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WEEKLY ANALYSIS

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FAVOR REAL ESTATE AND EQUITIES OVER EUROPEAN BONDS

Limited recession in 2023. Inflation surprises the ECB. End of restrictive cycle closer to 5%. Rising yield curves. Appreciation of the euro. Attractive valuations for securitized real estate and European equities.

Key points

- The European economy is still at a standstill
- The 2nd quarter is likely to remain very weak
- Leading indicators show further declines
- European households less worried than manufacturers
- Falling inflation exceeds ECB expectations
- The ECB is set to raise its key rates to 5%
- Bond yields have yet to adjust
- Euro supported by interest-rate differentials
- Securitized real estate penalized by extreme pessimism
- European equities benefit from higher PEs and returns

The European economy is still at a standstill

The eurozone's GDP trend is resisting the headwinds, recording a modest contraction of -0.1% in Q1 2023. For several quarters now, economists have been predicting a recession in the eurozone, which has yet to materialize. The slowdown in eurozone activity is clear, but the economy's performance is not deteriorating as much as the consensus had predicted. It has to be said that the eurozone economy has once again beaten these negative expectations by recording another quarter of GDP stagnation rather than a collapse in economic momentum. The economy's overall resilience seems largely due to the +1.6% growth in government spending and capital goods investment (+0.6%), while household consumption slipped by -0.3%. The difficulties encountered by households are therefore very real, although the contraction in spending is lower than the previous quarter's -0.9%.

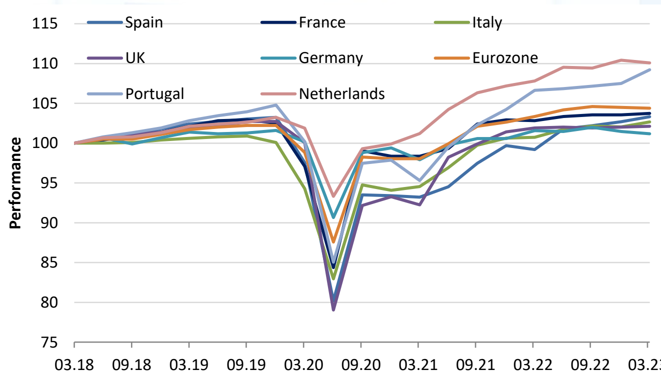
Exports contracted very slightly by -0.1%, while imports fell by -1.3%. This stagnation of GDP in the Eurozone is relatively similar to that of the European Union as a whole, which recorded a +0.1% increase in activity. The resilience of the European economy, in the current context of a serious decline in real purchasing power caused by rising inflation, remains surprising. The European economy, however, is staggering under the weight of the -0.3% loss in value, following a -0.4% fall in GDP in its now in technical recession.

Germany once again recorded the most disappointing national performance of the eurozone's main member countries. Italy (+0.6%), Belgium (+0.5%), Spain (+0.5%), France (+0.2%) and above all Portugal (+1.6%) ended the quarter with growth, while the Netherlands (-0.7%) and Germany (-0.3%) made a negative contribution to overall growth.

The 2nd quarter is likely to remain very weak

The eurozone economy is unlikely to record significant growth in Q2, and may even stall again. We expect GDP to remain very slightly up at +0.1%, thus avoiding another technical recession. Economic surprises have continued to be negative in recent months, limiting growth prospects. Q2 performance could just be sustained by further public spending.

Quarterly GDP growth - Europe



Sources: Bloomberg, BBGI Group SA

In contrast to our outlook for stagnation in the European economy in the 1st half, which is likely to weigh on the full-year result, the ECB's adjusted forecasts look more optimistic. The institution still estimates that for the year as a whole, GDP growth could approach +1%, without government support, with public spending forecast to grow by 0% in 2023. However, we expect government spending to increase, but this will certainly be offset by a reduction in household spending. The service sector will undoubtedly be hardest hit by the loss of household purchasing power.

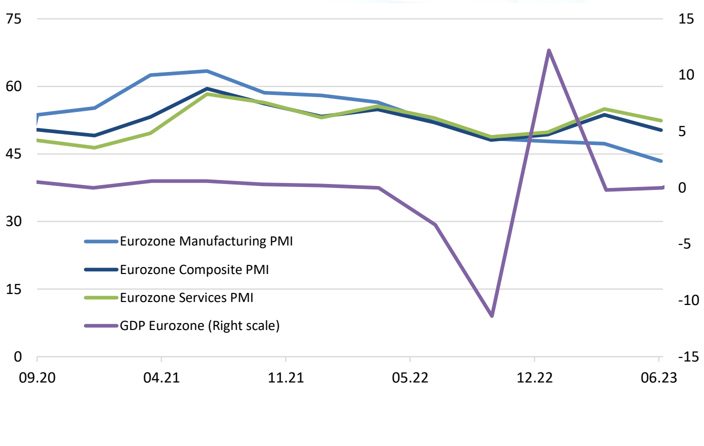
Industrial production in the eurozone was again highly volatile in Q2, with a low point of -1.4% in March and a very slight rise of +0.2% in April. These fluctuating monthly figures do not yet point to any real positive trend, but the sector did show resilience in April, which could make a positive contribution to the overall result for the quarter if May and June pick up again. It should be noted, however, that the bulk of this slight rebound in April was due to the positive results of France (+0.8%) and Ireland (+21.5%), while the other countries recorded declines in production.

Leading indicators show further declines

The latest releases of PMI leading indicators for June failed to live up to economists' expectations, and clearly suggest a probable slowdown in the manufacturing sector and reduced momentum in services. In one month, the composite indicator fell from 52.8 to 50.3, just above the growth threshold. This result was largely driven by the Services segment, which nonetheless struggled to cope with the various pressures in June, slipping from 55.1 to 52.4.

The leading manufacturing PMI indicators for the eurozone continue to decline in the contraction zone, falling in June from 44.8 to 43.6. They are approaching their lowest levels reached at the height of the pandemic in the 1st half of 2020. The trend in the PMIs suggests that the eurozone economy will find it difficult to record growth in Q2 and the following months, as it continues to be affected by the higher level of interest rates and financing. Trends in the main parameters used to assess credit conditions also suggest that they will deteriorate in Q2 for both households and businesses, thereby increasing the risk of a weakening in the economy and consumption.

Eurozone PMI and GDP indicators



Sources: Bloomberg, BBGI Group SA

European households less worried than manufacturers

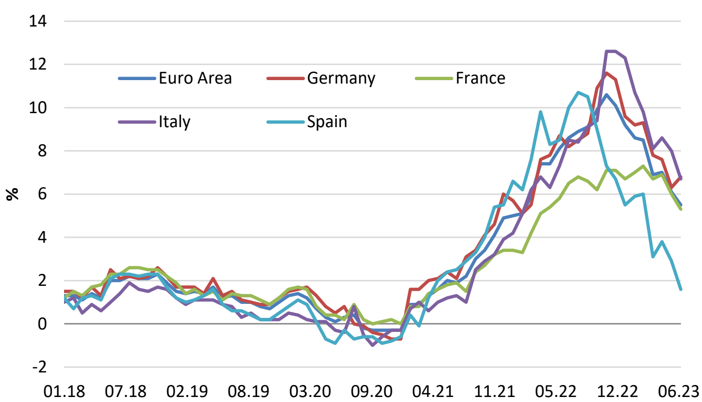
Household confidence for the month of June is advancing and improving slightly, despite rising financing costs and declining purchasing power. The European Commission's indicator remains gloomy, however, with a reading of -16.1, although it has clearly recovered from its September low of -28.7. The main concern remains price trends, which are having a dramatic impact on household purchasing power. The latter are still worried about CPI trends, despite a marked decline in this measure over the past few months and the peak reached in October 2022. On the contrary, indices measuring confidence in both industry and services continued to decline in June, sliding to their lowest level since October 2021. These persistently lacklustre levels of confidence are likely to influence economic performance in the quarter just ended and over the coming months, suggesting that economic conditions will remain very weak as we enter the second half of the year.

Falling inflation exceeds ECB expectations

Eurozone inflation surprised observers by continuing to decline in June, coming in at +5.5% year-on-year, down significantly on May's +6.1%, thanks to a reduced increase of +0.3% month-on-month. It is now well below the maximum level of +10.7% reached in October 2022. After eight months of declining prices, inflation remains a key concern for households, but it may already be declining enough to help reduce household uncertainty. This June is notably due to a positive base effect linked to the sharp rise in energy and food prices recorded in June 2022, which was not repeated in June 2023. The energy/food segment has made a clear contribution to the fall in inflation in Europe over the last few months, with a negative contribution and a significantly lower weighting. The index excluding food and energy does not follow quite the same trend, but also surprises favorably with an increase limited to +5.4% year-on-year thanks to a virtual stagnation of +0.1% month-on-month.

In addition, producer prices are still down -3.2% according to the latest published measurement, and are now also well below their 2022 highs. This trend is already having a positive impact on consumer prices, and will have a further positive impact on CPI over the coming months. Inflation has now already reached the ECB's target of +5.4% for the year as a whole, suggesting that prices are now falling faster than the ECB had expected.

Eurostat CPI—all items (Eurozone YoY)



Sources: Bloomberg, BBGI Group SA

The ECB is set to raise its key rates to 5%.

Despite inflation falling to +5.4% year-on-year in June, and the ECB's estimate of +5.4% for 2023 as a whole, the ECB doesn't seem ready to consider this result better than it had hoped. The institution is not changing course and still wants to show its determination to fight inflation in order to lower price trends to +2%. With this in mind, the ECB once again raised its key rates in June by 0.25%, noting in particular that the inflation outlook was still too high and that the expected decline was indeed materializing, although at an insufficient pace. She also stressed that the high degree of uncertainty called for a flexible policy linked to the constant evolution of available data. In other words, the ECB confirms that it will assess the inflation outlook, taking into account a broad spectrum of economic and financial information in order to adjust its policy. Key rates are now at 4%, but still well below annual inflation.

Despite expectations of one or two further hikes, the consensus today is for a limited increase, which could already reach a monetary tightening cycle peak of around 4.5%. However, we consider this unlikely, unless the CPI accelerates sharply downwards over the summer. In our view, the peak of the cycle should be closer to 5% at the end of the year, before the European Central Bank decides on a pause phase. Christine Lagarde, President of the ECB, has reiterated the objective of bringing inflation back to 2%, which in our view cannot be achieved by a premature pause in key rates at 4.5%. The ECB must also take account of different national trends, and in particular the persistent tensions of higher inflation in Germany. Consequently, we believe that the risks of further monetary tightening in the eurozone are being underestimated by investors. The ECB is lagging behind the inflation cycle overall, and despite its more assertive rhetoric, we believe it will have to adjust its key rates several more times before it actually has enough impact on prices to achieve its objective. Despite the recent change in the expected projection of these rates, we believe that the ECB will raise its key rates three more times.

Euro bond yields have yet to adjust

Interest rate decorrelation between European and US bond markets is set to intensify over the coming months. While monetary policy is in a pause phase in the USA, and key rates (5.75%) are above inflation (3.9%), in Europe, ECB rates (4%) are still much lower, and should still rise above 5.5% to be above inflation rates.

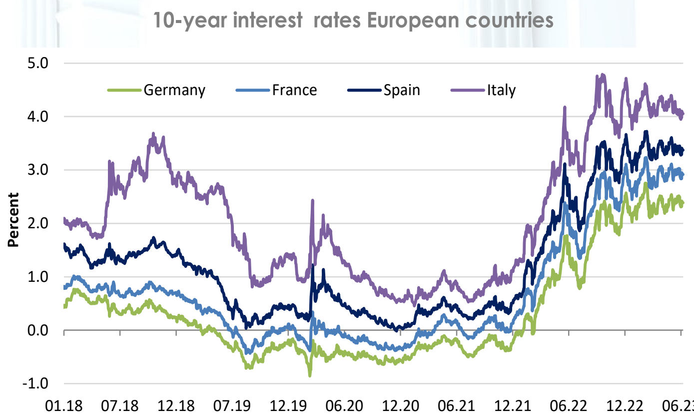
Medium-term US government bond yields (4.1%) are also higher than the current level of US inflation. In Europe, five-year government yields are just 2.6%, almost 300 basis points below the CPI index of +5.4%. In this context, it seems extremely unlikely to us that European bond yields will stabilize at these levels in the immediate future. Ten-year German government yields (+2.4) need to tighten significantly simply to close the gap with the inflation rate, especially as German inflation is still at +6.8%.

Since October 2022, German government ten-year yields have stabilized at just below 2.5%, after rising 300 basis points since the nadirs of 2021 at -0.5%. In our view, this level of yield is clearly insufficient in view of inflation, and corresponds to a negative real yield of -1.4% in the short term and -3% on ten-year yields.

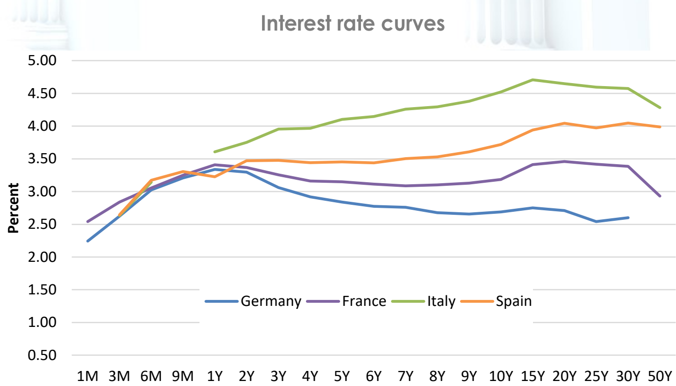
We believe that investors should therefore demand a less negative or even positive real return, which would imply that euro yields should soon resume their upward trend. In this context, an increase of one hundred basis points cannot be excluded on all German government maturities, while the yield curve is practically flat between two-year and ten-year maturities.

The European capital market is highly risky, and in the context described above, any risk of a rise in market yields may have different consequences depending on the quality of national debtors, but the upward trend is shared by all. Italian (3.9%), Spanish (3.2%), Portuguese (2.9%) and Greek (3.5%) government bonds, for example, will not be spared from the expected adjustment, despite their higher yields.

Now is not the time for yield pick-up strategies, but for managing the risk of capital losses.



Sources: Bloomberg, BBGI Group SA



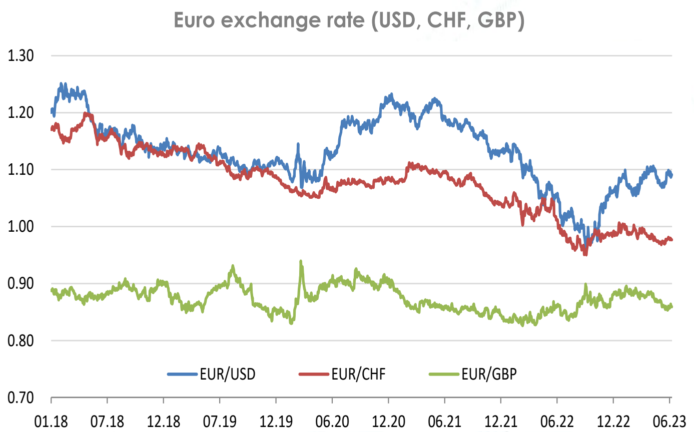
Sources: Bloomberg, BBGI Group SA

European currency supported by interest rate differentials

Since the pause in US monetary policy in June and the reduction in SNB rate hike increments, the US and Swiss monetary policy cycles are no longer in phase with the expected evolution of ECB policy.

European monetary policy will continue to tighten by raising key interest rates for longer. Over the coming months, the ECB will certainly be one of the most restrictive of the major central banks. Market expectations for the level of key rates marking the end of the current monetary tightening cycle will continue to evolve over the coming months, but our six-month expectations seem to favor a widening of the yield spread with Swiss and Japanese rates in favor of the euro, as well as a narrowing of it with dollar rates, which will also potentially support an appreciation of the European currency against these three currencies.

For the next few months, this environment should support a euro appreciation of around +5% against the dollar and franc. Our outlook for the next quarter is therefore favorable for the European currency.



Sources: Bloomberg, BBGI Group SA

Securitized real estate penalized by extreme pessimism

Securitized real estate in Europe is still suffering from the effects of inflation, the ECB's restrictive monetary policy and interest-rate pressures over the past twenty-four months. The risks of instability in the financial system caused by the SVB's bankruptcy have once again created uncertainty, damaging the valuation of securitized real estate investments by making access to credit more difficult.

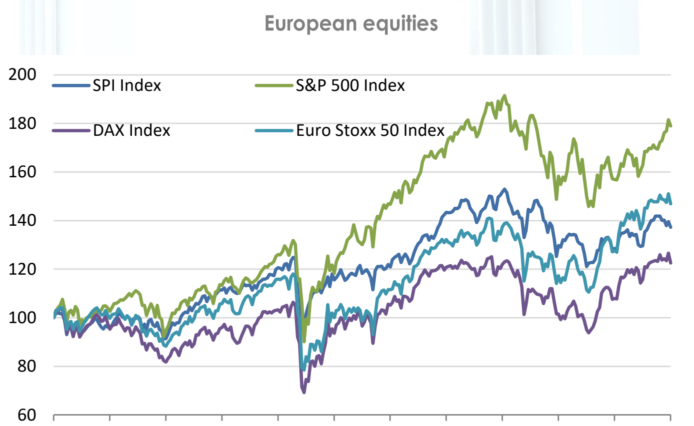
The EPRA Nareit index is struggling to stabilize after falling -25% between February and March, and is still close to its lowest level, down -50% since August 2021. In our view, the collapse in listed European real estate prices is clearly excessive, even in the context of the continued rise in interest rates mentioned above. At less than 50% of their book value, some properties have already taken these risks into account, even though their financing and rental income are not really threatened.

We therefore believe that the European real estate market offers rare investment opportunities.

European equities benefit from higher PEs and returns

Unlike listed real estate assets, which are still being penalized by rising interest rates, European equity markets are not worried about changes in financing costs and the discounting of future income. Nor are they worried about the real risk of an economic slowdown threatening the eurozone, and they seem rather convinced and enthusiastic about the valuation differential still very favorable to European equities. The banking crisis has only temporarily affected investor confidence, which has since pushed the Euro Stoxx 50 index upwards, enabling it to return to its November 2021 peak with a gain of almost +16% since the start of the year. Despite this progress, European stocks are still at a significant discount to US stocks. The valuation of 12.4x earnings for 2023 is thus lower than the S&P500's PE of 20.4x.They also look attractive relative to Japanese (19.2x) and Swiss (17.2x) equities, and are on a par with Chinese stocks (11.9x). The average dividend yield in Europe (3.4%) is also attractive, well above that of the United States (1.5%) and Japan (1.8%) in particular.

Despite a slight year-to-date outperformance of two percent versus the S&P500, European equities still deserve to be favored in the 2023-2024 outlook, unless the ECB's next rate hikes end up disrupting investors' appreciation of risks and opportunities.



Sources: Bloomberg, BBGI Group SA

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