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Eurozone: Signs of a bottoming out

There are gradually more signs that the eurozone economy is bottoming out after a deceleration that started in January 2018. However, for the time being, a strong upturn doesn't seem to be in the offing implying that 2020 is unlikely to see much stronger growth than we saw in 2019

From left, ECB President Christine Lagarde, European Commission President Ursula von der Leyen, European Council President Charles Michel, and European Parliament President Sassoli

Source: Shutterstock

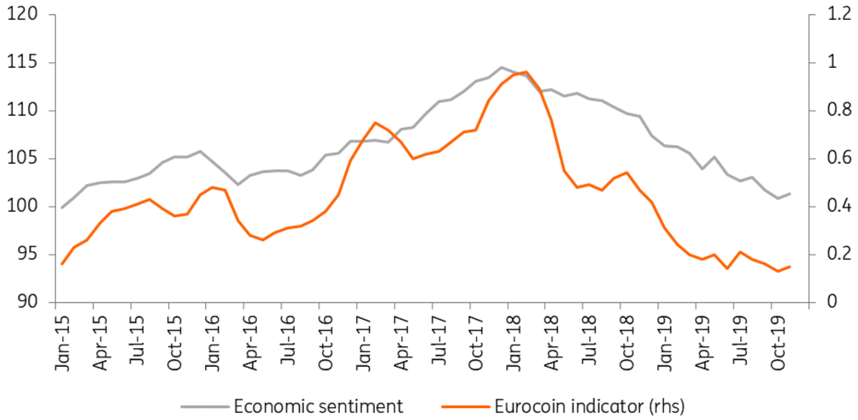
Living on trade hopes

An increasing number of indicators suggest that the downturn is coming to an end. The German Ifo-indicator rose for the third month in a row in November, while the European Commission's economic sentiment indicator registered a stronger than expected increase last month. The eurocoin indicator, a real-time estimate of the underlying growth pace, rose slightly from 0.13 in October to 0.15 in November, although this still suggests rather weak growth.

A phase one trade agreement between China and the US would be good news for Europe too. The eurozone is, as a matter of fact, a more open economy than both China and the US, which explains why the fall in international trade on the back of the trade war provoked significant collateral damage in Europe. Other positive news was the fact that President Donald Trump didn't announce higher tariffs on European cars. This would have been an additional blow to the already battered

German car industry.

Signs of a bottoming out



Source: Refinitiv Datastream

Subdued upturn

While the news flow has been improving, we don't expect a robust upturn. The more cyclical business climate indicator even decreased to -0.23 from -0.20 in October. This chimes with a further fall in the assessment of order books in the industrial sector. Employment expectations declined in all sectors in November, which might have a dampening effect on consumption. Several big German firms announced significant lay-offs over the last month.

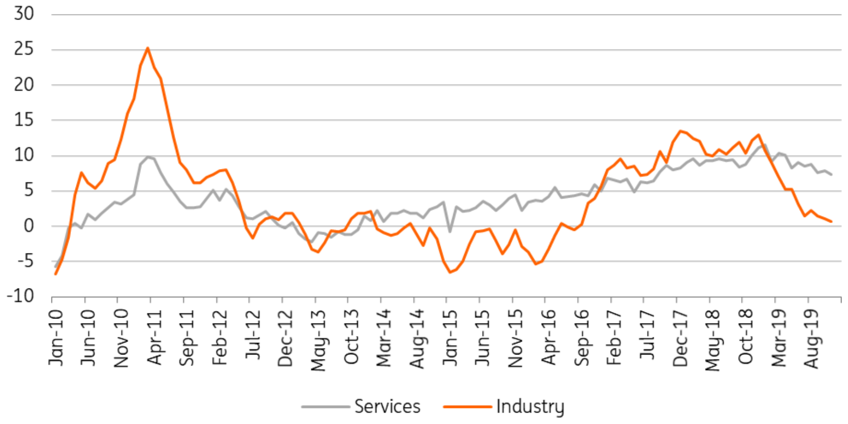
Admittedly, German unemployment figures remain reassuring, but such headline news might make the consumers more cautious. German retail sales actually dropped by 1.9% month-on-month in October, from 0% in September. On the year, retail sales were still up by 0.8%, but this is a significant deceleration from previous months. We are therefore looking at quarterly growth rates for the eurozone close to 0.1% in both the last quarter of 2019 and the first quarter of 2020. Even with a gradual acceleration from 2Q20 onwards, the eurozone will struggle to print an average growth rate above 1.0%. We pencil in 0.7% GDP growth in 2020 and 1.0% in 2021.

Limited pricing power

Inflation increased from 0.7 to 1% in November with core inflation rising from 1.1 to 1.3%. Except for energy prices, all the underlying series increased, with the largest jump happening in services prices. Could this be the start of an upward trend?

Looking at wage dynamics, which have been strengthening over the last year, it is tempting to say that the Phillips curve is finally reasserting itself with the tighter labour markets finally leading to stronger inflation. However, this process is unlikely to gain much traction over the coming year. As a matter of fact, in the consumer surveys labour market perspectives have been deteriorating over the last few months, a phenomenon that is likely to temper wage inflation. At the same time selling price expectations have been falling in both industry and services, a sign that Eurozone businesses still have little pricing power. To be sure, we think indeed that inflation is likely to creep higher, but it will happen at a snail's pace. Both for 2020 and 2021 it still looks unlikely that average inflation is going to come out above 1.5%

Selling price expectations



Source: Refinitiv Datastream

Monetary policy on hold

On monetary policy, little change is to be expected over the next two years. A lot of attention will focus on the strategic review, but it can take a while before any conclusions are reached and we doubt whether this will induce any short term policy change. As for bond yields, we have the feeling that the worst is behind us.

With monetary policy having reached its limits and more calls on fiscal policy to play its role, bond yields are likely to settle in a gentle upward trend. However, the short run is still likely to see some volatility, as the short term dataflow might temper the expectations on the strength of the upturn.

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