Euro Area Member Divergences Provide Opportunities

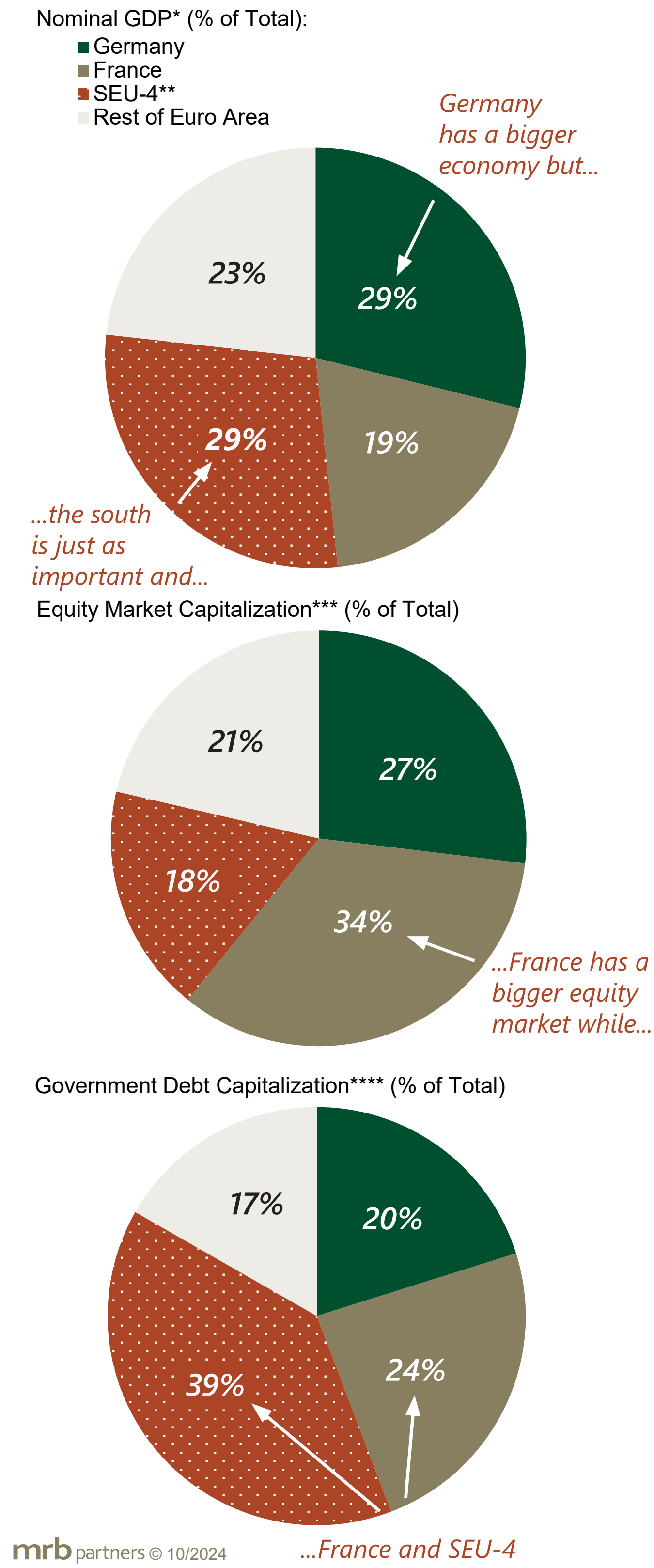
- The aggregate euro area economy has been dragged down in recent years mainly by sluggishness in Germany and the weak manufacturing and industrial sector.
- However, economies in the key four southern euro area countries (SEU-4, which includes Greece, Italy, Portugal and Spain) are much stronger than generally perceived and have been positively diverging from Germany and the overall region.
- Investors tend to use Germany as their economic barometer for the aggregate euro area, given that it is the member nation with the largest GDP weight. However, this is misleading since the stronger SEU-4 members have a similar aggregate GDP weight. Fixation on Germany risks being too bearish on euro area trends and missing out on investment opportunities.
- France, which has the second largest euro area economy, tends to be much more reflective of the aggregate euro area economic situation than Germany. Also, France has a larger equity and government debt market. At a minimum, investors should pay more attention to France heading forward for signs that the overall euro area is breaking out of this decade's funk.
- Monetary policy has not been a drag in the euro area, but regardless, the ECB is cutting rates to help support the regional economy. This will fuel stronger activity among SEU-4 member nations, providing investment opportunities in their equity and housing markets.
- To the extent that the central bank tries to shore up activity in the currently sick German economy, it could provide a boost for France. Better growth in the latter would meaningfully improve the investment narrative for the aggregate region, supporting regional equity and currency outperformance.
- We are adding an equity pair trade of long SEU-4 versus Germany in the **MRB *TradeBook***. We will also add a long position in SEU-4 home prices to reflect this theme, albeit recognize that not all of our clients directly purchase real estate.
- In terms of fixed income, the improvement in the SEU-4 will ensure that government bond spreads versus the anchor, Germany, remain tight for the foreseeable future.
- Lastly, we continue to favor the euro currency versus our list of economic "weak-link" currencies, including the Canadian dollar. We also favor the euro to the U.S. dollar, albeit material gains will likely await evidence that France and the overall euro area economy are gaining greater traction. We hold long EUR/CAD and long EUR/USD positions in the **MRB *TradeBook***.

The euro area economy is widely perceived to be driven by Germany and by its large manufacturing and industrial sector. However, this has not been true for many years. Nonetheless, German manufacturing activity and sentiment gauges remain the go-to business cycle indicators for many investors, and the current weak readings have caused concerns regarding the trajectory of the aggregate euro area economy. Fixation on the region's sickest member provides a misleadingly pessimist perspective and risks missing substantial investment opportunities within the region and relative to global benchmarks.

Germany is the member nation with the largest GDP, accounting for 29% of the aggregate euro area. However, the four major southern euro area members (SEU-4, which include Greece, Italy, Portugal and Spain) in aggregate account for the same GDP weight of 29% (**chart 1**). Simply put, the SEU-4 members are just as important for the euro area economy, and currently have much more vibrant economic trends. France's economy, which is currently sluggish but stronger than Germany, accounts for another 19% of regional GDP.

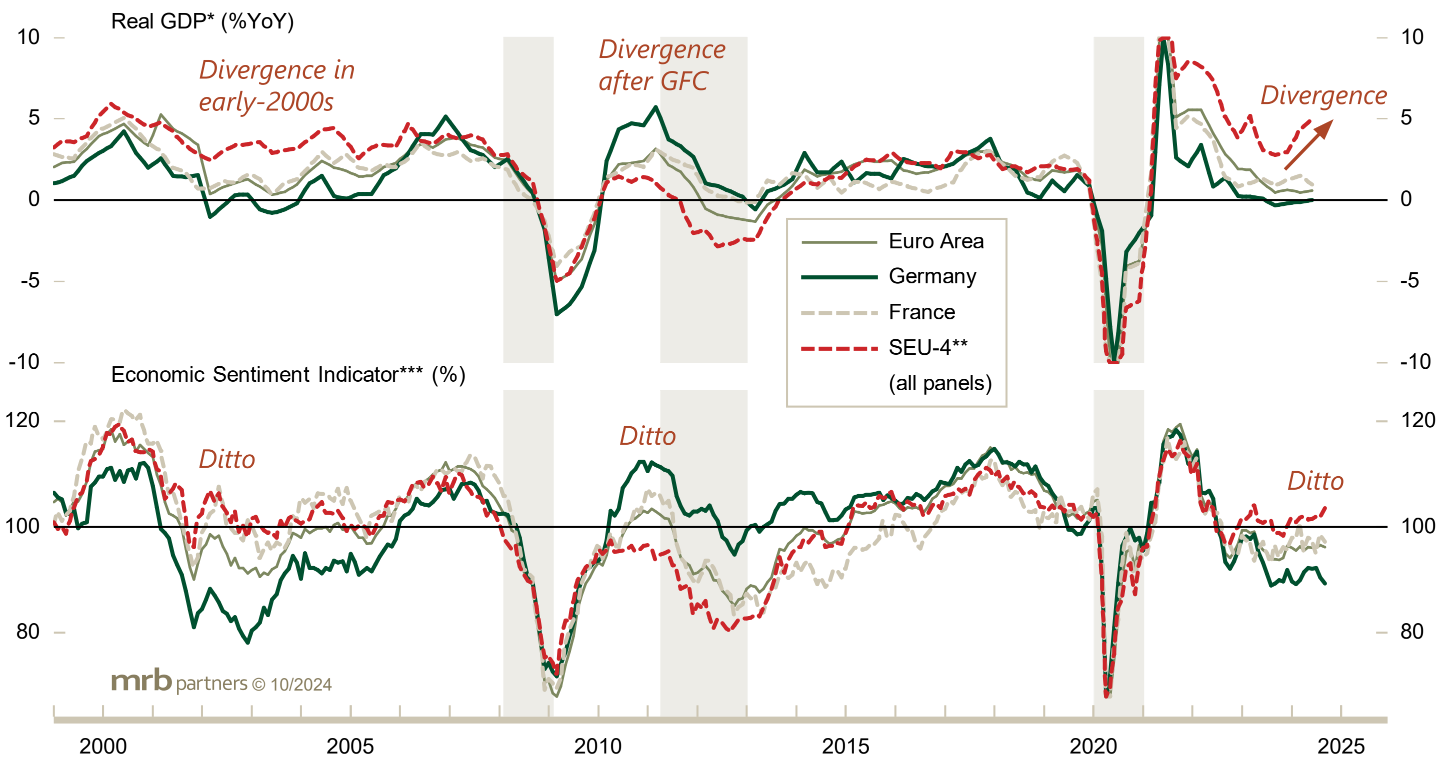
In terms of investment strategy, Germany's importance is reduced further by the fact that France has a much larger equity market capitalization (accounting for 34% of the aggregate euro area equity market) compared with Germany (27%). Also, the SEU-4 nations have a much larger weight when it comes to government debt capitalization (39%), compared to Germany (20%). We are not dismissing Germany's importance within the region, but using the German economy and financial asset markets as the "rule of thumb" barometer for the overall euro area provides a very misleading picture of the aggregate region.

Chart 1 **Euro Area Is Not Just About Germany**



* Source: Eurostat
** GDP-weighted aggregate of Greece, Italy, Portugal & Spain
*** Source: MSCI
**** Source: IMF

Chart 2 **Economic Growth Divergences Among Members Is Becoming An Every Decade Theme**



* Truncated at 10 and -10; source: National Source
** GDP-weighted aggregate of Greece, Italy, Portugal and Spain
*** Truncated at 68; source: European Commission Survey
Note: Shaded for Center for Economic Policy Research-designated euro area recessions

This report delves into the growing divergences between Germany and the SEU-4. We also analyze France which ***currently*** provides a better barometer than Germany for the overall region. Moreover, we outline how easier ECB monetary policy, driven by weakness in Germany, will create investment opportunities within the region and should ultimately lead to a more constructive shift in aggregate euro area economic trends in the coming 6-12 months. The latter will be crucial in reshaping the investment narrative for the region.

Germany is stagnating while southern euro area is growing rapidly

GDP Growth And Economic Sentiment (chart 2)

- For much of the 2000s (the years following the formation of the common currency union in 1999), the German economy struggled while other parts of the euro area (including the SEU-4) boomed as economic activity transferred to the lower cost parts of the region. After or "Starting in" 2008, many of the member nations that benefitted from the wealth transfer experienced housing fallouts and a sovereign debt crisis. These economies delevered and massively underperformed Germany until the mid-2010s after the ECB provided an open-ended commitment and their households had largely repaired theirbalance sheets.

- Once again there has been a notable divergence within the region. This time around Germany is the sick member of the region. German real GDP has stagnated (roughly 0% annual growth) since early-2023, driven by weakness in its manufacturing and industrial sector, along with a lack of consumer spending.

- In contrast, real GDP in the SEU-4 is expanding at a brisk 5% annual rate. Among these, Italy is currently running the hottest with real GDP rising close to 7% year-over-year, albeit all SEU-4 members are contributing to the current divergence in economic growth.

- France is in between these extremes, with real GDP growth currently around 1%, roughly in line with the aggregate region.

- Notably, economic sentiment is consistent with an ongoing divergence within the euro area. The business confidence gauge from the European Commission Survey is currently above the boom/bust line for the SEU-4, around the boom/bust for France and the overall euro area, while very depressed for Germany.

Purchasing Managers Indexes (chart 3)

Manufacturing is weak while services are doing much better

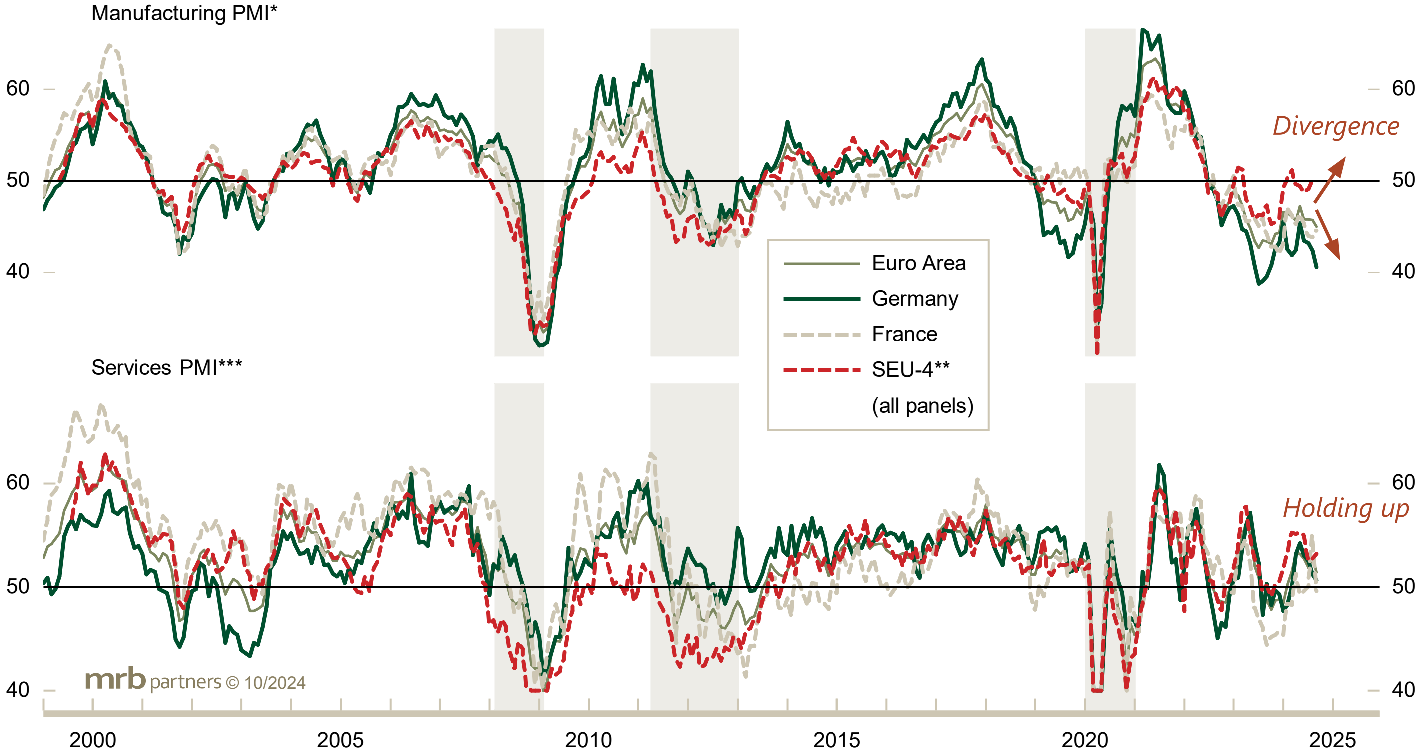
- The euro area economy is widely perceived among investors to be driven by the industrial or manufacturing sector. In turn, the PMI Manufacturing Index for Germany (the largest member economy) has historically been a go-to business cycle indicator for many, and the current weak readings have caused recession concerns.

- While manufacturing is weak throughout much of the euro area, there is a substantial divergence within the region, with the extremely pessimistic Germany PMI Manufacturing Index currently an outlier. This provides an overly bearish perspective for the region. Notably, manufacturing confidence in the SEU-4 has recovered to the boom/bust line.

- In contrast, the PMI Services survey shows a indicates a choppy recovery for most members of the euro area, including Germany. Service sector confidence in the SEU-4 is particularly upbeat, aided by strong tourism.

- What is important to note is that manufacturing only accounts for about 15% of total euro area GDP, compared with almost 70% for the service sector. Moreover,

Chart 3 Be Careful Using German PMI Manufacturing As A Go-To Indictor



* Source: Markit Economics; excludes Portugal
** GDP-weighted aggregate of Greece, Italy, Portugal and Spain
*** Truncated at 40; excludes Greece and Portugal; source: Markit Economics
Note: Shaded for Center of Economic Policy Research-designated euro area recessions

manufacturing jobs only account for 14% of total employment. Thus, we recommend that investors pay much greater attention to the service sector when assessing the aggregate euro area economy.

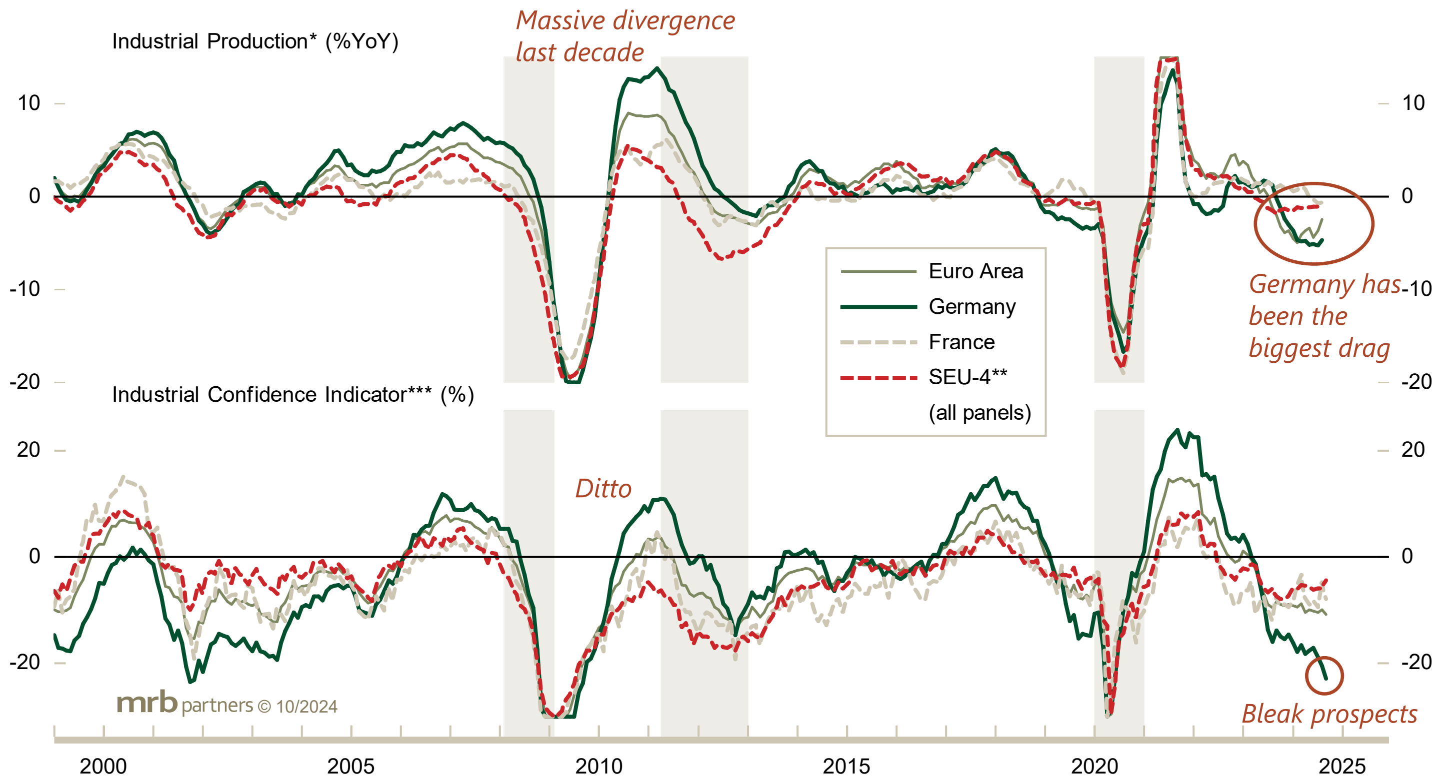
Manufacturing & Industrial Sector (chart 4)

The overly depressed German industrial sector reflects a competitiveness problem

- Manufacturing has been weak across the globe over the past couple of years, as consumers spending rotated to services following a pandemic-related goods binge. This has weighed heavily on Germany, given the outsized importance of its manufacturing and industrial sector which also supports manufacturing capex in other countries.

- That said, Germany has notably weaker industrial production growth than the rest of the euro area (consistently contracting since late-2022), and industrial confidence is very depressed relative to other member nations. This warns of a more profound problem, namely that German auto and machinery companies now lack competitiveness and struggle against rivals in other countries, most notably China.

Chart 4 **Germany's Struggle Is Due Its Large And Weak Manufacturing & Industrial Sector**



* Truncated at 15 and -20; source: Eurotstat
** GDP-weighted aggregate of Greece, Italy, Portugal and Spain
*** Truncated at -30; source: European Commission Survey
Note: Shaded for Center for Economic Policy Research-designated euro area recessions

❍ Industrial production and sentiment in France and the SEU-4 is weak, but much better than Germany (particularly Greece). Importantly, these economies tend to have a much smaller manufacturing sector and are driven more by service sector trends, which have been considerably stronger (see below).

There has been a substantial improvement in consumer confidence…

…the key is if it leads to greater spending

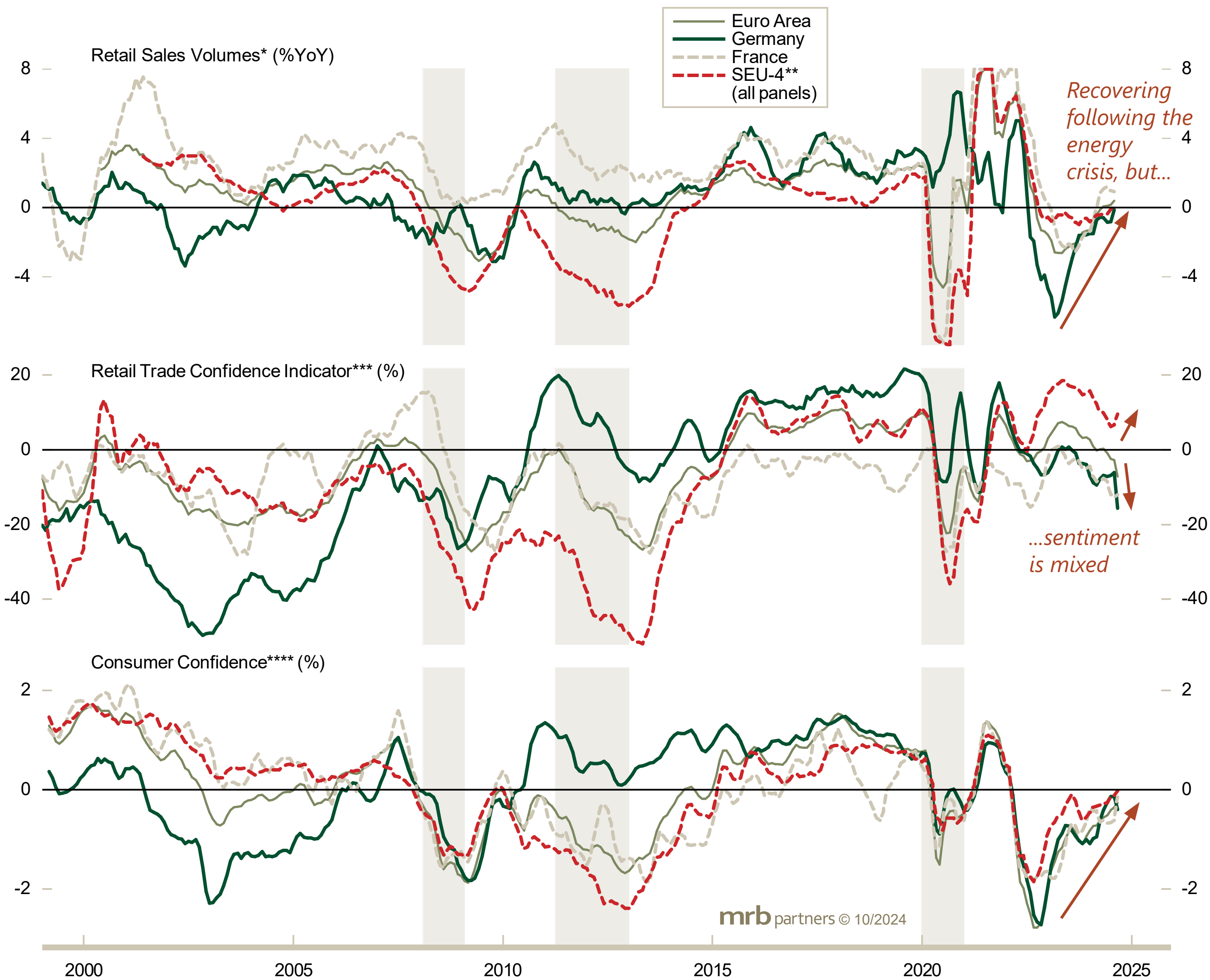
Retail Sales And Consumer Confidence (chart 5)

❍ Retail sales volumes have steadily improved following the 2022 European energy crisis, with Germany experiencing the most remarkable bounce, albeit from an exceptionally depressed growth rate.

❍ Italy is the only country in the SEU-4 with negative retail sales growth. Greece, Portugal and Spain have among the strongest retail sales volumes in the euro area. France is a decent gauge for retail sales in the overall euro area, and is now in positive territory, albeit still very subdued.

❍ While retail sales have improved across the region, confidence among retailers varies markedly. Retailers are upbeat in the SEU-4 while pessimistic in the rest of the region.

Chart 5 **Retail Sales Have Firmed, But Confidence Is Mixed**



* Truncated at 15 and -20; smoothed; source: Eurotstat
** GDP-weighted aggregate of Greece, Italy, Portugal and Spain
*** Smoothed; source: European Commission Survey

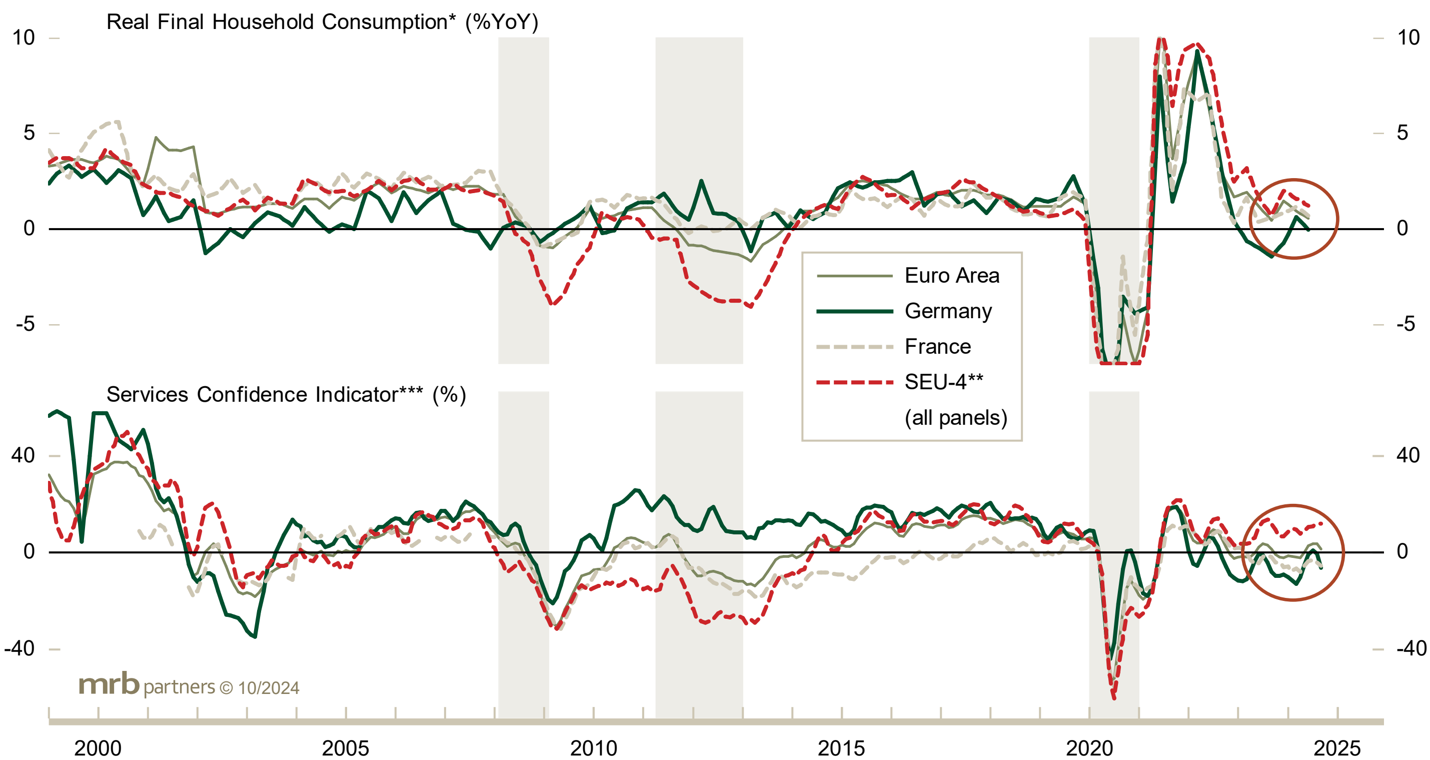
Household Consumption And Service Sector Confidence (chart 6)

Southern euro area households are more willing to spend

- Real final household consumption expenditure has been relatively subdued, along with service sector confidence, in the aggregate euro area. Trends in France are consistent with the euro area average.

- A mild contraction in German consumer spending has acted as a drag for the overall region. The industrial sector is the primary source of weakness for Germany, but this is being reinforced by a funk in the consumer sector, due to poor employment and

Chart 6 **Household Consumption And Service Sector Confidence Is Stronger In The South**



* Truncated at 10 and -10; source: National Source
** GDP-weighted aggregate of Greece, Italy, Portugal and Spain
*** Truncated at 68; source: European Commission Survey
Note: Shaded for Center for Economic Policy Research-designated euro area recessions

wage prospects (see below). Fortunately, German households have an ample savings cushion to serve as a firewall against recessionary forces, albeit they show limited desire to use much of their savings currently.

❍ Conversely, the SEU-4 members have the strongest consumption, which is consistent with upbeat service sector sentiment measures. Note that the service sector plays a much larger role in these economies, which also have a greater exposure to tourism. This has reinforced their relatively more constructive trends.

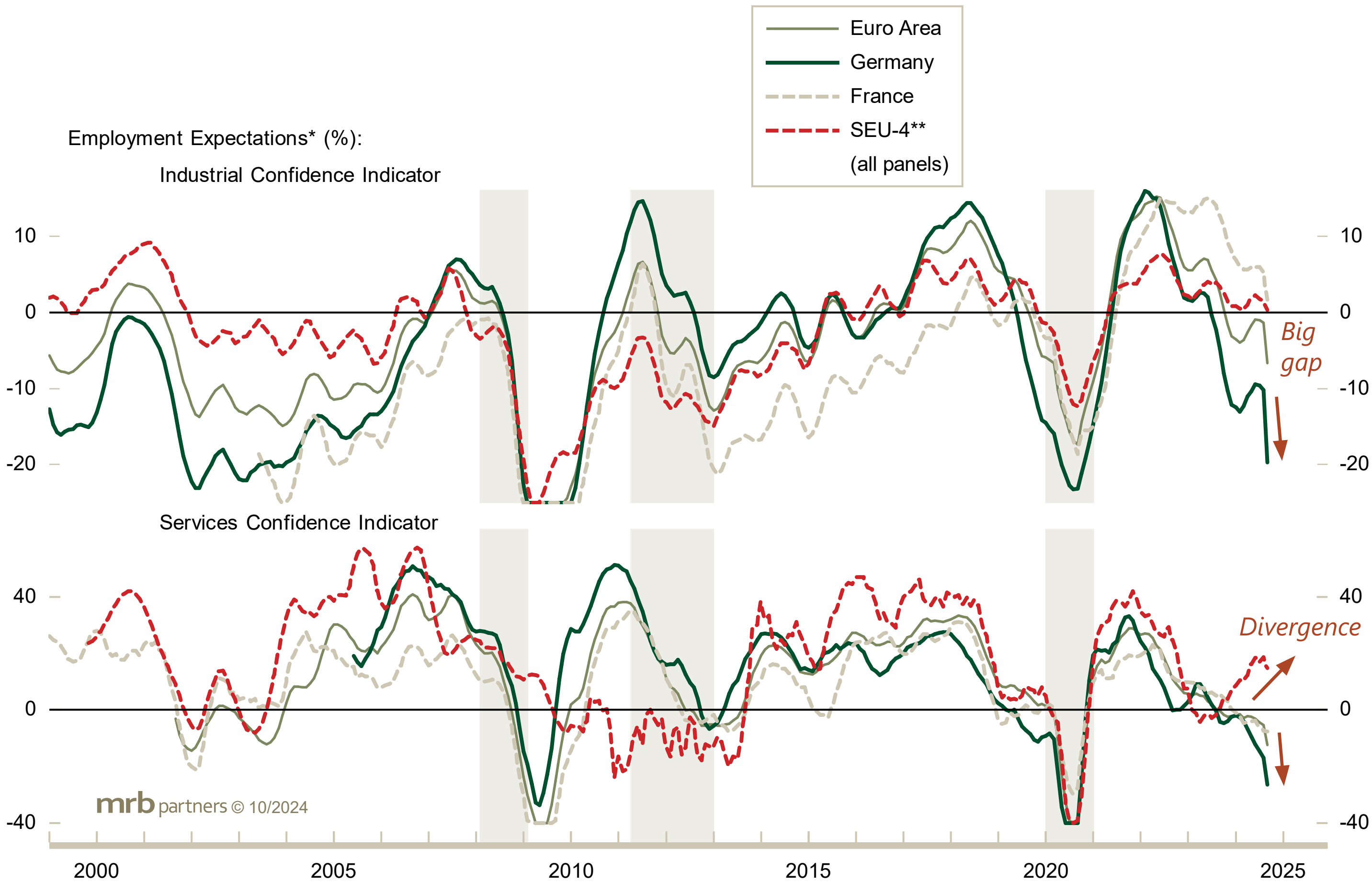
Employment Trends (chart 7)

Employment trends are very weak in Germany while improving in the south

❍ Consistent with the business sentiment trends, employment expectations are diverging materially within the region. Expectations for employment within the industrial sector has steadily deteriorated since 2022, and the outlook for Germany is now bleak. Unfortunately, employment expectations for Germany's service sector have also deteriorated markedly.

❍ In contrast, the SEU-4 displays much stronger prospects. Employment expectations for the industrial sector is soft but service sector businesses are signaling a desire to add staff (i.e. the confidence measure is decisively above its boom/bust line).

Chart 7 **Employment Trends Are Diverging Substantially**



* Smoothed; truncated; source: European Commission Survey
** GDP-weighted aggregate of Greece, Italy, Portugal and Spain
Note: Shaded for Center for Economic Policy Research-designated euro area recessions

❍ France and the overall euro area are somewhat disappointing as employment confidence has softening as of late.

Unemployment And Wage Growth (chart 8)

The unemployment rate is low in Germany but rising...

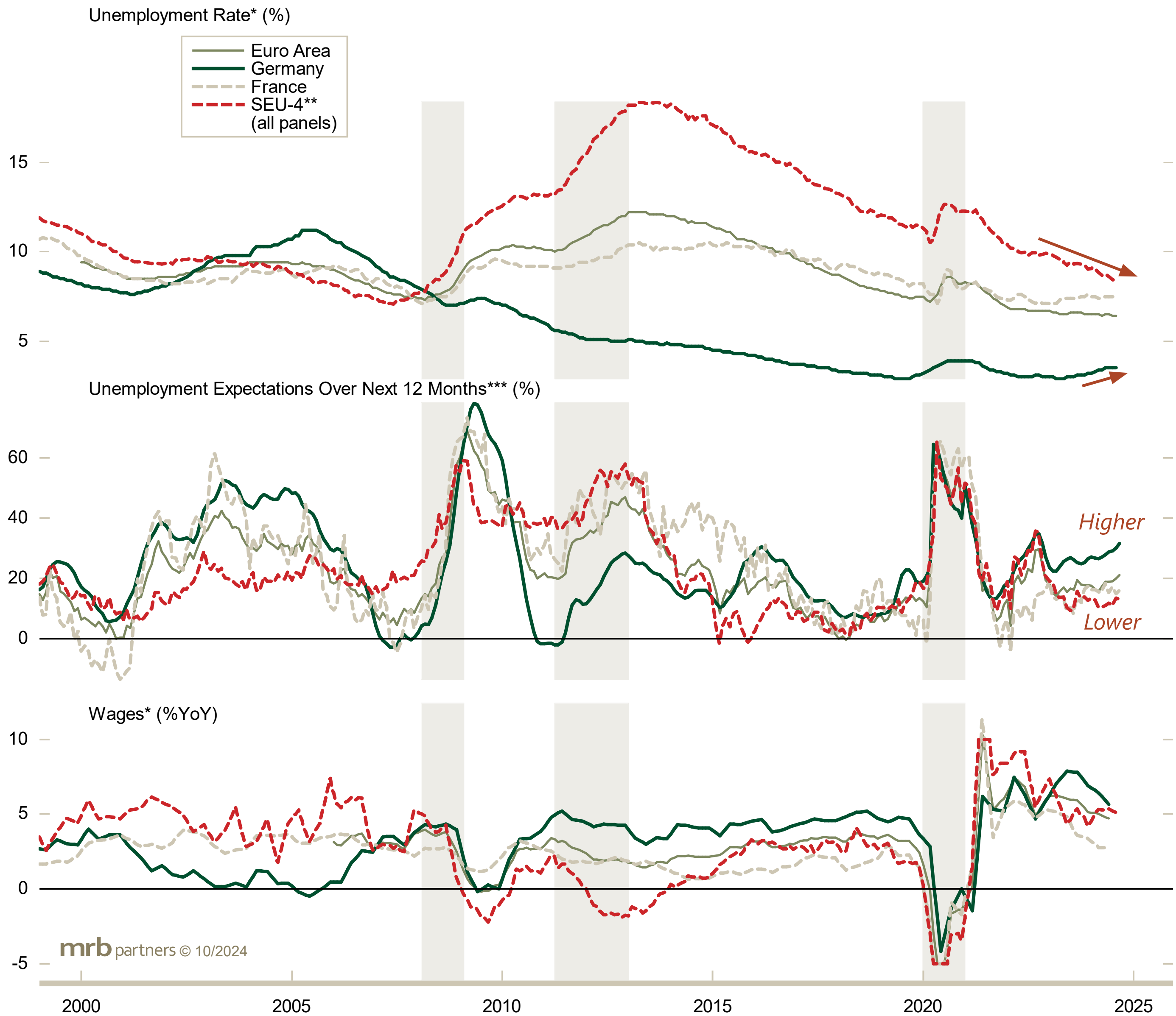
...while high in the SEU-4 but falling

❍ The unemployment rate for the aggregate euro area is at 6.4% and has been grinding lower, while France has flattened off around 7.5%. Expectations for unemployment in the year ahead have mildly deteriorated as of late, which provides support for ongoing ECB rate cuts.

❍ While the unemployment rate has been slowly rising in Germany, the level is still very low at a mere 3.5%. That said, unemployment expectations warn of a further deterioration over the next 12 months.

❍ Unemployment has been steadily declining among the SEU-4 members, which have an aggregate unemployment rate of 8.3%, compared to the 18% unemployment rate

Chart 8 **Wage Growth Is Healthy, But Unemployment Rates Are Diverging**



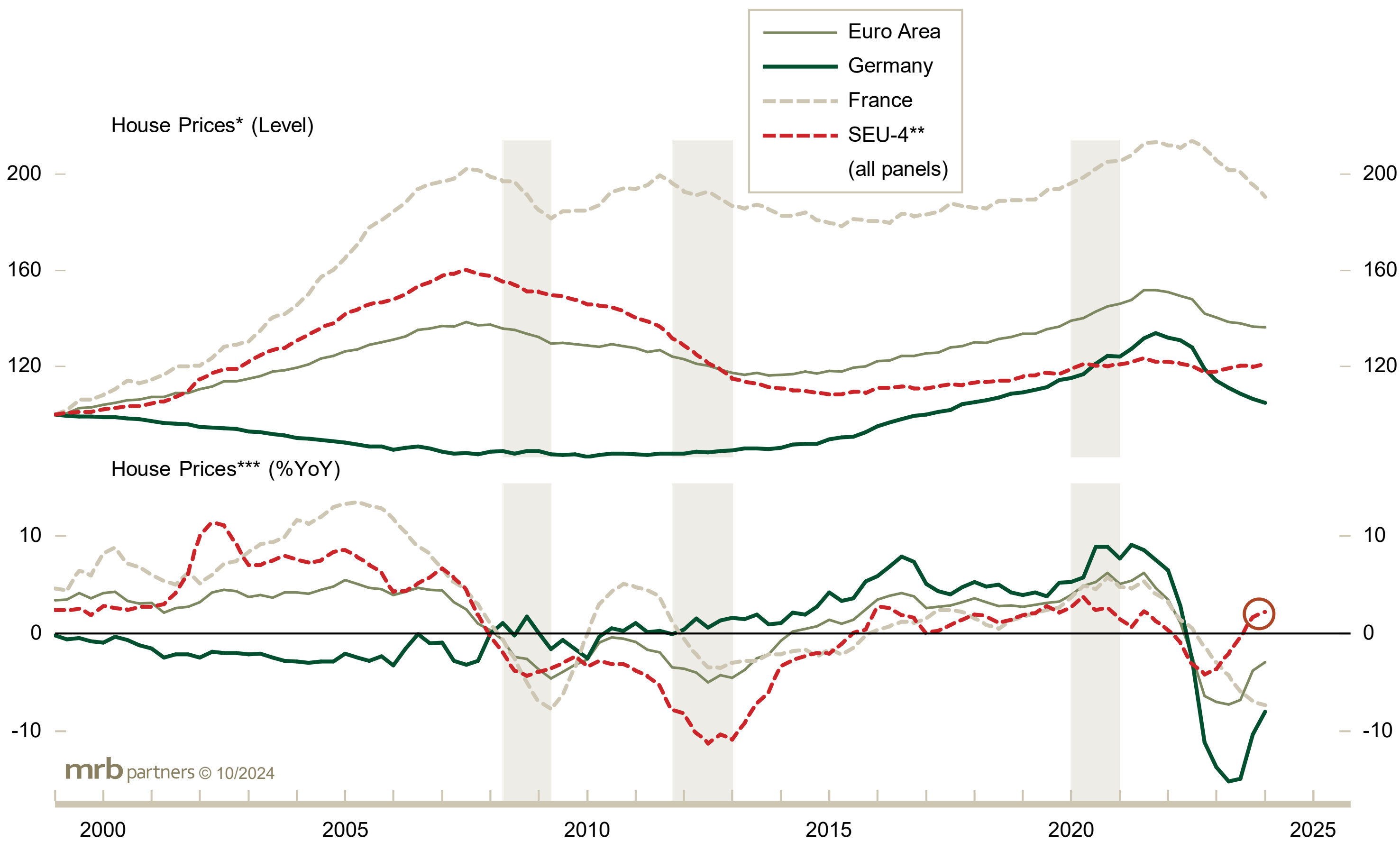
* Source: National Source
** GDP-weighted aggregate of Greece, Italy, Portugal and Spain
*** Source: European Commission Survey
Note: Shaded for Center for Economic Policy Research-designated euro area recessions

at the peak of the sovereign debt crisis. Forward looking expectations measures signal a continued improvement in the year ahead.

Wage growth is solid across the euro area

❍ It is notable that wage growth is reasonably consistent and solid throughout the region at around 4%. The reason is that Germany has a much tighter labor market even though the trend is deteriorating, whereas the EU-4 has relatively more labor market slack but is experiencing greater employment demand. Solid wages are also consistent with strong corporate profits and wide margins throughout the region, despite lackluster GDP growth. This ultimately provides underlying support for households and consumer spending.

Chart 9 House Prices Are Rising In The South, While Contracting Elsewhere



* Rebased to September 2007 = 100; source: National Source
** GDP-weighted aggregate of Greece, Italy, Portugal and Spain
*** Source: National Source
Note: Shaded for Center for Economic Policy Research-designated euro area recessions

House Prices (chart 9)

- German house prices experienced a material boost last decade from overly depressed interest rates as the ECB used extreme policy support to end the sovereign debt crisis and offset deleveraging among periphery members. However, German home prices have declined substantially over the past two years, as interest rates normalized and the Germany economy turned sluggish.

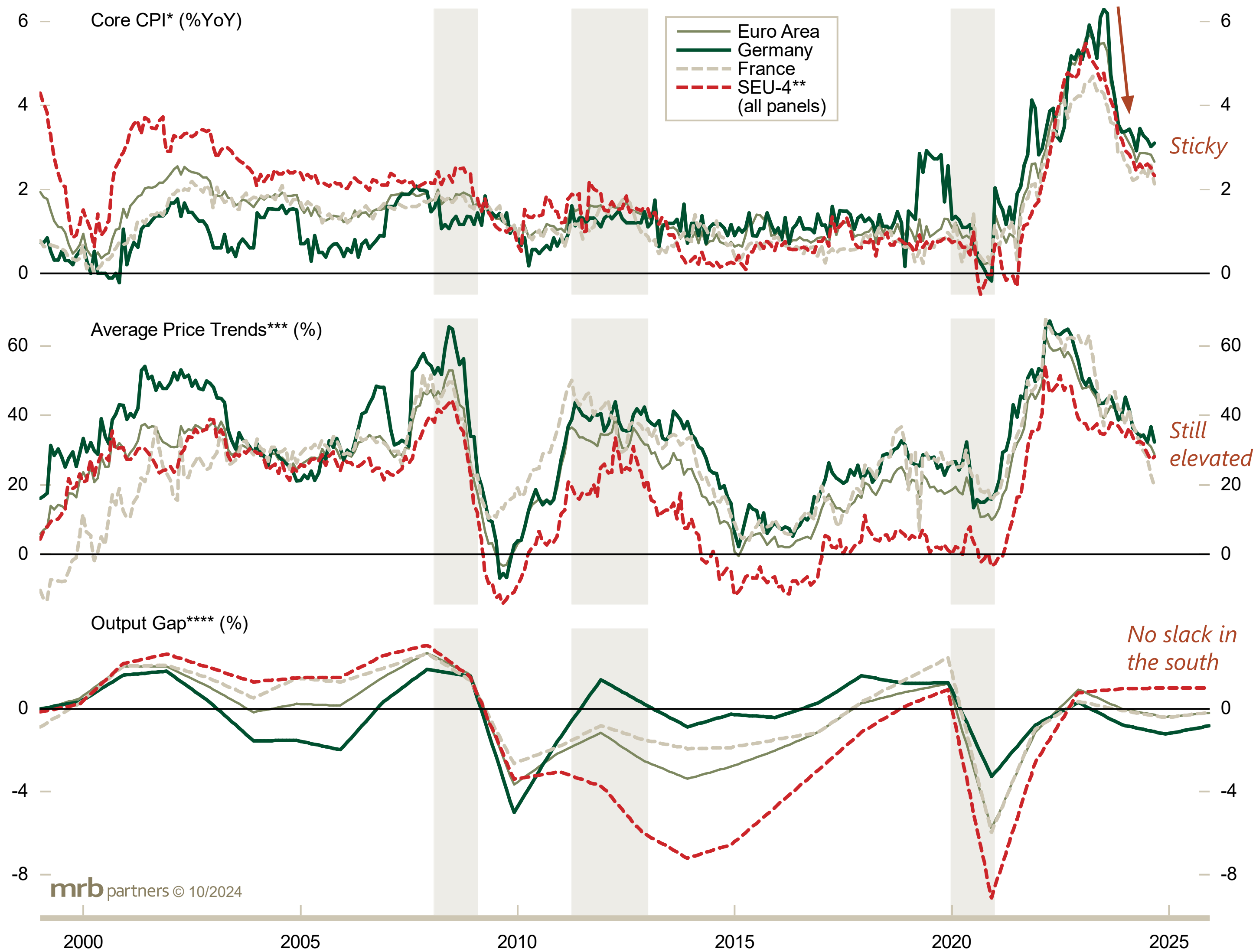
- In contrast, home prices among the SEU-4 suffered deep losses from 2008 until the mid-2010s and then only edged higher. While these housing markets took a hit in 2022 along with the rest of the region, home prices have been rising over the past 18 months. This trend is likely to persist as economic fundamentals improve in these countries, at a point when ECB rate cuts will help cap and even lower borrowing rates.

- Home prices are still mildly contracting for the euro area as a whole on a year-over-year basis, but should improve provided the aggregate economy gradually gains traction, as we expect.

Home prices are starting to rise in the south…

…a trend that should persist

Chart 10 Inflation Has Moderated But Remains Sticky Across The Board



* Source: National Source
** GDP-weighted aggregate of Greece, Italy, Portugal and Spain
*** Average of past 12 months and next 12 months; source: European Commission Survey
**** Source: European Commission
Note: Shaded for Center for Economic Policy Research-designated euro area recessions

❍ For those clients that make private asset investments in real estate, we recommend buying housing in the SEU-4 economies and will add this alternative investment position to the **MRB *TradeBook.*** Note that we made a similar recommendation for German home prices for much of last decade and booked a 100% profit on this position in 2022.

Inflation is leveling off in the euro area

Consumer Price Inflation (chart 10)

❍ Core CPI inflation is roughly around the same levels across the region, as are inflation expectations, despite differences in regional growth trends. This is largely because other than domestically focused services, prices tend to be set for the region as a whole based on euro area (or global) supply and demand forces.

- In aggregate, the euro area has a modest negative output gap (albeit mostly due to Germany) and inflation has declined steadily, although largely due to an unwinding of pandemic-related supply distortions. Nonetheless, this provides latitude for the ECB to cut rates.

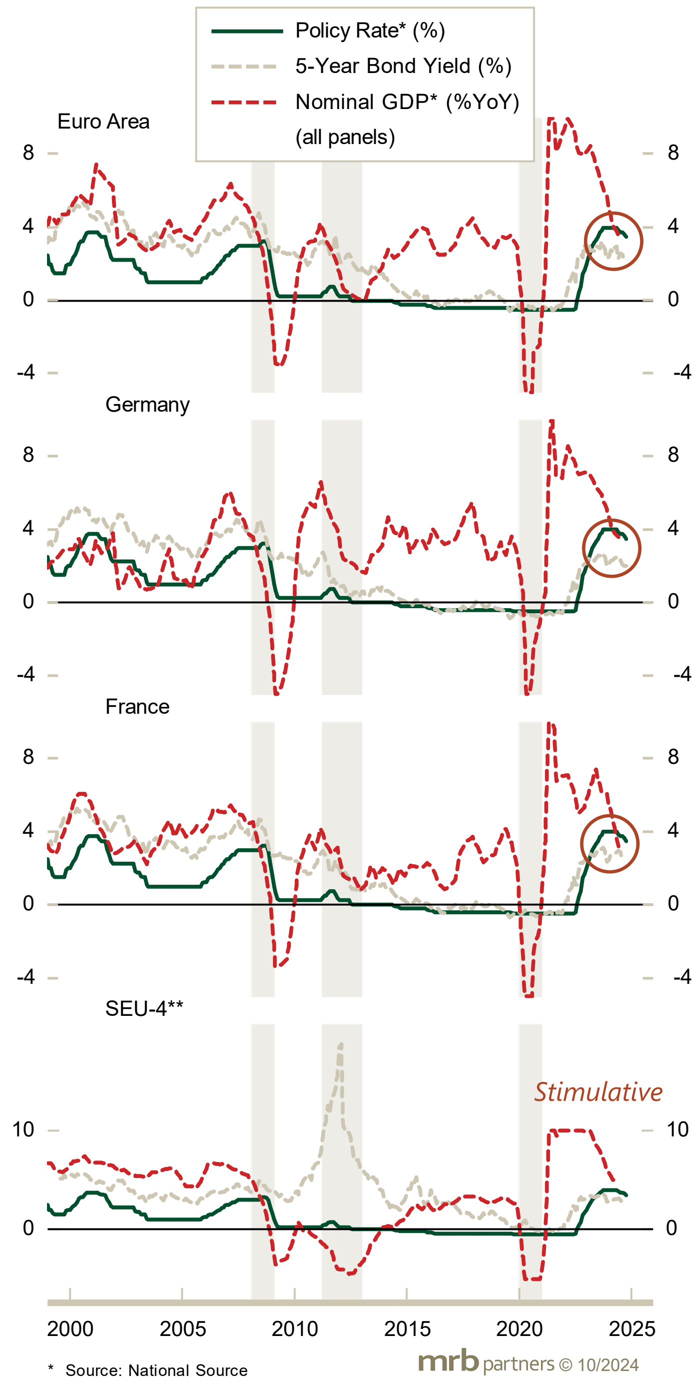
- That said, the latest trends suggest that core consumer price inflation is starting to prove sticky slightly above the ECB's target and well above the 1% run rate of last decade. This is consistent with our view.

Monetary Policy (chart 11)

- The gap between nominal GDP growth and policy rates is often a useful metric of the amount of policy accommodation within an economy. When ECB policy rates (or a proxy for the cost of capital) is decisively below nominal GDP growth (or the average return on capital), policy is generally supportive of economic activity, housing, and equity prices. In contrast, when the gap closes or interest rates are higher, the reverse is true.

- The stimulative gap has seemingly closed for the aggregate euro area, including Germany and France. That said, the yield curve is currently inverted, which means that lower longer-term bond yields are providing support. Regardless, the ECB is now cutting rates which should widen the gap between GDP and borrowing costs across the curve.

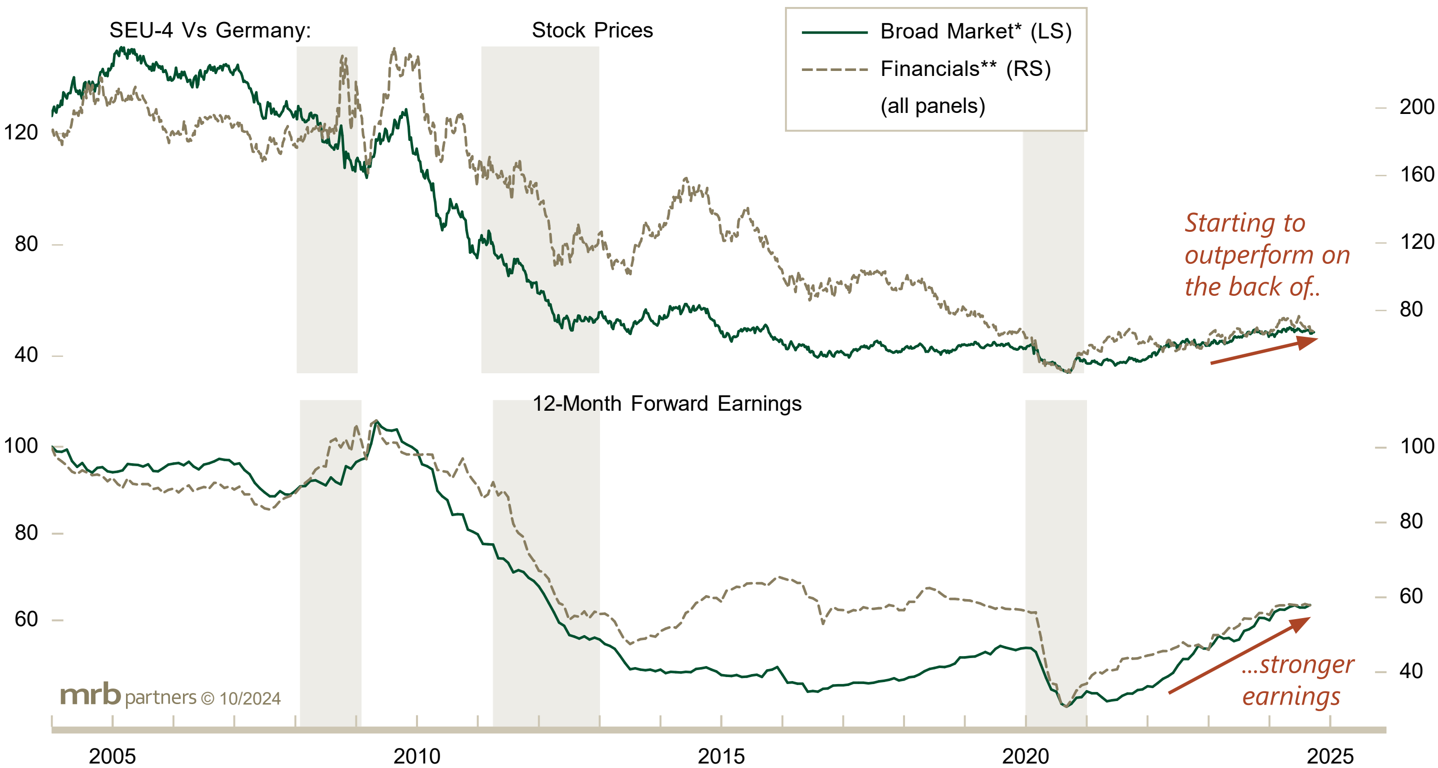
Chart 11 ECB Support For Germany Will Boost France And Turbo-Charge The South



* Source: National Source
** Equally-weighted aggregate of Greece, Italy, Portugal and Spain
Note: Shaded for Center for Economic Policy Research-designated euro area recessions

- It is notable that the SEU-4 still has a positive gap between nominal GDP and both policy rates and bond yields. With growth prospects improving and the ECB set to ease further, this gap will widen and further reinforce (or even turbo-charge) economic growth and risk asset prices among these member nations.

Chart 12 **Southern Euro Area Has Already Started To Outperform Germany**



* Equally-weighted aggregate of Greece, Italy, Portugal & Spain; source: MSCI
** Equally-weighted aggregate of Italy & Spain; source: MSCI
Note: Shaded for Center for Economic Policy Research-designated euro area recessions

Equities (chart 12)

- Easier monetary policy by the ECB should lead to higher equity prices in absolute terms for the euro area, and a rise in the stock/bond ratio.

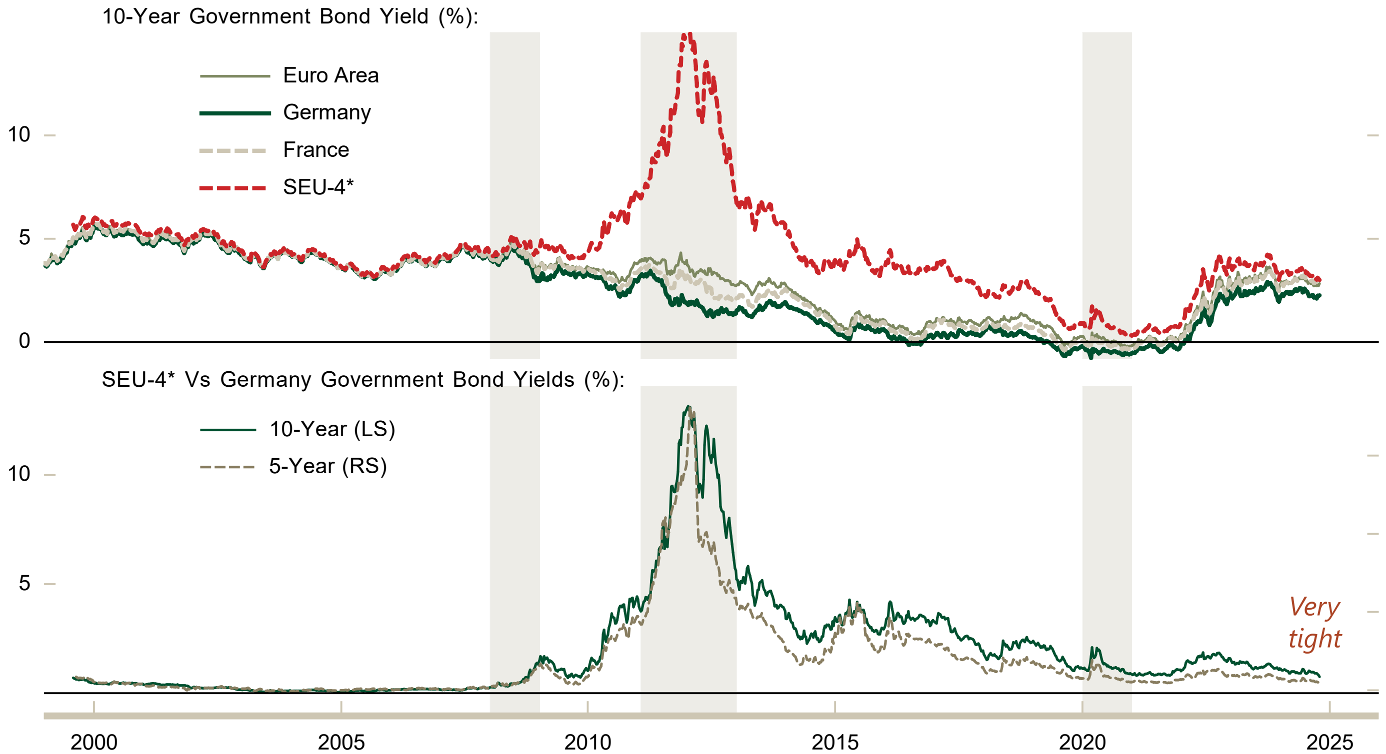
- In relative terms, we favor the euro area over the global equity benchmark as more robust than expected global growth, and improving trade cycle, favors the relatively cheaper euro area market[1]. That said, it will likely take a stronger economic growth trend in France (and thus the overall euro area) to encourage global investors to embrace the euro area equity market.

- Within the region, the SEU-4 equity markets are already starting to outperform Germany on the back of stronger earnings. We believe this trend will persist and will add an equity pair trade of long SEU-4 versus Germany in the **MRB *TradeBook.***

Watch for an improvement in France (rather than Germany) for timing when global investors will better embrace euro area stocks

[1] **MRB:** "***Regional Equities: Policy Tailwinds For A Gradual Rotation***" September 24, 2024

Chart 13 Government Bond Spreads Will Stay Tight



* Equally-weighted aggregate of Greece, Italy, Portugal & Spain
Note: Shaded for Center for Economic Policy Research-designated euro area recessions

Government Bonds (chart 13)

- Based on our research, the aggregate region is more durable than widely perceived despite manufacturing weakness in Germany. Indeed, the region has limited imbalances and sizable household savings which will serve as a firewall against contractionary forces.

- Nonetheless, the euro area has modest economic slack which should contain near-term inflationary pressures and provide the ECB with flexibility to continue cutting rates. Indeed, we expect the ECB will bring forward rate cuts.

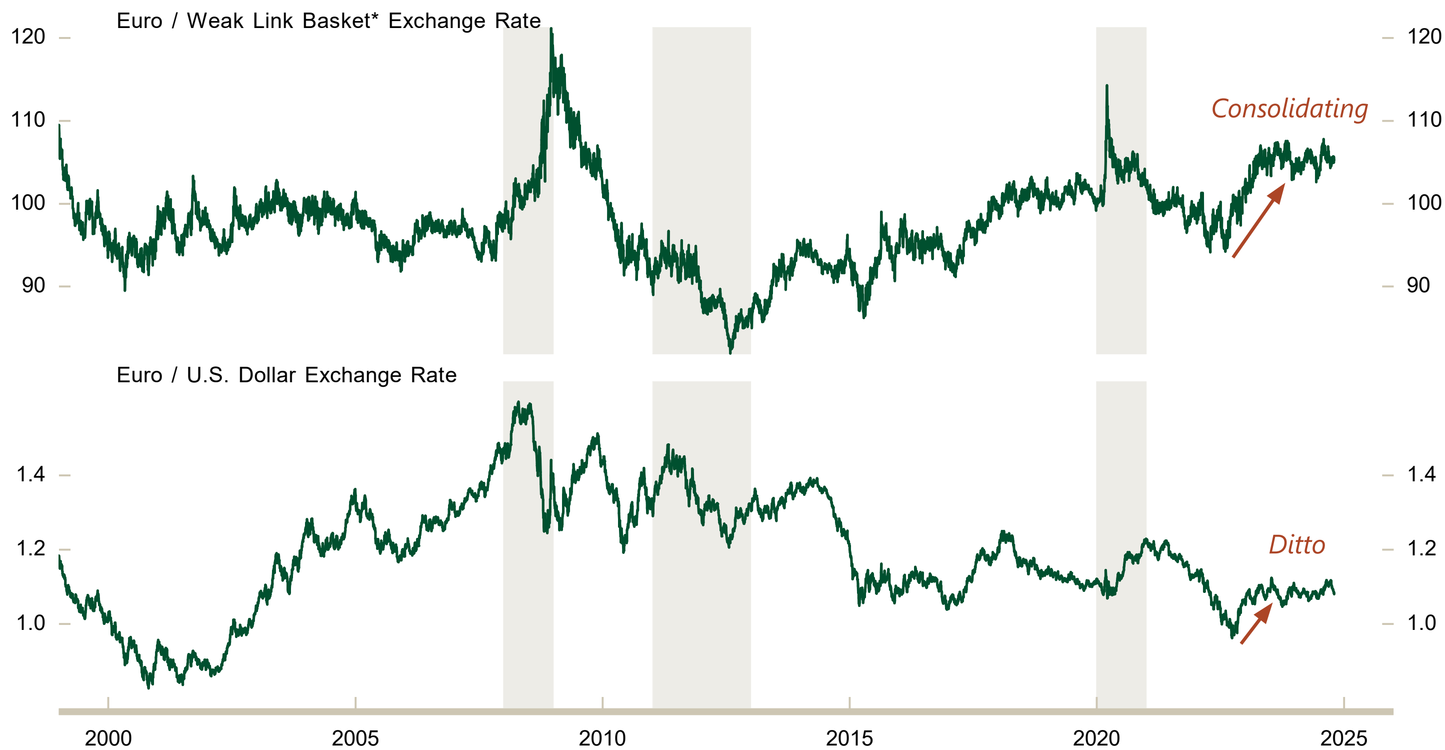
- The drags within the region are not caused by restrictive monetary conditions and the ECB cannot fix the Germany manufacturing sector. However, the central bank can try to provide offsetting support by stimulating other areas of the economy, namely encouraging greater consumer spending.

- Balancing these forces out, we are neutral on the euro area within a global (currency hedged) government bond portfolio[2]. Within the euro area, we expect that the material improvement in the SEU-4 economies will ensure that their government bond spreads remain tight versus German bunds (i.e. the anchor within the region).

Macro fundamentals should keep SEU-4 spreads tight vs Germany

[2] **MRB:** "*Weekly Macro Strategy:Policy Rates Rose, But Financial Conditions Stayed Positive*" October 18, 2024

Chart 14 The EUR Should Appreciate Over Time, Especially Versus The Weak-Link Currencies



* Equally-weighted aggregate of AUD, CAD, GBP, NOK, NZD and SEK
Note:Shaded for Center for Economic Policy Research-designated euro area recessions

Currency (chart 14)

Favor the euro currency but the next upleg will likely take stronger economic activity in France

❍ The euro currency has consolidated its gains on the back of greater expectations for ECB rate cuts and disappointments in aggregate growth prints (albeit mostly led by Germany). We still favor the euro over the expensive U.S. dollar on a 6-12 month horizon and expect relative growth trends to progressively support the currency, especially compared with currently depressed investor expectations for the region. However, material appreciation will likely await evidence that France and the overall euro area economy are gaining greater traction.

❍ That said, our preferred currency bet is to favor the euro over currencies that are exposed to economies that have housing bubbles and overleveraged households. These economic "weak link" currencies include the Australian, Canadian and New Zealand dollars as well as the Norwegian krone. ***MRB's Foreign Exchange Strategy*** is already positioned accordingly[3].

❍ We also have two long euro positions in the **MRB *TradeBook***, which include long EUR/CAD (up 10%) and long EUR/USD (up 7%). We recommend holding on to these currency positions as further upside is likely.

Santiago Espinosa I Strategist, Foreign Exchange & Absolute Return

[3] **MRB:** "***Global Foreign Exchange: Fed-Induced U.S. Dollar Weakness For Now***" September 5, 2024

MacroResearchBoard

mrb partners

Independent Investment Strategy

MRB - The Macro Research Board is a privately-owned independent top-down research firm that provides integrated, global, multi-asset investment strategy as well as actionable absolute and relative return ideas. Our views incorporate a long-term outlook based on in-depth thematic research, together with a rigorous set of frameworks and forecasting models/indicators that drive 6-12 month asset market performance. MRB's team of analysts and strategists leverage the firm's robust research engine and their extensive experience to form one cohesive house view and ensure that investment strategy is articulated in a client-friendly manner.

London
24 Old Bond Street, 3rd Floor,
London, W1S 4AP, United Kingdom
Tel (+)44 (0) 20 3523 9618

Montreal
1275 Ave. des Canadiens-de-Montréal, Suite 500
Montreal, Quebec H3B 0G4, Canada
Tel +1 514 558 1515

New York
1345 Avenue of the Americas, FL 2
New York, NY, 10105, United States
Tel +1 212 390 1148

For more information, please contact:
Client Relations
clientrelations@mrbpartners.com

MRB Research Coverage

Weekly Macro Strategy	Global Equity Strategy
Global Macro & Investment Themes	U.S. Equity Sectors Strategy
Tactical Asset Allocation Strategy	Global Fixed Income Strategy
Absolute Return Strategy	Foreign Exchange Strategy
Developed Market Strategy	Commodity Strategy
Emerging Market Strategy	Weekly Webcasts