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EUROZONE: DOMESTIC DEMAND DRIVES THE RECOVERY

Berenberg Macro Flash

Steady growth, more jobs, neither inflation nor deflation. While not exactly splendid, the outlook for the Eurozone economy is quite satisfactory. Supported by domestic demand, the Eurozone economy looks set to expand at a pace around its 1.6% trend rate later this year, in line with growth over the last five quarters. All in all, the Eurozone seems to have digested the somewhat irrational market turbulence of early 2016 as well as the current Brexit concerns quite well. While political risks loom large, notably the risk that the UK could eject itself from its major market on 23 June and strengthen anti-market protectionist forces across Europe in the process, the economic fundamentals are living up to expectations. Support from rising employment, a modest fiscal stimulus of 0.3% of Eurozone GDP and the ECB's well-tailored monetary policy seem to more than offset the lessening tailwind from cheap oil which had blown more strongly in late 2015 and early this year.

Economic sentiment in the Eurozone improved for the second time in a row in May, rising to 104.7 from 104.0 in April (revised up from 103.9) and a mini-trough of 103.0 in March, nicely above the 100 long-term average. While sentiment has not quite returned to the recent high 106.6 in December, which was followed by a 0.5% qoq rise in GDP in Q1, the May gain in sentiment is consistent with a GDP advance of at least 0.4% qoq in Q3. Although growth will likely slow down temporarily to 0.25% qoq in Q2 as a payback for the strong Q1 result and in the wake of the brief dent in sentiment early this year, the outlook beyond Q2 looks modestly encouraging.

Good news from home:

- Despite higher oil prices, **consumer confidence** rose strongly in May to -7.0 from -9.3 in April, helped by a significantly more positive assessment of the economy in general and the labour market in particular.
- Serving mostly domestic clients, **retail** and **construction** companies also became significantly more optimistic in May. Whereas sentiment in the **services sector** slipped slightly from 11.7 to 11.3, it corrected less than a third of the significant gain recorded in April.
- After a rise from -4.1 in March to -3.6 in April, **industrial sentiment** held steady in May at a level which, like almost all other readings of the sentiment indices, is modestly above the long-term average. While manufacturers downgraded their assessment of **export orders** slightly from -12.6 in April to -12.9 in May, well above the -19.0 long-term average, they recorded a gain in **overall orders** (up from -12.5 to -11.5 vs a -17.2 long-term average. Again, this suggests that the additional demand is coming more from home than from abroad.

A broad-based recovery. Once again, the country details show a very diverse picture. The old split between core and periphery, which was so dominant during the euro confidence crisis 2011 to 2013, has disappeared. For the erstwhile euro crisis countries, sentiment remains modestly above those of the Eurozone average and of Germany (see chart). Encouragingly, sentiment improved in **Italy** from 108.1 to a very strong 108.4 because of a noticeable gain in services. Despite the headline-grabbing protests against a rather modest labour market reform, sentiment advanced even more significantly in **France** from 101.6 in April to 103.1 in May, almost matching the recent high of 103.5 from October last year. By and large, Renzi and – by now – even Hollande now seem to be on the right track. Let's hope they persevere.

The exception remains small Greece where sentiment fell further in May to a recession-level 89.7 from 90.3 in April. Whereas hopes that Greece will be able to agree with its creditors and implement what it needs to do may have contributed to a small gain in Greek consumer and services confidence from very low levels, sentiment in Greek industry deteriorated significantly in May.

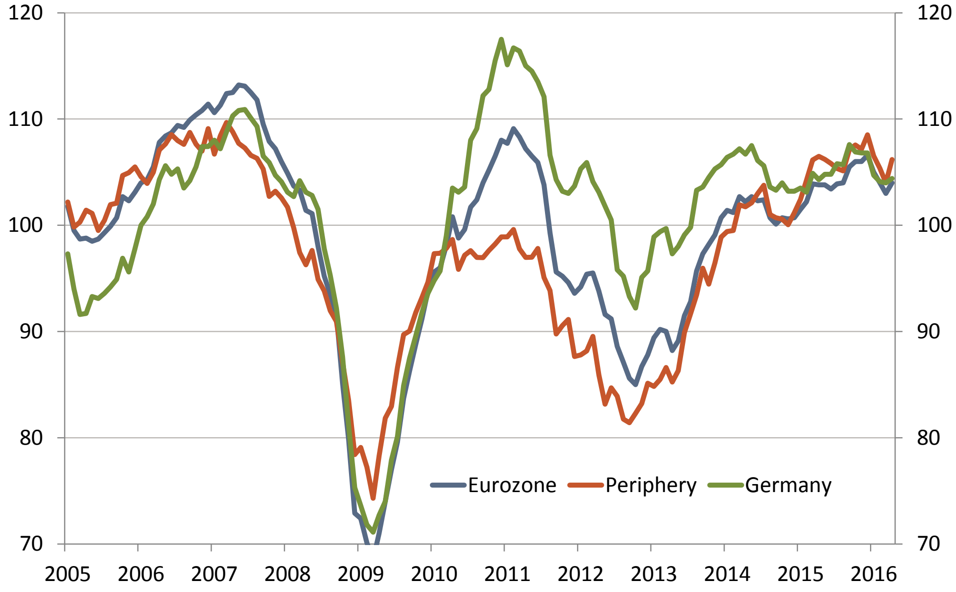
NEITHER INFLATION NOR DEFLATION

Encouragingly for the **ECB**, which is striving to nudge **inflation** gradually back to its “close to but below 2%” definition of price stability, inflation expectations rebounded across the board in the Eurozone in May while staying at reasonably low levels. Manufacturers raised their assessment of selling price expectations from -2.8 in April to -0.7 in May (long-term average 4.8), service companies followed suit with a rise in selling price expectations from 4.0 to 5.8 (long-term average 3.0) while consumers upgraded their expectations of price trends for the next 12 months from 2.9 to 3.4, far below the long-term average of 19.2. All in all, less subdued oil prices and satisfactory gains in domestic demand are nudging the inflation outlook back towards more normal.

Monthly data are volatile. The broad-based economic sentiment indices give a slightly more upbeat message than the much narrower PMI indices for May, which had signalled a marginal slippage in the Eurozone because of some setback at the euro periphery. That strong gain in consumer confidence, which is included in the European Commission’s sentiment index but not the PMIs, may explain part of the discrepancy. With German Ifo expectations also rising in May, the overall crop of survey data for the month of May backs our view that economic momentum in the Eurozone will likely firm modestly in the next few months after a possible dent in early Q2.

For the ECB meeting on Thursday, this is a comfortable backdrop. The ECB can say that, while it is very early days, its March stimulus package may be contributing a little to the resilience of Eurozone domestic demand. In the wake of a rebound in oil prices and strong Eurozone GDP in Q1 , the ECB will likely raise its projections for growth and inflation modestly. Without ruling out a further stimulus, that will make it easy for the ECB to stay on the sidelines for the foreseeable future. The ECB can wait and see how its March stimulus unfolds.

Chart 1: Great convergence at a satisfactory level
Economic sentiment in the Eurozone, Germany and the euro periphery



Periphery. Weighted average for Italy, Spain, Greece and Portugal. Source. European Commission

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