


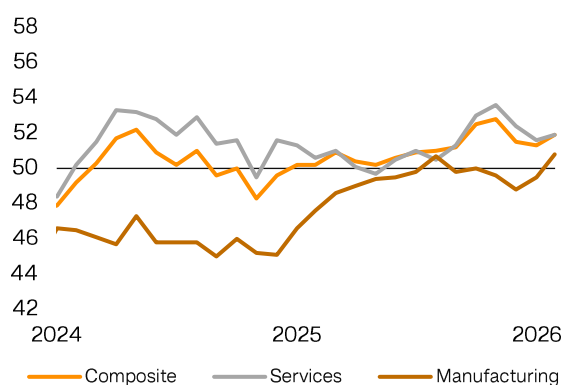
*Market Monitor – Europe***Outlook Clouded by Energy Supply Disruptions**

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- The eurozone's manufacturing sector returned to growth in early 2026, while the UK economy faced a mixed backdrop.
 - Eurozone inflation held steady, while UK price growth eased further.
 - The surge in energy prices has complicated the monetary policy outlook, with markets pricing in a potential hike by the ECB and a pause for the BoE.

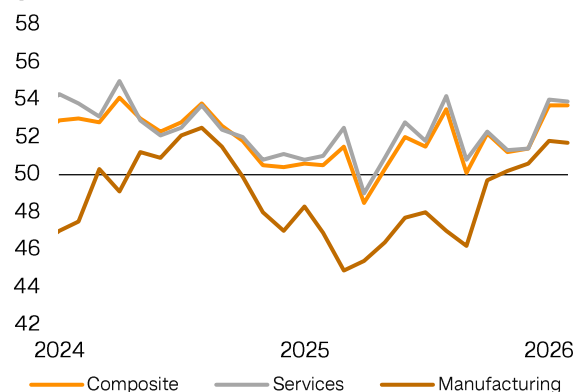
Eurozone and UK Economy Overview

The eurozone economy gained momentum in February, spearheaded by a manufacturing sector recovery. The eurozone composite Purchasing Managers' Index (PMI) rose to 51.9 in February from 51.3 in January, marking the 14th consecutive month of expansion. Crucially, the Manufacturing PMI climbed to 50.8, moving into growth territory for the first time since August 2025. This industrial revival was driven by the strongest rise of new orders since April 2022. Along with the manufacturing rebound, the services sector maintained a steady acceleration, with the Services PMI ticking up to 51.9 in February. Across major member states, sentiment in Germany continued to improve, with its composite PMI rising to 53.2 in February, up from 52.1 in January. This robust performance was seen across both the manufacturing and services sectors, supported by increased federal spending on infrastructure and defense. Concurrently, activity in Italy's and Spain's composite PMI remained in expansionary territory at 52.1 and 51.5, respectively, while France's composite PMI pointed to a marginal decline at 49.9. Overall, the bloc is anticipated to maintain a steady expansion in Q1 2026.

The UK economy faced a mixed backdrop in early 2026. UK GDP growth reached 1.3% in 2025, a modest improvement over the previous year's 1.1%. That said, monthly GDP stagnated in January 2026, following growths of 0.1% in December and 0.2% in November 2025. Notably, the services sector stalled, with only 6 out of 14 subsectors reporting output gains in January. This suggested that the economy was yet to recover from uncertainty surrounding the autumn budget. Furthermore, the UK unemployment rate rose to 5.2% in October to December 2025, the highest level in five years. Conversely, business optimism improved, as the UK composite PMI inched up further to 53.9 in February from 53.8 in January, supported by rising output across the services sector (Feb: 53.9; Jan: 54.0) and manufacturing sector (Feb: 52.0; Jan: 51.8). Despite the increase in headline PMI figures, the survey respondents highlighted a deep drop in staff levels.

Eurozone PMI


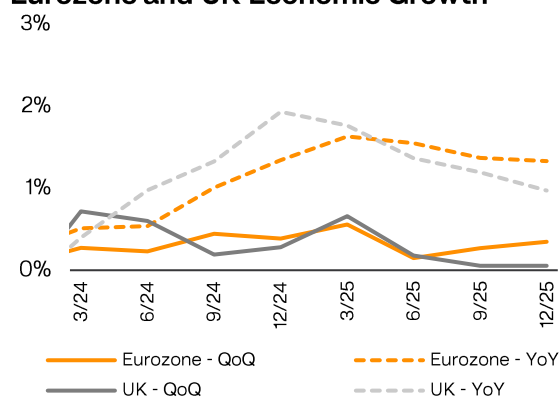
Source: Bloomberg

UK PMI


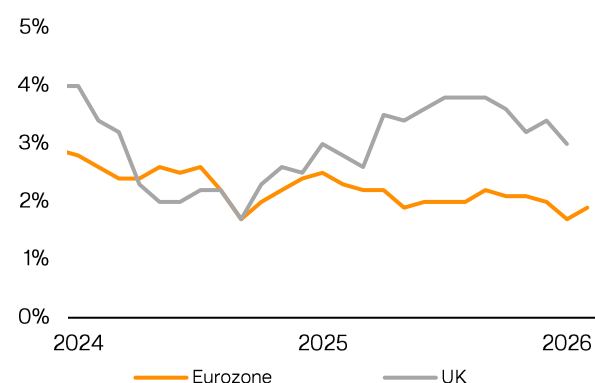
Source: Bloomberg

Eurozone inflation held steady. The latest Eurostat flash estimate indicated that headline HICP inflation edged up slightly to 1.9% year-on-year (YoY) in February, up from 1.7% in January. While energy prices remained a major disinflationary force (-3.2% YoY), core inflation (excluding energy and food) rose by 0.2 percentage point to 2.4%. Specifically, services inflation increased to 3.4% YoY in February, up from 3.2% in January. During the month, price pressures were probably driven by Italy, where inflation rose by 0.6% month-on-month. This pickup was largely due to the hosting of the Olympic Games in Milan, as price gains were concentrated in tourism-related services, such as hotels and restaurants.

UK price growth eased further. Headline CPI fell to 3.0% YoY in January, down from 3.4% in the previous month. Core inflation dipped slightly to 3.1% from 3.2% YoY. Services inflation, a key gauge of domestic price pressures, also slowed slightly to 4.4% from 4.5% YoY. The moderation was largely driven by slower price gains in transport, food & non-alcoholic beverages and education. Education prices stayed flat this January, contrasting with a 2.4% rise a year earlier. Airfares also contributed, falling 26.5%, sharper than the 19% drop in January 2025. Notably, softer readings for education costs were associated with base effects from the VAT rise on school fees in 2025.

Eurozone and UK Economic Growth


Source: CEIC

Inflation Rate (YoY)


Source: CEIC

Recent Energy Price Surge Sparks Policy Dilemma for Central Banks

The sudden surge in energy prices has fractured the monetary policy outlook across European central banks. Recent geopolitical escalation in the Middle East, marked by the military conflict in Iran and the subsequent disruption of the Strait of Hormuz, has triggered a massive exogenous supply shock, pushing oil and gas prices to surge in early March. Given a heavy reliance of energy imports in the region, the current energy turmoil has led to a rapid re-pricing of anticipated policy changes by the ECB and the BoE.

The European Central Bank (ECB) is expected to stay on hold in its March meeting, with markets pricing hikes in 2H 2026. While the ECB is widely expected to hold rates steady on 19 March, attention will be centred on the ECB's assessment of the inflation outlook and its implications on future monetary policy. A sustained rise in energy prices could heighten the risk of a rerun of the 2022 energy crisis, which followed the military conflict between Russia and Ukraine. As of 17 March, financial markets expected the ECB to hike rates more than once by the end of 2026. Overall, the ECB is likely to execute a measured approach in its communications while retaining the flexibility to act if inflation risks unexpectedly overshoot.

The Bank of England (BOE)'s easing path is likely to face a sustained pause. With the disinflation process gradually gaining traction, coupled with a weakening labour market, the BoE was originally anticipated to continue rate cuts in 2026. However, escalating inflation uncertainty is likely to force the central bank to adopt a prudent stance. Markets are currently pricing in a sustained hold, forcing the BoE to keep rates higher for longer. Therefore, the development of global energy supply will play a crucial factor in determining whether the BoE would continue its rate cuts in 2026.

Looking ahead, should the ongoing geopolitical tensions in the Middle East become protracted, the European economy will face a complex matrix of macroeconomic headwinds, including weakened business sentiment, severed supply chains, surging energy costs, and restrictive monetary conditions. These downside risks will threaten to derail the region's economic recovery.

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