Europe’s Struggles Are Just Beginning

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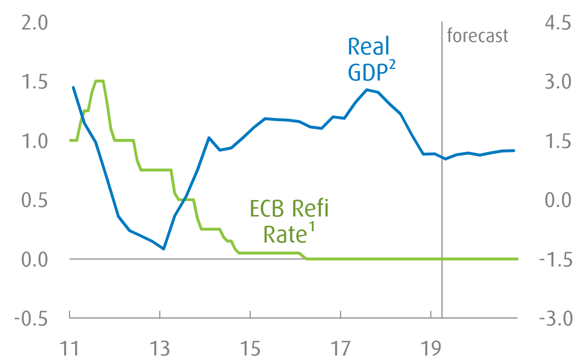
Perhaps the biggest downside surprise for the global economy in the past year has been Europe. While picking up somewhat in Q1, Euro Area GDP has risen just 1.2% y/y, half the pace of a year earlier. And, the euro is down 6%. Where next for the world’s largest trading bloc?

It has been nearly a year since the ECB signalled the end of quantitative easing, *“subject to incoming data”*, and that rates would stay at record lows *“at least through the summer of 2019”*. That declaration put the central bank firmly on the road to normalization. Over the following six months, as the economy slowed and the ECB trimmed the growth outlook, President Draghi defended the decision to remain on the path to end QE: *“We’re talking about weaker momentum, not a downturn.”* Besides, there were special factors at play, such as the implementation of new emissions-testing processes which stalled German car production, and political tensions which rippled through the Continent, including: Italy’s stand-off with Brussels over its national budget; Angela Merkel’s decision not to run for Chancellor again; and, the start of France’s Yellow Vest protests. All serious concerns, but the ECB could not be seen reacting to political developments. Plus, manufacturing and service PMIs had weakened, but Euro Area inflation was still on target, making it difficult to change course on the decision to stop asset purchases—lest it be accused of panicking. But, when QE ended in December, the ECB did not push the planned date for rate hikes far into the distance. Only in March did the central bank finally throw in the towel, not only changing the guidance to *“through the end of 2019”*, but introducing a new set of quarterly targeted longer-term refinancing operations, aka TLTRO-III, to keep credit flowing.

Chart 1
Flattish Growth
Euro Area

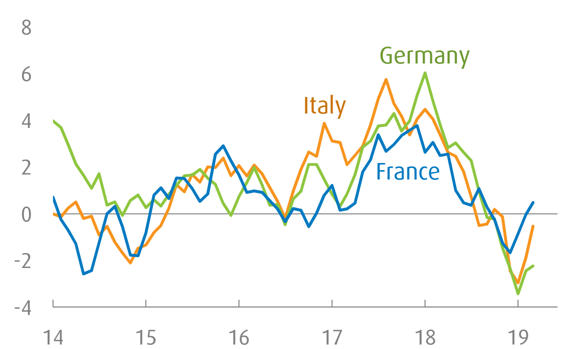


¹ (lhs : %) ² (rhs : y/y % chng)
Sources: BMO Economics, Haver Analytics

Trade War Looms

As the Euro Area economy continues to struggle, it now faces another large source of uncertainty: **the prospect of a trade war with the U.S.**, which is particularly worrying for **Germany**. The country is highly export-reliant (nearly 50% of GDP), and exports to the U.S. make up around 8.5% of the total (3% of GDP), mostly motor vehicles, machinery, pharmaceuticals, and computers/electronics. These cyclical industries are already feeling the effects of slower global demand, so potential U.S. tariffs on European cars would be another hit. (President Trump will make that decision by May 18th.) Germany is also under pressure from the rest of Europe to relax its fiscal rules and use some of its budget surplus for economic stimulus, but it is extremely reluctant to do so. No wonder German business executives are gloomy, as the latest Ifo survey showed. At least German domestic demand, though slowing, is 2% above year-ago levels, with record low joblessness underpinning consumer spending. In **France** and **Italy**, exports account for a smaller, but still significant, share of the economy (one-third), but other issues are

Chart 2
Production Declines Slow
(3-mnth m.a. : y/y % chng)
Industrial Production ex. Construction



Sources: BMO Economics, Haver Analytics

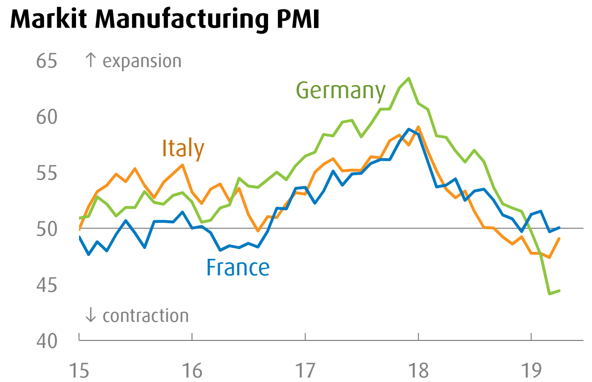
weighing. In France, the Yellow Vest protests are hurting consumer spending; and, in Italy, growth is being held back by weak competitiveness (the country is ranked #31 of 140 countries in the World Economic Forum's Global Competitiveness Index, well behind the rest of the G7).

Political Winds Blow

There is fear that there will be public backlash from years of fiscal austerity and structural reforms. Although these steps helped lift the Euro Area out of its debt crisis, it is **possible that the reform process could stall**, which is why the **upcoming May European Parliamentary elections are important to watch**. Newer political parties are capitalizing on public resentment after years of austerity and on controversial issues such as immigration. A softer economy simply compounds the situation. Nationalism has been rising throughout Europe (in fits and starts) and the influence of these newer parties, from all over the political spectrum, has grown. Adding to this volatile mix will be the presence of the U.K., and Nigel Farage's Brexit Party. And, candidates are faced with what is typically low voter turnout (1979: 62%, 2014: 42.6%). Also making this election important is that the top four jobs are up for grabs: Head of the European Commission (currently held by Jean-Claude Juncker), the European Council (Donald Tusk), the European Parliament (Antonio Tajani), and the ECB (Mario Draghi). All in, the populist parties could sway the vote enough to cost the mainstream European parties—centre-right EPP and centre-left S&D—their primacy and disrupt the legislature's normal business activities, such as determining the EU's budget.

Chart 3
Manufacturing Hardest Hit

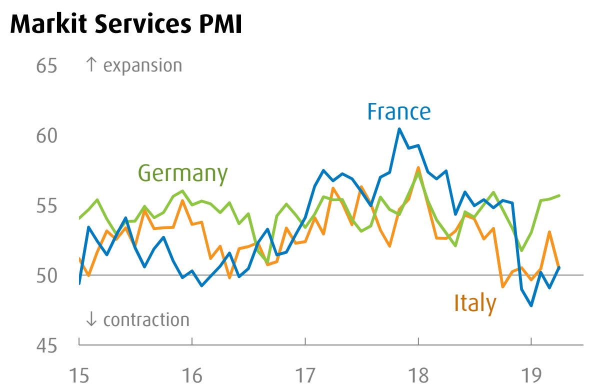
(s.a. : diffusion index)



Sources: BMO Economics, Haver Analytics

Chart 4
Services Activity Less Weak

(s.a. : diffusion index)



Sources: BMO Economics, Haver Analytics

Domestic politics are already reflecting these changes. In **Germany**, voters were angry over Angela Merkel's policies on migrants, costing the ruling CDU a large number of seats and Merkel's job as party leader, which she had held for 18 years. This has opened up the question of who will next lead Europe's largest economy, and the newest CDU leader must contend with more potential coalition partners than before. It is not just the Social Democrats, but the FDP, the Greens, and now, the far-right Alternative for Germany (AfD) are jockeying for position.

In **France**, President Emmanuel Macron's La République En Marche!, made up of individuals from the left and the right, has a vision for a more unified Europe while revving up the economy with business-friendly tax and fiscal policies. However, President Macron was forced to put aside his dreams of a *"European renaissance"* in order to deal with domestic unrest. Marine Le Pen's far-right National Rally party (formerly known as the National Front) took the opportunity to call out the government's policies and introduced a new 23-year old radical, Jordan Bardella, to appeal to the youth vote, while trying to win support from environmentalists on the left. And it is working; recent polls have the National Rally in the lead.

There has already been plenty of change in **Italy**. The centre-left Democrats were ousted last year and replaced by a coalition government made up of the anti-establishment Five-Star Movement and Northern League. Although the parties' leaders are often at odds, they are united when defending their fiscal plans to Brussels. And, though Italy fell into recession in the second half of 2019, the downturn has ended. Now, Matteo Salvini has been busily forming his own European party, with the European Alliance of Peoples and Nations made up of various politicians from the Continent, bound by some similar views; mainly, anti-immigration.

Finally, **Spain's** recent federal election saw Pedro Sanchez return as Prime Minister, but his left-wing Socialist party failed to win a majority and may need to lean on Catalonian separatists to govern. Meantime, the far-right VOX party entered Parliament for the first time since the country became a democracy.

Bottom Line: European economic growth remains weak at a time when the region is readying for a fight at the international level (trade) and battling it out within the Continent (populists). The ECB is unlikely to return to asset purchases but will likely commit to keeping rates lower for far longer than *"the end of 2019"*, which should put a lid on the euro. These more accommodative financial conditions will support GDP growth. But, with trade tensions building in the second half of this year and into 2020, we are not expecting much of a pickup beyond 1¼%.

View from our European Head of FX Strategy

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The EUR has already had a rough first half of the year, and our view is that risks facing the currency will remain biased to the downside, through the parliamentary elections in May and into the second half of 2019. The political fractures that will be made apparent in the elections should ultimately make the Eurozone more unwieldy to govern, leaving the bloc woefully exposed to the next global downturn, whenever that occurs. Brexit has a role to play as well, and not only because the risks of "no deal" are still lingering. Many voters will view the current Brexit impasse as another example of a bloc that is unattractive to remain a part of but also impossible to exit, and this strikes us as a recipe for a protracted period of political tension. We anticipate further dovish pivots from the ECB over the balance of the year, and short-EURUSD remains one of our preferred trades in FX, not least because it offers investors attractive carry. We in FX Strategy see the pair trading at 1.09 in 3M.

There is one upside risk to our bearish EUR call worth mentioning in the form of growth-positive fiscal policy. It is conceivable that at some point, an agreement amongst member states and the Eurogroup could be reached, aimed at relaxing the bloc's draconian fiscal rules. Such an agreement would be a significant short-run positive for the EUR that would probably allow the ECB to adopt a less "dovish" policy stance over time and possibly even allow ECB President Draghi to be replaced by a more "hawkish" successor, such as Jens Weidmann. At this stage, we assign this scenario a very low probability, but with so many moving parts in play, including international trade tensions, this is a risk worth monitoring.