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# Let's Hope the Good News Keeps Coming - but don't Rely on the Eurozone to Deliver

- **Markets have started the year on a positive note**
- **Investors hope that this week's trade talks will deliver further good news**
- **It's probably a little late to be jumping into the current rally in equities**
- **Structural problems still hold back the eurozone economy and the euro**

Risk markets have continued their rebound through the early weeks of the year. However, as our feature article on the eurozone explains there are still structural challenges ahead. In the near term, it feels like equities can make a little more progress. The S&P 500 at 2664 appears to be targeting the 2700 level with a shot at the peak of the fourth quarter of 2800. If the Chinese and US were able to find a trade deal, together with a permanent re-opening of the US government, the markets could push on. However, we would caution investors to remember the recent low for S&P 500 of 2351, some 12% below current levels. That is the measure of potential losses an investor can make for jumping into the markets so late in the rally.

**Feature – Eurozone economy struggling to structurally reform**
It looks as if a mid-winter chill has descended on eurozone growth prospects. Over the last two weeks, we have seen a cascade of negative news. Even in Germany industrial production slid late last year to leave the economy close to a recession. Italy looks to have again entered a recession is due to the market fall-out from the struggle between its government and the EU Commission. Economists expect the EU to record growth just below 2% in 2018, and only 1.5% in 2019. Although this level of growth is close to the region's sustainable rate of growth, there is a still a sense that further disappointments lie ahead. The pace of manufacturing activity is running at the weakest in five and a half years, based on surveys of eurozone industrial confidence. A report in the media last Friday indicated that the German government is now in effect only expecting 1% GDP growth in 2019 as against 1.8% expected just months ago.

Economists had previously tried to explain away the eurozone slowdown on one-off factors such as emission regulation changes in the car industry or the civil unrest in France. However, the eurozone manufacturing cycle has been slowing since early 2018 in line with the emergence of serious global challenges. The slowdown in Chinese growth and the US Administration's aggressive trade negotiations have proved to be a drag on most major

economies. That sugar rush of rising export demand after weakness in the euro so apparent in 2017, is undoubtedly now past and the region must look to support closer to home. Brexit is still a real and present risk to growth especially in a no-deal outcome that would primarily affect France and the Benelux economies this year if ports are congested.

It's not all bad news. There is some undeniably good domestic news. Factors that impaired domestic demand during the eurozone crisis are not so present today. Rising employment and real income growth should support private consumption. Unfortunately, monetary conditions are mixed. There is some lending growth. However, credit expansion is uneven as banks in some countries (Italy for instance) try to shed bad loans. That said, measures of narrow money supply growth, which is correlated with domestic spending, remain solid. Indeed, overall credit growth is still positive however the ECB is slowly retreating from its support of lending through the quantitative easing.

The absence of a robust trend in investment spending is a concern for the markets. Without investment, we struggle to see how the EU's region’s productivity will advance. Unfortunately, the ongoing weakness of industrial confidence is restraining investment spending. In December 2018, the purchasing managers reading for eurozone services sector was the lowest since November 2014 as new business growth and business confidence weakened.

The weak economic news flow over the year-end, has also triggered real angst over the structural, long term outlook for the region, coming on the 20th anniversary of the introduction of the euro. The Economist magazine was scathing about the eurozone growth record since the financial crisis…'Greece has been outgrown by Sudan and Ukraine. Cyprus and Italy have been beaten by Brazil and Iran; France and the Netherlands by Britain'. The magazine lays the blame for the disappointment at the door of excessive fiscal austerity. That looks doubtful as in an ageing population any such stimulus is only likely to be seen as taxes in the future. In any event, eurozone governments in aggregate may be stimulating activity in the coming years. The critical disappointment we feel is the fact that the real benefits of a single currency area haven’t been allowed to emerge. At a time when its real rigidities are helping to depress confidence and investment. A reformed, fully developed euro area with a common budget addressing weak areas, a transfer union or safe asset as a risk-free option, unified pooling of risk in banking and a proper deposit insurance framework. It may all sound like a pipe-dream still, but the current, half-baked structure still looks vulnerable in the coming downturn.

Where does this leave the ECB? So far calm and measured, but last week we saw the first signal of concern that the current slowdown is more than a blip, prompting hints of a future downgrade to forecasts. Having halted asset purchases just weeks ago, the Council may have to sit on its hands to see how China-trade tensions work out. Where they will still focus of course is on ensuring only an acceptable rise in the cost of funding to the banks as well as adequate credit availability overall. It will be a year for patience but then action if growth drops markedly.

Eurozone asset markets have made progress like others since the start of the year but still largely failed to outperform – something we expect to continue. To be fair, the market’s

performance is far better than the domestic economy. However, the euro has failed to take advantage of all of the issues facing the dollar in part because the market believes that the balance of risks remains that US monetary policy will remain tighter than the eurozone for the foreseeable future.

The markets' focus this week will be on the US-China trade talks with the two sides meeting in Washington. The meeting will provide a forum for the two teams to map out a way forward that can be presented back to the respective Presidents in the hope that they can reach an agreement before the deadline of March 1st. In our view, the markets have already discounted a positive outcome so anything that suggests the talks are stuttering would probably lead to a setback in equity markets in particular.

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