BII Perspectives

BLACKROCK INVESTMENT INSTITUTE

Is the Eurozone Recovery for Real?

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The eurozone has been caught in cross-currents over the past few months. The European Central Bank (ECB) in March doubled down on its efforts to stimulate inflation by taking its deposit rate deeper into negative territory and expanding its asset purchases program. Since then, a slew of positive economic activity data from across the region appeared to signal the stimulus was working.

Yet data on inflation and inflation expectations, as well as corporate earnings, have disappointed. Market concerns have been growing about the stability of Italy's fragile banking system. And investor sentiment toward Europe has soured, as reflected in hefty flows out of equity exchange-traded products focused on the region.

Is the eurozone's consumption-led growth uptick sustainable? We, along with a group of senior BlackRock portfolio managers, spent some time in Frankfurt, Berlin and Milan earlier this month to understand what is taking place on the ground.

Our key conclusions:

- The recent pickup in economic activity likely has legs, but progress on structural reforms and a rebound in investment are needed to make the recovery sustainable beyond the next 12-18 months.
- Growth in Germany's "golden decade" looks to be plateauing. The economy is doing fine, but signs of complacency are starting to seep in, with backtracking on some economic reforms.
- The periphery and the core in Europe are finally starting to converge. Italy is a bright spot. Reforms to jumpstart the economy, such as a more flexible labor market, are showing early results. An October referendum on the government's reform agenda will be critical.
- Small business loan rates have come down and private credit is growing again. This is a key development and makes the state of the banking sector critical to the outlook. Banks are facing profitability challenges from increased regulation and negative interest rates.
- Italy's banks look vulnerable due to a mountain of crisis-era bad debts. A new bailout fund and rules that aim to strengthen creditors may help nurse the sector back to health, but we expect slow progress. This leaves the financial system and economy vulnerable.
- Key risks to the outlook include a possible Brexit vote and a renewed refugee influx that poses integration challenges with no discernible economic benefits in the short run.

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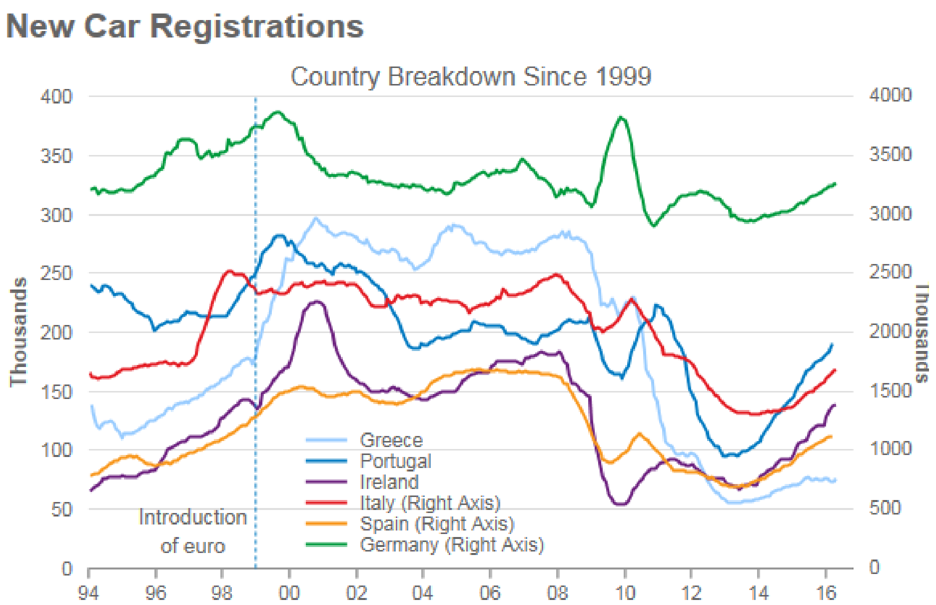
About BII

The BlackRock Investment Institute (BII) provides connectivity between BlackRock's portfolio managers, originates economic and markets research, and publishes investment insights. Our goals are to help our fund managers become better investors and to produce thought-provoking content for clients and policy makers.

May 16, 2016

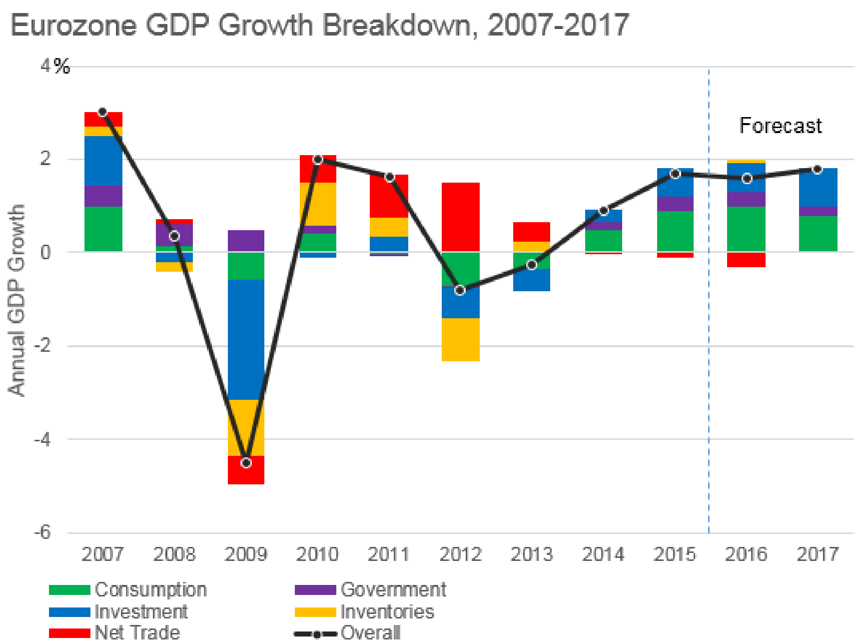
The European Recovery Has Legs …

The economic recoveries in both Germany and Italy appear sustainable, mirroring a trend across the eurozone as a whole. This is because the recoveries have been driven by robust consumption. Household consumption in Germany rose a robust 1.9% in 2015. In Italy, car registrations shot up 21% in the first quarter from the prior year, reflecting a trend seen across the region. See the chart below.



Source: Thomson Reuters Datastream, European Automobile Manufacturers' Association and BlackRock Investment Institute. May 12, 2016

Rising real disposable incomes are fueling higher consumption. Low inflation, somewhat higher wages, and – most importantly – higher employment are the causes. Public sector spending, after years of retrenchment, is also contributing. This is especially true in Germany. Last, a recovery in credit growth that started in 2015 is playing a key role. We expect these drivers to persist at least through 2016. Importantly, they make the recovery less vulnerable to the level of the exchange rate than during periods when net exports were the primary engine of growth. Net exports are expected to be a modest net drag on eurozone economic growth this year, as the chart below shows.

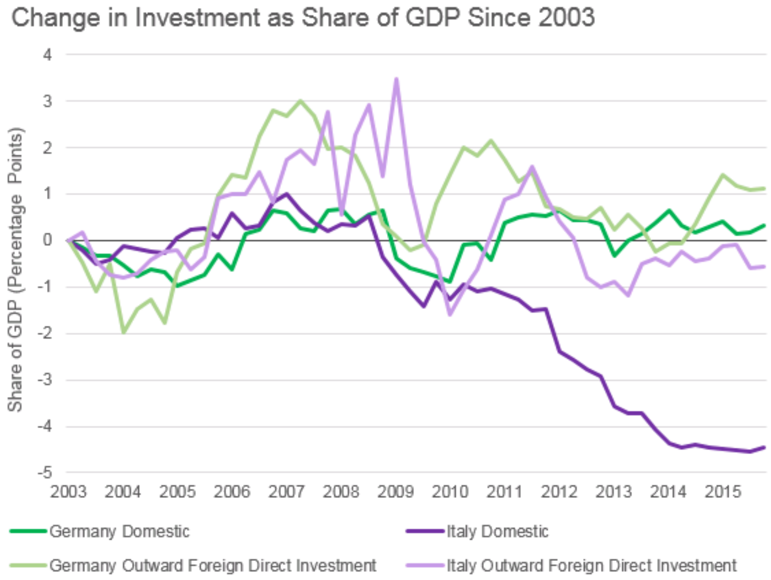


Source: BlackRock Investment Institute, Eurostat and European Commission (EC), May 2016.
Note: 2016 and 2017 numbers are EC forecasts.

… But Needs Investment for Longer-Term Growth

Still, this recovery is too sluggish for comfort. Growth is higher than potential, to be sure, but not so much that it would boost corporate earnings or lead to a rapid decline in unemployment as we have seen in the U.S. or the UK. What would be needed for a substantial acceleration of growth? To sustain the recovery beyond a cyclical rebound, we need to see a significant and sustainable pick-up in investment.

This is not yet happening. Even well-performing companies appear to be maintaining capacity in Europe at best, while investing in emerging markets and North America – where they see brighter long-term growth prospects. See the rise in Germany's outward investment in the chart below. Domestic investment is belatedly showing some signs of a pickup, but from a very low levels, especially in Italy. It may take a while to regain its vigor.



Sources: BlackRock Investment Institute and Oxford Economics, May 2016.
Note: Domestic investment is based on gross fixed capital Investment.

German Uncertainty and Italian Optimism

Against this backdrop, the ECB's efforts to cut the cost of borrowing may amount to pushing on a string. Business leaders and policymakers in Germany cite high uncertainty as the key dampener of investment appetite, along with concerns that another downturn is likely in the next few years. This is striking in a country where the current chancellor is expected to remain in office after 2017 elections and policy to remain little changed. We see three culprits:

1. Geopolitical uncertainties, notably around a potential British exit from the European Union (Brexit), but also around Russia and other large emerging markets such as China.
2. Popular opposition (focused on consumer protection standards) to the Transatlantic Trade and Investment Partnership trade deal, making its adoption unlikely.
3. A toxic public debate around ECB policies. ECB policymakers are seen as recklessly playing with fire. In our view, they are simply misunderstood.

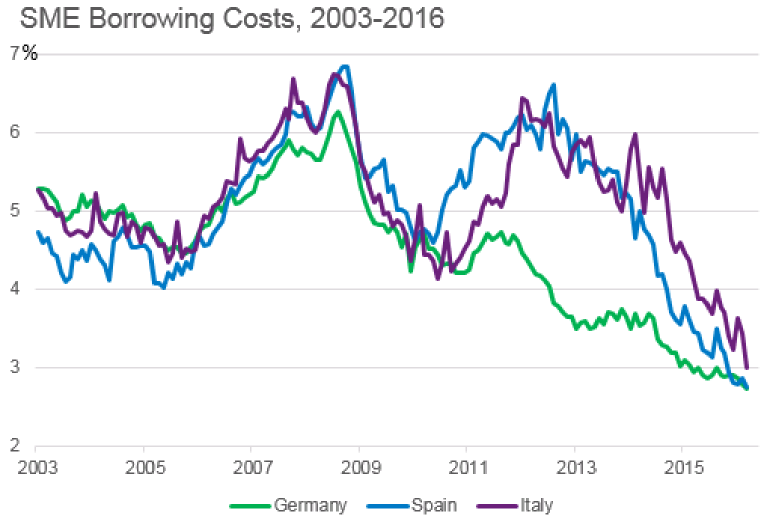
In Italy, the mood among entrepreneurs and business leaders is sunnier. Global risks hardly register – and the focus is on growth-boosting structural reforms such as the freeing up of the labor market. Yet access to credit remains a problem for most firms (both in quantity and price). Total credit is between five to seven percentage points of GDP below historical standards, according to the Bank of Italy. This reflects the weakness of banks. Companies with access to capital markets, however, stand to benefit significantly from the ECB's new corporate bond purchases.

To see a sustained pick-up in investment, expected returns need to go up. Less global uncertainty, a further recovery in demand and capacity constraints could set in motion a virtuous cycle. Yet ultimately we need faster productivity growth. Are we likely to get this? It's at least plausible: In Germany, competitive pressures from rising labor costs could give greater impetus for productivity-enhancing investments. In Italy, the cumulative impact of structural reforms (if fully implemented - a big if) and a further easing of financial conditions should increase returns on investment.

Do Not Count on Many More Stimuli

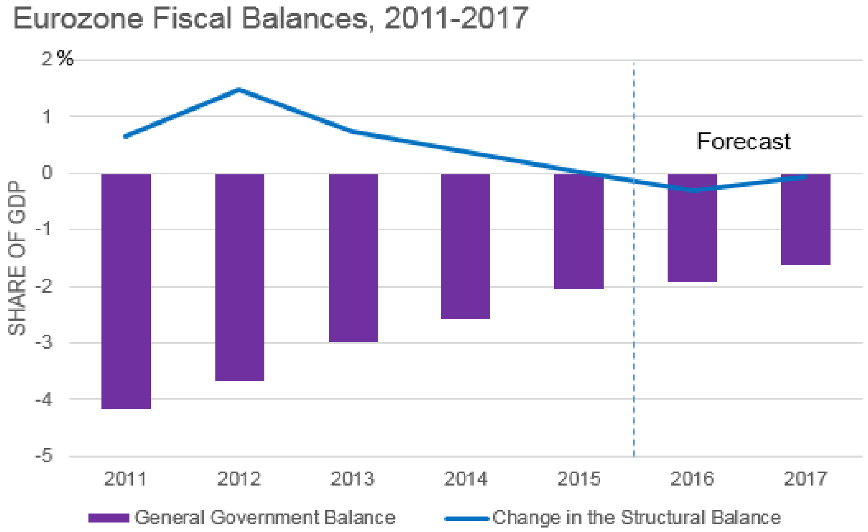
Other sources of stimulus are unlikely to play out. ECB policies have had a material positive impact on financial conditions and financial fragmentation, but it is not clear how much lower borrowing costs can be pushed. We see additional monetary easing as unlikely unless realized inflation falls far short of the ECB's most recent projection path.

Private credit is expanding after years of contraction, albeit at a modest pace. This is a driver for short-term growth, and highlights how the health of the banking system is critical for the eurozone's outlook. Our diagnosis: We do not see any immediate systemic risk but recognize European banks are severely challenged by factors ranging from low rates to bad debts. See pages 6-8 for details. Small business borrowing costs have come down significantly (see the chart below), but credit is not always easy to come by for those businesses that need it.



Sources: BlackRock Investment Institute and European Central Bank, May 2016.
Note: Loans to Non-Financial Corporates of up to 1 million euros for 1-5 years.

Fiscal policy has loosened as eurozone governments are spending the windfall from lower interest on sovereign debt. Nominal budget deficits are declining. The structural budget balance – which removes the impact of the business cycle – is turning expansionary. This effect is modest, however, and is set to peter out by 2017. See the chart below.



Source: BlackRock Investment Institute and European Commission (EC), May 2016.
Note: The 2016 and 2017 numbers are EC forecasts.

We do not see refugee inflows significantly boosting growth for many years, given long integration lags and skill sets. If anything, the influx of refugees represents a downside risk - if the agreement with Turkey to stem the flow falls apart or if new routes open that lead to lasting border closures in the Schengen area.

There is widespread dissatisfaction with Europe's economic governance framework. Reforms to complete the fiscal union and banking union could go a long way to boost sentiment – both in the core and in the periphery. Here, too, progress appears unlikely any time soon, even in the event of a Brexit.

Yet there may be a window of opportunity after French and German elections in 2017 to revive further European integration efforts – at a time when the effects of cyclical stimulus start to wear off. The key to sustained growth, however, will be structural reforms to improve resource allocation in each and every eurozone economy. And here, an unexpected picture emerges.

Converging Economic Paths

Labor market reforms implemented under former Chancellor Gerhard Schröder in the mid-2000s paved the way for a decade-long boom in German employment growth. Yet this golden age breeds complacency. In fact, there has been a roll-back of some labor market reforms such as the introduction of a minimum wage, restrictions on temporary work and the lowering of the retirement age. German labor costs were flat for much of 2000s, whereas those in peripheral nations such as Spain soared. The trend has now reversed.

This could in theory be compensated for by structural reforms in other areas. Yet there is little political incentive or pressure to move in that direction. German industry and government appear focused on digitization and innovation. Yet it is not clear how much action is actually taking place – and whether it will happen on a sufficient scale.to make up for a lack of structural reforms and labor market rigidities.

In Italy, by contrast, a massive program of structural reforms is underway. The sources of Italy's misallocation of resources are pervasive, long-standing and deeply entrenched. Prime Minister Matteo Renzi's agenda touches all the bases: reforms to the labor market, public administration, taxes, insolvency regimes and the judicial system.

A key test of Renzi's ability to deliver on this hefty agenda will be an October referendum on constitutional reform. Even if successful, implementation will take time to deliver results. Most reforms so far have "grand-fathered" existing contracts to minimize opposition from vested interests. Vulnerabilities such as very high public debt and weak banks will remain, but eventually the reform agenda should make a difference to Italy's competitiveness, just as labor market reforms did for Germany's.

The good news is that convergence between Germany and Italy since 2010 came through wage reflation in the economically stronger economy (Germany), not through weak productivity. This is exactly how a successful currency union should work, in our view, and what the eurozone needs to be sustainable in the long term. One must hope that other countries, notably France and the periphery, take the same path. Market pressures forced Portugal and Spain to make a good start in this respect, but both have started back-sliding. This could lead to renewed market tensions down the road. France has a good chance of getting on the reform path after the May 2017 election, we believe.

What It Means for Asset Prices

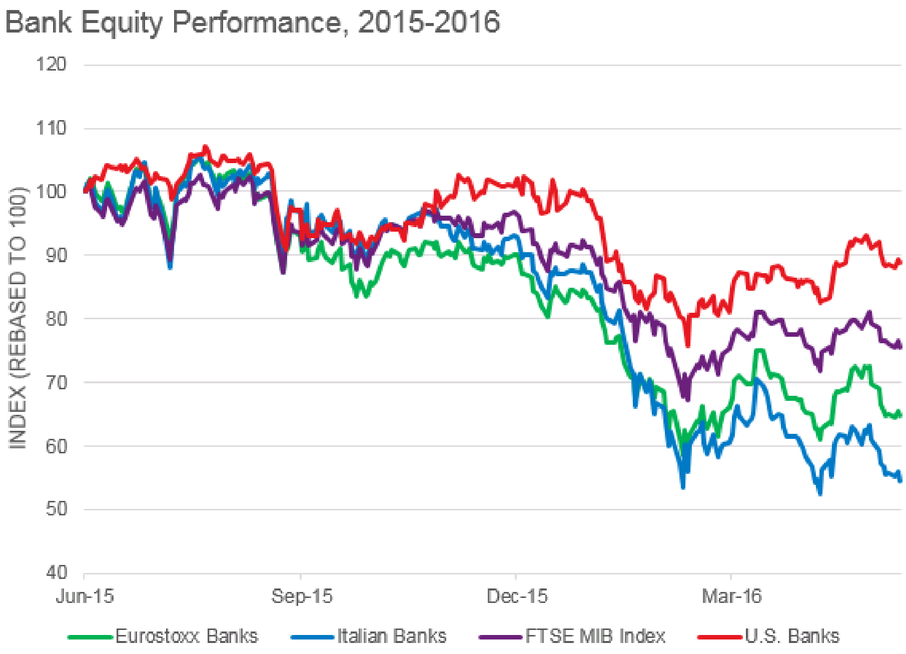
Judging by the eurozone's biggest core and peripheral economies, the recent disfavor that Europe's risk assets have fallen into does not seem entirely justified. We expect growth to remain decent by European standards for the foreseeable future. We like peripheral spreads and selected eurozone corporate credit. Demand for these assets is underpinned by a thirst for income amid negative interest rates and the ECB's expanded bond purchases. They have, however, become more expensive due to the flight to safety amid global recession fears.

We are overweight European equities - although it is tough to gain exposure to sectors that are benefiting from the uptick in consumption. Security selection is crucial because large-cap indices are dominated by financials (we dislike) and exporters. Real estate, however, looks well supported by rising wages and employment, particularly in Germany.

That said, we see the risks as being primarily to the downside, given the vulnerability posed by the combination of weak banks and public balance sheets in several peripheral countries. For investors with a long-term horizon, it will be essential to watch the structural reforms horse race unfold. This will hold the key both to growth performance and sustainability of the large debt burdens a number of countries remain plagued with.

Zooming in on Banks

Most European financial institutions are still wrestling with insufficient capital, whereas their U.S. peers have taken their medicine. Increased regulation, outdated business models, negative rates and overstaffing are posing challenges to already poor profitability. European banks have been battered this year: Stock prices have swooned (see the chart below), credit default spreads have spiked and funding costs risen.



Sources: BlackRock Investment Institute, Eurostoxx, MSCI and FTSE, May 2016.

Some blame the ECB's negative rates policy, but we believe this explanation is unconvincing outside of Germany. The ECB's policies generally hurt banks' net interest income (NII) – but they are helpful in other areas. Banks on the eurozone's periphery, for example, have benefited from the increased value of their sovereign debt holdings in the wake of the ECB's asset purchase program. In fact, the ECB argues the net impact of its monetary policy should be generally positive for banks in the period 2014-2017, as improved credit quality and capital gains offset NII losses.

German Banks: Slow Death by Low Rates

The weaknesses of the banking sector are widespread – but of a very different nature in Germany and Italy. In Germany, much of the banking sector has a business model that is fundamentally ill-suited to a prolonged environment of negative interest rates. This is causing much grief in the politically well-connected sector.

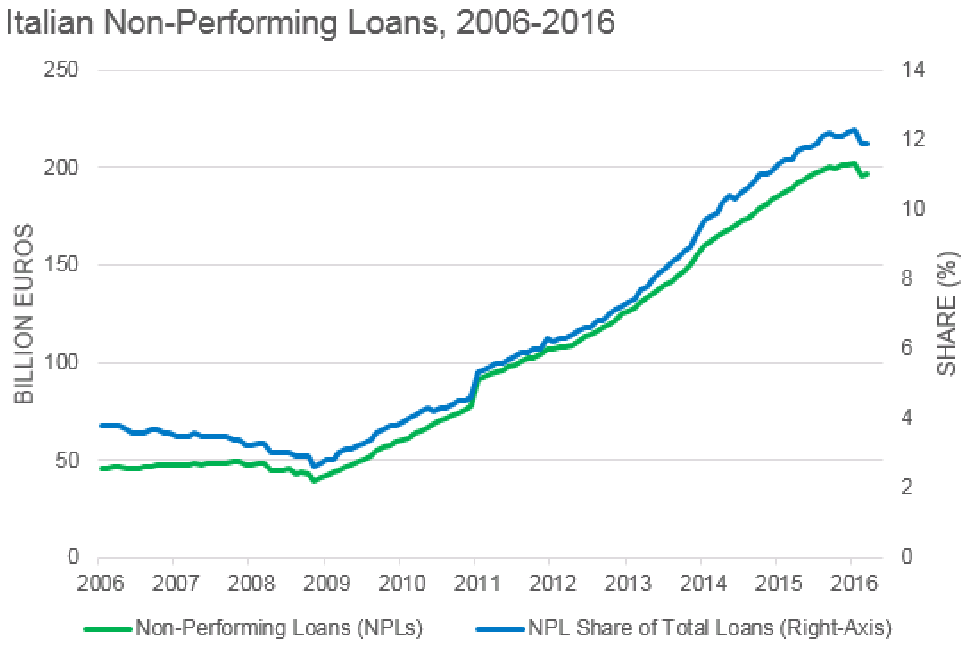
Germany's banking malaise is a slow burn of declining net interest income and revenues, especially for small and less diversified banks such as *Sparkassen* (savings banks) and co-operative banks. Most of these banks expect a considerable decline in NII by 2019, according to a Bundesbank survey of 1,500 small- and medium-sized banks taken in mid-2015. German banks have mostly stayed out of the headlines, with the market's attention focused on Italian banks. A big reason is that few German banks have publicly listed equities (although many maintain a presence in debt markets). In addition, the risks to German banks appear less imminent thanks to a backdrop of healthy domestic growth and strong property markets.

German banks face a choice between raising the cost of credit and banking through fees or seeing a slow erosion of their profits and equity base, in particular in the absence of a major expansion in loan volumes. It remains unclear how much of the pressure on NII has led to greater risk taking through higher duration and higher credit risk. Proactive adjustments to business models are usually only a last resort, in our experience. Banks would do well to invest in operational efficiency and search for alternative sources of revenue such as fee income, in our view. Fortunately, some of this is happening already. Yet in the worst-case scenario, it could lead to consolidation in the sector, which would actually enhance efficiency over time.

Italian Banks: Weighted Down by Bad Debt Overhang

In Italy, by contrast, the danger is not one of slow death as much as sudden execution. The largest banks and many smaller ones are broadly sound. Their balance sheets, however, are clogged with a large stock of non-performing loans (NPLs). The pile of NPLs is no longer growing – but has not started to shrink materially either. This constrains banks' ability to provide the economy the credit it needs. A number of smaller players have weak capital positions and are vulnerable to bank runs.

Bad debts in Italy have quadrupled since 2008 and amounted to €197 billion as of March, or 11.9% of total loans, according to the Bank of Italy. See the chart below. Net of existing provisions this comes to €83 billion, implying a carrying value for the worst loan category of 42 cents on the euro before considering collateral such as real estate and personal guarantees.



Sources: BlackRock Investment Institute and Bank of Italy, May 2016.

The Italian government is constrained in what it can do to resolve this situation. EU state aid rules preclude public support, and putting banks through resolution would, under new EU rules, involve a bail-in of private creditors. These private creditors are often households in Italy, as tradition and fiscal incentives have led to 10% of household wealth being invested in so-called "bail-in-able" bank securities, according to Bank of Italy. Bail-ins, therefore, equate to political suicide.

Carrying values of NPLs have been subject to much debate this year – despite a comprehensive assessment and stress test in 2014 as well as a supervisory review and evaluation in 2015. The reasons include poor NPL valuations of four bailed-in banks at about 18 cents on the euro in November; private equity (PE) commentary seeing NPL values generally below banks' carrying values; and the ECB request in March for a €1 billion capital raising by Banco Popolare to lift NPL coverage levels ahead of its acquisition with Banca Popolare di Milano. This brought into question the capital adequacy of Italy's banks and led to market concerns of additional capital raisings.

As a result, efforts to clean up Italy's banking mess have been marked by paralysis. Banks have been unwilling to take write-downs that would further undermine their capital position, while PE firms have refused to pay top euros for loans that have little chance of recovery. The result? Nothing much has happened. There are two developments that could break the impasse: a new bailout fund and attempts to speed up Italy's insolvency process.

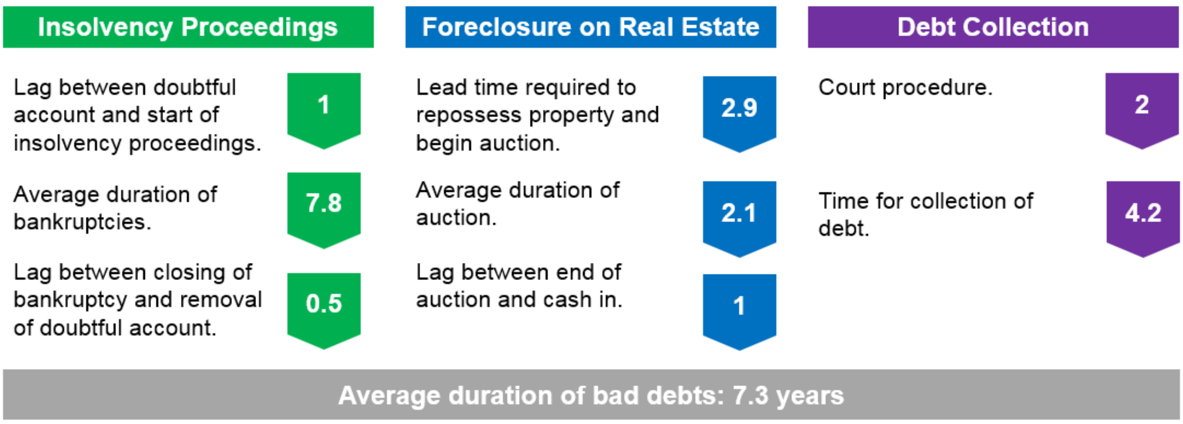
Atlante: A Fund to Shoulder the Burden

Italy has set up the Atlante (Atlas) private sector fund to buy up capital raisings by banks that are shunned by investors as well as deal with the root cause of the system's illness: NPLs. The fund raised a smaller-than-expected €4.25 billion (€4.7 billion including leverage) from some 70 Italian financial institutions last month and immediately put more than a third of the funds to work to buy an entire offering by troubled regional lender Popolare di Vicenza. A failed offering would have sent shockwaves through the system, we believe. Atlante will likely have to support Veneto Banca's upcoming €1bn capital raising, too, in the absence of market interest or an alternative solution.

The remainder of around €2bn can be used to acquire junior debt of NPL securitizations through the so-called GACS program. It could enable investment in €35-50 billion of gross NPLs through the use of leverage and mezzanine tranches acquired by third-party institutional investors.The fund can buy NPLs at prices that reflect lower funding costs, capital charges and return targets than PE firms. This means banks could sell off loans at close to book value and avoid having to raise more capital. In all, Atlante should be able to take at least some NPL's from banks' balance sheets and facilitate a more active marketplace for NPLs. NPL pricing will require external verification over the medium term, however, in our view. This is why a change in foreclosure reforms is crucial to generate real value.

Bankruptcy Reforms: A Big Help

Lengthy foreclosure procedures in Italy are a key burden in the NPL work-out process. It takes an average of seven to eight years for a dispute to make its way through the courts. This means banks have to wait longer to cash in on collateral and consequently take larger marks on bad loans than otherwise required.



Source: Cerved

Reforms now are shifting the balance away from protecting debtor's interest to those of creditor. Laws against repossession (*patto marciano*) that date back to medieval times are being replaced with a simple contract that allows creditors to seize collateral if the borrower skips three payments for new loans and existing ones on voluntary basis. Optimists see this reducing work-out times to seven to eight months for foreclosures and to three to four years for insolvencies.The reforms are a big positive –but they are not mandatory for existing NPLs. Borrowers, especially those that have already defaulted, may not have enough incentives to renegotiate their loans on the new terms.

Bottom Line on Italy's Banks

There is a tangible benefit in Atlante's having removed tail risks associated with the capital raisings of both Vicenza and Veneto, and we see the measure to speed up insolvency process as a clear benefit. Yet we do not expect an immediate vindication of Italian banks' balance sheets. The new foreclosure rules will trickle through the system as banks adjust contract structures. So we see the overall foreclosure experience improving only gradually. Until then, the system remains exposed to sudden shifts in confidence triggered by developments surrounding weaker banks.

Conclusion: Italy has made progress on the viable solution to nurse the system back to health: mobilize private sector capital. The concern here is that there is simply not enough capital in the system to both recapitalize the small banks and shrink the stock of NPLs at a market-clearing price. The measures described above are unambiguously steps in the right direction, but they appear to be small compared with the magnitude of the problem. Progress is likely to be very slow. This leaves the financial system and the overall economy vulnerable for some time to come, in our view.