PANTHEON MACROECONOMICS

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THE **EUROZONE** IN H1 2017

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A Late-Cycle EZ Economy: Higher Inflation and Modestly Lower Growth

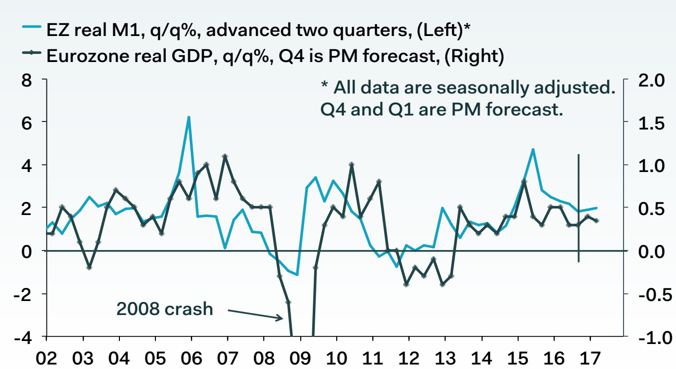
* **The Eurozone economy will have a bright start to 2017, but we think growth over the year as a whole will slow modestly compared with 2016.** Accelerating narrow money growth and low inflation created ideal conditions for the EZ business cycle upturn in 2015 and 2016. But the growth mix is changing. Inflation is rising, and M1 growth is slowing at the margin. We expect real GDP to rise 1.4% in 2017, down slightly from 1.6% in 2016. The slowdown will be concentrated in the latter part of the year.

* **Inflation in the Eurozone will increase sharply in 2017, but it will stay lower than the ECB's 2% target.** We think inflation in the euro area will overshoot to nearly 2% in Q1, and *average* 1.3%-to-1.4% over the year as a whole, significantly higher than the 0.2% average in 2016. Higher energy inflation, due to base effects in oil prices from last year's crash will be the key driver of the rise. But we also think core inflation will rise above 1% as a lagged response to higher GDP growth. Divergence between the major economies, however, will be an important theme. Core inflation and wage pressures in Germany already are accelerating, but the inflation trend will stay more subdued in France, Italy and Spain.

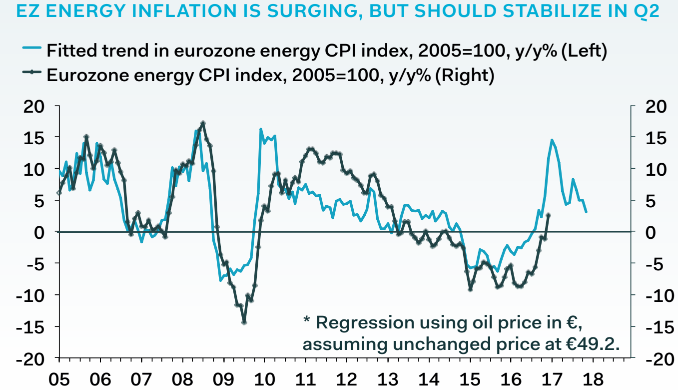
* **The return of inflation points to higher bond yields, but the ECB has committed itself to a dovish stance.** The central bank will very gradually start to remove monetary stimulus this year, and a further reduction in the pace of QE is a good bet in Q4. But Mr. Draghi's comment that the ECB wants to remain a "sustained market presence" in EZ bond markets suggest that the bar for completely ending QE is high.

* **Political uncertainty has emerged as a key threat to the EZ economy.** Economic data point to a healthy economy in the Eurozone, but political risks could dent confidence later this year. Presidential and parliamentary elections in key EZ countries this year could bring deeply anti-EU politicians closer to power, which likely would hurt business sentiment in particular. And the coming Brexit negotiations with the U.K. point to a sub-optimal *economic* outcome, where the free flow of goods and services is curtailed.

STABLE GDP GROWTH IN THE EUROZONE AT THE START OF 2017



EZ ENERGY INFLATION IS SURGING, BUT SHOULD STABILIZE IN Q2



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* **Will higher inflation curb EZ consumers' enthusiasm?** Households in the euro area will remain an important driver of GDP growth, but the boost to real incomes from near-zero inflation earlier in this business cycle has faded. We think growth in consumers' spending will slow to 1.3%-to-1.4% in 2017, from 1.6% in 2016 and a peak of nearly 2% in 2015.

* **Construction boosted investment in the Eurozone at the end of 2016, will it last?** Construction account for almost half of total capex in the euro area, and survey data indicate that the boost from the sector will continue in the first half of 2017. In manufacturing, the main surveys also indicate that growth will remain solid, but the bar for much further improvement is high in countries such as France and Spain.

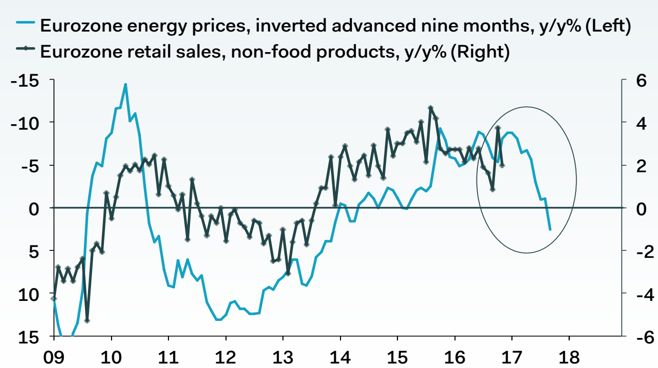
* **Recycling of the Eurozone's current account surplus will remain a key story in 2017.** Negative interest rates, QE and a current account surplus means the Eurozone will remain a source of excess liquidity to global capital markets. The current account surplus will remain close to 3% of GDP in 2017, but likely decline modestly compared from 3.3% in 2016. We see signs in the Q4 data that outward FDI is taking over from portfolio flows as the main source of aggregate outflows from the Eurozone.

* **The German economy is still best in class.** Both investment and consumers' spending likely accelerated in Germany at the end of 2016, and survey data suggest the good news will continue at the start of 2017. The economy is now at full employment, though, and wages and house prices likely will accelerate in 2017, raising the risk of overheating in some sectors. The ECB won't be worried about this to begin with, but it will present a tricky issue later in the year as the central bank decides whether to end QE.

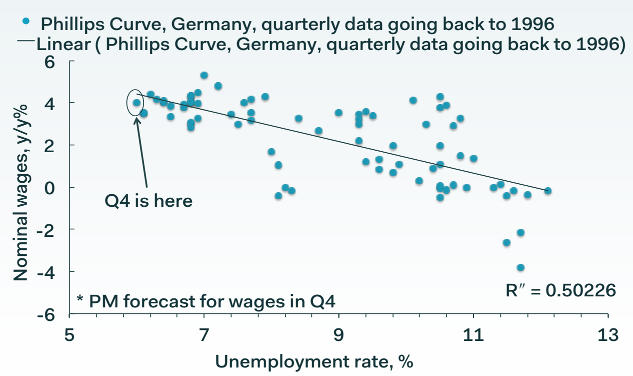
* **Spain will slow, but will continue to lead France and Italy.** GDP growth in Spain probably slowed marginally to 3.0% in 2016, from 3.5% in 2015, and we expect a further slowdown to about 2.3% in 2017. This looks disappointing, but it would still be an impressive headline given where economy is coming from. It would also mean that Spain will continue to lead France and Italy, where growth will remain below 2%.

* **Financials hold the key to outperformance of EZ equities.** The MSCI EU ex-UK has started 2017 on the front foot, boosted mainly by banks. This is consistent with higher inflation pushing up long-term rates. But other sectors are expensive, however, and we think growth in excess liquidity will slow this year.

WILL HIGHER ENERGY PRICES DENT EZ CONSUMERS' SPENDING?



HOW MUCH FURTHER CAN UNEMPLOYMENT IN GERMANY FALL?



Forecast summary:

Economic Activity (y/y%)	2015	2016	2017	2018	2019
Eurozone GDP	2.0	1.6	1.4	1.0	1.3
Contribution of Household Consumption	1.1	0.6	0.4	0.2	0.4
Contribution of Government Consumption	0.5	0.5	0.4	0.4	0.2
Contribution of Investment*	0.6	0.4	0.5	0.1	0.6
Contribution of Net trade	-0.2	0.1	0.1	0.3	0.2
Germany GDP	1.3	1.7	1.5	1.1	1.3
France GDP	1.0	1.1	1.1	0.8	1.2
Italy GDP	1.0	1.1	1.0	0.8	1.2
Spain GDP	3.5	3.0	2.3	1.7	1.6
Labor Market and Prices					
Eurozone unemployment (end of year)	10.4	9.9	9.7	10.0	10.4
Eurozone CPI y/y% (end of year)	0.2	0.9	1.5	1.2	1.0
Eurozone labour productivity growth y/y%	0.9	0.9	0.9	0.7	0.8
Other					
Eurozone current account, % GDP	3.2	3.2	2.8	3.1	3.2
Eurozone budget deficit, % GDP	-2.1	-2.0	-2.0	-2.5	-2.9
Government debt, % GDP	90.4	88.0	89.5	91.0	91.5
ECB refi rate, Q4 average	0.05	0.00	0.00	0.05	0.00
10-year benchmark rate, Q4 end	0.6	0.5	1.0	0.6	0.5
Eurostoxx, Q4 end	3267	3400	3300	3000	3600
ECB deposit rate, Q4 average	-0.3	-0.4	-0.4	0.0	-0.1
ECB Monthly QE pace, Q4 average	N/A	€80B	€60B	€30B	€60B

* Includes inventories