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## Europe Rejects Austerity; ECB Warming Up Its Printing Press

Europe's recent elections have unsettled financial markets due to uncertainty over the future course of European economic policy. The focus has been predominantly on Greece because of the risk that new leadership will reject austerity commitments and potentially default on Greece's debt. Despite these concerns, we believe that last year's write down of Greek debt has largely prepared the European banking system for default, with the primary risk of loss shifted to government sponsored lenders such as the International Monetary Fund (IMF), the European Central Bank (ECB) and the European bailout fund. Furthermore, we believe ECB President Mario Draghi would act forcefully to limit any resulting liquidity problems on the global financial system. Thus, we think any shifts in Greek policy would have only a temporary impact on financial markets.

By contrast, we believe that the election of Socialist candidate Francois Hollande as President of France is likely to have more profound and long-lasting effects on financial markets and the global economy. If Hollande's party receives a majority in June's parliamentary elections, as polls currently suggest, then his election is likely to mark the end of austerity policies in Europe. Specifically, Hollande is likely to push for a far more activist monetary policy by the ECB ("stealth" quantitative easing).

Contrary to the hopes of his electorate, we do not think that Hollande's policies will improve France's economic prospects, and his retreat from structural economic reform may keep French equity markets depressed (as well as any other European markets that follow France's lead). [However, a more aggressive ECB could greatly improve growth prospects for Germany and developed economies outside of the Euro bloc \(especially the US and the UK\).](#) [In addition to its economic impact, ECB quantitative easing should ultimately prove supportive of global equity markets and "weak" Europe's bond markets.](#)

### THE END OF HOOVERNOMICS

The dominant Euro bloc economies -- Germany and France -- have been united in their approach to the European debt crises for the past four years. German Chancellor Angela Merkel and French President Nicolas Sarkozy forcefully advocated a combination of government spending cuts, tax increases, and a relatively restrictive monetary policy as the solution to Europe's debt woes. We have dubbed this policy mix "Hoovernomics" due to its similarity to the Hoover administration's mistakes in the early 1930s. Thus far, this policy prescription has proven no more successful in the 2010s than in the 1930s, and European voters are rebelling against politicians advocating this "tough medicine" approach to Europe's debt problems.

In his campaign, Hollande promised to refocus European economic policy on growth rather than austerity as a solution to debt problems. As a left-of-center politician, Hollande defines growth policies almost exclusively as new government spending initiatives (such as his promise to add 60,000 government workers). He strongly opposes the kind of labor market and regulatory reforms that have proven successful in promoting

growth in Germany. However, crippling debt burdens create a daunting obstacle to Hollande's vision for a European growth initiative – while France may be able to finance new spending initiatives, the fiscal reality facing most other highly indebted European economies is that markets will not lend them the money to continue running large budget deficits.

Without new sources of government funding, fiscal stimulus simply is not an option for Spain, Italy, Ireland, and the other peripheral euro zone nations. Such financing could be possible if Germany was willing to provide credit guarantees (e.g., euro bonds) but German taxpayers are understandably opposed to such a solution. This need for new sources of government funding explains Hollande's insistence that the ECB substantially increase its purchases of government debt.

*We wouldn't be in such a mess if the European Central Bank very early on had massively bought sovereign bonds. ...It would be much simpler if the central bank could just directly fund the debt of European countries.*

*Francois Hollande April 16, 2012*

*Source: Bloomberg News*

Hollande wants the ECB to use its monetary printing press not just to prop up European banks (as in the recent €1 trillion Long Term Refinancing Operation), but also to provide funding support for European governments through large scale purchases of their bonds. The Federal Reserve and Bank of England have each provided such funding support (a policy known as quantitative easing, or QE), thus enabling the US and UK governments to borrow at extremely low rates despite record peacetime debt loads and budget deficits.

#### **“STEALTH” QUANTITATIVE EASING**

Large-scale government bond purchases by the ECB would monetize the deficit spending of troubled borrowers such as Spain and Italy, and could reduce the pressure for painful budgetary and economic reforms. Prior to Hollande's election, France and Germany were united in their opposition to QE. With Hollande's election, especially if supported by gains in June's parliamentary elections, Germany becomes the primary obstacle to European adoption of more aggressive monetary policies.

Using ECB money printing to finance large scale government bond purchases would create a theoretically unlimited new source of demand and largely eliminate the risk of default by Spain or Italy, in our view. Thus QE could substantially lower borrowing costs across Europe. Lower rates would reduce the impact of interest payments on both Spain's and Italy's budgets, allowing higher government spending levels without necessarily increasing the overall budget deficit.

Standing in the way of these potential economic benefits would put Germany under intense political pressure. German policymakers will need to choose between:

1. Remaining the lone advocate for a conservative monetary policy;
2. Bowing to overwhelming political pressure and allowing QE; or
3. Leaving the European Union.

Without French support, we do not believe that Germany can continue to dictate economic policy for the rest of Europe. Furthermore, we believe that the political and economic costs of abandoning the euro are too high to be a viable option. Indeed, Chancellor Merkel is currently exploring a political coalition with parties advocating even tighter European economic integration. We believe that German policymakers will ultimately accede to large, persistent but *quiet* ECB sovereign debt purchases. The Federal Reserve and the Bank of England formally announced their QE programs and provided specific targets for their government bond purchases. More opaque policy announcements from the ECB might help make the strategy more palatable to Germany by providing some degree of political cover (i.e., “stealth” QE).

**INVESTMENT IMPLICATIONS**

Quantitative easing in Europe – whether stealthy or overt – would be broadly supportive of risk assets as the deflationary discount due to European Hoovernomics is removed from global financial markets. Undercapitalized European banks have scant capacity to recycle printed money into additional loans, lowering the initial risk of QE’s inflationary impact. However, the euro would continue to decline if the ECB aggressively increases the supply of its currency.

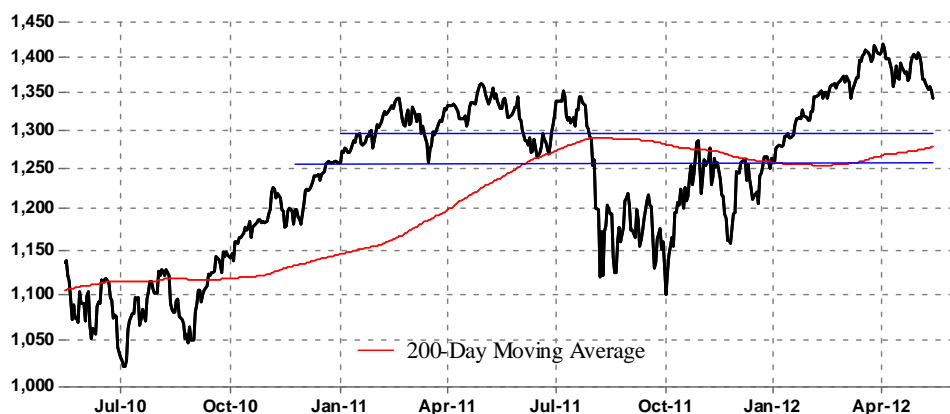
By crafting monetary policy for its weakest members, the ECB would create a windfall for Germany, in our view. Germany’s export machine would kick into a higher gear thanks to renewed deficit spending power in its European trading partners and the competitive advantages, relative to the rest of the world, of a lower euro. This added sales and earnings momentum should be more than sufficient to allow rising German stock prices to offset the negative impact of a lower euro on US investors.

Other European stock markets should also benefit from a more aggressive ECB, but earnings growth and price appreciation may be limited by Hollande’s (and potentially Italy’s and Spain’s) retreat from productivity enhancing economic reforms. Earnings could also be inhibited by significantly higher marginal tax rates. Thus, stock market gains outside of Germany are more likely to be partially or completely offset by a declining euro.

Bonds of the weaker borrowers (especially Spain and Italy) are likely to rally in response to stealth QE, but the bond markets that have been used to hedge deflation risks (those of the US, UK, and Germany) could suffer from rising rates as risk premiums are reduced. Gold and other precious metals should find support as the increased supply of money finds its way into financial markets.

The short-run uncertainties created by the European elections may overshadow these long-term market benefits. The current market pullback could continue until after Greece’s status is resolved, France’s parliamentary elections are concluded, and Germany’s acceptance or rejection of QE has become clear. However, we believe that the ultimate result of the recent European elections – stealth QE by the ECB – is yet another reason for this summer’s pullback to be far milder than the steeper declines of the summers of 2010 and 2011, with strong support for the S&P 500 between 1260 and 1292 as shown on the chart below. We think the S&P 500 will finish the year near the high end of our 2012 trading range at 1450.

**S&P 500**



Source: FactSet Research Systems; Past performance is no guarantee of future results.

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