GIAM Macro & Market Research - Market Commentary

January flash PMIs' fall a further blow to the ECB's benign base case

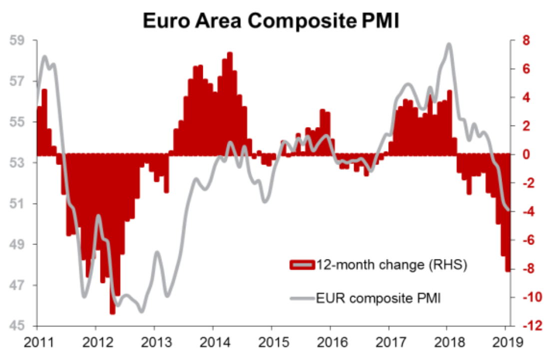
- **With a reading of 50.7, the euro area composite flash PMI for January fell to the lowest level since July 2013 amid employment creation losing steam.**
- **The deterioration in sentiment was mainly driven by faltering service sector sentiment in France suggesting ongoing headwinds from the yellow vests.**
- **Today's PMI data would suggest a meagre Q1 GDP growth rate of just 0.1% qoq, highlighting downside risks to euro area activity and the domestic recovery.**
- **The January PMIs are a further challenge to the ECB's benign macro scenario.**

Dear Colleagues,

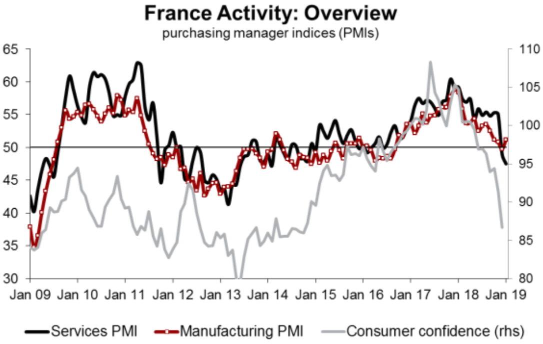
This morning the release of the January flash PMIs for the euro area again defied expectations of a rebound and continued to weaken further. The euro area flash composite PMI was reported at 50.7, down from 51.1. Among sectors, confidence receded in the service sector (50.8, from 51.2) as well as in the manufacturing sector (50.5, from 51.4).

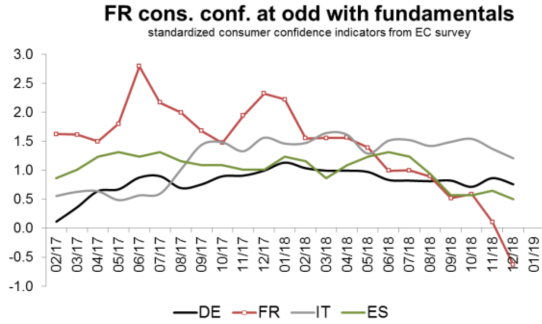
Taking a deeper look into the euro area PMIs, we have the following observations:

1. Following a surprising rise of the ZEW earlier this week, today's release of the January Flash PMIs **defied expectations that sentiment would stabilize on a broader basis**. The January composite PMI reading is the lowest since July 2013 and 0.3 standard deviations below average.



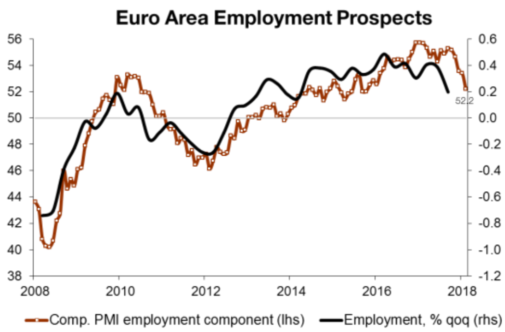
2. Among countries, the development was heterogeneous: Whereas the German flash composite PMI advanced for the first time since August 2018, the French equivalent receded, plummeting to 47.9 (or 0.8 standard deviations below normal), the worst reading since December 2014. This difference is mainly due to the fact that service sector sentiment rebounded in Germany (to 53.1, from 51.8) but fell significantly further in France (to 47.5, from 49.0). We conjecture that the poor development in France is due to the **yellow vest protests** that dampened sentiment and new business expectations.

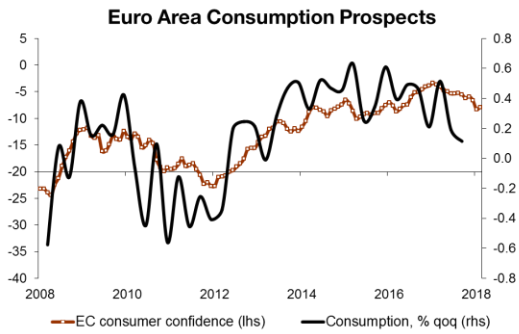




3. Forward-looking components gave differing signals: On the euro area level service business expectations stabilized and export orders improved whereas the deterioration of composite new orders and manufacturing new orders continued. However, the fact that "new business" receded also within the German service sector PMI suggests that a **broader based moderation of activity in the European service sector is ahead**. Also, the employment component of the composite PMI – while continuing to signal expansion – weakened. Moreover, today's PMI data also imply that in Italy, Spain and Ireland (for which flash PMIs are not released) composite PMI sentiment receded on average 0.4 by index points. All in all, these readings suggest that a **swift recovery of sentiment does not look likely**.

4. Apart from the yellow vest protests in France, it seems that **trade related uncertainties** as well as **concerns about an unorderly Brexit** among firms are taking their toll. All in all, the January PMIs question the strength of the euro area recovery as the level of the composite PMI implies a growth rate of only 0.1% qoq which would be even below our projected Q4/2018 GDP growth rate of ¼ % qoq. With the PMI approaching the threshold of 50, the **risk of stalling activity and hence a derailing of the domestically driven recovery increases**.





5. Looking ahead, however, we conjecture that successful trade negotiation between the US and China but also between the US and the EU as well as the ultimate elimination of the risk of an unorderly Brexit will reduce uncertainty and thereby support activity again. However, the poor start into the year by the PMI's highlights the downside risks to activity. If by and large confirmed also by other indicators we will **need to adjust our 2019 euro area growth forecast of currently 1.4% to the downside**.

6. Latest comments from ECB officials – e.g. Mersch stating that slowdown was broadly in line with the base scenario – increasingly look optimistic against today's PMI data. There is an increasing probability that the **ECB will have to adjust its growth projections** (according to December 2018 projection 1.7% for 2019/20) **further to the downside** when updated in March. Moreover, the January sentiment data will give tailwinds to the voices in the Governing Council pledging for a postponement of the first rate hike, maybe even by means of adjusting the forward-guidance.

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