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U.S. AND EUROZONE ECONOMIES TRADE PLACES

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Is the U.S. economy's outperformance of the eurozone coming to an end? There are signs it may be. Several economic surprise indices, which measure data surprises relative to forecasts, now place the U.S. on a lower score than the eurozone for the first time since the beginning of the year—implying a weaker consensus outlook for the U.S. economy than for Europe's. Other surprise indices have not yet flipped in favor of the eurozone but show that the gap is narrowing—if this continues, there could be major implications for the U.S. dollar and bund yields.

"Surprise" indices reflect economic performance relative to expectations—in other words, the difference between what economic data show and what economists expected it to show. The eurozone's strong growth last year caused economists to ramp up their expectations; so when growth slowed from February this year, the currency bloc's surprise index rating collapsed. At the same time, tax cuts and fiscal stimulus meant that growth in the U.S. beat expectations, pushing its surprise index score higher. Now the data are beginning to converge—the eurozone is delivering more stable growth while U.S. data are beginning to soften—hence, the crossover between the two regions.

There were several reasons for the slowdown in eurozone growth earlier this year, including the stronger euro, the weather, and a downward blip in German government spending, all of which have reversed. President Trump's trade crusade also affected European exporters' sentiment, although it's probably too early for it to have had a big impact on actual production and investment. The true impact of Trump's trade policies will probably be felt further down the line—but whether they hurt Europe or the U.S. more will depend on how other countries respond.

The recent disappointment in U.S. data is more difficult to explain. Capacity constraints are probably one important factor: The latest U.S. Purchasing Managers' Index (PMI) report cited U.S. companies' difficulties sustaining the rapid pace of new orders growth experienced in the first half of the year, which is not surprising given that the cycle is getting old and unemployment is low. The new housing market has also been slightly weaker than expected, partly due to deteriorating affordability but also due to a mismatch between supply and demand.

So given all this, what can we expect from the central banks? The European Central Bank (ECB) has already said it will not hike rates until September or October next year, and while the eurozone's growth has stabilized at a robust pace (around 1.6% year over year), it's not strong enough to suggest that the bank will deviate from that plan. The weakening outlook for the U.S. does cast some doubt on how long the Fed can continue its hiking path, though—a view backed by the rates market, which after the September meeting is now pricing in only two more Fed hikes (in December and March).

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There’s an interesting disconnect between the rates and FX markets, though. The dollar has yet to suffer, which implies that FX markets are still buying into the story of a “strong U.S. economy and weak rest of the world” outlook. As the U.S. dollar usually moves with changes in short-term forward interest rate differentials—and we believe the Fed will stop hiking at some point next year and that the ECB will begin to hike—that should eventually cause the dollar to weaken against the euro.

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Bund yields could also rise if the eurozone’s economic surprise index score continues to improve. Our analysis shows that the probability of a rise in bund yields goes up significantly as the surprise indices move from negative into positive territory. Currently, cash forward rates are pricing that the ECB will hike rates by only about 100 basis points cumulatively over the next five years, which seems inconsistent with the stabilization of gross domestic product growth above potential. Even a modest steepening of the expected rate path would cause bund yields to increase by approximately 25 basis points. This keeps us underweight bunds, despite myriad geopolitical and emerging market concerns.

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