Daily Note

EA GDP: GREEN SHOOTS? NOT SO FAST

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- **Preliminary Q1 GDP confirms weak exports and rising inventories**
- **Consumption remains buoyant and Spanish capex accelerates**
- **The worst might be behind us, but the rebound is still a quarter away**

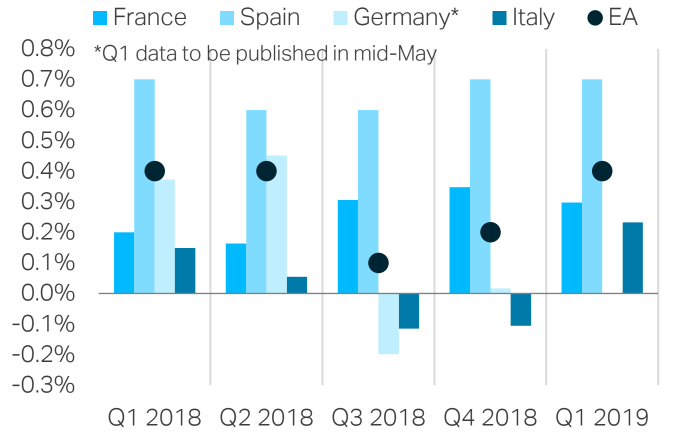
Are you an optimist or a realist? Data are always open to interpretation and the same set of numbers can lead to different forecasts. The preliminary Q1 GDP figures for the euro area (EA) published yesterday are no exception. Optimists are reading the modest QoQ acceleration – both at EA aggregate level and in Italy – as a sign that the EA is out of the woods earlier than expected (see left-hand chart below). In contrast, we stick to our view that, although the worst of the slowdown might now be behind us, many indicators suggest that the current soft patch will last until the end of Q2.

As usual, we will need to wait until German data are published in mid-May to have a complete breakdown of EA GDP, but we can already draw four conclusions about the growth outlook by cross-referencing the details of Spanish and French GDP (see chart overleaf) with higher-frequency indicators.

First, exports are still struggling significantly. In France, exports virtually stopped growing in Q1 (+0.1% QoQ) while in Spain they actually fell by 0.5% QoQ. If manufacturing new orders are any guide, Germany is set to do even worse. The sequential contraction in January and February (-2.1% and -4.2% MoM respectively) was essentially accounted for by non-EA foreign orders. Some indicators considered to lead EA manufacturing, such as the Swedish manufacturing PMI, have shown timid signs of stabilisation recently. Similarly, the latest EU Commission survey of export order-book levels stopped falling for the first time in eight months (right-hand chart). However, though welcome, none of these signs justifies expecting a rapid improvement in EA exports.

The worst of EA growth might be behind us...

Real GDP growth, QoQ



Source: National sources, Datastream, TS Lombard

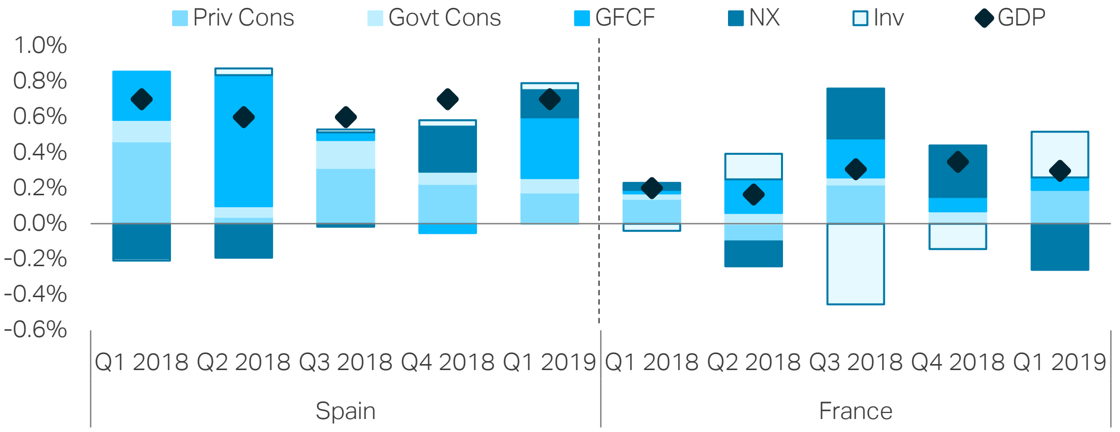
...but inventories and exports still a problem

Euro area: standardised net balance, SA

Source: DG ECFIN, Datastream, TS Lombard

Unfortunately, the EA looks more like France than Spain

Real GDP growth, QoQ and pp. contribution



Source: INE, INSEE, Datastream, TS Lombard

Second, the inventory build-up in Q1 implies lower production later this year. In France, net exports subtracted 0.3% from GDP growth in Q1 (see chart above). Weakness in foreign demand was offset by a rise in inventories. In Germany, while both IFO and Markit surveys are likely to overstate the magnitude of the current inventory overhang, they continue to point to rising stocks of finished goods. Declining imports in EMs and China, coupled with sector-specific dynamics (e.g. the car industry), will put a lid on production in Q2.

Third, consumption is the strongest driver of EA growth. A mildly expansionary fiscal stance, contained inflation and sustained nominal wage expansion have fostered steadily declining unemployment and still-supportive real disposable income growth. The GDP breakdown for both Spain and France reinforces this point. In addition, Spanish seasonally adjusted retail sales in March grew by 1.7% YoY, beating expectations of 1.4% and providing further evidence of resilient domestic demand. Net of the disruption caused by the 'yellow vest' protests, French consumption is also expected to improve in response to government measures passed in January and further steps announced more recently to boost households' purchasing power. In general, sectors of the EA economy that rely more on domestic demand than on exports such as services and construction have been outperforming. This is most obvious in Germany, where construction output and services have accelerated briskly since the start of the year.

Fourth, Spain confirms once more that it is an important EA growth engine. Spain's positive momentum is in line with our expectations. As we've highlighted in recent notes (e.g. here), Spanish industrial production seems close to a turning point. The Q1 surge in capex – especially for machinery and equipment – is consistent with this hypothesis but it contradicts the country's mostly negative business sentiment surveys.

Finally, Italy requires extra care. Q1 growth of 0.2% QoQ nominally lifts Italy out of recession, but it's not meaningfully different from 0%. In its press release, ISTAT explained that domestic demand net of stocks contributed negatively to growth while external demand made a positive contribution. We'll need to wait for the full GDP details in a month to have a sense of the quality of this growth, but since Italy looks more similar to Germany and France than to Spain, we suspect rising inventories played a role in boosting the headline figure.

With ECB President Mario Draghi trying every rhetorical trick in the book to kindle inflation, real M1 starting to expand again and Chinese fiscal stimulus in the pipeline, we think EA growth is now testing a floor. However, no quick rebound seems in sight yet.