Daiwa Capital Markets

Europe Monthly

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Overview

Despite the heightened financial market turbulence at the start of the year, **euro area GDP growth** likely remained steady in the first quarter of 2016 thanks to firm consumer spending. But economic confidence has weakened. So, we expect GDP growth in the euro area to slow slightly over the near term. And, overall, GDP growth in 2016 will be softer than in 2015. **Inflation,** meanwhile, seems likely to remain subdued over the forecast horizon. So, while **the ECB** announced a range of new easing measures in March, extra stimulus – including from fiscal policy – seems likely to be required to prevent 'lowflation' and negative rates becoming a permanent feature of the euro area economy.

In **the UK**, GDP growth likely slowed in Q1 to its softest rate since 2012, while inflation is set to remain very weak too. And the near-term economic outlook is clouded by the **Brexit referendum**, which could have a profound economic and financial market impact. **The BoE** will not respond to new economic data until after the referendum has passed. However, whatever the outcome, monetary tightening looks to be a very long way off.

Key issues

There was never any doubt that ***the ECB*** would ease policy in March. But in many ways it beat investor expectations.

- In terms of ***rates***, the ECB cut the deposit rate by 10bps to -0.40%, and the main refi rate and marginal lending rate by 5bps to zero and 0.25% respectively. The door to further rate cuts was left open with forward guidance stating that rates will remain at the new levels or below for an extended period of time, and well past the horizon of the asset purchase programme (currently due to end in March 2017).
- In terms of ***QE***, the ECB increased its monthly asset purchases by a greater-than-expected €20bn to €80bn. And investment-grade euro-denominated bonds issued by non-bank corporations established in the euro area will be included in the list of assets eligible for purchase for the first time from June.
- In terms of ***liquidity provision***, the ECB unveiled a new series of four targeted longer-term refinancing operations (TLTROII), each with a maturity of four years, also starting in June. While funds borrowed under the operations will be subject initially to the refi rate prevailing at the time of take-up (so 0% currently), for banks whose net lending exceeds a benchmark the interest rate will be lowered and will be able to fall as low as the deposit rate (presently -40bps). So, the ECB could effectively pay banks to borrow money.

The TLTROII programme, whereby banks will be incentivised to lend into the real economy with the carrot of being paid to borrow from the ECB, should be more effective at the margin at supporting bank lending. But the cost of finance is only one consideration of banks when deciding whether to lend or not. Of at least equal importance is how the underlying economy, and hence the loan itself, is expected to perform. And on that measure it's far from certain that the ECB's latest initiatives will prove transformative to the economic outlook. Certainly, the size of the boost from increased QE when the yield curve is already so low and flat is a matter for debate. And the effectiveness of negative rates is questionable not least given the possible harmful impact on economic confidence and the health of the banks.

On our ***central forecast***, euro area GDP growth will remain tepid. So, inflation will likely remain below 1%Y/Y this year and no higher than 1½%Y/Y across the forecast horizon, and extra policy stimulus will be needed to prevent 'lowflation' and negative rates becoming a permanent feature of the euro area economy. But there is no obvious next move for the ECB. A further increase in its monthly rate of asset purchases currently does not look feasible. Even with BoJ-style tiering, some members of the Governing Council would object to a further rate cut for fear of the impact on the banks. And Draghi is right to argue that other policymakers – notably governments in countries such as Germany that have the budgetary room for manoeuvre – should boost demand and inflation via new fiscal stimulus to take some of the pressure off the central bank. Alas, there is no sign that politicians, particularly in Berlin, are listening.

We do not expect further action from the ECB until the autumn. By then, economic conditions might have further deteriorated. At the top of the list of near-term risks is the ***UK's 'In-Out' referendum*** on EU membership on 23 June. We currently expect to see the 'Remain' camp win. But we recognise that the opinion polls are hard to interpret. And with older voters in particular on average backing Brexit, voter turnout might be key and we acknowledge that a surprise victory for the 'Leave' camp cannot be ruled out. Brexit would result in significant financial market volatility and likely imply a substantive net economic cost for the UK of uncertain magnitude: the UK Treasury calculates that – under the Canadian model preferred by many of the 'Leave' camp – the UK economy could be about 6% smaller than otherwise by 2030 if the UK exits the EU. A victory for 'Leave' would be expected to hit sterling and UK asset prices and could well send the UK economy into an initial recession and subsequent years of weak GDP growth. With the UK being one of its most important export markets, that would be bad news for the euro area. And with populism rising amid the failures to get to grips with the euro and refugee crises, the political consequences of Brexit for the euro area would likely be profound too.

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Euro area

- Euro area GDP growth in the first quarter of 2016 appears to have remained steady. After accounting for more than half of all economic growth in the euro area in 2015, consumer spending looks to have maintained a relatively firm rate of expansion in the first quarter of 2016. Retail sales rose for the fourth consecutive month in February to stand almost 2½% higher than a year earlier, with growth on a three-month basis the strongest in more than a year to signal a possible pickup in spending momentum at the turn of the year. Meanwhile, still benefiting in particular from the release of pent-up demand in the periphery countries following the crisis, growth in new passenger car registrations remained strong in Q116, up almost 9%Y/Y, suggesting continued willingness on the behalf of households to make big-ticket purchases.

- Other recent euro area economic data have beaten expectations too. After a surge in January, industrial output was bound to fall back in February. However, the retreat was more gentle than anticipated. As a result – bucking the moribund global trend for the sector – the average level of manufacturing output in the euro area over the first two months of the year was more than 1% above the average in Q4. So, while evidence points to another disappointing quarter for exporters, data due 29 April are likely to show that euro area GDP growth in Q116 was sustained at the 0.3%Q/Q rate of the previous two quarters. At the country level, Spain seems bound to have led the way again with growth in the region of 0.6%Q/Q, with Germany also stronger than the euro area average and France and Italy a touch softer than the euro area average.

- One reason for the steady growth in consumer spending in the first quarter is the improvement in the labour market, with the euro area unemployment rate having fallen in February to 10.3%, almost 1ppt below the rate a year earlier and the lowest since August 2011. However, beyond Spain, some of the positive momentum in the labour market appears recently to have been lost. For example, the number of French jobseekers rose to another record high in February and the Italian unemployment rate is no lower than last summer having previously established a clear downtrend. And with the number of people employed in the euro area still about 2½ million below the pre-crisis peak, wage growth seems bound to remain very muted, a factor that will increasingly act as a restraint on consumer spending.

- Indeed, while economic growth in the first quarter appears to have been well maintained, the risks to the outlook appear skewed to the downside. Surveys show that economic sentiment has deteriorated over recent months, not least due to the aforementioned financial market turmoil, similar bouts of which seem likely to reoccur over coming quarters. Consumer confidence fell in March to the lowest level since 2014 suggesting a softening of household spending growth ahead. Key measures of business confidence, such as the Commission sentiment index and PMIs, have slipped to their weakest levels in a year, suggesting that fixed investment will likely remain subdued. And with no sign that global trade is set suddenly to step up a gear, GDP growth in 2016 will likely fall short of the rates recorded in 2015 in the euro area and each of the four largest member states with the sole exception of Italy.

- Euro area GDP growth will therefore remain inadequate to provide any significant boost to underlying inflation. Principally due to increases in services prices associated with the timing of the Easter holidays, headline CPI rose in March, but only as far as zero. We expect CPI to fall back into negative territory in April. And with the core inflation measure – which excludes energy and food prices and provides the best guide of underlying pressures – still just 1%Y/Y, in the absence of a prolonged rally in the oil price or a sharp unexpected weakening in the euro exchange rate, we expect inflation to remain below 1%Y/Y until next year and remain no higher than 1½%Y/Y over the coming two years.

UK

- At least in part due to uncertainty surrounding the country's future in the EU, the UK economy has slowed, perhaps notably so. Despite an increase in March, the composite PMI fell almost 1pt in Q116 to 54.2, a three-year low, with weakness in the indicators for services and manufacturing alike. Retail sales growth looks to have softened following a strong January. Industrial production in the first two months of the year was 1% lower than the Q415 average, with exports and construction output similarly having weakened from late last year. Employment growth has slowed to the lower end of the range of the past four years. Overall, we now also expect GDP growth in Q116 to be just half the 0.6%Q/Q rate seen in final quarter of 2015, which would be the softest rate since 2012.

- As in the euro area, inflation in the UK picked up in March principally due to price changes related to the timing of Easter. Headline CPI rose to 0.5%Y/Y, the highest level since 2014, with the core measure up to 1.5%Y/Y. Given the calendar effect, we expect inflation to move back down in April. And due to the absence of cost pressures generated in the labour market, despite the weakening of sterling by more than 10% in trade-weighted terms since late November, underlying inflation looks set to remain some way below the BoE's target over the coming couple of years suggesting no pressing need to tighten policy. Regardless of the economic data, however, the BoE looks set to sit on its hands and leave policy unchanged until the referendum on EU membership is out of the way. And having judged that a vote to leave would hit demand, possibly weaken long-term growth and have large adverse effects on asset prices, while the MPC has not committed to a particular course of action in the event of a vote to leave, the ultimate impact of such an outturn might be to increase the likelihood of future easing.

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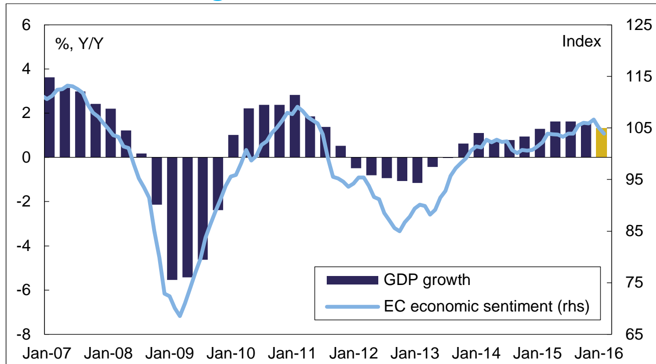
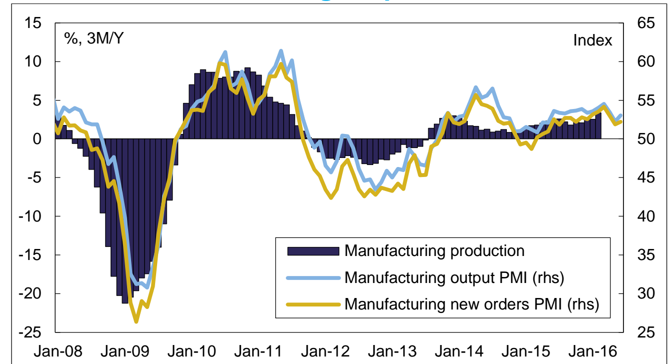
Euro area: GDP growth* and economic sentiment



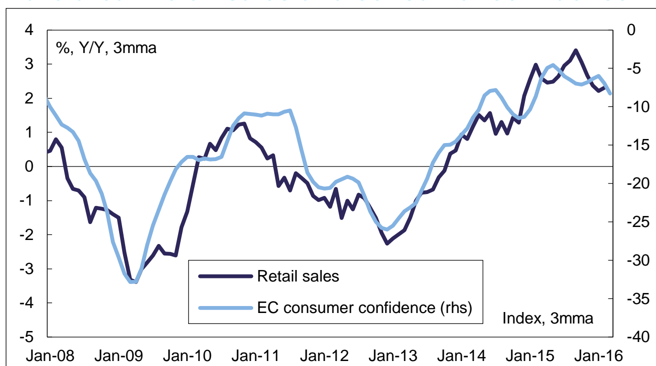
*Daiwa forecast for Q116. Source: Datastream and Daiwa Capital Markets Europe Ltd.

Euro area: Manufacturing output and PMIs*



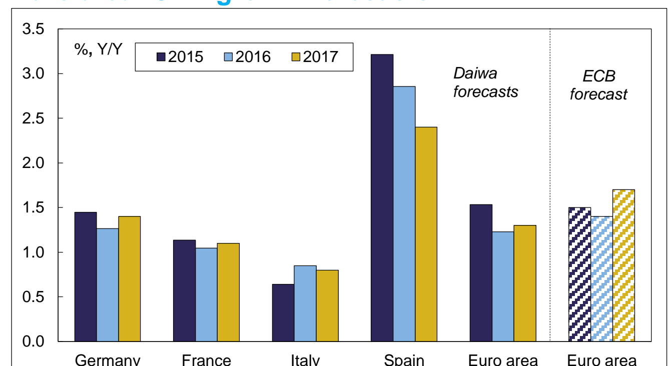
*PMIs have three-month lead. Source: Datastream, Markit & Daiwa Capital Markets Europe Ltd.

Euro area: Retail sales and consumer confidence



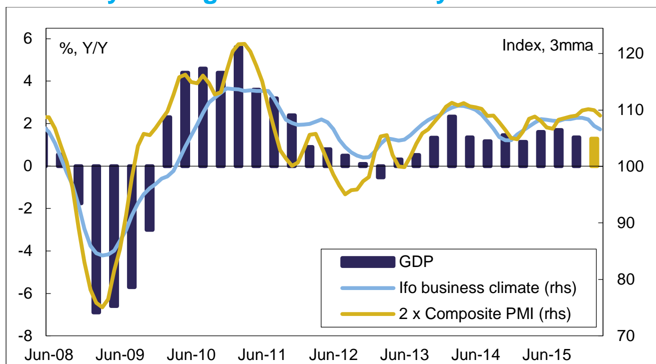
Source: Datastream and Daiwa Capital Markets Europe Ltd.

Euro area: GDP growth forecasts



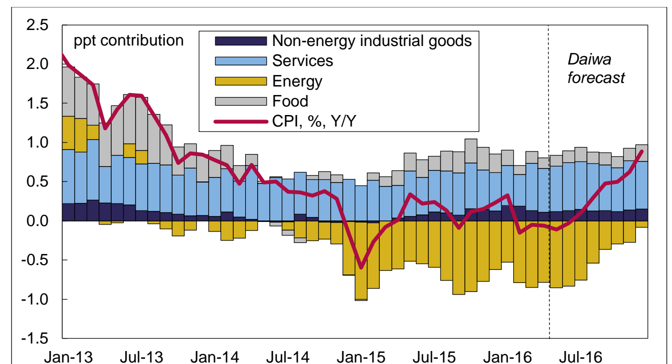
Source: Datastream, ECB and Daiwa Capital Markets Europe Ltd.

Germany: GDP growth* and survey indicators



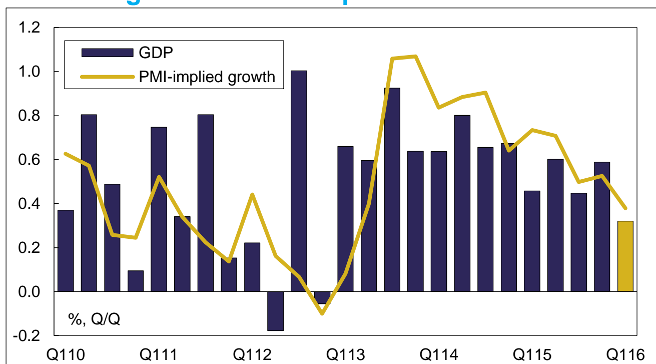
*Daiwa forecast for Q116.
Source: Datastream and Daiwa Capital Markets Europe Ltd.

Euro area: Inflation and forecast



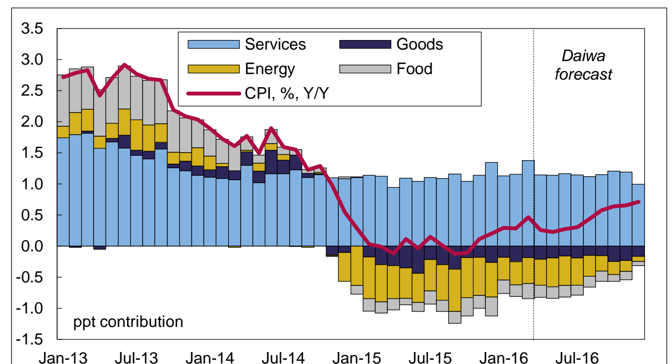
Source: Datastream and Daiwa Capital Markets Europe Ltd.

UK: GDP growth* and composite PMI



*Daiwa forecast for Q116.
Source: Datastream and Daiwa Capital Markets Europe Ltd.

UK: Inflation and forecast



Source: Datastream and Daiwa Capital Markets Europe Ltd.

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