Eurozone: Revisiting growth

Special

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Summary

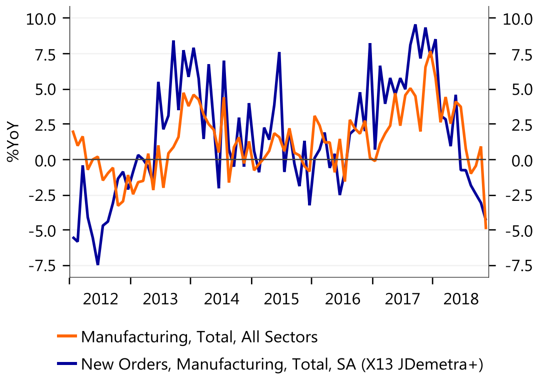
- The disappointing recovery of the German car sector, the yellow vests in France and slowing external demand lead to a downward revision of our growth figures for 2018Q4 and 2019Q1
- For the Eurozone we expect a flat number (0%) in 2018Q4 and a small recovery in 2019Q1 (0.4%)
- Persistent weakness in Eurozone activity data have raised doubts about the ECB's ability to raise rates in 2019
- Risk factors remain Brexit, the US-China trade war and a further slowdown in external demand, most notably from China

A quarter to forget

The final quarter of 2018 was a quarter one would rather forget. Most notable, of course, was the significant volatility in financial markets. For European equities, it was the worst quarter since 2011Q3, with the Eurostoxx broad index falling more than 13%. The 10y swap rate fell almost 20bp from the previous quarter reaching 0.8%, not exactly a level one would expect to see in the midst of an economic expansion. Concerns about the impact of the trade war, tightening monetary policy in the US and slowing growth in China –with the obvious knock-on effects on global demand– were key factors behind the negative sentiment in global financial markets.

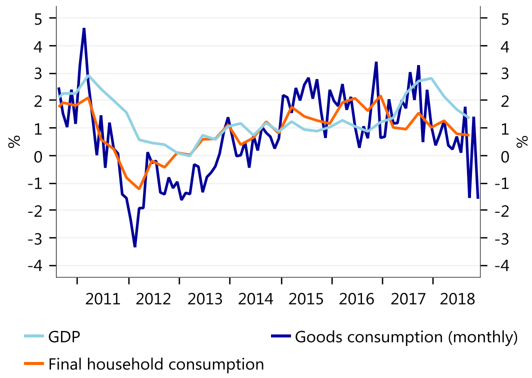
The Eurozone was as much the victim as it was the culprit. The euro slipped some 1.5% against the dollar even though the Italian populist government reached a deal with Brussels over an amended budget plan. Meanwhile, the 'gilets jaunes' revolt in France caused the economy considerable damage, with household spending on goods for November plunging to -1.6% y/y in volume terms, the worst figure since 2013. Meanwhile, the German car sector did not show a convincing pick-up in activity following the slump in Q3, caused by difficulties in the sector to adjust to the new EU emission standards. Reports of slowing demand for cars in China were obviously not supportive either.

Figure 1: German industrial activity slowing sharply towards end-2018



Source: Macrobond

Figure 2: 'Gilets jaunes' revolt hits French consumer spending



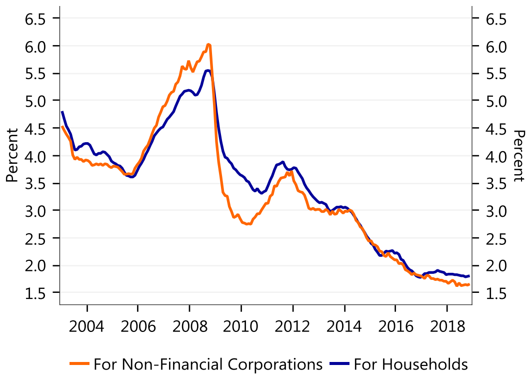
Source: Macrobond

Overall, persistent weakness in Eurozone activity data have therefore added to investors' doubts about the ECB's ability to raise rates in 2019. Towards year-end the OIS curve flattened to a point where a first rate hike wasn't fully priced in until summer 2020(!), although this dynamic reversed somewhat in recent days. We mostly attribute this U-turn to Fed Chairman Powell, who signalled the possibility that the Fed could pause its hiking cycle if so required. With the US market no longer priced for any rate hikes this year, this has supported global markets, and also appears to be the reason why investors are now revisiting their ECB odds again.

However, on the face of it, the extent of weakness in recent economic data in the Eurozone is clearly inconsistent with our view that the ECB can still raise rates this year. Although, in our opinion, the ECB Governing Council's aim to 'normalise' is also driven by concerns over bank profitability and financial stability risks stemming from too low or negative interest rates, its ability to raise rates this year now hinges on whether the recent weakness has been due to temporary factors and whether the economy still has sufficient resilience to reverse course later this year.

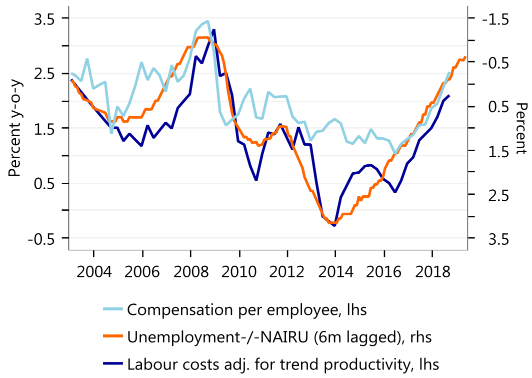
Therefore, our economists have taken a deep dive and asked themselves whether the economy still has sufficient juice to reverse course this year and leave behind the dreadful performance of the last two quarters. The answer to that question is still a "yes", but not without considerable caveats.

Figure 3: Lowest borrowing costs for households and businesses... ever?



Source: Macrobond

Figure 4: Falling unemployment and rising wages now going hand in hand



Source: Macrobond, Rabobank

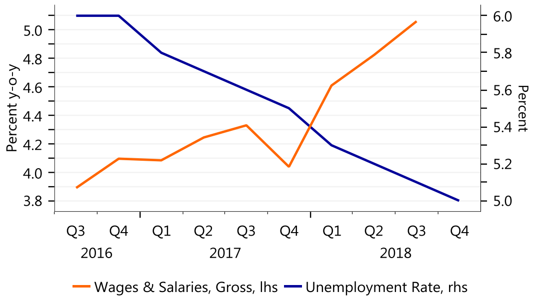
Revisiting our growth outlook

In view of recent data our +0.4% q/q forecast for 2018Q4 has become too optimistic; a flat number (0%) for Q4 now seems likely. Moreover, we feel that the balance of risks is tilted towards a weaker growth figure for 2019Q1, even though several factors that depressed growth in 2018H2 could actually turn into a small boost in H1. Our less positive outlook for 2018Q4 and 2019Q1 translates into reduced GDP growth estimates for 2018 (by 0.1pp to 1.8%) and 2019 (by 0.3pp to 1.4%). The recovery in the German car sector has been slower than expected and inventories are still high, but we believe that the worst is behind us.

The flash-estimate of annual GDP growth in Germany for 2018 indicated that the economy avoided a technical recession in Q4. The expectation now is a small plus for Q4 (0.1% or a bit higher). The government will be supporting economic growth in the coming years with plans to invest 151.6 billion euros through 2022. The labour market remains tight, with unemployment at low levels and growth in negotiated wages finally picking up, which should provide support to the economy in 2019 (Figure 5).

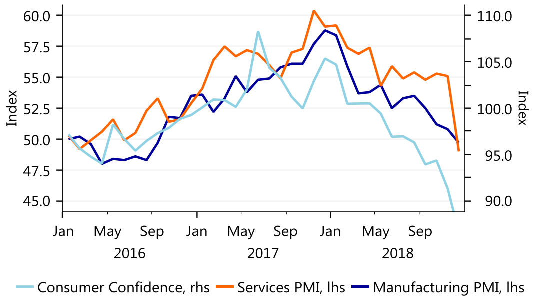
In a similar vein, the response of the Macron government to the protests hasn't been a resounding success, but it does leave room for consumption to recoup some of the losses seen in Q4. The 'Gilets Jaunes' Protests had their impact on the streets of Paris, but were also reflected in drops of the Manufacturing sector confidence, Services sector confidence and Consumer confidence (Figure 6). Macron reacted to the protest by withdrawing the fuel tax that incited the public rage and promised a spending package including a rise in minimum wages. In the meantime the economic damage has been done and the Eurozone-wide slowdown in activity compounds to France's domestic issues. We have therefore revisited our 18Q4 and 19Q1 outlook for France, adjusting downward the Q4 projection by -0.2%-point to 0.0% on the back of a sharp fall in consumption and the Q1 projection by -0.1%-point to 0.3% as we expect consumption to fall further in the beginning of the year before recovering.

Figure 5: German labor market provides support for domestic demand



Source: Macrobond, Rabobank

Figure 6: Confidence indicators dropped amid 'Gilets Jaunes' Protests



Source: Macrobond, Rabobank

All is not lost

Arguably, the protests in France have actually helped forge a budget deal between Italy and Brussels and as such it suggests that budgetary policy in Europe could offer some support this year. Italy remains a weak performing country and could well be the first one to enter a technical recession, our current forecast is -0.1% GDP growth in 18Q4, giving two quarters in a row of negative growth and hence a technical recession.

Our main concern is that the reversal in domestic activity will be (partly) offset by slowing external demand, notably from China. Risk factors in the near-term are obviously (a hard) Brexit and (a further acceleration in) the US-China trade war. But also domestically, the upcoming elections for European Parliament look set to be used by nationalist/populist politicians to raise their voices, which could cause concerns about Europe's ability to effectively respond to the challenges it faces. So, should any of these risks materialize this could feed further caution amongst businesses and households, pushing back the recovery in growth.

But more fundamentally, and from a medium-term point of view, things are not looking that bad. ECB monetary policy remains accommodative. Companies and households are still facing the lowest borrowing rates in the Eurozone's history and the fall in oil prices since October should give households a shot in the arm, where the export sector is now enjoying a 3% weaker effective exchange rate. And, crucially, in most European countries the labour market situation is still gradually improving. In fact, in an increasing number of countries businesses are now complaining about a shortage of labour and equipment. This is gradually feeding into higher wages. Moreover, the energy transition and capacity constraints are also leading companies to invest more. Press agency Reuters reported this month that global automakers – led by Volkswagen – are planning at least $300bn of investments in the next 10 years on electric vehicles (although, admittedly, a sizeable proportion of those investments will be in China).

All in all, we feel there is some room for recovery over the course of this year. But it will be very hard to return to the vigorous growth numbers seen in 2017 and early 2018.

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