THE EUROZONE ECONOMIC MONITOR

JULY 14, 2016
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EZ GDP growth slowed sharply in the second quarter, but it follows a surge in Q1.

Brexit uncertainty will weigh on GDP growth in Q3, but the EZ economy won't fall into recession.

French inflation rebounded last month, and it will continue to edge higher in coming months.

EZ GDP Growth all but Stalled in Q2, as Domestic Demand Slowed

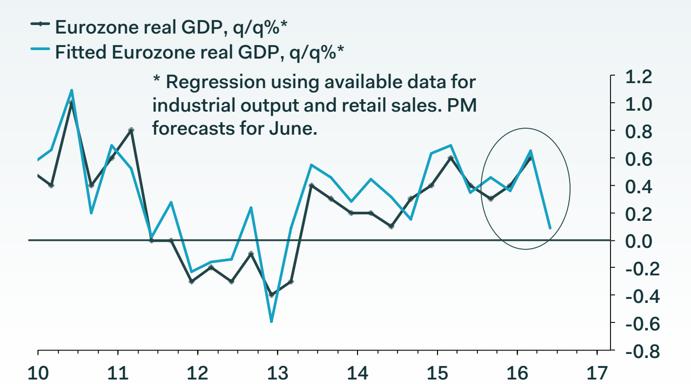
Data yesterday showed that industrial production in the Eurozone stumbled in May. Production fell 1.2% month-to-month, driven by weakness in all major economies and falling output in all sub-industries. The poor headline follows an upwardly revised 1.4% jump in April, which means that production rose marginally in the first two months of the second quarter. But the outlook for Q2 as a *whole* is grim. ***We think output* fell *0.1% quarter-on-quarter, following a 0.8% jump in Q1.*** This forecast includes a 1.1% month-to-month rebound in June, which implies that risks are firmly tilted to the downside for euro area industrial production in the second quarter.

After combining our forecasts for manufacturing and retail sales, we think the euro area economy all but stalled in the second quarter. Our model predicts that real GDP rose a meagre 0.1% quarter-on-quarter in Q2, down from a 0.6% jump in the first quarter. We think net exports prevented a calamity, however, by boosting growth by 0.1 percentage points. This pushes our forecast for GDP growth up to 0.2%.

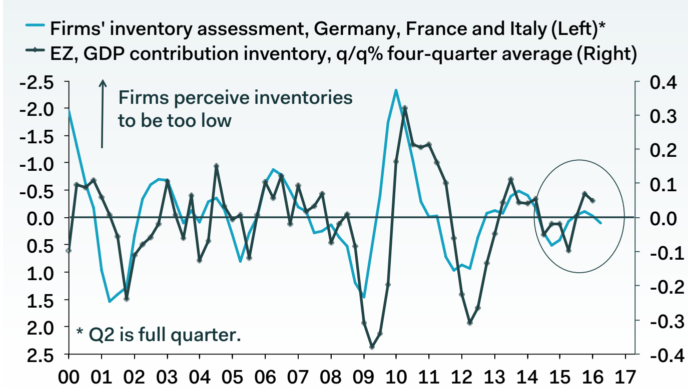
Gross investment is the main wild card for the Q2 GDP report, and risks are tilted to the downside. Capital formation surged in Q4 and Q1, and mean-reversion points to a Q2 slowdown.

We think inventories will be a key drag. Survey data in the three largest Eurozone economies suggest that manufacturers' assessment of their inventory levels increased to "above average" in Q2. This implies a reversal of the 0.4pp inventory boost to EZ GDP growth since Q3 last year. *The hit to growth from inventories likely will be spread over more than one quarter, but the reversal probably* began *during the second quarter.* Overall, we think gross capital formation *fell* marginally in the second quarter, mainly due to a slump in construction. This will be a disappointment to markets, but it has to be seen in the context of the aggregate 2.2% leap in Q4 and Q1.

EZ GDP GROWTH LIKELY PLUNGED IN THE SECOND QUARTER...



...PARTLY WEIGHED DOWN BY A CORRECTION IN INVENTORIES



Consumers' spending also likely slowed in the second quarter, after a sharp rise in Q1. We forecast that growth slowed to 0.1%-to-0.2% in Q2, from 0.6% in the first quarter, based on available retail sales data. Weaker growth in France likely was the key driver of the EZ-wide weakness in household consumption.

Slower euro area GDP growth won't play well with the ECB amid rising political uncertainty, and will help the central bank over the line with the decision to extend QE in September. ***Looking ahead, survey data in Q3 likely will signal a modest slowdown, on the back of the rising uncertainty following the U.K. referendum.*** But we still think that GDP will rise by an average of 0.3% quarter-on-quarter in the second half of the year. This is consistent with full year growth of 1.4%-to-1.5%, only marginally lower than the market's, and our own, pre-Brexit expectations.

French inflation rebounds, and will rise further

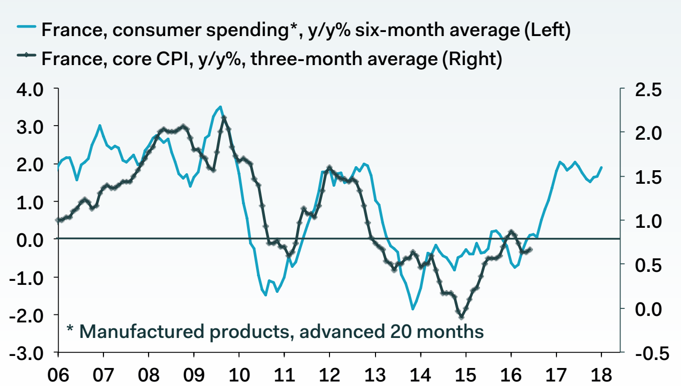
Easing deflation in energy prices pushed French inflation higher last month. Yesterday's final CPI report showed that inflation rose to 0.2% in June, from 0.0% in May, mainly as a result of energy prices falling "only" 3.1% year-over-year, after a 5.7% decline in May. Base effects likely will push the year-over-year rate significantly higher in coming months. The reduction in energy price deflation offset a fall in food inflation, which was pushed down by a 4.0% year-over-year plunge in fresh produce prices. *Seasonal adjustments in France generally can't cope with the wild swings in fresh food prices.* The statistical office recently changed the methodology used to seasonally adjust fresh food prices, which should smooth the volatility, eventually. In the short run, though, the break in methodology is set to push the year-over-year rate of fresh food price inflation *higher* in July, August, and September.

June core inflation was unchanged at 0.7%, mainly due to steady services inflation at 1.0%, which offset a 0.5% fall in manufactured goods prices. The persistent fall in French goods prices is due to administered prices in some over-the-counter medicines. Healthcare products account for 4.7% of the CPI index, which means that the average 3.7% year-over-year drop during the past year has depressed the CPI by 0.2pp.

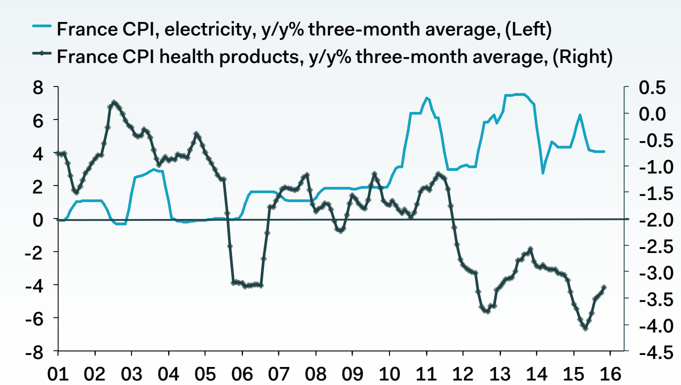
Managed electricity prices are another peculiarity in the French inflation data. France's electricity supply is mainly powered by the domestic nuclear industry, where retail prices have been rising about 4%-to-5% year-over-year. This means that the pass-through to French households' finances from swings in oil prices is lower than in other EZ economies.

Overall, core inflation is a very long lagging indicator in France, and we think it will gradually edge higher this year. The strong increase in consumers' spending implies that core inflation will rise to 1.5% next year. Allowing for structural headwinds, though, we think a rise to 1%-to-1.2% is a better bet.

FRENCH CORE INFLATION WILL INCREASE TO ABOUT 1% THIS YEAR



ADMINISTERED PRICES ARE DISTORTING FRENCH CPI DATA



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THIS WEEK IN BRIEF

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

Monday, July 11

- **No significant data released.**

Tuesday, July 12

- **D: Final Inflation, Germany (6) 08:00 CET**

Inflation in Germany rose to **0.3%** year-over-year in June, up from a 0.1% increase in May. A rebound in energy prices, and higher services inflation were the key drivers of the gain. We expect inflation to increase to 1.5% in the next six-to-12 months.

Wednesday, July 13

- **D: Final Inflation, France (6) 08:45 CET**

Inflation in France increased to **0.2%** year-over-year in June, from 0.0% in May. A rise in energy price inflation was the main driver. We think inflation in France will rise towards 1% in the next six-to-12 months, lifted by higher core inflation and energy prices.

- **D: Industrial Production, Eurozone (5) 11:00 CET**

Industrial output in the euro area fell **1.2%** month-to-month in May. This pushed the year-over-year rate down to 0.5% from a revised 2.2% in April. Declines in capital and energy goods production were the main drivers of the decline. Industrial output slowed significantly quarter-on-quarter in Q2, and this likely weighed on real GDP growth.

Thursday, July 14

- **No significant data released.**

Friday, July 15

- **D: Car Registrations, EU27 (6) 08:00 CET**

We think car registrations in the EU27 rose **6%** year-over-year in June, down from a 16% rise in May. Declining growth in Italy and Spain probably were the main drivers of the fall, but growth likely also slowed in France. Strong demand for new cars continued to boost consumers' spending in the second quarter but growth likely will slow in Q2, as momentum in the periphery wanes. **Consensus: N/A.**

- **D: Final Inflation, Eurozone (6) 11:00 CET**

Inflation in the Eurozone likely rose to **0.1%** year-over-year in June, from -0.1% in May, as both core inflation and energy prices rebounded. We think inflation in the euro area will rise to about 1.2%-to-1.4% in the next six-to-nine months. It will be driven by higher services inflation and higher energy prices, due to the rebound in oil prices. **Consensus: 0.1%.**

- **D: Trade Balance, Eurozone (5) 11:00 CET**

We think the euro area's trade surplus fell to **€21B** in May, from €28.0 in April. The likely slowdown in the U.K. economy will dent the EZ trade surplus this year, but growth in the U.S. should remain robust. **Consensus: €25B.**

PANTHEON EUROZONE FINANCIAL CONDITIONS DASHBOARD

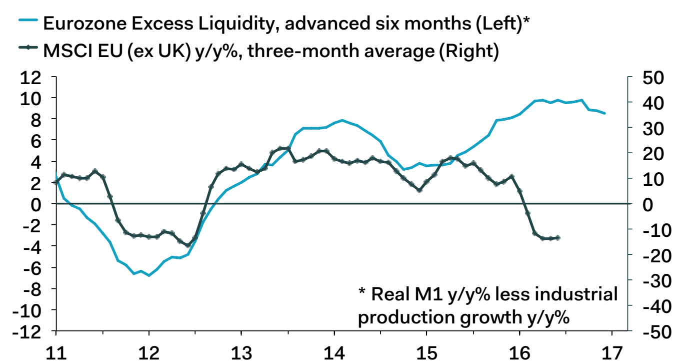
Market	Valuation*	Six month change, %	y/y, %
Eurostx 50	0.6	-6.4	-19.6
Dax 30	0.2	-2.2	-14.5
CAC 40	0.7	-3.3	-14.9

* 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)	-2.5	-40.4	-60.3
FRA (10-2)	-2.2	-51.3	-71.6
ITA (10-2)	-1.7	-27.9	-60.9

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

EUROZONE EXCESS LIQUIDITY VS MSCI EU (EX UK)



Eurozone equities continue to trade sideways amid elevated political uncertainty. The ECB likely will extend QE in September, but is unlikely to ease further.

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

GDP			
Q4 2015	0.3	2014 year:	0.9
Q1-16 (adv)	0.6	*2015 year:*	*1.6*
Q2-16 forecast	*0.2*	*2016 year:*	*1.5*
Q3-16 forecast	*0.4*	*2017 year:*	*1.2*
Q4-16 forecast	*0.3*		

CPI y/y, %		Unemployment, %	
June	0.1%	May	10.1%
July	*0.3%*	*June*	*10.1%*
August	*0.5%*	*July*	*10.0%*
September	*0.6%*	*August*	*10.0%*
October	*0.8%*	*September*	*9.9%*