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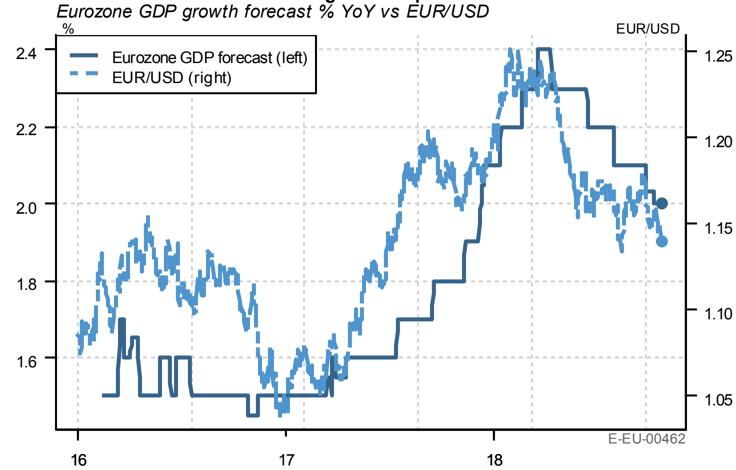
A European re-convergence: Today's note looks at prospects for European growth and ECB policy.

Europe: Germany, the ECB & everyone else

Are we seeing a bottom in European growth? The ECB sounded fairly bullish at its last meeting. This is an important question because it impacts the dollar (since the euro accounts for 58% of the currency basket against which the dollar is measured), and EMs, which export significantly to the Eurozone. Moreover, since 2017, growth forecasts have had a significant influence on the euro.

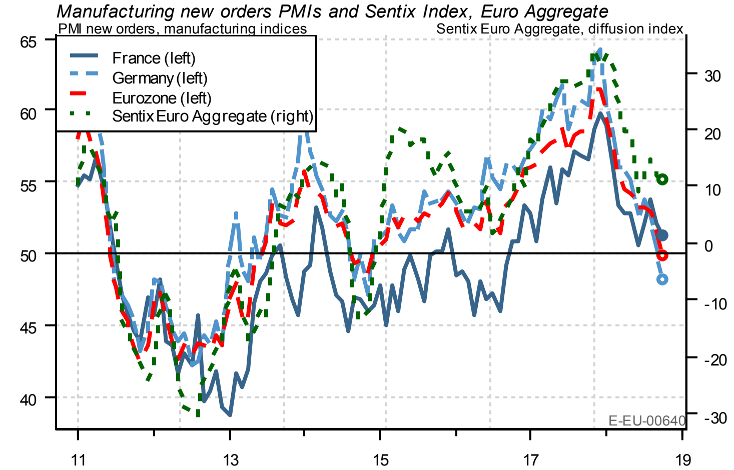
Eurozone growth expectations
Eurozone GDP growth forecast % YoY vs EUR/USD



Pavilion Global Markets (data via Bloomberg)
Shaded areas = U.S. recessions

Interestingly, the ECB's optimism stands in stark contrast to business survey data. 'Soft data' is often dismissed, but it sometimes leads hard data and therefore is useful to forward-looking investors. After a brief stabilization this summer, both the Sentix Euro Aggregate Index and the new orders component of manufacturing PMIs have continued to deteriorate. In fact, at the Eurozone and German national level, they are in contraction. These are hardly encouraging signs of a future stabilization in Eurozone growth.

Look out below!
Manufacturing new orders PMIs and Sentix Index, Euro Aggregate



Pavilion Global Markets (Markit, Sentix data via Bloomberg)
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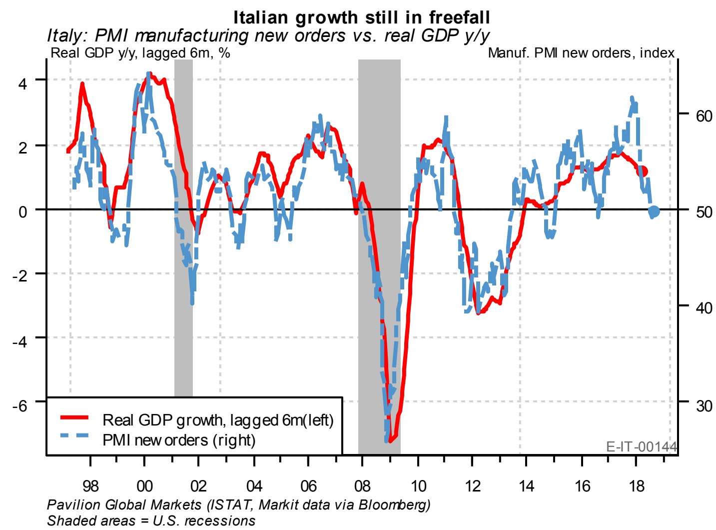
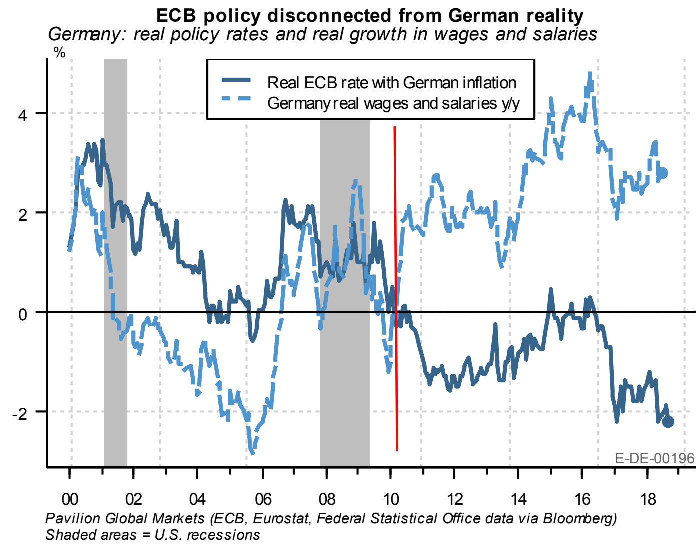
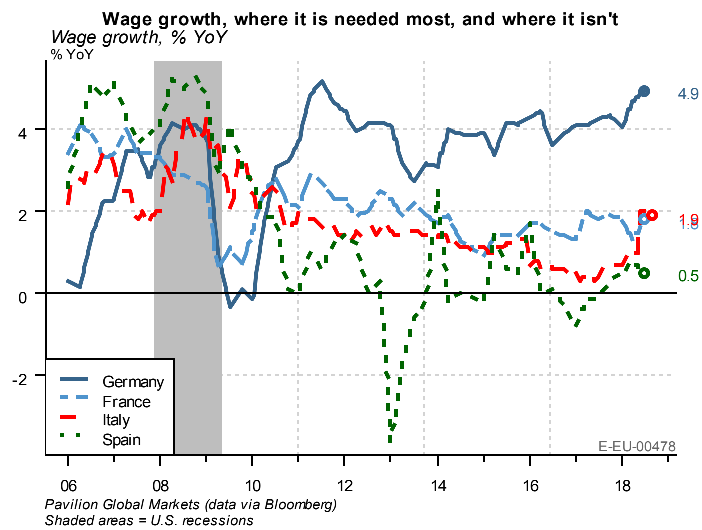
What is perhaps more striking about the ECB's fairly optimistic tone is that it is at odds with the economic deterioration in Italy, the bloc's third largest economy. Italian policy makers are in a tough spot; growth indicators are in freefall, very few structural reforms have been passed or implemented, and, in an unprecedented move, the European Commission has rejected Italy's draft budget, calling for the country to further reduce its fiscal deficit. This suggests Italy's growth outlook is likely to become increasingly strained, at a time when Italian debt sustainability has forced its way back into the global financial lexicon (see: *"Those three words: Italian government debt"*, Aug 9).



The challenge for the ECB, is that while it ostensibly conducts monetary policy for the bloc, German economic conditions have typically mattered most—until the GFC. At that point, ECB policy and German economic conditions became detached, as ECB policy focused on crisis mitigation. Now, there is a shift among global central banks, including the ECB, away from providing accommodation. This suggests we are seeing ECB policy reconnecting, albeit slowly, with German economic conditions, which warrant tighter policy.

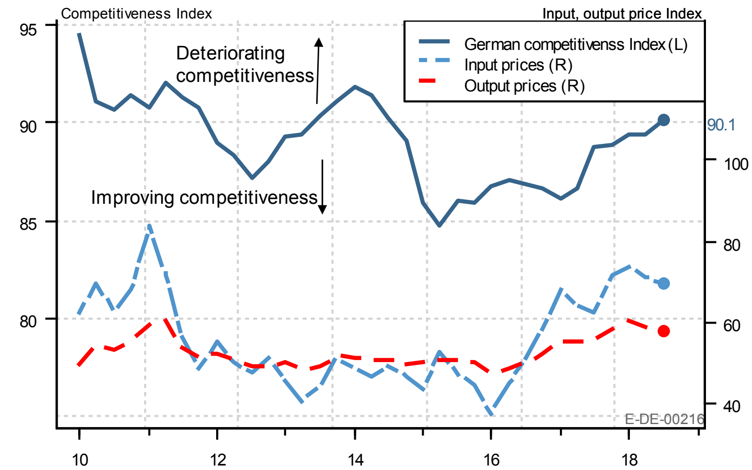


Indeed, German wage growth is currently running at about 5% year-over-year! This is very different than other large Eurozone economies, where wage growth has been uneven or showed only nascent strength, and in any event is paltry in real terms.



Very strong wage growth in Germany is beginning to impact competitiveness. Input prices are outpacing output prices for German manufactured goods, as wage growth and rising energy prices pinch manufacturers. At the same time, weaker economic conditions elsewhere—especially in Europe—have limited the ability of manufacturers to raise output prices.

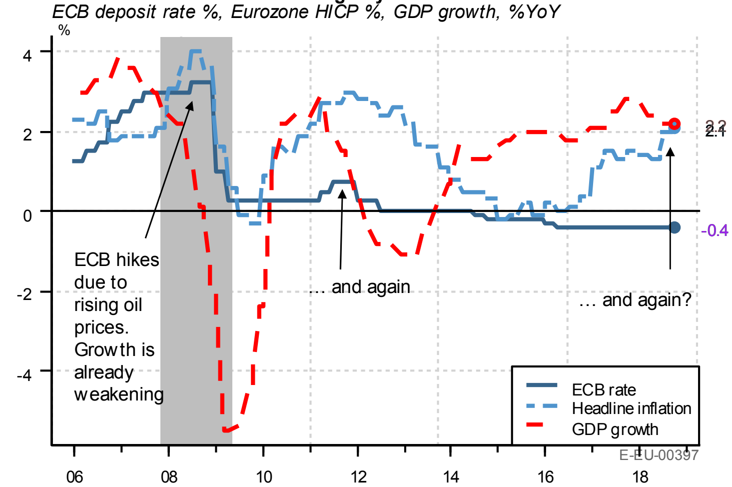
German manuf. competitiveness (higher=worse) vs. Manuf. PMI input/output prices



Pavilion Global Markets (ECB, Markit data via Datastream)
Shaded areas = U.S. recessions

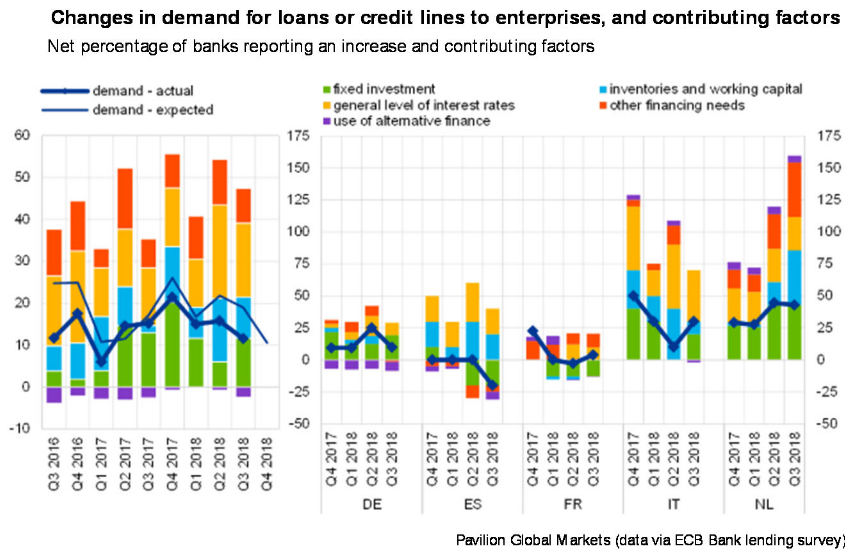
The ECB's move toward less monetary stimulus has been rooted in two developments. Firstly, headline inflation is rising at 2.1%, although core inflation remains rather subdued, at just 1.1%. Typically, central banks look through headline inflation, but the ECB has had the track record of tightening monetary policy in response to rising headline inflation, even when GDP growth was slowing. In this context, we would not be surprised to see the ECB continue to use the justification of rising headline inflation to reduce stimulus.

Groundhog day: ECB edition
ECB deposit rate %, Eurozone HICP %, GDP growth, %YoY

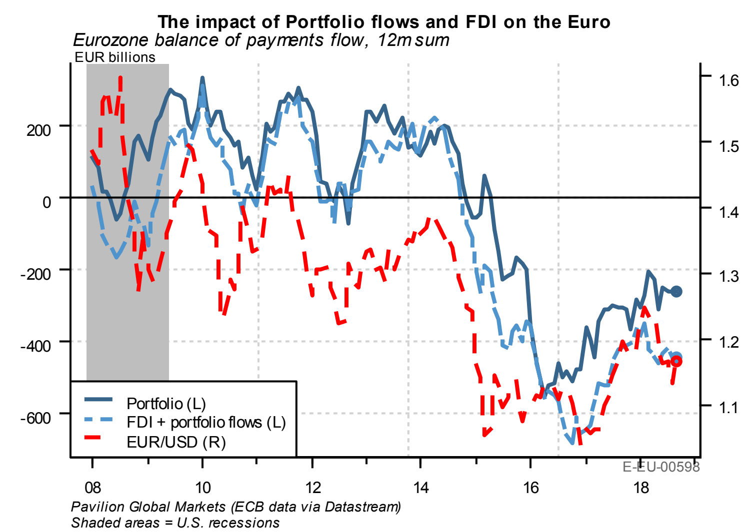


Pavilion Global Markets (data via Bloomberg)
Shaded areas = U.S. recessions

The second development that has provided the ECB some comfort in tightening policy is the recent improvement in credit growth across the bloc. However, looking at the ECB's own credit survey, three things become immediately apparent. Firstly, overall credit demand is slowing. Secondly, with the exception of Italy and the Netherlands, credit for fixed asset investment is slowing across the large Eurozone economies. Lastly, 'the general level of interest rates' appears to be the predominant reason for borrowing, suggesting credit demand is merely being pulled forward, before credit conditions tighten.



Tighter monetary policy and higher bund yields should attract savings back to the Eurozone, especially from German savers. The impact of this on the euro will likely be offset by weaker FDI and equity portfolio flows as interest rate and economic growth differentials continue to bolster the dollar.



Bottom line: The ECB appears ever ready to reduce monetary accommodation, despite waning economic growth across the currency bloc. This largely results in a nascent reconnecting of ECB policy to German economic conditions.

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