Article on Euro Zone growth and bond rating upgrades

It wasn't long ago that economists were worrying about the threat of a populist takeover in the Europe and predicting an investment led boom in the USA. However, since the start of the year, ratings agencies have upgraded their growth forecasts for Europe's largest economies and slashed its predictions for the United States. Moody's is expecting growth in the Euro region to exceed expectations, and has upgraded its growth forecasts for the three largest economies; Germany, France & Italy. On the other hand, the UK economy post the Brexit vote in June 2016 has evidenced a noticeable slowdown, growing at its slowest pace since 2012. The Bank of England has downgraded its estimate of how fast Britain's economy can grow post Brexit.

The upgrades in Europe follow recent official figures showing robust growth in the second and third quarters of 2017, with particularly strong Consumer Spending and PMI figures. IHS Markit declared in August that it will follow Moody's in upgrading the growth forecasts for the region. Robust indicators in the Euro Zone countries suggest that growth should accelerate through the rest of the year, while the consumer confidence indicator being at a 16-year high shows us that the recovery in the region is mostly consumer-driven. The unexpected extent of the recovery has helped drive the euro to multi-year highs, touching 1.2036 vs the US$ in September 2017. This has prompted concerns among economists that a high-euro would be a headwind for export-driven economies like Germany. However, it is unlikely that the appreciated euro will derail the recovery in the region.

Earlier in September, S&P upgraded Portugal from BB+ to BBB-, making it an investment grade bond. Similarly, Moody's upgraded Ireland's rating to A2, changing its outlook to Stable. These upgrades were based on the outperformance of the economies this year, with improving fiscal metrics and public debt ratios continuing to decline. Post the upgrades, the spread between the 10-Year Portuguese debt and its German equivalent narrowed to 208 basis points, its lowest since it crossed 1,000 points during the Euro Zone crisis in 2012. Standard & Poor's became the first of the big three credit rating agencies to lift Portugal back to investment grade. Portuguese government bonds have been among the euro zone's best performing markets this year, marking a turnaround from jitters about Portugal's rating outlook at the end of last year. The upgrade is now likely to attract more portfolio investment and has sparked speculation about Portugal's inclusion in major investment grade bond indices. This will help the government's efforts of diversifying the investor base.

In contrast to the Euro Zone, the US economy has been weaker than expected since the start of the year, leading to Moody’s cutting the US growth forecasts from 2.4% to 2.2%. The ratings agency is also less confident about President Trump’s commitment to ramp up infrastructure investment, cutting its forecast for 2018 growth from 2.5 per cent to 2.3 per cent because of lower fiscal stimulus than previously assumed. Geopolitical risks could significantly complicate the picture further, with any escalation of the current situation with Korea, having severe negative implications on the economy. Changes in monetary policy are another major risk to the US economy’s outlook, with the Fed looking at another interest rate hike in December 2017.

The UK's withdrawal from the EU remains the key downside risk for the Euro Zone economy given the sizable trade and migration flows between the two regions. However, the overall economy continues to perform strongly, a sign of better-than-expected resilience and testament to the flexibility and competitiveness of the region. The Euro zone should try to use the recovery to build up its resilience to future economic downturns. French President Emmanuel Macron has proposed widespread reforms including on taxes and defense policy, but it remains to be seen how keen German Chancellor Angela Merkel is. With the European Central Bank continuing with its easing policy and the Federal Reserve in the US looking to raise interest rates again in December this year, we could see the spread between Euro Zone 10 year yields and the US Treasury 10-year yields increase further.

The Eurozone economy is not flourishing currently, but there are good reasons to believe the recovery could go on for a few years, in sharp contrast to Britain’s worsening outlook.