Market Monitor – Eurozone

ECB Delivers First Rate Hike in 11 years

ECB raises interest rate sharply by 50 basis points

The European Central Bank (ECB) kicked off monetary normalisation for the first time in 11 years with a rise of 50 basis points at its July meeting, exceeding both market expectation and its previous forward guidance, in an attempt to contain persistently high inflation. However, the eurozone economy is softening rather rapidly amid the Russia-Ukraine conflict, energy and food supply tensions, and soaring prices. Growing concerns about a possible recession could pose a challenge to the ECB's monetary normalisation going forward.

Eurozone's inflation continued to accelerate and exceed the ECB's 2% target. A flash estimate of the inflation rate in July 2022 accelerated to 8.9% year on year (YoY). Amid the ongoing Russia-Ukraine conflict and the threat of its natural gas supply being shut off, energy prices registered double-digit growth rate for the sixteenth consecutive month at 39.7% YoY in July, while prices rises for food, alcohol, and tobacco accelerated from 8.9% YoY to 9.8% YoY in July.

Meanwhile, the rate hikes could lead to an increased divergence of bond yields across the member states, which is known as "fragmentation". In response, the ECB has approved a new bond purchase scheme called the Transmission Protection Instrument (TPI) to ensure effective transmission of monetary policy across the eurozone and prevent a disorderly yield surge for bonds of indebted member states, though the details have yet to be announced. Subject to certain criteria, the TPI allows the ECB to purchase securities issued by member states experiencing a deterioration in financing conditions not warranted by economic fundamentals. This newly-established tool could help alleviate the fragmentation risk during the process of monetary normalisation.

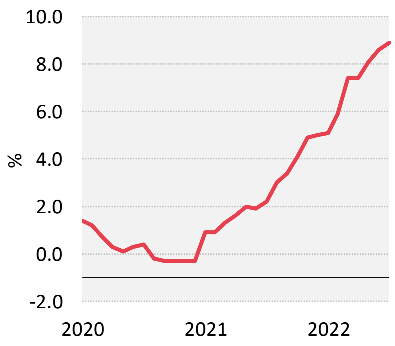
Looking ahead, additional rate hikes in an orderly manner are expected to gradually bring inflation back to the ECB's 2% target over the medium term. Elevated inflation will remain the key factor determining monetary policy for the ECB, which is becoming more data-

ECB raises policy rates for first time in 11 years to contain elevated inflation, amid expectation of further rate hikes ahead.

Energy supply uncertainty, sanctions on Russia, and geopolitical developments cloud the eurozone's economic outlook in the near term.

Currency and bond markets reflect rising concerns about potential recession.

Eurozone Inflation



Source: Bloomberg, data as of 29/7/2022

dependent and is not offering forward guidance. Given the elevated energy and food prices as well as a weak exchange rate for the euro, high inflation is expected to persist at least for a few more months, raising the odds of further rate hikes at upcoming ECB meetings. Continuous monetary tightening is likely to aggravate the financial burden on both companies and households. Furthermore, the EU countries have agreed to a voluntary 15% reduction of natural gas demand this winter, in response to unstable gas supply from Russia. If the gas supply situation worsens, energy prices could spike chaotically, risking a sharp economic downturn in the eurozone and putting the ECB in a dilemma.

Energy shortage poses a rising threat to economic stability

Retail sales in the eurozone remained bumpy as a result of accelerating price pressures, registering a decline of 1.2% month on month (MoM) in June after a rebound of 0.4% MoM in May. Sales in non-food products declined by 2.6% MoM in June, and sales of food, drinks, and tobacco have also declined for three months in a row with a fall of 0.4% MoM in June.

Industrial production improved with a MoM growth of 0.8% in May, up from 0.5% MoM in April, amid a boost from backlogs being fulfilled, with increased output of both capital and consumer goods. However, energy production declined by 3.3% MoM in May, indicating pressures from an unstable supply. On the external front, exports increased by 4.8% MoM in May, outpacing a growth of 2.0% MoM for imports. Nevertheless, the eurozone registered a trade deficit of €26.0 billion in May amid elevated energy prices.

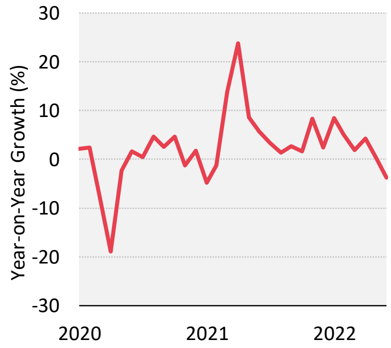
Amid the threat of an unstable gas supply from Russia, the likelihood of energy rationing in some countries of the eurozone has increased notably, possibly disruption economic activity for both industry and households. Energy supply is a vital issue particularly for Germany. Germany's gas storage levels were only around 65% in July, far lower than the 95% target for November. Gas supplies from Nord Stream 1 remain unstable, with capacity further reduced to 20% from late-July onwards, far below the level before the Russia-Ukraine conflict. Insufficient energy supplies could lead to the implementation of gas rationing measures for both industrial users and households this winter.

Accordingly, the eurozone's composite purchasing managers' index (PMI) fell sharply, with the manufacturing PMI dropping into contraction territory at 49.8 in July. The services PMI also decelerated from 53.0 in June to 51.2 in July, still somewhat above the boom-bust dividing line of 50.

Greater fears of recession induce greater financial market volatility

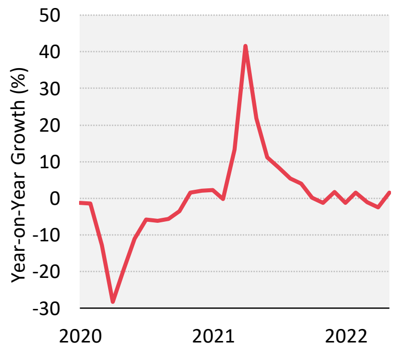
In July, European equity markets moved in response to corporate earnings, a larger-than-expected rate hike, economic data, and investor sentiment. The equity index across major markets has recovered over the past month from the consecutive declines seen since early 2022. However, unstable energy supply and the ongoing Russia-Ukraine conflict have added to worries about a possible recession. There have also been increasing market concerns about political turmoil in some member states arising from the resignation of Italy's prime minister, Mario Draghi. These disturbances have added to volatility in the euro and the bond markets.

Eurozone Retail Sales



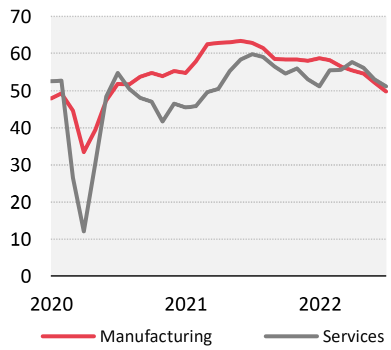
Source: Bloomberg, data as of 3/8/2022

Eurozone Industrial Production



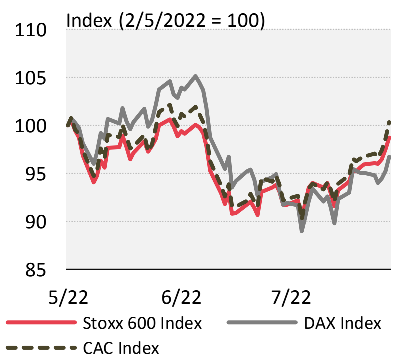
Source: Bloomberg, data as of 13/7/2022

Purchasing Managers' Index



Source: Bloomberg, data as of 3/8/2022

Stock Market Indices



Source: Bloomberg, data as of 29/7/2022

The pan-European Stoxx 600 index increased by 7.6% in the period between end-June and end-July. The German DAX index accelerated by 5.5% during the same period, while the French CAC index rose by 8.9%.

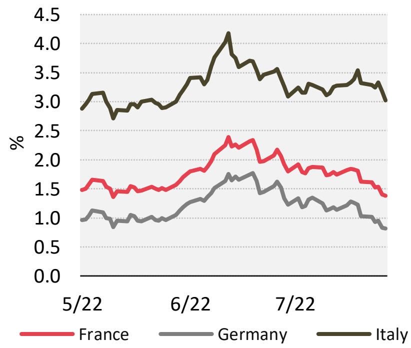
Heightened market worries about a recession also led to a growing risk-averse sentiment, resulting in a decrease in German government bond yields and a weaker euro. The euro's exchange rate dropped below parity with the US dollar at one point on 13th July. As of 29th July, the euro was trading at USD 1.022, down 2.52% from USD 1.0484 as at end-June. As of 29th July, Germany's 10-year government bond yield had decreased to 0.817%, notably lower than the 1.336% seen at end-June.

The political turmoil in Italy and the ECB's interest rate hike have given investors a gloomier view of Italian bonds, causing Italy's bond yields to rise and widening the yield spread between 10-year Italian and German government bonds to 2.21% as of end-July, up from 1.9% at end-June.

Euro against USD

Source: Bloomberg, data as of 29/7/2022

10-Year Government Bond Yield



Source: Bloomberg, data of at 29/7/2022

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