Market Monitor – Europe

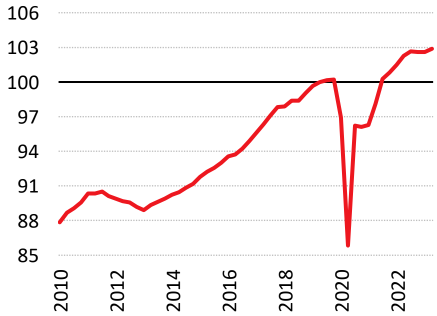
Economy Steadily Held but Cost Pressures Persists

- The eurozone economy held up relatively well in Q2 with France and Spain growing faster than Germany. The UK economy stalled in April and May.
- Headline inflation continued to decelerate but sticky core inflation remains the focus of central banks which will maintain a tight monetary policy for an extended period.
- The European economy is expected to record a modest expansion with high cost pressures from financing cost to labour cost possibly dragging the economy.

European economy held up in Q2 alongside a solid labour market

The eurozone economy showed resilience in Q2 registering a 0.3% quarter-on-quarter (QoQ) growth after a stagnation in Q1. France's gross domestic product (GDP) growth accelerated from 0.1% in Q1 to 0.5% QoQ in Q2, supported by stronger external demand for automobiles. France's export rebounded by 2.6% QoQ in Q2 after a QoQ contraction of 0.8% in Q1. Domestic demand remained soft with household consumption falling 0.4% QoQ in Q2. Meanwhile, Spain's GDP grew by a robust 0.4% QoQ in Q2. With a buoyant tourism sector, solid domestic demand, and strong labour market, households' consumption rebounded by 1.6% QoQ in Q2 while gross fixed capital formation accelerated from 1.7% in Q1 to 4.6% QoQ in Q2, led by an increase in construction activities.

Eurozone Real Gross Domestic Product (2019 = 100)



Source: CEIC, BEA Economic Research Department

The German economy remained stagnant amid downward pressure from the manufacturing sector. Manufacturing remained a major pressure to the German economy with its purchasing managers' index (PMI) staying below 50 for over a year and hitting 38.8 in July 2023, the lowest since May 2020. High interest rates, global economic slowdown, and geopolitical uncertainty continue to weigh on goods demand and new orders performance. The shrinking backlog of work added further pressure to the manufacturing sector, weakening corporate expectations for future production ahead.

The UK economy stalled in April and May, weighed down by production and construction activities. The UK GDP edged down by 0.1% month-on-month (MoM) in May after a MoM growth of 0.2% in April. Specifically, the MoM decline in production widened from 0.2% in April to 0.6% in May, and the construction sector declined for the third consecutive months with a MoM drop of 0.2% in May. The services sector largely stalled in May but arts, entertainment and recreation services led the rise by a MoM growth of 1.9% in May, reflecting continuous divergence across economic sectors.

Employment condition held steadily with upward wage pressures in Europe. Eurozone's unemployment rate stayed at a historical low of 6.4% for the third straight months in June, which helped to solidify household income expectation. The Eurozone's consumer confidence index also improved to -15.1 in July, of which the sub-index for financial situation over the next 12 months increased to -5.0, a step closer to the level of -3.1 prior to the Russia-Ukraine conflict in February 2022. Meanwhile, the UK's unemployment rate edged up to 4.0% during March – May 2023, but the growth in average weekly earnings remained elevated at 7.3% year-on-year (YoY) over the same 3-month period. A steady employment market is now the key to better support the household sector in the midst of a high inflation and rate environment.

Core inflationary pressure remained robust with interest rates projected to be higher for longer

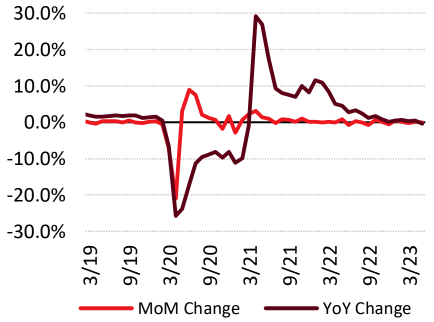
Headline inflation continued to trend lower while the core inflationary pressure remained sticky. Eurozone's headline inflation decelerated from 5.5% in June to 5.3% YoY in July, largely driven by a wider decline of energy prices from 5.6% to 6.1% YoY in July. The food, alcohol and tobacco prices stayed at a double-digit growth of 10.8% YoY in July, albeit slowing for the fourth consecutive month. Moreover, core inflation remained unchanged at 5.5% YoY in July, led by strong service prices. Services inflation accelerated from 5.4% in June to 5.6% YoY in July. The prices in restaurants and hotels as well as in recreation and culture remained elevated at 7.7% and 5.8% YoY in July, respectively.

In the UK, headline inflation moderated from 8.7% in May to 7.9% YoY in June. A deceleration in UK's headline inflation could be attributed to a notable slowdown of energy inflation from 8.4% to 3.2% YoY in June. Similarly, the core inflation just recorded a decline of 0.2 percentage points from 7.4% to 7.2% YoY in June. Amid the tight labour market and strong demand for travel and leisure activities, the core inflation is likely to remain sticky for the months ahead.

The European Central Bank (ECB) and the Bank of England (BoE) raised rates again. Following the 25-basis point (bp) hike in June, the ECB raised its deposit facility rate again by 25 bps to 3.75% in July. Meanwhile, the BoE also increased its policy rate by 25 bps to 5.25% in early August. The consecutive rate hike actions by the ECB and BoE have notably tightened financial conditions across Europe which could increasingly dampen both investment and consumption demand. Despite strong core inflationary pressure keeping ECB and BoE's monetary policy sufficiently tight for an extended period, they also turned to be more data dependent and opened the door for a rate hike pause in their future meetings.

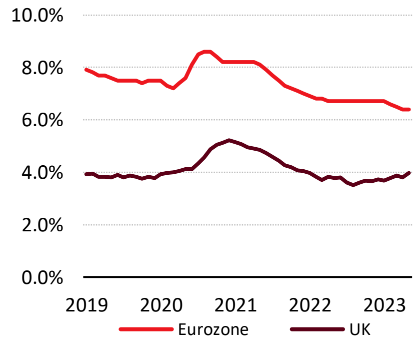
Looking ahead, the European economy is expected to record a modest expansion in 2H 2023. Steady employment conditions and income expectations will continue to support consumption activity in Europe. However, the sticky core inflationary pressure and

Monthly UK Gross Domestic Product



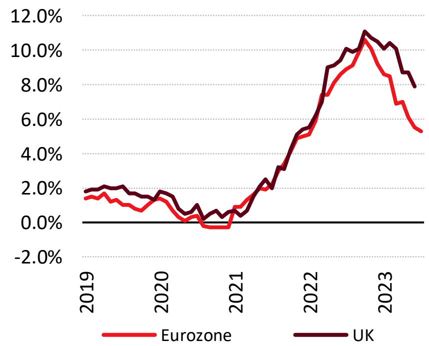
Source: CEIC

Unemployment Rate



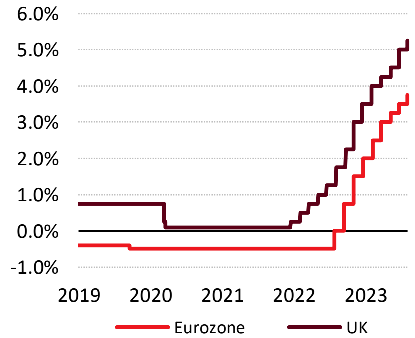
Source: CEIC

Inflation Rate



Source: CEIC

Policy Rate



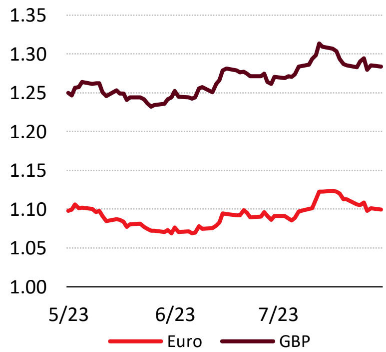
Source: CEIC

sustained monetary tightening will likely exacerbate the cost burden of both households and enterprises, with investment and consumption activities gradually slowing down ahead. Overall, the European economy will hinge on the pace of inflation deceleration, monetary policy tightening, global economic slowdown, geopolitical development, etc.

The financial market extended its recovery amid positive sentiment

Investors' sentiment stayed positive amid gradually slowing inflation and renewed expectations of interest rate hikes likely to be peaking soon. A faster deceleration of US inflation has boosted investors' sentiment with lowered expectations of further future rate hikes. Moreover, the slowing down of UK inflation in June also alleviated market concerns for aggressive rate hikes by the BoE. The favourable policy support by the Mainland authorities also drove the performance in sectors such as materials and mining, etc. At the end of July, the UK FTSE 100 index, German DAX index and French CAC index extended its gain by 2.2%, 1.9% and 1.3%, respectively, when compared to end-June. The euro and British pound closed at US$1.0997 and US$1.2835 in July, respectively, representing an appreciation of 0.8% and 1.0%, respectively, over the previous month.

Euro & British Pound against USD



Source: Bloomberg, data as of 31/7/2023

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