Whither Real Growth in Europe?

Worrying Signs for the Short and Long Term

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Why This Matters?

Bond yields in major European countries have fallen to historical lows. According to our models, bond markets in Europe are pricing in higher recession risk in the short term, and a continuation of near zero growth with high uncertainty in the long term. These long-term macro trends imply a continuation of low bond yields and high equity premium in Europe.

Who Should Read This Paper?

The issues in this paper are important for managing the long-term risk of public and private assets, and should be of interest to the risk and investment strategists, and asset allocators.

Introduction

Two of our recent notes took the position that investors have focused too much attention on US recession fears. We proposed that bond markets are pricing in expectations of lower long-term growth, and suggested that equity and bond investors should concentrate on long-term macro indicators.

Unfortunately, macro economic risks are much more acute in Europe. Our models suggest that bond markets are pricing in much lower long-term growth, and that higher levels of macroeconomic risk are producing higher equity premiums on European versus North American equities. And, because our estimates of long-term growth in Europe are so low, our models indicate a higher probability of a short-term recession. Let's start with the bond market.

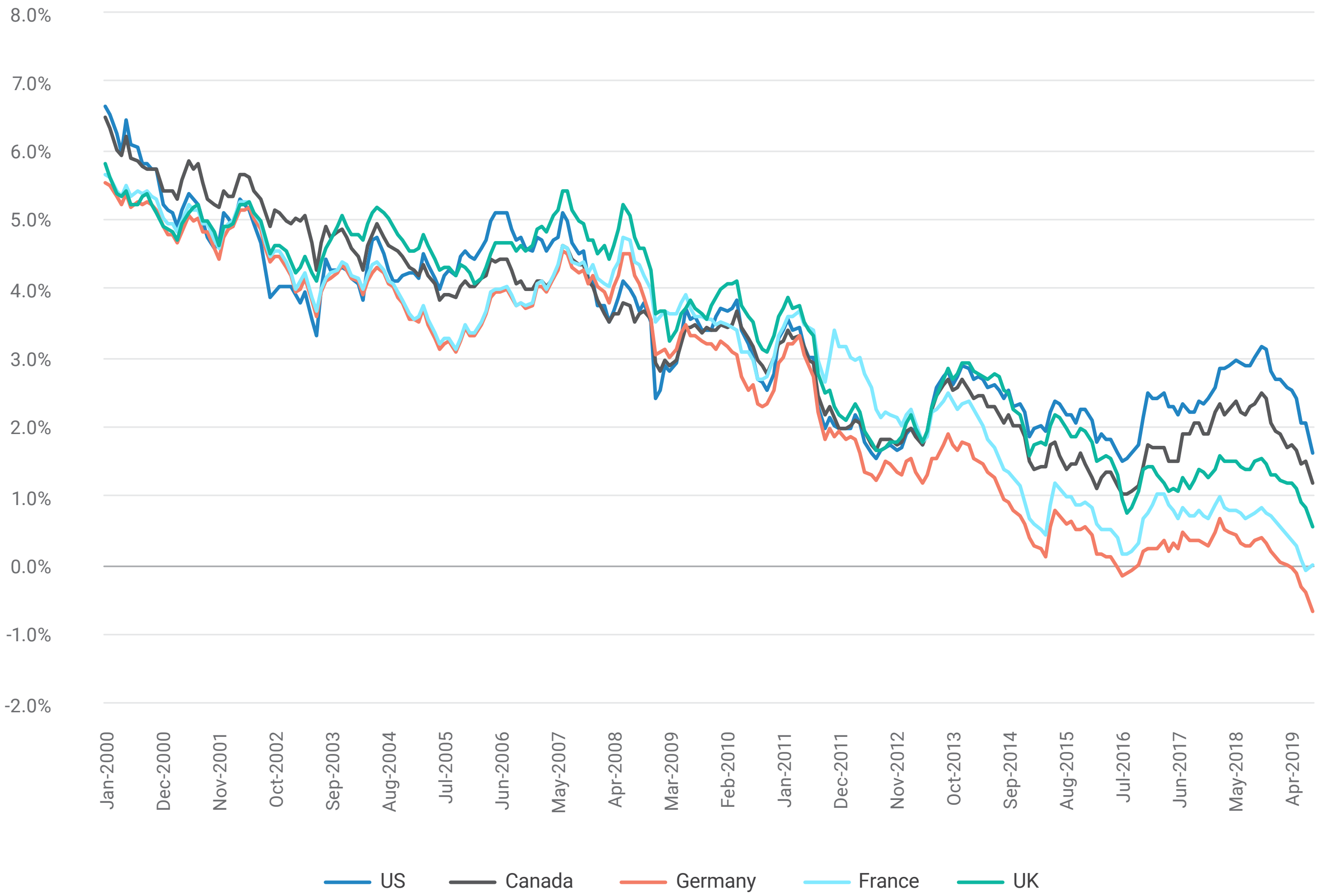
Low Bond Yields

Exhibit 1 shows the evolution of 10-year constant maturity government bond yields in the US, Canada and major European markets. Every market showed the same pattern- yields collapsed following the global financial crisis of 2008 and have remained well below their historical average since.

However, although all markets followed the same general pattern, there are distinct differences between markets. In particular, yields in Europe have been persistently near zero, turning even negative in Germany since May. Similarly, UK bond yields took a severe hit in the months following the June 2016 referendum, and dipped again in the last three months to near zero levels. By contrast, 10-year yields in Canada and the US, while quite low, are still hovering in largely positive territory.

Exhibit 1 - Low Bond Yields

10-Year Constant Maturity Government Bond Yield (Annualized, %)



SOURCE: FEDERAL RESERVE BANK OF ST. LOUIS

Low Long-Term Real Economic Growth

After accounting for relatively low and stable inflation rates, it seems that nominal bond yields are pricing in market expectations of low real growth. The Navega prior for long-term real growth confirms this point. Exhibit 2 shows our priors for long-term real growth in Canada, the US, France, Germany and the UK. According to our models, long-term real growth in Europe is hovering around zero, and even negative in the UK. By contrast, North American real growth, while anemic by historical standards, is still positive and higher than European growth.

Exhibit 2 - Low Long-Term Real Economic Growth

Country	Long-Term Expected Real GDP Growth (Annualized, %)
US	1.7%
Canada	1.5%
Germany	0.1%
France	0.5%
United Kingdom	-0.3%

SOURCE: NAVEGA STRATEGIES LLC RESEARCH

Higher Recession Risk in Europe

Expectations of lower long-term real growth have implications for both short-term recession probabilities and long-term equity returns. Let's start with the issue of a recession. From a strictly mechanical point of view, lowering the long-term growth rate increases the odds of a recession. This point is illustrated in Exhibit 3, where we use our model to calculate recession probabilities in Canada, the US, France, Germany and the UK. Again according to our model, the odds of a short-term recession are substantially higher in the major European economies than in Canada and the US.

Exhibit 3 - Higher Recession Risk in Europe

Country	Real GDP Growth Year-Ahead Forecast (Annualized, %)	Year-Ahead Forecast Volatility (Annualized, %)	Recession Probability Over the Next Year
US	1.7%	1.4%	4%
Canada	2.0%	1.3%	1%
Germany	0.2%	1.8%	62%
France	0.8%	1.0%	13%
United Kingdom	-0.1%	2.5%	80%

SOURCE: NAVEGA STRATEGIES LLC RESEARCH

High Macro Uncertainty and Equity Premium in Europe

The figures in Exhibit 3 don't tell the whole story, though. In addition to a decrease in the long-term growth rate, our models also suggest that long-term macroeconomic volatility (in other words, risk around long-term trend) is higher in the major European economies than in the US. This point has significant implications for the pricing of equities. Basic principles of finance tell us that equity valuations reflect the expected discounted value of current and future cash flows. Higher long-term macroeconomic volatility translates into higher future cash flow volatility. This volatility is a risk that is reflected in higher premiums.

These points are illustrated in Exhibit 4. The exhibit shows our model's estimate of long-run macroeconomic volatility and associated equity premiums in Canada, the US, France, Germany and the UK. We can see that long run macro risk in these three European economies is about two percentage points higher than in Canada and the US. And, we can see that the higher long run macro risk translates into equity premiums that themselves are about two percentage points higher.

Exhibit 4 - High Macro Uncertainty and Equity Premium in Europe

Country	Long-Term Real GDP Growth Volatility (Annualized, %)	Long-Term Equity Premium (Annualized, %)
US	3.1%	4.0%
Canada	3.0%	3.2%
Germany	5.2%	5.9%
France	5.3%	6.7%
United Kingdom	5.2%	6.3%

SOURCE: NAVEGA STRATEGIES LLC RESEARCH

Lessons For Investors

Despite the higher risks of recession in Europe versus North America, we would suggest that investors focus their attention on the long run risks. This includes tracking the underlying drivers of long-term growth; analyzing the exposure of their portfolios to long run macroeconomic risk, and re-examining their portfolio construction and rebalancing practices.

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