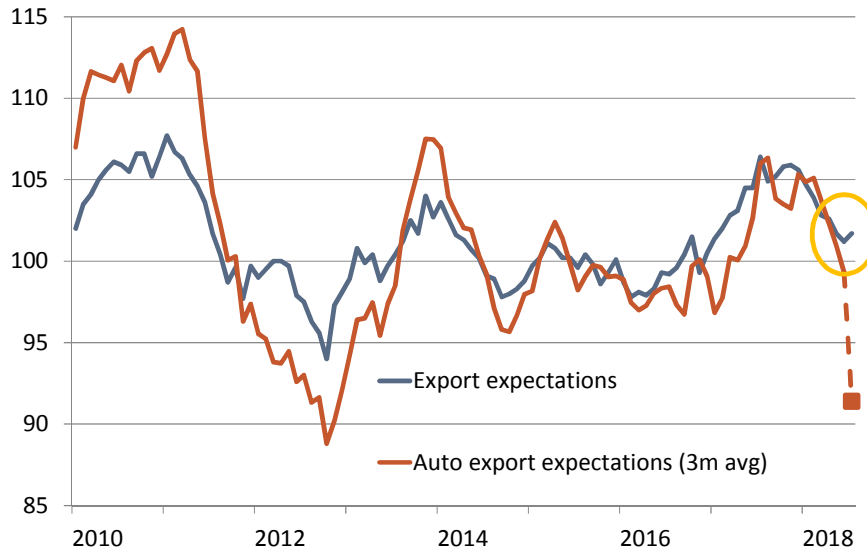


27 July 2018

Eurozone soft patch: coming to an end soon?

German export expectations: small uptick in July despite serious car tariff troubles



Export expectations for the three months ahead, German manufacturing industry as a whole and car industry sector; long-term average = 100; three-month moving average for car export expectations, last red dot gives monthly value for July 2018. Source: Ifo

- Beyond the soft patch:** After a stellar performance in 2017, Eurozone growth slowed down to a rate close to its underlying 1.5% trend in the first half of 2018. Flash GDP data for Q2 due on 31 July will likely confirm this assessment with a 0.4% qoq gain and a risk that growth could come in at 0.3% instead. Although the evidence is still very mixed, some indicators such as the recent near-stabilisation in sentiment indices, strong credit growth in June 2018 and a further easing of lending standards ahead as indicated by the European Central Bank's bank lending survey support our view that growth could re-accelerate to an annualised pace of 2% from Q4 2018 onwards.
- Reasons for the slowdown:** The Eurozone upswing lost some momentum so far this year for four reasons. First, a harsh winter and a flu epidemic retarded growth temporarily in Q1. Second, higher oil prices added 0.6ppt to the Eurozone's annual inflation rate by June 2018, squeezing the amount of real income households have to spend on other goods and services. Third, after an unusual surge in exports, which had lifted real export growth to 6.7% yoy in Q4 2017, some moderation seems normal. Fourth, trade tensions stoked by US President Donald Trump have weighed ever more heavily on business expectations and the outlook for investment since March 2018.
- Clearer skies ahead:** The winter and the flu epidemic are history. Unless oil prices surge much further, the current drag on gains in real disposable incomes and private consumption should gradually fade. Even if oil prices stay at current levels instead of coming down modestly in response to more US and OPEC supply, they would add only 0.3ppt to Eurozone headline inflation by December 2018. That leaves the export outlook the key issue to look at.
- Watching the swing factor:** Due to Germany's strong focus on exports of highly cyclical goods such as cars and machinery, its manufacturing sector is often the key swing factor in the Eurozone. After declining seven months in a row, export expectations in the German Ifo survey picked up slightly in July. Remarkably, overall export expectations brightened a little despite a further massive hit to the car sector (see chart). In this industry, which accounts for 18.5% of all German exports of goods, export expectations fell to their lowest level since October 2012. Due to Trump's threat to impose tariffs on EU car exports to the US, expectations in this sector were almost as depressed in July as they had been at the worst of the euro crisis.
- A ray of hope:** Of course, a marginal uptick in export expectations in one single month is no convincing evidence of a turnaround to come. But that these expectations improved while US-EU trade tensions centred on cars were at their worst does indicate that global demand remains solid. The more competitively valued euro exchange rate may also help. Wednesday's US-EU agreement to negotiate instead of slugging it out in tit-for-tat retaliation has reduced the risk of a genuine trade war for the time being. A rebound in car export expectations should thus lift overall expectations further in coming months. That would set the stage for slightly stronger Eurozone growth soon.

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