

Sujet traité : Club Med change de narrative / Club Med Flips The Script

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SPECIAL REPORT

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Club Med Flips The Script

- 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.

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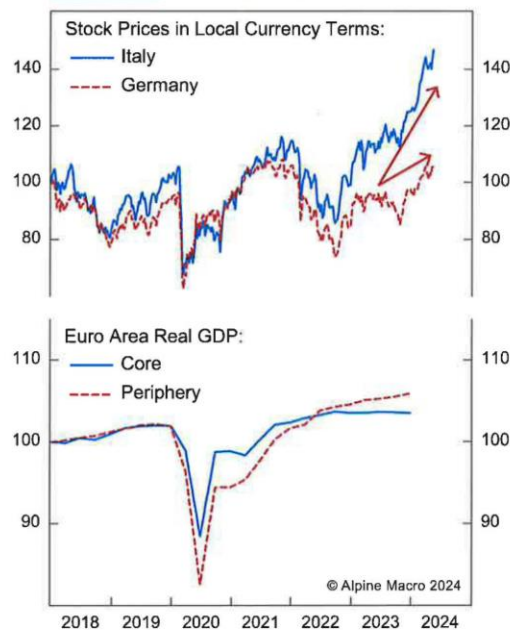
The southern European states¹ are mounting a comeback. The economic laggards of yesteryear, once hobbled by a sovereign debt crisis and derided for perceived profligacy, are now outperforming the traditional euro area powerhouses (Chart 1).²

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.

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

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

Chart 1 Breaking Away



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

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.

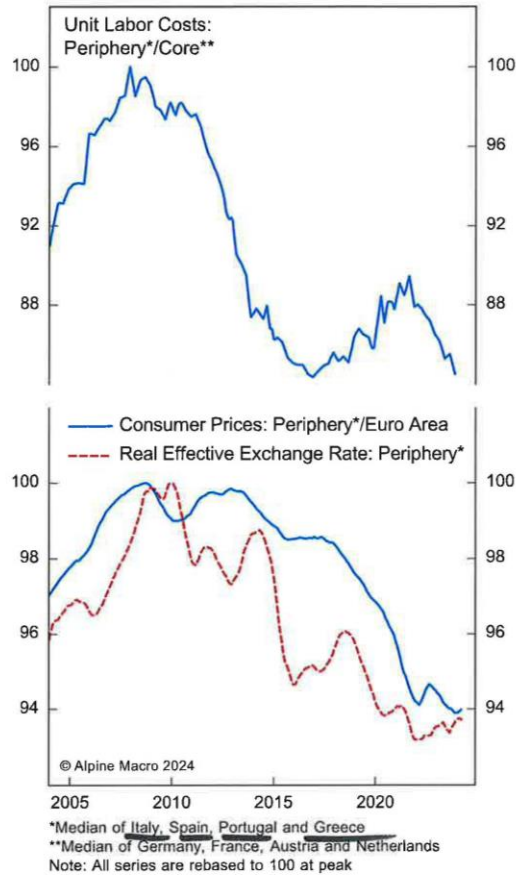
This structural adjustment has largely played out through two mechanisms:

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).

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):

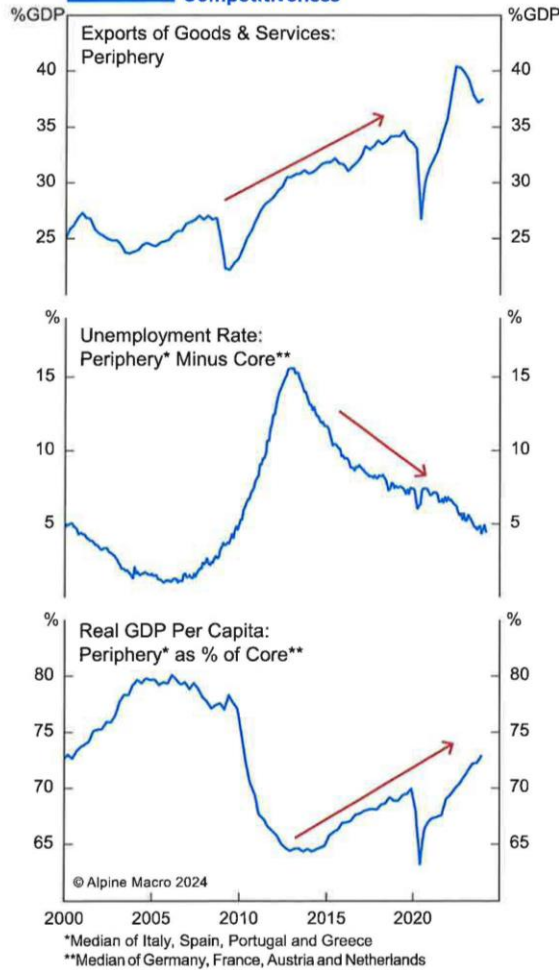
- Exports of goods and services have jumped from about 25% of GDP at the onset of the debt crisis to nearly 40% currently.

Chart 2 A Deep Internal Devaluation...



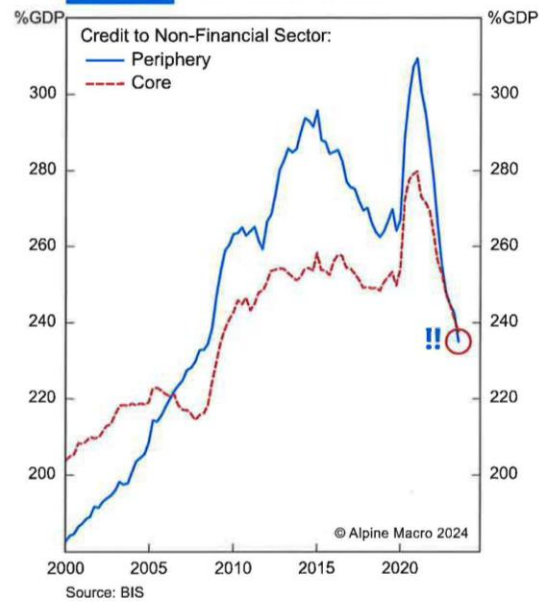
- The labor market has healed, with the spread in unemployment rates relative to core euro area economies now returning to levels seen in the 2000s.
- Outside of a pandemic-related distortion, productivity has persistently outpaced that of core economies over the past decade.

Chart 3 ...Has Boosted Periphery Competitiveness



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

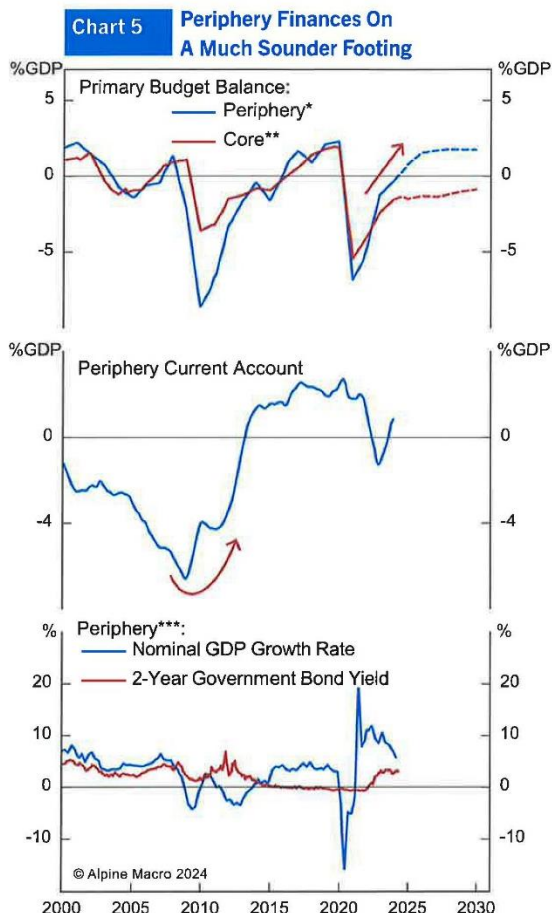
Chart 4 Debt-Ridden No More



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%

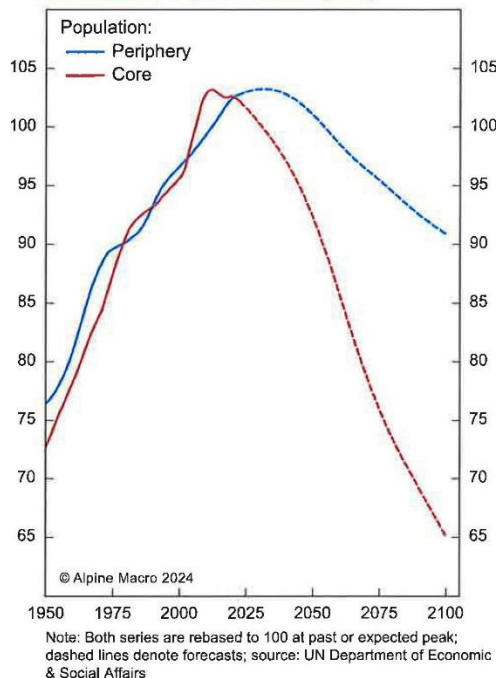


*Median of Italy, Spain, Portugal and Greece
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 Note: Dashed lines denote forecasts; source: IMF, OECD, National Central Banks

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



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.