Deflationary pressures, weak economic growth and mounting political risks are weighing on the outlook for the European economy.

Robert Lind, a Capital Group economist, offers his views on the pressing issues affecting the outlook for the European economy.

- The euro zone economy enjoyed a cyclical rebound in 2015 and early 2016, supported by easy monetary policy, less fiscal drag and low oil prices.
- But the economy is again losing pace as these effects fade and investors fret about negative interest rates and mounting political risks.
- With inflation well below 2%, the European Central Bank will likely extend its already aggressive bond-buying program.

Seven years have passed since the depths of the global financial crisis, but Europe's economy continues to struggle in the aftermath.

In 2015 and early 2016, the euro zone appeared to turn a corner, boosted by central bank stimulus measures, rapidly declining energy prices and a pronounced move away from fiscal austerity.

But the effects of these powerful tailwinds are beginning to fade. Negative interest rates are taking a severe toll on the European banking system. Deflationary pressures are threatening the profit outlook for many companies.

With the U.K.'s June 23 vote to leave the European Union – and other nationalist movements threatening to take the same course – political risks are high throughout the 19-member euro zone. Many of these risks appear to be priced into markets, as the valuations of European assets remain relatively low.

Challenging Investment Environment

The European economy is still quite fragile. The rate of economic growth is likely to be lower on average than we have seen in the past. We used to think the euro zone would grow by 2% to 2.5% a year, but the prospective growth rate now looks no higher than 1% to 1.5%.

That kind of slow growth leaves the economy vulnerable to unexpected shocks. If China's economy were to slip further, or if we see a slowdown in the U.S. economy, that would feed through into Europe fairly quickly. Political risk has also risen significantly. The future of the European Union is less secure than at any time since its formation.

Negative Interest Rates a Dangerous Experiment

Europe's aggressive use of negative interest rates is a "through the looking glass" kind of experiment. We are in unfamiliar territory. It started in Sweden and Switzerland, and it has rapidly spread across the euro zone.

In recent months, criticism has grown over the way the European Central Bank's monetary policy is affecting the economy. ECB officials have argued that negative rates should ultimately lead to stronger economic growth, which will benefit the banking system.

However, net interest margins have fallen precipitously for many of Europe's largest banks. Policymakers may be starting to recognize that negative rates are having a counterproductive effect, and I don't think that they can ignore that problem much longer.

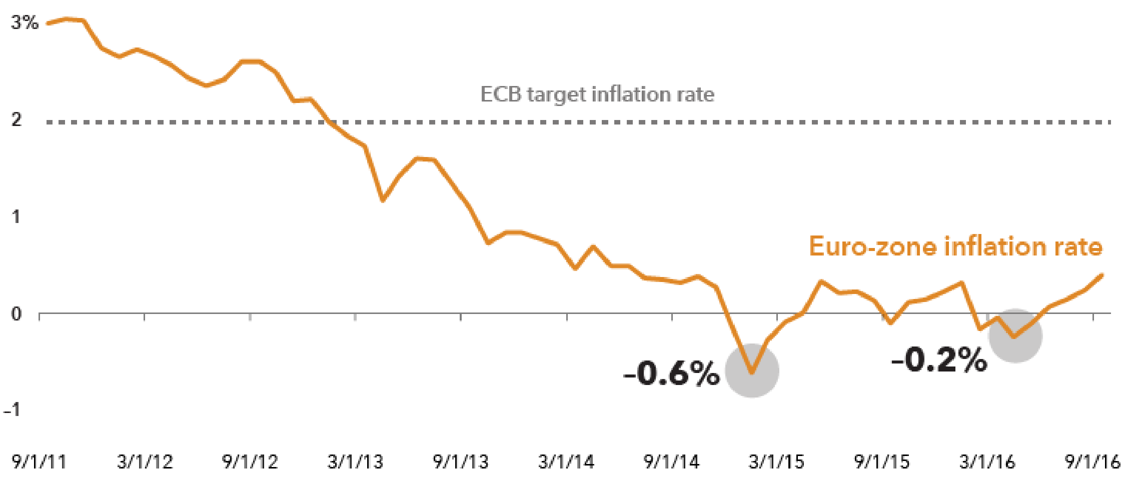
Political Risk Is On the Rise

I also have concerns about the political environment in Europe – not just in the U.K. where they are preparing to leave the EU, but also in other major European nations. Politicians in Germany, France and Italy are finding it extremely difficult to deal with an environment where economic growth is slow, pension liabilities are growing, and health care costs are rising along with aging populations.

Important elections are coming up in all three of those countries, including a December referendum on constitutional change in Italy. If that election goes against the Italian prime minister, we could see the formation of a new government and demands to abandon the euro zone.

That would be a major shock. It would be far bigger than anything we have seen so far with Brexit, and it could potentially pose an existential crisis for the EU. It's something we need to watch closely.

Europe's Deflationary Dilemma



Sources: Eurostat, Thomson Reuters Datastream as of 9/30/16.

Inflation Remains Below Target

Euro-zone inflation is far lower than it should be. The ECB has already employed extremely aggressive policy measures, including negative rates and a massive bond-buying program, but inflation continues to fall below the central bank's 2% target rate. I think over the course of the next few months the ECB will decide to do more.

Cutting rates further into negative territory is probably no longer an option, so I expect the ECB to extend the timeline of its bond-buying program beyond March 2017 and to expand the types of assets it can purchase. We will probably see an announcement before the end of the year.

Fiscal Stimulus May Be Necessary

What will it take to turn things around in Europe? Among the most significant measures governments can take is a more pragmatic approach to fiscal policy.

I think political leaders are slowly coming to the conclusion that they have a greater responsibility to provide support to their economies, principally through looser fiscal policy. That sentiment is encouraging in the wake of several years of intense austerity programs.

Europe Is Down But Not Out

Many of these macroeconomic concerns are already reflected in security prices. For example, the valuation gap between U.S. and European equities is significant. Many European companies are dominant, world-class leaders in their respective industries. These companies serve a global marketplace, but in many cases their share prices have been discounted because they are based in Europe.

Heading into 2017, I believe Europe will experience a gradual upturn in economic growth. It probably won't be spectacular, but it should be enough to drive some degree of improvement in corporate earnings.

At the same time, provided we can get through the political events of the next 18 months without a major negative shock, we should see a diminution of the political risk that has placed a dark cloud over Europe's economic recovery story.

Under that scenario, we could see a more positive investment environment in the years ahead.