BEA 東亞銀行

Economic Research

February 2023

Market Monitor – Europe

Subdued Economic Activity Takes Time for a Full Recovery

- In view of notable declining energy prices and relatively warm winter, European economic activity is hovering at a low level; whether the UK economy will avoid a technical recession remains to be seen

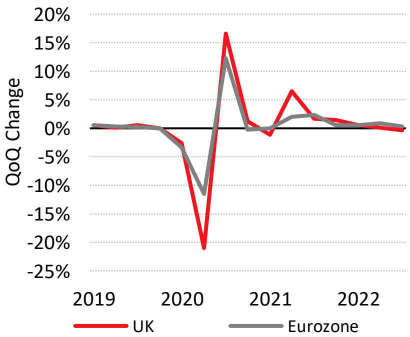
- Looking forward, geopolitical uncertainty, elevated inflation and a rapidly tightening monetary policy, etc. will continue to constrain European economic performance, but eurozone outlook is expected to be better than that of UK

- The central banks tightened monetary policies further, but current rate hike cycle has yet to end

Energy prices declined, and European growth has stabilized at low level

European growth is hovering at a low level, mainly due to a significant drop in energy prices and a mild winter; whether the United Kingdom (UK) economy avoids a technical recession depends on its economic performance for December 2022. Even though the eurozone economy continues to be restrained by geopolitical uncertainty, elevated inflation and a rapidly tightening monetary policy, etc., energy prices have dropped significantly in recent months, coupled with warmer-than-expected winter and no rationing of energy supplies, the eurozone avoided a recession, and the preliminary gross domestic product (GDP) rose 0.1% quarter-on-quarter (QoQ) in Q4 2022, better than market expectations. The GDP of France and Italy increased by 0.1% and 0.2% QoQ respectively, while Germany and Italy fell by 0.1% and 0.2% QoQ respectively. In addition, the UK economy also maintained a modest growth, slowing from a month-on-month (MoM) increase of 0.5% in October 2022 to 0.1% in November. The FIFA World Cup supported consumption and partially offset the impact of strikes. However, unfavourable factors such as strikes, elevated interest rates and inflation, the depreciation of the GBP exchange rate, and falling property prices are still brewing. After the UK economy contracted by 0.3% QoQ in Q3 2022, whether the UK economy will fall into a technical

Eurozone & UK GDP Growth

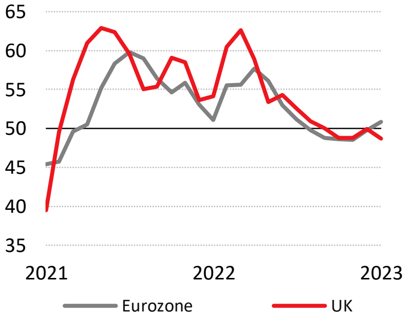


Source: Bloomberg

recession, a contraction of two consecutive quarters, depends on the GDP data for December 2022.

Industrial sectors in the eurozone have remained relatively stable, while economic activity in the UK remained sluggish. Driven by the significant drop in energy prices, industrial production in the eurozone rebounded from a 1.9% MoM decline in October 2022, and rose by 1.0% in November. The production of intermediate products recorded a MoM increase for the first time since May 2022. However, eurozone retail sales softened to a MoM drop of 2.7% in December 2022 after a slight rebound of 1.2% MoM in November implying that the price pressure on consumer incentives has not fully subsided. Meanwhile, strikes in the UK have affected domestic production activities. Coupled with elevated interest rates and inflation, households' purchasing power and business investment sentiment are hindered, sustaining the pressure on the UK's economy. After remaining unchanged in October 2022, UK industrial production fell by 0.2% MoM in November. The monthly decline in retail sales also expanded again, from 0.5% in November to 1.0% in December.

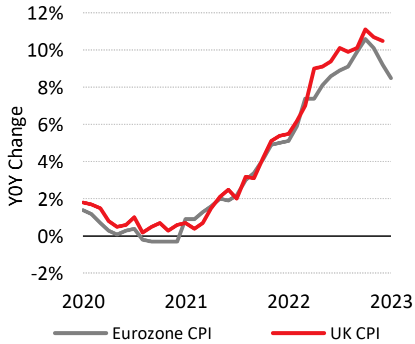
Services Purchasing Managers' Index



Source: Bloomberg

Looking ahead, geopolitical uncertainty, inflation far exceeding the policy target and the rapid monetary tightening will continue to constrain the European economic performance. The outlook for the eurozone is slightly better than that of the UK. With a significant drop in energy prices, inflation in the eurozone is expected to decelerate at a faster rate, barring further volatilities due to the implementation of price caps for Russian petroleum products, which will help improve market sentiment, consumption and business investment incentives. On the contrary, the scale of strikes in the UK continued to expand, together with large accumulative interest rate hikes, the consolidating real estate market and weak confidence, all of which slowed down the pace of recovery in the UK. After contracting for five consecutive months, the Eurozone Services Purchasing Managers Index (PMI) returned to the expansionary territory of 50.7 in January 2023; the consumer confidence index rose further to -20.9, the highest since March 2022. However, the UK market sentiment remained weak. The services PMI fell from 49.9 in December 2022 to 48.7 in January 2023, staying at the contractionary territory; the GfK consumer confidence index fell again from -42 to -45. According to the latest forecasts of the International Monetary Fund, the eurozone and the UK will expand by 0.7% and contract by 0.6% respectively in 2023. The UK is the only G7 economy expected to post negative growth.

Eurozone & UK Inflation Rate

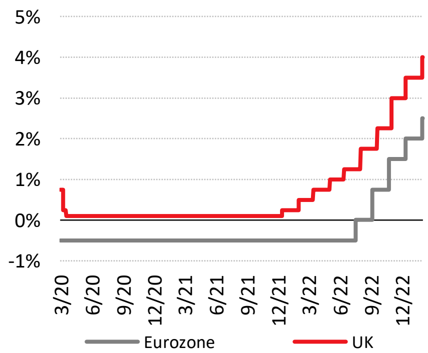


Source: Bloomberg

The central banks raised interest rates again

Inflation in the eurozone and the UK has only come off its highs, with core inflation remaining elevated. Driven by the significant decline in energy prices, overall inflation in the eurozone has slowed for three consecutive months. Its flash estimate in January 2023 has fallen to 8.5% year-on-year (YoY), which is 2.1 percentage points lower than the historical high in October 2022; for December 2022 UK's headline inflation fell slightly by 0.6 percentage points to 10.5% from a high of 11.1% in October. Natural gas prices continued to fall. The European benchmark gas price (Netherlands TTF natural gas futures price) closed at about €57/MWh at end-January 2023, down 27% from the end of 2022, and fell more than 83% from the high seen at August 2022. However, core inflationary pressures remain high, reflecting widespread inflationary pressures in both economies. Factors such as demand recovery amid post-pandemic reopening, geopolitical uncertainty, and supply chain disruption continue to affect prices, taking time for elevated

Policy Rates in Eurozone and UK

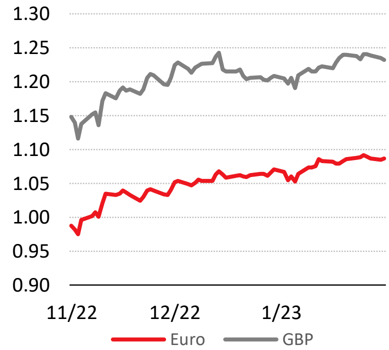


Source: Bloomberg, data as of 3/2/2023

inflation in both regions to retreat. The core inflation rate in the eurozone stayed at 5.2% in January 2023, while that of the UK remained unchanged at 6.3% in December 2022.

The central banks of both regions have further tightened monetary policy, and the current rate hike cycle has yet to come to an end. In early February 2023, both the European Central Bank (ECB) and the Bank of England (BoE) announced a 50-basis point rate hike, and their policy rates rose to 2.5% and 4.0% respectively. The BoE estimates that its policy rate will rise to around 4.5% in mid-2023, and its remarks have softened slightly. In the past, it reiterated that it will respond forcefully when necessary. In its current statement, it stated that further tightening in monetary policy would be required if there were to be evidence of more persistent pressures. The ECB is inclined to raise interest rates by 50 basis points again in March, and said it will maintain interest rates at a restrictive level to ensure that inflation falls back to the policy target of 2.0%, but the extent and pace of subsequent rate hikes will depend on economic performance.

Euro & British Pound against USD

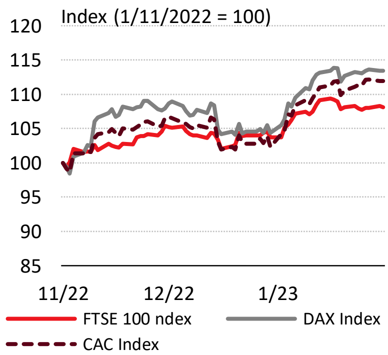


Source: Bloomberg, data as of 31/1/2023

Financial market sentiment turned optimistic

Stabilizing economic data in the eurozone and cooling market expectations for interest rate hikes, help improve investor sentiment. The European economy performed slightly better than expected, and the uneasiness about the energy crisis has gradually subsided, which has strengthened the market's confidence in the economic and corporate earnings outlook. In addition, the US Federal Reserve has slowed down the pace of rate hikes, and the market expects that rate hike cycle may soon come to an end, weakening the US dollar performance. As of the end of January 2023, the euro and British pound closed at US$1.0863 and US$1.232, respectively, representing an appreciation of 1.5% and 2.0% compared to end-2022. In terms of the stock market, the German DAX index, the French CAC index and the British FTSE 100 index rose by 8.7%, 9.4% and 4.3% respectively compared with end-2022.

Stock Market Indices



Source: Bloomberg, data as of 31/1/2023

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