Economic Research

July 2021

Market Monitor – Eurozone

European Central Bank Keeps Dovish Stance

Supply-side inflationary pressure is showing impact

Services sector recovers, but manufacturing experiences inflationary pressure.

With inflation rising, the ECB sticks to a dovish monetary stance.

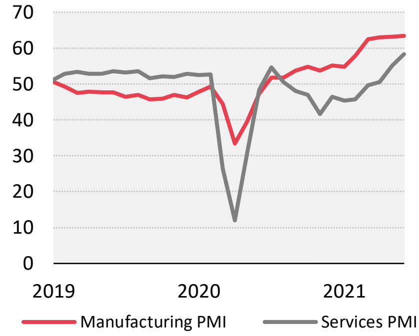
European shares rise, while the euro falls against a stronger USD.

Retail sales in April dropped 3.1% month-on-month, after rising 3.3% in March. Nevertheless, more recent data shows a significant improvement. The final reading of the services PMI jumped from 55.2 in May to 58.3 in June. With new Covid-19 cases trending downward as the vaccination drive gathered pace, restrictions were loosened, boosting consumer sentiment.

The manufacturing sector continued to perform well. Industrial production beat estimates in April, rising 0.8% month-on-month. The manufacturing purchasing managers' index (PMI) was steady at 63.4 in June, the highest level on record. However, supply-side inflationary momentum is pressuring manufacturers, with a substantial rise in average input costs and bottlenecks of essential supplies. For example, according to the Ifo Institute, 44% of German construction companies indicated problems in sourcing materials on time. Soaring prices for steel, lumber, and copper will eat away at the EU's EUR 800 billion recovery fund, with a sizeable share already funding vast infrastructure projects.

Eurozone inflation surged to 2% in May, achieving the European Central Bank (ECB)'s target of "below but close to 2%". This was up from 1.6% in April, mainly due to a sharp rise in energy and services costs. Energy prices rose 13.1% year-on-year. Core inflation, which excludes food and energy prices, was relatively more modest and edged up 0. 1 percentage points to 0.9%. However, elevated commodity prices, supply chain disruptions, and a surge in demand following the scaling back of lockdown measures will continue to drive up inflation, as seen globally.

Purchasing Managers' Index



Source: Bloomberg, data as of 6/7/2021

The ECB remained dovish

Meanwhile, the ECB has remained dovish, keeping interest rates low and its vast bond-buying programme unchanged at its June meeting. ECB president Christine Lagarde stated that the bank remained committed for the pandemic emergency purchase programme (PEPP), which provides low interest rates and liquidity to eurozone economies, to continue until at least Q1 2022. In the markets, there is a lingering memory of the premature unwinding of monetary policy in 2011, which led to a worsening of the eurozone sovereign debt crisis.

Yet it is not easy to tell if the rebound will be sustainable through Q3 and beyond. 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.

Gains in European stocks supported by dovish ECB stance

US Federal Reserve Chair Jerome Powell reiterated that inflationary pressures were transitory and seemed to soothe market fears about unexpected tapering of monetary stimulus. European stocks were also lifted by the ECB's decision to continue its loose monetary policy for the sake of improving business sentiment in Europe. Germany's Ifo Institute business climate index rose to 101.8 in June, beating market estimates, while a similar index for France, the INSEE business confidence index, rose to 107. The pan-European Stoxx 600 Index rose 1.4% between end-May and end-June. At the same time, the German DAX Index was up 0.7% and French CAC Index was up 0.9%.

Government bond yields edge lower

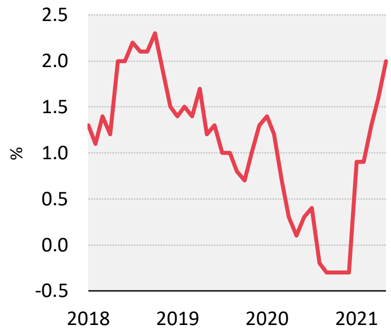
Eurozone bond yields edged lower, following their US counterparts (after the Fed downplayed the impact of a recent surge in inflation), and due to the ECB's signal that it would not be tapering off its bond purchases in the coming months. By 30th June, German 10-year government bond yields were at -0.207%, lower than -0.187% seen at the end of May.

On 30th June, the extra yield demanded by investors to hold 10-year Italian bonds rather than their German equivalents was about 1.026 percentage points, down from 1.096 percentage points at end-May.

Euro weakens with strengthened US dollar

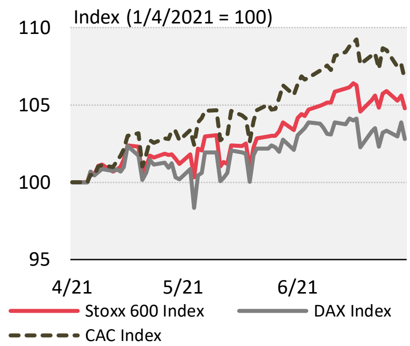
The euro had dropped by 3% against the US dollar as of 30th June and was trading at USD 1.1858, compared with USD 1.2227 as at end-May. The euro was dragged down by a strengthened US dollar following a more hawkish turn at the June meeting of the US Federal Reserve's rate-setting committee (a majority of the members projected two rate hikes by the end of 2023). Meanwhile, the ECB's dovish monetary policy stance validated market belief that the Fed will tighten its monetary policy ahead of the ECB in this cycle.

Eurozone Inflation



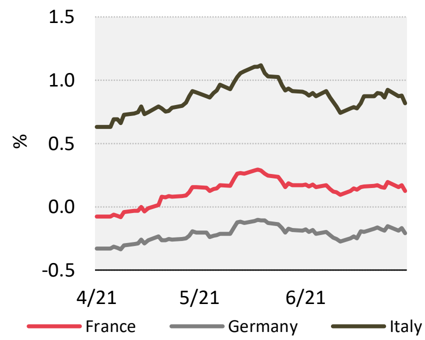
Source: Bloomberg, data as of 25/6/2021

Stock Market Indices



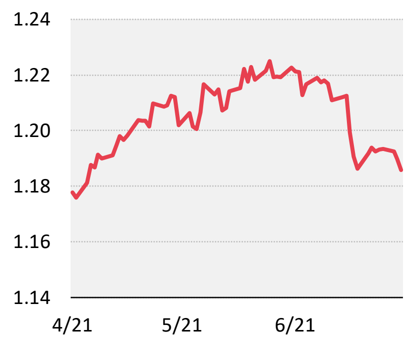
Source: Bloomberg, data as of 30/6/2021

10-Year Government Bond Yield



Source: Bloomberg, data of at 30/6/2021

Euro against USD



Source: Bloomberg, data as of 30/6/2021

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