BEA 東亞銀行

Economic Research

January 2022

Market Monitor – Eurozone

Uncertainty over Covid-19 Risk Will Delay Economic Normalisation

ECB starts scaling back pandemic-related stimulus amid elevated inflation

In the face of soaring inflation, the European Central Bank (ECB) announced in December that it would gradually reduce the pace of asset purchases in the coming quarters. In particular, net asset purchases under the €1.85-trillion Pandemic Emergency Purchase Programme (PEPP) will be scaled back over the course of Q1 2022 and be discontinued at the end of March 2022. In order to avoid disruption, the ECB is to expand its conventional Asset Purchase Programme (APP) from the current monthly pace of €20 billion to €40 billion in Q2 2022, and to €30 billion in Q3 2022, to cushion the impacts of exiting from PEPP. A monthly pace of €20 billion will be maintained from October 2022 onwards, "for as long as necessary", before the ECB starts to raise key interest rates.

Eurozone inflation remained elevated at 4.9% in November, a fresh record high, up from 4.1% in October. Energy prices continued to be the main culprit, surging by 27.5% year on year in November.

The eurozone economy improved slightly in October, but increasing Covid-19 risks arising from the Omicron variant are clouding the market outlook. Eurozone retail sales increased by 0.2% month on month in October, up from a fall of 0.4% in September. On the external front, exports increased by 2.4% month on month in October while imports increased by 4.3%, resulting in a trade surplus of €2.4 billion.

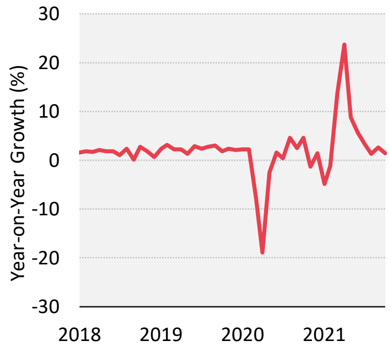
Industrial production rebounded by 1.1% month on month in October, up from a 0.2% monthly drop in September. Germany's industrial production led the rise among member states, with a monthly increase of 3%. The preliminary manufacturing purchasing managers' index (PMI) remained in robust expansionary territory at 58 in December, down from 58.4 in November. Meanwhile, the preliminary reading of the eurozone services PMI decreased to 53.3 in December, compared to 55.9 in November.

Multiple headwinds including Covid-19 pandemic and supply chain disruptions remain a drag on economic activity in 2022.

European Central Bank begins to roll back pandemic-related asset purchase programme.

Stock market is boosted as the fears over Omicron variant subsides.

Eurozone Retail Sales



Source: Bloomberg, data as of 3/12/2021

Economic recovery will remain subdued in 2022 amid multiple headwinds

Covid-19 infection rates in Europe were rising in December 2021, prompting a fresh wave of lockdown measures. Renewed outbreaks of Covid-19, supply bottlenecks and elevated inflation will weigh on eurozone economic activity entering 2022. A worsening Covid-19 situation and associated tightening in social distancing measures will dent consumer sentiment, dragging the shift of consumption from goods to services. Meanwhile, elevated inflation will also likely lower real disposable income and restrain consumption incentives accordingly. Supply bottlenecks are expected to persist into 2022, putting pressure on suppliers' delivery times and making it difficult for manufacturers to acquire key materials on time. Against this backdrop, the eurozone economy will remain challenged by multiple ongoing headwinds in the first half of 2022.

Having said that, if the eurozone can control the pandemic outbreak in the latter half of the year, with booster jabs and better cures, the economy could improve across its member states. Precautionary excess savings accumulated during the pandemic may also be unleashed as uncertainty about the Covid-19 situation decreases and domestic consumption is given the green light. In addition, easing supply bottlenecks will also help to normalise the manufacturing process.

On the fiscal front, the European Recovery and Resilience Facility (RRF) is expected to continue to help narrow the gap of recovery among member states in 2022. In particular, some countries hard hit by the pandemic such as Italy and Spain will receive more funds under the RRF than other member states such as France and Germany. The EU's fiscal stance will remain accommodative in 2022, with reduced taxes and further social transfers compensating households for rising energy prices.

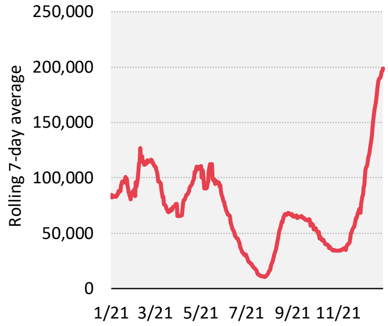
According to economic projections by the ECB, real GDP growth is forecast to ease to 4.2% in 2022, down from an estimated 5.1% in 2021. In the meantime, the inflation rate is projected to further pick up, rising from an estimated annual growth rate of 2.6% in 2021 to 3.2% in 2022.

European stocks rebound amid lower fears over Omicron variant than before

The european equity markets improved in December from a slump in late-November induced by the emergence of Omicron coronavirus variant. There have been increasing updates about Omicron variant, which helps allay market concerns over potential economic impacts. For example, Pfizer and BioNTech stated that their booster vaccine could be effective against the Omicron according to their joint laboratory results. Market fears eased compared to the end of previous month, fueling the rebound in the equity markets. Nevertheless, the end of ECB's PEPP in 2022 as well as hawkish monetary actions by the US Federal Reserve (Fed) induce a tightening monetary environment going forward, affecting companies' financing conditions.

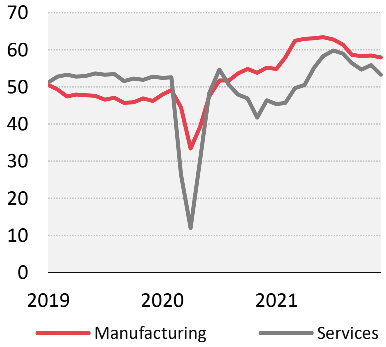
The pan-European Stoxx 600 Index had increased by 5.4% as at 31st December compared to the level of end-November. During the same period, the German DAX Index rose by 5.2% while the French CAC Index advanced by 6.4%.

Covid-19 Daily Confirmed Cases in Eurozone



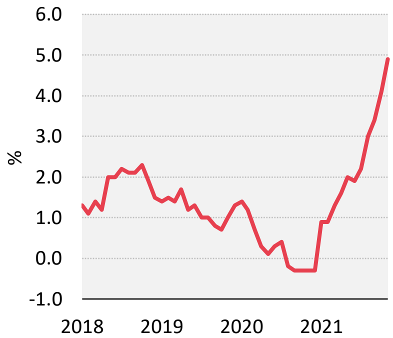
Source: Bloomberg, data as at 31/12/2021

Purchasing Managers' Index



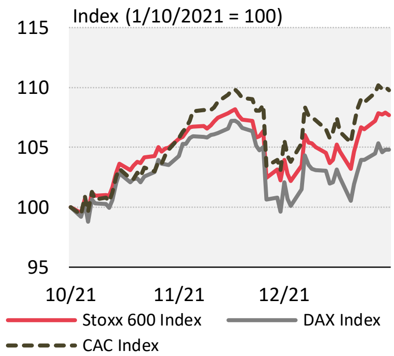
Source: Bloomberg, data as of 16/12/2021

Eurozone Inflation



Source: Bloomberg, data as of 17/12/2021

Stock Market Indices



Source: Bloomberg, data as of 31/12/2021

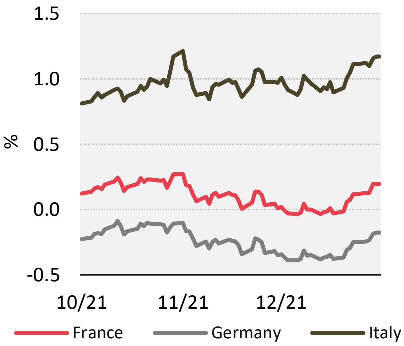
Government bond yields accelerate

Market fears over Omicron variant appeared to have decreased in December compared to late-November, when the emergence of Omicron coronavirus variant turned on risk-off sentiment. Improving market sentiment prompted the investors to return to risky assets, lowering the demand for safe-haven assets.

In addition, although the ECB announced an end of PEPP in March 2022, ECB president Christine Lagarde signalled flexibility concerning asset purchases, particularly for Greek government bonds, which are excluded from the APP owing to their low credit rating. In particular, the ECB will reinvest the proceeds from its PEPP into Greek government bonds in order to keep up monetary assistance to the Greek economy. As of the end of December, Germany's 10-year government bond yield was reported to be -0.177%, up from -0.349% at end-November.

On 31st December, the extra yield demanded by investors to hold 10-year Italian bonds rather than their German equivalents was about 1.35 percentage points, slightly up from the level of 1.32 percentage points seen at end-November.

10-Year Government Bond Yield

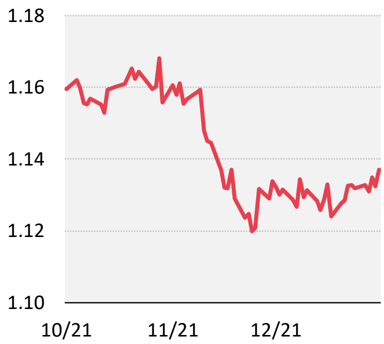


Source: Bloomberg, data of at 31/12/2021

Euro strengthens amid weaker US dollar, but pressures ahead

The US dollar weakened at the end of December, supporting the euro. As of 31st December, the euro strengthened by 0.28% against the US dollar and was trading at US$1.137, slightly up from US$1.1338 as at end-November. However, the euro is expected to remain under pressure going forward, considering the divergence of monetary policy between the US Fed and the ECB. While US inflation is hitting a historical high, the US Fed has also announced that it will taper off its asset purchases more quickly, and more Fed officials now expect to implement rate hikes of at least 75 basis points in 2022. Meanwhile, the ECB adopted a temporary increase of APP following the retirement of PEPP.

Euro against USD



Source: Bloomberg, data as of 31/12/2021

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