

# Eurozone

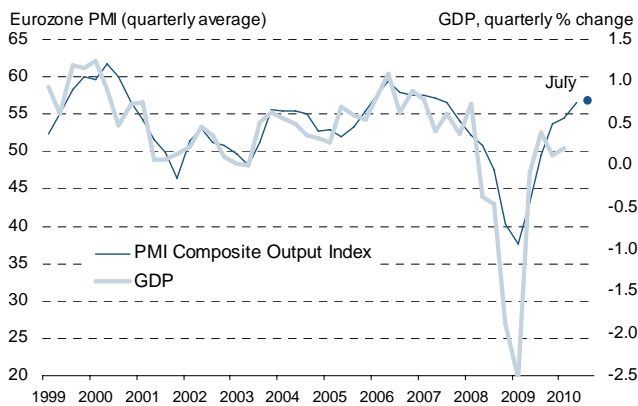
## Surprise strong start to the second half of 2010, but slower export growth and weaker business confidence dull the outlook

### Strong start to 2010 Q3

The **Markit Flash Eurozone Composite Output Index** rose from 56.0 in June to 56.7 in July. Although the index remained below April's post-recession peak, the July level was slightly above the average reading seen in the second quarter (56.6) and confounded market expectations of a further slowing in the rate of expansion.

With the July reading broadly in line with the Q2 average, which was in turn roughly consistent with quarterly GDP growth of 0.6% to 0.7%, the Eurozone economy looks to have enjoyed a surprisingly strong start to the second half of the year.

### Eurozone GDP



The survey showed that manufacturing continued to lead the recovery, expanding at a significantly faster rate than services. However, the PMI™ nevertheless suggests that manufacturing growth has slowed from the surging 3.1% quarterly rate of growth recorded by official data in May to a pace more in the region of 2%.

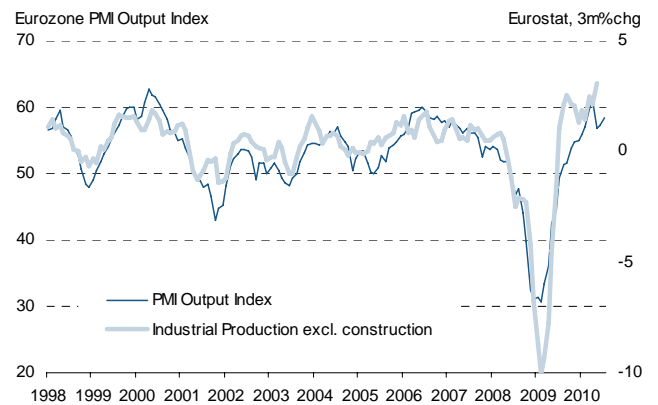
### Improved domestic demand?

Manufacturing order book growth appears to have likewise slowed since earlier in the year (orders surged 25% higher than a year ago in May), but remains strong and even picked up again slightly in July. Interestingly, the manufacturing sector's New Orders

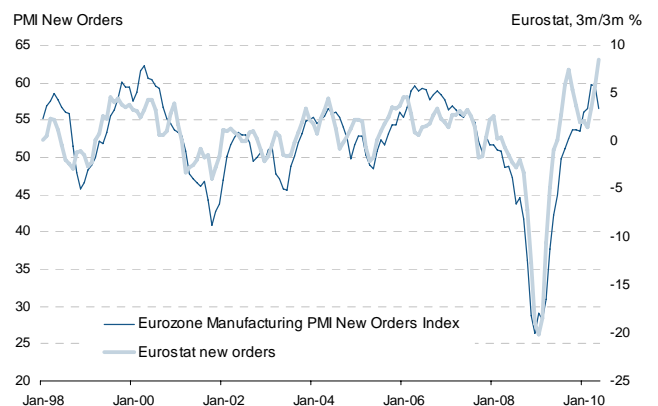
Index rose in July despite the New Export Orders Index falling. This suggests that improved domestic demand provided the impetus to the stronger manufacturing order book growth at the start of Q3. Incoming new business in the service sector also picked up from a four-month low seen in June, which likewise indicates a probable improvement in domestic demand.

This improvement in domestic demand could be linked to labour market gains: the PMI survey showed employment rising for the third consecutive month, with job creation still subdued but nonetheless the strongest since April 2008.

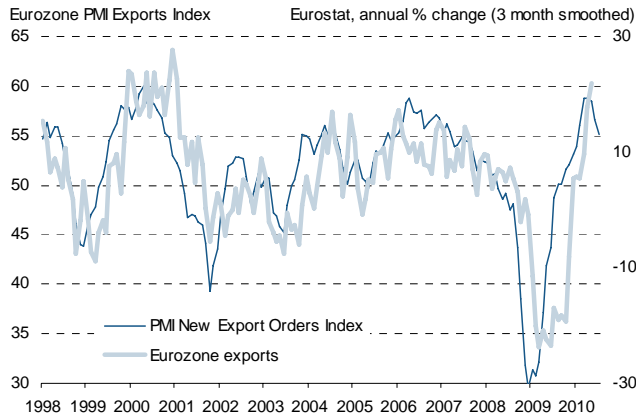
### Manufacturing output



### PMI manufacturing orders



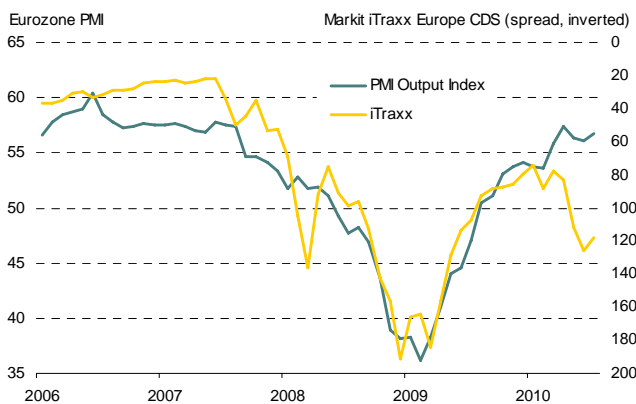
### PMI manufacturing export orders



### Stress tests

Better demand conditions could also be attributed to the easing of the region's sovereign debt crisis. The willingness of the authorities to conduct bank stress tests, plus successful auctions of government debt in peripheral countries, has allayed fears of government default and contagion to the banking sector. This is reflected in the credit markets, with the Markit iTraxx Europe index showing a reduced perceived risk of default in July. However, the market's reaction to the stress tests, due tomorrow, is likely to be important in relation to business and consumer confidence going forward, as recent history tells us that ongoing worries in the financial system can quickly lead to slower economic growth.

### PMI and credit default risk



### Not all good news

Other data from the flash release also suggest that the upturn in July should be treated with caution. In particular, if exporters continue to struggle in the face

of slower global trade flows in coming months, it leaves the region dependent upon a strengthening of domestic demand to drive economic growth.

In this respect there are some worrying signs. First, expectations about activity levels a year ahead in the service sector grew less optimistic for the third month running, suggesting the weakest outlook since last November.

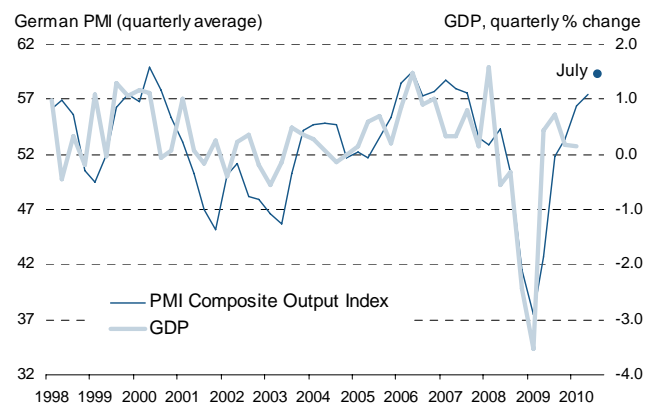
Second, although employment growth is picking up, the rate of job creation remains well below that seen in the strong growth years prior to the recession, and high levels of unemployment look likely to persist for some time, acting as a drag on growth.

Third, the flash release only provides detailed data for France and Germany (more national data are provided in the final release), and shows that these two countries continued to provide the main stimulus to euro area growth. Conditions in the periphery, on the other hand, appear to have deteriorated, suggesting an increasingly uneven picture of growth in the euro area.

### Germany and France lead growth of manufacturing and services respectively

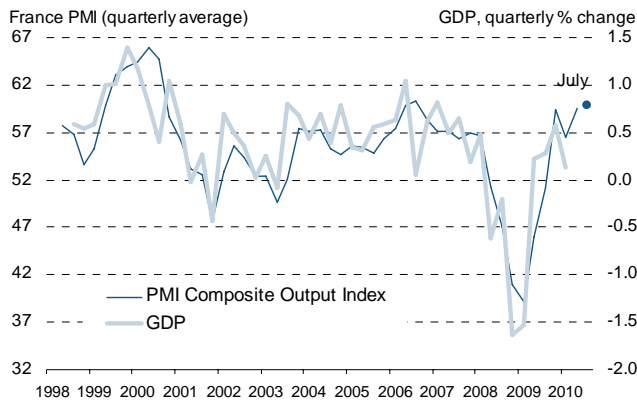
Germany saw a particularly sharp acceleration in growth in July, the Composite Output Index rebounding from 56.7 in June to 59.3, matching the 39-month high seen in April. The July reading was also well above the 57.5 average seen in Q2. While the PMI signalled German GDP growth slightly in excess of 1% in Q2, a further acceleration to 1.5% is signalled for Q3 by the July data, providing that the index holds steady in the remaining two months of the quarter.

### Germany GDP

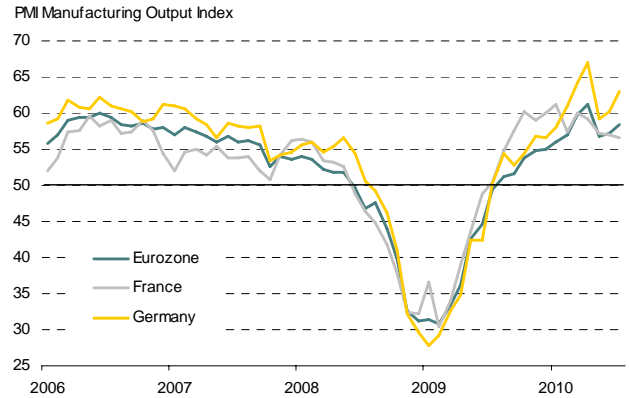


The Composite Output Index for France meanwhile rose from 59.6 in June to 59.9 in July, also slightly above the average of 59.6 seen in Q2. The PMI was consistent with French GDP rising by approximately 0.6%-0.7% in Q2 and suggests a continuation of this rate of growth at the start of Q3.

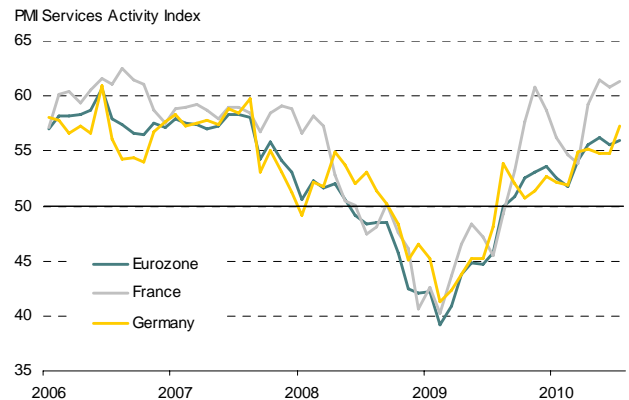
**France GDP**



**Manufacturing output**



**Service sector output**



**German service sector boost**

The July flash data also show us that Germany continues to drive the manufacturing upturn while France leads in terms of service sector expansion. However, notwithstanding our previously stated concerns about the durability of domestic demand in the euro area, a particularly encouraging feature of the July data was an acceleration in growth of service sector activity in Germany to the strongest since August 2007, perhaps suggesting that domestic consumption in the region's largest national economy is beginning to revive.

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