Economics

DBS Flash

Eurozone: Policy normalisation plans on ice

DBS Group Research | 18 February 2019

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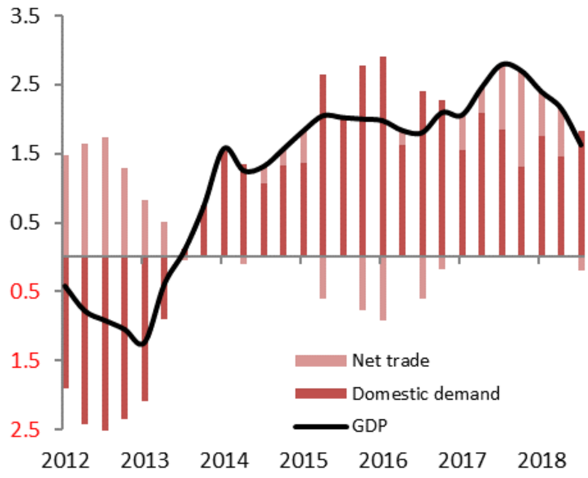
- *The European Commission has dialled down growth expectations for the Eurozone.*
- *Survey indicators have been slowing for several months, with real data playing catch-up since 2H last year.*
- *Accordingly, we have revised down our 2019 and 2020 growth forecasts.*
- *Slow growth and low inflation will pull the brakes on policy normalisation plans.*
- *Liquidity support through TLTROs could be on the cards if recession risks rise.*
- *Political risks have resurfaced, particularly the rise of far-right politics in the bloc's core economies, with Spain returning to a cycle of leadership instability.*
- *Uncertainty over Brexit progress is the key near-term risk.*
- *We continue to look for further EUR downside.*
- *Beyond safe-haven flows, a dovish ECB might be a signal for investors to add risk and yield.*

The European Commission joined the International Monetary Fund (IMF) in dialling down growth expectations for the Eurozone and European Union (EU). A slowdown has been underway since early last year, initially driven by transitory domestic factors and weakness in sentiment-based indices. A tougher global environment since has magnified downside risks for 2019. This will push the European Central Bank's (ECB) to pull the brakes on policy normalisation plans, even as QE ended in December last year.

External trade sector drags growth lower
percentage pts

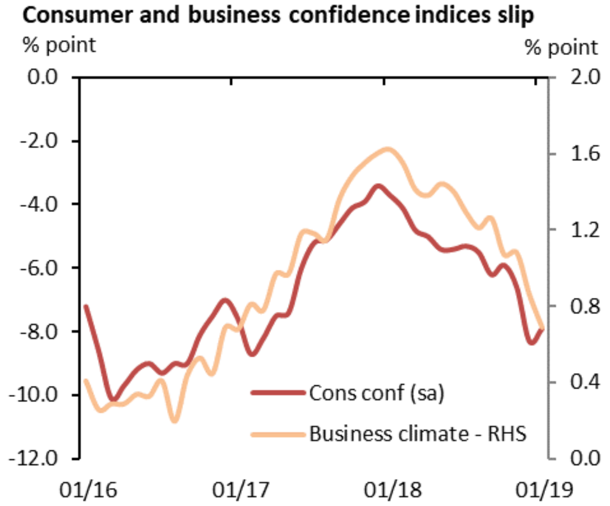


Source: CEIC, data transformations are by DBS Group Research

After expanding by an average of ~2% YoY for three successive years, Eurozone's growth is likely to slip into a lower gear this year. Growth has retreated for five successive quarters, from a peak of 2.8% YoY in 3Q17 to 1.2% in 4Q18. Apart from cyclical forces, seeds of the current slowdown were sown largely domestic catalysts i.e. stricter regulations on the auto industry and simmering political challenges. Concurrently, global trade entered a correction phase, compounded by uncertainty regarding trade policies, particularly US-China tariff-exchanges, slowing global manufacturing activity and loss of momentum in China/ US/ Asia growth. The overhang of Brexit-driven uncertainty has been an additional headwind.

High-frequency data mirrors this cautious view. Survey indicators have been slowing for several months, with real data playing catch-up since 2H last year. **Signs of slowdown are concentrated in the trade and manufacturing sectors.** With the US stepping up tariff action with its key trading partners, including China and the EU, manufacturing and trade activity had begun to weaken since late 2018, led by a downturn in the core economies.

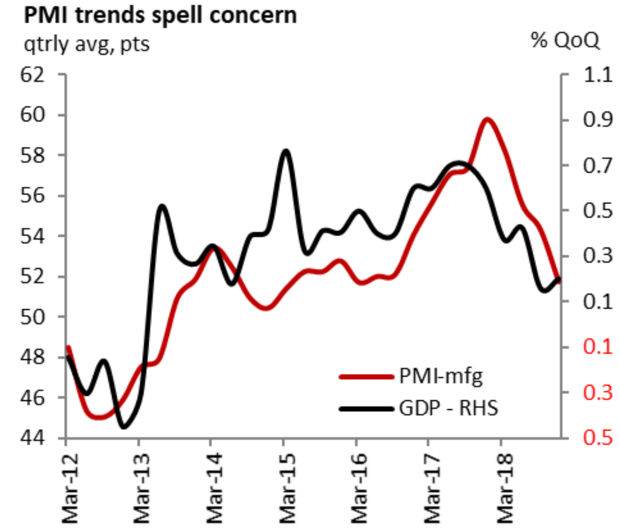
Consumer and business confidence indices slip



Source: CEIC, EC DG for E&FA, EU, DBS Group Research

There are fresh risks that Germany (and Japan) might be in the eye of the next storm next, as the US government considers imposing tariffs on autos and parts imposed into the US.

PMI trends spell concern



Source: Markit, Bloomberg, DBS Group Research

Eurozone industrial production shrank 2.0% YoY in 4Q18, from an already tepid 0.7% in 3Q. Manufacturing PMI has declined by over 10points since the start of last year, while the service gauge is under strain since mid-2018. Capacity utilisation rates peaked around the same time, and have been grinding lower, albeit at still elevated levels in the cycle. Exports came under pressure late last year, hurt by lower manufactured goods and commodity shipments. The geographical breakdown of Eurozone's external trade has also raised its vulnerability, as a third of EU28 exports head to US and China.

Amongst the core-4, Germany narrowly skirted a recession in 4Q18, but the industrial sector is struggling to gain a foothold from a slump in auto sector activity following tighter emission standards, and fresh troubles brewing on account of potential US tariffs. France and Spain were relatively stable, albeit at weak levels, but Italy slipped into a technical recession. This left growth in the Eurozone falling to its lowest level - easing to 1.2% YoY (0.2% QoQ sa) vs 1.6% in 3Q, creating a weak statistical start to 2019.

Add to this is a tough political backdrop for the currency bloc (as we discuss in the next section). Even as we expect consumption (helped by low sub-8% unemployment rates and better wage growth) and investments to pick part of slack, the underlying loss in momentum has tilted the bias for weakness, as spillover effects are likely.

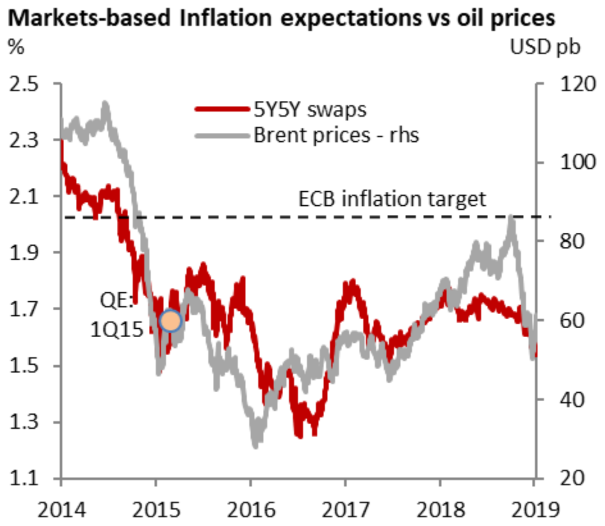
We lower our 2019 growth forecast to 1.2% YoY and 2020 to 1.5% (vs previous 1.8%). Downside risks stem from a deterioration in the US-China trade tensions, a disruptive Brexit, policy mistakes by global central banks and a starker slowdown globally, particularly China..

Sub-target inflation lowers odds of policy normalisation

The European Central Bank (ECB) acknowledged a shift in the growth outlook "to the downside" in its January review, even as recession risks were downplayed. This sets the stage for a downward revision in its GDP projections from the current 1.7% for 2019 and 2020 at the March rate review.

Inflation has concurrently subsided with a moderation in global energy prices. Headline inflation is expected to ease to 1.3-1.4% YoY in 1Q19 vs 2% ECB target and vs a peak of 2.1% in 3Q. Core inflation has been stuck in the 0.9-1.1% range. Weak growth could depress demand-led inflation forces further. Markets-based inflation expectations gauge i.e. 5Y5Y breakeven forwards has also been slipping as seen in the chart above.

ECB staff projections for inflation at 1.6% and 1.7% this year and the next, also likely to be revised down. We dial down our forecasts to 1.2% for 2019 (vs previous 1.4%) vs 2018's 1.7% and 1.3% for 2020 (vs 1.4%).



Source: Bloomberg, DBS Group Research

The ECB withdrew from QE purchases since this year but assured that the practise of rolling over existing bonds it holds will continue. Room to manoeuvre on the policy front is limited with the policy rate still at 0% and the deposit facility rate at -0.4%. Apart from pushing back rate hikes to 2H 2020, focus will be on supporting the economy through another round of targeted long-term refinancing operation (TLTROs) to replace maturing ones.

With ECB President Mario Draghi due to step down in 4Q this year, markets are likely to monitor remarks of key contenders for the post, with the Banque de France head Francois Villeroy de Galhau and Governor of the Dutch central bank Klass Knot in the running. Both officials have called on the ECB to maintain an accommodative policy considering the deteriorating growth outlook.

Political challenges plague the outlook

German politics, which was erstwhile a stabilising influence for the region, is facing problems of its own. Following the ruling party's weak performance in regional parties, Chancellor Merkel plans to step down after 2021, after already handing over the party leadership. At the same time, far-right Alternative for Germany has widened its reach with a presence in all regional parliaments in Germany and emerging as the largest opposition party in the Bundestag. With the dominant parties likely to take a backseat, the domestic landscape is likely to turn more fragmented and reform decisions tough to enact.

Italy has fended off a short-term tussle over fiscal targets with the European Union, albeit with the economy already in recession and further negative impact on growth likely consolidation will push Rome to question its austerity plans this year. Add to this, Italy-**France**'s relations have come under pressure as Italy's populist government appeared to back anti-reform forces in Paris. French President Macaron faces mounting pressure to renege on key reforms in recent months in face of strong protests, but he has been able to gain some traction in recent weeks on assurances of a compromise.

Despite better growth prospects, **Spain** remains stuck in a cycle of political instability. Days after the parliament rejected the minority Socialist government's 2019 budget, Spanish PM Pedro Sanchez called for snap elections due on April 28. The Catalan separatist parties who had sided with the Socialist party in June 2018 to back PM Sanchez, switched allegiance to join the opposition centre-right People's Party to reject the 2019 budget plans. A coalition government is likely to return to power, with budget spending plan, reforms and growth likely to take a hit in the interim.

Finally, a disorderly Brexit is a major risk. Risks of the government exiting the EU without a deal have risen sharply as the March 2019 deadline approaches (see here). Hopes have surfaced that to avert a no-deal Brexit, UK might seek to extend Article 50 to hold new elections and/or a second referendum. These options will, however, be challenged by the European Parliament elections on 23-26 May, where in the EU would probably prefer the UK to revoke Article 50, abandon Brexit and remain in the EU until UK lawmakers know what they want and can agree on. Put simply, the risk of a no-deal Brexit cannot be totally ruled out.

Risk-haven flows have returned on German Bunds, with 10Y yields barely above the water. Divergence between the growth prospects, and by extension rate differentials, of the US and Eurozone, will continue to weigh on the EUR/USD. Beyond safe-haven flows, a dovish ECB might be a signal for investors to add risk and yield, and see interest return to the likes of Italian bonds.

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).