EUROPEAN ECONOMICS UPDATE

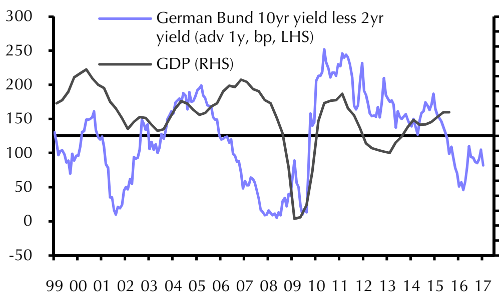
11th Feb. 2016

Will market turmoil prompt a euro-zone recession?

- **Several financial market indicators are warning of an impending euro-zone recession. For now, even we think that is too pessimistic. But it supports our non-consensus view that growth is set to slow. And if asset prices continue to fall, the probability of a deeper economic downturn will rise.**
- While the recent turmoil in financial markets has in part reflected concerns about euro-zone banks (see our *European Economics Update*, "Bank troubles intensify downside risks to growth", published 10th February), it has largely been a result of developments outside the euro-zone. Nevertheless, the currency union has not been immune to spillovers. In fact, some market indicators appear to suggest that the euro-zone itself is headed for recession.
- For example, at around 80bp, the difference between the yields of 10-year and 2-year German Bunds is low by past standards. This suggests that investors see little chance of short-term rates rising over the next ten years – perhaps reflecting pessimism about the outlook for growth and inflation. (See Chart 1.)
- **Meanwhile, the recent declines in equity prices suggest that output might already be falling.** Over recent years, equity prices have been a fairly reliable and timely guide to the performance of the real economy. On past form, the declines in euro-zone equities over the past year look consistent with annual contractions in GDP of more than 1%. (See Chart 2.)
- **But what does this really mean for the economy? The first key issue is whether these indicators tell us anything new about how the economy is performing now. We are sceptical.** For one, we have argued for some time on our China and Global Economics services, among others, that concerns about global growth and, as a result, the declines in equity prices, are overdone. There are also various reasons why the performance of equities can diverge from that of the economy over long periods of time, such as changes in company's profit margins. It is plausible that with euro-zone demand still weak, firms are having to compete fiercely for business by reducing prices, which reduces their margins.
- What's more, quantitative easing and the low level of interest rates have changed how Bund yields respond to economic developments, which could mean that the steepness of the yield curve should now be interpreted differently. In any case, it does not have a strong record of predicting changes in economic activity. (See Chart 1 again.)
- **However, the second key issue is whether the market turmoil could *cause* a recession in the euro-zone. On this point, there are probably more reasons to be worried.** Admittedly, the share of households' financial wealth accounted for by equities has fallen by about 10 percentage points since 2000, to 26%. And credit conditions remain tighter than before the crisis, implying that spending decisions might now depend more on what happens to current income than what happens to wealth and the resulting change in consumers' ability to borrow. So the impact of equity price movements on spending via so-called "wealth effects" might have diminished.

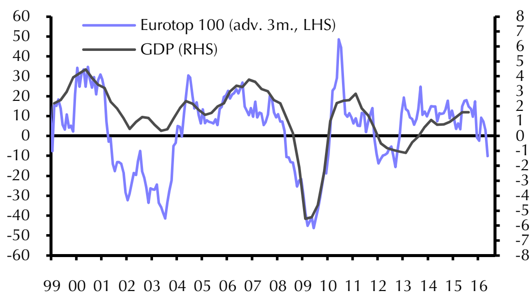
(Continued on page 2 overleaf.)

Chart 1: Spread Between Yields of 10-year & 2-year Bunds vs. Euro-zone GDP



Sources – Thomson Datastream, Bloomberg, Capital Economics

Chart 2: Euro-zone Equity Prices & GDP (% y/y)



Sources – Thomson Datastream, Capital Economics

- **Nevertheless, the association between euro-zone equities and consumer confidence has remained fairly strong** (see Chart 3), suggesting that falling prices could make households less willing to spend.

- **Indeed, we estimate that the decline in equity prices this year has knocked off almost €300bn, or 1.5%, household financial wealth, which could have a large impact on consumer spending.** Chart 4 plots financial wealth against consumer spending and shows two scenarios for wealth over the next two years. Both assume that over this period non-equity wealth grows at its average rate over the past twelve months. They also both assume that households do not buy any more equities, so changes in equity wealth are entirely due to changes in equity prices. The first assumes that equity prices remain at their current levels, while the second assumes a further 10% fall.

- On past form, a 10% decline in equity prices could lead to consumer spending falling by around 1% this year. To be clear, this is not our central forecast. Just as Chart 4 shows that rising wealth in 2012 and 2013 did not translate to positive rates of spending growth (perhaps because consumer confidence fell), declining wealth might not cause spending to fall. But it gives an indication of where the risks lie.

- **Meanwhile, there could also be a knock-on effect from lower equity prices on investment.** Indeed, on the basis of past form, the declines in equity prices point to annual contractions in investment of around 3%. (See Chart 5.) Other indicators do not paint a much more positive picture. The credit impulse, which puts bank lending on a comparable basis with GDP, suggests that investment growth will slow to zero later this year. (See Chart 6.) Granted, interbank lending rates have been falling in anticipation of looser monetary policy, which could feed through to lower interest rates on lending to firms. But it is unlikely that a 10 or 20 basis point interest rate cut would lead to a significant increase in borrowing.

- **The big picture is that we do not expect the euro-zone economy to contract this year. But the recent turmoil adds weight to our non-consensus view that growth will slow.** One of the main reasons for this view was that the positive effects of the weakening of the euro would fade. If sustained, the currency's recent strengthening would make these effects diminish more quickly than we had anticipated. **What's more, the longer the market rout continues, the bigger the downside risks become.**

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Chart 3: Consumer Confidence & Equity Prices

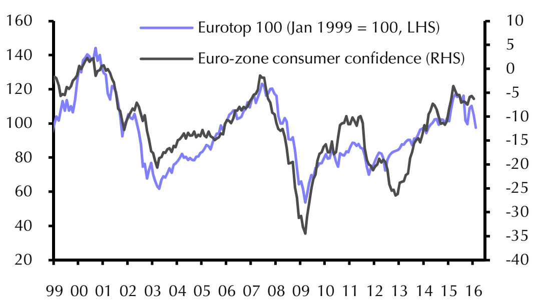


Chart 4: Household Wealth & Spending (% y/y)

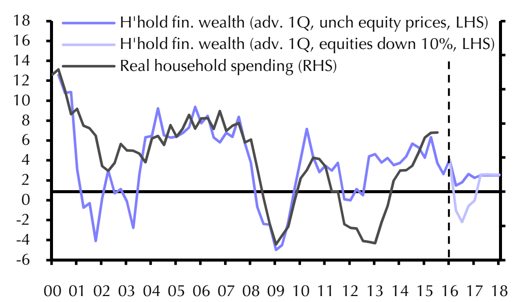


Chart 5: Equities & Investment (% y/y)

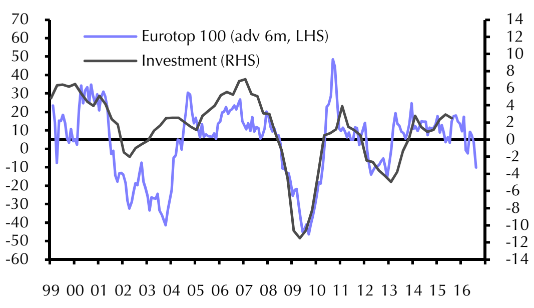
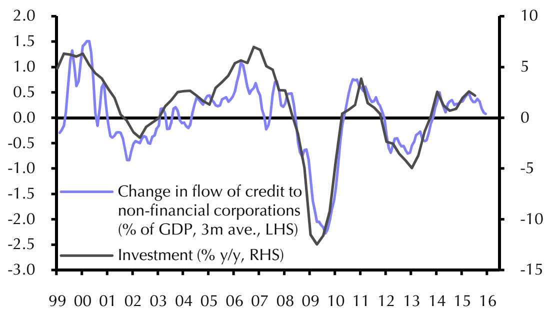


Chart 6: Credit Impulse & Investment



Sources – Thomson Datastream, ECB, Capital Economics