Why Europe Is Still Broken

Back in the day, playing European markets was a simple game. Industrial production across the European continent tended to rise and fall, pretty much in lock step with Germany’s IFO index of business activity. This relationship broke down with the creation of the euro and fully fractured after 2007. For example, consider yesterday’s worse than expected French industrial production, even while Germany continues to power ahead.

The pattern we have seen over the last decade has been a structural rise in German industrial output and a parallel decline in the industrial activity achieved by the rest of the eurozone’s main economies. My short form explanation of this predictable and yet depressing trend has been: “Too many houses in Spain, too many civil servants in France, too many factories in Germany.” The result of this changed European landscape is that investors need a different mindset when assessing leading indicators and surveys. The new formulation seems to run thus:

- When the IFO rises, German industrial production duly goes up. But when the IFO declines, German industrial production these days merely “stabilizes” rather than outright declining;
- Since 2007 a rise the German IFO has resulted in the industrial production of other eurozone nations falling, but less quickly (hooray!). And when the IFO has declined, industrial output outside of Germany has fallen far more rapidly than it did in the past.

This relationship is similar to the transmission mechanism you would expect under a gold exchange standard with the productivity of labor and capital growing faster in Germany than its neighbors.

The interesting thing is that the median cost of capital across the eurozone has not changed significantly during the crisis period; what has shifted is the dispersion around that median. And the countries which are on the wrong side of the spread have seen interest rates remain above their economies’ structural

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Checking The Boxes

Our short take on the latest news

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<th>Fact</th>
<th>Consensus belief</th>
<th>GK Research reaction</th>
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<td>UK unemployment rate fell to 7.7% in Jul, from 7.8% in Jun</td>
<td>Better than expected hold at 7.8%</td>
<td>Stronger UK data recently has raised expectations of early rate hikes in 2015</td>
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<tr>
<td>French current account deficit worsened to €3.2bn in Jul, from €1.4bn in Jun</td>
<td>N/A</td>
<td>More concerning is the poor growth rates of imports, exports, IP...</td>
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<tr>
<td>French govt unveiled 2014 budget with 80:20 mix of spending cuts to tax rises</td>
<td>Budget deficit now seen at 4.1% in 2013, up from 3.9% agreed EU target in April</td>
<td>Not enough; does little to address high labor costs; economic outlook weak</td>
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<td>Malaysia IP rose 5.4% YoY in July from revised a 3.7% in June</td>
<td>Better than expected 4.9%; led by mining (15.4%) and electricity (6.2%)</td>
<td>Sustained uptrend to confirm improving export outlook for 2H13</td>
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growth rates. The result is a massive deleveraging of the private sector, offset by a huge increase in state spending in the likes of France, Italy, and Spain, etc. The logic of the system is inherently at odds with the budgetary stipulations set within the Maastricht criteria. Hence, so long as interest rates are set way above the growth rate, “austerity” must fail miserably.

This system is inexorably causing the destruction of the industrial bases in Italy, France, Spain and the others. The lost revenues from productive activity is for the moment offset by Germany (together with the likes of Japan, Qatar and Saudi Arabia) accumulating financial assets issued by the governments of those nations that face slow strangulation. It can’t last.

A while ago, I argued that Germans might as well load much of their auto exports headed to eurozone countries on to a boat and sink it outside of Hamburg. It would do as much good as selling Audis in exchange for IOUs issued by bankrupt countries. But no problem—now those IOUs are held by the European Central Bank as shown by the still high Target 2 balances. Of course, what this really means is that no one really knows who is going to take the final loss and so the game continues (and this is the difference with a gold standard where cycles end with a simple depletion of the gold inventory).

The end game will come when sovereign nations inside and outside Europe stop accepting this rotten paper. This denouement will ultimately be a political decision which is hardly my area of confidence.

What I would say to those tempted by Europe’s “attractively valued” markets, is look elsewhere (US, UK, Sweden, Japan, dim sum bonds, etc.). For those who must be invested in the eurozone, continue to buy the equities of those companies which have managed to escape this death trap (a fair number of international best-in-class firms are listed in France) and buy German bonds as a hedge. This is a conditional recommendation since German bonds remain extremely expensive and my preference for a hedge is increasingly attractive US long bonds.