PANTHEON MACROECONOMICS

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THE EUROZONE IN 2015

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Low Growth, but Probably not a Renewed Sovereign Debt Crisis

* **Eurozone growth will remain disappointingly weak next year, but should accelerate modestly to 1.0%, from 0.8% this year**. The combination of negative interest rates, TLTROs and QE likely will be more potent than the market expects. Easing at the ECB will help support money growth and keep the search for yield alive in the Eurozone next year.

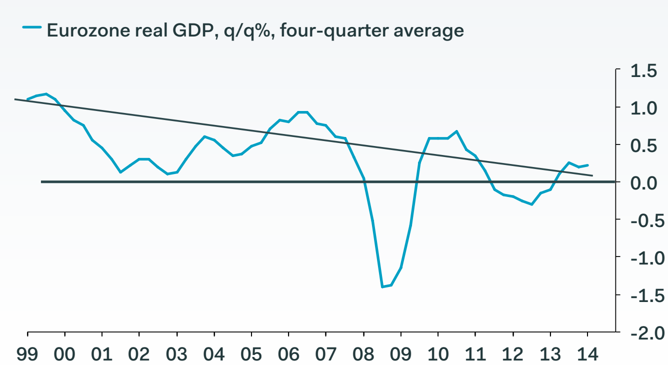
* The smoothed trend in euro area GDP growth is low and still slowing, but weak growth around a low trend does not equate to a permanent state of panic and crisis. Narrow money growth is the best leading indicator we have in the Eurozone, and it currently **signals no return to a crisis dynamic in the short run**. Indeed, the uptick in narrow money suggests economic growth should rise slightly in the coming two quarters.

* The Eurozone's current account surplus recently rose to an all-time high—a boost for financial stability—but also indicates an increasing reliance on external demand. This means that **the persistent slowdown in China, the conflict in Russia and premature aggressive tightening in the U.S. and the U.K. are all downside risks for next year.** Exports to the UK have been a key driver of the trade surplus, which means that Eurozone growth and sentiment will be surprisingly sensitive to BOE policy moves next year.

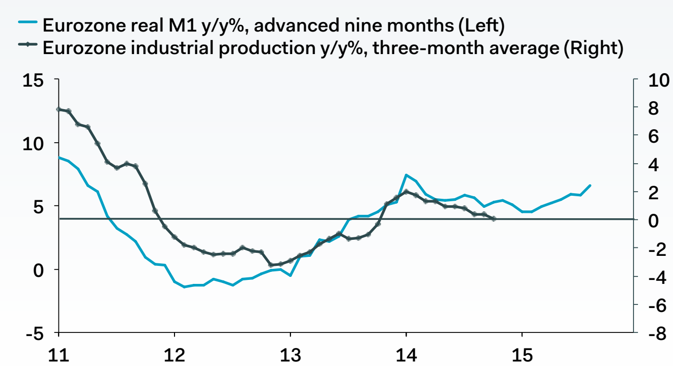
* We expect growth in **Germany to pick up slightly** as the manufacturing sector returns to modest expansion, but growth will remain low elsewhere in the Eurozone. In France, the economy likely will continue to surprise to the upside as growth continues to recover from a depressed level, but in Italy growth will be close to zero. Spain should maintain some momentum, but will likely slow down in the latter part of the year.

* Deflation has arrived in the Eurozone, mainly driven by the plunge in energy prices in the fourth quarter of last yea, It is crucial to note, though, that core non-energy industrial goods prices are also falling. Swings in headline inflation could add volatility to overall inflation next year, **but the key story is now that deflation pressures in the Eurozone are broad-based**.

A TREND WHICH WILL BE VERY DIFFICULT TO BUCK IN EUROPE...



...BUT THE BUSINESS CYCLE IS STILL ALIVE



THE **EUROZONE** IN 2015

* Low bond yields in the periphery and France continue to defy logic, but Mr. Draghi's OMT pledge and private QE will likely do the trick a little longer. Look for volatility in short-term yields and widening current account deficits in the periphery for signs that risks are rising. **On current trends Spain and Portugal will run external deficits in the first half of next year**, potentially changing the story for the bond market and the economy quite dramatically.

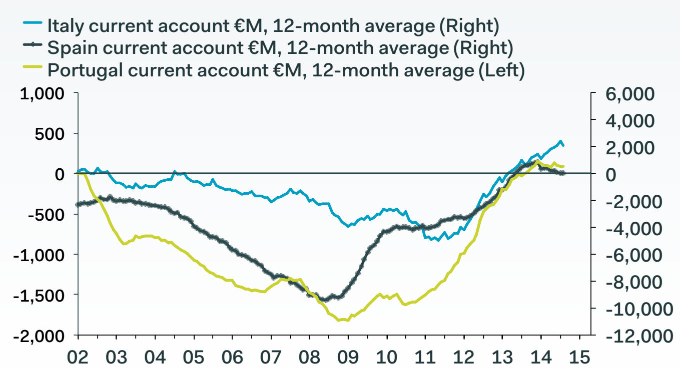
* Sovereign QE is coming in the euro area, we expect an announcement in the first quarter. **Corporate bond purchases will likely be announced first, but given that the economy is now in deflation, the risk of government bond purchases as soon as January has increased.** This is because of Mr. Draghi's recent comments that low energy prices could de-stabilise already very-low inflation expectations.

* The divide between the Fed and the ECB has been a key story this year with respect to the widening spread between the 10-year Treasury and bund yield. Monetary policy divergence will remain an important theme in 2015, and it will express itself in private credit markets. The ECB is now a buyer of private credit assets, while the Fed is preparing to hike rates as early as in the coming Spring. **This creates fundamentally different dynamic for corporate bond markets in the Eurozone and the U.S.**, and this will be one of the most important cross-market themes next year.

* **The euro should continue to drift gradually lower next year,** but we are less bearish than the consensus, due to the rising external surplus. That said, 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. Expect the euro to weaken when volatility is low, but strengthen—against high beta currencies—as volatility rises.

* Eurozone equities will be supported by higher excess liquidity growth in the first quarter, and monetary easing should help throughout the year. But in an environment with low nominal growth, corporates face difficulties growing their top lines, and this means earnings are under structural pressure too. **Multiple expansion and sentiment will remain key,** but also volatile, drivers of stock prices in the euro area next year. Finally, investors should expect sector rotation to be a key determinant of excess returns; we prefer financials as this sector is uniquely positioned to take advantage of the ECB's private QE program.

SPAIN AND PORTUGAL WILL SOON ENTER THE DANGER ZONE AGAIN



LOOK FOR CREDIT IN THE EUROZONE TO OUTPERFORM NEXT YEAR