BEA 東亞銀行

Economic Research

October 2022

Market Monitor – Europe

Mounting Risks of Recession

Service industries are recovering as economies reopen, but elevated inflation and geopolitical tensions are dampening growth momentum

With the gradual reopening of the economy, services and cross-border tourism in Europe have significantly recovered since Q2 2022. However, the European manufacturing and construction industries have been hit by ongoing geopolitical tensions and supply chain disruptions as well as elevated prices for energy and raw materials. Moreover, the prolonged and potentially escalating Russia-Ukraine conflict, disruptions to the supply of the natural gas, and rapidly changing monetary policies are likely to push the eurozone economy into a recession very soon.

Entering into Q3 2022, production and retail activities in the eurozone weakened gradually. Industrial production fell by 2.3% month on month (MoM) in July, while production of capital goods fell by 4.2%. The production level remains 1.8% below that of end-2021 in Germany, which is the country hardest hit by the energy supply disruptions and geopolitical tensions. Following a 0.4% MoM drop in July, retail sales in the eurozone declined again by 0.3% in August. Germany and UK also registered 1.3% and 1.6% MoM decline in August after 0.7% and 0.4% MoM growth in July, with the August's decline offsetting all of the July gains.

On the other hand, both the eurozone and UK labour markets stayed strong, with the eurozone unemployment rate edging down to 6.6% in August and the UK's falling by 0.2 percentage points from the February – April period to 3.6% in May – July. Wages in the UK continued to record strong growth, and the growth of average weekly salary including bonuses stayed elevated at 5.5% YoY from May to July, down from 6.9% between February and April.

ECB and BoE continue to raise policy rate aggressively amid elevated inflation.

Eurozone and UK labour markets stay strong despite emerging signs of slowdown.

UK's mini-budget triggered volatility in UK bond market and the BoE rolls out bond buying programme to stem a market rout.

Elevated inflationary pressure unlikely to change in the near term

The European energy supply outlook remains clouded by the sharp reduction of natural gas supply from Russia, including the attacks on the pipeline and the infinite suspension of supply through Nord Stream 1, despite member states actively building up their natural gas reserves, coordinating energy usage, and lowering the cost burden on households and companies. Energy prices rose for the eighteenth consecutive month, rising 40.8% YoY in September and driving the headline CPI to a fresh record high of 10.0%. Member states are formulating a series of supportive measures to offset the negative impact from elevated inflation and energy shortages, for example by considering a levy on the windfall profits of fossil fuel companies to provide subsidies for households. Currently, the European Union has agreed to reduce its gas demand by 15% this winter, while also making better than expected progress in building up gas reserves. Inflation in the eurozone could peak as soon as Q4 2022 and gradually decelerate in 2023 from the heights of this year, though it will continue to stay above the target set by the European Central Bank (ECB) for an extended period.

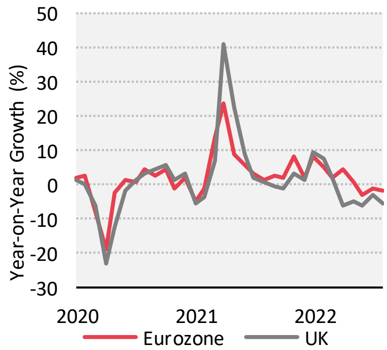
Similarly, inflationary pressure is staying elevated in the UK. With energy prices moderating somewhat in August, the headline CPI edged down by 0.2 percentage points to 9.9% YoY, while the core CPI edged up 0.1 percentage point to 6.3%. Amid the sky-high inflationary pressure, the new prime minister, Liz Truss, announced an alleviation package worth GBP 150 billion in early September, potentially capping the average household energy cost at an average of GBP 2,500 per year.

Aggressive monetary tightening in both the eurozone and UK

Given the elevated inflationary pressure will exceed the ECB's 2% policy target for a while, the Bank raised its policy rate by an aggressive 50 bps in July and 75 bps in September to contain inflation and anchor inflation expectations. As the ECB expects eurozone inflation will stay significantly higher than its policy target next year, the Bank is expected to swiftly raise rates to the neutral or even tightening level until inflation shows a clear trend towards its policy target.

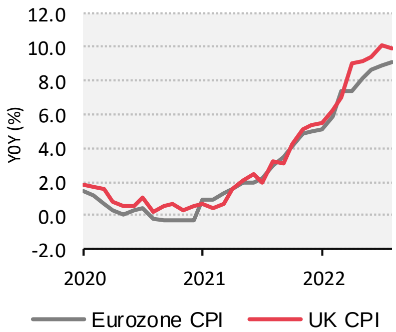
In September, the Bank of England (BoE) raised its Bank rate by 50 bps to 2.25%. However, the Truss administration announced a huge fiscal expansion in its "mini-budget", including the cancellation of corporate tax rises, a cut to the basic rate of income tax, Stamp Duty cuts for property market, and other measures in a similar vein. The fiscal package immediately sparked market worries over the fiscal sustainability of the British government and even fears that inflation could be driven up further, resulting in the expectation of huge rate hike by the BoE in November and higher volatility in the UK's financial markets. In order to stem a market rout, the BoE responded by announcing a plan to buy GBP 65 billion worth of long-dated gilts and delayed the start of its programme to sell down its government bond holdings. Furthermore, the Truss administration abandoned plan to scrap tax cut on high earners to regain market confidence.

Eurozone & UK Retail Sales



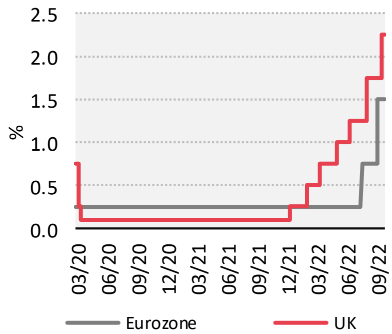
Source: Bloomberg, data as of 30/9/2022

Eurozone & UK Inflation Rate



Source: Bloomberg, data as of 30/9/2022

Policy Rates in Eurozone and UK



Source: Bloomberg, data as of 30/9/2022

Eurozone and the UK on the edge of recession

Looking forward, a prolonged and potentially escalating Russia-Ukraine conflict, natural gas supply disruptions, elevated inflationary pressure, and rapidly changing monetary policy will continue to cloud the eurozone economic outlook. Energy shortages will disrupt industrial production and dampen business confidence, while high inflation pressure and interest rate hikes will squeeze household and corporate budgets, leading to a higher risk of recession. Currently, the markets expect the eurozone economy to grow by 2.9% in 2022 and 0.3% in 2023.

Despite the announcement of a fiscal expansion package, the UK economy is also clouded by numerous uncertain factors including: whether the British government can make adjustments to regain market confidence, the inflation outlook, the UK's relationship with the European Union, and a potential second referendum on Scottish independence. According to a Bloomberg survey, the UK economy is expected to grow by 3.5% in 2022, up by 0.1 percentage point from the previous month's survey, and to contract by 0.2% in 2023, down by 0.7 percentage points from the previous month.

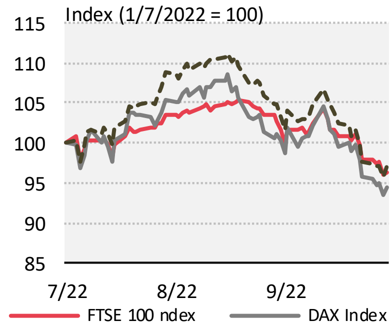
European financial markets see heightened volatility amid monetary tightening and intensified geopolitical tensions

As the US Federal Reserve (Fed), ECB and BoE continued to aggressively raise policy rates at their September's meetings to curb elevated inflation, coupled with intensified geopolitical tensions, Europe's equity markets corrected alongside major global market in September. The German DAX index, French CAC index, and the UK FTSE 100 index dropped by 5.6%, 5.9% and 5.4% in September respectively.

The hawkish policy stance of the Fed and strong US dollar exchange rate continued to weigh on the euro and pound's performance. As of 30th September, the euro was trading at USD 0.9802, down 2.5% from USD 1.0054 as of end-August. Meanwhile, the pound depreciated against US dollar by 3.9% over the same horizon.

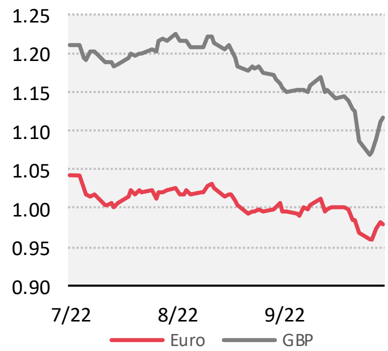
With the expectation of ongoing rate hikes by the ECB, Germany's 10-year government bond yield increased by 57 bps from August to 2.108% at end-September. The yield spread between 10-year Italian and German government bonds also widened by 6 bps to 2.41% as of end-September. The UK's 10-year government bond yield briefly surged above 4.5%, after the "mini-budget" triggered worries over the British government's fiscal sustainability. The UK 10-year government bond yield then declined to 4.093% at end-September, up 129 bps from end-August.

Stock Market Indices



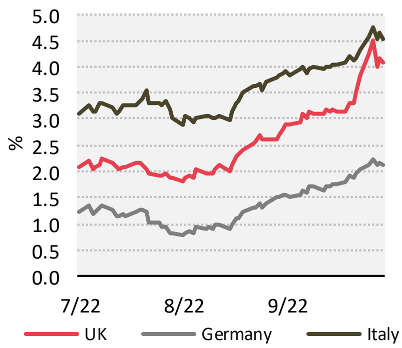
Source: Bloomberg, data as of 30/9/2022

Euro & British Pound against USD



Source: Bloomberg, data as of 30/9/2022

10-Year Government Bond Yield



Source: Bloomberg, data of at 30/9/2022

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