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Economy

Escape velocity for European growth

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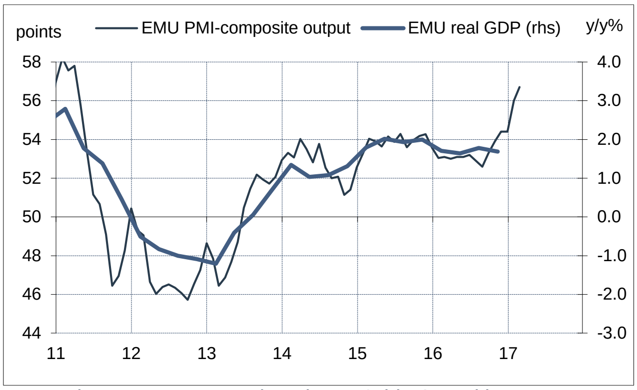
Over the past six months, the business climate in the Eurozone has witnessed an upsurge that has rarely been seen in the past. Whilst it is true that market agents occasionally get carried away, either on an upward or downward trend, business chiefs tend to provide a more reliable assessment of the real economy. What they are saying is that the recovery in the Eurozone is a long way from exhausting its acceleration. For two years now, real GDP growth figures have beaten consensus forecasts. This is also likely to be the case in 2017 and even 2018. As our forecast is currently out-of-consensus, this strengthens our views.

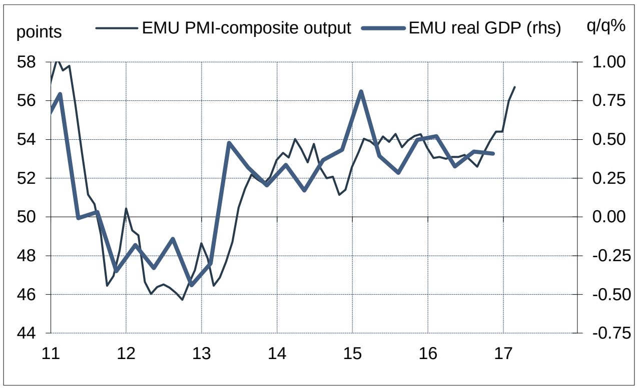
The European recovery is still a long way from its full speed

The improvement in the business climate is a global phenomenon. For the Eurozone, the rebound is all the more spectacular given that Europe is suffering from an existential crisis for which there is no end in sight (or so it is said). From a cyclical viewpoint, nothing could be further from the truth. In March, the PMI composite index, which covers activity in the manufacturing and services sectors, stood at its highest level since 2011 (56.7 points), well above its average during expansion phases (53.9). Its surge since the end of last summer has been impressive. Such a level on the PMI index is associated with real GDP growth in the Eurozone of more than 3% year-on-year (lhs) and more than 0.7% quarter-on-quarter (rhs). To recap, in Q4 2016, annual growth stood at around 1.7% and quarterly growth at 0.4%. Even accounting for a degree of exaggeration on the sentiment indices, there is little doubt that growth in the Eurozone is set to accelerate.

Eurozone: PMI index and yearly GDP growth PIB



Eurozone: PMI index and quarterly GDP growth



Sources: Thomson Reuters, Bloomberg, Oddo Securities

Experience tells us that the business climate sometimes gives a slightly distorted image of the real economy. In the US there is currently a gap - but not a divergence - between the confidence indices, that stand at levels unseen for years, or even decades, and other statistics ("hard data"), that are solid but do not suggest a significant acceleration in the short term. Is the same true of Europe? There is one major difference between the two zones. In the US, the new president has promised businesses a policy that will be more favourable to them (tax cuts, deregulation). In Europe, there is nothing of the sort. In fact, we are constantly wondering whether the populist wave will sweep away one or several countries on the continent. This risk was has been avoided in Austria and the Netherlands. Next will take place the elections in France[1], in Germany and, the most uncertain of all, in Italy. **Clearly, the current political uncertainty is not acting as a drag on business leaders' sentiment in Europe, probably because they believe**

[1] *On this subject, please refer to our numerous recent notes, for example: "French elections: plan A, plan B, plan M" (February 7), "Q&A on the French elections" (February 20), "A French* House of Cards" *(March 8), and "Who really wants to reform France?" (March 21)*

that a political accident, although possible, is highly unlikely. Conversely, once the elections are over, economic conditions could reflect an improvement, for example if, in France, the next president implements a tax-cutting policy and an easing of regulations hampering businesses[2], or if, in Germany, the fiscal policy is eased by the next coalition. In any case, the upturn in business sentiment is a) strong, b) perceptible in all sectors and c) visible in all of the region's major economies.

EMU: PMI indices *

		H2 2015	Q1 2016	Q2 2016	Q3 2016	Q4 2016	Q1 2017	March 2017
EMU	manufacturing	52.5	51.7	52.0	52.1	54.0	55.6	56.2
	services	54.1	53.3	53.1	52.6	53.4	55.2	56.5
	composite	54.0	53.2	53.1	52.9	53.9	55.7	56.7
Germany	manufacturing	52.6	51.2	52.8	53.9	55.0	57.2	58.3
	services	54.8	55.1	54.5	52.3	54.5	54.5	55.6
	composite	54.6	54.2	54.2	53.8	55.1	56.0	57.0
France	manufacturing	50.2	49.9	48.2	48.9	52.3	53.1	53.4
	services	51.3	49.8	50.7	52.0	52.0	56.3	58.5
	composite	51.2	49.8	50.2	51.6	52.0	55.9	57.6

*for services and composite, output index

As our regular readers know, we have been positive on Europe's macroeconomic outlook for at least two years now[3]. We took this position when we noted that credit conditions and employment conditions started to improve concomitantly. Here is the perfect combination to achieve a durable and self-sustaining recovery, especially if, at the same time, the policy-mix turns more supportive (more expansionary monetary policy and less restrictive fiscal policy). Over the past two years, the decline in unemployment and the pick-up in bank loans to the private sector have been confirmed and bolstered, impervious to numerous external "shocks" (terrorism, Brexit). Our growth forecast for 2017 and 2018 is above 2% for the Eurozone, and for most of its member states, whilst the consensus is forecasting an average rate of 1.5%, which would imply a fairly significant slowdown as of the coming months. **With statistics such as the PMI indices, clearly our out-of-consensus forecasts are underpinned and we think that the other forecasters will have to revise their estimates upwards**.

Given more solid economic conditions, the ECB can only amend its particularly cautious – and, in places, highly alarmist– analysis of the past two years. Earlier this month, the ECB still thought that the risks on European growth were tilted to the downward. We believe the opposite is true. The ECB will undoubtedly have to review its position, but the most likely scenario is that it does so gradually. **We can easily imagine Mario Draghi saying in June that the risks are balanced, no more, no less. Being more overtly optimistic would risk fuelling market speculation concerning a premature normalisation of the monetary policy**. After all, core inflation is low and, apart from Germany, there is no upward pressure on wages. All told, the ECB has its reasons for extending out to 2018 (in any case, over a good portion of the year) its asset-purchasing policy. The real normalisation of policy rates will take place after the end of QE[4].

This, with some variants, is what Emmanuel Macron, the frontrunner, and François Fillon, relegated to the rank of outsider, are proposing.
[3] *See, for example, our monthly macroeconomic note for March 2015: "Buy Europe".*
[4] *Some ECB officials have suggested that the ECB could well hike its rates before the end of QE. Were this to happen, this could only be a "technical" adjustment, in our view, to bring the spread between the refi rate (0%) and the deposit rate (-0.4%) back to its usual level of 25bp, as opposed to 40bp at present. A rate tightening cycle initiated before the end of QE is unlikely.*

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