Economic Research

April 2022

*Market Monitor – Eurozone*

# Growing Pressure on Multiple Fronts Impedes Economic Recovery

## Geopolitical conflict weighs on economic recovery

Eurozone inflation accelerated to a record 5.9% in February, up from 5.1% as reported in January. Energy prices continue to be the main culprit for elevated inflation, followed by rising pressure from food prices. Energy prices surged by 32% year on year in February, up from 28.8% in the previous month. Meanwhile, the annual growth of prices for food, alcohol, and tobacco accelerated for 4 months in a row, rising by 4.2% yearly in February. Soaring prices for mainstay goods such as energy and food will exacerbate households' living costs, undermining incentives to spend on services or luxury goods.

Industrial production decreased by 1.3% year on year in January, dragged down by an 8.4% annual decline in the production of capital goods. The geopolitical conflict is expected to exacerbate supply chain disruption and trade in some major raw materials, weighing on manufacturing. For example, restrictions on shipments and flights to and from Russia will cause rearranged shipping routes and reduced capacity, leading to higher costs in shipping. Furthermore, Ukraine is a major producer of neon, a key ingredient for manufacturing semiconductors. The military conflict between the two countries has caused a halt in neon production, adding pressure to the already-strained supply chain for semiconductors. The preliminary eurozone manufacturing purchasing managers' index (PMI) dropped to 57 in March, down from 58.2 in February.

Eurozone retail sales increased by 0.2% month on month in January 2022, up from a monthly decline of 2.7% in December 2021 but missing the market expectation of a 1.5% monthly growth. Among sub-items, the sale of automotive fuel in specialised stores saw a larger decline in January, decreasing by 1.3% month on month. The drag of automotive fuel reflected weakening purchasing power of households due to soaring energy prices, restraining the recovery momentum in retail sales.

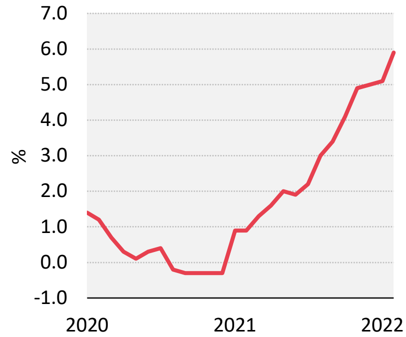
In terms of external trade, the eurozone continued to record a trade deficit of €7.7 billion in January 2022, narrowing from €9.7 billion in December 2021. Exports increased by

**Russia-Ukraine conflict will push up inflation further, dragging on economic recovery.**

**Heavy dependence on Russian energy gives fresh impetus to accelerating renewable energy development.**

**War and geopolitical tensions remain key focus for investors and drive movements in the stock market.**

**Eurozone Inflation**




Source: Bloomberg, data as of 17/3/2022

3.4% month on month in January, while imports increased by 2.3% monthly.

Looking ahead, the geopolitical crisis between Russia and Ukraine will add further pressure to the momentum of economic recovery, which has already been hit by repeated Covid-19 outbreaks, supply chain bottlenecks, and elevated inflation. As Russia and Ukraine are major exporters of wheat and corn, in addition to energy factors, it is expected that food inflation will rise further owing to supply constraints. In the near term, although economic activity in the eurozone has started to normalise amid the relaxation of Covid-related restrictions, consumption-driven recovery momentum will soften with expected price rises for daily staples and increasing economic uncertainty.

## Energy dependence on Russia raises attention to ESG

Russia's invasion of Ukraine has led to increased attention on what environment, social, and governance (ESG) considerations mean for the economy. Europe relies heavily on imports of natural gas from Russia, accounting for about 40% of its energy, which might be cut by Russia as a response to EU sanctions. Furthermore, there has been rising expectation among consumers that the companies they buy from should not have business connections with Russia.

The EU has announced that it plans to reduce Russian gas imports by two thirds by 2023, while some governments in Europe are looking to further accelerate the investment in renewable energy. Germany in particular is aiming to accelerate the growth of its solar energy and wind projects. Its economy minister stated that faster expansion of renewables is the key to reducing Germany's dependence on Russian fuels. Therefore, developing renewable energy is not only a means to tackle climate change, but also to strengthen energy security. In addition to environmental considerations, some European companies have announced their withdrawal from stakes in Russian companies in a bid to meet public expectation.

## European stocks remain under pressure

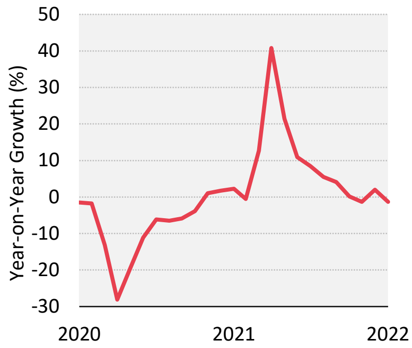
The war between Russia and Ukraine weighed on Europe's equity market throughout March. The EU has further widened its sanctions on Russia, banning exports of luxury goods and automobiles that meet certain criteria. Meanwhile, investors have been keeping a close eye on the progress of Russia-Ukraine peace negotiations, which are expected to influence market sentiment going forward.

The pan-European Stoxx 600 index increased marginally by 0.6% in the period between end-February and 31st March. During the same period, the German DAX index fell slightly by 0.3%, while the French CAC index remained stable.

## Government bond yields continue to trend upwards

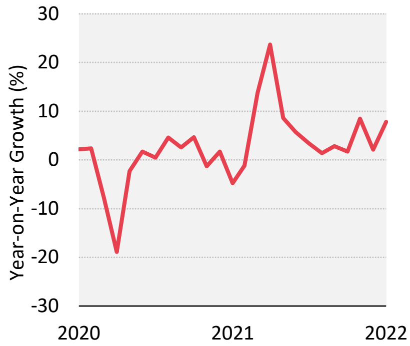
European government bond yields continued to trend upwards in March. Market focus partly shifted back to monetary tightening and surging inflation. Taking into account the current uncertain environment and ongoing soaring prices, the European Central Bank (ECB) revised the net purchase schedule of its Asset Purchase Programme (APP). Monthly

**Eurozone Industrial Production**



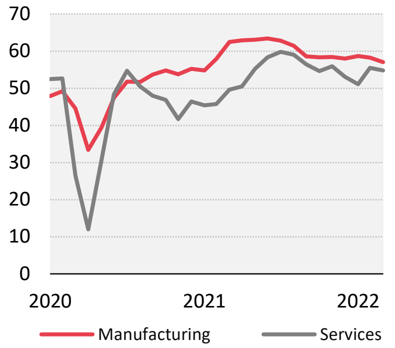

Source: Bloomberg, data as of 15/3/2022

**Eurozone Retail Sales**



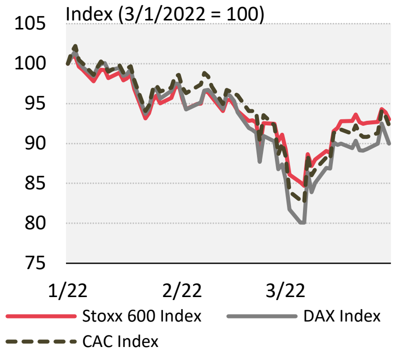

Source: Bloomberg, data as of 4/3/2022

**Purchasing Managers' Index**




Source: Bloomberg, data as of 31/3/2022

**Stock Market Indices**



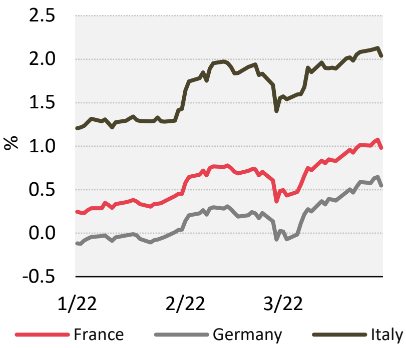

Source: Bloomberg, data as of 31/3/2022

net purchases under the APP will be reduced from €40 billion to €30 billion in May, and to €20 billion in June.

Moreover, the US Federal Reserve (Fed) announced it would raise the fed funds rate by 25 basis points after its monetary policy meeting in March, in line with market expectation. It is expected that there may be rate hikes at each of the meetings this year.

During the period between end-February and 31st March, Germany's 10-year government bond yield increased further from 0.135% to 0.548%. As of 31st March, the extra yield demanded by investors to hold 10-year Italian bonds rather than their German counterparts was about 1.49 percentage points, down from 1.57 percentage points seen in the previous month.

**10-Year Government Bond Yield**




Source: Bloomberg, data of at 31/3/2022

## Euro slides against US dollar

As of 31st March, the euro had slid by 1.35% against the US dollar and was trading at USD 1.1067, down from USD 1.1219 as at end-February. The euro remains under pressure amid the unresolved Russia-Ukraine military conflict and expanded sanctions on Russia, as well as the increasing disparity of monetary policy between the US and the eurozone. While the US Fed has started its rate hike cycle, the ECB remains cautious and is sticking to a "data-dependent" approach as regards the decision to tighten its monetary policy. If the war between Russia and Ukraine persists, demand for the US dollar as a safe-haven currency will remain substantial, likely limiting the extent of any rebound for the euro.

**Euro against USD**


Source: Bloomberg, data as of 31/3/2022

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