



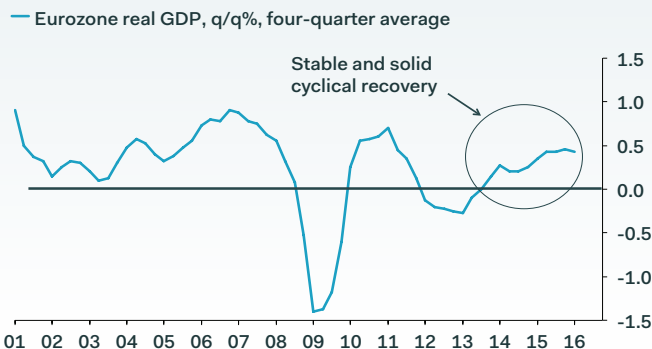
THE EUROZONE IN H2 2016

CLAUS VISTESEN, CHIEF EUROZONE ECONOMIST

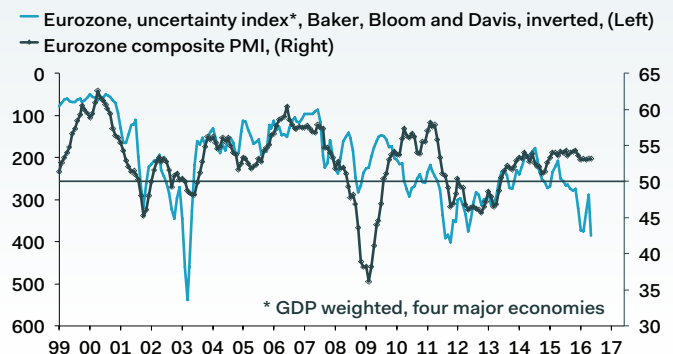
The EZ Business Cycle upturn is Peaking, but no Recession Imminent

- * **The Eurozone economy is in decent shape, but the jump in Q1 GDP growth won't be sustained.** We think real GDP growth in the Eurozone will be about 1.5% this year, similar to last year's pace. The jump in Q1 GDP growth is encouraging, but growth weakened in the second quarter, as domestic demand slowed. We think growth will slow next year to 1%-to-1.2%, which is our estimate of long-run trend.
- * **Political uncertainty has emerged as the key risk, but the economy should be resilient this year.** Uncertainty over the U.K.'s future relationship with the EU, a potential second bailout in Portugal, and looming banking and government crises in Italy all have the potential to threaten the EZ's economic recovery. But an accommodative ECB should be enough to prevent a return to crisis and panic this year.
- * **Consumers' spending is slowing, but not collapsing.** The record boost to the Eurozone economy from consumers' spending last year will fade, but private spending won't collapse. We expect growth in household consumption to fall towards its long-run trend of 1.0%-to-1.2% this year. Higher energy prices will be the key drag on spending the second half of the year.
- * **Eurozone investment has picked up, but an inventory correction looms in the short run.** We doubt that the strong upturns in manufacturing investment and capex in construction Q4 and Q1 signal a sustained recovery. Construction investment likely mean-reverted, downwards, in the second quarter, and survey data indicate that inventories will weigh on gross investment in coming quarters.
- * **The ECB will extend QE, but increases in the pace of asset purchases and further rate cuts are unlikely.** The uncertainty following the U.K. referendum and the sluggish upturn in inflation suggest the ECB will extend QE by six months, to September 2017. We think this will be announced in September this year. But this will disappoint markets, which appear to expect more QE and additional rate cuts.

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

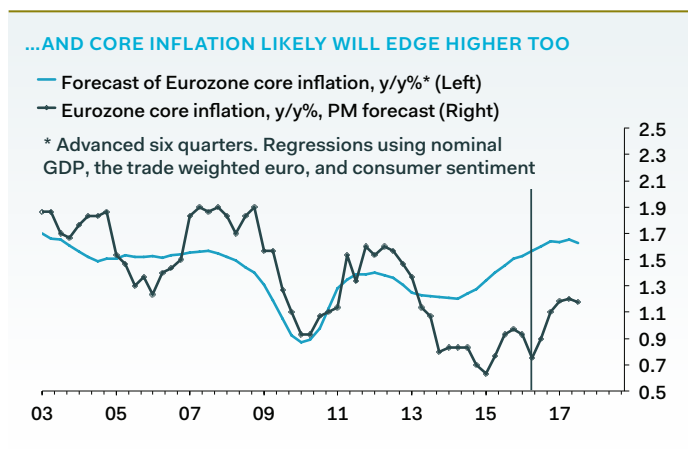
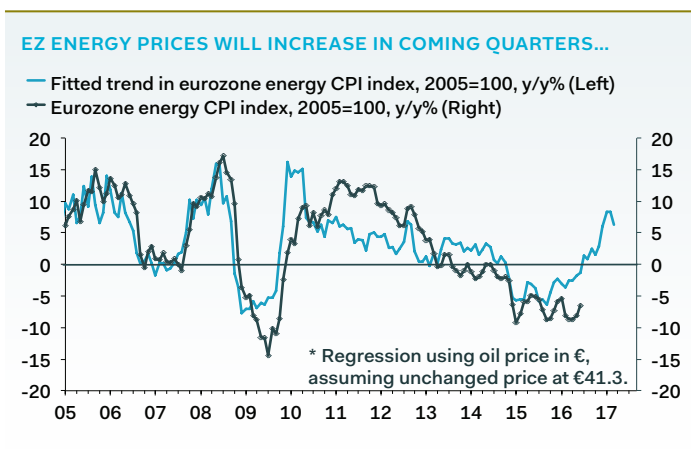


...BUT CAN THE ECONOMY WITHSTAND POLITICAL UNCERTAINTY?



THE EUROZONE IN H2 2016

- * **The EZ has escaped deflation for good in this cycle; inflation will rise to 1.2%-to-1.4% this year.** The recovery in oil prices and the likely lagged response of core inflation to higher GDP growth point to higher inflation in the euro area. It will remain below the ECB's 2% target, but a recovery in inflation pressures will threaten the extremely low level of bond yields across the curve.
- * **Eurozone credit markets will continue to storm higher on ECB support.** The ECB's decision to add corporate bonds to QE has propelled EZ credit markets higher, and further upside is likely into year-end. But the plunge in yields means that investors are not being adequately compensated for underlying business risk in the private debt markets. We don't think this will end well, but the end is not yet in sight.
- * **Capital outflows from the Eurozone have reached new records, and likely will continue.** Negative interest rates, QE and a current account surplus means the Eurozone will remain a source of excess liquidity to global capital markets. The trade surplus likely will take a hit from a short-term slowdown in the U.K. economy, but the income balance likely will provide offsetting support. Overall, we think the current account surplus will end the year at 2.8% of GDP, slightly lower than the 3% surplus in the fourth quarter of last year.
- * **GDP growth in Germany will increase marginally this year to 1.6% this year, from 1.4% in 2015.** The German economy likely stalled in the second quarter, after a 0.7% quarter-on-quarter Q1 surge in GDP. Consumers' spending will slow, but investment likely will pick up. Overall, we think the marginal acceleration in growth this year will mark the cyclical peak, before a slowdown next year.
- * **French GDP growth also likely will accelerate slightly, to 1.2% this year from 1.0% in 2015.** A strong consumer likely will boost French growth, but it will remain underwhelming compared with the pre-crisis pace. General elections next year will increase political uncertainty and hold back business investment, which will weigh on GDP growth.
- * **Spain's economy will slow this year.** Recent elections in Spain gave some clarity, but a minority coalition between the Conservatives and the Citizens will be vulnerable to a rebellion by the smaller parties. The economy will continue to outperform its peers this year, but growth will slow after last year's 3.5% surge, as investment in manufacturing and consumers' spending softens.



THE EUROZONE IN H2 2016

Forecast summary:

Economic Activity (y/y%)	2015	2016	2017	2018	2019
Eurozone GDP	1.6	1.5	1.2	0.8	1.2
Contribution of Household Consumption	0.8	0.5	0.4	0.2	0.4
Contribution of Government Consumption	0.3	0.6	0.5	0.4	0.2
Contribution of Investment*	0.9	0.5	0.1	0.0	0.6
Contribution of Net trade	-0.5	0.1	0.1	0.2	0.2
Germany GDP	1.4	1.6	1.1	0.9	1.3
France GDP	1.4	1.2	1.0	0.7	0.9
Italy GDP	1.0	0.9	0.9	0.6	0.9
Spain GDP	3.5	2.0	1.5	1.3	1.3

Labor Market and Prices

Eurozone unemployment (end of year)	10.4	9.9	9.7	10.2	10.6
Eurozone CPI y/y% (end of year)	0.2	1.1	1.4	1.2	0.8
Eurozone labour productivity growth y/y%	0.8	0.9	0.8	0.7	0.7

Other

Eurozone current account, % GDP	3.2	2.8	2.8	3.2	3.4
Eurozone budget deficit, % GDP	-2.1	-2.0	-2.0	-2.7	-2.9
Government debt, % GDP	90.8	88.0	89.5	91.5	92.5
ECB refi rate, Q4 average	0.05	0.00	0.00	0.00	0.00
10-year benchmark rate, Q4 end	0.6	1.0	1.1	0.6	0.5
Eurostoxx, Q4 end	3267	3400	3200	3000	3600