Leading indicators point to a meaningful acceleration in Eurozone GDP growth this year...

...But the recovery won't last on consumption alone; investment growth needs to participate too.

Higher growth and QE should offer decent support for risk assets despite elevated valuations.

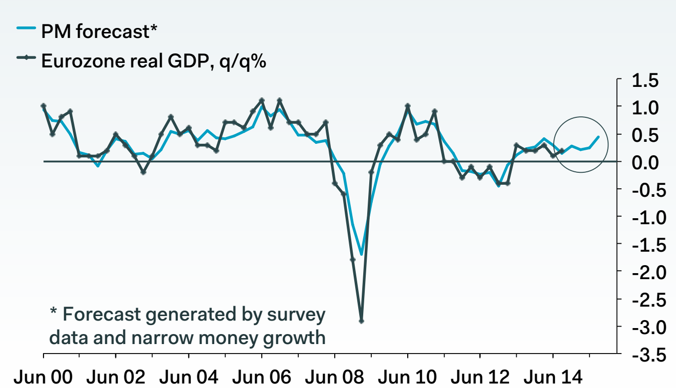
A Brighter Cyclical Outlook is Taking Shape in the Eurozone

GDP data today will probably show that the Eurozone economy accelerated to 0.3% quarter-on-quarter in Q4, up from 0.2% a quarter earlier. Industrial production came in disappointingly at 0.0% month-to-month in December, but this is not enough to change our forecast in the light of solid data on household spending. Consensus forecasts for growth this year were slashed following the setback last summer, but we think that expectations will soon be increased again. Our first chart shows a model using industrial production, retail sales, sentiment, and narrow money growth to capture the trend in GDP growth, and to predict it two quarters ahead.

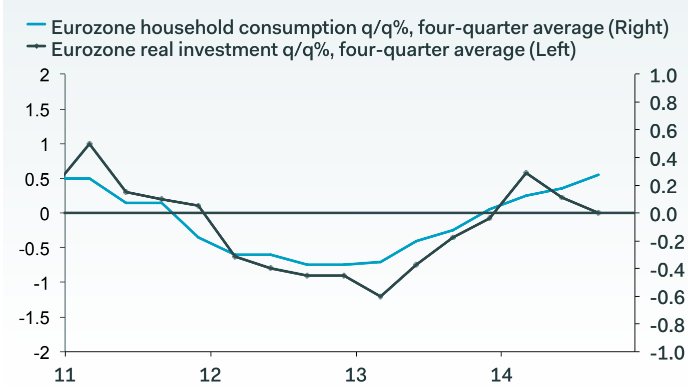
We don't have a crystal ball, but leading indicators are now sending a convincing message that GDP growth in the Eurozone can increase to 1.5% annualised this year from its current 1.0%. The forecast beyond one quarter almost exclusively relies on rising narrow money growth, but our upbeat expectation is supported by a number of other positive catalysts. On the policy front, sovereign QE will support investor sentiment, and keep bond yields low. Equity earnings and exports should benefit from the lagged impact of euro weakness for most of this year. Finally, energy price deflation is providing a boost to discretionary spending. *The Eurozone's deep-rooted structural growth problems will continue to fester, but we think the market could shift its focus somewhat this year towards a story of cyclical recovery and super-easy monetary policy at the ECB.*

Downside risks to our optimistic outlook, though, are substantial largely because the recovery, so far, has relied on the consumer. The trend in Eurozone household consumption growth has risen steadily since the recession in 2012, currently at its highest rate since the end of 2007. A strengthening consumer is a welcome cyclical story, but it won't be enough, on its own, to pull the economy to a sustainable recovery.

CYCLICAL UPSIDE FOR THE EUROZONE ECONOMY THIS YEAR...

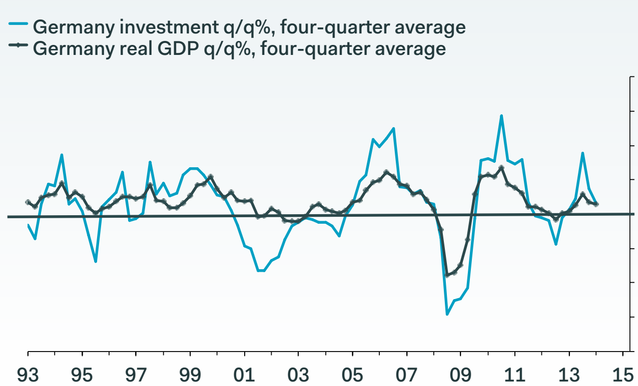


...BUT ONLY IF INVESTMENT GROWTH JOINS THE PARTY



Investment in the euro area has slowed down worryingly in the past three quarters, and we are still waiting for signs of recovery. As we explained in our two previous *Monitors*, private capex in France and Italy have collapsed following the crisis, effectively leaving Germany to do the heavy lifting. The boost from a weaker euro to exports should help the prospects of a private investment cycle this year, but the key question is whether it will be broad-based. In a perfect world, investment growth in Germany, France, and Italy recover in tandem with higher demand in emerging markets. In a less perfect world, the Eurozone will remain dependent on German exporters' ability to leverage demand in the U.S. and the U.K. *Incorporating the former as a base case amounts to wishful thinking, and we have to assume that the key to recovery, once again, will be the German manufacturing sector.* Our next chart shows that it is difficult to expect an upturn in the euro area's largest economy without support from investment.

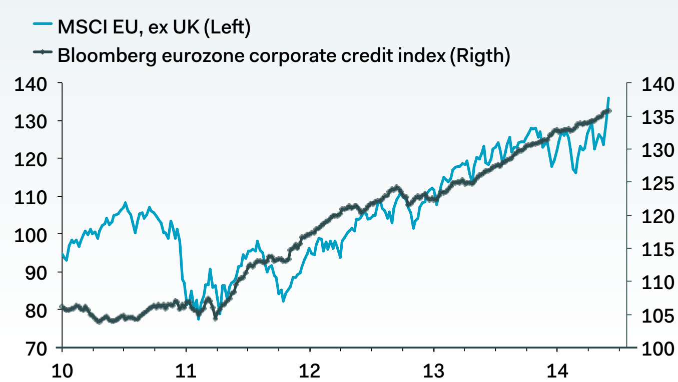
NO CYCLICAL RECOVERY IN GERMANY WITHOUT INVESTMENT



Turning to asset markets, the prospect of cyclical upside in the Eurozone should not change the story of monetary policy divergence between the Fed and the ECB. The spread between benchmark 2-year yields in the U.S. and the euro area has recently reached new highs, and we expect this trend to continue. With short-term rates in the Eurozone below zero, the spread will likely be driven higher by rising yields in the U.S., consistent with economic data pushing forward the day of reckoning for the first rate hike by the Fed.

Better economic data, in combination with QE, should also incite investors to abandon safe-haven assets in favor of higher and riskier investments further out the risk spectrum. We expect bond yields in the periphery to remain compressed, and corporate bonds should also remain in high demand. The hunt for yield in European fixed income markets has already taken on absurd proportions, but this trend will probably intensify this year. With the market increasingly expecting the Fed to move on rates sooner rather than later, compressed yields in Europe will attract companies with the ability to issue multi-currency liabilities. The announcement of Apple's CHF bond issuance this week was merely a shot across the bow, and we expect much more to come this year.

QE WILL HELP MAINTAIN THE TREND IN EUROZONE RISK ASSETS



In terms of benchmark yields, structurally low rates in Germany are consistent with the pledge to balance its budget this year, and the ECB increasing demand through QE. But with German 10-year yields currently trading at a record low of 0.35%, though, it is perfectly possible for benchmark rates to rise slightly while still obeying the laws of supply and demand. *This prediction also fits the story of investors selling their safe haven positions to the ECB, using the proceeds to go hunting for yield elsewhere.* Credit spreads, in other words, are likely to compress further in Europe this year from already very tight levels.

CLAUS VISTESEN **+44 191 2600 308**
claus@pantheonmacro.com Twitter: @ClausVistesen

THIS WEEK IN BRIEF

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

Monday, February 9th

- **D: Germany Exports (12)/08:00 CET**

Exports in Germany rose **3.4%** month-to-month in December, equivalent to a decent 7.0% rise year-over-year. Demand from the U.K. and the U.S. remained the main drivers of export growth.

- **D: Sentix Investor Survey (02)/10:30 CET**

The headline Sentix rose **12.4** in February from 0.9 in January; the expectations index surged to 27.5 in February from 13.5 in January.

Tuesday, February 10th

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

French Industrial production increased **1.5%** month-to-month in December, equivalent to a 0.1% drop year-over-year. Industrial output fell 0.4% quarter-on-quarter.

Wednesday, February 11th
No significant data released.

Thursday, February 12th

- **D: Final German Inflation (01)/08:00 CET**

Inflation in Germany fell to **-0.4%** year-over-year in January from 0.2% in December, slightly lower than the initial estimate, -0.3%. The plunge in energy prices remains the key driver, but underlying inflation pressures are weakening too in the Eurozone's largest economy.

- **D: Eurozone Industrial Production (12)/11:00 CET**

Industrial production was **unchanged** month-to-month, equivalent to a 0.2% fall year-over-year. Strength in the major economies was offset by sharp drops in Ireland, Greece and Portugal.

Friday, February 13th

- **D: Advance France GDP (Q4)/07:30 CET**

Real GDP in France probably increased **0.2%** quarter-on-quarter in Q4, down from 0.5% in Q3. Growth was likely held back by poor consumption and investment. The contribution from net trade should be flat. **Consensus: 0.1%.**

- **D: Advance German GDP (Q4)/08:00 CET**

German GDP likely rose **0.5%** quarter-on-quarter in Q4 from 0.1% in Q3. Consumer spending will likely be the key driver, with net trade a drag on the headline. **Consensus: 0.3%.**

- **D: Advance Eurozone GDP (Q4)/10:00 CET**

Eurozone GDP probably rose **0.3%** year-over year in Q4, up from 0.2% in Q3. Germany and Spain will be main drivers of the gain, with Italy and France still poor. **Consensus: 0.2%.**

- **D: Eurozone Trade Balance (12)/10:00 CET**

The trade surplus in the euro area likely rose to **€21.5B** in December from €20.0B in November. Lower oil imports and a weaker euro boosting exports to the U.S. and the U.K. will likely continue to push the nominal trade balance to new highs in the next six months. **Consensus: €21.0B.**

PANTHEON EUROZONE FINANCIALS CONDITIONS DASHBOARD

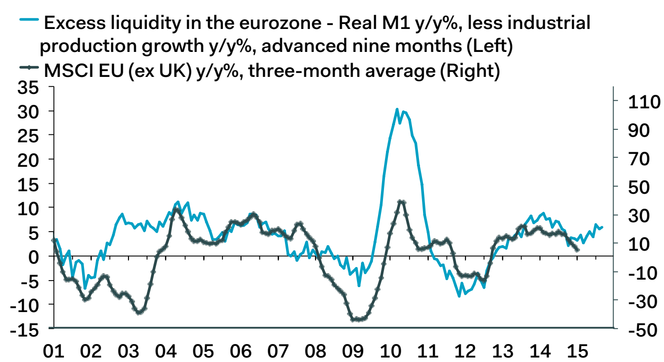
Market	Valuation*	Six month change, %	y/y, %
Eurostx 50	1.3	13.2	12.0
Dax 30	0.1	20.1	16.8
CAC 40	1.4	13.4	11.2

* 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)	-2.4	-48.60	-100.6
FRA (10-2)	-2.1	-67.60	-133.6
ITA (10-2)	-1.5	-109.4	-161.2

** 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 have firmed significantly in the past month, consistent with excess liquidity, but also driven by QE. We expect Eurozone equities to do well in Q1.

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

GDP			
Q1 2014	0.2	2013 year:	0.5
Q2 2014	0.1	2014 year:	0.8
Q3 2014	0.2	*2015 year:*	*1.0*
Q4 forecast	*0.3*	*2016 year:*	*1.1*
Q1 forecast	*0.3*		
Q2 forecast	*0.2*		
CPI y/y, %		**Unemployment, %**	
December	-0.2%	December	11.4%
January	*-0.6(a)%*	*January*	*11.4%*
February	*-0.6%*	*February*	*11.4%*
March	*-0.6%*	*March*	*11.3%*
April	*-0.5%*	*April*	*11.3%*