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EUROZONE UPDATE: UPSIDE RISK FOR Q2 EUROZONE GROWTH

Berenberg Macro Flash

For tomorrow's preliminary flash estimate of GDP growth in Q2, we expect to see a soft reading of 0.2% qoq. This is mainly an arithmetic effect following the stellar first quarter (0.6%). Underlying fundamentals continued to improve. Taking the average of the first two quarters (0.4%), the Eurozone grew broadly at trend so far this year. Despite Brexit uncertainty in Q2, soft data remained upbeat, suggesting some upside risk to our Q2 call. This would follow the strong upside surprise seen in Q2 data for the UK, 0.6% qoq in Q2 versus expectations of 0.5% qoq.

<u>No real signs of Brexit in the soft data yet</u>

With the Brexit risk materialising on June 23, the Eurozone growth outlook has weakened. We forecast Eurozone growth of 0.2% qoq in Q3 and Q4, roughly half of its trend rate. On a positive note, the limited post-vote data, so far, remains largely unchanged versus the pre-vote period. Risks to the outlook look less titled to the downside than before.

Confidence gauges, usually the first indicator for how the economy responds to downside shocks remain upbeat. Some forward-looking surveys, especially those with a financial market angle, have deteriorated (ZEW and Ifo expectations). But the recurrent theme is that expectations are worse than current activity. Survey measures of the current situation point to stable growth among Eurozone businesses. July PMIs, Ifo current assessment, today's European Commission economic sentiment indicator and other national confidence indices this week (Italy and France) do not indicate a negative impact of the Brexit vote yet.

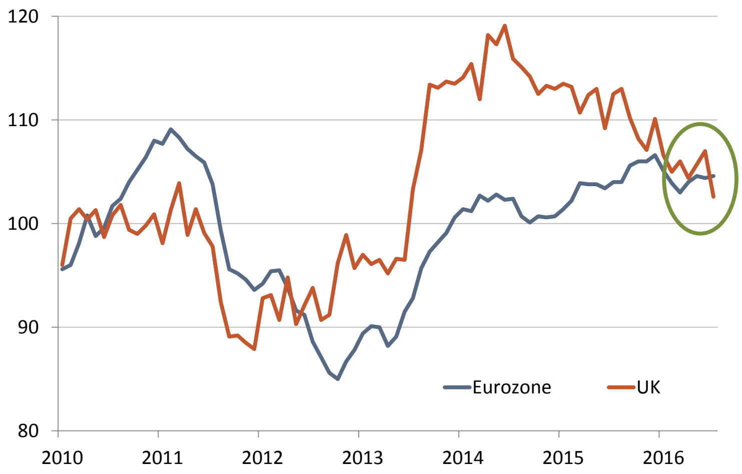
<u>Explaining the better than expected data</u>

The severely adverse scenario of a possible domino effect following Brexit, with fears spreading across the channel that surging Eurosceptic parties call British-style referenda on EU or Eurozone membership remains limited for now. Please see our report on the domino risks for more info. So far, market indicators such as yield spreads between peripheral and core sovereign bonds haven't reacted to the Brexit vote. This is in sharp contrast to the euro crisis when markets were worried that Europe could unravel on the back of troubles in tiny Greece. Peripheral-core spreads widened sharply, prompting Mario Draghi to make his 'whatever it takes' remarks. This time around the ECB have been decidedly neutral. This is a big positive. Importantly, Brexit is first and foremost a UK issue. The discrepancy of the latest readings of business and consumer surveys and between the UK and the Eurozone is quite compelling in this regard (see chart).

<u>Political risks still loom large</u>

Beyond Brexit, what other risks need to be watched in the Eurozone? Struggling Italian banks could add to political tensions in Italy. Italy is the main focus of our concerns in Europe after Britain. Mr Renzi's government could be at risk if he loses the referendum on constitutional reform this October, potentially leading to early elections. In France and Germany, attacks may cause support for Eurosceptic parties to rise. In Spain, political stalemate of the last seven months continues. But downside risks to growth in Spain, the fastest growing of the crisis economies, remain limited. The Spanish economy continues to recover nicely, despite the lack of clear leadership.

Economic sentiment indicator (Eurozone vs. UK)



Source: European commission

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