Economic Research

June 2022

Market Monitor – Eurozone

Specter of War Dims Economic Outlook

Major economic indicators show weakening signals

Eurozone economic performance weakens in the face of the Russia-Ukraine war and soaring inflation in energy prices.

ECB president Christine Lagarde sends clear signal of upcoming rate hikes to contain elevated inflation.

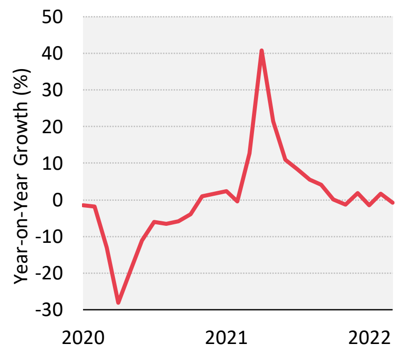
Equity markets are influenced by market sentiment

The eurozone's industrial sector has been hit by the Russia-Ukraine War and surging inflation. Industrial production declined by 1.8% month on month in March, down from a 0.5% monthly gain as seen in February. Supply chain disruptions and elevated energy inflation are weighing on manufacturing. Output of capital goods fell by 2.7% month on month in March, while that of intermediate goods fell by 2%. Germany is one of the member states showing a larger monthly decline, dropping by 5% month on month in March. The eurozone manufacturing purchasing managers' index (PMI) fell for a fourth month in a row to 54.6 in May, down from 55.5 in April.

On the external front, the eurozone's trade deficit continued to expand in March, reaching its lowest level since the start of current records in 1999. The trade deficit was €17.6 billion in March, having expanded from an upwardly-revised €11.3 billion in February. Higher costs of imported energy remained the main culprit for the widening trade deficit. In March, imports increased by 3.5% on a monthly basis while exports increased by 0.9%.

Retail sales weakened in some major economies amid deteriorating consumer sentiment. France's turnover in retail trade decreased by 0.8% month on month in April. In particular, new car sales dropped by 6.9% month on month, while furniture sales fell by 7.5%.

Eurozone Industrial Production



Source: Bloomberg, data as of 13/5/2022

The eurozone's inflation estimate increased to 8.1% in May, up from 7.4% in April. Energy prices registered double-digit annual growth in May for the 14^{th} consecutive month, rising by 39.2% year on year. The annual growth of consumer prices excluding energy, food, alcohol, and tobacco (core consumer prices) has remained on an uptrend since the start of 2022, rising from 3.5% in April to 3.8% in May.

In the face of elevated inflationary pressure, it has become increasingly clear what moves the European Central Bank (ECB) plans to take next in terms of rate hikes. ECB president

Christine Lagarde sent a clearer signal in a blogpost in May that the ECB could increase interest rates in July and will likely be in a position to end negative interest rates by the end of the 3rd quarter. The process of monetary normalisation after the first rate hike will depend on the medium-term inflation outlook.

Looking ahead, the eurozone will continue to be the major economic region hit hardest by the Russia-Ukraine conflict, which is impacting consumer sentiment and the manufacturing sector. Furthermore, markets will likely continue to focus on the ECB's monetary normalisation and its progress in bringing inflation back to the 2% target.

First steps in reducing reliance on Russia's energy

The European Union has committed to ending its dependence on Russian fossil fuels in the longer term. In mid-May, the European Commission outlined the REPowerEU Plan, which includes additional infrastructure investment worth €210 billion by 2027 to transform its energy system and the creation of a new EU Energy Platform to diversify supplies. Moreover, the European Commission has also proposed increasing its 2030 target for renewable energy sources in the EU's overall energy mix from 40% to 45%.

However, in the short run, more use of coal and nuclear energy is still needed to bridge the supply gap until enough renewable energy such as solar and wind are available.

Market sentiment influences the European equity markets

Investor sentiment continued to be clouded as multiple headwinds still remain in place, weighing on equity markets during early and mid-May. In particular, corporate earnings is under pressure by slowing global economic growth as a result of the Russia-Ukraine war and monetary policy tightening by some major central banks. However, market sentiment appeared to improve moderately in late-May alongside some positive news. For instance, China (one of the major trading partners for Eurozone and second-largest economy in the world) announced to relax its lockdown measures.

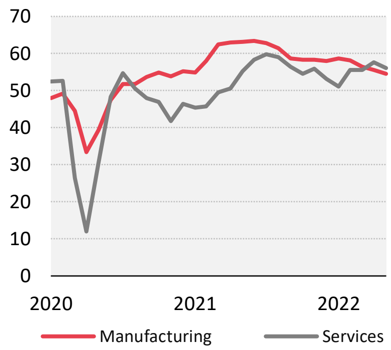
The performance of european equity markets are mixed. The pan-European Stoxx 600 index fell by 1.6% in the period between end-April and end-May. During the same period, the German DAX index increased by 2.1%, while the French CAC index fell by 1%.

Government bond yields accelerate

The hawkish policy direction signalled by Christine Lagarde has enhanced market expectation for an environment of increasing interest rates in the months ahead. Against this backdrop, eurozone government bond yields have stayed on the uptrend. As of 31st May, Germany's 10-year government bond yield increased to 1.122%, up from 0.938% in end-April.

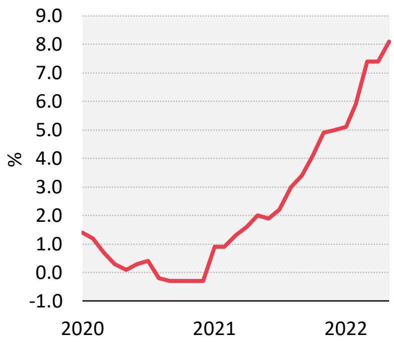
Alongside a plan of monetary normalisation in the eurozone, there are increasing concerns over the resilience of some indebted economies as headwinds from the Russia-Ukraine war persist. Market concerns have caused investors to demand a bigger premium in interest rates to lend to more indebted economies. The extra yield demanded by

Purchasing Managers' Index



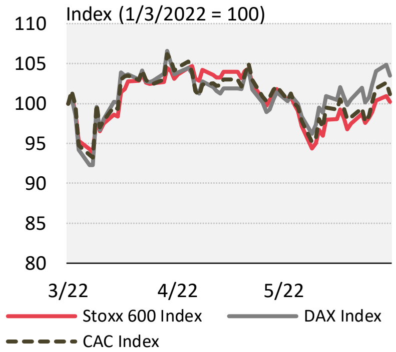
Source: Bloomberg, data as of 6/6/2022

Eurozone Inflation



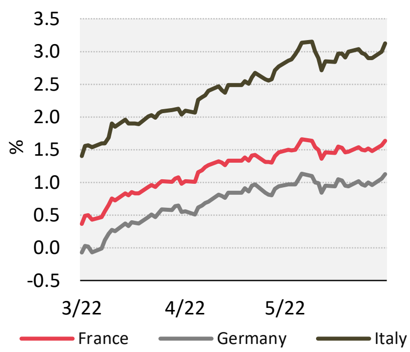
Source: Bloomberg, data as of 31/5/2022

Stock Market Indices



Source: Bloomberg, data as of 31/5/2022

10-Year Government Bond Yield



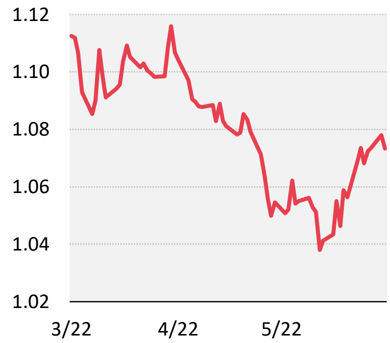
Source: Bloomberg, data of at 31/5/2022

investors to hold 10-year Italian bonds rather than their German counterparts was nearly 2 percentage points as of 31st May, up from 1.84 percentage points at the end of April.

Euro rebounds with expectation of imminent rate hikes

As of 31st May, the euro had rebounded by 1.79% against the US dollar and was trading at USD 1.0734, up from USD 1.0545 as at end-April. During end-March and end-April, the euro depreciated by 4.72% against the US dollar. The remarks by ECB president Christine Lagarde about rate hikes in July and ending negative interest rates has strengthened the euro's prospects, reversing its previous weakness. The news about the ECB's monetary forthcoming normalisation is expected to have an increasing influence on the euro going forward.

Euro against USD



Source: Bloomberg, data as of 31/5/2022

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