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THE WEEKLY **EZ** ECONOMIC MONITOR

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German manufacturing stalled at the start of Q2, but construction is pushing ahead.

Labour costs in Germany accelerated in Q1, and leading indicators signal further upside.

Industrial production in France was stung by falling energy output in April; a rebound beckons in May.

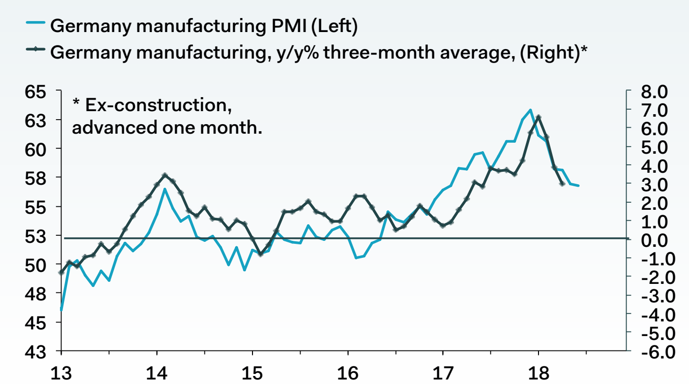
German Construction is Pushing Ahead; Manufacturing is Stalling

The bad news in German manufacturing keeps coming thick and fast. Data on Friday showed that industrial production fell 1.0% month-to-month in April, depressing the year-over-year rate to 2.0%, from an upwardly-revised 3.8% in March. This headline was much worse than the consensus forecast for a 0.3% rise, but the 0.7 percentage point upward revision to the March headline was a positive surprise. *The adjustment brings the Q1 hard data closer into line with the advance GDP numbers.* Importantly, this revision goes some way to solving the mystery of why the monthly data in Q1 initially pointed to a collapse in growth, in contrast to the GDP data, which now suggest that domestic demand did reasonably well.

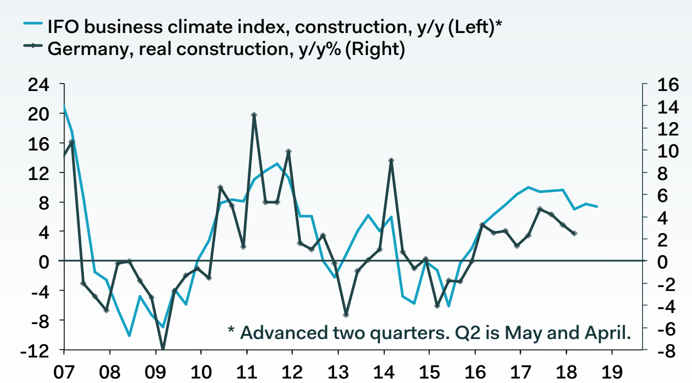
The details revealed a sharp divergence between sluggish manufacturing and strong construction. The former plunged 1.7% month-to-month, reversing the gain in March. Core goods output fell across the board, and energy production also slipped, probably due to above-average temperatures, which depressed spending on utilities. The year-over-year rate fell to a 14-month low of 2.0%, extending the slowdown since December, but survey data suggest that the worst is over. The IFO manufacturing orders index rose slightly in May, and our first chart shows that the PMI indicates that output growth will average about 2.5% in the next two-to-three months.

The main downside risk to German manufacturers in the short term is an escalation in the trade conflict between the EU and the U.S. The measures taken so far—U.S. steel and aluminium tariffs and the EU's response—were expected by markets, although investors were hoping they wouldn't happen. But risks are rising that further measures will follow. As we go to press, the G7 meeting in Quebec is about to take place, amid an increasingly deteriorating relationship between Mr. Trump and his European counterparts. Any *additional* measures would rattle business confidence and markets. If the White House

THE SLOWDOWN IN GERMAN MANUFACTURING IS OVER... WE HOPE



THE GERMAN CONSTRUCTION INDUSTRY IS PURRING ALONG



moves to impose tariffs on the European auto industry and its suppliers, for example, we are certain that headline business survey data in Germany would be knocked back further.

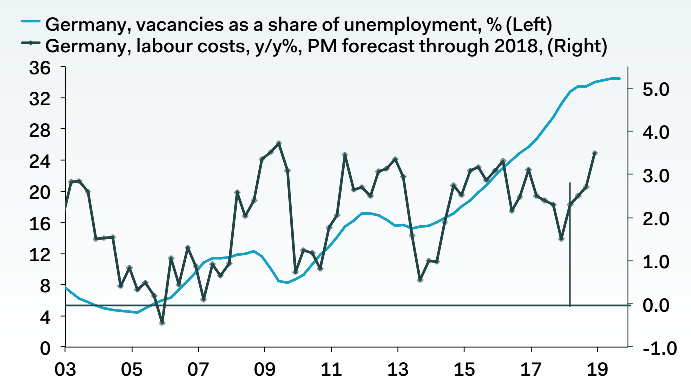
Meanwhile, in the construction sector—which is relatively well-insulated from global trade squabbles—conditions are excellent. Output jumped 3.3% month-to-month in April, following an upwardly-revised 1.5% rise in March. Construction capex jumped 2.0% quarter-on-quarter in Q1, but we doubt that this performance will be repeated in Q2. The trend, however, is solid, and probably rising slightly. The IFO construction sentiment index increased to an all-time high in May, and our previous chart shows that it signals further good news in coming quarters.

Further upside for German labour cost growth?

The final two reports in Germany on Friday showed that the economy's trade surplus slipped slightly at the start of Q2, but that wage growth accelerated in Q1. A 2.2% month-to-month rise in imports was the primary driver of the €3.3B decline in the external surplus, to €20.4B. Net exports constrained headline GDP growth by 0.1 percentage points in Q1, and the lagged effect of the stronger euro points to further downside in Q2.

Unit labour costs, meanwhile, rose 2.3% year-over-year, accelerating from a 1.5% rise in Q4. The gain was split between a 2.1% increase in wages, and a 2.9% rise in non-wage costs, respectively. These data are less than perfect. In Q4, growth plummeted because the number of hours worked declined—as sickness leave fell—compared to Q4 in 2016. We think the employee compensation numbers are better, but we see no reason why momentum in labour costs shouldn't increase further in coming quarters. Our previous chart shows that the tightening labour market sends a clear signal for the trend in labour costs.

A FURTHER RISE IN GERMAN LABOUR COSTS IS A GOOD BET

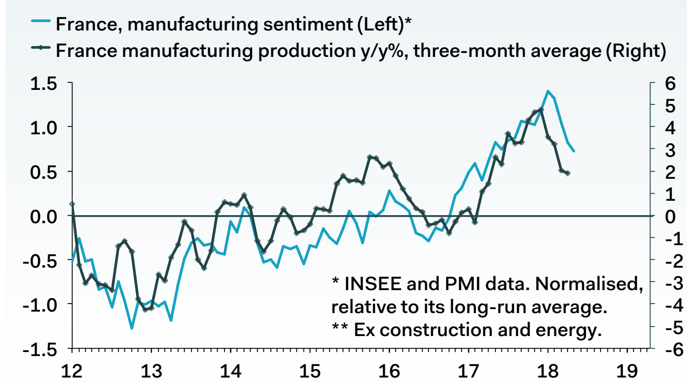


French energy production plunged in April

Finally, in France, industrial production also stumbled at the start of Q2; output fell 0.5% month-to-month in April, lifting the year-over-year rate slightly, by 0.2pp to 2.1%. The details, though, were better than the headline. The main hit came from a 6.9% plunge in energy production due to mild weather, but temperatures cooled again in May, so we expect a 5.0% reversal in next month's report.

Elsewhere, manufacturing, ex-energy, increased 0.4%, and the year-over-year rate jumped by 2.5pp to 3.0%. A leap in production of transport equipment—primarily aircraft—and strength in the food and beverage industry offset falling production in electronic equipment, oil refining and pharmaceuticals. Our final chart shows that manufacturing has slowed recently, but similarly to the situation in Germany, leading indicators suggest that the slowdown is over.

WILL FRENCH MANUFACTURING SLOW FURTHER IN Q2?



We recently hosted a seminar with the topic: "A familiar sense of crisis in the Eurozone." Click here to see the replay.

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THIS WEEK IN BRIEF

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

Monday, June 11

- **No significant data released.**

Tuesday, June 12

- **Payrolls, France (5) 07:30 CET**

We think total payrolls, excluding agriculture, increased **0.3%** quarter-on-quarter in Q1, similar to the pace in Q4, in line with the consensus and first estimate. **Consensus: 0.3%**.

- **D: ZEW, Germany (6) 11:00 CET**

The headline ZEW investor expectations index probably plunged to **-20.0** in June, from -12.1 in May. **Consensus: -14.5.**

Wednesday, June 13

- **D: Industrial Production, Eurozone (4) 11:00 CET**

We think industrial production in the Eurozone fell **0.9%** month-to-month in April, depressing the year-over-year rate to 2.0%, from 3.0% in March. **Consensus: -0.6%**.

- **D: Employment, Eurozone (Q1) 11:00 CET**

Employment in the EZ probably increased **1.3%** year-over-year in Q1, slowing from a 1.6% rise in Q4. **Consensus: N/**A.

Thursday, June 14

- **D: Final Inflation, Germany (5) 08:00 CET**

We think inflation jumped to **2.2%** in May, up form 1.6% in April, in line with the initial estimate. Energy and services inflation likely were the primary drivers. **Consensus: 2.2%**.

- **D: Final Inflation, France (5) 08:45 CET**

Inflation in France likely increased to **2.0%** in May, from 1.6% in April, boosted by higher energy inflation. **Consensus: 2.0%.**

- **D: ECB Rate Decision, Eurozone (6) 13:45 CET**

The ECB will keep its key refinancing and deposit rates unchanged today at **0.00%** and **-0.4%**, respectively. The central bank also likely will signal its intention to end QE later this, but in true ECB fashion, we think Mr. Draghi will hold back on the final details and modality of how QE will be wound down in the fourth quarter. **Consensus: Refi-rate: 0.00%, deposit rate: -0.4%**.

Friday, June 15

- **D: Car Registrations, EU 27 (5) 08:00 CET**

New car registrations likely were **flat** year-over-year in May, slowing from a 9.0% rise in April, as May in 2018 had less working days than in 2017. The trend probably is stable at 5-to-6% year-over-year. **Consensus: N/A**.

- **D: Final Inflation, Eurozone (5) 11:00 CET**

We think inflation in the Eurozone jumped to **1.9%** year-over-year in May, from 1.2% in April. Services and energy inflation jumped, but non-energy goods inflation fell. **Consensus: 1.9%**.

- **D: Trade Balance, Eurozone (4) 11:00 CET**

The seasonally adjusted trade surplus in the Eurozone likely fell to **€20.5B** in April, from €21.2B in March. A slight fall in Germany's surplus probably was the primary driver of the rise. The deficit in France was unchanged on the month. Net exports in the EZ likely will remain sluggish in Q2. **Consensus: €20.0B**.

- **D: Labour Costs, Eurozone (Q1) 11:00 CET**

We think labour costs in the Eurozone increased **1.6%** year-over-year in Q1, accelerating slightly from a 1.5% rise in Q2. A tightening labour market points to growth of about 2.0% at the end of the year. **Consensus: N/A**.

PANTHEON EUROZONE FINANCIAL CONDITIONS DASHBOARD

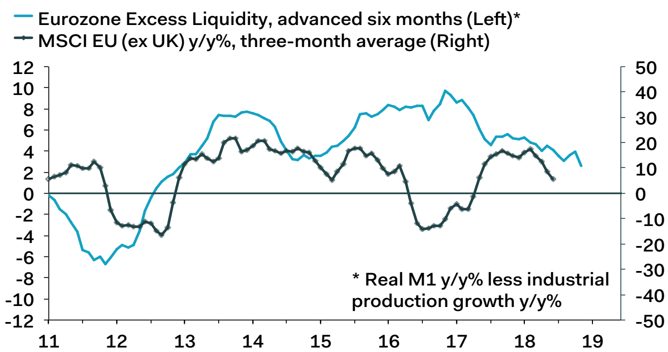
Market	Valuation*	Six month change, %	y/y, %
Eurostx 50	-0.5	-4.1	-4.0
Dax 30	-0.6	-3.1	-0.5
CAC 40	-0.2	+0.8	+2.7

* 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)	-2.5	+4.7	+10.0
FRA (10-2)	-2.3	+9.0	+18.5
ITA (10-2)	-2.6	-60.2	-91.3

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

EUROZONE EXCESS LIQUIDITY VS MSCI EU (EX UK)



Eurozone equities have rebounded in May, but now face resistance from the looming face-off between the EU and Italy over the new government's economic policies. We see a relatively small risk of a huge contagion, but it won't help.

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

GDP			
Q3 17	0.7	2016 year:	1.8
Q4 17	0.7	*2017 year:*	*2.5*
Q1 18 (2nd E)	0.4	*2018 year:*	*2.0*
Q2 18 forecast	*0.5*	*2019 year:*	*1.7*
Q3 18 forecast	*0.4*	*2020 year:*	*1.4*

CPI y/y, %		Unemployment, %	
March	1.3%	April	8.5%
April	*1.2%*	*May*	*8.5%*
May	*1.9%*	*June*	*8.4%*
June	*2.0%*	*July*	*8.4%*
July	*2.1%*	*August*	*8.3%*