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EUROZONE SENTIMENT STILL LOOKS PROMISING DESPITE SMALL CORRECTION

Berenberg Macro Flash

Eurozone economic sentiment index (ESI), February

	Economic sentiment
Actual:	**114.1**
Previous:	114.9
Consensus:	114.0
Berenberg:	113.5

Eurozone economic momentum falls slightly but remains very high : Confirming other recent surveys (PMI, IFO), Eurozone economic sentiment index receded slightly in February to 114.1 after 114.9 in January. Despite the second monthly slippage in a row, the Q1 average so far (114.5, January and February combined) is the highest in 17 years. This indicates some upside risk to our call that Eurozone GDP growth will maintain its Q4 pace of 0.6% qoq in Q1. Although confidence dropped slightly in most sectors and countries in February, confidence levels remain close to cyclical highs. The economy is still firing on all cylinders. On a country basis, Greece (+2.4 points), Austria (+1.6), Italy (+1.5) and the Netherlands (+0.4) recorded significant gains in February while sentiment fell the most in France (-2.7), Germany (-1.6) and Spain (-0.7).

The gain in confidence in Italy and the still strong reading for export orders in manufacturing suggest that political uncertainty in Italy and lagged impact of the euro appreciation are not the major drivers of the modest correction in sentiment. To some extent, the recent volatility in financial markets may have dampened the earlier exuberance among consumers and businesses somewhat. The outlook for 2018 remains promising amid a synchronised global upswing.

Less inflation pressure: Selling price expectations fell modestly in the services, retail trade and construction sector after a significant increase in January. Consumer price expectations over the next 12 months also receded in February after rising sharply in January. While core inflation (1.0% in January) is likely to edge up in coming months, inflation pressures remain muted. This supports a continuation of the accommodative monetary policy stance of the ECB.

Italian economic sentiment increases ahead of elections: Surprisingly, the Italian headline index jumped to 111.6 in February after 110.1 in January despite large uncertainty about who will be in power after the 4th March election. The Q1 economic sentiment average of 110.9 is the second highest reading since 2001. The industrial and construction sectors are doing particularly well with sentiment in both sectors at the highest or joint-highest level since 2007.

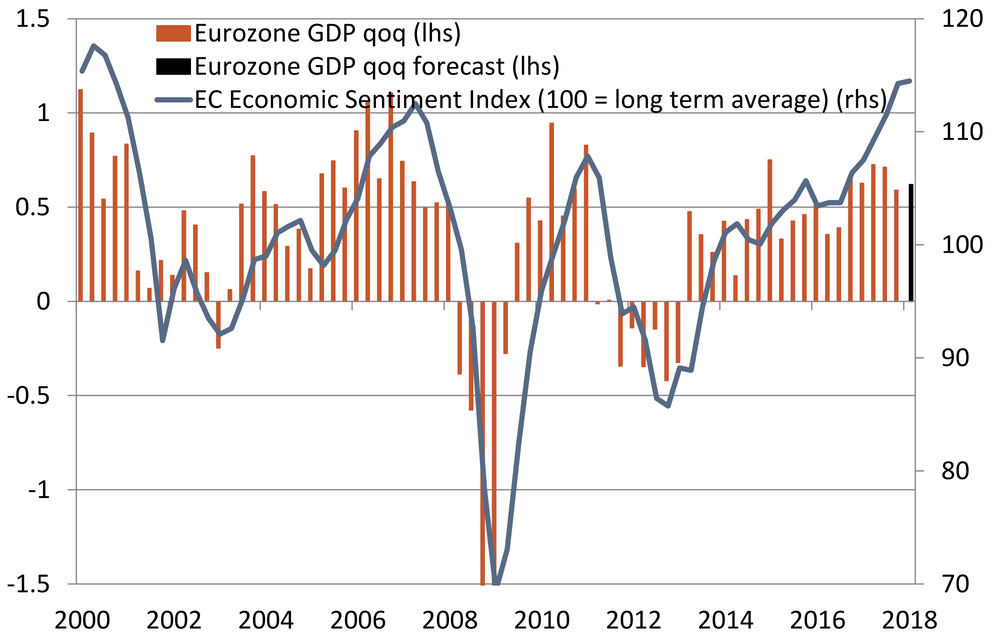
We see the Italian election as one of the top political risks for Europe this year. The thee tail risks to watch are Italexit, reform reversal and pressure on public finances.

(1) After Le Pen lost the French election, some of the eurosceptic parties in Italy such as the Five Stars (M5S) have significantly toned down their anti-euro rhetoric. Only an unlikely coalition of M5S and the radical right may possibly want to hold a referendum on the euro. We assign no more than a 2% risk to that scenario.

(2) Most parties want to reverse some of the pension and labour market reforms implemented over the last years by Mario Monti and Matteo Renzi which had helped to restore investor confidence in Italy and create over 1 million jobs. After the election, some small-scale reform reversals are likely.
(3) More pressure on public finances: A combination of a reversal of the pension reform, higher government spending and lower economic growth could raise the budget deficit and public debt. Italy's debt-to-GDP ratio is the second highest in the EU after Greece (c132%).

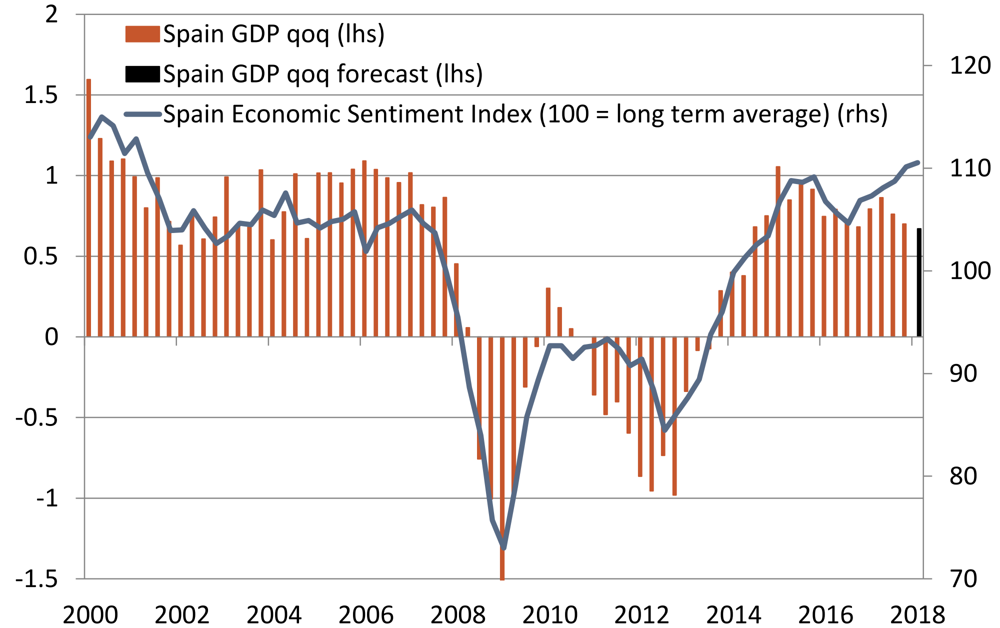
A government supported by a grand coalition is the most likely outcome (70%). We see 10% probability of a centre-right/right-wing victory, a 10% chance of new elections and 10% likelihood that Five Stars will head the government in an alliance with either a mainstream party or the radical right. Former prime minister Silvio Berlusconi is likely to be kingmaker after the election, although his centre-right Forza Italia party received only c16% in recent opinion polls and despite the fact that he is barred from office. The best-case scenario for the economy and investors would be a technocrat-led grand coalition that may introduce a few new reforms while not undoing many previous reforms. The worst-case scenario would be a coalition consisting of the anti-establishment Five Star Movement together with other radical parties, which we see as highly unlikely but not fully impossible.

Chart 1: Eurozone economic sentiment index (quarterly average) vs. GDP qoq growth (in %)



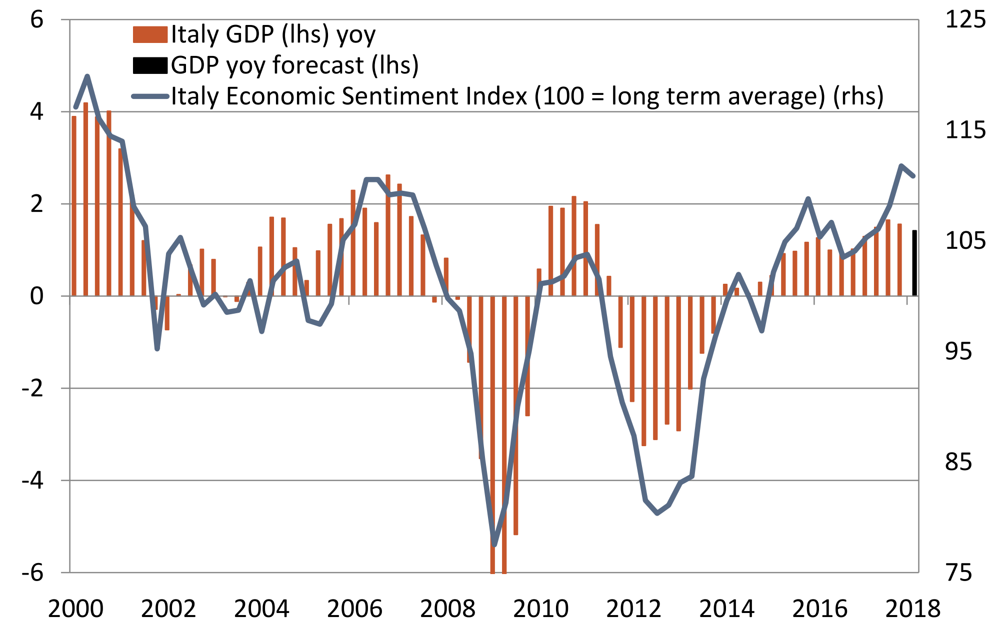
Sources: European Commission, Eurostat. January and February's average economic sentiment index reading is a proxy for 1Q 2018

Chart 2: Spain economic sentiment index (quarterly average) vs. GDP qoq growth (in %)



Sources: European Commission, Eurostat. January and February's average economic sentiment index reading is a proxy for 1Q 2018

Chart 3: Italy economic sentiment index (quarterly average) vs. GDP yoy growth (in %)



Sources: European Commission, Eurostat. January and February's average economic sentiment index reading is a proxy for 1Q 2018

Eurozone economic sentiment, by sector

	FEB	JAN	DEC	NOV	OCT	SEP
Economic sentiment	114.1	114.9	115.3	114.0	113.5	112.5
Industry	8.0	9.0	8.8	8.1	8.0	6.7
Services	17.5	16.8	18.0	16.4	16.2	15.4
Consumer	0.1	1.4	0.5	0.0	-1.1	-1.2
Retail	4.3	5.2	6.0	4.3	5.5	3.0
Construction	4.2	4.7	3.1	1.7	0.5	-1.5

Eurozone economic sentiment, by country

	FEB	JAN	DEC	NOV	OCT	SEP
Germany	114.4	116.0	115.4	113.8	113.8	111.8
France	109.7	112.4	113.9	111.6	109.8	111.3
Italy	111.6	110.1	111.8	111.8	111.7	110.6
Spain	110.2	110.9	110.0	110.5	109.9	109.6

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