BBGI GROUP Global Investments

Economic Research

WEEKLY ANALYSIS

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The economic trend in the Eurozone strengthens

GDP growth accelerates to +1.9%. Franco-German couple rekindled. Fall in political uncertainty. Clear increase in company profits. Consensus is optimistic.

Key points

- The Eurozone is still able to produce surprises, with a stronger than forecast economic trend
- Better growth prospects for the Eurozone in 2017
- Reforms in France versus fiscal expansion in Germany?
- Real terms interest rates remain negative despite waning inflation
- Consumer confidence is at its highest since 2008
- The ECB is laying the groundwork for gentle "normalisation" of its monetary policy for 2018
- European company profits are confirming our positive expectations in 2017
- The consensus is now much more optimistic and is regularly revising its profit forecasts upwards

The Eurozone is still able to produce surprises, with a stronger than expected economic trend

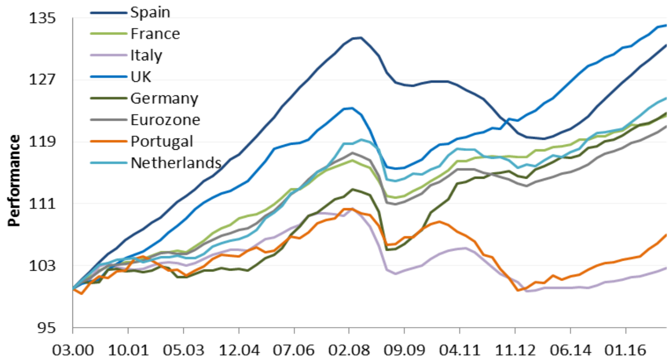
European economic performance surprised forecasters in the 1st quarter. With GDP growth of +1.9% year on year, European growth is proving better than forecast, posting better results than the US economy, which is often considered to be well ahead on the global economic recovery cycle.

As such, the Eurozone is seeing one of the best continuous periods of growth in economic activity since 2011, once again growing (+0.6% over the quarter, for annualised growth of +2.3%). When broadened to the 28 members of the European Union, GDP came in slightly lower (+0.4%).

We were expecting the largest two economies, Germany and France, to make a contribution of around +0.5%. As in the previous quarter, Germany and Spain are being aided by an exceptionally good economic trend (+0.6%), whilst France (+0.3%) and Italy (+0.2%) are lagging behind a little.

However, optimism is making a come-back in Europe, with economic growth posting regularly increasing performances, and political factors seeming to diffuse. The European economy was indeed behind the US economic cycle, but the latest growth figures show more similar performances. Politically, electoral uncertainty has disappeared with the election of President Emmanuel Macron, and the success of the new political movement LREM in the legislative elections, giving it an overwhelming majority in the National Assembly. In the United Kingdom, the results of the early elections called by Prime Minister Theresa May rather seem to reduce the likelihood of a hard Brexit, which should enable negotiations to get underway with a slightly less aggressive tone. The ECB chief also seems increasingly convinced of the improved economic conditions in the Eurozone; in fact, the ECB has increased its GDP growth forecasts to +1.9% for 2017 and +1.7% for 2018.

Evolution of European GDP



Sources: Bloomberg, BBGI Group SA

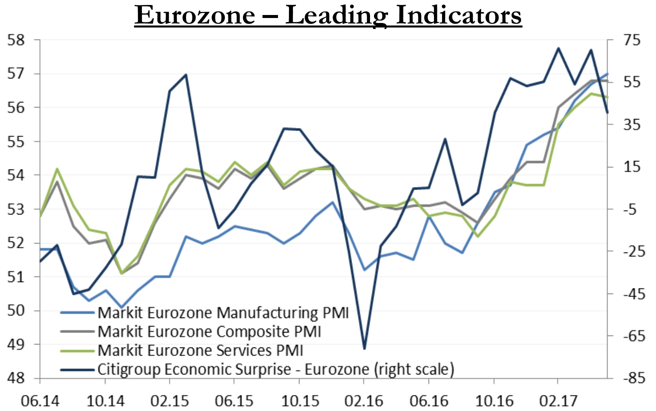
Better growth prospects for the Eurozone in 2017

It should be noted that the Eurozone recovery has been shoring up for a few months now, and could still surprise observers, with annual growth at its strongest since 2008.

This economic acceleration is in part propped up by several exogenous and some endogenous factors. Firstly, the growth in global trade is propping up European exports, as well as company profits and productive investments. However, it is first and foremost the drop in unemployment from 12% to 9.3% which is helping the positive developments in consumption and demand. In the 1st quarter, the employment level exceeded pre-crisis levels. Nevertheless, this situation did not lead to faster wage increases, which remained relatively weak (+1.5%). This trend is undoubtedly not strong enough to trigger a more marked recovery in inflation and encourage a change in monetary policy before 2018. Mario Draghi highlighted this as an essential criterion for any change in policy.

In terms of leading indicators, PMI indices for May are still showing a clear recovery in activity in Europe. Composite PMI improved once again in May (56.8), and is now at its highest level for six years; average PMI for the 2nd quarter should therefore also be higher, and point to a bolstering of activity between March and June. This de facto allows us to hope for GDP growth of perhaps higher than +0.6%.

Eurozone – Leading Indicators



Sources: Bloomberg, BBGI Group SA

Industrial production increased +0.5% in April, boosted by the energy segment; it should also contribute to more sustained GDP growth.

As such, GDP posted its 16th consecutive quarter of growth; the rises could step up the pace over the coming months.

Reforms in France versus fiscal expansion in Germany?

Emmanuel Macron's first visit to Berlin was not only symbolic. First and foremost, of course, it marked the much needed rekindling of the Franco-German couple, at a time when the European Union is heading into difficult negotiations with the United Kingdom, and when Transatlantic relations are jeopardised by the unpredictable agenda of the new president, Donald Trump. This turning point is perhaps already enough to breathe new hope into the economic trend needed to recast the European ideal, which has been left cracked over a decade of unprecedented economic crisis.

As we have already mentioned, Eurozone growth is highly dependent on Germany's good will in consenting to certain adjustments which are required for the positive economic trend that has been in place for a few quarters to strengthen. The wind is perhaps changing on budgetary austerity, and the Eurozone might follow the change in thinking already seen in the United States, China, Japan and Canada, for example. However, this change in paradigm will certainly come at a cost.

Are we already seeing early signs of a change in German doctrine with the first exchanges between Emmanuel Macron and Angela Merkel?

We should not forget that a few quarters ago, the two Ministers for the Economy (Emmanuel Macron and Sigmar Gabriel) had already laid the foundations of mutual understanding. Will we soon see, as announced by the new president, France undertake the reforms needed to persuade Germany to change policy and support a recovery in investment and public spending? Could we leave behind austerity, which has certainly contributed to the success of Eurosceptic and extremist political parties and candidates, and see a new form of economic policy coordination?

The French president's economic project undoubtedly involves giving France back her credibility, so that once finally reformed she can legitimately lead the Eurozone towards a new form of solidarity. But the path to reform will not be smooth, even though the French population seems determined, or resigned, to trying a different type of politics after being disappointed by ineffective governance over the last few years.

For the time being, Chancellor Merkel is supporting Emmanuel Macron in his desire to reform the Eurozone, and has mooted the idea of creating a shared finance ministry and budget for the Eurozone "if it is clear that we are really strengthening the structure of the economy and doing sensible things".

Proposals from the working group set up after the French presidential elections are eagerly awaited in order to strengthen Eurozone integration. It is expected to set out its conclusions on the 13th July, and will likely tackle issues such as fiscal convergence, company taxation, convergence of economic policy, investment initiatives, and accelerating institutional overhaul.

The idea of a Eurozone budget, voted on by the Eurozone Parliament and implemented by a Eurozone Minster for the Economy and Finance is making headway.

Germany seems to have been charmed by the new president, and will certainly want to take part in re-shaping Europe. However, they will demand certain guarantees, which President Macron seems prepared to give them. Three months ahead of the German legislative elections, Angela Merkel will be rightly cautious. Nonetheless, it should not be forgotten that never before has there such an ambitious project proposed, with such real chances of realisation.

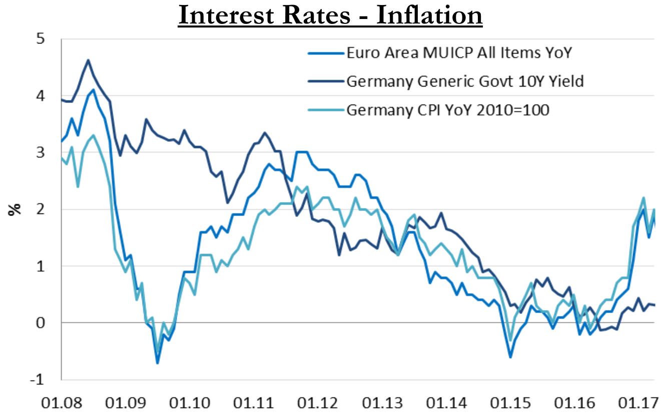
In the end, perhaps Germany will be more willing to put in place anti-cyclical policy, which will benefit the Eurozone, if it gets the guarantees it is asking for.

Real terms interest rates remain negative, despite waning inflation

After an expected rise in inflation in the 1st quarter to its highest levels since 2012, price indices are showing some signs of running out of steam. A few weeks ago, we pointed out that the main vector of the inflation recovery would now no longer contribute to such a great extent to price rises. The trend in crude oil price rises will be weaker over the coming months, and its impact on inflation lesser. Equally, it is too early to see any real boost to inflation from the jobs market, which is for now too far from its friction point for wage rises to help price rises. Eurozone inflation therefore dropped from 1.9% to 1.4% in May, which is already close to the ECB forecast for 2017.

As such, monetary policy normalisation can still wait until 2018, but with long rates in Euros having stabilised at just above zero, real terms interest rates remain rather markedly negative. This scenario should prop up spending and investment.

Interest Rates - Inflation

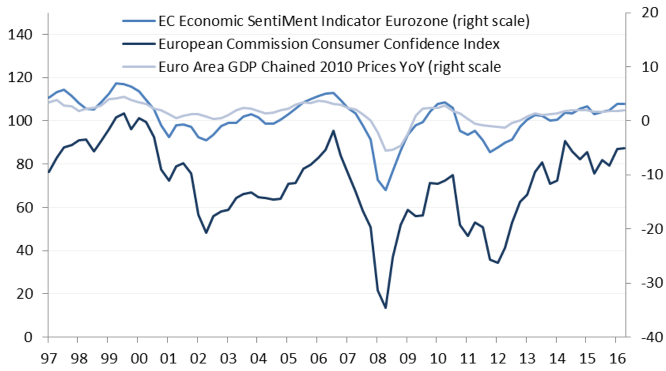


Sources: Bloomberg, BBGI Group SA

Consumer confidence at its highest since 2008

The European Commission's household confidence indicator rose again in the 2nd quarter. Sentiment has improved rather considerably, bolstered by the improvement in conditions on the jobs market.

Eurozone GDP, Economic Confidence and Consumer Confidence

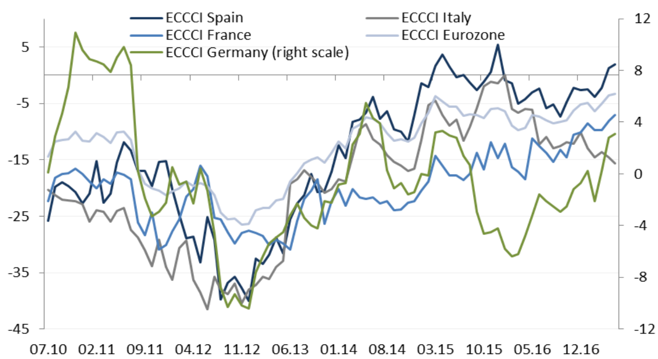


Sources: Bloomberg, BBGI Group SA

Household confidence is now higher than the average for the last twenty years, and at its highest point since 2008. The consumer and business confidence index is also showing renewed optimism, which is at its highest levels since the start of the financial crisis.

The situation is not yet euphoric, but the positive trend is indeed propping up spending, up +2.5% year on year. In most countries, we are seeing a welcome return to cautious optimism, which should also later prop up spending and GDP growth.

Confidence Indicators



Sources: Bloomberg, BBGI Group SA

The ECB is laying the groundwork for gentle "normalisation" of its monetary policy in 2018

The positive economic surprises posted over the past few months and the fall in political risks enabled the ECB chief to give an even more optimistic message at the outcome of the last ECB meeting.

The ECB's economic projections are encouraging, approaching +2% GDP growth for 2017, and coming in just under that for 2018/2019. Inflation forecasts have been revised downwards and are now only predicting likely rises limited to 1.5% on average until 2019. Mario Draghi does not yet seem convinced of the upward trend, and has let it be understood that monetary conditions remain an important factor in propping up price rises.

The asset purchase programme is being maintained at 60 billion a month until December, or longer if necessary, which we believe to be increasingly unlikely given the current developments in the European economy. The ECB seems to be approaching a turning point in its monetary policy. However, we will likely have to await September for the next indication regarding new policy and the end of the asset purchase programme. If economic developments in Europe do not run into any troubled waters in the second quarter, we believe that the ECB will likely scale back its programme at the start of 2018, before taking its time to increase its key rates.

There is but a slight chance of these rates being increased before the end of 2018. This change will be made gradually, like in the United States, unless growth and inflation step up the pace in 2018.

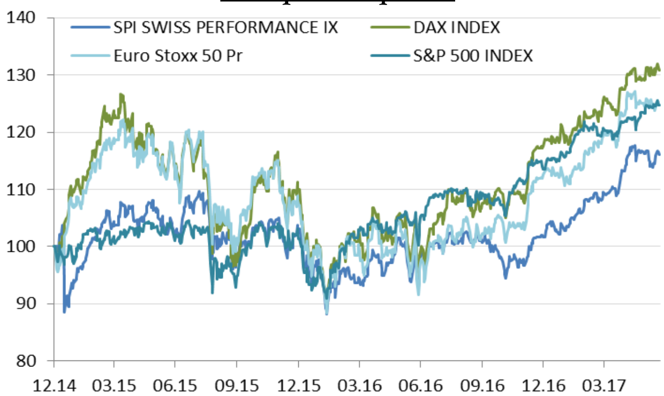
European companies' results confirm our positive expectations for 2017

European equities had been abandoned due to political risks in 2016, but since then they have benefited from a phase of revaluation, which has continued into the 2nd quarter 2017. Over the last six months, the main European assets have increased +19%, easily outperforming US assets (+12%).

The 1st quarter company results were particularly robust, propping up price rises. Most companies came in better than forecasts, both in terms of sales and profit per share. We would need to cast our minds back to 2010 to find a 70% positive surprises ratio for Eurozone companies. At around 15x profits, however, the valuation of European assets is no longer as attractive, though not excessively so.

After several quarters of stable profit growth, the consensus has been much more optimistic since the start of the year, and is regularly revising its profit forecasts upwards. Profit growth of the top 50 assets is estimated at +10% for 2017 and 2018, which represents PE of 15x and 13x respectively.

European Equities



Sources: Bloomberg, BBGI Group SA

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