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THE EUROZONE IN 2015

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Cyclical Recovery Set to Continue, but Inflation will Follow Too

* **Real GDP growth in the Eurozone remains on track for 1.5% this year, a significant acceleration from 0.9% last year**. Consumers' spending cannot continue to drive the cyclical recovery, however, and investment growth needs to take over. We are cautiously optimistic that this will happen in the second half of the year, to offset the inevitable slowdown in consumption.

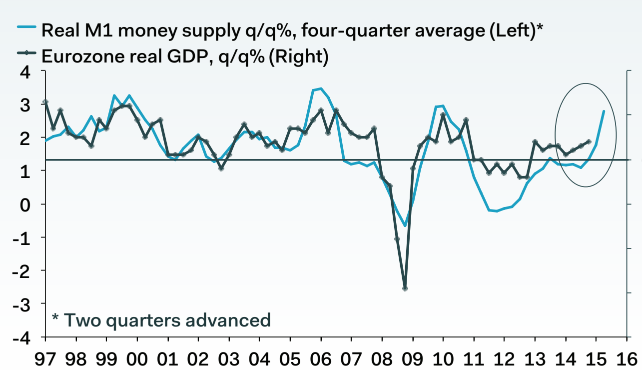
* The underlying trend in euro area GDP growth is low and still slowing, but weak growth around a low trend does not equate to a permanent state of panic and crisis. Narrow money growth, the best leading indicator we have in the Eurozone, **currently signals the strongest cyclical recovery since the initial rebound following the financial crisis in 2008.**

* The current account surplus in the Eurozone will likely increase to close to 3% of GDP this year. **Excess liquidity in the euro area, combined with QE and negative interest rates, has become a key driver of global carry trades.** Gross portfolio outflows and net external lending have surged and foreign corporates have shifted to Eurozone capital markets for raising new debt.

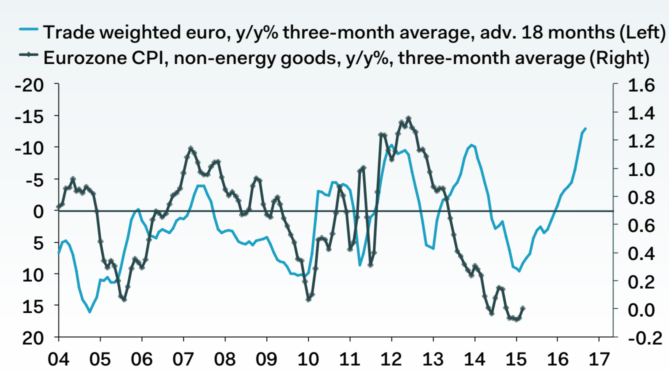
* Growth in Germany disappointed in the first quarter, with real GDP up only 0.3% quarter-on-quarter, but the poor performance was mainly due a big, but likely temporary, hit from net trade. **Net exports should come roaring back in Q2**, and domestic demand probably will remain firm, supporting the cyclical recovery in the Eurozone's largest economy.

* **Inflation pressures remain weak in the Eurozone, but we are increasingly confident that inflation reached a cyclical trough in the first quarter.** The lagged boost from the weaker euro should help push up tradable goods prices, and the surge in consumer sentiment since the middle of last year points to cyclical upside for services prices. The recovery will likely be very moderate, however, and not enough to pose a threat of the pace of ECB asset purchases until the end of the year, at the earliest.

A STRONG CYCLICAL RECOVERY IS UNDERWAY IN THE ZONE...



...BUT INFLATION SHOULD RISE GRADUALLY TOO



* Interest rates will remain low in the Eurozone for a long time yet, but recent bond market volatility shows that sovereign QE is not a one-way street for investors. **Steepening yield curves are fully consistent with a slow recovery in growth and inflation expectations, amid persistent and aggressive forward guidance keeping short-term rates in check.**

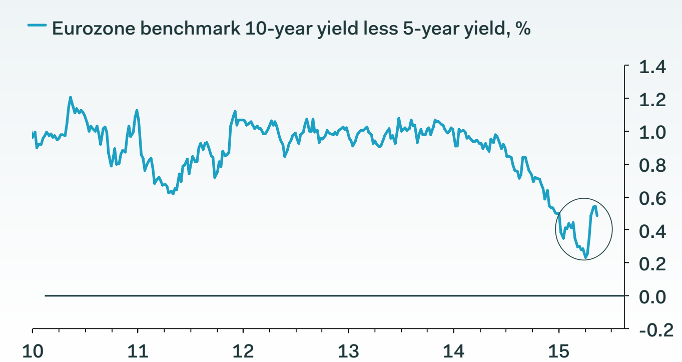
* A tightening labour market in Germany, generating rising wage pressures, poses the greatest risk to sovereign QE, but it is unlikely to emerge until the end of the year. **Recent dovish comments by Mr. Draghi indicate that the ECB currently remains committed to the full implementation of its QE program.** In the short run, stronger domestic demand in Germany will also be welcomed as means of constraining the country's surging current account surplus.

* The divide between the Fed and the ECB is still a key story for bond and credit markets. Sovereign QE in the Eurozone is incentivizing global corporates to issue debt in euros. **This creates fundamentally different dynamics for corporate bond markets in the Eurozone and the U.S.**, which will be a key cross-market theme next year.

* **All eyes on the FOMC for the next move in the Euro.** The first leg down in the euro was driven by ECB QE and a negative deposit rate; further sharp depreciation will likely be due to a rise in U.S. short-term rates when the Fed moves in the fall. Looking at flows, the *combination* of negative interest rates and capital outflows will likely dominate the boost from the current account as the euro finds its place as a funding currency for global carry trades. We still expect the euro to weaken when volatility is low, but strengthen—against high beta currencies—as volatility rises.

* Eurozone equities have struggled recently, consistent with profit-taking following a surge in Q1. But excess liquidity, measured as the growth rate of narrow money over inflation and industrial production, is highly supportive for further upside this year. **Multiple expansion and sentiment will remain key drivers, but a weaker euro should also help earnings**. The recent moderate increase in inflation expectations and steepening of benchmark yield curves favour energy and financials, which usually outperform on a relative basis when inflation rises.

FINALLY, A STEEPER YIELD CURVE IN THE EUROZONE?



THE FED PROBABLY NEEDS TO MOVE TO PUSH THE EURO LOWER