Weekly Economic Commentary

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Snapshot: Europe

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Highlights

The nations facing the most turmoil in the coming quarters (and likely years), including Greece, Portugal and Ireland, together account for less than 5% of the eurozone's economic output.

Europe is less dependent on the consumer, but much more dependent on trade, construction, and the government sector compared with the United States.

Countries within Europe that export to nations outside the European Union may be best positioned.

Economic Calendar

Wednesday, February 22
Existing Home Sales
Jan

Thursday, February 23
Initial Claims
wk 2/18

Friday, February 24
U of M Consumer Sentiment
Feb

New Home Sales
Jan

This week is another quiet week for economic data and events in the United States, and with only a scattering of corporate earnings reports due out, markets will likely focus their attention overseas for direction. Saber-rattling in Iran as inspectors from the International Atomic Energy Agency make a two-day visit to Iran as well as the reserve requirement ratio cut by the People's Bank of China (PBOC) over the weekend of February 18-19 will compete with the aftermath of the $172 billion bailout deal for Greece that was reached earlier this week.

We have seen a lot of news out of Europe over the recent months. At this juncture, we thought it would be helpful to step back and take a closer look at the European economy. We will examine the size of Europe's economy relative to the United States, the composition of the European economy, again compared to the United States' economy, and also detail the largest economies within the overall European economy.

In our *2012 Outlook*, (published in late 2011), we wrote that we expected the European economy to experience a mild recession in 2012. At the time, although our forecast for Europe's economy in 2012 was below consensus, many market observers expected a far worse outcome for the European economy in 2012. Since then, most of the economic data in Europe has come in better than expected. While this improvement has not yet been reflected in the consensus forecasts, financial market participants and even a few notable central banks have taken notice. For example, the better-than-expected performance of the European economy in early 2012 relative to the most pessimistic forecasts has probably allowed China's central bank, the People's Bank of China (PBOC), to hold off on another easing of monetary policy until this past weekend (February 18–19).

The Big Picture

Europe is defined as the 27 nations within the European Union. Seventeen of those nations currently use the euro as their currency, and the European Central Bank (ECB) serves as the central bank for these countries. These 17 nations are collectively known as the eurozone nations. This group includes (in order of size of their respective economies):

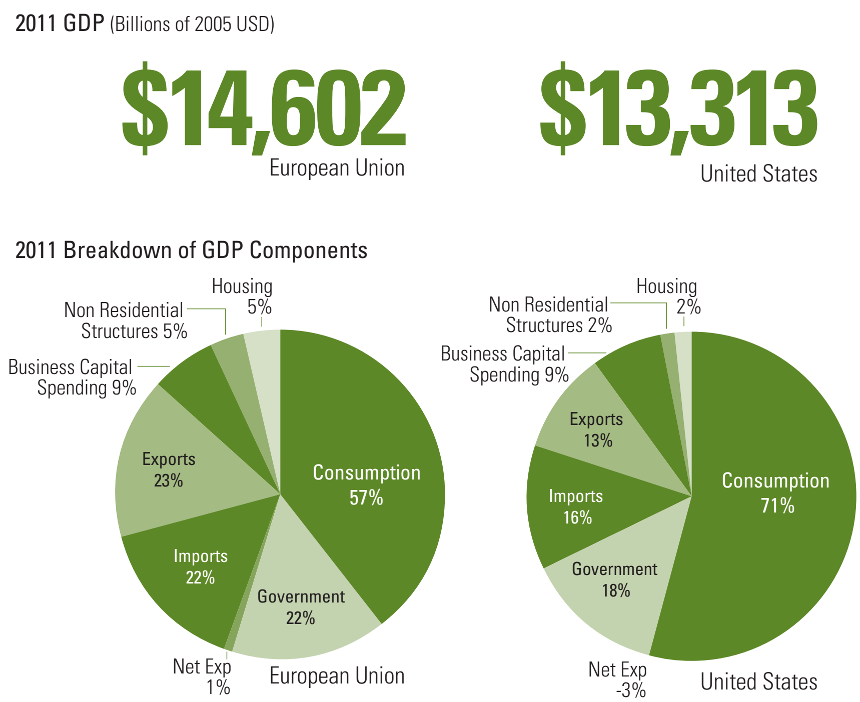
Germany, France, Italy, Spain, the Netherlands, Belgium, Austria, Greece, Finland, Portugal, Ireland, Slovakia, Luxembourg, Slovenia, Cyprus, Estonia and Malta.

The 17 nations that are part of the eurozone, along with the other 10 European nations, comprise the European Union, a 27-member confederation of nations that share a single market, but not a single currency, government, central bank, etc. The 10 nations that are members of the European Union, but do not use the euro or the ECB (again, arranged by the size of their economies) are:

The United Kingdom, Poland, Sweden, Denmark, Czech Republic, Romania, Hungary, Bulgaria, Lithuania and Latvia.

While sharing some of the economic and trade linkages with the 17 nations that use the euro and the ECB, each of these 10 nations has its own currency and central bank. To make matters even more confusing, Switzerland, Norway and Iceland are also European nations with sizable economies, but are not members of the eurozone (17 nations) or the European Union (27 nations) and also have their own currencies and central banks.

1 2011 GDP: European Union vs the United States

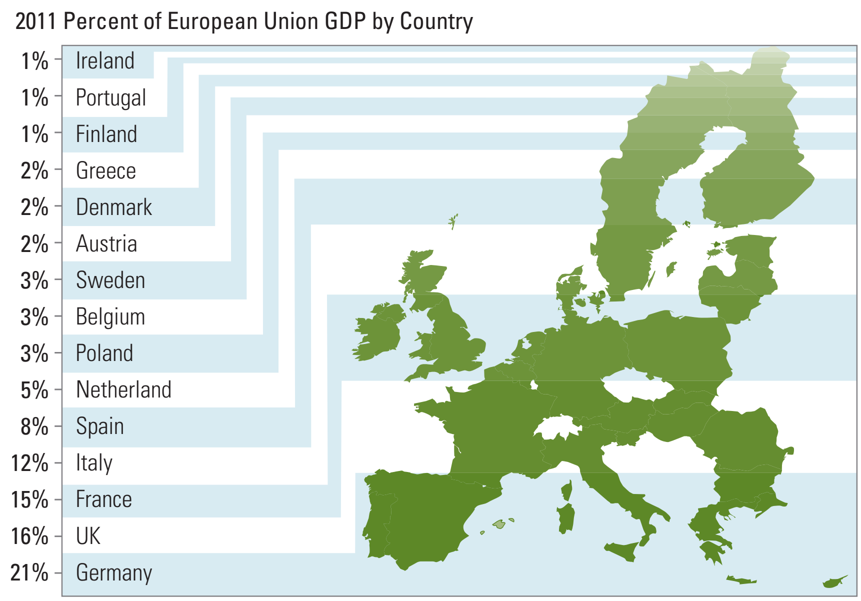


Source: LPL Financial, Eurostat 02/20/12

Europe's Economy Up Close

The combined economic output, as measured by inflation-adjusted gross domestic product (GDP), of the 27 nations that comprise the European Union is slightly larger than the GDP of the United States, and about 50% larger than China's [Table 1]. Last week's *Weekly Economic Commentary*, "Trade Offs," discussed the trade between the European Union, the United States and the emerging markets, noting that trade between the United States and European was dwarfed by the trade between the emerging markets and Europe. The emerging markets' growing co-dependence with Europe is often cited as a reason why China will ultimately participate in a more global solution to Europe's sovereign debt issues. On the flip side, the economic slowdown in Europe, although less severe than feared in the summer and fall of 2011, has almost certainly slowed economic growth in China which, in turn, was one of the catalysts for the cut in Chinese banks' reserve ratio requirements engineered by the PBOC over the weekend of February 18–19.

2 A Closer Look at 2011 European Union GDP



Source: LPL Financial, Eurostat 02/20/12

Zooming in on European Economic Power

European economic power is concentrated in a handful of nations, with Germany, the UK (a member of the European Union but not the eurozone), France, Italy and Spain accounting for 75% of economic output in Europe. By comparison, the top 20 states in the United States account for 75% of United States' economic output. The bad news is that both Italy and Spain, which together represent 20% of Europe's economic output, are heavily indebted nations, and budget cuts and tax increases in these nations will likely further slow economic output in 2012 and beyond.

The good news is that the nations facing the most turmoil in the coming quarters (and likely years), including Greece, Portugal and Ireland, together account for less than 5% of the eurozone's economic output. By comparison, Florida represents about 5% of United States GDP, as does the combined output of the 15 smallest states within the United States. Still, the issue is not that countries like Greece, Portugal and Ireland will be in recession this year (and likely for many years to come) as they restore their fiscal health. The market's concern is that a European financial institution exposed to the sovereign debt of these nations (and economies) might be unable to meet its obligations and trigger a Lehman-like credit freeze-up in Europe, which would likely spread quickly to the United States and around the globe.

Though not detailed in the nearby chart, there is a wide dispersion in the composition of GDP among the individual European Union members. For example, while Spain's economy is made up of close to the average of 57% consumer spending, the economies in Greece (75% consumer spending), Portugal (67% consumer spending) and, to a lesser extent, Italy (60% consumer spending) are heavily dependent on consumer spending. In turn, these nations face severe cuts to government spending (and government jobs) and social programs, which could make it difficult for these consumption-based economies to get back to "normal" anytime soon.

Composition: European Economic Output

The European Union's dependence on government spending will likely wane, while its reliance on trade will likely increase, given its large export exposure to the emerging markets

The composition of economic output in Europe (relative to the United States) reveals an economy that is much less dependent on the consumer, but much more dependent on trade, construction and the government sector than the United States. One other key difference is that the eurozone runs a trade surplus, while the United States runs a persistently large trade deficit. Looking ahead, the European Union's dependence on government spending will likely wane (as it is likely to do here in the United States in the coming years), while its reliance on trade will likely increase, given its large export exposure to the emerging markets. (Please see last week's *Weekly Economic Commentary* for details of Europe's export profile).

Given the rather dire outlook for economic growth in Europe this year (and over the next several years), nations within Europe that derive a significant portion of their economic growth from exports to nations outside of the European Union may be better positioned than European nations that rely more heavily on government spending or domestic consumption for growth.

For example, exports (to nations outside the European Union) make up 24% of Ireland's GDP, and exports also represent large components of the economies in Belgium (24%), Lithuania (22%), Estonia (19%) and the Netherlands (17%). On the other hand, Greece, where exports to countries outside the European Union account for only 3% of GDP, Portugal (6%), Spain (23%), France (8%) and Italy (9%) may have difficulty "exporting their way out" of their current economic malaise absent a radical shift in the composition of their economies in a short period of time. We hope to explore this aspect of European economic activity in future publications. ■

LPL Financial Research 2012 Forecasts

- GDP 2%*
- Federal Funds Rate 0%^
- Private Payrolls +200K/mo.†

Please see our *2012 Outlook* for more details on LPL Financial Research forecasts.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

* Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

^ Federal Funds Rate is the interest rate at which depository institutions actively trade balances held at the Federal Reserve, called federal funds, with each other, usually overnight, on an uncollateralized basis.

† Private Sector – the total nonfarm payroll accounts for approximately 80% of the workers who produce the entire gross domestic product of the United States. The nonfarm payroll statistic is reported monthly, on the first Friday of the month, and is used to assist government policy makers and economists determine the current state of the economy and predict future levels of economic activity. It doesn't include:
- general government employees
- private household employees
- employees of nonprofit organizations that provide assistance to individuals
- farm employees

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Stock investing involves risk including loss of principal.

International investing involves special risks, such as currency fluctuation and political instability, and may not be suitable for all investors.