THE WEEKLY EZ ECONOMIC MONITOR

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Headline inflation in the Eurozone will fall further in coming months, probably to as low as 1.1-to-1.2%.

EZ services inflation jumped in January, and wage growth suggests that it will remain elevated.

Inflation in non-energy goods is not moving, and the window is closing for a further pick-up.

Eurozone Inflation Data are Not a Threat to Markets, For Now

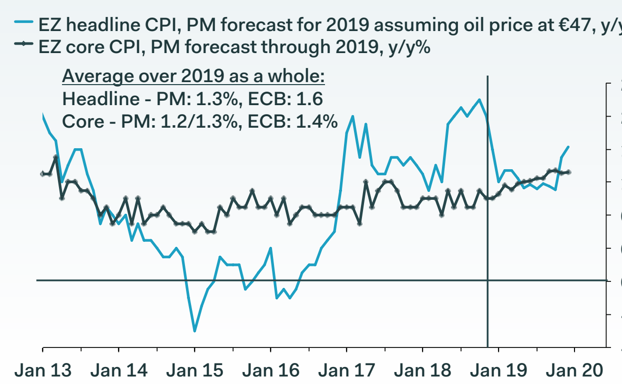
The days of +2% inflation in the Eurozone are long gone. Data on Friday showed that the headline rate slipped to 1.4% year-over-year in January, from 1.6% in December, thanks to a 2.9 percentage point plunge in energy inflation to 2.6%. The crash in oil prices started in October, but the feed through to EZ energy inflation has been longer than usual thanks to low water levels on the Rhine, which acted like a supply shock in Germany and northern France, preventing the distribution of fuel and other production inputs via river barges. Oil prices have gained ground in recent weeks, but we think energy inflation can fall further in the short term. *Our first chart shows that an oil price of around €50 would push the headline down to about 1.0% in the first half of the year, even assuming a gradual pick-up in the core rate.*

Speaking of which, core inflation edged higher in January, by 0.1pp to 1.1%, propelled by a jump in services inflation to 1.6%, from 1.3% in December. Non-energy goods inflation, however, fell by 0.1pp, to 0.3%. We can't make any inference based on one month's data, and we are also on alert for revisions, given that the German index was rebased at the start of the year, necessitating a shift in Eurostat's methodology. In any case, the split between rising services inflation and a stagnant goods CPI is consistent with leading indicators.

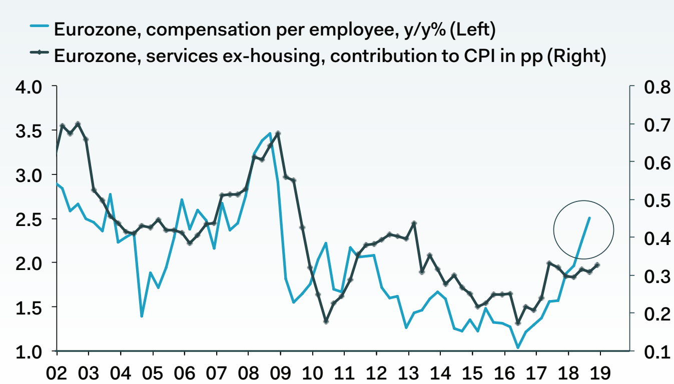
The headline economic activity data have disappointed in recent quarters, but from the point of view of domestic inflation pressures for non-tradables—mainly services—risks are very much tilted to the upside. Unemployment is still falling, and our next chart shows that wage growth per employee has shot up to just under 2.5% year-over-year as of Q3, the fastest pace this side of the financial crisis.

Even allowing for structural shifts in the relationship between wages and non-tradable inflation, services inflation should rise further. Our next chart focuses on the contribution to headline inflation from services ex-housing. It has been stable since 2017 at just over 0.3pp, but we think an increase to 0.4-to-0.5pp through 2019 is a good bet, irrespective of the fact that *GDP growth* probably will slow further, by about 0.6pp to 1.2%.

EUROZONE HEADLINE INFLATION TO FALL FURTHER IN H1...



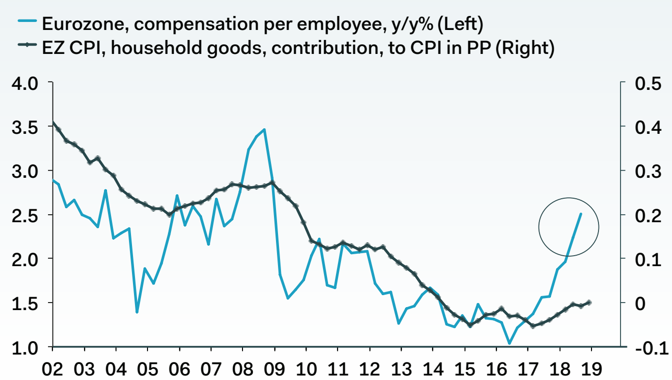
...LOOK OUT FOR FURTHER INCREASES IN EZ SERVICES INFLATION



Inflation in consumer goods is going nowhere

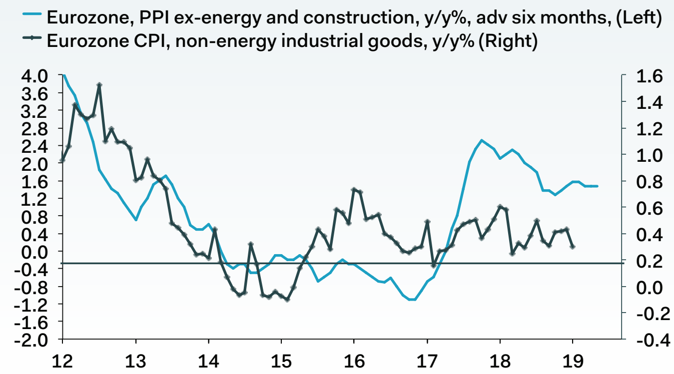
Even if services inflation conforms to its behaviour in previous expansions, we struggle to see how core inflation can get anywhere near the ECB's objectives. *Inflation in non-energy goods accounts for 40% of the overall core rate, and it is under pressure from both structural and cyclical forces.* Our next chart shows that inflation in household goods is trending down with only a passing link with the fluctuation in wage growth. Indeed, the headline CPI contribution from household goods inflation has been slightly below zero since 2014. Competition in global goods markets has intensified in the past 15-to-20 years, thanks to the entry of China and other emerging markets into the global manufacturing process. This globalisation of supply chains in consumer goods, in turn, means that *domestic* wages are playing an increasingly smaller role in dictating firms' ability to raise prices to consumers.

INFLATION IN HOUSEHOLD GOODS STILL LOOKS STUCK



Inflation in household goods rose slightly last year, but we doubt that it will get much further this year. Our final chart shows that inflation in non-energy goods has gone nowhere, despite the core PPI ranging between 1.5% and 2.0% since the beginning of 2017. In the short run, non-energy inflation should be able to reach 0.5-to-0.6% in the next few months, but risks are looming for the second half of the year. Producer price inflation in China has rolled over, and it normally directs the key euro area and German indices lower with a lead of three-to-six months. This suggests that the Eurozone non-energy CPI will start to *decline* in the latter part of 2019.

NO RESPONSE TO A HIGHER PPI FROM THE NON-ENERGY CPI?



No danger for the ECB and markets?

In total, we think the EZ core inflation rate will edge higher, to 1.3% at the end of the year, but risks are tilted to the downside, given the shift in the outlook for goods inflation. In the language of the ECB, we think core inflation will average 1.2-to-1.3% this year, well below the 1.4-to-1.5% predicted by the central bank. This is mainly a *credibility* problem for the ECB, which has persistently reiterated its confidence that inflation was converging to target, despite evidence to the contrary.

Unless the Eurozone slumps into outright deflation, however, low inflation shouldn't be a huge problem for markets. It means that conditions for rates remain predictable; namely, they'll remain low for an extended period, locked into place by the ECB's forward guidance. In this context, the debate about whether Mr. Draghi manages to step down with a deposit rate hike, to -0.2% from -0.4%, in September is trivial.

We still think the ECB will push the button in Q4, but also that the central bank will seek to compensate for this move by extending the existing TLTROs, or perhaps even announcing new ones. The main source of uncertainty is that we don't know the make-up of the governing council after Mr. Draghi and Mr. Coeure leave. ***Assuming continuity, however, the current inflation environment in the Eurozone remains benign; deflation risks have been vanquished, but risks of overheating are still a dim and distant prospect.***

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THIS WEEK IN BRIEF

Note: "**D**" prefix denotes Datanotes for these releases.

Monday, February 4

- **D: Sentix, Eurozone (1) 10:30 CET**

We think the Sentix investor sentiment index rose to **zero** in February, from -1.5 in January, driven by the recent rebound in EZ equity prices. **Consensus: -1.1**.

Tuesday, February 5

- **D: Final PMIs, Eurozone (1) 10:00 CET**

The composite PMI in the Eurozone probably slipped to **50.7** in January, from 51.1 in December, driven primarily by a big fall in the French services index, and further weakness in German manufacturing. Overall, the survey suggests that EZ GDP growth slowed further at the start of the year. Our forecast is in line with the initial estimate. **Consensus: 50.7**.

- **D: Retail Sales, Eurozone (12) 11:00 CET**

We think retail sales in the euro area declined **2.0%** month-to-month in December, depressing the year-over-year rate to -0.2% from +0.9% in November. A crash in Germany was the primary driver, but we suspect that the January data will deliver an upward revision of these data. **Consensus: -1.6%**.

Wednesday, February 6

- **D: Factory Orders, Germany (12) 08:00 CET**

New orders likely jumped **1.4%** month-to-month in December, but the year-over-year rate likely fell further to -5.5%, from -4.3% in November, due to base effects. A rebound in export orders probably was the main driver. **Consensus: 0.2%**.

Thursday, February 7

- **D: Industrial Production, Germany (12) 08:00 CET**

We think output jumped **1.9%** month-to-month in December, lifting the year-over-year rate to -2.5%, from -4.3% in November. Rebounds in consumer and capital goods probably did the heavy lifting. **Consensus: 0.7%.**

- **D: Trade Balance, France (12) 08:45 CET**

We reckon the French trade deficit narrowed to **€4.0B** in December, thanks to a jump in exports, mainly in aerospace and naval equipment, consistent with the message from the advance Q4 GDP data. **Consensus: €4.0B.**

Friday, February 8

- **D: Trade Balance, Germany (12) 08:00 CET**

The seasonally adjusted trade surplus in Germany likely fell marginally in December, to **€18.3B** from €18.9B in November, thanks to a dip in exports. The headline non-seasonally adjusted surplus probably dipped to €16.5, from €20.4B in November, in line with normal seasonal patterns. External demand was a big drag on GDP growth in the second half of 2018, but we think the pressure will fade in the first half of this year, as exports rebound, a bit. **Consensus: 18.0B.**

- **D: Industrial Production, France (12) 08:45 CET**

We think industrial production in France rose **1.2%** month-to-month in December, pushing the year-over-year rate up to -1.0% from -2.1% in November. A rebound in the auto sector and continued strength in non-auto transport equipment probably were the main drivers. **Consensus: 0.8%.**

PANTHEON EUROZONE FINANCIAL CONDITIONS DASHBOARD

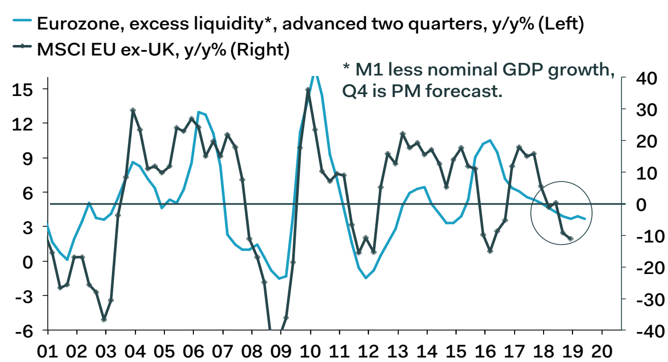
Market	Valuation*	Six month change, %	y/y, %
Eurostx 50	-1.0	-8.9	-10.0
Dax 30	-0.8	-11.4	-12.6
CAC 40	-0.6	-8.4	-6.4

* P/E ratios in standard deviations from 10y average (>1.5 = expensive, <-1.5 = cheap)

Bonds	Curve**	Six month change, bp	y/y, bp
GER (10-2)	-3.5	-25.1	-56.0
FRA (10-2)	-3.2	-9.9	-38.5
ITA (10-2)	-1.6	+40.3	-3.7

** Curve in standard deviations from its 10y average (>1.5 = historically steep, <-1.5 = historically flat)

EUROZONE EXCESS LIQUIDITY VS MSCI EU (EX UK)



EZ equities continue to edge higher, though we doubt that February will be as good as January. The recent dovish tilt by global central bankers will help, but excess liquidity continues to signal only modest returns.

PANTHEON'S EUROZONE ECONOMIC FORECASTS (GDP: REAL GDP Q/Q%)

GDP			
Q3 18	0.2	2016 year:	1.8
Q4 18 forecast	0.2	*2017 year:*	*2.5*
Q1 19 forecast	0.4	*2018 year:*	*1.9*
Q2 19 forecast	*0.3*	*2019 year:*	*1.2*
Q3 19 forecast	*0.2/0.3*	*2020 year:*	*1.1*

CPI y/y, %		Unemployment, %	
January	1.4%	November	7.9%
February	*1.2%*	*December*	*7.9%*
March	*1.0%*	*January*	*7.9%*
April	*1.4%*	*February*	*7.9%*
May	*1.2%*	*March*	*7.9%*