IT'S HARDER
to stay easy at the ECB

As growth waxes stronger in Europe, policymakers will intensify their debate over tightening versus accommodative policy. For now, the doves appear to hold sway.

With European politics, it's important to calibrate one's pessimism. The likelihood of a disruptive outsider winning power in a major European country is small. As we write, Marine Le Pen has made it to the second round of the French election, but it appears likely she will lose to centrist Emmanuel Macron by a large margin.

And yet the French appetite for outsiders reinforces the message of the Dutch elections in March: Many of the traditional political alignments are crumbling. Troublingly, the sour public mood, the strong support for outsider candidates, and the hostility to economic reform are critical constraints on Europe's longer-term economic outlook.

Encouraging signs in the near term

However, we must acknowledge the positive short-term outlook in Europe. Our Nowcast for the European economy is at a level not seen since early 2011, when GDP growth was running at an annualized pace of over 3%.

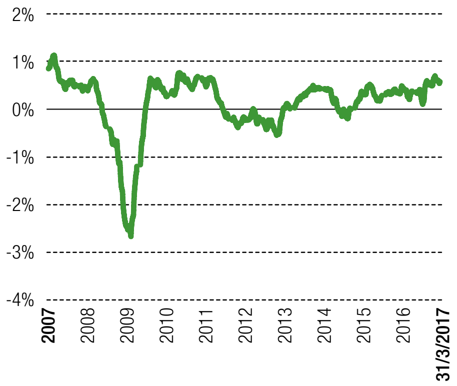
Purchasing managers index data are also at a six-year high. And while confidence indicators have improved, we do not see the same large gap between "soft" and "hard" data that is present in the United States.

The composition of European growth is also quite encouraging. While Germany is still leading the expansion, the gap between Germany and other countries has closed, with both France and Italy looking stronger. We are not entirely convinced that Italy has left its troubles behind, but the French economy appears to be authentically recovering and could do even better after the election.

Significantly, domestic demand is growing at a reasonable pace. In Germany, some of the improvement in business sentiment has been driven by the pickup in China, but this is not a typical German export-driven recovery. Exports are playing a role, but with domestic real wages rising and investment beginning to grow, Germany is benefiting from an important domestic demand component as well.

Cyclical improvement is evident in Europe

Europe GDP Nowcast



Source Putnam. Data as of March 31, 2017. We base our Europe GDP Nowcast on a tailored methodology that captures daily data releases for the most essential growth characterisitics for Europe - including purchasing managers' index data, industrial production, retail sales data, labor market metrics, real estate price indexes, sentiment indicators, and numerous other factors. The mix of factors used may change over time as new indictators become available from data sources or if certain factors become more, or less, predictive of economic growth.

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The immediate pressure on the ECB has eased with the latest inflation data. The flash inflation report for March was a big surprise, with reported inflation well below market expectations.

There are many reasons for this. There was a big drop in food price inflation, for example, and the shift in the timing of Easter (from March last year to April this year) seems to have had a big impact on a number of large components.

We do not think the inflation outlook is much different, but month-to-month swings clearly affect the headline numbers.

The ECB hawks continue to advocate an early change in monetary policy.

In the German press in early April, Jens Weidmann, President of Germany's central bank — the most influential member of the European system of central banks — was quoted as saying the time is approaching "*to lift the foot slightly off the gas pedal*."

> The debate continues, however, and markets remain sensitive to changing interpretations of exactly what the next ECB move will be and when it will take place

In response to this argument for an earlier end to quantitative easing, the ECB doves have been unusually forceful.

Peter Praet, the ECB's chief economist, adopted an optimistic tone when discussing Europe's cyclical economic improvement, but was also clear that inflation remains too low and shows few signs of rising decisively.

He was also clear in his view that the forecast trajectory of inflation and the economy assumes monetary policy remains very accommodative, and that therefore strong data are not a reason to change policy.

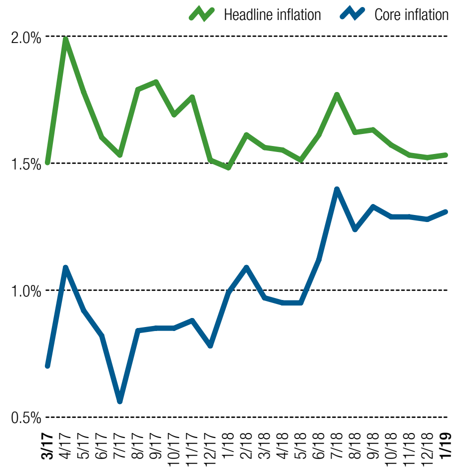
ECB President Mario Draghi was also decisive in early April, arguing that the inflation outlook was too weak to justify any shift in policy.

"*A reassessment of the current monetary policy stance is not warranted at this stage,*" he said, in an attempt to close down debate.

The debate continues, however, and markets remain sensitive to changing interpretations of exactly what the next ECB move will be and when it will take place. As before, we think the risk is that the ECB surprises on the hawkish side.

Inflation may not be a dramatic problem in Europe

Eurozone inflation forecast



Source Putnam.

About the macro report

The Macro Report is written by members of Putnam's Fixed Income team. With backgrounds in applied economics, currency and interest-rate analysis, and sovereign and local bond market dynamics, this group conducts macroeconomic research in support of Putnam's global fixed-income strategies.

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