

Research

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Global Political Insights

The New Eurozone Political Geometry: What Economic and Market Implications?

- The struggle to form a government in the aftermath of inconclusive Greek elections last weekend has turned many market-watchers into micro-political analysts, counting seats and attempting to decipher the platforms of new and sometimes marginal Greek political parties for coalition-forming potential.
- At the same time, assessing the prospects for France's mid-June legislative elections has also begun in earnest, with investors fearing that the strong performance from the far Right and far Left in the first round of the French presidential elections could signal a challenge for incoming President Francois Hollande in securing a legislative majority.
- We think that excessive focus on these short-term outcomes misses the broader point: in the eurozone: the fragile consensus behind austerity in the periphery and tolerance for bailouts in the core is rapidly eroding as anti-establishment sentiment grows in both, giving way to a new, more fluid political geometry.
- Among the key components of the new political geometry are a revolving door of leaders, constantly altering the power dynamics, a host of new/extreme/alternative political parties (NEAPs) and ever-shorter political honeymoons, as voters become quickly disappointed with the meaningful absence of alternatives to austerity.
- Taken together, we believe we may be in the early stages of a sort of "political adjustment" to accompany the processes of fiscal and structural adjustments.
- There is a lot bad news baked in European share prices, in our view. But, a messy Greek exit is probably not. Neither is an earnings recession for European corporates. This needs a much sharper regional recession than our economists forecast or a synchronized global recession, which is not our base case.
- Two-way market risk is elevated in the near-term. Politicians and policy makers may have to work overtime to contain risks over the coming months. Within European equities, investors should continue to back the structural re-rating of growth and quality names. We also suggest a Euro break-up strategy.

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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The New Eurozone Political Geometry: What Economic and Market Implications?

The struggle to form a government in the aftermath of inconclusive Greek elections last weekend has turned many market-watchers into micro-political analysts, counting seats and attempting to decipher the platforms of new and sometimes marginal Greek political parties for coalition-forming potential. At the same time, assessing the prospects for France's mid-June legislative elections has also begun in earnest, with investors fearing that the strong performance from the far Right and far Left in the first round of the French presidential elections could signal a challenge for incoming President Francois Hollande in securing a legislative majority.

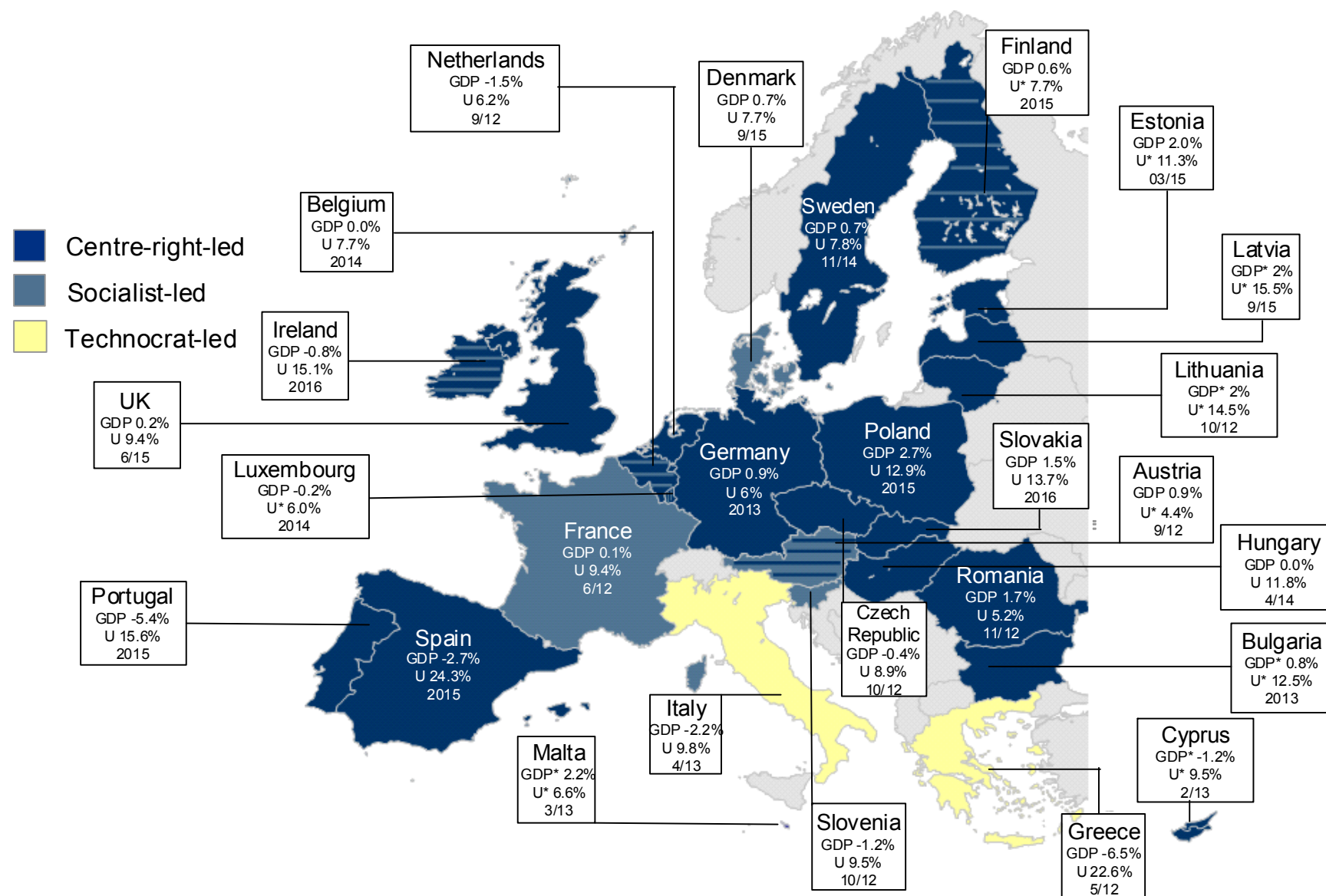
We do not rule out the potential for a late-breaking compromise agreement or caretaker national unity government to emerge in Greece, although we think such an outcome is both unlikely and would be, at most temporary, with new elections around June 17th more likely. For France, we are of the view that Hollande's Socialist Party is likely to gain either an outright majority or a working coalition with parties such as the Left Front and/or the Greens. Still, we think that excessive focus on these short-term outcomes misses the broader point: in the eurozone, the fragile consensus behind austerity in the periphery and tolerance for bailouts in the core is rapidly eroding as anti-establishment sentiment grows in both, giving way to a new, more fluid political geometry.

The use of the term "new political geometry" is intended to convey more than simply heightened political risks in the eurozone. Rather the sense of political dynamics in flux, including in Germany, where weekend elections in Nordrhein-Westphalia saw not only gains for the opposition SPD and a weak performance for Merkel's centre-right CDU, but also a surprise boost for the government's beleaguered coalition partner, the Free Democrats. This result should not be over-interpreted to suggest significant weakness for Merkel's leadership, as her party was not expected to win. More subtly, we think the combination of political changes elsewhere in the EA will provide the Chancellor, one of the few leaders in the Advanced Economies to see her popularity rise despite the challenges of the crisis, with a useful pretext to move to the centre. In the months ahead, we believe she may move to position the CDU for another of the Grand Coalitions with the SPD, which regarding the influence of the SPD in the Bundesrat (upper house of parliament) is de-facto already at work.

Among the key components of the new political geometry are a revolving door of leaders, constantly altering the power dynamics (enter "Frangela"), a host of new/extreme/alternative political parties (NEAPs), and ever-shorter political honeymoons, as voters become quickly disappointed with the meaningful absence of alternatives to austerity.

Taken together, we believe we may be in the early stages of a sort of "political adjustment" to accompany the processes of fiscal and structural adjustments. The trouble is, the processes are on a collision course that could create political paralysis at best and increase the risks of negative consequences at worst during a particularly challenging period in the eurozone crisis, where the risks of a Greek exit ("Grexit") have risen to 50-75%, in our view (please see [Global Economics Flash - 'Grexit' Back In The Spotlight](#)).

Figure 1. Europe political map



Source: GDP and U by CIRA, GDP* and U* by IMF Economic Outlook, Election Dates by IFES Election Guide

Note: GDP represents forecast economic growth for 2012, U unemployment forecast for 2012, (XX/XX) corresponds to date of next major elections. Lines in a country represent a coalition government, with the main color as the political orientation of the leading Party, e.g. Austria's main party: socialist-led.

What's more, temporary emergency solutions, such as instituting unelected technocratic governments, as happened in Greece and Italy in 2011, cannot be expected to continue for an extended period. Instead, the dismantling of old political parties and the emergence of new ones, or lists of individuals rather than parties, could lead to a re-formulation of the political landscape of some countries. We would also not be surprised to see calls for the restoration of the monarchy or other highly unlikely "extreme" political responses in the most problematic cases. But investors should not place much faith in the durability of political solutions that lack popular legitimacy.

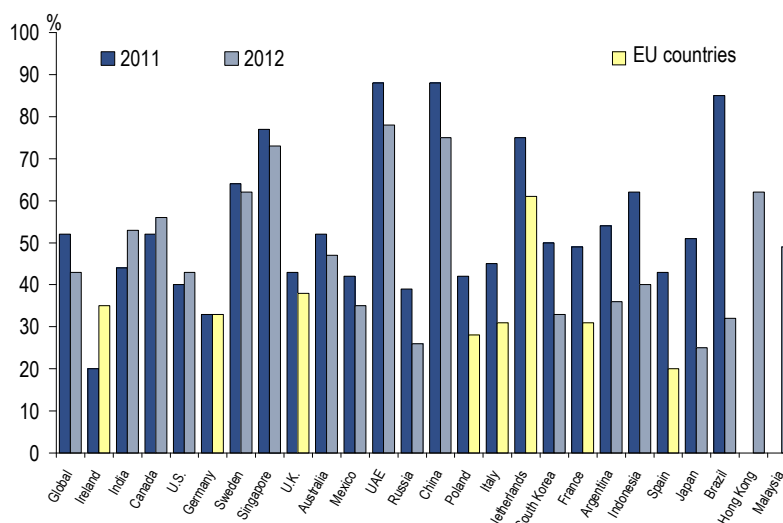
Trustbusters?

Since the global financial crisis, public trust in both government and business has declined sharply, underscoring rising anti-establishment and anti-elite sentiment.

For example, in Italy, public support for political parties has dropped to an all-time low of just 4% following a spate of prosecutions surrounding the improper use of public funds in financing political parties. Such poor ratings for political parties at large are likely a significant part of the reason that Italy's unelected, non-politician Prime Minister Mario Monti still enjoys approval ratings of between 40 and 50%. The vacuum is also helping fuel the rise of Italy's newest political party, the 5-Star Movement, led by Genoan comedian Beppe Grillo, currently polling in 3rd place, supplanting long-established parties.

As we noted in the wake of the Arab Spring, anger over perceived corruption and cronyism is a frequent catalyst for galvanizing public sentiment, potentially unifying segments of the population against regimes. This risk is not limited to dictatorships or non-democratic regimes.

Figure 2. Public trust in government has declined sharply



Source: Edelman Trust Barometer (<http://www.scribd.com/doc/79026497/2012-Edelman-Trust-Barometer-Executive-Summary>)

Note: The 2012 Edelman Trust Barometer online survey sampled 25,000 general population respondents with an oversample of 5,600 informed publics in two age groups (25-34 and 35-64) across 25 countries. All informed publics met the following criteria: college-educated; household income in the top quartile for their age in their country; read or watch business/news media at least several times a week; follow public policy issues in the news at least several times a week.

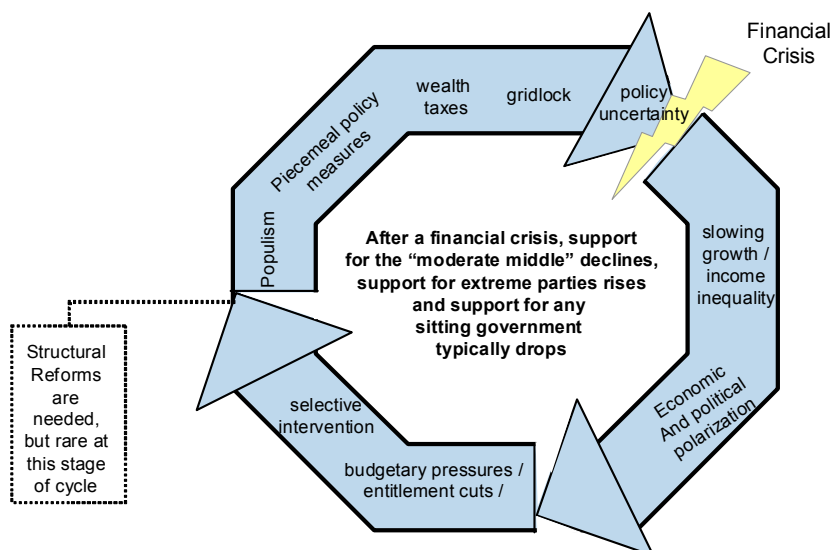
In the European context, we think revolution remains unlikely, with elections and protests allowing opportunities to vent political frustration. But public tolerance for the fixtures of the political scene offering policies from the standard playbook may be wearing thin. In Greece, 5 years into a sharp adjustment, this process is the most advanced, with only 30% of the public voting for either of the two main parties that have run the country since the end of military dictatorship in 1974. Elsewhere, mainstream parties continue to command a majority, albeit in most cases a shrinking one.

We think the Greek outcome is unlikely to be replicated in other eurozone countries and reflects the country's specific circumstances, but note that all around Europe, protest parties of various stripes are gaining momentum, even though with seemingly unformed platforms and unclear policy agendas. The potential for new, extreme and alternative political parties to influence Europe's political geometry may be under-appreciated by markets focusing on each outcome as a discrete event rather than as part of a wider macro trend (and one not limited to Europe: witness the continuing influence of the Tea Party movement in the US). Such parties may make inroads at the local and parliamentary level for many years before they might be expected to win higher political office.

2012: Revenge of the Protest Party?

The backlash against austerity that was abundantly clear in the electoral outcomes in France and Greece, preceded by the centre-right Dutch government's collapse over its failure to pass an austerity budget and the stirrings of pre-election dynamics in Germany and Italy, which must hold elections by 2013, points to a new and more uncertain phase in the eurozone's political geometry, four years into the crisis. With few eurozone countries governed by the same leaders they were last year and amid the sharp uptick in public anger against mainstream politicians, we fear it will become increasingly difficult for leaders to enjoy the degree of legitimacy necessary to demand sacrifices from the public — let alone pass controversial crisis-related legislation.

Figure 3. History suggests little appetite for reform, greater risk of polarisation in the aftermath of financial crises



Source: Mian, Sufi, Trebbi (2012), "Resolving Debt Overhang: Political Constraints in the Aftermath of Financial Crises", National Bureau of Economic Research, and Citi Investment Research and Analysis

This new, more risky political phase represents a reversal of the 2011 trend along the eurozone periphery of government collapses followed by electoral victories by mainstream opposition parties, who had actively campaigned on pro-austerity platforms, typically winning parliamentary majorities (Portugal, Ireland, Spain). In the core countries, the rise of alternative parties was evident during the same period, with the True Finns and the Dutch Freedom Party (PVV) entering parliament for the first time, albeit with relatively small numbers of seats.

The collapse of the “moderate middle” and rise of alternative, new and extreme parties has been well documented as consistent with the aftermath of financial crises generally (*Mian, Sufi, Trebbi, Resolving Debt Overhang: Political Constraints in the Aftermath of Financial Crises, NBER 2012*). We have been tracking this trend for the past 12 months and note the emergence of 3 broad categories of political alternatives in the European context.

Figure 4. New, Alternative and Extreme Parties (NEAPs) are on the Rise

Party	Country	Number of Seats	Political Orientation
Pirate Party	Germany	45 out of 1,834*	Internet freedom
Sinn Fein	Ireland	14 out of 166	Left / Irish Republicanism
Palikot's Movement	Poland	43 out of 460	Liberalism
Socialist Party	The Netherlands	15 out of 150	Left
The 5-star Movement	Italy	20% in polls	Direct democracy
Golden Dawn	Greece	21 out of 300	Far right / Nationalism
Syriza	Greece	52 out of 300	Far left
Independent Greeks	Greece	33 out of 300	Right / Nationalism
Jobbik	Hungary	46 out of 386	Far right / Nationalism
True Finns	Finland	39 out of 200	Nationalism
Freedom Party	The Netherlands	23 out of 150	Right
Freedom Party	Austria	34 out of 183	Right
Respect	U.K.	1 out of 650	Left / Environmentalism
Scottish National Party	U.K.	69 out of 129**	Left / Nationalism

Source: BBC, CIA Factbook, and Citi Investment Research and Analysis

Note: **correspond to seats in the Regional Parliaments, **correspond to seats in the Scottish Parliament.

1. Unaligned Alternatives: “Alternative” parties, such as Germany’s Pirate Party, often described as an “Internet-based” party, with a vague platform advocating free Wi-Fi access and free public transportation, and Poland’s Palikot’s Movement, also popular with the under 40s and offering a secular political alternative. At this stage these parties do not present a challenge to the established political order in terms of their political priorities. Nevertheless the Pirates’ rapid rise — gaining 7.5% of the vote in Germany’s largest state, Nordrhein-Westphalia, in the May 12 regional elections — is a result that allows them to enter their fourth state parliament.

2. New Nationalists: The second type of party gaining strength is a re-branded existing political party, frequently one with a historically nationalist agenda, such as Ireland’s Sinn Fein, the Scottish National Party, France’s National Front, The Netherlands’ and Austria’s Freedom Parties, Finland’s True Finns, and Greece’s Golden Dawn. These parties have broadened their base and increased their share of voter support by expanding beyond their core “brand proposition” to include anti-EU and/or anti-euro sentiment (or, in the case of the SNP, anti-Whitehall sentiment).

This strategy has brought disenchanted voters from both the Left and the Right, and likely helped deliver the National Front’s strongest performance to date in the first round of the French presidential elections, an outcome the party’s leader will aim to build upon in the upcoming legislative elections in mid-June.

3. Anti-Establishment Heroes: Greece's Syriza, France's Left Front, Italy's 5-Star Movement. It is the success of Greece's Syriza party that has most rattled markets, with its promise to tear up the Memorandum of Understanding with the Troika and attempt to negotiate more favourable terms. Syriza's surprise success in the May 6 elections, where it came second in the polls, appears to have accelerated its support in the election's aftermath. The party seems likely to increase its share of the vote in the event of new elections, a factor that may have the effect of helping the mainstream and pro-MoU parties to overcome their differences.

With the exception of Syriza in Greece, the proportion of the vote controlled by NEAPs typically remains small, yet their growing success in attracting disaffected voters produces a number of effects. Most notably, NEAPs are altering the electoral arithmetic, granting them influence beyond their relatively small numbers, which can be used as either spoilers or dealmakers. The Freedom Party in the Netherlands was able to trigger the collapse of the government over its austerity budget despite the fact that the Dutch politicians are among the most pro-austerity in Europe. Greater popularity for NEAPs also serves to fragment parliaments, making the passage of legislation more problematic.

The Agony of Austerity

As unemployment levels continue to rise, economic recovery falters, and citizens increasingly blame the political establishment and Brussels for their predicament, we think 2012 will see further erosion to the "moderate middle", providing an opportunity for more new and extreme parties gain additional support.

We believe this trend will be found in both core and periphery, and will produce increasingly weaker multi-party coalitions that are more prone to collapse and less amenable to coalescing around the kind of "just in time" last-minute policy compromises that staved off adverse outcomes in 2011. A cycle of elections-collapse-elections-collapse, with each election bringing a weaker coalition, is therefore a distinct but unwelcome prospect at the very time when continued commitment toward the fiscal integration agenda is most needed.

Incoming French President Francois Hollande's campaign promise of growth instead of austerity is highly unlikely to translate into concrete, near-term results, suggesting that any concessions he is able to win from Berlin and the European Central Bank on pro-growth measures could be little more than political gestures, unlikely to change the reality for the man on the street. But he is not alone in his desire to focus on a growth agenda: the participants in the new anti-austerity chorus have grown more credible, numerous and louder, spanning Mario Monti in Italy, Mariano Rajoy in Spain and now France's Francois Hollande.

We do not see a change of approach in respect of the front-loaded fiscal austerity measures that have been mandated, and his supporters are likely to be disappointed in the slow rate of return on structural reforms. But we think that Hollande's victory on a campaign platform of an alternative to austerity, however unlikely to transpire, could breathe new life into the defunct European Social Democratic parties, and possible Syriza-clones elsewhere in Europe. Such a policy stance would, of course, invite the immediate discipline of the bond markets.

Figure 5. Unemployment continues to rise as growth stalls

Countries	GDP 2012F	Unemployment 2012F	Next Major Elections
Austria	0.9	4.4*	Sep-12
Belgium	0	6.2	May-15
Bulgaria	0.8*	12.5*	2013
Cyprus	-1.2*	9.5*	Feb-13
Czech Republic	-0.4	8.9	Oct-12
Denmark	0.7	7.7	Sep-15
Estonia	2.0*	11.3*	Mar-15
Finland	0.6	7.7*	2015
France	0.1	9.4	Jun-12
Germany	0.9	6.0	2013
Greece	-6.5	22.6	Jun-12 (TBC)
Hungary	0	11.8	Apr-14
Ireland	-0.8	15.1	2016
Italy	-2.2	9.8	Apr-13
Latvia	2.0*	15.5*	Sep-15
Lithuania	2.0*	14.5*	Oct-12
Luxembourg	-0.2	6.0*	2014
Malta	2.2*	6.6*	Mar-13
Netherlands	-1.5	6.2	Sep-12
Poland	2.7	12.9	2015
Portugal	-5.4	15.6	2015
Romania	1.7	5.2	Nov-12
Slovakia	1.5	13.7	2016
Slovenia	-1.2	9.5	Oct-12
Spain	-2.7	24.3	2015
Sweden	0.7	7.8	Sep-14
United Kingdom	0.2	9.4	Jun-15

Source: GDP and Unemployment by CIRA, GDP* and Unemployment* by IMF Economic Outlook, Election Dates by IFES Election Guide

Note: TBC stands for To Be Confirmed

Perhaps counter-intuitively, we think that the heightened calls for growth could well be met with more emollient words from German Chancellor Angela Merkel, who faces elections by 2013 amidst rising popular opposition to bailouts. Never one to miss a political opportunity, the Chancellor will, we suspect, use Hollande's victory and the advent of their new working relationship, inevitably to be called "Frangela" (replacing "Merkozy"), to endorse aspects of his pro-growth agenda, thereby stealing a march on her center-left rivals, the SPD. In any case, we see adopting the language of growth if not committing significant additional funds, as a low-cost political option in an election year. And domestically, Merkel might use the increasing fiscal room on Germany's own budget to put in place some growth-supporting measures.

With the Irish referendum on the EU fiscal compact due on May 31st and looking likely to be a referendum on the incumbent government, and possible new elections in Greece in June alongside French legislative elections in two rounds, the coming months will continue to feature political signposts — opportunities for disgruntled citizens to voice their frustrations. With Italian and German elections due by 2013, the eurozone's political geometry will likely continue to shift and reformulate in new and potentially unexpected ways.

What are the economic consequences of a rejection of current austerity policies?

Austerity is painful because it depresses economic activity (typically referred to as growth in this debate, although the term 'growth' really ought to be reserved for matching expansions of actual output and potential output). Less austerity (and perhaps the same NPV of austerity measures spread out over a longer period of time) would be less painful, if it could be implemented. Unfortunately, in Europe, the reason that so much austerity is implemented in the periphery is not that someone forgot to push the growth button. Growth is not a policy but an outcome produced by good policies, good institutions, good initial conditions, good funding conditions of the public and the private sector, a good external environment, and good luck. Restoring fiscal sustainability is always painful and will (almost) always depress the level of economic activity. There may be an optimal speed of correction of a fiscal imbalance of a given size. If European countries pursue fiscal tightening very aggressively and with a significant negative impact on output and employment, does this mean that the timing and speed of fiscal austerity is wrong? Only, in our view, if the optimal fiscal consolidation programme is conceptualised without imposing a key constraint: the ability to fund the transition from fiscal unsustainability to fiscal sustainability on affordable terms.

Once the funding constraint is recognised, anti-austerity is a powerful web of emotions, but not a coherent set of policies unless (a) the markets will fund you at sustainable rates if you reduce the severity of the austerity and/or (b) there are non-market sources of funds available to fund the larger deficits almost certainly associated with 'less austerity'. (a) is relevant only for the US, Japan and Germany (of the economically significant players). None of the periphery countries (Greece, Ireland, Portugal, Spain, Italy, Cyprus), or the soft core (Belgium, Austria, France, the Netherlands) would be able to fund themselves on affordable terms in the markets if they relaxed their austerity programmes substantially. So for them, a call for less austerity is a call for additional concessional funding from the EFSF/EFSM/ESM/EIB, the IMF or the ECB/Eurosystem.

The resources available to the EFSF/EFSM/ESM are not going to be increased significantly in the foreseeable future. The EIB may get what's left in the EFSM (about €12.5 bn or so) as additional capital, which it can then leverage to boost infrastructure or green investments. But even if it were to double the lending capacity of the EIB (about €80bn a year), the increase would be less than 1 percent of euro area GDP. The IMF now has probably \$389bn + \$430bn = \$819bn to play with, but it will not do more than 1 euro for every 2 or 3 lent by the EFSF/ESM. That just leaves the ECB/Eurosystem as not merely the lender of last resort to periphery sovereigns, but a lender of last resort that takes considerable sovereign credit risk exposure when it purchases sovereign debt outright in the secondary markets (through the SMP) or when it lends to zombie banks that offer periphery sovereign or sovereign-guaranteed debt as collateral.

The ECB can be pushed where it does not want to go to some extent, but probably not enough to permit a meaningful relaxation of fiscal austerity in the periphery. It should continue to intervene to prevent disorderly sovereign defaults, but not necessarily to prevent orderly sovereign debt restructuring involving PSI, as in the case of Greece. It will continue to intervene to prevent the collapse of systemically important banks and other financial institutions (SIFIs), but it may reluctantly agree to the restructuring of unsecured bank debt (subordinated first, but if necessary also senior) if the alternative is the ECB/Eurosystem getting stuck with an ever-growing exposure to weak sovereigns and weak banks. It is significant that both Draghi and Constancio have recently called for a European Bank Resolution regime and a

European Resolution Fund (bank recapitalisation fund) for the 34 largest banks. No doubt, before senior unsecured bank debt can be restructured, depositors will need to be given preferred creditor status to other senior unsecured creditors. The ECB leadership will likely also want Commissioner Barnier's proposals for a pan-EU (or pan-euro area) bank resolution regime (the bail-in model) to be formally presented, submitted to the EP and put in place.

But a political mood increasingly inclined towards a rejection of austerity without matching funding is bound to mean more sovereign debt restructuring in the euro area periphery and more unsecured bank debt restructuring.

It is true that there is an obstacle to less austerity other than insufficient funding. That is the prevailing orthodoxy on the part of the Commission, which reflects the Teutonic consensus that austerity alone may be expansionary and that austerity combined with structural reforms that liberalise labour markets, deregulate the professions and other over-regulated industries, privatise state-owned enterprises and reduce red tape everywhere is definitely expansionary. As regards the first proposition, that contractionary fiscal policy is expansionary, there is no evidence to support it and lots of evidence against it. Contractionary fiscal policy is indeed contractionary. Not self-defeating, in the sense that there is a Keynesian Laffer curve (fiscal tightening actually increases the government deficit because it has such negative effects on the level of activity), but definitely contractionary and costly.

If more resources were to become available, from whatever source, to fund a relaxation of austerity policies, it is possible that the Teutonic Consensus would prevent a renegotiation of the existing fiscal agreements between euro area member state governments and the Commission, either as part of a troika programme (for Greece, Ireland and Portugal) or as part of the regular surveillance of national economic policies of EU and especially euro area member states by the Commission. The change in the political climate reflected in the victory of Hollande, the popularity of no-to-austerity parties in the Greek election and the fall of the Dutch government over a dispute concerning fiscal austerity among the parties supporting the coalition government may weaken the influence of the Teutonic consensus. Mario Monti as early as November 2011 (please see [Europe: Economics Daily](#) – 25 November 2011) stated that should Italy's government deficit overshoot the benchmark agreed with the Commission not because of bad faith by the Italian policy-makers but because of bad luck (that is, not because of wilful non-implementation of agreed-upon measures but because of a weaker-than-expected performance of the real economy), he would not want the original targets to be met within the originally planned time horizon by implementing yet more austerity measures.

The IMF, through the interventions of its Chief Economist Olivier Blanchard, supports the view that fiscal policy should not be perversely pro-cyclical by insisting that the original targets and target dates for fiscal consolidation continue to be adhered to even if the fiscal outcomes disappoint through no fault of the country implementing the austerity programme.

We are therefore likely to see some willingness by the Commission and the troika to let the automatic fiscal stabilisers work when there are 'good faith' budget deficit overshoots, as long as the existing resources of the troika are adequate to the task and as long as the necessary supportive actions of the ECB/Eurosystem do not exhaust the ECB/Eurosystem's willingness to take on additional exposures to the periphery sovereigns. This could be through SMP purchases of periphery sovereign debt in the secondary markets or, to us more likely, through further LTROs that, combined with financial repression in periphery countries that either are

not yet on troika programmes or that are on troika programmes but continue to fund themselves in part in the markets (our central scenario for Spain this year and a likely scenario for Italy at some stage), permit the sovereigns of countries such as Spain and Italy to fund themselves in the primary markets on affordable terms.

None of this is, however, likely to eliminate the high probability (50-75% in our view) that Greece could exit the euro area. Around 70% of the Greek electorate wishes to stay in the euro area but 70% of that same electorate also rejects the Memorandum of Understanding (the next installments of the troika programme with its further fierce fiscal tightening and its radical structural reforms of politically-sensitive institutions). The fact that rejecting the MoU means saying goodbye to the €90bn of additional troika funding is either not part of the public's awareness or is denied. The deputy leader of Syriza has stated publicly that the troika "will be begging Greece to take the money".¹ We believe him to be mistaken. Austerity and structural reform fatigue in Greece are real, but so is the growing awareness in the rest of the euro area (and not just in the hard core) that it makes no sense to throw good money after bad. Better to use all available resources to limit the fall-out for the rest of the euro area from a Greek exit, than to postpone the inevitable, increasing the expected loss to the troika and the ECB conditional on a Greek exit occurring and undermining any incentives other periphery countries may have to put their fiscal houses in order and restructure the inefficient and unproductive parts of their economies.

US and UK observers and commentators fall into two camps. One camp believes that Greece will exit and that it will be impossible to ring-fence or firewall the consequences. As a result there will be a de-facto unravelling of the euro area, leaving a rump-Greater DM zone. The other camp believes that, at the last moment, Mr Stratoulis will be proven right and some combination of Germany plus the rest of core Europe, the IMF and the ECB will open their wallets and fund the Greek sovereign despite a failure to comply with the fiscal austerity, structural reform or privatisation conditionality of the MoU. Such a one-sided transfer union — effectively an open-ended and uncapped commitment to fund a sovereign that is unwilling or unable (and now also would have no incentives) to pursue fiscal sustainability and structural reform — is not compatible with the survival of the euro area, in our view, because it would drive Germany and the rest of core Europe out of the euro area. But if the belief that the troika is bluffing becomes widespread in Greece, a Greek exit could be near indeed.

Implications for European Equities

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The three biggest risks to European equities continue to be: 1) debt, 2) politics, and 3) electorates. It has been rare, over the past many years, to have considered political risk in a "Top 3" European equity risk list, rarer still to have two out of three slots accounted for by political risk. Many investors ask us why we split out 2) and 3) as they both come under the same political risk banner. True, but status quo political risk can shift quickly when electorates vote. We have seen that in practice over the past week or so with market reaction from not all that surprising election results in Greece and in France. German bund yields have been driven to record lows and there has been a more general sell-off in risk assets.

¹ "They will be begging us to take the money," Syriza deputy Dimitris Stratoulis said on Friday. "Financial Times" March 12, Greece Lurches towards fresh elections, <http://www.ft.com/cms/s/0/32932994-9c3e-11e1-955d-00144feabdc0.html#axzz1uos7sTA2>

Overall, political risk — the Eurozone's New Political Geometry, the rise of the NEAPs and stronger support for New Nationalists — presents an unhelpful backdrop for Europe's economy, the corporate sector and for equity markets.

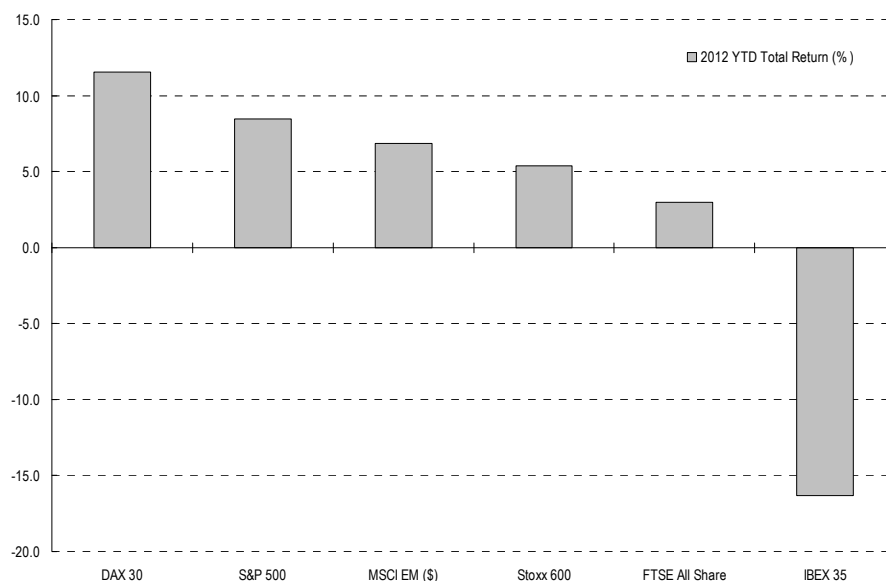
Here, we consider the implications of recent political developments across Europe on the outlook for European equity markets. There is a lot of bad news already baked into share prices, but a disruptive Greek exit probably is not, nor is a collapse in profits or global economic recession. Investors should also recognise that Europe has many companies that have high levels of non-European exposure and strong balance sheets. We think that Europe is a good place for global investors to come shopping, but our advice is to “try on before you buy and stick to quality products”.

We also highlight the clear divergence of performance across Europe between the “haves” and the “have-nots” and suggest a euro break-up hedge for more bearish investors. In a world of de-leveraging and lower and divergent growth, our overall strategy is still to back the structural re-rating of strong credit, growth and quality within the equity market.

Europe vs

Recent events have put the spotlight back on a country that accounts for 0.3% of global GDP and 0.1% of global equity markets — Greece. But, despite events in Greece, investors should be careful before treating Europe as one equity market bloc. We see both risk and opportunity in European equity markets.

Figure 6. European Equities Provide Best & Worst of 2012 YTD Total Returns (Local FX, %)

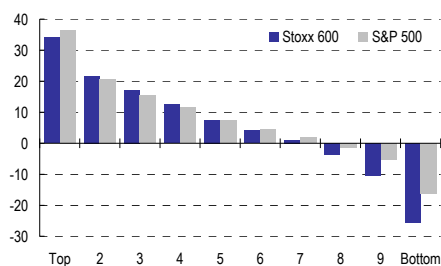


Source: Datastream and Citi Investment Research and Analysis

Figure 6 shows YTD total returns for various equity market indices around the world. German equities (DAX 30) have beaten US equities (S&P 500), with overall European equities (Stoxx 600) not too far behind MSCI emerging markets. Spanish equities, representing the periphery of Europe, have done poorly in absolute and relative terms.

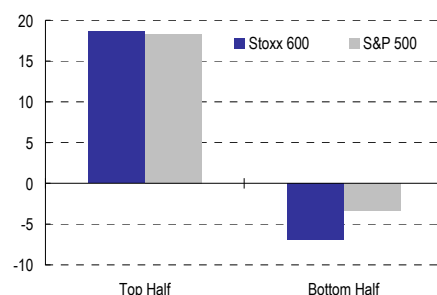
While investors may be surprised at the resilience of headline European markets so far this year, given the depressing newsflow, they may also be surprised to learn that European equities have also done better than US equities YTD.

Figure 7. Decile Perf. YTD — US & Europe



Source: DataStream

Figure 8. Decile Perf. YTD — US & Europe



Source: DataStream

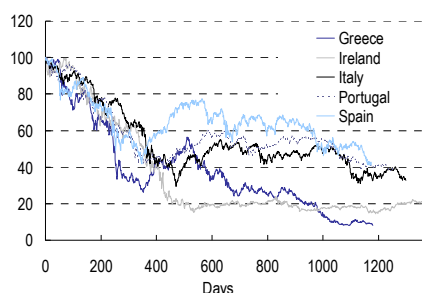
This is not true at an index level, with the Stoxx's 5% return comparing unfavourably to the S&P 500's 8% return. But, it is true if we look at alpha generation within the European and US market. Figure 7 shows the performance of both markets' constituents, ranked by decile. Investors would have only enjoyed stronger returns in the US in one of the best five performing deciles. Looking at an average of the top five deciles shows that Europe also just edges the US in terms of return opportunity YTD (Figure 8).

Europe has also offered investors bigger equity downside risk, which is less impressive. But, overall, this means that there has been greater opportunity for stock-pickers in Europe rather than in the US so far this year.

Priced in?

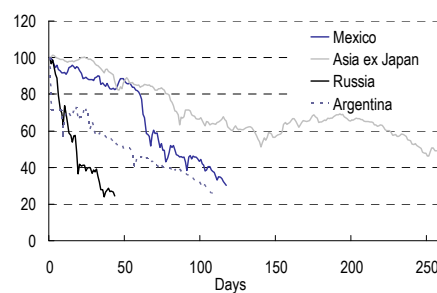
So, how much of the Euro Area sovereign debt crisis is priced in to equity markets? Within European equities, the epicenter of pain has been in Greece (and other peripheral markets) and in Banks. Figure 9 shows that peripheral equity markets are 60-90% lower than their rebased 2007 highs. This is similar to equity market falls in many previous emerging market crises over the past few decades² (Figure 10). A key difference, however, between the current Euro Area crisis and previous EM crises is the reduced policy tool-kit carried by the Europeans. In particular, currency devaluation is not initially an option.

Figure 9. Euro Crisis Equity Perf 2007 - Now



Source: DataStream

Figure 10. EM Crisis Historic Equity Perf



Source: DataStream

²[European Portfolio Strategist - Pan-European — Risk Assessment](#)

Euro Area banks have given up all of their early year liquidity-driven gains and have returned to their price/book lows of the past 30+ years. The sector now trades at 0.4x book value, below 2H11 lows and just above the March 2009 trough (0.33x). Bank share prices are already pricing in some combination of dilution and write-down risk.

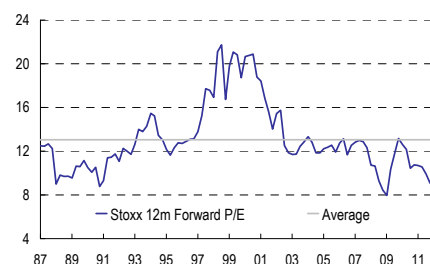
At a broad market level, European equities have had a normal pull back from the 1Q 2012 highs falling 8-10%. Using price to book or P/E, we are around 13% above the lows we touched in May and October 2011. Against the longer-run data, the equity market is around 25% below average. Equities do not look expensive.

Figure 11. Price to Book 1980-12



Source: DataStream

Figure 12. PE 12m fwd 1987-12



Source: DataStream

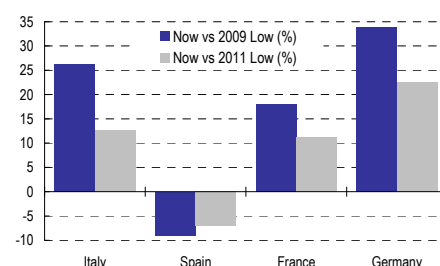
Figure 13 looks at the market ex Fins and this is at the same 13% above its valuation lows of last year. However the market ex Fins is around 10% below its long-run average rather than the 25% for the market. Still attractively valued but less so than the overall market.

Figure 13. PB ex Fins 80-12



Source: : DataStream

Figure 14 Ex Fins P/B now vs Previous Lows



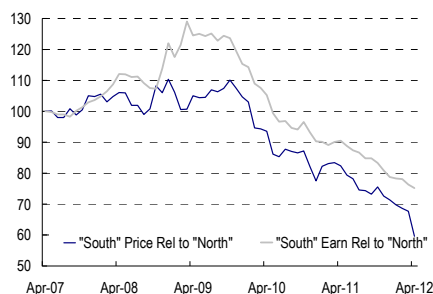
Source: : DataStream

Figure 14 looks at the main Eurozone economies equity market valuations using non-Fins price to book. Spain is making new lows, while Italy and France are around 10% above the 2011 lows. Germany stands out. The haves of growth and stronger balance sheets are unsurprisingly more highly regarded by the market. Equities against their own long-run history look attractively valued but not once-in-a-generation cheap. Compared to last year, markets are not sending a definitive buy sign either but valuation is supportive to ongoing gains, in our view, providing there is no earnings collapse nor a synchronised global recession.

North vs South

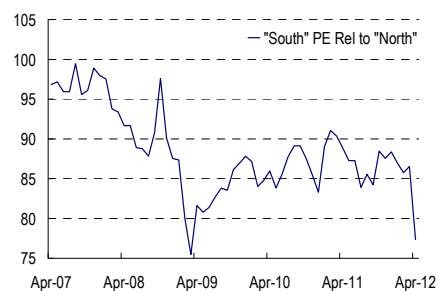
What about within Europe? Here we find a simple story of divergence at a country level. We have split Europe into “North” and “South” for several years now. The Southern bloc is Ireland, Greece, Italy, Portugal and Spain. The rest of Europe, including non-Euro Area countries, i.e. Switzerland, UK etc., is included in the Northern bloc.

Figure 15. North vs South – Price & Earnings



Source: Datastream & CIRA.

Figure 16. North vs South – P/E



Source: Datastream & CIRA.

Figure 15 shows the price and earnings relative trends of Northern versus Southern Europe. There has been consistent earnings and price underperformance from the South over the past 2-3 years. There has been a close relationship between underperforming economic activity and underperforming corporate profits. Structurally, we find it hard to see this relationship changing in the near-future and continue to expect earnings and price trends to head lower over the coming 12-18 months.

However, Figure 16 also shows that there has been a sharp de-rating of Southern European equities in the past couple of months. This is the sharpest de-rating during the underperformance of the past 2-3 years. We have recently written that there may actually be a near-term opportunity for this underperformance to abate or even reverse³.

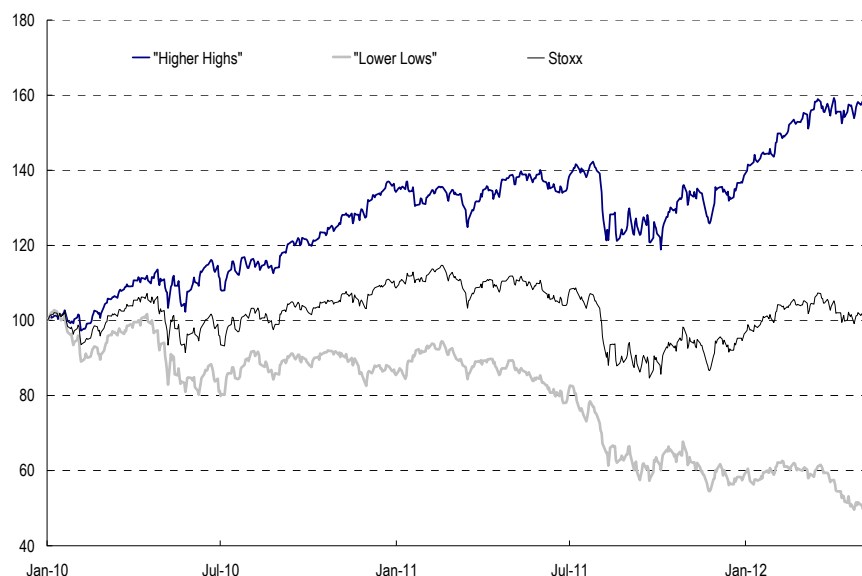
Haves and have-nots

We find further evidence of performance divergence if we cut the market another way. Figure 17 shows the performance of Higher Highs (HHs) and Lower Lows (LLs) since the start of 2010. HHs are stocks that have consistently made higher share price highs at 3 clear market mini-peaks in this period. LLs have done the opposite, hitting consistently lower share price lows over the past 18 months.

There are almost 200 (out of the Stoxx 600) European HH stocks, compared to around 70 LL stocks.

³ [European Equity Strategy — The Spain Trade, Part 2 — 25th April 2012.](#)

Figure 17. Higher Highs (HHs) & Lower Lows (LLs) — Strong Get Stronger



Source: Citi Investment Research and Analysis

It is easy to see gloom and doom. Coverage of European politics and economics is pretty depressing for all concerned. But, from an equity market perspective, we have shown that there are many bright spots in Europe. There are plenty of European companies whose share prices continue to head in one direction — up.

Figure 18. “Higher Highs” Which Are Also World Champions and Defensive Growers

Aggreko	Experian	L’Oreal	SABMiller
British American Tobacco	Fresenius Med. Care	Novo Nordisk B	SAP
Compass Group	Inditex	Pernod-Ricard	SGS N
Diageo	Jeronimo Martins	Publicis Groupe	Syngenta

Source: Citi Investment Research and Analysis

Figure 18 shows those HHs, which have also appeared in our World Champion basket⁴ and also in our Defensive Growth earnings strategy⁵. The former looks for European companies that are “global leaders” in what they do. The latter are stocks that we think offer investors an earnings “call option”, with lower than market earnings falls in the 2008-09 earnings and market recession or better earnings growth expected by Citi analysts in the next two years.

As with our World Champion and Defensive Growth strategy, we are happy to pay up for companies which offer superior growth profiles in a world of lower growth and lower leverage. That is the price you have to pay in a structural re-rating of growth.

⁴ [European Equity Strategy — Buying Dips — 12 April 2012.](#)

⁵ [European Portfolio Strategist — Eating Cake — 29 March 2012.](#)

Break-up risk

Some investors may be more bearish than us and our economists regarding the future of the Euro Area. While we have a high probability of Grexit in our base case, investors who want to properly protect portfolios against an episode of mass disorderly sovereign debt default across the Euro Area will have few places to hide. No wonder core rates are trading where they are.

Figure 19. The Euro Break-Up Hedge Strategy

Stock	RIC	Country	Mkt Cap €m	EM Exposure	Net Debt/Ebita 2012E
SABMiller	SAB.L	UK	31002	80	2.5
British American Tobacco	BATS.L	UK	78190	68	1.2
Novozymes	NZYMb.CO	Den	5008	62	0.4
Richemont	CFR.VX	Swit	23773	55	-1.6
Telenor	TEL.OL	Nor	10092	50	1.0
Unilever (UK)	ULVR.L	UK	33962	47	1.1
Carlsberg B	CARLb.CO	Den	6625	43	2.3
Swatch B	UHR.VX	Swit	10430	42	-1.3
Diageo	DGE.L	UK	48131	38	2.0
Vodafone Group	VOD.L	UK	105376	38	1.8
Nestle R	NESN.VX	Swit	151386	32	0.8
Reckitt Benckiser Group	RB.L	UK	26909	29	0.6
Imperial Tobacco Gp.	IMT.L	UK	31758	27	2.6
Novo Nordisk B	NOVOB.CO	Den	45878	25	-0.5
TeliaSonera	TLSN.ST	Swed	10919	25	1.3
Novartis R	NOVN.VX	Swit	108469	23	0.5
Roche	ROG.VX	Swit	91834	22	0.6
Burberry Group	BRBY.L	UK	7769	20	-0.6

Source: DataStream & CIRA

From an equity perspective, we offered our euro break-up strategy first in early December⁶. We suggested European stocks domiciled outside of the Eurozone that also had high sales/profit exposure to EM would be best positioned to offer some kind of break-up hedge. Most have low earnings volatility and strong balance sheets too.

Many of these stocks also appear in some of our mainstream strategies such as World Champions, Defensive Growth and even CDS-adjusted dividend yields. Perhaps this is where the bulls and bears can both meet. The bulls will like the growth qualities. The bears will like the defensive qualities.

Strategy outlook

Politics has taken the spotlight again in Europe. Recent election results were not all that unexpected but markets have reacted strongly. Core bond yields have headed to new record lows and risk assets have sold off sharply. Investors are long uncertainty/short answers, which is never a helpful position.

There appears to be a lot of bad news baked into share prices. But, a messy Greek exit, were that to occur, is probably not. Neither is a collapse in European corporate earnings, which would need a much more aggressive regional recession than our economists are forecasting or a synchronised global recession.

While we remain optimistic on the outlook for European equities over the coming 12-18 months, political and economic uncertainty presents near-term two-way risk for equity investors. Greek exit could be closer. Our economists believe that it is, on balance, more likely that Greece leaves the euro. Politicians and policy makers will probably be very busy over the coming months. Various “disaster” puts may well be tested.

⁶ [European Market Outlook — Barbell — 1 December 2011.](#)

Figure 20. Stocks Mentioned in Report (Data as at 14th May 2012)

Stock	RIC Code	Rating	Price	Currency
Aggreko	AGGK.L	1	22.03	£
British American Tobacco	BATS.L	2	31.35	£
Burberry Group	BRBY.L	2	14.67	£
Carlsberg B	CARLb.CO	2	497.7	DK
Compass Group	CPG.L	1	6.425	£
Diageo	DGE.L	2	15.635	£
Experian	EXPN.L	1	9.285	£
Fresenius Med. Care	FMEG.DE	2	52.85	E
Imperial Tobacco Gp.	IMT.L	1	25.43	£
Inditex	ITX.MC	1	68.68	E
Jeronimo Martins	JMT.LS	1	14.01	E
L'Oreal	OREP.PA	2	91.75	E
Nestle R	NESN.VX	2	55.15	SF
Novartis R	NOVN.VX	2	49.72	SF
Novo Nordisk B	NOVOb.CO	1	837	DK
Novozymes	NZYMb.CO		149.8	DK
Pernod-Ricard	PERP.PA	1	79.74	E
Publicis Groupe	PUBP.PA	2	37.945	E
Reckitt Benckiser Group	RB.L	1	34.5	£
Richemont	CFR.VX	1	54.3	SF
Roche	ROG.VX	2	157.1	SF
SABMiller	SAB.L	1	25.26	£
SAP	SAPG.DE	1	48.865	E
SGS N	SGSN.VX	2	1746	SF
Swatch B	UHR.VX	1	397.8	SF
Syngenta	SYNN.VX	2	313.7	SF
Telenor	TEL.OL	2	103.8	NK
TeliaSonera	TLSN.ST	1	46.25	SK
Unilever (UK)	ULVR.L	2	21.02	£
Vodafone Group	VOD.L	1	1.72	£

Source: Citi Investment Research and Analysis

Notes

Appendix A-1

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