ALPINEMACRO
A Unique Mind On The Markets

SPECIAL REPORT

May 20, 2024

Club Med Flips The Script

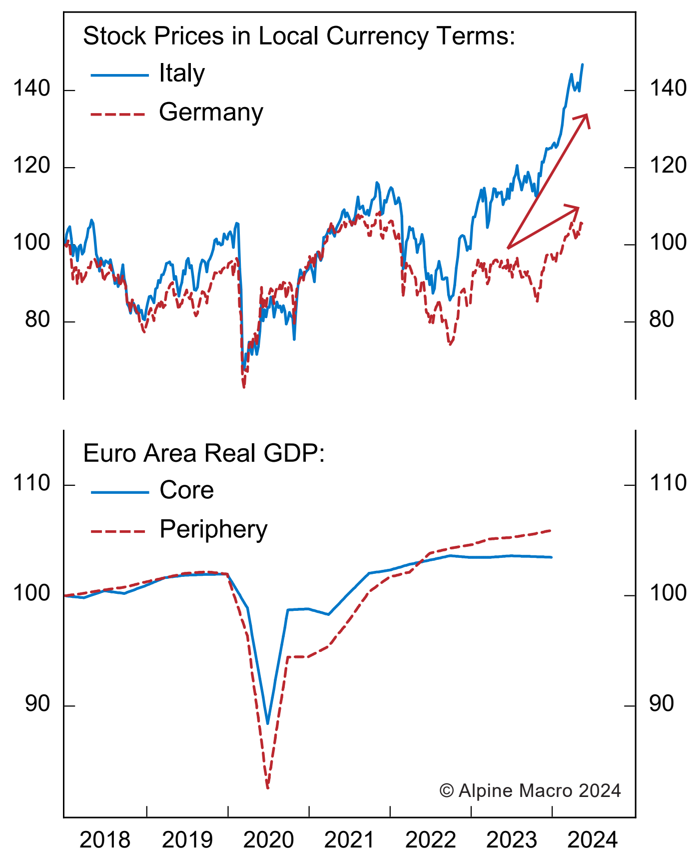
In This Report

- The once troubled economies of southern Europe have largely addressed their severe macro imbalances over the past decade.
- This structural adjustment is positioning the region for growth, free from the specter of economic or financial instability.
- Thanks to a sounder economic footing, periphery economies are fully reaping auspicious cyclical factors.
- These tailwinds include thriving tourism and service sectors, substantial fiscal backing from the EU, and a rejuvenated banking industry liberated from negative interest rates.
- Investors should raise exposure to peripheral euro area economies, particularly favoring Italian stocks given their attractive valuation, improved profitability, and significant weighting in financials.

The southern European states[1] are mounting a comeback. The economic laggards of yesteryear, once hobbled by a sovereign debt crisis and derided for perceived profligacy, are now outperforming the traditional euro area powerhouses (**Chart 1**).[2]

This partly owes to exogenous geopolitical and energy shocks, as well as a Chinese growth malaise, that have disproportionately affected the core economies. Nevertheless, the structural outlook for the periphery has meaningfully improved, enabling the region to capitalize on favorable cyclical tailwinds.

Chart 1 **Breaking Away**



*MSCI Large, Mid & Small Cap
Note: All series are rebased to Jan 2018=100

1 This 'periphery' region comprises Italy, Spain, Portugal, and Greece.

2 This 'core' region comprises Germany, France, Austria, and the Netherlands.

The key takeaway is that investors should consider owning more of their equities given strengthened fundamentals and still-attractive valuations.

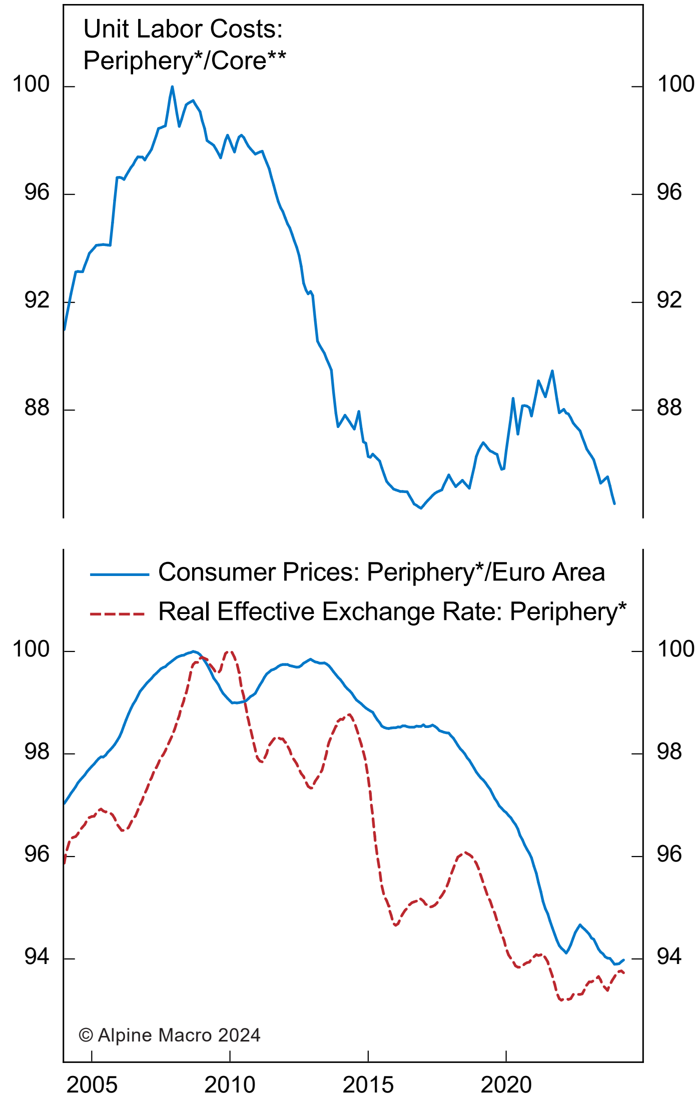
Paying The Piper

Following the debilitating debt crisis last decade, periphery economies sought easier financial conditions and a much weaker euro to alleviate their deflationary pain. The former was hindered by an imposed policy straitjacket, while the latter was constrained by stronger northern economies that supported the common currency. Consequently, the southern economies were forced to go through a brutal internal devaluation, similar to what Germany did in the early 2000s.

This structural adjustment has largely played out through two mechanisms:

1. Significant job losses stemming from the severe economic downturn, along with wage cuts necessitated by debt rescue programs, led to a substantial decline in unit labor costs relative to northern neighbors (**Chart 2**, top panel).
2. Intense deflationary pressures restrained price levels relative to other economies in the euro area, thereby resulting in a sharp exchange rate depreciation in real terms (**Chart 2**, bottom panel).

Chart 2 **A Deep Internal Devaluation...**

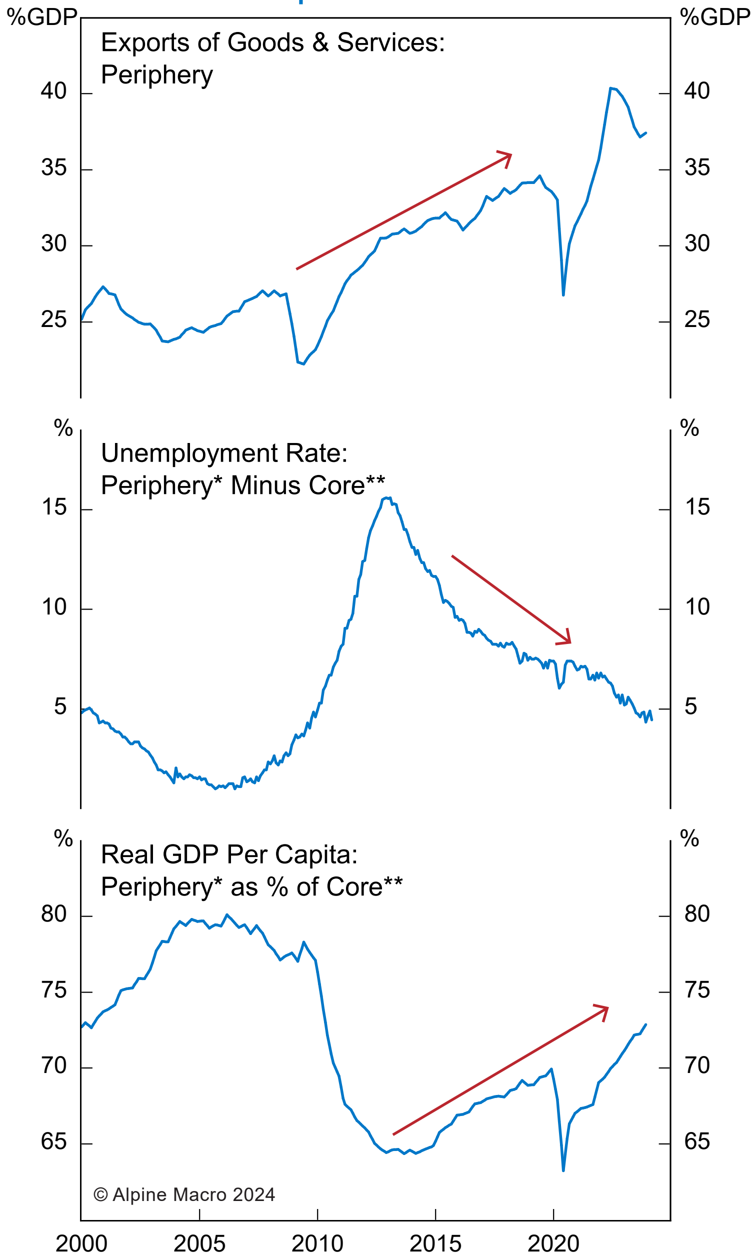


*Median of Italy, Spain, Portugal and Greece
**Median of Germany, France, Austria and Netherlands
Note: All series are rebased to 100 at peak

The combination of wage compression, a falling currency, and other efficiency-enhancing reforms has markedly bolstered the external competitiveness of the southern economies (**Chart 3**):

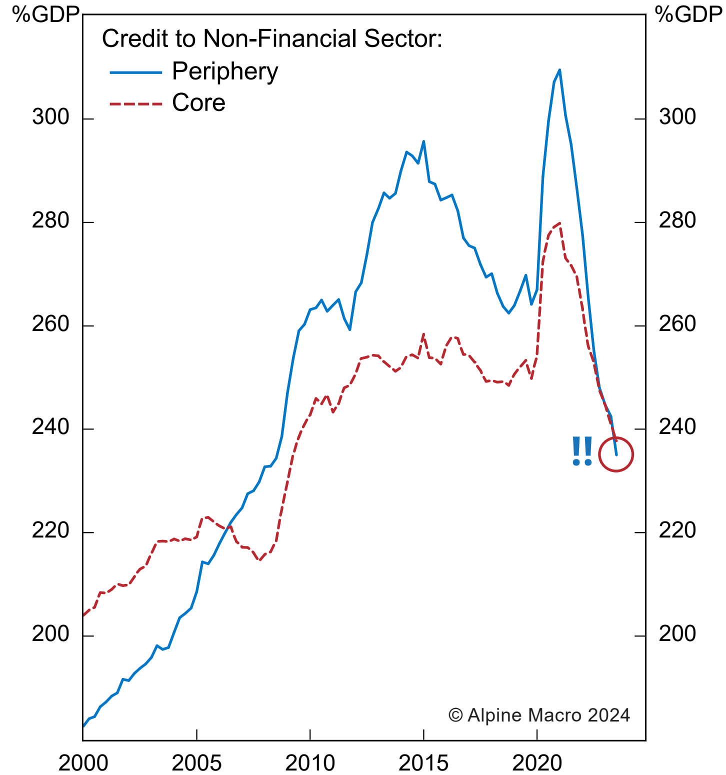
- Exports of goods and services have jumped from about 25% of GDP at the onset of the debt crisis to nearly 40% currently.
- The labor market has healed, with the spread in unemployment rates relative to core euro area economies now returning to levels seen in the 2000s.
- Outside of a pandemic-related distortion, productivity has persistently outpaced that of core economies over the past decade.

Chart 3 ...Has Boosted Periphery Competitiveness



*Median of Italy, Spain, Portugal and Greece
**Median of Germany, France, Austria and Netherlands

Chart 4 Debt-Ridden No More



Source: BIS

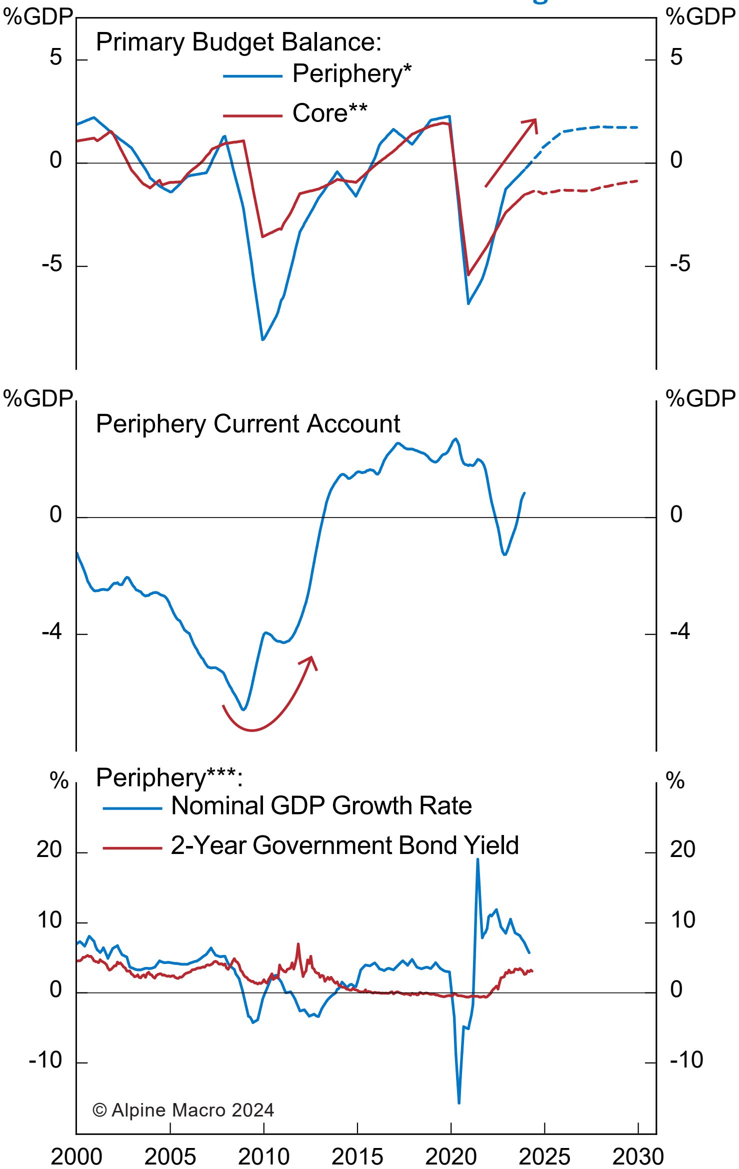
Of course, runaway debt was the primary instigator of the euro area crisis last decade. This meant that any restructuring necessitated a parallel and drastic deleveraging among all sectors of the economy. **Chart 4** illustrates how aggregate credit extended to the non-financial sector has fallen from a peak of nearly 300% of GDP to 235% at present. Incredibly, the debt load of the bloc is now slightly *below* that of the core.

Vastly improved debt sustainability suggests that the region is unlikely to run into the same debilitating solvency issues (**Chart 5**):

- Periphery governments are no longer plagued with large fiscal deficits. In fact, they were already running persistent primary surpluses prior to the pandemic. While the latter blew a hole in their balances, the projection is for further steady improvement, particularly when compared to the core economies.

- The aggregate current account for the periphery is now in surplus, compared to a deficit of nearly 7%

Chart 5 Periphery Finances On A Much Sounder Footing

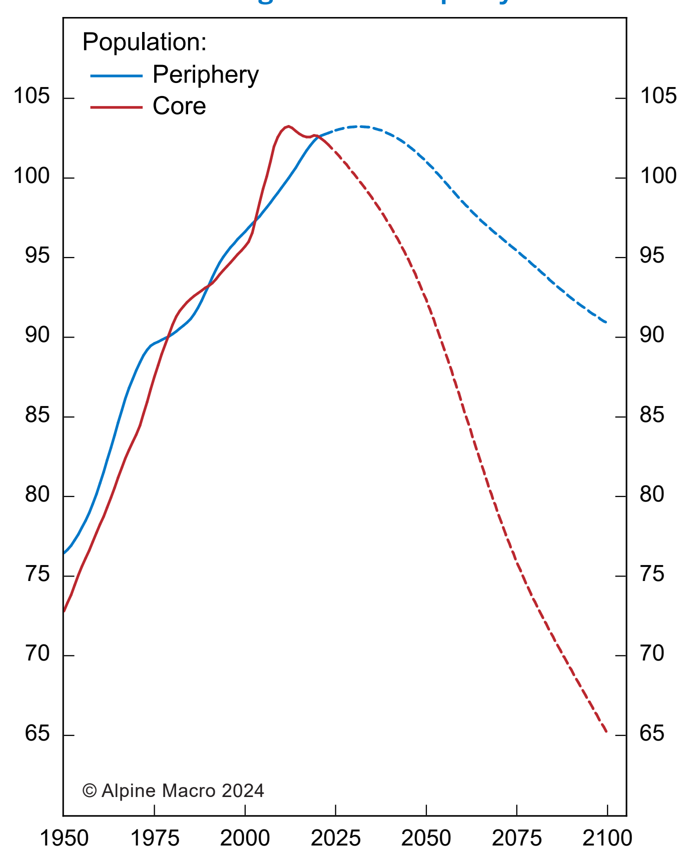


*Median of Italy, Spain, Portugal and Greece
**Median of Germany, France, Austria and Netherlands
***Median of Italy, Spain and Portugal
Note: Dashed lines denote forecasts; source: IMF, OECD, National Central Banks

of GDP back in 2009. Essentially, these economies are now generating excess savings that reduce their reliance on fickle external financing.

- Debt sustainability is reinforced by nominal growth rates exceeding interest rates by a considerable margin.

Chart 6 Poor Demographics A Structural Negative For Periphery



Note: Both series are rebased to 100 at past or expected peak; dashed lines denote forecasts; source: UN Department of Economic & Social Affairs

To be sure, the structural issues of the southern economies have not been completely alleviated. For one, the peripheries face serious demographic headwinds. Their collective population already peaked last decade and is projected to decline much more rapidly than their core counterparts (Chart 6). Governments will need to encourage immigration and greater labor force participation to offset a shrinking workforce and tax base.

Bottom Line: southern Europe's severe macro imbalances have been largely corrected, thereby priming the region for growth without the looming threat of economic or financial instability.

PIGS Can Fly

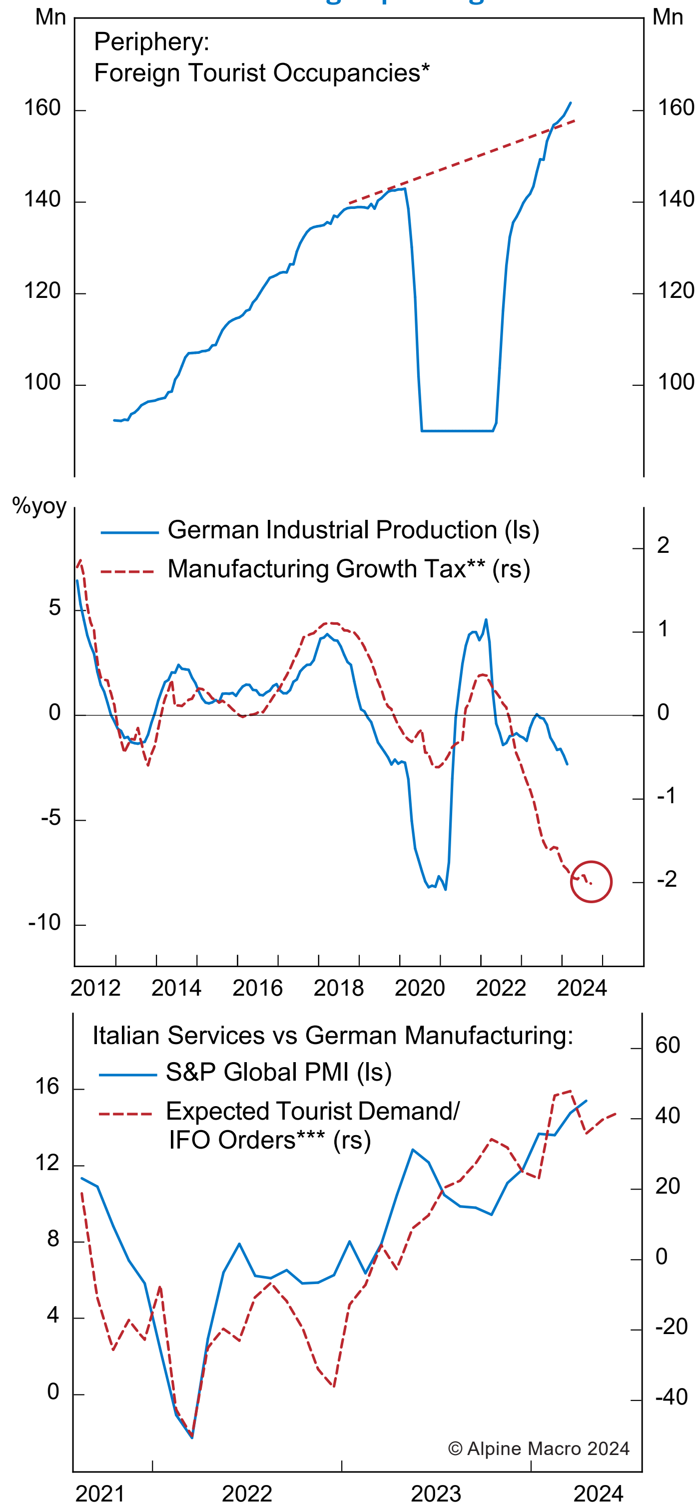
Though the periphery is now on sounder economic footing, it is a confluence of *cyclical* factors which have allowed it to steal a march on the rest of Europe in recent years. Fortunately for these economies, these tailwinds should either endure, or at the very least, not morph into headwinds.

As service-oriented economies, the peripheries have adeptly capitalized on the post-pandemic shift away from goods consumption. This shift, along with having a cheap currency in real terms, is fueling a tourism boom that is lifting economic activity across the region. The impact should not be understated, as tourism accounts for a substantial 7% share of gross value added for the periphery, compared to less than 4% for the rest of the EU. “Revenge spending” among travelers is driving tourist occupancies beyond their pre-Covid trend, with surveys indicating few signs of a slowdown in momentum (**Chart 7**, top panel).

In contrast, industrial-centric euro area economies have been battered by soaring energy costs, a downward swing in Chinese activity, and surging interest rates. Germany, whose manufacturing sector makes up around 20% of GDP, has been particularly hurt. The “growth tax” should continue to weigh on its industrial activity for at least the remainder of the year (**Chart 7**, middle panel).

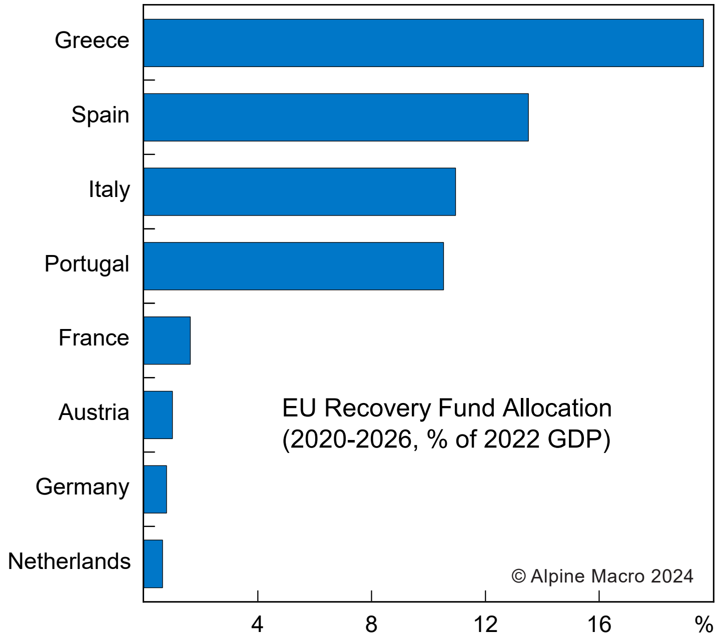
In tandem, surging Mediterranean tourism and a subdued manufacturing outlook across the continent should catalyze a further outperformance of the Italian economy compared to Germany (**Chart 7**, bottom panel).

Chart 7 Italy Is Leveraged To Post-Pandemic “Revenge Spending”



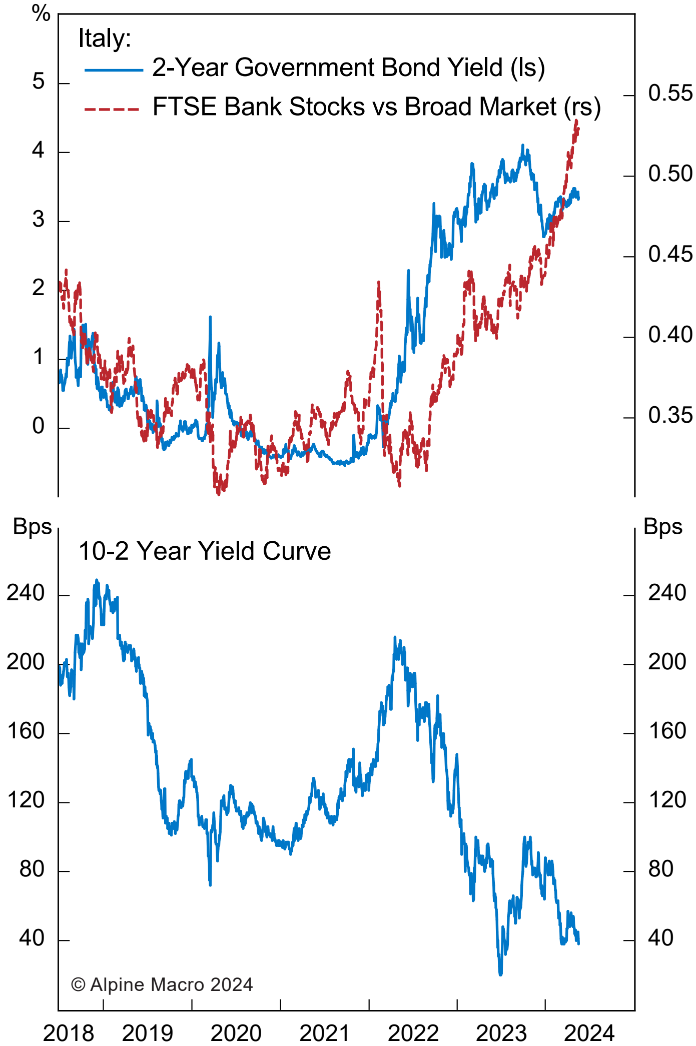
*Truncated at 90; source: Eurostat
**German electricity prices, 2-year bund yields and Chinese manufacturing PMI imports, standardized; advanced by 6 months
***Advanced by 2 months

Chart 8 A Massive Fiscal Tailwind



Source: European Commission

Chart 9 Italian Banks Have Benefited From Positive Yields



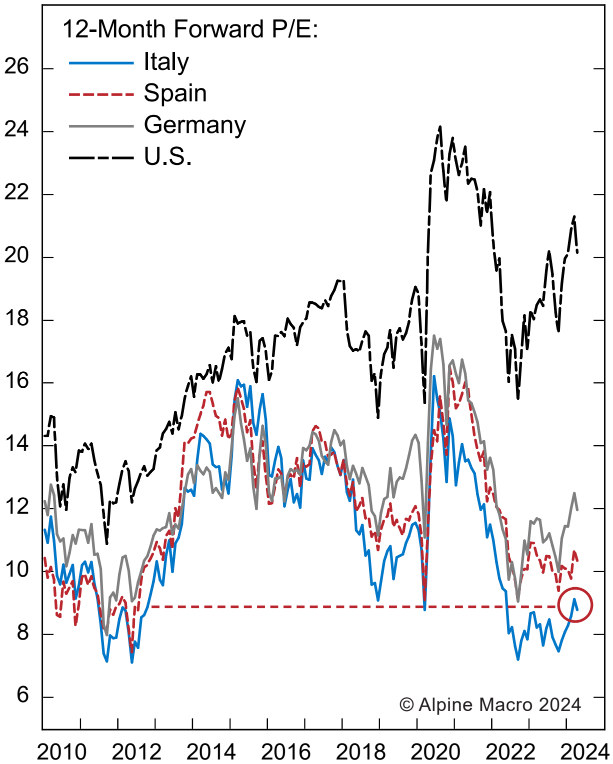
Favorable macro policies are also playing a key role in propping up the periphery.

On the fiscal front, the benefits of the EU pandemic recovery fund are largely flowing to southern Europe. The full disbursement of funds ending in 2026 is economically meaningful, ranging from 9-18% of GDP for the peripheries (**Chart 8**). Italy and Spain have received roughly 50% and 25% of their allotted shares, implying that forthcoming stimulus over the next 3 years should amount to about 5% and 9% of their respective GDP.

As for monetary policy, the rising short end of the curve has not been a one-way negative for the region's banks. Rather, the removal of negative nominal rates has provided relief to the banking sector by halting the erosion of its capital base (**Chart 9**). Looking ahead, the yield curve is likely to steepen as inflation edges closer to target and the ECB resorts to slashing rates. Not only would this enhance banks' profitability, but it would also aid loan origination and further catalyze growth in the periphery economies.

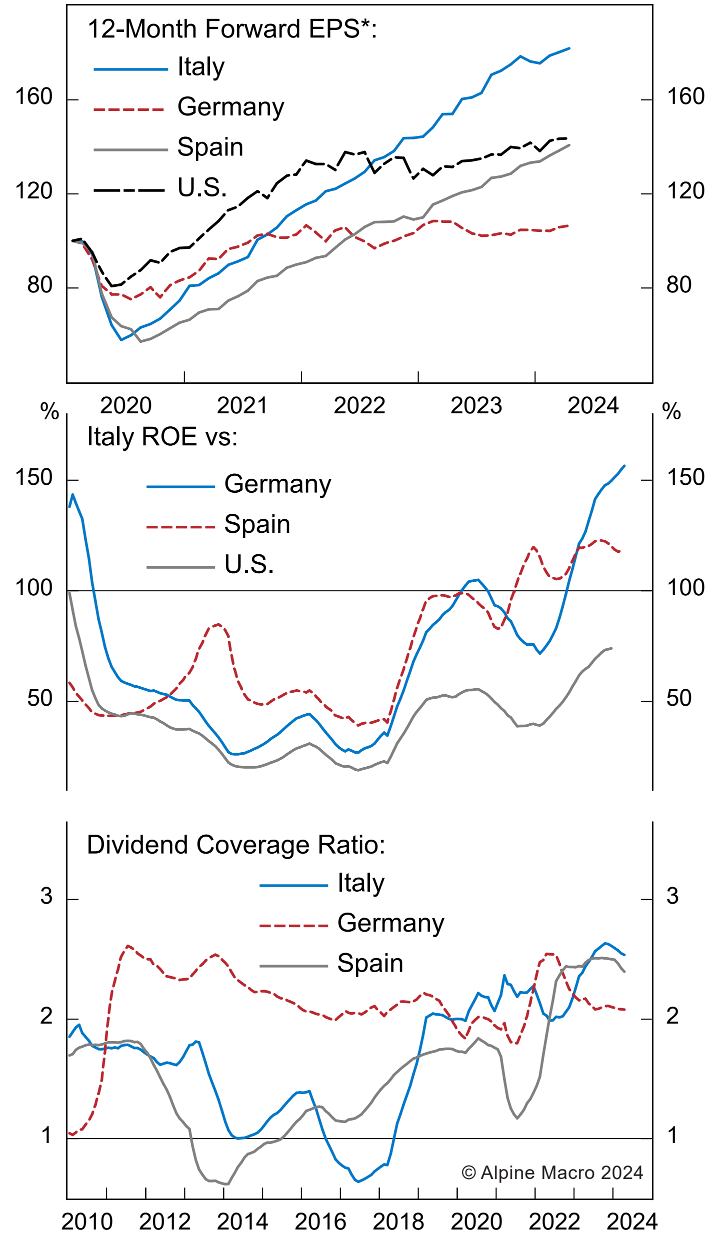
Bottom Line: favorable cyclical factors have upheld growth in the periphery economies. They include greater exposure to flourishing tourism and services industries, generous fiscal support from the EU, and a revitalized banking sector liberated from negative interest rates.

Chart 10 Italian Stocks Offer Compelling Value...



Source: MSCI

Chart 11 ...Enhanced Profitability...



*Large, Mid & Small Cap; rebased to Jan 2020=100
Source: MSCI

Investment Implications

Given their propitious macro backdrop, investors should consider owning the equities of southern euro area economies. Among these, Italian stocks hold particular appeal for the following reasons.

First, Italian equities are priced highly attractively, even after their recent streak of outperformance. They currently trade at 9X forward P/E, just marginally higher than their levels during the peak of the debt crisis (**Chart 10**). This compelling valuation carries over on a cross-sectional basis as well, sitting nearly 30% below Germany and a striking 60% below the S&P 500.

Second, strengthening fundamentals strongly refute the notion that Italian stocks are a value trap:

- 12-month forward EPS is surging and is now 80% above the readings seen just prior to the pandemic (**Chart 11**, top panel). This stellar performance has even trounced the U.S., where earnings expectations have risen by just 40% in comparison.

- Since 2018, the return on equity (ROE) of Italian firms has staged a pronounced rebound from extremely depressed levels (**Chart 11**, middle panel). It has recently surpassed the ROEs of Germany and Spain, while reaching 75% of U.S. levels compared to an all-time low of 20%. This points to improved efficiency in utilizing equity capital and a higher likelihood of sustaining profits over the long term.

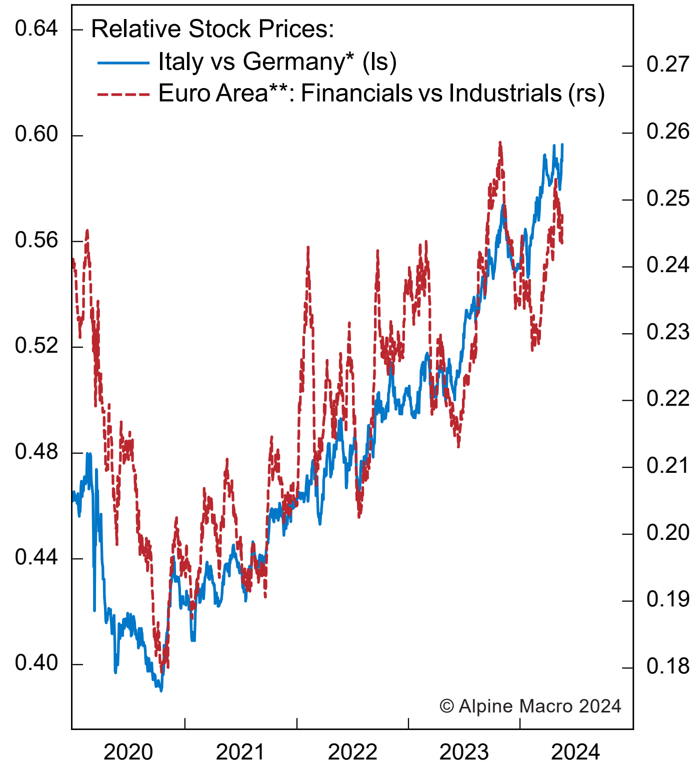
- Italian equities offer a chunky dividend yield of 4.6%, compared to 4.2% for Spain and 3.3% for Germany. Crucially, the Italian market now boasts a leading dividend coverage ratio of 2.5X, a drastic improvement after having fallen below 1X last decade (**Chart 11**, bottom panel). Firms are therefore likely to sustain dividends in the future, or even potentially increase them.

Finally, equity performance is often tied to a bourse's sectoral composition. **Chart 12** demonstrates the outperformance of Italy's financials-heavy market compared to Germany's industrials-focused one. As noted above, forthcoming ECB rate cuts should steepen yield curves and fatten bank profits. Conversely, the industrial sector may continue to lag due to sluggish Chinese growth and persistently high energy costs. Italian stocks stand to benefit.

Bottom Line: investors are advised to raise equity exposure to the periphery euro area economies. Favor Italian stocks given their attractive valuation, enhanced profitability, and large weighting in financials whose next leg of outperformance will come from a steepening yield curve.

Bassam Nawfal
Chief Asset Allocation Strategist

Chart 12 ...And A Sizable Weighting In Surging Financials



*MSCI Large, Mid & Small Cap
**Source: FTSE
Note: Returns are expressed in local currency

Investment Recommendations						
Tactical Investment Positions (3 - 6 months)						
Recommendations	**Open Date**	**Open Levels**	**Stop**	**Closing Date**	**Closing Levels**	**P&L Since Inception**
Long 10-Year German Bunds/Short 10-Year JGBs	08/07/2023	2.6%/0.62%	-	-	-	4.4%
Long U.S. Regional Banks (ETF: KRE)	12/04/2023	48.12	45	-	-	8.1%
Long Latin American Equities (ETF: ILF)	12/04/2023	27.78	25	-	-	5.7%
Long Russell 2000 (ETF: IWM)	01/08/2024	196.73	185	-	-	6.0%
Long Chinese Equities (ETF: MCHI)	03/04/2024	38.91	Rolling -8%	-	-	20.3%
Long Gold (ETF: GLD)	04/01/2024	207.82	-	-	-	7.6%
Long S&P 500 Energy (ETF: XLE)	03/25/2024	93.26	-	-	-	1.8%
Long Italian Equities (ETF: EWI)	04/08/2024	37.36	-	-	-	5.3%
Short 10-Year JGBs	04/29/2024	0.83%	-	-	-	0.3%
Short EUR/USD	04/29/2024	1.07	-	-	-	1.3%
Long Nikkei 225 Hedged	05/06/2024	38,835	-	-	-	0%

Note: P&L is calculated using daily closing prices.

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