Economic Research

# WEEKLY ANALYSIS

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# Is a recession looming in Germany and the Eurozone?

**Contraction over the last quarter in Germany? Leading indicators rather bleak. ECB remains confident. Policy rates unchanged. New opportunities in equities.**

## Key points

- GDP growth down -0.2% in Q3
- German industrial output drops -1.9%
- Slowdown in Europe is intensifying
- Five largest EU economies are weakening
- Leading indicators not optimistic
- Confidence gives way to concern
- Euro surprisingly stable
- ECB already in electoral mode?
- Outlook for euro fixed income markets in 2019?
- Following the Q4 shock, European equities offer new opportunities
- Significant adjustment of valuation and risk levels
- European equities command a 25% risk premium

## Slowdown in Europe is intensifying

**The outlook remains uncertain for the euro area as a whole given the likelihood of a sharp slowdown in Q4. GDP growth had already dropped from +0.4% in Q2 to only +0.2% in Q3, bringing the Eurozone's yoy GDP growth down to +1.7%. Contrary to expectations the growth rate thus dropped below its recent trend. The -0.2% contraction of the German economy in Q3 was the main contributor to this decline.**

**The German auto sector in particular seems to have been one of the main factors contributing to the slowdown. The euro's correction of close to -10% from 1.24 to 1.14 against the dollar in Q2 did nothing to support European exports over the last few months.**

**Foreign demand was thus more affected by the tariffs issue and the uncertainty related to the risks of a trade war than by the depreciation of the euro. However, most observers still expect the European economy to achieve a growth rate of +2% in 2018 and +1.6% in 2019, despite Germany's mediocre recent performance. The risk of recession in Europe thus remains limited and is only of around 20%, barely more than in the US (15%).**

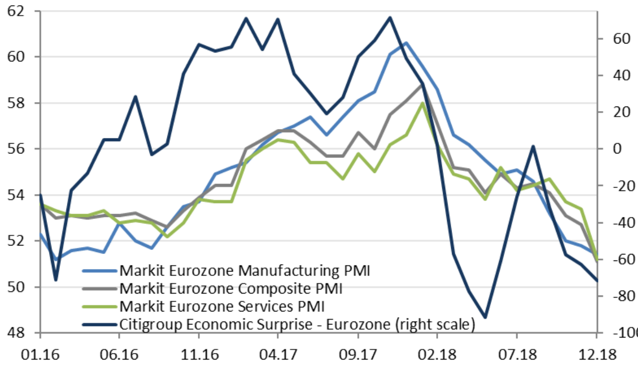
## Legitimate concerns regarding German GDP

The situation in Germany does not seem to be showing any clear signs of improvement in particular with regard to industrial activity, which portends a rather disappointing economic performance in Q4 for the Eurozone's largest economy as well as a difficult start to 2019. Forecasts for the Eurozone thus remain shrouded in uncertainty, as noted in our previous analyses. The latest industrial production figures for Germany for November (-1.9%) were unexpected and suggest that the sector contracted for the third month in a row. These results constitute the sector's worst quarterly performance of the current economic cycle and are unfortunately not limited to the auto sector. However, they could be offset by a stronger performance of the services sector and consumption (retail sales were up +1.4% in November), as household confidence remains stable. Nevertheless, the economy continues to falter in Germany, increasing forecasting risks for the beginning of 2019 for the euro area as a whole, even though the situation in some other countries is more positive. The ECB does not seem to be unduly concerned with regard to these developments for now. The bank notes that the Eurozone's economy continues to behave in line with expectations, highlighting the positive trends in the job market and their likely impact on wages and inflation. However, the ECB did slightly reduce its growth outlook to +1.7% for 2019 (real GDP) and to +1.6% for inflation.

## Leading indicators not optimistic

As Q4 came to a close, most leading indicators gave no concrete sign of picking up. The Eurozone unfortunately seems to be following the same trend that prevailed in the previous quarter. Indicators remain equivocal but are steadily deteriorating. Indeed, the Markit composite PMI index slid further in December to 51.1, well below the 58.8 high reached in January 2018, with both services (51.2) and manufacturing (51.4) falling back. The Eurozone's economic performance is still closely tied to Germany's, which was still not showing any sign of recovery at year end. Germany's manufacturing PMI index fell from 63.3 at the beginning of the year to 51.5 in December 2018, in line with leading indicators overall, which closed the year on a downward trend at 51.6. The -1.9% decline in industrial output in November brings the sector's yoy contraction to -4.7%. Concerns are thus legitimate in regard to the health of both the German and the European economies.

**Eurozone – Leading indicators**




*Sources: Bloomberg, BBGI Group SA*

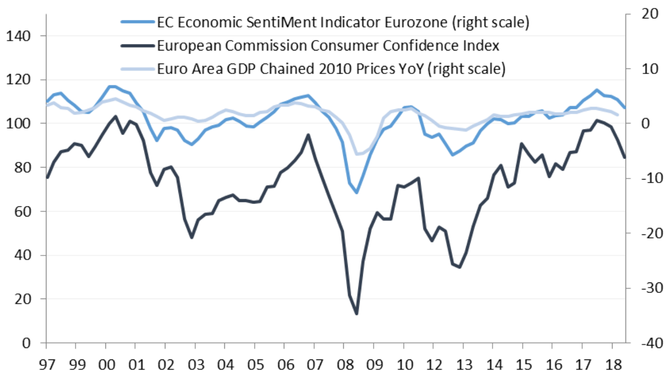
The situation is not bright for the second largest European economy, which has lost some momentum with the yellow vest crisis. France's composite PMI index fell below the growth threshold to 48.7 in December. Overall, growth forecasts for the Eurozone are increasingly uncertain in this context both for Q4 and for the beginning of 2019.

However, momentum in the job market is fortunately increasing steadily. The unemployment rate (7.9%) in Eurozone countries dropped for the first time below 8%, thus returning to its year-end 2008 level, a 50% decrease in unemployment compared with the 12% high reached in 2013. It is drawing nearer to the EU's 6.7% unemployment rate, thus constituting one of the positive factors pointing to a possible upswing of GDP.

## Confidence gives way to concern

Similarly to the PMI indices, various measures of household and business confidence also continue to point south. The European Commission Economic Sentiment indicator has declined for 12 consecutive months. Households and businesses seem increasingly concerned with regard to the trade dispute between the economic superpowers. Various factors impacting confidence in Europe include the fall in exports and the risks related to a hard Brexit coupled with other political uncertainties, such as the Italian crisis. The business climate indicator declined in the five largest economies, with a more significant decline seen in Spain.

**Eurozone GDP, economic sentiment and consumer confidence**



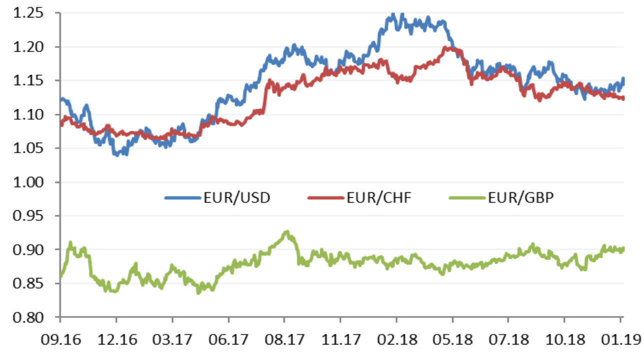

*Sources: Bloomberg, BBGI Group SA*

## Euro surprisingly stable

The Eurozone's challenging economic environment stands in rather sharp contrast to that prevailing in the US. Fears of a recession have been raised in both cases, but the Eurozone is decidedly more at risk, as the US economy continues to grow without encountering any real obstacle.

However, the euro surprisingly was not negatively impacted over the past several months by this factor, which should have penalised it. The interest rate spread between the euro and the US dollar and diverging economic performances did not cause any significant movement. The current exchange rate of 1.15 USD to the euro likely already incorporates a good number of euro area risk factors.

Euro exchange rate (USD, CHF, GBP)




*Sources: Bloomberg, BBGI Group SA*

**The current stabilisation could then give way to a stronger euro in 2019 if growth prospects normalise. Accordingly, the long-term interest rate spread could decrease and benefit the single currency.**

## ECB already in electoral mode?

ECB president Mario Draghi's term will end in May, just after the European elections and before the central bank committee meeting on 6 June 2019. As his tenure comes to an end in just a few months, Draghi was likely hoping to leave the economy in better shape than what we just described. Indeed, just a few months ago he could still legitimately hope that European growth would accelerate, allowing him to leave the ECB with the belief that he had fulfilled his mission. However, this was of course assuming that the pressure exerted by the US president with regard to tariffs and the strain caused by Brexit would not cause as much uncertainty as they have, to the point of imperilling the results achieved over the past eight years by shattering the economic momentum that seemed to be accelerating in the Eurozone. The imminence of Draghi's departure is perhaps not without influencing the ECB's assessment of the economic situation. Indeed, the bank's continued optimism, in spite of a slew of worrying data, leads us to believe that the bank does not wish to call its policies into question.

In any event, current economic data will not alter at least one of the elements of current stated monetary policy. Indeed, already there was no question of a rate hike in Q1, but in the current environment, it seems unlikely that a hike would be announced before Q4 2019. Nevertheless, the ECB did revise downward its forecast for European GDP growth to +1.9% for 2018 and in particular to +1.7% for 2019. The bank is thus increasingly taking into account the risks of a decline in foreign demand. It also kept its rates steady at -0.4% on deposits (banks' excess reserves) and 0.25% on its marginal lending facility. With regard to liquidity injections via government debt repurchasing, even though the programme ends in January 2019, this does not mean that the ECB will be completely passive. For a prolonged period, the bank will continue to reinvest maturing government debt in order to maintain as long as necessary favourable liquidity conditions and a high level of monetary support.

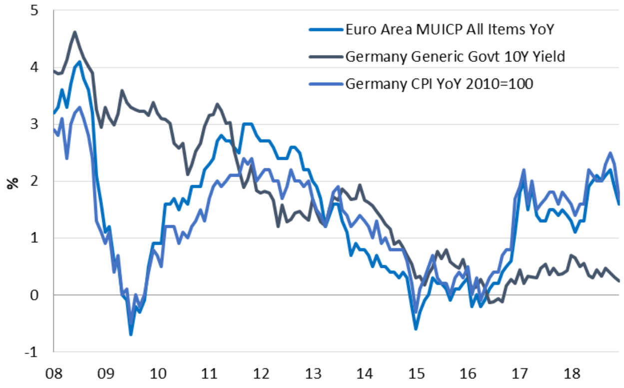
**The ECB will look for several more quarters of accelerating growth and improvement in the job market to take action with regard to policy rates. Inflation will have to be resilient for the bank to feel comfortable changing its position without risking having a negative impact on economic and financial conditions. Moreover, the bank will likely wait for the euro to weaken and inflation to pick up before raising rates.**

## Outlook for euro fixed income markets in 2019

The economic slowdown in the EU unsurprisingly reduced upward pressure on long-term euro rates. The risks of an adjustment or of a rate shock across the entire yield curve thus are now significantly lower. Inflation is trending down, due in particular to the drop in energy prices, and is not currently a threat requiring a quick adjustment in rates. President Draghi still seems convinced that the job market will show increasing signs of upward pressure on wages, which will ultimately lead to an increase in underlying inflation over the next few months. Indeed, the trend is positive, as the unemployment rate dropped below 8% for the first time in ten years. Inflation was only 1.9% in November, or 1% excluding food and energy. We believe that these short-term trends are somewhat counter to the ECB's assessment. They also affect the estimation of long-term rates' normal levels, which is tied to the assessment of inflationary trends, the growth rate, and the ECB's quantitative policy.

**The risk of an increase in long-term rates is somewhat deferred for now given the economic slowdown, but it is possible that demand for government securities will be significantly impacted by the termination of the ECB's purchasing programme, causing volatility to increase in euro fixed income markets. Recall that ECB purchases had absorbed almost the entirety of net new sovereign bond issuance in the euro area in 2018.**

### Interest rates - inflation




*Sources: Bloomberg, BBGI Group SA*

**Assuming Germany does not go into recession, the yield on the 10-year German Bund will likely be closer to the 0.55% level reached in October.**

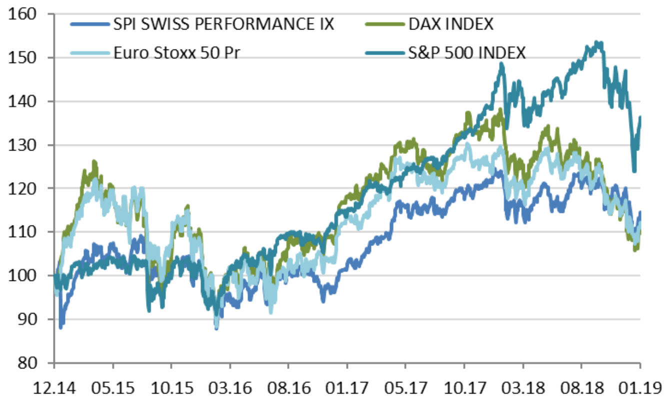
## After the Q4 shock, European equities offer new opportunities

European equity markets were strongly impacted by the deterioration in economic statistics in various countries in the euro area, even though the approximately -15% decrease in the share price of the largest European stocks between September and December 2018 was no more dramatic than that of US stocks, which fell more recently and more steeply.

In spite of diverging price and value corrections amongst geographic regions, the valuation of European equities remains persistently lower than that of US equities, without it leading to any obvious arbitraging or share price revaluation. Still today the overall PE ratio of the European market (11.9x 2019 earnings) remains very attractive. Compared with the US's PE ratio (15.1x 2019 earnings), the valuation gap remains at around 25%, which is a relatively significant risk premium, as we noted at the end of September.

European stocks maintain a valuation and yield (3.6% vs. 1.9%) advantage, while the earnings outlook for 2019 is converging with that of US stocks. European equities should see investors flow back in, although the macroeconomic environment is currently uncertain and the news flow rather bleak. However, the uncertainty related to the protectionist threat coming from the US will likely subside gradually once an agreement is reached amongst the parties.

### European equities




*Sources: Bloomberg, BBGI Group SA*

**The drop in prices and valuation levels provides new investment opportunities in Europe.**

**European equities will likely benefit from an easing of international tensions and from investor arbitrage generated by European shares' risk premium.**



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