THE **EUROZONE** ECONOMIC MONITOR

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Industrial production in Germany rose to a six-year high in December, but slowed over Q4 as a whole.

Base effects are challenging for German manufacturing capex in Q4, despite solid surveys.

The French trade deficit fell in December, but the trend warns of deteriorating competitiveness.

Is the Acceleration in German Manufacturing Output Over?

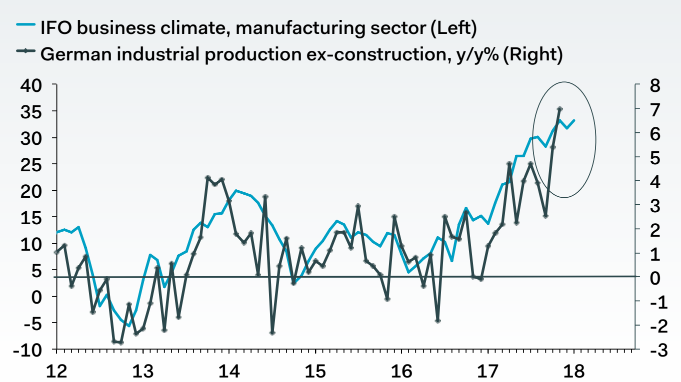
Industrial production in Germany stumbled at the end of Q4. Data yesterday showed that output fell 0.6 month-to-month in December, though this drop has to be seen in light of the downwardly-revised 3.1% *jump* in November. Production was constrained by weakness in capital and consumer goods, offsetting a rise in intermediate goods output. Energy production rebounded from a sharp drop in November, due to milder weather, while construction fell by 1.7%.

This was a soft report overall, but the headline was impressive in the face of challenging base effects. Industrial production fell sharply in December 2016, signalling a month-to-month decline in December 2017, even with a robust year-over-year rate. But yesterday's data defied this headwind, with the result that the year-over-year rate leapt to 6.5%, a six-year high. Our first chart suggests that production has now *overshot* slightly, relative to the survey data, and the message is similar if we look at new orders. *A further near-term acceleration is unlikely, but Q1 growth should remain firm, at 5%-to-6%.*

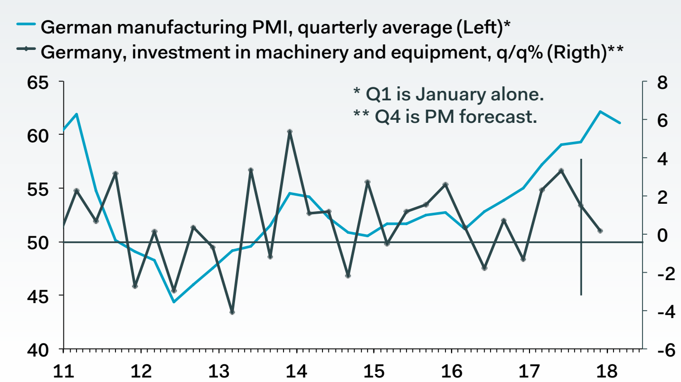
The December data also indicate that manufacturing provided a lift to the economy in Q4, albeit slightly less than in Q3. Assuming no revisions, industrial production rose 0.7% quarter-on-quarter in Q4, slowing from a 1.1% rise in Q3. The picture is more complicated, however, in *investment*. In principle, the survey data suggest that the quarter-on-quarter rate accelerated further at the end of last year. *But significant upward revisions to machinery and equipment capex in Q3 and Q2 have created enormous unfavorable base effects for the Q4 number.*

Investment in machinery and equipment rose 5.9% year-over-year in Q3, and even if we assume a punchy acceleration to 7.5% in Q4, the quarter-on-quarter rate would still plummet to 0.2%, from 1.5% in Q3. *Overall, investment in manufacturing performed strongly last year, but we worry that the Q4 headline will be tainted by these base effects.*

GERMAN INDUSTRIAL PRODUCTION WON'T ACCELERATE FURTHER



BASE EFFECTS ARE CHALLENGING FOR INVESTMENT DATA IN Q4



A great Q4 for French trade, but trend is worrying

In yesterday's other economic news, the French trade deficit narrowed dramatically to €3.5B in December, from €5.6B in November, helped by a 5.9% month-to-month leap in exports. This sharp increase in external demand fully reversed the cumulative 2.2% decline in exports between September and November. Imports rose 0.4%, only partially rebounding from a 0.7% dip in November. Across countries and products, a big increase in transport equipment exports to Asia—most likely Airbus aircraft deliveries—provided an important lift. The rise in exports, and a better services surplus, helped to reduce the overall current account deficit to €0.9B, from €3.3B in November.

The advance GDP data already signalled that net exports boosted growth in Q4; yesterday's report confirms that story. Rising oil prices boosted the import deflators, depressing *real* imports; they *fell* 1.2% quarter-on-quarter, after a 2.2% *rise* in Q3.

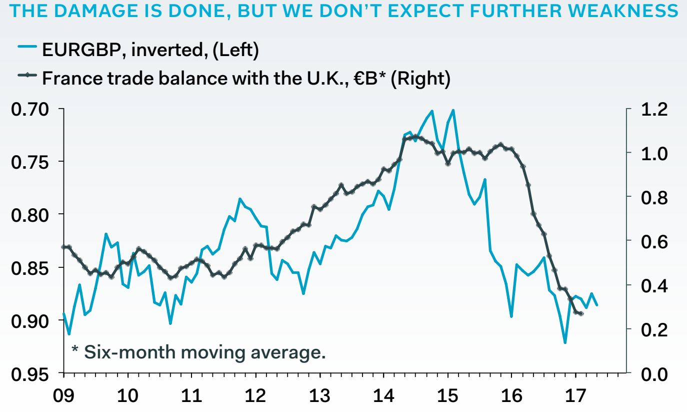
The strong Q4 does not alter the deteriorating *trend* in the economy's external deficit. As we explained in our *Monitor* yesterday—see here—the current account deficit widened to just over 1% of GDP last year, the highest since 2015. A reduced services surplus is part of the explanation. Tourist footfall fell significantly following the 2015 and 2016 terrorist attacks. It recovered somewhat at the start of 2017, helping the services surplus, but the improvement has been marginal. In the 12 months ending December, French ran a services surplus of €325M, far below the trend of €1.0-to-€1.5B before the terrorist attacks.

Brexit also has been a headwind. The euro rose over 30% against the pound in the wake of the referendum, all but eviscerating France's trade surplus with the U.K. Our previous chart shows that the French trade advantage with Britain fell from an annualised €12B at the start of 2016, to a mere €3.5B late last year. The collapse probably is over, at least for now.

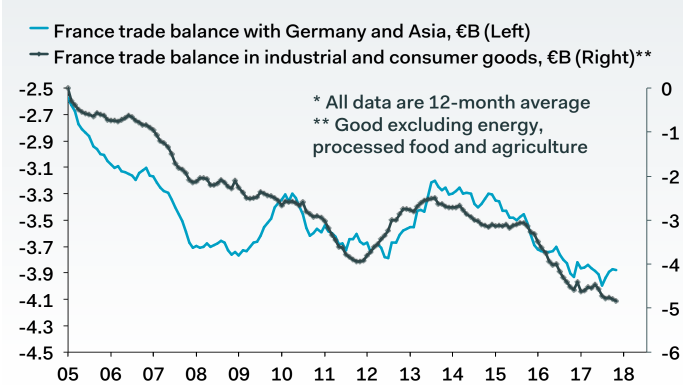
Weak tourism, and a stronger currency following the U.K.'s decision to leave the EU, are not the only headwinds for the French trade balance. ***France runs a structurally deteriorating manufacturing trade deficit with Asia and Germany.*** Before the financial crisis, the French trade balance in consumer and industrial goods was nearly zero. It has since widened to a significant deficit, in tandem with a worsening trade disadvantage with Germany and Asia. France's problem is that its manufacturing industry is highly reliant on imports to fill its inventories and create finished products. *The national account data show that net exports and inventory accumulation are almost perfectly inversely correlated.*

Finally, even the French food and agricultural industry has seen its trade surplus more than halving since 2013, from about €1.0B to €0.4B, mainly due to higher imports of food products.

THE DAMAGE IS DONE, BUT WE DON'T EXPECT FURTHER WEAKNESS



FRANCE'S DISAPPEARING COMPETITIVENESS IN MANUFACTURING?



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THIS WEEK IN BRIEF

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

Monday, February 5

• D: Final PMIs, Eurozone (1) 10:00 CET
The composite PMI in the Eurozone increased to **58.8** in January from 58.1 in December, slightly above the consensus and initial estimate, 58.6. The PMIs point to robust GDP growth in the Eurozone at the start of the year.

• D: Sentix, Eurozone (2) 10:30 CET
The headline Sentix investor sentiment index dipped to **31.9** in February from 32.9 in January. Investor sentiment has been lifted by a strong global stock market at the start of the year, but weakness looms next month if the present price action is sustained for long.

• D: Retail Sales, Eurozone (12) 11:00 CET
Retail sales in the Eurozone fell **1.1%** month-to-month in December, depressing the year-over-year rate to 1.9% from a revised 3.9% in November. Our forecast suggests that retail sales rose a mere 0.3% quarter-on-quarter in Q4, but we think Q1 the data will be much better.

Tuesday, February 6

• D: Factory Orders, Germany (12) 08:00 CET
Factory orders in Germany leapt **3.8%** month-to-month in December, depressing the year-over-year rate to 7.2%, from an upwardly-revised 9.1% in November. The strong headline was due to base effects, which required a punchy month-to-month gain to maintain the year-over-year close to the pace implied by the economic surveys.

• Budget Balance, France (12) 08:45 CET
The budget deficit in France narrowed to **€67.8B** year-to-date from €68.9B last year. Strong GDP growth means that tax revenues increased. Overall, the budget deficit in France fell last year to just under 3% of GDP.

Wednesday, February 7

• D: Industrial Production, Germany (12) 08:00 CET
Industrial production in Germany fell **0.6%** month-to-month in December, following a downwardly-revised 3.1% rise in November. The year-over-year rate rose to 6.5%, from a revised 5.5% in November.

• D: Trade Balance, France (12) 08:45 CET
The trade deficit in France narrowed to **€3.5B** in December, from €5.6B in November. A 5.9% month-to-month in exports was the key driver, offsetting a small rise in imports. Net trade added a significant boost to Q4 GDP growth.

Thursday, February 8

• D: Trade Balance, Germany (12) 08:00 CET
The headline non-seasonally adjusted trade surplus in Germany likely dipped to **€21.0B** in December from €23.7B in November. We think the seasonally adjusted surplus fell to €19.2B, from €22.3B in November. **Consensus: €21.0B**.

Friday, February 9

• D: Industrial Production, France (12) 08:45 CET
We think industrial production in the Eurozone increased **0.2%** month-to-month in December, lifting the year-over-year rate to 3.8% from 2.5% in November. Energy production will be hit by warm weather at the start of Q1, but the new orders-to-inventory ratio points to a solid trend in core manufacturing production. **Consensus: 0.2%**.

PANTHEON EUROZONE FINANCIAL CONDITIONS DASHBOARD

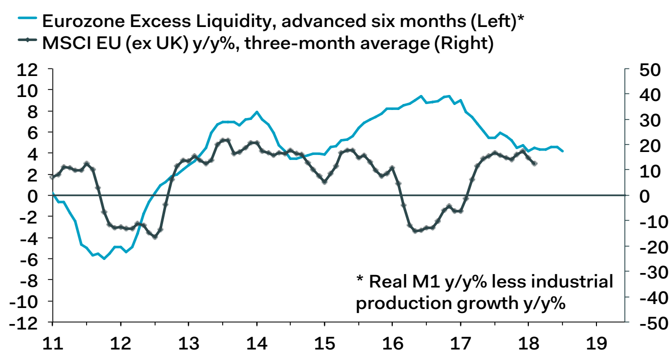
Market	Valuation*	Six month change, %	y/y, %
Eurostx 50	0.1	0.7	7.9
Dax 30	-0.1	4.3	10.1
CAC 40	-0.1	3.3	11.4

* 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)	-1.9	+13.8	+13.8
FRA (10-2)	-2.0	+18.5	-21.9
ITA (10-2)	-1.0	+10.0	+8.2

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

EUROZONE EXCESS LIQUIDITY VS MSCI EU (EX UK)



Equities in the Eurozone have struggled to make headway. A strengthening euro has pegged back earnings expectations, and more recently, weakness a jump in global bond yields also have been a drag.

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

GDP			
Q2 17	0.7	2015 year:	2.0
Q3 17	0.7	*2016 year:*	*1.8*
Q4(a) 17	*0.6*	*2017 year:*	*2.5*
Q1 18 forecast	*0.5*	*2018 year:*	*2.0*
Q2 18 forecast	*0.5*		

CPI y/y, %		Unemployment, %	
January	1.3%	December	8.7%
February	*1.4%*	*January*	*8.6%*
March	*1.5%*	*February*	*8.6%*
April	*1.5%*	*March*	*8.6%*
May	*1.6%*	*April*	*8.5%*