



Can European growth recover without Germany?

GDP up +0.2% in Q2. Germany poses a problem. The ECB to inject 20bn/month for two years. Rebound of the euro. Asset rotation favourable to European equities.

Key points

- Contraction of Germany's GDP hampers growth in Europe
- Underlying trends in consumption and investment remain positive
- Leading indicators may have seen the worst and finally seem to be looking up
- German manufacturing sector at its lowest
- -0.5% decline in industrial production in April
- Gradual improvement in confidence
- Possible rebound of the euro
- ECB firmly committed to supporting economic growth
- Real yields still attractive despite falling inflation
- Is the recession factored into long-term euro rates?
- Next rotation of investment flows in favour of European equities

Contraction of Germany's GDP hampers growth in Europe

After a positive surprise in Q1, GDP growth in the euro area was severely impacted by Germany's negative growth (-0.1%) in Q2. Germany has thus undergone two non-consecutive quarters of moderate decline due to issues in its automotive sector and, more broadly, given the trade war and possible sanctions.

Germany has narrowly avoided a technical recession but has been hit hard by the general slowdown of the global manufacturing sector. The German economy has achieved unfortunate records

these last few months with industrial production down -5.2% yoy (the sharpest fall in ten years) and a -8% decrease in exports (sharpest drop in three years). The German industrial complex has thus been hit very hard by the uncertainty regarding trade issues and the risks of recession, which are much more real and likely than in the US, especially in the absence of a clear turnaround in the Chinese-American conflict.

The Eurozone's quarterly GDP growth rate thus weakened from +0.4% to +0.2% in Q2, mainly due to Germany's economic slump. Employment growth followed the same trend with job creation up + 0.2% over the period (+0.4% in Q1). Within the EU, the Spanish and Dutch economies performed well, with GDP growth of +0.5%, significantly better than the results achieved in France (+0.3%) and Belgium (+0.2%), while Italy has been stagnant for several quarters.

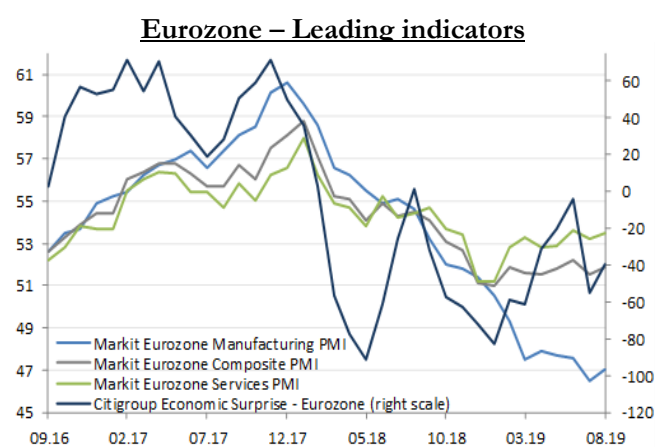
Underlying trends in consumption and investment remain positive

Consumption (+0.2%), investment (+0.5%) and public spending (+0.3%) have been driving growth in Europe while the manufacturing sector and exports faced a drop in demand. Private consumption, government spending and investment each contributed +0.1% to GDP growth overall. These rather robust domestic fundamentals are in contrast with the manufacturing sector's difficulties. These positive factors seem more resilient and have somewhat boosted reasonable hopes regarding the capacity of Europe's economy to avoid a more pronounced slump in the next few months. The European economy is likely to grow significantly more slowly in 2019 (+1.1%) than in 2018 (+1.9%), while risks of a recession are estimated at less than 20% for 2020.

Leading indicators may have seen the worst and seem to be looking up

The large majority of national composite PMI leading indicators remain encouraging and quite clearly above the growth threshold of 50. Indeed, the Eurozone's composite PMI further increased slightly in August to 51.9, driven by the services PMI (53.5), on the rise since its low point in December 2018.

The strong performance of the service sector thus offset the results, already known, of the struggling manufacturing PMI (47.0), which has thankfully been stabilising since March already. The composite PMI has consequently improved since the beginning of the year, confirming the positive trend it began eight months ago.



German manufacturing sector at its lowest

Hence, Germany is the main cloud on the European horizon, which is not as dark as it may seem. Manufacturing leading indicators have dropped continuously and now lie at their lowest level of the last ten years (43.5). They are pulling the composite index down, while services, at 54.8 and on the rise in August, are showing a totally different and more optimistic picture.

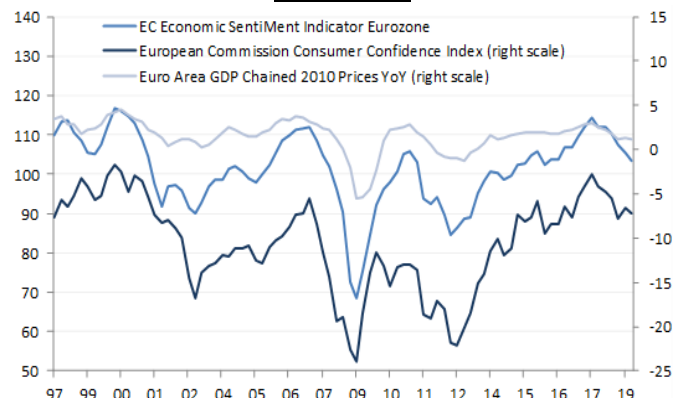
Industrial production in the Eurozone slipped further by -0.4% in July, which is still better than in June (-1.6%), and year-on-year the -2% contraction is slightly better than performance at the end of 2018, which showed a drop of -4% over one year.

Germany's industrial production is still driving overall performance down, although it should be noted that the latest figures published (-0.6%) are a little less worrisome.

Gradual improvement in confidence

Positive trends in the employment market further strengthened in August thanks to new job creation (+0.2%). The unemployment rate for countries in the Eurozone (7.5%) has fallen back to the level that prevailed in late 2008, which corresponds to a drop in unemployment of 35% compared with the 12% peak reached in 2013.

Eurozone GDP, economic sentiment and consumer confidence



Sources: Bloomberg, BBGI Group S.A

The European Commission's indicator reflecting economic sentiment has improved since the beginning of the year and has been stabilising for several months after falling steadily in 2018. It is obviously too early to talk about a return to optimism at this stage, but most of the other sentiment indicators also paint a more encouraging picture. Confidence indicators for Germany also point to a clear shift towards a more positive trend following the ECB's latest announcements, which reasserted the central bank's commitment to maintaining strong policies in support of European growth.

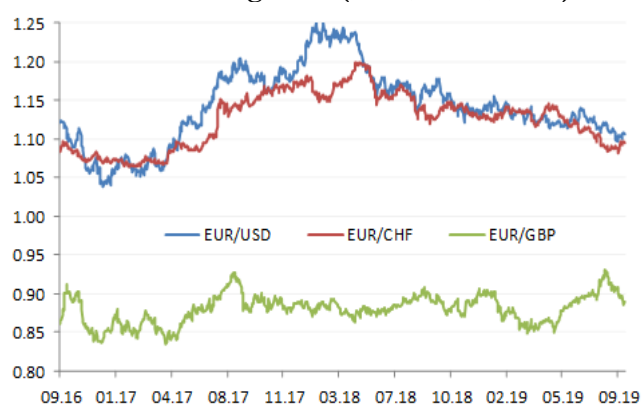
Possible rebound of the European currency

The worsening economic conditions in the Eurozone, essentially due to the German manufacturing sector's specific situation, ultimately had a relatively limited effect on the valuation of the European currency against the dollar in the last quarter. Indeed, the decline of German manufacturing PMIs weakened the euro, driving it down towards the lower end of its fluctuation band of between 1.12 and 1.16 against the dollar over the full period affected by worsening leading indicators between November 2018 and July 2019.

The exchange rate only fell below 1.12 temporarily due to the return of uncertainty in financial markets in August.

The EUR/CHF exchange rate also fell from 1.14 to 1.08, the Swiss franc benefitting from its safe-haven status until August. We believe the current level of the euro integrates most of the negative expectations regarding the risks to the German economy. The support measures announced by the ECB will likely breathe a little life back into the euro unless Donald Trump ends up targeting Germany more actively and severely regarding trade. A normalisation of growth prospects could nevertheless encourage investors to return to the European currency at its current levels, supporting an upturn in the EUR/USD and EUR/CHF exchange rates to 1.14.

EUR exchange rate (USD, CHF, GBP)



Sources: Bloomberg, BBGI Group SA

ECB firmly committed to supporting economic growth

The President of the ECB Mario Draghi is about to leave the bank, as he announces a new package of measures aimed at boosting growth in Europe. The Governing Council announced a 0.1% cut in the deposit rate at its last meeting, a gesture that was expected and ultimately had little effect. A further reduction could happen before the end of the year. However, if we are to believe the latest comments made by the Governing Council, the ECB will likely keep its rates unchanged until inflation moves closer to its 2% target, confirmed by continuing momentum. In the meantime, the ECB has relaunched a bond purchase programme in amounts of EUR 20bn per month for as long as necessary.

This programme will likely be maintained for a while following the implementation of a rate normalisation policy in future. So far, we believe that this change in policy is unlikely to happen within the next 24 months. Consequently, the asset purchasing and quantitative

easing programme could reach EUR 500bn. Inflation trends are also a major factor that may modify these forecasts if they remain anaemic.

The ECB has also announced a new system that will prevent banks from being penalised for excess reserves by determining a multiple calculated based on the minimum required reserves. Set at six at the moment, this multiple will exempt close to EUR 800bn from being subject to a negative rate. The ECB has also reduced its outlook for inflation from 1.3% to 1.2% for 2019. Forecasts for 2019 GDP have also been reduced from 1.2% to 1.1%.

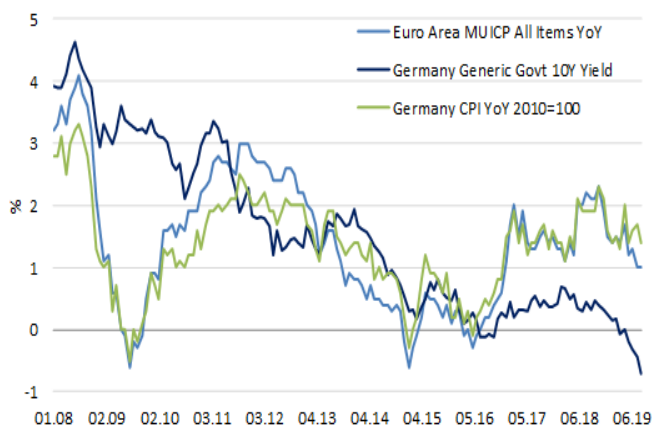
Real yields still attractive despite falling inflation

Inflation has recently strayed a little further from the European Central Bank's target according to all established measures. The CPI excluding food and energy for the Eurozone fell to 0.9%, i.e. a little below the average for the last three years, while the global index dropped from 2.3% in October 2018 to 1% in August, its lowest point since January 2017. As for producer prices, the PPI's drop to 0.2% is even more pronounced and is no great comfort to the ECB. Recent development in capital markets have thus caused real yields on twelve-month maturities to drop slightly further, reaching -1.3% at the end of August, quite clearly below real yields of -0.1% in 2016. With the drop in ten-year rates to -0.7% at the end of August and inflation at 0.9%, real yields could fall even farther to close to -1.6%. Moreover, the fall in real yields in euros is a particularly positive factor for future European growth. The cost of financing investment, consumer credit and mortgage financing is thus very clearly negative and will likely boost demand in the next quarters.

Is the recession factored into long-term euro rates?

Anxiety increased in August in capital markets, which have all been rather significantly affected by the same probably unfounded expectations regarding the future of the global economy. Months have thus gone by since September 2018, and fears of a recession have not been quelled despite steadily improving economic statistics, in the US in particular, and preventive monetary policy actions meant to reassure markets. Firstly, long-term interest rates have dropped in the US, dragging in their wake most rate markets and especially Europe's ten-year rates. In this specific case, falling euro rates are clearly more justified due to the real risks of recession in Germany. In this environment, we have seen a truly exceptional flattening of the euro yield curve with negative absolute and real yields on all maturities of less than 25 years.

Interest rates – inflation



Sources: Bloomberg, BBGI Group S.A

Euro capital markets have thus already factored in the recession risks in Germany and positioned themselves to benefit from the ECB's future European debt purchases.

Next rotation of investment flows in favour of European equities

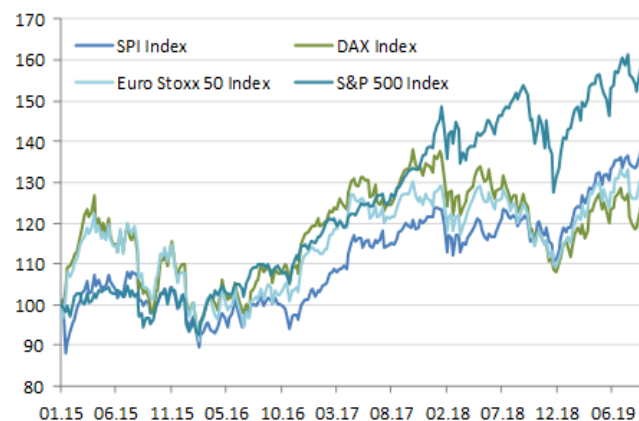
Domestic and foreign investors seem increasingly more inclined to focus on euro-denominated debt rather than European equities. This partly explains the continuing decline of rates in euros and the continuously attractive valuation level of European equities. Indeed, at the beginning of the present quarter, their relative valuation (PE 14.6x) remains eye-catching compared to US valuations (PE 18.2x) thanks to a “discount” of approximately 25%.

The expected revaluation phase has thus not happened yet, while the persistence of low rates, due to the ECB's announced policy, will likely now be perceived as an enduringly positive factor for European equities.

In terms of yield, European companies offer a dividend yield of 3.5%, clearly above the 1.9% yield offered by the S&P500. Nevertheless, the performance of the Euro Stoxx 50 since the beginning of the year (+18%) is still very similar to that of the US market (+19.9%) in local currencies.

This valuation gap might be explained for the moment by the perception of a greater sensitivity of European stocks to external shocks such as the slowdown in China or in developing countries. Investors might thus be more convinced for the moment by the capacity of American companies to withstand such shocks rather than European stocks. Consequently, better economic conditions are likely to be the determining factor in terms of any outperformance of European equities.

European equities



Sources: Bloomberg, BBGI Group S.A

The strengthening of a long-term expansionist monetary policy is likely to help growth prospects improve sufficiently to trigger a long-awaited rotation of bonds to equities. Such a rotation will logically drive equities in the Eurozone to outperform.

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BBGI Group SA
 Rue Sigismund Thalberg no 2
 1201 Geneva – Switzerland
 T: +41225959611 F: +41225959612
 info@bbgi.ch - www.bbgi.ch