Economic Insight

The Eurozone: Where do we go from here?

21 May 2015

Here is a sight you seldom see: the Eurozone economy outgrowing both the US and UK. The first estimate of GDP* growth for 2015 Q1 showed the region expanding by 0.4%, compared with 0.1% in the US and 0.3% in the UK. Spain was the star turn, at 0.9%, with France a surprise winner, too, at 0.6%. Germany and Italy put in pretty solid performances, at 0.3%, and even Greece – while once more back in recession – shrank less than expected. It isn't only in its data that the Eurozone has surprised in recent weeks: the region's bond markets have been exceptionally volatile, with German bunds giving up around five months' worth of price gains in the space of little more than five days. To what extent, if any, are the two events connected – and what do they tell us about the outlook for Eurozone activity and markets?

The data have certainly given Eurozone bond markets pause for thought, not only on activity but also inflation. The latest headline consumer prices index (CPI) shows the region pulling out of a four-month period of deflation, with prices unchanged in the year to April. Furthermore, rising oil prices – up at $65 per barrel (pb) on the Brent crude measure, from a low point earlier in the year of $45 pb – will, if sustained, tend to push up headline CPI inflation rates relative to expectations during the remainder of the year. The acceleration in GDP in Q1 also appears to confirm the European Central Bank's (ECB's) view that the risk of serious deflation is receding as labour markets strengthen, consumer demand picks up and improved credit flows encourage investment activity. Taking their cue from the data, therefore, the region's bond markets seem to have reined back their worst fears on deflation risks.

Even so, the numbers hardly justify the full extent of bond-market moves. The region's growth record may be improving, but it is far from stellar: over the year to date, the Eurozone expanded by only 1.0%, while the UK grew by 2.4% and the US 3.0%. Furthermore, the Eurozone's GDP outperformance in Q1 was flattered by the negative impact of severe weather on the US economy. Plenty of spare capacity remains, given an unemployment rate of over 11%, and we expect inflation to trail the ECB's target of "below but close to" 2% for several years to come – even by 2018, Eurozone CPI is projected to average only 1.6%. Deflation worries may have receded, but this does not mean that we have moved seamlessly into a world of 'reflation' risks.

More likely, the data impact has been boosted by technical factors, such as overcrowding of investor positions. In other words, if large numbers of investors were betting that bond yields would only fall – on the assumption that heavy ECB bond-buying under the quantitative easing (QE – the central bank's policy of introducing new money into the monetary system) programme would support prices (which move inversely with yields) – then the change in the tone of data, reduction in deflation risks and resulting speculation that the ECB would 'taper' its QE purchases may have caused a general move for the exit that amplified what would otherwise have been a more muted market response.

*GDP=Gross Domestic Product, the total value of all the finished goods and services produced in a country annually.

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So where do we go from here? Three factors could play a part. First, the data: a return to negative inflation or disappointment on the activity side could tempt investors back into their low-yield bets. Second, market views on central bank actions are likely to be pivotal. Any hint that the ECB could add to bond purchases, either in response to weak data or increasing risks (Greece being the most obvious at present), could renew downward pressure on yields. Equally, signs of a pick-up in wage or price inflation, or accelerating activity, could cause another bout of speculation over ECB 'tapering' and a snap back up in yields. And the ECB will not be the only central bank influencing bond markets in the months ahead – far from it. US Federal Reserve rhetoric on the timing and path of prospective rate rises is at least as likely to weigh on investors' minds. Finally, technical factors such as investor positioning or regulatory pressures could continue to amplify or dampen down policy- or data-driven influences.

Given the range of factors involved, a sustained move in one direction seems improbable. Volatility is far more likely to be the order of the day, over the next few months at least.

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Economic insight 21/5/15