BEA東亞銀行

Economic Research

November 2022

Market Monitor – Eurozone

Multiple Efforts to Counteract Headwinds

Multiple efforts to tackle energy crisis and contain inflation

European Union working on proposals to tackle energy crisis, while ECB raises interest rates again to control inflation.

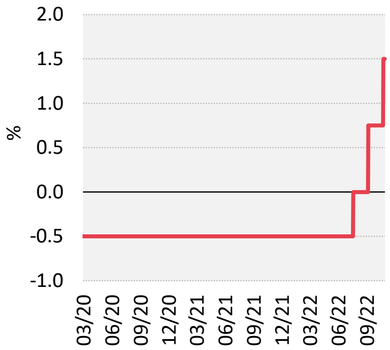
Further downward pressure signalled by weak indicators of market sentiment.

Financial markets rebound with hope that peak Fed hawkishness will end soon.

Amid the ongoing Russia-Ukraine war and the sharp reduction of gas supply from Russia, the European Union (EU) is facing immense pressure to manage the energy crisis for the coming winter through multilateral negotiations. In October 2022, eurozone inflation reached another record high, driven by consecutive double-digit rises in energy prices, putting significant pressure on the European industrial and consumer sectors. After raising the interest rate by 50 bps in July and 75 bps in September, the European Central Bank (ECB) then raised it by another 75 bps in October, putting the deposit facility rate at 1.50%, the highest level since January 2009. The ECB takes a more cautious approach in normalising its balance sheet, with expectation of further discussion in the coming meeting. With most indicators of economic conditions and market sentiment showing a decline, it is highly probable that the eurozone economy has already entered a recession, and its future recovery will depend on how geopolitical tensions, energy supply, elevated inflation, etc., can eventually be resolved.

In mid-October, the EU tabled a package of proposals to tackle the energy crisis for its members to negotiate. The EU will jointly purchase at least 13.5 billion cubic meters of natural gas, establish an allocation mechanism among the member states, and continue to work on fixing a dynamic cap for Europe's benchmark gas price – the Netherlands' Title Transfer Facility (TTF). Further negotiations among the member states are expected, given their diversity of interests. On a positive note, the TTF gas price has declined notably from €195/MWh in late-September to €123/MWh as of end-October as a result of the EU's discussions to resolve the energy crisis and because many of its member states have greatly improved their gas storage infrastructure. As of 31st October, the EU's gas storage had reached 94.8% of capacity, while Germany's was at 98.9%. Given that energy supply remains tight, gas prices are expected to stay elevated in the near term. Further volatility cannot be ruled out if this winter is colder than usual or if there are further geopolitical crises.

Policy Rate in Eurozone



Source: Bloomberg, data as of 9/11/2022

With inflation having reached a fresh record high far above the ECB's policy objective, the bank is continuing to tighten its monetary policy stance expeditiously to avoid the expectation of further inflation getting out of control. In October, the ECB raised its policy rates by another 75 bps, a total rise of 200 bps in just three months. In the upcoming meeting, the ECB will reassess inflation outlook, the measures taken so far, and transmission lag of monetary policy to decide on its future rate hikes and balance sheet normalization. Looking ahead, the ECB is expected to deliver more rate hikes to contain inflation, but it will remain cautious about further tightening or balance sheet normalisation, given the eurozone's gloomy economic outlook, the fragility of the financial markets, and particularly the pressure faced by some indebted member states.

Economic and sentiment indicators show decline

Over the past month, indicators of the eurozone economy and market sentiment have declined amid elevated inflation, an energy supply crisis, geopolitical tensions, and continued monetary tightening. It is highly probable that the eurozone economy has already entered a recession, and its recovery will likely be a bumpy road for some time to come.

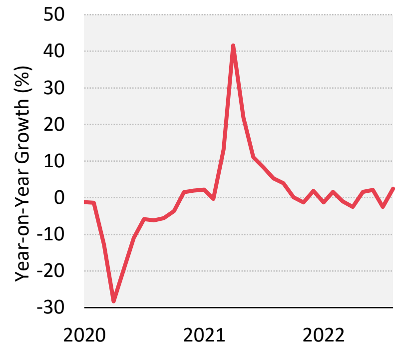
The eurozone's industrial production in August remained 2.1% below the level at end-2021. Production in intermediate goods continued to fall for a second consecutive month, registering a drop of 0.5% month on month (MoM) in August after a MoM decline of 0.9% in July. The fall of production in intermediate goods will also weigh on production of capital and consumer goods going forward. Production in Germany was also hard-hit by the indefinite suspension of gas flow through the Nord Stream 1 pipeline, registering a MoM decline of 0.4% in July and 0.5% in August.

Meanwhile, retail sales in the eurozone rebounded slightly, but its gain cannot offset previous declines. Retail sales in the bloc remained unchanged and grew 0.4% MoM respectively in August and September, not enough to fully recover the loss of 1.1% and 0.2% recorded in June and July. The figures implies subdued retail market, with more time needed for a meaningful recovery. Germany, the largest economy in the eurozone, recorded a moderate increase of 0.9% MoM in September, compared to 1.4% decline in August. Germany's retail sales in September remained 0.8% lower than that of end-2021.

Inflation hit another record high at 10.7% year on year (YoY) in a flash estimate in October. Energy prices accelerated further from a 40.7% YoY rise in September to 41.9% YoY in October. Prices for other major items also continued to rise further. Food, alcohol, and tobacco prices accelerated from an 11.8% YoY increase to 13.1% YoY in October, while services prices rose from a 4.3% YoY rise to 4.4% YoY, indicating that inflation is becoming more entrenched. With inflation remaining far higher than the ECB's policy objective, the bank will continue its monetary policy tightening, creating downward pressure on industry and the retail sector, both of which are already suffering from geopolitical tensions and the gloomier economic outlook.

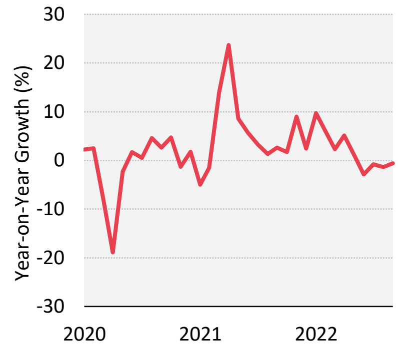
Finally, sentiment indicators show that the economy might already be in a recession, with the eurozone manufacturing purchasing managers' index (PMI) decelerating further from 48.4 in September to 46.4 in October. This indicator has stayed in contractionary territory for 4 months in a row and is now at a 29-month low.

Eurozone Industrial Production



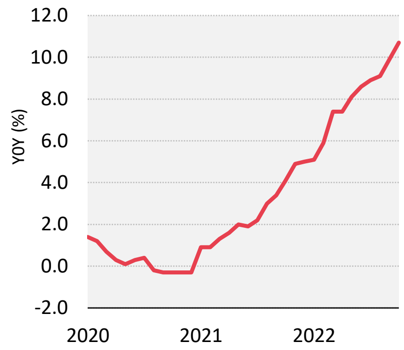
Source: Bloomberg, data as of 9/11/2022

Eurozone Retail Sales



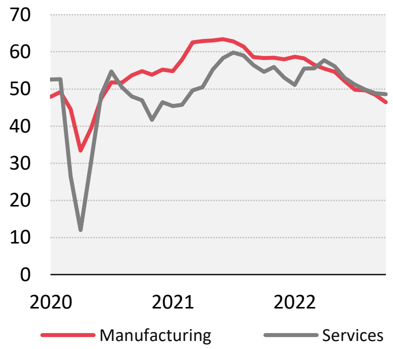
Source: Bloomberg, data as of 9/11/2022

Eurozone Inflation Rate



Source: Bloomberg, data as of 9/11/2022

Purchasing Managers' Index



Source: Bloomberg, data as of 9/11/2022

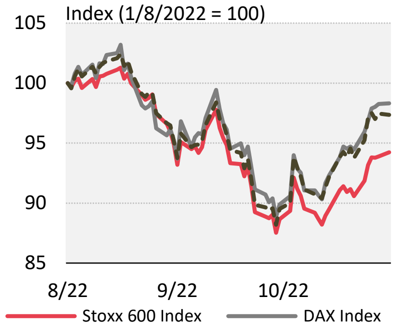
Financial markets recover with expectation of slower tightening pace

Over the past month, global equity markets improved somewhat in the expectation that central banks will soon be over their peak hawkishness. In October, both the Reserve Bank of Australia and Bank of Canada announced rate hikes that were smaller than expected, while some US Federal Reserve officials also talked about a potential slowing of monetary tightening pace in their speeches, all of which gave some support to the global financial markets. However, the eurozone economic outlook remains clouded by numerous uncertainties. Company profits there will likely be hurt, which could further limit the rebound in European equity markets.

The German DAX index rose 9.4% in October, the French CAC index rose 8.8%, and the pan-European Stoxx 600 index rose 6.3%. The euro had a small rebound in October as the US dollar retreated, with markets expecting the US Fed's peak hawkishness to come to an end soon. As of 31st October, the euro was trading at USD 0.9882, up 0.8% from USD 0.9802 as at end-September.

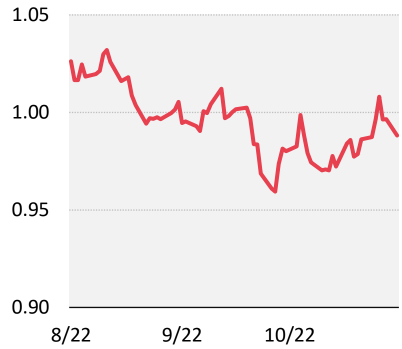
Germany's 10-year government bond yield increased slightly from 2.11% at end-September to 2.14% at end-October. The yield spread between 10-year Italian and German government bonds has narrowed to 2.16% as of end-October, down from 2.41% at end-September.

Stock Market Indices



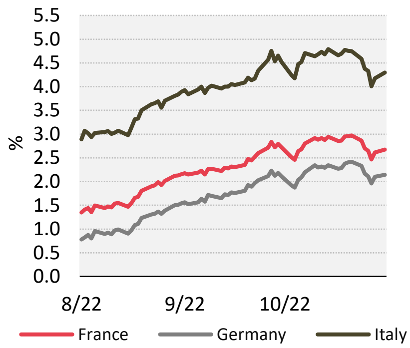
Source: Bloomberg, data as of 31/10/2022

Euro against USD



Source: Bloomberg, data as of 31/10/2022

10-Year Government Bond Yield



Source: Bloomberg, data of at 31/10/2022

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