Market Monitor – Eurozone

ECB Scales Back Bond Purchases

Progress in vaccinations supports business activity

Eurozone retail sales fell 2.3% month-on-month in July, and 3.1% year-on-year, after a 5.4% increase in June, as the effect of stores reopening begins to fade, while consumer increased spending on services. The preliminary reading of the services purchasing managers' index (PMI) trended downwards from 59 in August to 56.3 in September.

Industrial production rose 1.5% month-on-month and 7.7% year-on-year in July, exceeding market expectation, although supply chain bottlenecks continued. Exports rose 1% in July from June, while imports increased 0.3%. Meanwhile, manufacturers tried to adapt to persistent semiconductor shortages and shipment delays, with the manufacturing PMI registering 58.7 in September. Though down from 61.4 in the previous month, this was still well above the 50 threshold.

Progress in vaccination campaigns also supported business activity. Despite early missteps in vaccine procurement, over 70% of the EU's adult population were fully vaccinated by mid-September. Countries are continuing to boost vaccinations through various policies. For example, Italy is the first European country to make it compulsory for all workers to have a Covid "green pass" consisting of a proof of vaccination, a negative test, or recovery from the virus. This measure is expected to become effective on 15th October. Around 3,000 healthcare workers in France were suspended for failing to comply with mandatory Covid vaccination.

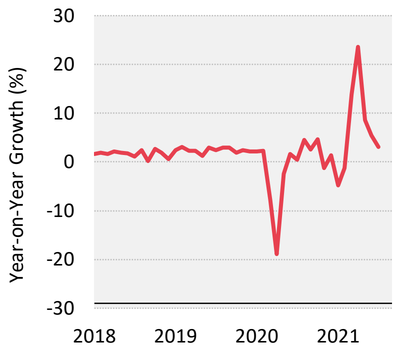
Eurozone inflation estimate reached a 13 -year high of 3.4% in September, up from 3% in August. Core inflation, which excludes food and energy prices, advanced to 1.9%, up from 1.6% in August. Rising costs in areas such as shipping and energy will continue to push up inflation in the coming months. European Central Bank (ECB) president Christine Lagarde reiterated that the surging prices were only temporary, but she expected price hikes would shoot past the ECB's 2% target this year.

Progress in vaccination supports business activity, while industrial production improves faster than expected.

ECB announces it will slow its monthly PEPP purchases, signalling economic optimism.

Worries about the global economy and the pandemic drag down stock market performance.

Eurozone Retail Sales



Source: Bloomberg, data as of 4/9/2021

ECB scales back its bond purchases

The ECB announced after its September monetary policy meeting that it would keep the scale of the pandemic emergency bond-purchasing programme (PEPP) unchanged at 1.85 trillion euros (US$2.2 trillion). But it would trim the monthly amount of purchases during Q4, as economic activity recovers and inflation surges higher. However, Lagarde stressed that the move was not a “tapering off”, but a “recalibration”, as the ECB has not changed the size of PEPP, nor its end-date, which is set for March 2022. The scheme was in place to safeguard the eurozone economies, especially as the Delta variant was still clouding Europe’s recovery.

As economic data showed a strong start to Q3, with a continually supportive monetary policy, there is generally more market optimism about economic recovery for the rest of the year. Market consensus is a 5.1% year-on-year economic growth for Q4 this year, and a 5% economic growth for the whole year, followed by a 4.3% growth in 2022. Meanwhile, the inflation projection is 3.2% in Q4 and 2.2% for the whole year, with 1.6% for next year. In the longer term, the challenge will be how and when to remove monetary stimulus without jeopardising the economic recovery.

In addition, the OECD has warned that with a stuttering recovery and loose monetary policies by the ECB, the pandemic crisis could leave the EU countries with lasting scars. For example, the southern European economies are lagging behind due to their heavy reliance on tourism and small firms. As such, they are struggling with debts. Countries including Italy, France, and Spain are expected to fail to abide by EU borrowing rules this year and next. On the other hand, Germany has been performing well amid the crisis, with a prudent economic policy and only modest borrowing.

European stocks dragged down by worries about global environment

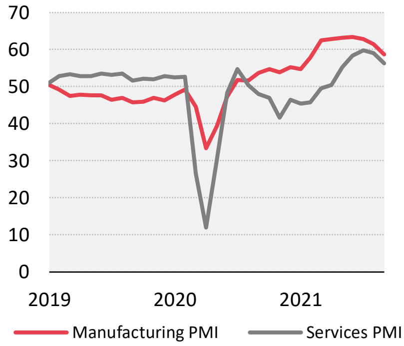
The European equity markets closed lower due to worries about decelerating global growth, elevated inflation, and the pandemic, alongside growing fears of an Evergrande default and the chain effects on China’s other property developers and financial institutions. Furthermore, the US Federal Reserve (Fed) has signalled that asset purchases will start to be tapered off in November, and a growing number of officials expect an interest rate hike next year, compared with a slight majority who expected a hike in 2023 in a June projection.

The pan-European Stoxx 600 Index declined at 3.4% between end-August and end-September. At the same time, the German DAX Index was down 3.6%, while the French CAC Index was down 2.4%.

Government bond yields edge higher

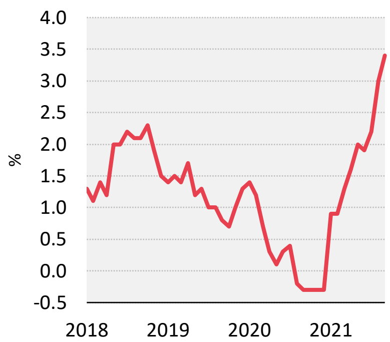
Although the ECB stressed it was not tapering off its PEPP, slower purchases indicated its optimism about the eurozone’s economy recovery. Moreover, a flurry of debt sales also pushed yields higher. In mid-September, the EU raised more than 85 billion euros for a newly-syndicated 7-year bond to back its coronavirus recovery fund. Germany raised 3.9 billion euros from its 2-year bond, while Italy raised 5.75 billion euros from selling 3, 7, and 30-year bonds. By 30th September, German 10-year government bond yields were at -0.199%, up from -0.383% at the end of August.

Purchasing Managers' Index



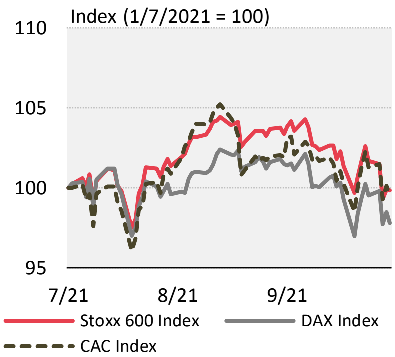
Source: Bloomberg, data as of 4/10/2021

Eurozone Inflation



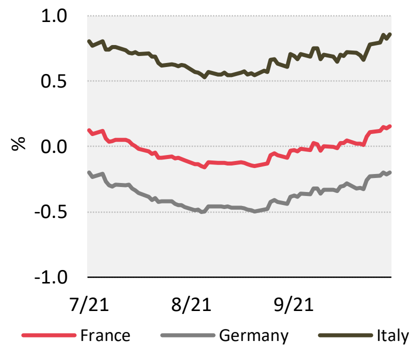
Source: Bloomberg, data as of 2/10/2021

Stock Market Indices



Source: Bloomberg, data as of 30/9/2021

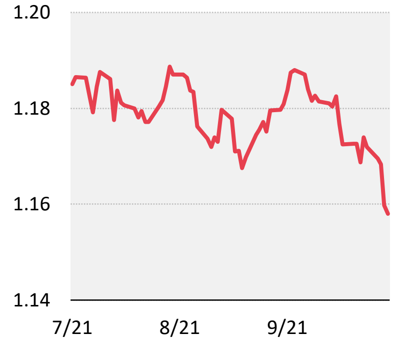
10-Year Government Bond Yield



Source: Bloomberg, data of at 30/9/2021

On 30th September, the extra yield demanded by investors to hold 10-year Italian bonds rather than their German equivalents was about 1.06 percentage point, down from 1.09 percentage points at end-August. A well-received Italian debt auction reduced the risk premium.

Euro against USD



Source: Bloomberg, data as of 30/9/2021

Euro under pressure

The euro had dropped by 1.9% against the US dollar as of 30th September and was trading at US$1.158, compared with US$1.1809 at end-August. The euro was under pressure as the Fed signalled a tapering off of bond purchases by the end of this year, while more Fed officials expect a late-2022 rate hike or three 0.25% hikes in 2023, but the ECB has implied no tapering off of its PEPP in the foreseeable future. Meanwhile, risk aversion increased over concerns about the spillover effect of China's Evergrande crisis.

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