MARKET INSIGHT

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Redmayne Bentley

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Europe: Closer to the Fire

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EUROPE: CLOSER TO THE FIRE

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Inflationary and, therefore, monetary policy problems are global thanks to post-COVID supply chain issues and a constrained energy market. Yet Europe stands closer to the fire than perhaps most economies. I say that in both a literal sense, due to its proximity to Russia and Ukraine and its heavy reliance on Russian gas supplies, as well as metaphorically, thanks to it having been the last mover from the lowest base in terms of interest rates.

The European Central Bank (ECB) has, like most central banks, been behind the curve in terms of its response to inflation. For a long period, the ECB's key concern was a deflationary one and its negative interest rate policy also served heavily-indebted southern European countries well (another major concern), so it is little surprise the ECB was the least keen to raise rates. However, for the first time in eleven years the ECB finally did so this July, raising its key interest rate by 0.5% to zero and ending eight years of negative rates.

Concern has swiftly moved to focus on how the ECB is going to balance its need to get inflation under control. Euro area annual inflation was at 8.9% in July versus its 2% target, while trying to prevent surging borrowing costs creating another European debt crisis.

Europe is not normally far from a political episode and so it has proved again with what some are calling a 'populist coup' in Italy seeing market darling Mario Draghi ousted as Prime Minister. This saw both Italian bonds and stocks fall heavily following both the 'coup' and the interest rate rise and so has seen European policy makers agree a new bond-buying programme focused on offsetting any large rises in borrowing costs for the region's most indebted countries.

This feels very much like the ECB is stuck between the proverbial 'rock and a hard place', not wanting to drive a recession by raising borrowing costs too much and yet trying to respond to rising food and energy prices following Russia's invasion of Ukraine. Consumer confidence is already nearing recessionary territory, measures of manufacturing (Manufacturing PMI) are showing contraction and the market has sold off. It is difficult to call if troubles to come are priced in, that feels very much subject to whether inflationary pressures ease and the new bond-buying programme staves off a government debt crisis. Given the divergence in political and economic situations across the region, it feels too precarious to be an investment opportunity at this stage and more akin to a coin toss. High-quality global companies listed in Europe are a different matter and could find themselves sold off with more regionally focused names; those companies are worth watching as things develop in the region.

STOCK FOCUS

FERRARI

OSCAR SHEEHAN | INVESTMENT EXECUTIVE

To put things mildly, it's been a rough 2022 for European markets. The unfolding tragedy in Ukraine has caused a great deal of suffering while also thrusting the continent into economic hardship. On the whole, things look as if they may get worse before they start to get better. Despite this difficult macro environment, some European companies have proven their resilience and posted record breaking profits during the first half of the year.

Perhaps unsurprisingly, one such company is Ferrari. In Q2 2022 the company posted an adjusted earnings before interest and tax (EBIT) of €323m, comfortably ahead of expectations of €295m. It now predicts record-breaking profits of €1.15bn - €1.18bn this year. This growth is primarily being fuelled by car sales rising by over 29% to 3,455 in Q2. The decision to stop shipping to Russia in March of this year has done almost nothing to halt surging profits. This is not surprising when we consider that, in 2021, fewer than 100 vehicles were delivered to Russia out of the roughly 11,000 global deliveries made. Increasing demand in the Americas and China has more than covered any losses sustained in Russia. It is worth noting that earnings before interest, taxes, depreciation, and amortization (EBITDA) margins are predicted to pull back slightly to 35.3% compared to 35.8% in 2021. However, in the face of climbing manufacturing costs and supply chain issues, maintaining such impressive margins is a phenomenal achievement.

The company freely admits that the increased profit estimates are mostly the result of favourable foreign exchange conditions as the Euro has struggled this year. Despite this, there are several more structural reasons to be confident in Ferrari's long-term success. It is aiming to expand production to 20,000 units by the end of the decade, with 15,000 being predicted by 2026. This increase in volume is expected to generate revenue growth of 6% per year, with prices expected to rise an additional 3% to 5% annually on top of this.

Increasing production isn't always a smart move for exclusive luxury brands so it is fair to ask what, exactly, is driving this

expansion? Globally, countries are shifting away from petrol powered cars and towards electric vehicles as they attempt to decrease their carbon emissions. Here in the UK, the sale of new petrol and diesel cars will be banned from 2030. Ferrari had been slow on the uptake; in 2013 then chairman Luca di Montezemolo stated that it would “never manufacture an electric car” as it went against everything Ferrari stood for. Times have changed, and in order to adapt Ferrari has appointed Benedetto Vigna as its new CEO. Vigna has over 26 years’ experience in the microchip industry, and hiring such a successful engineer to sit at the head of the company is a clear indication that Ferrari is taking this transition seriously. This reinvention is borne out in its forecasts, with the company’s first fully electric vehicle expected to be on the market in 2025. The speed of this evolution should not be understated, with 40% of all newly-produced models expected to be electric vehicles by 2030; Ferrari is fast becoming a serious player in the luxury electric car market.

Despite excellent margins, unparalleled brand recognition and record-breaking profits, Ferrari’s share price has dropped nearly 10% in 2022. Maybe we shouldn’t be shocked that a company with a price-to-earnings-ratio of 50.5 at the start of the year has struggled during a down cycle, especially when we consider the average in Europe is 14.86. However, it is important to remember that the vast majority of European stocks have taken a hit this year and Ferrari has performed in line with the MSCI Europe index, impressive given how high its valuation had risen.

Ultimately, a company’s share price only ever tells an incomplete story. Ferrari may well have lost almost 10% of its value this year, but it did so while turning in record profits and beating industry expectations. On top of this, in Benedetto Vigna it has found the right hand to steer it through the EV revolution, in which it is becoming a major player. A cursory glance at Ferrari’s share price may give cause for concern, but on closer analysis the company is well positioned for long-term success. If all goes to plan, the current drawdown will be seen as nothing but a bump in the road in an otherwise successful transition for the company. ■

INSIGHT

EUROPE'S DEBT PROBLEM

BEN STANIFORTH | RESEARCH ANALYST

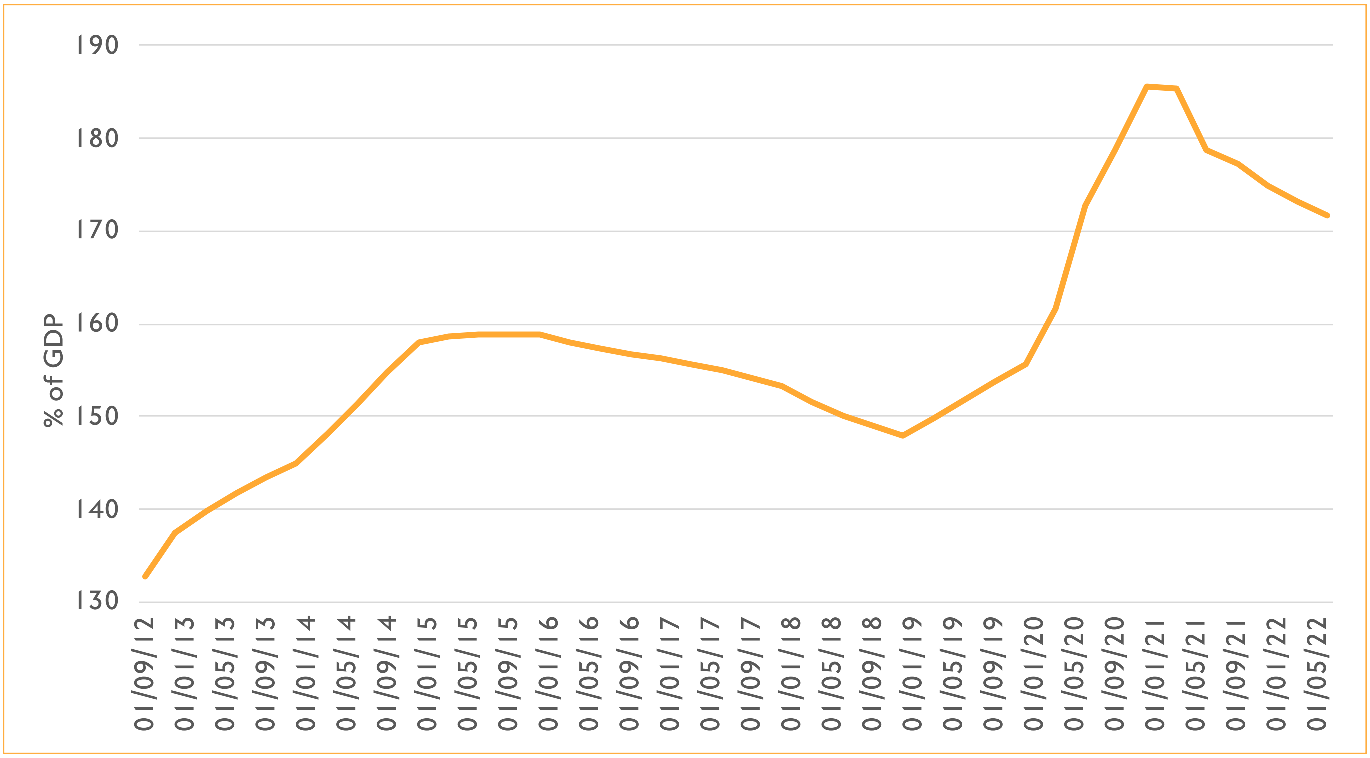
For years now, Europe has feasted on low interest rate debt in order to finance its growth. This nearly came to a head after the global financial crisis of 2007/08 raised serious concerns over many European nations' ability to repay the interest on the swelling debt pile. Portugal, Spain, Greece and Italy, amongst others, ran into serious trouble as their increasing debt-to-GDP ratios required bailouts and caused a sharp decline in economic activity, nearly bringing the countries to their knees.

This was, of course, eventually resolved and restructured and they lived to fight another day. However, a severe lack of growth since then and a further swelling of the debt pile thanks to a surge in borrowing to fund multiple pandemic-related incentive schemes, has now caused debt-to-GDP ratios to rise above 100% for many countries. Venezuela holds the unenviable title of the number one position in this area with a ratio in excess of 304%, with Greece and Italy close behind at 210% and 157% respectively. Spain, Belgium, France and the UK also feature on the list of 100%+ countries. A value of over 100% effectively means that a country possesses more outstanding debt than the level of economic activity it is able to produce in a single year and signals alarming levels of credit within a country's financial system.

Back in 2008, while still in trouble, Italy was considered by many as 'the best of the worst', in a situation not quite as bad as Greece or Portugal, but still in trouble nonetheless. Now, thanks to industry reforms and a dialogue with lenders, those countries are in a better position.

One of the main issues within the Italian economy has been persistent low growth, something that has plagued the country for a number of years now. While this has been an issue across most of Europe, many economies have grown just enough to justify higher debt levels and, as such, are now not in such a problematic position. Italy, however, has averaged a quarterly GDP growth of -0.013% over the past 15 years, during which the US has averaged 1.79%, pushing higher the major indicators of economic health such as wages.

Chart 1: Gross Government Debt as a % of GDP - ITALY



Source: Factset

So why has Europe, and in particular Italy, suffered from such sluggish growth for so long? As with most complicated questions, the answer is that it is down to a number of factors. One key area that Italy has been left behind in is the use and adoption of technology. Both Italian businesses and consumers tend to prefer traditional forms of transacting, communicating and interacting, with aspects of modern life that we in the UK take for granted, such as e-commerce, being somewhat less commonplace across the country. Production has also remained a stagnant problem, with nepotism commonplace across industry and government, placing underqualified people in positions of power, and producing a less efficient, qualified and effective workforce that is often happy to remain as is.

Instability has also remained a common part of Italian politics. Many will remember Silvio Berlusconi's flamboyant personality and political style alongside his so-called bunga-bunga parties and 2013 conviction for tax fraud which landed him a four-year sentence and barred him from serving in any legislative office for six years. More recently, however, Italian Prime Minister and former European Central Bank (ECB) President Mario Draghi offered his resignation thanks to one of the coalition parties that initially supported him refusing to back him in a confidence vote. The resignation was, however, rejected by the Italian head of state, again plunging Italy into political turmoil as commentators lambasted the lack of leadership within the country.

Interest rate rises, one of the only tools at central bank's disposals to combat inflation, has been surging particularly in the US and UK, with Europe also following suit, albeit far more tentatively. In July, the ECB raised rates for the first time since 2011 after signaling restraint over raising rates earlier in the year. A 0.5% increase translates into billions of Euros in additional interest payments for the country, something that it is unlikely to be able to afford. This increase in borrowing costs will, in all likelihood, reduce public spending and help for consumers in order to shore up its finances, at a time when many will struggle to absorb the inflated energy costs.

With interest rates aggressively rising across the western world, inflation surging to new highs each month, spiraling levels of debt and questions over whether Russia will cut off Europe's energy supplies, Italy has not been in such a tough position since the fallout of the global financial crisis. It will take a mammoth effort to fix the major problems Europe is facing and, with economic pain likely to be inflicted across the continent, things are likely to get worse before they get better. ■

TOPIC OF THE MONTH

ENERGY AND ITS EFFECTS ON THE EUROPEAN ECONOMY

STEPHEN DONE | INVESTMENT RESEARCH

The European Union has long aimed to reduce its dependency on fossil fuels, with political commitments to reducing carbon emissions to hit net zero by 2050. A key priority in reaching this target is to decarbonise electricity generation through reduced use of fossil fuels and increased use of green alternatives. Natural gas burns cleaner than oil or coal and is widely used as a cleaner substitute for both in the production of electricity. As coal, the most polluting fuel, is being progressively phased out in Europe, many countries have resorted to natural gas as a transitional resource between hydrocarbons and renewables.

Natural gas prices have been surging due to a combination of increased global demand and supply constraints. A series of market, geographic and political factors have coalesced into a perfect storm within the natural gas market that threatens to derail the post-pandemic economic recovery, strain households' disposable income and drag the EU's green transition under scrutiny.

By 2024, demand for natural gas is forecast to grow 7% from pre-pandemic levels, with economic recovery, longer and colder winters, the phasing out of alternative fuels and reduced efficiency of wind turbines due to changing weather conditions being contributing factors. European gas production is in decline, with several North Sea gas deposits running dry and a hesitation in further investment due to predicted phasing out of natural gas in upcoming years. This had resulted in Europe becoming increasingly dependent on gas imports, primarily from Russia and Norway, which, therefore, gives geopolitical strength and control over Europe to Russia.

Following the outbreak of the Ukrainian war, European lenders imposed large sanctions on Russian imports of gas, which supplied more than 40% of all European natural gas imports in 2019 and 2020. In response, Russia has reduced supplies through Europe to around 20% of capacity at present, with fears mounting that Russia will weaponise its energy exports this winter by cutting off gas supplies completely. Vladimir Putin has been inflicting severe pain on European businesses and households, as pressures build to listen to and oblige Russian demands to ease such pressures. Russia wants a relaxation of sanctions, but also wants the introduction of the Nord Stream 2 pipeline to become active, connecting Russia directly to Germany. This pipeline, which is a bilateral Russian-German vision, will see gas flows bypass Ukraine into Europe and would undermine Ukrainian support that has occurred during the war, as it would heavily affect the Ukrainian economy.

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This insecurity has led to governments around Europe looking for other solutions to prepare for the weaponisation of gas from Russia. One alternative source is liquified natural gas (LNG), which is shipped across the sea in large tankers instead of through infrastructure pipelines. However, this is also experiencing intensifying competition from around the world, with Asia currently the premium destination for LNG, with China, Japan and South Korea being the world's three largest importers. There is currently a race to secure supplies for winter storage, with fears of being priced out as desperation from Europe increases later in the year. The US (which has increased output in 2022 with production up 18%) exported three-quarters of its LNG to Europe between January and April, which tripled the 2021 average. The US has promised to support Europe, as global powers condemn the Kremlin and move away from its energy. This significantly increases the importance of the US within the energy market, increasing geopolitical power, alongside granting the opportunity to take advantage of higher profit margins from surges in energy prices.

Alongside alternative energy sources, EU energy ministers have signed off on a deal for all countries to, 'voluntarily', reduce gas consumption by 15% until March 2023, to accelerate growth of storage levels. However, a north-south battle began over the proposal, with southern European countries, who benefit from

a lower reliance on Russian gas, raising concerns on the results of reduction for citizens with many countries being placated with several exemptions and derogations.

With the growing threat of a possible energy crunch, governments are embroiled in a fierce debate over who should have priority in a possible energy battle - companies or consumers. Current EU rules state private households and critical infrastructure are protected from gas shut-offs, with most of the burden expected to fall on the most energy- and gas-intensive companies, which are primarily in the chemicals, base metals, refined metal products and glass sectors. However, this could lead to large cuts in production and plant shutdowns, which, alongside reduced consumption in the economy through decreased disposable income, could plunge many of Europe's economies into a recession.

One of the most heavily affected countries is Germany, with 55% of gas imports currently coming from Russia, predominantly through the Nord Stream 1 pipeline. This is mainly due to its geographical location, its transition away from coal and its traditional rejection of nuclear power. In 1970, when the mutually beneficial signing of the first Russia-Germany gas pipeline was signed, worries around the security implications had been dismissed by reassurances Germany would never rely on Russia for even 10% of its gas supplies. Now, Russia's geopolitical control over Germany is apparent, with Russia supplying significant amounts of natural gas, oil and coal imports which are essential for the survival of the German economy. Germany is now the fulcrum for Vladimir Putin's pressure, with demands for Nord Stream 2 at the forefront. Germany has announced that further Russian cuts would trigger a severe recession and have the ability to cripple the German economy; however, conceding to the Kremlin and pushing Ukraine towards armistice would be political suicide.

The reliance of Germany – and of Europe as a whole – on Russian fossil fuel resources is an issue that requires short-term solutions, including cutting demand and finding alternatives; however, these historic circumstances should trigger a rethink of long-term energy policy in Europe, with potential for an energy-efficiency drive and the development of resources throughout Europe, promoting renewable energy, slowing climate change and improving energy security. ■

UNIONS AND A POTENTIAL WAGE PRICE SPIRAL

JAMES EADES | INVESTMENT RESEARCH

1794 marked the formation of the first union, the Federal Society of Journeymen Cordwainers, a union for leather workers and cobblers. The union was developed to stop the erosion of their industry by greedy factory owners at the start of the Industrial Revolution. Consequently, union power within Europe began to germinate and a symbiotic relationship between worker growth levels and union power began to take place. As a result, trade union membership across Europe grew from approximately 100,000 in the 1850s to 1m in 1874 as the labour force began to realise the impact of collective barging through unionisation on improved labour conditions, rights and pay. This revolutionised the way employees were viewed by their employers and subsequently tightened the boundaries of what was and wasn't acceptable in terms of workers' roles and duties and putting some of the power back into the hands of employees.

Union growth throughout history has been fairly procyclical, closely following the business cycle; in many countries a rise in unemployment tends to reduce union growth and density. However, union momentum is generally heightened during periods where workers view themselves to be at a disadvantage compared to the market, economy and/or company performance. We tend to see most movement when companies don't react to macroeconomic signalling and conditional changes, for example, periods of high inflation and unchanged wage growth or periods of low economic growth with potential wage or job cuts as businesses experience recessionary squeeze, forcing them to make cost saving cuts.

Across Europe we can see key differences in trade union density by region: Scandinavian countries such as Denmark, Iceland, Sweden, and Finland on average have a trade union density of around 70.8% of the total work force; this is down 9% from 2000, but still considerably higher than countries such as the UK, Germany, Spain, Italy or France who collectively have an average of 19.2% of labour in a union compared to 23.5% in 2000. It is important to add, however, that youth union membership figures significantly declined over the last ten years while female memberships remain at an all-time high. The major decline in density across Europe is largely due to increased structural, cyclical and institutional factors with companies allowing colleagues to have their voices heard through in-house employee decision making.

Despite a decline in union density across Europe, it certainly doesn't mean they've not been active and influential across multiple markets over the last year. Some of the most impactful union action taking place in Europe this summer has been within the airline industry, with companies such as Lufthansa, Ryanair and the airport operator ANA taking strike action. The disruptive nature of the strikes had been voted on by members of the union based on a collective view that wages aren't keeping up with current inflation rates, as well as unfavourable working demands which may be over the normal workload.

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An example of the impact of strike action was seen at the end of July 2022, when Lufthansa ground staff took strike action over a pay dispute. The union Verdi, which represents the ground staff, demanded a 9.5% pay hike, or at least €350 per month, for around 20,000 workers. This came after a series of complaints from workers about being underpaid and overworked as employees begin to feel the real inflationary squeeze induced by the rising oil prices across the western world. After numerous negotiations between Lufthansa and Verdi, the airline offered an increase of €150 per month for the rest of this year and another €100 from the start of 2023, plus a 2% increase from mid-2023 dependent on the company's financial results. Verdi rejected the offer, saying it was insufficient to offset soaring inflation, which hit 8.2% in Germany in June. Consequently, the ground staff held a one-day strike, causing over 1,000 flight cancellations which saw Lufthansa prioritise first-class clients over its budget airline trips to reduce the overall cost of the strike and affecting thousands of customers awaiting holiday flights. As a result of the strike, both Lufthansa and Verdi agreed on an attractive 18-month wage agreement which sees an increase in gross base salaries of 8.3% for workers earning €6,500 a month and of 19.2% for those making €2,000; the rate at which workers will see an increase will also be dependent on the years of service at the company.

Lufthansa isn't the only company that has been pressurised to take wage action for its workforce. ANA Aeroportos de Portugal, the airport authority of Portugal which manages around ten airports, is expecting a three-day strike action after both the Civil Aviation Workers' Union (SINTAC) and the Commercial Aviation Staff Union (SQAC) accused ANA and French Group Vinci of not paying staff wages reflective of the current economy and workload while the organisations continue to make millions in profit.

Could the combination of rising wages and record high inflation cause a wage price spiral across the EU? Potentially - a wage price spiral occurs when rising wages cause an upward pressure on the price of goods and services in the economy, subsequently inducing further inflation. Industrial action across multiple markets and sectors could certainly be a factor in a wage price spiral environment. This is because, when firms raise wages, employees have greater disposable income. Rising wages mean more spending power and consumer choice, thus increasing the demand levels across the economy for goods and services. By using supply and demand analysis we know that when demand rises while supply remains constant, consumers have greater flows of money chasing fewer goods, therefore, the price of goods or service rises. When goods move up in price, demand for higher wages also moves up as firms begin to make higher short-term profits; rising wages cause firms to transfer these additional costs onto the goods or services being sold to maintain profit margins. This back-and-forth movement of both wage and price growth is what is known as the wage price spiral. The extent to which this spiral could take grip on the European economy will depend, at least somewhat, on how powerful unions are in bargaining higher wages, but also on how low the unemployment rate is across the economy and how impactful monetary policy is in dampening the speed of a potential wage price spiral. ■

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