Economics

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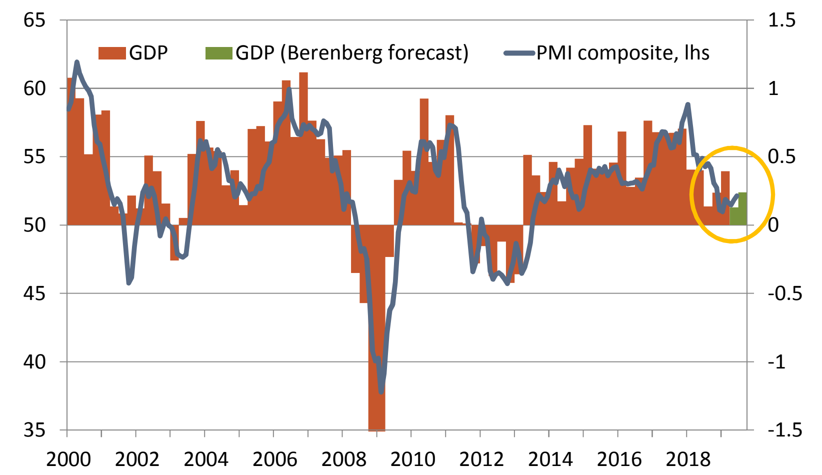
21 June 2019

Eurozone: bottoming out amid the storm

Edging up slightly: Eurozone PMI survey points to moderate growth



Monthly data for PMI composite (50=no change), left-hand-scale, quarterly data for GDP growth, qoq in %, right-hand-scale. Source: Markit, Eurostat

- **The strength at home:** Resilient domestic demand continues to shield the Eurozone economy at least somewhat from the raging external storms. Despite the unexpected escalation in the US-Chinese trade war in early May, purchasing managers in the Eurozone upgraded their assessment of output growth modestly to a seven-month high in June. Although new orders for manufactured goods fell sharply again, a stronger inflow of new orders into the service sector raised the overall reading for new orders in Markit's flash PMI reading for June.
- **Not so fickle after all:** Businesses seem to be more relaxed about the outlook than financial analysts. The slight gain in the PMI survey for June to 52.1 after 51.8 in May stands in sharp contrast to the ZEW survey of investors and analysts. In June, the ZEW balance of respondents expecting a positive versus negative Eurozone outlook for the next six months dropped to -20.2 from -1.6 for May. Still, the contrast is less glaring than it looks at first glance. According to Markit, purchasing managers also scaled back their expectations for growth in the coming year to their lowest level since October 2014. The reason is obvious, according to Markit: "Manufacturers reported particular concerns about slowing demand in export markets and the disruptive impact of trade wars." The Eurozone continues to face downside risks.
- **Moderate growth ahead:** The PMI data points to moderate growth in the Eurozone. Gains in domestically-oriented services are more than offsetting a modest decline in the more export-oriented manufacturing sector. Ongoing increases in employment, real wages and disposable incomes, as well as a modest fiscal expansion of some 0.2% of Eurozone GDP this year, support domestic demand.
- **Volatile data:** The profile of quarterly Eurozone GDP gains could be somewhat volatile, though. Special factors such as a rebound from an exceptionally weak end to 2018, a mild winter that boosted construction in early 2019 and an unusually late Easter that delayed factory holidays into April, had raised GDP growth to a 0.4% qoq pace in Q1 2019. As these effects go into reverse, we look for growth to slow to a mere 0.1% qoq in Q2. Monthly data on output and exports for April suggest that GDP is stagnating in Germany and Italy in Q2, with a clear risk of a small decline instead. Thereafter, growth could return to a 0.2% gain in Q3 followed by 0.4% qoq in late 2019 if trade tensions ease.
- **No need for drastic ECB action yet:** The ECB stands ready to act if growth or core inflation fall short of expectations. The PMI data do not signal a need for drastic action yet. Following Mario Draghi's ultra-dovish Sintra speech, we expect the ECB to change its guidance in July to pave the way for potential rate cuts, vowing to keep rates at "present or lower levels" instead of just "present levels". The ECB may also tie its guidance more explicitly to core inflation.
- **Adieu gilets jaunes:** The small gain in the Eurozone PMI has been driven mostly by France. The early 2019 hit from "yellow vest" protests is over and President Emmanuel Macron has vowed to intensify his pro-growth structural reforms. Encouragingly, French job creation accelerated to its fastest pace since October 2018 in the PMI survey.

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