EUROZONE

FISCAL POLICY LAGGING BEHIND MONETARY POLICY

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MACRO | ECONOMY | EQUITY MARKET

Fiscal Policy dragging Eurozone's growth

The Eurozone's economy appears to be at an inflection point. But its future is based upon policy reforms within the central bank and within individual countries. Unlike other markets, where we have opinions to over and under-weight the equity markets, we think there is too much risk to take an outsized bet. Hence, we think it is prudent to continue our Neutral weight recommendation on the Eurozone. Our top ETF and Unit-Trust recommendations are at the back of this report.

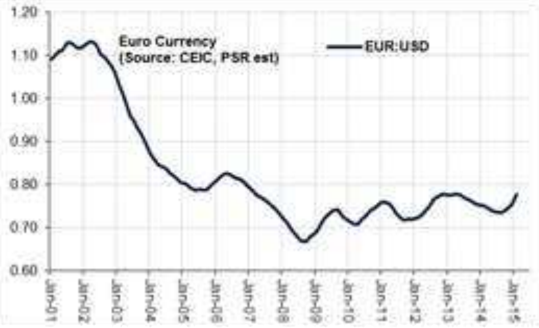
The economy is poised to show some positive growth this year, supported by a budgetary policy that should be less restrictive than in recent years. The region has been volatile in past few months, but confidence surveys among consumers, investors and businesses have all risen beyond market expectations. The Eurozone's recovery should shift toward domestic consumption as the recovery progresses barring any economic shocks. Households are set to benefit from lower energy prices. Low crude oil prices should boost net household income by at least 0.3% in 2015. These factors will support a more robust pace of household spending growth this year.

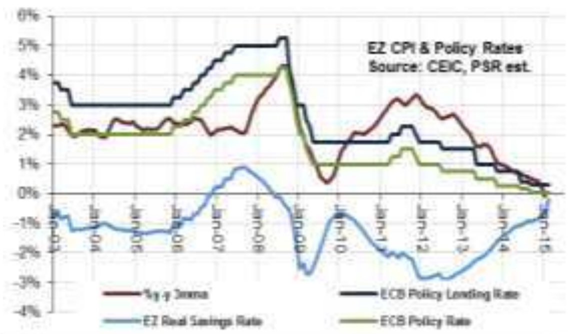
An increasingly supportive credit cycle should help the Eurozone's economic recovery with growth in money supply accelerating and lending conditions improving on trend. The euro has weakened sharply in recent months since the ECB's quantitative easing announcement and the Swiss National Bank's end to its exchange rate peg.

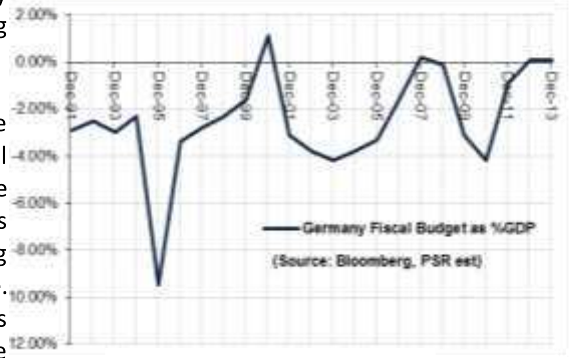
Spain, Portugal, Estonia, and Finland are having elections this year, following after the colorful results in Greece. We do not believe that the incumbents will remain in power. There is a good chance that the policy consensus will be debated, and that this will lead to serious political tensions between the eurozone countries like what we saw by the win of Syriza in Greece.

The ECB's achieving its inflation target will not be easy because other Eurozone policymakers are focused on generating economic growth. So far, ECB has played a significant role in strengthening the institutional framework of the eurozone in recent years. For example, an amended Stability and Growth Pact (SGP), the introduction of the European semester, and the formation of the banking union should lead to more effectively managed Eurozone. It has also managed to stir the economy by implementing extraordinary loose Monetary Policy through both conventional and unconventional methods. However ECB's problem is that, while it can buy time by intervening in the financial markets, it cannot do anything about the underlying structural problems in the eurozone. Only the politicians can do this.

This is why it is especially disappointing that national politicians in most of the large member state in many respects have failed to build upon a structure to bring fiscal stability in the region. The economy with the best cyclical position remains to be Germany. The country's government budget is in balance, its government debt is declining and unemployment is low and therefore ample potential for stimulating economic growth, for example through useful investments in physical infrastructure. However it does not look as though this is on the cards at the moment. Germany is also not making much progress on structural reforms. The relatively favorable developments in recent years are mainly due to the reforms made by Gerhard Schröder (the predecessor of Chancellor Angela Merkel). Since that time, Germany has shown little or no policy leadership with regard to the economy.

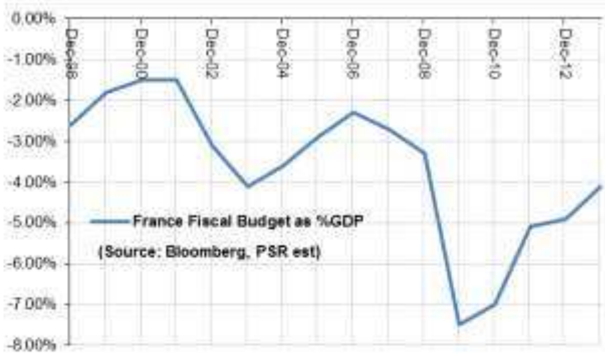




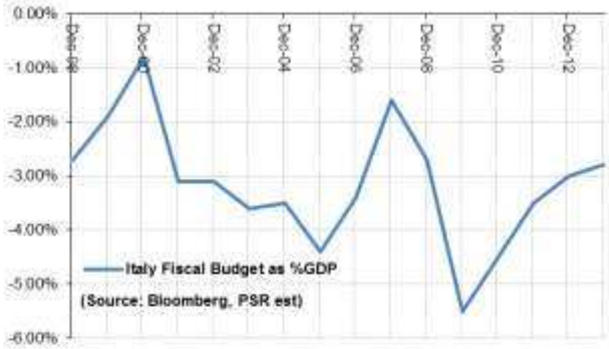


Osama Bakhteyar
osama@phillip.com.sg
+65 6531 1793

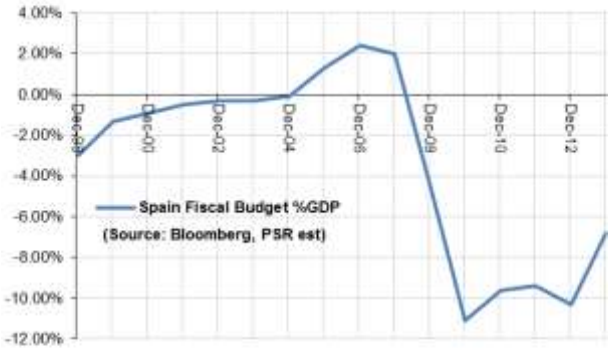
The lack of policy leadership from Germany is a significant factor in the weak growth generated by the eurozone. Unfortunately, Germany is not alone. France, Europe's second largest economy, is not pursuing a decisively business-friendly policy either. Economic growth in France should mainly be generated by private consumption and government spending. We do not expect any recovery in 2015 French business investment. Unemployment is stagnant at over 10% and government finances are developing negatively, with a deficit of over 4% of GDP and government debt that is approaching 100% of GDP. France is also lagging far behind in regards to economic reforms that are desperately needed. The country features weak government finances, an inefficient labor market and extensive bureaucracy. Years of lack of reforms mean that the country now has almost no room in its fiscal budget to ease the painful short-term effects of structural reforms with more spending.



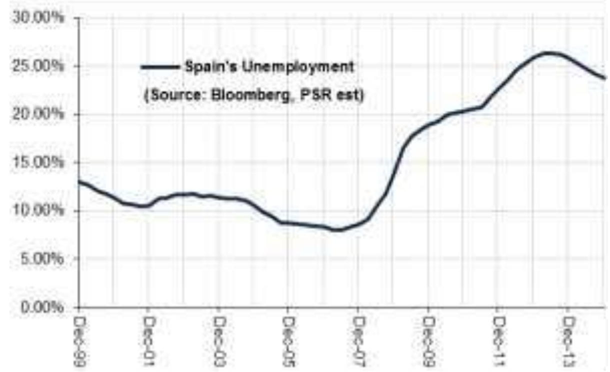
Italy's economic growth story is in the margin of error of stagnation. Unemployment is rising further and government finances are weak. The Italian budget deficit of 2.5% of GDP is below the 3% norm, but the country's already excessive government debt should rise further in 2015 to around 140% of GDP. The country has a long way to go in dealing with its problems, since as in France much maintenance work is well overdue. Italy also still has a lot of bureaucracy, a poorly functioning labor market and a relatively rapidly ageing population. Much needs to change, and Italian politics are so sluggish that everything could still go wrong.



In contrast, the Spanish economy appears to be improving already as domestic demand is helped by declining unemployment, readily available financing, greater consumer confidence and lower oil prices. The nearly 4% fall in unemployment expected from 2013 to 2015 is also impressive. Falling oil prices and monetary intervention by the ECB should translate into higher economic growth and less deflation by pushing private consumption and investment further. Government finances are slowly but steadily recovering, but the country is not yet out of the danger zone. While the growth comeback in Spain has been impressive, it remains premature in our view to assume that a truly self-sustaining recovery has taken hold. The recent popularity of Podemos might hurt equity investors with increase in volatility. We will be issuing separate short report on Spain soon.



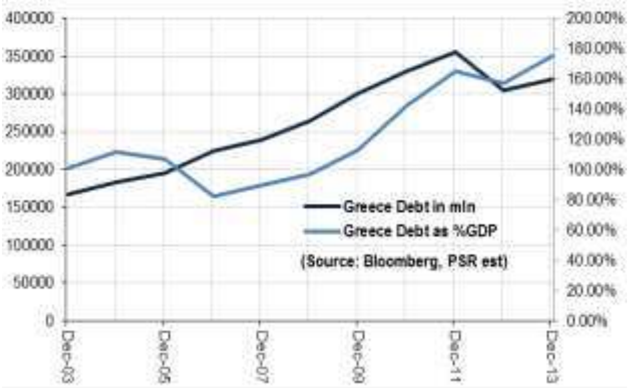
While the more successful policymakers are encouraging private domestic consumption (spending and investment). Eurozone policy focus has been on reorganizing government finances, at the expense of domestic spending (eg, austerity). Eurozone remains relatively strong compared to most of the rest of the world. However, Eurozone's institutional framework is incomplete. It still has its key weakness: the Bloc's monetary policy (driven by troika) is not connected to fiscal policy, which is still determined by democratically elected sovereign governments.



The eurozone member states, particularly the smaller ones, would be prudent to maintain a wide margin to their maximum deficit ceiling of 3% under the SGP framework. Even before the introduction of the euro, there were warnings that the smaller member states faced a risk that their economic cycles would be out of step with the European average. The ECB sets its monetary policy on the basis of the eurozone average, which in practice means that it focuses on price developments in the large member states. So it is very much possible that policy will not be appropriate to the economic development of the smaller countries. This means that the smaller countries need greater flexibility in their budgetary policy, while the SGP imposes strict budgetary norms. We also have to recognize that even countries that behaved properly with respect to budgetary policy in the run-up to the crisis like Spain and Ireland can still encounter serious problems due to large savings deficits building up in the private sector.

Analysis on Grexit

In Greece Syriza came out as a winner marking a watershed moment for Europe where the political constraints of the current austerity-led bailouts are becoming apparent. The Greek electorate has called time on policies that have led to severe economic hardship while delivering little in terms of reform. It is far too early to say what the outcome of the negotiation process might be between the Greeks and the Troika. The next few months represent a difficult time, with northern European governments making few concessions, while Syriza will demand changes to the existing arrangements.



We believe a Greek exit (Grexit) is a scenario that all parties want to avoid. It would be economically disastrous for the Greeks, might cause cascading crises of confidence in some of the Eurozone's weaker economies, and would probably cause a shock to global economy. However, this should be considered a lower probability scenario. However, failure to reach a mutual agreement cannot be ruled out.

Grexit – We think that Grexit is unlikely. But assuming Grexit happens, there could be some serious implications to that. Mostly the negative consequences would be to Greece itself that will be secluded from further funding by the ECB, EU or IMF. Even if Syriza were to provoke such an outcome in the coming months, we would expect strong financial stress in the form of a bank run and another round of new elections before an exit could happen. You would see very high inflation, a collapsing drachma, and significant loss in real household earnings.

For Europe, even without a complete breakdown of the euro, a Greek exit will leave the ECB holding billions of dollars of Greek debt and few options. The euro could face devaluation and leave Eurozone countries vulnerable to masses of investors retreating to safer shores. The fragile Eurozone has already been facing declining consumer prices and news of a Greek exit could lead international investors to liquidate their European assets. The scenario could create a cash-flow problem and deflationary spiral thereafter. Furthermore, if Greece exits the Eurozone, investors will begin to view the weaker European economies – Cyprus, Ireland, Portugal, Spain, and possibly Italy – as risks. European countries will be forced to pay more to borrow money, and their equities might become tainted. Nevertheless, long-term view is that Eurozone might be better off without the embattled Mediterranean nation dragging it further into debt. Feeding more to a flawed system of governance only exacerbates the final cost.

The European Union accounts for about one-fifth of global trade. As the fallout from the crisis spreads from Greece to the EU, chances are that it would not stop there. A slowdown in Europe could lead to further shocks to the world energy market and damage to global exports. While the world economy and the American economic engine, in particular, are stronger than they were during the last Greek crisis in 2012, we fear that with interest rates near zero, the global economy may not be strong enough to weather a Greek exit and full-blown European crisis.

Conclusion

After a long and, especially in southern Europe, a deep recession, the eurozone economy is showing signs of recovery. In our base scenario, economic growth will continue in 2015. But it will take a long time before the damage caused by the crisis is repaired. The effects of the recession will be felt for a long time in the labor market, especially in the southern member states. Europe therefore needs a strong boost to spending in combination with structural reforms in the lagging countries in order to get growth back on track. An immediate reduction in the taxation of labor, combined with a subsequent and gradual increase in VAT, could boost consumption and introduce new expectations for inflation.

There are several risks to the recovery. Inflation is too low and is eerily close to deflation, a phenomenon that the ECB can do little to prevent. Poor policy decisions, especially in France and Italy, is undermining these countries' growth potential and forms a threat to stability in the European financial markets. On top ECB is almost running out of ammunitions now. Despite the application of numerous unconventional measures, the ECB is not succeeding in achieving its inflation target of around 2%. The ECB's deposit facility now pays a negative rate of interest. The special stimulation programs (LTRO and TLTRO) have not yet had the full desired effect on bank lending. And the real impact of Quantitative Easing is yet to be seen. What the eurozone needs is a strong boost to spending in combination with monetary funding. Only then will the newly created money actually appear in the real economy in the form of real spending.

But 2015 should see several headwinds turn to tailwinds — including the lagged effect of a weakening euro, easing fiscal austerity and more certainty in the banking sector. These factors, together with sharply lower oil prices, will support a strengthening Eurozone recovery.

Investment Actions

Unit Trusts

- Templeton - European
- Schroder - European Equity Alpha
- Schroder - ISF European Smaller Companies

ETFs

- DBX Tracker MSCI Europe - IH3
- VGK Vanguard European Stock Index

Contact Information (Singapore Research Team)

Management		
Chan Wai Chee (CEO, Research - Special Opportunities)	yebo@phillip.com.sg	**Research Operations Officer** Jaelyn Chin chinjn@phillip.com.sg
Macro | Equities	**Market Analyst | Equities**	**US Equities**
Soh Lin Sin sohls@phillip.com.sg	Kenneth Koh kennethkohwk@phillip.com.sg	Wong Yong Kai wongyk@phillip.com.sg
Bakhteyar Osama osama@phillip.com.sg		
Finance | Offshore Marine	**Real Estate**	**REITs**
Benjamin Ong benjaminongcw@phillip.com.sg	Caroline Tay carolinetayyy@phillip.com.sg	Dehong Tan tandh@phillip.com.sg
Telecoms | Technology	**Transport & Logistics**	**Consumer**
Colin Tan colintanwh@phillip.com.sg	Richard Leow, CFTe richardleowwt@phillip.com.sg	Shane Goh shanegohla@phillip.com.sg

Contact Information (Regional Member Companies)

SINGAPORE
Phillip Securities Pte Ltd
Raffles City Tower
250, North Bridge Road #06-00
Singapore 179101
Tel +65 6533 6001
Fax +65 6535 6631
Website: www.poems.com.sg

MALAYSIA
Phillip Capital Management Sdn Bhd
B-3-6 Block B Level 3 Megan Avenue II,
No. 12, Jalan Yap Kwan Seng, 50450
Kuala Lumpur
Tel +603 2162 8841
Fax +603 2166 5099
Website: www.poems.com.my

HONG KONG
Phillip Securities (HK) Ltd
11/F United Centre 95 Queensway
Hong Kong
Tel +852 2277 6600
Fax +852 2868 5307
Websites: www.phillip.com.hk

JAPAN
Phillip Securities Japan, Ltd.
4-2 Nihonbashi Kabuto-cho Chuo-ku,
Tokyo 103-0026
Tel +81-3 3666 2101
Fax +81-3 3666 6090
Website: www.phillip.co.jp

INDONESIA
PT Phillip Securities Indonesia
ANZ Tower Level 23B,
Jl Jend Sudirman Kav 33A
Jakarta 10220 – Indonesia
Tel +62-21 5790 0800
Fax +62-21 5790 0809
Website: www.phillip.co.id

CHINA
Phillip Financial Advisory (Shanghai) Co Ltd
No 550 Yan An East Road,
Ocean Tower Unit 2318,
Postal code 200001
Tel +86-21 5169 9200
Fax +86-21 6351 2940
Website: www.phillip.com.cn

THAILAND
Phillip Securities (Thailand) Public Co. Ltd
15th Floor, Vorawat Building,
849 Silom Road, Silom, Bangrak,
Bangkok 10500 Thailand
Tel +66-2 6351700 / 22680999
Fax +66-2 22680921
Website www.phillip.co.th

FRANCE
King & Shaxson Capital Limited
3rd Floor, 35 Rue de la Bienfaisance 75008
Paris France
Tel +33-1 45633100
Fax +33-1 45636017
Website: www.kingandshaxson.com

UNITED KINGDOM
King & Shaxson Capital Limited
6th Floor, Candlewick House,
120 Cannon Street,
London, EC4N 6AS
Tel +44-20 7426 5950
Fax +44-20 7626 1757
Website: www.kingandshaxson.com

UNITED STATES
Phillip Futures Inc
141 W Jackson Blvd Ste 3050
The Chicago Board of Trade Building
Chicago, IL 60604 USA
Tel +1-312 356 9000
Fax +1-312 356 9005
Website: www.phillipusa.com

AUSTRALIA
Phillip Capital Limited
Level 12, 15 William Street,
Melbourne, Victoria 3000, Australia
Tel +61-03 9629 8288
Fax +61-03 9629 8882
Website: www.phillipcapital.com.au

SRI LANKA
Asha Phillip Securities Limited
No-10 Prince Alfred Tower,
Alfred House Gardens,
Colombo 03, Sri Lanka
Tel: (94) 11 2429 100
Fax: (94) 11 2429 199
Website: www.ashaphillip.net

INDIA
PhillipCapital (India) Private Limited
No.1, 18th Floor
Urmi Estate
95, Ganpatrao Kadam Marg
Lower Parel West, Mumbai 400-013
Maharashtra, India
Tel: +91-22-2300 2999 / Fax: +91-22-2300 2969
Website: www.phillipcapital.in

TURKEY
PhillipCapital Menkul Degerler
Dr. Cemil Bengü Cad. Hak Is Merkezi
No. 2 Kat. 6A Caglayan
34403 Istanbul, Turkey
Tel: 0212 296 84 84
Fax: 0212 233 69 29
Website: www.phillipcapital.com.tr

DUBAI
Phillip Futures DMCC
Member of the Dubai Gold and
Commodities Exchange (DGCX)
Unit No 601, Plot No 58, White Crown Bldg,
Sheikh Zayed Road, P.O.Box 212291
Dubai-UAE
Tel: +971-4-3325052 / Fax: + 971-4-3328895
Website: www.phillipcapital.in

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