



Focus Europe

Dark clouds, no storm yet

Dark clouds have been gathering since the beginning of the year, but we do not see a storm yet. Europe is dealing with an external demand shock and a deflationary shock. Both threaten inflation, but the latter boosts domestic demand. Hence, external headwinds have not yet been sufficient for us to revise down our central expectation for euro-area growth, but the risks are rising. That said, the inflation outlook has clearly deteriorated.

A modest weakening of the euro area data, tighter financial conditions as well as a more dovish Fed, BoE and BoJ increase the potential for a more aggressive ECB easing. (i) We continue to see a deposit rate cut as a near certainty, but it won't be enough. (ii) Hence, we persist with our call for an increase in the synergies between the negative deposit rate, QE and TLTROs. (iii) Furthermore, we think that data will have to surprise on the upside to avoid a temporary acceleration of the monthly QE purchases.

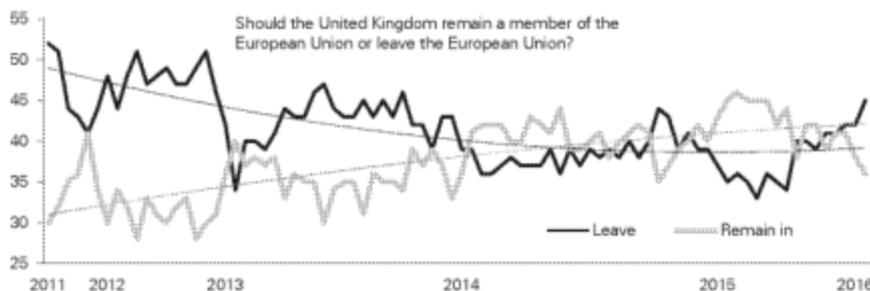
The euro area final January PMIs confirmed the softer flash reading. Despite the monthly decline, all the major activity indices remain consistent with ongoing recovery. The negative news was the slightly larger decline than before in the prices indices, adding to ECB concerns over low inflation. *SIREN-Momentum* was broadly unchanged this week. *SIREN-Surprise* remained close to its 15 month low.

The euro area January core HICP inflation print was a positive at the margin, suggesting that some of the loss in momentum at the end of last year may have been due to temporary factors. Still, progress this year is expected to be very slow, and headline inflation may well stay around zero until the summer.

This week's draft UK/EU renegotiation looks set to pave the way for a UK referendum on EU membership in June. We expect the UK to remain in, but polls suggest a non-negligible risk of exit. So far, the EU issue has had little impact on monetary policy, nor should it in our central forecast. Weaker growth and inflation have increased market fears of a near-term easing. But if the BoE's generally optimistic medium-term forecasts prove correct, then the next move is still likely to be a hike.

We also include links to three recent reports: an updated assessment of the possible coalition combinations in Spain; a preview of the coming election in Ireland where another periphery economy is heading for parliamentary fragmentation and possible minority government; and an analysis of the Italian bad banks proposal which while positive is far from being a game-changer.

Risk of Brexit rises – if you believe the polls



Source: YouGov, Deutsche Bank

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