THE WEEKLY **EZ** ECONOMIC MONITOR

FEBRUARY 18, 2019
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Car sales data in the Eurozone are telling an increasingly dire story for the domestic market.

Structural shifts in the market for new cars are out-weighing still-decent cyclical demand.

Spain is heading for the polls, again, on April 26; the status quo looks like the probable likely outcome.

This Will be a Long Year for Domestic Car Sales in the EZ

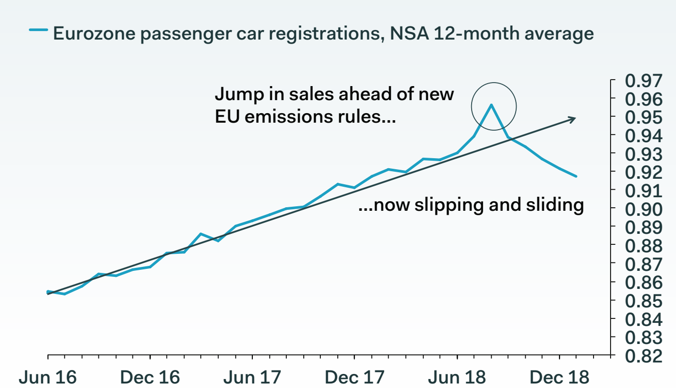
The EZ manufacturing data have shown signs of a rebound in the auto sector recently. Production jumped at the end of 2018, partly reversing the slide in the wake of new EU emissions regulations in September, and the survey data suggest that new orders-to-inventory ratios improved in January. *Unfortunately, the demand data have so far been unable to confirm these green shoots*. New car registrations in the EZ fell 5.6% year-over-year in January, only marginally better than the 7.6% decline in December. The declines were modest in Germany and France, by 1.1% and 1.4% respectively, but demand plunged in Spain and Italy, at 7.6% and 8.0% respectively. Elsewhere, the 49.6% leap in Lithuania stood out, driven, we suspect, by strong one-off demand by one or more car-sharing firms.

The poor EZ headline growth rates is partly driven by unfavourable base effects. The registration of 1.2M new cars in January was the second-strongest start to the year since the financial crisis, eclipsed only by January last year, hence the negative year-over-year rate. It is normal for base effects to drag down growth rates as the expansion matures, and a broader look at the data reveals that growth has been slowing since the beginning of 2017. The hangover from the run-up in demand ahead of the new emissions rules also has driven down growth, but neither that nor base effects can account for all the down-shift in demand, as our first chart suggests.

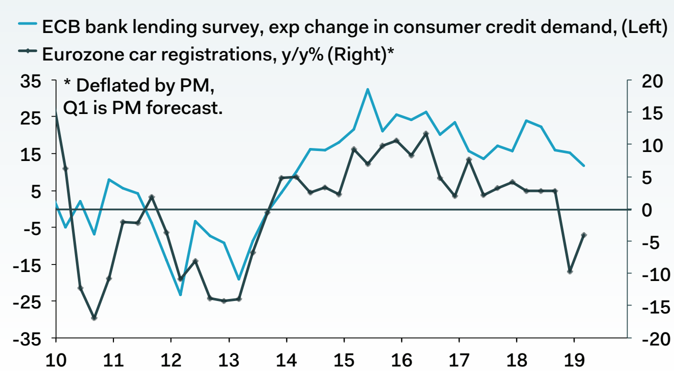
Even factoring-in the jump in sales ahead of the new emissions rules, and the strength in January volumes, the smoothed trend is now falling rapidly, with no evidence of an upturn. We think it will stabilise soon, but the reprieve for the *growth* numbers will be short-lived. The run-up in sales to clear inventory ahead of the shift in regulation began at the end of Q2, indicating that the year-over-year rate will slump towards the middle of the year. ***This suggests that headline growth in car registrations will remain subdued for six more months, at least.***

This sombre outlook is at odds with the usual leading indicators for car purchases. Falling unemployment and lower headline inflation mean that real wage growth likely will pick up this year, and our next chart shows

THE SLOWDOWN IN NEW CAR SALES IS INTENSIFYING



DEMAND FOR CONSUMER CREDIT TO LIFT CAR SALES IN Q1?



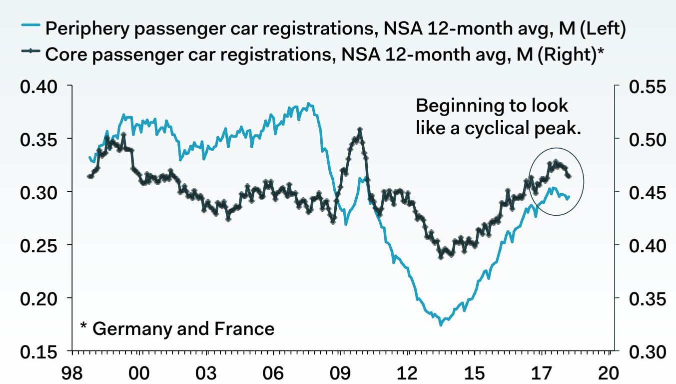
that banks continue to see solid demand for consumer loans, normally an important driver of the willingness to make purchases of large durable goods. In addition, the Commission's aggregate consumer sentiment data also look solid enough. The sub-component surveying households' willingness to make large purchases in the next 12 months remains close to a cyclical high.

These tailwinds, however, are not necessarily enough to negate the structural uncertainty currently weighing on the sector. The new emissions rules, and the industry's difficulties in adjusting to them, are part of a structural shift in the market away from internal combustion engines towards electrification. Normally, such changes are implemented slowly, but governments are moving quickly. This, in turn, probably is prompting *some* households to postpone the replacement of old vehicles, or opt for used models, "waiting out" the transition to new technology.

The newsflow on the production side points to a similar story. Industry analysts are telling ominous stories about a "peak in the demand cycle" and Germany's largest labour force union, IG Metall, is warning that demand for its workers will begin to decline soon. It is predicting that firms will switch resources away from a focus on keeping production lines churning to less labour-intensive investment in R&D and re-tooling to boost capacity in electric vehicle production.

The problem for the major car producers is that they now find themselves in a situation where they're holding excess capacity in increasingly obsolete products at a point in the cycle when demand already is slowing. The car industry won't change overnight, but we see clear signs that the industry is now taking seriously the transition towards trends such as electrification, shared car schemes and autonomous driving, all of which are hugely disruptive to the status quo.

A CYCLICAL PEAK IN EUROZONE CAR SALES?



Once more unto the breach in Spanish politics

In our *Monitor* of February 5—see here—we painted an upbeat picture of the Spanish economy, but the country's political situation is dysfunctional. Few observers believed that Prime Minister Pedro Sanchez could remain in office for long after he wrested power away from the incumbent Conversative Mariano Rajoy in a no-confidence vote last year. This prediction was confirmed last week. On Friday, Mr. Sanchez threw in the towel, announcing that new elections will be held on April 28, which will be the third vote since 2015. The decision comes after the government's proposal for a new budget was vetoed by parliament earlier in the week.

For *markets,* the only question that matters in European elections is whether one or more of the leading parties are campaigning on a pledge to hold a referendum to leave the EU or the Eurozone. ***In Spain, this risk is virtually non-existent.*** The only openly EU-sceptic party, Podemos, has been sliding in the polls recently, to just under 15%, and is in any case unlikely to lead a frontal assault on Spain's EU membership.

Instead, this election is all about domestic *politics as far as we can see; more specifically, the Catalan question.* Mr. Sanchez finds himself the current predicament because of his inability to reconcile the wildly diverging positions on the issue of Catalan independence. The Conversative parties are angry with Mr. Sanchez for what they perceive as too much leniency to Catalan secessionists. And the Prime Minister's reliance on the Catalan nationalists to vote with him has been hurt by the decision to proceed with trials of 12 leaders of the independence movement. *We are no experts in Spanish politics, but our current reading of the polls suggests that the most likely result of the April elections will be the status quo, and more dysfunction.*

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THIS WEEK IN BRIEF

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

Monday, February 18

- **No significant data released**

Tuesday, February 19

- **D: Current Account, Eurozone (12) 10:00 CET**
We think the headline current account surplus rebounded to **€24.0B** in December, from €20.3B in November, lifted by a higher trade surplus. **Consensus: N/A**.

- **D: ZEW, Germany (2) 11:00 CET**
The headline ZEW expectations index likely edged higher to -10.0 in February, from -15.0 in January. **Consensus: -13.5**.

- **D: Construction, Eurozone (12) 11:00 CET**
Advance data suggest that construction output in the Eurozone fell **0.9%** month-to-month in December, driving the year-over-year rate down to -1.3% from +0.8% in November. A big fall in Germany was the primary driver, but we suspect that it will be revised up next month. **Consensus: N/A**.

Wednesday, February 20

- **No significant data released.**

Thursday, February 21

- **D: Final Inflation, Germany (1) 08:00 CET**
Headline inflation likely dipped by 0.3pp to **1.7%** in January, in line with the initial estimate. **Consensus: 1.7%**.

- **D: Final Inflation, France (1) 08:45 CET**
We think that inflation fell to **1.2%** in January, from 1.6% in December, in line with the first estimate. **Consensus: 1.2%**.

- **D: Business Sentiment, France (2) 08:45 CET**
The headline manufacturing confidence index likely was unchanged at **103** in February. **Consensus: 103**.

- **D: Advance PMIs, France (2) 09:15 CET**
We think that the composite PMI in France rose to **49.5** in February, from 48.2 in January, driven by a strong rebound in the services index after the odd fall in January. **Consensus: 49.5.**

- **D: Advance PMIs, Germany (2) 09:30 CET**
The composite PMI in Germany likely was unchanged at **52.1** in February. The services index likely fell a bit, but we are betting on a small rise in the manufacturing PMI. **Consensus: 52.0**.

- **D: Advance PMIs, Eurozone (2) 10:00 CET**
We think the composite PMI in the EZ rose to **51.5** in February, from 51.0 in January, lifted by a small rebound in manufacturing and stability in services. **Consensus: 51.1**.

Friday, February 22

- **D: Detailed GDP, Germany (Q4) 08:00 CET**
Real GDP likely was **flat** quarter-on-quarter in Q4 in line with the initial estimate. **Consensus: 0.0%**.

- **D: IFO, Germany (2) 10:00 CET**
We think the headline business climate index rose to **99.8** in February, from 99.1 in January. **Consensus: 99.0**.

- **D: Final Inflation, Eurozone (1) 11:00 CET**
Inflation probably slipped to **1.4%** year-over-year in January, from 1.6% in December, in line with the first estimate. The core rate probably rose, by 0.1pp to 1.1%. **Consensus: 1.4%**.

PANTHEON EUROZONE FINANCIAL CONDITIONS DASHBOARD

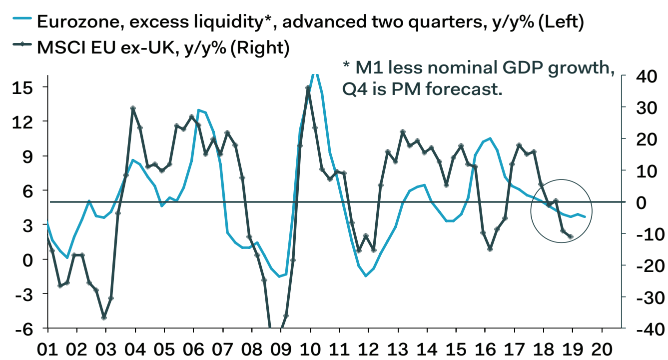
Market	Valuation*	Six month change, %	y/y, %
Eurostx 50	-0.9	-3.9	-5.4
Dax 30	-0.8	-7.5	-9.3
CAC 40	-0.5	-3.6	-2.4

* 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)	-3.7	-29.8	-61.7
FRA (10-2)	-3.3	-11.2	-38.6
ITA (10-2)	-1.5	+53.8	+19.0

** Curve in standard deviations from its 10y average (>1.5 = historically steep, <-1.5 = historically flat)

EUROZONE EXCESS LIQUIDITY VS MSCI EU (EX UK)



EZ equities are still pushing on from the bottom late last year, driven by attractive valuations and dovish comments from central bankers. Excess liquidity indicators still warn of lower returns, but for now the market doesn't care.

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

GDP			
Q4 18	0.2	2016 year:	1.8
Q1 19 forecast	*0.4*	*2017 year:*	*2.5*
Q3 19 forecast	*0.3*	*2018 year:*	*1.8*
Q3 19 forecast	*0.2/0.3*	*2019 year:*	*1.1*
Q4 19 forecast	*0.2/0.3*	*2020 year:*	*1.0*

CPI y/y, %		Unemployment, %	
January	1.4%	December	7.9%
February	*1.2%*	*January*	*7.9%*
March	*0.9%*	*February*	*7.9%*
April	*1.4%*	*March*	*7.9%*
May	*1.3%*	*April*	*7.8%*