PANTHEON MACROECONOMICS

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THE **EUROZONE** IN H2 2017

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The Eurozone Economy is Doing Well, but Will it Last?

* **The Eurozone economy is doing great, but will the good times last?** We find ourselves caught between two positions as we head into the latter part of 2017. The Eurozone economy is doing better than we expected at the start of the year, forcing us to upgrade our GDP growth forecast to 1.8% in 2017, which is 0.4 percentage point higher than in January. We think Q1 GDP growth will be revised up, and that reported Q2 numbers will be very strong too. But we also think the acceleration is over, and we struggle to follow the emerging view that GDP growth in the euro area is headed for sustained growth of 2%.

* **The outlook is balanced, not unequivocally positive.** We agree with the upside risks for the EZ economy highlighted by the consensus. The economy's cyclical upturn has strengthened, at the margin, and has become more broad-based in the past nine months. Political uncertainty has morphed into an opportunity for bold reforms in France and strengthening economic cooperation between Berlin and Paris. But risks loom too. The Brexit-induced slowdown in the U.K. will hit EZ manufacturing exports; the Fed is raising rates; and we also fear that China's economy will lose momentum in the latter part of the year. In addition, expectations could be dented if EU politicians don't deliver, which wouldn't be the first time.

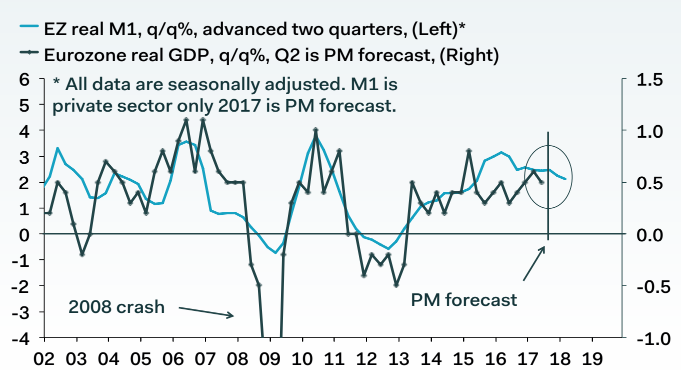
* **Have EZ survey data peaked for the year?** The upturn in the main Eurozone business survey signals that GDP growth was close to 2% annualised in the first half of the year. We expect the Q1 and Q2 data to confirm this, eventually, after final revisions. We also think, however, that the main surveys will weaken in the second half. The stronger euro warns that the EZ manufacturing PMI will decline soon, and the services PMI also recently has shown signs of weakness.

* **EZ consumers' spending likely is slowing.** Inflation is normalising amid stable, or only slightly rising, nominal wage growth. This slowdown in *real* wage growth will push growth in consumers' spending down from a record pace in 2015 and 2016. Real wage growth in Germany will hold up, but we fear for real wage dynamics in France and Italy. We think EZ household consumption will increase 1.5% in 2017, slowing from 1.9% in 2016, reducing full-year GDP growth by about 0.3 percentage points, other things equal.

* **Growth in investment has accelerated.** A revival in the construction sector is the key driver of the upturn in EZ investment. Construction in Germany has been going strong since the beginning of this cycle, but we see signs that growth in the other major economies is starting to contribute too. Manufacturing capex also has strengthened and likely will continue to support growth in the second half of the year.

STEADY AS SHE GOES FOR THE EUROZONE ECONOMY SO FAR...

...BUT WE DOUBT THAT GDP GROWTH IS *ACCELERATING*



* **The German and Spanish economies remain strong, and France likely is picking up too.** Robust growth in Germany and Spain will remain the driver of headline EZ growth in the next six months. In France, construction investment will be the key source of any upside risks, but much stronger GDP growth here requires a reduced drag from net trade, which looks like a long shot.

* **Core inflation in the Eurozone will increase to about 1.4% at the end of 2017.** A tighter labour market and stronger GDP growth should be enough to push EZ core inflation up gradually in the next six months. The core rate will remain well below the ECB's target, but it likely will rise fast enough to force the central bank to think about taking the next small step toward exiting unconventional monetary policy.

* **EURUSD consolidation above 1.15, would create problems for the ECB.** The central bank assumes a value of EURUSD of about 1.08-to-1.09 in its recent inflation forecast, implying that risks are tilted towards another modest downgrade of the bank's core inflation forecast in September.

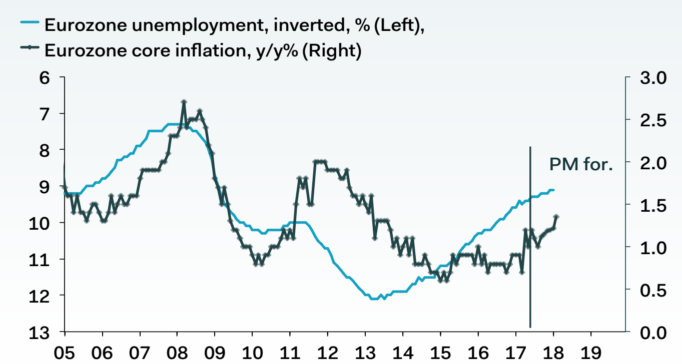
* **The ECB will extend QE, but reduce the pace in Q1 2018. Don't rule out a deposit rate hike early next year.** We think the ECB will reduce the pace of QE to €40B per month starting in January 2018; we think this will be announced in December. We think QE will remain in place until the end of 2018, with the ECB tapering to zero at the start of 2019. Our forecast is for a slower exit from QE than the consensus, leaving room for a deposit rate hike in the first half of 2018. This would make sense if, as we expect, the Fed continues to push rates higher.

* **We think 10-year benchmark yields will increase to 0.8% at the end of 2017, but what about the curve?** The path of least resistance is for EZ long-term bond yields to edge gradually higher in the latter part of 2017. But we also think short-term rates will rise, limiting curve steepening. We think the spread between two-year and 10-year yields in the EZ will increase to 140bp, only about 40bp higher than now.

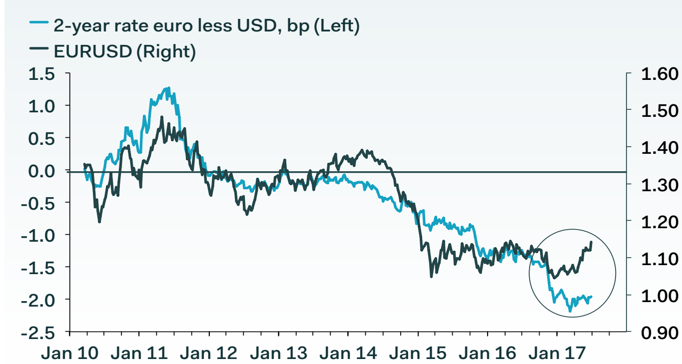
* **EZ corporate bonds and short-term rates are most at risk as the ECB tiptoes toward tighter policy.** QE has led to a shortage of short-term German bonds, pushing two-year yields well below the deposit rate. And private QE has turned the ECB into the marginal buyer of corporate bonds in the Eurozone in both the secondary and primary market. As the central bank moves to adjust policy, corporate bonds and German short-term bonds are at risk of a big repricing. The ECB will try to communicate its exit carefully, but don't assume volatility will remain low forever.

* **Eurozone equities wobbled at the end of Q2 but should finish 2017 on a strong note.** The summer and early autumn are notoriously treacherous for equity markets, but we think the benchmark EZ equity index will post strong returns for 2017 as a whole. Earnings revisions have picked up, and the cleanup in the banking sector is underway, so far without any major accidents.

CORE INFLATION IN THE EUROZONE IS RISING...SLOWLY



WILL EURUSD STEP BACK INTO LINE WITH RATE DIFFERENTIALS?



Forecast summary:

Economic Activity (y/y%)	2015	2016	2017	2018	2019
Eurozone GDP	2.0	1.8	1.8	1.5	1.1
Contribution of Household Consumption	1.0	1.1	0.7	0.5	0.3
Contribution of Government Consumption	0.3	0.3	0.2	0.3	0.4
Contribution of Investment*	0.9	1.1	1.2	0.7	0.3
Contribution of Net trade	-0.3	-0.6	-0.3	0.0	0.2
Germany GDP	1.3	1.9	1.9	1.5	1.2
France GDP	1.0	1.2	1.4	1.5	1.2
Italy GDP	1.0	1.1	1.0	1.1	0.8
Spain GDP	3.5	3.0	2.9	2.7	2.4
Labor Market and Prices					
Eurozone unemployment (end of year)	10.4	9.6	8.8	8.5	8.4
Eurozone CPI y/y% (end of year)	0.2	1.1	1.6	1.8	1.6
Eurozone labour productivity growth y/y%	0.9	0.9	1.2	1.0	0.9
Other					
Eurozone current account, % GDP, Q4	3.2	3.4	3.3	3.2	3.2
Eurozone budget deficit, % GDP	-2.1	-1.5	-1.4	-1.6	-1.8
Government debt, % GDP	90.4	89.2	88.0	88.5	89.5
ECB refi rate, Q4 average	0.05	0.00	0.00	0.00	0.00
10-year benchmark rate, Q4 end	0.6	0.3	0.8	1.2	0.6
Eurostoxx, Q4 end	3267	3300	3800	3900	3700
ECB deposit rate, Q4 average	-0.3	-0.4	-0.4	-0.3	-0.1
ECB Monthly QE pace, Q4 average	N/A	€80B	€60B	€20B	€0B

* Includes inventories