THE **EUROZONE** ECONOMIC MONITOR

MAY 16, 2018
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Weakness in Germany and France hit EZ GDP growth in Q1, and a downward revision is coming.

The consensus for Eurozone growth in 2018 still looks too optimistic to us, but only slightly so.

A global growth shock and higher rates usually precede EZ recessions; neither are likely in 2018.

Is Eurozone GDP Growth Heading for 2.0% this Year?

Yesterday's economic reports mainly were backward-looking, but provided further evidence that the Eurozone economy hit the skids at the start of the year. Eurostat's second estimate for Q1 GDP confirmed that growth slowed by 0.3 percentage points to 0.4% quarter-on-quarter, depressing the year-over-year rate to 2.5%, from 2.8% in Q4. *This headline was in line with the consensus and initial estimate, but we think it will be revised down to 0.3% when the third estimate is released, on May 24.*

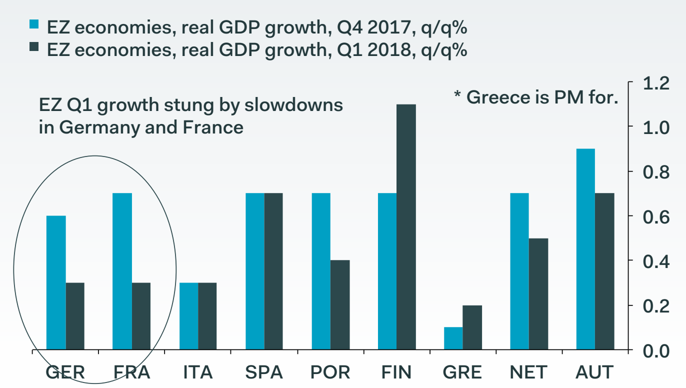
The separate Q1 GDP report for Germany revealed that growth slowed to 0.3% quarter-on-quarter from 0.6% in the fourth quarter, 0.1pp below the consensus. In addition, we think French Q1 GDP growth eventually will be revised down by 0.1pp to 0.2%, reflecting below-expectations March manufacturing output.

Elsewhere, the headlines came in below expectations. In the Netherlands, growth eased to 0.5%, from a downwardly-revised 0.7% in Q4, below the consensus, 0.6%. And in Portugal, the pace of GDP growth slowed to 0.4%, some 0.3pp lower than in Q4 and also undershooting the consensus, 0.6%. *Our first chart provides an overview of the Q1 data right now, confirming that the slowdown was broad-based, but also that fading growth in the core economies was the key driver of the aggregate slowdown.*

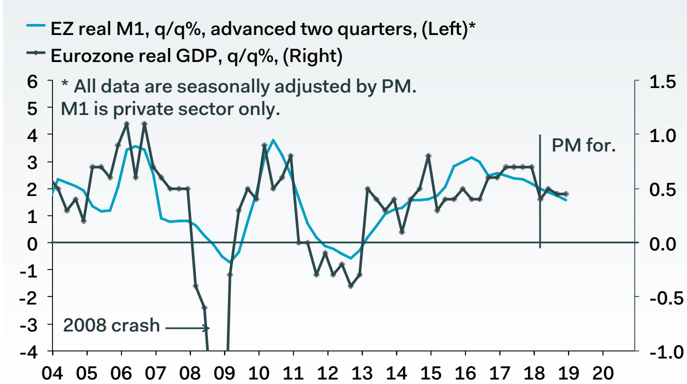
The key *positive* story in the GDP data was that the Spanish and Italian economies maintained their momentum at the start of the year, albeit with markedly divergent headlines. Growth in Spain was unchanged at 0.7% quarter-on-quarter, while Italy only managed 0.3%. Finally, Finland was the main outlier to the upside, with punchy Q1 growth of 1.1% quarter-on-quarter, 0.4pp faster than in Q4.

We have to wait a few more weeks to see the detailed data for the Eurozone as a whole. But we are reasonably sure that slowdowns in net exports, manufacturing and construction were the key drivers of the disappointing start to the year.

BLAME THE CORE ECONOMIES FOR SLUGGISH GROWTH IN Q1



THE EUROZONE ECONOMY IS SLOWING, BUT GENTLY DOES IT



What happens next?

Looking ahead, we think growth will slow further, but the impression—from the Q1 swoon in industrial production and retail sales—that the EZ economy is falling off a cliff is misplaced, at least in the near term. But we are concerned about the deterioration in narrow money growth; if it continues, we will have to adjust our forecast for 2019 down. For now, our previous chart shows that the trend in real narrow money points to slower momentum, not a collapse.

Our key story for headline GDP growth in 2018 is that the year-over-year rate will fall from a high of 2.8% in Q4 2017 to just under 2.0% at the end of this year. For that to happen, quarter-on-quarter growth would have to average 0.5% between now and the end of the year. This is certainly worse the 0.7% trend for most of last year, but not catastrophic. Our full-year forecast is 2.0%, lower than the 2.3% and 2.4% consensus and ECB estimates, respectively. This is not a huge divergence, given the volatility of these numbers. For the record, we think the central bank will revise down its forecast slightly in June, to reflect the sub-par Q1 GDP headline.

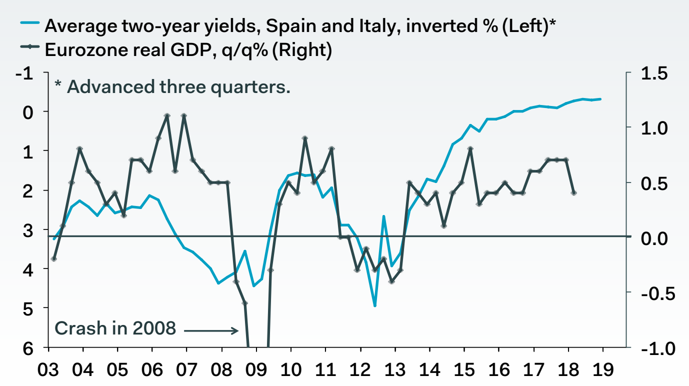
The combination of an extended business cycle and fading growth is ominous. In particular, we think that headline growth in Germany is now slowing more quickly than markets think. Unlike the rest of the major EZ economies, the German expansion has lasted a long time, and we fear the economy is running out of capacity to grow above trend. A central part of our forecast for 2019 and 2020 is that the German economy will *underperform* France and Spain, as well as the Eurozone aggregate.

That said, an EZ *recession* is unlikely. ***Historically, recessions in the Eurozone usually have been a combination of two factors: tightening financial conditions via an increase in short-term rates, and a sharp slowdown in either the U.S. or Asia.*** A sudden increase in rates can either be home-grown, because the central bank suddenly gets spooked by higher inflation, or imported via a higher cost of external funding. *At present, we see little risk of either.* We think core inflation will rise in the next 12-to-18 months, but nowhere near fast enough to bring about panic at the ECB. In any case, the central bank maintains aggressive forward guidance as a key part of its communication strategy. We think the deposit rate will edge higher next year, but looking ahead, rates will remain low for a long time.

Elsewhere, the Eurozone now runs a whopping current account surplus, of almost 4% of GDP. *More importantly, the periphery runs surpluses too.* In this environment, international capital markets will struggle to pull off a speculative attack on the weaker bond markets in the Eurozone. Our previous chart shows that inverted yield curves in the periphery preceded the recessions during both the financial and sovereign debt crises. *We see little risk of a repeat anytime soon.*

In the global economy, our Chief Asia Economist, Freya Beamish, thinks growth in China is slowing. Similarly, our Chief U.K. Economist, Samuel Tombs, see clear signs of a slowdown across the Channel. China and the U.K. are important trading partners for the euro area, so we shouldn't underestimate these signals. *For now, though, we are not willing to downgrade our forecast for 2018 GDP* further *on this basis.* In addition, the outlook in the U.S. points to upside risk. Our Chief Economist, Ian Shepherdson, expects growth across the pond to hit 3.0% this year, 0.7pp *higher* than in 2017.

A LIMITED RISK OF SHARPLY TIGHTER FINANCIAL CONDITIONS?



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THIS WEEK IN BRIEF

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

Monday, May 14

- **No Significant Data Released.**

Tuesday, May 15

- **D: Advance GDP, Germany (Q1) 08:00 CET**

Real GDP in Germany rose **0.3%** quarter-on-quarter in Q1, slowing from a 0.6% jump in Q4. The year-over-year rate fell by 0.6 percentage points to 2.4%. Net exports and government spending slowed, while investment supported growth.

- **D: Final Inflation, France (4) 08:45 CET**

Inflation in France was unchanged at **1.6%** in April, in line with the initial estimate. The core rate slipped 0.1pp to 0.8%.

- **D: GDP, Eurozone, Second Estimate (Q1) 11:00 CET**

Real GDP rose **0.4%** quarter-on-quarter in Q1, in line with the initial estimate. The year-over-year fell by 0.3pp to 2.5%.

- **D: Industrial Production, (3) 11:00 CET**

Industrial production in the Eurozone increased **0.5%** month-to-month in March, lifting the year-over-year rate to 3.0% from a revised 2.6% in February.

- **D: ZEW Investor Sentiment, Germany (5) 11:00 CET**

The headline ZEW investor sentiment index in Germany was unchanged at **-8.2** in May.

Wednesday, May 16

- **D: Final Inflation, Germany (4) 08:00 CET**

We think headline inflation in Germany was unchanged in April at **1.6%** in line with the initial estimate. Energy and food prices rose, but the core rate fell in part due to the Easter effect, which depressed services inflation. **Consensus: 1.6%**.

- **D: Final Inflation, Eurozone (4) 11:00 CET**

Inflation in the EZ likely slipped to **1.2%** year-over-year in April, from 1.3% in March, primarily due to a 0.2pp fall in core inflation to 0.7%. The Easter effect depressed services inflation and non-energy goods inflation failed to rebound strongly from the fall in March. We think both will rebound in May. **Consensus: 1.2%**.

Thursday, May 17

- **D: Car Registrations, EU27 (4) 08:00 CET**

We think new car registrations jumped **8.0%** year-over-year in April, from a 1.0% fall in March, in part due to favourable calendar effects. **Consensus: N/A**.

- **D: Construction, Eurozone (3) 11:00 CET**

We think construction in the Eurozone slipped **0.7%** month-to-month in March, lifting the year-over-year rate to 0.3%, from 0.1% in February. **Consensus: N/A**.

Friday, May 18

- **D: Current Account, Eurozone (3) 10:00 CET**

The seasonally adjusted current account surplus probably rose to **€36.0B** in March, from €35.1B in February. The current account surplus likely will remain close to, but just under, 4% of GDP in coming quarters. **Consensus: N/A**.

- **D: Trade Balance, Eurozone (3) 11:00 CET**

We think that the seasonally adjusted trade surplus in the Eurozone increased slightly to **€22.0B** in March, from €21.0B in February. Net exports likely were a slight drag on GDP in Q1, mean-reverting from a very strong boost to headline growth in the second half of last year. **Consensus: €21.0B**.

PANTHEON EUROZONE FINANCIAL CONDITIONS DASHBOARD

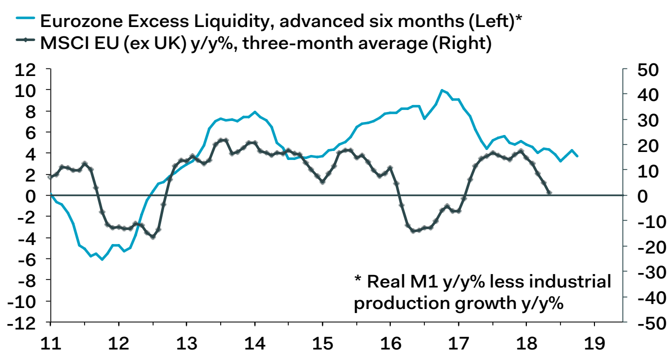
Market	Valuation*	Six month change, %	y/y, %
Eurostx 50	-0.4	-0.8	-1.9
Dax 30	-0.6	-1.0	+1.2
CAC 40	-0.2	+3.0	+2.5

* 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)	-2.3	-1.6	+7.4
FRA (10-2)	-2.3	-7.8	-0.8
ITA (10-2)	-1.4	+0.5	-26.3

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

EUROZONE EXCESS LIQUIDITY VS MSCI EU (EX UK)



Trailing returns on the MSCI EU ex-UK are still underperforming the trend in excess liquidity, indicating that the recent rebound should continue. That said, the outlook for excess liquidity is darkening as M1 growth slows.

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:*	*1.9*
Q3 18 forecast	*0.4*	*2020 year:*	*1.7*

CPI y/y, %		Unemployment, %	
March	1.3%	March	8.5%
April	*1.2%*	*April*	*8.5%*
May	*1.5%*	*May*	*8.5%*
June	*1.7%*	*June*	*8.4%*
July	*1.8%*	*July*	*8.4%*