# Macro Keys
## Eurozone: What's important for the rest of 2016?

Economics

Global

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**After a solid first half, what are the main themes for the rest of the year?**
The Eurozone economy has weathered the turbulence of the H1-16 surprisingly well – average quarterly GDP growth rates were well above trend. Initial evidence also suggests that the growth impact of the UK Vote to Leave is likely to be moderate. What should we expect for the rest of the year? We see three themes and two risks.

**First, referendum fallout stronger in manufacturing than in services**
Sentiment indicators post-June on balance suggest that heightened uncertainty has only had a moderate adverse impact on investment so far for the Eurozone. This is also corroborated by our Evidence Lab survey of Eurozone corporates. Some weakness is visible in the manufacturing sector, but should continue to be outweighed by gains in the quantitatively more important services sector. Consumer confidence has remained very robust. We forecast Eurozone GDP to grow by 0.2-0.3% q/q in H2 – slower than in H1 (average 0.4%), but not dramatically so. Manufacturing PMIs indicate that cross-country divergence of growth is set to increase. Italy registered particularly large declines after the UK referendum, while the Netherlands seems less affected.

**Second, headline inflation to rise – and maybe core as well**
With the energy price drag waning, headline inflation is set to rise towards the end of the year, to perhaps 1% y/y, from 0.2% in August. This may also lift core inflation from its 0.8% level, as components such as transport prices were also downwardly affected by energy prices. However, oil prices present a big two-way risk for inflation. Underlying price pressures in Germany have increased, presenting further upside for Eurozone inflation, though it is unclear how swiftly these will be reflected in core CPI.

**Third, more monetary and probably also more fiscal stimulus**
We still assume the ECB will eventually decide on an extension of QE beyond March 2017, but believe it is likely to wait with a decision until 8 December. Communication challenges will be formidable, not least because of the rise in inflation in the meantime, suggesting potential for volatility. Technical changes to the public sector purchase programme might well happen earlier. More stimulus may also come from fiscal policy. Continuing declines in government interest payments in the low yield environment provide room for manoeuvre for public spending, and we have argued before that public spending is a powerful transmission channel of ECB QE. We expect governments to use this fiscal space, especially ahead of the elections in France and Germany next year. Discussions about tax relief for households are already in full swing in Germany.

**Fourth, political risks back in focus**
European political uncertainty will continue in H2. High on the agenda is the Italian constitutional referendum in the fall. Expectations that Prime Minister Renzi would step down if the reform is voted down in the referendum have declined following the announcement of new general elections in 2018 (regardless of the outcome). However, the proposed changes to the setup of the Senate stated in the referendum are seen by political observers as an important structural reform, implying potential for disappointment if voted down (even if not followed by a leadership change).

**Fifth, don't forget about external risks**
The focus is on European domestic uncertainties, but external risks have not gone away. The Fed is expected to hike rates (we think in December). While our base case is for a modest GDP growth slowdown in China in H2, our analysts argue that one should not lose sight of the downside risks. While we believe the Eurozone's domestic demand-led growth remains relatively resilient against shocks, a combination of political uncertainty and a sufficiently large external shock could well tilt the balance.

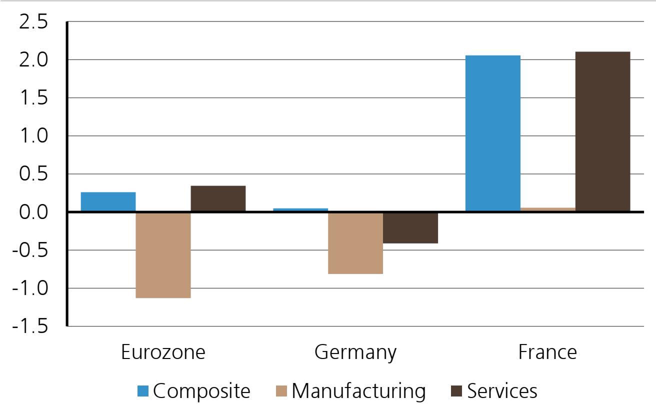
## First, referendum fallout stronger in manufacturing than in services

As we have argued recently, sentiment indicators post referendum have been mixed so far, but overall suggest only a moderate adverse impact on investment in the short run for the Eurozone. This is also corroborated by our Evidence Lab survey of Eurozone corporates. Weakness is more visible in the manufacturing sector, but should continue to be outweighed by gains in the quantitatively more important services sector (Figure 1). Consumer confidence has remained very robust – consumers' propensity to make major purchases stands at a 15-year high (Figure 2).

We believe Eurozone GDP will likely grow by 0.2-0.3% q/q in H2 – thus slower than in H1 (average was 0.4%), but not dramatically so. Our alternative downside scenario, with growth essentially grinding to a halt in H2, looks increasingly unlikely. That said, manufacturing PMIs indicate that cross-country divergence of growth will likely increase. Italy registered particularly large declines after the UK referendum, while the Netherlands seems less affected (Figure 3).

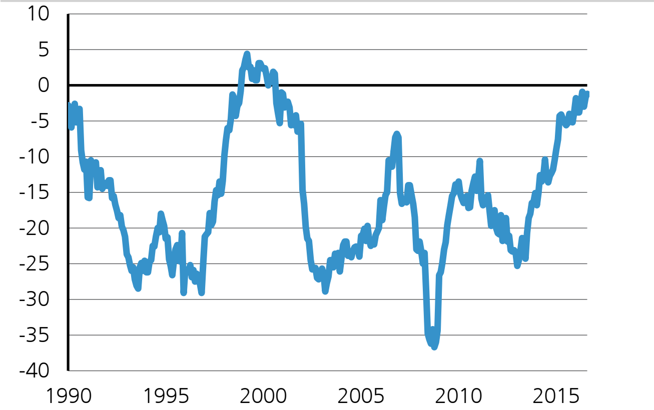
The next important data releases are the flash European Commission Consumer Confidence on 22 September and the September flash PMIs on 23 September.

**Figure 1: Change in PMIs post-UK referendum**



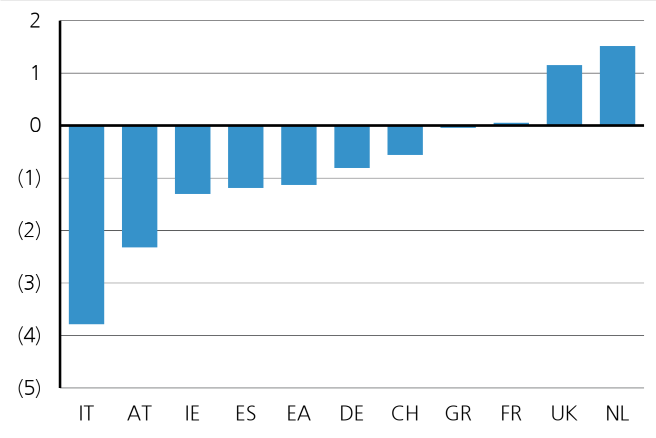

Source: Haver, UBS

**Figure 2: Eurozone – consumers' propensity to make major purchases, % net balance**



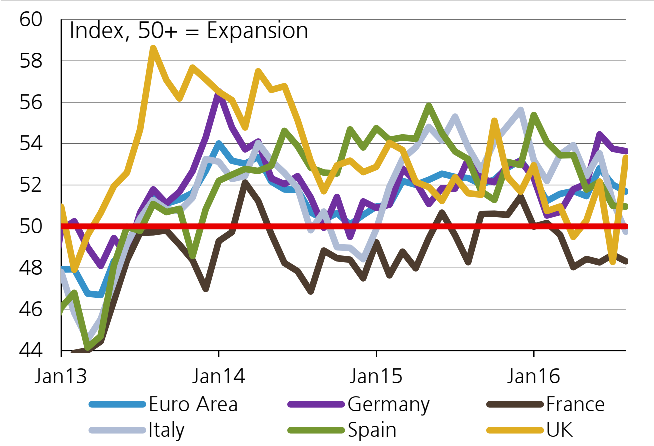

Source: Haver, UBS

**Figure 3: Change in Manufacturing PMIs, August vs June**




Source: Haver, UBS

**Figure 4: Manufacturing PMIs**




Source: Haver, UBS

## Second, headline inflation will rise – and maybe core as well

As past energy price declines gradually filter out of annual consumer prices, headline inflation is set to rise towards the end of the year, to perhaps 1% y/y, from its August level of 0.2% (Figure 5). This may also lift core inflation somewhat from its 0.8% level, as components such as transport prices were also downwardly affected by energy prices. However, oil prices present a big two-way risk for inflation. Apart from the energy price effect, underlying price pressures in Germany have increased, presenting further upside for Eurozone inflation, though it is not clear how swiftly these (in particular higher housing rents) will be reflected in core consumer prices.

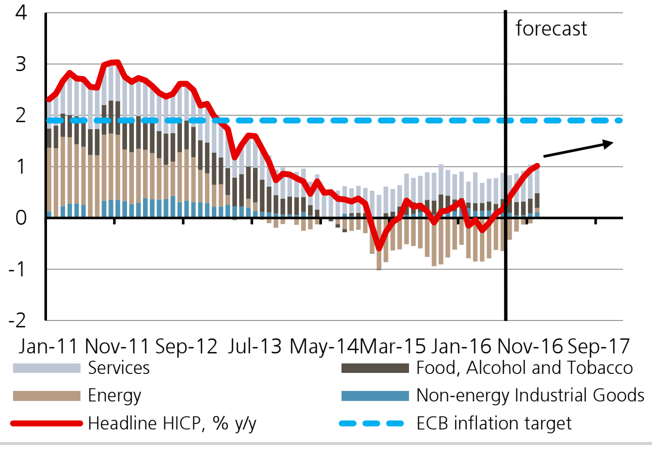
The next HICP flash release is on 30 September.

## Third, more monetary and probably also more fiscal stimulus

The ECB will be relieved to find that the adverse growth effect of the UK Vote to Leave will only be moderate in the short term. We still assume the ECB will eventually decide on an extension of QE beyond March 2017, but believe it is likely to wait with a decision until 8 December (see ECB: What should we expect next week?). However, communication challenges will be formidable, not least because of the rise in inflation in the meantime, suggesting potential for volatility. Technical changes to the public sector purchase programme might well happen earlier, potentially next week or on 20 October.

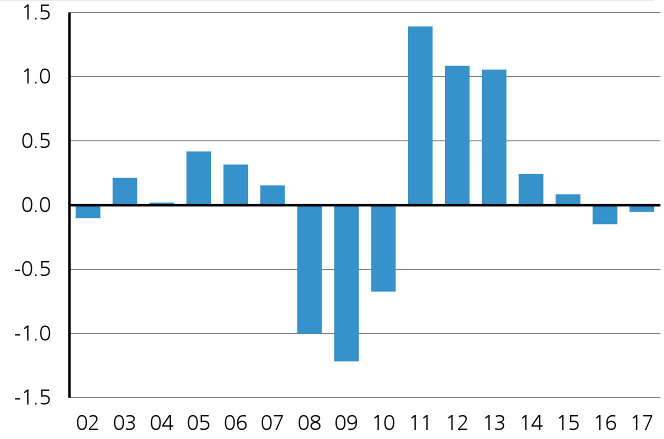
More stimulus may also come from fiscal policy. Continuing declines in government interest spending in the low yield environment open up more room for manoeuvre for public spending (at least for headline deficits), and we have argued before that hence public spending is a powerful transmission channel of ECB QE (Figure 6). We expect governments to use this fiscal space, especially as we get closer to the major elections in France and Germany next year. Discussions about tax relief for households are already in full swing in Germany.

**Figure 5: Contributions to Eurozone HICP inflation, pct pts**




Source: Haver, UBS

**Figure 6: Eurozone – fiscal impulse, change in cyclically-adjusted budget deficit, % of GDP**



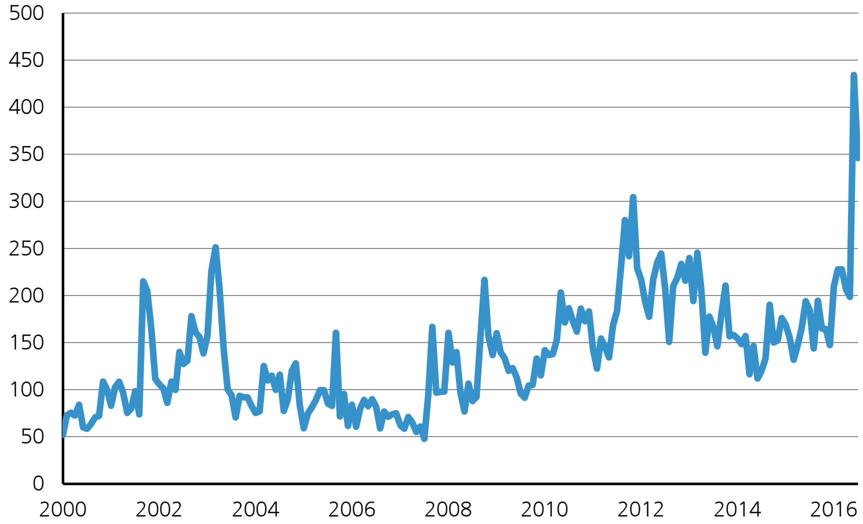

Source: Haver, UBS

### Fourth, political risks back in focus

European political uncertainty will continue to be a factor in H2 (Figure 7). High on the agenda is the Italian constitutional referendum, which is likely to take place in October/November. Expectations that Prime Minister Renzi would step down if the reform is voted down in the referendum have declined somewhat following the announcement of new general elections in 2018 (regardless of the referendum outcome). However, the proposed changes to the setup of the Senate stated in the referendum are seen by political observers as an important structural reform, implying potential for disappointment if voted down (even if this were not followed by a change in leadership).

In September, German elections will take place in the state of Mecklenburg-Vorpommern (4 September) and Berlin (18 September). They will be watched for gauging the mood of German voters ahead of general elections in September 2017. There may also be more news about the eventual UK exit from the EU – including a clear date for triggering Article 50 – which may shift sentiment in either direction. We believe the potential adverse impact of political uncertainty is higher on business investment than on private consumption.

**Figure 7: European Economic Policy Uncertainty Index, Mean=100**




Source: Haver, UBS. Note: Index is constructed based on European newspaper articles regarding policy uncertainty; see www.policyuncertainty.com

### Fifth, don't forget about external risks

The focus is mostly on European domestic uncertainties currently, but external risks have not gone away. The US Federal Reserve is expected to hike rates (we believe most likely in December, see Digging out at Jackson Hole?) and the presidential elections take place in November. And while our base case is for only a modest GDP growth slowdown in China in H2, one should not lose sight of the downside risks (see What Might Disrupt the "China Calm"?). While we believe the Eurozone's domestic demand-led growth remains relatively resilient against shocks, a combination of political uncertainty and a sufficiently large external shock could well tilt the balance.

## Valuation Method and Risk Statement

Risks include macroeconomic variables (such as GDP growth rates and inflation), economic slowdown, a weakening currency, global economic events, and government policy changes.

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