EURO AREA: Q1 GDP GROWTH & INFLATION

RECOVERY IS AROUND THE CORNER

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SUMMARY

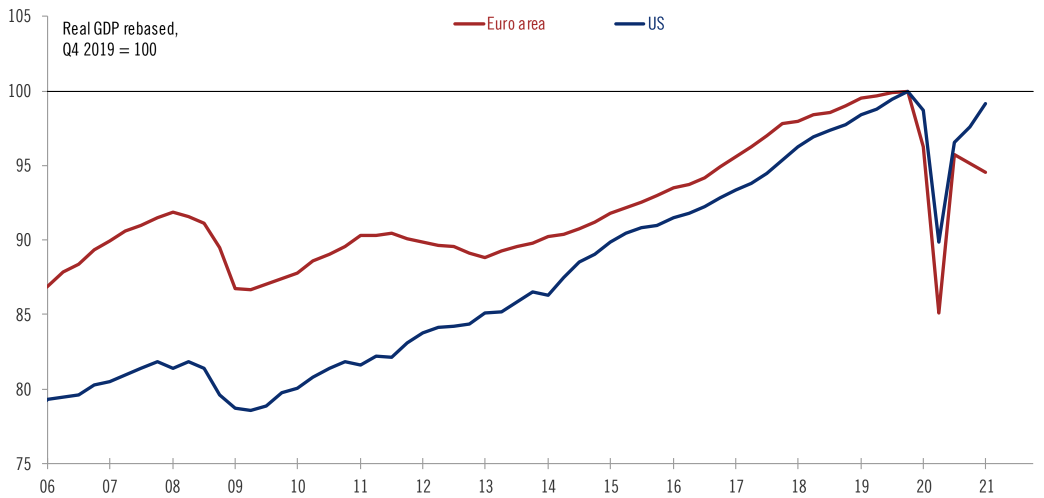
› Flash GDP estimates released today confirmed the euro area has gone through a double-dip recession. But forward indicators suggest that the worse is probably behind. We continue to expect a consumer-led rebound in the euro area in late Q2/early Q3. Our central forecast is that euro area GDP will expand by 4.3% in 2021 and 4.5% in 2022. The pace of vaccinations and economic policy, particularly fiscal policy, remain key to prospects.

› Turning to inflation, in the flash release for April, euro area headline HICP rose to 1.6% y-o-y from 1.3% in March, while core inflation moderated to 0.8 %y-o-y from 0.9% the previous month. Looking ahead, HICP inflation is expected to edge higher on the back of energy prices and supply bottlenecks. Core inflation data is set to become more erratic. We expect HICP headline inflation to average 1.4% in 2021 and 1.1% in 2022, while core inflation in the euro area is expected to average 0.9% in 2021 and 2022.

A (limited) double-dip recession

According to Eurostat's flash estimate, **euro area GDP fell by 0.6% q-o-q in Q1, after a drop of 0.7% in Q4**. This confirms that the euro area is experiencing a limited double-dip recession and leaves GDP 5.5% below its pre-covid level (see *chart 1*).

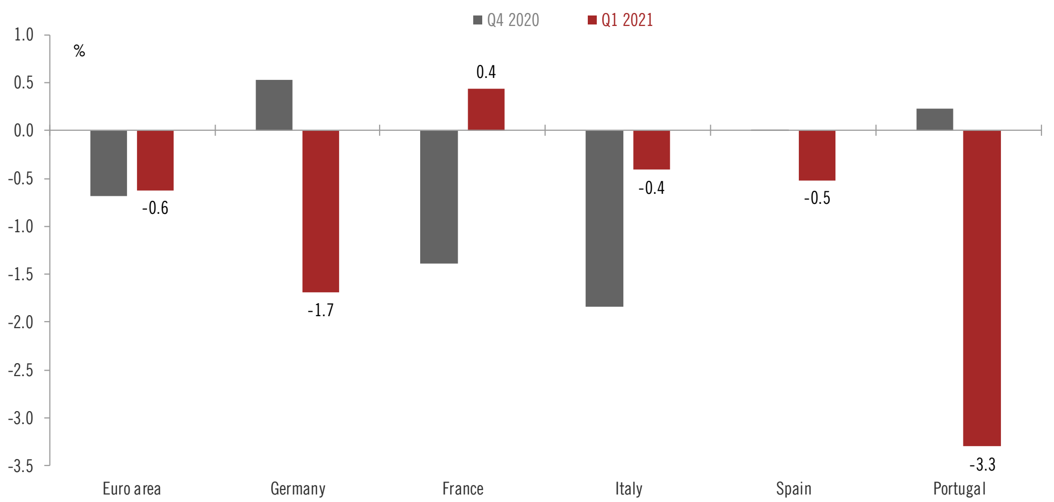
CHART 1: EURO AREA VERSUS US – REAL GDP REBASED, Q4 2019=100



Source: PWM - AA&MR, Eurostat, BEA, 30 April 2021

Country wise, **data were mixed, largely depending on the stringency of lockdown measures**. German GDP fell by 1.7% q-o-q in Q1, after +0.5% in Q4 20. Growth was dragged down by the impact of covid-19 restrictions on household consumption. By contrast, the federal statistical office pointed to the positive contribution of exports to German GDP. In France, GDP growth rebounded slightly in Q1 (+0.4% q-o-q), with strong investment in manufacturing and construction. GDP data were broadly in line with expectations in Italy (-0.4%) and Spain (-0.5%). The main downside surprise in today's preliminary GDP releases came from Portugal (-3.3% q-o-q).

CHART 2: EURO AREA – QUARTERLY GDP GROWTH



Source: PWM - AA&MR, Eurostat, 30 April 2021

Overall, measures to contain covid-19 remain the key determinant of individual countries' performance. The preliminary GDP report suggests that economies are becoming more resilient than before, possibly because consumers and companies have adapted to mobility restrictions. Restrictions have also become more targeted, focusing on sectors such as retail, transport, hospitality and arts and leisure. One important difference with the first wave of the pandemic in 2020 is that euro area manufacturers are benefiting from a strong global manufacturing cycle. This is partially offsetting the drop in the services sector.

Encouraging high-frequency data

Looking ahead, **surveys have been encouraging, indicating that the worse is probably behind for the euro area**. Manufacturing activity remains strong, although growth is being held back by supply problems. The service sector continues to lag, principally reflecting ongoing social restrictions to combat the pandemic. There has also been good news on the employment front.

Economic momentum will probably accelerate in late Q2/early Q3 as countries progressively reopen. Vaccination campaigns in the euro area have lagged those in the US and the UK, but the pace of vaccination has improved significantly over the past few weeks. This will allow restrictions to be progressively relaxed and hasten the economic normalisation already underway, led by increased consumer spending. **Whether international travel restrictions are lifted or not will be important for southern European countries in particular.**

Economies will also continue to benefit from the strengthening of global growth, helped along by US fiscal stimulus. The launch of Next Generation EU (NGEU) will also support the recovery even if the boost will be probably only be felt from Q4 on.

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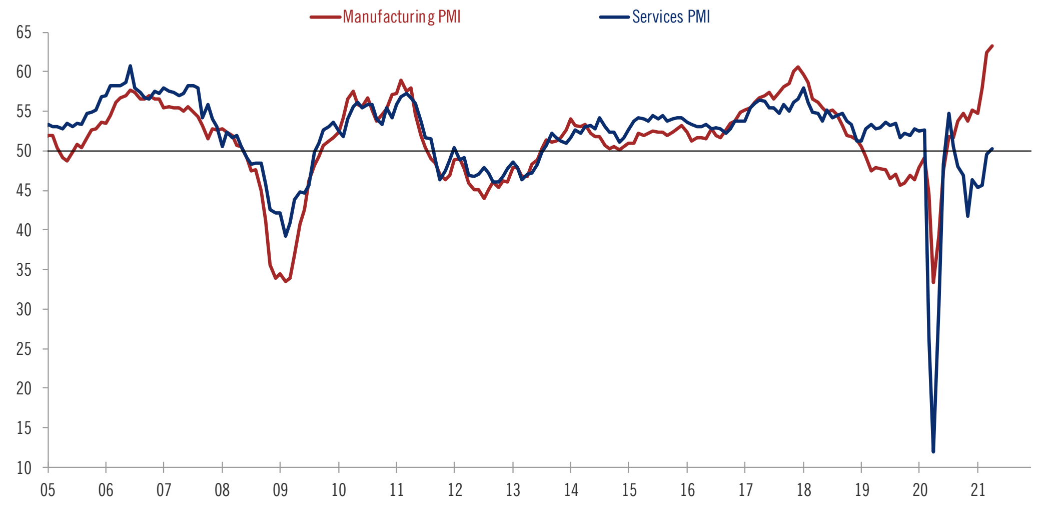
All in all, we continue to expect a consumer-led rebound in the euro area in late Q2/early Q3. Our central forecast is **that euro area GDP will expand by 4.3% in 2021 and 4.5% in 2022**, with risks broadly balanced. The pace of vaccinations and policy support remain the key determinants of the euro area's economic prospects.

CHART 3: EURO AREA PMI SURVEYS

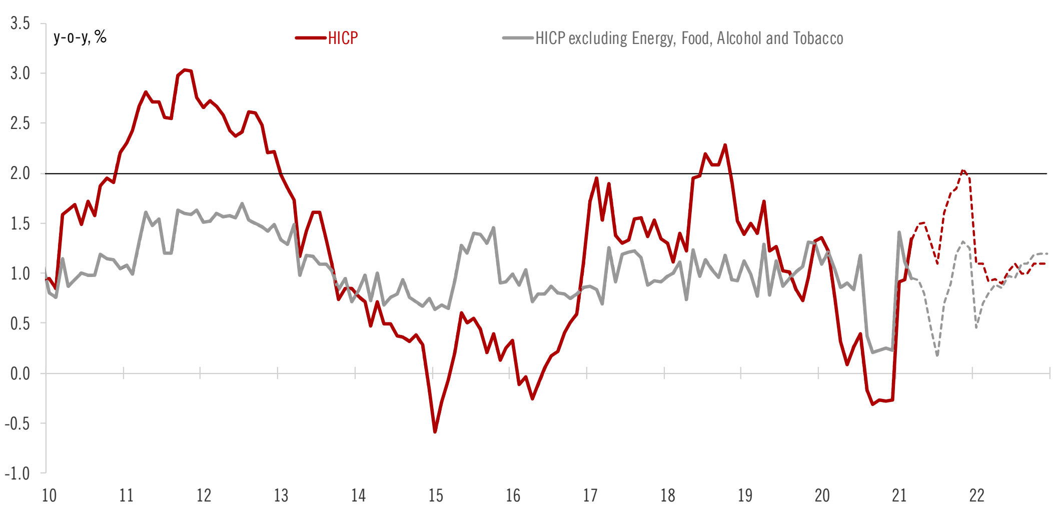


Source: PWM - AA&MR, IHS Markit, 30 April 2021

Inflation edges higher

According to Eurostat's Flash estimate, **HICP headline inflation edged higher in April to 1.6% y-o-y, after 1.3% in March, while core inflation moderated to 0.8 %y-o-y from 0.9% the previous month**.

CHART 4: EURO AREA HICP INFLATION WITH FORECASTS



Source: PWM - AA&MR, Eurostat, 30 April 2021

The breakdown by main expenditure categories showed that services inflation fell to 0.9% y-o-y in April (from 1.3% previously), and non-energy industrial goods inflation

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rose 0.2 percentage point (pp) to 0.5% y-o-y. Of the non-core components, energy inflation surged 6.0pp to 10.3%, while food, alcohol and tobacco inflation fell to 0.7% y-o-y in April from 1.1% in March.

Looking ahead, base effects in energy and supply bottlenecks will lift euro area HICP headline inflation temporarily while core inflation is set to be more erratic for the rest of this year. **We expect HICP headline inflation to average 1.4% in 2021 and 1.2% in 2022 and core inflation to average 0.9% in both 2021 and 2022.** Risks to our forecasts are tilted to the upside, mainly due to inflation pressures resulting from supply bottlenecks.

ECB: all eyes on June

The press conference following the ECB's policy meeting in April produced little fresh news. The ECB reiterated that asset purchases under its Pandemic Emergency Purchase Programme (PEPP) would continue at a 'significantly' higher pace this quarter than during the first months of the year. ECB president Christine Lagarde said that "any phasing out in PEPP purchases has not been discussed, because it is simply premature". Indeed, after a slow start, we expect PEPP purchases to accelerate to a level about the equivalent of EUR80 bn per month from April to June.

But the ECB's Governing Council remains divided. The battle between hawks and doves has just started as monetary policy becomes more data dependent: better economic data could galvanise the hawks into action. **Calls to taper PEPP purchases from as soon as Q3 will probably grow louder**.

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