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Mamma Mia! Here we go again: The Eurozone is in trouble

With cooling global growth and trade tensions acting as a negative drag on the economies of key global players such as the US and China, it was always likely that the Eurozone as a bloc would suffer, owing to its open markets and export-driven economy. As global growth headwinds have increased in recent months, economists have expressed concern over an apparent deterioration in economic conditions in the bloc, raising concerns over potential for economic recession in the Eurozone.

Following on from the global financial crisis in 2008, it can be argued that the Eurozone economy never fully recovered, with a long-lasting economic and political fallout which continues to weigh on the worst afflicted countries within the bloc over a decade later. After another week of bleak economic data and political turmoil, it appears that downside risks can no longer be ignored by investors, with European markets selling off over the week.

The Problem

In another week of disappointing economic data, Eurozone Q2 GDP growth was confirmed at 0.2%, following a 0.4% expansion in Q1. Germany's GDP contracted and Italy's economy stagnated as both trade and domestic demand made zero contribution to growth. GDP growth slowed in France and Spain. A breakdown of Q1 and Q2 GDP for key Eurozone countries below shows the decline in economic growth between the two quarters.

Table 1: Key Eurozone GDP Growth by country

	Q1 GDP Growth	Q2 GDP Growth
Germany	0.4%	-0.1%
Italy	0.1%	0.0%
France	0.3%	0.2%
Spain	0.7%	0.5%
Austria	0.4%	0.2%
Belgium	0.3%	0.2%
Lithuania	1.2%	0.9%
Slovakia	0.7%	0.4%
Netherlands	0.5%	0.5%
Portugal	0.5%	0.5%
Cyprus	0.7%	0.7%

While still early in the third quarter, leading economic indicators suggest that the Eurozone economy is struggling to regain its footing, with the key manufacturing industry in decline. Weak inflation figures for July complement the picture of a Eurozone economy stuck in a low gear, while the July PMI figures confirmed continued weakness in key sectors within the economy. Until now, the Eurozone economies have been boosted by strong domestic demand, however there are signs that the downturn is spreading into domestic factors, with corporate earnings for the first half of 2019 beginning to reflect lower profitability and demand owing to greater uncertainty. We now expect the European Central Bank to introduce further stimulus in September in an attempt to boost the bloc, and governments to introduce fiscal stimulus in an attempt to combat country-specific issues.

The recent re-escalation of US-China trade tensions and the increasing probability of a no-deal Brexit are expected to continue to add to the headwinds, dampening hopes for a Eurozone recovery in the second half of the year. According to Chris Williamson, Chief business economist at IHS Markit, “there are signs that the scale of the manufacturing downturn is starting to overwhelm [the bloc]”.

The Weakest Links

Earlier this week it was confirmed that the industrial recession affecting Europe’s largest economy appears to be more severe than first anticipated. After a decade of growth, Germany has shifted from the economic powerhouse within the bloc to the weak link. Following the country’s narrow escape from technical economic recession last year, according to data released today, the German economy contracted by 0.1% in Q2, as government spending failed to counteract a slump in exports and declining construction capital formation. The contraction raises concerns that turmoil in the automotive industry, trade tensions and the prospect of a disorderly Brexit could plunge the world’s fourth largest economy into its first recession for over six years. As the cyclical bellwether for the Eurozone economy, there is a risk that a German recession could induce recession for the whole bloc.

Italy also remains a weak link, as two decades of low growth continues to drag on the bloc, with entrenched economic and political problems which threaten long term growth. The latest development in the Italian political scene is the potential collapse of the current ruling coalition and threat that Italy may be ruled by one of the most populist government in Europe. This did not come as a surprise given the ideological differences between the two parties and the recent surge in the polls for the Lega party, however the coalition was expected to survive until next year. As a result, Italian bond yields are rising again, adding headwinds to the Italian economy which is already in stagnation according to Q2 GDP. Another bout of political instability in the weakest link Eurozone economy is not good news considering the economic outlook is deteriorating sharply.

The Importance of Industrials

The European Industrial sector continues to drag economic growth in the bloc, with industrial production providing more evidence that industry is the economy’s Achilles heel. Yesterday it was announced that Eurozone Industrial Production slumped 2.6% from a year earlier in June, following a 0.8% decline in May, driven by capital and intermediate goods. The sector is facing a perfect storm of headwinds which continue to weigh on the outlook:

- **Weak Global Trade:** Global trade is expected to grow at the slowest pace since the global financial crisis, driven by the ongoing trade war and country-specific shocks. This has deeply impacted European exporters’ demand prospects, a huge blow to the region’s export-driven economies.
- **Automotive Sector Decline:** The European automotive sector is afflicted by slowing global growth and domestic demand, with production dropping around 6% in the first half of the year, driving the industry into contraction. At the same time, the car sector faces challenges to invest in hybrid and electric cars driven by consumer demand and regulatory changes.
- **High Uncertainty**: Uncertainty within industrial firms has been contributing to a sharp reduction in inventories. This will curb domestic investment intentions amid falling efficiency and reduce demand for European investment goods.

The Eurozone economy remains dominated by the wide divergence between the struggling manufacturing sector which is grappling with a deterioration in the external environment and the more resilient services, but there are increasing signs of spillover, leading to a deterioration in the growth outlook. The investment outlook is weakening, as loans to corporates have decreased since 2018 levels, and the export outlook is worsening, suffering the impact of rising protectionism and fears of a full-blown trade war.

Expectations for Stimulus

The ECB is expected to announce further stimulus in September, with markets anticipating rate cuts and possible new asset purchases, however it is our view that weakness is now ingrained within the Eurozone economy, and external risks remain unchanged, therefore stimulus is not expected to patch the holes in the Eurozone economy. Additionally, with other key economies also pursuing monetary policy easing, rate cuts are not expected to solve the bloc's problems. The Eurozone's problems have been caused by external factors, therefore unless external conditions improve, the problems will not be solved in the near term.

Risks to watch out for

- **Continued Political Risks**
  Political risks are never far away in Europe, and the tide can quickly turn. The Brexit outcome, Italian snap election and potential for a re-escalation in the independence turmoil in Catalonia should be watched closely.

- **Trade Concerns & Currency Movements**
  Exports are vital to the Eurozone economy, and therefore a sharp rise in the Euro, particularly if policymakers abroad become more dovish, could mean that net trade becomes a drag on GDP. Additionally, a trade war with the US would be very damaging to growth given that trade uncertainty is already significantly impacting exports before substantial tariffs have been applied.

- **Monetary Policy Tightening**
  The ECB is expected to maintain accommodative monetary policy for an extended period, however if inflation begins to rise, the ECB could surprise markets to the upside, pushing bond yields and the euro higher, which could slow growth.

Navigating Eurozone weakness

As we continue to see significant risks in the Eurozone economy, we are not currently exposed directly to traditional European equities, with exposure coming from cautious multi-asset funds and a long/short European strategy which is positioned to gain when European equity markets decline. Our outlook remains negative on this region, and we are expecting a continued decline in European equity markets and retain limited exposure to European bonds due to excessive risks. As the economic conditions improve, we may look to re-allocate to this region, however for now the value at risk is not attractive in our view.