In Search of Stability & Growth

If only Europe was more like the US

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There's been a lot that might distract us of late - if it's not recent gyrations in the stock market, it's the twists and turns in the tortuous Brexit process or President Trump's tweets on trade that are proving difficult to ignore. As a UK national especially, it's impossible not to have a keen interest in Britain's eventual choice of political and economic future.

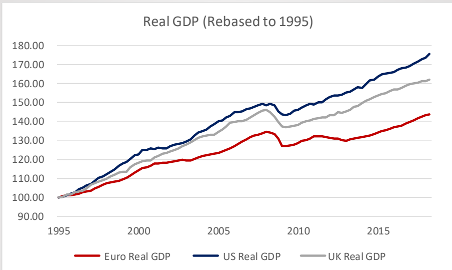

Figure 1. The US has shown better growth since the Stability & Growth Pact (Data source, Federal Reserve Bank of St Louis)

In the end, however, investment decisions come down to economics. The two largest economic blocks in the world, albeit with China catching up fast, remain the US and the European Union. Moreover, the market value of listed equities in these two markets still account for more than 70% of world indices - making the right allocation between these two regions is crucial.

The backdrop against which we build a portfolio needs to be a positive and dynamic one - the best place to start in this respect is to look at what's worked so far.

The United States for the last century, and so far in this one, has had a distinct advantage over Europe. It has more than three hundred million people speaking the same language, using the same currency managed by one Federal Reserve. They share the same constitution, abide by the same federal laws and share an identity built, generally, around the virtue of economic success.

The EU, with a combined population much greater than the US, has tried to emulate many of these traits through decades of political and economic integration.

So far, however, its aspirations have failed to translate into the economic success the US still enjoys.

The US remains significantly more productive, has higher growth, sustains higher levels of employment and nurtures successful corporations in a way Europe finds difficult.

The history of European integration is complex, but some key moments define its economic development. Building on the Treaty of Rome, the Single Market Act sought to complete the creation of a single market by 1992 - it was this Act which set the trajectory towards the free movement of people, capital, goods and services (the Four Freedoms) that define the Union today. That same year The Maastricht Treaty set the EU on a path to eventual monetary union in 1999, the macro-economic glue for which was the Stability & Growth Pact of 1997. With mandatory fiscal discipline, the reasoning went, the common currency and the integrity of the single market would sustain.

Although the Stability & Growth Pact has proven difficult to enforce in practice, it has had a significant impact on the performance of the Eurozone economy in aggregate over the last twenty years or so.

Taking 1995 as the inflection point, when European economic integration went exponential, *Figure 1* shows the real GDP of both areas rebased to that year (we also show the UK). The picture is clear, the US has maintained a much stronger growth trajectory despite close to 25 years of European hyper-integration.

Figure 2 compares labour productivity in the two regions. If the Eurozone had developed at the same pace as the US since 1995, on this measure at least, it would be 32% more productive than it is today. While Europe implemented the Stability & Growth Pact, the US simply became more efficient and more productive, more quickly.

One could go on. If the Euro Area had developed in lock-step with the US since 1995, its industrial manufacturing output would be 10% higher, retail sales would be 46% higher and gross fixed capital formation 26% higher[1]. Outside the realm of key

[1] Data Source, Federal Reserve Bank of St Louis

economic indicators, the number of patent applications, for example, would have been 76% higher[2].

While the Stability & Growth Pact hasn't engendered growth, neither has it engendered stability when compared with the US.

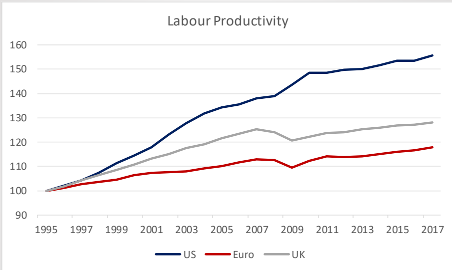

Figure 2. The US has become more productive more quickly (Data source. Federal Reserve Bank of St Louis)

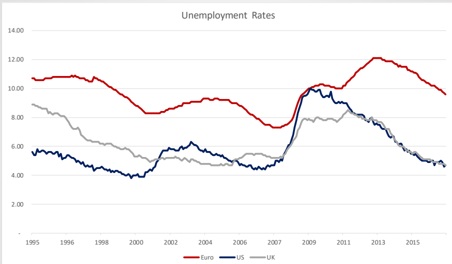

Figure 3. The US has consistently sustained higher levels of employment than the Eurozone (Source. IMF)

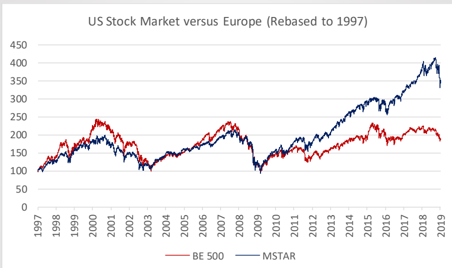

Figure 4. Bloomberg Europe 500 v Morningstar US Index (MSTAR)

Figure 3 brings the Eurozone's core problem into sharp relief. Unemployment, the most destabilising of economic phenomena, has remained structurally higher than in the US (and the UK) since integration accelerated. Europe is still unable to keep people in work anywhere near as successfully as the more dynamic US.

Moreover, although the Global Financial Crisis emanated from the US housing market, the US financial system now looks more stable than Europe's. Bank capital to asset ratios in the US are, on average, 39% higher than in the Eurozone[3]. As private debt is most often the source of financial instability, the most stressed levels in this regard are inside the EU. In fact, US private debt (Households and non-financial corporations) to GDP is currently 151% versus 174% for the Eurozone as a whole. Against individual Eurozone countries in this respect, the US would rank eleventh (the UK would rank the same)[4].

Economic statistics aside, the corporate picture tells the same story. At Equitile, we monitor more than two thousand companies in the developed world with a market value above five billion dollars. Amongst other things, we especially look for those companies which rank highly on their growth, the consistency of that growth and their ability to generate cash. Where possible, we examine financial histories going back to the turn of the millennium. Of the 100 companies that rank most highly on this analysis, only eleven are in the Eurozone, the US has sixty-six of them.

It is no wonder, when you look at the relative performance of US and European stock markets since 1995, that the US continues to do so well relative to Europe. *Figure 4* shows the Morningstar MSTAR Index of US companies versus the Bloomberg European 500 and shows clearly how the US response and recovery in the aftermath of the Global Financial Crisis led to a much more rapid improvement in the outlook for US corporations.

In many respects, none of this should be surprising.

The World Bank's *Ease of Doing Business Survey* ranks the US eighth in the world with only one EU economy, Denmark, ranking higher (the United Kingdom ranks ninth, just below the US). Moreover, the World Economic Forum's *Global Competitive Report*, who's Index measures 140 economies against 98 indicators, describes the United States economy as "*closest to the frontier, the ideal state, where a country would obtain the perfect score on every driver of productivity*"[5].

The relative dynamism of the US has a myriad of explanations;

Managerial culture, although arguably compromised in recent years, is less political and more performance driven than in Europe. Moreover, as American companies remain more dependent on capital markets, they tend not to tolerate latency as readily.

A team of researchers from Harvard Business School, the London School of Economics and McKinsey systematically surveyed management practices in 10,000 companies in twenty countries over ten years. Their study covered various factors covering

[2] World Intellectual Property Organisation

[3] IMF, Global Financial Stability Report 2017

[4] IMF DataMapper

[5] Doing Business 2019, World Bank

operational management, monitoring, targets and people management. Their conclusion says it all – "*while Americans are bad at football (or soccer, as it's known as locally), they are the Brazilians of Management.*"[6]

While the US offers the most fertile environment for taking risk and creating value, it deals with mistakes and allows the write-off of legacy capital and debt in ways Europe makes difficult.

US bankruptcy laws, particularly, are amongst the most expedient in the world. By way of extreme example, General Motors, a company with revenue equivalent to half the GDP of Greece in 2009, was in and out of the Chapter 11 administration process within thirteen months – much of the firm's debt was written off and the assets sold into a new entity (capitalized largely by the state) with little impact on the operation itself. By contrast, Greece entered discussions with the EU at the same time and has, to date, "failed" to go bankrupt – it's GDP however is now 40% lower than it was in 2009 and is only 30% bigger than, now relisted, General Motors.

For Europe, integration, underpinned by The Stability & Growth Pact, might have been motivated by worthy ideals but attempts to create a single economic area to match the US, and meet the competitive opportunities and challenges stemming from Asia, haven't worked. One can ask whether that's because the European Union's political project is economically flawed or whether it's because it hasn't gone far enough – either way, so far, it's not delivering.

It was Tsar Nicholas I of Russia who reputedly coined the phrase "the sick man of Europe" to describe the Ottoman empire. Since then, many countries have taken that mantle; Britain in the late 1970s, Germany in the 1990s and arguably Italy and France today. On the headline numbers at least, it's not unfair to describe the Eurozone as a whole today as the *Sick Man of the Developed World*.

The US on the other hand has many challenges of its own, not least dealing with the growing economic reach of China, but the backdrop its economic dynamism has provided since 1995 is unlikely to become less supportive.

Conclusion

The Equitile Resilience Fund has, since launch, had high exposure to the US economy and stock market. Today, the Fund has more than 80% of its investments in the US – a record high.

The economic success of the US versus the relative malaise of Europe is important from an economic and investment perspective but it also presents an interesting segue into to the United Kingdom's political crossroads.

The final assessment of Britain's choice will, in the end, come down to economics – which economies it most emulates and aligns with will determine its future success.

In the first instant, however, it will come down to politics - back to distraction.

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[6] Harvard Business Review, Why American Management Rules the World, 2011

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