BEA 東亞銀行

Economic Research

May 2022

Market Monitor – Eurozone

Ongoing Geopolitical Tensions Heighten Downside Risks

Soaring energy prices remain the key culprit of elevated inflation

Surging inflation remains the major economic risk in the eurozone, stoking concerns over post-pandemic recovery momentum. The continuous elevated inflation reading has also been raising market attention about possible tightening actions by the European Central Bank (ECB). Eurozone inflation estimate climbed further to 7.5% in April, substantially higher than 5.1% seen in January. Amid the ongoing war between Russia and Ukraine, energy prices continued to soar by 38% year on year in April, following the surge of 44.4% seen in March. Meanwhile, consumer prices excluding energy, food, alcohol, and tobacco (core consumer prices) also rose by 3.5% from a year ago in April, well above the ECB's 2% inflation target. The higher-than-targeted rise in core consumer prices reflects the fact that inflationary pressure has become increasingly entrenched in the economy.

Eurozone retail sales decreased by 0.4% month on month in March, down from the 0.4% monthly growth seen in February. Although there had been relaxation of Covid-related restrictions in some member states such as Germany and France in March, worries over Russia-Ukraine war constrained consumers' incentives. Retail sales in France decreased by 1.9% month on month in March, further down from monthly drop of 0.2% in February. The eurozone services purchasing managers index (PMI) increased to 57.7 in April from 55.6 recorded in March.

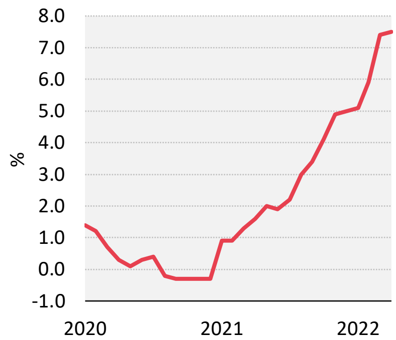
Industrial production in the eurozone improved in February with a monthly gain of 0.7%, up from a monthly decline of 0.7% in January. The monthly fall of output in energy and capital goods has been offset by monthly growth in consumer goods. The production of durable consumer goods led the rise, with a monthly growth of 2.7% in March. On the external front, the eurozone continued to record a trade deficit for the fifth consecutive month. The trade deficit reached €9.4 billion in February, widening from a €7.7 billion deficit in January. In February, imports increased by 1.5% month on month due to rising energy import prices, while exports rose by 0.8% month on month. The eurozone manufacturing purchasing managers index (PMI) fell to 55.5 in April, down from 56.5 seen

Geopolitical tensions cause energy prices to soar further, heightening economic downside risks.

ECB expected to end asset purchases soon, but uncertainty remains about rate hike schedule.

Ongoing geopolitical crisis will serve to reduce risk appetite.

Eurozone Inflation



Source: Bloomberg, data as of 6/5/2022

in March.

Looking forward, the ongoing war between Russia and Ukraine is expected to dampen market and consumer confidence in the eurozone. The continued sanctions on Russia will add to pressure on the supply chain of energy products and major raw materials, which will hamper recovery for the eurozone's manufacturing sector. Meanwhile, rising uncertainty will also heighten households' incentives to save and lower willingness to consume, leading to a slower recovery in retail sales despite the gradual relaxation of Covid-related measures.

ECB expected to withdraw asset purchase scheme in Q3

After its monetary policy meeting in April, the ECB has delivered further clarification on its policy direction in the face of growing downside risks including surging inflation and ongoing geopolitical tensions. ECB officials judged that net asset purchases under the asset purchase programme (APP) should be concluded in the third quarter of 2022. Moreover, any adjustments to key ECB interest rates will be gradual and will take place "some time" after the end of the APP.

However, compared to other major central banks such as the US Federal Reserve (Fed) or Bank of England, the ECB's policy shift toward a more hawkish stance is mild and slow. ECB president Christine Lagarde also acknowledged that the ECB will continue to lag behind the US Fed in tightening monetary policy despite rising inflation. In other words, the eurozone is expected to face a higher risk of stagflation compared to other advanced economies implementing tightening measures.

European equity markets remain under pressure by multiple shocks

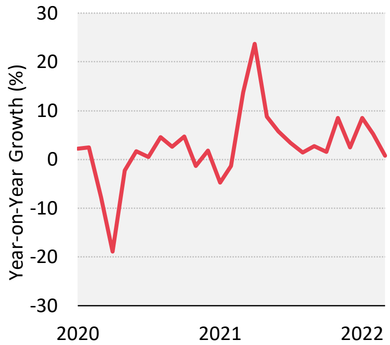
The ongoing Russia-Ukraine crisis, surging inflation, and concerns over tightening in some major central banks remain key pressures on investor sentiment. The ongoing geopolitical crisis and associated sanctions add to business uncertainty for eurozone enterprises. Meanwhile, elevated inflation and the monetary tightening by some major central banks will raise market worries over rising operating costs and suppressed profit margins.

The pan-European Stoxx 600 index decreased by 1.2% in the period between end-March and end-April. During the same period, the German DAX index dropped by 2.2%, while the French CAC index fell by 1.9%.

Government bond yields continue uptrend

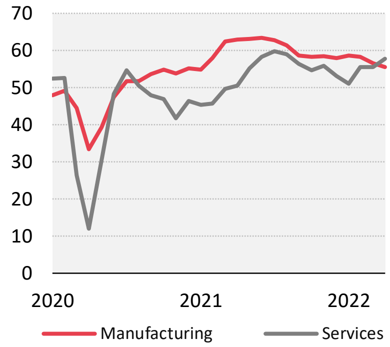
European government bond yields extended their uptrend in April. The ECB signalled that it would end net asset purchases in Q3 2022, strengthening market expectation of a gradual tightening. Although there is still uncertainty about the ECB's next moves on rate hikes, soaring inflation in the eurozone is expected to drive up the movement of eurozone government bond yields, following the trend seen in the US. In order to tame elevated inflation, the US Fed announced to raise the fed funds rate target by 50 basis points in early May and outlined the plan of reducing its asset holdings.

Eurozone Retail Sales



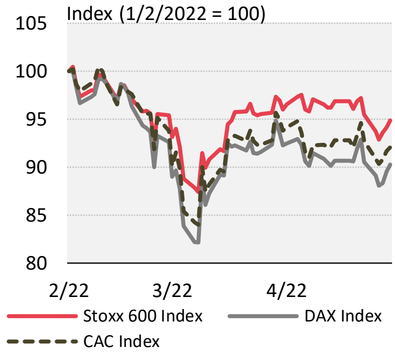
Source: Bloomberg, data as of 6/5/2022

Purchasing Managers' Index



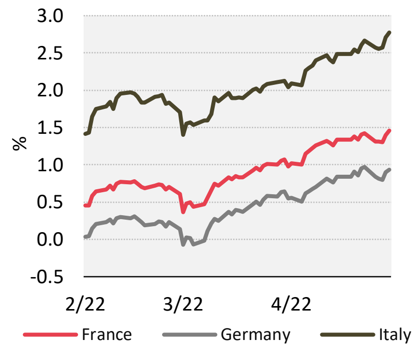
Source: Bloomberg, data as of 6/5/2022

Stock Market Indices



Source: Bloomberg, data as of 29/4/2022

10-Year Government Bond Yield



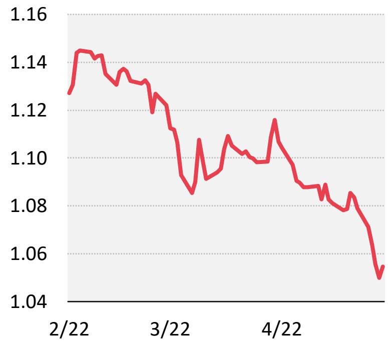
Source: Bloomberg, data of at 29/4/2022

As of 29th April, Germany's 10-year government bond yield had accelerated further to 0.938%, compared to 0.548% at the end of March. Meanwhile, the extra yield demanded by investors to hold 10-year Italian bonds rather than their German counterparts was about 1.84 percentage points as of 29th April, notably up from 1.49 percentage points seen at the end of March.

Euro continues to weaken

As of 29th April, the euro had decelerated by a further 4.72% against the US dollar and was trading at USD 1.0545, down from USD 1.1067 as at end-March. The unresolved Russia-Ukraine geopolitical crisis has continued to cloud the eurozone economy with rising downside risks. In particular, the sanctions on Russia may further exacerbate supply chain bottlenecks and soaring energy prices, dragging on economic growth. Furthermore, the ECB's pace of monetary tightening is viewed as slower and more cautious compared to that of the US Fed, with a widening interest rate differential expected going forward. A bleak economic outlook and a more cautious pace of monetary tightening are expected to weaken demand for the euro.

Euro against USD



Source: Bloomberg, data as of 29/4/2022

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