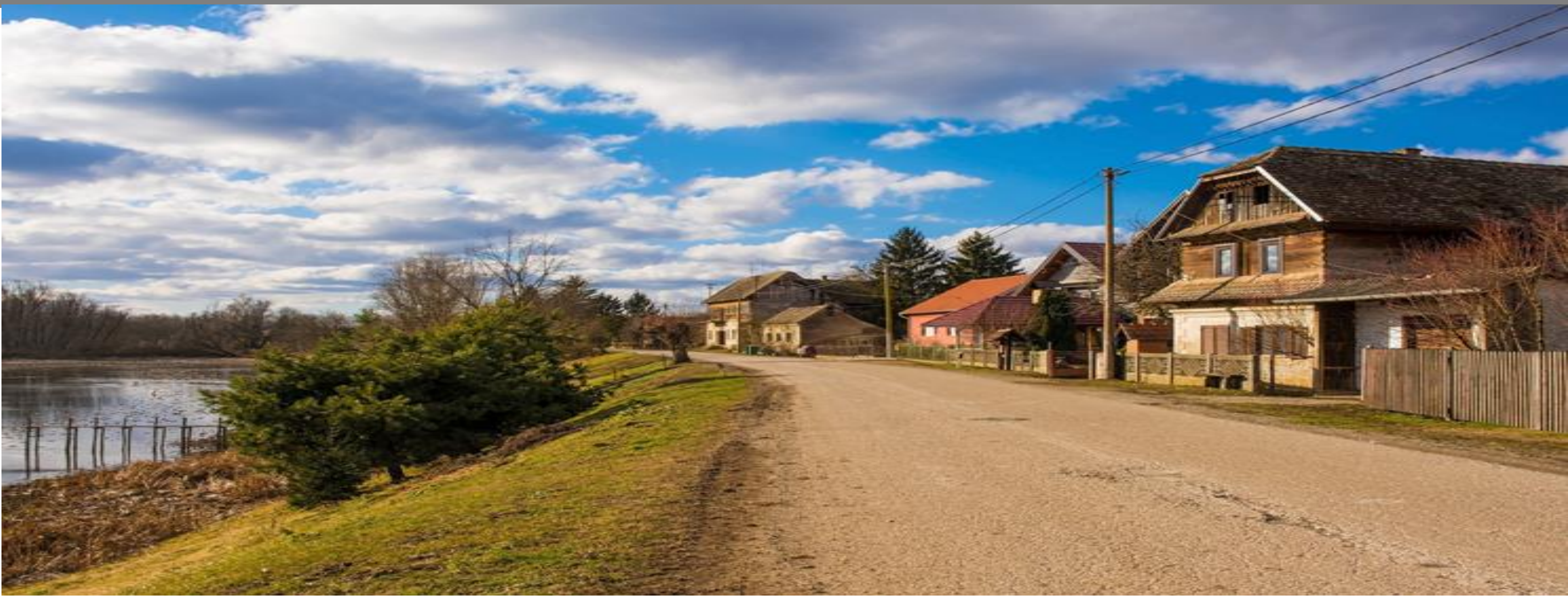
Economic Research

May 2025

Market Monitor – Europe

Growth outlook clouded by trade tensions



- The UK reached a trade deal with the US, while the outcome of the EU-US trade negotiations remains highly uncertain.
- The European Central Bank and Bank of England cut rates again. Eurozone inflation held steady in April, while UK inflation eased in March.
- Trade tensions induced volatility in European stock markets, while their currencies appreciated notably against the US dollar.

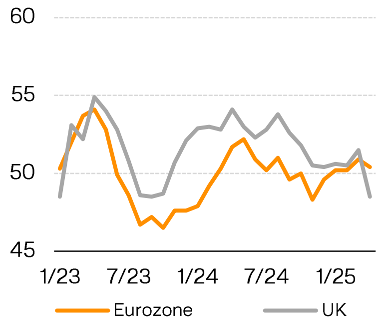
Trade tensions dampened the growth outlook in Europe

The UK reached a trade deal with the US, while the outcome of the EU-US trade negotiations remains highly uncertain. On 8 May, the UK announced a trade agreement with the US by agreeing to reduce tariffs on American ethanol and beef imports in exchange for lower tariffs on steel, aluminium and car exports. However, the 10% tariffs remain in place for most of UK exports. Meanwhile, the EU has started trade negotiations with the US, but holds stark differences with the US regarding regulations on technology companies, digital levies and value-added tax. At present, the EU is subject to 25% US tariffs on steel, aluminium, and cars, as well as 10% baseline tariffs on most other exports. At this stage, it remains highly uncertain how and when the EU would resolve its trade disputes with the US. The EU is said to impose additional tariffs on US goods if ongoing trade negotiations fail.

More EU countries took steps to increase public spending. As of early May, 16 EU countries have decided to request the activation of the EU's emergency clause to increase defence spending by up to 1.5% of GDP without breaking fiscal rules. Moreover, the German's new coalition government published its coalition agreement in April, outlining the establishment of a Germany Fund "Deutschlandfonds" worth at least EUR 100 billion to make strategic investments and support small & medium enterprises. The agreement also confirmed that total federal infrastructure spending between 2025 and 2029 will be around EUR 150 billion under a planned EUR 500 billion infrastructure fund. Abovementioned measures to boost public spending could provide an offset to mitigate the drag from US tariffs.

The eurozone economic growth surprised to the upside in Q1. The eurozone's GDP growth accelerated from 0.2% quarter-over-quarter (QoQ) in Q4 2024 to 0.4% in Q1 2025. Among the major eurozone member states, Spain's economy outperformed with a robust 0.6% QoQ expansion, followed by Italy's at 0.3% and Germany's at 0.2%, while France's economy only grew marginally by 0.1%. Indeed, headline growth was boosted by Ireland's strong QoQ growth of 3.2%, given its high concentration of US multinational companies. Despite this, growth looks set to weaken amid tariff uncertainties. The eurozone composite PMI fell from 50.9 in March to 50.4 in April, driven by a decline in the services PMI from 51.0 to 50.1, though the manufacturing PMI improved slightly from 48.6 to 49.0. Furthermore, the eurozone's economic sentiment indicator dropped to 93.6 in April from 95.0 in March, with broad-based declines across sectors and in consumer confidence.

Eurozone and UK composite PMI



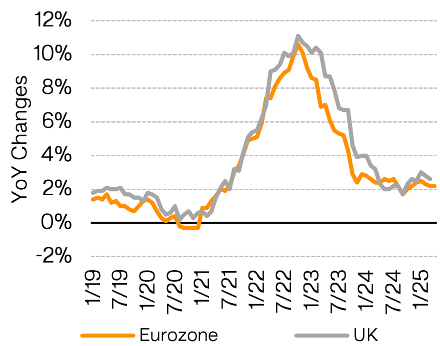
Source: Bloomberg

The latest data showed downside risks to the UK economy. Monthly UK GDP expanded by 0.5% month-on-month (MoM) in February, up from zero growth in January. This solid performance was driven by a resilient services sector and a pickup in production output. That said, similar to the eurozone, the UK economy looks set to slow ahead, as its composite PMI fell sharply to 48.5 in April from 51.5 in March. Both the services and manufacturing PMIs were in contraction at 49.0 and 44.9 in April, underscoring heightened downside risks faced by the UK economy.

The ECB and BoE cut rates again on growth concerns

The European Central Bank (ECB) cut rates again in April amid escalating tariffs. On 17 April, the ECB decided to reduce key policy rates by 25 basis points (bp), bringing its deposit facility rate to 2.25%. The ECB highlighted that the growth outlook has deteriorated due to rising trade tensions. While the ECB stressed a data-dependent approach ahead, financial markets priced in more rate cuts in 2025.

Inflation Rate



Source: CEIC

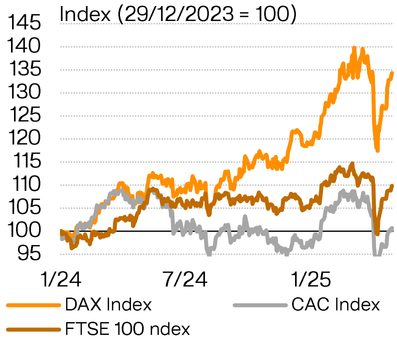
The eurozone inflation remained steady. The eurozone headline CPI inflation was unchanged at 2.2% year-on-year (YoY) in April. A large decline in energy prices, driven by lower oil prices, offset higher services inflation, which was influenced by the timing of the Easter holiday. Moving forward, domestic cost pressures are expected to ease as wage growth moderates and productivity improves. However, a weaker global economic backdrop and potential trade diversion away from the US market could complicate the eurozone inflation outlook as well.

UK inflation continued to ease. The UK's headline inflation rate eased from 2.8% YoY in February to 2.6% in March. This moderation was driven by a deceleration in services inflation, which eased to 4.7% YoY from 5.0%. Moving forward, price pressures remain elevated, as businesses are likely to pass on higher labour costs from higher wages and the increase in national insurance to consumers. In May, the Bank of England (BoE) voted by 5-4 to cut the Bank Rate by 25 bps to 4.25%, with 2 members preferring to cut by 50 bps and 2 other members voting for no cuts. The BoE's statement stated that a gradual and careful approach to further monetary policy easing remains appropriate. Going forward, we anticipate that the BoE is inclined to cut rates further, given greater concerns surrounding growth and inflation.

Trade tensions induced financial market volatility

European stock markets underwent a volatile month while their currencies appreciated notably against the USD. Major equity indices fell sharply following the US announcement of reciprocal tariffs on 2 April, but rebounded after the US softened its stance and paused the reciprocal tariffs for 90 days. The UK's FTSE 100 and France's CAC 40 fell 1.0% MoM and 2.5%, respectively, while Germany's DAX gained 1.5%. The euro and pound strengthened against the US dollar, rising sharply by 4.7% MoM and 3.2%, respectively, as investors allocated capital away from US dollar-based assets.

Stock Market Indices



Source: Bloomberg

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