Market Monitor – Europe

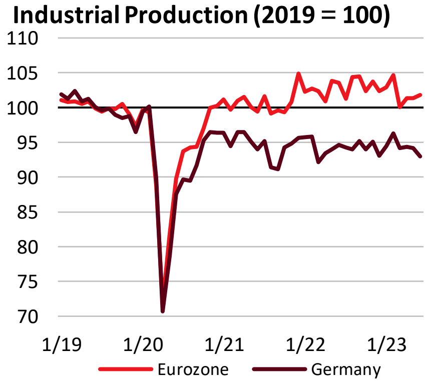
Mixed Growth Picture with Rising Uncertainty Ahead

- The European economy showed a mixed growth picture: the German economy stayed stagnant due to a weak manufacturing sector; the Spanish and UK economies grew faster with the support of the services sector.
- With sticky inflationary pressure and resilient labour markets, the European Central Bank (ECB) and Bank of England (BoE) are likely to hike rates again.
- The European economic outlook remains highly uncertain amid tightened monetary conditions, household income squeezes, and weaker business sentiment.

A mixed growth picture across Europe

Subdued export demand and the industrial sector led to stagnation in Germany. Global goods trades have been under pressure, driven by household income squeezes, shifting consumption patterns from goods to services, and corporation staying cautious in inventory building. This cyclical trend impeded Europe's export-led industrial sector. In Q2 2023, industrial production in the eurozone only recovered slowly after a sharp fall in March, with weaker overall production levels than those of Q1 2023. As a major manufacturing hub in the region, Germany was not immune and recorded a 0.2% and 1.3% month-on-month (MoM) decline in industrial production in May and June, resulting in stalled gross domestic product (GDP) growth of 0% quarter-on-quarter (QoQ) in Q2. Meanwhile, the risks to Germany's economic outlook are still tilted to the downside, as Germany's ifo business climate index fell for the 4th month in a row to 85.7 in August.

Industrial Production (2019 = 100)



Source: CEIC

A strong tourism recovery benefited the Spanish economy. Among the major eurozone economies, Spain continued to record relatively fast growth, driven by strong demand for its tourism sector. Spain's GDP expanded by 0.4% QoQ in Q2 2023, after a 0.5% growth in Q1 2023. In Q2 2023, Spain's tourist expenditure surged by 67.5% QoQ and 20.1% year-on-year (YoY), respectively. A buoyant tourism sector also supported Spain's retail sector, which rose by 2.2% QoQ in Q2 2023.

The UK economy expanded modestly amid higher service consumption and a rebound in government expenditure. The UK's GDP growth increased from 0.1% QoQ in Q1 2023 to 0.2% in Q2 2023. Monthly GDP figures also indicated a visible rebound in June, with 0.5% MoM growth, up from -0.1% in May and 0.2% in April. Government expenditure was a notable growth driver in Q2 2023, rising by 3.1% QoQ following a 1.8% drop in Q1 2023. It mainly reflected higher spending on public administration and defence. Household consumption was another source of growth, which increased by 0.7% QoQ in Q2 2023 after stagnating in Q1 2023. The growth in household consumption was mainly reflected in transportation, recreation & culture, restaurants & hotels, and energy spending.

Sticky price pressure leaves room for further monetary tightening

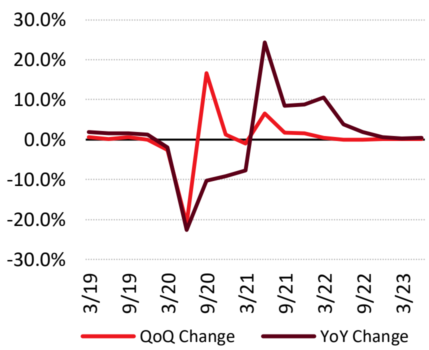
Disinflation in the eurozone was progressing gradually. The eurozone's headline inflation stalled at 5.3% YoY in August, somewhat distorted by the end of German transport subsidies and changes in its components' weight. Core inflation, which excludes energy and food, came down from 5.5% YoY in July to 5.3% in August, staying near its historical high of 5.7% in March. On a monthly basis, core inflation accelerated visibly from -0.1% MoM in July to 0.3% in August. Overall, recent inflation readings indicate that underlying inflationary pressure remains high.

Inflation in the UK hovered around elevated levels. The UK headline inflation dropped from 7.9% YoY in June to 6.8% in July, which was weighed down by lower gas prices after the price cap reset. Nonetheless, core inflation remained unchanged at 6.9% YoY in July. Besides, services inflation rebounded to 7.4% YoY in July. Restaurant and hotel prices were a major contributor to inflation in July, with their prices rising by 9.6% YoY, probably boosted by buoyant travel activity during the summer holidays.

High wage growth suggests persistent inflationary pressure in the UK. Although the UK labour market somewhat softened with its unemployment rate increasing further from 4.0% in March - May to 4.2% in April - June, average total pay growth (excluding bonuses) accelerated to 7.8% YoY and 0.1% in nominal and real terms over the same horizon, respectively. Positive real growth in earnings signalled some improvement in households' purchasing power, which could support consumer spending and possibly underlying inflationary pressure as well.

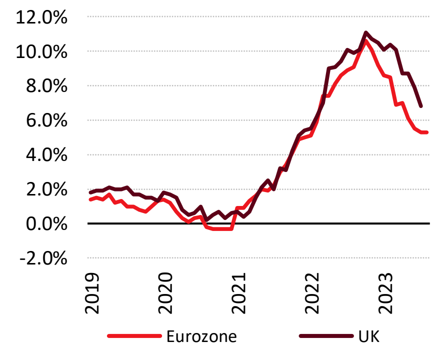
The ECB and BoE are likely to maintain a hawkish monetary stance. Compared to the US, core inflation in the eurozone and the UK were both far too high, making the case for the ECB and the BoE to hike rates again stronger. During the Jackson Hole symposium in August, ECB President Christine Lagarde reiterated in a speech that the fight against inflation is not yet over, signalling the need to keep interest rates at restrictive levels. Similar hawkish forward guidance was delivered by BoE officials. However, the lagged impact of the previous rapid interest rate increases is likely to surface gradually, as a notable slowdown in growth momentum has been noted recently, especially with the softening trends in the labour market and purchasing managers' index (PMI) readings. As such, the ECB and the BoE are likely to become data-dependent and a pause is on the horizon, even though their policy rates are also expected to stay higher for longer.

UK Gross Domestic Product



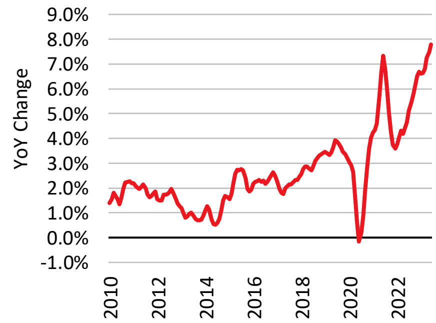
Source: CEIC

Inflation Rate



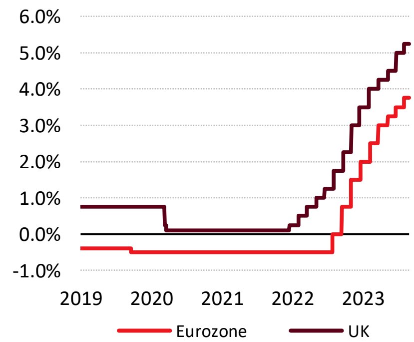
Source: CEIC

UK Nominal Average Weekly Earnings (excluding bonuses)



Source: CEIC

Policy Rate



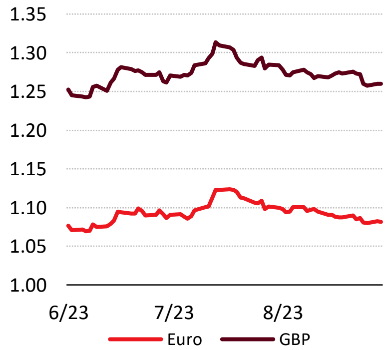
Source: CEIC

The European economic outlook remains highly uncertain amid tightened monetary conditions, household income squeezes, and weaker business sentiment. Higher borrowing costs in Europe have discouraged credit demand. Together with the softening hiring intention and high inflation environment, consumption and investment sentiment will also be affected. Moreover, the recent slowdown in the manufacturing sector is also spreading to the services sector. Most notably, the eurozone and UK services PMI fell sharply to contractionary territory at 47.9 and 49.5 in August, marking an end to months-long expansion.

The financial market retreated amid an uncertain economic outlook

Market sentiment turned more cautious. With inflation remaining above the policy targets in the US and Europe, market participants have increasingly priced in that policy rates will stay higher for longer, leading to high volatility in risk assets. Besides, the investors reiterated their concerns over the global economic slowdown. These fuelled risk-averse sentiment and strengthened the US dollar exchange rate. At the end of August, the UK FTSE 100 index, German DAX index, and French CAC index declined by 3.4%, 3.0%, and 2.4%, respectively, when compared to end-July. The euro and British pound closed at US$1.0843 and US$1.2673 in August, respectively, representing a depreciation of 1.4% and 1.3% over the previous month.

Euro & British Pound against USD



Source: Bloomberg, data as of 31/8/2023

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