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EUROZONE PMIS DOWN AS DOMESTIC ECONOMY SNEEZES

Berenberg Macro Flash

Eurozone PMI, October

	Composite	Manufacturing	Services
Actual:	52.7	52.1	53.3
Previous:	54.1	53.2	54.7
Consensus:	53.9	53.0	54.5
Berenberg:	54.0	52.8	54.7

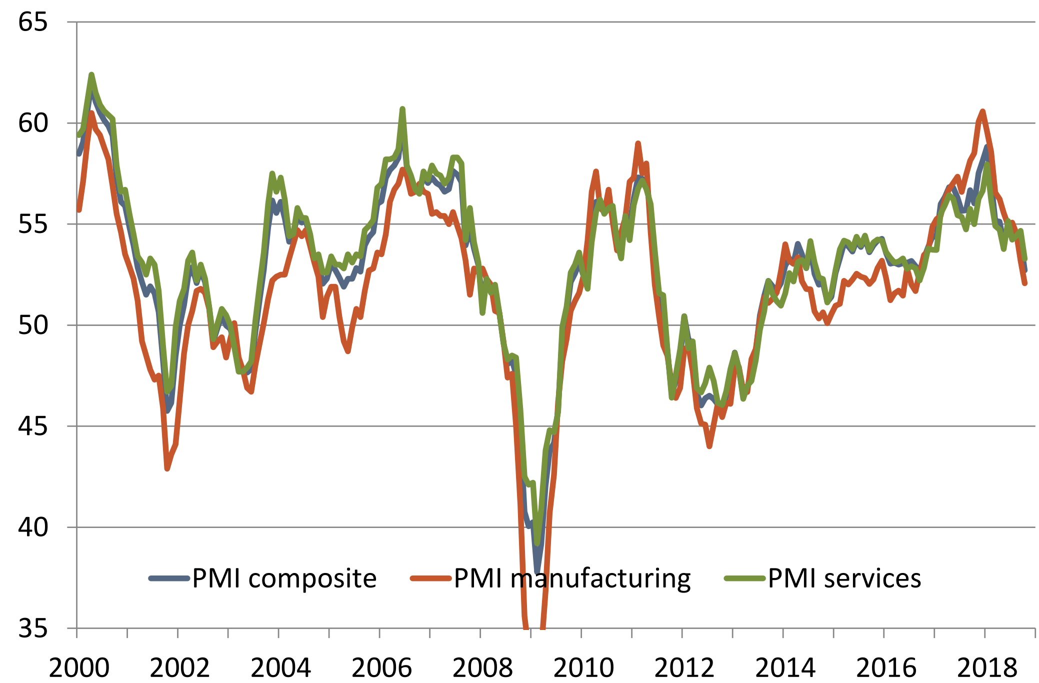
More significant spillovers: Export-reliant manufacturers have struggled to steer through a more challenging external environment this year. Meanwhile, domestically-oriented service providers in the Eurozone seemed relatively unaffected and reported solid gains thanks to a virtuous circle of rising employment, income and consumption. According to October's PMI surveys, this is no longer the case. The PMI composite's significant drop from 54.1 in September to 52.7 was driven by the service sector more than the manufacturing sector (see chart 1). All the main measures of business performance (output, new orders and employment) slowed down, with services only in France bucking the trend. Contributing 75% to GDP, the service sector is crucial for the Eurozone economy – when it sneezes, the economy catches a cold, not a good prospect with winter not having started, yet. So far this year, the domestic economy has been the bedrock of Eurozone growth. While it is early days, today's PMI surveys suggest that the external environment's headwinds may wear out the bedrock more than expected and that the risks to our call of trend growth from Q4 onwards are tilted to the downside.

Cocktail of risks: Comparing the quarterly averages, the PMI composite's downward trend this year is apparent. After 57.0 in Q1, the PMI composite dropped to 54.7 in Q2, before slipping further to 54.3 in Q3. Especially pronounced was the slowdown among export-reliant manufacturers. For the first time since 2013 export orders dropped in october, according to the PMI surveys. The ever strengthening cocktail of risks stemming largely from elsewhere such as a further escalation of the US-China trade war, a disorderly hard Brexit, emerging market turbulence and an Italian accident waiting to happen, has been a source of increasing concern. While none of the major risks has materialised, yet, taken together, they have mattered and continue to do so, which is why we nudged down our forecasts for the Eurozone, recently. October's market woes with the EuroStoxx50 dropping by more than 7% added to the strong cocktail of risks. As financial markets often lead the real economy, concerns arose over the recent weeks that the equity sell-off could herald an economic downturn soon.

Still solid domestic fundamentals: Amid sustained external headwinds we have kept a close eye on the domestic economy which had held up firmly in H1 2018. We expect domestic fundamentals to remain healthy, although higher oil prices will probably restrain consumption growth somewhat in H2 2018 (see chart 2). Continued employment gains and a recent pick-up in wage growth are driving confidence, income and consumption. Businesses expand their facilities as orders keep coming in at a still healthy pace and they struggle to find new workers amid labour shortages. Healthy net bank flows to (non-financial) businesses pushed the Eurozone's annual growth rate of bank loans to (non-financial) businesses to a positive 4.3% in September (after 4.1% in August) pointing to continued momentum in the overall Eurozone economy. Temporary problems in the auto sector due to the stricter emission testing standards (WLTP) from September onwards may have caused GDP growth to slow down to 0.3% qoq in Q3, after 0.4% in Q2 and Q1. But, in late 2018 and throughout 2019 we expect growth to return to the trend rate of 0.4% qoq.

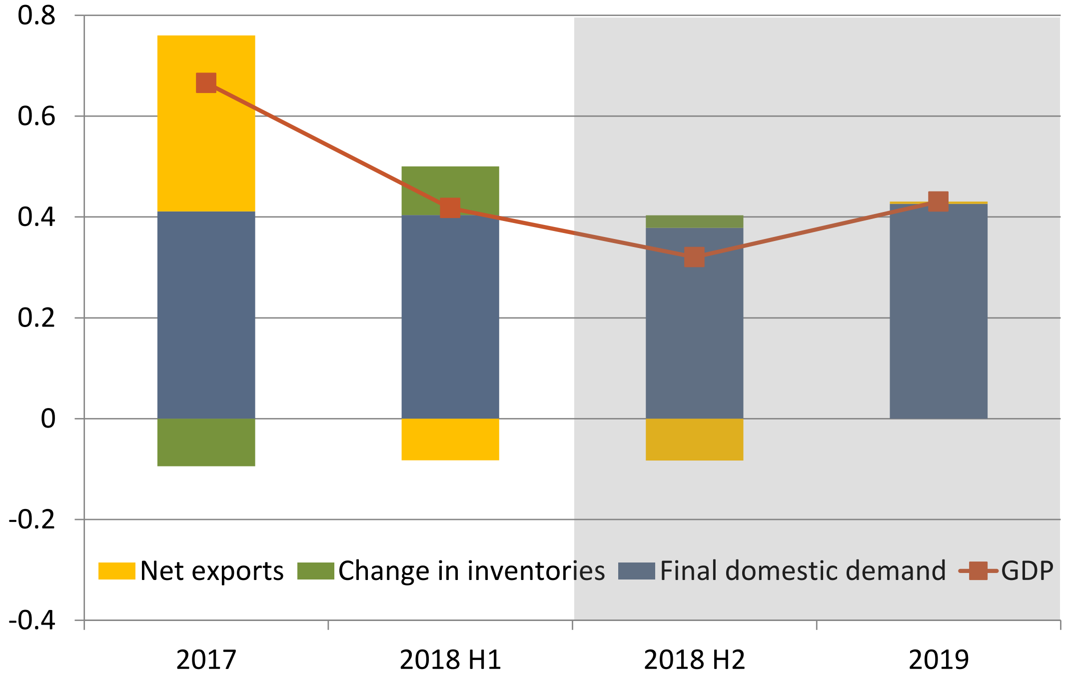
But how solid? Seemingly unshaken by the market sell-off in October, consumer confidence in the Eurozone improved slightly from -2.9 in September to -2.7 in October – even though it remains below January's 16-year high of 1.4 and the 2017 average of -2.5. This bodes well for ongoing gains in private consumption. After all, negative wealth effects play little role for private consumption in the Eurozone as a big chunk of households do not own a stake in financial markets. However, the PMI surveys suggest that the risks to our call of trend growth from Q4 onwards are tilted to the downside. It does not take much more uncertainty across the globe to cause a further major drop in sentiment and a delay of investment decisions. In such a scenario, the current cocktail of risks could hit the Eurozone domestic economy more significantly with growth falling below trend.

Chart 1: Eurozone PMI composite, manufacturing and services



Source: Markit

Chart 2: GDP components – domestic demand stable, sharp correction in net exports



Average qoq change in %. Berenberg forecast for 2018 H2 and 2019. Sources: Eurostat, Berenberg

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