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Is the Eurozone Fated to Japanification?

Peter Donisanu
Investment Strategy Analyst

Key takeaways

» *For some investors, the eurozone's low growth and low inflation environment today is reminiscent of Japan's own historical post-financial crisis challenges.*

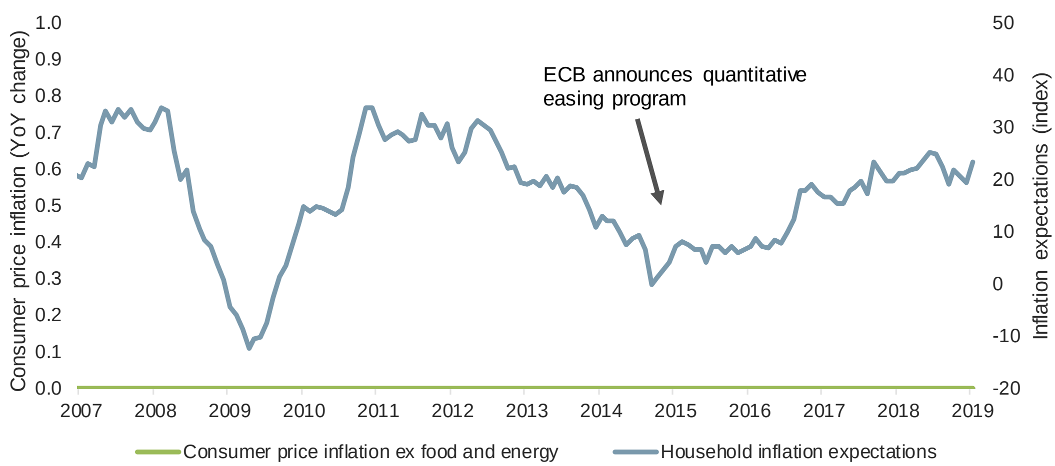
» *While we observe some similarities, we believe that recent price developments and scope for future fiscal spending suggest that "Japanification" of the eurozone is not inevitable.*

What it may mean for investors

» *We believe that European leaders' work toward financial stability and greater fiscal integration remain supportive of eurozone investments as part of a long-term, broadly diversified, strategic exposure to developed market stocks and bonds.*

Japan experienced a credit-driven economic bust in the 1990s that ushered in a period characterized by low gross domestic product (GDP) growth and price deflation. Today, the eurozone economy, by some measures, appears to be following a similar path. Like Japan, the currency bloc has faced weak economic activity and deflation concerns since its post-global financial crisis (GFC) bust in 2007. Even so, we believe it may yet be premature to call Japanification of the eurozone an inevitability.

Chart 1. Eurozone inflation expectations have risen since extraordinary European Central Bank (ECB) policies



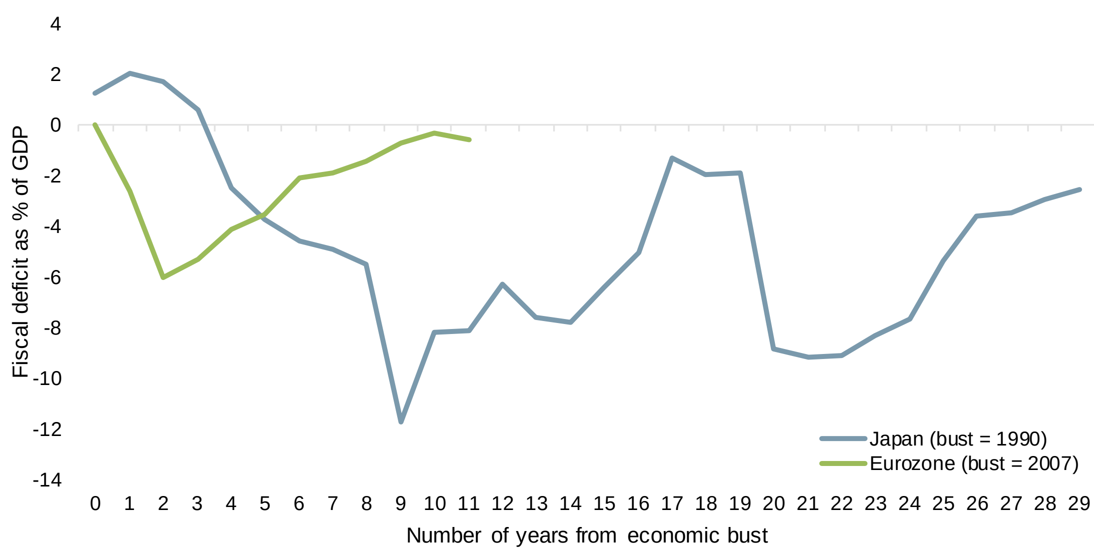
Sources: Wells Fargo Investment Institute, Bloomberg, June 7, 2019. YoY=year over year.

Is the eurozone fated to Japanification?

Two factors could set the eurozone's future path apart from Japan's past: 1) recent price developments and 2) scope for future fiscal spending. First, while core inflation in the eurozone remains below the ECB's 2% target, price trends in other areas of the economy have moved higher. Eurozone core inflation has largely remained above 0.5% since 2007, and household inflation expectations have moved higher following extraordinary ECB policy measures in 2015 (see Chart 1). By contrast, Japanese core inflation went from 3.2% in 1990 to -0.4% by 2000 and remained below zero (deflation) for the next seven years.

Along these same lines, eurozone residential property prices are up 9% from their 2008 peak, and wage growth over the past 10 years has averaged 2%. On the other hand, in the decade following Japan's economic bust, home prices and wages contracted and in some cases failed to recover to pre-crisis levels. Arguably, monetary policy has been helpful in buoying inflation expectations, yet targeted government expenditures such as infrastructure spending could help jumpstart sclerotic growth across the eurozone. And when compared to Japan's experience, eurozone leaders arguably have scope to ramp up fiscal spending.

Chart 2. Scope for spending—eurozone fiscal deficits have narrowed since 2009



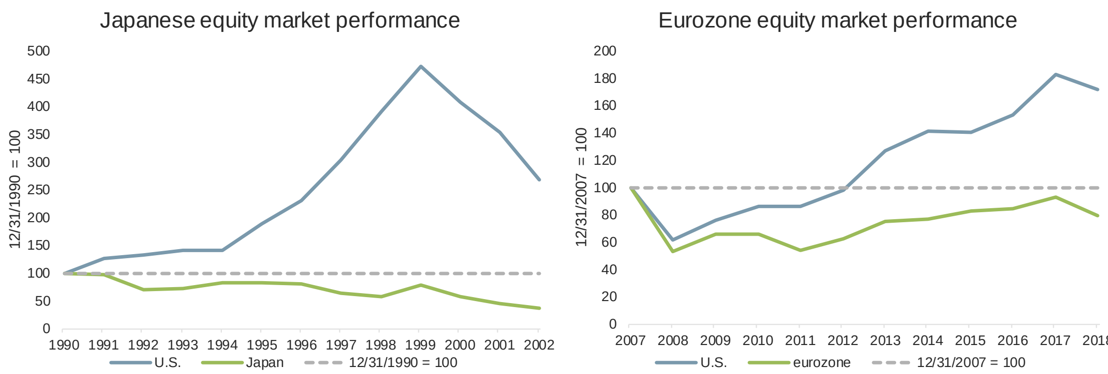
Sources: Wells Fargo Investment Institute, Bloomberg, June 7, 2019.

For example, Japanese government spending (as a percent of GDP) went from a 2% surplus at the end of 1990 to an ever widening deficit over the course of a decade. In the post-GFC period, eurozone leaders increased government expenditures for a limited time but, keeping a keen eye on fiscal conservatism, reducing deficit spending to 0.6% of GDP (Chart 2) more recently. Simply put, government leaders could increase expenditures beyond self-imposed deficit rules but have chosen not to do so. This has been a point of contention for some eurozone leaders, particularly in Italy and Greece.

Investment implications

Japan's economic bust not only led to a period of stagnant economic activity, it also translated into paltry relative returns in the country's equity markets (Chart 3). In certain respects, investors today may be scrutinizing policy developments in the eurozone to determine whether the region will follow in Japan's footsteps—and, if so, whether the value of eurozone investments should be discounted in a manner similar to Japan's investments. The eurozone is arguably at a policy crossroads that could determine whether economic fundamentals will remain supportive of investing in the region over the long term.

Chart 3. Weak economic recoveries impact on Japanese and eurozone equity prices



Sources: Wells Fargo Investment Institute, Bloomberg, June 7, 2019. Note: Data represent price returns for MSCI U.S., MSCI Japan, and MSCI European Economic and Monetary Union indices. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.** Please see the end of the report for the definitions of the indices.

Developments due out over the coming months, particularly presidential appointments to the ECB and European Commission may influence the direction of monetary and fiscal policy, and more importantly, whether or not growth and inflation dynamics in the region will follow in the footsteps of Japan's past. For now, European leaders' current efforts toward financial stability and greater fiscal integration ultimately may support a faster economic and financial market recovery than Japan's recovery from its debt crisis. We recommend a modest allocation for long-term investors but do not advise overweighting that allocation at present while uncertainties remain elevated.

Economic Calendar

Date	Country	Report	Estimate	Previous
6/11/2019	US	NFIB Small Business Optimism	--	103.5
6/11/2019	US	PPI Final Demand YoY	--	0.022
6/11/2019	US	PPI Ex Food and Energy YoY	--	2.40%
6/11/2019	US	PPI Ex Food, Energy, Trade YoY	--	0.022
6/11/2019	UK	Jobless Claims Change	--	24.7k
6/11/2019	JAPAN	Core Machine Orders MoM	-0.80%	3.80%
6/12/2019	US	MBA Mortgage Applications	--	--
6/12/2019	US	CPI YoY	--	0.02
6/12/2019	US	CPI Ex Food and Energy YoY	--	0.021
6/12/2019	US	CPI Core Index SA	--	261.735
6/12/2019	US	CPI Index NSA	--	255.548
6/12/2019	US	Real Avg Hourly Earning YoY	--	0.012
6/12/2019	US	Monthly Budget Statement	--	$160.3b
6/12/2019	SPAIN	CPI YoY	0.80%	0.80%
6/12/2019	AUSTRALIA	Participation Rate	65.80%	65.80%
6/13/2019	US	Initial Jobless Claims	--	--
6/13/2019	US	Continuing Claims	--	--
6/13/2019	US	Import Price Index YoY	--	-0.002
6/13/2019	US	Export Price Index YoY	--	0.30%
6/13/2019	US	Bloomberg Consumer Comfort	--	--
6/13/2019	GERMANY	CPI YoY	1.40%	1.40%
6/13/2019	CHINA	Retail Sales YTD YoY	8.00%	8.00%
6/14/2019	US	Retail Sales Advance MoM	--	-0.20%
6/14/2019	US	Retail Sales Ex Auto MoM	--	0.001
6/14/2019	US	Retail Sales Ex Auto and Gas	--	-0.20%
6/14/2019	US	Industrial Production MoM	--	-0.005
6/14/2019	US	Capacity Utilization	--	0.779
6/14/2019	US	U. of Mich. Sentiment	--	--
6/14/2019	US	Business Inventories	--	0.00%
6/14/2019	FRANCE	CPI EU Harmonized YoY	1.10%	1.10%
6/16/2019	UK	Rightmove House Prices MoM	--	0.90%
6/17/2019	US	Empire Manufacturing	--	17.8
6/17/2019	US	NAHB Housing Market Index	--	66
6/17/2019	US	Net Long-term TIC Flows	--	-$28.4b
6/17/2019	US	Total Net TIC Flows	--	-$8.1b
6/17/2019	INDONESIA	Exports YoY	--	-13.10%

Source: Bloomberg as of June 7, 2019.

Risk Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets.

Definitions

MSCI EMU (European Monetary Union) Index captures large and mid-cap representation across the 10 Developed Markets countries in the EMU.

MSCI Japan Index is designed to measure the performance of the large and mid-cap segments of the Japanese market. With 321 constituents, the index covers about 85% of the free float-adjusted market capitalization in Japan.

MSCI U.S. Index is designed to measure the performance of the large and mid-cap segments of the U.S. market. With 624 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in the U.S.

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