Market Monitor – Europe

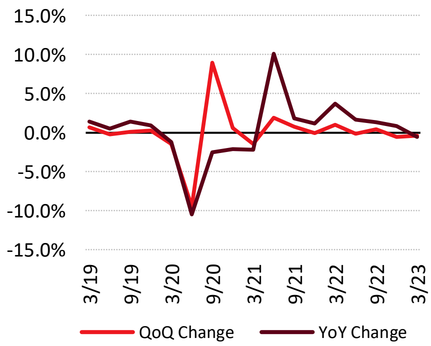
Slowing Recovery Momentum

- The German economy entered into a technical recession, weighed down by household consumption; while the UK economy nearly stalled in Q1.
- Headline inflation continued to decelerate in the eurozone and the UK, but the ECB and the BoE are stepping up their monetary policy tightening.
- Looking ahead, the European economy is expected to sustain a mild recovery, supported by a resilient labour market and improving consumer sentiment.

Mixed economic performance in major European economies

Eurozone's economy was largely steady in Q1 2023, but the German economy entered into a technical recession as per the latest estimate on gross domestic product (GDP). The regional economy was driven by positive growth in France, Italy and Spain. However, Germany's Q1 2023 GDP was revised downward to a 0.3% QoQ decline after contracting by 0.5% QoQ in Q4 2022. The drop was largely attributable to the weakness in household consumption, which decreased by 2.3% QoQ. With persistently high inflation, the resulting lower real purchasing power led consumers to reduce their spending in food and beverages, clothing and furnishings, etc. That said, gross fixed capital formation grew by 2.8% QoQ, of which construction and machinery & equipment expanded by 3.9% and 3.2% QoQ, respectively.

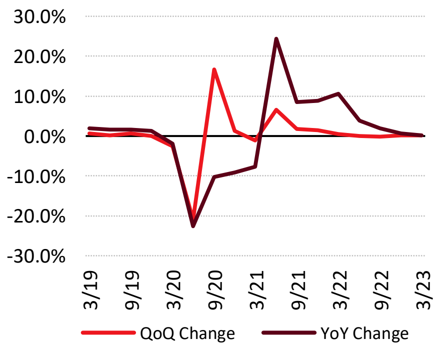
Germany Gross Domestic Product



Source: CEIC

The UK economy nearly stalled with a 0.1% QoQ growth in Q1 2023 amid a drag from strikes and a cost of living squeeze. Across industries, the construction sector had the fastest output growth at 0.7% QoQ, while the services sector and production sector only grew modestly by 0.1% QoQ. In terms of major expenditures, private consumption showed a 0.1% QoQ growth, while gross fixed capital formation increased by 1.3% QoQ. The sluggish performance of the services sector and private consumption likely reflected the impacts from industrial actions as well as the squeeze from elevated inflation. A worsening momentum was also noted in the monthly GDP estimates as the headline growth deteriorated from 0.47% in January, to 0.05% in February, and finally to -0.28% in March.

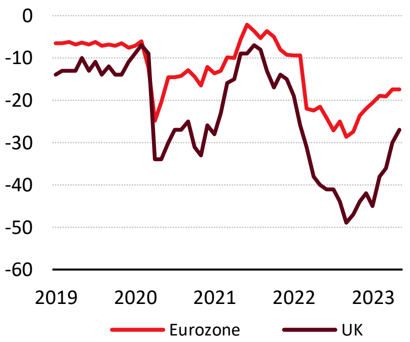
UK Gross Domestic Product



Source: CEIC

Consumer sentiment continued to recover amid a steady labour market. Eurozone's consumer confidence index edged up slightly from -17.5 in April to -17.4 in May; while the UK's GfK consumer confidence climbed up from -30 to -27 during the same period, of which the sub-index indicating the personal financial situation over the next 12 months sharply increased from -13 to -8 in May. A resilient labour market helped to bolster the positive consumer sentiment, with the eurozone unemployment rate declining to a record low of 6.5% in April. The UK unemployment rate edged up slightly but remained low at 3.9% in Q1 2023 (up from 3.7% in Q4 2022), with the year-on-year (YoY) growth in average weekly earnings remaining high at 6.7% in Q1 2023 (unchanged from Q4 2022). A steady employment situation helped lift a recovery in consumer confidence in the eurozone and the UK from the trough in Q3 2022, during which there was deep pessimism over a potential contraction caused by insufficient energy reserves over the winter.

Consumer Confidence Index

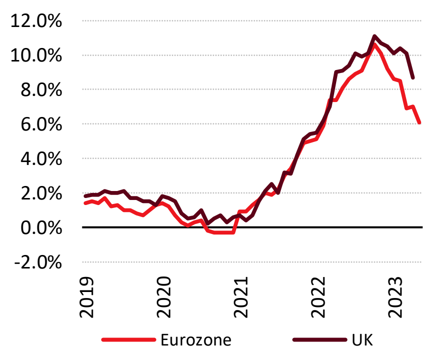


Source: CEIC

Inflation eased but at varying degrees of progress

The UK and the eurozone displayed a diverging trend in lowering inflation. Eurozone inflation decelerated further to 6.1% YoY in May, down from 7.0% YoY in April. Price gains of major items mostly slowed in May, signalling signs of easing inflationary pressure. Given a high base of comparison, energy prices declined by 1.7% YoY in May. In addition, the price gains of food, alcohol & tobacco as well as services decelerated slightly from 13.5% and 5.2% in April to 12.5% and 5.0% YoY in May. Accordingly, core inflation eased from its peak at 5.7% in March to 5.3% YoY in May. Regarding the UK, inflationary pressure remained high, though headline inflation fell from 10.1% in March to 8.7% YoY in April. Some items have continued to show high price growth. Specifically, inflation in food & non-alcoholic beverages was still elevated at 19.0% YoY in April; the price growth for recreation & culture even accelerated from 4.6% in April to 6.3% YoY in May. Unlike the eurozone, services inflation in the UK showed no signs of slowing, pushing up the core inflation from 6.2% in April to 6.8% YoY in May.

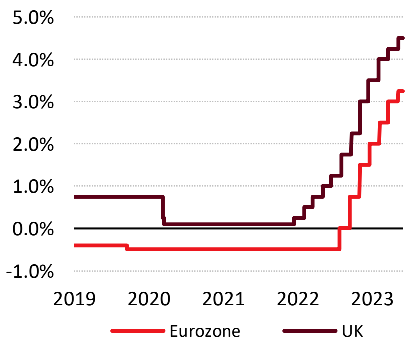
Inflation Rate



Source: CEIC

The European Central Bank (ECB) and the Bank of England (BoE) are set to continue their monetary tightening amid high inflation. Both the ECB and the BoE raised their interest rates by 25 basis points in May as inflation remained far above their policy targets. With a slower-than-expected deceleration in inflation in the eurozone and the UK, the inflation will likely continue to exceed policy targets. There is still room for the ECB and BoE to further tighten monetary policy ahead and maintain rate hike cycle. Looking ahead, interest rates in Europe are anticipate to rise further, with the ECB likely to take a larger rate rise than the BoE.

Policy Rate



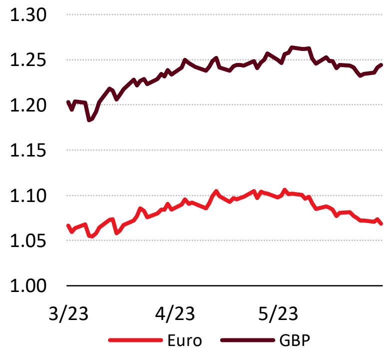
Source: CEIC

Looking ahead, the European economy is expected to expand mildly. A resilient labour market and improving consumer sentiment remains a major pillar of support for the economic recovery in the region. Demand for tourism and recreational services will likely stay strong in the upcoming summer travel season. However, rapid monetary tightening and persistent geopolitical tensions will likely weigh on business confidence, reducing their incentives to enhance investment, potentially causing disruptions to production. Taken together, the European economy is expected to recover at a modest pace, albeit with rising downside risks.

Risk-off sentiment returned along with rising uncertainties

Investor sentiment has turned to risk-off, pressuring the equity market. In May, the European financial markets were battered by the uncertainties over the negotiations of the US debt ceiling, as well as recessionary fears caused by the downward revision to German GDP growth in Q1 2023. At end-May, the UK FTSE 100 index, the German DAX index and the French CAC index dropped by 3.2%, 1.6% and 5.2%, respectively, compared to end-April. Moreover, market expectations for another rate hike by the US Federal Reserve has increased notably following a stronger-than-expected rise in the core personal consumption price index. The euro and British pound closed at US$1.0689 and US$1.2441, respectively, representing a depreciation of 3.0% and 1.0% over the same time horizon.

Euro & British Pound against USD



Source: Bloomberg, data as of 31/5/2023

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