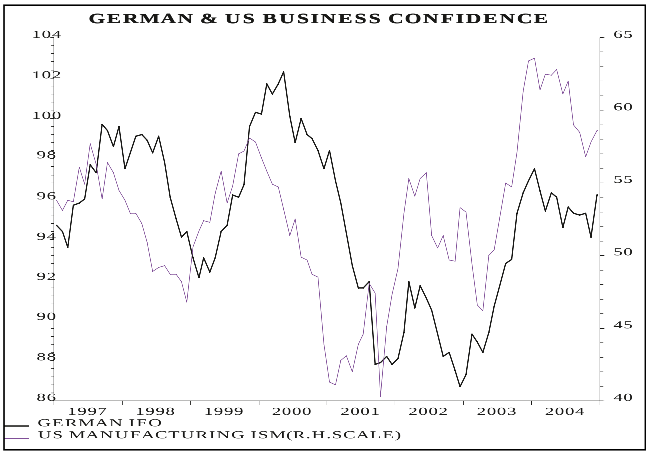
GFC ECONOMICS

DAILY COMMENTARY

EUROLAND GROWTH TO DISAPPOINT IN 2005

The recovery in business confidence in Euroland during December has fuelled hopes that the economy is emerging from its soft patch. In fact, the aberration should prove to be the revival in confidence, rather than the weakness in growth. Recent manufacturing data in Germany has been very downbeat and depressed labour markets, along with a strengthening currency, should ensure that Euroland growth remains very sluggish over the coming year. Low growth, the rising euro and falling inflation should succeed in thwarting the ECB's desire to raise interest rates. Indeed, Mr Trichet took a less hawkish tone in his press comments today, and the next move by the ECB continues to look more likely to be a rate cut, than a rate rise. Consequently, EGBs should continue to outperform Treasuries, particularly at the short end.



Business confidence recovers

Euroland business confidence picked up somewhat in December. The composite Euroland purchasing managers' index rose to 52.5 from 51.7 in November, its first gain in five months. While the service sector PMI was unchanged in December at 52.6, the manufacturing PMI rebounded to 51.4 from 50.5. This improvement in sentiment, however, has to be put in context. Manufacturing confidence has not even reversed all of its decline in November, and remains well down on the levels seen earlier in the year. All the same, it cannot be dismissed completely out of hand, as it has been backed up by the other main forward looking survey indicators. For one, Belgian business confidence rose in December, even if it remained below its October level. Most impressive and arguably hardest to explain, is the rise in German business sentiment, which may be tied to the strengthening in the US ISM index. IFO business confidence rose from 94.0 to 96.2 in December, its highest level since May. This increase was broadly based, with both the present situation and expectations components turning up and the gains extending to the manufacturing, retailing, wholesale and construction sectors. The current situation index is even at its highest level in three years, though this is much more a reflection of how weak the economy has been over this period, rather than a sign of any great strength. GDP growth may only have been 1.3-1.4% y/y in Q2/Q3 last year, but this was still the best performance since 2001.

The rise in confidence shown by the IFO survey has been backed up by the ZEW sentiment index, which edged higher in December and rose significantly in January. In fact, this increase is only of limited significance. The ZEW index declined much more sharply than the other measures of confidence in H2 last year, and the recent gains still leave the index below its October reading and at its lowest level since summer 2003. One would have more faith in this rise in business optimism if it were backed up by an improvement in recent 'hard' economic data, or there was reason to believe the fundamentals were set to improve. Unfortunately, it is not. Recent industrial data in Germany - while volatile and needing to be treated with just as much caution as the survey data - has been decidedly downbeat. Industrial production fell 1.7% m/m in November and is now down 0.7% on a year earlier. Construction and energy saw the sharpest m/m falls and manufacturing output declined a more modest 0.4% m/m. Even so, it has still slowed sharply and is now up only 0.1% y/y, compared with a high of 5.6% y/y in August. Furthermore, manufacturing orders declined 2.3% m/m in November, more than reversing their gains in September and October, and leaving orders on a downward trend since

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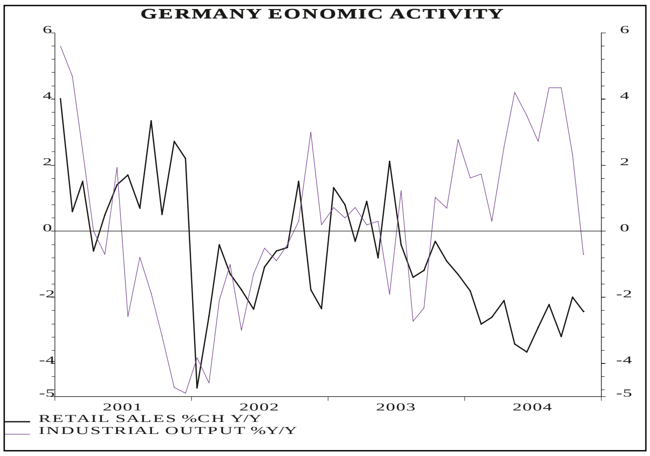
July. This weakness in turn fits with today's GDP data for 2004. While the Q4 numbers have not been released, the FSO did say that investment stagnated following its strong gain in Q3.

Meanwhile, on the all important consumption front, the picture is not much brighter. The FSO stated that spending improved somewhat in Q4. Better than expected Christmas trading has also fuelled a rebound in retailer confidence. But this turn for the better has to be set against the fact that consumption was down 0.7% y/y in Q3, while the most recent 'hard' retail sales data were very disappointing. Retail sales volumes fell 2.0% m/m and 2.4% y/y in November. The most that can be said is that consumer spending is now stabilising, following its decline over the previous couple of years. Critically, there is still no real sign the labour market is strengthening, though the reforms are distorting the data. Recent gains in unemployment are being boosted by the need for social security recipients to register as unemployed. Equally, the steady rise in employment seen since the start of last year has been exaggerated by state supported schemes, such as the notorious 'one euro jobs'.



Wage gains did pick up sharply in October to 2.3% y/y from 0.9% y/y in November, but this is probably just a statistical vagary. Average earnings growth has been running at around 1-1.5% y/y over the past year, and companies remain intent on beating down wage costs wherever possible. There is no indication of any improvement in worker bargaining power despite the rise in corporate profitability, and wages should, as a result, continue to struggle to hold their own in real terms. Consumption will be held back, not only by a lack of income growth but also by a rising saving ratio. The latter edged up again in Q3 and should continue to climb as labour market reform and pension worries take their toll.

The improvement in business confidence in Germany is, therefore, at odds with recent hard economic data and the fundamentals going forward and should be treated with considerable scepticism. German growth, however, is not the only area of uncertainty regarding the euro-zone economy at the moment. The French consumer is adding to the confusion. Having retreated to the sidelines after a sharp rise in spending in Q2 last year, the consumer has recently sprung back to life. Household consumption surged 1.5% m/m and 6.5% y/y in November. However, the reality is that this strength is unlikely to be sustained any more than that in the spring while the labour market remains so sluggish. Finally, the Euroland GDP numbers themselves are a source of considerable debate and the revised data released yesterday did little to clarify the picture. Third quarter growth was left unchanged at 0.3% q/q and there were no major revisions to the composition, which remains as puzzling as ever. A 0.4% q/q fall in final sales was offset by a heavy build up of inventories. The puzzle concerns the extent to which the reported sharp run-up of stocks is just a figment of the statisticians' imagination. If it is for real - and it is not backed up by the survey data - the drag on growth going forward will depend on how much of the Q3 surge in imports simply went into inventories.

All this leaves the outlook for Euroland growth short term rather clouded in uncertainty. By the spring, however, the likelihood is that the fog will have lifted somewhat and it should be clearer that the ECB's hopes of a broadening out of the recovery are unlikely to be fulfilled. The prospect longer term remains for a rate cut, rather than a rate rise. Any renewed surge in the euro can only bring the data of a rate cut that much closer.