Multi-Asset Solutions Weekly Strategy Report

Global markets and multi-asset portfolios

November 25, 2019

IN BRIEF

- Comparisons between the eurozone and Japan are commonplace, especially following periods of soft economic data such as we have seen in the eurozone for much of 2019.
- While there are some similarities between the eurozone and Japan, we do not believe that the eurozone is destined to simply repeat the "lost decades" suffered by Japan in the 1990s and 2000s.
- Both blocs have aging populations and have seen significant derating of the banking system, but the demographic challenge in the eurozone is less severe than that facing Japan; further, the eurozone does not face the same private sector deleveraging pressure that Japan had to contend with as the asset bubble of the 1980s unwound.
- Persistently low inflation will likely keep comparisons between the eurozone and Japan alive, but a comparison with Switzerland is equally valid, in our view. This leads us to take a somewhat more optimistic long-term view of the eurozone's prospects.

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WHY EUROPE CAN AVOID JAPAN'S "LOST DECADES"

After a year in which we saw a combination of trade and tariff uncertainty and a general slowdown in global manufacturing, it is perhaps little surprise that Germany narrowly avoided a technical recession. Germany is widely recognized both as a manufacturing and industrial powerhouse, and also as the driving force behind the eurozone economy. Weakness in Germany contributed to a general dip in confidence across Europe and a slew of soft manufacturing data for much of the year. In parallel, it also revived comparisons between the eurozone and Japan, raising the question of whether the eurozone is inevitably on track to repeat the "lost decades" that Japan suffered in the 1990s and 2000s.

There are some clear commonalities between the two regions: both have aging populations, both have experienced a period of deleveraging, have an inefficient banking sector, and exceptionally low policy rates. However, there are also important differences: demographics on aggregate are less extreme, deleveraging occurred in the eurozone government, not in the private sector, and both banking sector derating and the move to quantitative easing happened far quicker in Europe than in Japan.

While we see ongoing disinflationary forces at play in Europe and recognize the need for further restructuring of the banking system, we do not believe that the eurozone is on a monotonic path to Japanification. Exploring the case for and against, we can better understand how Europe can avoid following Japan's path.

Less severe demographic drag

Those who worry that Europe could repeat Japan's lost decades of deflation and secular asset market declines focus first on demographics. Any suggestion that a shrinking labor force might boost wage inflation was mostly disproven in Japan. Lower potential growth from a shrinking workforce, together with the deflationary forces of private sector deleveraging and lower spending patterns by older cohorts, weighed on nominal growth.

In some countries – Italy and Germany notably – demographic trends are concerning, but on aggregate the demographic drag is less severe than in Japan. According to Eurostat, the age dependency ratio[1] across the eurozone will rise from just over 30% today to just under 50% in the next 20 years. But there is a wide spread across countries, with Ireland's ratio projected at around 35% while Italy's approaches 60%; by contrast, Japan's dependency ratio is expected to top 80% by the end of the 2030s. The propensity of European citizens to save via fixed income markets may lead to some tolerance of disinflation. Increasingly, though, eurozone policymakers recognize the importance of preventing consumers' expectations of lower prices from becoming entrenched.

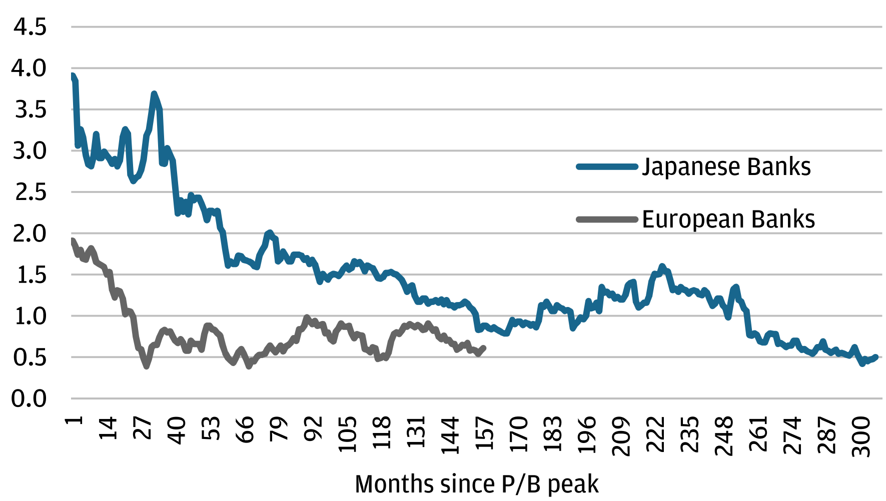
In the 1990s Japan faced the aftermath of an asset and property market bubble. The corollary of this bubble bursting was a prolonged period of private sector deleveraging that weighed on aggregate demand and price inflation. Certainly, parts of the eurozone enjoyed a debt-fueled boom in the early 2000s, following the convergence of rates towards lower, German levels in the 1990s. But Europe's asset boom was far less extreme, and much less pervasive than that in Japan. The eurozone sovereign debt crisis of 2010-2012 followed pockets of sharp deleveraging and reductions in government expenditure; swift and decisive action from policymakers avoided an existential threat to the euro itself.

The banking sector is central to both the European and Japanese economies. Prolonged deleveraging, writing down non-performing loans, and rebuilding capital

[1] Old age dependency ratio: population > 65 divided by working age population (15-65)

EXHIBIT 1: PRICE TO BOOK VALUE (JP PEAK IN JULY 1987; EU PEAK IN NOVEMBER 2006)

Both eurozone and Japanese banks have seen meaningful derating from the peak in Price-to-Book valuation. Now at approximately 0.5X we believe that much of the derating in eurozone banks is done. It is further noteworthy that derating in the eurozone was considerably quicker than the comparable experience in Japan.



Source: Bloomberg, J.P. Morgan Asset Management; data as of November 22, 2019. For illustrative purposes only.

buffers acted as a drag on the monetary plumbing in both economic blocs. As a result, both eurozone and Japanese banks now trade at around 0.5x price-to-book (**Exhibit 1**), but while the derating took almost 20 years in Japan, it unfolded much more quickly for eurozone banks. Visibility on eurozone bank balance sheets is much higher as a result of the stress tests, and the rebuilding of capital, now essentially complete, was largely funded by private sector sources.

Speedier policy response

Central banks in both the eurozone and Japan have adopted ongoing policies of negative rates and quantitative easing. In the absence of tiering (only recently implemented in Europe) negative rates are a major headwind to bank earnings. Nevertheless, the policy response to the eurozone crisis – while rather slow by U.S. standards – was much quicker than the policy response in Japan in the 1990s. It can be argued that Europe's negative rates environment is creating a liquidity trap and introducing a paradox of thrift[2] to the economy. But even then, the speed of policy easing relative to Japan in the 1990s is noteworthy. In addition, credit is expanding in the eurozone, providing a welcome stream of lending income, whereas in Japan credit growth was negative for long periods in the 1990s and 2000s.

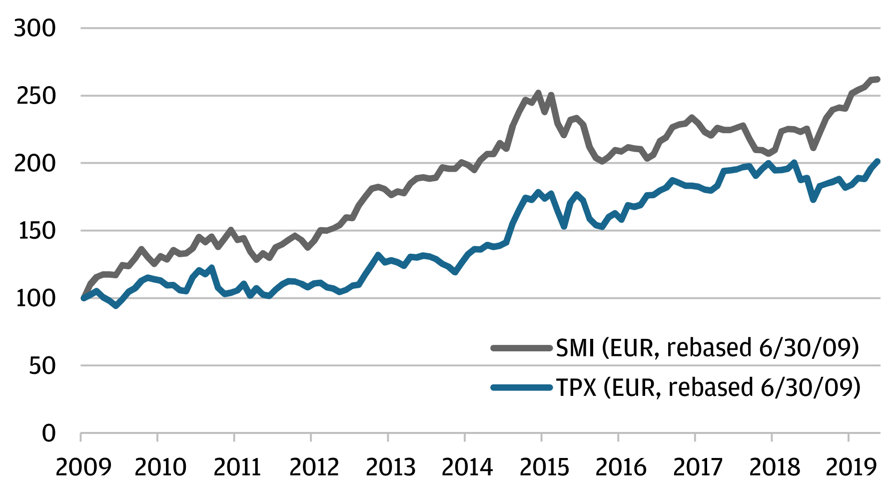
In sum, while we acknowledge passing similarities between the economies of the eurozone and Japan, Europe is not necessarily condemned to relive Japan's lost decades. Certainly there are risks, but we believe that it would require a series of meaningful policy errors to consign the eurozone to this fate. We are encouraged further by the debate that the new European Central Bank president, Christine Lagarde, has initiated over more expansionary fiscal policy. Given ultra-low rates, the eurozone has the fiscal space which – if appropriately deployed – could further distance Europe from Japan.

There is another, less frequently discussed example of a low inflation, low rate, highly advanced economy to which Europe might also be compared: Switzerland (**Exhibit 2**). The Swiss economy, while considerably smaller than that of the eurozone, has adapted well to the challenges of low inflation and a strong currency. As a result, Swiss equities have outperformed Japanese equities by around 60% in EUR terms since the global financial crisis. Perhaps those nervous about how the eurozone plots its future course through low inflation and population aging might start by looking close to home for a more optimistic comparison.

[2] Paradox of thrift: the idea that individuals save more during recessions, here extended to assume that at lower levels of savings rate individuals will need to save greater amounts to achieve the same outcome, thereby taking money out of circulation and slowing velocity of money.

EXHIBIT 2: JAPANESE AND SWISS STOCK MARKET RETURNS 1980-2019

The eurozone is commonly compared to Japan since both economies have aging populations and low inflation. However, we see more parallels to Switzerland, which has successfully adapted to a low inflation, low interest rate and strong currency economy. Compared with Japan, the Swiss index (SMI) has outperformed the Japanese equity index (TPX) by around 60% in EUR terms since the global financial crisis.



Source: Bloomberg, J.P. Morgan Asset Management; data as of October 31, 2019. For illustrative purposes only.

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