BTMU Economic Brief

Euro zone – Some moderation in confidence indicators but activity to remain robust

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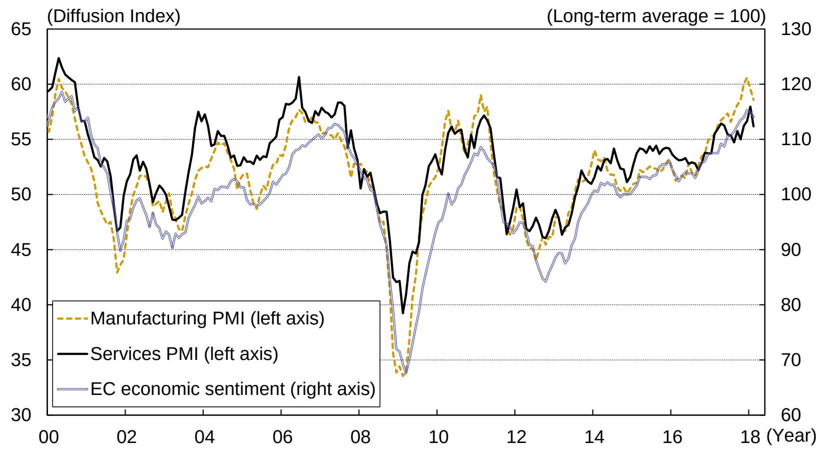
1. Introduction

Euro zone GDP increased by 2.5% in 2017. A figure of 0.6% QoQ in Q4 gives a carry-over effect of 1% into average annual growth for 2018. Meanwhile, survey measures reached long-term highs. The European Commission's economic sentiment gauge had not been higher since mid-2000, and the manufacturing PMI reached a series record (Chart 1).

Chart 1: Euro Zone Confidence Indicators

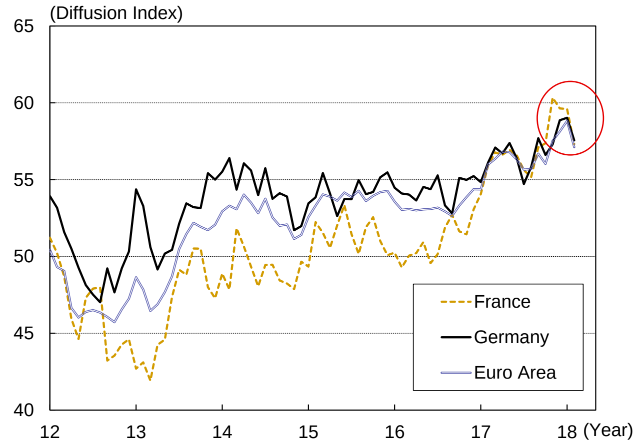


Source: IHS Markit, European Commision, BTMU Economic Research Office

2. Moderation

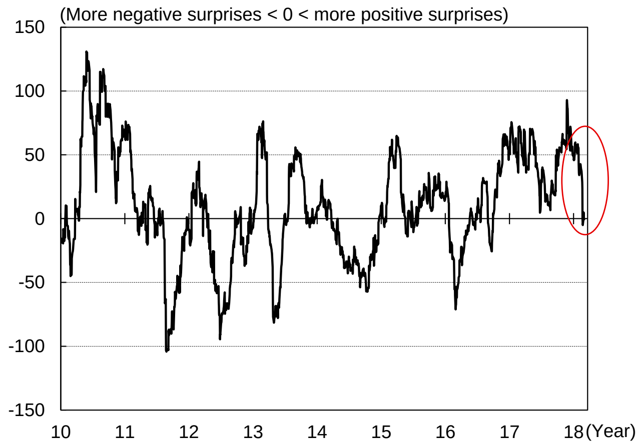
There are signs of moderation in the latest survey data for February. The composite PMI for the euro zone slipped back from 58.8 to 57.1. The German and French figures fell from 59.0 to 57.6 and 59.6 to 57.3 respectively (Chart 2). It was not just the PMIs – the European Commission's economic sentiment index fell in February (from 114.9 to 114.1). Several key national indicators also weakened. In Germany, the ZEW measure of economic expectations fell to 17.8 from 20.4 in January, and the current situation number also declined. In France, INSEE's business climate slipped back. The Belgian National Bank's consumer confidence indicator, which is sometimes viewed as a good proxy for the euro zone as a whole, declined as well.

Chart 2: Composite PMI



Source: IHS Markit, BTMU Economic Research Office

Chart 3: Euro Zone Economic Surprise Index



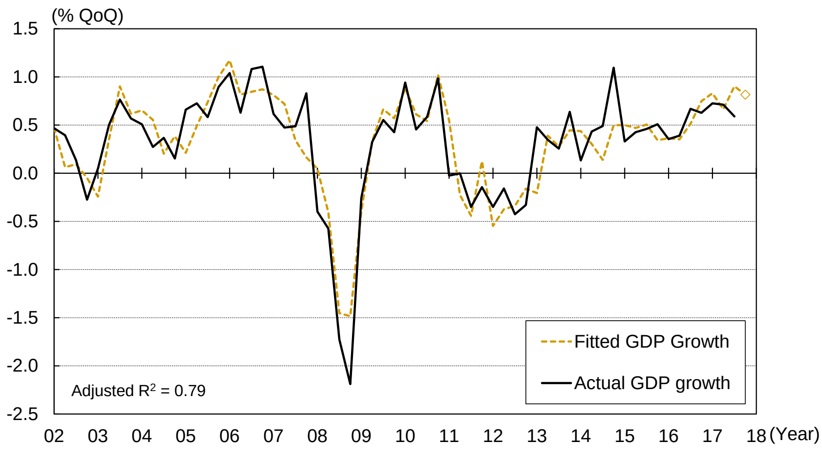
Source: Citi, BTMU Economic Research Office

These numbers (the weaker flash PMIs and disappointing ZEW figure in particular) have dragged down Citi's economic surprise index for the euro zone (Chart 3). This measure aggregates data surprises (actual vs Bloomberg consensus) weighted by historical effects on FX spot rates. It is naturally mean-reverting but can be useful for judging turning points. Do February's numbers signal a significant shift in euro zone activity?

To our minds, slightly softer confidence figures over the coming months seem likely. The recent weaker figures could reflect concerns over political uncertainty in Germany and the Italian elections. In Germany, SPD members eventually voted for a grand coalition with Angela Merkel's conservative bloc and a stable government will be formed. However, in Italy, a period of protracted negotiations seems likely after anti-establishment parties made large gains but there was no clear winner. This, and the legacy of the mid-February financial market volatility, could cause sentiment to deteriorate further.

Nonetheless, the PMIs are likely to remain at levels associated with firm GDP growth. Even if the PMIs fall by a similar degree again in March, our models suggest this would be consistent with GDP growth of over 0.8% QoQ (3.3% annualised) in Q1 2018 (see Chart 4). Some moderation in sentiment may bring the numbers more in line with actual economic activity.

Chart 4: Euro Zone Actual GDP Growth and PMI Model Output



Source: IHS Markit, Eurostat, BTMU Economic Research Office

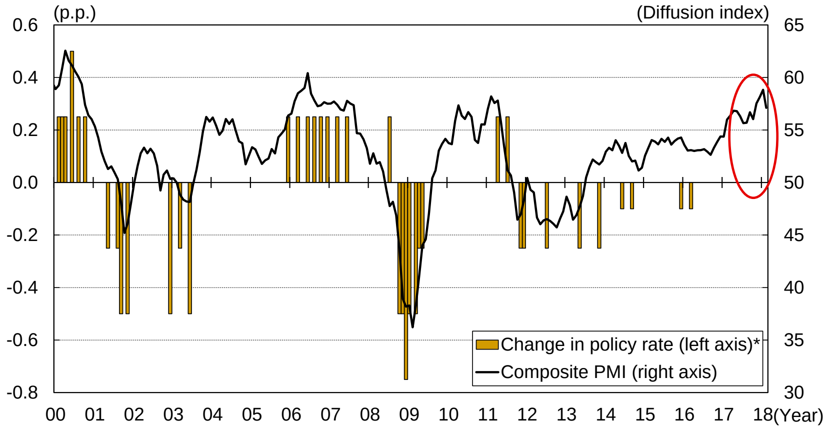
Looking at the details, the forward-looking components of the PMI remain positive. Future business expectations in services increased for the third straight month to a very buoyant 68.2. Encouragingly, the employment expectations components remained strong. The capacity utilisation gauge and backlogs of work are high. This bodes well for investment and suggests unemployment will keep on improving. Higher pricing power, especially in manufacturing, suggests firm domestic demand. While new export orders in manufacturing slipped back, presumably due to recent euro strength, the component remains at a robust level (57.0).

3. Monetary policy

The exchange rate is cause for concern for the ECB (there was a lot of discussion about FX in the account of the January meeting). A stronger euro reduces import prices and may make it harder for inflation to converge with its target of just below 2%. The PMI was not encouraging in this respect as input prices declined in the composite measure.

Our current call is for the ECB to extend its net asset purchases from September until December this year, albeit at a slower pace.[2] If, as we expect, business confidence moderates slightly then an extension becomes more likely. Recently, the positive news flow had caused the hawkish members of the Governing Council to be increasingly vocal. Indeed, the PMIs are at a level consistent with rate hikes in the past (Chart 5). Slightly softer numbers may ease the pressure for a hard stop to net asset purchases in September.

Chart 5: Euro Zone Composite PMI vs ECB Key Rate Changes



Note: MRO rate until Q4 2015 when deposit rate is used.
Source: IHS Markit, ECB, BTMU Economic Research Office

[2] See http://www.bk.mufg.jp/report/ecoeu2017e/BTMU-Economic-Brief-Euro20171213.pdf

4. Conclusion

Various euro zone confidence indicators ended 2017 at long-term highs, but there have since been weaker figures. We expect this trend of slight moderation to continue. Worries over market volatility and the political situation in Italy are likely to contribute. It is not necessarily reason for concern, though. Confidence numbers had been looking high compared to GDP, and underlying domestic activity remains firm. Nonetheless, weakening sentiment follows our expectations for GDP growth to be a little softer in 2018 (we forecast 2.3% YoY).