathetic to.

Allison Nathan: Okay, great. Yeah. I mean, just to clarify then, so, your perspective is the markets do seem to be focused on these near-term positive catalysts. But there are longer term structural reasons to be more optimistic about the region?

Rich Privorotsky: Yeah, absolutely. You know, I think having traded through the sovereign crisis in 2011 there were multiple points where we thought, you know, Europe which be pushed further apart. And it certainly moved that way through the process of austerity. I think from a very structural perspective, the pandemic and the fiscal expansion has just drawn it slightly closer together. And that has disbanded, maybe, some of the structural fears about why an investment here is always fraught with risk. But being a trader sitting in a trading seat, I probably hear more of the short-term arguments than the long-term ones.

Allison Nathan: So, I mean finally, you mentioned the Macron French election as a pivotal turning point in the markets. We obviously have some pretty important elections coming up in the region in the next year. We also have, still, a lot of unknowns about the virus variants and how they will develop. What are clients most worried about in terms of these types of risks and what do you see as the most worrying risks and potential inflection points for the region ahead?

Rich Privorotsky: So, there are quite a few, as there always are, in Europe. Look, if we're talking about election stuff, you know, one, I think, in the near term, the recovery trade in Europe is certainly predicated on that continued process of reopening and vaccination.

If we look at the UK, we just had a delay in the reopening. It was fairly well expected. So, you know, I think it was reasonably well received. But I do think for Europe specifically, there isn't so much concern. And if something like to Delta variant were to pop up in the European geography and have similar issue delaying recovery, that might be a very short-term concern for the market, but one that I don't think we've necessarily priced. So, something that I think we would probably keep an eye on.

In the medium term, there are quite a few elections coming up. I would say, one, we have the German election in September. And this is not one that's particularly, I think, seen as a risk at all for Europe. But it does have implications, I think, for the rates market depending on how prevalent Greens end up being and whether the black zero is taken away and defensive expansion becomes hard coded within Germany. And so, that will affect the relative rotation pending on what's going to work and what's not.

The more serious risks are probably what happens in Italy in February around the presidential election and, you know, whether Draghi steps into the presidential seat, which then causes a political rift. That's reasonably far enough away right now that people aren't too concerned, but it's certainly something that will potentially be an issue.

And then the big one is the French election. And you know, we have some regional elections coming up that will give us a guidepost as to how that's progressing. And the crazy, crazy tail risk there is that there will be a coalition of the left that faces off against Le Pen in the first round that takes Macron out of the picture. That's very, very unlikely. And of course, you know, the perennial fear is, you know, Le Pen versus Macron in the second round where Macron is still very well expected to win. But, you know, it's Europe. It's politics. There are always surprises and twists and turns in the tail. Those are kind of the three that we're aware of.

I think, ultimately, as long as we continue to see a unified Europe, one that is unified in fiscal expansion, I would say the longer-term prospects of the geography look very attractive as we start to move from fiscal expansion back into a version of austerity or version of balanced books and we once again, inevitably, end up probably discussing similar thematic that we had in the early part of the 2010s.

So, you know, I think certainly from my seat, the next few months look like a relatively clear glide path. I do think Europe will benefit if rates do go higher, which I think is a fairly consensual view across the street. And ultimately, I think that sets up pretty well with what we hope to be some decent FPs and more confidence around the Fed. So, all of that in the short term looks okay assuming none of the virus concerns start to reemerge.

So, I would say from our perspective on the desk, the flows have

been fairly constructive. We remain constructive on the geography. And I think that's certainly been a more pro-cyclical bent through the summer.

Allison Nathan: Rich, thanks for joining us.

Rich Privorotsky: My pleasure.

Allison Nathan: That concludes this episode of Exchanges at Goldman Sachs. Thanks for listening. And if you enjoyed this show, we hope you subscribe on Apple Podcasts and leave a rating and comment.

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