Economic Research

January 2024

Market Monitor – Europe

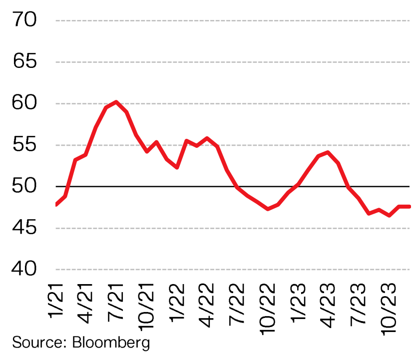
Growth Remained Weak But Sentiment Somewhat Improved

- The eurozone's economy remained sluggish, but consumer sentiment has somewhat stabilised. The UK's economy looks set to hold largely steady.
- Inflation eased further, but the disinflation outlook is still uncertain amid robust wage growth and heightened geopolitical tensions.
- The ECB and the BoE signalled their intention to maintain their restrictive monetary stance. EU members agreed on a new fiscal framework.

Economic activity remained mixed

Weak growth momentum persisted in the eurozone. The eurozone composite purchasing managers' index (PMI) held unchanged at 47.6 in December 2023 after a slight improvement in November 2023. The average composite PMI in Q4 2023 is slightly lower than that in Q3 2023, pointing to a continued stagnation in the eurozone's GDP in Q4 2023. Tighter financing conditions served as a major drag, hitting rate-sensitive sectors like manufacturing and construction activities. That said, consumers in the region turned less gloomy, with the consumer confidence index by the European Commission rising for the second month to -15.1 in December 2023. This was probably driven by improved real household income, given robust wage growth, easing inflation and a low unemployment rate.

Eurozone Composite Purchasing Managers' Index



Source: Bloomberg

Business surveys indicated signs of bottoming out in the UK's economy. The UK's monthly GDP estimate saw a 0.3% month-on-month (MoM) contraction in October 2023, with the services, production and construction sectors shrinking by 0.2%, 0.8% and 0.5%, respectively. On a three-month basis, the economy showed no growth from July to October 2023. Adverse weather conditions from heavy rainfall and strong winds were viewed to have an effect on construction and certain service activities. Meanwhile, the UK composite PMI accelerated from 50.7 to 52.1 in December 2023, with the services PMI picking up sharply from 50.9

to 53.4, which offset a steeper downturn in the manufacturing PMI from 47.2 to 46.2. Overall, despite a mixed performance across sectors, upbeat business expectations suggested a potential turnaround for the UK economy to head into a mild recovery ahead.

Inflation eased further, but its outlook remains uncertain

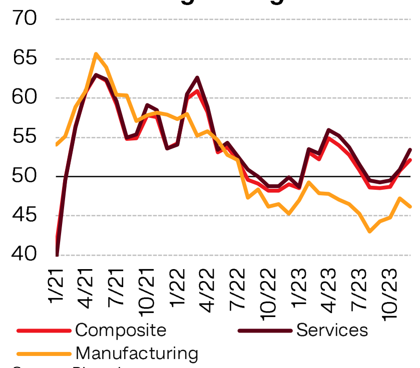
The eurozone's core inflation retreated further despite a rebound in headline inflation. Headline inflation rebounded from 2.4% to 2.9% year-on-year (YoY) in December 2023, the first re-acceleration since April 2023, reflecting the reduction of German government subsidies on energy. The YoY decline of energy prices narrowed from 11.5% to 6.7% YoY. Services inflation stayed flat at a still high level of 4% in December 2023, while core inflation slowed further to 3.4% in December 2023 from 3.6% YoY. However, the recent disinflation trend is likely to be complicated by the increases in VAT on food in restaurants and cafes in Germany, tobacco taxes in Italy, regulated energy prices in France, and the rising tensions in the Red Sea.

The UK's inflation showed a further slowdown. The UK's headline and core CPI inflation slowed to 3.9% and 5.1% YoY in November 2023, with their month-on-month (MoM) rates at -0.2% and -0.3%, respectively. Overall, the inflation readings were lower than expectations. Across the major components, goods inflation softened to 2.0% YoY in November, while services inflation also retreated but stayed high at 6.3%. This showed that the recent inflation slowdown was mainly driven by goods components. Furthermore, wage growth in the UK has been stronger than in other advanced economies. In August - October 2023, the growth of weekly labour earnings (excluding bonuses) remained elevated at 7.3% YoY. And the minimum wage is set to increase by 9.8% in April 2024. These are likely to extend the persistence of elevated services inflation. The inflation risks from geopolitical tensions also remain high.

Central banks in Europe reached their peak rates and remain cautious about a dovish shift in policy stance. Both the European Central Bank (ECB) and the Bank of England (BoE) maintained their policy rates unchanged at their December meetings. Unlike the US Federal Reserve (Fed), the ECB and BoE officials did not reveal much detail about their plans for rate cuts in 2024, as the progress in disinflation was cited as a major consideration for monetary policy decisions. Even though the ECB and the BoE maintained a restrictive tone, financial markets priced in that rate cuts by both central banks would come as early as 1H 2024.

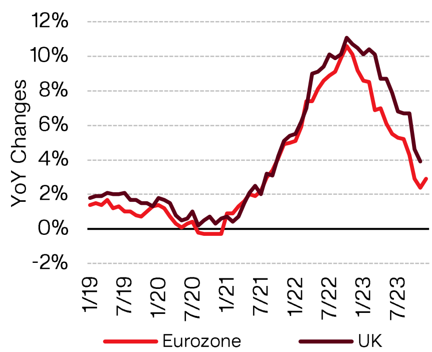
EU members agreed on a new fiscal framework. Following a 3-year suspension of fiscal rules from 2020-2023 due to the pandemic, EU members agreed on a reform of fiscal rules in December 2023. The new deal will have no impact on the EU's fiscal policy in 2024, as national budgets for 2024 have been approved. It suggests that the impacts will gradually be seen from 2025 onward. While the two fiscal benchmarks, namely the 60% debt-to-GDP ratio and the 3% annual deficit limit, are unchanged, the new rules introduce more flexibility for fiscal

UK Purchasing Managers' Index



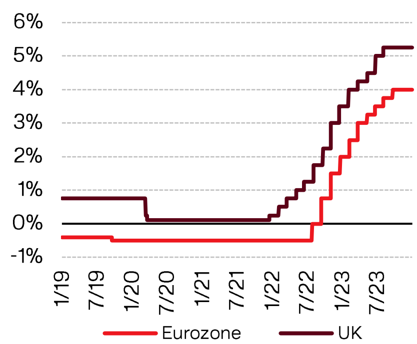
Source: Bloomberg

Inflation Rate



Source: CEIC

Policy Rate



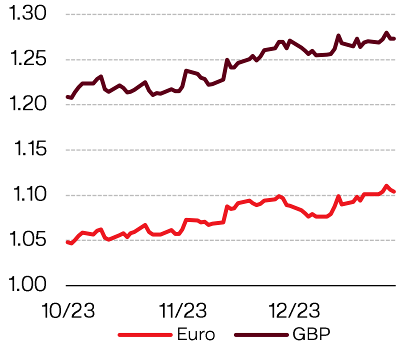
Source: CEIC

spending, while the requirements of bringing down debt to the benchmarks remain in place. Overall, the new deal reflects a policy path to normalise fiscal spending in the post-pandemic era, which will mean a more neutral or even restrictive EU's fiscal stance in the medium term.

Financial markets extended their rally amid buoyant sentiment

Risk-on sentiment surged, fuelled by the Fed's dovish pivot. In December 2023, the Fed signalled larger rate cuts in 2024 than the September projections, reviving risk-on sentiment in global financial markets. This led to a sharp decline in US government bond yields and the US dollar exchange rate, boosting equity and currency performance in Europe. At the end of December 2023, the UK FTSE 100 index, the German DAX index and the French CAC index rose by 3.7%, 3.3% and 3.2%, respectively, compared to end-November. The euro and British pound closed at US$ 1.1039 and US$ 1.2731 in December 2023, respectively, representing an appreciation of 1.4% and 0.8% over the previous month.

Euro & British Pound against USD



Source: Bloomberg, data as of 29/12/2023

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