2016 OUTLOOK

From 'secular stagnation' to 'surprisingly normal'

As we look forward to 2016, we could begin to see a continued recovery in the regional economy and the narrative edging from 'secular stagnation' to 'surprisingly normal'.

THE CASE FOR A POSITIVE GROWTH SURPRISE

The last years in Europe have been characterised by low growth and low inflation. With the picture on global trade in particular weakening over the course of 2015, the consensus position has moved squarely to considering 2016 as a 'cut and paste' of the previous year. 2015 has also been a year where the complexities that characterise the European Union - both in terms of governance and policy - have again been at the forefront of investors' minds, which has lent further weight to the arguments that emphasise the denial of cyclical potential as a result of structural factors.

There is a case to be made however, that economic growth across the eurozone will surprise positively, supported by improvements in consumption as not only employment, but importantly, wage growth improves. Clearly in such a heterogeneous region, this effect will not be uniform but it will be widely enough felt to impact measures of growth and inflation to the extent that it begins to look and feel more like a normal recovery, rather than a permanent slump.

A positive view on economic growth does not, however, translate into a straight optimistic view on aggregate stock index levels, although it would certainly argue in favour of a more positive view at the margin. Instead, subscribing to the idea of the market view shifting from 'secular stagnation' to surprisingly normal' implies the potential for an environment where current leadership within the market is challenged. The normalisation process that occurs is one where stock level volatility rises relative to the overall market, creating greater opportunities for stock picking investors.

WHERE COULD BETTER NEWS COME FROM?

The challenge with any more positive view on economic growth in Europe is articulating the key drivers. Historically, Europe has been seen primarily as a beneficiary of global trade and the poor data, especially over the recent six months, suggests that this driver should be largely counted out.

I think that growth in the coming years will derive primarily from a normalisation process where employment (which was significantly impacted during the sovereign debt crisis of 2011/12) improves to the point where wages increase in real terms, and broader confidence in government, institutional and household solvency grows to the point that we see the multiplier effect - so noticeable by its absence - finally returning. We are also likely to see a continued strong performance from those economies within the region which instigated political reform in the wake of the sovereign crisis - particularly to allow them to capitalise on the positive potential of the weakness in the single currency and the relatively low cost of land and labour. Spain and Ireland appear to have emerged with not only strong growth, but a better quality of growth than in the years preceding the financial crisis. Reform in many key European economies has a long way to run and the effects are generally felt after a period of time. Yet despite the complex political landscape, I feel that there is enough momentum in this direction for the overall trend to continue.

Germany is key to the overall picture for a number of reasons. First, continued positive development across the economy in 2015 - despite not only the absence of a pick-up in global trade, but a marked deterioration in many developing markets - should start to challenge the notion that Germany is an economy wholly reliant on industrial production and exports of finished goods. With the outlook for wage growth across the economy strengthening and positive returns from both equity and property over recent years

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influencing greater propensity for 'ownership', consumption could be a positive driver - both domestically and for the region as a whole. Second, while politically and socially challenging, the influx of migrants to the region, and Germany in particular, will necessarily shift the government position away from austerity, augmenting growth at the margin in the near term. In due course, this will force investors to rethink the longer-terms growth potential of the economy where the received wisdom of negative demographic trends again challenged the case for self-sustaining economic growth.

WITHER QE?

One potential result of the above could be that the inflation picture at the end of 2016 will be very different to the one that we have currently. Accepting that there is an underlying disinflationary impact from technology and the new business models that leverage its capability, a positive swing in real wages and the annualisation of the large fall in energy prices could see price growth in Europe revert much closer to the longer-term trend. In such an outcome, we could see significant pressure on the ECB to begin tapering its quantitative easing (QE), given that the QE impact on the real economy still garners a wide range of opinion. Unlike in Japan, where there is a greater consensus among the leadership that QE is the right strategy to return the economy to growth, there are enough dissenting voices within the European leadership to potentially create a shift toward a more normal strategy for monetary policy.

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