

THE EUROZONE ECONOMY IS IN RARE GOOD FORM ...SO WHAT SHOULD INVESTORS WORRY ABOUT?

EUROZONE ECONOMIC CHARTBOOK, OCTOBER 2017

DATA AS AT OCTOBER 9TH | CLAUD VISTESEN, CHIEF EUROZONE ECONOMIST
WWW.PANTHEONMACRO.COM | +44 191 2600 308



IT'S ALL GOING SWIMMINGLY IN THE EUROZONE...FOR NOW

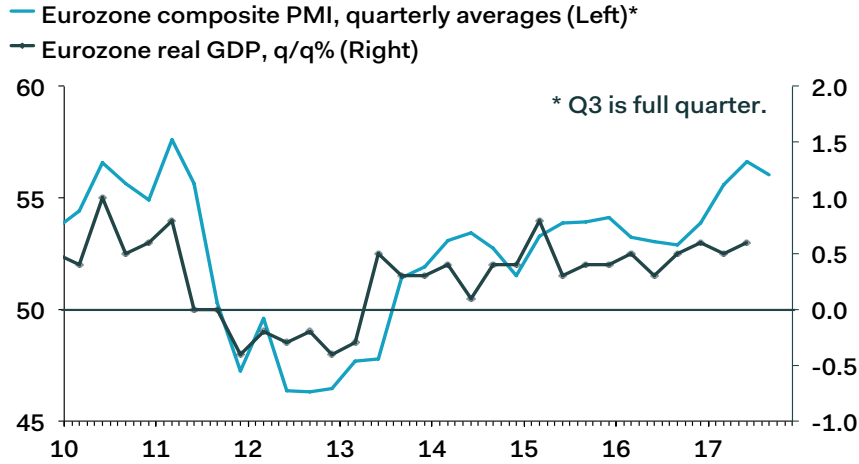


Summary

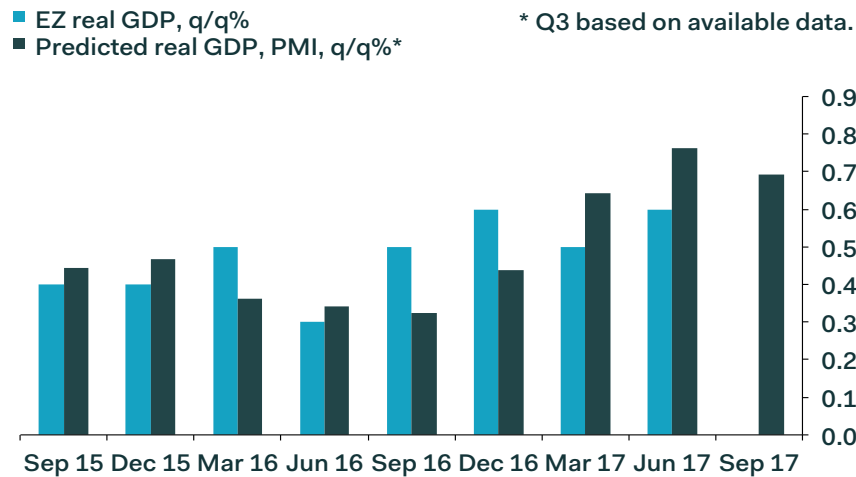
- **The near-term economic outlook in the Eurozone is unchanged and bullish.** Sentiment data continue to signal robust GDP growth in the Eurozone, and while the main surveys probably are overestimating the trend, they indicate upside risks to the headline GDP print. Hard data for Q3 have been mixed so far, but broadly supports the story of steady growth. Consumers' spending likely slowed in the third quarter, but we think manufacturing accelerated to provide offsetting support. Looking further ahead, real M1 growth signals steady growth until the end of Q1 next year, at least.
- **Markets aren't good at pricing political risks in the Eurozone.** In Germany, Mrs. Merkel faces a tough coalition building exercise; in Spain, the stand-off between the central government and Catalonia has intensified; finally, Italian elections loom next year, which almost certainly will see the significant rise of populist EU-sceptic parties. Investors have to consider these risks because they will move markets. Their impact tends not to last long, though, and the Eurozone economy has been resilient to the slings and arrows of political risk in this business cycle. Eurozone breakup risks inevitably will be discussed, again, around the Italian elections, but this is the dog that never barks in the euro area.
- **Dip in September core inflation won't sway the ECB; QE is set to be reduced and extended.** The ECB has a decision to make on QE in Q4, but markets have made it an easy one for the central bank. We think the ECB will extend QE by six months to June 2018, with an aim to review the program for the potential of a further extension. It also likely will reduce the pace of QE, by €20B, to €40B per month starting January. Our forecast is in line with the consensus, but we think the final details won't be delivered until December.
- **Monetary policy divergence is back as a theme for financial markets.** The Fed is on the move again, while the ECB has pledged to keep the front-end pinned until the end of next year, at least. This ought to have clear investment implications; sell the euro and buy risk assets in the Eurozone relative to the U.S. The reality, however, is that the outlook for wider interest rate differentials has not been a perfect leading indicator for the euro and relative EZ equity performance recently.



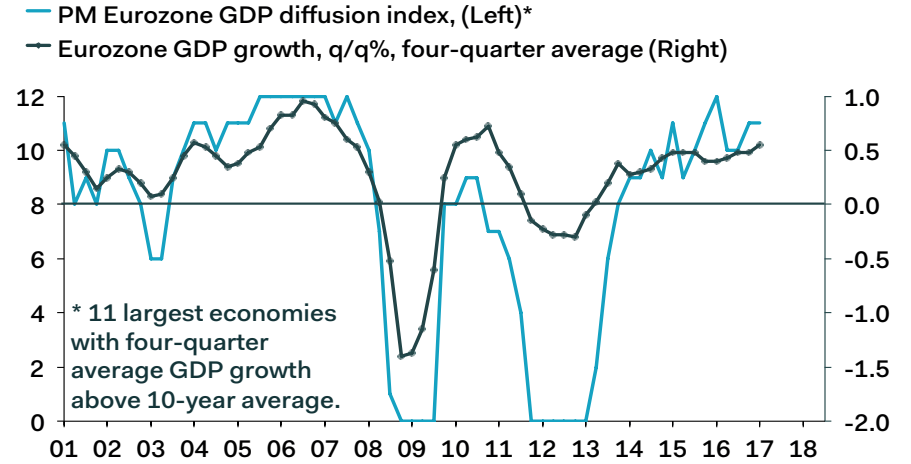
1. THE PMI POINTS TO SOLID Q3 GDP GROWTH IN THE EUROZONE...



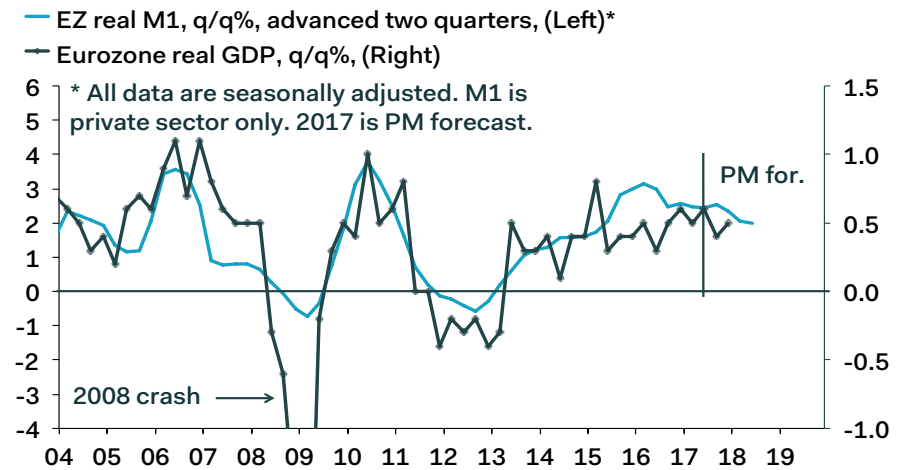
2. ...BUT IT HAS BEEN SLIGHTLY TOO OPTIMISTIC THIS YEAR



3. THE ECONOMIC RECOVERY IN THE EZ IS NOW BROAD-BASED...

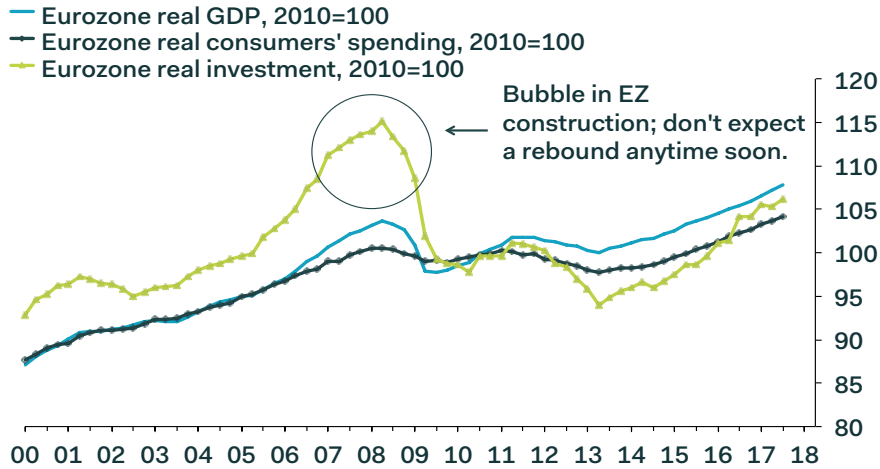


4. ...AND IS SET TO CONTINUE UNTIL Q1 NEXT YEAR, AT LEAST

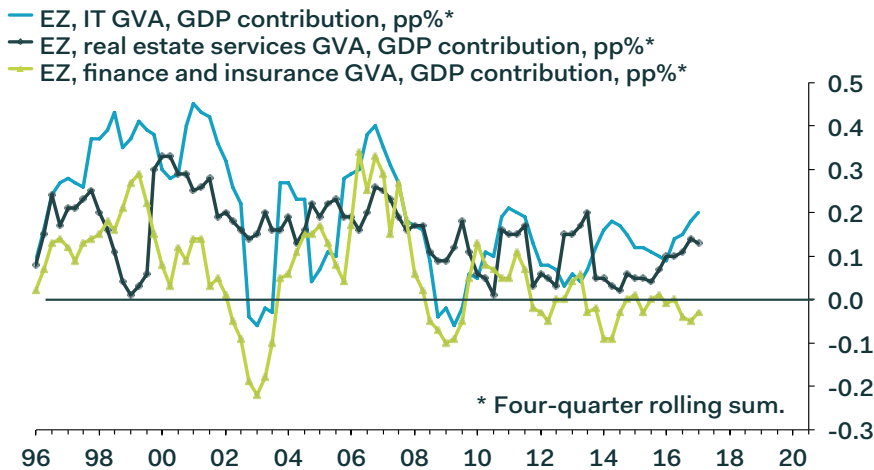




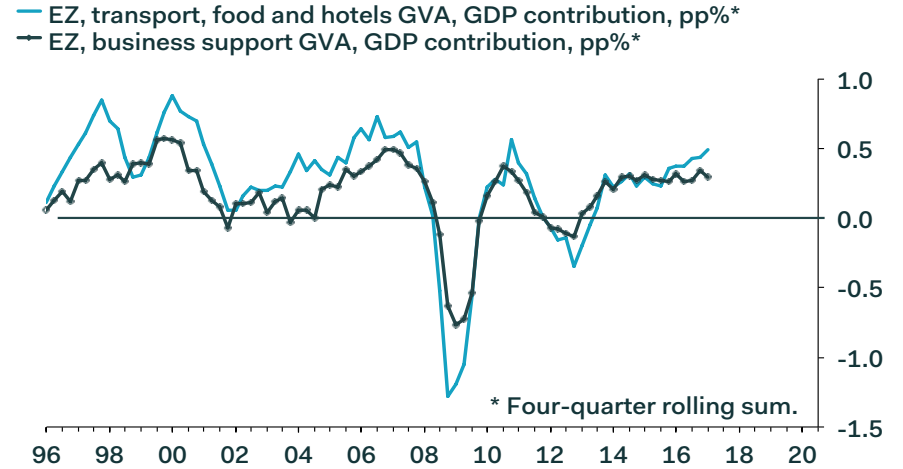
5. SOLID UP-TREND IN THE MAIN EUROZONE GDP COMPONENTS



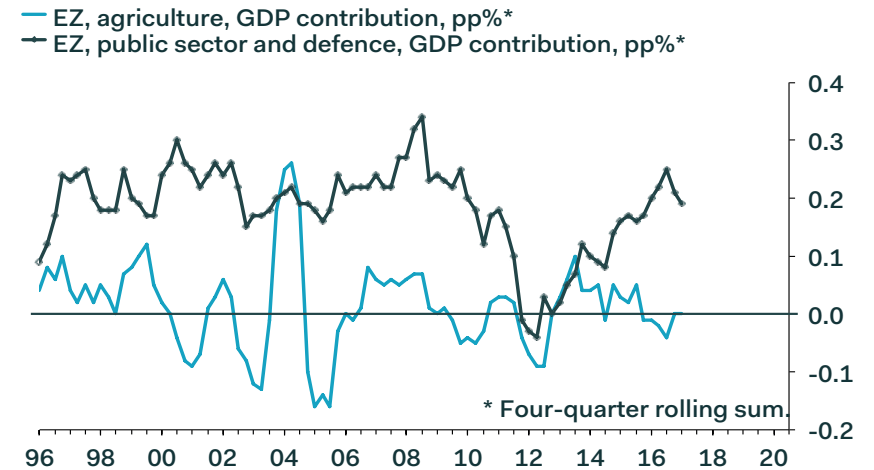
6. FINANCE IS UNDERPERFORMING OTHER KEY SERVICES SECTORS...



7. ...BUT TRANSPORT AND HOSPITALITY ARE FLYING HIGH

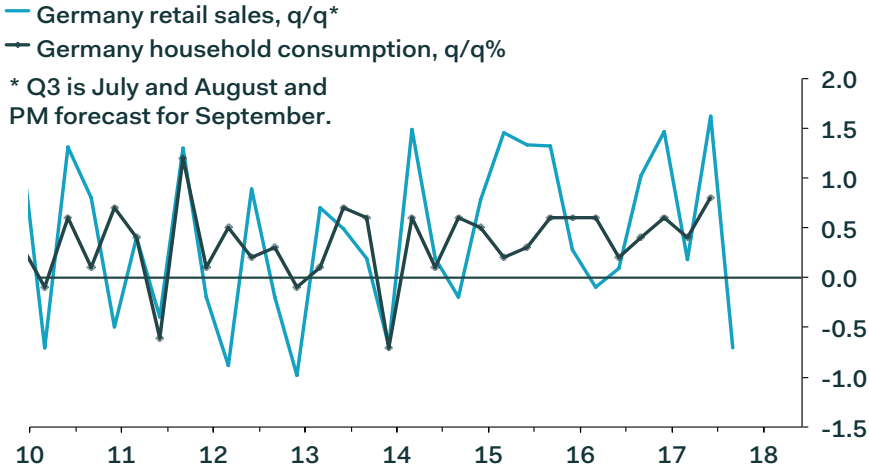


8. THE DRAG ON GROWTH FROM FISCAL AUSTERITY IS OVER

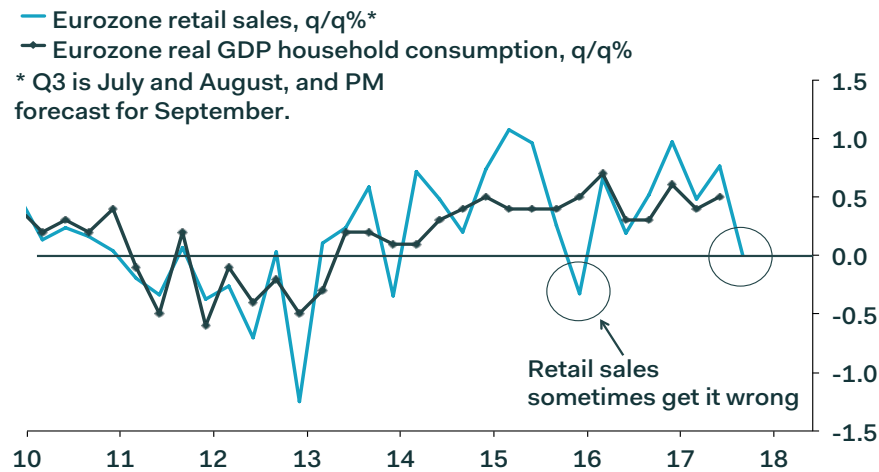




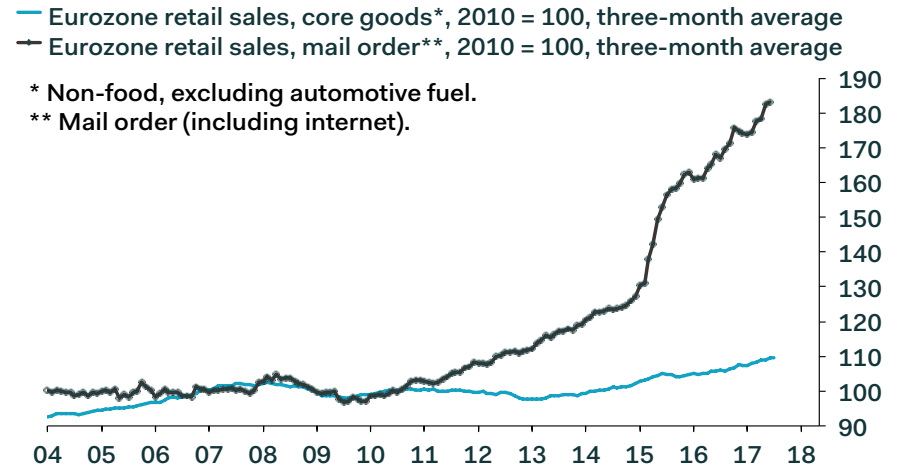
9. BRACE FOR A SLOWDOWN IN GERMAN CONSUMERS' SPENDING IN Q3



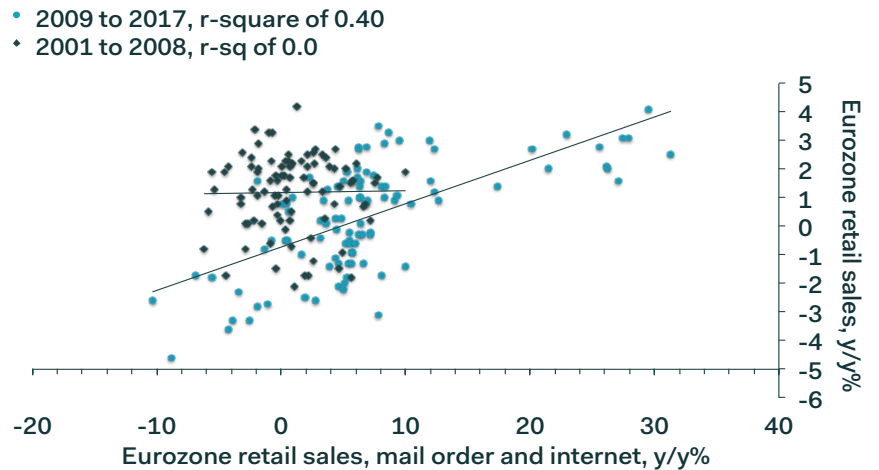
10. ...WHICH PROBABLY WEIGHED ON EZ CONSUMERS' SPENDING



11. EUROZONE ONLINE RETAIL SALES IN GOODS ARE SOARING...



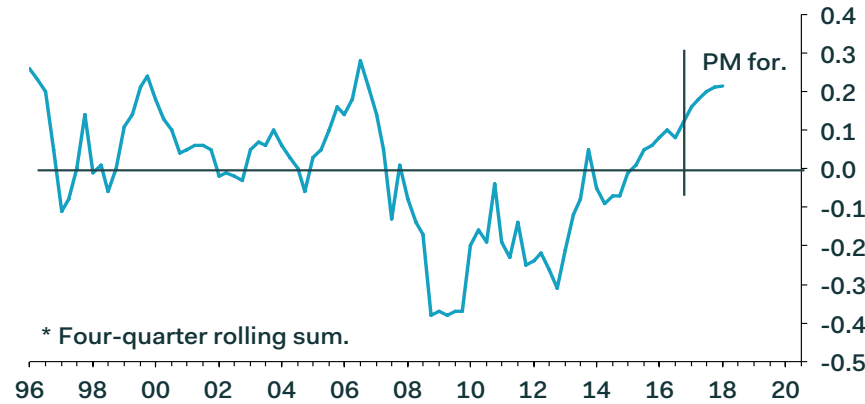
12. ...AND NOW ARE A KEY DRIVER OF THE HEADLINE DATA





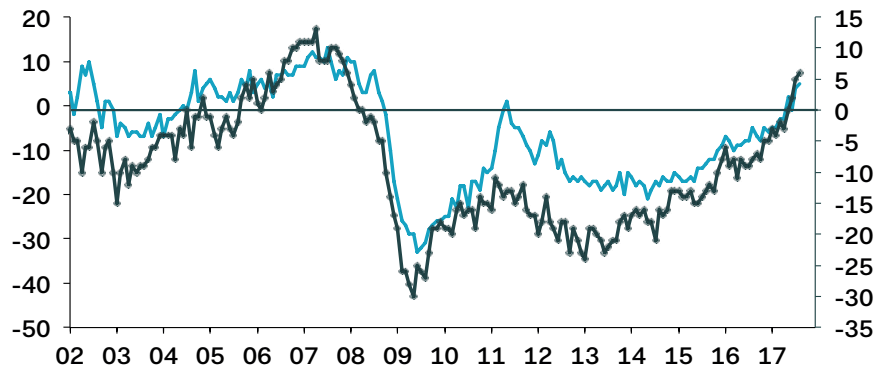
13. EZ CONSTRUCTION SLOWED IN JUNE, BUT SHOULD REBOUND SOON

— EZ, construction GVA, GDP contribution, q/q%, pp*



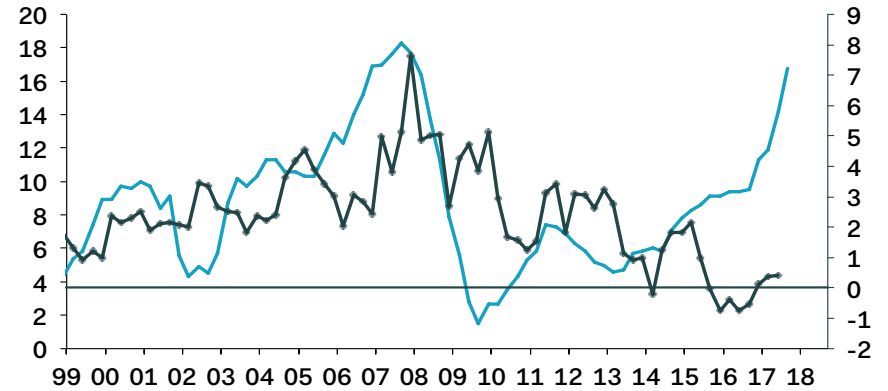
14. LEADING INDICATORS FOR CONSTRUCTION ARE SURGING...

— EZ sentiment, selling price expectations
— EZ construction sentiment, employment expectations



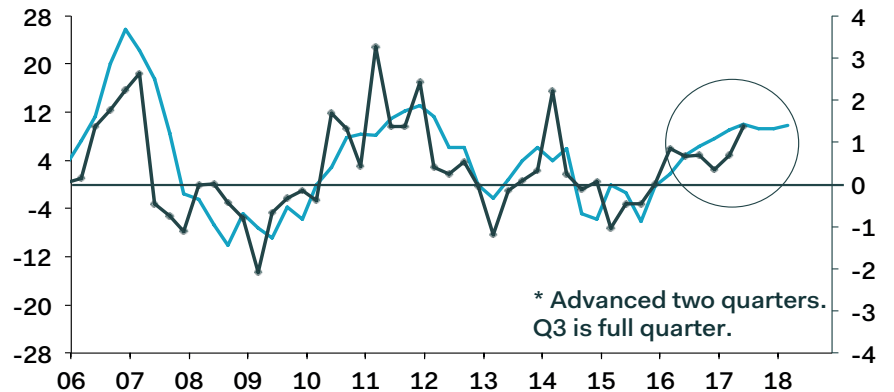
15. AND WAGE PRESSURES SHOULD START TO BUILD SOON

— EC construction sentiment, labour shortages, (Left)
— Eurozone unit labour costs, construction, y/y% (Right)



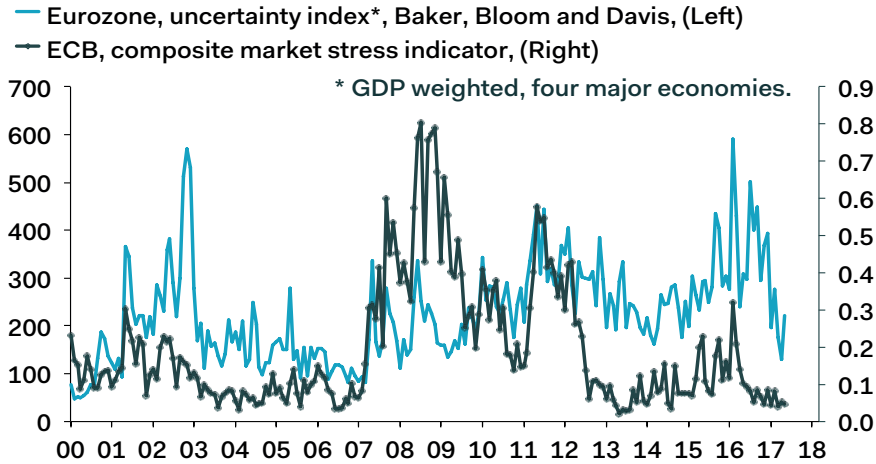
16. ...AND THE STORY IS SIMILAR IN THE FRENCH CONSTRUCTION SECTOR

— IFO business climate index, construction, y/y (Left)*
— Germany, real construction, q/q% four-quarter average, (Right)

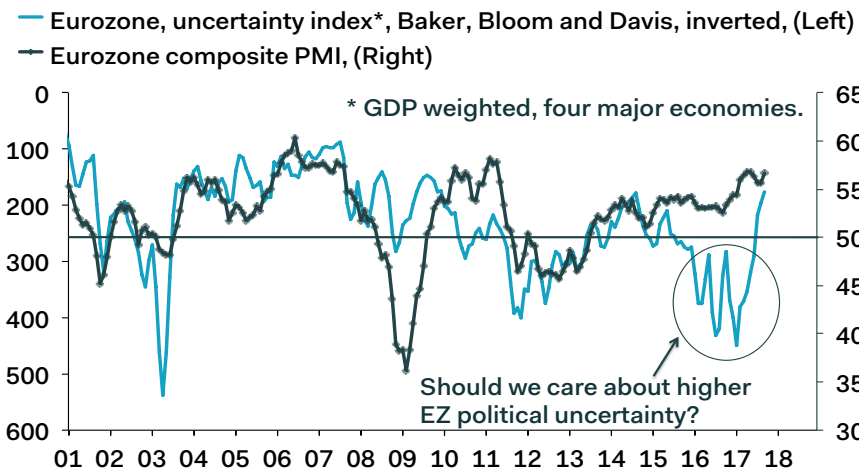




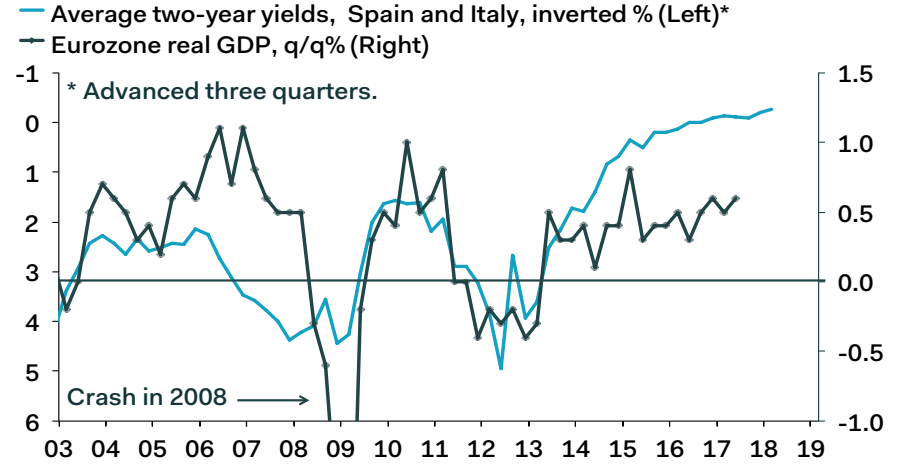
17. MARKETS CAN'T AFFORD TO DISREGARD POLITICAL RISKS...



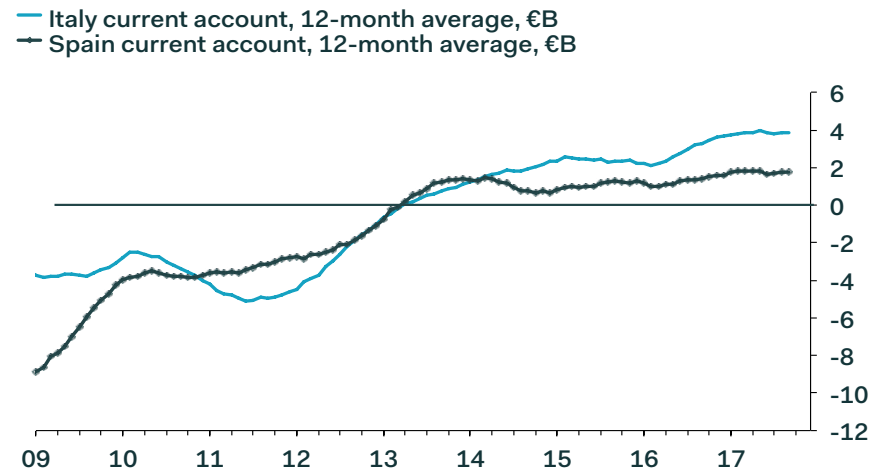
18. ...BUT THE ECONOMY HAS NOT BEEN AFFECT MUCH IN THIS CYCLE



19. FUNDING COSTS IN THE SOUTH IS A GOOD INDICATOR OF STRESS...

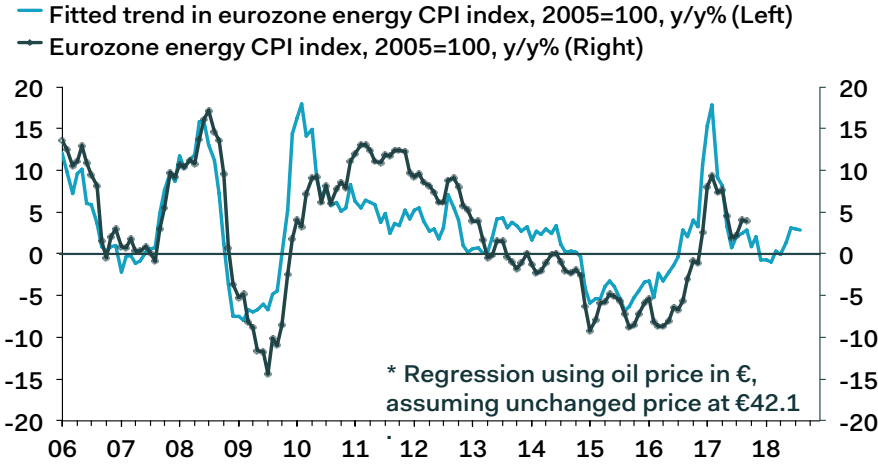


20. ...BUT EXTERNAL SURPLUSES POINT TO LOW RISKS OF A BLOW-OUT

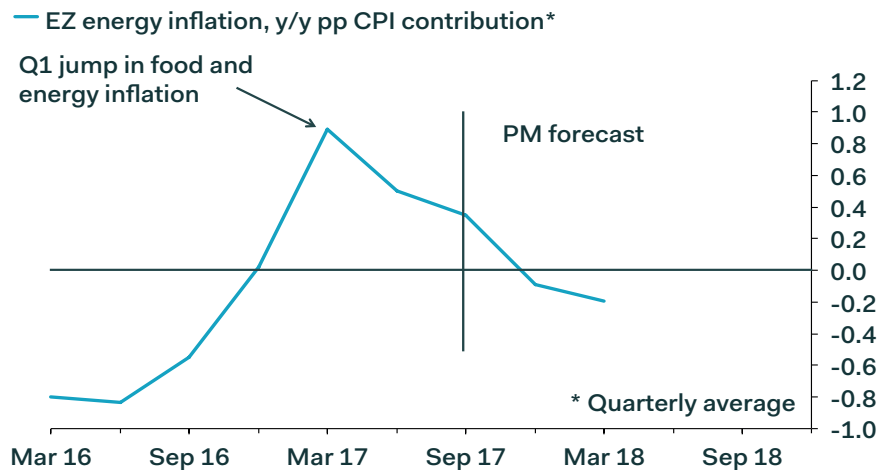




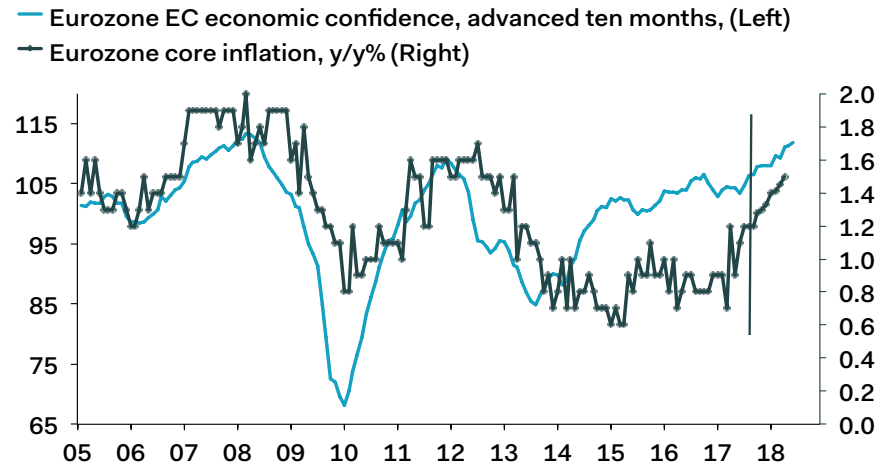
21. EZ ENERGY INFLATION JUMPED IN AUGUST, BUT WILL FALL SOON...



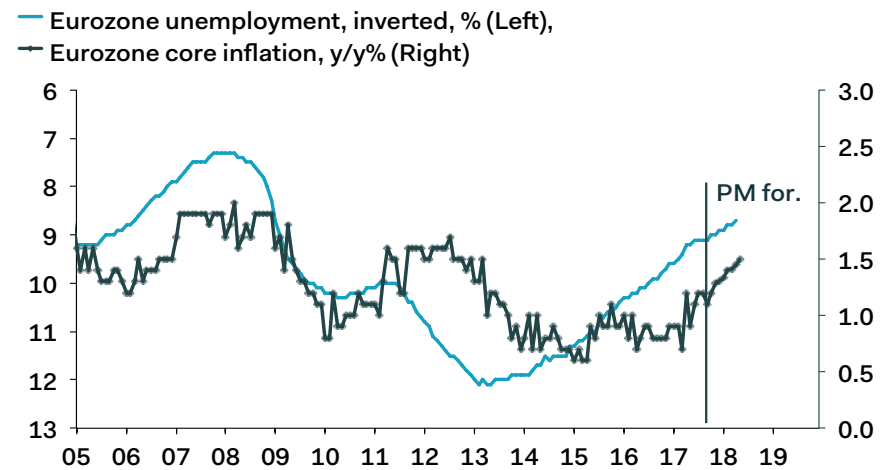
22. ...IT LIKELY WILL BE A DRAG ON THE HEADLINE IN Q4 AND Q1



23. BUT CORE INFLATION IS NOW RESPONDING TO STRONGER GROWTH...

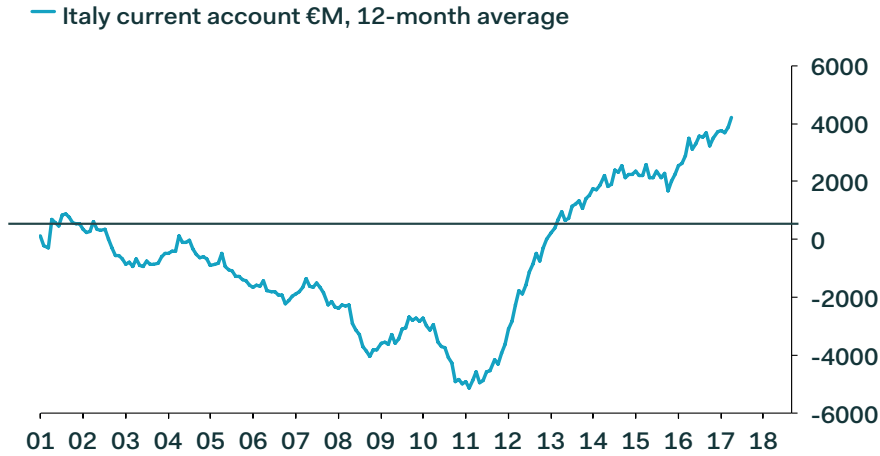


24. ...AND A TIGHTER LABOUR MARKET ALSO SIGNALS A HIGHER CORE RATE

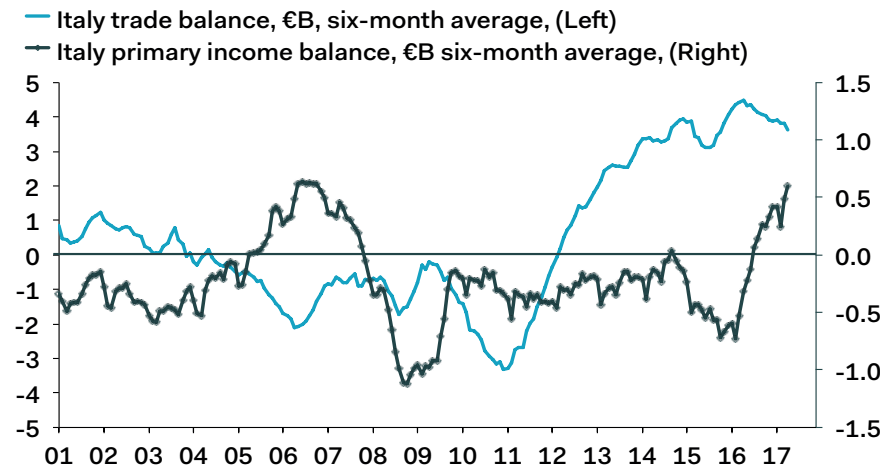




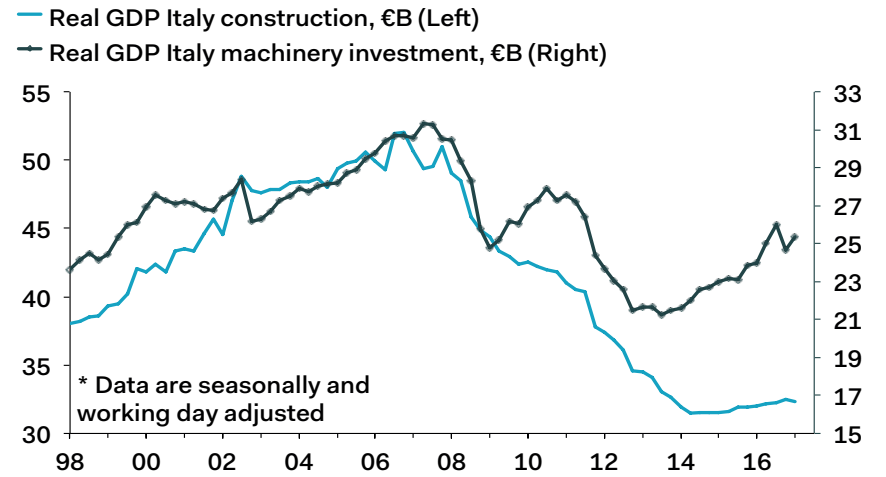
25. THE ITALIAN CURRENT ACCOUNT SURPLUS IS SOARING...



26. ...MAINLY DUE TO A JUMP IN NET FOREIGN ASSET INCOME



27. CONSTRUCTION SHOULD BE A KEY SOURCE OF UPSIDE SURPRISES



28. WILL ITALIAN BOND SPREADS WIDEN INTO NEXT YEAR'S ELECTION

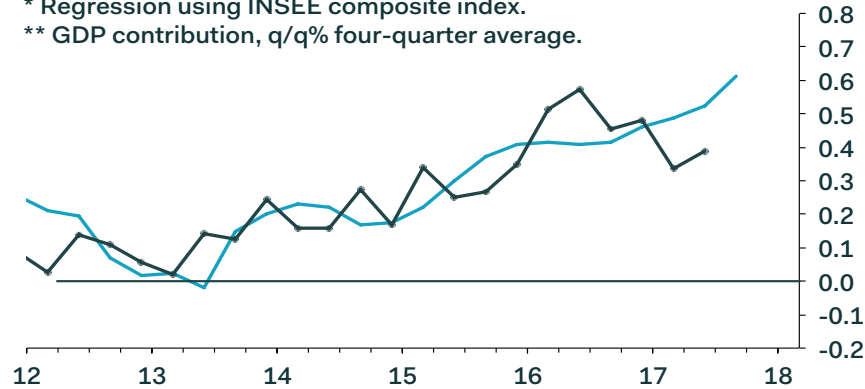




29. DOMESTIC DEMAND GROWTH IN FRANCE SHOULD PUSH HIGHER

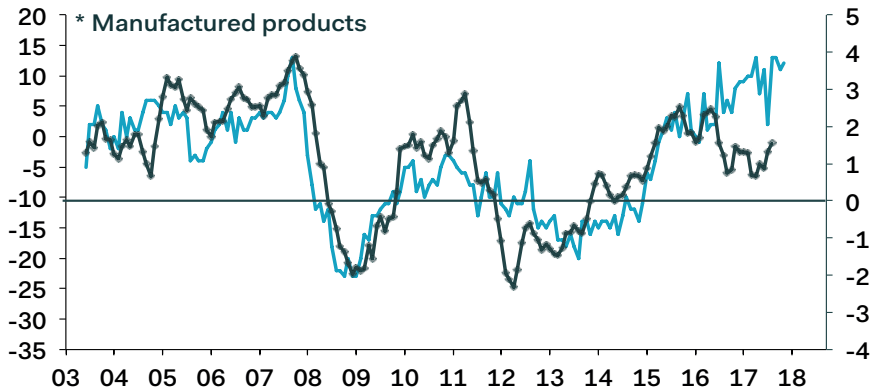
— France GDP, domestic demand ex-inventories, fitted q/q%*
— France GDP, domestic demand ex-inventories, q/q%**

* Regression using INSEE composite index.
** GDP contribution, q/q% four-quarter average.



30. CONSUMERS' SPENDING SHOULD ACCELERATE FURTHER IN Q4

— INSEE, buying opportunities, advanced three months (Left)
— France, consumer spending*, y/y% three-month average (Right)



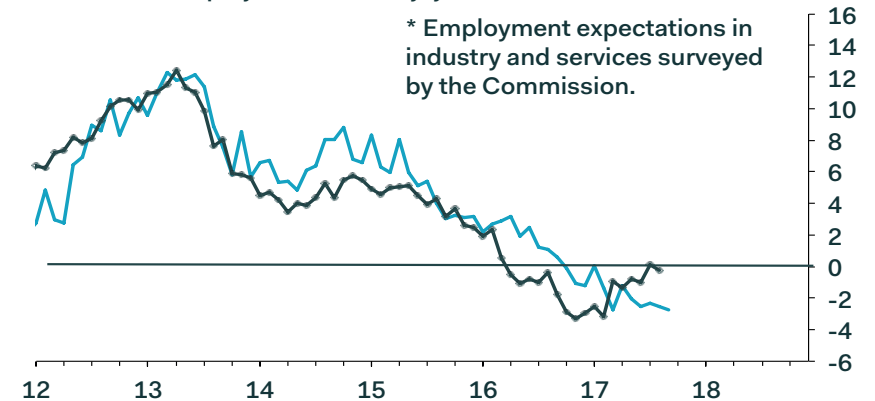
31. FRENCH UNEMPLOYMENT HAS ODDLY JUMPED IN RECENT MONTHS...

— INSEE, unemployment expectations, (Left)
— Unemployment rate France, % (Right)

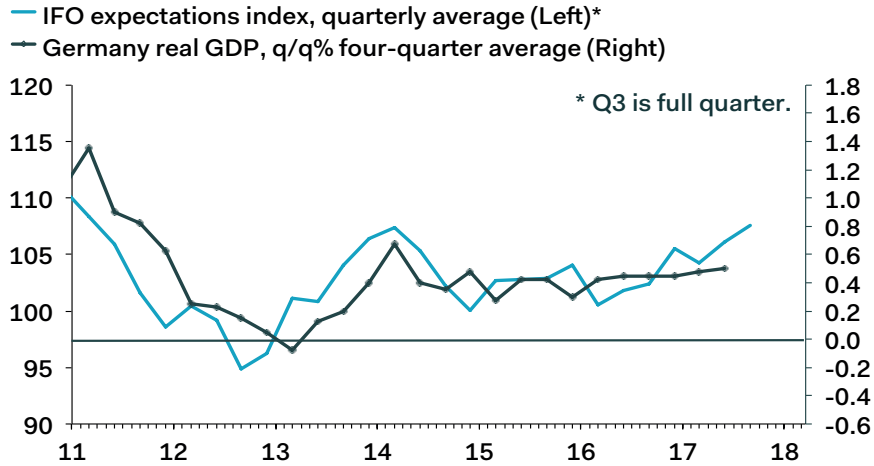


32. BUT WE DOUBT THE INCREASE WILL BE SUSTAINED FOR LONG

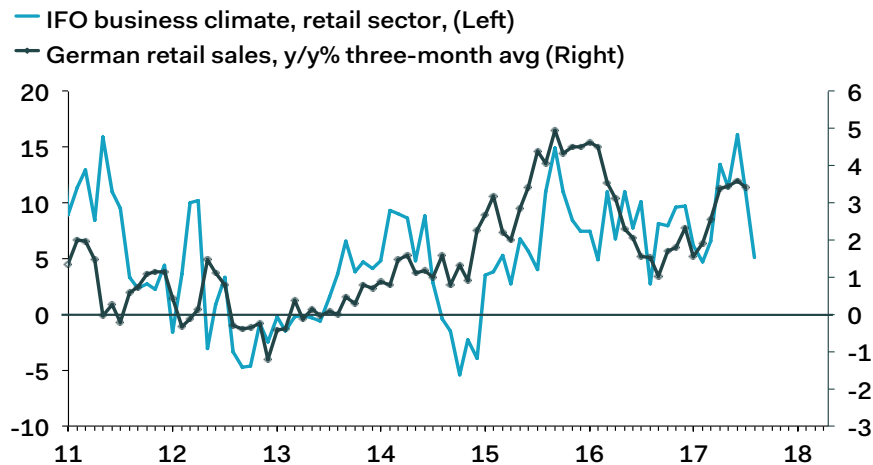
— France, modeled unemployment claims*, y/y%
— France, unemployment claims, y/y%



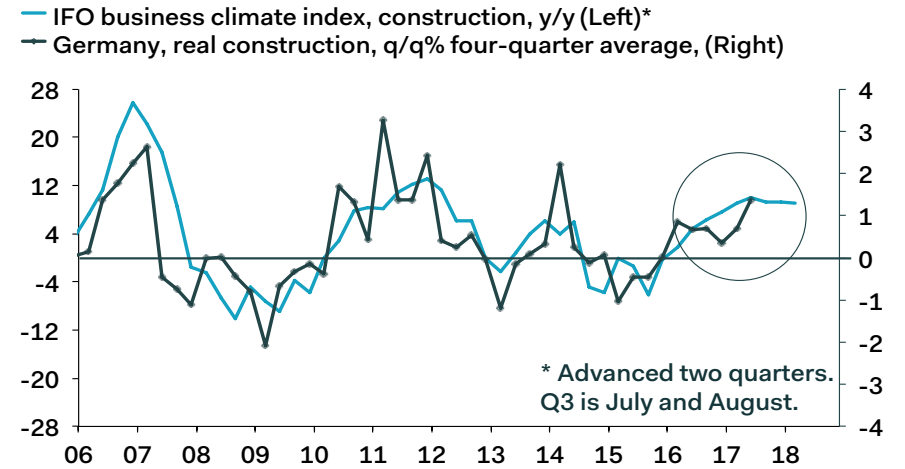
33. THE NEAR-TERM OUTLOOK FOR THE GERMAN ECONOMY IS ROBUST



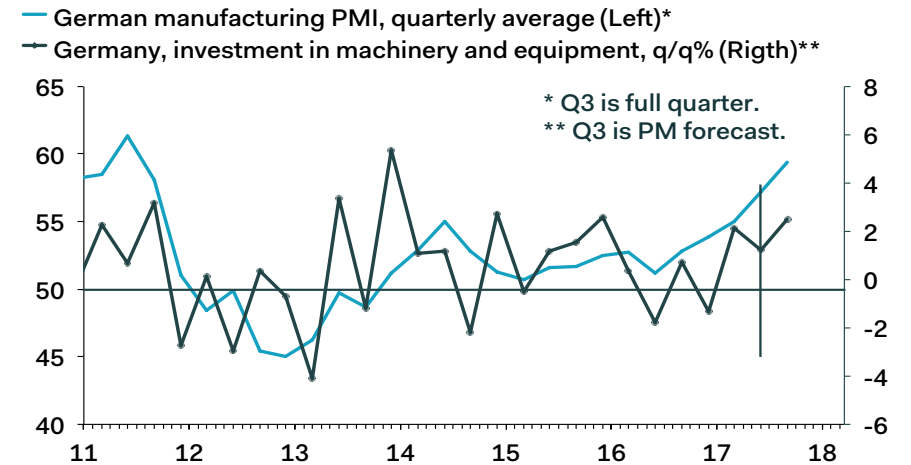
33. RETAIL SALES COULD SLOW IN THE COMING MONTHS...



34. ...BUT CONSTRUCTION INVESTMENT IN GERMANY IS SIZZLING

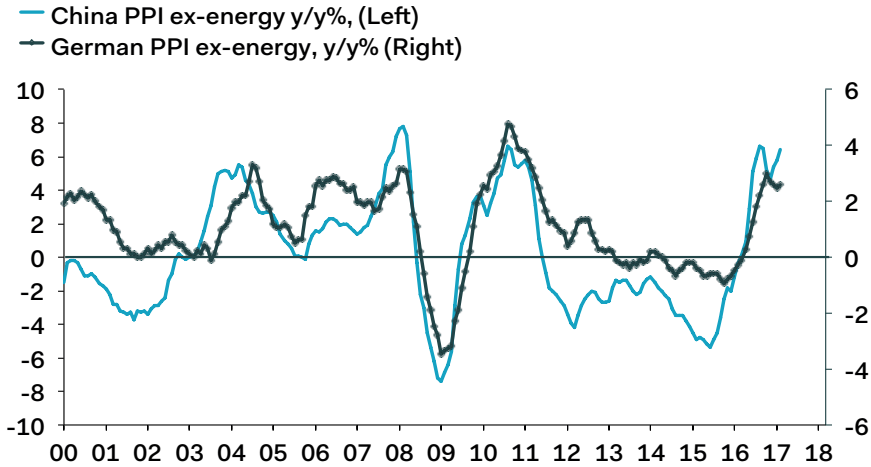


35. ...AND THE OUTLOOK FOR MANUFACTURING IS SOLID TOO

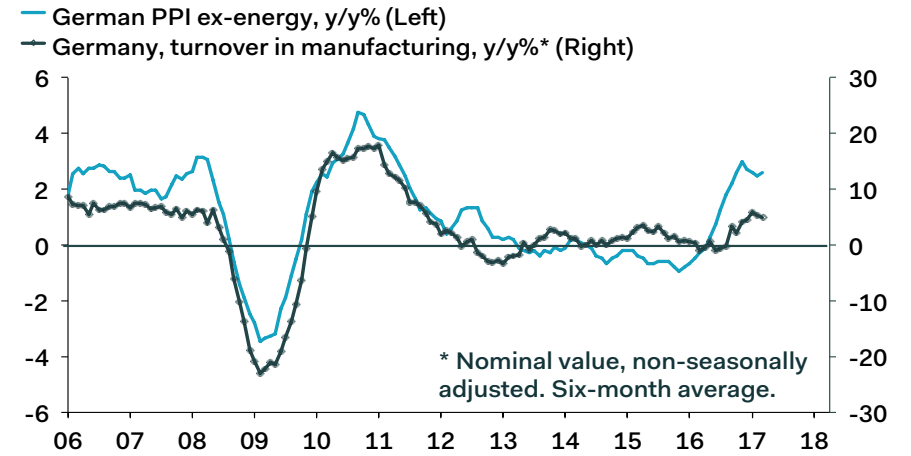




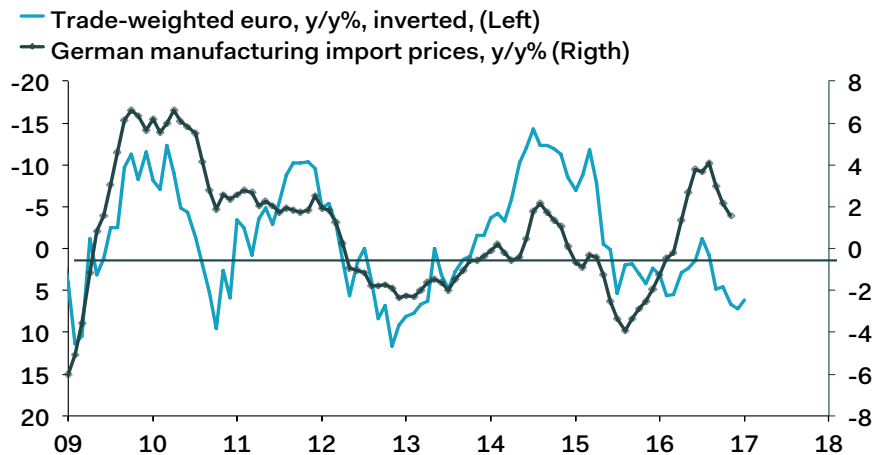
36. GERMAN CORE PPI SHOULD STAY RESILIENT IN THE SHORT TERM...



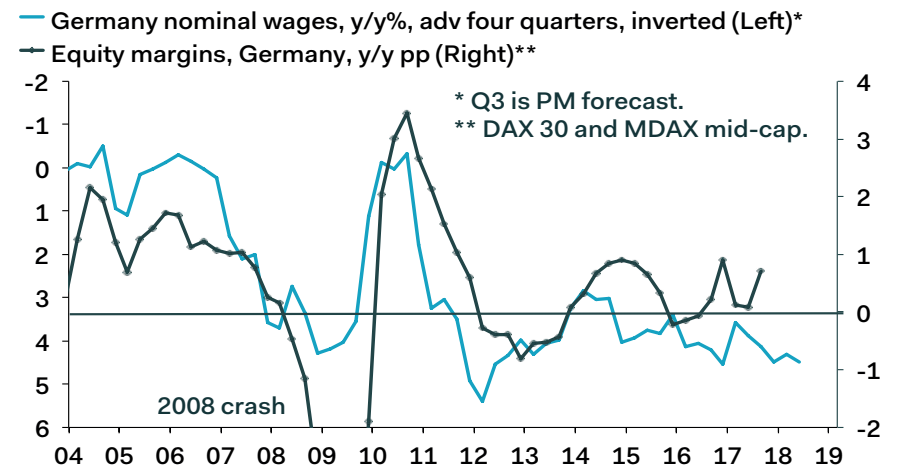
38. A DROP IN PPI INFLATION WOULD DENT REVENUE GROWTH ...



37. ...BUT A STRONGER EURO HINTS AT LOWER IMPORT PRICE INFLATION

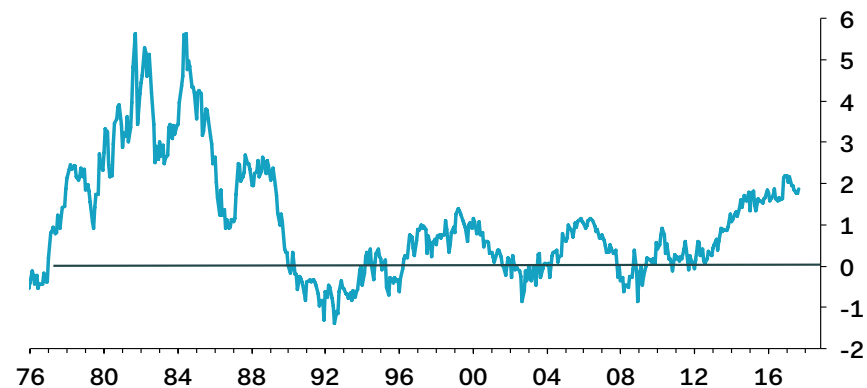


39. ...AND HIGHER WAGES COULD THREATEN MANUFACTURING MARGINS



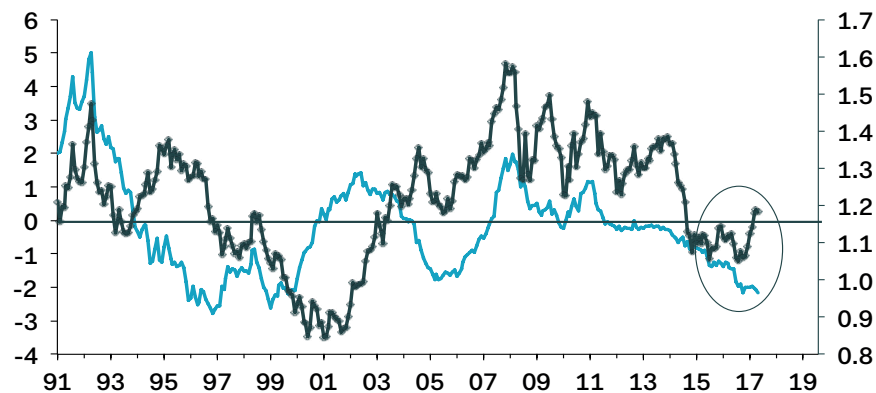
40. LONG-TERM BOND SPREADS ARE WIDE, BUT COULD WIDEN FURTHER

— U.S. 10-year yield less German 10-year yield, %



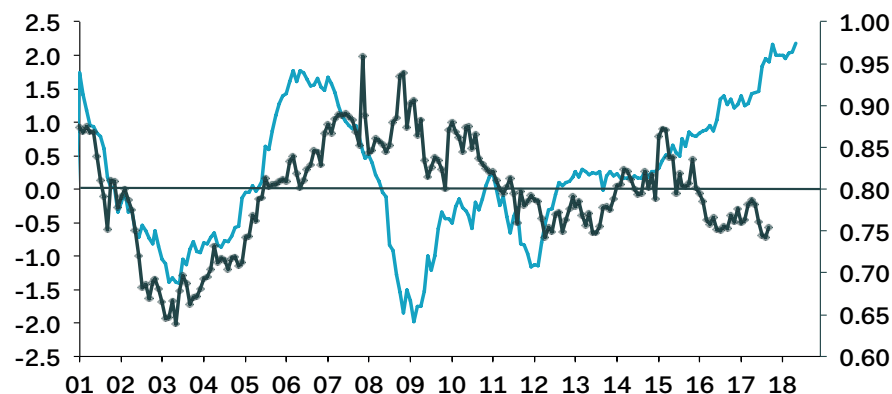
41. EITHER THE CURRENCY OR THE BOND MARKET IS WRONG

— German 2-year yield less U.S. 2-year yield, % (Left)
— EURUSD, (Right)



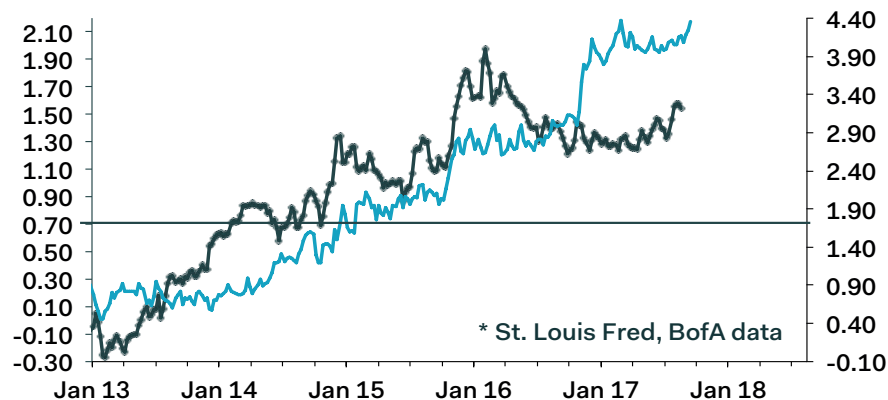
42. WILL RELATIVE EZ EQUITY VALUATIONS PUSH HIGHER SOON?

— Two-year yield, U.S. less Eurozone, advanced eight months, % (Left)
— Price-to-sales-ratio MSCI EU ex-UK to MSCI World, (Right)



43. FURTHER RELATIVE SPREAD TIGHTENING IN THE EUROZONE?

— Eurozone-U.S. high yield bond spread %, (Right)*
— US 2-year yield less eurozone 2-year yield, % (Left)



Economic Activity (y/y%)

	2015	2016	2017	2018	2019
Eurozone GDP	2.0	1.8	2.0	1.7	1.5
Contribution of Household Consumption	1.0	1.1	0.8	0.5	0.4
Contribution of Government Consumption	0.3	0.3	0.4	0.3	0.4
Contribution of Investment*	0.9	1.1	0.8	0.6	0.5
Contribution of Net trade	-0.3	-0.6	0.0	0.0	0.2
Germany GDP	1.3	1.9	2.2	1.7	1.5
France GDP	1.0	1.2	1.6	1.6	1.4
Italy GDP	1.0	1.1	1.4	1.3	1.3
Spain GDP	3.5	3.0	2.9	2.6	2.4

Labor Market and Prices

Eurozone unemployment (end of year)	10.4	9.6	8.9	8.6	8.5
Eurozone headline CPI y/y% (end of year)	0.2	1.1	1.1	1.7	1.6
Eurozone core CPI y/y% (end of year)	0.9	0.9	1.4	1.6	1.6
Eurozone labour productivity growth y/y%	0.9	0.9	1.1	1.0	0.9

Other

Eurozone current account, % GDP, Q4	3.2	3.4	2.9	2.7	2.5
Eurozone budget deficit, % GDP	-2.1	-1.5	-1.4	-1.6	-1.8
Government debt, % GDP	90.4	89.2	88.0	88.5	89.5
ECB refi rate, Q4 average	0.05	0.00	0.00	0.00	0.30
10-year benchmark rate, Q4 end	0.6	0.3	0.7	1.1	1.2
Eurostoxx, Q4 end	3267	3300	3750	3850	3700
ECB deposit rate, Q4 average	-0.3	-0.4	-0.4	-0.4	0.0
ECB Monthly QE pace, Q4 average	N/A	€80B	€60B	€20B	€0B

* Includes inventories