Market Monitor – Europe

Increased Economic Pressures Likely to Constrain the Pace of Recovery

- The sluggish German economy adds downside risk to the pace of regional recovery while the UK economy remains stable in Q2.
- A sticky inflation solidified the expectations of continuous monetary tightening, which might increase the cost of borrowing and weigh on rate-sensitive sectors.
- Looking ahead, the European economy will maintain a mild recovery, supported by the sustained demand for leisure activity and steady employment condition.

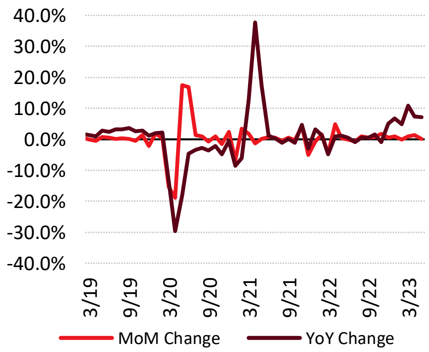
An uneven recovery with Germany being the main drag

The eurozone economy continued to show an uneven recovery. On one hand, the Spanish economy stayed resilient. The average retail sales in Spain during April and May expanded by 2.0% compared to Q1 2023, and its services purchasing managers index (PMI) registered at 53.4 in June, the eighth consecutive months staying at above 50, was largely driven by tourism and catering services. A robust performance in retail sales and services sector will likely extend the steady momentum of the Spanish economic growth in Q2.

However, the German economy entered into a technical recession in Q4 2022 and Q1 2023, with its goods producing sector notably flagging amid the global economic slowdown, rapid monetary tightening and elevated inflation. Industrial production in Germany stalled in April, while the retail sales in April remained 0.1% below Q1 2023 level. Germany's ifo business climate index declined for the second straight months to 88.5 in June, hitting the lowest since January 2023. A subdued German economy will likely offset the growth momentum of other member states such as Italy and Spain.

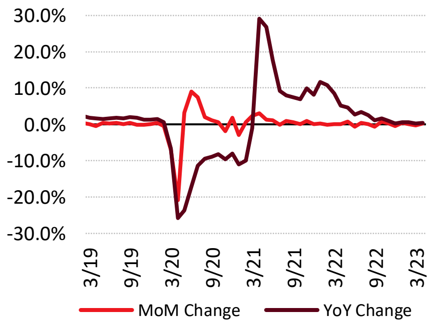
The UK economy somewhat stabilized in April, underpinned by the recovering services sector. UK gross domestic product (GDP) rebounded by 0.2% month-on-month (MoM) in April after a fall of 0.3% MoM in March of which the services sector served as the major contributor with a MoM growth at 0.3%. Although the construction sector was softened by a MoM decline of 0.6% in April, it remained 3.6% above the level in the same period last year.

Spain Retail Sales



Source: CEIC

Monthly UK Gross Domestic Product



Source: CEIC

BEA 東亞銀行

Economic Research

July 2023

UK retail activities continued to signal growth in Q2. UK retail sales extended a moderate growth of 0.3% MoM in May following a rise of 0.5% MoM in April, partly supported by the extra bank holiday for the King's coronation. Moreover, the stronger demand for outdoor-related goods and summer clothing also benefitted non-store retailing with a MoM growth of 2.7% in May. On the other hand, elevated inflation, particularly in the food-related products, have squeezed households' purchasing power, leading to a MoM decline of 0.5% in food stores sales.

Persistent inflation strengthened the expectations of further tightening

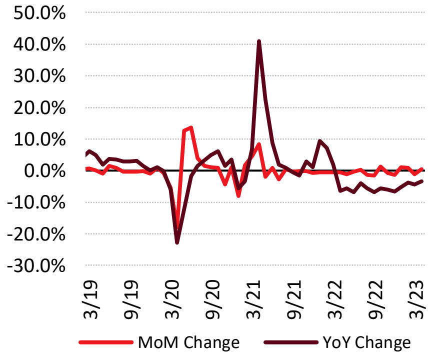
Eurozone's headline inflation decelerated from 6.1% year-on-year (YoY) to 5.5% in June, slightly lower than market expectation. A moderation in headline inflation was largely due to a high comparison base, a wider decline in energy prices and a softening food inflation. The YoY decline in energy prices widened from 1.8% to 5.6% in June. The inflation in food, alcohol and tobacco moderated further for the third consecutive month to a still elevated 11.7% in June. However, the services inflation re-accelerated to 5.4% in June after a moderation to 5.0% in May, largely due to the distortion of a discounted transportation fee in Germany last year. Thus, core inflation edged up by 0.1 percentage points (ppt) to 5.4% in June. Among the member states, inflationary pressure in Italy and Spain decelerated further with headline inflation decreasing from 8.0% and 2.9% to 6.7% and 1.6%, respectively, in June. The inflation in Germany rose again from 6.3% to 6.8% in June, driven largely by the base effect related to its services inflation.

On the other hand, UK headline inflation remained elevated at 8.7% YoY in May, continuously higher than that of the eurozone and the US. In the UK, the inflation in food & non-alcoholic beverages remained elevated at 18.3% YoY in May. Services inflation continued to gather steam with an average MoM growth accelerating from 0.3% in Q1 to 1.2% during April and May, leading to a 7.4% YoY growth in May. Both food-related and services inflation in the UK stayed far stronger than eurozone's. Specifically, the average MoM growth in recreation & culture prices increased from 0.6% in Q1 to 1.0% during April and May. Accordingly, the core inflation continued to trend upward by 0.3 ppts to 7.1% in May. UK inflationary pressure remains strong and is yet to show a steady trend of returning to the policy target.

The European Central Bank (ECB) and the Bank of England (BoE) will continue their monetary tightening campaign for a longer period to contain inflation. In June, the ECB increased its policy rates by 25 basis points with the deposit facility rate rising to 3.5% while the BoE raised its policy rate by 50 basis points to 5.0%. A tight labour market, a strong growth in employees' earnings and services inflation has lengthened the central banks' fight to bring down inflation to the policy target. During the ECB Forum on Central Banking, ECB President Christine Lagarde and the BoE Governor Andrew Bailey reiterated that they will maintain monetary policy tightening and see a lower likelihood for an exit this year. However, the continuous increase in interest rates will likely exacerbate the burden on homeowners and corporates, which will possibly soften the growth momentum in the region ahead.

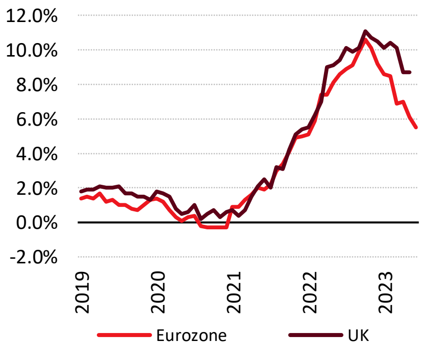
Looking ahead, the European economy will maintain mild recovery but the weakness in Germany could be a drag. Steady employment conditions, improving consumer confidence in the eurozone and the UK, and increased demand for travel and social activity from reopening will continue to support the mild recovery in Europe. However, the persistent inflation and tightened monetary conditions will likely constrain business

UK Retail Sales



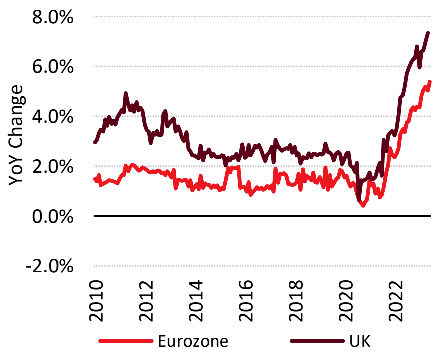
Source: CEIC

Inflation Rate



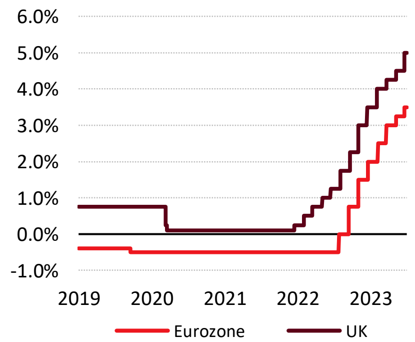
Source: CEIC

Services Prices



Source: CEIC

Policy Rate



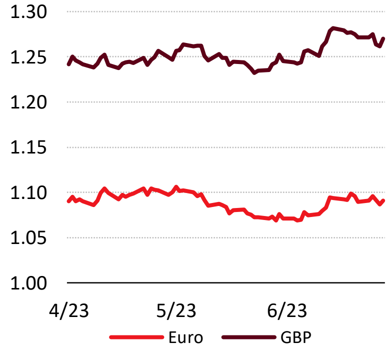
Source: CEIC

confidence and worsen the cost of living squeeze in the region. Moreover, the weakness in Germany's manufacturing has yet to show signs of recovery, which could add pressure to the recovery momentum for the rest of 2023

The improvement of the financial markets hinges on rate hike prospects and the regional economic outlook

The financial market rebounded in June while uncertainties constrain the upside potential. The equity market has once supported by the expectation of US rate's pause though it was quickly reversed after the Fed signalled further rate hikes ahead. Moreover, recent indicators, like the PMIs, showed subdued business activity and sentiment in Germany and France. At the end of June, the UK FTSE 100 index, the German DAX index and the French CAC index rebounded by 1.1%, 3.1% and 4.2%, respectively, when compared to end-May. Nevertheless, a hawkish tone and further rate hike expectations by the ECB and BoE has been favourable to their currencies. The euro and British pound closed at US$1.0909 and US$1.2703 in June, respectively, representing an appreciation of 2.1% for both currencies over June.

Euro & British Pound against USD



Source: Bloomberg, data as of 30/6/2023

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