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THE **EUROZONE** ECONOMIC MONITOR

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The French sovereign debt rating downgrade passed without fanfare, but is it a sign of things to come?

Industrial production in France rose at the start of Q2 and looks on track for a rebound after a poor Q1.

The PMIs suggest a mild cyclical upswing is now underway in the Eurozone economy.

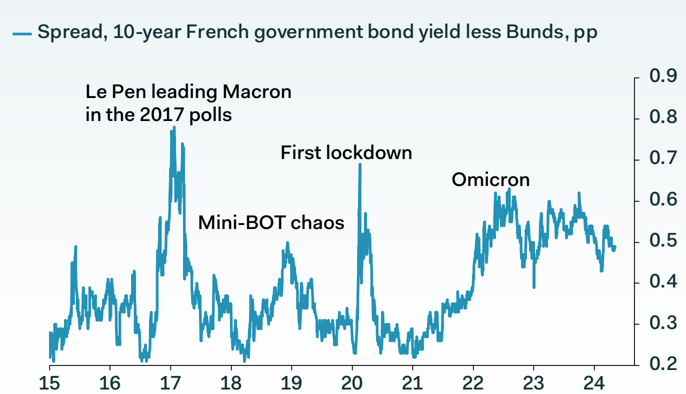
The sovereign debt downgrade in France that 'never happened'

S&P's French sovereign debt rating downgrade last week—to AA- from AA previously—was the macro-economic equivalent of the philosophical parable that 'if a tree falls in a forest and no one is around to hear it, does it make a sound?'. The news was duly sensationalised by the financial media, but markets didn't care. Ten-year yields in France have *declined* since the downgrade, and the spread versus German Bunds is unchanged. *This non-reaction to the downgrade is consistent with our view that global institutional checks and balances on public finances—which in Europe includes the EU's fiscal rules—have been diluted since the pandemic and war in Ukraine.* Governments need to spend and invest more, and bond markets have by and large corrected to this new reality.

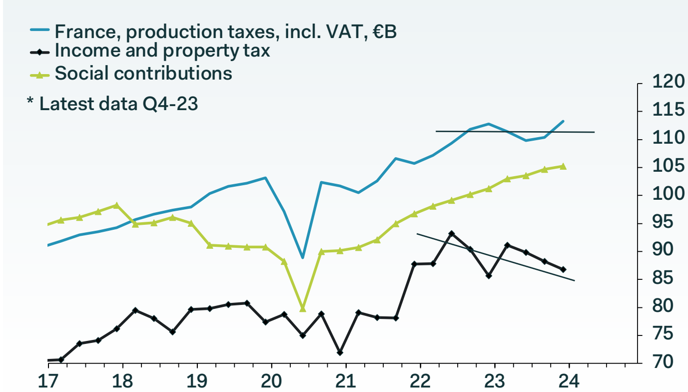
That said, France's downgrade by S&P is a warning shot across the bow, all the same. Rating agencies move slowly, but, as nominal GDP growth slows, re-establishing the link between still-wide deficits and rising government-debt-to-GDP ratios, further downgrades are in store, and not just in France. It is virtually impossible to predict when or if a sovereign debt rating downgrade could be the straw that breaks the camel's back, forcing markets to take a more acute and activist view on public debt sustainability in the EZ. ***The market response to a rating downgrade in Italy, for example, would be a big test for the relative calm in EZ government bonds.***

In the specific case of France, meanwhile, a rating downgrade has been coming since the news earlier this year of a much-wider-than-expected budget deficit for 2023, at 5.5%. The government has since pledged a sharp reduction in government spending between now and 2026 to bring the deficit back down to 3%. But no one believes this will happen, which has increased the spectre of higher taxes. We've received questions about whether this is realistic given that France has one of highest labour tax burdens in the OECD. Our reply: needs must. Our next chart shows that the trend in nominal income & property taxes has been *falling* slightly since mid-2022, implying a significant inflation-adjusted tax *cut*.

SHOULD THIS SPREAD BE HIGHER?



HOW WILL FRANCE FORCE THE BLACK LINE TO RISE AGAIN?



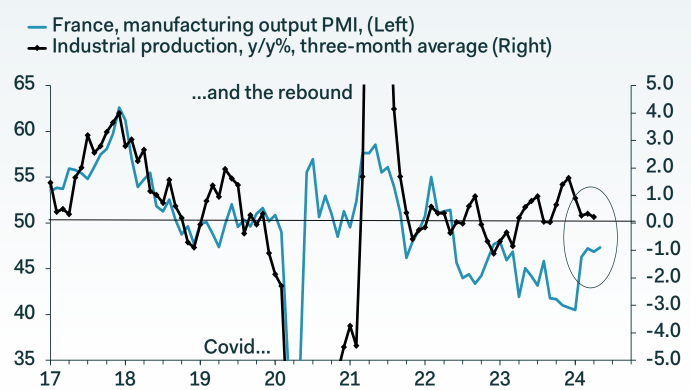
We don't doubt that the government will attempt to cut spending to reduce the deficit, but it won't be able to rely on this mechanism alone. An increase in taxes, likely by broadening the base, has to be part of the solution. More generally, we think the government's pledge to return the deficit to 3% of GDP by 2026 is wishful thinking. *We look for a 4.5%-of-GDP deficit by then, split between a primary deficit of 2.5% and 2.0% in net interest rate costs.*

A Q2 rebound in French manufacturing? Probably

In yesterday's economic news, industrial production in France rose by 0.5% month-to-month in April, reversing a revised 0.2% decline in March. The increase was driven by strong gains in output of clothing, pharmaceuticals, paper products and capital goods, ex-transport. By contrast, output in transport equipment, food & beverages as well as oil refining fell. The increase leaves the Q2 carry-over—the rise over the quarter if production is stable in May and June—at +0.5%, hinting that industrial output is on track for a rebound, following a 0.5% fall in Q4.

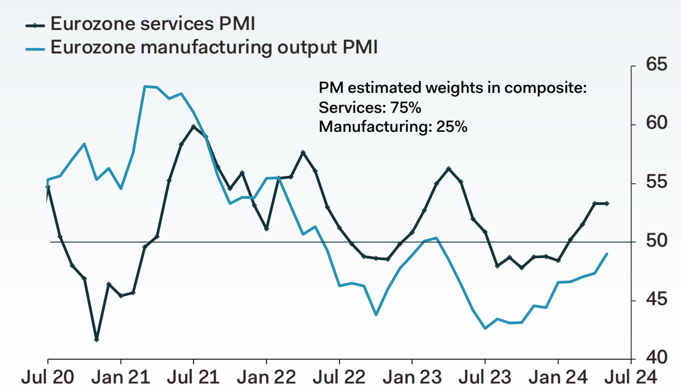
We think that's a decent bet, but risks are tilted to the downside. Our next chart shows that the manufacturing output PMI still points to slowing output growth, on a year-over-year basis, despite rebounding in recent months. Similarly, INSEE's new-orders-to-inventory ratio has also rolled over in the past few months, signalling a dip in production growth. *The good news is that a fall in the year-over-year rate in May and June is consistent with unchanged output on a monthly basis, so the Q2 rebound is still on, just about.*

INDUSTRIAL OUTPUT GROWTH IN FRANCE IS STILL ANAEMIC

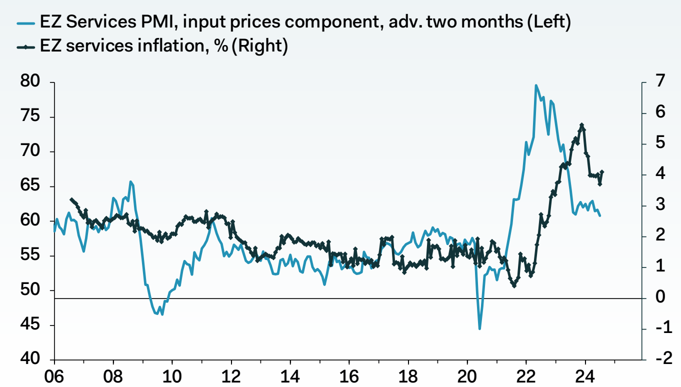


Yesterday's final economic report confirms that the EZ composite PMI rose in May, to 52.2, from 51.7 in April, fractionally below the initial estimate, 52.3. ***In a nutshell, the PMIs are now signalling that a mild cyclical upturn is underway in the Eurozone.*** Services are leading the charge, as our penultimate chart shows, but the recession in manufacturing is easing too. At this rate, the EZ economy will soon be flying with two working engines instead of just one. That said, we still look for a slight slowdown in Q2 GDP growth, to 0.2% after a 0.3% increase in Q1, as construction output and investment fall sharply in Germany, mean-reverting from a weather-induced leap at the start of the year. Finally, we just want to re-emphasise that the output price PMI in services clearly suggests that consumer price inflation in this sector will come down soon. Our final chart shows this sub-index signals services inflation at 3% in due course.

A CYCLICAL UPTURN IS UNDERWAY IN THE EUROZONE...



...AND SERVICES INFLATION WILL FALL, EVENTUALLY



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THIS WEEK IN BRIEF

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

Monday, June 3

D: Final Manufacturing PMI, Eurozone (5) 10:00 CET
The EZ manufacturing PMI rose to **47.3** in May, from 45.7 in April, marginally below the first estimate.

Tuesday, June 4

Switzerland, CPI (5), 07:30 CET
Headline CPI inflation in Switzerland was stable in May, at **1.4%** year-over-year. Price rose by 0.3% on the month.

D: German Unemployment Rate (5), 08:55 CET
Unemployment in Germany was stable in May, at **5.9%**, with claims rising by 25K on the month.

Wednesday, June 5

D: Industrial Production, France (4) 08:45 CET
Industrial production in France rose by **0.5%** month-to-month in April, after a revised 0.2% drop in March.

D: Final PMIs, Eurozone (5) 10:00 CET
The composite PMI in the EZ rose to **52.2** in May, after 51.7 in April, trivially below the first estimate, 52.3.

Thursday, June 6

- **D: Factory Orders, Germany (4), 07:00 CET**
We think factory orders rose by **2.5%** month-to-month in April, reversing weakness in March and February, consistent with the improvement in the surveys. **Consensus: 0.6%.**
- **D: Industrial Production, Spain (4), 08:00 CET**
Industrial output in the Spain likely edged up by **0.1%** month-to-month in April, after a 0.7% decline in March**. Consensus: N/A**
- **D: Retail sales, Eurozone (4), 11:00 CET**
We reckon retail sales in the euro area declined by **0.7%** month-to-month in April, due principally to a fall in food spending, depressed by Easter seasonals. **Consensus: 0.2%.**
- **D: ECB Rate Decision, Eurozone (6), 13:15 CET**
The ECB likely will cut its deposit and refinancing rates by 25bp, to **3.75%** and 4.25%, respectively, in line with expectations. This likely will be a hawkish cut, however, with Ms. Lagarde all but explicitly ruling out a July cut. **Consensus: 3.75%.**

Friday, June 7

D: Industrial Production, Germany (4) 08:00 CET
We think industrial production in Germany fell by **1.5%** month-to-month in April, after a 0.4% decline in March, due principally to a fall in construction output. **Consensus: 0.1%.**

D: Trade Balance, Germany (4) 08:00 CET
The trade surplus in Germany likely dipped to **€20.5B** in April, after €22.4B in March. **Consensus: €25.5B.**

D: Trade Balance, France (4) 08:45 CET
We think the seasonally adjusted trade deficit in France widened to **€6.5B** in April, after €5.4B in March. **Consensus: -€5.4B.**

D: Detailed GDP, Eurozone (Q1) 11:00 CET
We reckon the third and detailed report will show that real GDP in the Eurozone rose by **0.3%** quarter-to-quarter in Q1, after a 0.1% decline in Q4. The details likely will indicate that investment in construction, mainly in Germany, and consumers' spending, ex-Germany, drove growth. **Consensus: 0.3%.**

PANTHEON FINANCIAL CONDITIONS DASHBOARD

Market	3m/3m , %	6m/6m , %	y/y, %
Eurostx 50	-1.3	10.8	13.3
Dax 30	4.0	2.7	-1.7
CAC 40	-2.1	6.9	8.0

Bonds	Curve	Six month change, bp	y/y, bp
GER (10-2)	-4.0	-9.0	-13.0
FRA (10-2)	-4.2	-6.0	-22.0
ITA (10-2)	-4.0	-42.0	-50.0

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

PANTHEON FINANCIAL FORECASTS

	4pm Friday	End-month: Mar 24	Jun 24	Sep 24	Dec 24	Mar 25
Deposit Rate	4.00	4.00	**3.75**	**3.50**	**3.25**	**3.25**
Refi Rate	4.50	4.50	**4.25**	**3.65**	**3.40**	**3.40**
ECB BS, €B*	N/A	-€25B	**-€25B**	**-€33B**	**-€33B**	**-€35B**
10-year Bund	2.60	2.30	**2.50**	**2.30**	**2.50**	**2.60**
10-year BTP	4.00	3.66	**3.50**	**3.30**	**3.50**	**3.60**
Eurostx 50	4976	5083	**5050**	**4700**	**4500**	**4450**
EUR/USD	1.09	1.08	**1.10**	**1.12**	**1.15**	**1.15**

Forecasts in bold. *Change in balance sheet, ex-TLTROs, end month.

PANTHEON ECONOMIC FORECASTS - EUROZONE

Quarterly, period average:

	Q1 24	Q2 24	Q3 24	Q4 24	2023	2024	2025
GDP, q/q%	0.3	**0.2**	**0.4**	**0.4**	-	-	-
GDP, y/y%	0.4	**0.4**	**1.0**	**1.4**	0.5	**0.8**	**1.5**
Employment, y/y%*	1.0	**0.7**	**0.4**	**0.6**	1.7	**0.7**	**0.7**
Unemp. rate, %*	6.5	**6.5**	**6.6**	**6.6**	6.5	**6.6**	**6.6**
HICP, y/y%	2.6	**2.5**	**2.2**	**2.5**	5.5	**2.4**	**2.5**
Core HICP, y/y%	3.1	**2.8**	**2.6**	**2.8**	5.0	**2.8**	**2.5**
Budget Bal., % GDP	-	-	-	-	**-3.5**	**-4.0**	**-4.0**
Cur. acc't., % GDP	-	-	-	-	2.0	**1.5**	**1.5**

Forecasts in bold. *End period.

Monthly, end period

	Jan	Feb	Mar	Apr	May	Jun	Jul
HICP, y/y%	2.8	2.6	2.4	2.4	2.6	**2.6**	**2.4**
Unemp. rate, %	6.5	6.5	6.5	6.4	**6.4**	**6.5**	**6.6**

Forecasts in bold.