European Economic Perspectives

Eurozone: What this week's PMIs will tell us...

Economics

Europe including UK

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July flash PMIs: The first serious data point post the UK referendum

Four weeks after the UK Vote to Leave and with substantial uncertainty about the potential economic effects, this week's July flash PMIs (out on Friday, 22 July) will provide a first glimpse of how the Eurozone outlook is likely to be impacted. To gauge what could lie ahead, we looked at how PMIs reacted during seven uncertainty shocks that have hit the Eurozone over the past 15 years. We use the results to provide a rough guide for interpreting the July PMI release: a fall by up to 1.5 points would be in line with our baseline growth scenario, a decline by 2 points would point towards additional downside risk, and a fall by 3-4 points would be similar to a Lehman-type shock (see our 29 June publication, Eurozone: A first damage assessment, for details about our revised forecasts and scenarios).

The July PMIs will only give a first indication of the way forward – looking further ahead, our analysis of past shocks suggests three takeaways:

Uncertainty shocks typically dampen Eurozone PMIs for six months

Not all past shocks were followed by sharp falls in the PMIs, but the skew is clearly on the downside. On average, during past uncertainty shocks, Eurozone Composite PMIs fell by 3 points during the first three months after the event, and remained at that depressed level for another three months before rising again. The pre-event level is typically reached once again 8-10 months after the shock.

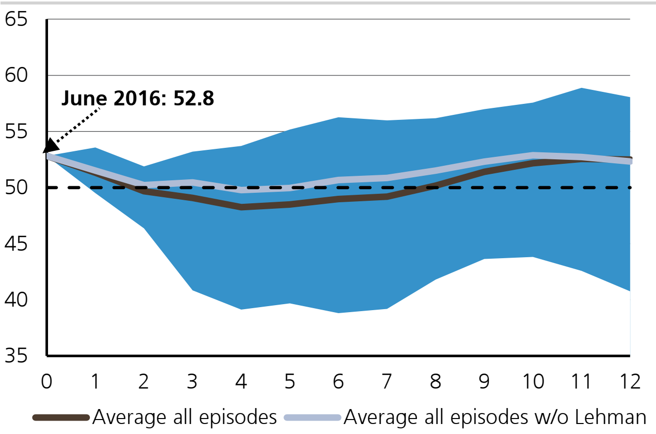
Manufacturing PMIs hit harder than Services PMIs

Manufacturing PMIs, on average, fell by around 4 points over a six-month period after past shocks, while the Services PMIs fell by around 2 points.

Germany Manufacturing PMI hit most

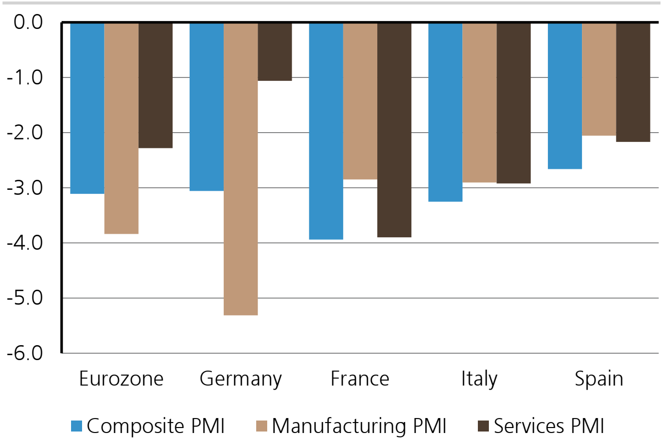
Across countries, Germany has typically registered the steepest fall in the Manufacturing PMI, while France has, on average, experienced steeper falls in the Services PMI. The German ifo index tends to experience somewhat smaller declines than the German Manufacturing PMI, and tends to return to its pre-shock level earlier.

Figure 1: Manufacturing PMI outcomes post shocks, Eurozone



Source: Haver, UBS

Figure 2: Average PMI decline six months post shock (points)



Source: Haver, UBS

UBS Research THESIS MAP **Eurozone: Scenarios for the shock of UK Vote to Leave**

PIVOTAL QUESTIONS

Q: Will Eurozone growth suffer post the UK referendum, and if so, by how much?

We view the Vote to Leave primarily as a major uncertainty shock that comes on top of the impact of weaker UK activity. In addition to having lowered our base-case forecast by 0.1pp and 0.4pp for 2016 and 2017, respectively, we have sketched out a substantial downside case, whereby growth would fall by 0.2pp this year and 0.9pp in 2017. The July PMIs provide a first indication as to which way the economy is heading.

Q: How might the shock play out?

We have analysed seven 'shocks' that have hit the Eurozone over the past 15 years, ranging from 9/11 to the Cypriot bailout in 2013. We find that not all shocks lead to meaningful economic damage, growth declines occur mainly over two quarters, and fixed investment tends to react most. This also implies that it is not weaker trade with the UK that concerns us most, but a sharp fall in Eurozone investment, likely following a decline in business sentiment as indicated by the PMIs.

Q: How will the ECB react?

Heightened uncertainty and weaker growth imply that the likelihood of more dovish ECB monetary policy has risen. While an increase in QE seems unlikely in the short term, we think the ECB's decision is now likely to be skewed further towards an extension of asset purchases beyond March 2017, with a decision likely to be announced on 8 September or 8 December, when it will once again issue staff macroeconomic forecasts. Business sentiment indicators will likely be an important guide.

UBS VIEW

Our base-case forecast is for Eurozone growth to fall to 1.5% and 1.3% in 2016 and 2017, while in a substantial downside scenario, GDP growth would reach only 1.4% this year and 0.8% next year.

EVIDENCE

To derive our scenarios, we have analysed seven shocks that have hit the Eurozone over the past 15 years, ranging from 9/11 to the Cypriot bailout in 2013. We have scrutinised the size, length and 'anatomy' of these shocks to the PMIs at the Eurozone level as well as across the major Eurozone member countries.

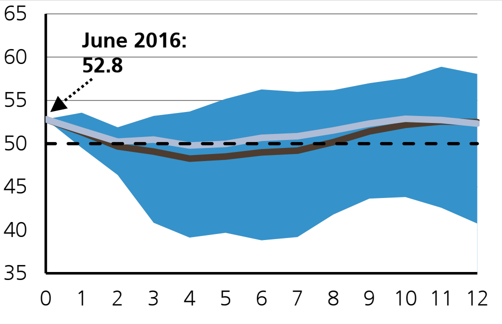
WHAT'S PRICED IN?

Post the UK referendum, equity markets have been very volatile and price in zero to slightly negative earnings growth for 2016, and hence very subdued nominal GDP growth. Market gauges of inflation expectations show scepticism about a lasting recovery in inflation.

UPSIDE/DOWNSIDE RISKS:

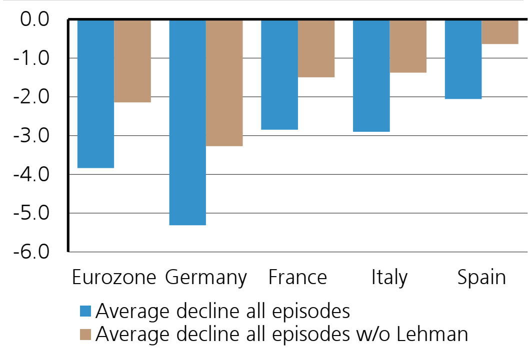
Downside: Prolonged uncertainty about exit negotiations and EU integration/disintegration.
Upside: Uncertainty to subside more rapidly, in which case our optimistic scenario becomes more likely.

Figure 3: Eurozone Manufacturing PMI outcomes post shocks



Source: Haver, UBS

Figure 4: Average Manufacturing PMI decline six months post shock (points)



Source: Haver, UBS

Looking at past uncertainty shocks

We view the UK Vote to Leave primarily as an uncertainty shock to Eurozone growth, with adverse effects of net trade to be rather small in comparison. To reflect the uncertainty about the outlook, we presented both our new baseline forecast with a moderate shock to growth and a more substantial downside scenario (Eurozone: A first damage assessment, 29 June 2016). To gauge the extent of growth revisions, we looked at seven uncertainty shocks that have hit the Eurozone over the past 15 years, ranging from September 11 (2001) to the Crimea invasion in 2014.

We now apply this analysis to the evolution of PMIs in order to draw lessons for what to expect in the months ahead, and to gauge which growth outcome is most likely.

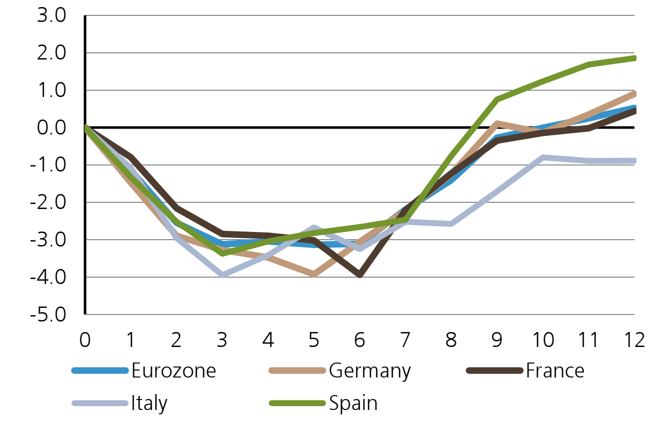
Sentiment tends to be hit over six months

After past uncertainty shocks, PMIs tended to fall in the first three months after the event and remained at that level for another three months before rising again (Figure 5). The average decline is around 3 points, which would imply a fall in the Eurozone Composite PMI to around 50 by September, and starting to rise again at the beginning of 2017.

Manufacturing hit more than Services

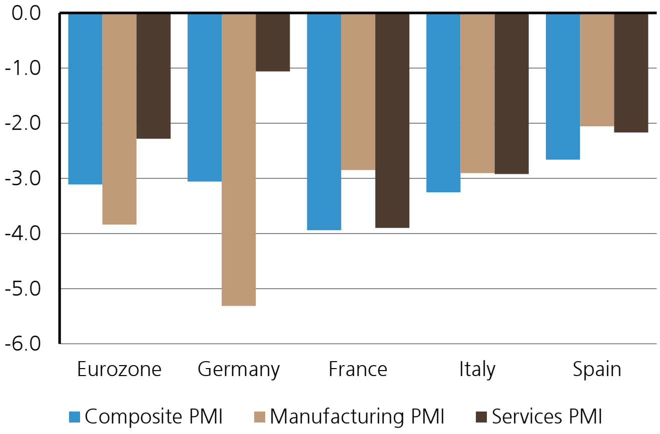
The hit to Manufacturing is around 1 point sharper than for Services, in particular reflecting a more sensitive reaction of the German Manufacturing PMI (Figure 6).

Figure 5: Average performance of Composite PMIs in the months post shocks



Source: UBS
Note: Chart denotes change in PMIs relative to the level in the month preceding the shock. We take the average performance of seven shocks since 2001.

Figure 6: Average PMI decline six months post shocks



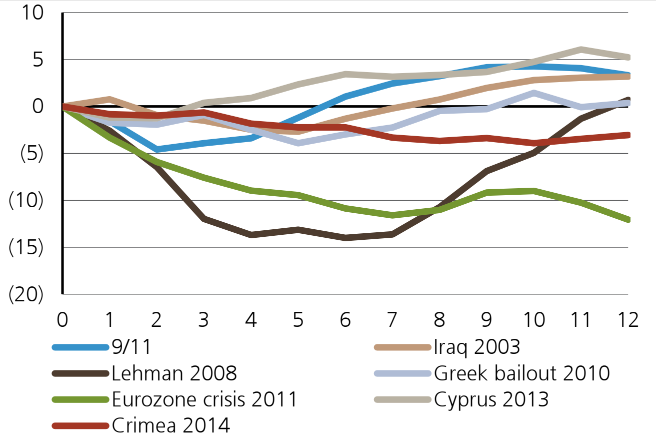
Source: UBS

Not all shocks are equally bad

Looking across the past 15 years, the uncertainty shocks related to Lehman in 2008 and the Eurozone crisis in 2011 tended to drive down PMIs the most (Figure 7). Other shocks were followed by more moderate declines in the PMIs, or even did not impact sentiment indicators, such as the Crimea 2014 event. Overall, this suggests that, looking ahead, an unchanged Manufacturing PMI reading is likely to

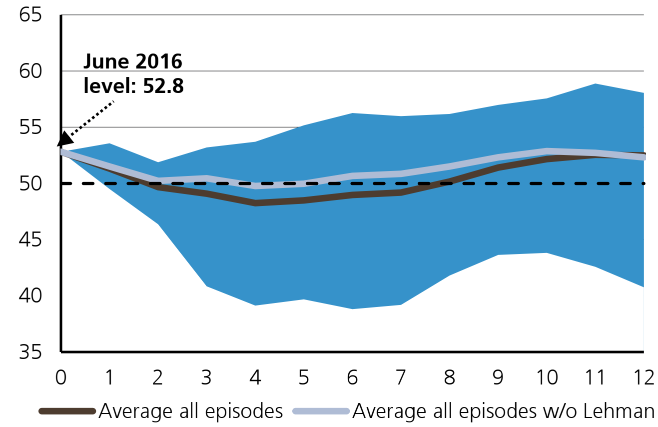
be the best-case scenario, while a worst-case scenario (i.e. a Lehman-type shock) could see PMIs falling to the low 40s over the coming six months (Figure 8).

Figure 7: Performance of Manufacturing PMIs in the months post shocks



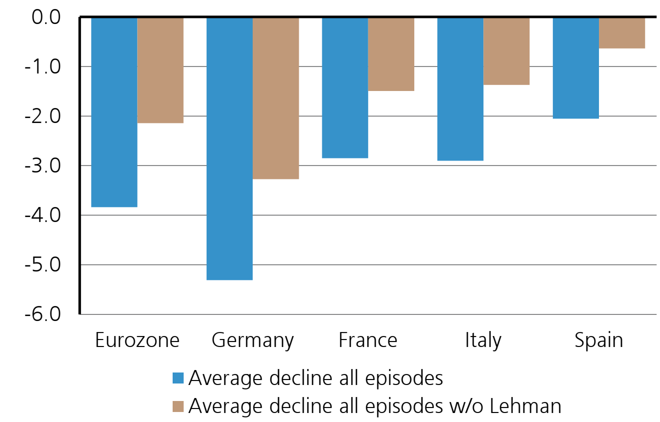
Source: UBS
Note: Chart denotes change in PMIs relative to the level in the month preceding the shock.

Figure 8: Range of Manufacturing PMI outcomes in the months post shocks



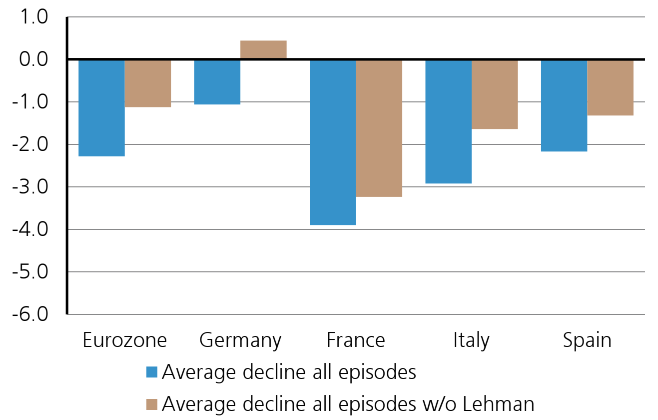
Source: UBS

Figure 9: Average Manufacturing PMI decline six months post shock



Source: UBS

Figure 10: Average Services PMI decline six months post shock



Source: UBS

A roadmap for the 22 July flash PMIs

The July PMIs (out on Friday, 22 July) will provide only a first glimpse of the likely impact of the UK Vote to Leave on the outlook and one should certainly not over-emphasize one month's reading. However, one can tentatively draw some conclusions based on the anatomy of past uncertainty shocks. On this basis, we would interpret the potential outcomes as follows (Figure 11):

- **Baseline scenario of moderate growth losses:** Roughly corresponds to declines in the Composite PMIs of around 1.5 points (somewhat more for Germany and for Manufacturing PMIs);

- **Additional downside risk:** Roughly corresponds to declines in the Eurozone and German Composite PMIs of around 2 points, and around 2.5 points for Manufacturing PMIs (likely less reaction in France);

- **Worst-case scenario akin to Lehman 2008:** Roughly corresponds to falls in the Composite PMIs by 3-3.5 points and 4.5 points for Manufacturing PMIs (again primarily Eurozone and Germany).

Figure 11: Interpretation of July PMI levels

		July level under different types of shock		
	June level	Moderate growth loss scenario (average reaction to past uncertainty shocks w/o Lehman 2008)	Downside growth scenario (similar to September 11 shock)	Lehman 2008 shock
Eurozone Composite PMI	53.1	51.5	51.0	50.0
Germany Composite PMI	54.4	52.5	52.0	51.0
France Composite PMI	49.6	48.0	48.0	48.0
Eurozone Manufacturing PMI	52.8	51.0	50.5	48.0
Germany Manufacturing PMI	54.5	53.0	51.5	50.0
France Manufacturing PMI	48.3	46.5	46.5	44.5

Source: UBS

What to watch

22 July: Flash PMIs for Germany, France and the Eurozone (Jul)

25 July: Ifo business climate index for Germany (Jul)

28 July: European Commission sentiment indicators (Jul)

29 July: Eurozone flash estimate of GDP (Q2); Eurozone flash HICP estimate (Jul)

1 August: Final Manufacturing Eurozone PMIs (Jul)

3 August: Final Services/Composite Eurozone/UK PMIs (Jul)

24 August: Flash PMIs for Germany, France and the Eurozone (Aug)

25 August: Ifo business climate index for Germany (Aug)

October: Referendum on constitutional change in Italy

Valuation Method and Risk Statement

Risks include macroeconomic variables (such as GDP growth rates and inflation), economic slowdown, a weakening currency, global economic events, and government policy changes.

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