

# ECOWEEK

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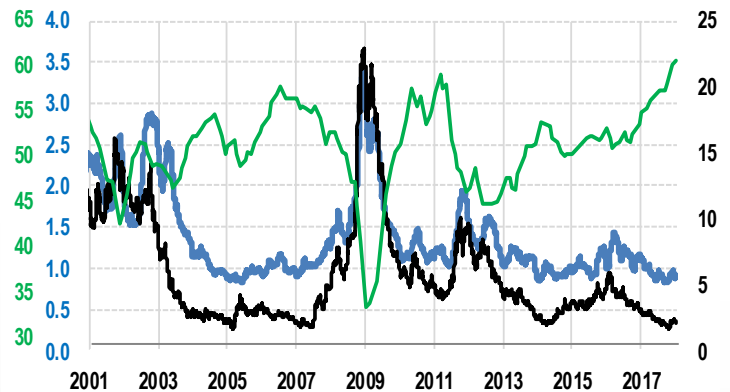
## Eurozone: will a slowdown cause a jump in uncertainty?

■ Eurozone growth is robust ■ Sentiment indicators and the drivers of final demand all point towards ongoing strength ■ At some point however, growth will slow down ■ Whether this will cause a jump in uncertainty very much will depend on the financial environment

On several occasions, IMF managing director Christine Lagarde has stated that it's time to fix the roof when the sun is shining. Judging by the updated growth forecasts released earlier this week, the sun will keep on shining. The IMF expects 2.2% growth in the eurozone this year and 2.0% next (we forecast 2.4% and 1.8%). Apart from doing roof repair, prolonged good economic weather should also be used to reflect on what will happen when seasonal change brings cooler temperatures. Theoretically, slower growth increases economic uncertainty: households and companies wonder how the slowdown could impact their income, asset values and earnings expectations. Resilience will depend on the job one is doing or the business you're in. A common way to visualise uncertainty consists of calculating the dispersion of daily returns of the components of a stock market index. When the economic outlook worsens, the share price of companies will react in different ways depending on the resilience of earnings. Using this approach, the chart shows the return dispersion of the Eurostoxx 50 constituents as a proxy for eurozone uncertainty. Comparing its evolution with the Markit manufacturing PMI, a measure for the eurozone business cycle, shows that the relationship is not stable: cyclical slowdowns sometimes see an increase in uncertainty but not always. There must be other factors at play. An obvious place to look is the interest rate environment considering that share prices depend on the earnings outlook, the level of the risk free rate and the required risk premium. To that end the high yield bond spread versus Bunds has been added to the chart. It is a measure of financial frictions and investor risk appetite or aversion. There is a very high correlation between the equity return dispersion and the high yield bond spread. This doesn't come as a surprise: more often than not, news which is bad for the shareholder will tend to be bad for the corporate bond holder as well. From a macroeconomic perspective this result implies that economic slowdowns do not necessarily cause a big increase in uncertainty: fluid financing conditions or the appearance of financial frictions will make a big difference. When the sun is shining we should build a dashboard to track the change of seasons. Financial data have as much a role to play as traditional activity and sentiment indicators.

### EUROZONE: UNCERTAINTY AND THE BUSINESS CYCLE

— PMI Manufacturing — Eurostoxx 50 volatility — Euro high yield & German 10y yield spreads (lhs)



Eurostoxx 50 volatility = 60-day moving average of the cross-sectional standard deviation of daily returns of the index constituents

Sources : Thomson Reuters, Markit, FRED, BNP Paribas

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