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What to watch: Eurozone's OK growth numbers, the big US dollar depreciation idea and an earnings season full of what ifs

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In summary

This week we look at three critical issues:

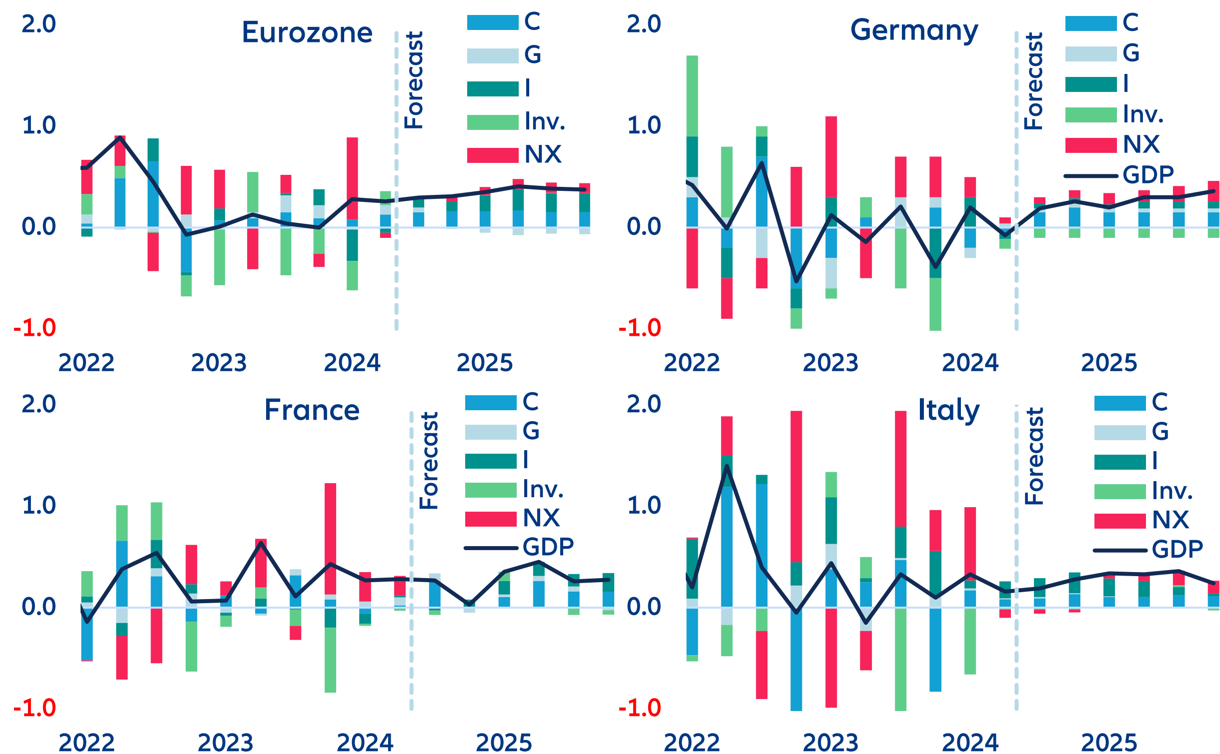
- **Eurozone GDP: Steady despite Germany's economic sputtering.** The Eurozone economy grew again by a robust +0.3% q/q in Q2 2024, slightly exceeding our own forecast. France (+0.3%) and Spain (+0.8%) performed better than expected, while Germany (-0.1%) was again weak as expected. Going forward, we expect Eurozone growth slightly above potential, supported by consumption and investment, given rising wages and remaining NGEU funds. Inflation in July surprised on the upside, inching up to 2.6% y/y (core 2.9%), given ongoing price pressures in the service sector. We therefore stick to our call of only one more cut by the ECB in 2024. But the next inflation readings must prove that the latest print was just a hiccup and not something more structural.
- **Will depreciating the dollar shrink the US trade deficit?** With the dollar at its highest in more than 40 years, tariff policy is unlikely to be enough to solve the US trade imbalance. On the campaign trail Donald Trump's inner circle has put forward the idea of a new Plaza Accord (22 September 1985) to depreciate the dollar, raising inflation concerns among observers especially large US retailers. Such a bold move would take time and require the cooperation of other countries willing to intervene and strengthen their own currencies, which would not be easy to secure even if a reward is offered in the form of a reduction in tariffs or privileged access to the US market. Such a decision would also require the Fed to sign off on it since the Treasury does not have enough dollars to sell. While historical evidence shows that depreciating the dollar can have an effect, it comes with a lag, and would translate into US monetary easing at a time when inflation is not entirely under control. Such interventionist currency policy would question the existing and very credible monetary policy framework and thus the dominant currency status for the USD.
- **Q2 earnings: A season full of what ifs.** The current earnings season has showed mixed results, with some sectors outperforming (communication services, technology) while others struggle (materials). In the US, the S&P 500 is seeing moderate growth, but investor caution is evident due to concerns about future earnings and revenue potential. In Europe, the luxury market and cyclical industries are facing slowdowns, though banks are performing well despite economic uncertainties. Looking ahead, a combination of economic resilience and easing monetary policy is expected to support further earnings and revenue growth. However, potential market corrections remain a concern, particularly in sectors where valuations may be stretched.

Eurozone GDP: Steady despite Germany's economic sputtering

The Eurozone economy grew by a robust +0.3% q/q (0.6% y/y) in Q2 2024, the same pace as in Q1, slightly exceeding consensus expectations but largely in line with our own forecast. This week's flash estimate does not contain any details as usual, but consumption should have been one of the positive pillars whereas net exports likely corrected to the downside after extraordinary strong growth in the previous quarter (Figure 1). Going forward, we expect Eurozone growth slightly above potential, thereby slowly closing the currently negative output gap. Growth should be supported by consumption due to rising wages, and investment partially thanks to remaining NGEU funds. A mild pick-up in global trade should also give some tailwind to net exports while government consumption is expected to be a drag, given fiscal tightening.

By country, the results were a mixed bag. German economic activity contracted by -0.1% q/q in Q2, in line with our expectations. This decline was reflected in all key economic indicators. Notably, investment in equipment and buildings saw a decrease, while consumer spending remained subdued despite significant increases in real wages. Additionally, international trade experienced fluctuations from missing global demand but managed to maintain a clear positive trade balance. Since the Covid-19 crisis, Germany has not managed to grow at all and thereby remains a clear outlier in Europe and globally (Figure 2). **France's GDP edged up by a strong +0.3% q/q in Q2**, above our expectations. Meanwhile, Q1 2024 and Q4 2023 GDP were revised up, meaning that the French economy will likely expand by much more than our +0.9% forecasted in June. While momentum looks solid on the surface, the French economy continues to be buoyed by international trade (strong exports and weak imports) and government spending. Household consumption remains lackluster, growing around +0.0% in both Q1 and Q2 while investment is mixed, supported by a few items in services (ICT, services to businesses) offsetting weakness in residential and manufacturing products. **Italy's activity expanded by +0.2% q/q in Q2**, in line with our estimates, paving the way for a gradual economic improvement in the rest of the year. The domestic component had a positive contribution to growth while net exports were a drag on activity. We suspect investment had softened, given the slowdown in construction activity following the Superbonus boom, despite supportive inflows of NGEU funds. Finally, **Spain continues to post solid growth**. GDP expanded by +0.8% q/q in Q2 2024, well above our and consensus expectations (+0.3%). Notably, exports of goods and services increased by +1.2% on the back of very strong tourism activity, while imports contracted by -0.2%.

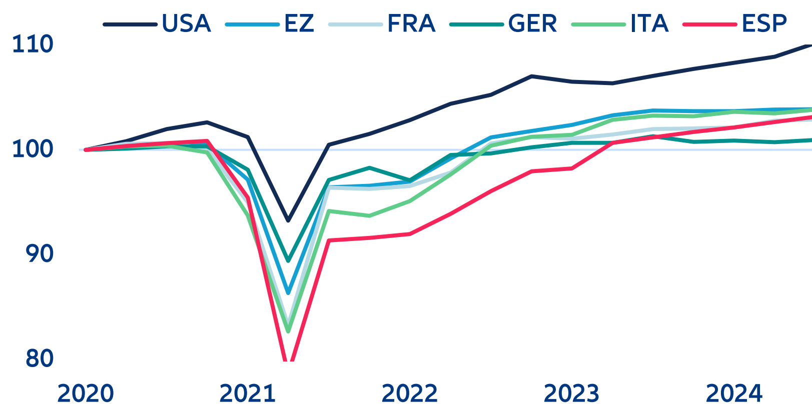
Figure 1: GDP contributions and Allianz Research forecasts, %



Sources: LSEG Datastream, Allianz Research

Notes: C stands for consumption, G for government spending, I for gross fixed capital formation, NX for net exports and Inv. for change in inventories.

Figure 2: Real GDP level , index (2019 Q4 = 100)

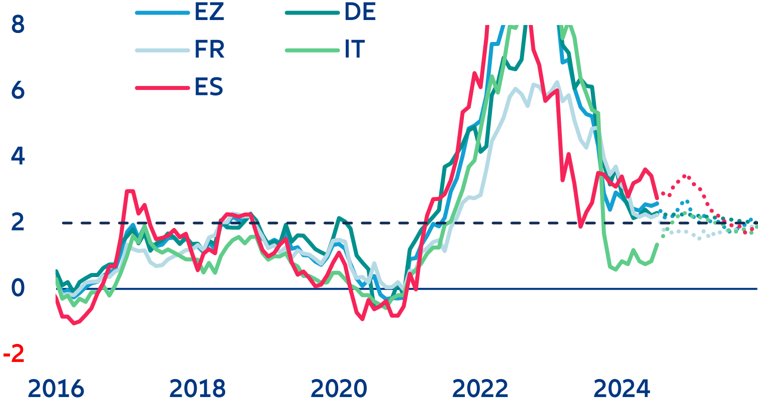


Sources: LSEG Datastream, Allianz Research

Meanwhile, inflation in the Eurozone surprised on the upside in July by inching up to 2.6% y/y from 2.5% in June. Core inflation stayed put at 2.9% y/y but was also above consensus and our estimates (Figure 3). Services inflation remains sticky and rose 4.0% y/y – a level around which it has hovered for nine months without showing any signs of deceleration. At the same time, energy inflation made a comeback by rising by 1.3% y/y after a prolonged period of negative to no growth. More worryingly, inflation rose sequentially by an annualized 4.6% m/m seasonally adjusted (saar) after three months below 2%. This was also driven by a pick-up in sequential core inflation to 3.7% m/m saar – clearly above the comfort zone of the ECB. **German** CPI rose to +2.3% y/y, up from +2.2% in June

(+0.3% m/m) and down from +2.4% in May. Despite this increase, disinflationary pressures persisted, with energy prices declining by -1.7%, while food prices rose by +1.3%. Core inflation remained sticky at +2.9%, while goods inflation edged up to +0.9% due to rising import costs. Services inflation remained at +3.9%, unchanged for the third consecutive month, and is expected to stay elevated as wages are projected to rise further. In **France**, inflation ticked up slightly to +2.3% y/y, pushed by higher energy prices (+1.4% m/m, +8.5% y/y), partly because of a +10% hike in retail gas prices. On the bright side, the other components continued to ease. Food inflation touched its lowest level since June 2021, easing to a soft +0.5% y/y. Goods inflation plunged into negative territory at -0.3% y/y. Finally, services inflation eased substantially to +2.6% y/y (-0.3pp), its lowest pace since March 2022. **Italy**'s inflation also surprised on the upside last month: prices grew by 0.5% m/m and 1.3% y/y on the back of higher energy prices (from -8.6% to -4.1%y/y) and stronger services prices, especially in recreational and cultural services. Encouragingly, core inflation remained stable at 1.9%. Conversely, in **Spain,** inflation decreased more than expected to 2.8% y/y in July from 3.4% in June (-0.5% m/m) due to lower electricity prices and strong base effects on food prices. Core inflation also eased to 2.8% from 3.0%, sending encouraging signs of softening services prices, which have proven very stubborn lately.

Figure 3: Inflation across Eurozone economies including Allianz Research forecast, % y/y



Sources: LSEG Datastream, Allianz Research

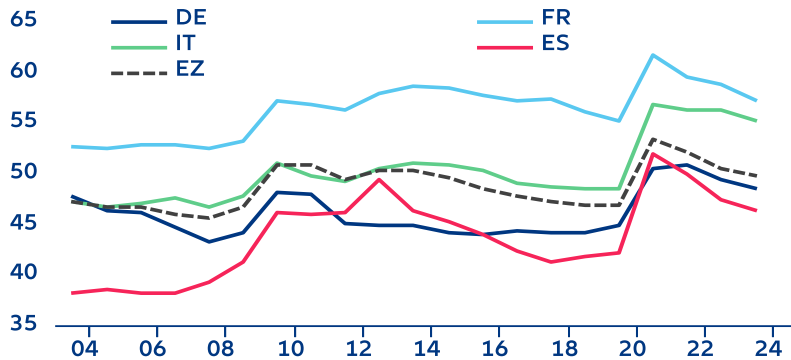
The latest data will complicate the outlook for the ECB, so we stick to our call of only one more rate cut in 2024, likely in September but potentially only later in the year. The uptick in inflation, in particular on a sequential basis, will certainly worry ECB policymakers. While growth was robust, it was also highly dispersed, with the largest economy, Germany, at risk of slipping into extended stagflation. Eurozone leading indicators such as PMIs or economic sentiment have worsened lately from still subdued levels. This confirms our view of a rather slow economic recovery of the Eurozone economy and justifies further rate cuts by the ECB. For a September cut, however, the next CPI print has to prove that the latest print was a hiccup and not something more structural.[1]

At the same time, Europe is trying to strike the balance between returning to fiscal rigor and fostering growth. Fiscal-consolidation constraints could be a further drag on growth while speeding up NGEU spending could support activity in the coming quarters as only 35% of funds have been disbursed more than halfway through the program (and even less effectively spent). Last week, the European Council officially launched an Excessive Deficit Procedure[2] for seven European countries, including France and Italy, which now need to closely tackle long-running fiscal challenges. We do not expect either country to bring their public deficits below the 3% reference value in the near-term; high government expenditures and interest payments will continue to weigh on the fiscal outlook.

[1] *See our recent analysis on inflation upside risks in 2024_07_12_What_to_watch.pdf (allianz.com)*
[2] *2024_06_21_what_to_watch.pdf (allianz.com)*

Therefore, France and Italy will likely face a troublesome "back to school" in September when they have to submit their medium-term fiscal plans to be assessed by the European Commission according to the new EU framework.

Figure 4: Government expenditure, % of GDP

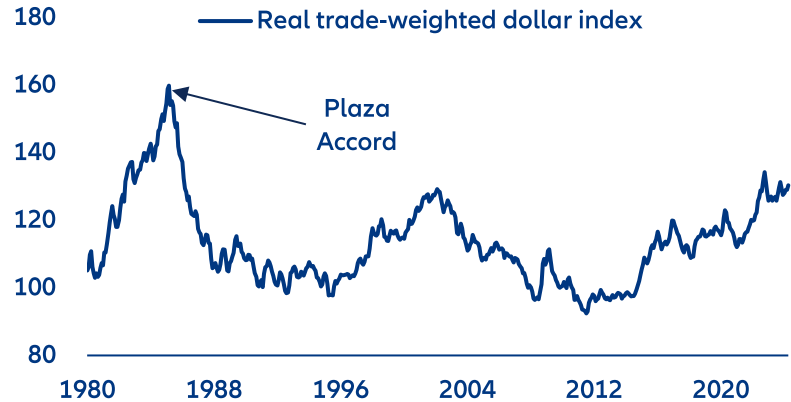


Sources: LSEG Datastream, Allianz Research

Will depreciating the dollar shrink the US trade deficit?

With the dollar at its highest level in 40 years, tariff policy is unlikely to be enough to solve the US's trade imbalances. On the campaign trail, Trump's inner circle has put forward the idea of a new Plaza Accord (22 September 1985) to depreciate the dollar. The US derives tremendous benefits from printing the world's reserve currency, not least via the weaponization of the dollar to enforce sanctions against "rogue" states and entities and the capacity to run powerful counter-cyclical fiscal policy despite large fiscal imbalances. But the flip side of having a reserve currency is that its value is stronger than it would otherwise be, hurting the manufacturing sector. While some "mainstream" economists believe the primary cause of the US's large trade deficit is excess consumption, notably excessive fiscal deficits, others (including several working on Trump's campaign) believe that aggressive mercantilist policies of trading partners such as China, South Korea, Japan and Germany are to blame. The argument goes that these countries are sending excessively cheap goods and capital to the US, depressing US savings and supporting US consumption. This then provides the justification for adopting aggressive countermeasures. Until now, the more vocal advocates of dollar depreciation – including Robert Lighthizer, a potential candidate for Treasury Secretary in case of a Trump victory – considered trade policy and dollar depreciation as mutually exclusive but this stance now seems to be shifting (Figure 5).

Figure 5: Trade-weighted Dollar Index



Sources: LSEG Workspace, Allianz Research

But it will not be easy to depreciate the dollar. First of all, not everyone in Trump's camp favors a dollar policy. Should Trump tap one of the other finance executives he is also considering to lead the Treasury Department, it is much less likely that he would pursue currency devaluation. Large US retailers would also oppose efforts to weaken the dollar, arguing that it would drive up inflation. Second, it may take time to achieve and would need the cooperation of other countries willing to intervene and strengthen their own currencies[3] , which would not be easy to secure even if a "reward" is offered. The Japanese government, on behalf of which the Bank of Japan can intervene in the currency market, may well sign off given that it has already done so regularly over the past months to address the weakness of the yen. The Bank of Korea could also potentially be interested. But we doubt that the People's Bank of China, the European Central Bank and the Bank of England would be willing to cooperate. Finally, a Trump II administration would also require the Fed to sign off on such a policy, too, since the Treasury does not have enough dollars to sell. The Fed would likely be reluctant as i) it would want to avoid being politicized by endorsing a weak dollar policy and ii) it would be scared off by the prospect of higher inflation because of higher import costs. In practice, applying that sort of pressure to the Fed would have to wait until Trump installs a more amenable Fed Chair in early 2026.

Such interventionist currency policy would also question the existing and very credible monetary policy framework, and thus the dominant currency status for the USD. Lighthizer has suggested that the US could target both the trade balance and the capital balance to restore the competitiveness of US products. For the trade balance, the US would slap tariff hikes or the threat of tariff hikes to extract concessions from trading partners (for instance, larger access to US products for their domestic markets). Trump is increasingly floating his idea of a ''Reciprocal Act'', i.e. imposing equivalent tariffs sector by sector than trading partners impose on the US. For the capital balance, the proposal is to weaken the dollar by instating a levy on foreigners' capital inflows (thus discouraging the purchase of US assets). That would mark a major shift in US policy as it would question the fully liberalized US capital account prevalent since the 1970s. To further depreciate the dollar, a "reward" system for countries who help the US could also be implemented . This could in the form of a reduction in tariffs or even privileged access to the US market.

Historical evidence shows that a USD devaluation can reduce the trade deficit, but with a lag. After the sharp USD depreciation of 1986-87, the US-Japan trade balance started to narrow from 1988. This is congruent with empirical evidence that currency depreciation typically starts to increase the trade deficit as imports become more expensive (the valuation effect), before exports start to pick up as they are cheaper (the quantity effect), outweighing the first effect. Incidentally, the US fiscal deficit started to narrow as well during the same period. Instead, the sharp rise in US tariffs in 2018-2019 under Trump I did not help to reduce the US trade deficit because of retaliation by trading partners and also because the dollar appreciated (notably against the Chinese yuan). In this respect, dollar policy seems to be more effective to achieve the stated goal of reducing trade imbalances than tariff policy.

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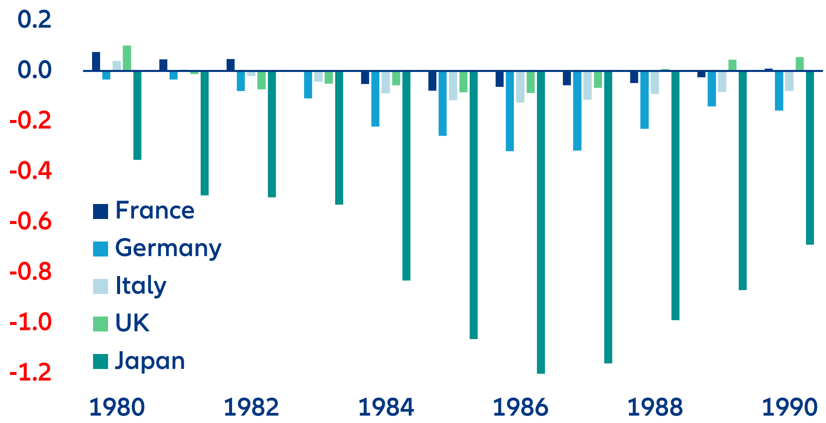
[3] *As in the past, the US would need other countries to help it engineer a substantial USD depreciation. For example, following the Plaza Accord in September 1985, the central banks of West Germany, France, the UK and Japan intervened on the currency market to sell their dollar holdings. The real dollar exchange rate depreciated sharply by 30% between September 1985 and hit its trough in April 1988. The threat of tariffs by the then Democrat-dominated US Congress (notably against Japan) was decisive to force the hands of the US' partners, as Lighthizer highlights.*

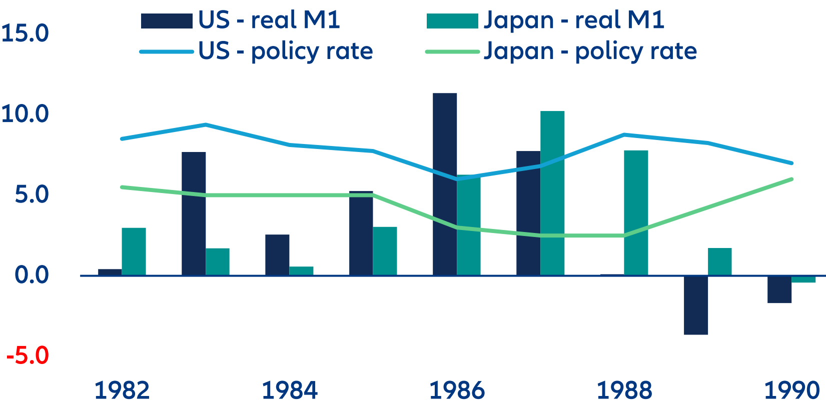
Figure 6: US bilateral trade deficit (% US GDP)



Sources: LSEG Workspace, Allianz Research

Should the US's trade partners agree to cooperate in achieving a coordinated depreciation of the dollar, this would mean monetary easing in the US at a time when inflation is still not under control. The spillovers on partner countries can be substantial. From the US perspective, selling dollars on the currency market is akin to a monetary policy easing as it increases the money supply. This is exactly what happened following the Plaza Accord, with inflation-adjusted US money supply accelerating sharply in 1986-87 (Figure 7), despite attempts by the Fed to sterilize part of this increase by issuing bills. For partner countries, on the other hand, selling dollars and purchasing their own currencies means monetary tightening. In 1986-87, the Bank of Japan pushed back against monetary tightening by increasing the money supply and decreasing its policy rate. As we have highlighted in previous reports, the imposition of tariffs would be inflationary in the US and lead to a more hawkish Fed. But if the US were to opt for a dollar policy, history shows that the US could struggle to control the rise of the money supply, which would fuel further inflationary pressures. For partner countries, helping to weaken the dollar would mean monetary tightening, unless they push back against it like Japan did in the 1980s.

Figure 7: US and Japan inflation-adjusted money supply (M1) growth (%) & policy interest rates (%)



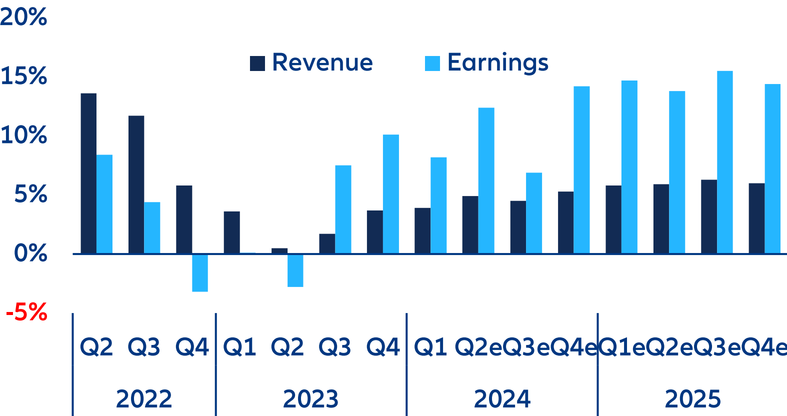
Sources: LSEG Workspace, Allianz Research

In the short term, the soundest policy would be to reduce the federal deficit, which would help cool inflation, ease short- and long-term interest rates and perhaps weaken the dollar. Lower fiscal deficits would also probably help reduce the trade deficit. One can argue that the strength of the USD is the reflection of the strength of the US economy and higher interest rates relative to Japan, Europe, and now China (higher interest rates are also the reflection, to some extent, of higher potential growth vs partners, barring China). In this context, a sound policy to cheapen the dollar would be to have lower interest rates, which could be achieved via lowering large debt issuance. Reducing very large deficits would also reduce excessive aggregate demand, help rein in inflation and allow a faster pace of Fed rate cuts conducive to a weaker dollar.

Q2 earnings: A season full of what ifs

At the midpoint of the Q2 earnings season, the US market is experiencing a mix of highs and lows, with some underwhelming reports from major companies shaking investor confidence. In the US, the S&P 500 has shown mixed results so far. While a higher-than-usual number of companies are beating earnings expectations, the extent of these positive surprises is lower than average at around 4.4%. Despite this, the overall blended earnings growth rate has reached about +12.6%, the highest since Q4 2021. Yet, investors are becoming increasingly cautious, rewarding companies less for exceeding expectations and punishing those that fall short more severely, especially when a few companies dominate the market capitalization and performance. This indicates growing unease about whether corporate revenues and earnings can meet future expectations. On the revenue side, S&P 500 companies have not met historical expectations. Currently, 60% of these companies have reported revenues above estimates, below the five-year average of 69% and the 10-year average of 64%. The average revenue reported is only 1.1% higher than estimates, falling short of the five-year average of 2.0% and the 10-year average of 1.4%. Despite these mixed signals, markets remain hopeful for a strong future performance, betting on a continued structural acceleration in earnings and revenues. Analysts still predict a robust earnings growth of +14.3% and +14.4% for 2024 and 2025, respectively, along with revenue growth projections of +5.3% and +6.0% (Figure 8).

Figure 8: S&P 500 earnings – revenue (y/y%)

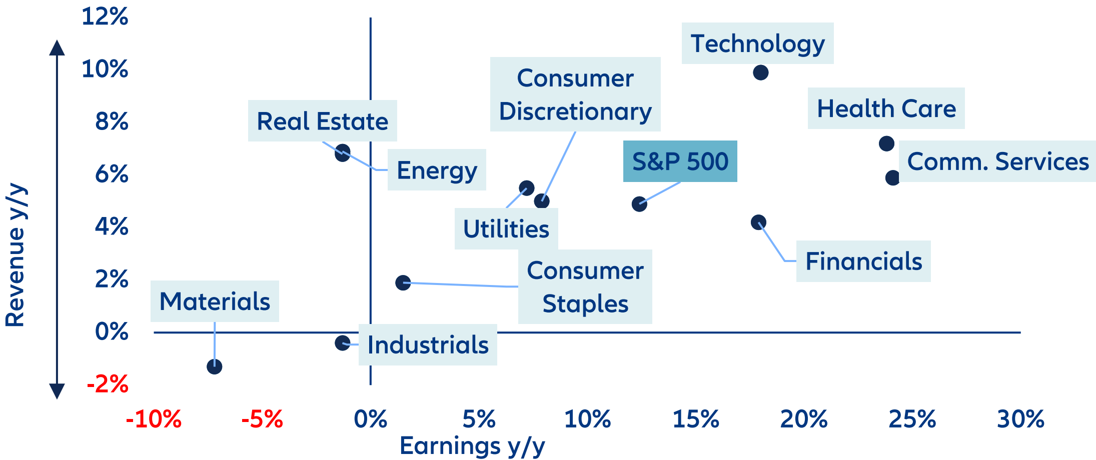


Sources: I/B/E/S, LSEG Datastream, Allianz Research

Seven out of eleven sectors have posted year-over-year earnings growth, with communication services, information technology, financials, and health care posting impressive double-digit increases, albeit due to a handful of top performers. On the downside, four sectors have seen a decline, with the materials sector suffering the most, dropping by -7.2%. When it comes to revenue, nine out of eleven sectors are performing well, with technology and health care leading the charge. Conversely, the materials sector has been lagging again with a -1.2% decline. Overall, the picture is quite positive, with most sectors, especially the largest by market cap, showing strong upward momentum. Only two sectors currently sit in the less favorable lower-left quadrant. Among the top performers, the communication services sector, led by Meta Platforms and Alphabet, boasted a remarkable +20.7% year-over-year earnings growth. However, without these giants, the sector's growth would have dropped significantly to +4.4%. In the information technology sector, NVIDIA has been a major driver, pushing the sector's growth to +17.2%. Without NVIDIA, this figure would shrink to +7.8%. The financials sector, with a +15.0% growth rate, owes much of its success to the insurance and capital markets industries; excluding these, growth would fall to +8.4%. Finally, the health care sector, with a +12.0% growth rate, is heavily influenced by Merck's performance. Without Merck, the sector would actually see a decline of -5.8%[4] (Figure 9).

[4] *Based on Factset earnings insights.*

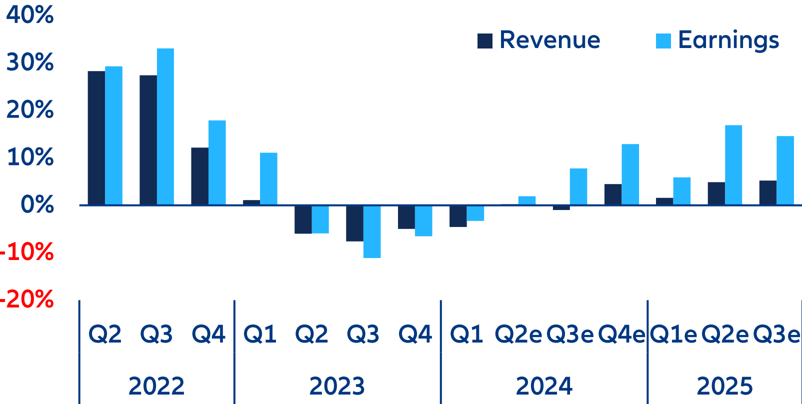
Figure 9: S&P500 sectors earnings – revenue (y/y%)



Sources: I/B/E/S, LSEG Datastream, Allianz Research

Meanwhile in Europe, the latest earnings reports are also bringing some encouraging news but market reactions have been cautious, likely due to economic concerns. Key sectors are showing resilience, indicating a stable outlook for European markets; 5.3% of companies have reported positive earnings surprises. However, the net beat on EPS has decreased to 21% from 29% last quarter, though this remains high by historical standards. Notably, aggregate earnings growth has turned positive, suggesting that European markets may be emerging from an earnings recession. Despite these promising signs, European markets, like in the US, have been more hesitant to reward companies for positive earnings surprises and quicker to penalize those that fall short of expectations. On the revenue front, the situation is less encouraging, with recent reports indicating growth close to 0%, hinting that we might still be in a revenue recessionary phase, even if earnings remain positive (Figure 10).

Figure 10: Stoxx 600 earnings – revenue (y/y%)



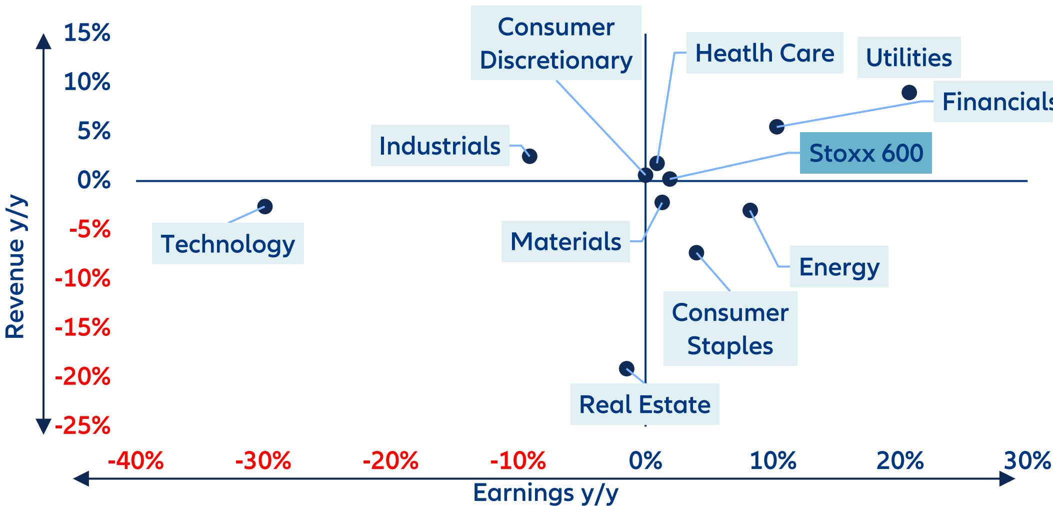
Sources: I/B/E/S, LSEG Datastream, Allianz Research

In the European market, seven of the eleven sectors are experiencing year-over-year earnings growth, mirroring trends seen in the US. Notably, the utilities and financials sectors have posted double-digit gains. Conversely, four sectors have seen a decline, with the technology sector experiencing a sharp -30% drop. Revenue growth, however, is less widespread, with only five sectors reporting positive performance, led by utilities and financials, while real estate and consumer staples continue to face challenges. Overall, the earnings outlook is positive, though revenue growth still lags, reflecting a slower-than-expected recovery in European consumer spending.

While macro trends such as AI and reshoring are driving performance in the US, in Europe the luxury slowdown and worries about China are more of a concern. The luxury market holds significant market weight and LVMH's first-half results showed just +1% year-over-year organic revenue growth, missing the +3% consensus estimate,

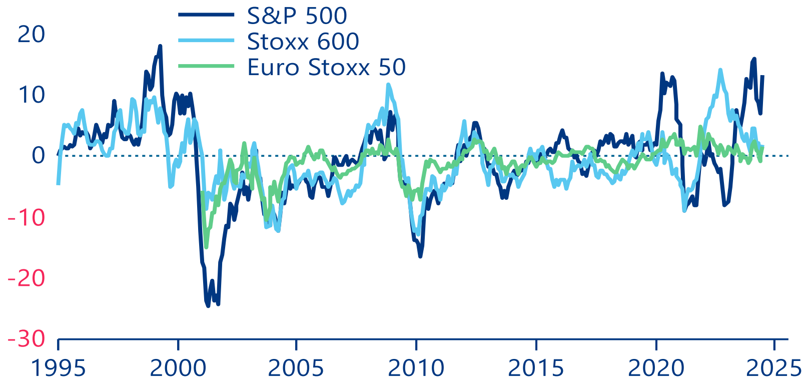
largely due to weak spending in China and among entry-level consumers in the US. Burberry's earnings also fell short of expectations, and Hugo Boss lowered its full-year guidance citing weaker demand in China and the UK. Only Hermes performed well, supported by high-end customers. The economic slowdown in China is affecting sectors beyond luxury. ASML, despite solid figures, faces a softer outlook amid potential US export controls to China. Stellantis missed earnings by 15%, citing intense competition from Chinese manufacturers in Europe. Daimler Truck Holding also reported a shortfall due to an impairment on its Chinese joint venture, highlighting weak local market conditions. In this context, concerns are rising about about companies with significant exposure to China. In the cyclical industries, an increasing number of companies are issuing profit warnings. Major players such as Airbus, Volkswagen, Lufthansa, H&M, Porsche, and Varta are each grappling with specific challenges. Ryanair, for example, missed earnings by 30% as airfares dropped significantly, indicating consumer resistance to high prices. On a brighter note, European banks are showing resilience. Despite the ECB's recent rate cuts, net interest income has remained strong. Early Q2 2024 results indicate that the banking sector is outperforming expectations. BNP Paribas and UniCredit posted earnings well above consensus, although Deutsche Bank reported a loss due to substantial credit provisions, despite strong underlying profits (Figure 11 & 12).

Figure 11: Stoxx 600 sector earnings – revenue (y/y%)



Sources: I/B/E/S, LSEG Datastream, Allianz Research

Figure 12: Equity Index vs Equally-Weighted Index (y/y%)

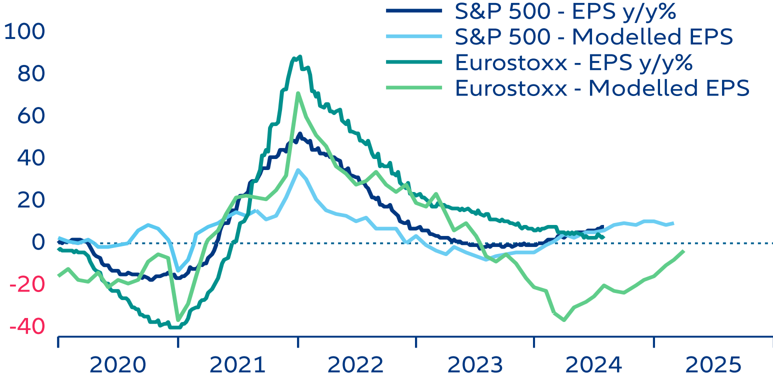


Sources: LSEG Datastream, Allianz Research

Looking ahead, despite the challenges of the current earnings season, we remain optimistic about an earnings recovery. Our macroeconomic indicators suggest that the combination of strong economic resilience and a shift in central bank policies will support revenue and earnings growth, driven by steady consumer demand. Consequently,

we anticipate positive equity performance in both 2024 and 2025, targeting a total return of +10-15% in 2024 and around +10% in 2025. However, we acknowledge the potential for market corrections, particularly in the US, where some sectors may currently be overvalued relative to their fundamentals (Figure 13).

Figure 13: Macro-based EPS growth estimations (y/y%)



Sources: LSEG Datastream, Allianz Research

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