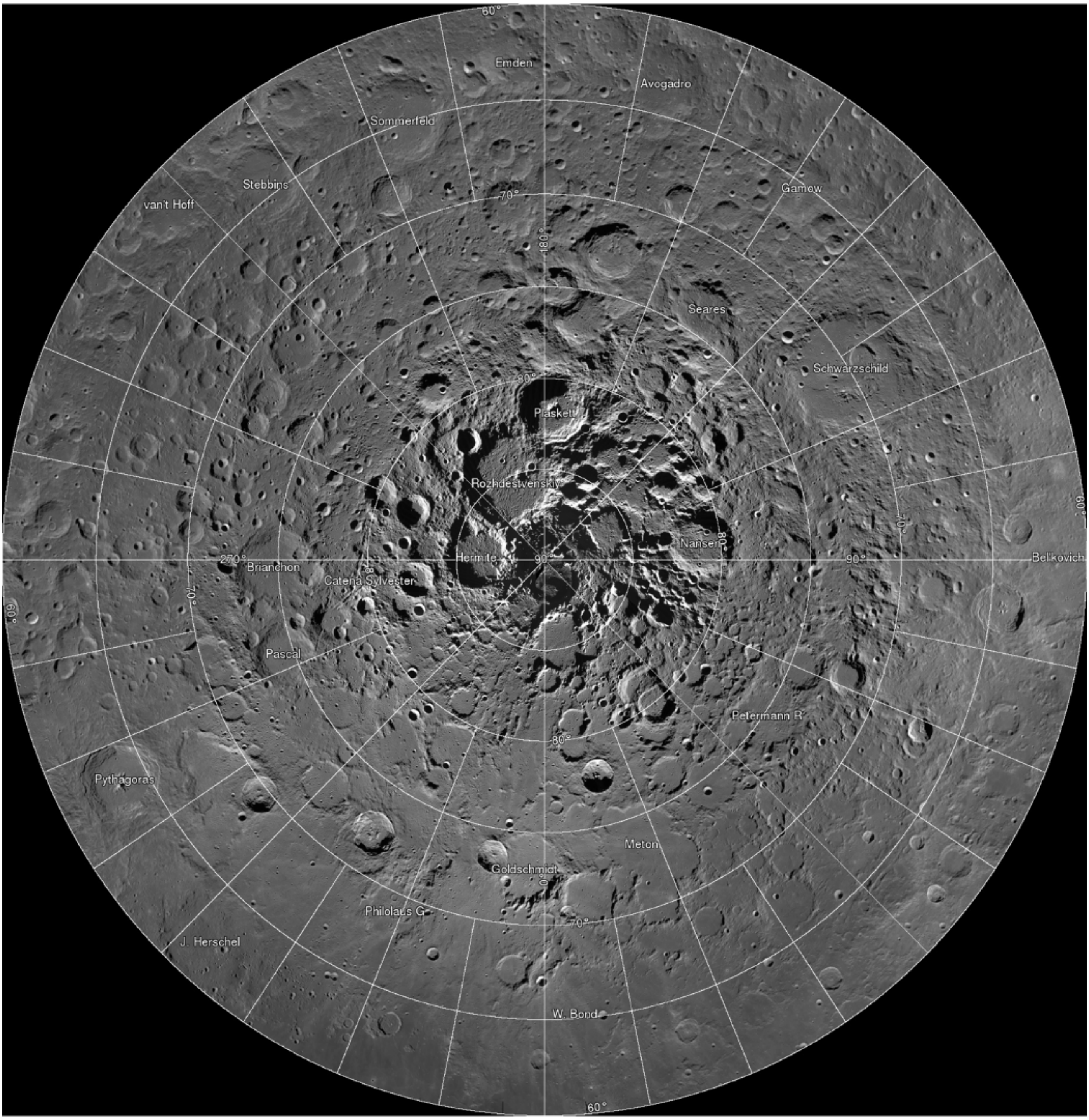
March 27th
Market Briefing



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"The hidden variable"

Market briefing

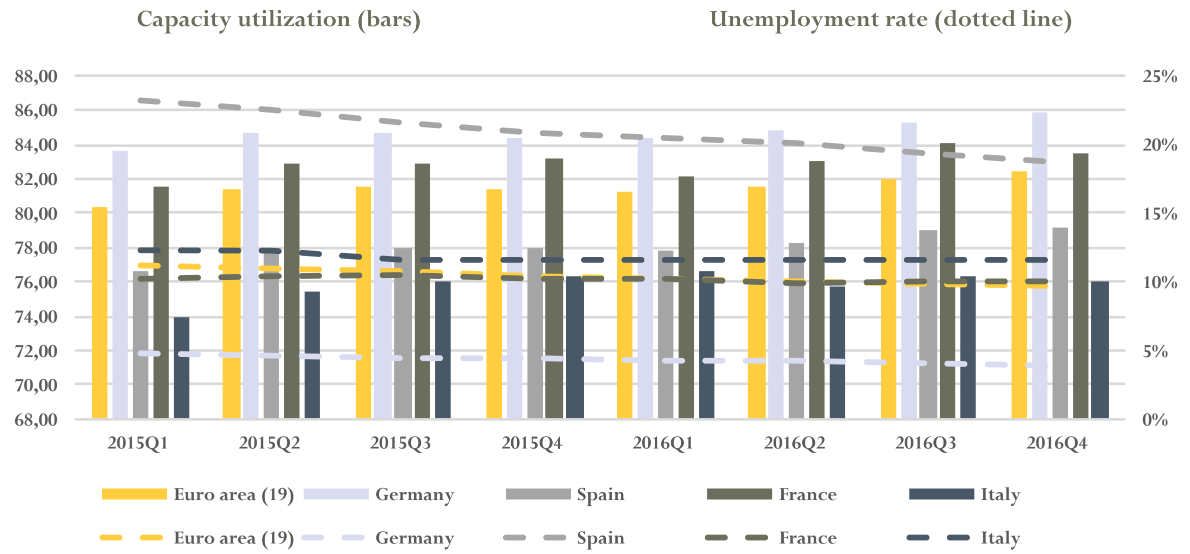
- The ECB may face in the coming months a thought decision: To hike or not to hike interest rates.
- Some are looking for clues at the politic environment while others are looking at inflation.
- The key variable may be hidding (and specifically in a particular place of Europe).

When he stated that "I'm convinced God does not play dice" Albert Einstein was arguing that hidden variables must be added to quantum mechanics in order to explain entanglement without action at a distance. On a more grounded level we see something similar in today's economic framework in the EU: Some hidden variable must be added in order to explain the current (and near-future) ECB´s interest rate policy. That variable is labor productivity. With inflation threatening to breach the 2% threshold, opinion articles in the media are asking when Mr. Draghi will act and raise interest rates. Some add into the equation the current political environment (specially in France) looking for an explanation of why we are still at zero. We don´t deny that there is some non-technical pressure to keep rates low in order to not encourage populism but core economics still guides Super Mario attitude towards the level of the ECB key interest rate.

Labor productivity in the EU is one key variable few analysts are looking at.

Let´s begin with the logic. Inflation evolution can be explained by the change over time of nominal wages and the change over time of productivity. In theory the inflation level shall be directly linked to the sum of both wages and productivity change rates. The ECB interest rate policy is basically based on the inflation level, aimed at keeping the latest just below the 2% threshold. Productivity also impacts GDP growth which, even not a variable the ECB must keep an eye on, is critical given the populist threat in the EU. Also productivity has an impact on the labor market which nowadays worries euro zone governments, basically because growth rates are determined by how fast the workforce can expand and how much output per hour worked can be generated. In the graph below (Source: ECB and Eurostat) we can see that the aggregate labor market in the Euro Zone is tightening with unemployment falling steadily although unevenly. Also, capacity utilization is rising which should add inflationary pressure and poise a threat over the productivity growth. Germany is by far the most extreme case with unemployment below 4% and capacity utilization above 85%. Spain on the other hand has a long way to go with unemployment above 18% and capacity utilization below 80%. France and Italy lie somewhere in the middle.

There are huge discrepancies in the Euro Area labor market



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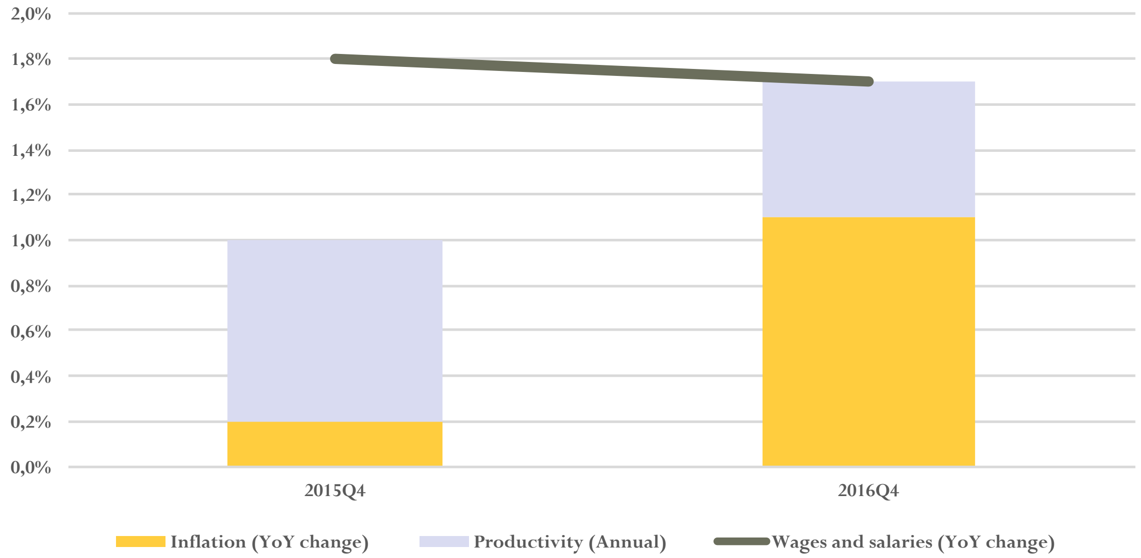
In the graph below (Source: Eurostat) it is compared the sum of inflation plus productivity growth against the growth rate of wages and salaries in the euro zone during the last two years. Back in 2015 there is an obvious gap of 0,8% but the most recent data, end of 2016, verifies the expected relationship. The difference observed in 2015 calls our attention because during that year unemployment was still above 10% and capacity utilization below 82% in the Euro Zone, but recently the equilibrium seems to have been restored. Truth is that the recent pick-up in inflation is largely due to the rising cost of energy and transportation, a rise that should not last. Therefore the Euro Zone desperately needs a rise in productivity in order to balance the labor market. Otherwise inflationary pressure will increase beyond the ECB's desired level.



Germany and France are at the lead (both with 1,2%) of the productivity growth in 2016 among the Euro Zone countries, and together with Spain (0,9%) all three are above the Euro Zone average (0,6%). Italy on the other hand shown a decrease (-0,8%) in productivity during 2016.

It seems that the Euro Zone can´t rely in Germany to keep growing without adding inflationary pressure. Low unemployment, high capacity utilization and high productivity growth are the signal that low-cost growth shall come from somewhere else. Italy and Spain are the candidates: Low capacity utilization and high unemployment.

Mr. Draghi seems reluctant to raise interest rates but his macroeconomic-grounded arguments are fading out. We are not saying he will announce in short a hike. Not at all. There is much at stake on the political scenery. We are just pointing to the fact that the context the Euro Zone has had in the last months is difficult to replicate in the near future.

If it were for the Germans the ECB would be ready to raise rates tomorrow, but data shows that close attention shall be paid to Spain and Italy. The Euro Zone needs these two countries to start to grow and to be more productive in order to keep the monetary union somehow balanced. Otherwise the differences among the countries sharing the common currency may go out of control. Northern Europe needs its southern neighbours to economically improve and rising rates is the last thing they need.

Although productivity has proven to be a variable that can surprise the most likely scenario is that in the coming months we will see the German economy growing at or below the Euro Zone average, France to slightly outpace that average and to Spain and Italy to show an increase in productivity without much pressure on their local wages and salaries. Or at least this is what some people in Frankfurt desperately want.

We suggest to pay close attention to how productive southern Europe becomes in the coming months. If Spain and Italy fail then Mr. Draghi will be in a difficult position. It seems that productivity shall be added as a variable to explain the Euro Zone interest rate level without a potential disaster.

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