Economics

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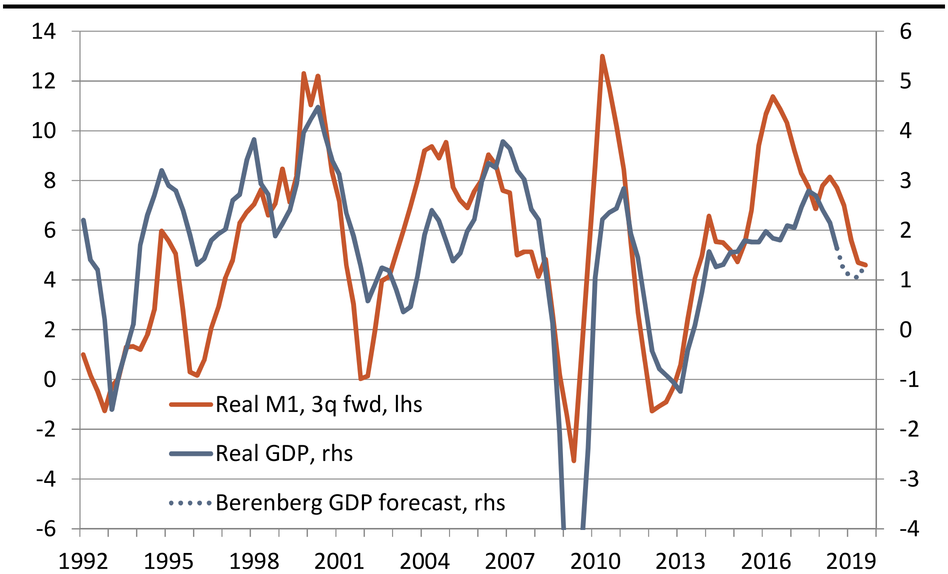
Eurozone: anatomy of a serious slowdown

- **Trade, emerging markets, oil, Italy, Brexit and more:** A series of external shocks and political risks has derailed the Eurozone upswing. Despite positive domestic fundamentals, growth has fallen below its 1.5% trend rate. In this report, we analyse the slowdown from two different angles: first, we examine the key indicators that usually help to gauge cyclical dynamics up to nine months in advance; and second, we look at the major shocks and risks that are currently restraining growth.
- **A bleak message:** Leading and coincident indicators offer little pre-Christmas cheer. Instead, they suggest that demand may soften further near-term. No key indicator currently projects a rebound for early 2019. Risks to our below-consensus call for Eurozone growth of 1.25% in 2019 are still tilted to the downside.
- **How bad can it get?** Leading and coincident indicators send conflicting messages on the potential depth of the downturn. Real M1 money supply is consistent with our call that the yoy rate of GDP growth will moderate only modestly further (see Chart 1). Reflecting extended market turmoil, financial indicators are much more negative. They are prone to raise false alarms, though. Business expectations, factory orders and sentiment surveys look less downbeat.
- **A cycle of fear:** The current downturn differs from many others. The Eurozone does not exhibit any domestic economic excesses that would require a cleansing. Instead, a series of external shocks and political risks has pushed the region into a cycle of fear. As uncertainty spreads, companies and households react more nervously to news which, in more settled times, they would have taken in their stride.
- **More than just a ray of hope:** Our look at these external and political factors nourishes hope: if the risks that markets and business are afraid of do not materialise in early 2019, the outlook could brighten considerably again.
- **The case for a spring 2019 rebound:** As the costs that trade tensions inflict on the US economy become more visible over time, we expect the US to strike trade deals with China and the EU before mid-2019. If so, sentiment in Europe's export-oriented industries can rebound fast. Also, oil prices are turning into a tailwind and the crisis in key emerging markets can bottom out soon. If Europe avoids the hard Brexit risk and Italy does not descend into a debt-crisis, growth can firm again.

Chart 1: Real M1 projects only a modest further downturn – but a new upturn is not yet in sight



Eurozone real M1 money supply, CPI deflated, advanced by 3 quarters, October 2018 real M1 as proxy for Q4, left-hand scale; real GDP, right-hand scale; yoy changes in %. Sources: ECB, Eurostat, Berenberg calculations

Key macro reports

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Anatomy of a serious slowdown

Downturns usually follow a pattern…

Every economic downturn is unique. But they all follow a pattern. Unless a sudden external shock disrupts the economic cycle, tighter monetary conditions usually flag a serious loss of momentum or a recession well ahead of time. After a subsequent drop in financial expectations and markets, business expectations become gloomier a little later before, finally, surveys assessing the current situation and actual data on economic activity head south. Over time, the self-reinforcing cyclical dynamics kick in. In an entrenched cycle of fear, the economy may bottom out below a level that economic logic would suggest.

…but the current loss of momentum is different

Downturns or recessions usually serve to correct prior excesses. However, the current loss of momentum is different. The Eurozone exhibits no wage, credit or investment excesses that would require a cleansing correction or recession. Nonetheless, the key indicators of the Eurozone business cycle are sending two clear signals: 1) the Eurozone is in a downturn; and 2) a turning point is not yet in sight. The Eurozone economy is likely to remain weak at least through Q1 2019. So far, the data neither confirm nor contradict our call that the Eurozone will pick up momentum again from spring 2019 onwards. Although our call for 1.25% GDP growth in 2019 is well below the Bloomberg consensus of 1.6%, leading indicators suggest that the risks to our forecasts are tilted to the downside as the downturn could turn out deeper or more protracted than we project.

Two ways to analyse the downturn

In this report, we analyse the downturn in two different ways: first, we examine the key leading and concurrent indicators that usually move ahead or in line with the overall business cycle; and second, we look at the key factors that are weighing on economic growth. Thereafter, we assess the outlook for 2019.

Predicting the cycle: the indicators that matter

Four sets of indicators to predict the cycle

To gauge the likely path of aggregate demand in the Eurozone in late 2018 and the first half of 2019, we look at four sets of indicators with various lead times over economic activity:

Real M1 money supply tends to lead turning points in the cycle by six to nine months. Real M1 growth remains at a satisfactory level. Having signalled some loss of momentum for 2018, real M1 does not (yet) point to a rebound for spring 2019.

Financial indicators are volatile but often signal economic turning points six to nine months ahead. These indicators currently look very bleak; however, they can send occasional false alarms and offer little insight into the potential severity of any downturn.

Economic expectations lead activity by up to three months. After a surge to near-record levels in 2017, expectations have receded significantly over the last 12 months. So far, expectations are still compatible with ongoing economic growth that dips only modestly below its trend pace; however, expectations may well darken further in the next couple of months amid heightened uncertainty and in the wake of the current market turmoil.

Economic sentiment and other indicators of business confidence have no significant lead time over activity. While these sentiment indicators have corrected significantly since February 2018, they mostly remain above their long-term averages. Following the drops in leading indicators, we probably have to brace ourselves for further declines in these coincident indicators.

Real money supply

Real M1 – no longer as reliable as it used to be

Real M1 money supply has been our favourite long-term lead indicator for decades. In the still largely bank-based financial system of the Eurozone, major changes in real money supply tend to signal economic turning points up to three quarters in advance. If companies and households have built up more liquid balances (M1), they will eventually spend some of the extra money.

Modest further loss of momentum ahead

Taken at face value, real M1 projects a further loss of momentum for Eurozone growth for late 2018 and the first half of 2019, roughly in line with our GDP forecasts (see Chart 1 on page 1). It does not (yet) signal the modest rebound in real GDP growth that we project for Q3 2019 in terms of the yoy rate of GDP growth. To get there, the qoq rate of growth would have to start firming again in Q2 2019 already.

Less need for liquidity buffers

However, the signal from real M1 has become less reliable and more difficult to interpret in the last three years. Households and companies changed their behaviour in the wake of the post-Lehman and euro crises. Shocked by these crises, they have accumulated much larger liquidity reserves than usual, as the major spurts in real M1 growth in 2009 and 2015 show. In both cases, the surge in real M1 vastly overstated the subsequent rise in spending. Conversely, the return to less buoyant real M1 growth in 2016 did not herald any loss of cyclical growth momentum thereafter. Instead, GDP growth accelerated strongly in 2017. Note that the 2015 surge in real M1 started just before the ECB introduced its asset purchase programme in March of that year. To some extent, the current slowdown in real M1 growth may be partly an unwinding of this effect as the ECB winds down its net purchases.

Enough money to finance more spending

Even today, liquidity balances of households and companies are still well above their long-term average. Households and companies would still have the money to raise spending if they wanted to. That makes it difficult to judge whether the renewed slowdown in real M1 growth that started in the second half of 2017 and has so far continued during 2018 really points to weaker demand growth in 2019. Alternatively, it may just reflect just another step in the return of the liquidity preferences of households and companies to more normal pre-crisis levels.

Financial indicators: ZEW expectations and equity markets

Markets do their best to gauge the future

Financial markets – and financial analysts – usually spot economic turning points well before they show up in the hard economic data. Markets do their best to gauge the future. In addition, moves in markets alter the financing conditions for households, companies and banks. This can affect the pace of economic growth.

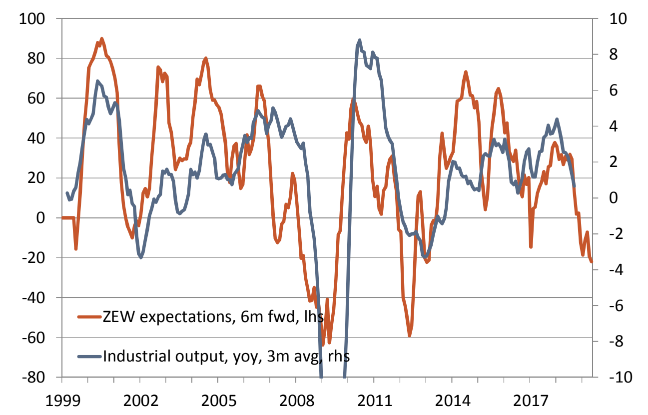
ZEW expectations point to bleak news ahead

Major shifts in the balance of optimists versus pessimists in the ZEW survey of investor and analyst expectations of future Eurozone economic growth tend to lead major changes in the region's industrial cycle by six (or sometimes nine) months. Taken at face value, the fall in the ZEW expectations balance to -22 in November 2018, its lowest level since July 2012, points to bleak economic news ahead.

But the ZEW can send false alarms

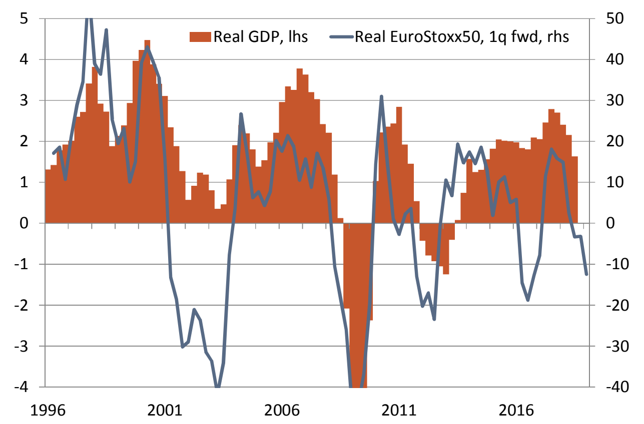
For two reasons, we need to treat the ZEW with a dose of caution, though. First, the ZEW tends to predict turning points but offers little clue about the actual strength of any downturn or rebound. Second, as investor expectations are much more fickle than the behaviour of households and companies in the real economy, the ZEW survey frequently sends misleading signals. For instance, the significant falls in the ZEW in late 2006, late 2014 and mid-2016 were not followed by noticeable losses of industrial momentum some six to nine months later: they were mostly false – or at least premature – alarms.

Chart 2: ZEW expectations versus industrial output (% yoy)



ZEW expectations brought forward by six months,left-hand scale; Eurozone industrial output ex construction, yoy change in %, right-hand scale.
Source: ZEW, Eurostat

Chart 3: Eurozone equity markets and GDP growth



EuroStoxx50, deflated by GDP deflator, advanced by one quarter; Eurozone real GDP, yoy changes in %. Trading days with 7 December as cut-off date as proxy for Q4 2018.
Source: Bloomberg, Haver Analytics, Berenberg calculations

Roughly the same holds for financial market indicators. For example, major moves in the EuroStoxx50 equity index often lead significant changes in GDP growth by one quarter (see Chart 3); however, equity markets offer little clue as to how pronounced a downturn could be. In the wake of the major fall in equity markets in the winter of 2015/16, actual growth in real GDP decelerated hardly at all from 2.0% in late 2015 to 1.8% yoy in the summer of 2016.

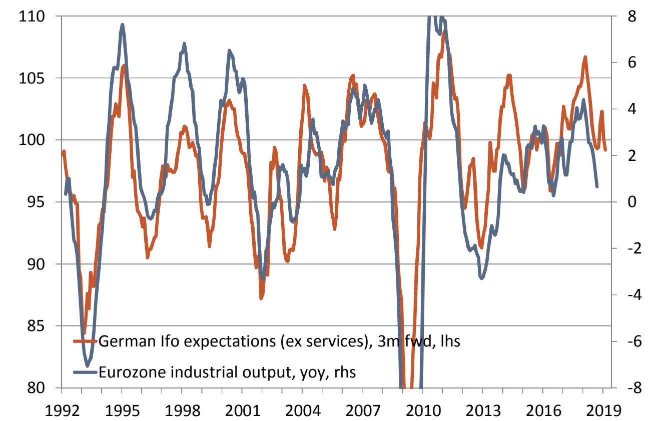
A grim message from markets

Industrial indicators: business expectations and factory orders

Expectations shape behaviour: if businesses expect better or worse times ahead, they adjust their investment plans accordingly. Expectations in Germany's industry and trade sectors, dominated by export-oriented and highly cyclical manufacturing, usually lead changes in Eurozone industrial output by some three months.

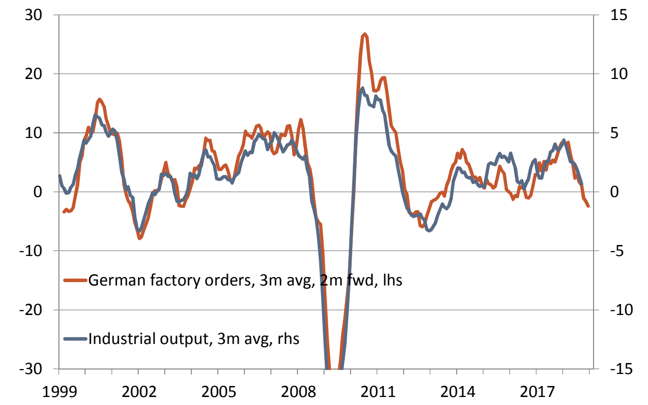
Expectations shape behaviour

Chart 4: German Ifo expectations and Eurozone output



German Ifo expectations (excluding services), advanced by three months, left-hand side; Eurozone industrial output, yoy change in %
Source: Ifo, Eurostat

Chart 5: German factory orders lead Eurozone output



Germany factory orders brought forward by 2 months, Eurozone industrial output ex construction, yoy %, 3-month averages
Source: Destatis, Eurostat

Respondents to the German Ifo survey are significantly less optimistic than they were a year ago (see chart 4); however, expectations have fallen only slightly below the long-term average. At this stage, the Ifo survey does not suggest that the industrial downturn needs to get worse – but it does not point to any imminent recovery either.

Output follows orders. Because German industry is particularly export-oriented and focused on cyclically sensitive goods such as machine tools and cars, German factory orders are a good predictor of Eurozone industrial output two months later. For the time being, German orders point to a slight decline in output (see Chart 5). As the service sector is usually less cyclical than manufacturing, this would still be compatible with some growth in real GDP, albeit at a rate well below trend.

Output follows orders: more downside ahead

Coincident indicators: economic sentiment and PMI indices

Economic sentiment and other indicators of business confidence usually move with the business cycle. Although they have no significant lead time over activity, they still provide useful insights because the surveys are available well before hard data are published.

Moving with the cycle

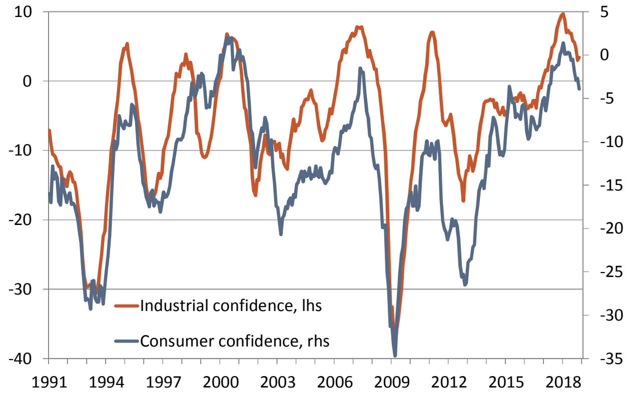
Since February 2018, industrial and consumer confidence levels have corrected significantly in the Eurozone. Both remain well above their long-term averages, though (see Chart 6). The less bullish sentiment is compatible with some loss of economic momentum from the fast pace of 2017; however, the actual slowdown in GDP growth has been much more pronounced than the correction in sentiment would have suggested. Roughly the same holds for the composite purchasing managers' index for the Eurozone. While flagging a major deceleration of the quarterly rates of GDP growth, hard data have mostly been weaker in late 2017 and the first three quarters of 2018 than the survey would have suggested (see Chart 7).

Not too bad yet

This makes it difficult to interpret the signal. On the one hand, the old relationship between surveys and actual growth may re-establish itself. In other words, the further fall in the coincident indicators need not herald a further downturn in the actual hard data. On the other hand, hard data may continue to take their cue from the direction of the surveys (still down) rather than the level of the survey (still mostly fine). On balance, the coincident indicators suggest that, abstracting from short-term distortions, the actual economic data are likely to weaken further in November and December 2018.

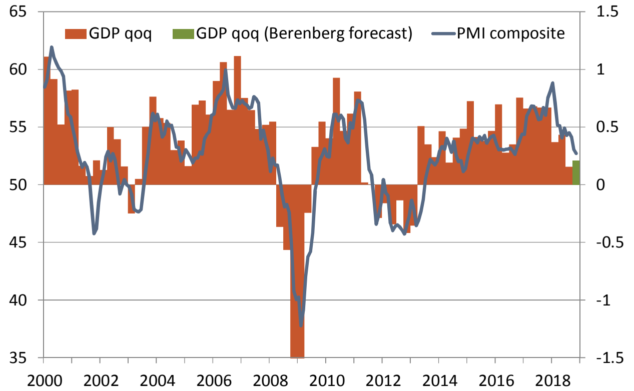
Sentiment could turn down further

Chart 6: Eurozone industrial and consumer confidence



Eurozone industrial confidence, left-hand scale, and consumer confidence, right-hand scale.
Source: European Commission

Chart 7: Eurozone PMIs versus GDP growth (% qoq)



Quarterly data for GDP, qoq growth in %, right-hand scale;, monthly data for composite output PMI, left-hand scale.
Source: Markit, Eurostat

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Reasons for the slowdown

Domestic fundamentals cannot explain the downturn

Domestic economic fundamentals cannot explain the Eurozone downturn: with core inflation hovering around a mere 1% since mid-2013, labour costs rising by 2% yoy in H1 2018, loans to the private sector increasing by 2.1% yoy (October 2018), and healthy gains in gross fixed capital formation of 3.2% yoy (Q1-Q3 2018 average), the Eurozone is showing no signs of the economic excess that would need to be purged out of the system in a downturn or recession. At 0.9% of GDP in 2017, the public deficit is also well under control. Eurozone growth has not hit any significant limit yet. While a lack of qualified workers is constraining the pace of growth in parts of the region, notably Germany, the ongoing gains in German core employment (up 2% yoy in Q3 2018) show that ongoing gains in supply still leave room for non-inflationary increases in demand.

Monetary and fiscal policy continue to support demand

By and large, domestic economic policy continues to support demand growth: although the ECB has scaled back its net asset purchases and looks set to end them in December, monetary policy is still highly accommodative. The real costs of capital remain ultra-low for most private and public borrowers, except for the Italian and Greek sovereigns and some segments of the high-yield market. Fiscal policy turned slightly expansionary in 2018. While the nominal effective exchange rate of the euro has risen by 4.6% since 2016 (Q3 2018 versus the 2016 average), most of the increase had already happened in the first half of 2017. Of course, exchange rates affect economic activity with a lag; however, the impact of the 2017 rise in the euro should have been largely digested by late 2018. It cannot explain the significant fall in leading indicators over the last few months. The 0.7% yoy increase in the effective exchange rate in Q3 2018 does not signal a significant problem for 2019.

Key factors behind the slowdown

Two remarkable changes

Comparing the sources of demand growth in 2017 with the data for the first three quarters of 2018 reveals two remarkable changes: 1) in 2017, net exports contributed 0.8ppt to Eurozone real GDP growth; in the first three quarters of 2018, net exports subtracted an average of 0.13ppt from the qoq rates of Eurozone growth and a cumulative drag of 0.4ppt so far this year; 2) while investment spending has largely held up in the first three quarters of 2018, the gains in private consumption have decelerated from an average yoy increase of 1.7% in 2017 to just 1.0% in Q3 2018.

Beyond the return to normal

After accelerating to a 2.7% yoy rate in H2 2017, a gradual return of real GDP growth to a rate around 2% over the course of 2018 and thus closer to the underlying 1.5% trend was probably on the cards anyway. The somewhat unexpected euphoria that had propelled economic sentiment to a 17-year peak in December 2017 was not quite sustainable. Beyond this return to normal, we can attribute the deceleration in Eurozone growth over the course of 2018 to the following factors.

The worst shock of all: Trump's trade wars

- **Trade war:** Eurozone industrial confidence suffered its worst monthly drop since the wake of the euro crisis in March 2018, just after US President Trump had announced his intention to impose punitive tariffs on steel and aluminium imports at the end of February. Surveys suggest that the trade war risk has been a major factor weighing on Eurozone business confidence ever since. In our view, the trade war anxiety is probably depressing the yoy rate of GDP growth in Q4 2018 by up to 0.4ppt.

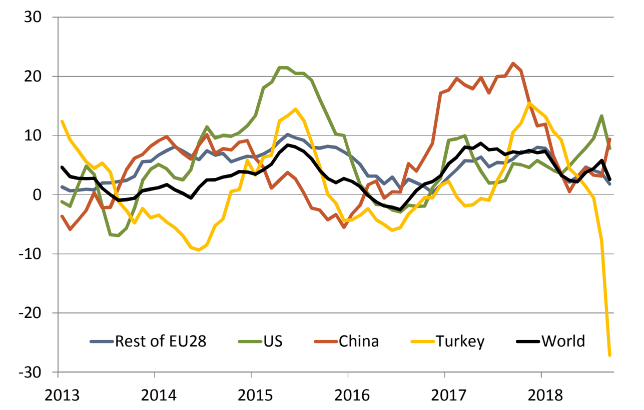
Exports to China are less dynamic – but still growing

- **Chinese slowdown:** Eurozone goods exports to China, which had surged at an average annual rate of 18.6% in the four quarters to Q3 2017, started to lose momentum from late 2017 onwards, as China became more serious about reining in credit growth. China buys 7.4% of all Eurozone goods exports. The China factor can explain some of the initial loss of momentum in Eurozone real GDP growth in early 2018 from the stellar pace of 2017; however, Eurozone goods exports to China were still rising at a satisfactory average rate of 4.4% yoy in Q2 and Q3 2018. We thus cannot blame China for the decline in GDP growth well below the 1.5% trend rate in Q3 2018. Of course, China may turn into a more noticeable drag on Eurozone export growth unless its stimulates its own demand more forcefully than it has done so far to cope with the costs of deleveraging and the damage inflicted by the US trade war against China.

- **Brexit:** Following dismal gains of just 0.35% yoy in 2016 and 1.05% yoy in 2017, Eurozone goods exports to the UK fell at an average rate of 1.6% yoy in the first eight months of 2018. For the Eurozone, the UK is the second most important export market after the US, taking some 12% of Eurozone goods exports. The pre-Brexit weakness in UK investment and overall growth has so far been no more than a modest irritant for the Eurozone. Up until Q3 2018, the effect on the actual performance of the region was probably minimal, accounting for no more than 0.1ppt of the Eurozone's loss in growth momentum. For late 2018 and Q1 2019, the shrillness of the current Brexit debate in the UK is likely to exacerbate the ongoing decline in Eurozone business expectations and confidence, though.

An irritant could turn into a larger problem if the UK cannot get its act together

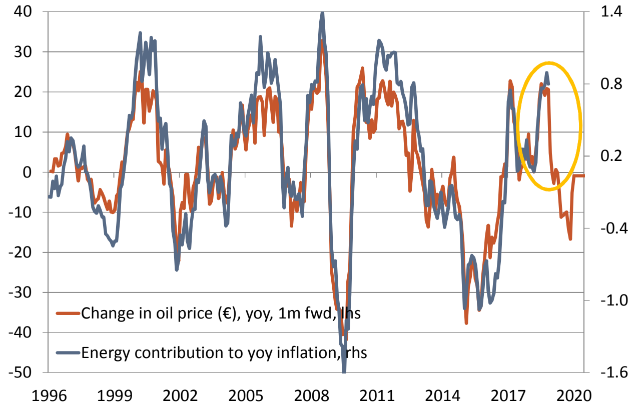
Chart 8: Sources of pain – Eurozone goods exports by region



Monthly data. Yoy change in %. 3-month average. Last value is yoy data for September 2018.

Source: Eurostat

Chart 9: Oil shock set to fade soon



Yoy change in price for barrel Brent crude, in €, adjusted for change in headline consumer prices (base year 2015); and energy contribution to Eurozone headline inflation, in ppt; oil price projection for November 2018 onwards based on constant oil prices at 3 December 2018 level.

Source: Haver, Eurostat, Berenberg calculations

- **Crisis in Turkey and some other vulnerable emerging markets:** In 2017, the Eurozone sold 1.6% of its goods exports to Turkey. Latest data (for September 2018) show a 27.2% yoy drop in Eurozone exports to the crisis-stricken country. For Q4, the rate of decline could easily be 30% or worse. On its own, this would subtract 0.17ppt from the yoy rate of Eurozone GDP growth.

A deep plunge

- **Radical misrule in Italy:** The spending plans of the radical government that took power in June, the resulting rise in risk premia and the concerns about parts of the banking system are taking their toll on Italy's economic performance. After a 0.1% qoq decline in Italian real GDP in Q3, the risks to our forecasts that the Italian economy will start to grow again slightly from Q4 onwards are tilted heavily to the downside. So far, contagion from Italy to other countries has remained limited. But the weakness in Italy, which accounts for 15.4% of Eurozone GDP, subtracts from overall growth in the Eurozone. To some extent, concerns about Italy, are probably weighing on exports to Italy and on economic sentiment in neighbouring countries.

As radicals hurt Italy, they subtract from Eurozone growth

- **Oil shock:** Higher oil process contributed 0.8ppt to the annual rate of headline inflation in the Eurozone in Q3 2018 after just 0.1ppt in Q1. Households had to spend more on petrol and heating oil, leaving them less money for other expenses. The resulting drag on the gain in real disposable incomes can probably explain about half of the deceleration in private consumption growth from 1.7% yoy in Q1 to 1.2% in Q3.

A major drag on disposable income growth

- **Car sector:** Specific problems in the German car sector stemming from the belated adjustment to new emission testing standards caused a 19.6% yoy decline in German passenger car production in Q3 and a similar drop in German car exports. Including the impact on related sectors, this factor probably subtracted about 0.35ppt from German and roughly 0.12ppt from Eurozone GDP growth in Q3. As ever greater numbers of German car producers' models are being certified as compliant with the new standards, the effect started to fade gradually in October.

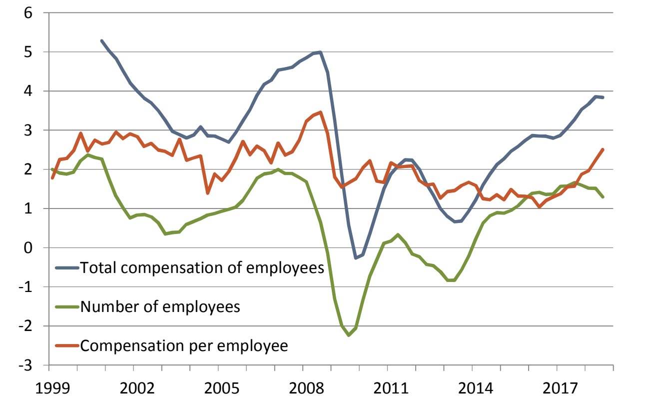
Cleaner cars, please

Reviewing the risks

Domestic fundamentals remain encouraging

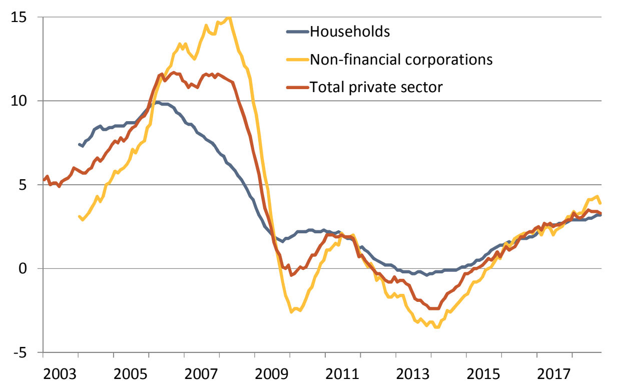
By and large, domestic economic fundamentals remain encouraging in the Eurozone. The ongoing gains in employment and wages (see Chart 10) and the firming of credit growth (see Chart 11) are just two of many examples that prove the point; however, the most recent data also show that the external shocks and political risks have started to seep into the domestic economy. Gripped by fear and facing weaker export demand, companies have slowed down the pace of hiring while consumers are also spending more cautiously. These are first signs that the self-reinforcing downward dynamics of the business cycle have started to set in, to some extent.

Chart 10: Healthy gains in Eurozone employment and wages



Quarterly data, yoy change in %. Sources: Eurostat, ECB

Chart 11: Monetary policy at work – the credit cycle has turned up



Bank loans to the non-bank private sector, adjusted for loan sale and securitisations, monthly data, yoy change in %. Source: ECB

Growth is likely to soften near-term

The leading and coincident indicators reviewed on pages 2-5 of this report give a clear message: growth is far more likely to soften further than to firm in the next two quarters; however, that does not mean that the results will be even worse than the surprisingly meagre 0.16% qoq rise in real GDP recorded in Q3. Without the specific problems in the German car sector, Q3 growth would have been close to 0.3% qoq for the Eurozone. A gradual rebound in German car production will probably add slightly to the quarterly real GDP gains in Q4 2018 and Q1 2019, partly offsetting the underlying downtrend in real GDP dynamics.

A succession of special factors makes the quarterly data volatile

We look for an increase in real GDP of 0.21% qoq in Q4 followed by 0.28% qoq in Q1. The start of 2019 could be slightly better than the end of 2018 due to lower oil prices and a likely rebound in French activity after some strike-related losses in November and December 2018. In the same vein, in Q1 2019, the German chemicals and energy sector will probably recover most of the output losses of Q4 caused by transport problems after water levels on the Rhine had fallen below critical levels during the autumn. While an unusually dry summer and autumn had cheered wine growers along the river, many merchant shippers have been grounded by a lack of water.

Will the shocks abate – and can the fear factor fade?

Abstracting from such short-term distortions, the outlook for 2019 will depend crucially on two major issues: first, will the external shocks and political risks abate somewhat, and second, can the downward cyclical dynamics be halted before the downturn turns into a recession? Below, we first review the key risks before we summarise the outlook.

Trade war: the wild card

Trade tensions stoked by President Trump weigh on Eurozone sentiment

Since March 2018, European companies have often cited trade tensions stoked by US President Trump as the single most important factor clouding the global outlook. Of course, the trade tensions currently focusing mostly on the US versus China should do at least as much damage to the US as to the less directly targeted but more export-oriented Eurozone; however, the US fiscal stimulus and – to some extent – the boost from ongoing deregulation – have so far offset the damage for the US. As a result, the fortunes of the US and the Eurozone, the two largest economic entities in the world, have diverged strongly in 2018 (see Chart 12).

In this respect, bad news may well turn into good news. As the stimulus impact fades and the US feels the costs of protectionism more strongly over the course of 2019, the political rationale for the US to strike deals with China and the EU should become stronger over time. Otherwise, mounting damage to the US economy could further impair Trump's prospects for re-election in 2020.

China has the tools to stimulate demand, if need be

China has tools to re-stimulate domestic demand

In early 2019, Chinese weakness may continue to weigh on Eurozone growth; however, with its high savings rate of more than 40% of disposable income, sufficient controls to prevent massive capital flight and subdued inflation of 2.5% yoy in September and October 2018, China has the tools to re-stimulate domestic demand if, when, and to the extent that its political leaders deem it desirable. Following three cuts in reserve requirements so far in 2018 and an announced tax cut on cars, we look for China to add one modest stimulus to the next in the coming months until it works – that is until growth stops decelerating for a while. As a result, we expect growth in exports to China to rebound over the course of next year.

Brexit

By 30 March, Brexit uncertainty should be mostly over

A no-deal hard Brexit would be a major shock for the Eurozone. Although it would hurt the much smaller UK much more than the big Eurozone, it would still be potent enough to turn a period of below-trend growth in the Eurozone into stagnation or worse for a couple of quarters. Amid the deafening noise, the tail risk of such a dismal outcome has receded from 20% to 10%, in our view. UK parliamentarians may not agree on much these days, but a clear cross-party majority seems ready to act to prevent a no-deal hard Brexit, if need be. One way or the other, the major Brexit risks will have been avoided – or will at least have become much more manageable – by 30 March 2019.

Turkey: the worst of the drag should be over next spring

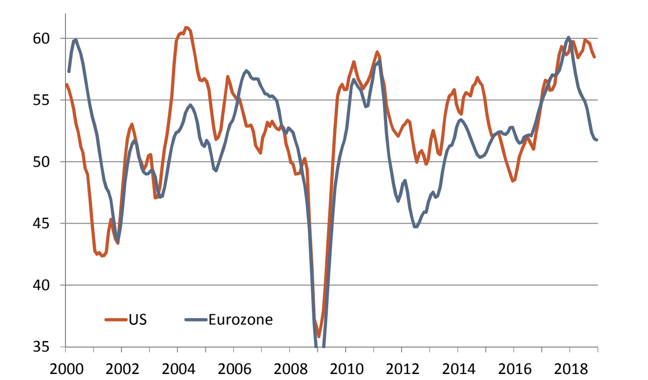
The plunge cannot last forever

The outlook for Turkey has become less dismal following its belated rate hike on 13 September and attempts to mend relations with the US and the EU. The country is suffering a standard emerging-market recession to correct prior credit and current account excesses. The downturn should be followed by a subsequent rebound. If Turkey hits bottom early next year, as we expect, Eurozone exports to the country should stop falling in spring 2019. Turkey will then cease to be a noticeable drag on Eurozone growth. The turnaround in Turkey's current account to a surplus of $0.8bn in September 2018 after average monthly deficits of $5bn in the first half of the year shows that the painful adjustment in Turkey is under way.

Other emerging markets may benefit from the Fed slowing its rate-hiking pace

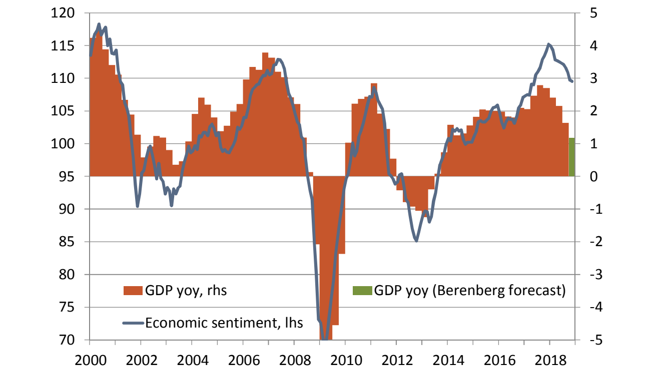
By and large, the same pattern should hold for some other vulnerable emerging markets such as Brazil and Argentina. With the US Fed likely to switch into wait-and-see mode soon, the pressure on emerging markets with significant dollar debt should ease somewhat next year.

Chart 12: Transatlantic gap – manufacturing PMIs Eurozone, US



Monthly data, 3-month averages.
Source: ISM, Markit

Chart 13: Eurozone economic sentiment and GDP growth



Eurozone economic sentiment, left-hand scale; real GDP, yoy change in %, right-hand scale. Source: European Commission, Eurostat

Italy: muddling through, as it cannot afford a crisis

For their own sake, the radicals need to get real

Unsurprisingly, the standoff between the radical government in Rome and the EU is hurting Italy much more than the Eurozone at large. Despite their fiery rhetoric, the radicals cannot ignore the economic costs of their spending plans for long. The resulting rise in risk premiums and the concerns about parts of the banking system are taking their toll. Instead of providing at least some debt-financed temporary boost to Italy's GDP, the alliance of 5Stars and the Lega seems to be hurting Italy already.

As discussed before, we expect Italy's government to back down somewhat under the pressure of markets. Anecdotal evidence of an emerging credit crunch in Italy seems to have registered, especially with the Lega, which draws a significant part of its support from small and medium-sized businesses in Northern Italy. According to media reports, the government is ready to implement its spending promises more slowly in order to keep the projected 2019 fiscal deficit at 2%. This suggests that Italy will probably muddle through noisily in 2019 instead of descending into a full-blown debt crisis that could also harm the overall Eurozone economy significantly for a while.

Oil: turning into a tailwind

As the oil shock fades, consumer spending can rebound

The drag from oil should gradually fade from December 2018 onwards. Due to base effects, the contribution of energy to headline inflation could fall substantially over the next ten months, with particular sharp dips in May or June 2019 (see Chart 9, page 7). The 25% drop in the oil price since late October bodes well for our assumption that real consumer spending in the Eurozone can become more dynamic again over the course of 2019.

Outlook: rebound during 2019, risks tilted to downside

A better spring after a grey winter

Economic sentiment remains well above average (see Chart 13). This shows that the downward cyclical dynamics are not deeply entrenched yet. Once the external shocks and political risks have receded somewhat, economic activity could thus start to rebound. We expect this to happen from Q2 2019 onwards. With luck, financial indicators will start to herald this during Q1 2019 already.

However, risks are heavily tilted to the downside

Of course, we cannot rule out two major risks: first, politics may go badly wrong – Trump may further escalate his trade wars, the UK may fall into the hard-Brexit trap or Italy's radical government may steer the country into a disruptive debt crisis; second, even if the big risks that are currently scaring companies and households fade over the course of 2019, as we expect, the fear factor may take on a life of its own for a while. Households and companies may now be so nervous that some smaller future disturbances, which they would shrug off in more settled times, could still inhibit their readiness to spend more money again for a few quarters. Unfortunately, the risks to our calls for the depth and duration of the current downturn remain tilted to the downside. For our detailed forecasts, see Table 1 below.

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Table 1: Eurozone economic forecasts

		2017	2018	2019	2020	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19	1Q20	2Q20	3Q20	4Q20
GDP	% y/y	**2.5**	**1.8**	**1.3**	**1.7**	2.4	2.2	1.6	1.2	1.1	1.0	1.3	1.6	1.7	1.7	1.7	1.7
	% q/q					0.4	0.4	0.2	0.2	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4
	%q/q ann.					1.5	1.7	0.6	0.8	1.1	1.6	1.7	1.7	1.6	1.7	1.7	1.7
Private Consumption	% y/y	**1.7**	**1.3**	**1.0**	**1.5**	1.7	1.4	1.0	1.0	0.8	0.9	1.2	1.3	1.4	1.5	1.5	1.6
	% q/q					0.5	0.2	0.1	0.2	0.3	0.3	0.4	0.4	0.4	0.4	0.4	0.4
Government Consumption	% y/y	**1.2**	**1.0**	**1.4**	**1.5**	1.0	1.1	0.9	1.0	1.4	1.3	1.5	1.5	1.5	1.5	1.5	1.6
	% q/q					0.0	0.4	0.2	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Investment	% y/y	**2.9**	**3.0**	**2.7**	**2.9**	3.5	3.0	3.1	2.5	3.0	2.2	2.7	2.8	2.9	2.9	2.9	2.9
	% q/q					0.1	1.5	0.2	0.6	0.6	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Final Domestic Demand [1]	% y/y	**1.8**	**1.5**	**1.4**	**1.7**	1.8	1.6	1.4	1.3	1.3	1.2	1.5	1.6	1.7	1.7	1.8	1.8
	% q/q					0.3	0.5	0.1	0.3	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Net Exports [1]	% y/y	**0.8**	**0.2**	**-0.3**	**-0.1**	0.6	0.7	0.0	-0.5	-0.4	-0.5	-0.2	0.0	0.0	0.0	-0.1	-0.1
	% q/q					-0.1	0.0	-0.3	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Stockbuilding [1]	% y/y	**-0.1**	**0.1**	**0.1**	**0.0**	-0.1	-0.1	0.3	0.4	0.2	0.3	0.0	0.0	0.0	0.0	0.0	0.0
	% q/q					0.2	-0.1	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Current Account Balance	EUR bn	**353**	**339**	**332**	**326**	106	94	61	78	105	94	58	75	105	94	55	72
	% of GDP	**3.2**	**2.9**	**2.8**	**2.6**												
Industrial Production [2]	% y/y	**2.9**	**1.5**	**1.3**	**1.5**	3.3	2.3	0.7	-0.1	0.9	1.2	1.5	1.4	1.4	1.4	1.5	1.5
	% q/q					-0.6	0.1	-0.1	0.5	0.4	0.3	0.3	0.4	0.4	0.4	0.4	0.4
Unemployment Rate [2]	%	**9.1**	**8.3**	**8.1**	**7.8**	8.5	8.3	8.1	8.1	8.1	8.1	8.1	8.0	8.0	7.9	7.8	7.7
CPI [2]	% y/y	**1.5**	**1.8**	**1.5**	**1.6**	1.3	1.7	2.1	2.0	1.7	1.5	1.4	1.4	1.5	1.6	1.7	1.7
General Govt. Balance	% of GDP	**-0.9**	**-0.7**	**-0.9**	**-0.9**												
General Govt. Debt	% of GDP	**86.8**	**84.5**	**83.1**	**81.3**												
ECB main refinancing rate [3]	%	**0.00**	**0.00**	**0.00**	**0.75**	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.25	0.50	0.50	0.75

[1] Contribution to GDP growth [2] Period averages [3] End of period

Source: Berenberg

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