Eurozone retail sales likely slowed sharply in Q3, pointing to downside risks for consumption...

...But services spending growth was stable, and survey data suggest retail sales will rebound soon.

Household balance sheets in the Eurozone are strengthening, which will support spending.

Consumers' Spending in the Eurozone Slowed in Q3

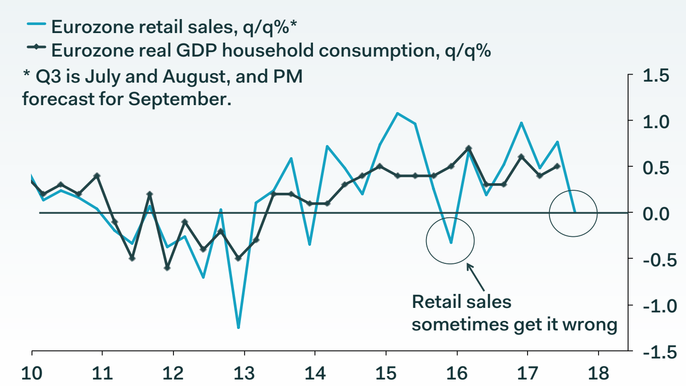
Yesterday's economic reports in the Eurozone will rekindle the debate on hard versus soft data. The final composite PMI rose to 56.7 in September, from 55.7 in August, in line with the first estimate. The report confirmed robust headlines in France and Germany, although the final readings were marginally lower than the initial estimates. The composite PMI in Spain also rose, while the Italian index dipped, due to weaker activity in services. Overall, the Eurozone headline was buoyed by strong activity in both manufacturing and services. This suggests that private sector activity in the Eurozone accelerated at the end of Q3, signalling upside risk to GDP growth. ***Hard data, however, are telling a story of more modest growth in Q3.***

Yesterday's EZ retail sales report is a case in point. Sales slipped 0.5% month-to-month in August, pushing the year-over-year rate down to 1.2% from a downwardly-revised 2.3% in July. The headline was constrained by weakness in France and Germany, but smaller economies, such as Austria and the Netherlands, also registered month-to-month declines.

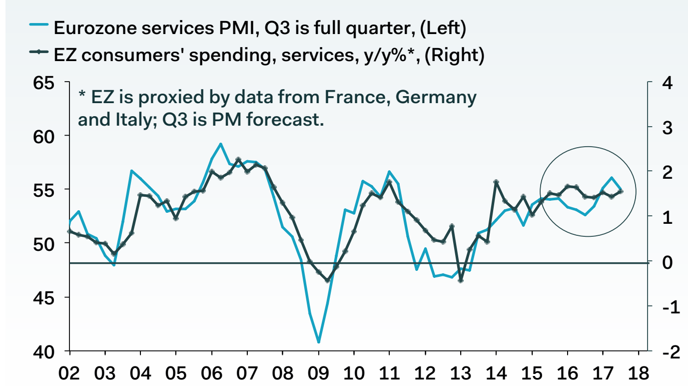
Barring an upward revision, these data suggest that euro area consumers' spending slowed significantly in the third quarter. We think sales rebounded to a 0.5% month-to-month rise in September, but this is not enough to prevent a grim forecast for Q3 as a whole. *We think retail sales were flat quarter-on-quarter, slowing sharply from a 1.0% jump in Q2.* A third quarter slowdown in consumption would support our view that slower real wage growth means that EZ consumers' spending is *not* accelerating in 2017.

Leading indicators, though, suggest that growth in retail sales is higher than implied by the August report. The Commission's headline consumer sentiment index implies that the underlying trend in retail sales growth is just under 3% year-over-year, and consumers' liquidity position also is robust. Growth in households' overnight deposits has slowed in the past six months, but it remains robust at just above 10% year-over-year.

RETAIL SALES POINT TO Q3 WEAKNESS IN CONSUMERS' SPENDING...



...BUT THE TREND IN SERVICES SPENDING GROWTH IS MORE STABLE



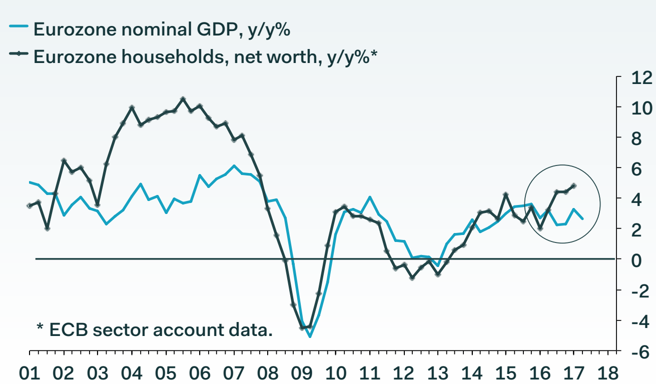
Additionally, consumers' spending in the Eurozone doesn't always track retail sales. Services spending accounts for just over half of total consumption, and the trend is more stable than in retail sales. The PMI signals Q3 consumption growth of about 1.5% year-over-year, enough to keep the quarter-on-quarter rate stable at 0.4%.

EZ households' balance sheets look robust

Looking beyond the Q3 story, the fundamentals are for households in the Eurozone as a whole look robust. Growth in gross disposable income—wage and non-wage earnings—increased to a post-crisis high of 3.2% year-over-year in the first quarter, offering strong support for consumption. Since the first quarter of 2016, growth in income has *exceeded* the rise in gross savings by about 2% on average. This is in contrast to earlier in the business cycle, from 2013 to 2015, when savings rose rapidly, as households were compensating for the hit to their balance sheets during the sovereign crisis. Whatsmore, the improvement in consumers' balance sheets is significant.

In Q1, the excess growth rate of EZ households' net worth over nominal GDP was at its highest since 2007. Financial markets have recovered from the crises in 2009 and 2012, and *house prices* now are rising again in all the major euro area economies. We doubt that momentum in net worth will rise to the heights of the pre-crisis boom, but the trend in consumers' wealth already signals upside risk to nominal GDP growth.

EUROZONE HOUSEHOLDS' BALANCE SHEETS ARE IMPROVING...



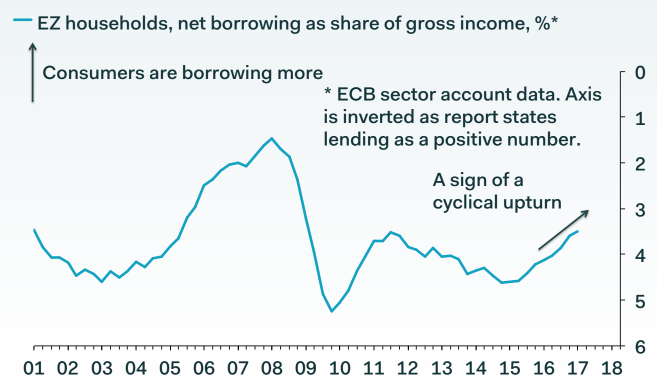
* ECB sector account data.

Also, households' net borrowing is rising again, which is a good indicator that the overall economy is in the midst of a cyclical upturn. Our final chart shows that net borrowing as a share of disposable income has been rising since the middle of 2015, consistent with the trend in the business upturns from 2002 to 2007 and the period right after the financial crisis.

Mortgages, which is 75% of total consumer debt outstanding, are the main driver of new household lending. It is rising about 3% year-over-year, at just about the same pace of nominal GDP growth. Growth in consumer credit, however, is rising nearly 6% year-over-year, *above* the pace of income and nominal GDP growth. This suggests that persistently low interest rates are pushing households to take on unsecured debt at a rate that can't be sustained. ***But we doubt that the good times will end anytime soon.***

Bad memories from the financial crisis mean that consumers will not go on a borrowing spree similar to in 2006 and 2007. But the current trend will continue in the near term, given the ECB's commitment to keep rates close to record low until the end of 2018, at least. A sharp rise in short-term interest rates independent of the ECB's policy stance—most likely in the periphery—would sting consumers, but this is unlikely. *Southern Europe runs current account* surpluses *now, which making it easier for the ECB to keep rates low.*

...CREATING INCENTIVES TO TAKE ON MORE DEBT



* ECB sector account data. Axis is inverted as report states lending as a positive number.

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THIS WEEK IN BRIEF

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

Monday, October 2

• **D: Final Manufacturing PMIs, Eurozone (9) 10:00 CET**
The Eurozone manufacturing PMI rose to a cyclical high of **58.1** in September, from 57.4 in August, slightly lower than the initial estimate 58.2. The advance data suggest that the rise was driven by better data in France and Germany. Headline PMIs in Spain and Italy, however, likely dipped slightly.

• **D: Unemployment, Eurozone (8) 11:00 CET**
The headline unemployment rate in the Eurozone was unchanged at **9.1%** in July. We think unemployment will fall further in Q4. We also think the recent nudge higher in French unemployment will reverse soon.

Tuesday, October 3
No significant data released.

Wednesday, October 4

• **D: Final PMIs, Eurozone (9) 10:00 CET**
The composite PMI in the euro area rose to **56.7** in September from 55.7 in August. The headline was boosted by strong manufacturing data in Germany. The PMI signals upside risks to GDP growth in the third quarter, but has been too optimistic in the past 12 months.

• **D: Retail Sales, Eurozone (8) 11:00 CET**
Retail sales in the Eurozone fell **0.5%** month-to-month in August, pushing the year-over-year rate down to 1.2%, from a downwardly revised 2.3% in July. Consumers' spending growth in the Eurozone is robust, but likely will slow in Q3. Sentiment is soaring, but real wage growth has slowed due to higher inflation and still-sluggish nominal wage momentum in most countries, with the exception of Germany.

Thursday, October 5
No significant data released.

Friday, October 6

• **Industrial Production, Spain (8) 08:00 CET**
We think industrial production rose **1.6%** month-to-month in August, pushing the year-over-year rate up marginally to 2.0%, from 1.9% in July. The Spanish economy remains the star-performer among the major economies in the Eurozone. We think full-year growth will be stable in 2017 at about 3% year-over-year. **Consensus: +0.1%.**

• **D: Factory Orders, Germany (8) 08:00 CET**
Factory orders in Germany likely jumped **1.6%** month-to-month in August, pushing the year-over-year rate up to 5.5%, from 4.9% in July. Survey data suggest that new orders growth will rise further in coming months. **Consensus: 0.7%.**

• **D: Trade Balance, France (8) 08:45 CET**
We think the French trade deficit narrowed to **€5.5B** in August, from €6.0B in July. Imports likely fell month-to-month, following the leap in July, while exports probably rose further. Overall, we think net trade will be a drag on quarter-on-quarter GDP growth in the third quarter. **Consensus: €5.4B.**

• **D: Budget Balance, France (8) 08:45 CET**
The nominal budget deficit in France likely widened to **€99.0B** year-to-date in August, about €3.0B higher than the deficit in the same period last year. Mr. Macron has vowed to cut expenditures, but we won't know until next year whether he will be successful. **Consensus: N/A.**

PANTHEON EUROZONE FINANCIAL CONDITIONS DASHBOARD

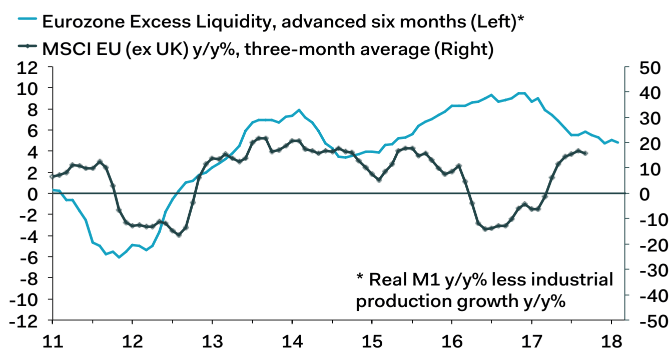
Market	Valuation*	Six month change, %	y/y, %
Eurostx 50	0.0	2.2	19.2
Dax 30	-0.2	3.7	21.5
CAC 40	0.0	3.6	19.3

* 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)	-2.0	+9.5	+59.9
FRA (10-2)	-2.1	-1.8	+41.6
ITA (10-2)	-0.8	+4.0	+106.7

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

EUROZONE EXCESS LIQUIDITY VS MSCI EU (EX UK)



The MSCI EU ex-UK continued to push higher in September, and starts Q4 on the front foot. The index is up nearly 10% year-to-date, but if returns follows the trend in excess liquidity, the performance should improve in Q4.

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

GDP			
Q3 16	0.3	2015 year:	2.0
Q4 16	0.5	*2016 year:*	*1.8*
Q1 17	*0.5*	*2017 year:*	*2.0*
Q2 17(A)	*0.6*	*2018 year:*	*1.7*
Q3 17 forecast	*0.5*		

CPI y/y, %		Unemployment, %	
September	1.5%	July	9.1%
October	*1.4%*	*August*	*9.0%*
November	*1.2%*	*September*	*9.0%*
December	*1.1%*	*October*	*8.9%*
January	*1.1%*	*November*	*8.9%*