PICTET 1805

Flash Note

Euro area: business surveys and activity

Reconciling soft and hard activity data

Pictet Wealth Management - Asset Allocation & Macro Research | 5 April 2017

Strong business confidence surveys in the euro area are consistent with economic growth moving up a gear from already high levels, despite lingering political uncertainty. However, hard data have been more mixed in recent months.

We expect both hard data to pick up and soft data to moderate in the next few months, leaving euro area real GDP growth at around 2% in annualised terms in H1, and around 1.5% in H2. In the end, we believe that upside risks to our GDP forecasts (1.5% in 2017 and 2018) are more limited than what PMI indices are signalling.

A more sustained and sustainable recovery should make the ECB more confident that the output gap will narrow steadily in the next couple of years. However, we continue to expect a very gradual normalisation of the ECB's policy stance as it waits until it sees the 'whites of the eyes' of core inflation.

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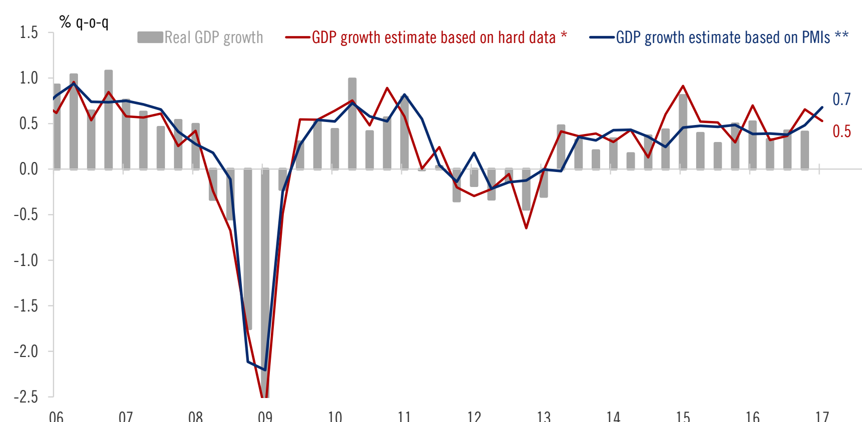
The latest confidence surveys in the euro area, including the March PMIs, have been remarkably strong, adding upside risks to our GDP forecasts. The euro area composite PMI is consistent with a growth rate of about 0.7% q-o-q in Q1, above our projection of 0.4%, and point to similar levels of growth in Q2. More generally, **'soft' survey data and 'hard' activity data have been diverging significantly of late amid large differences across countries.**

The global context and the hope of a more supportive fiscal policy, in particular, might help explain part of the discrepancy between hard and soft data, although the 'animal spirit' factor is likely more pronounced in the US. In Europe, technical factors, including weather distortions or sample issues have likely played a role. Still, the fact that business confidence has remained immune from political uncertainty may be a reflection of underlying economic conditions that are stronger than generally assumed.

Chart 1: 'nowcast' models for euro area GDP growth using hard and soft data



Source: Pictet WM – AA&MR, Eurostat, Markit. (*) Model based on industrial production excluding construction, retail sales, car sales and lagged GDP growth. (**) Model based on composite PMI and a dummy variable (Q4 08 - Q1 09).

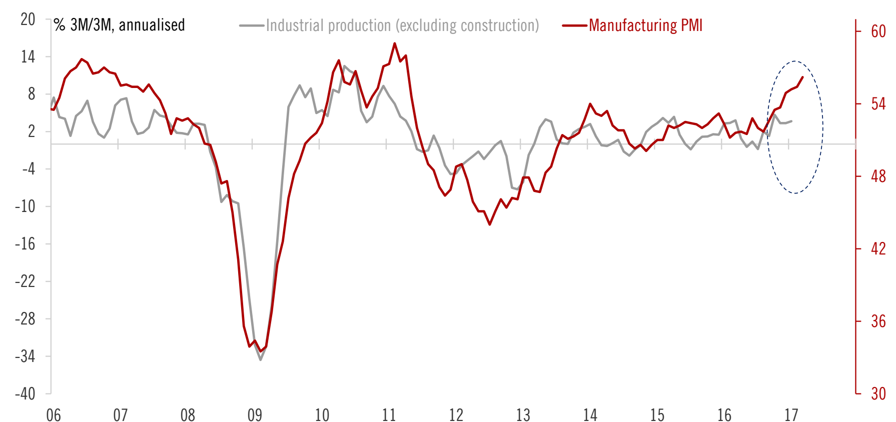
But mixed signals from hard data in Q1 (although only January/February releases are available in most cases as yet) **support our more cautious assessment of the pace of economic expansion**. Although we expect some catch-up, PMI indices have already tended to overstate GDP growth in the present recovery. As a result, **we are maintaining our GDP growth forecast for the euro area unchanged at 1.5% in 2017, with upside risks**. We expect both hard data to pick up and soft data to moderate in the next few months,

leaving real GDP growth at around 2% in annualised terms in H1, and around 1.5% in H2. **If we are right, upside risks to our GDP forecasts will prove more limited than soft indicators are signalling**.

So far, mixed hard data have contrasted with upbeat PMIs

Markit's euro area composite PMI survey closed the first quarter at a 80-month record high, pointing to a strong acceleration in economic activity. In line with PMI surveys, the European Commission's economic confidence index for March was also strong. Both surveys point now to euro area GDP growth of 0.6-0.7% q-o-q in Q1, after 0.4% q-o-q in Q4.

Chart 2: euro area industrial production and manufacturing PMI



Source: Pictet WM – AA&MR, Eurostat, Markit

By contrast, available hard data have been more mixed, suggesting that the economy made a slower start to 2017 than the surveys imply. **Industrial production excluding construction rose by 0.9% m-o-m in January**, weaker than consensus expectations (1.3%) and failing to compensate for the 1.2% decline recorded in December. Manufacturing output was also soft in January, increasing by 0.7% m-o-m after a fall of -1.1% the previous month. Meanwhile, **construction output** (-2.3% m-o-m) **was weaker than expected in January.** Average **retail sales in January-February** slowed from Q4.

Another conflicting signal has come from the banking and corporate sectors. February **bank credit flows were rather disappointing** and, more generally, the credit impulse has failed to accelerate to levels consistent with GDP trend growth at, or above 2%. One explanation could be that ECB' policies, especially corporate bond purchases, have led to a sharp increase in corporate bond issuance, possibly at the expense of traditional bank loans. Moreover, the euro area corporate sector continues to enjoy a (large) financing surplus, which should reduce its dependence on external funding.

All in all, available monthly hard data point to a euro area GDP growth of 0.4-0.5% q-o-q in Q1, less than surveys are suggesting. **Several factors might explain the recent divergence between soft and hard data.** One is the global context and the hope of more supportive fiscal policies, although this is likely more relevant to the US. In Europe, technical factors, including sample issues or temporary factors such as adverse weather conditions have played a role. Rising commodity prices have eaten into households' purchasing power, partly explaining the weakness in retail sales. Whatever

the reason, there is no escaping that business confidence has remained largely immune from political uncertainty. Meanwhile lagging indicators, such as employment, have continued to improve at a relatively steady pace. Better labour market conditions might partly compensate for the negative impact of rising commodity prices.

In Germany, the March Ifo business climate survey corroborated the strength of recent PMIs surveys. Both indices point to GDP growth of 0.7% q-o-q GDP growth in Q1. Yet **hard data in Germany have been less upbeat** for several quarters. It could be that the German private sector is moving closer to capacity constraints while the rest of the euro area fails to catch up, in turn reducing the upside for German exports and domestic demand.

In France, the **Markit PMI survey for March was much more upbeat than the main national indicators, collected by statistical agency Insee and the Banque de France**. This discrepancy could be linked to the sample size of the respective surveys: while Insee and the Banque de France question about 10 000 firms, the PMI's sample is much smaller (around 400 firms).

More generally, euro area countries are all at very different stages in the business cycle, and face idiosyncratic risks and constraints on capacity as a result. The divergence across countries also likely explains the failure of traditional indicators such as the PMIs to fully capture the actual pace of activity expansion relative to simple models that, by nature, are calibrated on the basis of past business cycles.

Either way, the ECB will have to tread very carefully

Unsurprisingly, the ECB has taken comfort from the improvement in euro area indicators. A more sustained and sustainable recovery should make the ECB more confident that the output gap will narrow steadily in the next couple of years. The hawks could even argue that if GDP growth accelerates further above potential growth (which the ECB assumes to be "slightly above 1%"), inflation may return faster than expected to its 2% target and policy normalisation would have to start sooner rather than later.

However, the outlook for price stability remains highly uncertain, despite the strengthening economic recovery. The (statistically distorted) March HICP release will only make the doves more convinced than ever that it will take time before the ECB's four inflation criteria are met. We continue to expect a very gradual normalisation of the ECB's policy stance as it waits until it sees the 'whites of the eyes' of core inflation, with risks tilted towards a (one-off) deposit rate hike in 2018, but also towards slower QE tapering than markets are expecting.

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