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EUROZONE: SOLID GROWTH AT A LESS EXUBERANT PACE

Berenberg Macro Flash

Eurozone PMI, July

	Composite	Manufacturing	Services
Actual:	55.8	56.8	55.4
Previous:	56.3	57.4	55.4
Consensus:	56.2	57.2	55.4
Berenberg:	56.2	57.2	55.4

The Eurozone starts the second half of the year on a solid footing despite a slight softening of momentum according to the flash reading of the composite PMI. Activity eased a little further in July after some slippage in June as manufacturers posted slower production increases. The July reading is slightly below the average recorded in Q2. This suggests that the pace of GDP growth will likely slow in Q3 from the unusually fast pace reached in the first half of the year.

Should we worry about the slight softening of momentum? No, probably not. We believe that currently weaker readings of forward looking indicators may owe to capacity constraints as firms struggle to keep up with demand. Backlogs have increased to the highest level for over six years. As companies continue to create jobs at a record pace to accommodate growing demand, they should manage to eliminate these constraints at some point. New orders remained elevated, driving business to ramp up facilities.

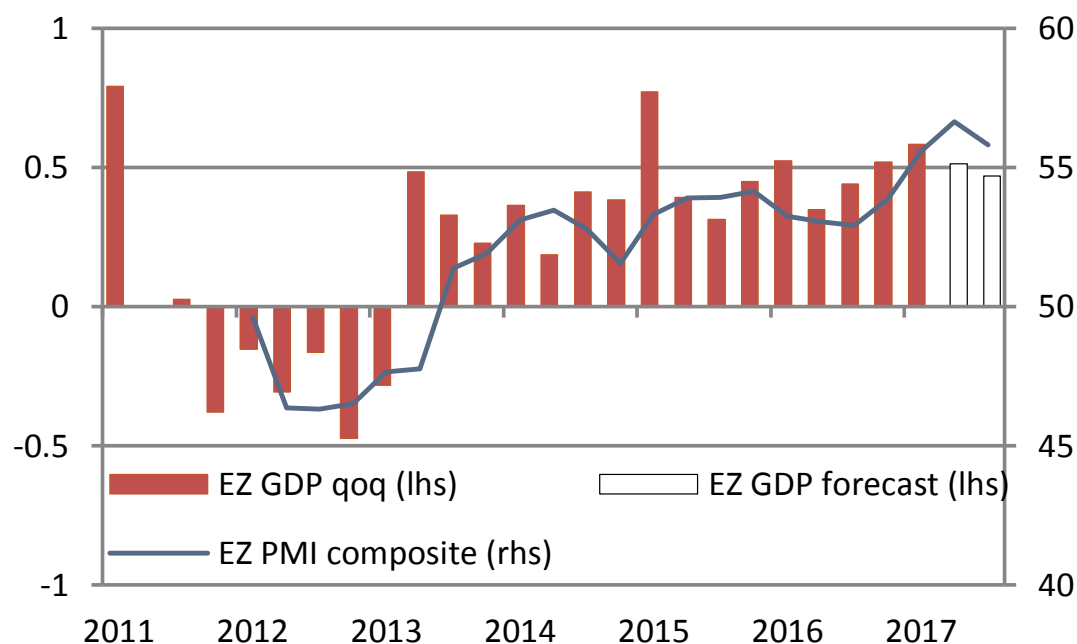
The composite PMI provides one of the first glimpses into the state of the economy in Q3. The PMIs have overstated the pace of expansion in recent quarters. Taken at face value, the quarterly average of the PMI composite output index suggested a rate of expansion of 0.6-0.7% qoq for GDP in Q2, further up from 0.6% in the first quarter – as such, softer forward looking indicators were almost a matter of time. Also, a likely annualised rate of growth beyond 2% in the first half is hard to maintain on a sustained basis for the Eurozone given a trend rate of 1.5%. We forecast somewhat more moderate growth of 0.5% in both Q2 and Q3 (see Chart) which translates into growth of 2.0% yoy in 2017. With a slightly more sustainable growth outlook for the next 6 months, and no more than a very gradual pickup in core inflation – the PMI survey showed inflationary pressures cooled further – the ECB can play it safe and will continue to tiptoe towards the exit from its aggressive monetary stance.

PMI numbers softened in the core countries of the Eurozone for which flash data is available, Germany and France, but the rates of expansion remained strong. For more on Germany and France, see below.



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Chart: Eurozone – PMI composite, GDP (qoq, in %) and Berenberg GDP forecast (qoq, in %)



Quarterly average for PMI, July 2017 as a proxy for Q3. Sources: Markit, Eurostat, Berenberg forecasts.

German loses a little steam but the outlook continues to be positive: According to a flash reading of the German PMIs in July, output growth in the German private sector slowed for the second month in a row. Both manufacturers and service providers reported less buoyant increases in activity, largely owing to new business inflows increasing at the slowest pace since the start of 2017. The recent appreciation of the Euro may weigh slightly on activity among previously very upbeat manufacturers. Tomorrow's Ifo survey could provide more clarity. That the reading for service providers fell to below 54 points is somewhat puzzling for an economy that enjoys a period of solid growth, near full employment and rising wages. July's softer numbers, however, follow the strongest PMI quarter in six years. This may point to some inherent volatility in the data. The quarterly average of the PMI composite index suggested a growth of 0.7-0.8% qoq in Q2. Those numbers likely exaggerate the underlying strength of the economy – we expect an expansion of 0.6%. The flash PMIs in July point to a further easing in momentum with lower readings for a second month in a row, in line with a softer rate of expansion in activity in Q3 than in the first half (0.4%). Underlying growth remains, however, robust as job creation accelerated, outstanding business continued to grow solidly and expectations remained unchanged at their high June levels.

French business activity remains robust while momentum softens for the second consecutive month. The small slippage in the composite owed to service growth retreating by more than expected. Output increased by less among manufacturers, too, but the PMI manufacturing, which includes survey variables beyond output, unexpectedly increased as firms noted the fastest pace in job creation for nearly 17 years. Continued high levels of confidence, new orders and backlogs suggest that the economy still carried enough momentum to start the second half in a decent fashion. GDP growth has likely remained solid at 0.5% qoq in Q2, but the pace of expansion should slow a little in the third quarter (0.4%). We expect some moderation in the survey data in the months to come as the soft data start to reflect closer the hard data.



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