European Economic Perspectives

Eurozone: strong data to embolden the hawks

Economics

Europe including UK

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Expecting stronger Eurozone growth in 2017, remaining cautious on 2018

Eurozone GDP grew by a strong 0.5% q/q in Q4 2016, while Q3 growth was revised upwards by 0.1pp to 0.4% q/q, thus rendering a 2016 growth rate of 1.7%. Strong growth in late 2016, but also indications of a good start to 2017, prompt us to raise our 2017 Eurozone GDP forecast to 1.5% from 1.3% (consensus 1.4%). However, we maintain our conservative 2018 growth projection of 1.2% (consensus 1.5%) as we expect higher inflation and commodity prices, as well as some tightening in financial conditions, to lead to a deceleration in domestic demand later in 2017 and 2018. We acknowledge potential upside risk from stronger exports, not least in the context of policy changes in the US.

Big jump in inflation in January, further rise to 2% expected by April

Driven mainly by energy pieces, Eurozone inflation (HICP) jumped up very significantly in January, to 1.8% y/y from 1.1% in December; core inflation stayed unchanged at 0.9% y/y. Given energy-related base effects, we project HICP to rise further to 2% by April, before easing somewhat. We now expect annual average inflation to pick up from 0.2% in 2016 to 1.8% in 2017 (prev. 1.4%) and 1.7% in 2018 (prev. 1.8%). We would highlight that our updated inflation forecast is now well above the ECB staff macro projection published in December, which had HICP at just 1.3% in 2017 and 1.5% in 2018. We firmly believe that the ECB will have to revise its projection markedly upwards when it releases new forecasts on 9 March.

Monetary policy debate to turn more hawkish, but our ECB call is unchanged

The sharp rise in inflation implies, in our view, that the monetary policy hawks will feel emboldened and demand more vocally a timely ECB move towards policy normalisation. Proponents of ongoing accommodation, however, will push back by questioning whether the rise in inflation is sufficiently durable, self-sustained, and broad-based. Overall, our ECB call remains unchanged: We expect the ECB to conduct monthly asset purchases of €60bn from April to December 2017, in line with its decision from 8 December. As of January 2018, however, we expect the ECB to start tapering and wind down its asset purchases over 12 months, i.e. until December 2018, with a decision due possibly as early as 7 September, or 14 December 2017 at the latest.

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 1.7% in 2016 to 1.5% in 2017 and 1.2% in 2018. Key will be the softening in domestic demand caused by higher oil prices/rising inflation, and a certain tightening in monetary conditions later in 2017 and 2018. 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 January 2017, HICP jumped to 1.8% y/y from 1.1% in December, 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 1.8% in 2017, and 1.7% 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: Draghi trying to keep the hawks at bay, 19 Jan). Rate hikes are unlikely before 2019.

UBS VIEW

We are constructive on Eurozone growth over the coming months, but expect **domestic demand** – so far the driver of growth – **to decelerate later in 2017 and 2018**. 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.

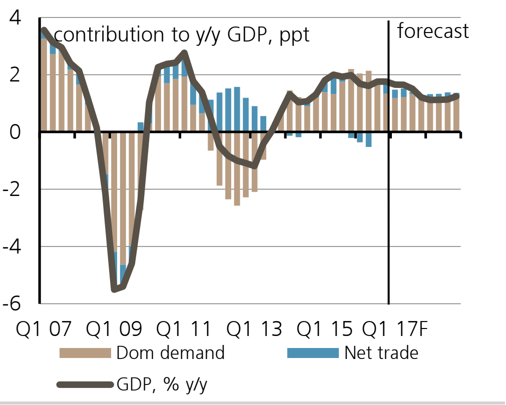
WHAT'S PRICED IN?

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:

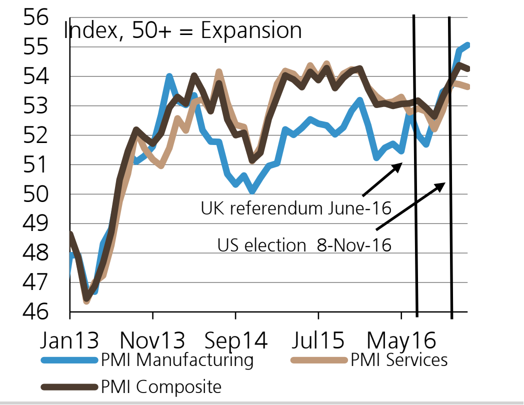
Positive risks could come from a big fiscal initiative in the US, with positive implications for European exports, an acceleration in Eurozone structural reforms, or simply from a swift reduction in uncertainty. Key **downside risks** could be: a negative Chinese growth shock, a rise in protectionism, 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 1: Eurozone GDP contributions (ppt)



Source: Haver, UBS

Figure 2: Eurozone PMIs

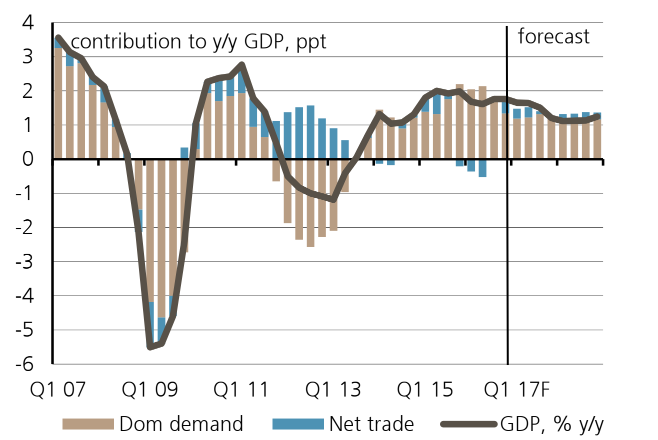


Source: Markit, Haver, UBS

Eurozone growth: positive surprise in Q4, evidence of strong Q1

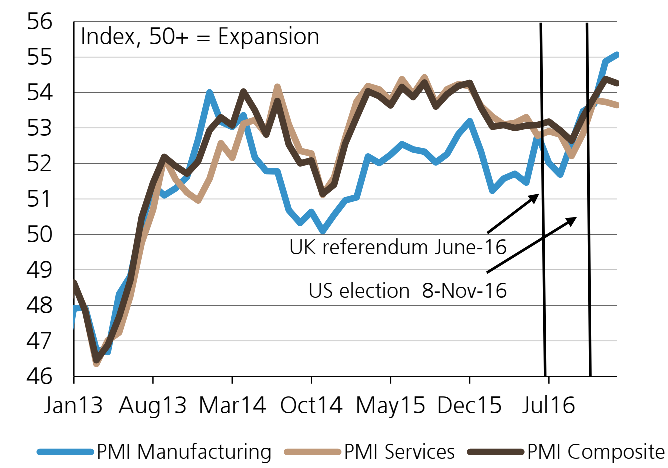
According to Eurostat's flash estimate, Eurozone real GDP grew by 0.5% q/q (1.8% y/y) in Q4 2016, after an upwardly revised 0.4% q/q in Q3. This rendered a 2016 growth rate of 1.7% (higher than our and consensus' forecast of 1.6%). The solid growth outcome is in line with the sharp improvement in sentiment at year-end signalled by PMIs that had led us to point out upside risks to our projection (Eurozone: strong finish to 2016, good start to 2017). Full details on the GDP data will only be made available on 7 March, but the indicator flow and GDP details from the French statistical office suggests that consumption held up well and that the manufacturing sector has benefitted from improved external demand, supporting investment. Manufacturing PMIs have outperformed the Services PMIs recently.

Figure 3: Eurozone real GDP & contributions forecast



Source: Haver, UBS.

Figure 4: Eurozone PMIs



Source: Markit, Haver, UBS

We raise our 2017 growth forecast to 1.5% from 1.3%

The prospects for annual 2017 growth now look better than before. Firstly, the stronger than expected Q4 2016 outcome implies that 2017 GDP starts from a higher level; this higher statistical carry-over should mechanically lift 2017 annual growth. Secondly, the continued robust data flow in January (Eurozone Jan flash PMIs suggest strong start to '17) suggests Eurozone GDP is likely to grow by 0.4% q/q in Q1 2017, rather than 0.3% q/q as we assumed so far. We thus raise our 2017 Eurozone growth forecast to 1.5% from 1.3% previously (consensus: 1.4%).

At the same time, we keep our 2018 GDP forecast of 1.2% unchanged (consensus: 1.5%). We continue to believe that domestic demand will face headwinds from higher inflation and oil prices as well as somewhat tighter financing conditions ahead of ECB tapering of QE (which in our view will start in 2018). We think fiscal policy support will not suffice to offset those headwinds and thus will not be a game-changer (A big fiscal push in the Eurozone?). These headwinds may dampen activity later than we thought before and could thus weigh in particular on the 2018 growth numbers. A much stronger than expected acceleration in external demand – for example through a US growth push – remains an upside risk. However, we prefer to remain cautious until there is more clarity, notably about specific policies in the US and their impact on growth.

Taking up our Germany, Italy and Spain projections for 2017

Across countries, growth in Q4 2016 picked up in France (0.4% q/q from 0.2%) and continued to be strong in Spain (0.7% q/q, same as in Q3). For Germany, the statistical office had already reported an early estimate of 0.5% q/q (up from 0.2%) for Q4. GDP growth in Italy will only be published on 14 February. While German annual growth of 1.8% in 2016 was in line with our and consensus' forecast, French growth at 1.1% is somewhat weaker than our previous forecast of 1.3% (consensus: 1.2%); Italy in our view will post a 1% growth rate for 2016 (vs. 0.7% in our prior forecast; consensus 0.9%).

Combining the Q4 2016 outcomes and a more optimistic view on Q1 given the latest sentiment readings, we increase our 2017 Germany GDP forecast to 1.5% (from 1.3% before; consensus 1.3%). This would still be a deceleration from 2016, in part because we think public spending growth will eventually slow as the number of refugees coming to the country has slowed materially (Germany: Are we too pessimistic on 2017 growth?). We also raise our 2017 forecast for Spain to 2.5% (from 2.3% before; consensus 2.4%) and Italy slightly to 0.9% (from 0.8% before; consensus 0.7%). We leave our 2017 forecast for France unchanged at 1.3%. We have not made changes to our 2018 projections, neither for the Eurozone aggregate nor for individual countries.

Figure 5: New, old and consensus real GDP forecasts

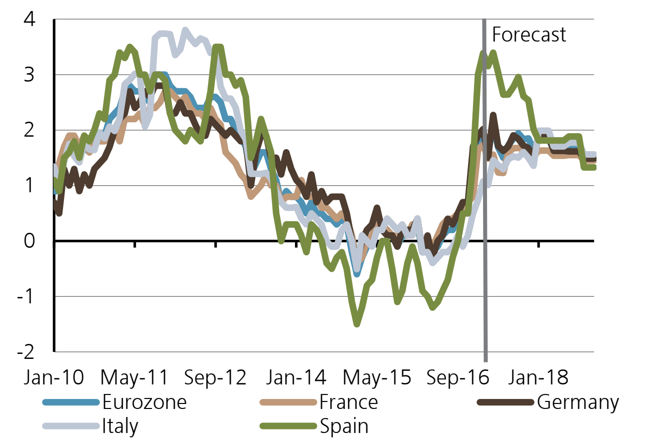
		New forecasts		Old forecasts		Consensus		UBS vs Consensus	
	2016	2017F	2018F	2017F	2018F	2017F	2018	2017F	2018F
Eurozone	1.7	1.5	1.2	1.3	1.2	1.4	1.5	0.1	-0.3
Germany	1.8	1.5	1.3	1.3	1.3	1.3	1.5	0.2	-0.2
France	1.1	1.3	1.4	1.3	1.4	1.3	1.4	0.0	0.0
Italy	1.0	0.9	0.8	0.8	0.8	0.7	0.9	0.2	-0.1
Spain	3.2	2.5	1.9	2.3	1.9	2.4	2.0	0.1	-0.1

Source: Haver, Consensus Economics, 9 January 2017, UBS.

Eurozone inflation: big jump, driven by energy

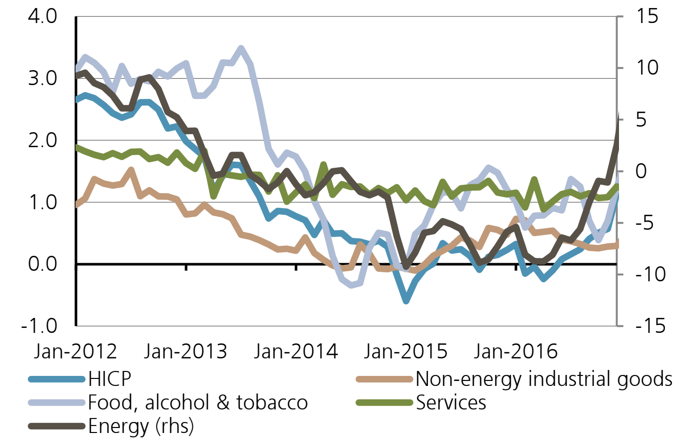
Eurozone inflation (HICP) jumped up very significantly in January, to 1.8% y/y from 1.1% in December. Core inflation, meanwhile, remained unchanged at 0.9% y/y. Hence the sharp rise in headline inflation was entirely driven by non-core components, above all energy, which increased by 8.1% y/y, as well as unprocessed food, which was up by 3.3% y/y. At the national level, Spain saw the sharpest rise, with HICP jumping to 3.0% y/y from 1.4%; in Germany (released yesterday), HICP rose to 1.9% y/y from 1.7% (see Germany: Inflation at 1.9% - Where next?), while France saw a rise from 0.8% y/y to 1.6%.

Figure 6: Inflation development in various countries



Source: Haver, UBS

Figure 7: Components of Eurozone HICP, % y/y

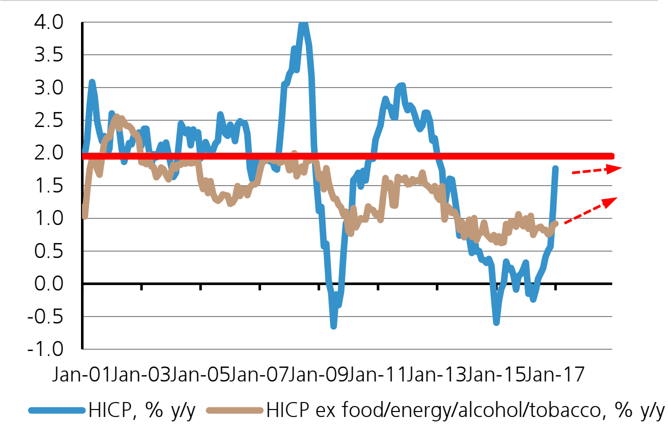


Source: Haver, UBS

Going forward, we expect base effects related to past energy price moves to remain a powerful driver of HICP over the coming months, keeping HICP at 1.9 y/y in February, 1.7% y/y in March and 2.1% y/y in April, before falling back below the 2% mark again; base effects are likely to turn around and allow HICP to moderate to perhaps 1.7% y/y in December. This trajectory would imply an average 2017 HICP of 1.8% (raised from 1.4%; consensus 1.4%). Next year, the impact from energy should be much more modest (given our oil price forecast of $65/bbl on average in 2018, following $60/bbl in 2017), but the tightening output gap should exert more influence, keeping HICP at around 1.7% y/y on average in 2018.

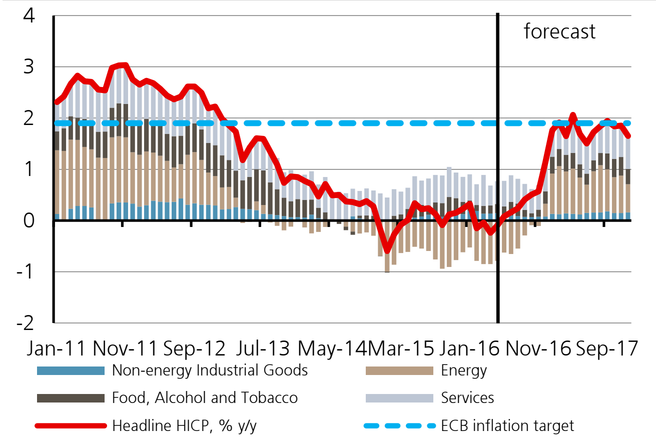
We would highlight that our updated inflation forecast is now markedly above the ECB staff macroeconomic projections published in December, which had HICP at just 1.3% in 2017 and 1.5% in 2018. We firmly believe that the ECB will have to revise its projection upwards when it releases new forecasts on 9 March.

Figure 8: Eurozone headline and core HICP, % y/y



Source: Haver, UBS.

Figure 9: Contributions to Eurozone HICP inflation, ppt



Source: Haver, UBS estimates

Hawks likely to feel emboldened

The sharp rise in inflation implies, in our view, that the monetary policy hawks will feel emboldened and demand more vocally a timely ECB move towards policy normalisation. We would also expect the ECB monetary policy debate to turn more politicised in the context of the German elections in September, in particular if

German inflation continues to outperform other Eurozone countries as it currently does. Yet, we think the hurdle towards the ECB abandoning the monetary policy roadmap that it presented on 8 December is very high; back then, the ECB said that it would conduct monthly asset purchases of €80bn until March, followed by €60bn from April to December 2017. In the last ECB meeting on 19 January, Mr Draghi said that, when assessing the inflation outlook vis-à-vis the target of "close to, but below, 2%", the ECB would want to see the following three criteria fulfilled:

1. The ECB is aiming for a **durable** convergence towards target, i.e. not just driven by energy-related base effects.

2. The recovery in inflation has to be **self-sustained**, i.e. it needs to persist even when unprecedented monetary policy support has ended.

3. **Eurozone** inflation (HICP) needs to return to target, not just the inflation rates of individual countries, such as Germany.

Based on this "check-list", the proponents of ongoing monetary policy accommodation are likely to argue that inflation is currently mainly driven by energy prices, so it is not clear that the inflation recovery is durable. Also, they might make the case that given ongoing risks, not least from European politics, it is not clear that the inflation recovery is sustainable.

ECB call unchanged: Tapering to start in January 2018

Hence, while we expect the monetary policy discussion to turn more hawkish now, our call remains unchanged. We expect the ECB to conduct monthly asset purchases of €60bn from April to December 2017, in line with its decision from 8 December. As of January 2018, however, we expect the ECB to start tapering and wind down its asset purchases over 12 months, i.e. until December 2018, with a decision due possibly as early as 7 September, or 14 December 2017 at the latest.

Figure 10: Real GDP forecasts, % y/y and % q/q

				2017				2018			
	2016	2017	2018	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Eurozone, % q/q				0.4	0.3	0.3	0.2	0.3	0.3	0.3	0.3
Eurozone, % y/y	1.7	1.5	1.2	1.7	1.6	1.5	1.2	1.1	1.1	1.1	1.2
Germany, % q/q				0.4	0.3	0.3	0.4	0.3	0.3	0.3	0.3
Germany, % y/y	1.8	1.5	1.3	1.5	1.4	1.5	1.4	1.3	1.3	1.3	1.2
France, % q/q				0.4	0.3	0.4	0.4	0.4	0.4	0.4	0.2
France, % y/y	1.1	1.3	1.4	0.9	1.3	1.5	1.5	1.4	1.5	1.5	1.3
Italy, % q/q				0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Italy, % y/y	1.0	0.9	0.8	0.8	1.0	0.9	0.8	0.8	0.8	0.7	0.7
Spain, % q/q				0.6	0.5	0.5	0.5	0.5	0.4	0.4	0.4
Spain, % y/y	3.2	2.5	1.9	2.9	2.5	2.3	2.1	2.0	1.9	1.8	1.7

Source: Haver, UBS.

Figure 11: Euro area inflation and its components, % m/m and % y/y

		% m/m			% y/y		
	Weight, %	Nov-16	Dec-16	Jan-17	Nov-16	Dec-16	Jan-17
All-items HICP	100.0	-0.1	0.5	-0.8	0.6	1.1	1.8
All-items *excluding*:							
energy	89.3	-0.1	0.4	-1.2	0.8	1.0	1.1
energy, unprocessed food	81.9	-0.1	0.4	-1.4	0.8	0.9	0.9
energy, food, alcohol & tobacco (CORE)	69.6	-0.2	0.4	-1.7	0.8	0.9	0.9
Food, alcohol & tobacco	19.7	0.3	0.3	0.6	0.7	1.2	1.7
processed food, alcohol & tobacco	12.2	0.3	0.0	0.2	0.7	0.7	0.7
unprocessed food	7.5	0.4	0.8	1.3	0.7	2.1	3.3
Energy	10.7	-0.2	1.8	2.5	-1.1	2.6	8.1
Non-energy industrial goods	26.2	0.0	-0.3	-3.5	0.3	0.3	0.5
Services	43.4	-0.3	0.9	-0.6	1.1	1.3	1.2

Source: Eurostat, Haver, UBS.

Figure 12: Euro area inflation and its components, *contributions* to m/m and y/y inflation

		% m/m			% y/y		
	Weight, %	Nov-16	Dec-16	Jan-17	Nov-16	Dec-16	Jan-17
All-items HICP	100.0	-0.1	0.5	-0.8	0.6	1.1	1.8
Food, alcohol & tobacco	19.7	0.1	0.1	0.1	0.1	0.2	0.3
processed food, alcohol & tobacco	12.2	0.0	0.0	0.0	0.1	0.1	0.1
unprocessed food	7.5	0.0	0.1	0.1	0.1	0.2	0.3
Energy	10.7	0.0	0.2	0.3	-0.1	0.3	0.9
Non-energy industrial goods	26.2	0.0	-0.1	-0.9	0.1	0.1	0.1
Services	43.4	-0.1	0.4	-0.3	0.5	0.5	0.5

Source: Eurostat, Haver, UBS.

Valuation Method and Risk Statement

Risks include macroeconomic variables (such as GDP growth rates and inflation), economic slowdown, a weakening currency, global economic events, and government policy changes.

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