PRIVATE BANKING INSIGHTS
Market Update

January 2015

Yves Cochez
Senior Vice President
Chief Investment Strategist

STATE OF THE UNION

As we heard from the leader of the free world a few days ago, the State Of The Union is strong and the shadow of crisis has passed.

But what about the State Of The "Other" Union across the pond and comprised of 19 member states sharing at least one thing in common – a rapidly plunging currency?

You would probably need to be under the (enjoyable) influence of several Duvels or Pastis (I wouldn't recommend Ouzo at this stage) to argue in a convincing manner that the state of the European Monetary Union is strong.

If you are among the select group of individuals whose investments are at least partially managed by Webster Private Bank, you would have noticed that you most likely have some investments in Europe, and we are convinced that, on numerous occasions, you have wondered what exactly was going through your portfolio manager's mind when all you hear and read about Europe is as depressing as a basketball game in Madison Square Garden.

The recent announcement by the European Central Bank (ECB) that it will start purchasing government securities is seen by many as a confirmation that the European economy is indeed very weak and in desperate need of an additional dose of stimulus.

We have contended for some time now that there is too much negativity among investors when it comes to the European economy and, while we welcome the Quantitative Easing (QE) program announced by the ECB, we believe the conditions were already in place for a more pronounced rebound in economic activity in the Eurozone. Several factors will help boost the European economy in coming quarters:

1. Fiscal austerity will not be a significant drag on growth. This is a major departure after years of fiscal retrenchment.
2. The Euro has fallen to its lowest level in 11 years against the U.S. dollar and is also weakening on a trade weighted basis. This will boost European exporters' competitiveness at a time when we also expect a recovery in global trade.
3. The plunge in oil prices is a boon for the Euro area given its status as a net oil importing economy. This will lead to an increase in real purchasing power and support corporate profit margins.
4. The credit cycle is turning and this is particularly important for an economy much more dependent on bank lending than the U.S.

WHY QE WAS NECESSARY

Importantly, most of the traditional benefits which were associated with QE in the U.S. have already been achieved to various degrees in Europe, even before last week's announcement. Indeed, bond yields are already at record low levels and credit spreads have already significantly tightened. As mentioned, the Euro is also a lot weaker than only a few months ago.

While the ECB has long refrained from embarking on a full-blown QE program, several important monetary policy decisions have already been implemented over the past few years. These measures include cutting the main refinancing rate and bringing the deposit rate into negative territory as well as providing banks with access to cheap liquidity in order to stimulate bank lending. Asset purchases were already in place but only limited to ABS and covered bonds.

In a world of near zero interest rates, QE will reinforce the effectiveness of these measures and help boost the EU economy, as well as raise inflation expectations.

The fact that inflation is now negative for the region is seen as a sign that Europe is headed towards deflation. We disagree. Plunging oil prices are the primary factor behind the drop in headline inflation while core inflation has been stable in recent months. Deflation is a threat when expectations of falling prices lead consumers and businesses to postpone spending. Households will not delay heating their homes even if they expect lower energy prices going forward. Market based inflation expectations have nevertheless continued to move lower. The ECB is following these trends very closely as declining inflation limits the effectiveness of monetary policy by raising the real level of interest rates.

QE will lead to a significant increase (1+ trillion Euros) in the size of the ECB balance sheet. Adding government and agency bonds to the current purchases of ABS and covered bonds was needed given the limited size of these two markets. This should put additional downward pressures on the Euro, particularly since the Fed is not expanding its balance sheet anymore. While QE will lead to €60 billion of security purchases on a monthly basis until at least September 2016, the program will be maintained until inflation moves back towards the ECB target of "close to but below 2%". Together with the TLTRO program and the recently completed bank stress-tests, QE should provide additional support to the nascent recovery in bank lending. The combination of QE and the various measures already implemented means that monetary policy in the Euro area will likely stay extremely accommodative for the next few years.

MARKET IMPACT - BUY EUROPEAN EQUITIES AND HEDGE THE EURO

Although it is always dangerous to draw parallels and there are some obvious differences, we believe European equities are at a stage not too different than U.S. equities in 2009:

1. Economic growth and the credit cycle are bottoming out.
2. Aggressive monetary policy involving asset purchases and measures aimed at supporting the transmission mechanism through bank lending are being aggressively implemented.
3. Corporate profits and ROEs are depressed (and ready to bounce back), a typical situation after a recession (the region suffered from a double-dip recession which only ended in 2Q2013). Operating leverage will lead to a strong earnings' rebound once top line growth recovers.
4. Tail risks are abating. While "Grexit" fears have come back to haunt investors, we still believe that the EU debt crisis has largely been contained (although the shadow of past crisis has not yet fully passed) as evidenced by tight peripheral credit spreads and in light of all the tools which are now available to deal with renewed economic and credit weakness (if need be).

Obviously, structural reforms are still very much needed in order to boost the long-term growth potential of the European economy (what Abe would call its third arrow) but, in the medium term, European equities should benefit from a combination of improving economic growth, rising earnings, a weak currency, extremely accommodative monetary conditions and attractive valuations, particularly relative to the U.S. market.

FOR MORE INFORMATION CONTACT YOUR WEBSTER PRIVATE BANK PORTFOLIO MANAGER OR EMAIL US AT PBINFO@WEBSTERBANK.COM.