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PARTNERSHIP SINCE 1590

MACRO NEWS 26/02/18

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EUROZONE OUTLOOK: RESILIENT GROWTH

Berenberg Macro Flash

After surging unexpectedly to cyclical peaks in December 2017 or January 2018, survey data for the Eurozone are now falling back. The European Commission's economic sentiment index for February due Tuesday will likely show a noticeable drop for the Eurozone. Do we have to worry? No, not much. Cyclical dynamics, the domestic policy stance and the international environment all suggest that – give or take some short-term fluctuations – the economic upswing will continue at a robust pace in the Eurozone. To some extent, a modest dose of bad news is actually good news. Some moderation in the data makes it even less likely than before that the cycle will overheat prematurely.

GLOBAL ECONOMIC BACKDROP

The world economy is enjoying a largely synchronised upturn. With the exception of Brexit-stricken Britain, demand is expanding at an above-trend rate in all major developed economies. By and large, emerging markets are also doing fairly well. Last year, China managed to raise its pace of demand growth while reining in the expansion of credit at least somewhat. The outlook for 2018 seems stable. Having overcome their 2015/2016 crisis, many other emerging markets are recovering. They benefit from solid demand growth in their major exports markets as well as from commodity prices that are neither too cheap for commodity exporters nor too expensive for commodity importers.

Judging by the number of years, the post-Lehman economic upswing that started in spring 2009 looks quite old. However, economic expansions do not die of old age. They end because excesses have built up that require a cleansing recession. Even in the US, which is cyclically much more advanced than the Eurozone because the US upturn was not interrupted by the euro crisis of 2011/2012, we find no clear signs of such pronounced excesses yet. Households, banks and many companies have strengthened their balance sheets, aggregate credit volumes are expanding at a normal rate close to 5%, and businesses have not (yet) overinvested into excess capacities they will not need in the future. We detect no big bubble waiting to burst. Despite edging up modestly, even US wage inflation remains well below the danger zone which may start at 3.25% or 3.5%. For now, US growth looks set to continue at a robust pace.

Markets worry that rising bond yields and higher central bank rates may choke off the economic upturn. While this may indeed happen a few years from now, such concerns still look very premature. Less depressed bond yields and a gradual return of monetary policy to a more normal stance are a by-product of the ongoing economic expansion and not a threat to demand growth. We need to distinguish between two very different causes for rate hikes:

(1) When demand growth gathers pace, central banks want to lean against it to prevent any serious overheating and the inflation risks it may entail. Such tightening merely serves to maintain a healthy pace of growth for longer.
(2) Only when central banks are concerned about serious excesses, for instance in credit growth, consumer demand or wage inflation, do they employ more aggressive rate hikes to slow down the pace of demand growth to below the trend rate, often causing a recession in the process.

So far, we are squarely in the first scenario. Even the US Fed merely wants to keep US growth on an even keel but not step on the brakes. While the Fed may raise rates four times by 25bp this year, this would be a response to a strong fiscal stimulus rather than an attempt to push growth below trend. The end of ECB net asset purchases in late 2018 and first ECB rate hikes from March 2019 should pose no major challenge for the economic outlook either against the backdrop of solid fundamentals.

Of course, neither central banks nor financial markets can fully predict how economies will react to more normal bond yields and central bank rates. Fortunately, the process is self-correcting. In the absence of serious credit or inflation excesses, central banks can act as a buffer. If rate hikes and/or a rise in bond yields threaten to derail growth, central banks could just change their tune. Some statements that – in case of an unexpected slowdown – policy would be tightened by less than envisaged would serve to bring yields and rate hike expectations down again.

EUROZONE OUTLOOK: STEADY AS SHE GOES

Despite the current correction in survey data, business and consumer confidence remain elevated in the Eurozone. Taken at face value, the survey data still suggest that growth could accelerate beyond the 2.7% average annual pace reached in the last four quarters. Some further moderation in these surveys would thus suit our call that growth will soften slightly to a 2.5% pace in 2018.

The macroeconomic backdrop remains auspicious:

- The ongoing **serious supply-side reforms** in France and the impact of earlier reforms in countries such as Spain as well as the modest progress in Italy since 2012 are raising the Eurozone's supply potential.
- With a real ECB refinancing rate of -1.0% (0% nominal refi rate deflated by core CPI of 1%), **monetary policy** remains very expansionary, as it was in 2017.
- Judging by the EU Commission's forecast for the cyclically adjusted primary balance of the Eurozone, the region can expect a **fiscal stimulus** of 0.2% of GDP in 2018, as in 2017. Whereas the full stimulus may not materialise in 2018 partly due to the long time it is taking to form a new government in Berlin, a modest fiscal boost of roughly 0.15% is probably still on the cards.
- Although the real effective **exchange rate** of the euro versus its top 19 trading partners has appreciated by 2.5% relative to its 2017 average, the euro remains competitively valued (2.7% below its ten-year average).

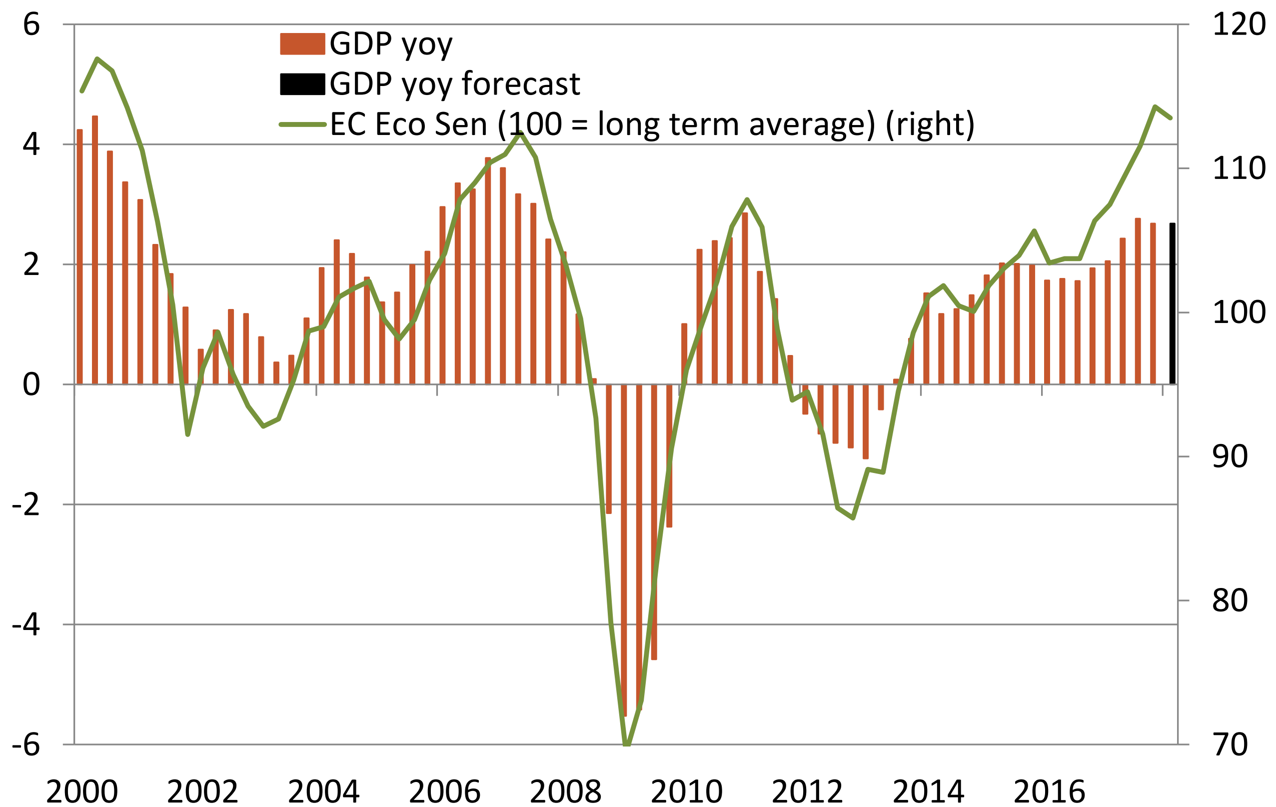
On its own, last year's rebound of the euro exchange rate to a more normal level (we see 1.25-1.30 as fair value in the sense of purchasing power parity) may subtract roughly 0.2 ppts from Eurozone growth this year. However, buoyant global demand for the region's cyclically sensitive exports should offset this modest loss in price competitiveness. We thus expect the growth in real exports to decelerate only slightly from an estimated 4.9% pace in 2017 to 4.2% in 2018.

Modest corrections in economic sentiment need not herald significant changes in actual demand growth (see chart below). For example, when the European Commission's economic sentiment index fell from 102.2 in May 2014 to 99.5 in September 2014, GDP growth accelerated from 0.14% to 0.43% qoq. The more significant correction in sentiment from 106.1 in December 2015 to 102.4 in March 2016 caused by concerns about emerging markets and the negative impact of low oil prices on US investment was followed by a modest deceleration of growth from an average pace of 0.48% qoq in Q4 2015 and Q1 2016 to 0.37% in Q2 and Q3 2016. Conversely, the further surge in economic sentiment in late 2017 had gone along with a modest deceleration in growth momentum from 0.71% qoq in Q3 to 0.59% qoq in Q4. Such fluctuations in sentiment and demand growth are well within the realm of the normal volatility in the data. After average quarterly gains of 0.66% qoq (2.7% annualised) in 2017, we look for Eurozone demand growth to slow slightly to an average of 0.6% qoq (2.4% annualised) this year.

Of course, life is full of risks. Beyond domestic political risks such as the potential fallout from the Italian election or – less importantly - a "no" to a renewed "grand" coalition in Germany from SPD members on 4

March, we need to watch US wage inflation and the creeping US protectionism. Both may pose serious threats to global growth if they get out of hand. So far, that is not the case.

Chart: Eurozone sentiment and real GDP growth



Eurozone economic sentiment (right-hand scale) and yoy rate of real GDP growth (left-hand scale), Berenberg estimates for 1Q 2018.
Sources: European Commission, Eurostat, Berenberg estimates.

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