BEA 東亞銀行

Economic Research **March 2022**

Market Monitor – Eurozone

Mixed Signals from Major Economic Indicators

Economy hit by energy inflation and COVID restrictions in late-2021

Eurozone retail sales decreased by 3% month on month in December 2021, down from a monthly growth of 1% in November. The strict virus-containment measures previously imposed by the Netherlands and Germany in December have noticeably constrained consumer activity. Retail sales in the Netherlands saw a sharp month-on-month drop of 9.2%, while in Germany they fell 5.5%, both declines exceeding the eurozone average.

Eurozone inflation was 5.1% in January 2022, and accelerated further to 5.8% in February in the flash estimate, with energy and food prices continued to accelerate. The war in Ukraine is likely to keep energy and other commodity prices elevated, and drive inflation higher.

Eurozone industrial production increased by 1.2% month on month in December 2021, beating market expectations of a 0.3% monthly growth. On an annual basis, the growth of industrial production returned to positive territory of 1.6% in December from a yearly decline of 1.4% in November. The improvement could be attributed to an advance in the production of capital goods, which grew by 2.6% month on month in December, up from 1.4% in November. The annual decline in the production of capital goods also narrowed in December. The preliminary reading of eurozone manufacturing purchasing managers' index was slightly down to 58.4 in February 2022, up from 58.7 in January.

On the external front, the increase of energy prices continued to accelerate the value of imports, contributing to a widening trade deficit in December 2021. The eurozone registered a trade deficit of €9.7 billion in December, expanding from a deficit of €1.8 billion in November. On a monthly basis, eurozone exports decreased by 0.6% in December, while imports increased by 3.1%.

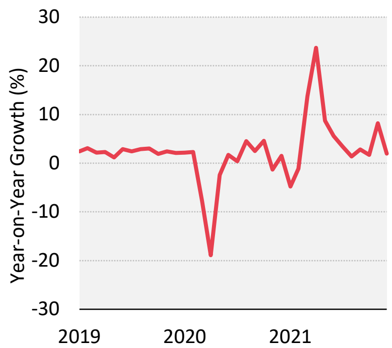
Some eurozone governments plan to end Covid-related curbs, with Germany announcing plans to ease virus-containment restrictions in 3 stages between mid-February and late-

Higher inflation adds to pressure on economic recovery, while governments plan to relax Covid-related restrictions.

ECB keeps vigilant approach to implementing a gradual shift in monetary policy.

Stirring of geopolitical tensions begins to ruffle stock markets.

Eurozone Retail Sales



Source: Bloomberg, data as of 4/2/2022

March. However, increased energy inflation and the gradual spill-over to prices of food and other consumer goods will dampen households' real disposable income and real savings accumulated during the pandemic. Weakening purchasing power in the bloc amid stronger inflation will restrict the recovery of the consumer economy.

ECB takes a more cautious approach to shifting monetary policy

In view of recent inflation readings surging to record highs, the president of the European Central Bank (ECB), Christine Lagarde, acknowledged after the bank's February policy meeting that the inflation outlook now featured more risk than in December. Moreover, she also noted that inflation is likely to remain elevated for longer than anticipated. Lagarde did not repeat the previous line that rate hikes are very unlikely in 2022, but rather said that the bank's stance would remain "data-dependent", meaning that more data will be required for upcoming meetings to arrive at a comprehensive judgment. However, the markets regarded this as the signal of a U-turn in monetary policy, causing market repricing amid an increased expectation of rate hikes in 2022 among institutional investors.

Following rising market expectation of rate hikes, the ECB president tried to mollify this sentiment with remarks made in the European Parliament. She stated that any shift of monetary policy would be gradual and there was no need to rush to premature conclusions at this point in time given the uncertain outlook.

There is a difference between the pace of inflation-induced rate hikes as expected by the ECB and that anticipated by the financial markets. Financial markets react to any perceived hints from officials by expecting a stronger shift in ECB monetary policy to tackle elevated inflation. However, the ECB tends to act cautiously in order to avoid economic disruption, having learnt the lesson of premature rate hikes in 2011.

European stocks remain under pressure

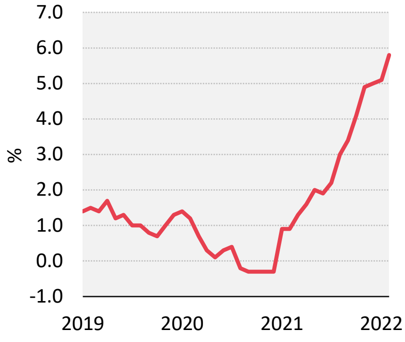
The Russia-Ukraine crisis became a key market focus over the course of February. The escalation into military conflicts between the countries in late-February, associated with sanctions on Russia by the European Union (EU), heightened market fears over the economic shocks of warfare and sanctions on European economy, which relies heavily on the imports of natural gas from Russia. Disruption from the supply of Russia's natural gas may push up the currently elevated inflation further. The risk adverse sentiment has caused significant sell-off in the European stock market. The geopolitical conflicts between Russia and Ukraine is expected to continue stirring market sentiment in Europe in the near term, before the market focus return to corporate earnings and rate hike progress in major economies.

The pan-European Stoxx 600 index fell by 3.4% in the period between end-January and end-February. During the same period, the German DAX index dropped by 6.5%, while the French CAC index decreased by 4.9%.

Government bond yields trend further upwards

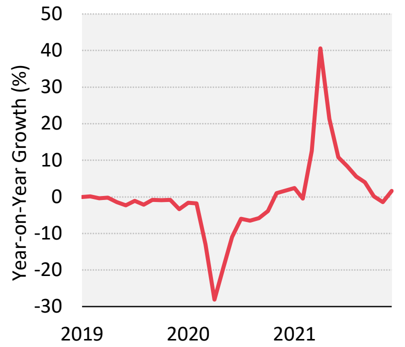
European government bond yields rose further in February, fuelled by market sentiment about rate hikes. Following record high inflation as well as the ECB's remarks on inflation risks in early February, market participants have been increasingly pricing in further

Eurozone Inflation



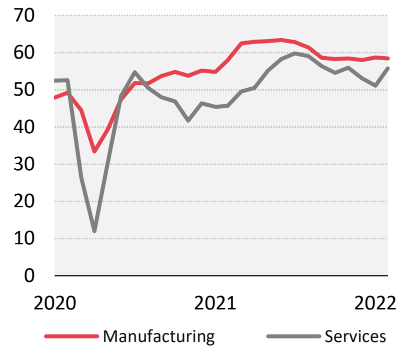
Source: Bloomberg, data as of 3/3/2022

Eurozone Industrial Production



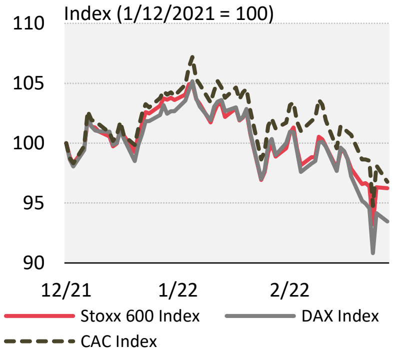
Source: Bloomberg, data as of 16/2/2022

Purchasing Managers' Index



Source: Bloomberg, data as of 28/2/2022

Stock Market Indices

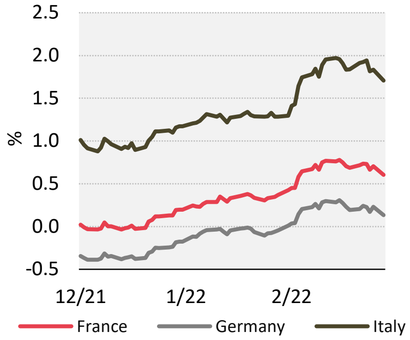


Source: Bloomberg, data as of 28/2/2022

monetary tightening actions and rate hikes by the ECB in the coming quarters, which is earlier than previously anticipated. However, the expectation of an earlier exit from the bond purchase programme also raised concerns over decreasing demand for the bonds of some indebted countries, such as Italy and Greece. Concerns about falling demand caused a sell-off in the relevant bonds, further increasing their yields. In the month through end-February, German 10-year government bond yields accelerated further to 0.135%, up from 0.011% at end-January.

As of end-February, 2022, the extra yield demanded by investors to hold 10-year Italian bonds rather than their German counterparts was about 1.57 percentage points, notably up from 1.28 percentage points as recorded at end-January.

10-Year Government Bond Yield

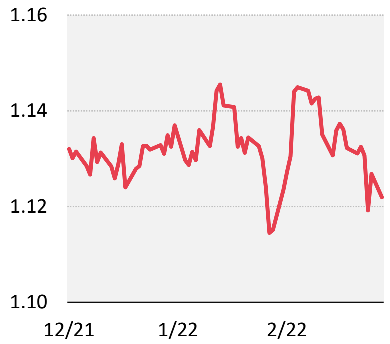


Source: Bloomberg, data of at 28/2/2022

Euro sinks against USD with outbreak of military conflict

As of end-February, 2022, the euro had sank by 0.14% against the US dollar and was trading at USD 1.1219, down from USD 1.1235 as at end-January. Investors priced in earlier-than-expected rate hikes by the ECB in early February, causing the euro to see a significant rebound. However, the attack launched by Russia on Ukraine in late-February has induced the US and the EU to impose sanctions on Russia as a response, including asset freezes and blocking some banks from the SWIFT international payments system. The outbreak of military conflicts between Russia and Ukraine and associated sanctions have heightened market fears, causing euro to sink and increasing the demand of the USD as a safe-haven currency in late-February.

Euro against USD



Source: Bloomberg, data as of 28/2/2022

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