

Flash Note

Euro area: business confidence

“Growing pains” but no reason to panic

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Euro area flash PMI indices fell sharply in March, below consensus expectations for the second month in a row. However, details were still largely consistent with a robust, broad-based economic expansion this year, if only at a slightly slower pace than last year. We forecast euro area GDP to expand by 2.3% in 2018.

The correction in business sentiment, from very high levels, was largely driven by the manufacturing sector and could reflect global trade concerns to some extent. However, some special factors appear to have amplified the drop, including large swings in inventories and supply chain delays, especially in Germany.

The correction in euro area business surveys in Q1 may well fuel additional ECB dovishness in the near term, but not to the point where the upcoming policy normalisation can be challenged, in our view.

Today’s first batch of euro area March business surveys looks worrying at first sight. **The drop in the euro area composite PMI index**, from 57.1 to 55.3 in March (consensus: 56.8), was the second one in a row and **the largest monthly decline in six years**. New orders fell to a 14-month low. The correction in business sentiment was predominantly driven by the manufacturing sector, which could reflect broader concerns of a trade war.

However, most business surveys remained at high levels in absolute terms, consistent with our forecast of a gradual deceleration in euro area sequential growth rates this year. Moreover, PMI sub-components were still encouraging overall, consistent with a mid-cycle pause more than anything else. Both the German IFO and the French INSEE surveys moderated in March, with the former still relatively close to all-time highs. Elsewhere in the euro area, output growth slowed to a 5-month low according to the PMIs.

In all, we view the sharp correction in euro area business surveys in Q1 as the consequence of an overshoot in late 2017 (relative to the actual pace of growth), which was likely **amplified by the inventory cycle**. Markit noted that **supply-side constraints** weighed on output growth in March (as well as “an unusually high prevalence of staff sickness” in Germany). It will be very important to see whether PMIs manage to stabilise at current levels, but so far our forecasts look on track (see Chart 1). We see no reason to change our assessment of the business cycle assuming trade frictions do not turn into a proper trade war. At the domestic level, we continue to forecast labour market conditions and investment spending to improve further.

Chart 1: euro area composite PMI and GDP growth



Source: Pictet WM – AA&MR, IHS Markit

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Table: PMI headline indices and sub-indices

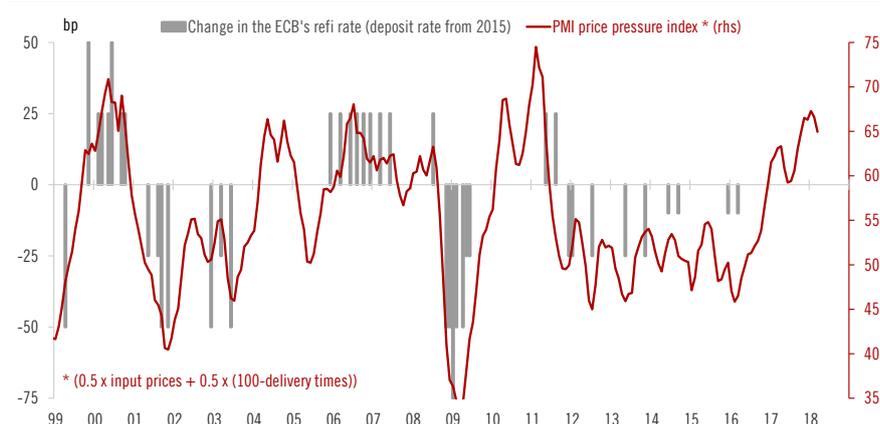
Euro area PMI indices		March (Flash)	February	3 months before	Monthly move
Composite	Headline	55.3	58.8	58.1	↓
	New orders	55.0	58.0	58.0	↓
	Employment	54.7	55.7	55.7	↓
Manufacturing	Headline	56.6	59.6	60.6	↓
	New orders	55.4	59.6	61.5	↓
	New export orders	54.7	58.2	60.6	↓
	Employment	56.4	58.0	58.2	↓
	Output prices	57.4	58.1	56.3	↓
	Input prices	65.6	70.7	67.9	↓
Services	Headline	55.0	58.0	56.6	↓
	New business	54.9	57.3	56.7	↓
	Employment	54.1	54.8	54.8	↓

Source: Pictet WM – AA&MR, IHS Markit

On average in the first quarter of this year, euro area PMIs were consistent with real GDP growth of around 0.7-0.8% q-o-q, according to Markit, a touch higher than our forecast (0.65%). While the balance of risks could indeed shift to the downside if the correction in business confidence were to be sustained, anecdotal evidence of supply chain delays and other temporary factors suggest that the underlying pace of activity expansion remains healthy.

Meanwhile, price and wage pressure continued to increase in March, if only at a slightly more moderate pace than in recent months. Our PMI price pressure gauge fell marginally further in March, to a six-month low (still in ‘ECB tightening’ territory). PMI components remained consistent with rising capacity constraints and tighter delivery times, which fell to all-time lows in Germany. Still, survey-based inflation expectations have proved to be very imperfect indicators of actual inflation in the recent past.

Chart 2: euro area PMI price pressure and ECB policy rates



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

In the end, today’s flash PMI reports may well fuel additional dovish comments from ECB members, but we do not think that they will materially influence their broader assessment of price stability over the medium term. More than ever, the focus will be on the downside risks to global growth and the adjustment to euro area core inflation. We continue to expect the ECB to announce a gradual tapering of QE in June or July, and to start hiking policy rates in Q3 2019 (see “[Rotation](#)”; 8 March 2018).

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