Market Monitor – Europe

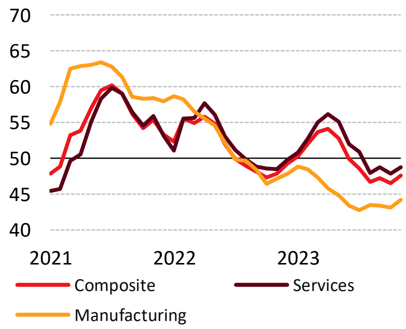
Economy Stabilised at Low Levels but Downturn Risk Remains

- The Eurozone's economy stabilisedslightly, despite remaining in contractionary territory. The UK's economic growth was muted in Q3, with stabilisation seen recently.
- The Eurozone's inflation decelerated at a faster pace. The UK's headline inflation fell markedly, but core inflation remained elevated.
- The ECB and BoE are likely to maintain a restrictive monetary environment until inflation shows more clear signals to return to their policy targets.

Economy showed signs of stabilisation but downside risk remains

The eurozone's economy stabilised at a largely stagnant level. Business surveys revealed early signs of a mild pickup in confidence. The Eurozone composite purchasing managers' index (PMI) increased slightly from 46.5 to 47.5 in November. While the PMI indicated a continued contraction, as both manufacturing and services PMIs increased during the month. Meanwhile, the Economic Sentiment Indicator in the eurozone went up to 93.8 in November, marking the second consecutive month of increase. While higher borrowing costs from monetary tightening would continue to weigh on business investment and consumer spending, recent indicators suggested that the eurozone economy would stabilise at a largely stagnant level.

Eurozone Purchasing Managers' Index

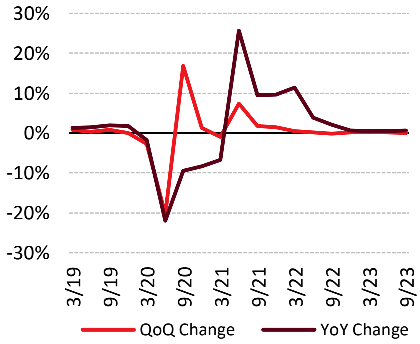


Source: Bloomberg

Divergence within the region remains notable. The German economic downturn eased somewhat, with its composite PMI rising from 45.9 in October to 47.8 in November, of which the manufacturing PMI jumped from 40.8 to 42.6, led by smaller declines in new orders and new purchases. However, Germany's constitutional court ruled that the government's re-allocation of EUR 60 billion in pandemic-related emergency funds into a climate and transformation fund was unconstitutional, which would lead to delays for several investment projects and add uncertainty to growth in 2024. Meanwhile, Italy's composite PMI increased from 47.0 to 48.1 in November, while France's composite PMI remained unchanged at 44.6 and Spain's composite PMI declined marginally to 49.8.

The UK's economic growth was muted in Q3, with stabilisation seen more recently. The gross domestic product (GDP) in Q3 stayed unchanged on a quarter-on-quarter (QoQ) basis. Among the major expenditure components, household consumption, gross capital formation and government consumption subtracted headline growth by 0.25 percentage points (ppts), 0.14 ppts and 0.10 ppts, respectively. Together, they offset a 0.43 ppts contribution from improving net trade. The weakened growth readings reflected the impact of high interest rates on business investment and consumer spending and lower public spending on health and education. That said, monthly figures showed a somewhat stabilising trend at 0.2% MoM in September, 0.1% in August and -0.6% in July. In the meantime, the UK's composite PMI returned to expansionary territory at 50.1 in November, after staying in contractionary territory for three consecutive months. Both the manufacturing and services sectors saw visible improvements in their PMIs.

UK Gross Domestic Product

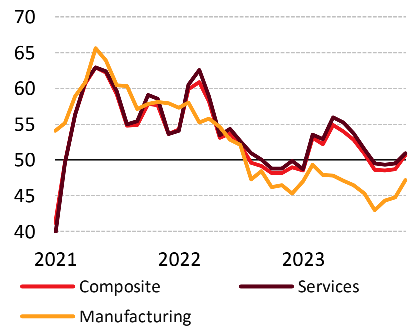


Source: CEIC

Inflation came down sharply, but more progress is still needed

The Eurozone's inflation decelerated at a faster pace. The eurozone headline inflation fell more than expected, from 2.9% in October to 2.4% year-on-year (YoY) in November, with a high comparison base and a broad-based slowdown among different components. In addition to the continued sharp YoY drop in energy prices (-11.5%), food, alcohol and tobacco inflation decelerated from 7.4% YoY to 6.9% in November. Services inflation also slowed from 4.6% YoY to 4.0%. Thus, core inflation eased further to 3.6% YoY in November, the slowest pace since June 2022.

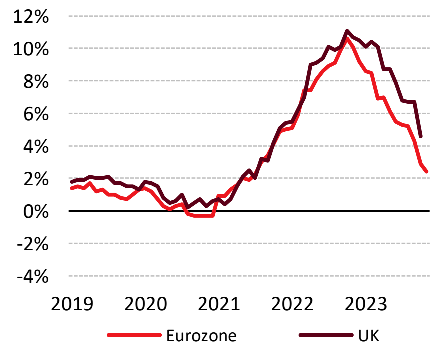
UK Purchasing Managers' Index



Source: Bloomberg

The UK's headline inflation also fell markedly, but core inflation remained elevated. After hovering around 6.7% to 6.8% YoY in the Q3 period, headline inflation in the UK cooled to 4.6% in October. The slowdown in headline inflation was driven by a smaller rise in housing and household services' prices, which reversed from a YoY growth of 6.9% in September to a decline of 3.5% in October. This was due to the slump in gas (-31.0% YoY) and electricity (-15.6%) costs. In comparison, services inflation only decreased slightly from 6.9% YoY to 6.6% in October, reflecting the impacts of strong wage growth and resilient demand for the services sector. In this connection, core inflation remained elevated at 5.7% YoY in October, far outpacing those in the US and the eurozone.

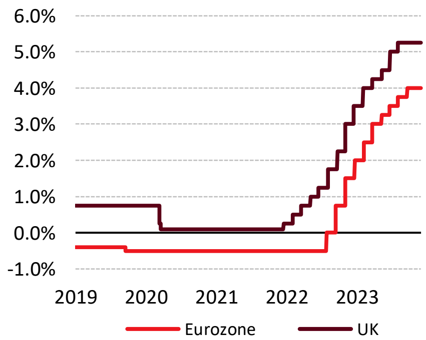
Inflation Rate



Source: CEIC

Central banks in Europe are likely to maintain a restrictive monetary environment until inflation shows more clear signals to return to their policy targets. While the policy rates of the European Central Bank (ECB) and the Bank of England (BoE) are widely expected to have reached their peak, officials from both central banks continued to underscore the need for a tight monetary stance to bring down inflation. In the near term, rate cuts are not expected from both the ECB and the BoE. Particularly, the BoE is likely to keep high rates for longer than the ECB, as the UK's underlying inflation pressure is much stickier.

Policy Rate



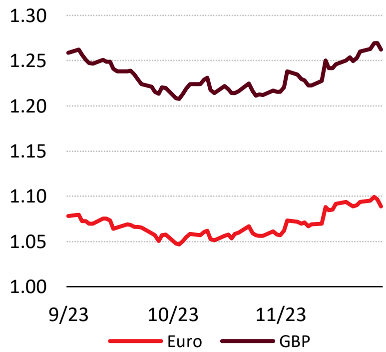
Source: CEIC

Looking ahead, European economies need stronger signs of recovery to escape stagnation. Overall, the recent stabilisation in confidence indicators is an encouraging signal for the region, but it is insufficient to conclude a bottoming out of the ongoing downturn. It is worth noting that the strong labour markets in the region have begun to soften. Besides, geopolitical tensions and monetary tightening continue to pose downside risks to the region. Regarding the inflation outlook, disinflation progress in Europe remains uncertain, as high wage growth would elevate inflationary pressure even on the back of weak consumer demand.

Financial market sentiment turned risk-on

Risk sentiment revived with rising expectations for a dovish pivot by major central banks. The slowdown in inflation fuelled optimistic sentiment among investors, with rising expectations for rates to reach their peak and more rate cuts by the major central banks in 2024. This resulted in a retreat in bond yields, which boosted equity valuations and led to a weakened US dollar. At the end of November, the UK FTSE 100 index, the German DAX index and the French CAC index rebounded by 2.8%, 10.7% and 6.7%, respectively, compared to end-October. The euro and British pound closed at US$ 1.0888 and US$ 1.2624 in November, respectively, representing an appreciation of 3.0% and 3.9% over the previous month.

Euro & British Pound against USD



Source: Bloomberg, data as of 30/11/2023

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