PICTET 1805

Flash Note

Euro area: Flash PMIs

Another broad-based rise in PMIS… and a headache for the ECB?

Pictet Wealth Management - Asset Allocation & Macro Research | 23 November 2017

The euro area composite PMI index surged well above expectations in November amid broad-based improvements across sectors and countries and the strongest pace of job creation in 17 years.

At face value, November PMIs look consistent with real GDP growth accelerating further in Q4, to 0.8% q-o-q in the euro area, 0.9% in Germany, and 0.7% in France. Upside risks to the near-term economic outlook imply that euro area GDP growth could remain close to, if not slightly higher than 2% in 2018.

Another important feature of PMI indices has been the slow but uninterrupted built-up in tensions on capacity. Price pressure rose to new cyclical highs in November, hinting at higher core inflation in 2018, as per our forecasts. This, along with above-potential GDP growth, may force the ECB to adjust its communication in a more hawkish way, as suggested by Executive Board member Benoît Coeuré this week.

AUTHORS

Frederik DUCROZET
fducrozet@pictet.com
+41 58 323 45 82

Pictet Group
Route des Acacias 60
CH - 1211 Geneva 73
www.pictet.com

We are running out of superlatives to describe the state of the euro area economy. The so-called 'Euroboom' is showing no sign of abating, with euro area PMI indices rising to new highs in November. Most PMI components were even more encouraging than headline numbers, including the strongest pace of job creation in 17 years, the highest level ever recorded for new export orders, and growing pressure on capacity utilisation.

The euro area composite flash purchasing managers' index (PMI) resumed its march higher in November, rising from 56.0 to 57.5 (its second-largest monthly rebound in over four years), against expectations of a stable reading. The improvement was broad-based across sectors and countries, with very strong rises recorded in manufacturing (from 58.5 to 60.0, led by Germany) and in the services sector (from 55.0 to 56.2, led by France).

Markit noted that **November PMIs were consistent with real GDP growth accelerating further in Q4**, to 0.8% q-o-q in the euro area (up from 0.6% in Q3), 0.9% q-o-q in Germany (up from 0.8% in Q3), and 0.7% q-o-q in France (up from 0.5% in Q3). Although business surveys have on average overstated the pace of growth in recent quarters, today's data signalled larger upside risks to the outlook. Outside the two largest euro area economies, the pace of activity expansion rebounded from October lows, although Markit noted that it was on course for the weakest quarter so far this year.

Table 1: PMI headline indices and sub-indices

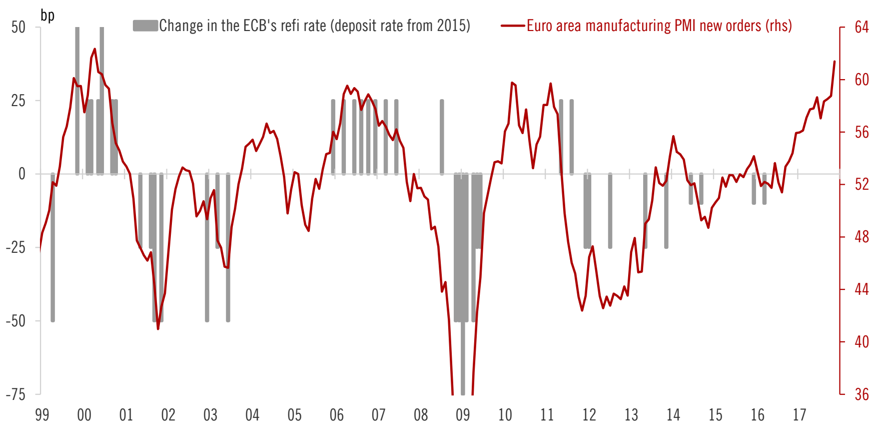
Euro area PMI indices		November (Flash)	October	3 months before	Monthly move
Composite	**Headline**	**57.5**	**56.0**	**55.7**	↑
	New orders	56.9	56.6	55.5	↑
	Employment	55.7	55.0	53.9	↑
Manufacturing	**Headline**	**60.0**	**58.5**	**57.4**	↑
	New orders	61.4	58.8	58.3	↑
	New export orders	60.8	57.8	58.5	↑
	Employment	57.9	57.3	55.5	↑
	Output prices	56.7	55.8	54.3	↑
	Input prices	69.4	66.4	59.4	↑
Services	**Headline**	**56.2**	**55.0**	**54.7**	↑
	New business	55.2	55.8	54.5	↓
	Employment	54.9	54.2	53.3	↑

Source: Pictet WM – AA&MR, Markit

Stronger growth and job creation will be welcomed by the ECB, but it may also create a communication challenge for next year. The good news is that the ECB's forward guidance implies that policy rates will remain on hold until 2019 as net asset purchases will continue until at least September 2018 (we continue to expect a gradual tapering until early 2019). The bad news for the doves is that the very accommodative monetary stance will be increasingly difficult to justify in the Euroboom context. Chart 1 and 2 are consistent with the ECB *tightening* its policy stance to a much larger extent than it is currently envisaging, at least based on a historical reaction function.

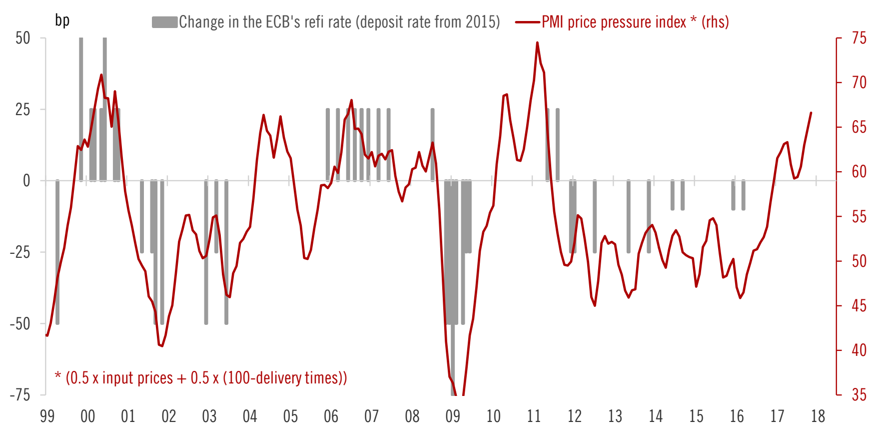
As Benoît Coeuré suggested in an interview this week, the ECB will be forced to make incremental changes to its communication at some point, including a possible "de-linking" between QE guidance and the inflation outlook and a greater emphasis on policy rates. Whether this proves to be enough will largely depend on the speed of the adjustment in core inflation, in our view, following a surprisingly large drop in October. Our impression remains that **the ECB will be happy to wait until it sees 'the whites of the eyes' of core inflation**, which is a nice way to say that they will remain behind the curve.

Chart 1: PMI export orders and ECB policy rates



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

Chart 2: PMI price pressure and ECB policy rates



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