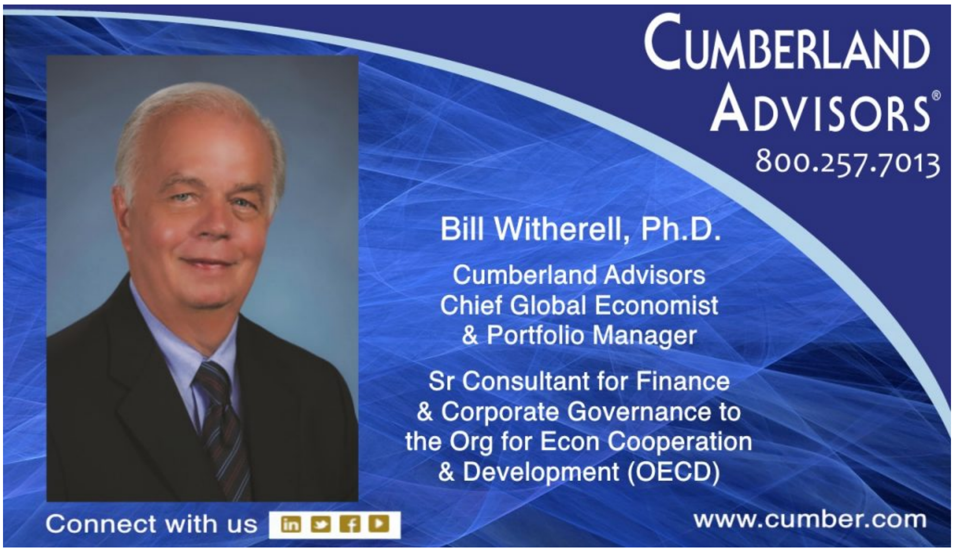
European Growth Concerns Deepen

The latest economic indicators reveal that the economic slowdown in Europe persists. President Draghi of the European Central Bank (ECB) has underlined the continued weakness, expectations for softer near-term growth, and downside risks. The International Monetary Fund (IMF) has lowered its economic projections for the euro area. Political uncertainties in Europe add to the headwinds affecting investor sentiment.



The HIS Markit Flash Euro Area Composite Purchasing Managers' Index (PMI) , which combines manufacturing and service sector data, fell to 50.7 for January, following a reading of 51.7 in December. The January mark was significantly weaker than the consensus expectation of 51.4. The moderation in the euro area's economic growth, which began a year ago, is continuing in the first quarter of 2019.

The Flash Composite PMI for France fell unexpectedly to 47.9 because a sharp drop in the services component more than offset a pick-up in the manufacturing component. Conversely, the Flash Composite PMI for Germany recovered slightly to 52.1, following a 66-month low of 51.6 in December. A further decline in the manufacturing component was offset by a stronger performance in the services sector. Adding in the other euro area economies, we observe overall declines in both manufacturing and services PMIs for the region. Manufacturing new orders as well as services incoming new business fell in January.

The IMF, in the quarterly update of its World Economic Outlook, lowered its projection of economic growth in the euro area to 1.6% in 2019. Last fall, their projection was for 1.9% growth. They continue to expect 1.7% growth in 2020. Subdued external demand due to a projected global growth slowdown is one reason for this weaker outlook for the euro area, particularly for Germany. The IMF cites some country-specific factors affecting the near-term outlook: revised auto emission standards in Germany, weak domestic demand and higher borrowing costs in Italy, and demonstrations and strikes in France.

The ECB Governing Council at its January meeting also warned that near-term growth prospects have softened. While markets will have to wait until the Bank’s March meeting for new economic projections, the risk assessment guidance has “moved to the downside.” Mario Draghi, ECB president, said, “We were unanimous about acknowledging the weaker momentum and changing the balance of risk for growth.” The Governing Council cited the continuing uncertainties of Brexit and trade disputes as important downside risks for the region. While the ECB did not announce any change in policy, market expectations for a rate increase later in the year have weakened. On the other hand, a new round of long-term refinancing operations (TLTROs) is looking more likely.

Euro area equity markets have joined in the global equity market recovery in January but are down significantly over the past 12 months. The iShares MSCI Eurozone ETF, EZU, is up 6.0% year-to-date January 25 but is still down 20.5% over the last 12 months. Similarly, the iShares MSCI Germany ETF, EWG, is up

6.3% year-to-date but down 23.7% over the past 12 months. The iShares MSCI France ETF, EWQ, is up 4.1% year-to-date and down 17.2% over the past 12 months. In these and the other euro area markets, the moderation in the euro area’s economic growth appears to be largely priced in. Also, several of the negative factors are likely to prove transitory, including the new emission standards in Germany and the demonstrations in France. While the uncertainties relating to Brexit remain high, the tail risk of a hard or no-deal break of the UK from Europe appears to have been substantially reduced. Positive developments with respect to Brexit and/or an easing of trade disputes with the US would certainly be welcomed by investors. We remain cautious with respect to the euro area in our International and Global portfolios, monitoring developments closely.

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Sources: Financial Times, Markit Economics, International Monetary Fund, Goldman Sachs Research, BBH Global Currency Strategy

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