

***SOM** Macro Strategies*

State of the Markets: The Normalization of the EMU

January 2018

Alan Brazil

# *SOM Macro Strategies*

## State of the Markets: The Normalization of The EMU

- ***Step 1: Macro Theme: The Normalization of The EMU***
  - Eight years after the start of the GIIPS crisis, economic growth in the EMU is normalizing and political risk is falling
  - Yet, valuations of EMU asset, particularly of the banks, have not
- ***Step 2: Fundamental Economic Framework***
  - EMU economic growth has rebounded and looks to accelerate
  - Yet, sovereign debt and NPLs, particularly for the GIIPS, is still a problem
  - More reforms are needed which could reignite political risk
    - Continuing low levels of inflation could put pressure on debt repayment
    - Employment rates are still high by historical standards
- ***Step 3: Find Potential Catalysts***
  - Accelerating world economic growth could provide tail wind to trade oriented EMU economies
    - German economic growth is accelerating
  - ECB is still supporting economic growth through monetary policy
  - Reforms have rebalanced the GIIPS economy supporting a further rebound of their economic growth
    - Belief in the EMU is growing
  - Economic growth could help solve the GIIPS NPL problem
- ***Step 4: Find Asymmetric Trade***
  - Trade 1: Buy EMU Banks
    - Profits rebound as economic growth and reforms solve NPL problem while accelerating credit originations
  - Trade 2: Buy EMU Equities
    - Economic growth in the world and the EMU will support earnings
    - Solving the GIIPS issues will remove one barrier to normalization of valuations
  - Trade 3: Buy Greek Sov Debt
    - Rebalancing and reform should push Greek Sov debt yields closer to Portuguese Sov debt
      - Greece is on track to get substantial debt relief from Troika lenders

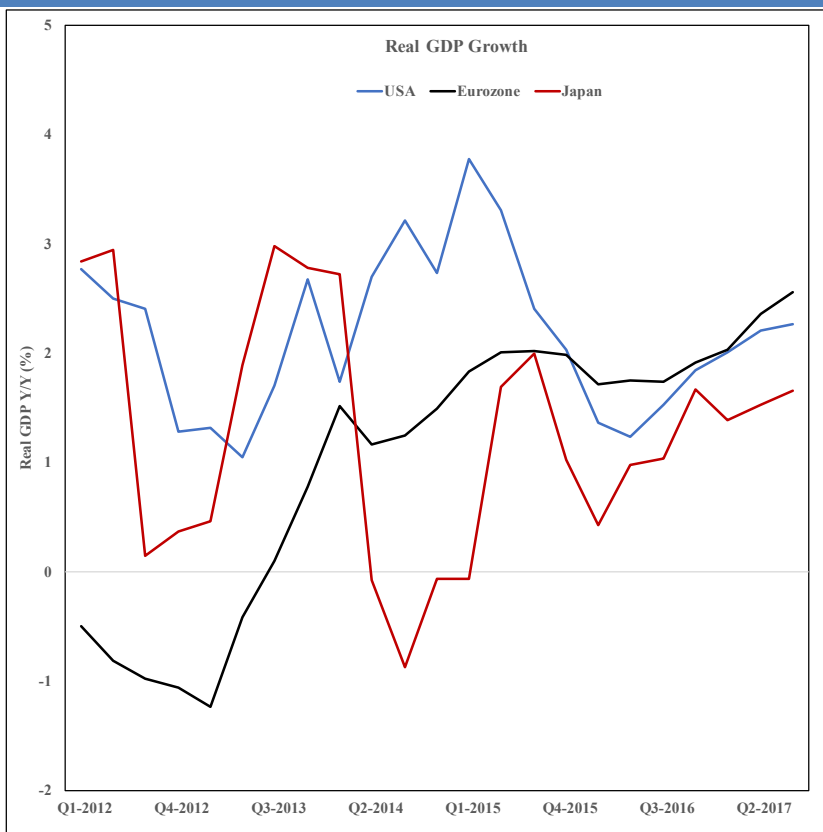
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## State of the Markets: The Normalization of The EMU

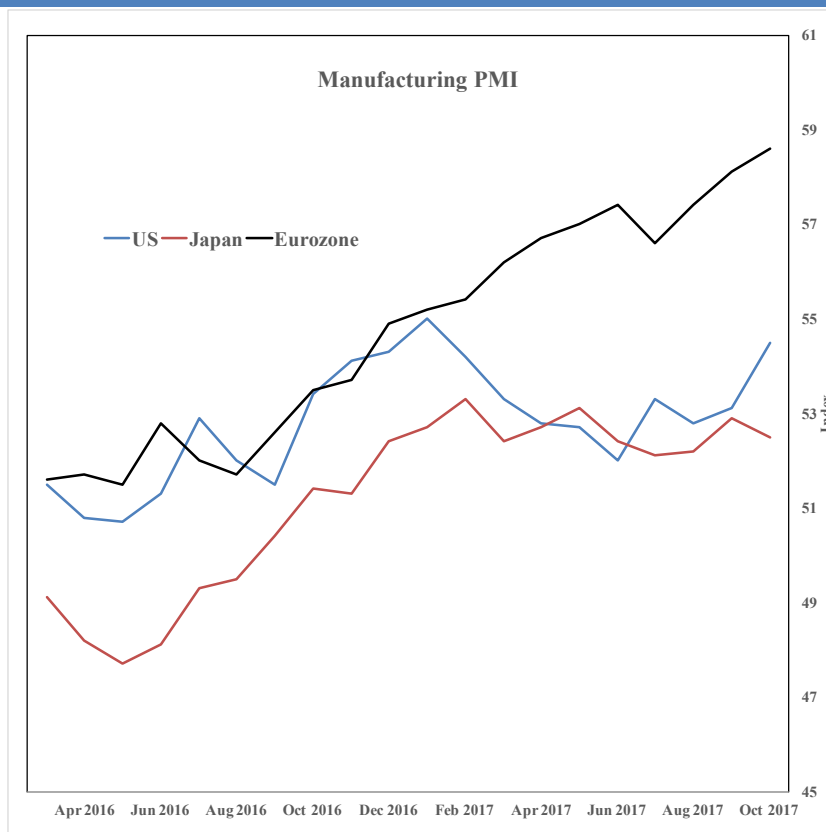
### Step 2: Fundamental Economic Framework

### Economic Growth In The Eurozone Has Normalized and Appears to Be Accelerating<sup>1</sup>

#### All Three Major Advanced Economies Aare Growth



#### Eurozone Growth Looks Strongest and Potentially Getting Stronger



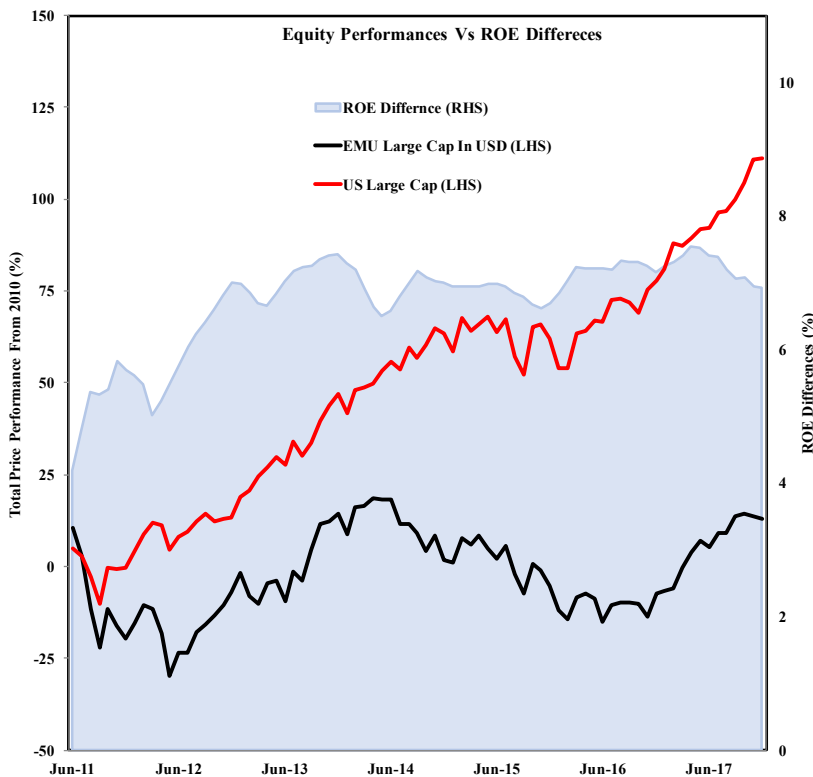
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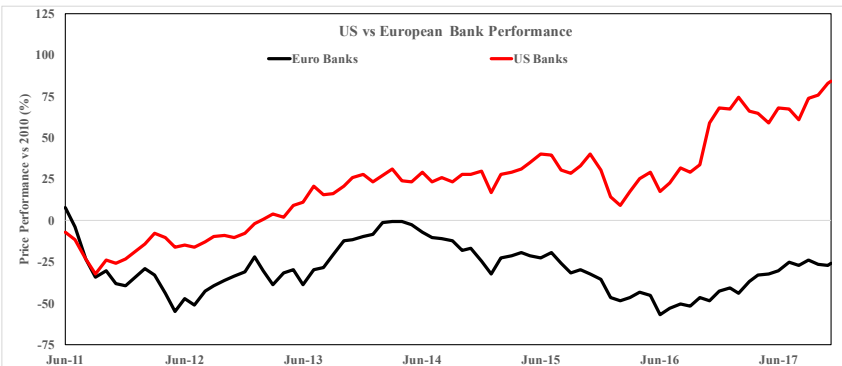
### Step 1: Macro Theme

### Yet, EMU Asset Prices Have Not Recovered From the GIIPS Crisis And Lagged The US Equity Rally<sup>1</sup>

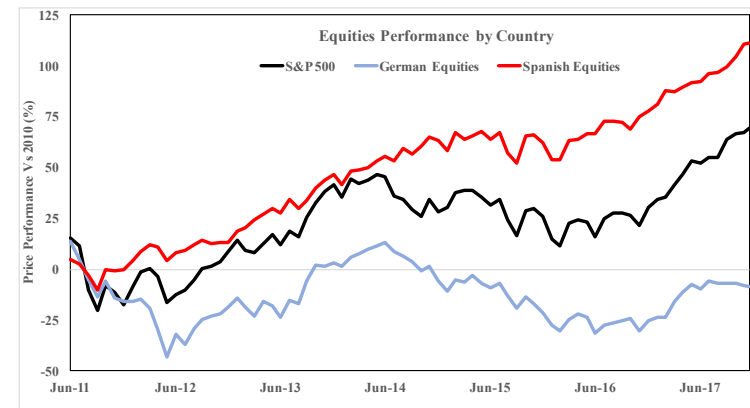
#### Equity Markets Have Not Yet Reflected Improving Eurozone Growth



#### US Vs European Banks



#### Both GIIPS and The German Equity Markets Have Lagged



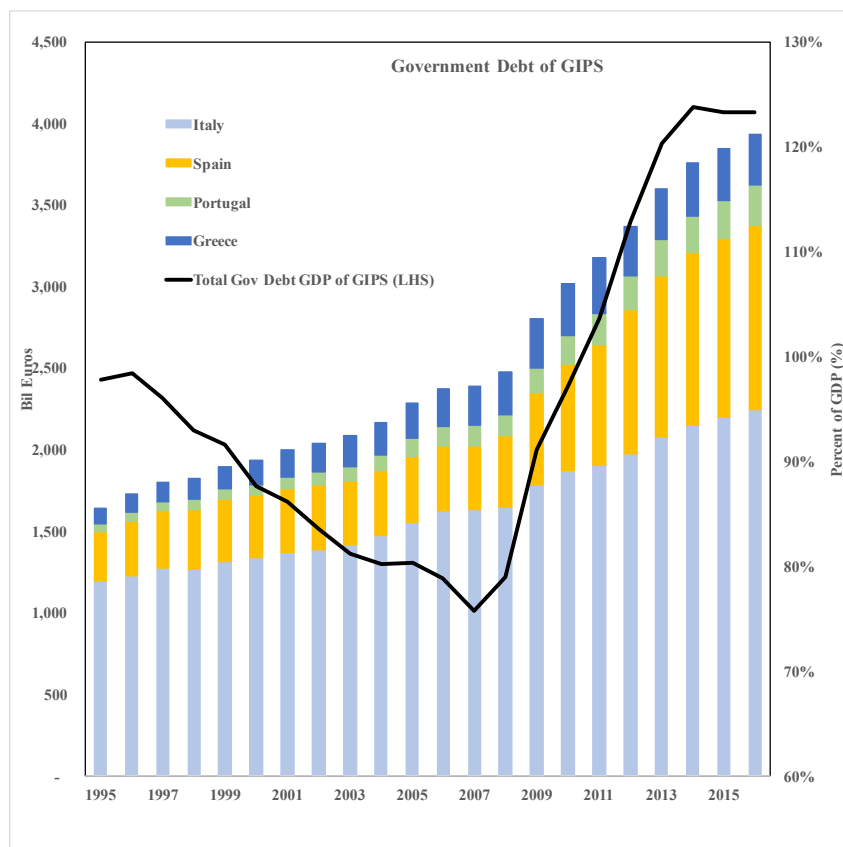
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## State of the Markets: The Normalization of The EMU

### Step 2: Fundamental Economic Framework

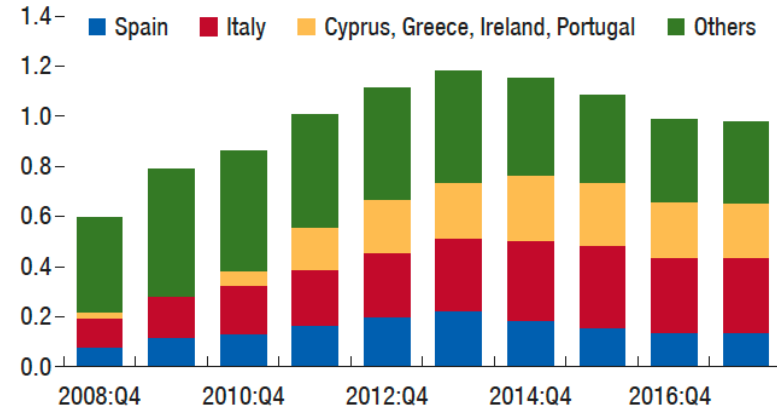
### Some of the Major Issues Confronting the GIIPS Have Improved But Still Remain a Problem

#### Government Debt Is Still An Issue For the GIIPS...<sup>1</sup>



#### As Is NPLs On GIIPS Bank Balance Sheets<sup>2</sup>

### 3. Euro Area: Stock of Nonperforming Loans (Billions of euros)



1. Federal Reserve Bank of St. Louis (Fred Data Base)
2. IMF, Europe Regional Economic Outlook Europe: Europe Hitting Its Stride, November 2017

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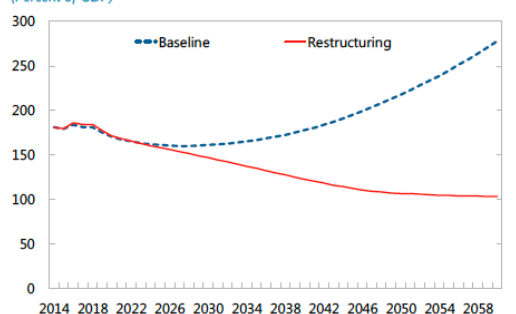
### Step 2: Fundamental Economic Framework

### Reform Is Still Necessary Which Could Still Created Political Risk

#### Greece Debt Problem Could Get Worse Without Further Reforms...<sup>1</sup>

Greece: GG Debt-- Restructuring Scenario, 2014-2060

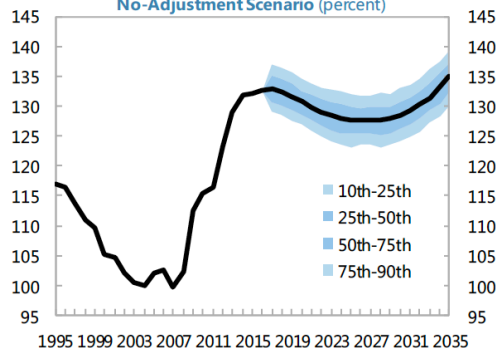
(Percent of GDP)



Source: IMF staff estimates.

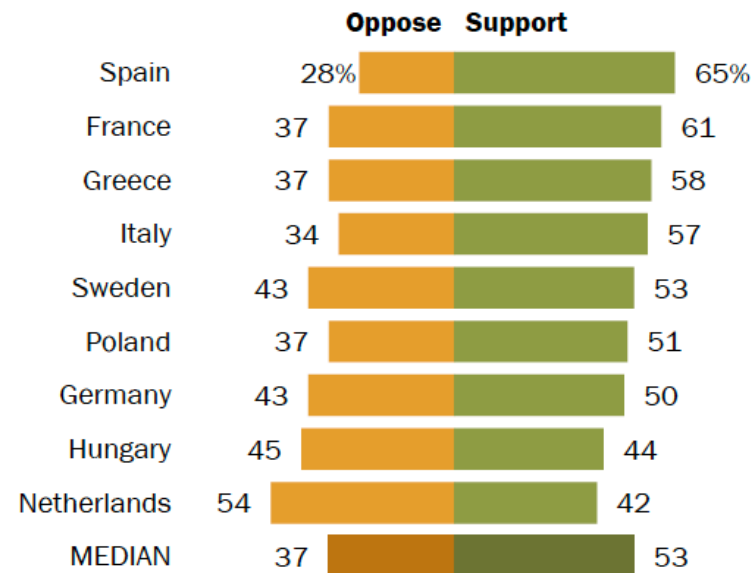
#### As Could Italian Debt<sup>2</sup>

Debt-to-GDP Ratio Under No-Adjustment Scenario (percent)



#### Further Reforms Could Spark More Euro exit Questions<sup>3</sup>

Would \_\_\_ holding a national referendum on our country's European Union membership



Source: Spring 2017 Global Attitudes Survey. Q44.

1. IMF, Article IV, Greece, May 2016

2. IMF, Article IV Italy, July 2017

3. Stokes, Wike, Manevich, Pew Research Center, "Post-Brexit, Europeans More Favorable Towards EU", June 2017

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## State of the Markets: The Normalization of The EMU

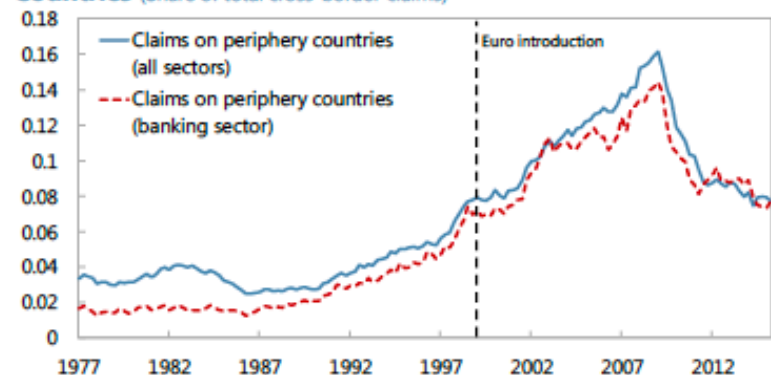
### Step 2: Fundamental Economic Framework

### The Balkanization of Southern Europe Is a Headwind To Growth<sup>1</sup>

Northern Europe Continues to Detach From The GIIPS

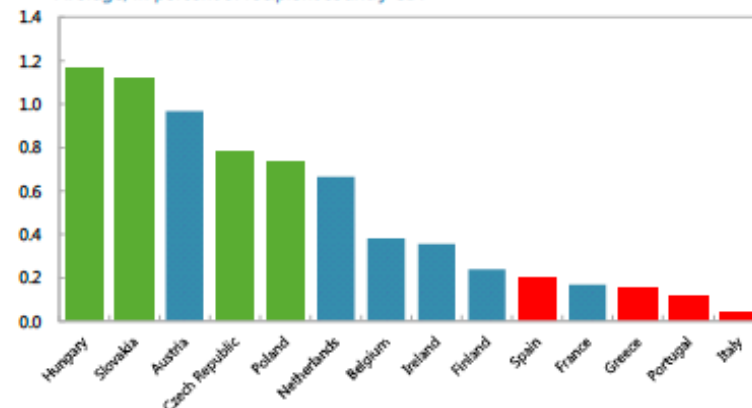
With Investment Going East Not South

**Core Country Banks' Cross-Border Claims on Periphery Countries** (Share of total cross-border claims)



Sources: BIS Locational Banking Statistics and IMF staff calculations. Periphery: Greece, Ireland, Portugal, Spain. Core: Austria, Belgium, Finland, France, Germany, and Netherlands (ex. Germany claims on banking sector due to data limitations).

**Outward Investment From Germany, 1995-2012**  
Average, in percent of recipient country GDP



Sources: OECD, Eurostat, and IMF staff calculations.

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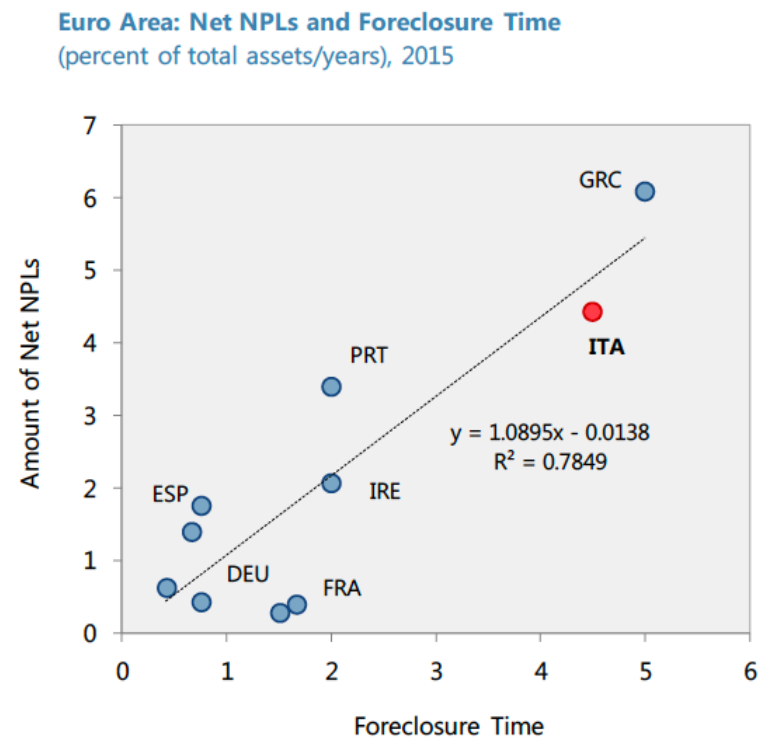
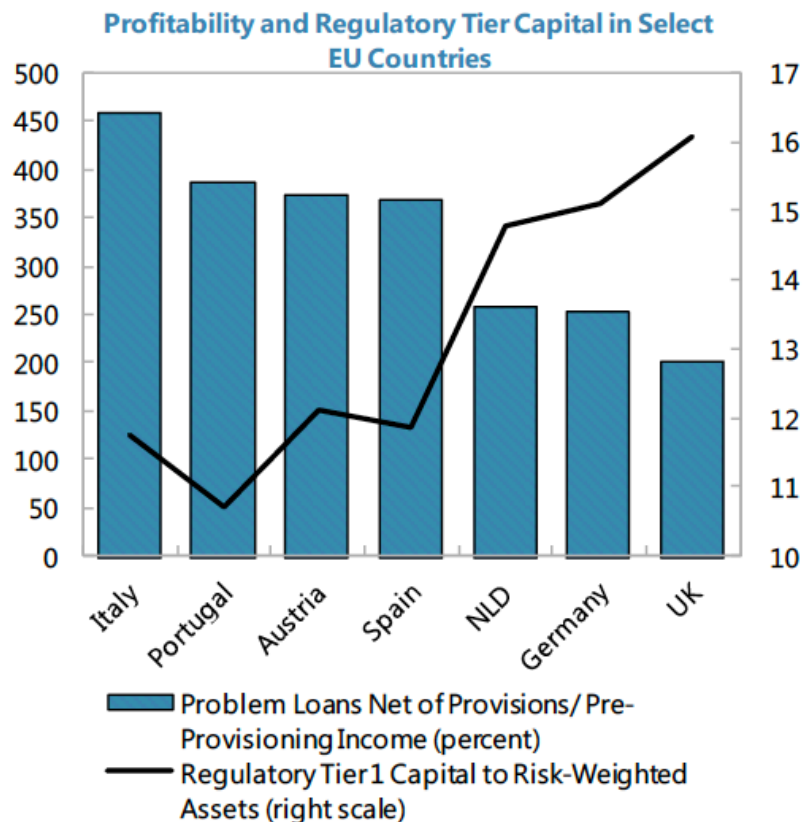
## State of the Markets: The Normalization of The EMU

### Step 2: Fundamental Economic Framework

### More Reform Could Ease The NPL Problem For Banks

NPL Problems Could Point to More Financial Crisis<sup>1</sup>

Dealing With NPLs Hindered By Structural Issues<sup>2</sup>



1. Garrido, Kopp, Weber, IMF Working Paper, "Cleaning-Up Bank Balance Sheets: ...For Italy", WP/16/135, July 2016
2. Jobst, Weber, IMF Working Paper, "Profitability and Balance Sheet Repair of Italian Banks", WP/16/175, August 2016



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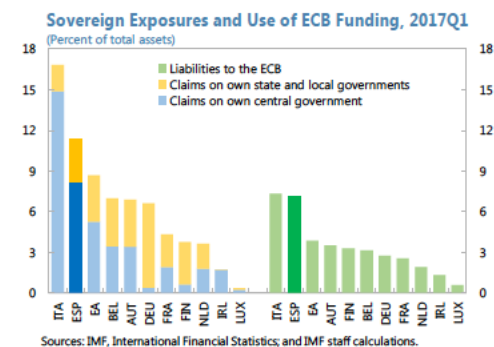
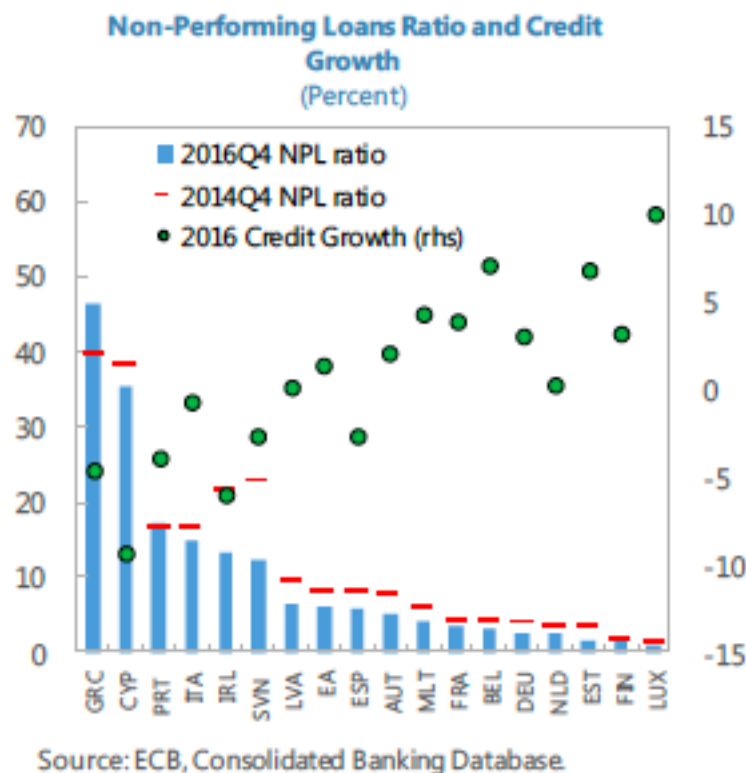
## State of the Markets: The Normalization of The EMU

Step 3: Find Potential Catalyst

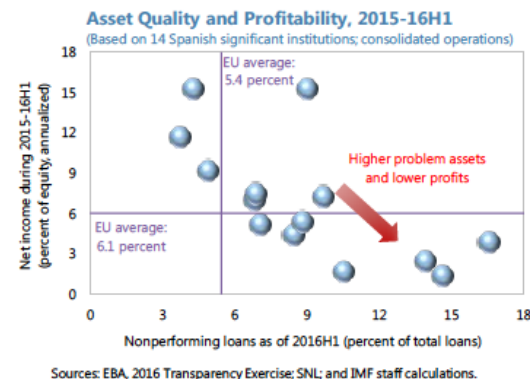
GIIPS NPL Problem Is A Constraint on Credit Growth And that Is A Headwind to Growth

NPLs Are Constraining GIIPS Credit Growth

Sov Debt Funded By ECB Replacing Credit At GIIPS Banks



NPLs Also Depress Profits and Valuations of GIIPS Banks



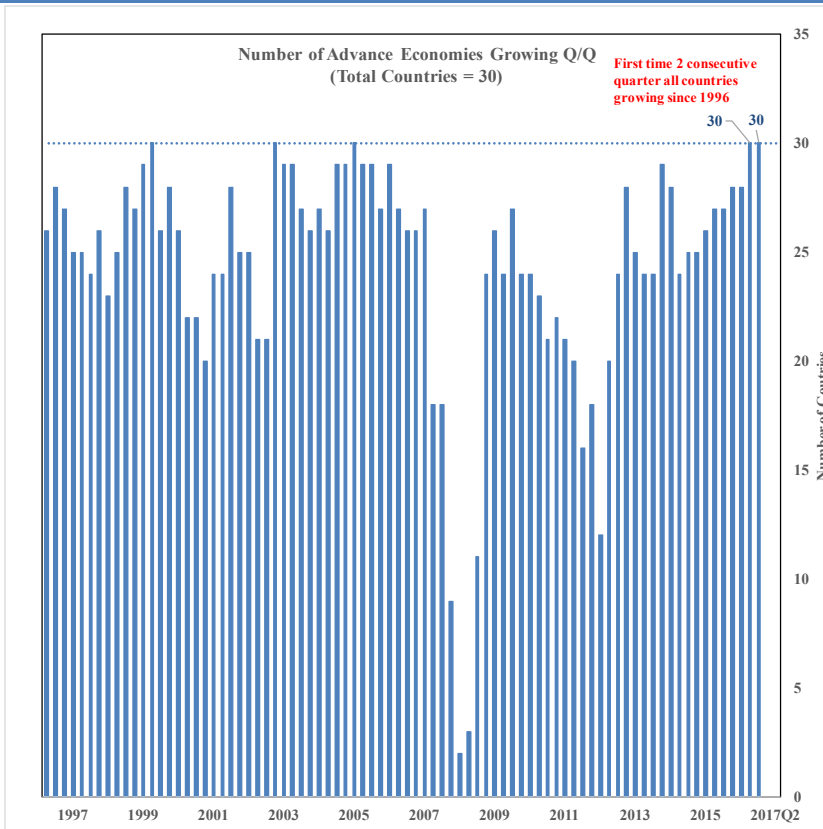
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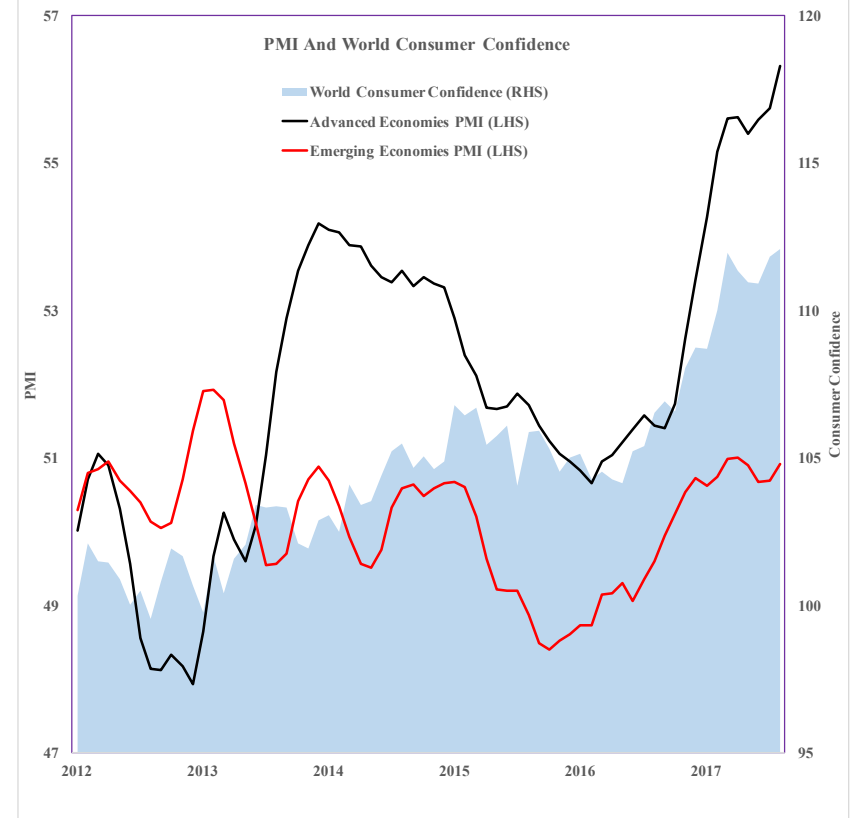
*Step 3: Find Potential Catalyst*

### World Growth Could Support Growth In The EMU<sup>1</sup>

#### Advanced Economies Are Growing At An Historically Pace...



#### Pulling EM Is Coming out of a Recession, Pushing up Confidence



1. IMF, World Economic Outlook Data Base

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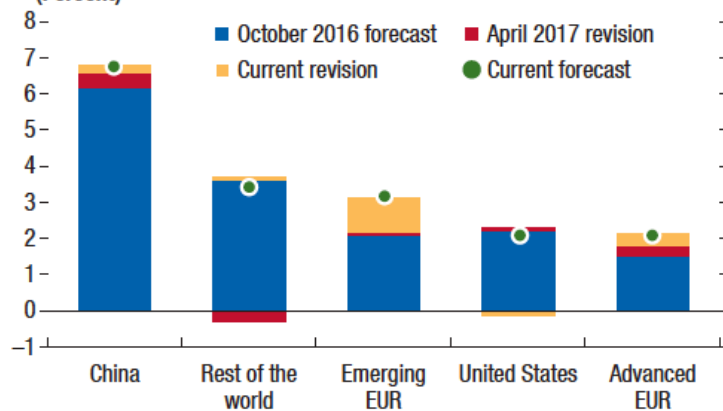
*Step 3: Find Potential Catalyst*

**European Growth Has Already Surprised to The Upside, And World Trade Growth Has Been A Factor**

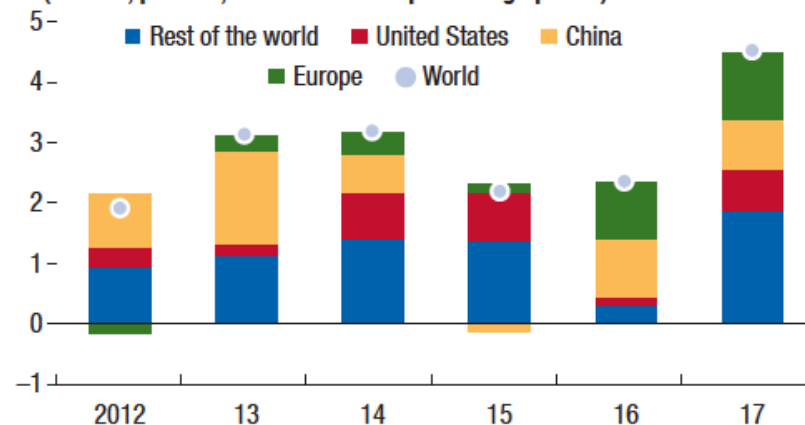
European Growth Has Been A Surprise

European Growth Has Also Fed World Growth Through Trade

**1. Revisions of Real GDP Growth Projections, 2017  
(Percent)**



**3. Contributions to Real Growth of Global Imports of Goods  
(Growth, percent; contributions in percentage points)**



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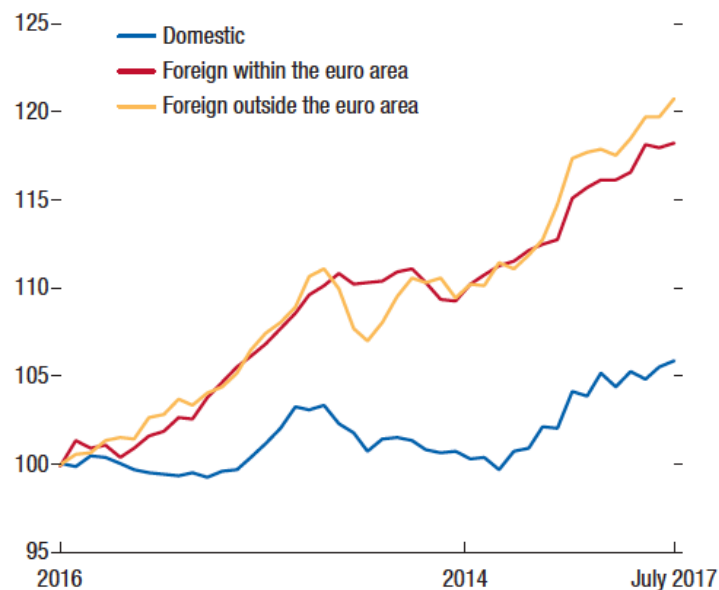
*Step 3: Find Potential Catalyst*

**Euro Trade Both Within Their Borders and To The Rest of The World Supports Investment**

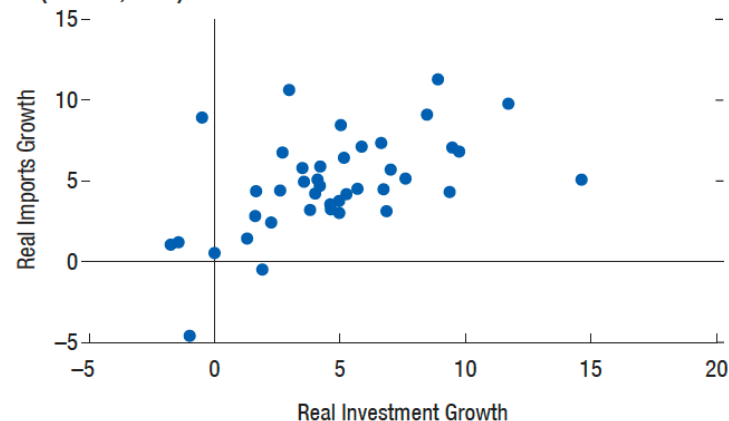
Trade Both Within and Outside the Zone Has Been Strengthening

Growth Has Supported a Investment Surge

**2. Euro Area Manufacturing: New Orders**  
(Index, January 2014 = 100; three-month moving average; SWDA)



**4. Europe: Real Investment and Import Growth**  
(Percent, 2017)



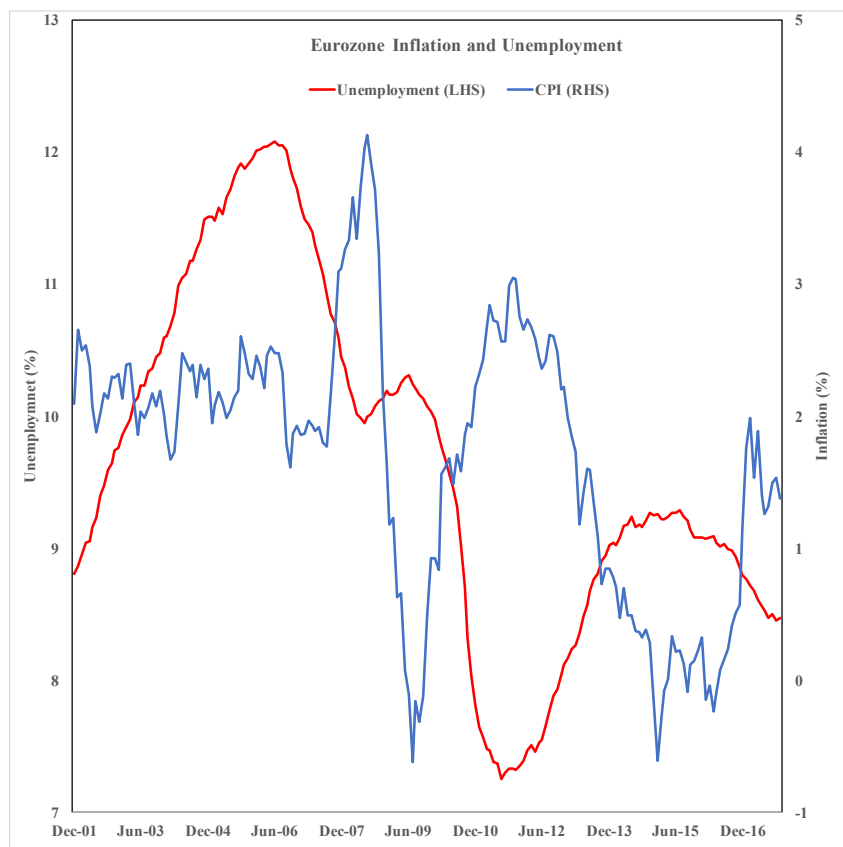
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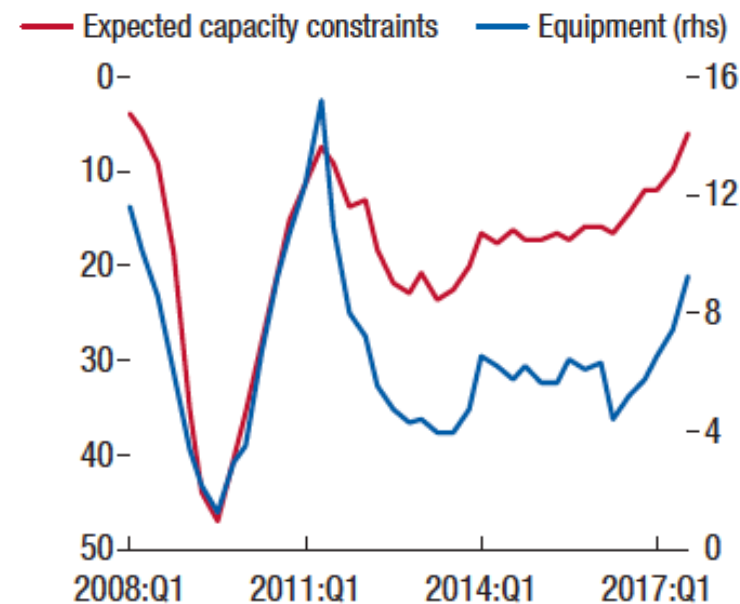
*Step 3: Find Potential Catalyst*

**Labor And Economic Growth Could Help With The Problem of Low Inflation**

**The Employment and Inflation Picture Brightening As Well<sup>1</sup>**



**Employment and Growth Could Lead to An Uptick In Inflation<sup>2</sup>**



1. Federal Reserve Bank of St. Louis (Fred Data Base)
2. IMF, Europe Regional Economic Outlook Europe: Europe Hitting Its Stride, November 2017

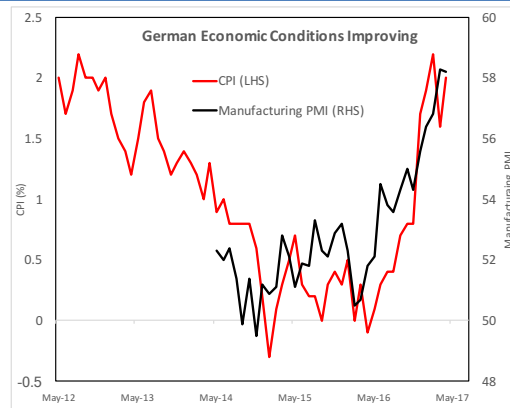
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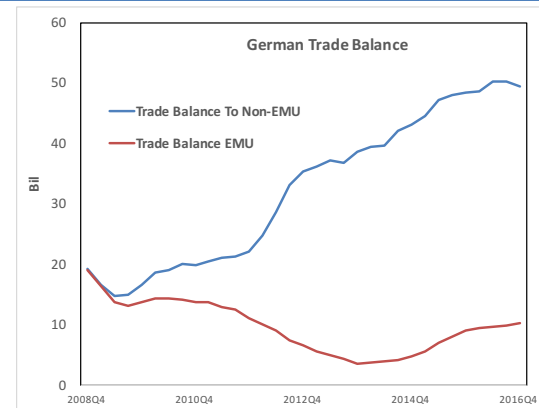
Step 3: Find Potential Catalyst

At The Core Of The Rebound is The German Economic Juggernaut <sup>1</sup>

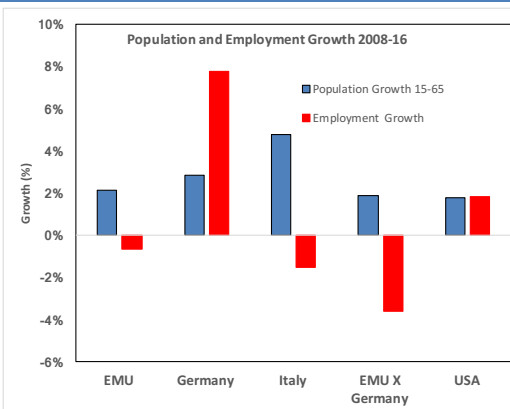
German Banks Are Turning This Cashflow Into Lending



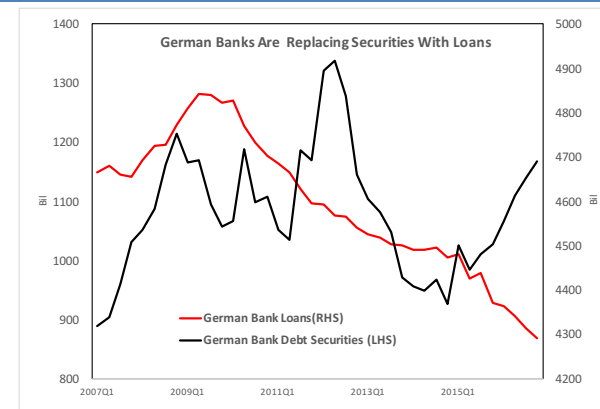
German Growth Supported By A Surge In Population/Labor Growth



Step 2: Economic Fundamental Framework



Economic Export Engine Producing Substantial Internal Cashflow



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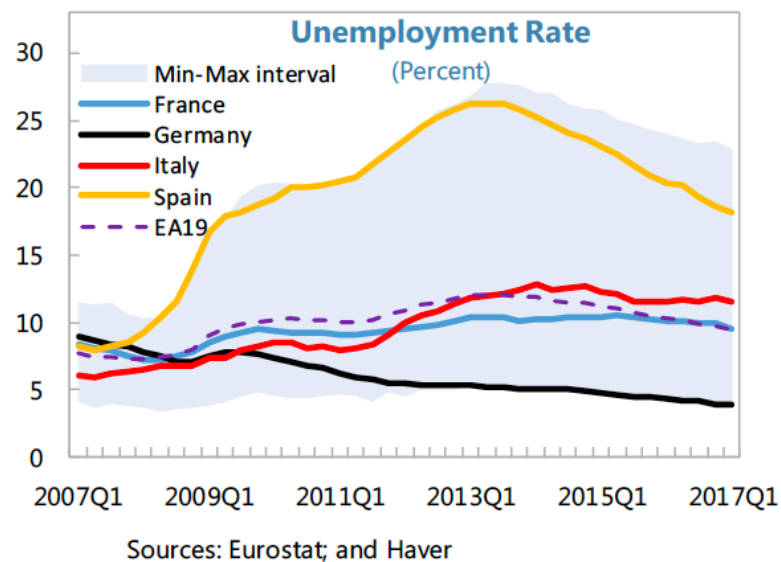
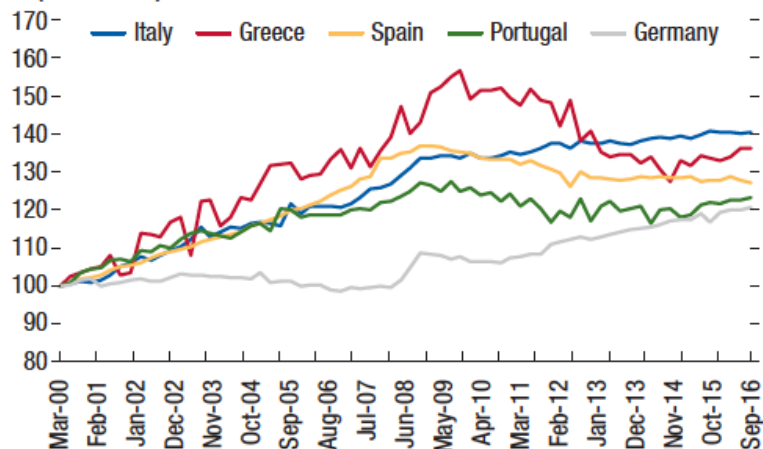
*Step 3: Find Potential Catalyst*

**GIIPS Reforms Have Reduced The Imbalances of GIIPS Labor Market With Rest of EMU**

**GIIPS Labor Markets Are Becoming More Competitive<sup>1</sup>**

**As A Result, GIIPS Labor Market Improving<sup>2</sup>**

**4. Unit Labor Costs  
(2000 = 100)**



1. IMF, Europe Regional Economic Outlook Europe: Europe Hitting Its Stride, November 2017

2. IMF, Article IV, Euro Area, July 2017

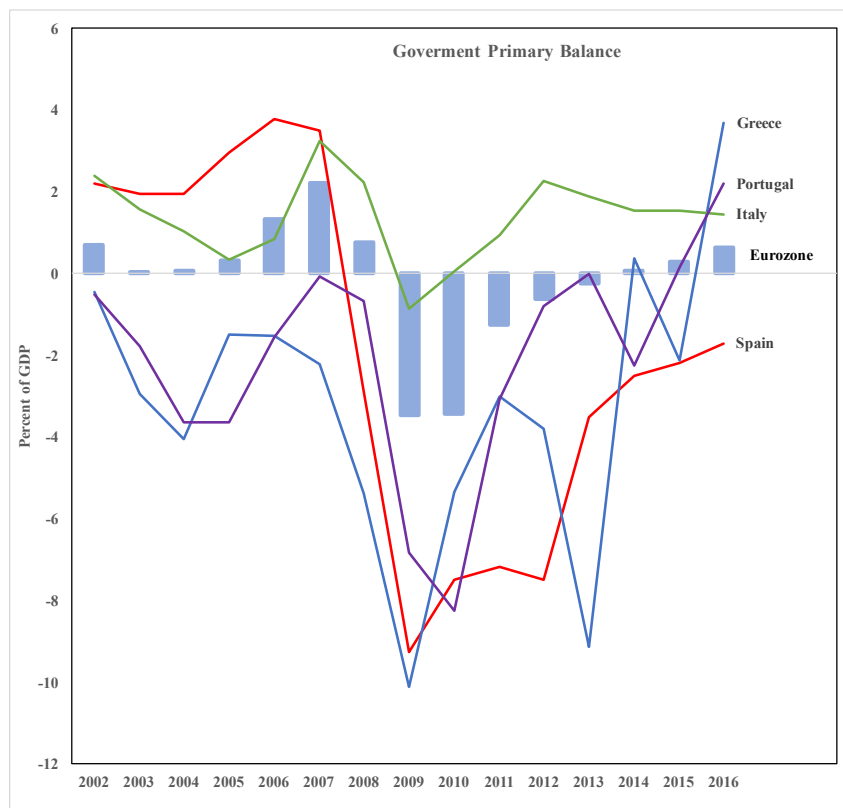
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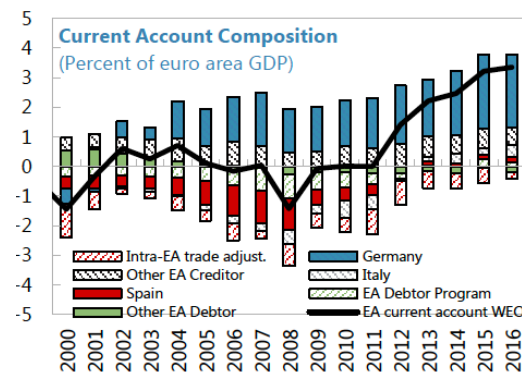
### Step 3: Find Potential Catalyst

### GIIPS Reforms and Economic Growth Have Closed Fiscal And Trade Imbalances

#### GIIPS Government Primary Balances Are Improving<sup>1</sup>

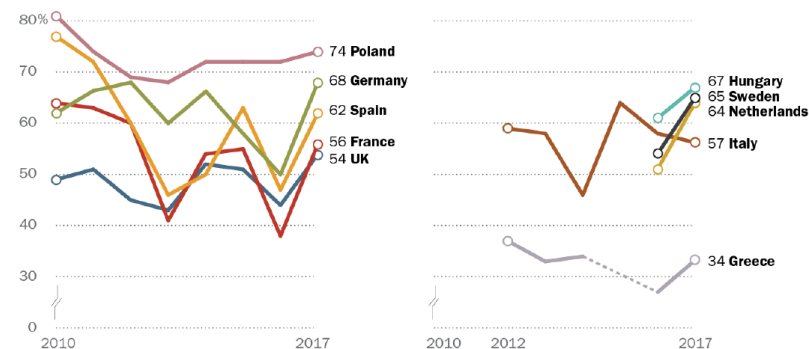


#### Current Accounts Are Improving As Well<sup>2</sup>



#### Negative Reaction To Reform Has Mostly Improved<sup>3</sup>

##### Favorable view of EU



1. Eurostat
2. IMF, Article IV, Euro Area, July 2017
3. Stokes, Wike, Manevich, Pew Research Center, "Post-Brexit, Europeans More Favorable Towards EU", June 2017



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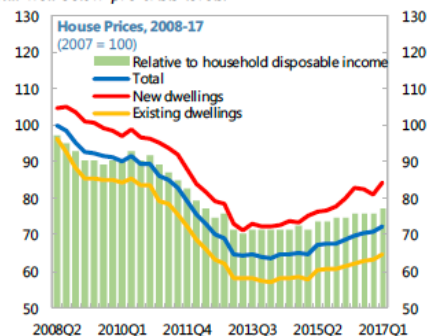
## State of the Markets: The Normalization of The EMU

### Step 3: Find Potential Catalyst

### Spain's Housing Markets Have Adjusted<sup>1</sup>

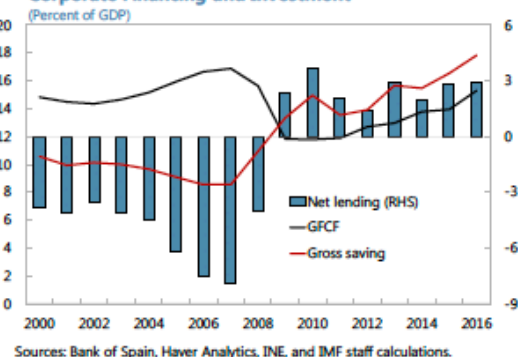
#### Spain's Housing Market Has Adjusted

House prices have started to recover, but are still well below pre-crisis levels.



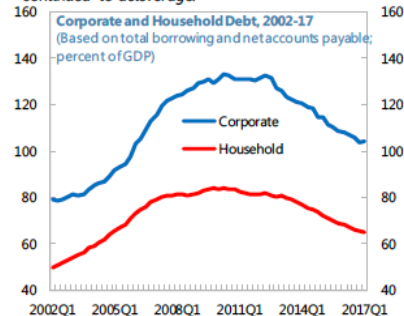
#### Investments By Spanish Corporates Is Now Funded Domestically

##### Corporate Financing and Investment



#### Private Sector Has Delevered

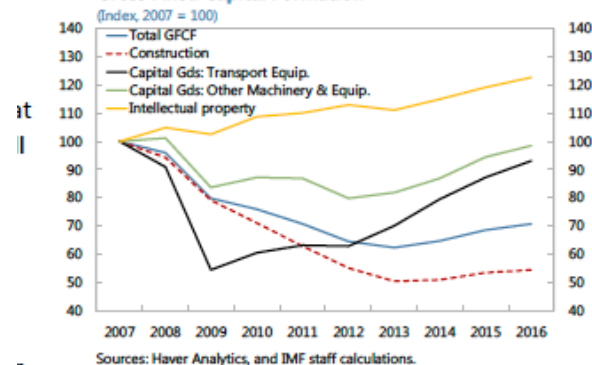
... as corporates and households have continued to deleverage.



...mainly due to weak credit demand.

#### Investment Has Rebounded Across Sectors

##### Gross Fixed Capital Formation



Sources: Haver Analytics, and IMF staff calculations.

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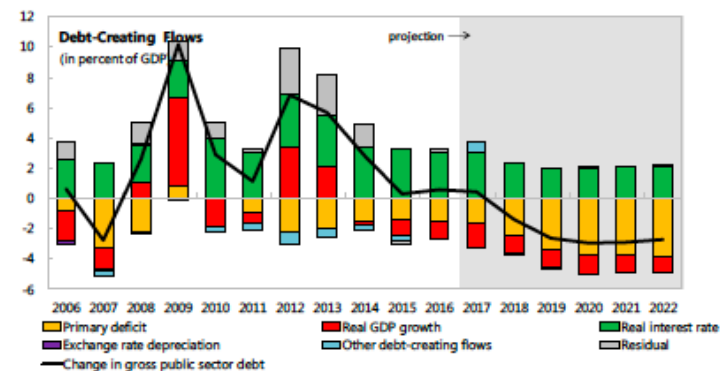
Step 3: Find Potential Catalyst

Italian Reforms Are Reducing Their Imbalances Supported By Wealth of the Country<sup>1</sup>

Economic Condition In Italy Are Improving

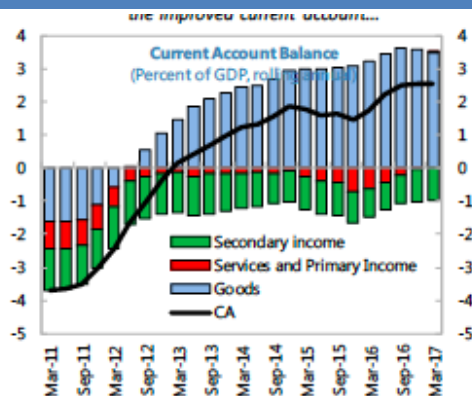


Government Debt Should Fall If Italy Follows Path of Reform

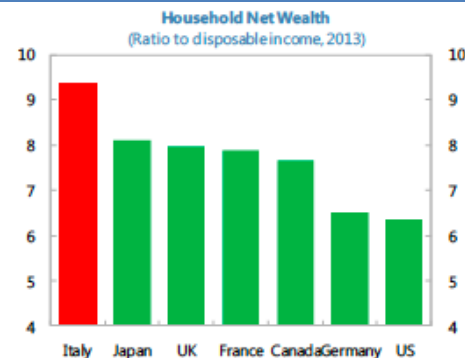


Source: IMF staff.

Trade Balance Moved To Be A Net Positive For Growth



Italy Has Internal Wealth To Fund Reform



Source: OECD.

1. IMF, Article IV Italy, July 2017

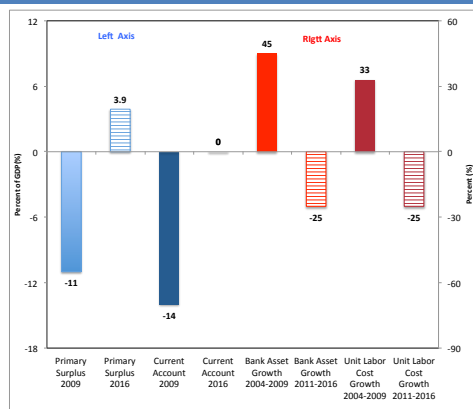
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## State of the Markets: The Normalization of The EMU

### Step 3: Find Potential Catalyst

### Greece External And Fiscal Imbalances Have Closed

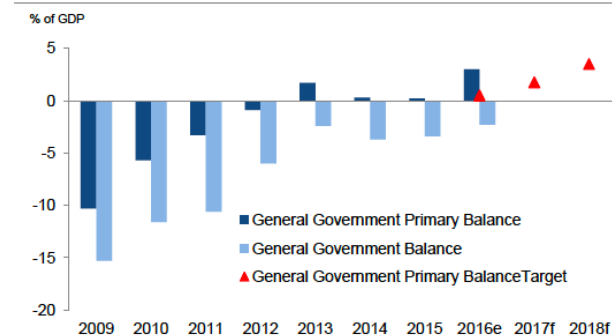
However, Recent Crisis Explains The Move <sup>1</sup>



Most Of The Improvement Has Come From Tax Reforms <sup>2</sup>

Greece Current Account Close To Zero Until Recently <sup>1</sup>

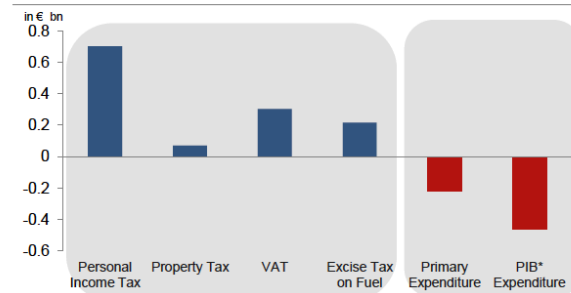
Fiscal Discipline Is Getting More Intense . . .



Source: Min.Fin.

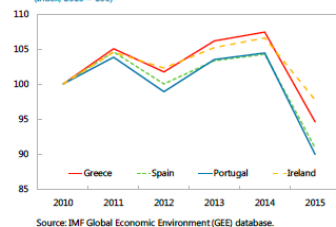
### Step 2: Economic Fundamental Framework

Drivers of the Over-Performance of Primary Surplus (State Budget) in 2016 Against the Target Set



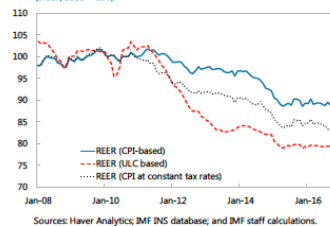
\* Public Investment Budget  
Source: Min.Fin.

Unit Labor Costs, 2008-15  
(Index, 2010 = 100)



Source: IMF Global Economic Environment (GEE) database.

Greece: Real Effective Exchange Rates  
(Index, 2010 = 100)



Sources: Haver Analytics; IMF INS database; and IMF staff calculations.

1. National Bank Greece Q4 2016 Earnings Report, March 2017
2. Eurobank, Q4 2016 Earnings Report, March 2017

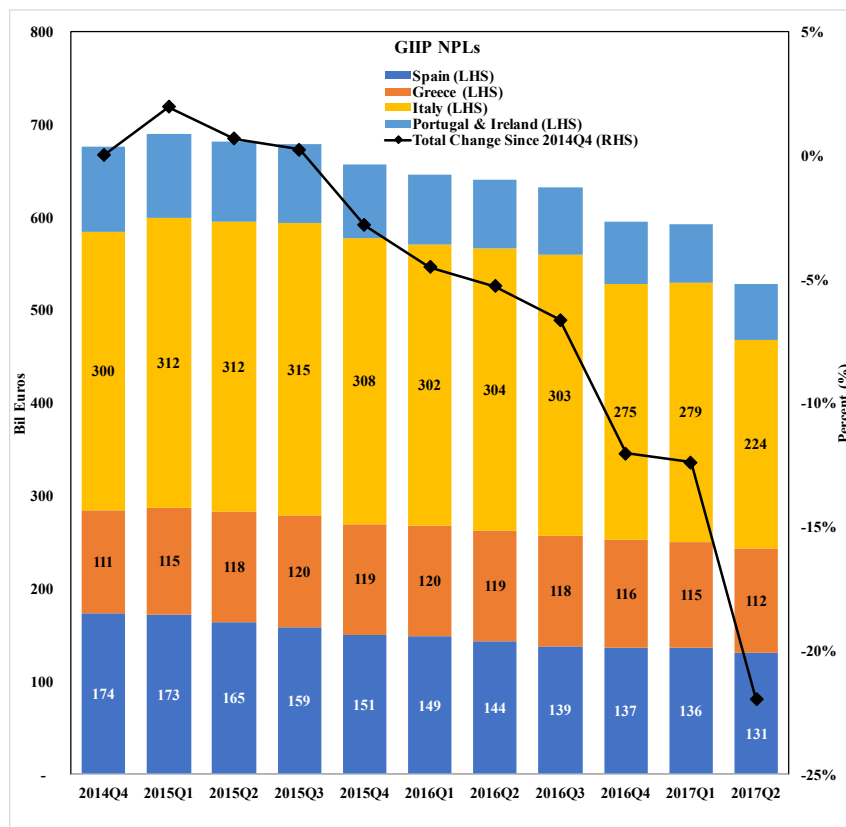
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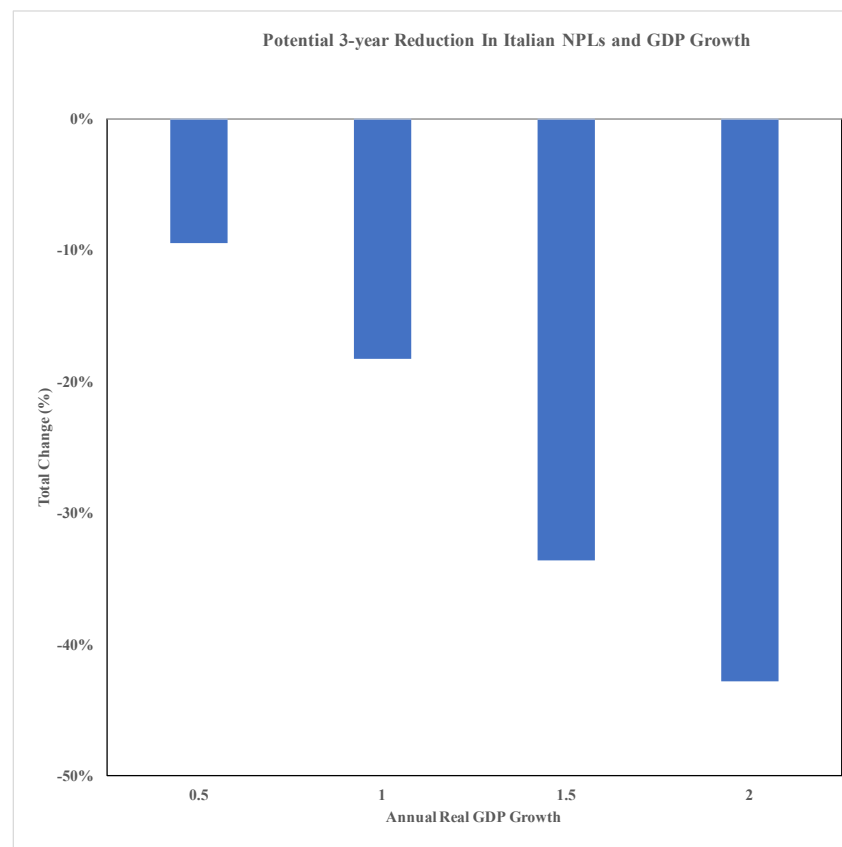
Step 3: Find Potential Catalyst

**GIIPS NPLs Problem Are Being Address By Write-downs/Capital Raises and Potentially By Growth**

Total NPLs Have Fallen



Economic Growth Could Solve The NPL Problem



1, Federal Reserve Bank of St. Louis (Fred Data Base)

2. Mohaddes, Raissi, Weber, IMF Working Paper, "Can Italy Grow Out of Its NPL Overhang", WP/17/66. March 2017

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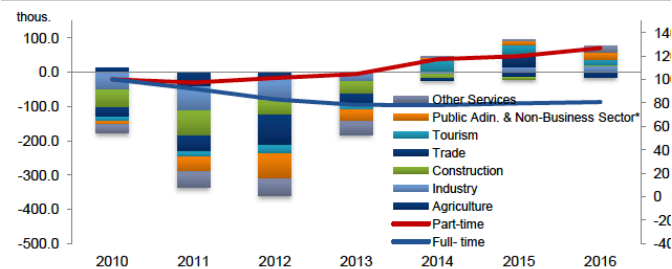
## State of the Markets: The Normalization of The EMU

### Step 3: Find Potential Catalyst

### Example of Greece: Economic Growth Could Help Solve the Bank NPL Problem

#### Greek Employment Picture is Brightening <sup>1</sup>

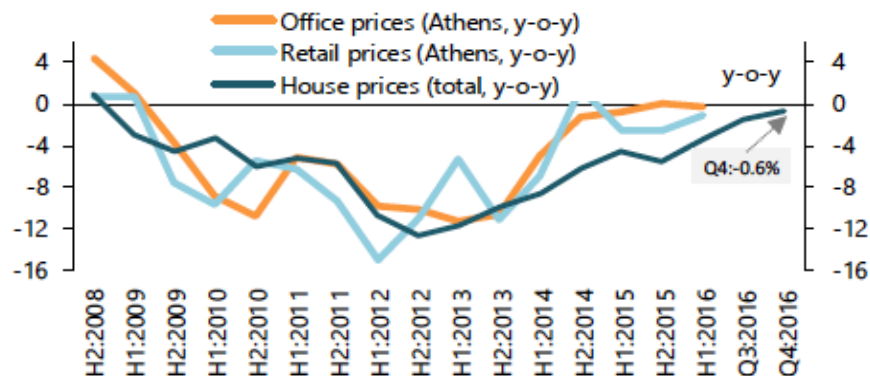
Unemployment Declined with New Jobs in Tourism, Industry and Public Administration



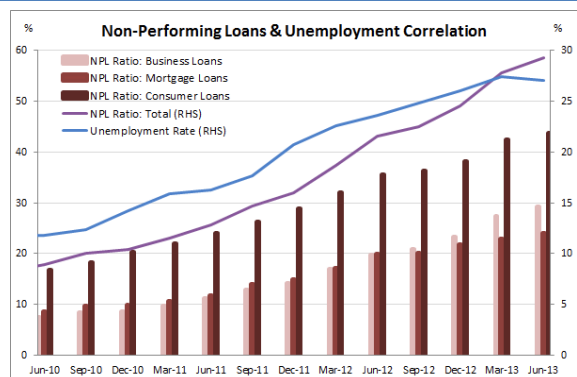
Bars: Contributions of New Jobs per Sector (yearly change in thousand employees, lhs)  
Lines: Full-time and Part-time employment (Index 2010=100, rhs)

\* Includes: Public Administration, Defence, Social Security, Education, Health, Arts

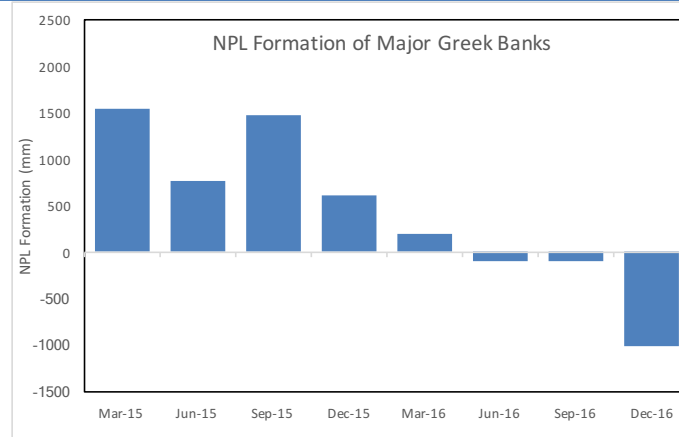
#### Real Estate Prices Are Starting to Rebound <sup>3</sup>



#### Greek NPLs Could Fall As Employment Rises <sup>2</sup>



#### NPLs Flows Has Turned Negative <sup>4</sup>



1. Alpha Bank Q4 2016 Earnings Report, March 2017
2. CEIC, "Non-Performing Loans In Greece Surge to A Record High", Newsletter, October 2013
3. National Bank of Greece, Q4 2016 Earnings Report, March 2017
4. Bank Earnings Reports, 2014-2016

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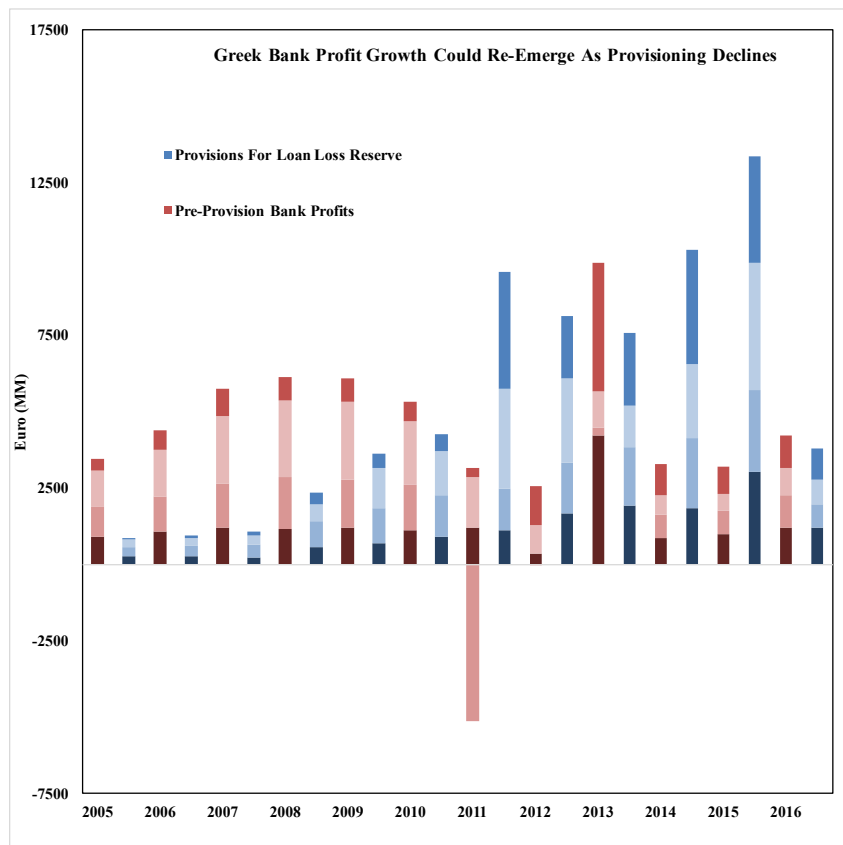
## State of the Markets: The Normalization of The EMU

Step 3: Find Potential Catalyst

### Solving NPL Problem Could Push GIIPS Bank ROEs Higher

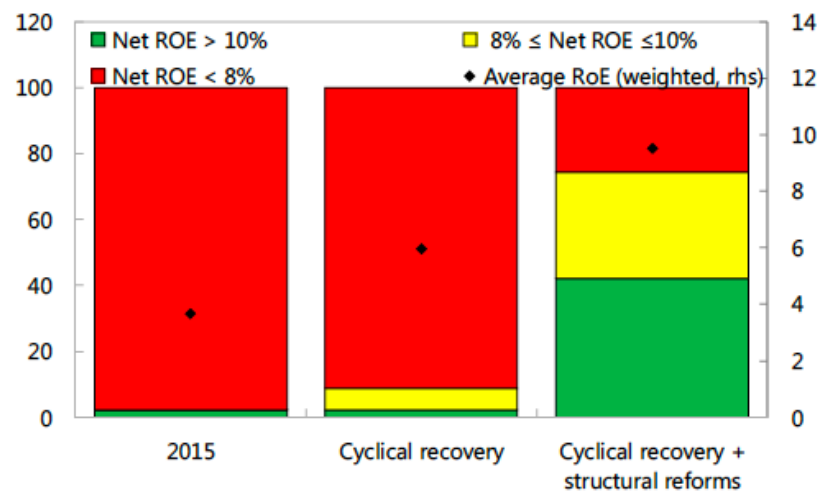
Solving NPLs Reveals the Strength of the Underling Engine

ROEs Go Up As NPLs Go Down



### Italian Banks Meeting Return on Equity Thresholds

(Percent of sample, by assets)



Sources: S&P Global Intelligence and IMF Staff Calculations

1. Bloomberg
2. IMF, Article IV Italy, July 2017

# SOM Macro Strategies

## State of the Markets: The Normalization of The EMU

Step 3: Find Potential Catalyst

**Trade: Buy EMU Banks--If Economic Growth Reduces New NPL Problem, Example Greece**

### Greek Bank NPE Analysis

- The major Greek bank have set aside almost 3/4s of the balance of NPL and over half of the balance of total NPEs
- Banks have reserved more than enough to withstand defaults if NPE growth has stopped
- Reasonable severe default/severity scenarios could actually be a net positive for Greek banks

### Some Default and Severity Scenarios <sup>2,3</sup>

Potential Adverse Senarios	
Historical Severity	65%
Severity Giving Full Credit to Collateral	50%
Defaulting All NPLs	79%
Defaulting All NPLs But Not Strategic Defaulters	63%

### Greek Banks Has a Substantial Cushion For NPL Problem <sup>1</sup>

Category	Balance (bil)
Risk-Weighted Assets	178
Gross Loans	227
NPLs	88
Additional NPE	24
Loan Loss Reserve	62
NPE Loan Collateral	58
Current Tangible Capital	32
CTI Needed 12% RWA	21

### Cushion Can Withstand A Severe NPL Outcomes <sup>4</sup>

Tangible Capital + Remaining LL Reserve Of Greek Banks After Scenario (Euro Bil)				
Severity	Default Rate			
	100%	76%	50%	25%
100%	-19	7	36	64
65%	20	37	56	74
50%	36	50	64	78
25%	64	71	78	85

1. Bank Earnings Reports Q4 2016, March 2017

2. Demertzis and Lehmann, "Tackling Europe's crisis legacy", Policy Contribution, Issue 11, 2017

3. imakopulos, et al. "Moral hazard and Strategic Default: evidence from Greek corporate loans", Bank of Greece Working Paper, July 2016

4. Calculations by Author

# SOM Macro Strategies

## State of the Markets: The Normalization of The EMU

### Step 4: Find Asymmetric Trade

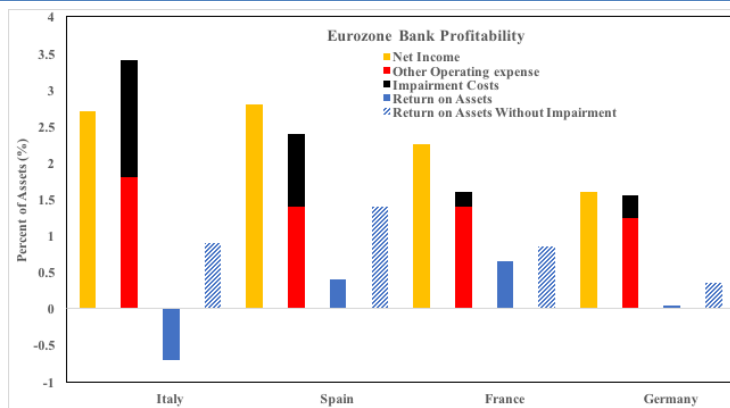
### Trade: Buy EMU banks—Growth Could Unleash Earnings by Improving NPLs and Credit Origination<sup>1</sup>

#### Trade Thesis

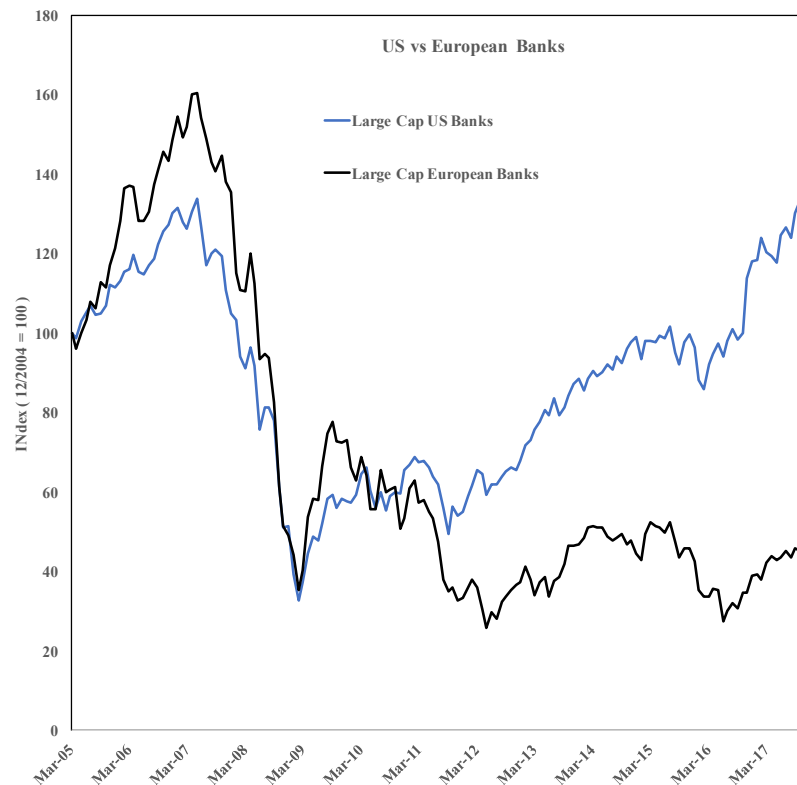
- EMU banks underperformance versus US banks could reverse as GIIPS issues are reduced
  - EMU banks have lagged US banks reflecting both the political risk as well as the GIIPS bank NPL problems
- Economic growth particularly in the GIIPS has reduced the political risk and potentially the NPL overhead
- EMU banks offer a asymmetric return profile
  - Current valuations more than reflect the potential impact of NPL losses but not the potential of substantial earnings growth as NPL provisions fall
  - Economic growth could also spur earnings growth from credit originations

***Risk is GIIPS reforms fail, NPLs and political risk rises***

#### Bank Prices Could Appreciate Substantially As NPLs Improve



#### European Banks Have Lagged US Banks Since the GIIPS Crises





# SOM Macro Strategies

## State of the Markets: The Normalization of The EMU

### Step 4: Find Asymmetric Trade

### Trade: Buy EMU Equities—Normalization of Growth Means Normalization in Valuations<sup>1</sup>

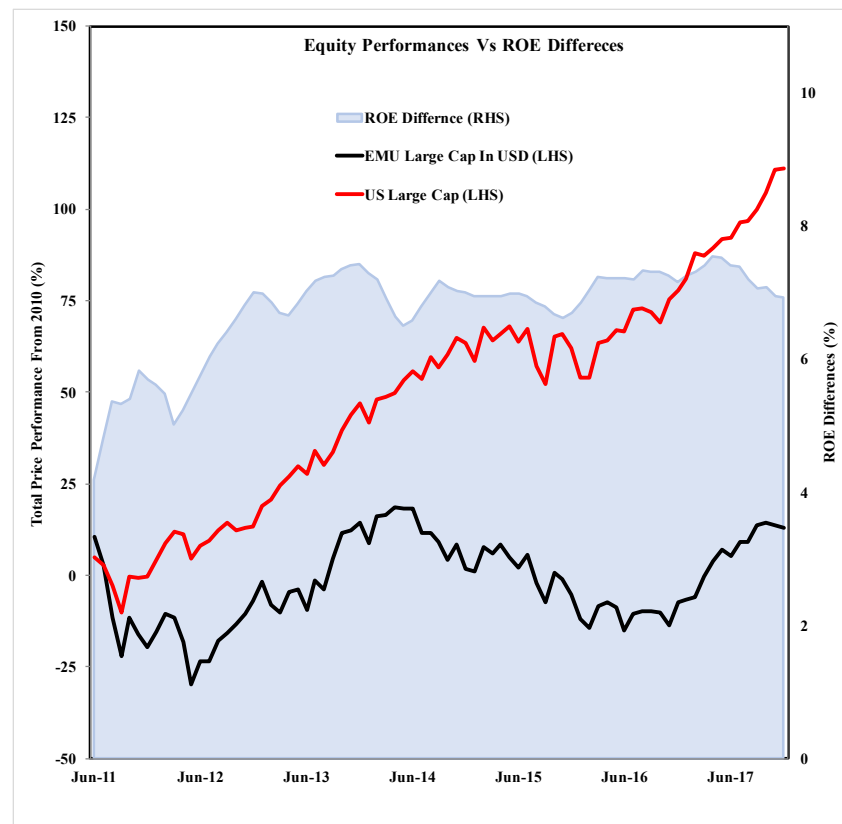
#### Trade Thesis

- EMU equities do not reflect the normalization of economic growth in EMU particularly the GIIPS
  - EMU equities have underperformed US equities even though ROE differences are unchanged
  - EMU economies have surprised to the upside with growth accelerating
  - ECB still accommodative
  - Largest headwinds of GIIPS political risk and their NPLs are improving
- The EMU index has additional convexity to the upside
  - Large exposure to GIIPS equities
  - Large exposure to financials, particularly GIIPS
- EMU normalization of valuation could push prices up substantially  
*Risk is political risk and valuations reflect a new normal*

#### European Equities Sources Of Positive Convexity

	Non-Financials	Financials	Total
EMU Non-GIIPS	67.6	12.0	79.6
GIIPS	13.3	7.1	20.4
Total	80.9	19.1	

#### EMU Equities Have Underperformed Vs US Equities



# SOM Macro Strategies

## State of the Markets: The Normalization of The EMU

### Step 3: Find Potential Catalyst

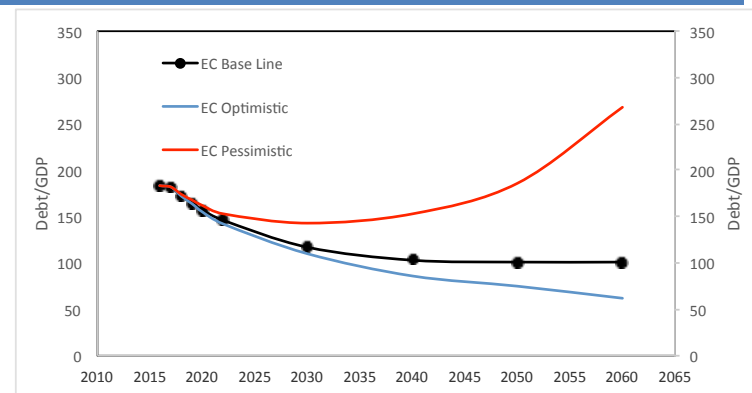
### The Third Program Agreement Ends Up With Debt Relief

#### Greece And EU Has Agreed On Next Set of Reform And Funding <sup>1</sup>

Expected Fiscal Savings from the 2015-16 Pension Reforms (Percent of GDP)				
	2015	2016	2017	2018
<b>TOTAL</b>	<b>0.2</b>	<b>0.7</b>	<b>1.2</b>	<b>1.5</b>
<b>Benefits</b>	<b>0.0</b>	<b>0.3</b>	<b>0.7</b>	<b>1.0</b>
Tightening early retirement rules	0.0	0.0	0.1	0.1
Phasing out social solidarity grant EKAS	0.0	0.0	0.3	0.4
Main pension benefit reform	0.0	0.1	0.2	0.2
Supplementary, lump-sum, and dividend fund reforms	0.2	0.2	0.2	0.2
Other (incl. wider eligibility for social pension, lower ceiling)	0.0	0.0	0.0	0.0
<b>Contributions</b>	<b>0.1</b>	<b>0.4</b>	<b>0.5</b>	<b>0.5</b>
Raising health contributions for retirees	0.1	0.3	0.3	0.3
Harmonizing contribution rules and base	0.0	0.0	0.0	0.0
Temporary increase by 1/0.5 pp in supplementary contributions	0.1	0.2	0.2	0.2

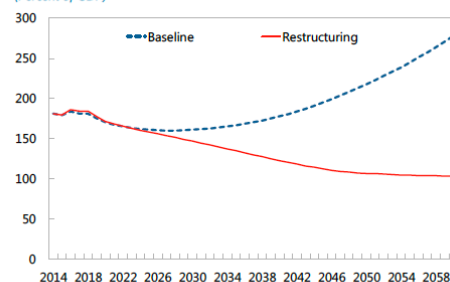
Source: IMF staff estimates.

#### EU Thinks That Greece Does Not Need It..<sup>2</sup>



#### But The EU Wants The IMF But The IMF Wants Debt Relief <sup>1</sup>

Greece: GG Debt-- Restructuring Scenario, 2014-2060  
(Percent of GDP)



Source: IMF staff estimates.

#### The EU May Be Forced To Give Relief Given They Are Too Optimistic <sup>3</sup>

	Year	EU	IMF
GDP real growth (year-on-year)	2016	-0.3%	0.4%
	2017	2.7%	2.7%
	2018	3.1%	2.6%
	Medium term	1.5%	1.5%
	Long term	1.25%	1.0%
Primary surplus (percentage GDP)	2016	0.5%	0.9%
	2017	1.75%	1.0%
	2018	3.5%	1.5%
	Long term	1.5%	1.5%
Privatisation revenues	2016-2018	18bn	3bn
	After 2018		5bn
Banks' buffer		-	10bn
Long-term market interest rate in the euroarea (ECB)	After 2018	-	3.8%
	2030 onwards	3-3.3%	-
Interest rates on Greek Govern- ment bonds	2018	5%	6%
	After 2018	5%	4.5-6%

1. IMF, Article IV Report Greece, May 2016
2. European Commission, "Compliance Report The Third Economic Adjustment Programme for Greece", First Review, June 2016
3. Report To European Parliament on "Greece's financial assistance programme", March 2017

# SOM Macro Strategies

## State of the Markets: The Normalization of The EMU

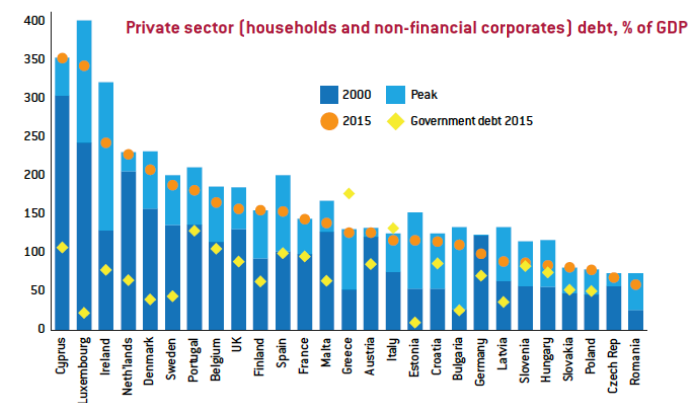
### Step 4: Find Asymmetric Trade

### Trade: Buy Greek Solveig Debt—Normalization Pushes Yields Down Closer to Portugal

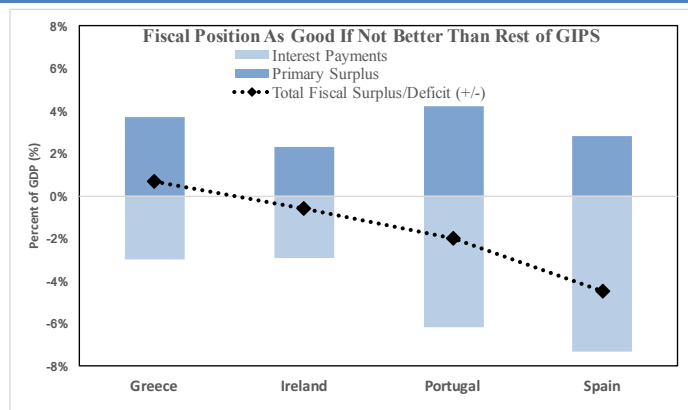
#### Trade Thesis

- Greece and EU/IMF agree on Bailout III but this time with **debt relief**
  - Greek government and EU have agreed on economic program
  - IMF is needed but they demand debt relief
  - Key date May 5/22
- Greece will be on a sustainable path for paying back debt
  - GGBs small percentage of total Greek government debt
- Demand for GGBs increases
  - Little supply of high yielding GGBs, only 34.5 bill after 2017
  - ECB buys as part of PSPP
    - Already ECB lifted restrictions on using GGBs for repo

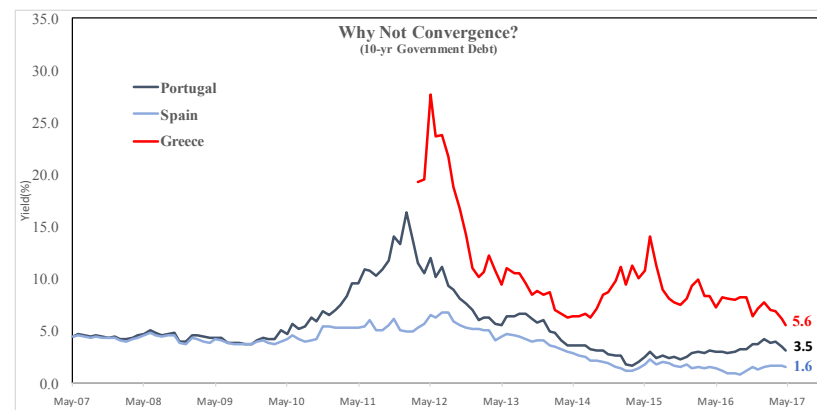
#### Taking Out Sov Debt Risk, Greece Debt Risk Also Looks Better <sup>2</sup>



#### Greek Fiscal Position Looks Better Than Rest of GIPs <sup>1</sup>



#### So, Buy Greek GGBs <sup>3</sup>



1. Eurostat  
 2. Demertzis and Lehmann, "Tackling Europe's crisis legacy", Policy Contribution, Issue 11, 2017  
 3. Bloomberg

# *SOM Macro Strategies*

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