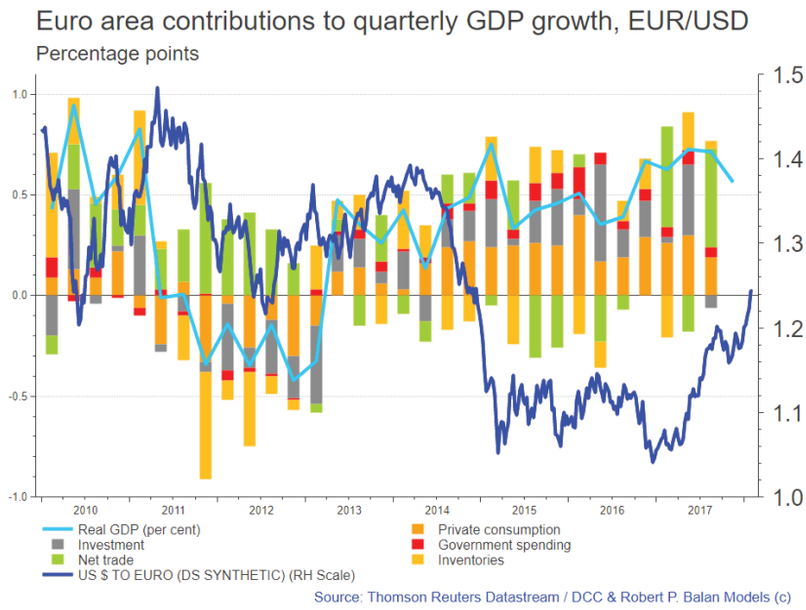
41 / Eurozone will keep growth momentum going in 2018 on weaker EUR/USD, but political risks will become even more elevated

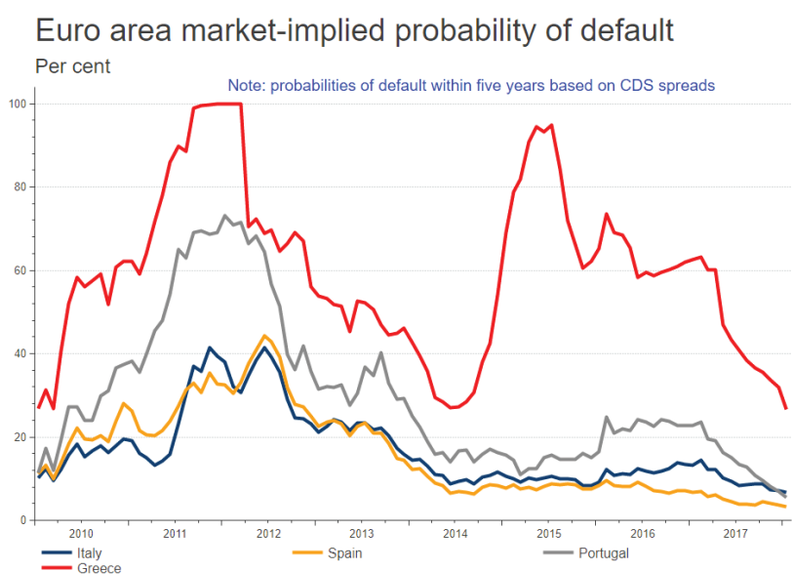
Last year, European economic growth accelerated after two years of steady but flat recovery, demonstrating once again the institutional resilience of the economic bloc -- consumer and business sentiment surged and the pace of economic growth was relatively unaffected by the political uncertainty that erupted during the year. **The outstanding performance was driven primarily by exports, despite a surging currency** *(see 1st chart on this page)* . **For 2018, we expect the cyclical economic upswing to continue; however, this year, we expect political risk to remain high or more likely, even escalate. Domestic political tensions have been seen recently even in countries that are registering solid rates of growth (Ireland), and in traditionally politically stable countries, such as Germany**. In Ireland, a long-running policing scandal brought Leo Varadkar›s Fine Gael-led minority coalition government to the brink of collapse in November 2017. Political analysts say that the embattled Varadkar›s government will likely call a snap parliamentary election in the first half of 2018, which the incumbents will likely lose.

In Germany, the difficulties of Madame Angela Merkel in forming a government dealt a severe blow to her image of authority. Furthermore, the inclusion in the Bundestag (the lower house of parliament) of the far-right populist Alternative for Germany (AfD) caused an uproar, despite polls having indicated for two years that this would happen. **Germany is not alone in this respect – the country is catching up with its neighbours, as recent elections across Europe show that electorates are increasingly favouring alternative or populist parties over mainstream parties and candidates. Expect more political fragmentation, and the emergence of unusual government coalitions and will mean a more complicated policymaking outlook across the region in 2018 and beyond**.



Source: Thomson Reuters Datastream / DCC & Robert P. Balan Models (c)

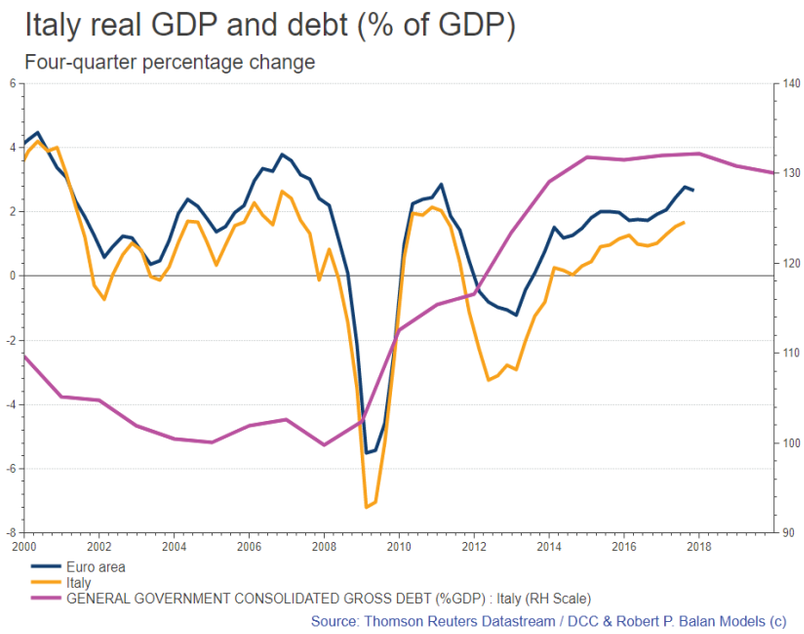
Political unrest remains high in Spain following the victory of separatist parties in the 21 December regional election in Catalonia. Although the central government is effectively ruling the region after Prime Minister Mariano Rajoy invoked Article 155, and there are doubts as to whether former Catalan President Carles Puigdemont will be able to head the new Catalan government, a separatist government with a solid parliamentary majority will likely be formed in the coming days. **Tension between the IMF and some euro zone members on the sustainability of Greece›s public debt could flare up again in 2018**. The discussion of debt relief has been deferred until after the third bail-out programme, which ends in August. However, another round of anxiety over possible PIIGS default is largely remote, if measured by market-related risk constructs *(see chart below)*.

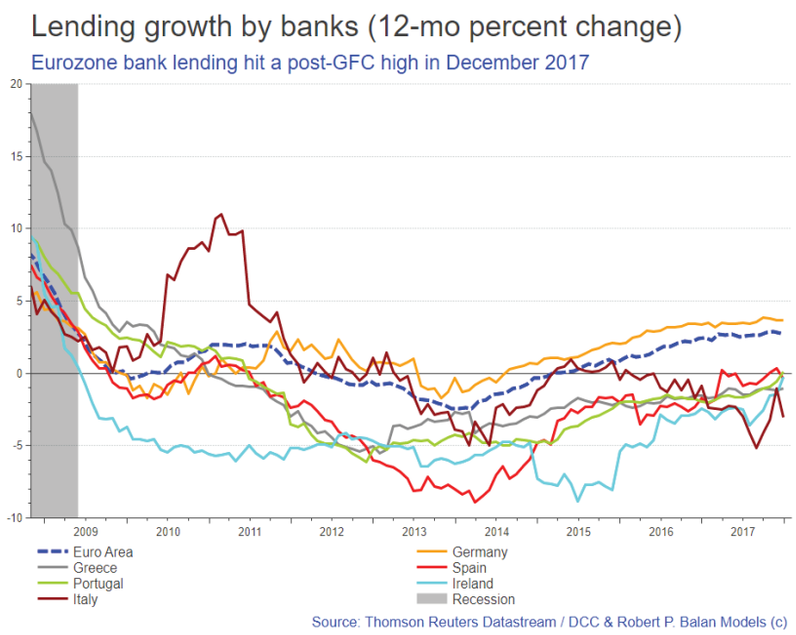


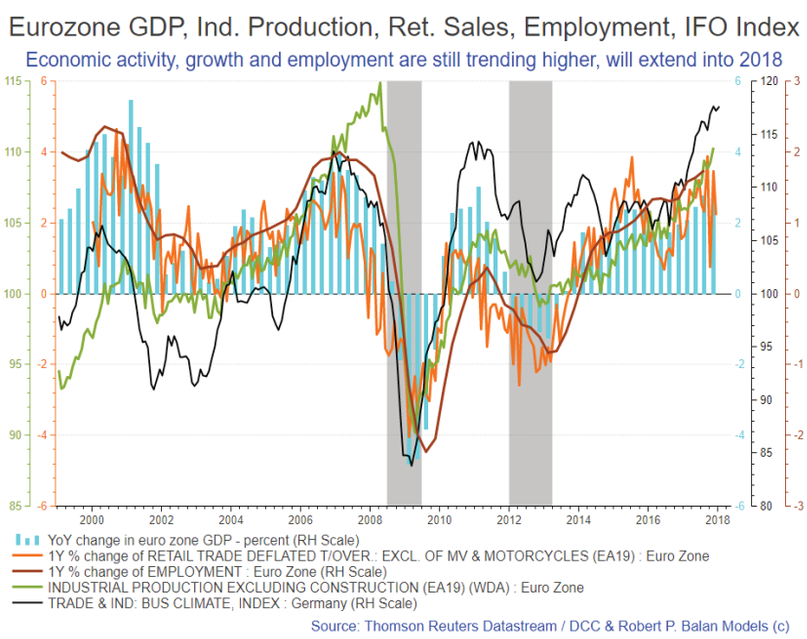
Source: Thomson Reuters Datastream / DCC & Robert P. Balan Models (c)

However, the biggest potential political risk to the eurozone is the Italian election on the 4th of March 2018. This is the immediate political hurdle that the eurozone needs to clear. Former Prime Minister Silvio Berlusconi's coalition is topping the polls, followed by a neck-to-neck race between a coalition of center-left parties and the populist Five Star Movement. The left-of-centre Democratic Party (PD), which runs the current government, remains in third place. **Matteo Renzi and his party (strong proponents of the EU), have collapsed in the polls, in part because of the fading popularity of the EU. All polls project a highly-fragmented parliament, and tough negotiations will be needed to form a new government, which will have to deal with an ailing financial system and relentless weak economic growth and elevated debt levels** (*see 1st chart on this page*). There remains a significant risk that the anti-EU position of the Italians has risen to a significant level that once again we are witnessing a backlash against the current political systems everywhere, which of course first manifested as Brexit in the UK. Nonetheless, the anti-EU sentiment in Italy has not yet reached the tipping point, and we do not see an Italexit during the course of the year.

Rising employment, high levels of positive sentiment and a loose monetary policy stance should continue to underpin domestic demand in the entire Eurozone this year. Low inflationary pressures should allow the ECB to maintain its ultra-loose monetary policy stance, while robust global growth will support the exports sector. Last month, the ECB halved the pace of monthly asset purchases under its quantitative easing (QE) programme, but they will run at this level (EUR30 bln) for most of the year, until September, after which markets expect a very gradual tapering of purchases. In a sign that the ECB's ultra-accommodative monetary policy stance is bearing fruit, corporate lending in the bloc hit a post-crisis high in December. (*see 2nd chart on this page)*







The positive momentum from 2017 is expected to be carried over into 2018; business sentiment remained at multi-year highs in France and Germany in January, while preliminary composite PMIs for both countries for the same month signaled that their economies continue to grow robustly. Another healthy expansion in real GDP of 2.1% is expected this year by the IMF. **This follows the IMF's estimated growth of 2.4% in 2017—the fastest annual growth rate since 2007. If confirmed, the euro zone's economy would have expanded for 17 consecutive quarters.**

The eurozone economy is enjoying the strongest period of economic growth in more than a decade, despite lingering political uncertainty and strong currency. The underlying strength of the bloc has so far, superseded concerns around the prospective change in monetary policy outlook and the recent gains in the euro. The positive momentum in economic indicators has initially heightened speculations that the European Central Bank (ECB) may hasten the reduction its monthly asset purchases, but Mr. Mario Draghi has tamped down on that speculation for fear of pushing the exchange rate of the EUR even higher, forestalling growth. **The euro posted its strongest year against the US dollar in over a decade in 2017, but the single currency remains well below its long-term average versus the US dollar**. As such, European equities have been able to withstand the euro's appreciation and have pushed higher in spite of it. But the impact of a strong EUR on equity valuations has a long distributed lag, and so it is only now that the impact of the recent EUR strength will negatively impact European equities. The negative influence should dissipate in a few weeks however.

As for the EUR itself, the current resurgence is primarily a reflection of the weakness of the US Dollar – its main competitor in the global FX arena. And our outlook is for a recovery of the US Dollar soon (as early as this month), and by extension, a weaker EUR should underpin the Eurozone growth prospects even further later this year (*see 2nd chart on this page*).