
THE OUTLOOK FOR EUROPE AND UNFINISHED BUSINESS

Wisdomtree EU
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On a recent “Behind the Markets” podcast, WisdomTree interviewed in its first segment Frederik Ducrozet, senior economist for Pictet Wealth Management, which was followed by a segment with Tamim Bayoumi, deputy director in the Strategy, Policy and Review Department of the International Monetary Fund and author of a great new book called *Unfinished Business: The Unexplored Causes of the Financial Crisis and the Lessons Yet to be Learned*. WisdomTree focused the conversation on the outlook for European equity markets and the economy, closing with a look back at the financial crisis for Europe and the current state of the European banking system as well as the euro area and monetary union itself.

Ducrozet Bullish on European Laggards

Ducrozet and his firm Pictet Wealth have a bullish bias to European equities, wanting to position toward more cyclical parts of European markets, including cyclical sectors, banks and small-cap stocks.

Ducrozet does not see signs of a slowdown in the European economic story and calls 2018 the year of the laggards—so countries such as France and Italy could outperform Germany from an economic growth perspective.

One of the risks of 2018 is Italy’s politics. From an economic growth perspective, Italy has lagged, and there is an election on March 4. Ducrozet does not believe the populist and more euro-sceptic Five Star Movement wins the election and forms a government, but that is a risk for the euro area in 2018.

Ducrozet sees the European economy getting stronger so that it is more resilient to political shocks. Further, following the Trump election and Brexit, Ducrozet sees it becoming harder for any of these political movements in Europe to push for an exit of the euro area. Particularly in Italy, he even sees the far-right parties walking back the idea of leaving the euro area.

Politics a Driver of Euro in 2017, Interest Rates in 2018?

Ducrozet believes the euro strength in 2017 was all about the French elections not going into a worst-case scenario, and that dominated other factors such as Fed policy and concerns from capital outflows from China. Monetary policy divergence and interest rate policies seem to have influenced a stronger dollar versus the euro. On the European Central Bank (ECB) front, the rising euro, particularly if it moves beyond 1.25, would be a headwind for inflation and give ECB president Mario Draghi more pause on potentially unwinding quantitative easing (QE)—so gains in the euro area look to be more

muted or even capped for 2018.

Talking the Talk but Not Walking Yet

Ducrozet does not see any hiking of the ECB negative interest rates in 2018. He sees forward guidance changing by this summer, when Draghi could bring a more hawkish and bullish tone and discuss ending QE around the end of 2018 on a three- to six-month gradual reduction, and he could hint at interest rate hikes for the middle of 2019. But even then, we still could have negative interest rates in 2019, so we are likely talking a low and negative rate environment for an extended period of time.

Unfinished Business with Tam Bayoumi

Later in the interview, we explored Bayoumi's book *Unfinished Business*, an exploration of the financial crisis. Bayoumi wrote the book because he saw the European financial crisis and the US financial crisis being parasitically intertwined.

How Did a US Housing Crisis Turn into a European Depression?

Bayoumi sees much of the crisis stemming from 1996 regulation that made European capital buffers subject to internal bank risk models. This is still true when banks run their own models for determining how much risk their balance sheets have and how much capital they need to hold. This helped lower the banks' cost of capital and gave incentives for US banks to offload riskier loans to US investment banks, which in turn sold these loans to European banks that had even lower costs of capital with their internal risk models.

US commercial banks, which had more stringent leverage ratios, came through the crisis much better than investment banks, which had fewer regulations and fewer capital requirements. European banks both use their internal risk models and have much higher leverage. Basel III will slowly change some of these internal risk models and start to introduce stricter leverage requirements.

Bayoumi Sees Challenge with Design of Euro Area

Bayoumi's book describes the history of the monetary union and some of the challenges from its creation, notably different views of the role of the euro by Germany and France. France viewed the single currency as necessary to create the more integrated European bloc and believed the union should provide support to countries that were having trouble, while Germany wanted more economic integration before introducing the single currency without support for countries that got in trouble. What we got because of the fall of the Berlin Wall was a French early currency union with a German no-bailout clause, which Bayoumi sees as the worst of both worlds.

Bayoumi sees this same core debate playing out today. President Emmanuel Macron of France wants a euro area finance minister who can lend to countries that get in trouble. Germany wants a euro area finance minister who can restructure the debt of countries that get themselves into trouble, which Bayoumi sees as the same France versus Germany debate that has been happening for 50 years.

Will Anyone Be Kicked Out of the Euro Area?

Bayoumi believes it unlikely a country will get kicked out of the euro area during a crisis; rather, after long periods of depressions for some countries, people will decide to reverse course after prolonged sluggish growth. There were earlier monetary unions in Europe that disbanded because of this exact problem. Bayoumi's book and conversation was an interesting take on historical events that led to the crisis and current situation.

Listen to the full conversation:

View the online version of this article [here](#).

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