

European Economic Perspectives

Eurozone: strong finish to 2016, good start to 2017

Economics

Europe including UK

Resilience continues, PMIs at multi-year highs

The latest PMI data – at a 67-month high – suggest the Eurozone economy finished 2016 on a firm footing, and bode well for the start of 2017. Business confidence has risen well above pre-UK-referendum levels – despite the uncertainty around Italian banking sector challenges and important European elections this year. We see possible upside risk to our Eurozone GDP growth forecasts of 0.3% q/q, 1.5% y/y for Q4-16. While this might not affect our 2016 growth assumption of 1.6%, it might – via a higher statistical overhang – imply upside risk to our 2017 GDP forecast of 1.3%.

Domestic demand still strong, external outlook perceived to be improving

What explains this resilience? Extending a well-established trend, domestic demand has remained resilient so far, due to improving labour markets, decent real wage growth, somewhat stronger fiscal policy, and ongoing support from the ECB. And recently, export expectations have improved a lot, presumably due to expectations for reflation scenarios in the US and somewhat brighter prospects for EM. This also explains why Manufacturing PMIs have recently risen above Services PMIs.

Short-term outlook constructive, but domestic demand to weaken over time

Where to from here? We maintain a constructive growth outlook for the months ahead, but think that the strong support that Eurozone domestic demand enjoyed in 2015/16 will eventually soften, as higher inflation takes its toll on household real income growth. Uncertainties related to the UK's exit from the EU and important European elections are likely to weigh on investment. We doubt that [moderately supportive fiscal policy](#) and stronger exports will make up for weaker domestic demand – hence our projection of GDP growth slowing from 1.6% in 2016 to 1.3% in 2017 and 1.2% in 2018. But we acknowledge the upside risk from stronger exports.

ECB: no immediate implications, but data strengthen the case of the hawks

We do not think the strength of the sentiment data and the pick-up in inflation in December has immediate policy implications for the ECB, as the Bank has only recently determined the course of its monetary policy in 2017. Yet, the latest data are likely to make future discussions in the ECB Governing Council more lively, and strengthen the hands of the hawks. We expect the ECB to start tapering as of January 2018, with a decision due possibly as early as 7 September, or 14 December at the latest.

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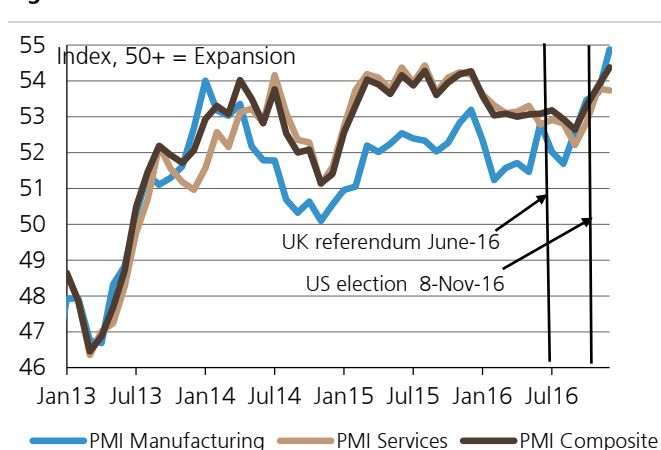
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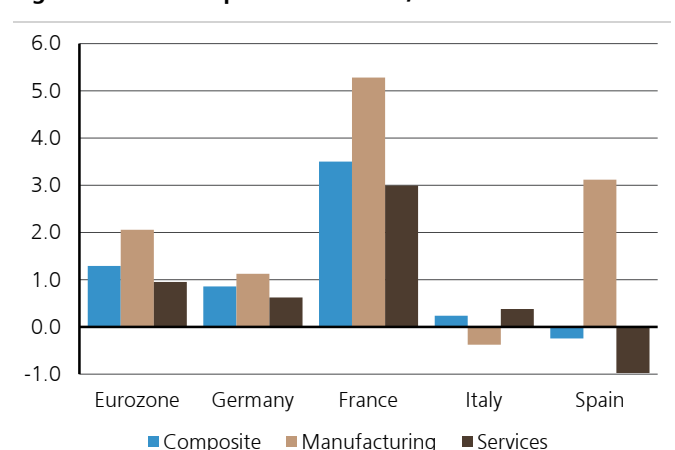
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Figure 1: Eurozone PMI


Source: Markit, Haver, UBS.

Figure 2: PMIs compared with June, ahead of the UK vote


Source: Markit, Haver, UBS.

UBS Research THESIS MAP **2017-18 Outlook: growth to slow a bit, inflation to rise, temporary extension of QE**

PIVOTAL QUESTIONS

Q: What is the Eurozone growth outlook for 2017/18?

We expect a [deceleration in GDP growth from 1.6% in 2016 to 1.3% in 2017 and 1.2% in 2018](#). Key will be the softening in domestic demand caused by higher oil prices and rising inflation. Yet, we are constructive on the growth outlook for the coming months.

Q: Will Eurozone inflation continue to rise?

Yes, but mainly driven by base effects related to oil prices. [In December, HICP jumped to 1.1% y/y from 0.6% in November](#), and the coming months are likely to see further increases. We expect headline inflation to accelerate from an average 0.2% y/y in 2016 to 1.4% in 2017, and 1.8% in 2018. Core inflation is likely to pick up more moderately, from 0.9% y/y in 2016 to 1.3% in 2018.

Q: How will the ECB react?

Following the ECB's decision to extend QE by nine months to December 2017 (€60bn per month), we expect the ECB to start tapering as of January 2018 and wind down its asset purchases over 12 months, i.e. until December 2018, with a decision due as early as 7 September, or 14 December at the latest (see [ECB: hawkish decision, dovish guidance](#), 8 Dec). Rate hikes are unlikely before 2019.

UBS VIEW

We are constructive on the Eurozone's resilience over the coming months, but expect **domestic demand** – so far the driver of growth – **to decelerate in 2017/18**. We doubt that [moderately supportive fiscal policy](#) and stronger exports will make up for weaker domestic demand.

EVIDENCE

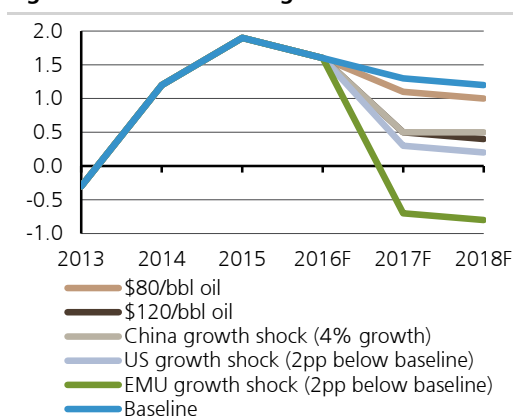
While [Eurozone PMIs have performed strongly in recent months](#), oil prices are up – and likely to rise further in our view – which is likely to cut into household purchasing power over time.

WHAT'S PRICED IN?

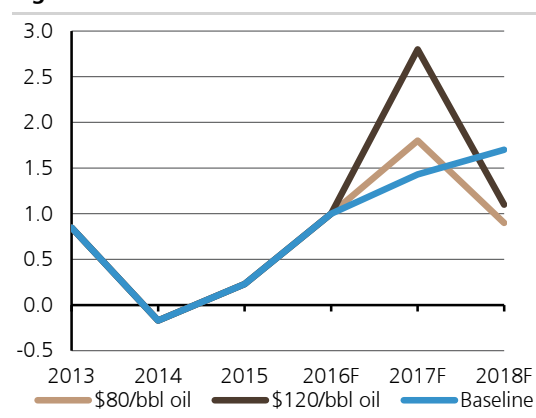
The 2017/2018 Eurozone growth projections by the ECB (1.7/1.6%), the European Commission (1.5/1.7%) and the IMF (1.5/1.6%) appear too high to us.

UPSIDE/DOWNSIDE RISKS:

Positive risks could come from a big fiscal initiative in the US, with positive implications for European exports, an acceleration in Eurozone structural reforms, or simply from a swift reduction in uncertainty. Key **downside risks** could be: a negative Chinese growth shock, a rise in protectionism, disruptive Fed tightening, a sharp rise in oil prices, severe disruptions around the UK's EU exit process, disruptive ECB tapering, or new Eurozone shocks.

Figure 3: Eurozone GDP growth scenarios

Source: Haver, UBS

Figure 4: Eurozone inflation scenarios

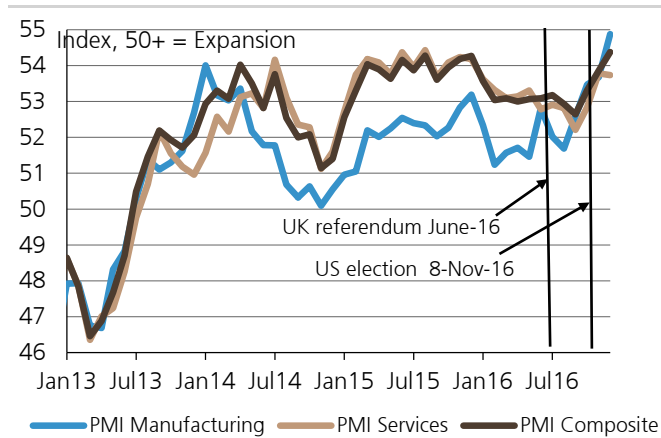
Source: Haver, UBS

Strong finish to 2016, promising start to 2017

The December PMI data, released last week, suggest that the Eurozone economy finished 2016 on a firm footing. The Composite PMI rose to 54.4 in December – a 67-month high and 0.5 points above both the Nov level and the Dec flash estimate. Results from Spain and Germany were particularly strong, but the French Composite PMI also rose nicely; only Italy dropped (to a still respectable 52.9), presumably due to weaker confidence in the context of banking sector challenges.

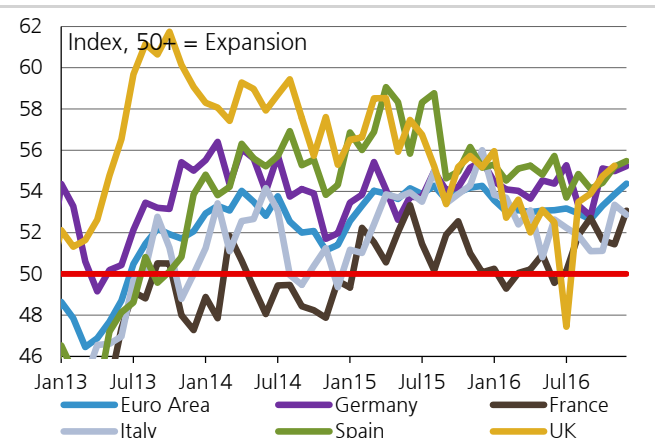
Eurozone PMI at a 67-month high in December

Figure 5: Eurozone PMIs



Source: Markit, Haver, UBS.

Figure 6: Composite PMIs

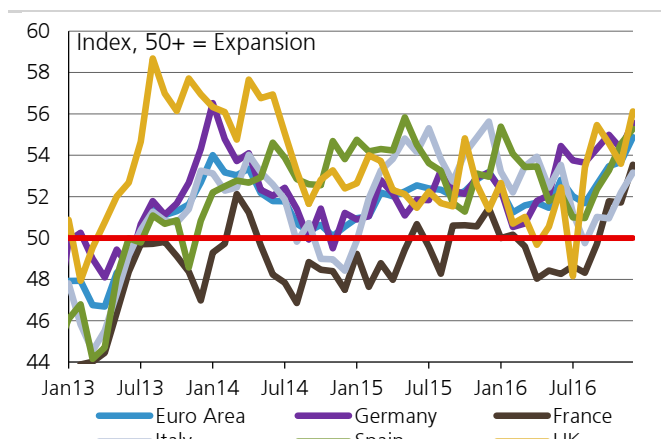


Source: Markit, Haver, UBS.

Eurozone manufacturing PMIs were the key driver of strength, posting their best reading since April 2011, and were broad-based across countries. Current production and new (export) orders picked up, likely supported by a weaker Euro, with backlogs hitting a multi-year high. This bodes well for activity and hiring over the coming months. According to Markit, the data point towards a GDP growth rate of 0.4% q/q in Q4 2016. We acknowledge possible upside risk to our own projection of 0.3% q/q, 1.5% y/y. While this might not affect our 2016 growth assumption of 1.6%, it might – via a higher statistical overhang – imply upside risk to our 2017 GDP forecast of 1.3%.

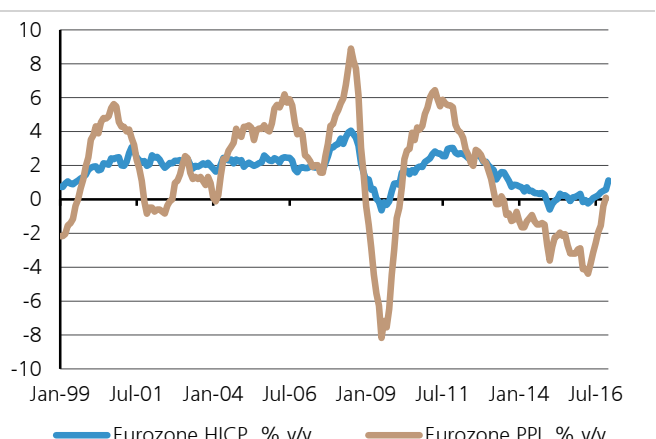
Sentiment in manufacturing is particularly strong

Figure 7: Manufacturing PMIs



Source: Markit, Haver, UBS.

Figure 8: Eurozone HICP and PPI (% y/y)



Source: Haver, UBS.

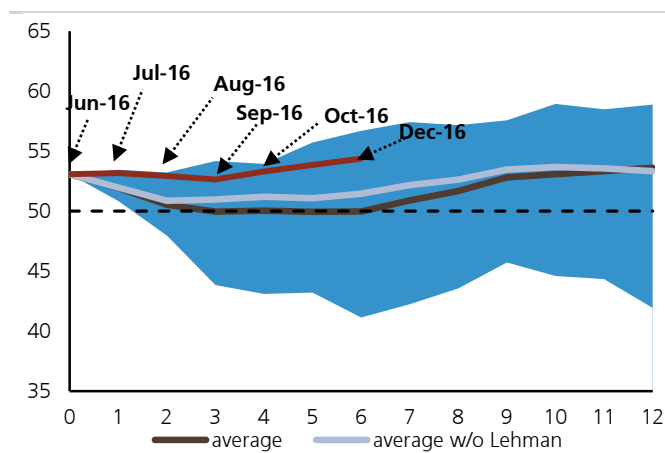
The PMIs also show a broad-based rise in input price inflation in December (to a 5½ year high), due to higher energy prices and the weaker Euro. This was also reflected in the December inflation data released last week, with HICP jumping to 1.1% y/y in December from 0.6% y/y in November. We expect a further increase to 1.4-1.6% y/y in January/February. PPI inflation, at -0.1% y/y in November, is still lagging consumer prices, but has already moved up from a bottom of -4.4% y/y in April 2016 (Figure 8, above).

Input prices are rising

Overall then, Eurozone business confidence has not only suffered a smaller-than-feared setback after the UK referendum and bounded back quickly, it has by now even risen well above pre-UK-referendum levels. This was despite the uncertainty related to the Italian banking sector challenges and the expectation of political challenges related to crucial elections in the Netherlands (15 March), France (23 April; 7 May), Germany (September) and possibly Italy sometime during the year.

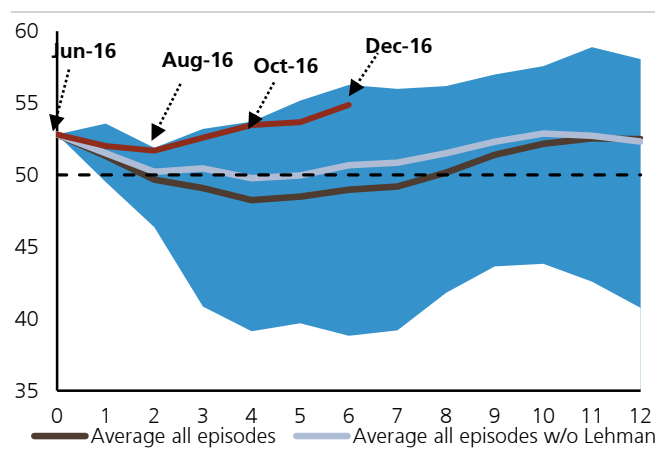
Eurozone business confidence has risen well above the levels ahead of the UK-EU referendum

Figure 9: Eurozone Composite PMI post shocks



Source: Markit, Haver, UBS. Note: Chart shows the average and min/max development of Eurozone Manufacturing PMIs in the months after an uncertainty shock in the past 15 years. For more details, see [Eurozone: What this week's PMIs will tell us](#)

Figure 10: Eurozone Manufacturing PMI post shocks



Source: Markit, Haver, UBS. Note: Chart shows the average and min/max development of Eurozone Manufacturing PMIs in the months after an uncertainty shock in the past 15 years. For more details, see our note [Eurozone: What this week's PMIs will tell us](#)

What explains this resilience? Extending a trend that has been in place for quite some time now, **domestic demand** (approximated by the Services PMIs) has remained resilient so far, due to improving labour markets, decent real wage growth, somewhat stronger fiscal policy, and ongoing support from the ECB. Recently however, expectations regarding the **external environment** (represented by the Manufacturing PMIs) have improved substantially, presumably due to the outcome of the US elections and related reflation scenarios, but also reflecting somewhat brighter prospects in EM on the back of rising oil and commodity prices. This also explains why Manufacturing PMIs have recently risen above Services PMIs.

Domestic environment still robust, perception of external environment much improved recently

Short-term outlook positive, followed by some softening

Where to from here, then? As we laid out in our [European Economic Outlook 2017/18](#), we expect a deceleration in Eurozone growth from 1.6% in 2016 to 1.3% in 2017 and 1.2% in 2018. We explicitly maintained a constructive growth outlook for the coming months, but argued that the exceptionally strong support that Eurozone domestic demand enjoyed in 2015/16 would eventually soften over the course of 2017/18, as higher oil prices and inflation would likely slow down

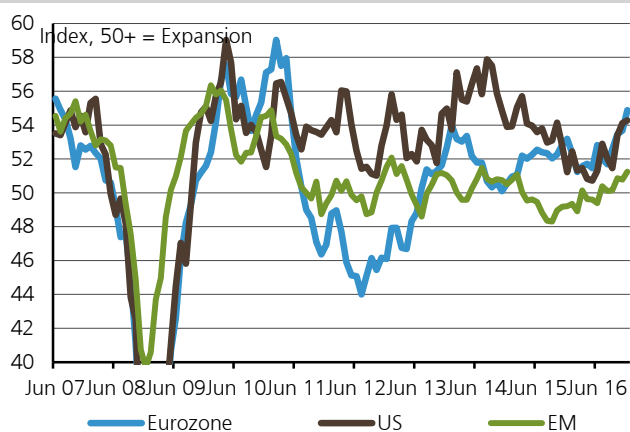
Domestic demand likely to slow down over the course of 2017/2018

the growth in household real incomes and as monetary policy support from the ECB gets weaker in H2 2017. Uncertainties related to the UK's exit from the EU as well as crucial elections in the Netherlands, France, Germany and possibly Italy this year are also likely to weigh on corporate investment activity. We feel that [moderately supportive fiscal policy](#) and somewhat stronger exports would probably not compensate for weaker domestic demand – hence our forecast of a deceleration in aggregate GDP growth.

Are we prepared to throw our conservative views on 2017/18 GDP growth overboard? Not at this stage. To reiterate, while we see upside risk for the coming months, we think the hypothesis of an eventual slowdown in Eurozone domestic demand later in 2017 and 2018 remains valid. What we do acknowledge, however, is upside risk from stronger exports, stemming not least from fiscal policy-induced reflation in the US. Business sentiment (manufacturing PMIs) and markets have already moved up in anticipation. Yet, for upbeat expectations to be met, real activity in the US (and subsequently Europe) needs to follow soon and rise above our base case forecasts (US GDP to accelerate from 1.4% in 2016 to 2.4% in 2017) – and this is not a foregone conclusion.

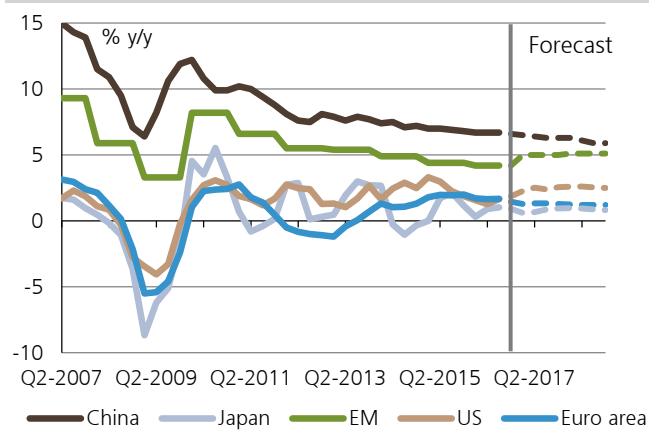
We acknowledge upside risk from potentially stronger exports

Figure 11: Manufacturing PMIs: Eurozone, US, EM



Source: Markit, Haver, UBS.

Figure 12: Real GDP growth around the world, %



Source: Haver, UBS estimates.

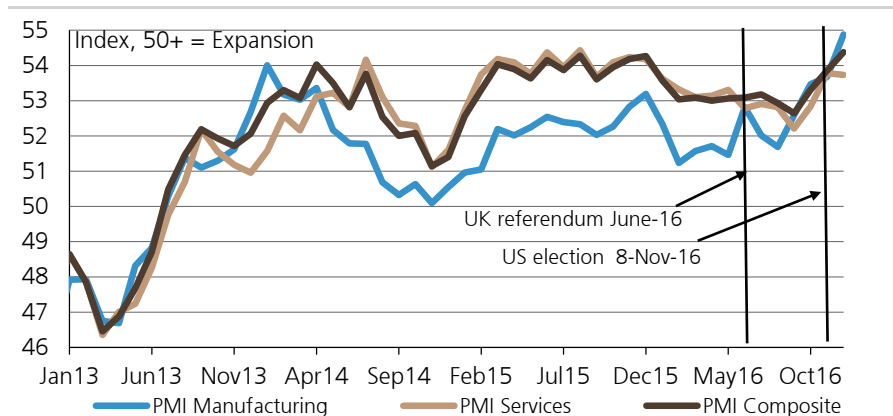
ECB: No immediate policy implication, but supporting the hawkish case

We do not think that the strength of the latest sentiment indicators and the pick-up in inflation in December have immediate policy implications for the ECB, as the Bank has only recently determined the course of its monetary policy in 2017. However, we think the latest data will likely make future discussions in the ECB Governing Council more lively, and strengthen the hands of the hawks. We expect the ECB to start tapering as of January 2018, with a decision due as early as 7 September, or 14 December at the latest (see [ECB: hawkish decision, dovish guidance](#), 8 December).

ECB unlikely to change course quickly, but strong data support the case of the hawks

Business sentiment – Eurozone

Figure 13: Eurozone PMI indexes



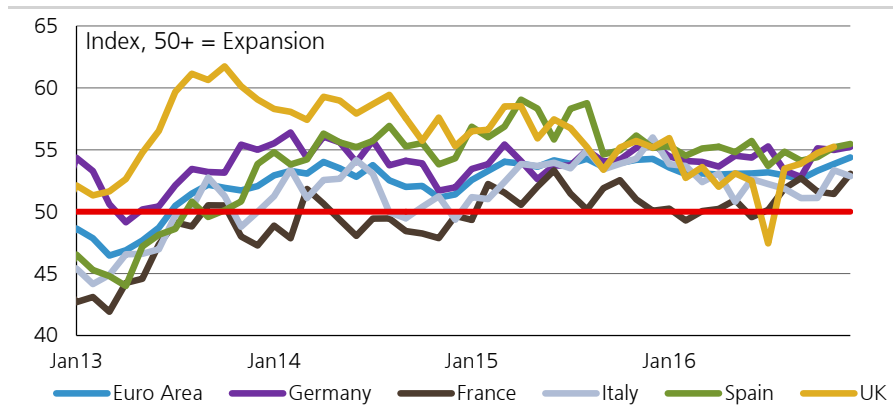
Source: Markit, Haver, UBS. Data up until December 2016. Next data release: 24 Jan. (www.markiteconomics.com/public)

Eurozone Composite PMIs rose to a 67-month high in December, suggesting a strong finish to 2016 and a solid start to 2017.

Sentiment in the manufacturing sector has improved a lot, presumably in expectation of a stronger external environment following the US election.

Sentiment in services remains strong too, as a reflection of solid domestic demand, which represents more than 70% of Eurozone GDP.

Figure 14: Composite PMIs

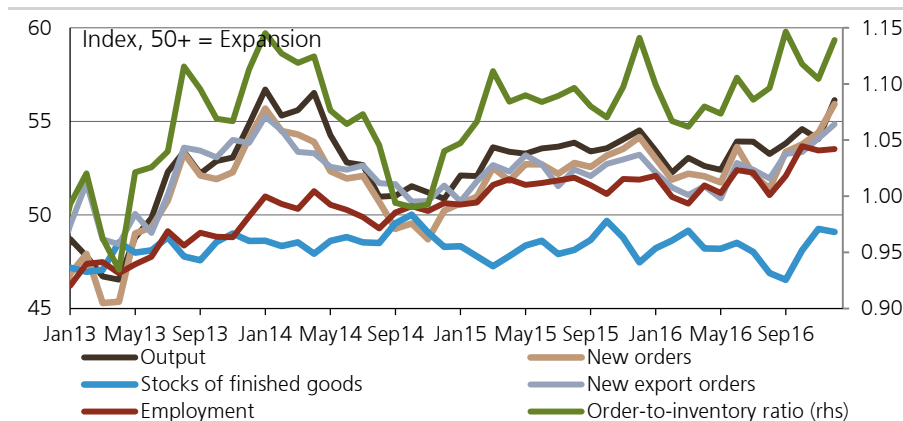


Source: Markit, Haver, UBS. Data up until December 2016. Next data release: 24 Jan. (www.markiteconomics.com/public)

Composite PMIs were particularly strong in Spain and Germany, but were also up nicely in France. Only Italy saw a decline (to a still respectable 52.9), presumably due to weaker confidence in the context of banking sector challenges.

Outside of the Eurozone, the UK PMI has recovered very strongly, but we doubt that this is sustainable.

Figure 15: Sub-components of Eurozone manufacturing PMI



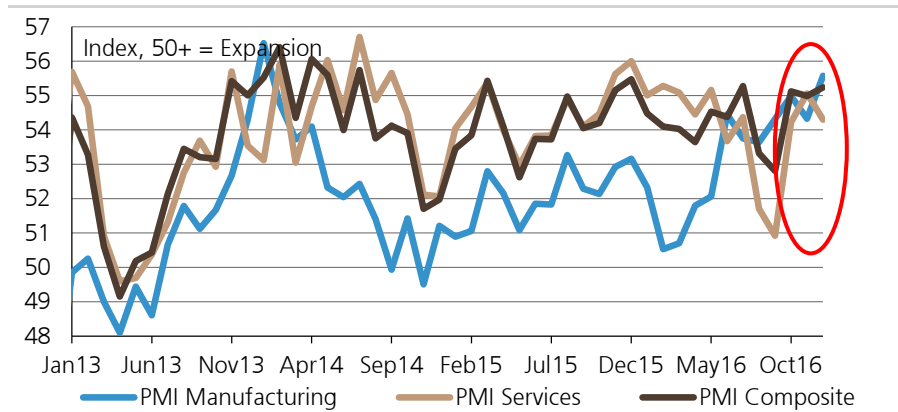
Source: Markit, Haver, UBS. Data up until December 2016. Next data release: 1 Feb (www.markiteconomics.com/public)

Within the manufacturing PMIs, the important sub-indices of output and new (export) orders have performed particularly strongly recently. Strong orders bode well for Q1 2017.

Business sentiment – Germany

Given its heavy economic weight in the Eurozone (29%) and its high export orientation, German data deserve particular attention.

Figure 16: Germany PMI indexes

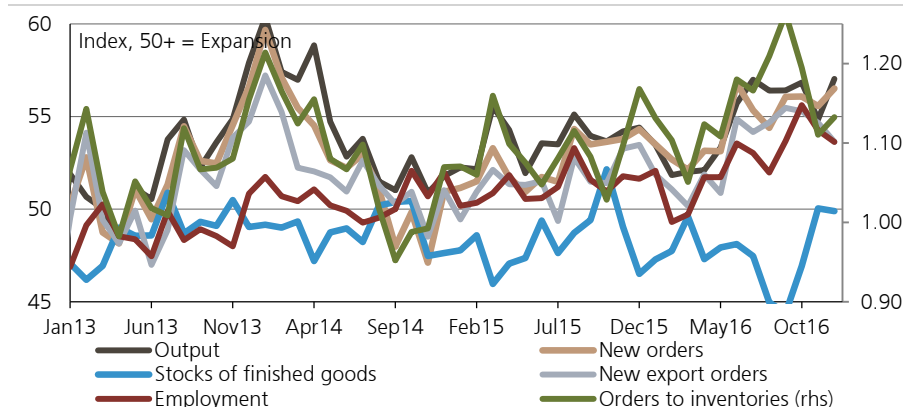


Source: Markit, Haver, UBS. Data up until December 2016. Next data release: 24 Jan. (www.markiteconomics.com/public)

Following the temporary setback after the UK referendum in June, the German manufacturing PMI has rallied impressively to 55.6 in December – a 3-year high.

As such, manufacturing PMIs now stand well above the services PMIs, which have softened a bit recently (54.3), but remain at overall solid levels.

Figure 17: German manufacturing PMI sub-components



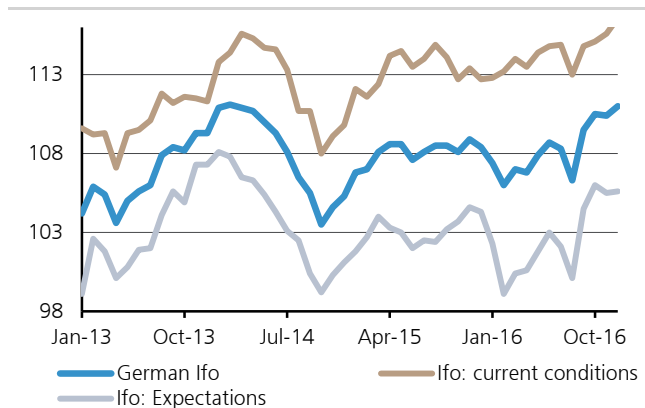
Source: Markit, Haver, UBS. Data up until December 2016. Next data release: 1 Feb. (www.markiteconomics.com/public)

Within the Manufacturing PMI, the sub-components 'Output' (57.0), 'New Orders' (56.5) and 'Backlogs of Work' (57.8) are particularly strong. This bodes well for the coming months.

Figure 18 and Figure 19, below: Similar to the Manufacturing PMI, the Ifo index has risen to a 3-year high (111.0). The ZEW has also picked up solidly in recent months.

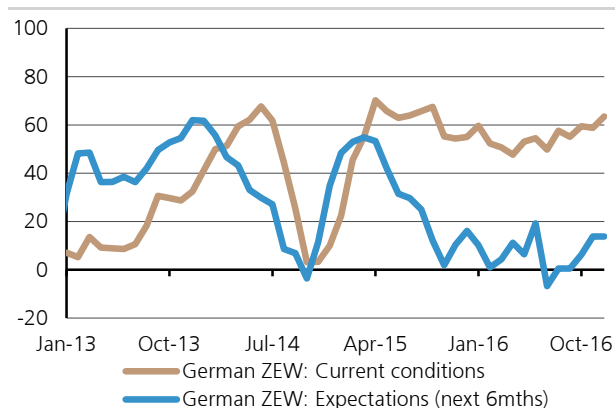
Both Ifo and ZEW show "current conditions" well above "expectations".

Figure 18: German Ifo



Source: Haver, UBS. Data up until Dec 2016. Next data release: 25 Jan (www.cesifo-group.de)

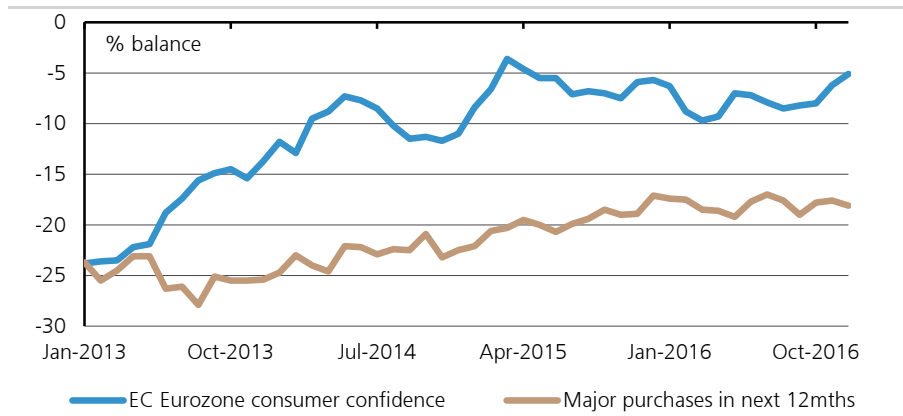
Figure 19: German ZEW



Source: Haver, UBS. Data up until Dec 2016. Next data release: 17 Jan (www.zew.de)

Consumer sentiment

Figure 20: European Commission's Eurozone consumer confidence index



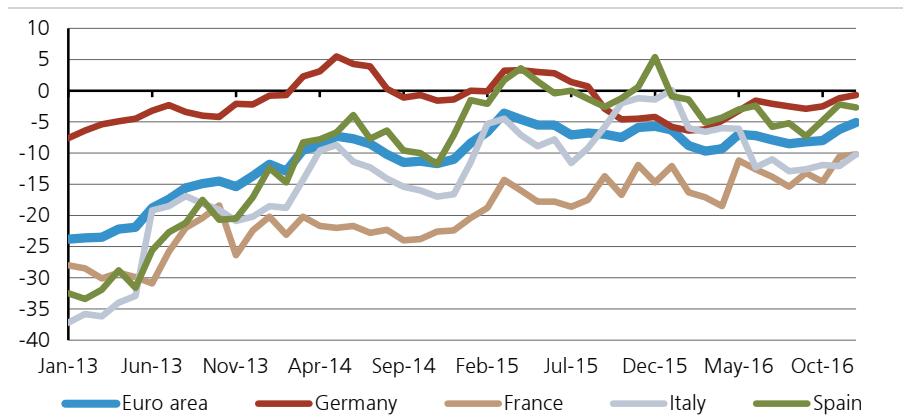
Source: Haver, UBS Last release: 6 Jan 2017 for December 2016.
 Next data release: 23 Jan (flash); (http://ec.europa.eu/economy_finance/db_indicators/surveys)

Eurozone consumer confidence has strengthened in Q4 2016. Consumers' willingness to conduct major purchases remains at solid levels.

This bodes well for household consumption, which represents the largest part of Eurozone GDP, at 56%.

Going forward, however, we expect the recovery in inflation and oil prices to create some headwinds to household consumption.

Figure 21: European Commission's consumer confidence indexes

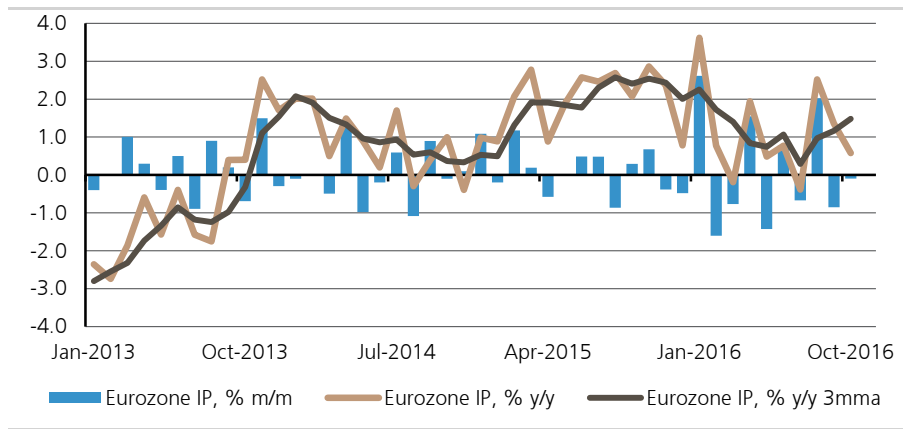


Source: Haver, UBS Last release: 6 Jan 2017 for December 2016.
 Next data release: country details 30 Jan; (http://ec.europa.eu/economy_finance/db_indicators/surveys)

Recent improvements in consumer confidence have been fairly broad-based across countries.

Industrial production

Figure 22: Eurozone industrial production (ex construction)

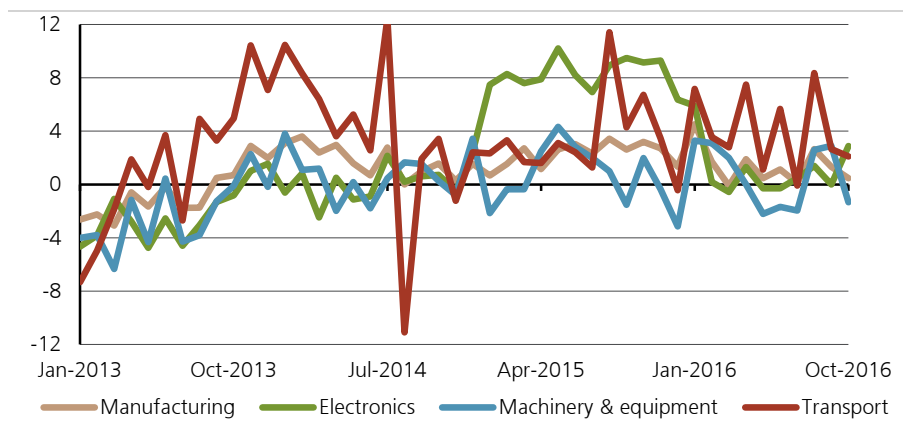


Source: Haver, UBS. Data up until October 2016, Next data release: 12 January (<http://ec.europa.eu/eurostat/news/release-calendar>)

Eurozone industrial production has recovered a bit over the fall, after a weak summer.

However, when seen against the strong manufacturing PMIs, IP is still relatively subdued. This should leave some room for upside over the coming months.

Figure 23: Eurozone industrial production: selected sub-components, % y/y



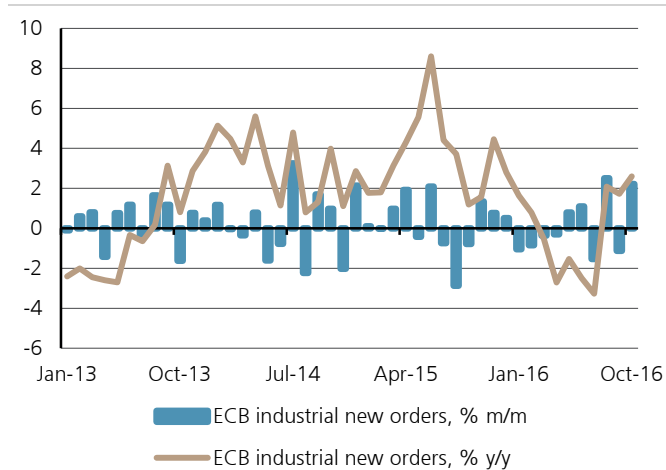
Source: Haver, UBS. Data up until October 2016. Next data release: 12 January (<http://ec.europa.eu/eurostat/news/release-calendar>)

Figure 23: IP sub-components remain volatile. Growth rates in machinery/equipment have dropped into negative territory again in November.

Figure 24, below: The ECB's index of industrial new orders has picked up nicely in recent months, finally catching up with the solid PMI 'New Orders' sub-component.

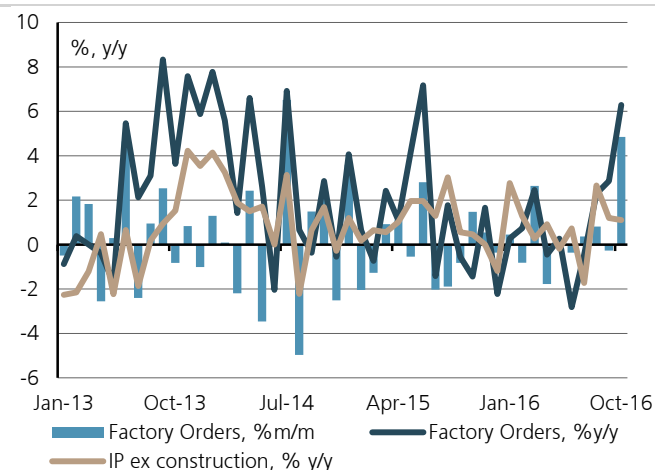
Figure 25, below: German factory orders (y/y) jumped up in October not least due to strong foreign orders.

Figure 24: ECB industrial new orders



Source: Haver, UBS. Data up until Oct 2016.

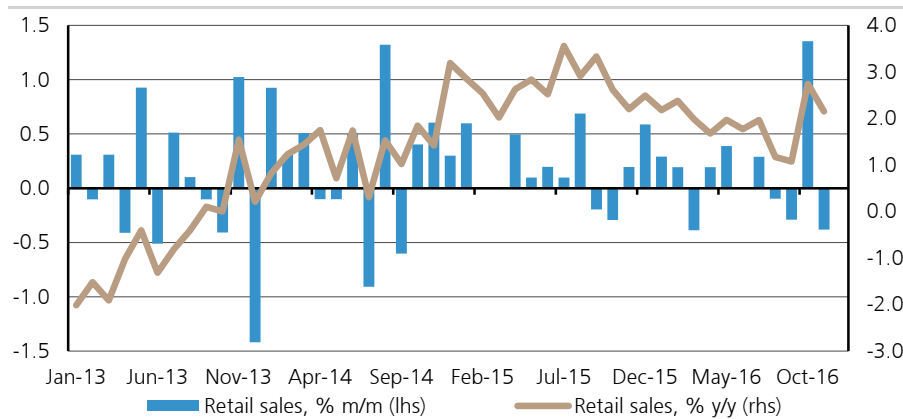
Figure 25: German factory orders and IP



Source: Haver, UBS. Data up until October 2016. Next data release: Orders 6 Jan, IP 9 Jan; (www.destatis.de/EN/PressServices/Press/preview/ReleaseCalendar.html)

Retail and consumption

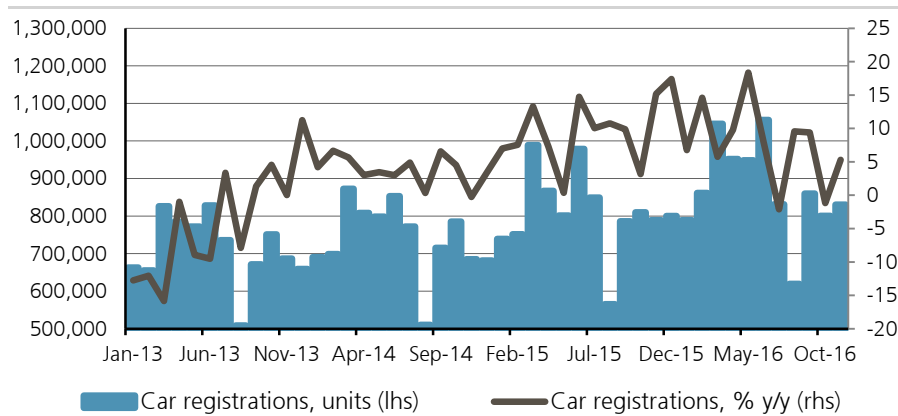
Figure 26: Eurozone retail sales (volume), % m/m and % y/y



After weaker prints in August and September, retail sales grew by 2.7% y/y in October, and 2.2% y/y in November.

Source: Haver, UBS Last release: 6 Jan 2017, for November 2016.
Next data release: 3 Feb (<http://ec.europa.eu/eurostat/news/release-calendar>)

Figure 27: Eurozone car registrations

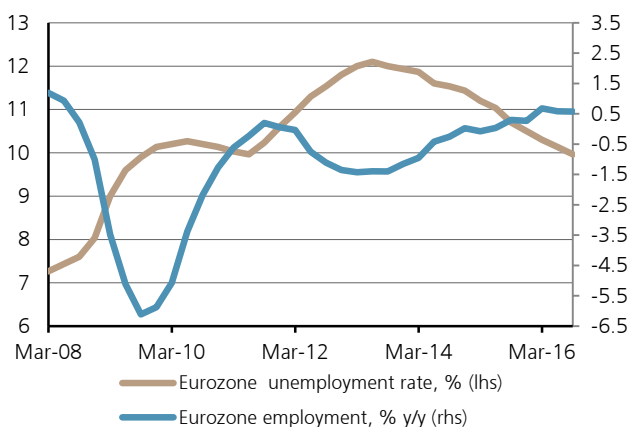


Car registration data perform solidly (5.3% y/y in November), not least due to pent-up demand in a number of former crisis-countries. However, the super-strong growth rates of 2015 and H1 2016 now lie behind.

Source: Haver, UBS. Data up until November 2016. Next data release: 17 Jan (<http://www.acea.be/statistics/tag/category/press-release-calendar>)

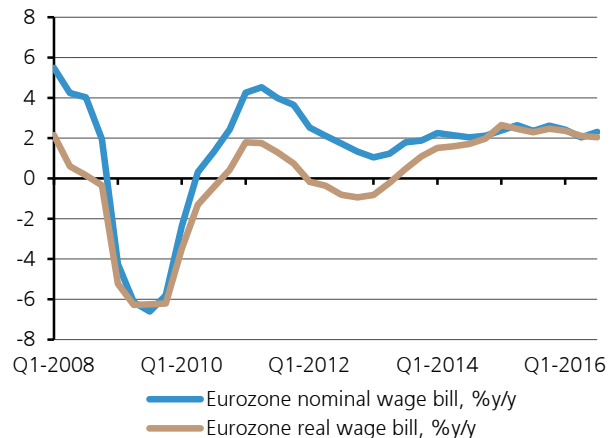
Key drivers of solid consumer confidence are improving labour markets and decent real income gains (Figure 28/Figure 29, below).

Figure 28: Unemployment rate & employment growth



Source: Haver, UBS Data up until Q3-16. Next data release: 9 Jan (unemployment), 15 March (employment). (<http://ec.europa.eu/eurostat/news/release-calendar>).

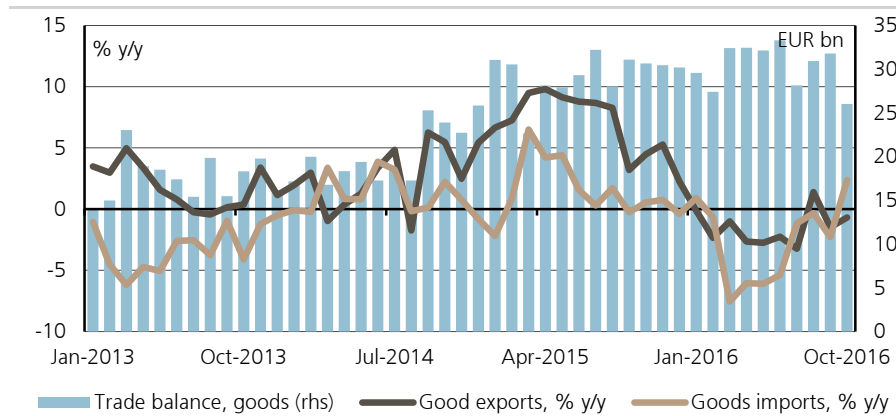
Figure 29: Nominal and real wage bill growth, % y/y



Source: Haver, UBS. Data up until Q3-16. Next data release: 20th Mar (tentative)

Trade

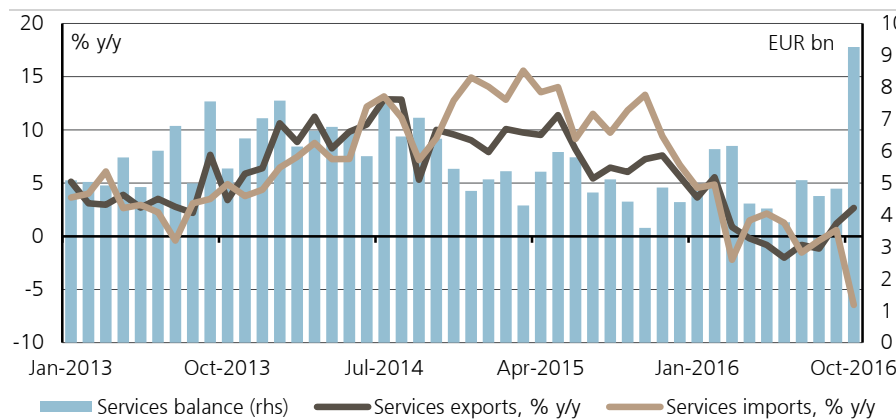
Figure 30: Goods trade, Eurozone



The growth rate in trade remains subdued (in EUR). Recently, imports surged ahead of exports, partly related to the pick-up in oil prices. Nevertheless, the Eurozone's trade surplus remains sizeable.

Source: Haver, UBS. Data up until October 2016. Next data release: 19 January (<http://ec.europa.eu/eurostat/news/release-calendar>)

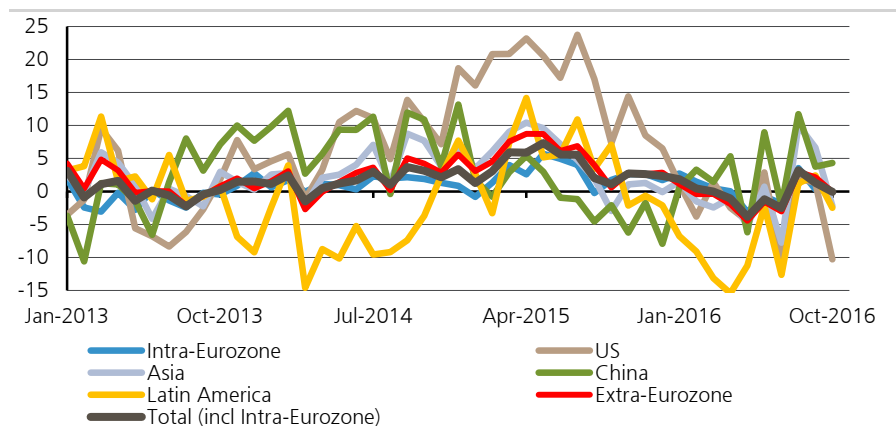
Figure 31: Services trade, Eurozone



Service imports fell sharply in October – for now, we assume that this was a one-off.

Source: Haver, UBS. Data up until October 2016. Next data release: 19 January (<http://ec.europa.eu/eurostat/news/release-calendar>)

Figure 32: Eurozone goods exports (value), % y/y (incl. Intra-Eurozone)

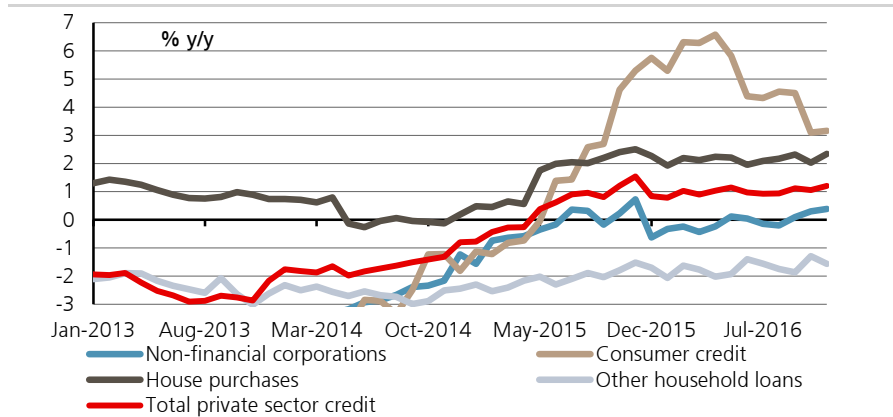


Export growth rates remain sluggish. Exports to US slipped to -10.3% y/y in October, while exports to China were up by 4.3% y/y.

Source: Haver, UBS. Data up until October 2016. Next data release: 19 January (<http://ec.europa.eu/eurostat/news/release-calendar>)

Credit

Figure 33: Eurozone private sector credit growth, % y/y

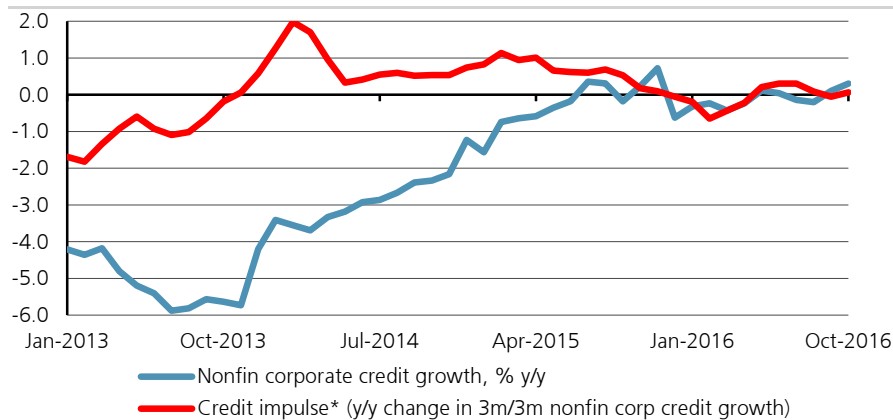


Source: Haver, Data up until November 2016. Next data release: 27 January, for Dec 2016. (<https://www.ecb.europa.eu/press/calendars/statscal/html/index.en.html>)

Credit growth remains subdued, at 1.2% y/y in November. Consumer credit and mortgages are growing at above-average rates, but credit to non-financial corporates – which we consider crucial from a business cycle perspective – is barely growing (0.4% y/y).

The deceleration in consumer credit is probably due to base effects – the growth rates of 2015 and Q1 2016 were unsustainable.

Figure 34: Corporate credit growth and credit impulse*

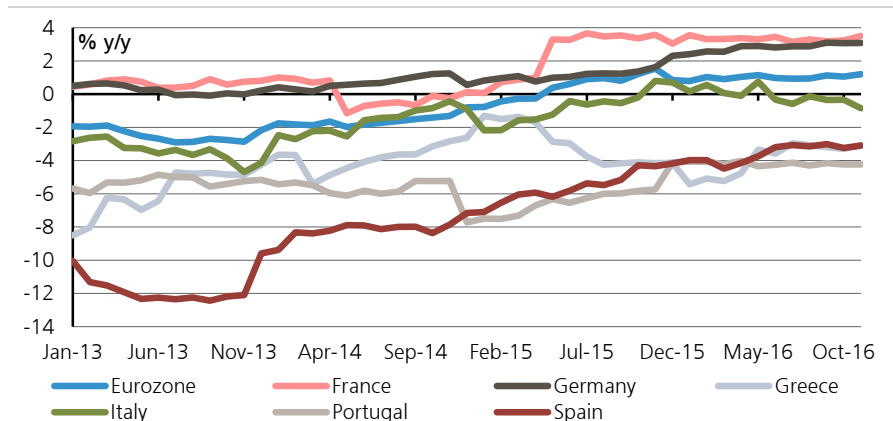


Source: Haver, UBS *y/y change in 3m/3m credit stock growth, where credit stock measures total outstanding nonfinancial corporations credit. Data up until November 2016. Next data release: 27 January, for Dec 2016. (<https://www.ecb.europa.eu/press/calendars/statscal/html/index.en.html>)

The Credit Impulse (i.e., the change in credit growth) is hovering around zero.

Despite the positive message of the ECB's recent Bank Lending Surveys, a full recovery in Eurozone credit growth should take more time.

Figure 35: Private sector credit growth, % y/y



Source: Haver. Data up until November 2016. Next data release: 27 January, for December 2016. (<https://www.ecb.europa.eu/press/calendars/statscal/html/index.en.html>)

Portugal, Spain and Greece continue to see negative credit growth, while Italy has slipped back into negative territory. Credit growth in Germany and France is solid, at 3% y/y.

ANNEX

Figure 36: Eurozone economic forecasts

% y/y, unless indicated				2016F				2017F				2018F			
	2016F	2017F	2018F	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP, local currency bn	10,707	11,026	11,372	-	-	-	-	-	-	-	-	-	-	-	-
Real GDP, % q/q	-	-	-	0.5	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Real GDP, % y/y	1.6	1.3	1.2	1.7	1.6	1.6	1.5	1.3	1.3	1.3	1.3	1.2	1.2	1.2	1.2
Consumer's expenditure	1.6	1.3	1.1	1.8	1.6	1.4	1.6	1.3	1.4	1.4	1.2	1.1	1.1	1.1	1.1
Govt Consumption	1.8	1.4	1.0	2.0	1.8	1.8	1.5	1.2	1.4	1.5	1.5	1.4	1.1	0.8	0.5
Fixed Investment	3.1	1.4	1.8	2.6	3.7	3.6	2.5	2.2	1.3	1.1	1.0	1.3	1.7	1.9	2.1
Exports	2.4	2.7	2.8	2.4	2.4	2.5	2.5	3.0	2.5	2.6	2.7	2.8	2.8	2.8	2.7
Imports	3.1	3.0	2.6	3.1	3.6	3.2	2.5	3.5	2.9	2.7	2.7	2.7	2.7	2.6	2.5
Domestic demand*	1.7	1.3	1.2	1.9	2.0	1.7	1.4	1.3	1.3	1.3	1.2	1.2	1.2	1.2	1.2
Net exports*	-0.2	0.0	0.2	-0.2	-0.4	-0.2	0.1	-0.1	-0.1	0.0	0.1	0.1	0.1	0.2	0.2
Nominal GDP (y/y)	2.4	3.0	3.1	-	-	-	-	-	-	-	-	-	-	-	-
Employment rate (%)	1.3	1.0	0.7	-	-	-	-	-	-	-	-	-	-	-	-
Unemployment rate (%)	10.3	10.0	9.8	-	-	-	-	-	-	-	-	-	-	-	-
HICP, % y/y average	0.2	1.4	1.8	0.0	-0.1	0.3	0.7	1.4	1.4	1.5	1.4	1.7	1.8	1.8	1.7
HICP, % y/y period-end	1.1	1.4	1.7	0.0	0.1	0.4	1.1	1.3	1.1	1.6	1.4	1.7	1.8	1.8	1.7
Wages	1.5	2.0	2.2	-	-	-	-	-	-	-	-	-	-	-	-
Budget balance (% GDP)	-2.0	-1.7	-1.5	-	-	-	-	-	-	-	-	-	-	-	-
Primary balance (% GDP)	0.3	0.5	0.9	-	-	-	-	-	-	-	-	-	-	-	-
Public debt (% GDP)	92.5	91.5	90.7	-	-	-	-	-	-	-	-	-	-	-	-
Current account (% GDP)	3.2	3.0	2.8	-	-	-	-	-	-	-	-	-	-	-	-
ECB refi rate (end period)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
3mth Euribor rate (end period)	-0.30	-0.30	-0.30	-0.23	-0.27	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30
German 10-yr bund yield (end period)	0.15	0.50	0.90	0.20	0.00	0.00	0.15	0.30	0.35	0.40	0.50	0.60	0.70	0.80	0.90
EURUSD (end period)	1.10	1.13	1.17	1.10	1.13	1.12	1.10	1.11	1.12	1.12	1.13	1.14	1.15	1.16	1.17

Source: Haver, ECB, European Commission, UBS.

Valuation Method and Risk Statement

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