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STRONG PMIS SUGGEST EUROZONE GROWTH MAY ACTUALLY HOLD UP IN H2

Berenberg Macro Flash

Eurozone PMI, September

	Composite	Manufacturing	Services
Actual:	**56.7**	**58.2**	**55.6**
Previous:	55.7	57.4	54.7
Consensus:	55.6	57.2	54.8
Berenberg:	55.6	57.2	54.7

Upside risks to our Eurozone GDP calls of moderation in Q3 and Q4: No sign yet of any slowdown in growth to come. Business activity in the Eurozone showed renewed momentum in September, according to the PMI composite. The gains in the PMI composite were broad-based among manufacturers and service providers. September's strong numbers largely reverse the downward trend since May which had stopped already in August. Whether this will continue in the coming months is unclear. We still see reasons to expect the pace of growth to moderate later this year: Capacity constraints and a stronger euro (+4% on a trade-weighted basis in Q3 so far compared to Q2) somewhat limit the upside potential. Firms' ongoing efforts to expand their production and stronger foreign demand partly offset these downside factors as the promising rebound in the PMI among export-oriented manufacturers shows. Still, the contribution by the manufacturing sector will likely be smaller after the exceptionally strong production in Q2.

ECB, go ahead: Despite the September bounce, the PMI average of the last three months (56.0) remains slightly below the Q2 level (56.6), when the economy expanded by 0.6% qoq – but above the 55.6 of Q1 when GDP grew by 0.5%. We expect 0.5% in Q3 and 0.4% in Q4. After today's PMI reading and the recent rise in other forward-looking indicators such as the ESI (10-year high in August), the risks to our call are, however, clearly tilted to the upside (see chart). Either way, the pace of growth will remain above the 0.4% qoq trend, strong enough to absorb spare capacity and drive prices and wages higher. The Eurozone PMI survey showed that customers have had to pay higher prices to ensure supply of both goods and services. The German PMI survey provided evidence that the strong appetite for new hires is driving salaries up at least somewhat. Even though these signs may still be subdued, they suggest that underlying inflation will continue to tick up, as we and the ECB expect. That growth is holding up nicely should provide the ECB with more comfort to go ahead with the recalibration of their monetary policy from January onwards.

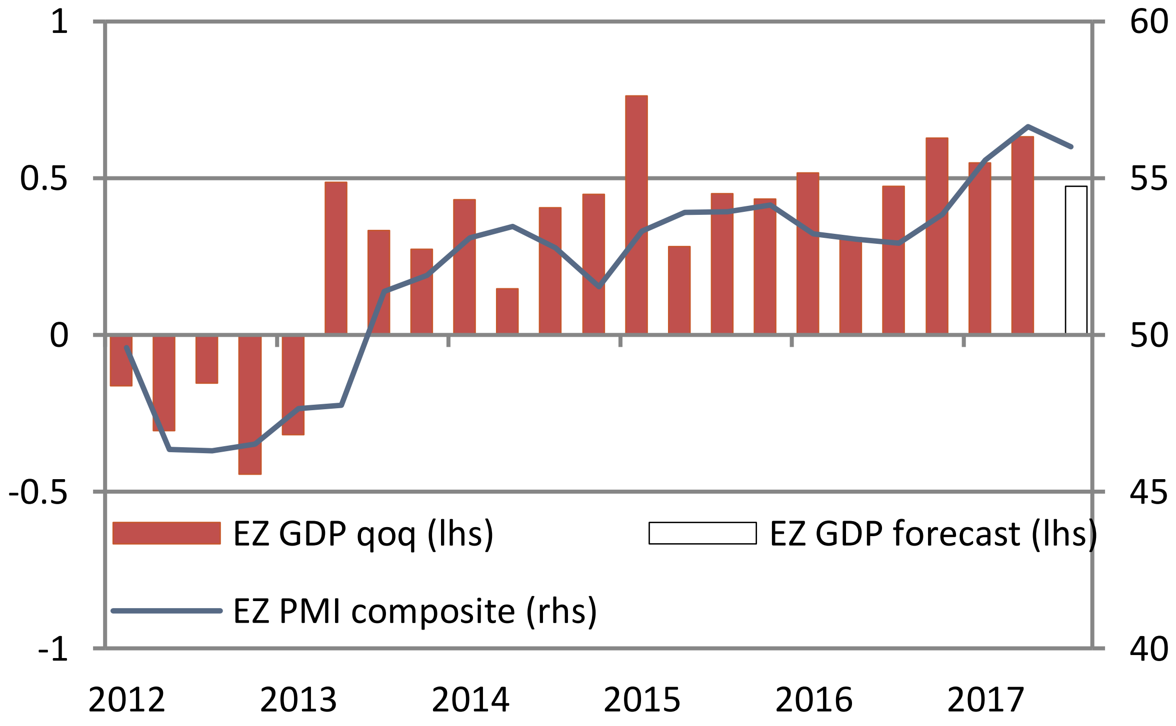
The rate of expansion in the Eurozone's largest two economics, Germany and France, was particularly encouraging. On a less positive note, business activity in the periphery waned to a 6-month low.

The German boom continues: Output in September expanded by the fastest pace in more than six years according to the PMI. Manufacturers recorded a buoyant performance in September (60.6 with 50 points signalling zero growth and a 2016 average of 53.2), thanks to strong export orders. Order books among both manufacturers and service providers rose by the most in six months suggesting firms will likely maintain, after some slightly weaker months, a healthy pace of expansion also in Q4. Still, comparing the Q3 average with the previous quarter, GDP growth should slow down a little, to 0.5% in Q3 and 0.4% in Q4, after 0.6% in Q2 and 0.7% in Q1. But there is an upside risk to our H2 call.

German firms are unfazed by election, euro strength, Diesel scandal, geopolitical risks: Ahead of general election, companies usually show some nervousness, or at least concern for political uncertainty – not so in Germany this time. After all, Merkel looks set to win her fourth term, with the only question remaining with which party/parties she will team up. Even if a stronger-than-expected showing of fringe parties may spring a surprise, German politics will not change significantly after the election, especially on European affairs. If Merkel manages to secure a coalition with the liberal FDP, expect a rockier start on European affairs. However, the FDP, once in government, will unlikely torpedo initiatives of Merkel and Macron to strengthen the cohesion of the EU/Eurozone. Domestic policy changes will be modest.

More good news for Macron: French business activity accelerated in September as the French PMI composite hit a six-and-a-half-year high. It brings the Q3 average to 56.0 which is slightly below the previous quarter's average (56.7). It supports our view of a slightly moderated pace of expansion of 0.4% qoq in Q3, after 0.5% in Q2, with risks to the upside. The gains were particularly strong among service providers, but manufacturers recorded a similar rate of expansion. To accommodate for stronger demand, firms stepped up their hiring efforts, with the rate of job creation accelerating. As backlogs are accumulating only at a fractionally softer rate than May's six-year record and new orders reached a new multi-year high, the current cyclical recovery looks far from over. France is in a good position for labour market reforms. Today, Macron's government looks set to give the reform of French labour law the final executive approval. The decrees will be formally ratified by a vote in parliament in the weeks ahead, which is a formality with Macron's party LREM holding a majority there. The ongoing protests are much smaller than they were against President Hollande's labour market in June 2016. The limited support for protests shows that most of the country continues to stand with the President's mandate to overhaul the country and lower the country's unemployment rate of currently 9.5%.

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



Source: Quarterly average for PMI. Sources: Markit, Eurostat, Berenberg forecasts.

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