BEA 東亞銀行

Economic Research

September 2022

Market Monitor – Eurozone

Economic Momentum Set To Weaken

Economy recovers in Q2 amid resumption of travel activity, as downward pressure builds

In spite of rising inflation and energy supply tensions, the eurozone economy showed modest recovery momentum in Q2, driven by economic reopening and a return of tourism. Indefinite suspension of gas delivery through Nord Stream 1 has raised worries of energy rationing and skyrocketing energy prices in the region, while a drought is reducing water levels on the River Rhine and could potentially disrupt maritime shipping and industrial supplies. In order to contain surging inflation and prevent inflation expectation de-anchoring, the European Central Bank (ECB) announced another large rate hike by 75 basis points (bps) after monetary meeting in September, and it is expected to raise rate back to neutral rate quickly. A rapidly tightening monetary condition could, no doubt, dampen consumer sentiment and industrial activity ahead.

The eurozone's gross domestic product (GDP) grew by 0.8% quarter on quarter (QoQ) in Q2, edging up from 0.7 % QoQ in Q1, with diverse growth momentum experienced in the various member states. Spain and Italy benefitted strongly from the recovery of tourism, with Spain's growth rates jumping from 0.2% QoQ in Q1 to 1.1% in Q2, and Italy's from 0.1% in Q1 to 1.1% in Q2. However, Germany, one of the main manufacturing hubs in the bloc, only grew by 0.1% QoQ in Q2 amid surging energy prices, a reduced gas supply from Russia, and plunging consumer and business sentiment.

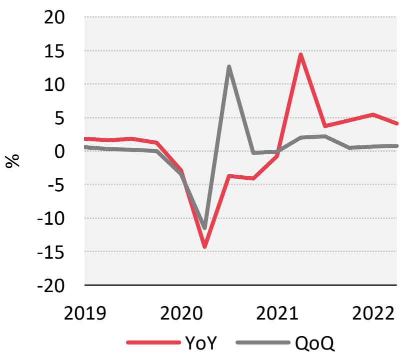
Industrial production in the eurozone grew modestly in June – with support from increased capital goods production, partly offsetting the declines in consumer goods, but Germany's production has not yet recovered from the drop seen in early 2022. Germany's production remains 1.5% below the level at the end of 2021. Production of capital goods rose by 2.6% month on month (MoM) in June, while that of non-durable consumer goods fell by 3.2% MoM, indicating a softening of consumer demand alongside surging inflation. On the external front, the eurozone continued to register a trade deficit for the ninth straight month, which amounted to €30.8 billion in June. The trade deficit could widen

Resumption of travel drives solid recovery, but the momentum is expected to ebb.

Multiple headwinds, including geopolitical tensions, energy supply, extreme weather, and a faster pace of tightening by the ECB are hindering economic recovery.

Risk-averse sentiment and looming threat of recession weigh on financial markets.

Eurozone GDP



Source: Bloomberg, data as of 8/9/2022

further in the near term amid elevated energy prices, dampening economic performance.

Consumer sentiment remained weak in response to a gloomier economic outlook, a prolonged Russia-Ukraine conflict, energy supply tensions, elevated inflation, etc., leading households to delay major purchases. A consumer confidence indicator for the eurozone registered -24.9 in August, below the level at the onset of the Covid-19 pandemic in early 2020. Retail sales in the eurozone increased slightly by 0.3% MoM in July, after a decline of 1.0% MoM in June. Retail sales in France, second largest economy in the bloc, fell for 2 months in a row, registering MoM decline of 0.9% in July.

Energy and weather exacerbate downside pressure

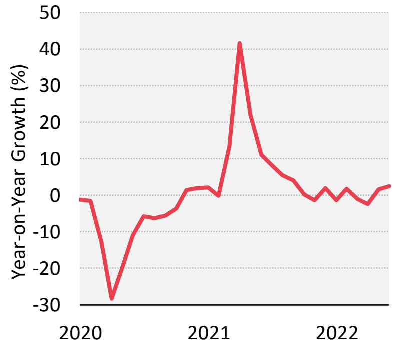
In view of the reduced gas supply from Russia, more stringent measures to control gas demand could be on the cards. Meanwhile, the heatwave in Europe is affecting the water level of the Rhine, potentially affecting the smooth running of an important trade route for products ranging from grains to coal and chemicals. The drought will also impact the output of agricultural products, worsening food supply and price pressures. Looking ahead, the eurozone economic performance will hinge on geopolitical tensions, energy and food supply, supply chain resilience, elevated inflation, the pace of monetary tightening, and other factors. The likelihood of an economic recession will increase notably if this winter is especially cold.

Inflation continues to hit record highs amid soaring food and energy prices, and could accelerate further ahead against the backdrop of geopolitical tensions as well as uncertain energy and food supplies. A flash estimate of inflation advanced from 8.9% YoY in July to 9.1% YoY in August. Prices of food, alcohol, and tobacco surged by 10.6% YoY in August, registering the first double-digit growth in the year.

With indefinitely suspended gas delivery through the Nord Stream 1 pipeline and an agreement by EU countries to reduce 15% of natural gas demand, households are expected to face higher energy cost this winter. For example, German gas users will face a surcharge for energy use from October onwards, estimated to be around €290 for a 4-person household. Meanwhile, electricity rates in Germany for next year, which are used as a European benchmark, reached €575 per MWh as of the end of August, almost six times compared to the same period last year. Although eurozone countries are making better than expected progress in terms of gas storage for winter this year, energy security remains a critical concern until effective diversification has been completed.

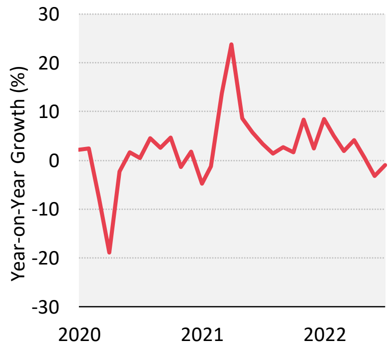
As such, inflation will remain far higher than the ECB's 2% target in the near term, and further large increases in interest rates are expected at the bank's next couple of meetings. Amid higher financing costs and inflationary pressure, together with the uncertain economic outlook, households and enterprises could become more cautious about spending and investing. The eurozone manufacturing purchasing managers' index (PMI) remained in contraction territory at 49.6 in August, down from 49.8 in July, while the services PMI has also declined from 51.2 in July to 49.8 in August, marking its first month into contraction territory since March 2021.

Eurozone Industrial Production



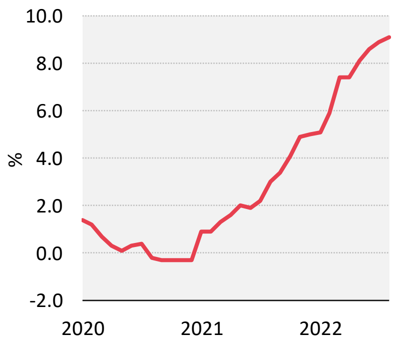
Source: Bloomberg, data as of 12/8/2022

Eurozone Retail Sales



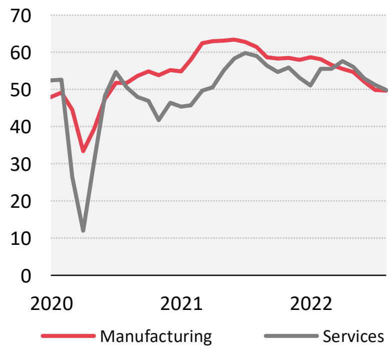
Source: Bloomberg, data as of 8/9/2022

Eurozone Inflation



Source: Bloomberg, data as of 31/8/2022

Purchasing Managers' Index



Source: Bloomberg, data as of 8/9/2022

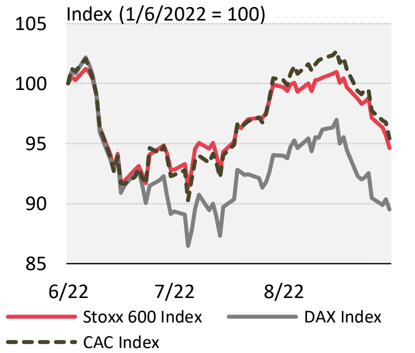
Financial markets weighed down by risk-averse sentiment and threat of recession

Amid a series of bad news stories, including an energy crisis, a heatwave, elevated inflation, rapidly tightening monetary policy, and declining PMI figures, the markets are increasingly worried about an imminent recession in the eurozone, which is dampening investors' appetite for risky assets. Meanwhile, the US Federal Reserve (Fed) pushed back the possibility of a rate cut next year during its Jackson Hole Symposium, leading to a period of repricing in the global financial markets. Against this background, the US dollar has strengthened further since mid-August.

The pan-European Stoxx 600 index decreased by 5.3% in August. The German DAX index dropped by 4.8% during the same period, while the French CAC index fell by 5.0%. The gloomier economic outlook and a hawkish Fed have weighed on the euro's exchange rate, which dropped below parity with the US dollar again. However, expectation of a larger rate hike by the ECB began to build towards the end of August, somewhat improving the euro's exchange rate. As of 31st August, the euro was trading at USD 1.0054, down 1.62% from USD 1.022 as at end-July.

With the expectation of ongoing rate hikes by the ECB, Germany's 10-year government bond yield increased to 1.541% at end-August, notably higher than the 0.817% seen at end-July. The yield spread between 10-year Italian and German government bonds had widened to 2.35% as of end-August, up from 2.2% at end-July.

Stock Market Indices

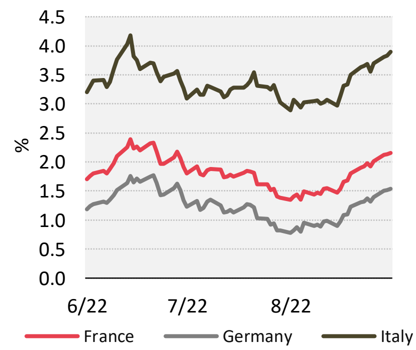


Source: Bloomberg, data as of 31/8/2022

Euro against USD

Source: Bloomberg, data as of 31/8/2022

10-Year Government Bond Yield



Source: Bloomberg, data of at 31/8/2022

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