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Euro Area To Start Disappointing Expectations Soon

*Based on a May 18, 2015
client bulletin.

The first-quarter GDP report for the euro area showed the economy growing at its fastest pace in four years. The first-quarter performance was not a surprise, given the strength in second-half-2014 business conditions. Euro area business saving (profits after taxes and dividends) rose in the last two quarters of 2014, driven almost entirely by gains in the current account surplus (chart 1). When we forecast the winter pickup in the euro area, we indicated that the improvement would probably last just a few months before the region's secular imbalances and large global exposure began to undermine conditions once again (see January 8 client bulletin, "Euro Area: Oil Price Drop and Weaker Euro Boost Short-Term Profits Outlook"). Thus, while euro area economic data on balance were solidly higher than expectations in the first quarter, data are likely to increasingly fall below expectations as the year progresses.

It will likely prove difficult for the euro area to continue substantially increasing its current account balance at the expense of the rest of the world. The record high euro area current account surplus at the end of last year represented an enhanced negative profit source for the rest of the world (especially the EMs outside of China). Moreover, the fact that the goods trade balance appears to have just held steady in the first quarter (chart 2)—in the face of a continued weakening in the currency and lower petroleum prices than in the fourth quarter of 2014—suggests that global trade flows were already deteriorating in the first few months of 2015. Indeed, both China's non-commodity imports and U.S. nonpetroleum exports have declined sharply.

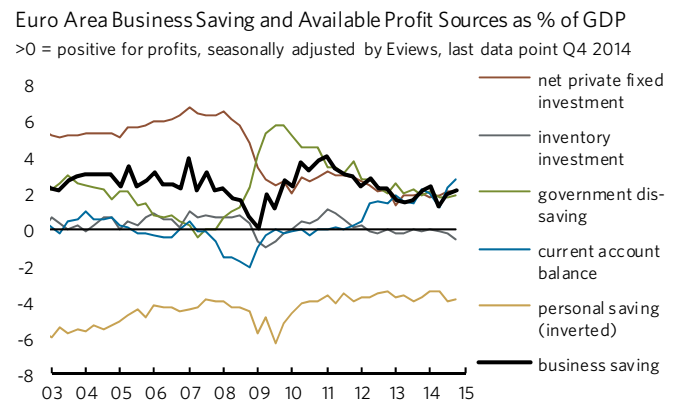
Therefore, the case for continued economic strength in the euro area into the second half of 2015 assumes some acceleration in domestic fixed investment in response to the economic pickup to date. However, even if investment growth does pick up, do not expect it to be of greater strength or duration than the brief and modest rise experienced in 2010 (charts 3-5). Anemic topline growth, excess capacity, and high corporate leverage

will continue to inhibit a sustained recovery in fixed investment (see September 16, 2013 client bulletin, "2014 Eurozone Earnings Unlikely To Meet Expectations").

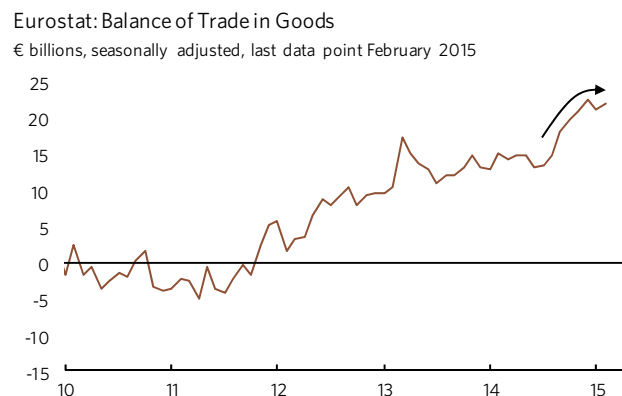
Even in the best case scenario, in which the expansion of the global economy more or less holds up through yearend and the euro area manages to increase its share of global markets, the euro area expansion will fail to match present market earnings

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Rise in H2 Euro Area Business Saving CHART 1



Trade Balance Appears To Have Been Flat in Q1 CHART 2



expectations. The positive surprises in the euro area economic data and company reports are for the most part behind us. While a few more months of performance similar to that in the first quarter are possible, conditions could begin to disappoint at any time. More important, the second half data will fall increasingly short of expectations. If the EM sector of the global economy staggers to the end of 2015 without collapsing, the euro area earnings may grow marginally in the second half, but if the EM sector does indeed fall into recession in the next few months, euro area earnings could be declining by the fourth quarter.

Investment Implications

- Euro area equities have run up on expectations of strong earnings growth and are increasingly vulnerable to earnings disappointments in the second half the year.
- The euro rally may eke out some further gains in coming weeks, but we expect the weakening trend to be reestablished by about midyear.
- The rise in high quality euro area government bond yields is not likely to persist in the second half. Yields have risen sharply with the help of stronger-than-expected economic data and rising oil prices, which have eased deflation concerns. Economic data are likely to be less supportive of higher yields in coming months. Moreover, contrary to common perception, declining oil prices are not deflationary; while they lower certain prices, they also support wages, raise profits, and thus fight income deflation, which is the real deflation concern. Similarly, the rising global oil prices of recent months do not mitigate the underlying deflationary conditions in the economy (see January 5 client bulletin, "Falling Oil Prices Do Not Worsen the Euro Area Deflation Threat").

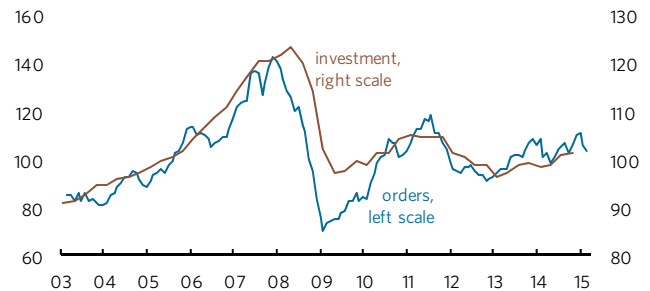
A Note on QE

It is worth noting that euro area sovereign bond yields are actually higher now than they were when the ECB began buying bonds on March 9. In the United States, bond yields have shown a tendency to rise during periods of actual QE implementation and to decline after various QE programs ended (chart 6). Central bank purchases are often clearly not the dominant forces in either the euro area or U.S. markets. The one likely benefit of QE to the euro area has been the weakening of the euro, yet here again policy announcements appear to have more influence than policy actions.

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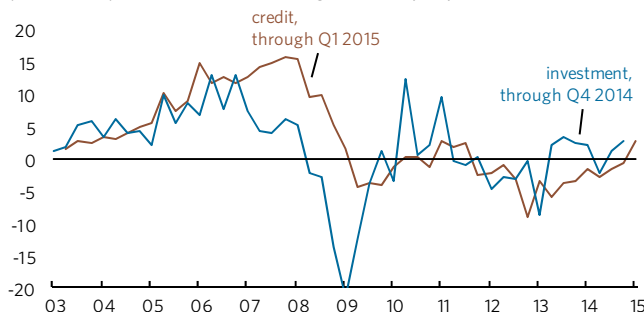
Orders Also Suggest Mild Euro Area Capex Pickup CHART 4

Bundesbank: German Capital Goods Orders from the Euro Area index, 2010 = 100, seas. adjusted, 3-month mov. avg., last data point March 2015
Eurostat: Euro Area ex. Germany Equipment and Machinery Investment € billions, seasonally adjusted, last data point Q4 2014



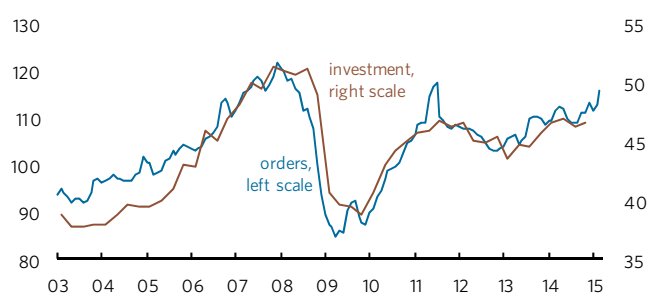
Bank Lending Growth Suggests Mild Capex Pickup CHART 3

ECB: Euro Area MFI Lending to the Nonfinancial Sector
Eurostat: Euro Area Gross Fixed Capital Formation
quarter-over-quarter annualized % change, seasonally adjusted



German Capex to Pick Up More Strongly CHART 5

Bundesbank: German Domestic Capital Goods Orders index, 2010 = 100, seas. adjusted, 3-month mov. avg., last data point March 2015
Eurostat: Germany Equipment and Machinery Investment € billions, seasonally adjusted, last data point Q4 2014

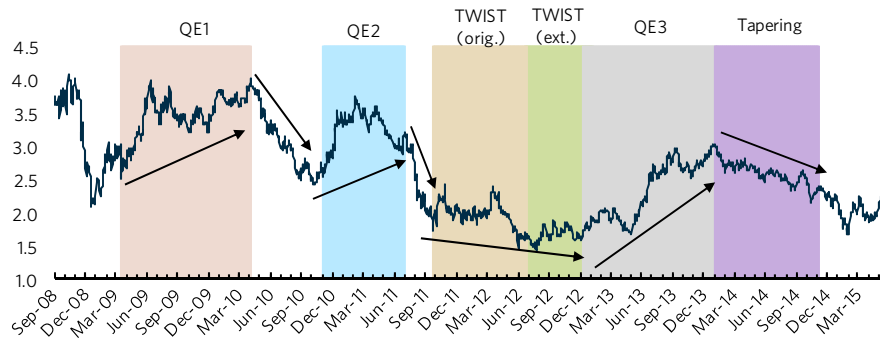


U.S. QE Action Timeline and 10-Year Treasury Yield

CHART 6

10-year U.S. Treasury Yield, % per annum, daily data September 1, 2008 to May 13, 2015

QE Timeline, shaded areas represent actual Fed Treasury purchases



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