BearBull
Global Investments Group

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Slight recovery in the Eurozone despite weakness in Germany

GDP up +0.2% in Q3. Germany holds out on the edge of recession. ECB maintains status quo. Change of outlook for long-term rates. Valuations in Europe's favour.

Key points

- Q3 slightly better than expected in the Eurozone
- Growth in Q3 driven by consumption, government spending and exports
- Leading indicators leave room for doubt
- Consumer confidence is not benefitting from reduced trade tensions
- Germany holds up despite the collapse of its industrial sector
- No new rate cuts by the ECB
- Possible strengthening of the euro
- Real yields slightly less negative but still conducive to investment
- Sharp rise in long-term rates
- European equities still more attractive than US stocks

Q3 slightly better than expected in the Eurozone

The Eurozone economy in Q3 may tentatively be climbing out of a period of weakness that has lasted several quarters, as recently published statistics point to GDP growth of +0.2% (+1.2% yoy) in the Eurozone in Q3.

Economic activity seems slightly better than predicted by the consensus forecast, which expected growth of only +1.1%.

Most importantly, the fact that this recovery is clearly visible in most economic sectors is relatively encouraging for prospects in 2020.

Nevertheless, the near-stagnation of GDP in Germany (+0.1%) after a -0.2% revision of its growth rate in Q2, continues to drive economic growth in the Eurozone downwards with no clear indication of any future reversal in trend.

In Q3, only Germany, Italy and Austria posted growth rates (+0.1%) below the average (+0.2%), while every other country in the Eurozone and the EU posted results in excess of +0.2%. The highest quarterly growth rates were recorded in

Poland (+1.3%), Hungary (+1.1%) and Estonia (+1%). Germany has once again this year fended off the threat of a technical recession but is still suffering from the overall slowdown of the global manufacturing sector. Factory orders dropped by -0.4% in October and -5.5% yoy.

The industrial complex in Germany is still plagued by uncertainty relating to trade issues, and the risks of a recession are thus logically much more real.

However, uncertainty relating to developments in global trade has decreased in the last few months, which will likely help sentiment, investment and consumption improve in the coming months. Quarterly GDP growth in the Eurozone has thus stabilised.

Growth in Q3 driven by consumption, government spending and exports

Private consumption (+0.5%), exports (+0.4%), government spending (+0.4%) and investments (+0.3%) have been driving European growth. In an environment that remains uncertain, these results contrast favourably with the ongoing difficulties in the manufacturing sector.

These positive factors seem more resilient, inspiring a reasonable sense of optimism regarding the European economy's ability to avoid a sharper downturn in the coming months.

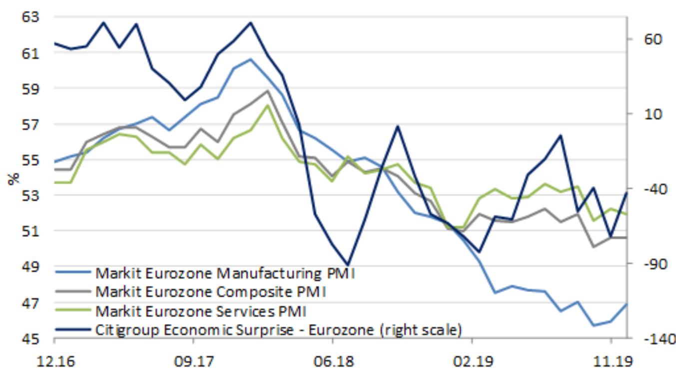
Europe's economy will likely grow significantly more slowly in 2019 (+1.1%) than in 2018 (+1.9%), while risks of a recession are estimated at less than 20% for 2020.

Leading indicators leave room for doubt

The large majority of national composite PMI leading indicators remain encouraging and stand well above the growth threshold of 50. The Eurozone's composite PMI recovered slightly in November, climbing from 50.3 to 50.6 as a result of improving sentiment in both the manufacturing sector and services.

Nevertheless, despite a 0.3-point increase to 46.9, the manufacturing PMI is still far from its theoretical growth threshold and is still a significant cause for concern for Europe's industrial sector. The services PMI jumped up 0.4 to 51.9 in November. While this figure in itself is synonymous with growth, it should be noted that it is still among the lowest since 2014.

Eurozone – Leading indicators



Sources: Bloomberg, BearBull

Germany holds up despite the collapse of its industrial sector

The German manufacturing index reached a new low in September at 41.7 before jumping back up in October and November (44.1). The manufacturing purchasing managers' barometer thus fell lower than it was during the downturn of the summer of 2012.

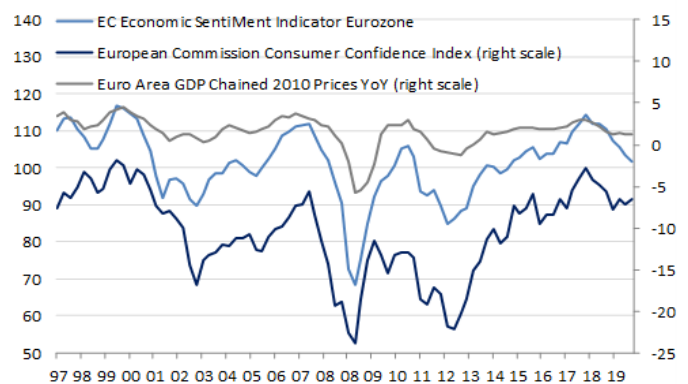
Despite this recovery, confidence is still far from heralding a recovery in production after a two-year-long decline. For the time being, fears that other economic sectors would be contaminated have fortunately been only moderately confirmed.

The services PMI fell in H2 2019 from 55.8 (June) to 51.7 (November), although it remains within a historically positive fluctuation range that supports the segment's growth prospects. In the construction sector, the rebound in the last three months signals more favourable prospects with an increase from 46 to 52 points between August and November. Germany's industrial production is still stuck in a downward spiral, contracting by another -1.7% in October, and -5.3% yoy. The impact of Germany's downturn on the Eurozone's industrial production is serious, but overall, Europe's industrial production is holding up, posting slightly positive growth of +0.1% in October.

Consumer confidence not benefitting from reduced trade tensions

The employment market has stabilised, and the unemployment rate in Eurozone countries remains unchanged at 7.5%, the level that prevailed at the end of 2008, which corresponds to a decline in unemployment of 35% in comparison with the 12% high reached in 2013.

Eurozone GDP, economic and consumer confidence



Sources: Bloomberg, BearBull

The European Commission's indicator, which measures the degree of economic confidence, has stabilised, although it does not point to brighter prospects. The consumer confidence indicator regarding economic expectations in Germany looks a little more dynamic, posting its strongest monthly growth in nine years.

However, the indicator that measures the general climate of consumption for December is less volatile and increased marginally from 9.6 to 9.7 in November. On the other hand, expectations with regards to the business cycle rebounded more sharply with a 15.5-point increase of the indicator. Confidence indices for Germany thus indicate a clear trend reversal. The reduced trade tensions and the decrease in rates in the US, in addition to political developments relating to Brexit, have certainly had a favourable impact on households' optimism.

No new rate cuts by the ECB

After its latest -0.1% rate cut in October, the European Central Bank us unlikely to make any new cuts in the coming months if economic conditions do not show any clear signs of deteriorating. A short time ago, the consensus still expected a new rate cut in June 2020, but the most probable scenario points to a status quo until 2022 before any new hike.

Despite persistent risks of a slowdown in the Eurozone due to the difficult economic situation in Germany, current monetary policy is deemed sufficient to overcome these risks. Nevertheless, the latest inflation figures in November (-0.3%) have rekindled risks of a deflation.

The new president of the ECB, Christine Lagarde will hold her first press conference on 12 December, which will likely follow the same line. She will undoubtedly address the issue of long-term strategic guidelines and possibly the idea of integrating issues relating to climate change in the ECB's global analysis.

More specifically, expected economic projections might be a little more optimistic, without straying too far from the forecasts already presented. In terms of the asset purchase and quantitative easing programme, Christine Lagarde's comments regarding the stimulus measures that were carried out in the first month will be key.

Possible strengthening of the euro

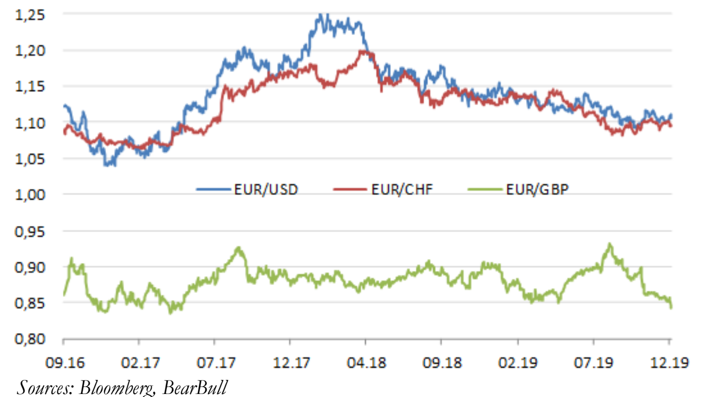
The deterioration of economic conditions in the Eurozone, mainly due to the specific situation of Germany's manufacturing sector, did not trigger any specific distrust of the euro by investors in H1.

The growing general uncertainty in July and August then triggered a short period of weakness, which ultimately stabilised with a euro/dollar exchange rate above 1.10. The yield spread remains quite clearly in favour of the dollar both in the short and the longer term.

Nevertheless, we now believe that the euro's current level factors in most of the negative expectations with regards to the risks to Germany's economy. The support measures announced by the ECB will likely breathe some life back into the euro unless Trump decides to ramp up the pressure on Germany's trade.

A normalisation of growth prospects will likely encourage investors to return to the European currency at its current levels, driving an increase in euro/USD and euro/CHF rates to 1.14.

Exchange rate in euros (USD, CHF, GBP)



Sources: Bloomberg, BearBull

Real yields slightly less negative but still conducive to investment

Inflation slipped into negative territory in November with a -0.3% drop over the month. Over one year, the CPI index rebounded from +0.7% to +1.0%, while inflation excluding food and energy barely reached +1.3%. In terms of producer prices, the data in October is barely positive over a month (+0.1%), but the falling PPI has now dropped -1.9% over twelve months. Producer price indices have decelerated sharply since their high (+4.9%) in October 2018 and are now in the red since August 2019.

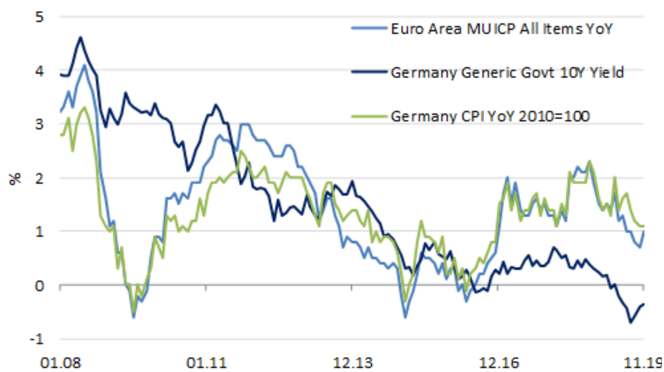
With falling inflation and an approximately 40-basis-point upswing in long-term rates in the last quarter, real yields have actually increased significantly in the Eurozone. Real yields on long maturities have gone from -1.3% at the end of August to -0.6% today. This correction of real euro yields is unlikely to have any major impact on the financing cost of investments, consumer credit and mortgage financing. Negative real yields, even reduced, will still foster in 2020 a recovery of demand, and investments over the next few quarters.

Sharp rise in long-term rates

For more than three months, a partial, yet rather significant change in investors' expectations regarding economic prospects and the appropriate relative level of interest rates has been occurring. A few months ago, falling euro rates were still justified by real risks of recession for Germany.

In the last few months, the relative decline in uncertainty has enabled a progressive increase in yields, which has almost cancelled out the exaggeration observed in August. The inversion of the euro yield curve during the summer thus normalised somewhat in the autumn with a rise in 10-year rates from -0.71% in August to -0.3% in November.

Interest rates – inflation



Sources: Bloomberg, BearBull

Euro capital markets have begun integrating the falling risks of recession, but they are not ready yet to gamble on a clear economic upturn and higher inflation, which will undoubtedly be essential for any rise in yields back into positive territory.

European equities still more attractive than US stocks

The performance of European equities (+19.5%) remains below that of the US market (+26.7%) since the beginning of the year. However, the outperformance of US stocks seems linked essentially to corporate share buy-backs. When corrected for this effect, the performance of European equities is actually similar.

At year-end, the valuation of European equities remains attractive. With a valuation of 15.9x expected 2020 earnings, they are at an almost -20% discount to US equities, with 2020 PE levels of 19.2x. Since 15 August, date of the trend reversal in the rate and equity markets, both markets have performed almost identically in terms of local or any other currency.

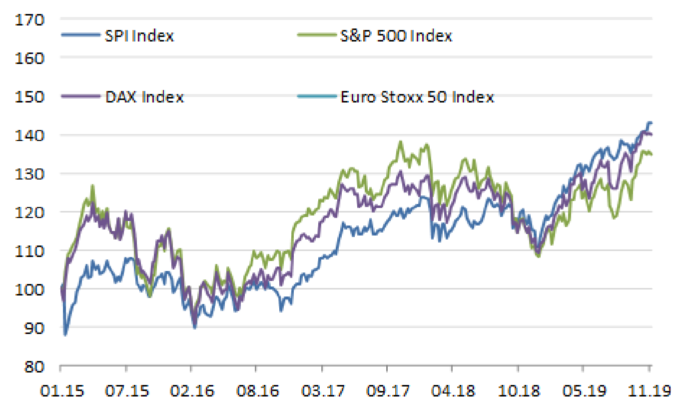
The persistently low rates in the Eurozone will likely lead to investors taking a renewed interest in European equities as well as to an expansionary phase for PEs.

Beyond the more attractive valuation levels, European companies also offer a clearly superior yield compared with US companies. Their 3.3% yield is thus 80% higher than the yield of S&P500 stocks on average (1.85%).

This valuation gap may be explained by the perception that European stocks are more sensitive to external shocks such as the slowdown in China and in emerging countries.

For now, investors may thus be more convinced by the capacity of US rather than European companies to withstand such shocks. Consequently, European equities will likely depend on better economic conditions to outperform.

European equities



Sources: Bloomberg, BearBull

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