## Economic Research

June 2021

*Market Monitor – Eurozone*

# Light at the end of the tunnel

## Economy shows signs of rebound from double dip recession

The eurozone economy contracted 0.6% quarter-on-quarter in Q1, in line with the bloc's initial estimate. At the same time, Europe's counterparts were seeing solid recovery, with the US reporting 1.6% growth in Q1 and China seeing a 0.6% expansion.

Luckily, there was a general market sense that the situation is turning around in Q2. For example, the website Indeed showed job openings rising in all major eurozone countries. The manufacturing sector has been the main driver of the eurozone economy since late 2020, but lately the services sector has been catching up. The manufacturing purchasing managers' index (PMI) peaked in April at 62.9 and dropped slightly to 62.8 in May. Meanwhile, the services PMI jumped from 50.5 to 55.1 in May's flash reading. Retail sales in March beat the market forecast and jumped 2.7% month-on-month, after rising 4.2% in February. It rose 12% year-on-year, despite new anti-pandemic restrictions across the EU during the month. With new Covid-19 cases trending downward as the vaccination drive gathers pace, restrictions are expected to be lifted soon, boosting consumer sentiment.

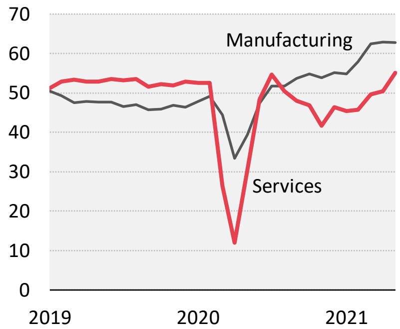
Eurozone inflation rose to 1.6% in April, up from 1.3% in March, mainly due to a sharp rise in energy and services costs. Energy prices rose 10.4% year-on-year. Core inflation, which excludes food and energy prices, went up 0.8% year-on-year. Europe is believed to be facing a lower inflation risk than the US. Core CPI has picked up since the end of 2020, but is much less pronounced than the headline rate and has remained below 1%.

## Uncertain whether the rebound is sustainable

It is too early to tell if the rebound is sustainable beyond Q2. New virus variants are still a big risk to economic recovery, while the currency bloc is working to reopen its borders and remove border controls.

- **Eurozone economy contracts 0.6% QoQ in Q1, but there are signs of a rebound.**
- **Manufacturing sector is the main driver, but the services sector is catching up.**
- **European shares rise, as do government bond yields, while the euro is lifted by a more optimistic Q2 outlook.**

**Purchasing Managers' Index**




Source: Bloomberg, data as of 24/5/2021

Moreover, the scaling back of government stimulus too soon will drag on economic performance. For example, the rise in unemployment was limited, thanks to governments subsidising the wages of furloughed workers. A retirement of these subsidies could significantly lift the unemployment rate and hamper the economy.

## Gains in European stocks contained amid inflation fears

Signs of accelerating inflation, especially in the US, have stoke fears that monetary stimulus will be dialled down and that interest rates could rise. However, the US Federal Reserve (Fed) repeated that it would keep up crisis monetary support, causing European equities to reach all-time highs. The pan-European Stoxx 600 Index rose 2.1% between end-April and end-May. At the same time, the German DAX Index was up 1.9% and France's CAC Index was up 2.8%.

## Government bond yields rise

Eurozone bond yields rose following their US counterparts after US consumer prices increased at a faster rate than expected in April, fuelling market fears of a lengthy period of higher inflation, which in turn caused eurozone government bond yields to rise. However, at the June meeting of the European Central Bank (ECB), its chief, Christine Largarde, helped contain the recent surge in yields when she said there was no plan to wind down the Pandemic Emergency Purchase Programme (PEPP).

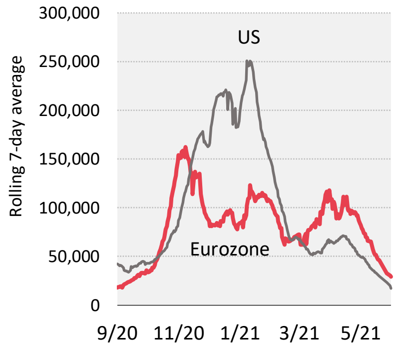
Meanwhile, German government bond yields remained steady, as investors opted for safe-haven debt markets after a sharp fall in cryptocurrencies. By 31st May, German 10-year government bond yields had risen to -0.187%, up from -0.202% at end-April.

On 31st May, the extra yield demanded by investors to hold 10-year Italian bonds rather than their German equivalents was about 1.096 percentage points, down from 1.1 percentage points at end-April.

## Euro strengthens with optimism about Q2 economic performance

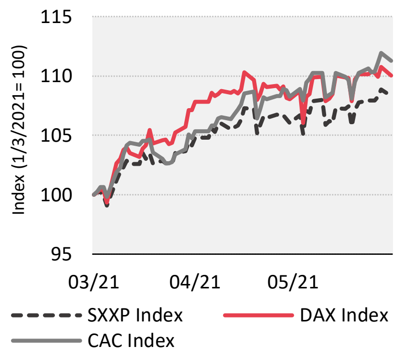
The euro had risen by 1.7% against the US dollar as of 31st May and was trading at USD 1.2227, compared with USD 1.202 as at end-April. The euro was lifted by a weaker US dollar, while optimism about a turnaround in the eurozone's Q2 economic performance after a poor first quarter. A strong pair of PMIs in May have added to the euro's positive momentum. However, the trend in June will be affected by both the ECB and the Fed's monetary policy meeting decision, and whether they will provide some clues about the continuation of their respective bond buying programmes.

**Covid-19 Daily Confirmed Cases**



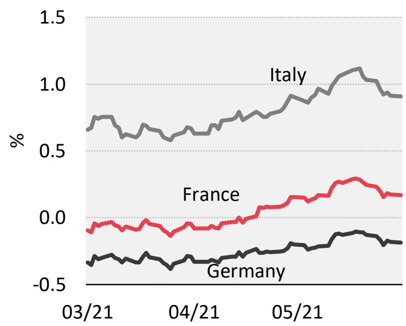

Source: Bloomberg, data as at 1/6/2021

**Stock Market Indices**



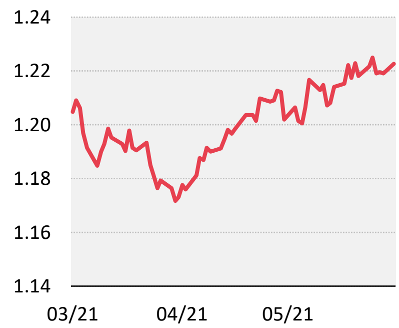

Source: Bloomberg, data as of 31/5/2021

**10-Year Government Bond Yield**




Source: Bloomberg, data of at 31/5/2021

**Euro against USD**




Source: Bloomberg, data as of 31/5/2021

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