Eurozone Q4: The beat goes on
The eurozone: Strong economics, shaky politics. Our opener to the quarterly report on the bloc's health

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Political events unable to slow Eurozone growth
While hopes of further steps to solidify the Eurozone construction are likely to be disappointed on the back of the German election results, the strengthening recovery has removed the sense of urgency in this regard. So far political events have not been able to slow the strengthening growth momentum and 2017 is likely to see the strongest growth year in 10 years. As inflation continues to undershoot; the ECB will likely lengthen its QE programme until the end of 2018, though with a much lower level of monthly purchases. The first rate hike is not be expected before 2019.

Eurozone economic indicators continue to surprise to the upside. The recovery is now firmly underway, with all GDP components contributing to the expansion. While the relatively robust growth pace is also likely to reduce tensions within the Eurozone, politicians will need to seize the occasion to structurally strengthen the Monetary Union.

Steps towards Eurozone integration looking slim
However, with chancellor Merkel's power reduced after the German elections and the less Eurozone-integration minded FDP likely to step into the coalition, the chances to see bold steps towards further integration look slim. While French president Macron presented ambitious proposals to deepen the European Union, his proposal of a common Eurozone budget, needed to dampen asymmetric shocks within the Eurozone, is probably a no-go for the new German government. This will not matter much as long as healthy growth continues. But the next slowdown could reawake some of the centrifugal forces within the Eurozone.

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One shouldn’t forget either that Italian elections will have to be held before May 2018. And even though Italian growth is now also picking up, the country continues to lag the rest of the Eurozone, which still underpins the chances of the more populist parties to come out on top. The economic recovery in Spain has been much stronger, but the escalating conflict between Catalonia and the central government is also likely to lead to more nervousness amongst investors, even though we remain convinced that an independent Catalonia won’t be the final outcome of the current turmoil. Before the end of the year some form of appeasement should be expected.

While the potential three-party (some even argue four as there are internal tensions within the political group of Merkel’s CDU and Bavarian sister party CSU) coalition in Germany is likely to remain rather hesitant in terms of further Eurozone reform, there seems to be an opening for a fiscal boost, something that would strengthen Eurozone recovery. We expect some fiscal stimulus in Germany to boost investment in digital infrastructure and education. The new Dutch government is also likely to put in place some fiscal stimulus. Fiscal policy in the Eurozone in general has been more supportive over the last two years and will continue to be in 2018.

The Eurocoin indicator, reflecting underlying GDP growth pace in the Eurozone, rose to 0.71 in September from 0.67 in August, increasing for the fourth consecutive month. Most forward looking indicators confirm the economy’s momentum. The assessment of order books in manufacturing in the European Commission’s survey rose to the highest level in 10 years in September. Interesting to note is that the export orders assessment also surged in September despite the strengthening of the euro exchange rate. September also saw a further increase in consumer intentions to purchase big ticket items over the next 12 months, to a level compatible with above 2% growth in consumption expenditure. A similar story is given by the PMI Manufacturing: manufacturing production expanded at the fastest pace in more than 6 years in September, while the rate of growth in new orders flirted with a historically high level. This encouraged manufacturers to hire new staff at the fastest pace in the 20 year history of the PMI survey.

Against this backdrop we believe our growth expectations were a bit too low and so decided to lift our GDP forecasts to 2.2% for this year and 1.8% for 2018. In the wake of the above these remain on the conservative side and might be further upgraded if all political hurdles are passed without too much tension on financial markets.

Preliminary inflation figures for September surprised on the downside. Headline inflation remained stable at 1.5%, while core inflation defined as inflation excluding energy, food, alcohol & tobacco prices fell back to 1.1% from 1.2% in August. However, the European Commission survey clearly indicates increasing pricing power amongst European businesses, while wage growth is also likely to pick up somewhat on the back of the falling unemployment rate. ECB board member Benoît Coeuré also highlighted that in the current economic circumstances the deflationary impact of a euro exchange rate strengthening is much more muted. With an increase in the annual growth rate of the M3 broad monetary aggregate to 5.0% in August 2017, from 4.5% in July, the fear of deflationary pressures should dissipate. That said, the upward trend in core inflation is likely to remain gentle. Our estimate of the Eurozone Phillips curve sees core inflation increasing to 1.6% at most by the end of 2018. So the risk of an inflation undershoot remains real, notwithstanding the improving economic backdrop.

October’s meeting is likely to be one of the greatest balancing acts in the ECB’s history. On the one hand, the ECB will have to announce some kind of tapering, given the increasing scarcity issues in terms of bonds to buy. At the same time it will have to try to avoid the markets interpreting the announcement as being overly hawkish, thereby leading to a premature tightening of financing conditions. We indeed believe that the ECB will reduce the monthly amount of purchases (possibly quite drastically, to c.€20-25bn), but could surprise the markets in terms of the length of the programme, potentially lasting until the end of the year. This would follow the same pattern as
the ECB’s first tapering decision in late 2016, when it announced the reduction of the monthly purchases from €80bn to €60bn for longer than markets had anticipated - another ‘lower for longer’. At the same time, the ECB will continue its efforts to shift the emphasis of monetary policy to interest rates again, soothing the markets with the implicit promise that a deposit rate hike is not to be expected before the end of 2018.

The idea of a spreading the amount of asset purchases over a longer time span has been highlighted by the ECB’s chief economist, Peter Praet, in a recent speech where he stated: “Probably, in conditions in which uncertainty is high, frontloading the accumulation of a given stock of purchases more forcefully signals the central bank’s commitment to inject the degree of accommodation necessary to support the recovery. By contrast, in more normal market conditions, the market’s capacity to engage in intertemporal arbitrage improves. Consequently, investors may become “more patient”, or, in other words, better able to evaluate the stimulus that can be expected to come from a purchase plan that is to be executed over a more extended time interval”.

As for bond yields, we believe that the forward guidance, reinforced by the lengthening of the QE programme, will limit the upward shock on yields. We see yields hovering around current levels over coming months, with the uncertainty surrounding the Italian elections (likely) in the first quarter of next year, limiting upward pressure on bond yields. In the second half of 2018 a gradual upward trend is likely to set in.