Economic Research

August 2021

Market Monitor – Eurozone

Covid-19 Variant Clouds Economy

Covid-19 variant clouding EU economy

The spread of the highly-contagious delta variant has caused spikes in daily new cases in Europe, and forced several major European countries, including France, the Netherlands, Italy, and Greece, to re-implement social restrictions. For example, France has mandated that all workers in the healthcare sector be vaccinated by 15th September, and introduced a "health pass" showing whether people are fully vaccinated, recently tested negative, or recovered from Covid-19, which is required to enter restaurants and other public venues. This pass will apply to all adults by 15th September, and to everyone aged 12 or above by 30th September. However, in France, Italy, and Greece thousands of people have demonstrated against these mandatory vaccination policies.

An EU "vaccine passport" was put forward as a means to resume normal domestic activity while combating the pandemic, in order to protect the nascent recovery of the economy, which grew 2% quarter-on-quarter in Q2 in the Eurozone. Eurozone retail sales rose more than expected in May, rising 4.6% month-on-month after a 3.1% drop in April. The final reading of the services PMI jumped from 58.3 in June to 59.8 in July. Meanwhile, the bloc's unemployment rate fell to 7.7% in June, down from 8% in the previous month and a peak of 8.5% in August 2020. Data from jobs site Indeed showed rising job vacancies in June across all the largest economies in the eurozone.

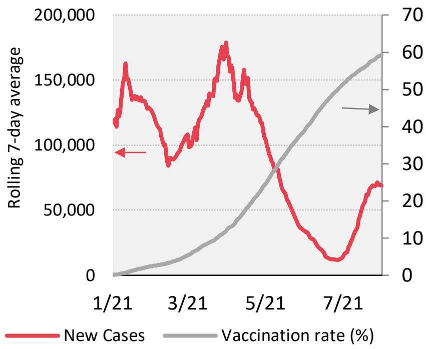
Industrial production fell 1% month-on-month in May, with widespread shortages of semiconductors, steel, copper, and other materials. Producers of motor vehicles, trailers, and semi-trailers were among the hardest hit. With supply-chain disruptions expected to continue throughout this year, the EU manufacturing sector is likely to be dragged down. The EU manufacturing purchasing managers' index (PMI) was at 62.8 in July, down from 63.4 in the previous month.

Several major European countries re-impose restrictions in response to spread of the delta variant.

Some countries opt for "vaccine passes" to resume normal activity, but this sparks public demonstrations.

Covid-19 variant drags down European stocks, while the euro rises against a weaker USD.

EU's Covid-19 Cases and Vaccination



Sources: Bloomberg; Our World in Data, data as at 31/7/2021

Eurozone inflation accelerated in July to 2.2%, according to a flash estimate, up from 1.9% in June. Core inflation, which excludes food and energy prices, was more modest and stayed at 0.9%. Prices in service and energy inflation grew at a faster rate.

Debate among hawks and doves in the ECB

Meanwhile, the ECB has shifted its inflation target to 2% in the medium term, up from "below but close to 2%". The central bank reached an early agreement that its new target is symmetric, meaning negative and positive deviations of inflation from the target are equally undesirable. The ECB will have a medium-term flexible objective, with moderate fluctuation in either direction expected in the short term.

The bank will include climate change considerations in monetary policy operations in the areas of disclosure, risk assessment, collateral framework, and corporate sector asset purchases. It will also adjust its framework for corporate bond purchases to incorporate climate change criteria.

Some economists expect inflation to rise in the second half of this year, fuelling a debate among ECB council members. Jens Weidmann of the Bundesbank recently called for the ECB to start winding down its EUR 1.85 trillion pandemic emergency purchase programme (PEPP) in order to keep inflation in check.

Gains in European stocks undermined by new Covid-19 variant

The spread of the Covid-19 delta variant in Europe dampened market sentiment at mid-July. Moreover, worries about supply chain bottlenecks weighed on automobile stocks. However, as the US Federal Reserve was reluctant to roll back its largest stimulus programme, equity markets were sent higher towards end-July and reached record high.

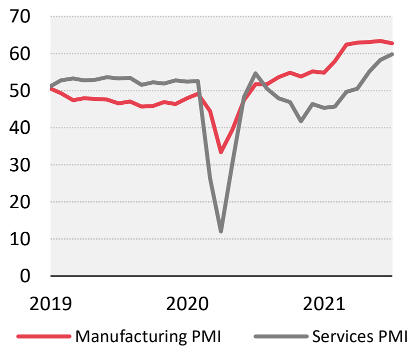
The pan-European Stoxx 600 Index rose marginally at 2% between end-June and end-July. At the same time, the German DAX Index was up 0.1%, while the French CAC Index was up 1.6%.

Government bond yields edge lower

Government bond yields have continued to fall. Concerns about higher inflation and rising Covid-19 infections causing a slowdown in economic recovery have weighed on investor sentiment and driven much capital towards safe havens such as the bond markets. By 30th July, German 10-year government bond yields were at -0.461%, lower than the -0.207% seen at the end of June.

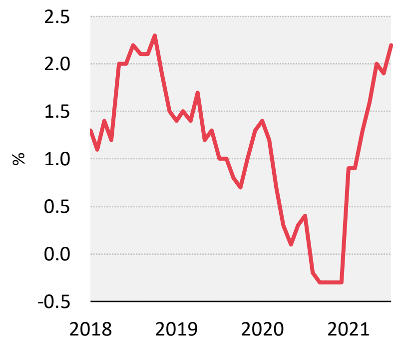
On 30th July, the extra yield demanded by investors to hold 10-year Italian bonds rather than their German equivalents was about 1.08 percentage points, up from 1.026 percentage points at end-June.

Purchasing Managers' Index



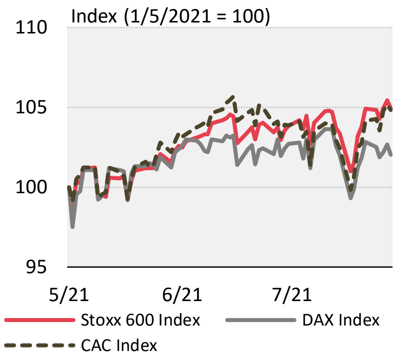
Source: Bloomberg, data as of 5/8/2021

Eurozone Inflation



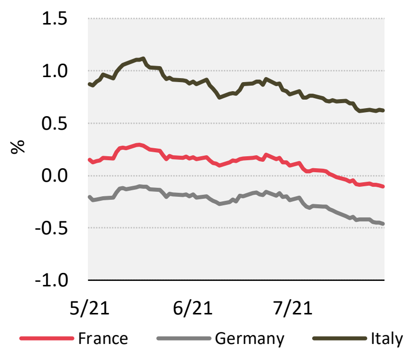
Source: Bloomberg, data as of 2/8/2021

Stock Market Indices



Source: Bloomberg, data as of 30/7/2021

10-Year Government Bond Yield

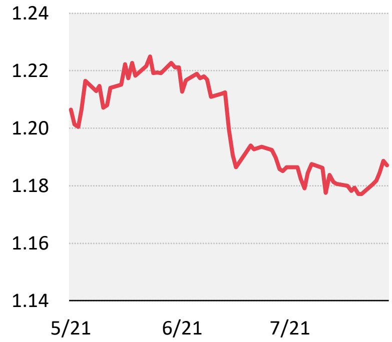


Source: Bloomberg, data of at 30/7/2021

Euro weakens in face of strong US dollar

The euro had risen mildly by 0.1% against the US dollar as of 30th July and was trading at US$1.1871, compared with US$1.1858 as at end-June. A resurgence of Covid-19 cases triggered a flow of capital towards safe havens. However, the dovish US Federal Reserve has sent US dollar lower, and the euro was strengthened.

Euro against USD



Source: Bloomberg, data as of 30/7/2021

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