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Euro Area: Oil Price Drop and Weaker Euro Boost Short-Term Profits Outlook

*Based on a January 8, 2015 client bulletin.

■ **Trend of U.S. equities outperforming eurozone equities may well temporarily reverse in next few months**

While many investors may be worried that the oil price plunge is exacerbating the deflationary pressures in the euro area economy, the short-term outlook for euro area profits has actually improved, thanks to the decline in oil prices and the depreciation of the euro. There are still enough problems not to disregard downside risks this winter, but the drop in oil prices will reduce imports and boost the trade surplus, a profit source, by about one percentage point of GDP, all else equal. Meanwhile, the ongoing decline in the euro is also providing support to the region's exports in real terms and, more importantly, euro terms (chart 1), thus helping the beleaguered euro area economy keep afloat in a difficult global environment.

Although these developments create a serious case for stronger euro area equity market performance, perhaps exceeding U.S. market performance this winter, there are still plenty of domestic euro area risks—including problems in Greece and potential new troubles in euro area banks—as well as disproportionate exposure of the euro area to global risks, including falling demand from emerging markets and potential financial shocks from oil exporters or other commodity-exporting countries. We view the latest developments as reason enough to take a hiatus from long-U.S./short-eurozone equity positions, but not reason enough to take the reverse position.

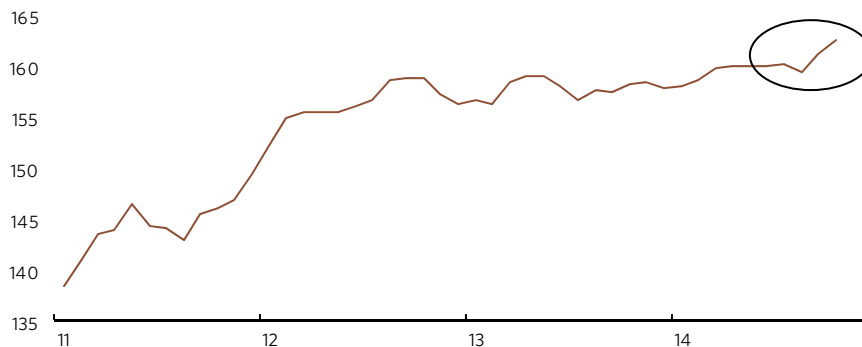
Over the course of 2015, unless price declines reverse, the negative effects of oil deflation on the world economy will begin to catch up with the positive effects. Moreover, as we look further into 2015, the euro area's challenges remain formidable. The current account is the only profit source making a signifi-

Euro Area Exports Are Picking Up

CHART 1

Eurostat: Nominal Euro Area Goods Exports

€ billions, seasonally adjusted, 3-month moving average, last data point October 2014



cant positive contribution to profits growth, and the likelihood of further deterioration in emerging markets poses a threat to European exports and income earned abroad.

We are maintaining our long-U.S./short-eurozone financials position because the deep, underlying problems of euro area banks can come to the fore independently of short-term economic trends. Accordingly, we view this as a long-term position that requires patience and tolerance for volatility. Among the threats to euro area financial institutions in 2015 and beyond are the following: 1) deflation (independent of falling oil prices), which tends to accentuate debt-service

problems and add to non-performing loans, 2) the flattening yield curve, which compresses net interest margins, 3) the potential for financial instability in Russia spreading to the currency union, and 4) rising financial stresses in emerging market firms, to which euro area banks have substantial exposure.

Obviously, the situation is fluid, but ultimately the long-term pressures for a major euro area balance sheet retrenchment remain the overriding concern. This eventuality will lead us to look for opportunities to reenter our broad long/short position alongside the financials position at some point later in the year.



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