WEEKLY ANALYSIS

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WHICH EUROPEAN ASSETS TO FOCUS ON?

Recession likely in 2023. ECB rate target at 4%. Decorrelation of monetary policies. Bullish recovery of domestic yields. Appreciation of the euro. Attractive valuations of securitized real estate and equities.

Key points

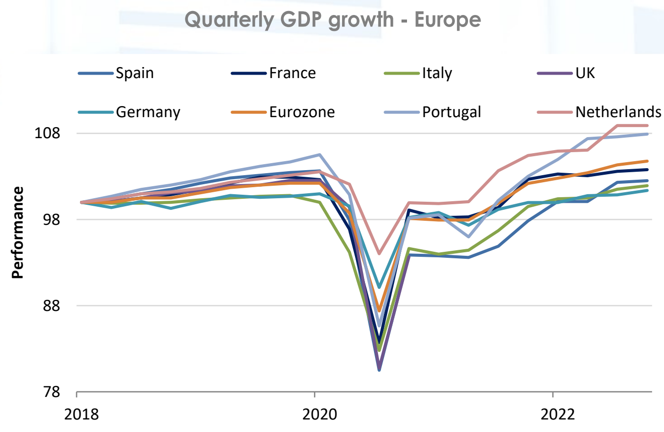
- European economy falters but still avoids a recession in Q4 2022
- Limited economic contraction in the first half of the year
- Leading indicators supported by services
- European households remain worried
- The services sector is holding back a net decline in inflation
- European trade deficit shrinks
- ECB reassures and raises key rates
- Euro bond yields decorrelated
- Euro likely to appreciate
- Real estate unfairly penalized by the banking crisis
- European equities resist uncertainty

European economy falters but still avoids a recession in Q4 2022

For several months now, economic forecasts have been pointing to a clear slowdown in activity in the euro zone, which would necessarily be followed by negative growth and a recession. It has to be said that the eurozone economy still belied these expectations in the last quarter of 2022. However, it did not take much for the end of the year to be marked by a decline in the economy. Indeed, GDP only barely avoided contracting at the end of December, thanks in particular to government spending up by 0.7% and more positive foreign trade results thanks to a -1.9% drop in imports. However, consumer spending, which fell by -0.9%, did suffer the predicted decline linked to the fall in real household purchasing power, which was also accompanied by a decrease in investment spending (-3.65%). The stagnation of GDP (0%) during the quarter still suggests the possibility of a future recession with reduced effects. The resilience of the European economy, in the current context of a serious decline in real purchasing power caused by rising inflation, remains surprising. The European economy is staggering under the weight of the -0.4% loss in value of its main economy. Germany recorded the most disappointing national performance of the major Eurozone member countries. Germany, in particular, suffered from a larger decline in private consumption (-1%) and investment (-2.5), while public spending supported domestic demand with an increase of +0.6%. France's ended the quarter with a modest increase (+0.1%) with a result close to Spain (+0.2%), Italy (-0.1%) and Portugal (+0.3%). Among the main countries of the Eurozone, the Netherlands recorded a significant higher dynamic thanks to an advance of +0.6%. The economic result of the European Union was slightly worse, with a drop of -0.1% in GDP.

Limited economic contraction in the first half of the year

The economic surprises were therefore rather positive during the last quarter and the beginning of the year did not cause any significant reversal of the situation. The growth outlook for the year as a whole therefore looks slightly less pessimistic (+0.5%), while the 12-month recession risks have decreased to only a 50% probability. Expectations for Q1 2023 suggest a limited contraction of -0.1% followed by a second quarter decline of -0.2%.



Sources: Bloomberg, BBGI Group SA

The euro zone should therefore enter a recession in the first half of the year without suffering a severe contraction of its GDP.

The ECB maintains its more optimistic forecasts for the evolution of the GDP and maintains its objective of +1% growth in the euro zone for the whole year and +0.1% in the first quarter. The +0.7% increase in consumer spending will be the main support for this growth according to the ECB.

Industrial production in the euro zone surprised favorably in January with a rebound of +0.7% after a weak December. However, the still volatile monthly data does not allow for the detection of a real positive trend, but the sector is still showing resilience that could contribute positively to the overall result for the quarter. The rebound in activity in Germany of +1.8% contrasted with declines in production in France (-1.9%), Spain (-0.9%), Italy (-0.7%) and the Netherlands (-4.3%). The next few months could be supported by the recovery in China and lower energy prices.

Leading indicators supported by services

In contrast to the slightly more positive developments in the industrial sector in Europe, the manufacturing PMIs are still showing signs of weakening momentum ahead. The leading manufacturing PMI indicators for the Eurozone have indeed fallen again to 48.5, still below the growth threshold, after a few months of stabilization. Despite a slight recovery between October 2022 and January 2023, this new decline still suggests a difficult situation for the manufacturing sector, which has been suffering for almost nine months now. The trend is clearly more favourable in the services sector, with the PMI asserting itself a little more strongly in March and moving more seriously into the growth zone from 52.5 to 55.6. The composite PMI thus advances a little more from 52 to 54.1 clearly in the growth zone at the end of March.

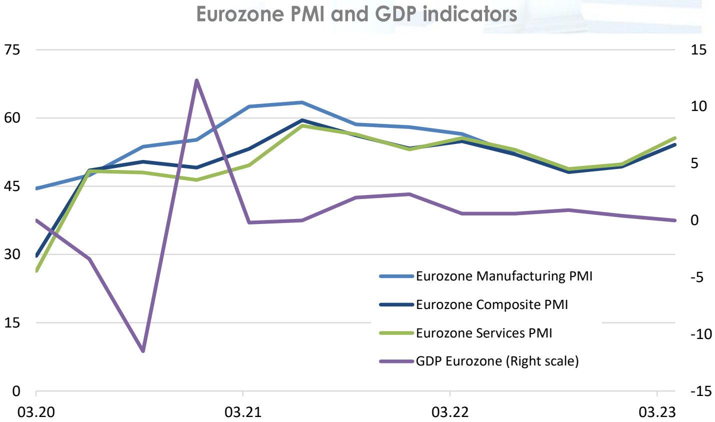
The positive trend in the services PMI suggests that the eurozone economy is resisting the effects of inflation and rising interest rates at the beginning of the year. On a regional level, France also seems to be doing better than Germany. General sentiment has improved with the sharp reduction in energy supply risks, with the worst case scenario envisaged for the current winter after the start of Russian intervention in Ukraine now averted. The decline in inflationary pressures, although still limited, is also contributing to this development. There have also been significant improvements in delivery times affecting supply chains.

European households remain worried

Household confidence for the month of March shows no tangible signs of improvement after the recovery seen since September. The European Commission's indicator is still particularly gloomy (-19), although it has clearly recovered from its September low (28.7). The main concern remains the evolution of prices and in particular energy costs, which are having a dramatic impact on household purchasing power. Households are still concerned about the CPI despite the beginning of a significant deceleration. After a significant contribution to the positive evolution of GDP in Q3, consumers seemed more concerned at the end of 2022, and at the beginning of this year, retail sales have notably slipped by -2.3% in January over one year despite a slight increase of +0.3% over the month in the euro zone. Nevertheless, consumer expectations for inflation in the medium term (3 years) have dropped from +3% to +2.5%. Beyond consumers, these concerns are also shared in economic circles. The Sentix index measuring confidence in both industry and services also marks a pause in its recent less pessimistic adjustment phase. These persistently low confidence levels are likely to influence economic performance in the coming months and also suggest a very uncertain economic environment in early 2023.

The services sector is holding back a net decline in inflation

The energy segment has made a clear contribution to the decline in inflation in Europe over the past several months, with a negative contribution and a significant drop in weight. This is also the case, to a lesser extent, for the food component, which is stabilizing but remains the main component of the overall price increase. The CPI benefited from several monthly declines in inflation between October and January before being hit by the +0.8% rebound in prices in February. The trend remains encouraging on a year-on-year basis, with inflation expected to slip below +8% soon. However, domestic factors remain tense and are holding back a sharper decline in inflation, which, excluding food and energy, is still rising and reached +5.6% on an annual basis at the end of February. Headline inflation in the euro zone is still far from easing enough to change the ECB's monetary policy. However, it seems to be pointing in a sufficiently favorable direction to allow for a slight improvement in household confidence. Moreover, the -2.8% drop in producer prices in January is a positive factor that could have a positive impact on the level of consumer prices. After having literally exploded by +43.2% in August 2022, the current level of +15% is already a convincing element.



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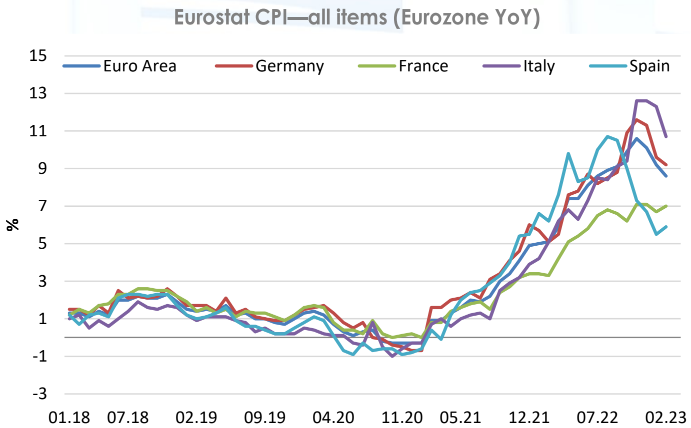


Sources: Bloomberg, BBGI Group SA

European trade deficit shrinks

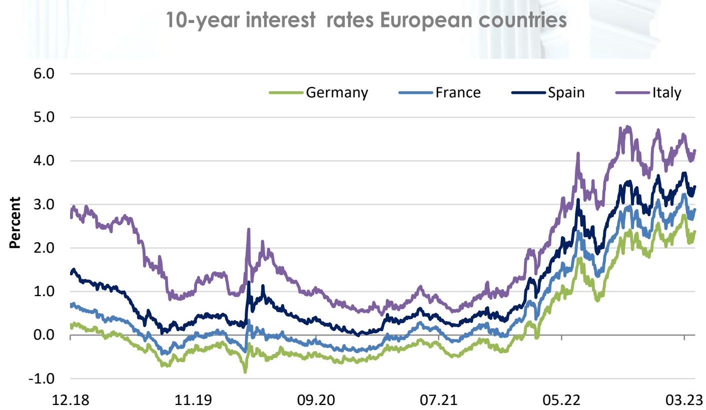
According to Eurostat, the European Union's seasonally adjusted trade balance improved slightly in January, with the adjusted deficit falling from 19.3 billion in December to 14 billion in January. The breakdown by country still shows a German surplus of 15.4 billion representing the bulk of the positive components. Italy also contributed positively with a surplus of 3.9 billion, followed by Denmark (1.9 bn) and Sweden (1.8 bn). The Netherlands was the largest national deficit with a result of 19.1 bn. The EU recorded surpluses with the United Kingdom (9.2 bn), the United States (6.7 bn) and Switzerland (4.2 bn), and large deficits with China (29.9 bn), Norway (7.9 bn) and Russia (5.2 bn), mainly due to energy imports. In February, Germany saw its exports to other countries outside the EU increase by 6.1% year-on-year, with a sharp rise to the United States (+19.4%), while those to China fell by -12.4%. The recovery of exports to emerging countries was also one of the highlights of this period, which saw a clear recovery in the direction of Turkey (+37.9%), Brazil (+33.8%) and India (+20.3%) at the expense of exports to Russia, which fell by -60.1%. The +2.1% increase in exports in February and a -3.4% contraction in imports should also benefit the gradual improvement of German and EU foreign trade.

ECB reassures and raises key rates

The ECB raised its key interest rates again in March, noting, among other things, that the inflation outlook was still too high and that the expected decline was indeed taking place, but at an insufficient pace. It also stressed that the high degree of uncertainty required a flexible policy linked to the constant evolution of available data. In other words, the ECB confirms that it will make assessments of the inflation outlook, taking into account a broad spectrum of economic and financial information to adjust its policy. This rate hike came in the midst of a period of doubt about the stability of the financial system that has not spared Europe. The Governing Council reassured that it was monitoring the situation very closely and that it stands ready to take the necessary measures to safeguard both price and financial stability in the euro area. The ECB views this crisis as serious but not systemic. The ECB expects the economy to strengthen with a recovery in industrial production supported by improved supply conditions and a recovery in confidence. Rising wages and falling energy prices should partially offset the loss of purchasing power, thereby supporting consumption. The last rate hike of 0.5% brought policy rates to 3.5%, but it seems that the final target of 4% is still far from the rate that will mark the end of the current monetary tightening cycle. The inflation forecast for 2023, which is well above this level, should be puzzling. The ECB is behind the inflation cycle and despite its more assertive rhetoric, we believe it will have to adjust its policy rate level several more times before it actually has a sufficient impact on prices. Despite the recent change in the expected rate projection for December, we believe that the ECB will make two or three more rate hikes.

Euro bond yields decorrelated

With the end of the restrictive monetary policy in the United States in sight, the next moderate rate hikes by the ECB should reduce the rate differential currently very favorable to dollar investments. The yield spread in the major capital markets between dollar and euro yields should follow the same path. U.S. Treasury yields have a good chance of stabilizing around the current 3.5% level before a further decline, probably driven by lower inflation, materializes. In Europe, German government yields are still below 2.5% for an inflation level that is much higher than in the US. In recent months, the international bond markets have remained relatively correlated, but we now believe that this correlation is likely to decrease significantly. We have certainly already seen the peak of the US rate cycle a few months ago, while the top of the euro yields is still ahead of us. The next few weeks will see a return of decorrelation between some capital markets and the US market. Ten-year German Bund yields were rising to new highs in early March prior to the banking crisis before taking advantage of an investor rush to safe havens. But with the crisis behind us, we believe that euro yields will start to rise again quickly. An increase of 100 basis points is not excluded on all maturities, while the yield curve is practically flat between the two-year and ten-year maturities. The European capital market presents greater opportunities and risks, and in the above-mentioned context any risk of a rise in market yields may have different consequences depending on the quality of national debtors. This is no longer the time for yield pick-up strategies, but for managing the risk of capital losses.



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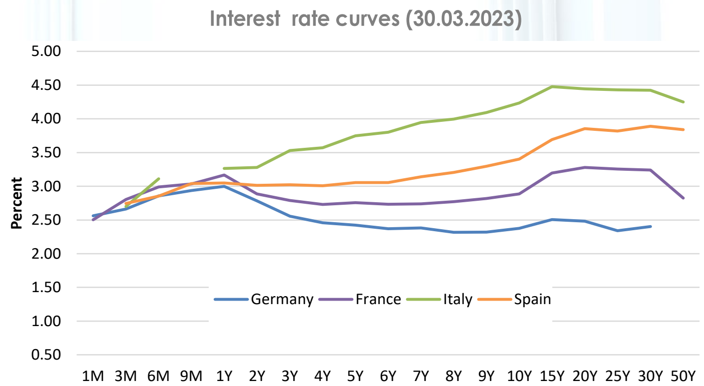
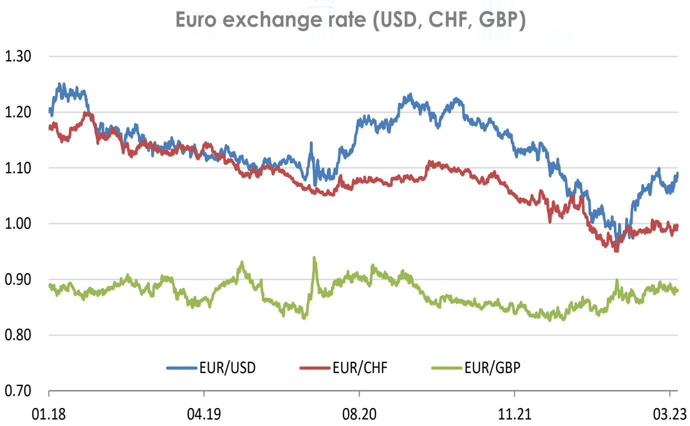


Sources: Bloomberg, BBGI Group SA

Euro likely to appreciate

The next evolution of European monetary policy will certainly be the most restrictive of the major central banks. Market expectations for the level of policy rates marking the end of the current monetary tightening cycle will continue to evolve in the coming months, but our six-month expectations are now 4.75% in the US (currently 5%) implying a 0.25% cut in Fed Funds in September. In the Eurozone, the ECB raised its main policy rate by 0.5% to 3.5%. The markets are now anticipating three more 0.25% hikes during the May, June and September meetings. We are concerned that the expected path of inflation in Europe will continue to disappoint and justify higher yields for longer. In the short term, the euro capital markets will logically have to adjust to the rise in short-term rates by a gradual increase in yields across all maturities. This adjustment phase should therefore reduce the yield spread that is currently less favorable to euro investments. This environment should support an appreciation of the euro for a few months. Our outlook for the next quarter is favorable for the European currency against the dollar, the Swiss franc and the yen.



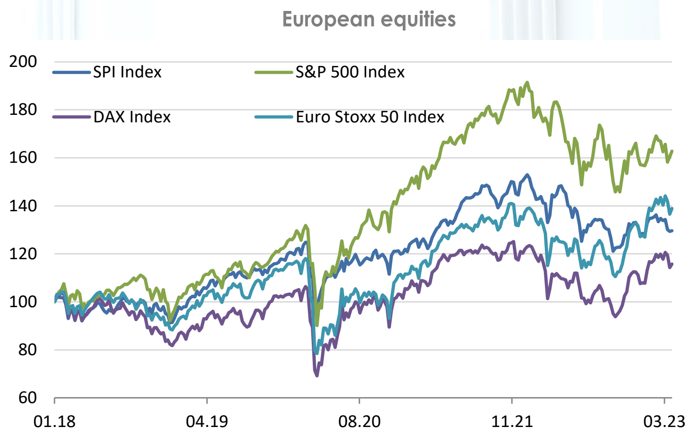
Sources: Bloomberg, BBGI Group SA

Real estate unfairly penalized by the banking crisis

Securitized real estate in Europe is still suffering from the effects of interest rate tensions and access to credit. The risks of instability in the financial system caused by the bankruptcy of the SVB have once again created uncertainty that is damaging to the valuation of securitized real estate investments. The EPRA Nareit index has fallen by -25% in two months, losing all the gains made since September 2022. The index is back to its lowest level, down -50% since August 2021. Increased uncertainty in Europe has logically affected risky assets, but in the case of European real estate, the valuation of certain companies is already, in our view, taking into account a decline in asset holdings as well as an increase in financing costs. At less than 50% of book value, some stocks present exceptional opportunities despite the context of rising financing costs. The European real estate market now offers unique investment opportunities.

European equities resist uncertainty

The banking crisis of the last few weeks, which had also affected European indices and in particular its banking sector, seems to have been fully digested by investors who are still convinced by the positive fundamentals of European stocks. The rebound of the Stoxx 50 index has allowed it to regain its previous peak of early March, while the banking sector is still far behind (-14%), despite a significant rebound of +10% from its low point of March 20. European stocks still have a significant discount to US stocks. The valuation of 12.3x earnings for 2023 is thus lower than the S&P500's PE of 18.5x. They also look attractive compared to Japanese stocks (16.5x) and are on par with Chinese stocks (12.1x). The average dividend yield in Europe (3.25%) is also attractive and far exceeds that of the US (1.7%) and Japan (2%) in particular. Thus, despite a +7% outperformance since the beginning of the year, European equities still deserve to be favored in the perspective of 2023, unless the next ECB rate hikes end up disrupting investors' appreciation of risks and opportunities.



Sources: Bloomberg, BBGI Group SA

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