September 6, 2019

The Eurozone heads towards recession

Governments need to act decisively to alter the economy's course

Eurozone data remain weak and the risk of recession is increasing. In fact, Germany may already be in recession. To avoid the whole region gradually slipping into contraction, governments need urgently to support growth by increasing fiscal stimulus. Without it, action by the ECB alone might boost investor risk appetite in the short term but is unlikely to be enough to prevent a further slowdown.

Source: Istock

Losing steam

The Eurozone economy is losing momentum and could be entering recession within the next few quarters. GDP growth fell to just 0.2% QoQ in Q2 from 0.4% in Q1. Forward-looking business surveys suggest economic momentum could deteriorate further from here.

Indeed, Germany may already be in technical recession (defined as two consecutive quarters of falling GDP). Its economy contracted by 0.1% QoQ in Q2, driven by a sharp decline in exports, and the Bundesbank expects a negative print for Q3 as well. France and Spain are more resilient for now, but are unlikely to avoid a slowdown if the rest of the Eurozone weakens as well.

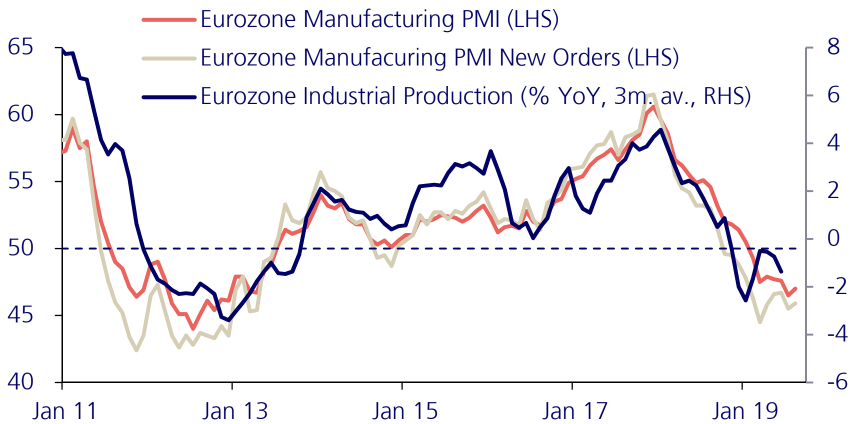
The manufacturing sector is already in recession

Industrial output growth has been negative or flat on a YoY basis since November 2018.

What's more, the Eurozone manufacturing PMI, a useful leading indicator, is well below the 50 expansion/contraction mark and close to its lowest levels in almost seven years.

Admittedly, some indicators within the survey, such as new orders, have stabilised in the past few months. However, this stabilisation is at very low levels still consistent with contraction and with no sign of a convincing rebound. Sentiment is also extremely vulnerable to an increase in global trade tensions.

Manufacturing is already in recession



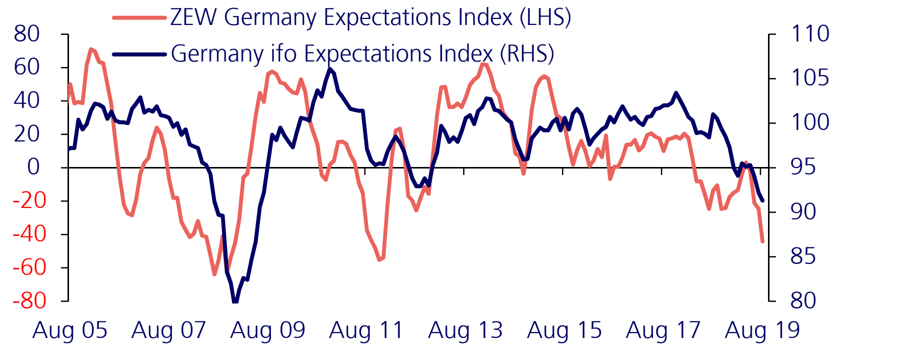
Source: Markit, Bloomberg

Germany under pressure

Indeed, the Eurozone's largest economy, Germany, has been particularly badly affected by the US-China trade war and the slowdown in China's economy and in other emerging markets. The move away from diesel and petrol fuelled vehicles towards electric vehicles has also impacted demand for German cars. More recently, the uncertainty created by Brexit has also had a negative impact.

The ifo survey of around 7,000 German businesses has declined to its lowest levels in seven years, and the German ZEW expectations survey is at levels last seen in 2008 and 2011, when in the throes of the Global Financial Crisis and European Debt Crisis, respectively.

Business confidence is plummeting in Germany



Source: Bloomberg

Manufacturing weakness is transmitting to services …

Confidence in the more domestically focused Eurozone and German service sectors, which had been more resilient up to now, also appears to be softening. This is a concern, because downturns often show up first in the manufacturing sector before moving into the service sector as manufacturing tends to respond more quickly to changing demand conditions. In addition, as companies cut back on hiring, consumer spending growth slows, impacting the more consumer focused service sectors. Indeed, wage growth has recently started to slow, and companies are reporting lower hiring intentions in both the services and manufacturing sectors.

… increasing the risk of recession

All this points to a further deceleration in Eurozone activity over the next few quarters from already weak levels, especially as we expect the US economy to continue slowing into 2020 as well.

Stimulus from China, which had played an important part in boosting Eurozone growth in 2016 and after the Global Financial Crisis, has also been much less aggressive this time around.

The upshot is that the Eurozone economy, which was growing at a trend-like but slow pace of around 1% over the past few quarters, is gradually edging towards stagnation and probable recession given current policies and our assumptions for global growth in 2020.

Low trend growth means the Eurozone is often susceptible to shocks

One of the Eurozone's main problems is that long-term or 'trend' growth is low, estimated to be only around 1% YoY, so it does not take many external or internal shocks to push the region into contraction.

In contrast, trend growth in the US is closer to 2% and its economy is less reliant on demand for its exports, giving it more resilience to external shocks in particular.

In addition, weaknesses in the Eurozone banking sector as well as the difficulties in coordinating the many countries and political systems of the region can all act as amplifiers to shocks, making their impact worse than they might otherwise have been.

The ECB has promised more stimulus …

At the latest ECB monetary policy meeting on July 25, it was strongly hinted that the central bank would soon announce a range of policy measures in an attempt to boost growth and inflation in the Eurozone. The introductory statement to the press conference was changed to emphasise that the ECB Governing Council (GC) expects interest rates to remain at present 'or lower' levels, suggesting a further cut to the deposit rate.

The statement also revealed that the ECB had tasked relevant committees to design a new quantitative easing (QE) asset purchase programme and look into tiering of interest rates or other mitigating measures to reduce the drag on bank profitability from negative interest rates.

We expect that at its next monetary policy meeting on September 12, the ECB will formally announce that it is cutting the deposit rate, by 10bps, to -50bps, (it may even cut by 20 bps), as well as restarting QE asset purchases. It may also show some flexibility with respect to previously self-imposed limits on the amounts of government bonds that it can buy.

The ECB will probably also announce that it is tiering the interest rate that it charges Eurozone banks for holding excess reserves in an attempt to mitigate the drag that negative interest rates have on bank profitability.

We expect the composition of asset purchases to be similar to the previous QE programme, i.e. consisting mainly of Eurozone government and corporate bonds. However, it is worth noting that Olli Rehn, the Finnish Central Bank Governor, in a recent interview with the Wall Street Journal (August 15) refused to rule out including equities in the mix of assets to be purchased as well. He also called for a "significant and impactful" policy announcement that would overshoot market expectations.

… but this is not enough by itself

Overall, while these measures probably would help boost short-term risk appetite, especially if the ECB also includes equities in the list of assets it intends to purchase or hints that it may do so in the future, we do not think these monetary policy actions by themselves will be enough to fundamentally change the outlook for the Eurozone economy.

In particular, we are skeptical that further cuts to interest rates will be of much benefit, and these could even be counterproductive depending upon how they are designed. For more on this, please see our Topical Thought "ECB stimulus misses mark due to banks", July 2019.

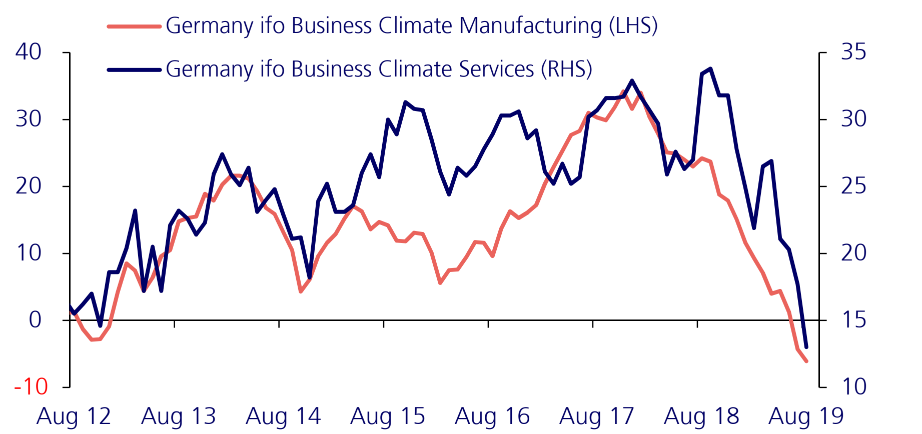
Fiscal policy needs to do more

The current problem in the Eurozone is not one of lack of access to capital for companies or too high interest rates (i.e. high cost of capital). Companies are not reporting any particular difficulty in accessing loans and the cost of these loans is often close to historic lows. In corporate bond markets, Eurozone investment grade companies can borrow at an interest rate of around 0.3% for five years for example.

Rather, the problem is one of deficient external and internal demand in the face of a number of shocks such as the trade war, China slowdown and Brexit as well as structural changes in the auto industry. In addition, fiscal policy is tighter than it needs to be. As a result, global demand conditions are weak, and businesses have been cautious to invest, hire and spend because of the uncertain policy environment.

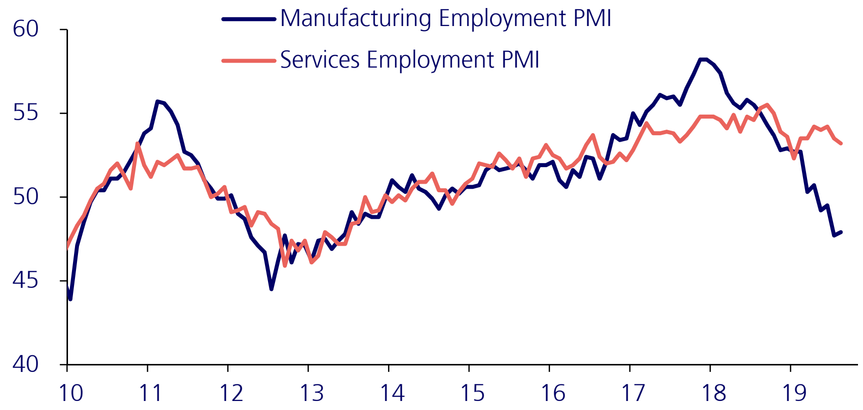
Indeed, fiscal policy needs to do more in order to support growth in our view. In particular,

Weakness in manufacturing is now transmitting to services



Source: Bloomberg

Eurozone Employment PMIs show a deteriorating labour market



Source: Markit, Bloomberg

those countries that have the capacity to spend more should do so, especially on infrastructure and investment, as this will help raise trend growth.

Germany has fiscal space

Germany, in particular, is one country where there remains a substantial amount of fiscal space to spend more. In contrast to the rest of the Eurozone, Germany has been running a budget surplus since 2014 (and it only ran a small budget deficit in 2012 and 2013). Indeed, its total government debt to GDP ratio is only 61%, much lower than the US, the UK or the rest of the Eurozone.

The coalition government's commitment to a black zero ("Schwarze null"), an annual budget balance of zero or higher (i.e. not running a budget deficit), may have to be re-thought. Flexibility may also have to be shown towards the so-called "debt brake", though this may be harder to do given that since 2009 it is enshrined in the constitution. This commits Germany to a structural deficit that does not exceed 0.35% of GDP in any one year.

Staggeringly, Germany can currently borrow at a negative interest rate of around –10bps for 30 years. This compares to 2009 when the 30yr Bund interest rate was around 4%. So financing extra spending is much cheaper than it was just a few years ago when the "debt brake" was introduced because of concerns that Germany's debt levels were too high and additional spending could lead to it snowballing out of control.

Debate has begun …

Recently, the debate on whether a fiscal policy boost is needed in Germany has intensified. There has been discussion of ear marking funds specifically for green investments that could be excluded from normal debt calculations, as well as greater use of automatic stabilisers to support growth and extra spending on infrastructure.

Over the past few years, various studies have highlighted the need for more investment in infrastructure. It is estimated that Germany spends 1% of GDP less than the OECD average on investments in roads and schools and at least 10% of bridges are thought to be in need of significant repair or upgrading.

… but more urgency is needed

However, the debate is ongoing and no firm decisions have been made yet. The risk is that a decision to use fiscal stimulus aggressively will only be made once the German and wider Eurozone economy is already clearly in a recession.

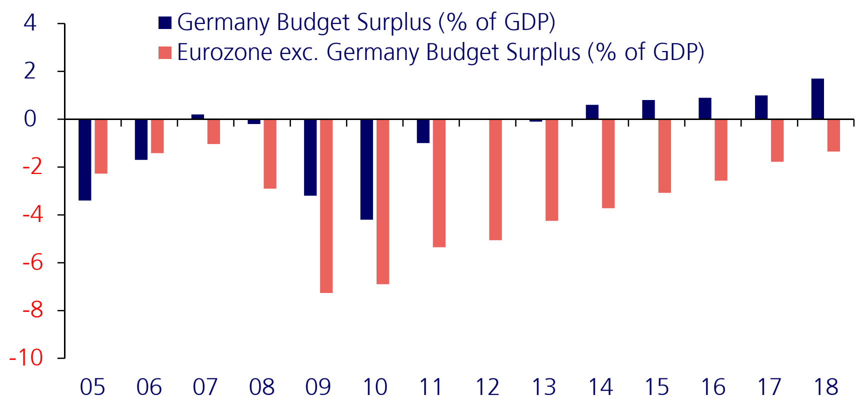
Conclusions

The Eurozone is in a precarious position, buffeted by external and internal headwinds, and potentially heading towards stagnation and recession, particularly as we expect the US and global economy to slow further over the next few quarters as well. Weakness in the manufacturing sector is gradually transmitting to the service sector, and the region's largest economy, Germany, may already be in recession.

The monetary authorities now appear to be realising the need for urgency and are preparing to loosen policy on September 12, with a range of measures likely, including restarting QE.

However, Eurozone governments still appear to be slow in recognising the seriousness of the situation and the need for a fiscal policy boost to accompany the monetary policy stimulus. Fiscal policy needs to do more to support growth and those countries that have the capacity to spend more should do so.

Germany runs a budget surplus, the rest of the Eurozone a deficit



Source: Eurostat, Bloomberg, Zurich MSME

Disclaimer and cautionary statement

Zurich Insurance Company Ltd
Investment Management
Mythenquai 2
8002 Zurich

173001631 (01/16) TCL

ZURICH®