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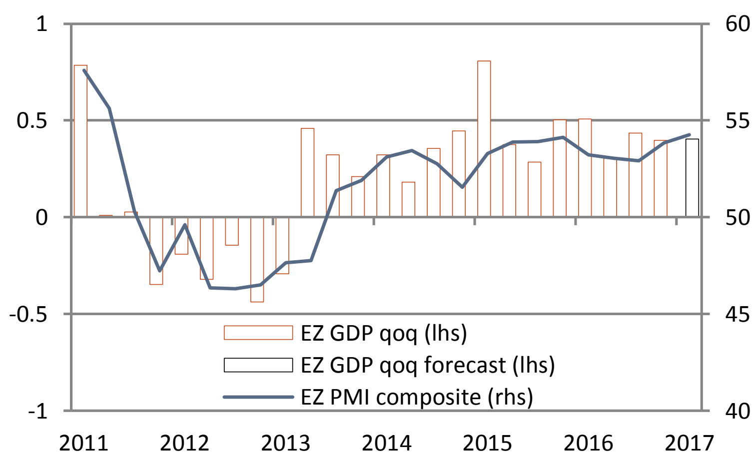
EUROZONE MACRO UPDATE: GROWTH AT TREND, OUTLOOK REMAINS POSITIVE

Berenberg Macro Flash

Eurozone Q4 GDP (2nd reading) – encouraging, broad-based growth at trend: Recovery in the Eurozone is on track, even though the second reading of Eurozone GDP for Q4 2016 came in below the first estimate, with the rate of expansion of 0.4% qoq falling short of the 0.5% released two weeks ago. Most likely, weaker-than-expected industrial production in major countries in December contributed to a lower second reading (with Italy being the exception). For the Eurozone on average industrial production fell by 1.6% mom in December, after growth of 1.5% in November. The sector, nevertheless, provided a positive contribution to the overall quarterly GDP number. Taking the three months of Q4 together, industrial production has grown by 0.8% qoq. For a more detailed analysis of the GDP expenditure components, we have to wait until 7 March for the third reading. On the back of solid industrial production, we expect investment recovered in most countries. The major contribution, however, continues to be household spending. As the recovery continues, employment gains and modestly rising wages support consumption. The neutral fiscal stance, if not fiscal stimulus in some countries also helps.

The outlook for 2017 remains positive. That the outlook is positive across the whole Eurozone, core and periphery, is especially encouraging. Leading indicators such as the PMIs and the European Commission's sentiment indicators, show that activity and confidence either held up or even improved at the start of 2017 (see **chart 1**). Of course, it is early on in the year, and the fit between surveys and hard data isn't always perfect. Nevertheless, with a small fiscal stimulus in most parts of the Eurozone and a very accommodative ECB monetary policy, the Eurozone seems to be on track for a year of growth at trend averaging 0.4% qoq per quarter in 2017 and 1.7% for the year overall. While a potential fiscal boost in the US and the on-going global upturn in demand suggest an upside risk to our outlook, political risks loom larger than before and warrant some modest caution.

Chart 1: Eurozone GDP qoq (in %) versus quarterly PMI composite



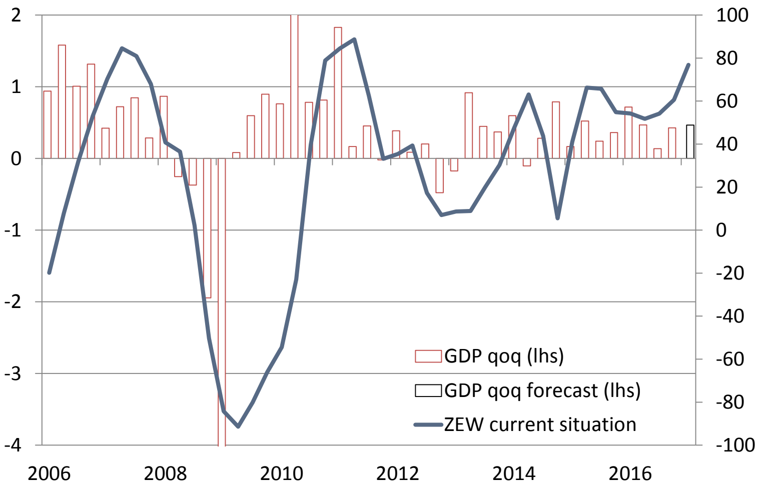
Source: Eurostat, Markit, Berenberg calculation

German Q4 GDP (1st reading) – growth accelerates to 0.4% qoq, outlook solid: While surprising on the downside, the German economy expanded by a rate of 0.4% in Q4 2016 and, thereby, recovered from the Brexit dent in Q3 (0.1%). The annual figure for growth of the Eurozone's largest economy in 2016 is 1.7%. Both the quarterly and annual figure came in below expectations, after an annual figure of 1.8% released on January 12 suggested growth of 0.5% qoq in Q4 2016 (the rate for Q3 was also revised down from 0.2%). While today no expenditure components were published, the German statistical office reported that economic activity picked up in Q4 on the back of stronger government consumption, a small gain from private consumption, a positive contribution from investment (especially building).

For 2017, we expect the shift from private consumption to government consumption and investment to continue. Energy prices are higher today, thereby, not providing the strong impulse to real disposable income and household spending they used to provide in 2016, on the one hand. The government, on the other hand, has turned into fiscal stimulus mode, with probably more to come after the elections in September. Investment could benefit from a Trump-led US recovery. According to PMI survey results, manufacturing companies have started to gear up their expansion plans. This would also boost exports. In Q4 2016, net trade, however, dragged down the overall number as imports increased by more than exports.

German ZEW – sentiment softer, but at high level: The headline expectations indicator of the ZEW survey dropped to 10.4 in February, from 16.6 in January. The drop comes after 6 consecutive months of improving sentiment since the post-Brexit low in July. The ZEW survey is the first of Germany's main surveys to be released in February. A major move usually signals turning points in the economy up to six months in advance. While confidence has weakened, we do not expect that we are at a turning point. What may have caused financial experts to turn more cautious this month could be concerns about the upcoming elections in Europe, a renewed crisis in Greece and some noise from US President Trump about protectionism. The indicator for the assessment of the current situation also fell, from 77.3 to 76.4, but remains at a high level after previously strong gains (January was the highest level since July 2011, see **chart 2**). The current assessment mostly reflects hard data for the last few months, hence relates to Q4. Recently softer data (industrial production and exports) may have weighed on sentiment.

Chart 2: German GDP qoq (in %) versus ZEW current situation

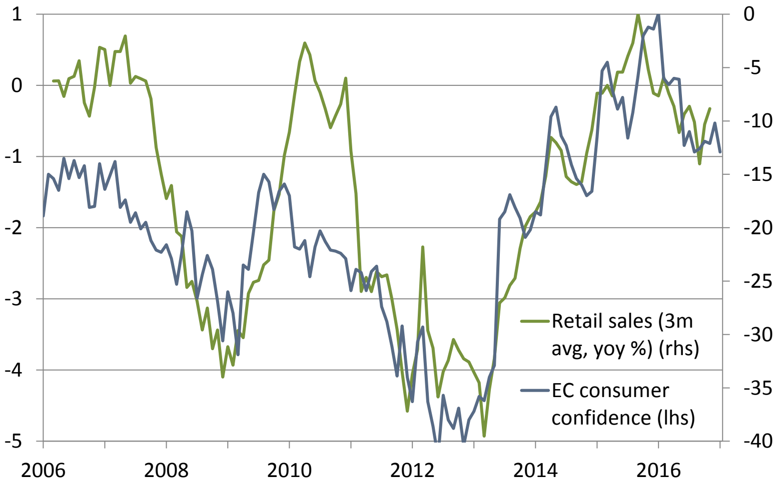


Source: Destatis, ZEW, Berenberg calculation

Italian Q4 GDP (1st reading) – sluggish growth, political uncertainty weighs on consumption: The Italian economy expanded by 0.2% qoq. Like in Q3, when industrial production expanded by 1.5% qoq, the stronger-than-expected industrial production data in December last week (1.4% mom, 1.3% qoq), contrary to the rest of the Eurozone, did not manage to push the GDP number to 0.3%, which was consensus. We remained more conservative at 0.2%. Why does growth remain so lacklustre? Households do not seem to provide their share to the economy: While retail sales have improved by 0.25% (average of October and November versus Q3), consumers are yet to recover from the summer 2016 blow when Brexit and concerns about the stability of the Italian banking system unsettled confidence (Istat and the European Commission's consumer confidence indicators are still below May 2016 levels, see **chart 3**). Also, why should confidence improve if the labour market doesn't send encouraging news: the unemployment rate has remained sticky around the high level of 12%. With the sword of early elections hanging over the country, and the outcome of these potential elections entailing considerable tail risks (referendum on the Euro), consumers' reluctance to spend and the labour market slack are unlikely to be resolved anytime soon.

While the risk of early elections has declined, as former Prime Minister Renzi has lost the internal battle against those in his party that want to wait until May next year, it is too early to tell whether he does not campaign once again for early elections when he reaffirms his leadership at a congress likely held in a few months. The best case for Italy would be at least another year of political stability, with the domestic economy starting to drive on the back of steady consumption growth as confidence returns and benefitting from the pick-up in global growth this and next year.

Chart 3: Italian retail sales volume (3m average, yoy, in %) versus consumer confidence



Source: Istat, European Commission

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