THE EUROZONE ECONOMIC MONITOR

MAY 10, 2019
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Markets are assuming a positive outcome in the U.S.-China negotiations today; is this complacent?

The Eurozone's trade surplus with the U.S. is rising, and tariffs probably wouldn't change that trend.

Currency effects would eliminate a modest U.S. tariff hike for EZ exporters, but not a full-blown war.

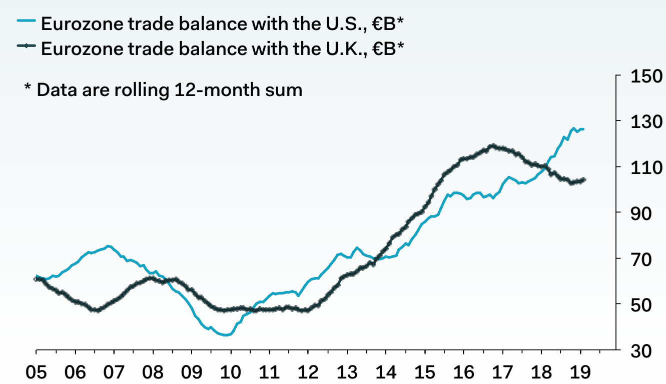
See No Evil, Hear No Evil in Today's U.S.-China Trade Talks?

As we head to press, investors are holding their breath over whether today's trade talks between the U.S. and China will be enough for Mr. Trump to step back from his pledge to increase tariffs on $200B of Chinese goods to 25%. Equities in the EZ, and elsewhere, have sold off this week, but we are fairly certain that investors' base case remains that a deal will be done. On balance, this probably is the right bet, but with Eurozone equities up nearly 15% year-to-date, including dividends, and bond yields in the periphery down across the board, we worry about the reaction if talks break down. ***EZ investors will be betting on some response by the ECB if the trade wars escalate, which is a fair bet, but in the short run, they're not priced for a substantial hike in tariffs on China, and a broadening of the goods hit.***

Meanwhile, in Brussels, politicians and bureaucrats will be wondering how to avoid a head-to-head fight with Mr. Trump prior to next year's presidential elections. From the EU's perspective, the groundwork for a deal has been done. Last year, Mr. Juncker and Mr. Trump struck a deal in the White House in which both parties agreed not to escalate the tariff wars while talks are ongoing. As part of the deal, the EU also is supposed to increase its imports of U.S. soybeans and natural gas, substituting for energy imports from Russia.

The Commission has little power over the import behaviour of individual EU economies, but for what it's worth, U.S. exports of soybeans and natural gas to Europe *have* increased since the middle of last year. Unfortunately for the EU's trade negotiators, the Eurozone's *overall* trade surplus with the U.S. also has grown steadily, as our next chart shows. *The 12-month smoothed surplus with the U.S. reached just under €130B in February, about 1.1% of GDP, up 15% from the same period last year.*

TRICKY TRADE NEGOTIATIONS AHEAD FOR THE EU BUREAUCRATS?

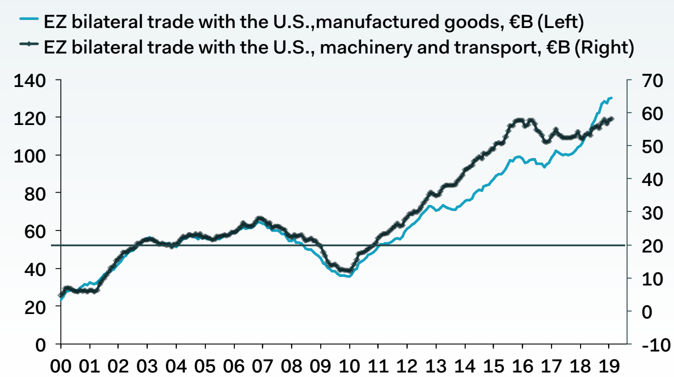


The *macroeconomic* rationale for this trend is straightforward. The EZ economy is very competitive with EURUSD at 1.10-to-1.15, and Mr. Trump's fiscal stimulus in an economy close to full employment has increased demand far in excess of domestic supply; as a result, the non-oil trade deficit has soared. From the vantage point of the Oval Office, however, the euro area's soaring bilateral surplus is a sign that America is losing out, and the U.S. president hates to lose.

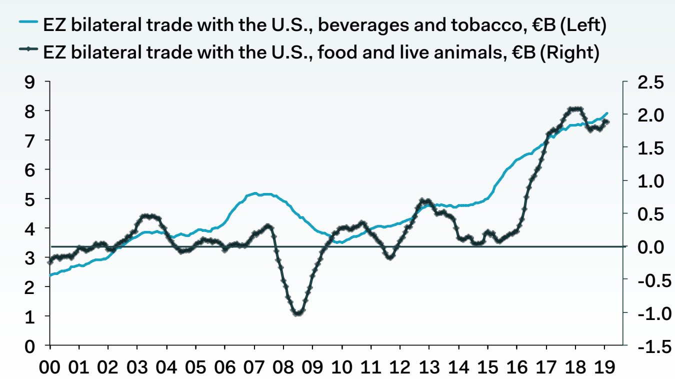
The Council of Ministers have given the EU Commission two, surprisingly ambitious, mandates for trade talks with the U.S. Brussels is prepared to eliminate all import tariffs on industrial goods, including cars, assuming the U.S. reciprocates and pulls back on the aluminium and steel tariffs already imposed. In addition, the EU wants to negotiate a reduction in regulatory barriers to trade, specifically for SMEs.

The EU's attempt to throw an olive branch to the U.S. by offering the reciprocal elimination of tariffs on industrial goods has been met with a cold shoulder by Mr. Trump. The U.S. president has cryptically referred to the "problem" that many Americans prefer to drive a European car. The "logic" here is that because the U.S. already runs a big deficit with Europe, a fifty-fifty deal wouldn't do much to shift the direction in flows of manufacturing goods. That's probably true. The Commission diplomatically estimates that eliminating tariffs on goods would increase U.S. exports to the EU by 9%, just 0.1pp more than the benefit accruing to EU exporters. Even if this calculation is accurate, though, it wouldn't do much to dent the trend in the EZ's soaring surplus in manufacturing goods with the U.S.

ZERO TARIFFS ON INDUSTRIAL GOODS WON'T HALT THIS TREND



ANOTHER EZ TRADE SURPLUS, BUT NUMBERS ARE SMALL OVERALL



Another snag in the negotiations is that the U.S. wants to include agricultural goods in the final deal, which is *extremely* difficult for the EU. The agricultural sector in Europe is well protected by external tariff barriers—as is the U.S. sector—and few political leaders in the EU are currently willing to give the Commission a mandate to trade on their behalf with the U.S. Our previous chart shows that the EZ trade surplus with the U.S. in food and drink has increased in the past few years, providing further ammunition for Mr. Trump, though the overall numbers are tiny compared to gross flows.

Some of the "what if" questions answered

The White House moves in mysterious and unpredictable ways when it comes to trade, but we can probably use the Chinese talks as a template. *If Mr. Trump decides to escalate the conflict with Europe, threats of tariffs in the range of 10%-to-25% probably are a good bet.* Brussels would retaliate in the form of targeted tariffs, for example on Harley Davidson motorbikes and Jack Daniels whisky, to attempt to exercise political pressure on Washington.

Financial markets wouldn't like a trade war between the EU and the U.S. European equities would sell off and EURUSD will fall, if the U.S. moves to impose tariffs on EU goods. The hit to the EZ *economy*, though, is difficult to calculate due to the largely unobservable import and export price elasticities. ***Currency effects likely would eliminate most of the distortions from a relatively modest tariff in the range of 5-to-10%.*** In short, we reckon EURUSD would fall by about the same amount as the tariffs, allowing U.S. importers to continue buying from their EU suppliers at unchanged dollar prices.

A tariff hike in the range of 20-to-25%, however, would lead to severe distortions across both markets. EZ exporters would have to absorb part of the hike via a hit to margins. This would be particularly painful in the auto sector, where traditionally thin margins already are under pressure from rising wages. In addition, the EU retaliation in such a situation also would escalate, compounding the damage. *Eurozone equities likely would decline 20-to-35% in such a scenario, with EURUSD sliding 10-to-15%.*

The *Eurozone Economic Monitor* will be on annual leave on Monday May 13th. Publication will resume on the 14th.

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THIS WEEK IN BRIEF

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

Monday, May 6

• **D: Final PMIs, Eurozone (4) 10:00 CET**
The composite PMI in the Eurozone dipped to **51.5** in April, from 51.6 in March, trivially lower than the first estimate, 51.3.

• **D: Sentix, Eurozone (5) 10:30 CET**
The Sentix investor sentiment index rose to **5.3** in May, from -0.3 in April, though it looks slightly stale in the face of the sharp fall in equities in response to Mr. Trump's trade tweets.

• **D: Retail Sales, Eurozone (4) 11:00 CET**
Retail sales in the Eurozone were **unchanged** month-to-month in March, driving the year-over-year rate down to 1.9%, from a revised 3.0% in February. Sentiment and real wage growth suggest that consumers' spending is picking up. Growth was depressed last year due to a rising savings rate, but we think the drag will fade this year.

Tuesday, May 7

• **D: Factory Orders, Germany (3) 08:00 CET**
New orders rose **0.6%** month-to-month in March, lifting the year-over-year rate to -6.0% from -8.1% in February. Rebounds in new orders for capital and consumer goods were the key drivers of the gain. New orders for intermediate goods fell.

• **D: Trade Balance, France (3) 08:45 CET**
The trade deficit in France widened to **€5.3B** in March, from €4.0B in February, thanks to a jump in imports, which offset a small increase in exports. Net trade was a drag on growth in Q1, but we expect a small gain in Q2.

Wednesday, May 8

• **D: Industrial Production, Germany (3) 08:00 CET**
Industrial output in Germany rose **0.5%** month-to-month in March, lifted by still-solid growth in construction and a jump in production of consumer goods. The year-over-year rate fell to -0.9% from a revised 0.2% in February. German manufaturing remains under pressure due to weakness in external demand and a large inventory overhang; the latter should make a big dent in Q2 growth.

Thursday, May 9

• **No significant data released.**

Friday, May 10

• **D: Trade Balance, Germany (3) 08:00 CET**
The headline non-seasonally adjusted trade surplus in Germany probably increased to **€23.0B** in March, from €18.0B in February, with the seasonally adjusted surplus edging higher by €0.4B, to €19.1B. Our forecast assumes that seasonally adjusted exports fell by 0.4% month-to-month, while imports slipped by 0.9%. Net exports were a huge drag on growth last year, but we think they will be flat this year. **Consensus: €20.B**.

• **D: Industrial Production, France (3) 08:45 CET**
We think industrial production in France fell by **0.9%** month-to-month in March, driving the year-over-year rate down to -0.5%, from +0.6% in February. Production of transport equipment, ex-cars, probably mean-reverted from a strong gain in February, and energy output likely slipped too. **Consensus: -0.5%**.

PANTHEON EUROZONE FINANCIAL CONDITIONS DASHBOARD

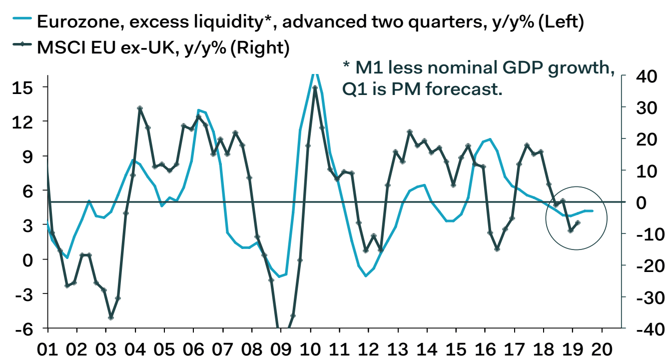
Market	Valuation*	Six month change, %	y/y, %
Eurostx 50	-0.2	+9.0	-1.4
Dax 30	-0.3	+7.8	-3.2
CAC 40	-0.3	+8.8	+0.5

* 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)	-3.7	-43.1	-50.1
FRA (10-2)	-3.4	-30.3	-36.3
ITA (10-2)	-2.0	-33.6	+1.2

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

EUROZONE EXCESS LIQUIDITY VS MSCI EU (EX UK)



Equities in the euro extended their run at the start of Q2, but have lost momentum at the start of May. They're still up over 15% year-to-date, though, so if the next few months present investors with sideways price action, no one should be surprised or disappointing.

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

GDP			
Q1 19	0.4(a)	2016 year:	1.8
Q2 19 forecast	*0.3*	*2017 year:*	*2.5*
Q3 19 forecast	*0.2*	*2018 year:*	*1.8*
Q3 19 forecast	*0.2*	*2019 year:*	*1.2*
Q1 20 forecast	*0.4*	*2020 year:*	*1.1*

CPI y/y, %		Unemployment, %	
March	1.4%	March	7.7%
April	*1.7%*	*April*	*7.7%*
May	*1.5%*	*May*	*7.7%*
May	*1.5%*	*June*	*7.6%*
June	*1.5%*	*July*	*7.6%*