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Economics Group

Special Commentary

Jay H. Bryson, Global Economist
jay.bryson@wellsfargo.com • (704) 410-3274

Eurozone: Diminution of Downside Risks?

Voters in France went to the polls on Sunday April 23 in the first round of that country's presidential election. After the votes had been tabulated, Emmanuel Macron, the candidate of the centrist En Marche! party, and Marine Le Pen, of the right wing National Front, were on their way to face off in the second round. The winner of the run-off election on May 7 will become the next president of France.

Most market participants were relieved that Jean-Luc Mélenchon, the candidate of the Left Party, did not make it into the second round. The fear was that candidates representing the far right and the far left, who both hold skeptical views regarding French membership in the European Union, would make it into the second round. Polls show that Macron should beat Le Pen handily in the second round. Polls obviously can be poor predictors, and anything can clearly happen between now and May 7. That said, the polls for the first round of the election turned out to be quite accurate. If Mr. Macron is elected president on May 7, then a downside risk to the French economy, and more broadly the overall euro area, from a potential unraveling of the European Union and/or the Eurozone will have dissipated.

Figure 1

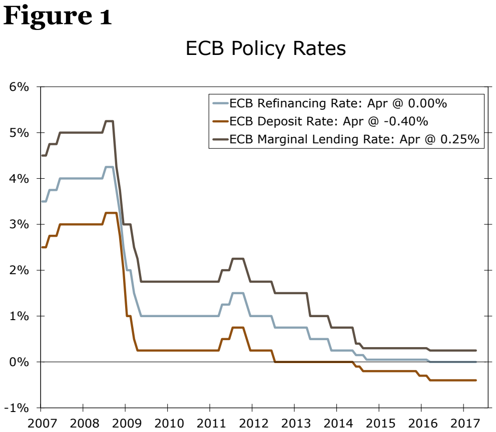
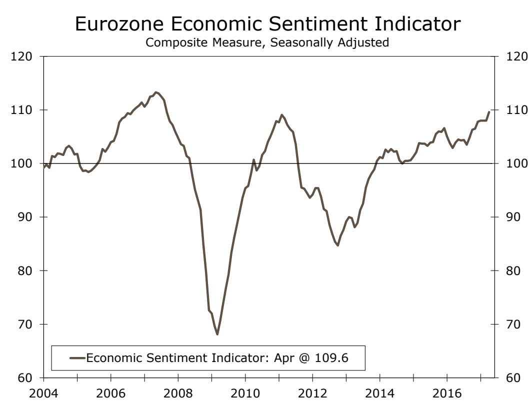


Figure 2



Source: IHS Global Insight, Bloomberg LP and Wells Fargo Securities

The Eurozone economy appears to be on solid footing right now, at least if sentiment indicators are to be believed.

The European Central Bank (ECB) held a regularly scheduled policy meeting on Thursday, at which the Governing Council kept its main policy rates unchanged, which was universally expected (Figure 1). In the statement ECB President Draghi read at the beginning of his press conference, the Governing Council stated that risks to the Eurozone outlook "are still tilted to the downside." However, the Governing Council also acknowledged that risks were "moving towards a more balanced configuration." Indeed, the Eurozone economy appears to be on solid footing right now, at least if sentiment indicators are to be believed. The economic confidence indicator in the euro area, which has been trending higher since last summer, rose to a new cycle high in April (Figure 2).

However, “hard” data generally show that economic growth in the euro area is not quite as strong at present as the “soft” data would imply. Yes, real GDP in Spain rose 0.8 percent (not annualized) on a sequential basis in the first quarter to keep the year-over-year rate of growth steady at 3.0 percent. But, Spain is an outlier. Real GDP in France grew only 0.3 percent sequentially and 0.8 percent year-over-year in Q1 (Figure 3). More generally, real GDP in the overall euro area likely rose at a sub-2 percent rate in the first quarter. In other words, the Eurozone economy continues to grow, albeit at a fairly modest pace.

In our view, the ECB will continue to buy €60 billion worth of bonds each month for the next few months.

Modest GDP growth has translated into benign CPI inflation. The overall rate of inflation currently stands just below 2 percent (Figure 4). Although the core rate of inflation is lower, it did shoot up from 0.7 percent in March to 1.2 percent in April. In our view, the ECB will continue to buy €60 billion worth of bonds each month for the next few months. Sometime this summer, however, the Governing Council could announce plans to “taper” its bond purchases further if the economic outlook remains sanguine and/or inflation continues to trend higher.

Figure 3

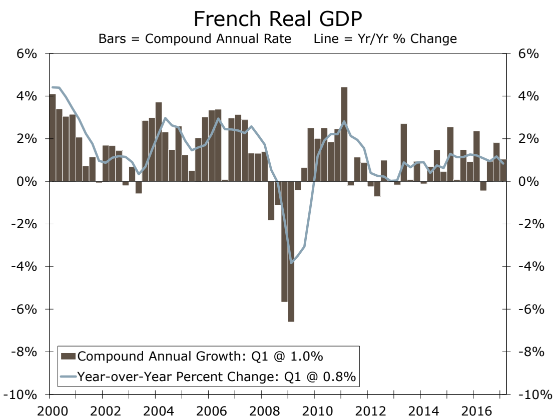
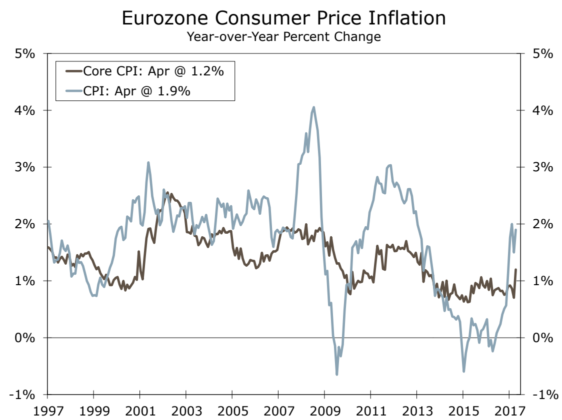


Figure 4



Source: IHS Global Insight and Wells Fargo Securities

Wells Fargo Securities Economics Group

Diane Schumaker-Krieg	Global Head of Research, Economics & Strategy	(704) 410-1801 (212) 214-5070	diane.schumaker@wellsfargo.com
John E. Silvia, Ph.D.	Chief Economist	(704) 410-3275	john.silvia@wellsfargo.com
Mark Vitner	Senior Economist	(704) 410-3277	mark.vitner@wellsfargo.com
Jay H. Bryson, Ph.D.	Global Economist	(704) 410-3274	jay.bryson@wellsfargo.com
Sam Bullard	Senior Economist	(704) 410-3280	sam.bullard@wellsfargo.com
Nick Bennenbroek	Currency Strategist	(212) 214-5636	nicholas.bennenbroek@wellsfargo.com
Anika R. Khan	Senior Economist	(212) 214-8543	anika.khan@wellsfargo.com
Eugenio J. Alemán, Ph.D.	Senior Economist	(704) 410-3273	eugenio.j.aleman@wellsfargo.com
Azhar Iqbal	Econometrician	(704) 410-3270	azhar.iqbal@wellsfargo.com
Tim Quinlan	Senior Economist	(704) 410-3283	tim.quinlan@wellsfargo.com
Eric Viloria, CFA	Currency Strategist	(212) 214-5637	eric.viloria@wellsfargo.com
Sarah House	Economist	(704) 410-3282	sarah.house@wellsfargo.com
Michael A. Brown	Economist	(704) 410-3278	michael.a.brown@wellsfargo.com
Jamie Feik	Economist	(704) 410-3291	jamie.feik@wellsfargo.com
Erik Nelson	Currency Strategist	(212) 214-5652	erik.f.nelson@wellsfargo.com
Misa Batcheller	Economic Analyst	(704) 410-3060	misa.n.batcheller@wellsfargo.com
Michael Pugliese	Economic Analyst	(704) 410-3156	michael.d.pugliese@wellsfargo.com
Julianne Causey	Economic Analyst	(704) 410-3281	julianne.causey@wellsfargo.com
E. Harry Pershing	Economic Analyst	(704) 410-3034	edward.h.pershing@wellsfargo.com
Donna LaFleur	Executive Assistant	(704) 410-3279	donna.lafleur@wellsfargo.com
Dawne Howes	Administrative Assistant	(704) 410-3272	dawne.howes@wellsfargo.com

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