BEA 東亞銀行

Economic Research

September 2021

Market Monitor – Eurozone

Manufacturing Sector Sees Slowing Momentum

Manufacturing sector sees slowing growth momentum

Although faced with the Delta variant, the EU currency bloc could rise out of its double-dip recession, with the economy having grown by 2% quarter-on-quarter in Q2 and 13.6% year-on-year. The easing of lockdown measures became possible, aided by a rapid vaccine rollout. About 64.6% of population in the EU have received their first Covid-19 vaccination, and 58% are fully vaccinated.

Eurozone retail sales grew by more than expected in May, rising 1.5% month-on-month after a 4.5% increase in May. The preliminary reading of the services PMI saw little change from 59.8 in July to 59.7 in August.

Industrial production fell 0.3% month-on-month and rose 9.7% year-on-year in June, reflecting ongoing disruption to supply chains which challenged the continual recovery in the manufacturing sector and faced manufacturers with higher costs. In particular, Ireland and Portugal witnessed the largest declines in industrial production on a monthly basis. The EU manufacturing purchasing managers' index (PMI) was at 61.4 in August, down from 62.8 in the previous month.

With fears of a fourth Covid-19 wave, Germany's ZEW Economic Sentiment Index fell in August from 63.3 to 40.4, versus a forecasted decline to 55.1. For the eurozone as a whole, the ZEW Economic Sentiment Index fell from 61.2 to 42.7. Economists had forecast a decline to 45.6.

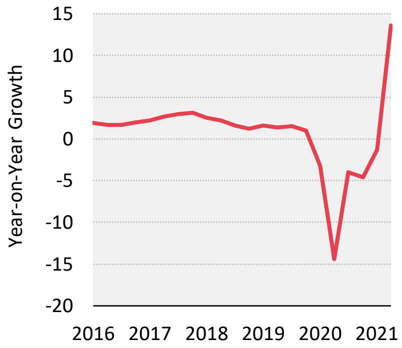
Eurozone inflation estimate accelerated further in August to 3%, up from 2.2% in July, hitting a 10-year high. Core inflation, which excludes food and energy prices, accelerated to 1.6%. Increased demand along with the easing of lockdown restrictions and a supply chain shortage is causing demand to outstrip supply, adding to inflationary pressure in the currency bloc.

Ongoing disruption to supply chains and new virus outbreaks challenge the manufacturing sector.

Inflation set to stay high, pressuring the ECB to taper off its Pandemic Emergency Purchase Programme. Market views are currently mixed.

Covid-19 variant drags down European stocks. Euro drops as ECB is expected to remain dovish for longer.

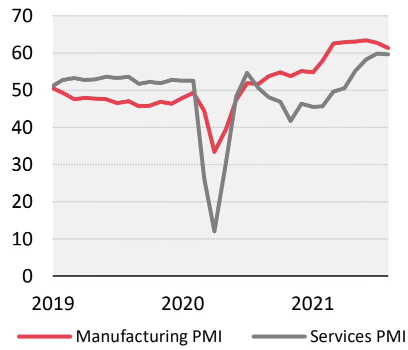
Eurozone GDP



Source: Bloomberg, data as of 31/8/2021

Economists predicted the economy would grow by 2.1% in Q3 and 1.2% in Q4, and revised up their inflation forecasts for a peak quarterly average of 2.8% in Q4, after which they expect inflation to gradually fall, reaching 1.5% for 2022 as a whole. The unemployment rate is forecast to take at least a year to reach its pre-crisis level of 7.4%. But the highly infectious Delta variant is still clouding the economic outlook as it continues to sweep across large parts of the EU.

Purchasing Managers' Index



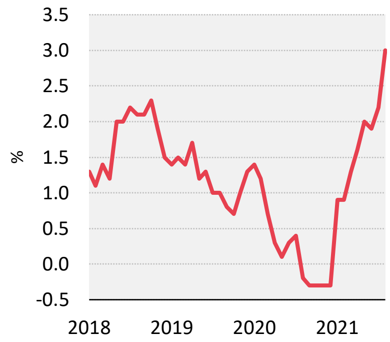
Source: Bloomberg, data as of 31/8/2021

Market views mixed about when PEPP will start to be wound down

The eurozone economy's fast recovery and expected elevated inflation is pressuring the European Central Bank (ECB) to taper off its Pandemic Emergency Purchase Programme (PEPP), similar to the situation for other major central banks. However, with the rise in Covid-19 cases due to the Delta variant, the ECB might adopt a wait-and-see approach until the end of this year to avoid any unwarranted spike in bond yields.

Currently, market views are mixed. In a poll by Reuters, slightly over half (52%) of surveyed economists predicted the ECB would announce a drawdown in Q4, while 42% predicted a September announcement. 45% expected tapering off to start in Q4, and a third predicted it would start in Q1 next year. Even when this emergency programme closes, the ECB will still have an active Asset Purchase Programme (APP) in place.

Eurozone Inflation



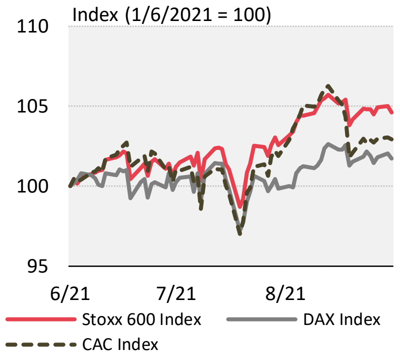
Source: Bloomberg, data as of 2/9/2021

European stocks weighed on by Covid-19

Upbeat economic data in the eurozone, as well as stable US inflation in June and July, propelled the eurozone equity markets to its longest 10 consecutive sessions of positive trading. However, it then dipped into red after the global spread of the Delta variant, worse than expected China economic data and US market sentiment, as well as geopolitical tensions, all of which raised fears of slowing global growth.

The pan-European Stoxx 600 Index rose at 2% between end-July and end-August. At the same time, the German DAX Index was up 1.9%, while the French CAC Index was up 1%.

Stock Market Indices



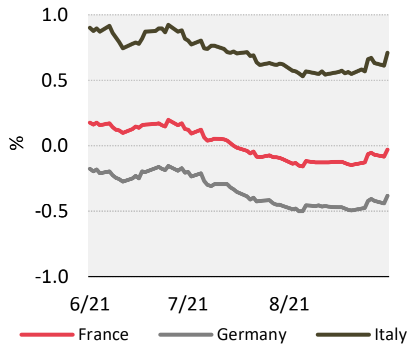
Source: Bloomberg, data as of 31/8/2021

Government bond yields edge lower

EU government bond yields dipped lower in the first half of August when US inflation data confirmed market expectation, which denied the Federal Reserve (Fed) leeway to start tapering off its bond buying sooner than expected. There is speculation that the ECB will continue its asset purchases for some time after its revision of the inflation target in order to support economic growth and the bond market, thus diverging from the policy of the Fed. Meanwhile, weaker-than-expected economic data from China and the sharp fall in US consumer sentiment drove up demand for safe haven assets.

However, later in the month, the higher-than-market-expected inflation in the Eurozone prompted market speculation about monetary tightening of the ECB soon. By 31st August, German 10-year government bond yields were at -0.383%, higher than the -0.461% seen at the end of July.

10-Year Government Bond Yield



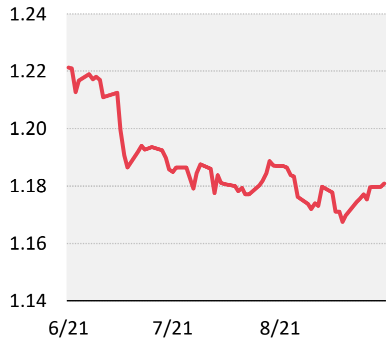
Source: Bloomberg, data of at 31/8/2021

On 31st August, the extra yield demanded by investors to hold 10-year Italian bonds rather than their German equivalents was about 1.09 percentage points, up from 1.08 percentage points at end-July.

Euro weakens ahead of expected divergence between Fed and ECB policy

The euro had dropped by 0.5% against the US dollar as of 31st August and was trading at US$1.1809, compared with US$1.1871 at end-July. Although the economic data in the eurozone was upbeat, concerns about Delta variant Covid-19 cases continued to cloud the market and heightened risk aversion. Moreover, the market generally believed the Fed would taper off stimulus earlier than the ECB. As such, the US dollar rose faster than the euro.

Euro against USD



Source: Bloomberg, data as of 31/8/2021

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