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# Germany hampers European growth and confidence

## Weak GDP growth in Q4 (+0.2%). Outlook for 2019 revised downward. ECB to reinject liquidity (TLTROs). Euro resilient. Take profit on equities.

### Key points

- European growth still very weak in Q4 2018 (+0.2%)
- Germany solely responsible
- European GDP up +1.2% yoy
- German economy narrowly avoids entering a technical recession
- Leading indicators may have already seen the worst but fail to bounce back
- Manufacturing PMI below 50
- Situation in Germany hampering confidence
- Euro stays resilient
- ECB announces a new series of TLTROs
- No rate hike but 700 billion in loans
- Bond market yields temporarily vanish
- European equities retain their risk premium after indices rise +13%
- Time to take profits on equities

### European growth still very weak in Q4 2018 (+0.2%)

**Signs of an economic slowdown in the euro area multiplied in Q4 2018, with a sharp downturn in Germany in particular. Indeed, the economic outlook for the Eurozone as a whole worsened due to legitimate concerns hampering economic activity in Germany and the latter's impact on growth in the Eurozone overall. GDP in the Eurozone and the EU ultimately progressed very slightly (+0.2%) after Q3 2018 growth was revised downward to only +0.1%.**

**The German economy narrowly dodged entering a technical recession thanks to nonnegative growth (+0.0%) in Q4, an outcome that Italy was unable to avoid following a second consecutive quarter of economic decline. Year over year, euro area GDP grew by +1.2%, slightly below the economic performance of the EU (28) (+1.4%).**

**The pace of growth thus slowed considerably in H2, mainly because of the weak performance of the German economy. Indeed, other European countries were more resilient, although they were not able to boost growth sufficiently to fully offset the German downturn, in spite of growth of +0.7% in Spain, +0.5% in the Netherlands, +0.4% in Portugal, and +0.3% in France. The German economy, which for a long time was the main engine of growth in Europe, is today significantly impacted by the decrease in international industrial demand.**

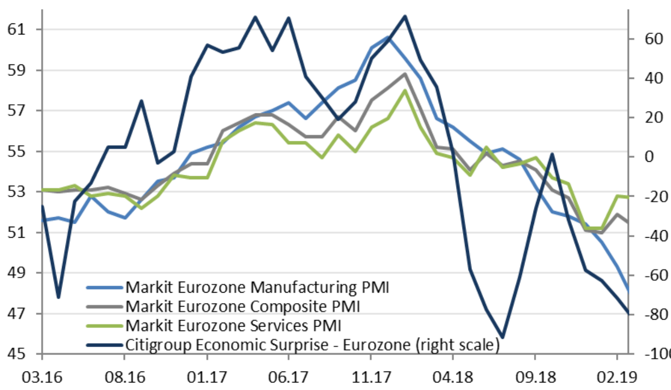
The largest economy in Europe is at a standstill and is threatening growth in other countries and regions in Central and Eastern Europe, which depend on German industry. The new European standards to which the German auto industry must conform are often mentioned as factors impacting the manufacturing sector along with the pressure exerted by Donald Trump. More generally, Germany has been more substantially impacted by the downturn in global demand for industrial goods of all sorts (equipment, machines, tools, vehicles, etc.) than its European partners. Global industrial production has thus contracted over the past few quarters, and this trend is also impacting intermediary goods and consumption goods. The weight of the industrial sector in Germany is significant and accounts for the country's poor performance compared to other EU members.

However, it is still somewhat premature to talk about a change in European growth drivers. We believe that the contraction in global industrial activity is more cyclical than structural for now and mostly tied to the uncertainty resulting from the US president's attitude towards his trade partners. An agreement is still expected between China and the US, which should result in a significant shift in economic sentiment and have a positive impact on global economic momentum in 2019.

## Leading indicators may have already seen the worst but fail to bounce back

Eurozone manufacturing indicators still have not improved and instead have decreased further in March 2019. Investors' concerns were already palpable when the Markit PMI manufacturing index dropped below 50 in February (49.3), and the index's fall to 47.6 in March is likely to further stoke concerns with regard to growth in Europe in Q2. Indeed, the index's current level is its lowest since April 2013. The composite index was also impacted, slipping from 51.9 to 51.3, but stayed in the growth range overall thanks to the relatively strong performance of the services segment.

**Eurozone – Leading indicators**




*Sources: Bloomberg, BBGI Group SA*

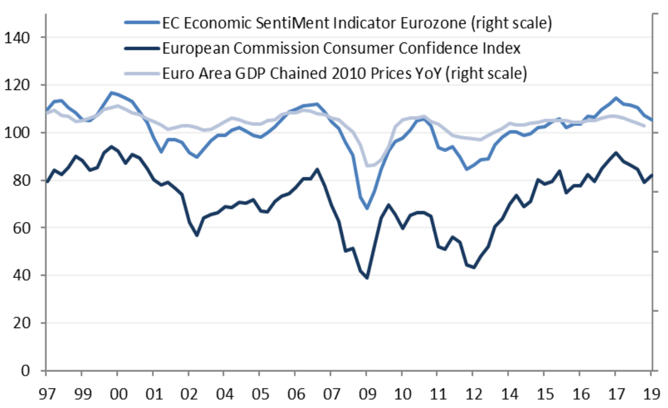
The performance of the Eurozone's economy is obviously suffering from its dependence on Germany, whose manufacturing PMI index fell even more sharply in February to 44.7, its lowest level since July 2012. The German industrial sector does not seem to be out of the woods yet. Industrial production contracted by -0.8% in February, and orders fell by -2.6%; no trend reversal is thus in sight. This is the third consecutive monthly contraction of industrial production.

Concerns are lingering and have even intensified substantially in view of the mediocre macroeconomic performance since the beginning of the year. The manufacturing sector is struggling, and leading indicators suggest that the sector's negative contribution to GDP growth may even intensify over the first three months of the year and in Q2.

## Situation in Germany hampering confidence

Positive momentum in the job market is steadily building. Unemployment in euro area countries (7.8%) continued to decrease, returning to its year-end 2008 level, namely a decrease in unemployment of 35% compared to the high of 12% reached in 2013. However, this has not been sufficient to improve household confidence, as consumers are justifiably worried about the negative trend reversal that occurred in H2 2018, which seems to be persisting in 2019.

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



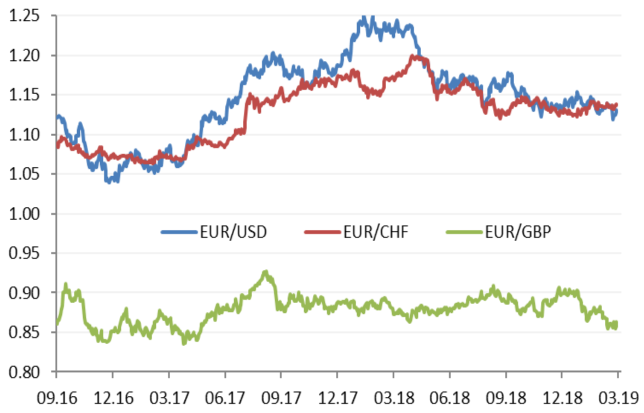

*Sources: Bloomberg, BBGI Group SA*

Similarly to the PMI indices, various measures of consumer and business confidence remain negative. The European Commission indicator gauging economic sentiment is only slightly less negative in March (-7.2) than it was in February (-7.4). Consumers, like businesses, seem to be increasingly concerned by the trade dispute between the world's leading economies. With Brexit just a few days away, the absence of a negotiated settlement is not helping in terms of calmly considering a withdrawal of the UK with no impact on the continent's economy. Yet, the ZEW Euro indicator, which reflects the economic outlook for the next six months, improved for the fifth consecutive month in Germany, although it remains in the negative zone, suggesting that pessimism is likely receding.

## Euro stays resilient

The economic environment has not improved in the Eurozone over the past several months. Nevertheless, the single currency has remained relatively stable despite an increasingly uncertain context. The decrease in euro-denominated yields has not really affected the currency, which stabilised at between 1.12 and 1.15 against the US dollar. Indeed, the interest rate spread to the US dollar and the divergence in economic performances have not caused any significant movements in the currency. The current exchange rate of 1.13 USD to the euro likely already incorporates the known risks of a downturn in the Eurozone.

**Euro exchange rate (USD, CHF, GBP)**




*Sources: Bloomberg, BBGI Group SA*

The current stabilisation could then give way to an appreciation of the euro in 2019, if the growth outlook normalises, which seems difficult to imagine currently. Otherwise, it appears likely that the euro/dollar exchange rate will fall in an environment characterised by strong downward pressure on long-term euro rates and a likely stabilisation of long-term US dollar rates.

## ECB announces a new series of TLTROs

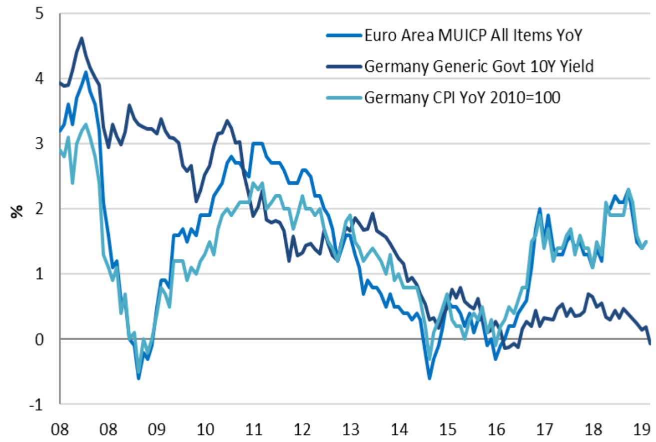
It is obviously not a huge surprise that the ECB changed its perception of the economic situation in Europe somewhat in light of the slowdown in the manufacturing sector and the weakness of the German economy. The growth forecast for the European economy announced at the ECB's most recent press conference was revised downwards from +1.7% (December forecast) to only +1.1%. Given the risk of an economic downturn in the Eurozone, the ECB decided to postpone raising target rates until 2020 and to resume policy loans to the banking sector.

This announcement does not come as a surprise, as we already expected the economic slowdown at the end of 2018 to result in a deferral of any rate hike to Q4 2019 at the earliest. As for the second announcement, the ECB changed its position rather radically, announcing a resumption of liquidity injections to start in September after terminating its asset purchasing programme in January 2019. These liquidity injections will take a new form, as they will be targeting the banking sector, aiming to boost economic activity via an increase in loans to businesses and households. These new bank refinancing operations (TLTROs) could amount to up to 700 billion euros and aim in particular to avoid a contraction in credit.

## Bond market yields temporarily vanish

The economic slump in the EU has had a major impact on euro interest rate markets over the past six months. While the growth outlook steadily declined as leading manufacturing sector indicators dropped, euro long-term rates suddenly changed course, resuming a downward trend reinforced by a concurrent correction in price indices. Indeed, inflation has been decreasing rather sharply in the euro area in the past few months due mainly to the fall in energy prices. The CPI index contracted from its October 2018 high of +2.3% to only +1.5% in February of this year. Excluding food and energy, however, the decline in the core CPI index from +1.2% to +1% is less significant.

**Interest rates - Inflation**




*Sources: Bloomberg, BBGI Group SA*

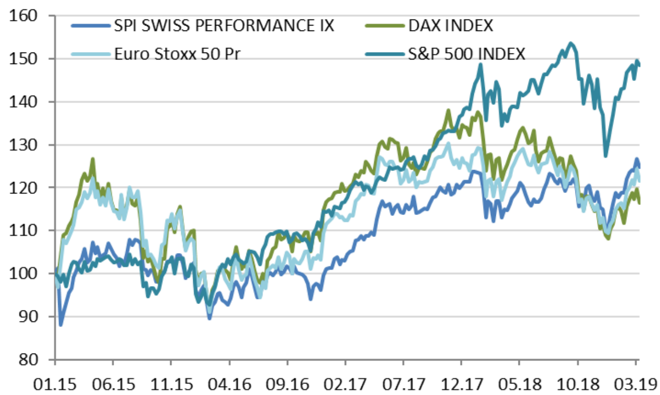
Investors' perception of where long-term rates should be at the beginning of 2019 shifted significantly as a result of these developments. Following European manufacturing PMI indices, euro long-term rates returned to their historic lows of 2016. The 10-year Bund yield is once again close to zero, indicating a rather extreme degree of pessimism among investors. President Draghi finally had to revise his expectations regarding inflation as well, in spite of his view that the vigour of the job market will put increasing upward pressure on wages, which will ultimately lead to an increase in underlying inflation over the next several months. The ECB forecast was thus lowered to +1.2% for 2019. Current trends point downwards, and the likelihood that long-term rates may rise has for now clearly receded in light of the economic weakness of the euro area. However, current levels of pessimism may already be extreme and are motivated in particular by the poor performance of the manufacturing sector. Leading indicators for the industry will have to stabilise and turn around in order for expectations regarding long-term rates to shift. More than ever we recommend avoiding euro-denominated bonds, as their medium-term outlook is mediocre.

## Profit taking in equity markets

Several months ago we noted that European equities would likely benefit from a probable decrease in international tensions at the beginning of 2019 and from favourable arbitraging by investors due to the European market's positive risk premium. Indeed, the performance of European equities was boosted by a more positive investment climate at the beginning of the year. The Euro Stoxx 50 index of the largest European blue chips, the Euro Stoxx index and the STX Europe 600 all posted performances of close to +13% in under three months. By climbing back to their September levels, European markets rapidly recouped losses posted in Q4 2018.

Following this encouraging growth, the European market's overall PE ratio bounced back sharply (13.2x 2019 earnings). However, given the rise of other equity markets, its valuation remains attractive on a comparative basis. The PE ratio of the S&P500 is already at 16.9x 2019 earnings, while that of the Swiss equity market is 15.3x. The valuation gap is holding at around 25%, a relatively significant risk premium, which has remained stable for several quarters. European shares maintain a valuation and yield advantage (3.6% vs. 1.9%), while the earnings outlook for 2019 is converging with that of US shares.

**European equities**




*Sources: Bloomberg, BBGI Group SA*

In spite of these positive factors, European equities are currently burdened by an uncertain macroeconomic environment and a discouraging news flow. The uncertainty tied to the protectionist threats by the US are, however, likely to gradually subside once an agreement is reached between the parties. Nevertheless, the European economy will also have to offer better prospects to warrant real outperformance by Eurozone stocks.

In this context, we recommend taking profits temporarily on European markets as a whole.

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