Difficult Quarter for Eurozone Stocks

Eurozone equity markets have encountered significant headwinds in the second quarter of this year despite continued robust economic growth above estimated potential for most Eurozone economies.

The continued strength of the Eurozone economies is emphasized in this month's "OECD Economic Surveys: Euro Area."[i] These economies have been growing since 2014. "GDP growth is expected to slow somewhat, but to remain strong by the standards of recent years," the survey states. OECD projects Eurozone GDP to grow by 2.2% this year and 2.1% in 2019, compared with 2.5% in 2017. Factors driving this growth are the continuing expansion of the global economy, a very accommodative monetary policy, and a mildly expansionary fiscal policy. Among the reforms cited by the OECD that are needed to strengthen the resilience of these economies are a rapid resolution of the continuing nonperforming loan situation, a reduction of financial fragmentation across national borders, and improvement of the European fiscal framework.

The European Central Bank (ECB) also expressed a positive view of the Eurozone economies on June 21 as it presented its plan for scaling down its monthly quantitative easing bond purchases during the remainder of the year and concluding its Asset Purchase Program at year-end. The ECB indicated that its policy rates will remain at the present levels at least through the summer of 2019.

The HIS Flash Eurozone Purchasing Managers' Index for June indicated that business activity regained some momentum after growth hit a one-and-a-half year low in May. The service sector was responsible for this improvement as manufacturing activity slowed further. Business expectations are depressed, with trade-war and political uncertainties cited as the biggest concerns.

Indeed, it is these concerns that have created the headwinds for equity markets during the second quarter. The worsening trade relations between the Eurozone and the US are a greater concern for Eurozone equity markets than for the US's, as the Eurozone is more dependent on trade and on the maintenance of the rules-based international trading system. While Europe will respond in kind to trade restrictions imposed by the United States, its scope for doing so without harming itself are limited. If the trade war continues to escalate, the effects on the region will be dire.

Political developments in Europe also have created uncertainties that undermine investor confidence. The election of a populist government in Italy is seen as a threat to European institutions and increases the difficulty of reaching an agreement on an EU-wide solution to the immigration issue. While the election of the centrist Macron in France last year led to optimism that the populist tide had turned, populist, EU-sceptic parties have gained ground not only in Italy but also in Eastern Europe. Even in Germany, where Angela Merkel has been able to extend her leadership of the country, she is confronted with the difficult task of finding a position on migration that is acceptable to her coalition partner, the Bavarian CSU party, which is seeking to ward off competition from the right-wing populist AfD in regional elections in October. Polls indicate that immigration is the most pressing issue in the region and is a major driver of EU populism. An "immigration summit" of EU leaders last weekend was unable to make any progress.

Another source of political uncertainty is the negotiations on Brexit: Major issues remain unresolved, and time is running out.

It is not surprising, therefore, that Eurozone equity markets have experienced heavy going this quarter, despite the positive macroeconomic situation. Over the last 90 days through June 25th, the return for iShares MSCI Eurozone ETF, EZU, is -5.11%, which compares with a positive return of 2.22% for the SPDR S&P 500 ETF Trust, SPY. Within the Eurozone there is considerable variation in returns over this period, ranging from positive gains of 3.48% for the Global X MSCI Portugal ETF, PGAL, and 2.54% for the iShares MSCI Ireland ETF, EIRL, to large losses, with returns of -10.21% for the iShares MSCI Italy Capped ETF, EWI, and -12.53% for the iShares MSCI Austria Capped ETF, EWO. For the first and second largest economies, the iShares MSCI Germany ETF, EWG, returned -5.79%, while the iShares MSCI France ETF, EWQ, performed less badly at -2.65%. Trade tensions are likely to determine whether these markets are able to recover in the second half of the year.

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[i] http://www.oecd.org/eco/surveys/economic-survey-european-union-and-euro-area.htm
Sources: OECD, HIS Markit, CNBC, Bloomberg, Goldman Sachs Economic Research

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