FLASH NOTE

EURO AREA: ECONOMIC ACTIVITY

NOT ALL SMOOTH SAILING

Author

NADIA GHARBI, CFA
ngharbi@pictet.com

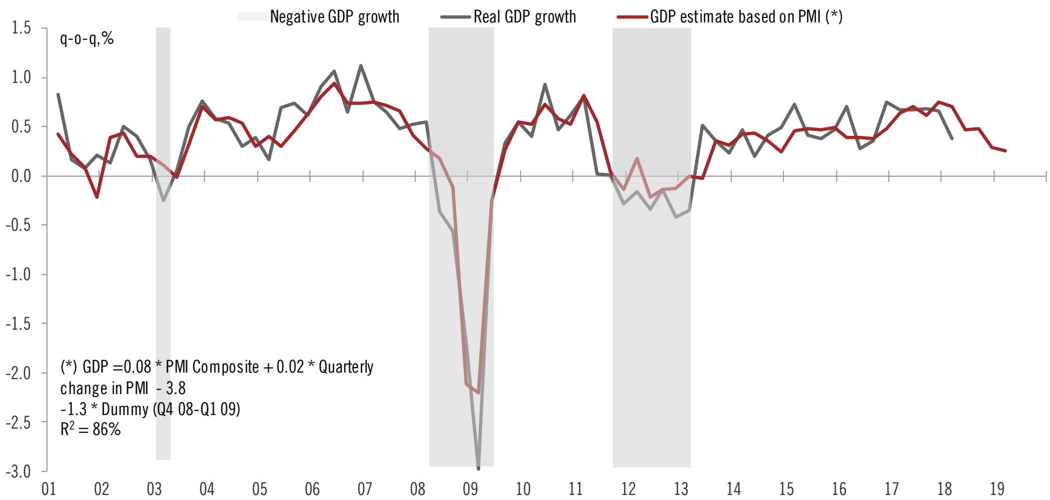
SUMMARY

› The big question about the euro area economy is when the bottom of the slowdown will be reached. A rebound was already expected in Q4 2018, but at the start of this year there are still few signs of recovery.
› January's Flash PMIs were weaker than expected and gave mixed signals. We expect confidence to be partially restored in H1 2019, as some idiosyncratic factors should abate in our view.
› 2019 will be a question of resilient domestic demand versus external weakness. Fundamentals supporting domestic demand, notably private consumption, remain healthy. But the external backdrop will remain challenging.
› Overall, we expect the euro area economy to slow in 2019, with real GDP rising by 1.4%, compared with close to 2% in 2018.

A weak start to 2019

The big question about the euro area economy is when the bottom of the slowdown will be reached. A rebound was already expected in Q4 2018, but at the start of this year there are still few signs of recovery. The euro area Flash composite PMI declined by 0.4 points to 50.7 in January, the weakest level since July 2013. At the sector level, the services PMI fell by 0.4 points to 50.8, while manufacturing PMIs declined by 0.9 points to 50.5. Manufacturing new orders and new export orders remained weak and below the economic expansion threshold level of 50. The one-year business outlook improved slightly in January, but remained close to a four-year low, as companies reportedly worry about trade wars, Brexit, the protests in France and sector-specific issues in the auto sector.

CHART 1: EURO AREA REAL GDP GROWTH AND GDP ESTIMATE BASED ON PMI



Source: PWM - AA&MR, Eurostat, IHS Markit

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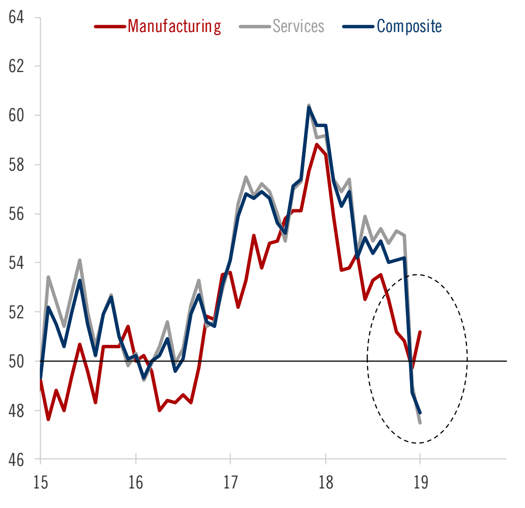
France: where is the pick-up in the services sector?

The weak euro area PMI was once again heavily influenced by France. The services PMI fell further in January to 47.5 from 49.0 in December. This was a bit disconcerting, given that the "yellow vest" protests eased at the start of the year and following the INSEE survey published yesterday. Meanwhile, the manufacturing PMI made a convincing increase in January, rising to 51.2 following its prior plunge. Finally, despite the further downturn in January, "firms reported higher optimism towards the business outlook. In fact, confidence was at its strongest since October 2018. Both manufacturers and service providers recorded an improvement in sentiment".

Germany: red flags in the manufacturing sector

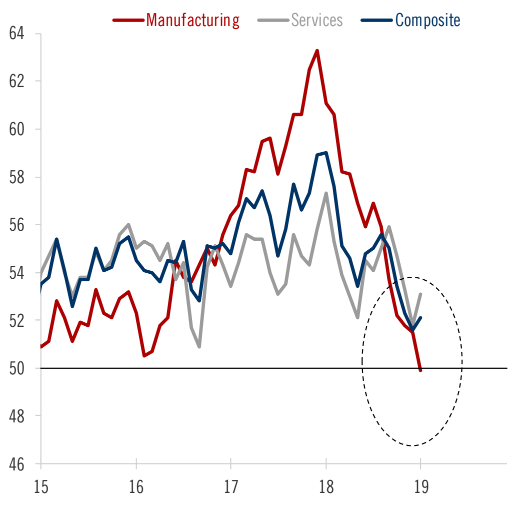
In Germany, the flash composite PMI rose to 52.1 in January, climbing 0.5 points on the back of strong services performance. However, for the manufacturing sector it fell to 49.9 in January from 51.5 in December. "Continued weakness across [the] auto industry, lower demand [from] overseas markets (particularly China) and heightened uncertainty", were all highlighted as factors dampening manufacturing activity. The sector's order book status continued to worsen, showing the steepest decline in incoming new work since 2012. Meanwhile, employment eased in both sectors, but remained solid.

CHART 2: FRENCH PMI SURVEYS



Source: PWM - AA&MR, IHS Markit

CHART 3: GERMAN PMI SURVEYS



Source: PWM - AA&MR, IHS Markit

2019 outlook: all eyes on domestic demand

The January euro area PMI level (50.7), if sustained in February and March, would point to a GDP growth rate of 0.1% q-o-q in Q1 2019, lower than our forecast (0.3% q-o-q) and highlighting the downside risks surrounding our scenario. We expect **confidence to be partially restored in H1 2019 as some idiosyncratic factors should abate in our view** (see our Appendix).

Nevertheless, **2019 will be a question of resilient domestic demand versus external weakness**. Fundamentals supporting domestic demand, notably private consumption,

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remain healthy. Continued job growth, accelerating wage growth, falling inflation due to lower oil prices and moderate fiscal stimulus are all factors that will support private consumption in 2019. Fundamentals that have supported growing investment – tight capacity, easy financial conditions and strong cash flows – persist as well, but this component of spending is the most vulnerable to global uncertainty and declining foreign demand.

The main driver of the slowdown last year – deteriorating foreign demand – remains the most serious downside risk. Weaker demand from China, stress in other emerging markets, and the threat of intensifying trade disputes imply a phase of weak global trade growth that will likely drag on euro area growth. Resilient domestic demand should partially compensate for this, but the greater risk comes from weakness in external demand spilling over into domestic demand, for example through a threat to the employment cycle or a loss in confidence.

Overall, 2019 will not be all smooth sailing for the euro area. We expect **the euro area economy to slow in 2019, with real GDP rising by 1.4%,** compared with closer to 2% in previous years. The balance of risks is tilted to the downside. The largest risks include the threat of auto tariffs, a disorderly Brexit, escalated trade tensions, China's economic slowdown and political uncertainty in some euro area countries.

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Appendix: Anatomy of a slowdown

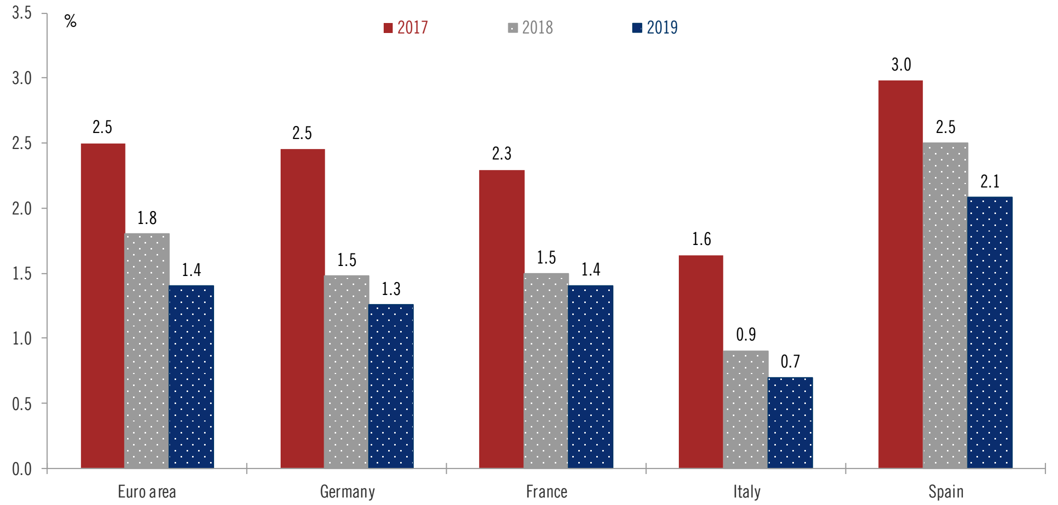
Euro area economic activity was buoyant in 2017. While a slowdown in 2018 was expected, its magnitude has surprised. Euro area GDP growth slowed from an average rate of 0.7% q-o-q in 2017 to 0.4% q-o-q in H1 2018 and 0.2% q-o-q in Q3 2018, with potentially still weaker growth in Q4.

A deeper look into GDP data reveals that the underlying slowdown has largely been driven by weaker exports. This may reflect a reversion of export growth to levels more in line with cyclical conditions following high growth in 2017. The delayed effect of the appreciation of the euro in late 2017 combined with the slowdown in some key markets, such as China and other emerging economies, may have also hurt export growth in 2018. Finally, part of the drop in export growth can be attributed to lower expectations linked to uncertainty around trade policy. The economy was also hit by a host of erratic factors. Notably, **the acute weakness in H2 2018 may have been exacerbated by idiosyncratic factors** that should or have abated:

- Political uncertainty over the 2019 budget eroded business and consumer confidence and led to a tightening of financial conditions in Italy
- New emissions standards have depressed car production, especially in Germany
- Below average water levels in the Rhine River in Germany appear to have prevented chemicals companies from shipping inputs and outputs at the end of 2018
- The “yellow vests” protests in France have had a dampening effect on activity

Because of the slow finish to 2018, **the statistical carry over effect is weaker**. As a result, our annual real GDP growth forecast was pushed down to 1.4% from 1.6% in 2019. Our country forecasts for France and Germany were also revised down on the back of weaker data at the end of last year.

CHART 4: EURO AREA REAL GDP GROWTH (2018 AND 2019 AA&MR FORECASTS)



Source: PWM - AA&MR, Eurostat

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