BEA 東亞銀行

Economic Research

March 2023

Market Monitor – Europe

Dark Winter Avoided

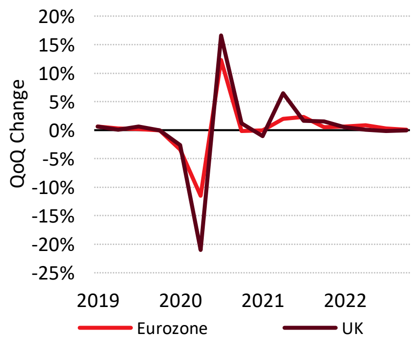
- Europe economy narrowly avoided a recession at the final quarter of 2022, where supply side activities remained under pressure and consumer sector mildly improved
- Looking forward, the growth momentum of European economy remains sluggish, but the risk of prolonged or deep recession has reduced
- Sticky inflationary pressure could mean more rate hikes ahead

Europe economy stagnated with uneven momentum

The eurozone economy narrowly avoided a recession in Q4 2022, but recent data showed the German economic contraction being revised further downwards. At its flash estimates, the eurozone economy registered at a marginal 0.1% quarter-on-quarter (QoQ) growth in Q4 2022, but the German economic contraction was further revised down from a QoQ 0.2% to 0.4%. Given Germany is the largest member state in the eurozone, a deeper economic contraction there could put the eurozone economy into a recession in Q4 2022 at its subsequent estimates. Meanwhile, the UK economy contracted by 0.5% month-on-month (MoM) in December 2022, resulting in a flat QoQ figure in Q4 2022 and similarly avoiding a technical recession after a slight 0.2% QoQ contraction in Q3 2022. In Q4 2022, the UK economy recorded an improvement of private consumption, government expenditure and gross fixed capital formation, offset by a worsening export performance. All in all, the worst case scenario of a deep recession during the winter period should be avoided, driven by a notable reduction in energy prices and a warmer-than-expected winter weather, etc.

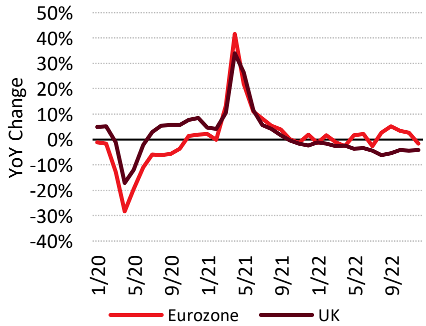
Supply side activities remain under pressure, while the consumer sector mildly improved recently. Eurozone's industrial production fluctuated over the course of Q4 2022, registering -2.0%, 1.4% and -1.1% MoM from October to December 2022 respectively. In December 2022, the production of intermediate and durable consumer goods declined by 2.8% and 1.4% MoM respectively. Meanwhile, the UK's industrial production increased moderately by 0.3% MoM in December 2022, driven by an increase of electricity and gas sector by 5.2%, while manufacturing production remained largely

GDP Growth



Source: Bloomberg

Industrial Production



Source: Bloomberg

unchanged. On the other hand, eurozone's retail sales rebounded slightly by 0.3% MoM in January 2023 after a 1.7% MoM drop in December 2022. Retail sales in the UK recorded a 0.5% MoM expansion in January 2023, following a 1.2% decline in December 2022.

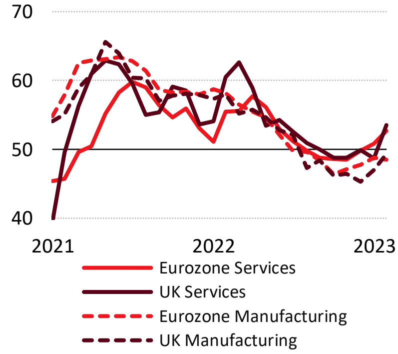
Looking ahead, the growth momentum of the European economy remains sluggish, but the risk of a prolonged or deep recession reduced. On one hand, the European economy is still affected by the headwinds of geopolitical tensions, elevated inflation and monetary tightening, etc. However, declining energy prices and a resilient employment market, etc., will likely boost market confidence and regional demand, with the recovery of the services sector outpacing that of the manufacturing sector. The eurozone and the UK services purchasing managers' index (PMI) accelerated from 50.8 and 48.7 in January to 52.7 and 53.5 in February 2023, while the manufacturing PMI of both economies stayed at a contractionary territory, registering at 48.5 and 49.3 in February. Moreover, post-Brexit trade disputes on the Northern Ireland Protocol has been was addressed by the a new agreement (Windsor Framework)that will establish a green lane and a red lane to separate the trade of goods travelling from Great Britain to Northern Ireland and from those continuing into the EU, possibly easing the supply chain disruptions between the EU & UK.

Sticky inflation pressure could mean more rate hikes ahead

Despite the peaking of eurozone and UK inflation, their pace of easing remains slower than expectations. In February 2023, eurozone inflation edged down by a mere 0.1 percent point (ppt) to 8.5%, driven by the stronger food and services price pressure, as compared to 0.6 ppt reduction in January. The food, alcohol and tobacco prices accelerated from a 14.1% year-on-year (YoY) in January to 15.0% in February, and services prices also edged higher from 4.4% YoY to 4.8%, offsetting the slowing energy price momentum from 18.9% YoY to 13.7%. Meanwhile, UK inflation also decelerated from 10.5% YoY in December 2022 to 10.1% in January 2023. Food and non-alcoholic beverages as well as services prices rose by 16.7% and 6.0% YoY in January 2023 respectively. Going forward, energy prices are expected to record a more notable easing after the one-year anniversary of the Russia-Ukraine conflict, but with the relatively high services prices, driven by the resilient employment market and robust wage growth, could mean more time and work is needed to drive inflation back to the policy target.

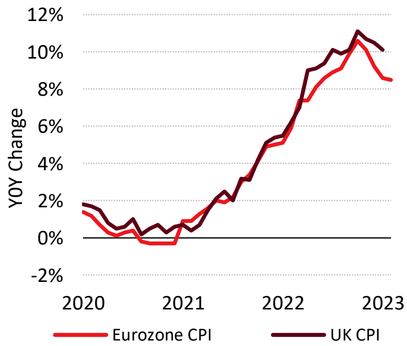
Amid stickier inflationary pressure, the European Central Bank (ECB) and the Bank of England (BoE) will continue to raise rates in the next couple of meetings and could maintain higher interest rates for longer. As signalled in its previous monetary policy meeting, the ECB is expected to raise its policy rate by another 50 basis points to 3.0% in March. Despite the sluggish economic growth momentum, the worst case of a deep recession has been avoided. Together with a slower-than-expected easing in inflation, it is believed that further rate hikes could be in store in its monetary policy meeting in May or even in June. In the UK, the remarks of the BoE have softened slightly in its monetary policy meeting in February, though further rate hikes is still expected in March, particularly if inflationary pressure becomes more entrenched. The tight labour market and robust wage growth could lead to stickier inflation pressure, and further rate hikes ahead.

Purchasing Managers' Index



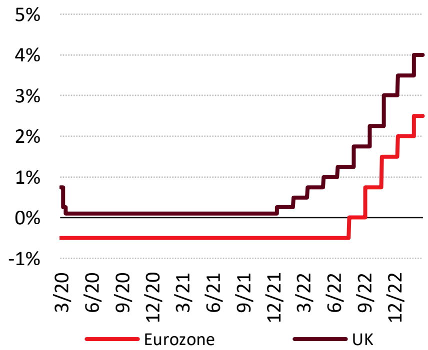
Source: Bloomberg

Inflation Rate



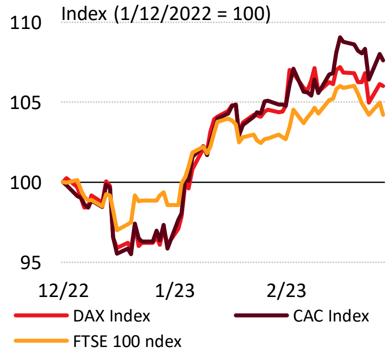
Source: Bloomberg

Policy Rates



Source: Bloomberg, data as of 28/2/2023

Stock Market Indices

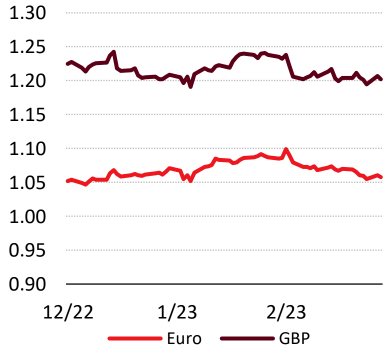


Source: Bloomberg, data as of 28/2/2023

Improving investor sentiment stimulated financial market performance

The financial market improved moderately, but rising expectations of US rate hikes add pressure to non-US currencies. With the market worries of a deep recession abating and the Mainland China's reopening fuelling hopes for the industrial sectors in Europe, investment sentiment moderately improved in February. The German DAX index, the French CAC index and the British FTSE 100 index rose by 1.6%, 2.6% and 1.3% respectively compared with end-January 2023. However, the US dollar strengthened again amid rising bets of further rate hikes by the US Federal Reserve after a series of stronger-than-expected data flows, including inflation. As of the end of February 2023, the euro and British pound closed at US$1.0576 and US$1.2022, respectively, representing depreciation of 2.6% and 2.4% compared to end-January 2023.

Euro & British Pound against USD



Source: Bloomberg, data as of 28/2/2023

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