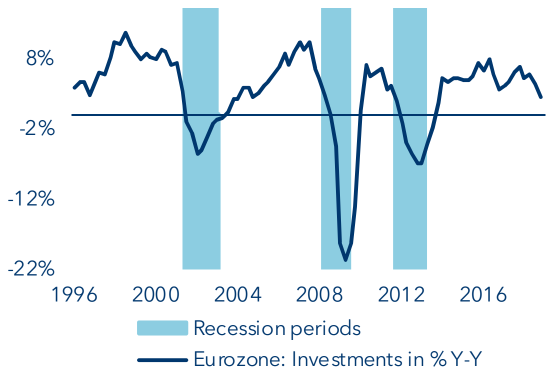
The VP Bank Eurozone recession barometer

News from the financial markets

A number of crucial leading indicators are heading south, new factory orders are dwindling, and growth forecasts are being scaled back: such is the current macroeconomic backdrop in the eurozone. Consequently, fears of an impending recession are on the rise. The VP Bank eurozone recession barometer reveals how high the probability of an imminent decline in eurozone gross domestic product (GDP) actually is.

In stark contrast to the ongoing robustness of the US economy, the recent readings from the European manufacturing sector are far from rosy. Here, the major industry federations are worried most about the trend in new orders. Accordingly, it would appear that the eurozone needs to steel itself for a rough patch in the current year. The question, though, is whether there even is a threat of recession. In this regard, the trend in fixed investments will play a key role. Granted, corporate capital spending does not account for a particularly large chunk of eurozone GDP (ca. 20%). Rather, the reason for this is its susceptibility to significant fluctuations. Whilst private consumption has tended to remain relatively stable at 54% of GDP, the volatility in capital spending have proven to be considerable. Companies react more quickly than households to changes in the economic environment. Production capacity expansions or new equipment purchase are usually only made when a favourable course of business is expected. If this is not the case, little or no money is spent on capital goods. So, precisely because these investments are subject to higher volatility, they often determine the welfare or woe of the overall economy. This is evidenced by the (still nascent) data record of the eurozone: since 1996, every economic slump has been accompanied by a sharp drop in capital spending (see chart).

Eurozone recessions versus changes in corporate capital spending



Sources: VP Bank, Thomson Reuters Datastream

Recession phases in the eurozone

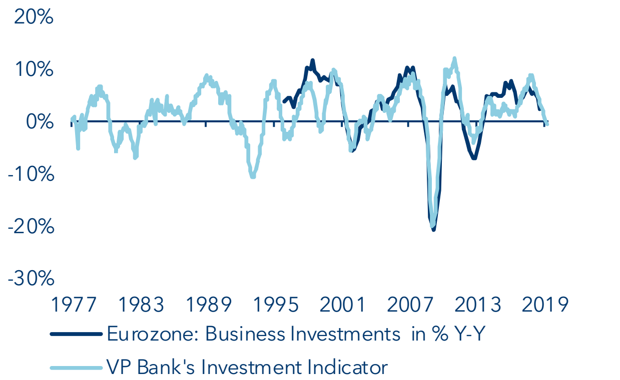
The Center for Economic Policy Research (CEPR) in Washington, D.C., compiles worldwide business cycle statistics. However, its data plot for the eurozone does not reflect a recession on the Old Continent in 2002 and 2003. This is surprising, as the global economy slid into an economic crisis following the bursting of the dot-com bubble and the attacks on the World Trade Center in September 2001. In the eurozone, Germany and Italy did in fact tumble into recession, while the common currency area as a whole recorded not only a considerable slump in capital spending and industrial production, but also a rising unemployment rate. At the time, it was essentially French consumers who saved the eurozone from an even sharper economic downturn. Nonetheless, since the macro circumstances in the eurozone back then indeed corresponded to a phase of economic contraction by all broader standards, we take the view that a recession prevailed in the period between Q3 2001 and Q1 2003.

Capital spending outlook is reason for concern

In effort to better assess both historical and upcoming corporate investment trends, VP Bank has developed an indicator that provides monthly information on eurozone companies' capital spending intentions. This was no simple undertaking, in that reliable economic indicators require a lengthy data history as their base. For the eurozone, the time series are not very extensive due to the currency union's relatively brief history so far. However, since German GDP accounts for roughly one-third of the eurozone's economic output, the overall trend in corporate capital spending can be approximated by the developments in Germany. To capture the latter on a monthly basis, we draw on three indicators; namely, the new factory orders readings, the OECD business tendency surveys for manufacturing (production tendency) and the French business climate index compiled by the "National Institute for Statistics and Economic Studies" (INSEE). It may come as a surprise that we rely in part on the INSEE business barometer. However, the dataset of the index dates back to the 1970s and reasonably replicates the German ifo business climate index as well as the economic situation in the entire eurozone.

With the help of these three indicators, a capital investment propensity indicator can be derived by means of principal component analysis. It reveals how the anticipated dynamic is lining up. The current picture suggests that there is considerable risk of a slowdown in corporate investment in new equipment (see chart below).

Eurozone: actual capital spending versus propensity to invest

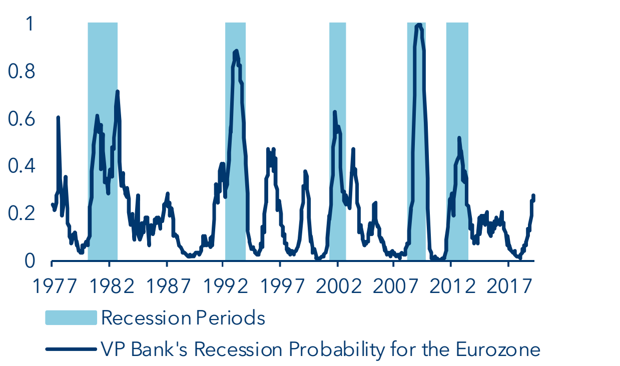


Sources: VP Bank, Thomson Reuters Datastream

Recession risk rising

The investment propensity index serves as the basis for calculating the VP Bank recession barometer for the eurozone. Currently, the probability of an economic contraction is 28% and thus as high as it was during the eurozone crisis years of 2011 and 2012. The readings for the most recent economic slowdown (2015 and 2016, when no recession actually ensued) have already been exceeded (see chart below). Only if and when the barometer shows a probability of well over 50% will the situation really become alarming.

The VP Bank recession barometer for the eurozone



Sources: VP Bank, Thomson Reuters Datastream

Given today's noticeable slowdown in economic activity, a recession probability of only 28% may appear low. The reason that the barometer has not (yet) climbed any higher can be found in history. In the 1990s, capital spending on plant and equipment declined significantly without sparking any overall economic contraction. At the time, private consumption was a reliable pillar that prevented a worse collapse, and it is entirely possible that the situation will play out the same way this time around. The ECB's expansive monetary policy continues to fuel domestic demand. Low interest rates are making debt bearable for private households and should also boost consumption and construction outlays in the coming quarters. Moreover, the favourable employment situation is another factor supporting consumer spending. The unemployment rate has recently fallen to 7.8%, almost back to the level where it stood before the outbreak of the financial crisis. At the same time, companies in an increasing number of countries are complaining that they are having a hard time finding qualified workers. This crystallises in the form of rising wages, which in turn make the cash registers ring even more often. In the further course of the year, the economic stimulus measures initiated by the Chinese government should also have a positive effect on the European continent. A first sign of this would be an increase in demand from the Far East, which should then be reflected in an improved new order inflow for companies in the eurozone. Viewed this way, the calculated probability of a recession (a mere 28%) appears to be quite plausible.

Summary

The likelihood of a recession in the eurozone is increasing. However, according to the VP Bank recession barometer, the 28% probability of that happening is not (yet) alarmingly high. Nonetheless, the recent acceleration of the upside move in the indicator is reason for caution. From a fundamental point of view, what is needed right now is above all an improvement in new factory orders for companies in the eurozone, a development that would prevent our barometer from rising further.

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