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EUROZONE OUTLOOK: A FIRMER RECOVERY

Berenberg Macro Flash

Good news from the Eurozone. One by one, the pieces are falling into place. After a soft patch in the second half of 2015, the Eurozone is returning to trend growth of roughly 1.6% yoy. Whereas the surprisingly strong GDP increase of 0.6% qoq in Q1 probably overstates the recent momentum a little, economic fundamentals as well as leading indicators point to a sustained upswing in the second half of this year after a likely temporary lull in Q2.

Following a brief spell of above trend growth at an average annualised rate of 1.8% from late 2014 to mid-2015, a decline in Eurozone exports to China and other emerging markets slowed the pace of expansion to an annualised rate of 1.25% in the second half of last year. Despite the serious market turbulence in January and February, the Eurozone economy started rather well into 2016. Once again, the widespread concerns that the Eurozone might fall prey to a deflationary downward spiral have been exposed as wrong.

Of course, the 0.6% qoq increase in Eurozone GDP reported today for Q1 looks a little too flattering. An unusual surge in industrial output in January has raised the overall GDP number. This particular strength in January should be seen partly as a payback for the somewhat weakish December data in the volatile Christmas holiday period. Notions that the Eurozone at a quarterly annualised rate of 2.2% expanded more than four times faster than the US with 0.5% annualised in Q1 are misleading. The US number seems to be the customary outlier to the downside at the start of the year that will be followed by a stronger Q2. In the Eurozone, the dip in most survey data in early 2016 as well as the bout of market turbulence suggests that the region will not be able to fully match the Q1 result in Q2.

For once, France surprised to the upside in Q1 with a 0.5% qoq gain in its GDP after 0.3% in late 2015. Spain managed to shrug off political uncertainty, maintaining its strong momentum with another qoq gain of 0.8%. Thanks to the Rajoy reforms, Spain is fundamentally in good shape. For both France and Spain, leading indicators project a less positive follow-up in Q2, though.

EXPECT TREND GROWTH BY MID-2016 AFTER A DIP IN Q2

Abstracting from the short-term volatility in the data, which probably reflects measurement and seasonal adjustment issues rather than underlying changes, the economic outlook for the Eurozone is modestly encouraging. The concerns that rocked markets in early 2016 are fading.

- China has unleashed another stimulus to support demand. While simply throwing money at structural problems is not a sustainable solution for China in the long run, it will likely work for the foreseeable future until China runs out of such money. We don't seem to be close to that moment of truth yet.
- The end of the rout in raw material prices as well as hopes for a political catharsis in Brazil underpin a less negative outlook for emerging markets.
- Despite a weak first quarter in line with similarly restrained starts to the previous years, the US still looks set to enjoy growth close to 2% this year, supported by healthy consumer incomes. As expected, the late-January concerns about a perceived US recession risk were far overdone.

We expect Eurozone exports to China and other emerging markets to hit bottom by mid-2016 at the latest. China is stimulating its economy again. No surprise here. If some flows of capital back into selected emerging markets enables them to reduce interest rates, domestic demand and the capacity to buy imports could edge up again in these countries later this year. With the end of the drag from emerging markets, Eurozone growth can expand close to its 1.6% trend rate for the foreseeable future after a likely correction in Q2.

The tailwinds from cheap oil and an undervalued euro are blowing less strongly now than they did last year. However, a new tailwind from a modest fiscal easing of 0.3% of GDP and on-going gains in employment of 1.2% yoy in Q4 2015 will support domestic demand over the course of this year. In addition, the significantly more aggressive stance of the ECB will likely lead to some modest firming of the credit cycle.

SURVEYS POINT TO MORE GROWTH BY MID-2016

Economic indicators and recent survey data are not fully conclusive yet. On balance, they support the view that Eurozone economic growth will strengthen again somewhat in a few months time after a likely dip in Q2:

- Financial market professionals raised their expectations for the cyclically sensitive German economy for the second month in a row in April according to the German ZEW survey, from a trough of 1.0 in February to 11.2 in April.

- German companies also became slightly more optimistic about the outlook for the next six months during March and April according to the German Ifo survey, from 99.0 in February to 100.4 in April, a few notches above the long-term average of 100. Note that the marginal decline in the Ifo headline index to 106.6 in April from 106.7 in March was caused by the early Easter holiday, which had shifted holiday shopping from April into March. That resulted in an artificial boost to retail sector sentiment in March and a corresponding correction in April. The less volatile manufacturing confidence had risen further in April even in the Ifo survey.

- In the European Commissions' broad survey of surveys, economic sentiment for the Eurozone rebounded in April from 103.0 to 103.9, erasing the drop in March. This is partly an Italian story. After a sharp fall in March, which may well have been the result of exaggerated concerns about the Italian banking system, economic sentiment recovered strongly in Italy in April. But even outside Italy, some gains in sentiment in countries such as Germany, the Netherlands, Belgium, Austria, Portugal and Cyprus offset a setback in France.

- By and large, the Eurozone periphery continues to reap the rewards of its earlier reforms. With the sad exception of Greece, hobbled by the refusal of the Tsipras government to implement the required reforms, confidence in all erstwhile euro crisis countries is well above average for the region, with Cyprus at an exceptionally strong 113.3, Italy at 108.1, Portugal at 106.5 and Spain at 106.1 versus an average of 103.9.

As in the US and the UK, I look for growth in the second half of 2016 in line with the longer-term trend, which we put at around 1.6% for the Eurozone, somewhat below 2.5% for the US and just above 2% for the UK. Such growth would be good enough to deliver further sustained gains in employment across the Eurozone. If so, the ECB would not need to even consider any addition to its monetary stimulus. In the wake of the backlash in German liberal-conservative circles against the ECB's March easing package, the ECB would probably not react to minor shortfalls in growth by scaling up its stimulus again anyway.

The key risk to our modestly optimistic economic outlook is obvious. Mind the politics. If the UK votes itself out of its biggest export market on 23 June, the resulting economic uncertainties and political repercussions in the UK and the Eurozone could derail the upturn across much of Europe for a while. We see a 35% Brexit risk. But if reason prevails, as we hope it will, today's encouraging GDP flash estimate for early 2016 will be followed by further healthy data from mid-2016 onwards after a brief lull in Q2.

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