

Eurozone

Flash PMI signals further gain in momentum during Q3 and into Q4, but upturn characterized by cost cutting and price discounting

- **Composite PMI Output Index sees strongest quarter since Q2 2008.**
- **But cost cutting continues amid weak pricing power.**

PMI quarterly averages up sharply in Q3...

The Flash Eurozone Composite PMI rose to 50.8 in September, pointing to a second successive monthly increase in the combined output of the manufacturing and service sectors. The month rounded off the strongest quarterly PMI reading since Q2 of last year, signalling a near-stabilisation of output following the four prior quarters of continual decline. The Q3 quarterly average of 49.4 compared with just 43.2 in Q2 and a record low of 37.6 in Q1.

Before the recession, the PMI had provided a very accurate indication of GDP trends (see chart 1) and, based on historical comparisons, regression analysis indicates that the Q3 PMI average of 49.4 equates to a quarterly fall in GDP of 0.1%. However, considerable uncertainty exists about the interpretation of the composite PMI reading for GDP in Q3 because official GDP data have exhibited greater volatility than the PMI during the recession¹.

Momentum continues to build

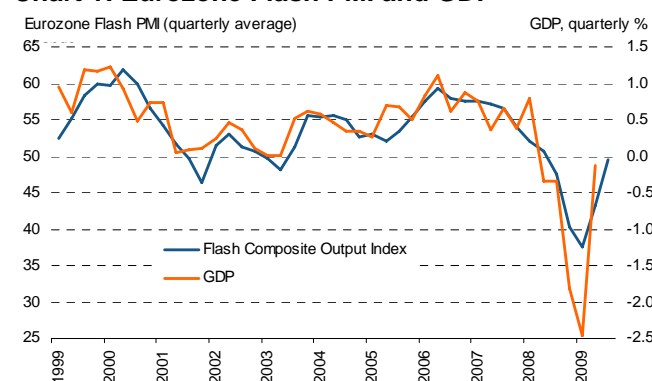
The divergences between GDP and the PMI should not detract from the PMI's main message, which is that

¹ The actual contraction of GDP in Q1 (-2.5%) was more severe than the PMI had indicated (-1.4%), while in Q2 the contraction was less severe (-0.1%) than the PMI had suggested (-0.8%).

On one hand, it is therefore possible that – as may have been the case in Q2 – Q3 GDP data may make up some of the ground lost relative to the PMIs in Q1, therefore resulting in a modest increase in GDP. On the other hand, if Q2 GDP data exaggerated the easing in the rate of contraction, Q3 GDP growth may print lower than the 0.1% decline seen in Q2. Given the higher volatility of GDP compared to the PMI, either outcome would not be a surprise.

the V-shaped trend in GDP growth remains on track. Most importantly, the momentum of the PMI during the course of Q3 was such that the quarterly rate of change in GDP signalled by the survey improved markedly from -0.4% in July to +0.1% in September. The upturn also spread from manufacturing to services, the latter seeing the first increase for 16 months in September, adding to hopes for a more broad-based and sustainable upturn.

Chart 1: Eurozone Flash PMI and GDP



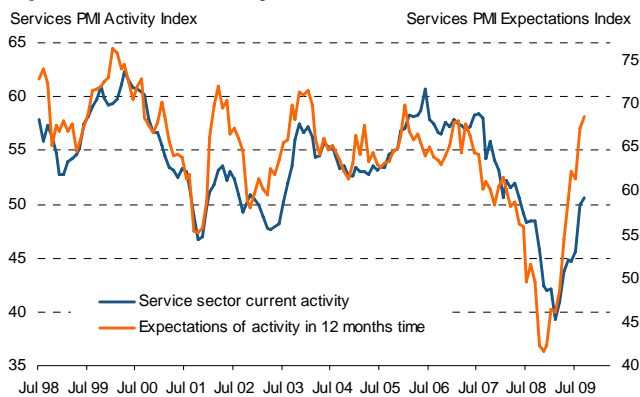
Sources: Markit, Eurostat.

Furthermore, forward-looking indicators from the flash PMI survey suggest growth momentum will be carried forward into Q4.

First, September saw expectations of business activity levels for the year ahead in the Eurozone service sector rise to their highest since January 2006, having staged a dramatic recovery from the all-time low seen last November.

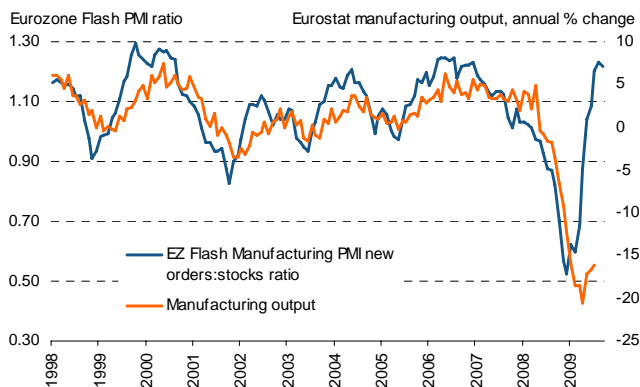
Second, in the manufacturing sector, inventories of finished goods continued to fall at an historically steep rate in September, while incoming new orders posted the strongest rise for 22 months. The resulting ratio of orders to inventories remained close to August's 32-month high, consistent with further output growth in coming months.

Chart 2: Eurozone Flash PMI service sector expectations for the year ahead



Source: Markit.

Chart 3 Eurozone Flash PMI manufacturing new orders/inventories as an indicator of output growth



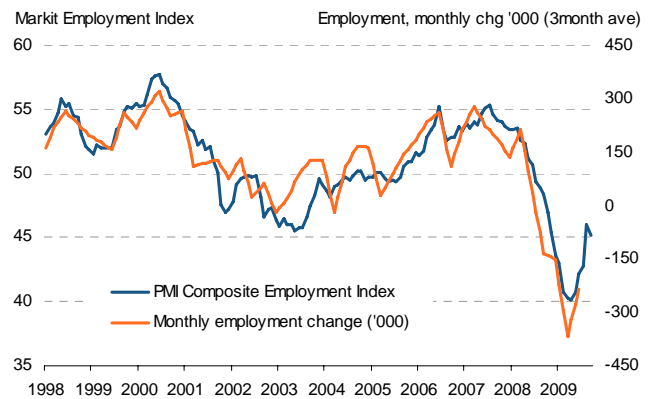
Sources: Markit, Eurostat.

Cost cutting and price discounting prevail.

The outlook is by no means clear blue skies, however. Recent improvements have been driven by unprecedented government stimulus packages, which will eventually need to be unwound. The car scrapping scheme in Germany has already run its course. Public spending is also likely to tighten as governments seek to bring their books back in order.

What's more, while a depression has no doubt been avoided, business conditions remain highly adverse in spite of the government interventions and record low interest rates. In particular, the PMI survey shows that companies clearly remain focused on cost cutting, as evidenced by the ongoing severe cut to inventories and further job losses, the pace of which re-accelerated in September.

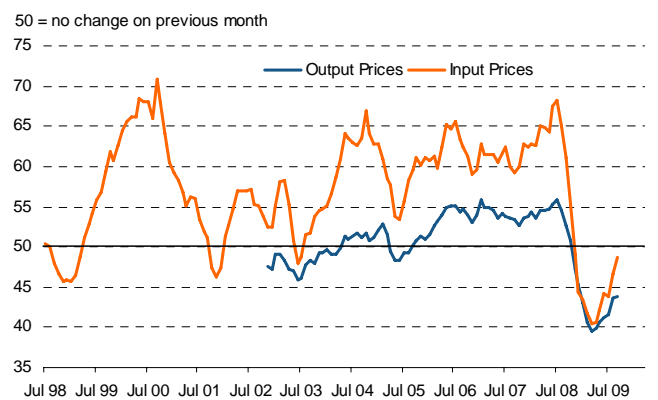
Chart 4: Eurozone employment



Sources: Markit, Eurostat.

The need to cut costs has been necessitated by the fact that any growth in new orders has largely been achieved through price discounting. Average selling prices across both manufacturing and services fell for the eleventh successive month in September (albeit at a slower pace than August).

Chart 5: Eurozone Flash PMI Composite Price Indices



Source: Markit.

The September flash PMI data therefore suggest that, while the recovery continued to gain momentum in Q3 and looks set to gain further ground in Q4, the upturn remains fragile. The rebound is still dependent on stimulus packages and price discounting, encouraging firms to seek ongoing cost reductions. This will most likely serve to subdue growth as we move into 2010.

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