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Prospects of significant Eurozone reform are shrinking

Economic news remains upbeat, but political strife won't encourage fundamental change

Upbeat economic news but increasing political worries

Eurozone economic indicators continue to surprise on 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 opportunity to structurally strengthen the Monetary Union.

However, with Chancellor Angela 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 deepening European ties look slim. While French President Macron presented ambitious proposals to advance 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 reawaken some of the centrifugal forces within the Eurozone.

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 coming out on top. The economic recovery in Spain has been much stronger, but escalating political tensions are also likely to lead to more nervousness amongst investors.

> *There seems to be an opening for a fiscal boost, something that would strengthen the Eurozone recovery*

While the potential three-party (some even argue four as there are inner tensions within the political group of Merkel's CDU and the 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 the Eurozone recovery. We expect some fiscal stimulus in Germany to boost investment in digital infrastructure and education. Fiscal policy in the Eurozone, in general, has been more supportive over the last two years and will continue to be in 2018.

A recovery with momentum

The Eurocoin indicator, reflecting the 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 of consumers' intentions to purchase big-ticket items over the next 12 months to a level compatible with above 2% growth in consumption expenditure. Against this backdrop, we believe our growth expectations were a bit too conservative and we have decided to lift our GDP forecasts to 2.2% for this year and 1.8% for 2018, with still some upward surprise risk.

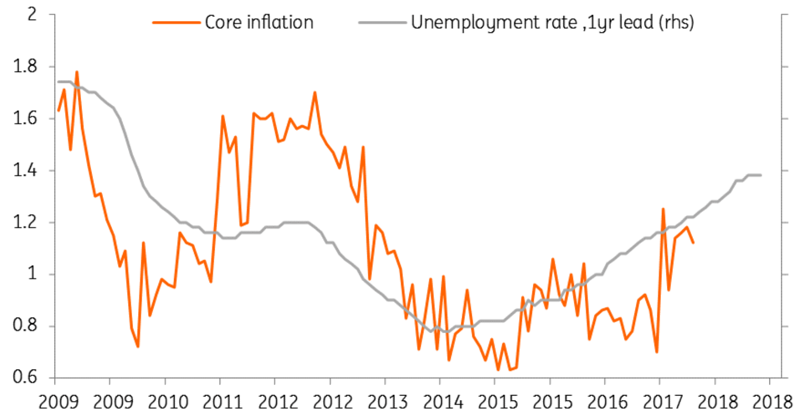
0.71 September Eurocoin indicator

up from 0.67 in August

Downside surprises to inflation

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. That said, the upward trend in core inflation is likely to remain gentle. Our estimate of the Eurozone Phillips curve (which shows the inverse relationship between unemployment and wage growth) sees core inflation increasing to 1.6% at most by the end of 2018.

Core inflation is expected to rise very slowly



Source: Thomson Reuters Datastream

Tapering: a challenging exercise

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 of its bond purchases, given the increasing scarcity issues in terms of bonds to buy. At the same time, it will have to try to avoid the market misinterpreting the announcement as overly hawkish, thereby leading to a premature tightening of financing conditions. We indeed believe the ECB will reduce the monthly amount of purchases (it could be quite drastic to about €20bn to €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 ECB Governing Council in Agreement

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.

Bond market's reaction to tapering

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.

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