We expect Europe to shake off its current soft patch later this year, getting a boost from China’s stimulus efforts and any resulting rebound in global manufacturing. If the global growth backdrop improves and one-off setbacks subside, solid domestic demand should drive the recovery. Highlights:

- Financial conditions have eased significantly since the start of the year, giving us more confidence that eurozone GDP growth will pick up in the second half of 2019. Our eurozone Growth GPS started to stabilise in mid-March, suggesting that the consensus forecasts for GDP over the next 12 months may reach a trough.

- The temporary dip in growth to levels below potential could have a silver lining. Economic slack has almost been eroded as the output gap closed. Thus the brief growth shortfall helps extend the business cycle by delaying economic overheating.

- Solid income growth – thanks to higher wage growth and decent job creation – along with fiscal easing and lower headline inflation should support consumer spending this year. An emerging shortage of workers, still elevated capacity utilisation rates and more favourable financing conditions should underpin a capital spending recovery. But a capex recovery also depends on a Chinese economic revival.

- The European Central Bank’s (ECB) accommodative policy reassures us on near-term growth prospects. But a perceived lack of policy levers to counter future downturns could rattle markets in the long term. Investment ideas that result from our macro view include: holding eurozone breakeven inflation rates and BBB-rated European corporate debt as well as tactically favouring the euro against the dollar. Even a relief rally in risk assets would seem plausible once Europe gets a spring in its step.

- There are some notable political risks to our favourable base case. Rising concerns about European fragmentation – weighing on equities and widening peripheral bond spreads – or about escalating trade tensions cannot be ruled out. We believe these risks are broadly reflected in market pricing compared with a year ago.

**Economic snapshot**

**BlackRock Eurozone Growth GPS vs. BlackRock Eurozone FCI, 2015-2019**

Sources: BlackRock Investment Institute, with data from Bloomberg and Thomson Reuters, April 2019. Notes: The GPS in blue shows where the 12-month consensus forecast may stand in three months’ time for the eurozone. The green line shows the rate of GDP growth implied by our financial conditions indicator (FCI), based on its historical relationship with our Growth GPS. The FCI is moved forward six months, as it has historically led changes in the Growth GPS. Forward-looking estimates may not come to pass.
Ready, set, recovery

Europe is still holding back global growth, having been a key support in prior years. Yet much of the eurozone weakness can be attributed to the fading support from export demand as world trade nosedived. As the most open G3 economy, Europe suffered more greatly.

In the coming months, we expect Europe to gradually move out of its tricky spot provided that the UK’s dragged-out Brexit debate doesn’t morph into a disruptive exit and rising US-EU trade tensions don’t shock confidence. The US slapping tariffs on European products – whether autos or other – should have only a moderate direct economic impact. Unless it sparks a broader confidence shock, this shouldn’t disrupt the solid domestic cyclical dynamic. And so we expect the upbeat domestic trend to reassert itself once global trade starts to normalise and idiosyncratic setbacks (auto production) and sector bottlenecks fade.

Eurozone growth is supported by accommodative monetary policy, a more expansionary fiscal policy stance, higher than normal capacity utilisation rates and labour markets approaching full employment. Our financial conditions indicator (FCI) shows that eurozone conditions have eased significantly in the first part of 2019 – an improvement that is on par with the one seen in early 2016. For that reason, we expect GDP growth to pick up and move slightly above trend levels (around 1.25%) in the second half of this year.

What underpins our call for a recovery? A rebound in the FCI, Chinese stimulus and fading headwinds. Half of the nearly 80 eurozone activity indicators, summarised in our eurozone Growth GPS nowcast, are starting to show meaningful improvement. We arrive at this supportive evidence via a months-to-cyclical dominance (MCD) approach – a method of seeing whether a variety of data series can help confirm a cyclical shift in the economy on the upside or downside. See the chart on the right.

Industrial data for the start of the year are still poor. Germany – where factory orders plunged in February – remains the weakest link. But other data – especially for the services sector – are holding up or starting to recover. And incoming information on near-term growth tentatively suggests building momentum at the start of the second quarter. Our eurozone Growth GPS started to stabilise in mid-March, indicating that the consensus forecasts for eurozone GDP over the next 12 months are close to bottoming out. The GDP forecast downgrades that began at the start of 2018 may have nearly run their course. Historically, our GPS signal has led consensus forecasts by about three months (see our interactive macro dashboard for more detail). This suggests that investors still have some time to position themselves for potential forecast upgrades.
Leaving the mid-cycle lull

As European growth starts to gain pace, if from subdued levels, our baseline scenario is that eurozone risk assets and the euro might benefit from these cyclical positives. At the same time, eurozone government bond yields look too low given the large gap between current yield levels and their long-run equilibrium range. The eurozone business cycle appears to be firmly in the mid-cycle stage, according to our cluster analysis explained in our January 2019 Slowing – but still growing. We believe the US is ahead of Europe and already in the late-cycle stage. Historically in the mid-cycle stage, GDP growth tends to hover sideways, labour productivity picks up and profit margins expand.

GDP growth in the eurozone slowed to a below-potential pace during the second half of last year. But there is a silver lining to this slowdown. Slower GDP growth delays economic overheating – when the economy reaches full capacity and the use of resources is above its long term trend. This is happening in the eurozone, we believe. As the labour market approaches full employment – although with slower job creation – wage pressures should increase further. Negotiated wages have already been rising for a while. More recently the wage drift – the voluntary extras companies pay above union wages – has also started to increase. Competition for workers seems to be heating up, with a rising share of companies reporting that staffing issues are a limit on their business. Even though at 7.8% the unemployment rate is still slightly above the pre-crisis low, the share of companies reporting staffing constraints is already much higher. This suggests that eurozone labour markets are experiencing a widening mismatch in terms of skills and locations. See the Labour and machinery limitations chart.

Solid income growth – thanks to higher wage growth and decent job creation – along with fiscal easing and lower headline inflation should support consumer spending this year. Some of the temporary factors that suppressed retail sales, car registrations and consumer spending – such as the introduction of new car emission rules and public unrest – may disappear in the first half of this year. Financing conditions for large ticket purchases are good and household net worth is improving, helping the eurozone consumer. But the savings rate might grind higher as job growth slows and uncertainty about the medium-term future increases.

A shortage of workers, above-average factory capacity utilisation rates and favourable financing conditions also support a recovery in capital spending. In our view, a turnaround in China should also help to boost capex plans. See our Global investment outlook Q2 2019 and the China capex connections chart. Note that business investment has historically been volatile. The capex recovery could again be derailed by corporate concern about an escalation of trade tensions and a resulting confidence shock. The eurozone economy is much more open than that of the US, so any surprise disruptions to global trade growth could also cause another capex setback.
Still problematic politics

The risks around our favourable base case are considerable – and they are mainly tied to potential political troubles. The UK has bought more time to hammer out a Brexit agreement, but uncertainty remains. There may be renewed escalation of the trade tensions between the US and EU, centred around car tariffs. US President Donald Trump has until May 18 to decide whether to take action against European car producers on national security grounds. And European Parliament elections in late May could result in a populist sweep of protest parties from both ends of the political spectrum. This would further erode the influence of pro-European centrist political forces.

Heightened concerns about Europe’s future would likely lead to a renewed widening in peripheral eurozone government bond spreads. See the Eyes on the wides chart. The 2020 budget season may refocus attention on the conflict between the Italian government and the European Commission. There are also going to be leadership changes this year in many EU Institutions, including at the ECB. The BlackRock Geopolitical Risk Indicator shows that investors are keeping a keen and wary eye on the risk of European fragmentation – it is the most prominent geopolitical concern for financial markets at the moment. See the Focus on fragmentation chart. It is not surprising that Europe is becoming increasingly under-owned.

We believe the ECB should pause further steps towards policy normalisation for the remainder of this year – and likely beyond – to ensure a return of inflation to its below-but-close-to 2% price stability objective. At the upcoming meetings, the Governing Council will set the TLTRO3 conditions, discuss tiering of reserves and review its monetary stance. While a further extension of forward guidance would likely be the first line of defence, additional policy action is also becoming more likely. The continuation of ultra-accommodative ECB policy is reassuring for near-term growth. But the perceived lack of policy levers to counter any future downturn could rattle markets in the long term. ECB President Mario Draghi could complete his eight-year term without once tightening policy. It is not clear whether his successor will get an opportunity to raise rates from -0.4% before the next downturn. If the next ECB policy move is to ease, there won’t be many options left in the monetary toolbox. In this situation, the ECB could either lift self-imposed constraints on its government bond purchases – the Public Sector Purchase Program (PSPP) – or move into new asset classes, such as equities or bank bonds, or push market interest rates even lower through rate cuts or forward guidance. Yet all of these options would likely face considerable opposition on the Governing Council.

Focus on fragmentation

BGRI score for European fragmentation, 2005-2019

Eyes on the wides

Eurozone 10-year yield spreads, 2005-2019

Sources: BlackRock Investment Institute, with data from Thomson Reuters, April 2019. Notes: We identify specific words related to this geopolitical risk and use text analysis to calculate the frequency of their appearance in the Thomson Reuters Broker Report and Dow Jones Global Newswire databases as well as on Twitter. We then adjust for whether the language reflects positive or negative sentiment, and assign a score. A zero score represents the average BGRI level over its history from 2003 up to that point in time. A score of one means the BGRI level is one standard deviation above the average. We weigh recent readings more heavily in calculating the average.
Mind the banks

A perception that the ECB is running out of policy levers, or that it faces political obstacles in deploying them, would likely weigh on European assets — notably the banks. A combination of negative interest rates and a relatively flat yield curve is already hampering European bank profitability, in our view. This weighs on credit creation, along with tepid credit demand. See the Tepid credit appetite chart. Yet bank lending has recently been stable, if at subdued levels, and the most recent data in 2019 suggest a mild pickup. And even with some of the latest Italian-driven volatility, credit spreads remain well below the peaks reached during the 2011-2012 crisis. See the Watch the swaps chart.

There is considerable variation within the banking sector in terms of profitability and valuations. So other factors also play a role in their success, including cost control, technological innovation, revenue diversification and legacy issues (non-performing loans).

The European Banking Union also remains incomplete. We believe that many investors see the creation of a European Deposit Insurance Scheme (EDIS) as crucial. A precondition for a EDIS is the further reduction of legacy risks, such as non-performing loans and concentrated government bond holdings. The most promising way to prevent another sovereign-bank doom loop — when a great deal of troubled sovereign debt is held by that country’s banks — could be to use the large exposure regime rather than capital adequacy requirements, in our view. The latter would require wider global support for it not to harm the competitiveness of European banks relative to their peers around the world, but the former could be designed for eurozone purposes.

We see a risk that the euro crisis reignites at some point in the future. The continent may face the fragmentation of its financial system if redenomination risk was perceived to rise again amid political disunity. Debt instruments that should infuse capital into banks at times of severe stress — especially AT1 CoCo bonds — are still untested in a major bank restructuring. Academic experts and policy practitioners are divided as to whether these instruments will be a reliable cushion against a systemic banking crisis or whether they could inflame one instead. In practice, there has only been one case of an AT1 write-down, where the instrument was used in the restructuring process in an orderly way. But this was an idiosyncratic episode: the ability of AT1 instruments to mitigate a wider systemic crisis remains untested.
Attractive valuations

There may be better opportunities on the other side of the Atlantic for growth-oriented global investors, in our view. We continue to prefer a "barbell" approach to risk taking in the late-cycle stage: quality stocks, income-generating bonds and emerging markets. Still, there are a number of investments in Europe worth highlighting.

Europe offers attractive asset valuations compared to history, especially in risk assets. Regional assets have cheapened further compared to a year ago as concerns about growth and politics increased. The exception to this are core government bonds, which we believe to be expensive compared to global peers.

As downward revisions to growth start petering out and incoming activity data begin to show signs of life, European risk assets might get a boost this year as value equities benefit. For any equity rally to have legs, investor concerns around a disorderly Brexit, global trade conflicts, European elections and Italian politics have to diminish, in our view. Given how under-owned Europe has become, even a tentative recovery might spark a relief rally.

Our analysis shows that a considerable chunk of the discount in regional assets can be pinned to increased investor concerns on European fragmentation, suggesting that political risks are more adequately priced at the moment. See the Crisis concerns chart. By looking at the eurozone equity market performance more closely and comparing it to moves in inflation-linked government bonds, we find that growth expectations played a limited role in the weak performance over the past year - while political risks played a large part.

One investment option in the fixed income space that does not require a growth comeback: long eurozone breakeven inflation rates, now at their lowest levels since 2016. We also continue to see compelling relative value in BBB-rated European corporate debt, even as we maintain a neutral view on European corporate bonds overall.

Another idea is a tactical long euro position against the US dollar. The euro has underperformed other risk assets during the 2019 market rally, in our view. The easier stance adopted by the ECB, ongoing forecast downgrades and worries over US car tariffs and political risk more broadly have weighed on the currency. We see much of this negative news as now reflected in the euro’s price. Yet the increasing use of the euro as a funding currency in carry trades could limit gains. On balance it is therefore unlikely that sustained appreciation of the currency would derail a recovery in the second half, in our view.

Crisis concerns

Contributions to change in European equity prices and the BGRI score for EU fragmentation, 2018-2019