

Market Monitor – Europe

Business Sentiment Weakens as Stagflation Risks Re-emerge



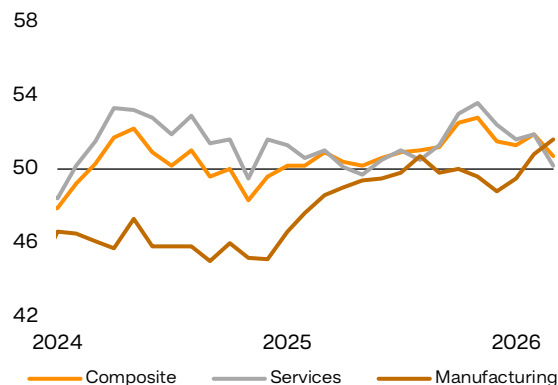
- Business sentiment in the eurozone and the UK weakened in March, as the Middle East conflict raised input costs, disrupted supply chains and delayed investment decisions.
- Eurozone headline inflation accelerated sharply on higher energy prices, while UK inflation remained elevated and faced upside risks from the ongoing energy shock.
- The ECB and BoE stayed put in March, with both highlighting a difficult trade-off between supporting growth and taming inflation.

Business sentiment weakened under the weight of geopolitical tensions

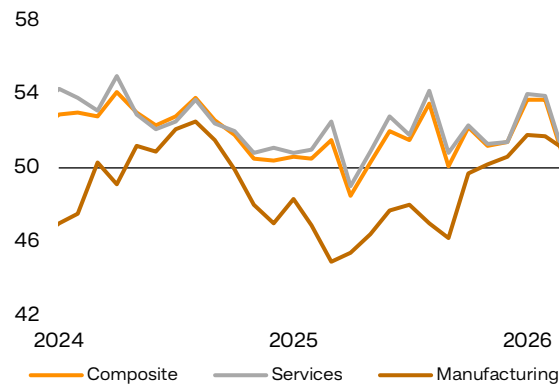
Rising input costs and longer delivery times have started to erode the eurozone's growth momentum. The eurozone composite purchasing managers' index (PMI) fell to 50.7 in March from 51.9 in February, marking the slowest pace of expansion in nine months, as services activity moderated sharply from 51.9 to 50.2. Meanwhile, the manufacturing PMI rose to 51.6 in March from 50.8 in February, but this strength was partly overstated by the upward push from longer supplier delivery times. The manufacturing PMI survey also pointed to a significant spike in higher input prices, with the war-driven inflation impulse set to drive final prices higher in the near term. Across the major member states, Germany continued to expand but at a slower pace, while France and Italy contracted and Spain retained its solid growth momentum.

UK activity also lost momentum toward the end of Q1. The UK composite PMI dropped to 50.3 in March from 53.7 in February, reflecting weaker manufacturing (from 51.7 to 51.0) and services activity (from 53.9 to 50.5). Survey respondents cited rising geopolitical uncertainty, higher fuel and transport costs, shipping delays and concerns over domestic economic policy, all of which

appeared to foster greater risk aversion and delayed investment decisions. With monthly GDP flat in January 2026, the March PMI data suggested that UK growth was likely subdued in Q1.

Eurozone PMI


Source: Bloomberg

UK PMI


Source: Bloomberg

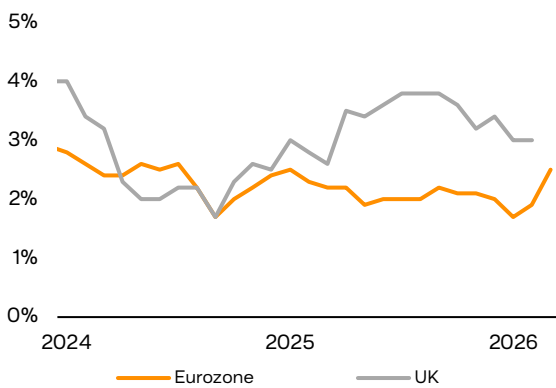
Eurozone inflation re-accelerated in March, led by energy. Eurozone headline CPI inflation rose to 2.5% in March from 1.9% year-on-year (YoY) in February. The increase was driven mainly by energy prices, with its growth swinging from -3.1% to 4.9% YoY as the conflict in the Middle East drove up oil and gas costs. By contrast, core inflation (excluding energy, food, alcohol & tobacco) edged down from 2.4% to 2.3% YoY in March, as price growth for services and non-energy industrial goods softened slightly. This suggested that underlying inflation pressure remained relatively contained for now. Even so, the renewed rise in energy prices is likely to squeeze households' spending power and complicate the disinflation process.

UK inflation remained elevated even before the current energy shock fed through. In February, UK headline CPI inflation held at 3.0% YoY, while its core inflation edged up to 3.2% from 3.1%. According to the Office for National Statistics, upward pressure from clothing & footwear, furniture and household goods were offset by downward contributions from alcohol & tobacco, transport, recreation & culture, and restaurants & hotels, leaving the headline rate unchanged in February. Going forward, the recent rise in energy prices is likely to push inflation higher. By early April, the UK national average price of gasoline was estimated to have risen by over 15% since late February, suggesting that further energy-driven inflation to be seen in the upcoming data. According to Bloomberg estimates, the current energy shock would add about 1 percentage point to UK CPI inflation by Q4 of 2026.

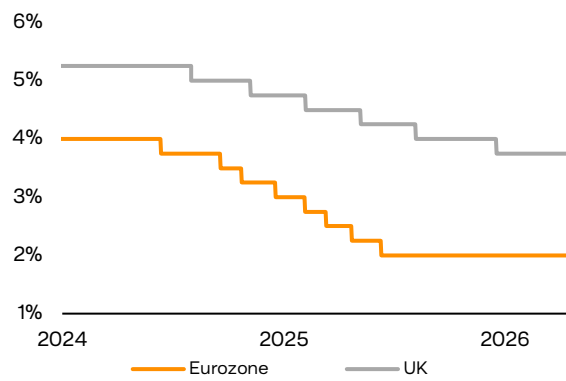
Central banks have become more alert to upside inflation risks

The European Central Bank (ECB) is closely monitoring inflation trends. The ECB kept its deposit facility rate unchanged at 2.0% in March and acknowledged that the conflict in the Middle East had intensified stagflation risks for the eurozone. The latest ECB staff projections raised headline inflation forecasts to 2.6% in 2026, 2.0% in 2027 and 2.1% in 2028, up from 1.9%, 1.8% and 2.0% in December's projections. Meanwhile, GDP growth projections were lowered to 0.9%, 1.3% and 1.4% for 2026-2028, down from 1.2%, 1.4% and 1.4% previously. The ECB President Christine Lagarde underscored that the ECB stood ready to adjust monetary policy if the energy shocks on inflation worsened. At present, financial markets priced in two 25-basis-point hikes by the ECB in 2026.

The Bank of England (BoE) stayed put in March. The BoE's Monetary Policy Committee voted unanimously to keep Bank Rate at 3.75% in March, compared with a 5-4 split in February. The minutes suggested that policymakers had become more concerned about the inflationary impacts of higher energy prices, which would lead the BoE to shift policy stance away from its original gradual easing plan. The latest BoE staff forecasts indicated that CPI inflation would likely remain between 3%-3.5% over the next couple of quarters, compared with an orderly disinflation trend toward the 2% target in previous estimates. Overall, recent developments would leave the BoE's policy outlook contingent on the scale and duration of the energy shocks.

Inflation Rate (YoY)


Source: CEIC

Policy Rate


Source: CEIC

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