Europe Watch | Economics

CALLING TIME-OUT

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- **EA manufacturing calls time-out, while Spain takes the lead for now**
- **German data are soggy: domestic new orders of capital goods crash**
- **The Bundesbank revises Germany's GDP growth for 2019 down to 0.6%**
- **The ECB is "determined to act in case of adverse contingencies"**
- **But, as expected, TLTRO III is just a financial stability tool**

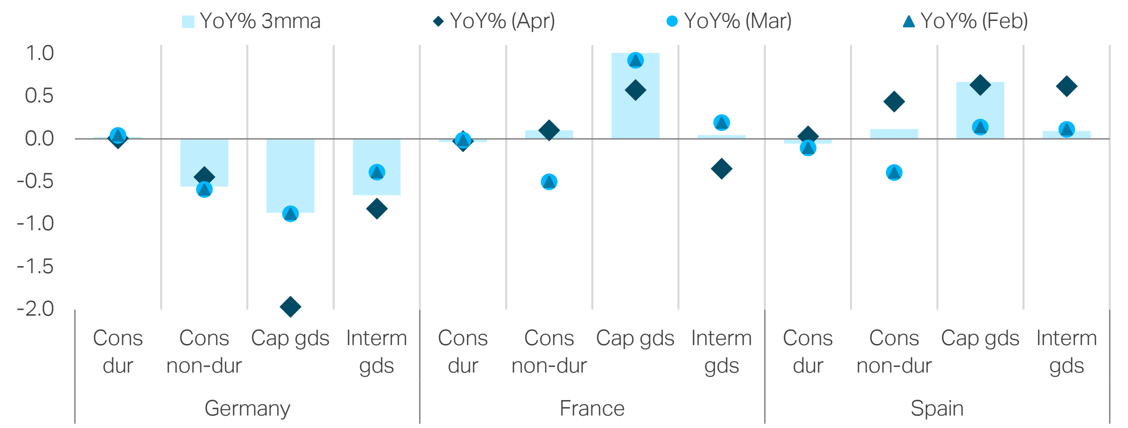
Euro area (EA) manufacturing continues to underperform. However, data released over the past month and earlier this week show that EA manufacturing has been contracting at a slower pace, testing a floor. Although German manufacturing remains extremely fragile and faced with significant challenges, Spain and France, thanks to limited exposure to Asian export markets, have been showing signs of stabilisation.

Spain: EA's manufacturing locomotive, for now. As we highlighted in the past, Spain stands out as a relative winner among the four largest EA economies, mostly thanks to the very price-competitive position it acquired in the aftermath of the Global Financial Crisis and its greater dependence on intra-EA demand compared to Germany and Italy. This view is confirmed once more by April industrial output. Chart 1 below shows that over the past three months, data has progressively improved in Spain. Headline manufacturing output figures had been sapped by negative energy goods performance, but things have turned a corner in April and the underlying momentum remains solid.

Moreover, limited accumulation of stocks in Spain – see Chart 7 below – means future production will face less of a headwind. However, based on EU Commission survey data (the latest data point on actual new orders refers to March), new orders for Spanish manufacturers

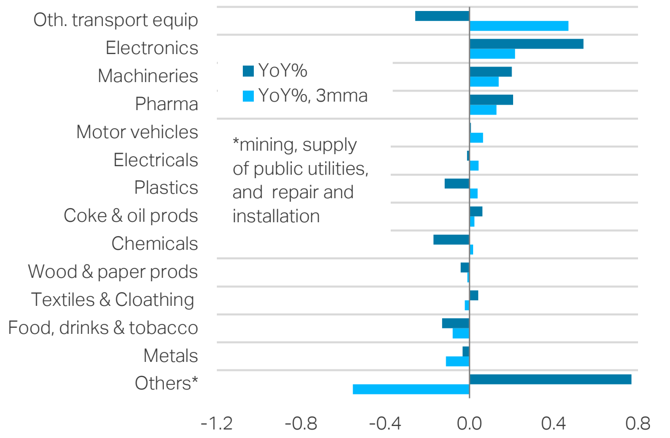
Chart 1: Spain at the helm of EA manufacturing, for now

Industrial production indices, volumes, SA, %pp. contribution



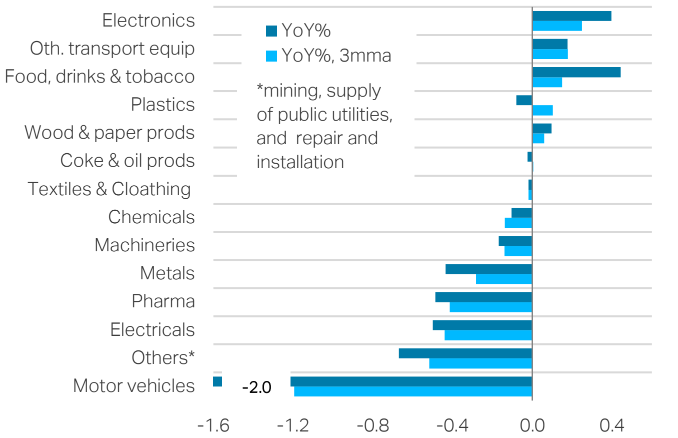
Source: Destatis, INSEE, INE, Datastream, TS Lombard calculations. *Last obs.: April 2019*

Chart 3: France stabilises through restocking
Industrial production indices, volumes, SA, %pp. contrib.



Source: INSEE, Datastream, TS Lombard. *Last obs.: April 2019*

Chart 2: Chronic German *malaise*
Industrial production indices, volumes, SA, %pp. contrib.



Source: Destatis, Datastream, TS Lombard. *Last obs.: April 2019*

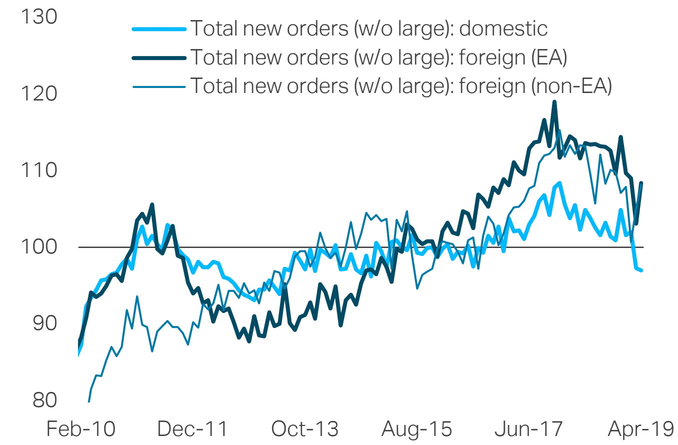
are likely to disappoint in Q2. This is consistent with expectations of a prolonged slowdown in EA growth, due to the deterioration of the global outlook.

Similar to Spain, French manufacturing has been insulated from the worst spillovers of the EM demand contraction and global trade slowdown. On the contrary, in France there seems to be significant pent-up demand. The *gilets jaunes* protests compressed households' consumption, while disposable incomes accelerated, and delayed firms' investment plans in 2018Q4 and in 2019Q1. Net of volatile items such as utility supplies and mining (lumped in "Others") or other transport equipment (which mainly reflects the beginning of a new production cycle for ships and aircrafts), Chart 2 shows that industrial output has stabilised over the past three months. The extra boost from restocking in April should reverse in May (see Chart 7 below), but looking through these fluctuations the outlook is relatively positive.

Chronic German *malaise*. The breakdown in Chart 3 shows that auto manufacturing and pharmaceutical products remain the heaviest drags on German industrial production (excluding construction). We should not expect this to change anytime soon.

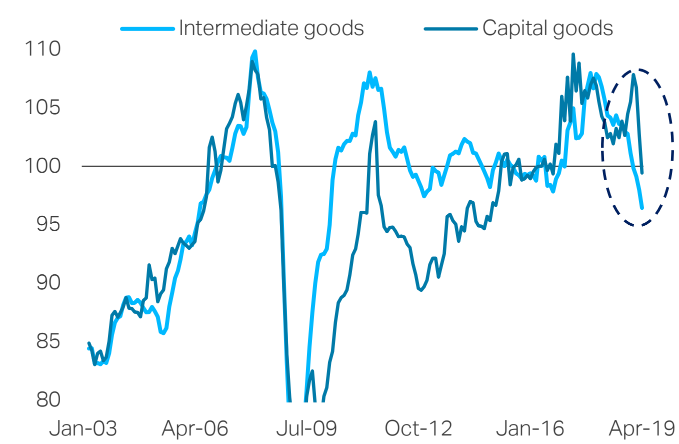
Beyond temporary factors such as the introduction of new emission tests, German (and EA-wide) car production reflects the global slowdown and the retaliatory tariffs China imposed on

Chart 4: Foreign-domestic divergence
Germany: new orders, 2015=100



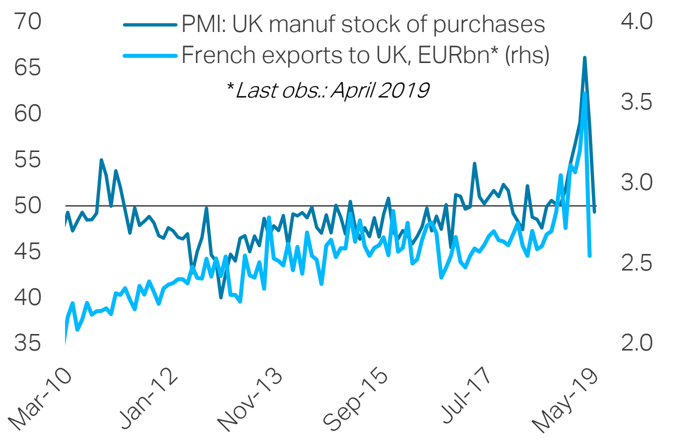
Source: Destatis, Datastream, TS Lombard

Chart 5: Domestic capital goods orders crash
Germany: domestic new orders, 2015=100, 3M MA



Source: Destatis, Datastream, TS Lombard

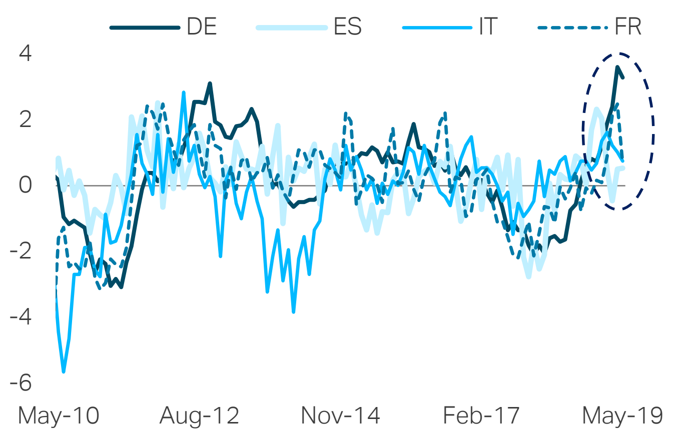
Chart 6: Brexit-induced trade boost reverses



Source: IHS Markit. INSEE. Datastream. TS Lombard

Chart 7: Stock levels start to normalise in May

Stock of finished products, SA, standardised net balance



Source: EC business surveys, Datastream, TS Lombard

car imports from the US. Indeed, most European SUVs that are popular in China are currently manufactured in the US. The ongoing deep contraction in Chinese new car sales (-17.9% YoY in May) is the result of all these negative forces. As far as pharmaceutical products go, we have explained that the negative contribution is almost entirely attributable to base effects, due to the launch of a new drug in the US which boosted production in 2018.

But other sectors are not faring well either – e.g. electrical components, metals and machinery. What's more, the slowdown in foreign demand is now starting to filter through to domestic demand. Chart 4 shows the lagged response of domestic orders to deteriorating foreign demand. More interestingly, and consistent with our expectations that German machinery and equipment capex is bound to slow markedly in the coming months, domestic capital goods orders have crashed and have also closed the gap with intermediate goods orders (Chart 5).

In this context, the Bundesbank revision of Germany's real GDP growth down to 0.6% for 2019 come as no surprise, and confirms our view that the slowdown in Germany and in other export-sensitive EA economies (e.g. Italy) will last for most of the current year.

The export boost from Brexit reverses. Two weeks ago we highlighted that Brexit-related factors boosted German exports and net trade data. Chart 6 illustrates how the same distortion affected French trade data. The figures for April released this morning show that the spike has now more than reversed. The end of the rush to stockpile was part of a greater one-off shock. To mitigate the disruption to production caused by Brexit, some firms – especially carmakers – decided to bring forward their scheduled UK factory maintenance period to April (it's normally in the summer) causing production and imports to drop further in the UK.

ECB – policy paralysis. To conclude, all elements point to a continuation of the current stagnation in the euro area. Moderate optimism for Spanish and French data seems justified only in comparison to the bleak outlook for Germany. In addition, as my colleague Shweta Singh wrote in today's Daily Note, the ECB fell short of markets' expectations (or hopes) by not sounding 'dovish enough'.

The ECB extended its interest rate forward guidance by seven additional months through mid-2020, and pledged to be "determined to act in case of adverse contingencies". Crucially, Mario Draghi said the Governing Council stands ready to restart QE, if necessary, as the pause in net asset purchases since the start of the year granted the ECB more room to intervene in the market.

However, the conditions under which the new round of TLTRO loans will be extended to EA banks (higher interest rates and reduced borrowing amounts) make clear that TLTRO III – as we expected – won't amount to much more than a financial stability tool. (The programme is necessary to avoid Basel III liquidity requirements being excessively punitive for fragile peripheral banking systems.) Moreover, as 5y5y inflation swap rates reach new lows, markets continue to question monetary policy's ability to revive inflation. In other words, Draghi doesn't appear to be allowed the luxury of a quiet ECB retirement.

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