Europe Monthly

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Overview

Stronger-than-expected GDP growth, higher oil prices, increased bank lending and the likelihood of a new deal between Greece and its creditors are among several factors to provide cause for cautious optimism about the **euro area** economic outlook. However, we expect GDP growth to slow in the second quarter, while inflation remains very low and looks set to rise only gradually over the near term. And the risks to the economic outlook are still skewed to the downside. Nevertheless, the ECB will not add to its stimulus over the near term.

One of the key immediate risks to the economic and financial market outlook is posed by the **UK** referendum on EU membership, with uncertainty surrounding the outcome already seemingly weighing on UK GDP growth and driving shifts in sterling. Although recent opinion polls suggest increased support to 'Remain' in the EU, a vote to 'Leave' still cannot be ruled out and would likely significantly hit UK GDP growth and sterling. While UK inflation would also likely rise in the event that the UK leaves the EU, we would expect the BoE to respond with further monetary easing. Indeed, given the recent loss of growth momentum, persistent low inflation and weak wage growth, a UK rate cut cannot be ruled out even in the event of a victory for the 'Remain' camp.

Key issues

In several respects, the **economic news-flow has become more favourable** for the ECB. Certainly, the flash **GDP** figures for the first quarter of 2016 appeared more promising with euro area growth of 0.5%Q/Q representing the highest rate for a year and outpacing the other major economies, most encouragingly with domestic demand evidently the main driver. Growth was also widely spread, with most countries seeing an acceleration at the start of the year. Additionally, for the first time, euro area output rose above the pre-crisis peak reached eight years earlier.

Passing that landmark for the recovery represents more cause for relief than celebration, providing a reminder that the euro area remains far behind most of its peers, with the UK having passed the same point almost three years ago and the US having done so almost five years ago. Indeed, despite its expansion in Q1, fixed investment remains about 10% below its pre-crisis peak. And while the unemployment rate continues to decline at a quicker pace than expected, down to a four-and-a-half-year low of 10.2% (16.4mn persons) in March, it remains roughly double the rates in the US and UK. On any objective measure, there remains a huge amount of spare capacity.

Moreover, the strong growth performance of the first quarter looks unlikely to be repeated over the near term. With monthly data suggesting that momentum softened in March, a reasonable bet for euro area GDP growth in Q2 would be a figure no higher than 0.3%Q/Q, the average rate during the economic recovery to-date. And with fiscal policy still making no significant contribution, full-year growth in 2016 might yet struggle to exceed significantly the 1.5% rate achieved last year.

In contrast to GDP, euro area **inflation** was weaker than expected in April with CPI back in negative territory and the core measure the lowest in a year. But thanks to the recent rise in the oil price, the **ECB**'s next economic forecasts, due on 2 June, will likely see the inflation outlook revised up. And with the critics of its negative-rate policy increasingly vocal, bemoaning its adverse impact on banks, pension funds, savers and (misguidedly) Germany's economy as a whole, the ECB will feel in no hurry to ease monetary policy further over the near term. Instead it will focus simply on implementing measures announced in March, such as purchases of corporate bonds and new long-term liquidity operations which will get underway next month.

Of course, policymakers cannot be complacent, and are aware of numerous downside risks to the outlook. Among the most notable, victory for the 'Leave' camp in the **UK referendum** on EU membership on 23 June would hit British financial markets and economic confidence. Shockwaves would likely be felt across the euro area too not least due to the political pressures that would likely be triggered in many other countries as well as the direct economic and financial linkages with the UK. While they suggest that the referendum outcome remains uncertain, however, on balance the most recent opinion polls increasingly suggest that the UK is likely to vote to 'Remain'.

While there are further tortuous negotiations to be completed, the probability of another summer of uncertainty about **Greece**'s future in the euro area, and a Greek default on its debt on payments due in July, appears to have diminished. After the Greek parliament adopted new pension and tax reforms and the government committed to legislate a mechanism to deliver extra automatic austerity should it appear off-track to meet its future budget targets, euro area finance ministers agreed to discuss on 24 May possible measures to enhance the sustainability of Greece's debt, including longer grace and repayment periods and other measures to reduce Greece's debt in NPV terms, albeit sadly not in nominal terms. It will still be difficult to reconcile fully the views of the Eurogroup, IMF and Greek government. And, given the likely damaging impact of the latest austerity package, the Greek economic outlook remains dire. But we expect a deal eventually to be reached to avoid a repeat of last year's unedifying political drama and associated Greek-specific financial stress.

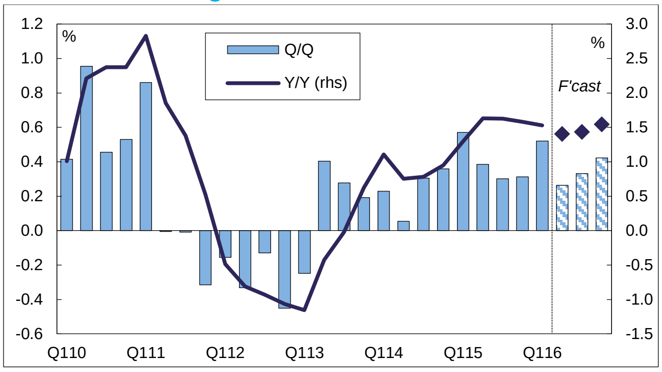
Euro area

- While the second 'flash' estimate of Q1 GDP saw euro area growth revised down by 0.1ppt to 0.5%Q/Q, this still represented the firmest quarter for a year. And growth was relatively widely spread. Predictably, Spain (0.8%Q/Q) and Germany (0.7%Q/Q, the strongest in two years) led the way. But France matched the euro area average with its best quarter in a year, as Italy met expectations as its economic recovery was sustained (0.3%Q/Q). The weakest performers remain the two member states hit hardest by the financial crisis and hampered by significant structural weakness, with Portuguese growth almost at a halt (just 0.1%Q/Q) and Greece chalking up another quarter of contraction (-0.4%Q/Q).
- Although no detailed expenditure breakdown has been provided at the euro area level, the national data published so far make clear that domestic demand was the driver. In France, household consumption rose more than twice the rate of GDP, the best showing in more than a decade, as joblessness fell to its lowest level in a year, and fixed investment rose the most in five years – at last some good news for François Hollande as he presses ahead with contentious labour market reforms and starts to lay the groundwork for next year's Presidential election. In Germany, consumption and investment reportedly provided the impetus, albeit with the latter flattered by mild weather which benefited construction, while net trade subtracted from growth, weighed down by continued soft global demand for capital goods.
- Consistent with the slight slowing in the annual GDP growth rate in Q1 to 1.5%Y/Y, we expect euro area quarterly GDP growth to moderate to 0.3%Q/Q in Q2. A weaker GDP figure would tally with the softening in economic sentiment seen since the end of last year reflected in the PMIs and Commission confidence survey, and would also be consistent with the profile of recent economic activity, whereby a very strong January was followed by a softer couple of months. For example, the first quarter brought the strongest growth in industrial production in almost three years, up almost 1%Q/Q, although a series-high gain in January was followed by successive declines in the following two months, a pattern matched in construction. Likewise, although retail sales in Q1 rose ¾%Q/Q, the most in a year, they fell back in March. Having taken a significant step up at the end of last year, new car registrations moved broadly sideways throughout Q1.
- The latest inflation data were disappointing with headline CPI falling back into negative territory, down 0.2ppt to -0.2%Y/Y to match February's twelve-month low. With inflation of food and energy little changed from the previous month, core inflation dropped 0.3ppt to 0.7%Y/Y, a twelve-month low. The principal cause was a marked decline in services inflation, all-but-reversing the increase in March related to the timing of the Easter holiday. Looking ahead, while we expect euro area inflation to remain below zero until July, it should rise steadily to close to 1%Y/Y around the turn of the year as base effects of past energy price declines reverse. Indeed, with the oil price now well above the assumptions of $34.9pb and $41.2pb for 2016 and 2017 respectively used in the ECB's March forecast, at the conclusion of the Governing Council's next policy meeting on 2 June Draghi will likely present upwards revisions to the inflation outlook. So, while there remains no shortage of causes for caution – e.g. core inflation remains stubbornly low, the 5Y5Y measure of market inflation expectations is still less than 1.50%, and the risks to the outlook are still skewed to the downside – for the time being the pressure is off the ECB to deliver more stimulus. However, in order to avoid a harmful premature tightening of financial conditions, we do expect the ECB in the second half of the year to extend the end of the asset purchase programme by a further six months to end-September 2017 at the earliest, although that decision might not be taken until December.

UK

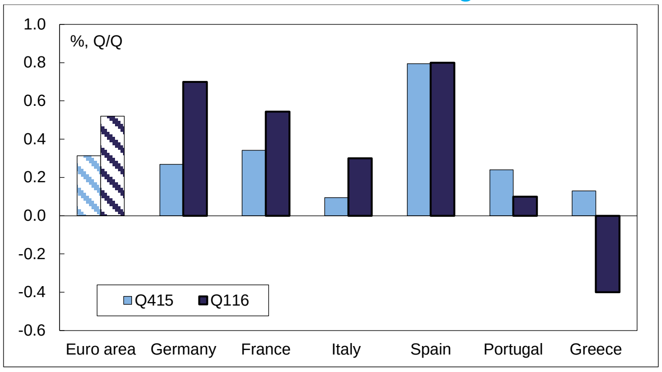
- Uncertainty surrounding the 'In-Out' referendum on EU membership due on 23 June currently dominates in the UK, weighing on economic activity and driving moves in sterling. According to the preliminary figures, GDP growth eased in Q1 by 0.2ppt to 0.4%Q/Q, matching the slowest pace of increase since the end of 2012 posted in Q315. Services activity growth slowed to 0.6%Q/Q, the softest in three quarters, while manufacturing output fell for the fourth quarter in the past five (down 0.4%Q/Q) and construction output retreated for the second quarter in the past three (down a touch more than 1%Q/Q). Surveys signal a further loss of momentum in Q2. For example, in April the services and manufacturing PMIs fell to their lowest levels in more than three years while the construction PMI fell to its lowest level in almost three years. Despite a firmer-than-expected performance for retail sales in April, the consumption trend appears to have weakened while investment might well be retreating. And net trade seems more likely than not to remain a drag on growth.
- We expect GDP growth to slow further in Q2 as referendum uncertainty becomes most acute. Predicated on the assumption of a victory for the 'Remain' camp, we then expect GDP growth to pick up again, although the rates seen earlier in the UK economic recovery in 2013 and 2014 seem unlikely to be repeated. Overall, we forecast GDP to rise just 1¾% in 2016, more than ½ppt less than the rate in 2015 and more than 1ppt less than in 2014, with growth set to be only slightly firmer in 2017. Meanwhile, inflation fell back to 0.3%Y/Y in April, with the core rate also dropping significantly, to 1.2%Y/Y. And while the recent depreciation of sterling and increased oil price look set to drive inflation higher over coming months, the increase will be very gradual with weak wage growth likely to keep inflation below target over the coming two years. As such, we see the BoE leaving rates unchanged over that period with increased risks of a rate cut.
- On balance, opinion polls released in mid-May suggest support to 'Remain' in the EU has increased. However, the outcome of the referendum remains uncertain with much likely to depend on how many people vote: if turnout is low, particularly among the young, the probability of a victory for the 'Leave' camp will rise. In that event, sterling would likely fall sharply, while the economy might well slide into recession and growth thereafter might be very sluggish. While inflation would likely rise above our forecast profile, we would expect the BoE to cut rates.

Euro area: GDP growth and forecast



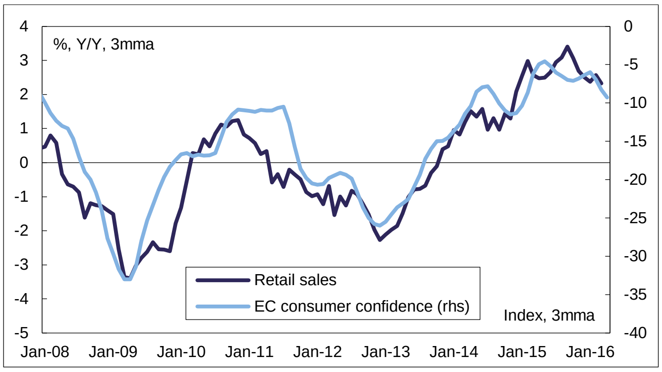
Source: Datastream, Eurostat and Daiwa Capital Markets Europe Ltd.

Euro area and member states: GDP growth



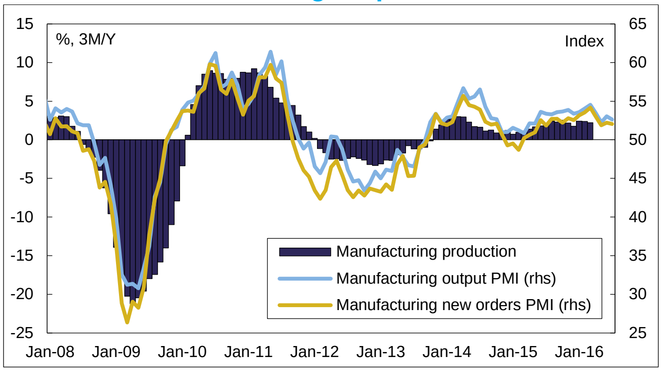
Source: Datastream, Eurostat and Daiwa Capital Markets Europe Ltd.

Euro area: Retail sales and consumer confidence



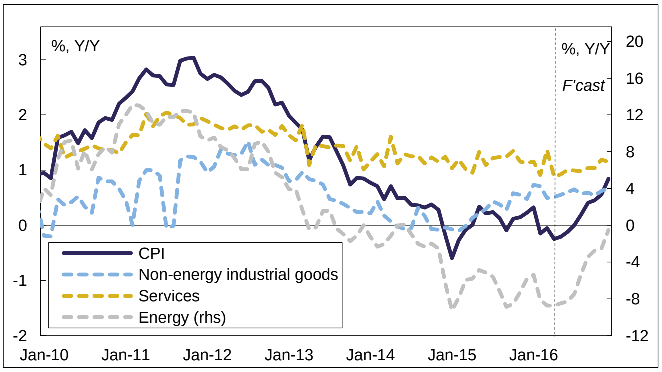
Source: Datastream and Daiwa Capital Markets Europe Ltd.

Euro area: Manufacturing output and PMIs*



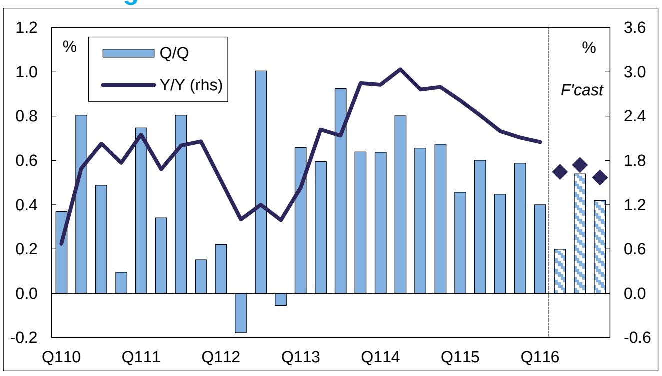
**3M lead. Source: Datastream, Markit and Daiwa Capital Markets Europe Ltd.*

Euro area: Inflation and forecast



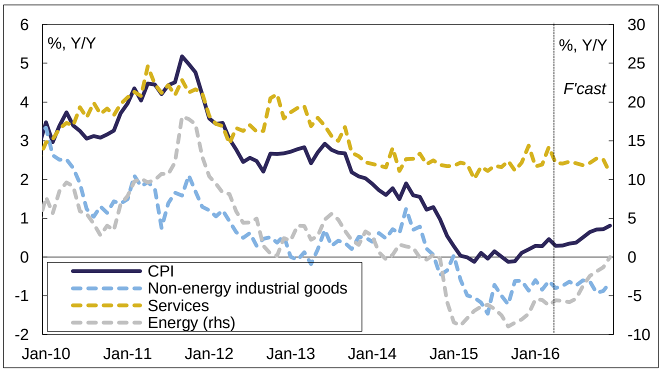
Source: Datastream and Daiwa Capital Markets Europe Ltd.

UK: GDP growth and forecast



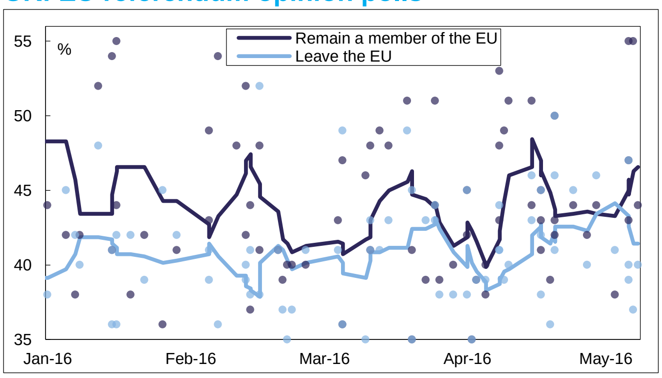
Source: Datastream and Daiwa Capital Markets Europe Ltd.

UK: Inflation and forecast



Source: Datastream and Daiwa Capital Markets Europe Ltd.

UK: EU referendum opinion polls



**The dots show individual polls and the lines are seven-poll moving averages.*
Source: whatukthinks.org and Daiwa Capital Markets Europe Ltd.

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