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Daily Note

THE MANY FACES OF THE EA SLOWDOWN

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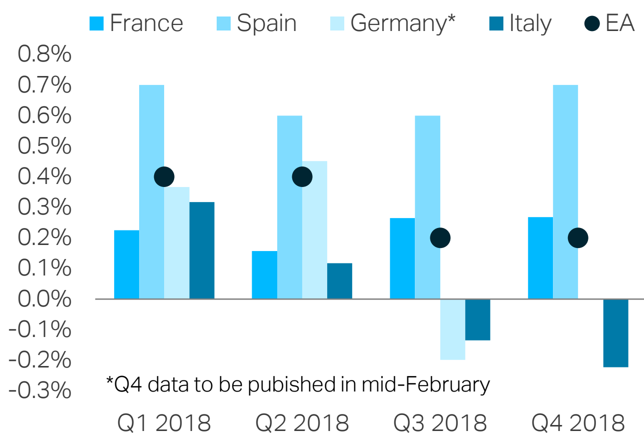
- **The euro area can't turn the page on 2018; more weakness to come**
- **Winners: France and Spain. Losers: Germany and Italy**
- **Growth is clinging onto domestic demand, but downside risks rise**

Turning the page on 2018? Not quite. This week's preliminary Q4 GDP data for the euro area (EA) don't set the seal on 2018. The sharp slowdown is bound to continue at least for H12019.

Trade pains. As we wait for the complete GDP breakdown, there's no question that weak demand from outside the EA is proving to be a drag on growth. The major causes are and will continue to be: (1) China's policy-induced slowdown, which has spilled over to EMs; (2) the US-China trade war, which affects the EA via supply chain disruption and an outright fall in global trade volumes; (3) the mutation of the trade war into an FX war, causing EA firms to lose competitiveness as the RMB depreciates. The time limit to this pain is set by the lag between the implementation of China's new monetary stimulus and its effect on the world economy. Unluckily, the minimum lag is about six months.

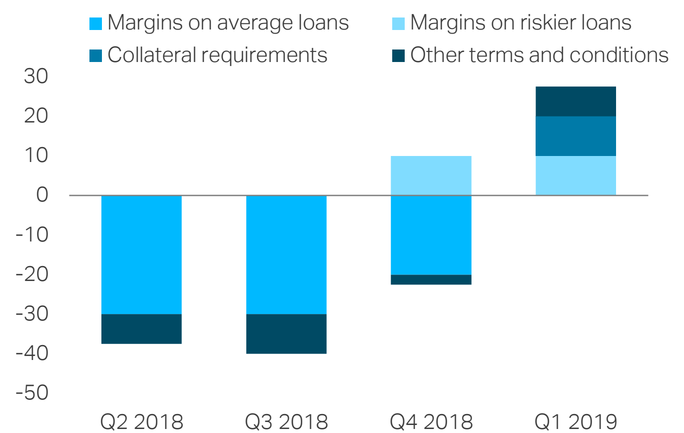
Country-level heterogeneity complicates things further. We don't expect any of the major EA economies to enter a prolonged recession this year, but we can distinguish between winners and losers. Its reliance on Chinese and EM demand makes Germany structurally a loser until proper stimulus kicks in (either China's or Germany's own – see below). The ongoing build-up in inventories will continue to hobble industrial production and capex. The only bright spot in Germany for now seems to be the construction sector.

Winners and losers
QoQ real GDP growth



Source: National sources, Datastream, TS Lombard

Italy: credit conditions deteriorate further
Net % of banks tightening terms and conditions



Source: ECB, Datastream, TS Lombard

Italy also counts as a loser. On the export front, the similarity of China's export basket and the RMB's decline have undercut Italy's competitiveness further. At home, higher sovereign spreads are affecting the real economy through increasingly stringent credit standards (right-hand chart above). Foreign demand and credit contraction paint a negative picture for firms' investment in coming quarters. For now, it's hard to see Italy grow more than 0.4-0.5% this year.

Spain and France: relative winners. In contrast, Q4 GDP data for France and Spain showed an unexpected pick-up in net exports (+0.2% QoQ for France and +0.3% for Spain) and a very limited inventory build-up. Judging from the order backlog, manufacturers in both countries look still quite busy (left-hand chart below). Similarly, today the Spanish manufacturing PMI was revised up from 51.1 to 52.4 (as opposed to the Italian and German ones, which fell more into contraction territory). However, it's unclear how long the good times will last.

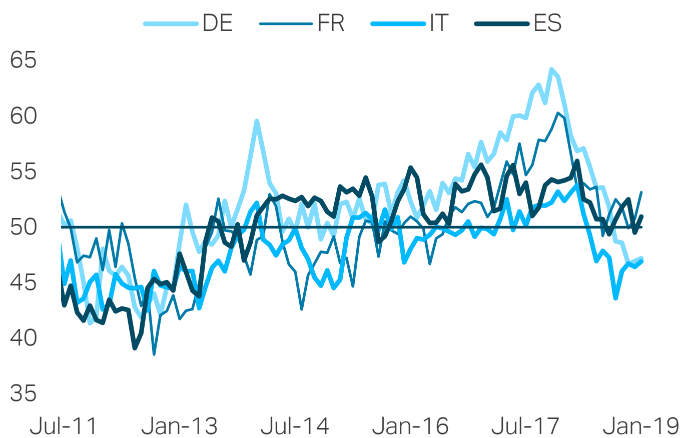
At any rate, robust domestic demand led by private consumption and government spending in Q12019 will take over as the primary driver of growth in both countries. In France, milder weather compared to Q12018, limited disruption from "yellow vest" protests, and the effect of President Macron's income-support measures will boost household purchasing power and consumption. A rebound in consumer confidence in January reinforces this hypothesis. In Spain, the 22% increase in the minimum wage that became effective last month will also contribute significantly to consumption growth.

The EA clings onto domestic demand but downside risks intensify. Receding energy costs and slowing inflation together with mounting wage pressures should underpin the expansion of real disposable incomes and consumption in the EA as a whole. This, in turn, should partially support capex. However, the downside risks to this scenario are rising. Chinese firms, pushed out of the US market by tariffs, will try to increase their market share elsewhere, including Europe. Deflation exported from China is likely to shrink the domestic market share of EA firms and thus endanger profit, capex, employment and wage growth.

The most effective medicine against this slowdown remains fiscal stimulus. The recent proposal by the new leader of Germany's Christian Democrats to cut taxes in case the economy were to deteriorate further is a step in the right direction. However, the German aversion to infrastructure spending remains a mystery.

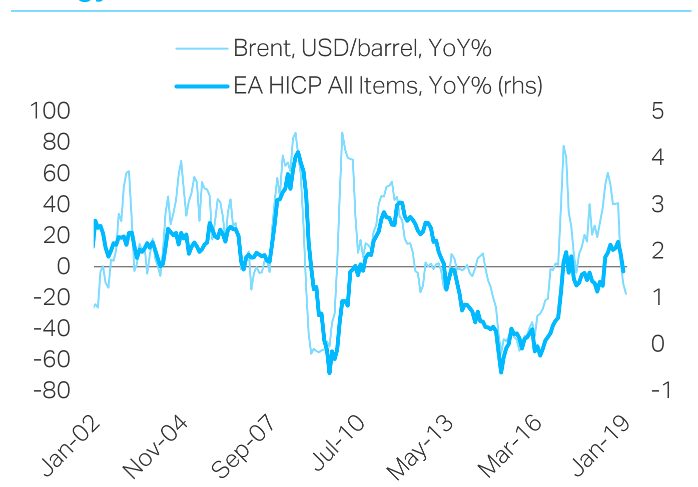
French and Spanish firms still moderately busy

Markit PMI: backlogs of work in manufacturing



Source: IHS Markit, Datastream, TS Lombard

Energy costs drive inflation lower



Source: EIA, Eurostat, Datastream, TS Lombard