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DESPITE MODEST GROWTH OUTLOOK, DEFLATION RISK MEANS LOW INTEREST RATES, WEAKER EURO LIKELY FOR SEVERAL YEARS

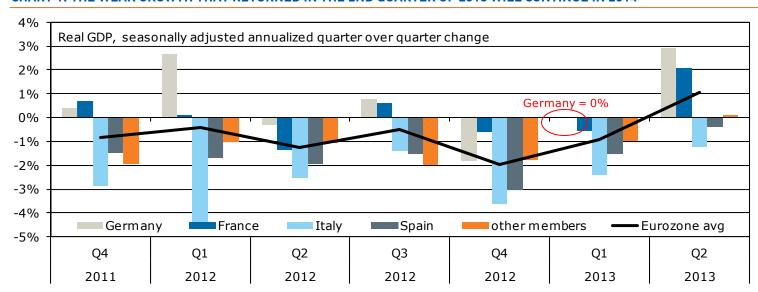
Eurozone output has turned a corner The Eurozone's recovery is underway. Real GDP returned to growth in the second quarter of 2013, registering a 1.1 percent quarter over quarter annualized increase after six consecutive quarters of contraction (See Chart 1). Germany led the Eurozone's recovery in the second quarter, contributing 79 percent of growth seen in the quarter despite comprising only 29 percent of Eurozone GDP. Other Eurozone economies improved less dramatically: output rose an annualized 2.1 percent in France, and fell in Spain and Italy although at a slower pace than in the preceding half-year. Third guarter sentiment surveys like the Markit PMIs, the ZEW, and the European Commission BCS index have hit the highest levels in over two years in the third quarter, and point to growth sustained in the second half of 2013 and into 2014.

With financial turbulence over. low effective interest rates are boosting investment

The recovery is fueled by easing financial tensions, which have allowed record low interest rates to boost investment in the Eurozone core. It is no coincidence that the two large economies lifting the Eurozone out of recession, Germany and France, are also the economies that avoided most of the financial dysfunction that drastically reduced private sector access to credit in the crisis countries in 2011 and 2012. If financial tensions in the Eurozone periphery continue to abate as expected in coming quarters, lower effective interest rates will similarly support consumption and real estate markets in those economies as labor markets and consumer sentiment stabilize.

Overall economic conditions and in particular labor market conditions vary drastically from the crisis-stricken peripheral economies and the Eurozone's core economy of Germany, as

CHART 1: THE WEAK GROWTH THAT RETURNED IN THE 2ND QUARTER OF 2013 WILL CONTINUE IN 2014





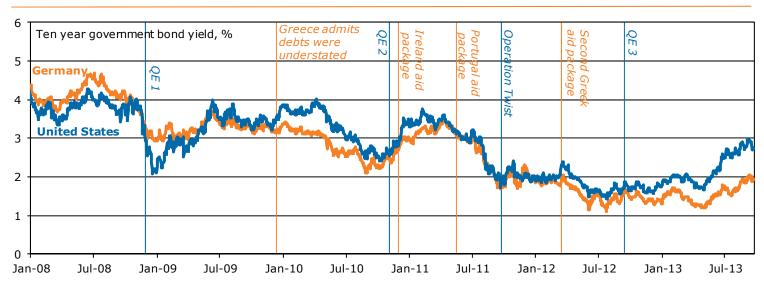
has been true throughout this cycle. While the unemployment rate is highest in Greece, Spain, and Portugal, where it was 27.9 percent, 26.2 percent, and 16.5 percent respectively in the most recent harmonized statistical releases of August 2013 (June for Greece, where data is reported with a lag), most of the 19 million unemployed Eurozone workers are in the largest economies (See Chart 3). Two thirds live in Spain, France, and Italy; in the latter two countries, unemployment rates of 11.0 percent and 12.2 percent respectively are close to the Eurozone average. The absolute number of unemployed workers is considerable in Germany as well, even though the unemployment rate of 5.2 percent in August 2013 was the lowest since the reunification of West and East Germany in 1990 (German national statistics put the unemployment rate at 6.9 percent in September, with different definitions explaining most of the divergence from Eurostat statistics).

A half decade of elevated Eurozone unemployment rates and sub-par growth is on tap

The Eurozone recovery will proceed very slowly, with persistent headwinds to growth from tax increases, spending cuts, financial sector tensions, and the aftereffects of Spanish, Dutch, and Irish housing busts. The Eurozone's unemployment rate, which at 12.0 percent in the third quarter of 2013 was near the highest since the euro was created, will likely remain elevated for about half a decade. During the Eurozone's last two cyclical recoveries, from 1997-2001 and 2004-2008, the unemployment rate fell at a fairly steady rate of 0.6 points per year. At that rate, it would take more than *six years* for Eurozone unemployment rate to fall from August 2013's 12.0 percent to a level more normal by Eurozone standards, perhaps 8.0 percent. During this period, an overhang of unemployment will likely make average wage growth slow and consumers relatively cautious, paralleling the U.S. recovery; Eurozone real GDP growth is likely to average about 0.8 percent in 2014 and pick up to a still-disappointingly slow trend rate of about 1.5 percent per annum in 2015-2016.

Expect Germany to keep outperforming the periphery – an aging workforce holds down Germany's unemployment rate Three factors explain the seeming decoupling of Germany's labor market, and to an extent its economy, from the rest of the Eurozone. The first is safe haven demand for German government securities, which made interest rates paid by German non-financial borrowers plummet in 2011 and 2012 at the same time that they spiked for borrowers in the crisis economies. Interest rates paid by non-financial borrowers are benchmarked against sovereign bond yields, and in Germany, safe haven demand has been so powerful that long term interest rates have been lower than comparable U.S. Treasury rates for the past 19 months despite the lack of a quantitative easing program in the Eurozone (See Chart 2). These extremely low interest rates have powerfully stimulated the German real estate sector. German fixed investment in housing rose 1.1 percent in year-ago terms in the second quarter of 2013, more than twice as fast as the 0.5 percent year-ago increase of German real GDP. Between the great recession's trough in the first quarter of 2009 and the

CHART 2: MONETARY STIMULUS FROM "FLIGHT TO SAFETY" IN GERMANY WAS AS POWERFUL AS Q.E. IN THE U.S.



second quarter of 2013, investment in housing rose a cumulative 20.6 percent, and accounted for three quarters of all the net increase in German real GDP.

The second factor behind Germany decoupling is the country's rapidly aging population and shrinking workforce. Between 2002 and 2012, Germany went from having one retirementage citizen for each four working-age members of the population to one retiree for each three in working ages. Over the same decade, the population in the years of peak labor force participation between the ages of 25 and 50 fell by 8 percent. Like China and Brazil, two other export dynamos that have maintained low unemployment despite a sluggish global economy, Germany owes its low unemployment rate in part to demographic developments. Labor market policies that support domestic demand in the downturn and have kept German exporters competitive over the longer run are the third factor behind Germany's decoupling. Its labor laws allow firms much more flexibility to reduce hours during a downturn or to increase workers' hours during a boom, without incurring severance or overtime expenses, than do laws in other European countries. In addition, the government partially subsidizes furloughed workers' lost income during slowdowns, cushioning aggregate demand and confidence. In exchange for supporting these programs, German manufacturers have historically been able to negotiate more modest salary increases with their workforces than are typical of other European economies.

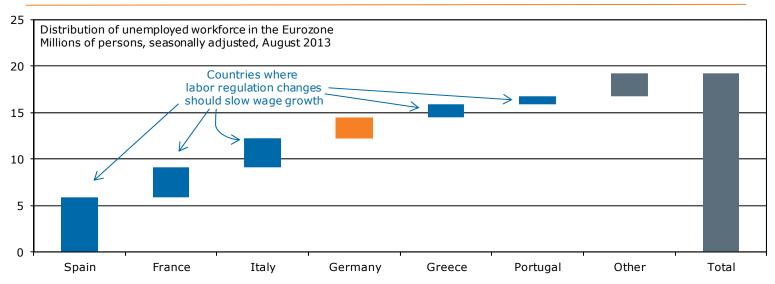
Labor policies
making corporate
German more
nimble than its
European rivals
help, too

The path to more competitive labor markets in Southern Europe is long and bumpy

Germany's dynamic export-oriented sector, resilient consumer sector, and solid housing market will likely make it the Eurozone's fastest growing economy for several years to come. In the long run, more flexible labor market policies adopted during the crisis by Spain, Italy, France, Greece, and Portugal may eventually boost competitiveness and economic growth in these economies. But the path to this outcome is long and uncertain: Germany's strength and resilience, so apparent during this latest recession, is the product of reforms enacted twenty years ago after the reunification of East and West Germany, and implemented consistently in the following two decades. With the most urgent phase of the crisis over, momentum for unpopular reforms in Southern Europe will be hard to sustain.

Weak demand and wage growth pose an important downside risk to the Eurozone inflation outlook for the next several years, one that so far seems mostly unacknowledged by the ECB. The reason is a touch obscure, but important enough to justify a detour into the nitty-gritty of monetary and labor economics. From the Eurozone's founding in 1999 to the crisis of 2008, inflation trended above the Eurozone's average in the currency area's southern

CHART 3: LABOR MARKET SLACK IS CONCENTRATED IN COUNTRIES THAT HAVE INSTITUTED MAJOR LABOR REFORMS



Sources: Eurostat, The PNC Financial Services Group Note: Data for Greece are unemployment as of the latest release of June, 2013 data

Increased wage
flexibility in
Southern Europe
may cause CPI
inflation to undershoot FCB forecasts

economies, where lax monetary policies, large public deficits, and crucially, nominal wage increases that outpaced growth in productivity or output per worker, were the norm before the currency union. While the southern Eurozone adopted the same monetary policy as the northern Eurozone before the crisis, and its governments mostly ran small deficits, the tradition of allowing wages to grow faster than productivity persisted, and contributed to higher trend inflation in those economies than in Germany, where wage increases closely tracked productivity growth (See Chart 4). In the run-up to the euro crisis, Southern European companies were able to fund large wage increases by passing on higher labor costs to their customers in higher prices for their products, the same "wage-price spiral" dynamic that contributed to CPI inflation reaching the high single digits in the United States for much of the 1970s. But since the crisis, sweeping labor reforms in Southern Europe are slowing wage growth, and in many cases are causing outright *declines* in wages. Goodbye, wage-price spiral. Goodbye, above trend inflation?

If inflation trends below target in 2014-2015 as seems plausible, a more dovish ECB will likely lead the euro to depreciate The ECB's September 2013 forecasts predict that CPI inflation in the Eurozone will average 1.5 percent in 2013 and 1.3 percent in 2014, close to the market consensus forecasts of 1.5 percent and 1.6 percent in 2013 and 2014, respectively. These forecasts seem consistent with how the Eurozone economy historically behaved during periods of slow growth, high unemployment, and muted increases in prices of oil or other commodities. They do not seem to account for a regime change in how price increases are negotiated in the private sector, which has caused the first deflation in Greece in 45 years (Again see Chart 4). To the extent that a structural change has indeed occurred in the Eurozone economy, inflation is likely to undershoot the ECB's target of inflation "less than, but close to, 2 percent" over the next several years. If so, the ECB is likely to keep benchmark short term interest rates at present levels at least until 2015; in addition, euro longer-term benchmark interest rates will likely fall. Given the high correlation of the euro-dollar exchange rate and the differentials between U.S. and Eurozone risk-free interest rates, this scenario seems likely to coincide with a euro weakening against the U.S. dollar through year-end 2014. Despite the uptick of the exchange rate to \$1.35 per euro after the Fed's September meeting, our price target for the exchange rate at year-end 2014 is unchanged at \$1.26.

CHART 4: LABOR REFORMS REDUCE SOUTHERN EUROPE'S CHRONIC INFLATIONARY PRESSURES

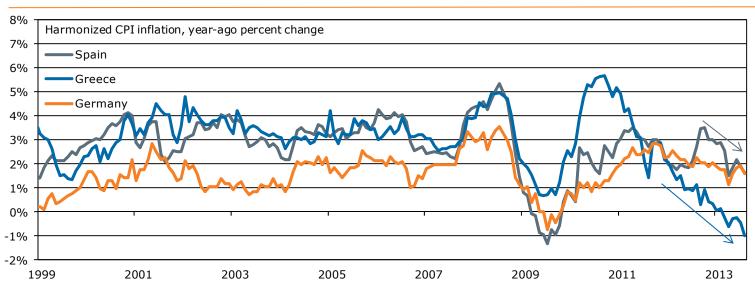


Chart sources: Eurostat, CEIC, The PNC Financial Services Group

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