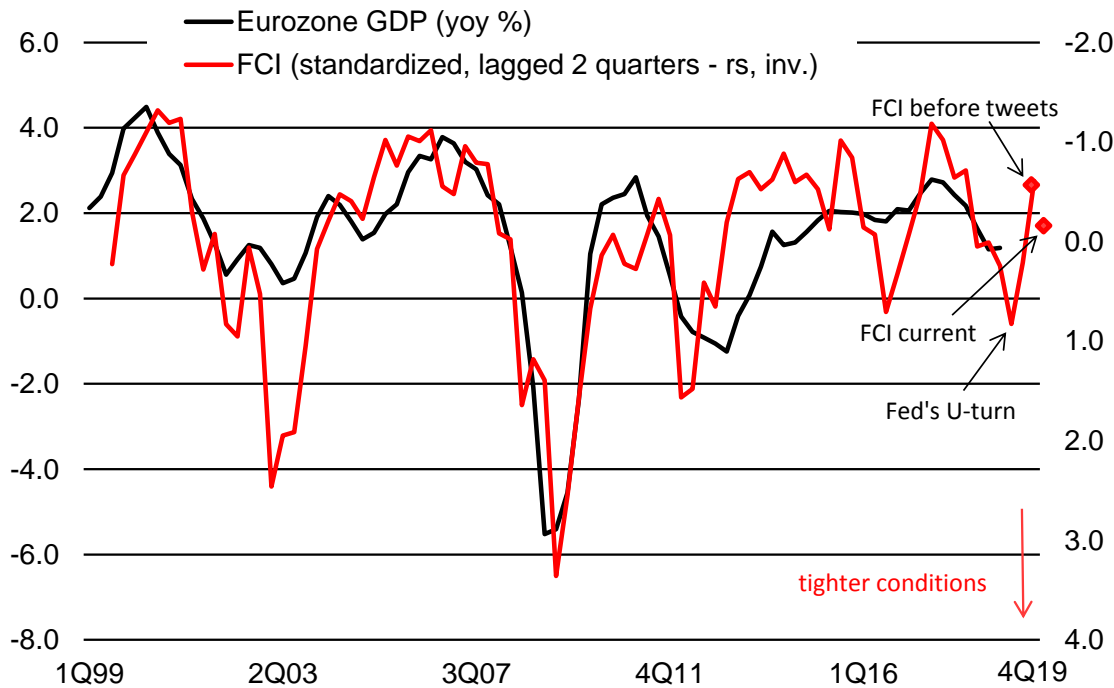


Financial conditions in the spotlight as market mood sours



Source: UniCredit Research

- Financial market developments play an important role in influencing the economic outlook, mainly through four channels: interest rates (both at short and longer maturities), the exchange rate, credit spreads and equity prices. In normal times, short-term rates are the main policy tool through which central banks can affect financial market conditions more broadly and, in turn, the real economy.
- Our chart shows the relationship between our Financial Conditions Index (FCI) for the eurozone and economic growth. Our FCI is a summary gauge that encompasses the four financial market channels mentioned above, augmented by implied volatility for the equity market. The FCI leads eurozone GDP growth by two quarters.
- Since the end of 2018 and until US President Trump's tweets on 5 May reignited the US-China trade dispute, the FCI had signaled a material easing in financial conditions. The improvement was mainly triggered by the Fed's U-turn on monetary policy and was also supported by rising expectations for a trade deal as well as early signs of stabilization in economic activity in China. These factors have been key for the recent green shoots in the eurozone (and global) economy, fueling expectations of somewhat better growth in 2H19. Today's eurozone PMIs show that progress remains tentative at this stage. In manufacturing, a less bleak outlook for orders and production was offset by weaker labor-market conditions; in services, the pace of expansion remains moderate.
- The recent escalation of the trade war has led to renewed tightening of financial conditions, mainly driven by lower equities prices, wider credit spreads and higher volatility. For the time being, the damage appears to have been contained, given that only about 25-30% of the improvement since end-2018 has been reversed. While the spillover effects of heightened uncertainty can go beyond those captured by financial conditions, the impact on growth via financial markets should prove manageable for now.

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