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MACROCOSM

When PIIGS Fly

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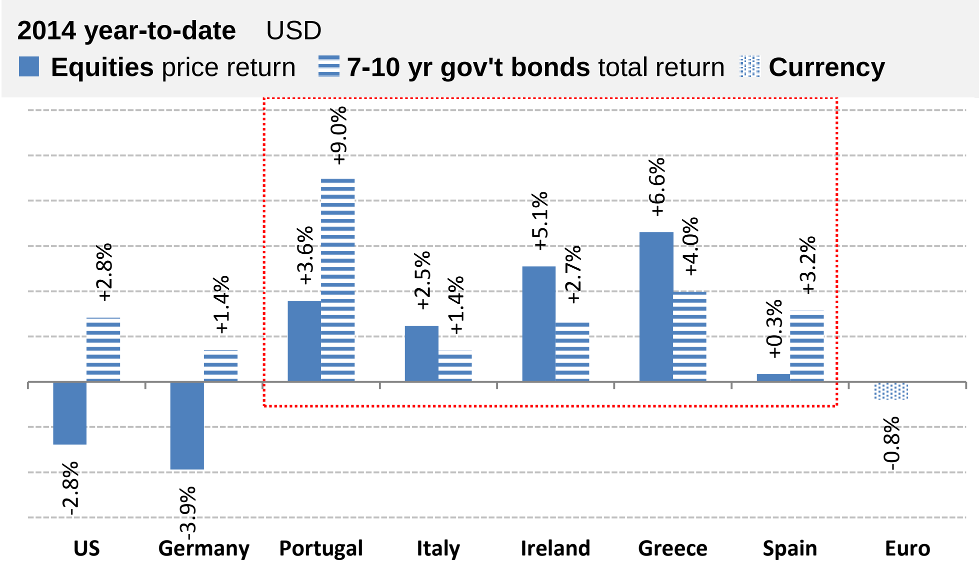
Donald Luskin with research input from **Lorcan Roche Kelly**

They're the best performers in 2014, despite assaults from emerging markets and Germany.

There's one region of the world that has been mostly immune to the sharp correction for equities that ushered in 2014. Ironically, it's the region that should have had to most to lose from re-awakened fears of global financial contagion, and the risk that the tapering of Fed asset purchases would punish economies most in need of liquidity. Both its equity markets and its sovereign bond markets are 2014's best-performing -- even when measured in terms of the strong US dollar. That island of strength is the so-called "PIIGS" -- the peripheral euro area: Portugal, Italy, Ireland, Greece and Spain (please see the chart below).



Source: Bloomberg, TrendMacro calculations

We said they'd be 2014's "top performers," and they have been so far (see "2013: The Year of Living Not Dangerously" December 31, 2013).

- And it's not because the PIIGS haven't participated in the great global equity rally of the last 18 months -- and so don't need a rest like other better-performing markets. In fact, the PIIGS have led the pack all the way -- ever since July 26, 2012, when ECB Governor Mario Draghi ended the euro currency crisis by promising to do "whatever it takes" (see the chart on the following page, and "On Draghi in London" July 26, 2012).

Update to strategic view

ECB, EUROPE MACRO, EUROPE STOCKS, EUROPE BONDS: The nations of the peripheral euro area -- the so-called "PIIGS" -- have been the best-performing equity and government bond markets of 2014. They've been robust to potential risks arising from political volatility in Turkey and Ukraine, and economic setbacks in Argentina and Brazil. And they didn't blink last week when the German Constitutional Court failed to ratify the legality under German law of the ECB's OMT program. We think the OMT is not, in fact, under threat. Besides, ongoing structural reform in the PIIGS has slashed unit labor costs, turned around unemployment, and revived forward earnings. Coming out of recession at last, PIIGS bonds are exhausted as speculations -- they are now high-yield plays -- and PIIGS equity markets are poised for superior returns as true cyclical growth plays.

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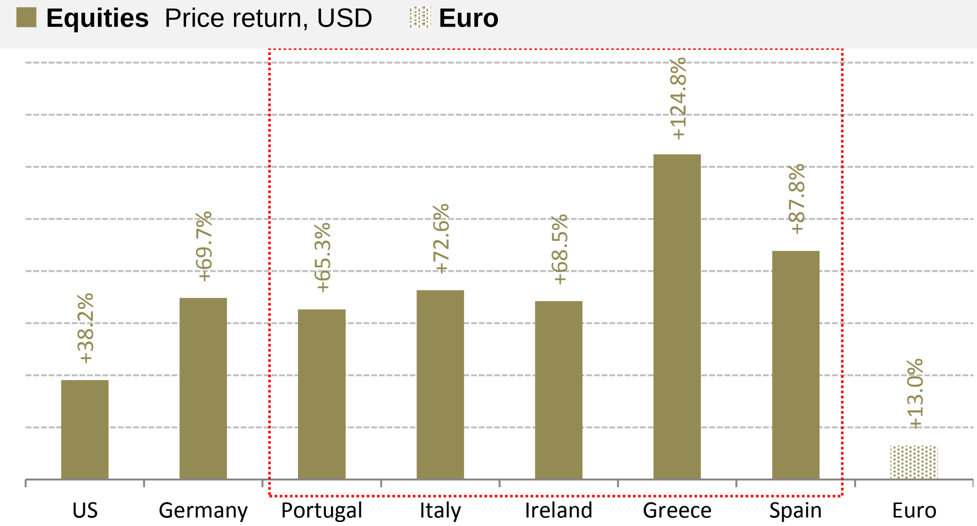
From July 25, 2012 to year-end 2013



Source: Bloomberg, TrendMacro calculations

This should have made the PIIGS more *technically* vulnerable to correction. But it would have seemed they were *fundamentally* vulnerable, too, given 2014's whiff of financial contagion. After all, it was itself ground zero for the worst contagion fears of 2010, 2011 and 2012, through what seemed like an endless succession of debt, banking and currency break-up crises.

- *That the PIIGS have been so robust now is a powerful signal in confirmation of our secular thesis that the era of financial contagion is over, enabling the global economy to get back to growth rates that have been unattainable after the Great Recession* (see "A Major Upgrade to our Strategic Outlook" September 12, 2013).
- *For the PIIGS themselves, it's strong proof that the situation on the ground supports, at long last, recovery from outright recession while the rest of world at least got along with moderate growth.*
- All the more so, considering the geopolitical and financial impacts for the euro area arising from 2014's emerging markets volatility.
- Turkey and Ukraine, two emerging economies now beset by particularly intense political turmoil, are right at the euro area's doorstep. Turkey has been in negotiations to join the European Union since 2005. And Ukraine, caught in a tug of war between Europe and Russia, is host to Gazprom pipelines that supply a quarter of Europe's natural gas.
- And Spain's largest banks -- so significant in local equity indices-- have significant asset and revenue exposures to Brazil and Argentina.

And then, last week, came a new threat from within the euro area itself: a decision from Germany's Constitutional Court failing to affirm the validity, under German law, of the European Central Bank's Outright Monetary Transactions program (OMT).

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- OMT is the formal result of Draghi's "whatever it takes" promise. Since the OMT backstop, the troubled sovereign bond markets of the over-indebted PIIGS have rallied miraculously, especially in USD terms. Now, with the exception of defaulting Greece, PIIGS bond returns match those of US Treasuries over the entire business cycle, even in USD terms (please see the chart below).

7-10 yr gov't bonds USD total return **From Draghi speech** **End 2007**
Euro **From Draghi speech** **End 2007**

Source: TrendMacro calculations

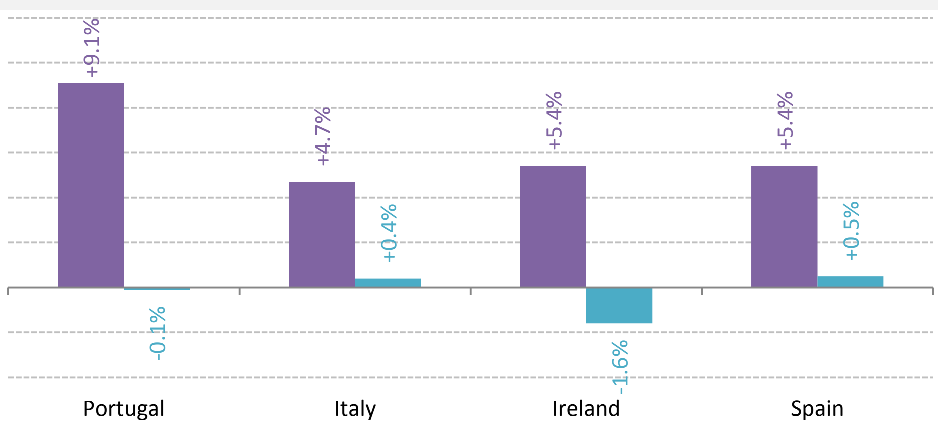
- Draghi's intervention is one of the most effective in the history of central banking, especially considering that OMT has never had to actually be employed.
- Nevertheless, any threat to its employment in some future emergency significantly weakens its power today as a boost to confidence.
- We don't think the German court's decision is actually a substantive threat.
- The court's decision is a complex one, with several dissents. Indeed it is hardly a decision at all. It kicks the suit -- brought by a group of dissident private German citizens -- to the European Court of Justice.
- This is the first time the German Constitutional Court has deferred to Europe in this way. So though it damages OMT by not giving it clear-cut approval under German law, it does something even better -- it declares German law itself to be irrelevant to the matter.
- *What better example of our fundamental strategic thesis of the euro area crisis? This is yet another step away from national sovereignty in favor of a United States of Europe* (see, among many, "Two-Tier Europe is Born" August 17, 2011).
- The European Court of Justice is a venue in which, surely, the ECB's wishes will get the greatest possible deference. In any event, it will likely be a year at least before we get a ruling.
- All that said, *if the German court's decision had come out in 2010, 2011, or 2012, the consensus would have seized on it as proof positive that Germany was abandoning the euro and abdicating its*

role as rescuer of last resort, sending shockwaves throughout global markets. <u>This time: not even a hiccup.</u>

How come? Why are the PIIGS not only not reacting to the German court's decision -- but turning in a good start to a year that's been so difficult everywhere else in the world? Other than defaulting Greece -- as indebted as ever? Isn't the OMT -- even assuming its continuing effectiveness -- just a crutch? Isn't it just a matter of time before the PIIGS collapse under their own debt?

- No. Taking that view would be to ignore the substantive progress that the PIIGS have made to reform their economies and restore competitiveness -- and thus launch a new growth cycle from a very low base.
- *There has always been the risk that, when the worst of the crisis passed, the PIIGS would consider themselves off the hook, and turn away from socially difficult structural reforms in product and labor markets, and in fiscal policy. <u>But this hasn't happened -- structural reform is alive and well, even with the worst of the crisis now so distant in the rear-view mirror.</u>*
- Consider Spain. We think Spain is the hinge of Europe, the country that matters the most -- it's a big economy that makes a difference on the world stage, has a fragile banking system amidst a devastated real estate market, and runs large fiscal deficits that expose it to death-spiral risk.
- Spain is now formally out of the bank rescue program funded by the European Stability Mechanism. Its government bonds have been the best-performing in the developed world. Yet having accomplished controversial anti-union labor reform in the midst of the crisis, this year it is taking on both pension reform and tax reform.
- Already, all the PIIGS have made astonishing progress in restoring labor force competitiveness. Nominal unit labor cost growth has been slashed across the board (please see the chart below).

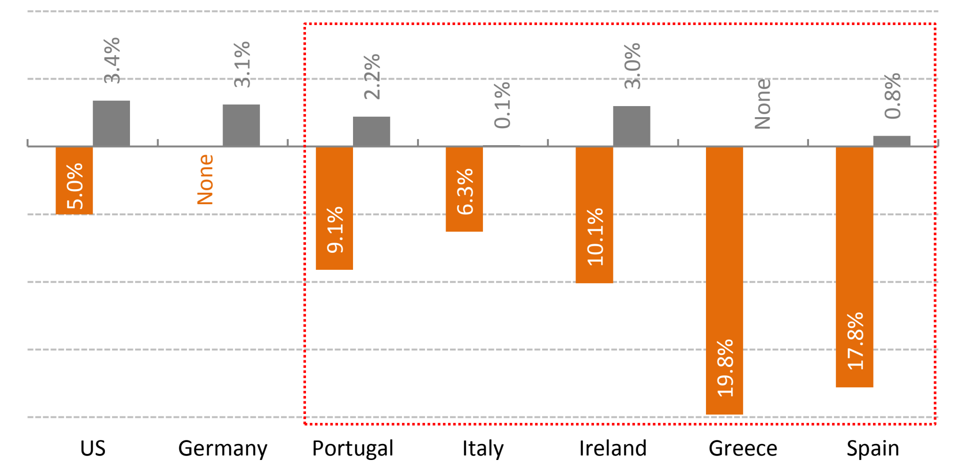
Nominal unit labor costs YOY **Pre-reform maximum from 2007** **Now**
Data for Greece not available



Source: Eurostat, TrendMacro calculations

- As a result, at last, persistent very high unemployment has finally begun to come down (please see the chart below).

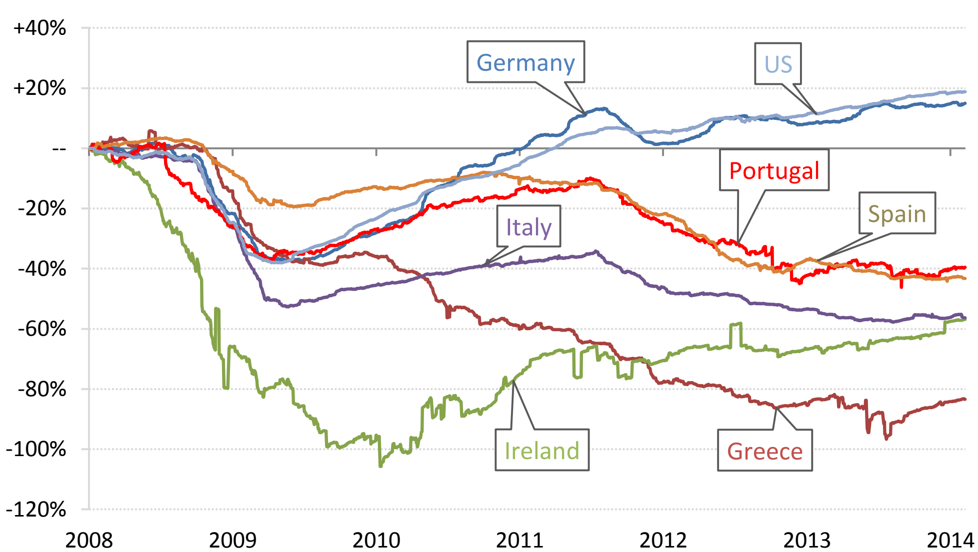
Unemployment rate
At worst, change from year-end 2007 **Now, improvement from worst**



Source: Eurostat, TrendMacro calculations

- Forward earnings are finally starting to improve, too. In the US and Germany, their growth has become only moderate after the ferocious bounceback from the worst of the Great Recession. The PIIGS, on an entirely different cycle, are now only just beginning to come out of the worst (please see the chart below).

Forward earnings Change from year-end 2007



Source: Bloomberg, TrendMacro calculations

For the rest of the world, the robustness of the PIIGS so far in 2014 signals the continuing restoration of confidence in the stability of the global financial system. This can accelerate the tepid growth of the Not So Great Expansion into something more like prior business cycles -- at least, we can look forward to closing the record output gap. But it means something entirely different for the PIIGS themselves.

- For the PIIGS, there's been no tepid growth that can now accelerate from moderate to robust. Instead there's been ongoing recession, out of which growth can now fundamentally change direction -- from negative to positive.
- For PIIGS government bonds -- after so many years of identifying them as the global markets' superlative investment opportunity -- at this point we see them as little more than good high-yield plays.
- But at this inflection point from recession to expansion -- especially against a global backdrop that we expect to improve -- PIIGS equity markets are powerful growth plays.

Bottom line

The nations of the peripheral euro area -- the so-called "PIIGS" -- have been the best-performing equity and government bond markets of 2014. They've been robust to potential risks arising from political volatility in Turkey and Ukraine, and economic setbacks in Argentina and Brazil. And they didn't blink last week when the German Constitutional Court failed to ratify the legality under German law of the ECB's OMT program. We think the OMT is not, in fact, under threat. Besides, ongoing structural reform in the PIIGS has slashed unit labor costs, turned around unemployment, and revived forward earnings. Coming out of recession at last, PIIGS bonds are exhausted as speculations -- they are now high-yield plays -- and PIIGS equity markets are poised for superior returns as true cyclical growth plays.