SIT BACK, RELAX, AND PRAY FOR THE BEST
A EUROPEAN MANIFESTO FOR THE AGE OF IRRELEVANCE

Bottom Line:
1 – European indices have underperformed since May and recent economic data has disappointed
2 – The European economy is not rolling over: it is settling at a sustainable growth rate
3 – M. Draghi turned a treacherous press conference into a success
4 – Greek bonds could benefit from the normalization of European monetary policy
5 – The European discount reflects the continent's irrelevance. That may not be such a bad thing.

In "Death in Venice", a German aristocrat willingly ignores the cholera plague that is ravaging the lagoon to pursue a doomed quest for youth, Platonic perfection, and immortality. As the rot spreads through the empty *palazzi*, the hero almost gratefully succumbs to the disease, overwhelmed by his own sense of decadence.

It is easy to hear the echoes of T. Mann's masterpiece resonate in 21st century Europe. German and French leaders seem too weary to do anything but watch the populist infection spread from Eastern Europe to England and Italy. Just as the pestilence of Venice mirrors Von Aschenbach's moral and creative decay, the rot of Italian politics is the outward symptom of the EU's internal tumors: the sclerosis of its decision-making processes, its sense of cultural decline, and the atrophy of its political, social, and civilizational ambitions. **Europe is crumbling under the weight of its morbid torpor**.

This report will take a more hopeful view of the continent's lethargy. Granted, Europe is slipping through Citigroup's economic surprise indices. But this soft patch simply means that **Europe is settling at a decent, and sustainable, pace of economic growth**, rather than adding fuel to the fire of an overheating economy with reckless deficit-spending. *Chi va piano va sano. E chi va sano va lontano.*


Death in Venice, L. Visconti, 1971

Monetary policy is in the same state of blissful indolence. Draghi has the luxury of waiting for the Fed to move and adjust accordingly. **His only concern is to prevent the Euro from rising too quickly** before he can contemplate Roman sunsets from his retirement house (or the *Palazzo Cighi* if Italy needs a savior next year).

In a news cycle that is dominated by the fire and fury emanating from the White House, and the oversized ambitions of Russian and Chinese emperors, Europe has indeed become irrelevant. Her fate is no longer hers to decide. But sometimes, **inaction is better than reckless, meaningless, and feverish trepidations**. Just ask Messrs Cohn and Tillerson.

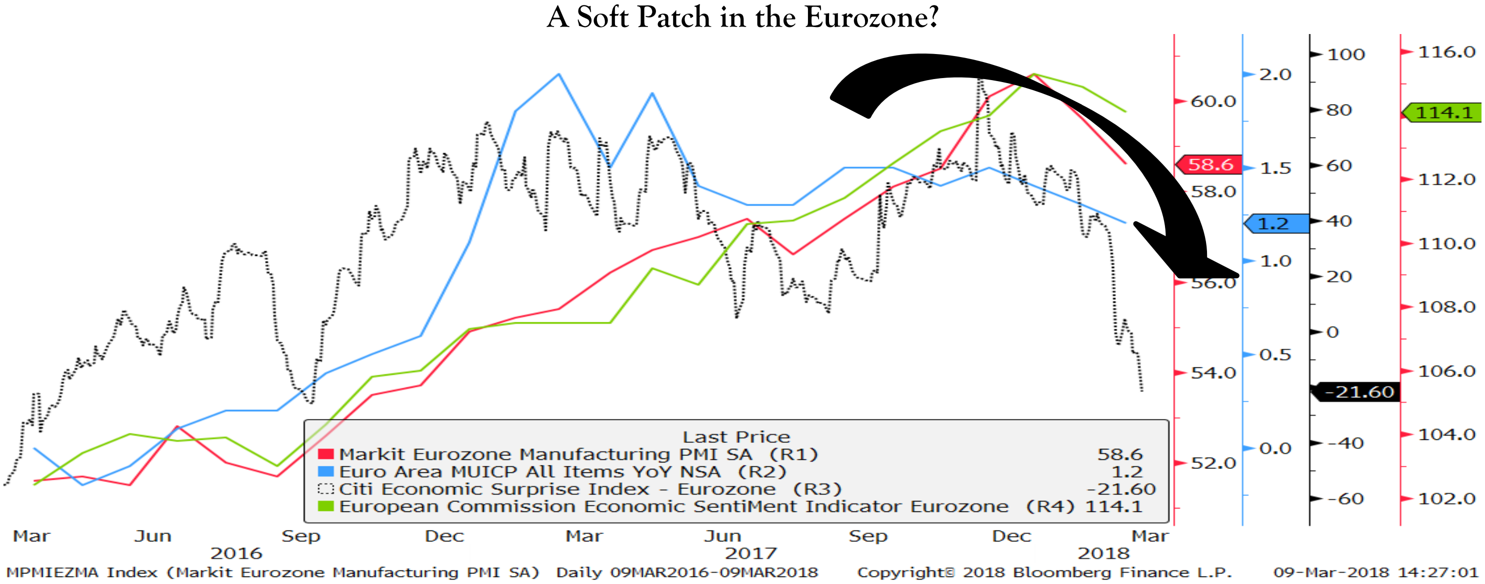
Soft Patch or Fake News?

What a difference a year makes! About a year ago, European indices were outperforming, pundits were certain that the Euro would fall to parity with the dollar, and the biggest political risk was France. A year later, the Eurostoxx 50 Index has underperformed almost every major global index (in local currency at least), M. Draghi spends his press conferences talking down the Euro, and France has become the continent's anchor of stability.

Relative Strength of the EuroStoxx 50 Index versus Main Global Indices

Consistent with the leading tendencies of equity markets, **recent economic data has confirmed the poor performance of European indices**. The Eurozone manufacturing PMI fell to 58 last month, the European Commission Economic Sentiment Indicator fell in the past two months, and, most worryingly for the European Central Bank and the normalization of monetary policy, headline inflation fell to 1.2% last month, against 1.9% a year ago. To add insult to injury, this European soft patch is taking place just as U.S. growth accelerates: the Citigroup Economic Surprise Index for the U.S. has jumped to 45, against *minus* 22 for the Eurozone.

A Soft Patch in the Eurozone?

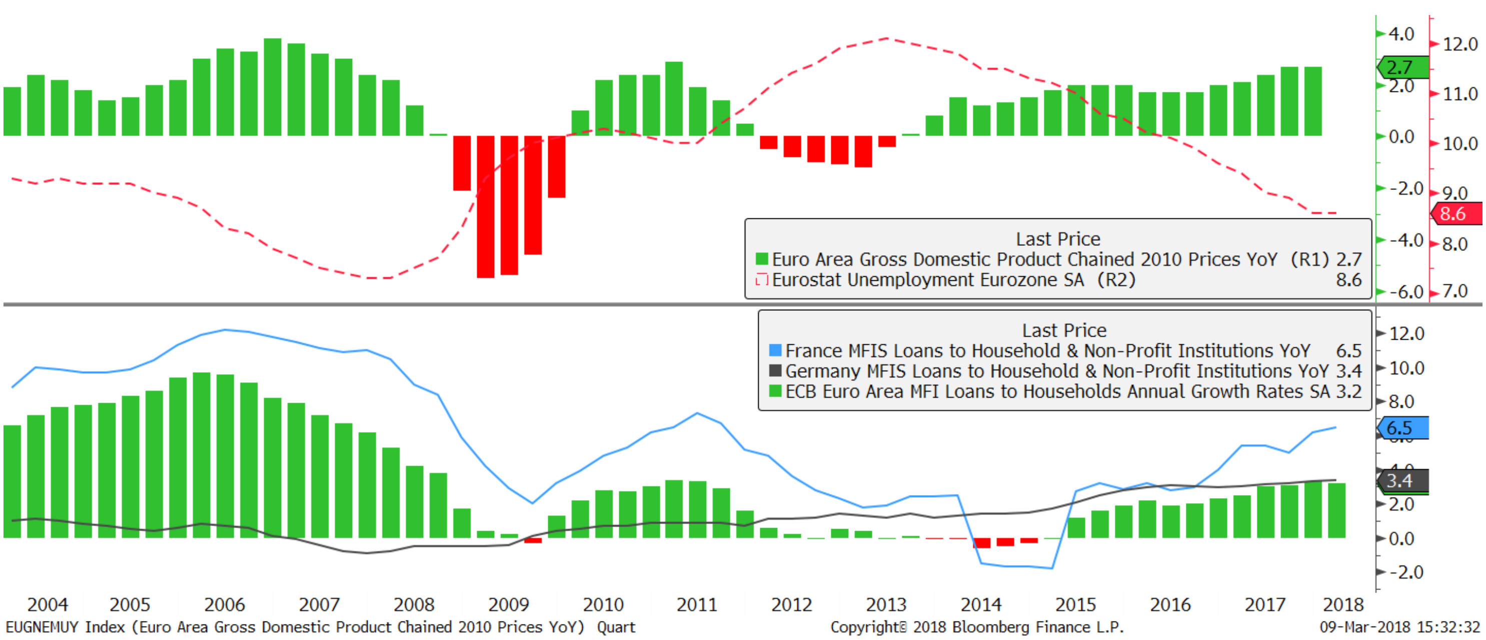


This narrative needs to be put in perspective. **Much of the underperformance of European indices is offset by a strengthening currency**. In dollar terms, Eurozone equities have outperformed equity indices in Japan, the U.K., Canada, China, India, and Australia since the start of the year. Also, the perceived economic soft patch may just mean that the eurozone economy is stabilizing at high levels, rather than rolling over. Both the manufacturing PMI and the consumer confidence index were at record highs prior to last month's prints. **Sentiment and economic surprise indices are usually normalized: it is impossible for them to keep rising forever**. Similarly, the drop in headline inflation mostly reflects the recent rise of the Euro, and the passthrough of the dip in commodity prices in early 2017. Last but not least, falling vegetable prices after an acute lettuce shortage last year have pushed down the headline index. Core eurozone inflation remained unchanged at 1%, pretty much where it has been for the past four years.

Stability should be welcome at this stage of the cycle. With unemployment rates at generational lows in most developed countries, the biggest risk is economic overheating. 2.7% real GDP growth and 8.6% unemployment rate is probably as good as it gets for the continent. These levels were the tipping point in the pre-2008 cycle: the price for above-trend growth in 2007 and 2008 was a massive credit bubble, which eventually set the stage for the brutal sovereign and banking debt crisis.

Bank credit to households is growing at a healthy, if not spectacular, 3.2% in the Eurozone, against almost 10% in 2006. The continental average is still dragged down by the slow recovery of bank lending in the periphery, but **household credit is growing at 6.5% in France**. Loans to households are also growing at a record rate in credit-adverse Germany. It is quite likely that the European economy will lag the deficit-powered U.S. expansion in the next months. But even J.M. Keynes argued for fiscal prudence during good times. As the Italians say, *« chi va piano va sano. E chi va sano va lontano »*.

Unemployment, Growth, and Credit in the Euro Area



Draghi's Early Retirement Gift

Like most workers about to retire, M. Draghi has one obsession: to not screw things up so close to the goal. He has a pretty good plan for that: a very slow and gradual plan to tilt the bank's talking points, reduce the pace of bond purchases, and eventually raise the deposit rate once or twice before his big going away party. Like most workers about to retire, M. Draghi has one nightmare: that some idiot will ruin his carefully laid-out plans.

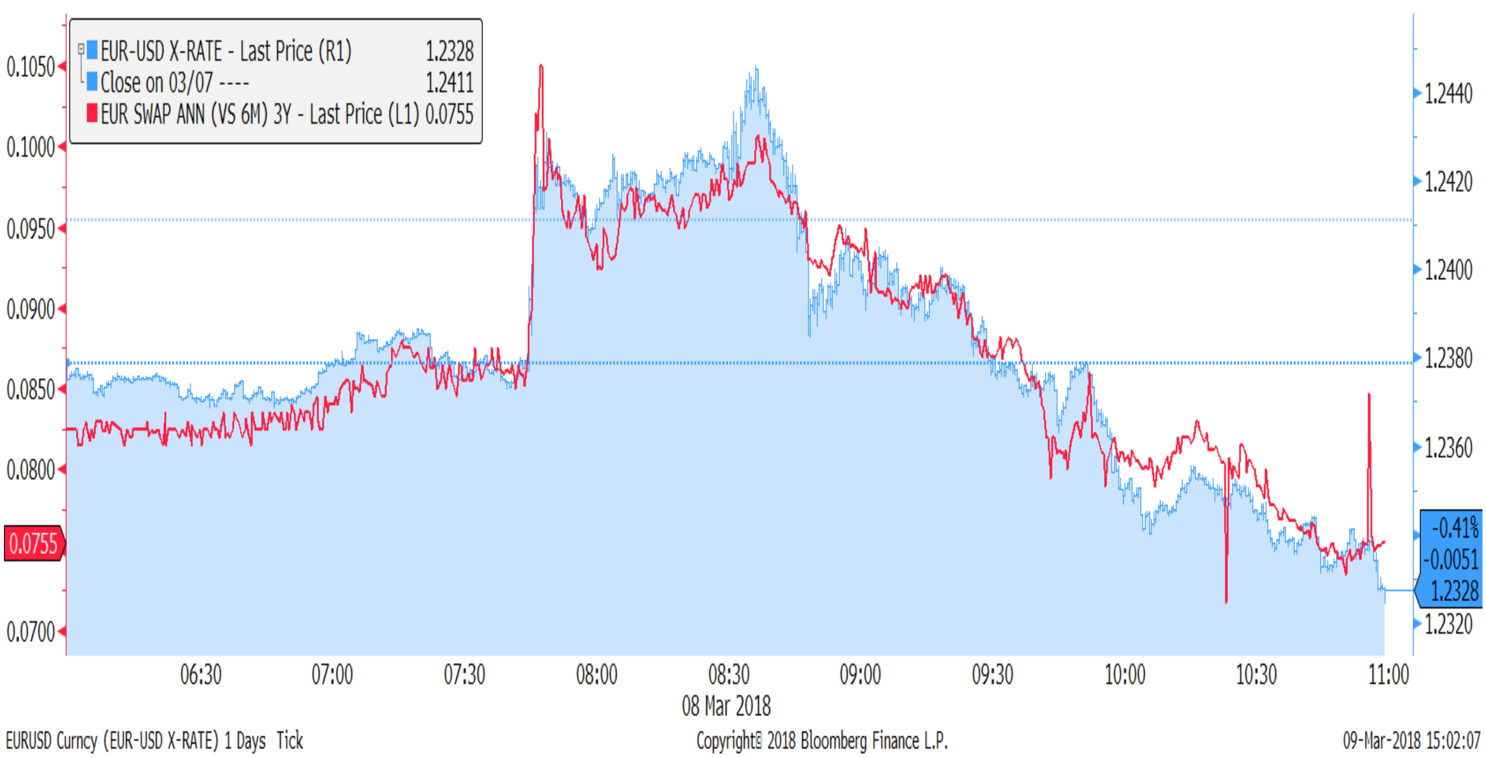
That nightmare scenario seemed to materialize in January after S. Mnuchin's weak dollar comments sent the Euro to $1.25. Mr Draghi spent what should have been a dull and eventless press conference putting down that fire.

Fortunately, unexpected events work both ways. Last week's press conference should have been much harder as M. Draghi needed to tweak the ECB's communication in a slightly less dovish way. Speculative traders held a record net long position on EUR/USD future contracts and the Euro did spike when M. Draghi removed the reference to an "increase of the asset purchase program in terms of size and/or duration".

But then, **M. Draghi was able to turn all the recent economic and political surprises in his favor**. Surprise tariffs from the White House? They should eventually lead to a stronger dollar. Political chaos in Italy? Political uncertainty would eventually result in a loss of confidence, and a more measured pace of monetary tightening. The February spike in volatility? It would amount to an unexpected tightening of financial conditions, which would have to be offset by easier monetary policy. Draghi's great balancing act was so successful that the Euro was lower by the end of the press conference and seems to have stabilized in a narrow 1.21 to $1.25 range.

Draghi's Silver Tongue

Euro and Swap Rate During the March 8 Conference



How might the future look for the European Central Bank by the time M. Draghi walks into the Roman sunset?

Unemployment will be below 8%. Inflation will close to, but below 2%. The Euro will be back to \$1.3, or even \$1.4, but it will have gone there gradually, as the ECB's skillful communication would have smoothed the bumps. All the "program" countries will have graduated from the European Stability Mechanism's financial assistance. With a bit of luck (France) and effort (Spain and Italy), no country will be in violation of the European rules on public deficits. Public sector debt, adjusted by ECB holdings, will have fallen to its pre-crisis level.

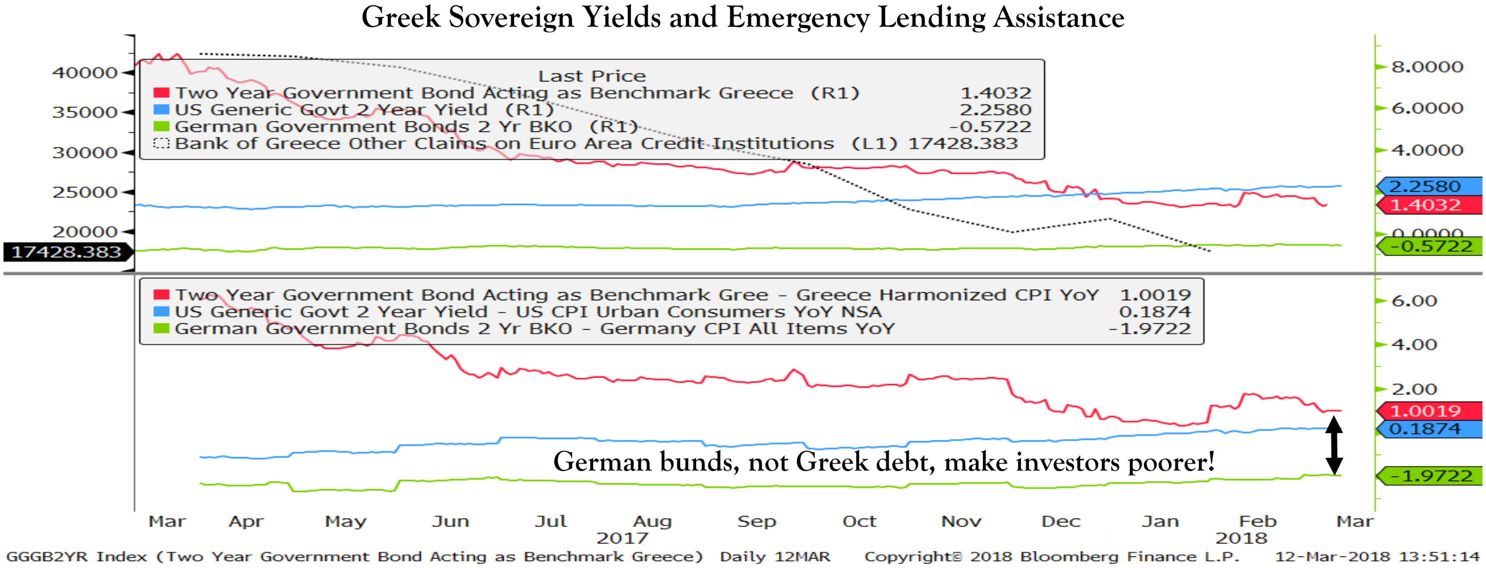
Five years ago, this scenario would have seemed like some sort of a dark joke. Two years ago, it may have been the secret dream of ECB economists, but anyone who would have voiced that in public would have been ridiculed. A year ago, this would have been a "James Bond" trade: one where the hero needs to from escape the shark tank, ski down the avalanche, and jump into the flying helicopter to rescue the girl. Today, it seems like the most probable path for the European economy, bar an outside catastrophe.

How could this scenario translate in capital markets? Last month, I suggested that 10-year Italian BTPs were a good way to buy the Euro without paying Mr. Draghi. I do not mind the credit risk, but 10-year bonds present a lot of duration risk given my secular outlook for higher, much higher rates. A client recently suggested that I looked at **2-year Greek notes**. I joked that it would be hard to convince investors to buy Greek debt at a lower yield than the comparable maturity U.S. treasuries. He offered a different, and interesting perspective: 2-year Greek debt offers a real yield of 1.2%, versus *minus* 2% in Germany. **The real "certificate of confiscation" in Europe are German bunds, not peripheral debt**!

Politics may also be a tailwind for this trade. The ECB's emergency lending to Greek banks has fallen to €17.4 billion last month, a quarter of its level when QE started. The *troika*'s assistance package ends in August, so **Greek bonds could potentially be eligible for the last months of the European Central Bank's Public Sector Purchase Program**. The amounts of Greek debt that the ECB would buy would be trivial, but the symbol would matter for markets.

That symbol may also matter for the political image of M. Draghi – this would be even better than G. W. Bush "Mission Accomplished" banner on the USS Lincoln. The optics on that would be so good that they could make Draghi a serious contender to come back as the proverbial white knight to save Italy from political chaos…

Greek Sovereign Yields and Emergency Lending Assistance



The Age, and the Virtues, of European Irrelevance

Watching the news flows lately, one would be forgiven for thinking that the Eurasian continent ends with the Dnieper river. The train of history seems to have left Europeans behind. Europe is so irrelevant that D. Trump is happy to sacrifice German steelmakers just to send China the message that the U.S. is serious about trade. In China, Xi Jinping extended his imperial power to his lifetime. Besides controlling the flow of information between more than one billion citizens, the "Chinese dream" ambitions to transform three continents. Europeans look at the Belt and Road initiative with a mix of bewilderment, envy, and, most of all, helplessness. With the upcoming elections, V. Putin will prove his total control of the Russian society, and the futility of the sanctions imposed by the European Union four years ago.

Europe has been completely sidelined in the main diplomatic hot spots of the world: from Syria to Iran, Korea to the South China Sea, Europe is a passive bystander, obediently waiting for the grown-ups to reach a decision. The only time Europe manages to make headlines is when it threatens to self-destruct. And then again, these threats are no longer taken seriously. Markets barely shrugged when Catalans made a pathetic attempt at independence last year. Italian bond yields were dead flat after an election when anti-EU forces gathered more than 55% of the votes.

I believe **this sense of historical irrelevance is ultimately the reason for the resilience of the European discount**. As I explained last July, differences in sector composition, leverage, or even growth expectations cannot fully explain the cheapness of European equities versus the other MSCI regions. Euro-breakup risk may have been a factor during the sovereign debt crisis, but why would the discount have persisted in the equity market, while it has all but disappeared in the bond and currency markets? For lack of a better explanation, I believe investors are punishing Europe for its lack of historical relevance.

Yet, it seems to me that the European model of rule by judges and technocrats may outlast the U.S. model of reality TV politics, and the Sino-Russian model of one-man rule. Just ask Mr. Cohn what he thinks of his likely replacement by TV personality Larry Kudlow.