Macro Insight

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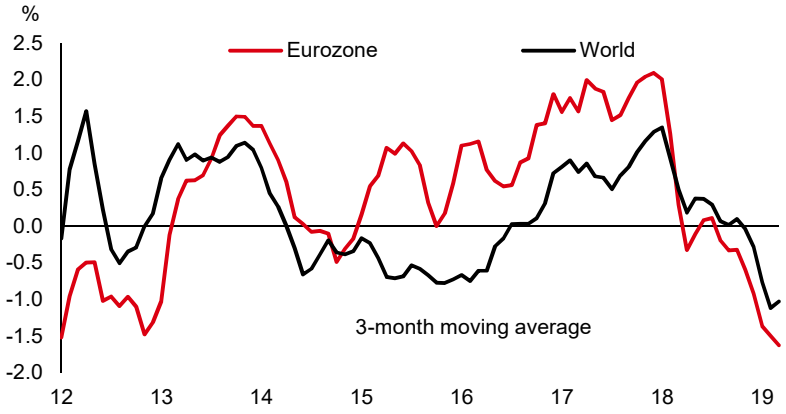
For Client Only

Eurozone: life in the slow lane

Eurozone economic growth has slowed markedly over the past year

Eurozone economic growth has slowed markedly over the past year. Our Nowcast, or "big data" approach to tracking the economic cycle, shows the deterioration has been greater than seen in the wider global economy (Figure 1).

Figure 1: Eurozone versus world Nowcast (difference from long term average)



Source: HSBC Global Asset Management, data as of 8 April 2019

The slowdown has been caused by a mix of cyclical and transitory factors

There is no one obvious reason explaining the slowdown, but rather we think a number of cyclical (or "fundamental") and transitory (or "temporary") factors have been at play. These are summarised in Figure 2.

Figure 2: What's behind the eurozone slowdown?

Cyclical		Transitory	
	Export growth has slowed amid weaker economic growth in China and regional trading partners (e.g. UK)		The **auto sector** has been hit hard by new emissions testing guidelines
	Industry facing **capacity constraints**, especially in Germany		**Extreme weather** has been disruptive, including heavy snowfall and a drought in the Rhine river
	The European Central Bank (ECB) ended its bond buying programme in December 2018		**Political uncertainty** (Brexit, Italy) has weighed on confidence. France has witnessed protests

Source: HSBC Global Asset Management, as of 8 April 2019

Germany has been hit harder than other eurozone economies, which is understandable given it is more exposed to Chinese demand, has a large auto sector and has been affected by the brunt of the bad weather.

Our views

We think a eurozone recession is unlikely this year, and thus remain comfortable to take advantage of favourable equity valuations in the region

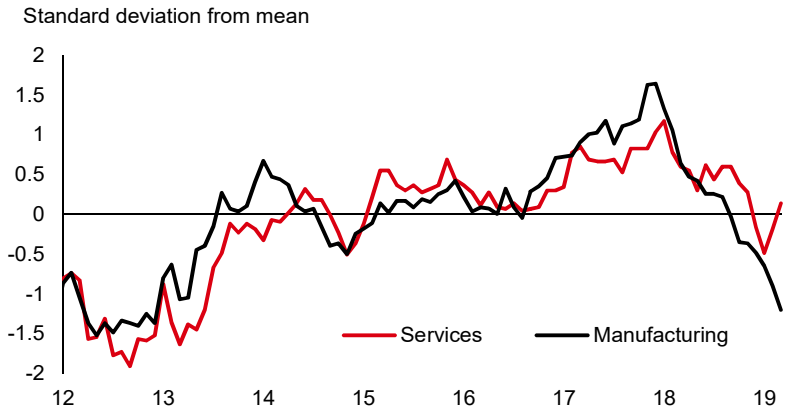
Current pessimism is overdone

A robust services sector is one reason to be optimistic about the growth outlook…

Despite the recent disappointing performance, we think there are a number of reasons to suggest current pessimism on eurozone growth is overdone.

1. **The eurozone services sector has held up relatively well** (Figure 3). This reflects a strong labour market and slowly rising wage growth. All in all, household spending power remains strong enough to keep domestically focused sectors of the economy in good health.

Figure 3: Eurozone PMI new orders

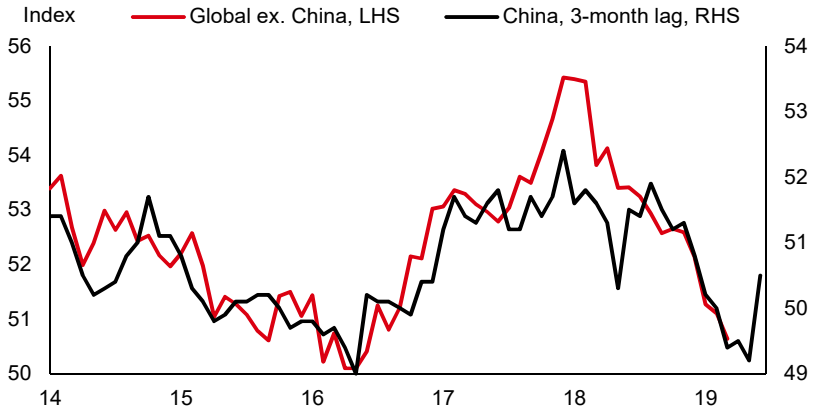


Source: HSBC Global Asset Management, data as of 8 April 2019

…while there is scope for a rebound in manufacturing

2. **Although the manufacturing sector is in a weak spot, there is scope for a rebound**. This could be driven by a recovery in China's economic growth rate just as a number of the above-mentioned transitory factors unwind. Recent PMI numbers from China are encouraging in this respect (Figure 4).

Figure 4: Manufacturing PMIs



Source: HSBC Global Asset Management, data as of 8 April 2019

The policy environment is also supportive. For example, interest rates will be on hold this year

3. **The policy environment remains supportive**. On the **fiscal front**, France is implementing an easing package this year in response to domestic discontent, while Italy's government is reversing the previous administration's plans to tighten policy.

   Meanwhile, the **ECB** has recently signalled that interest rates will remain unchanged for (at least) the rest of 2019. They are also planning to extend their programme of cheap loans to banks, which is important to support credit growth.

Market considerations

Pessimism around the eurozone growth outlook is unsurprising, and multiple risks require monitoring (China, trade tensions, Brexit/Italy). However, a solid labour market is buoying the domestic backdrop. The manufacturing sector can benefit from a potential rebound in Chinese growth and an unwinding of transitory disruptions. Policy is also supportive.

This gives us confidence that a **eurozone recession in 2019 is unlikely**. And with **eurozone equity** valuations still favourable (on a hedged basis), we believe they remain an **attractive proposition in global multi-asset portfolios**. This is in line with our overweight stance on global equities more generally.

One implication of more dovish monetary policy has been **valuations in the bond space being stretched further**. We believe it makes sense to remain underweight eurozone government and investment grade corporate bonds, although high-yield bond valuations are more consistent with a neutral positioning, in our view, and default rates remain low.

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