Weekly Analysis

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EUROPEAN EQUITIES RECOVER AFTER EIGHT MONTHS OF CONSOLIDATION

Risks of recession loom large. Inflation falling too slowly. Key rates towards 5%. Rising yield curves. Appreciation of the euro. Attractive valuations for securitized real estate and European equities.

Key points

- Eurozone economy avoids recession with +0.1% growth in Q2
- Further stagnation in quarterly GDP in Q3 and Q4
- Leading indicators point to recession
- Confidence indices fall again
- Falling inflation still insufficient for ECB
- ECB to raise key interest rates to 5%
- Economic slowdown will not prevent euro bond yields from rising
- Decoupling of monetary policies in favor of the euro
- Ongoing revaluation of securitized real estate
- Equities rise again after 8 months of consolidation

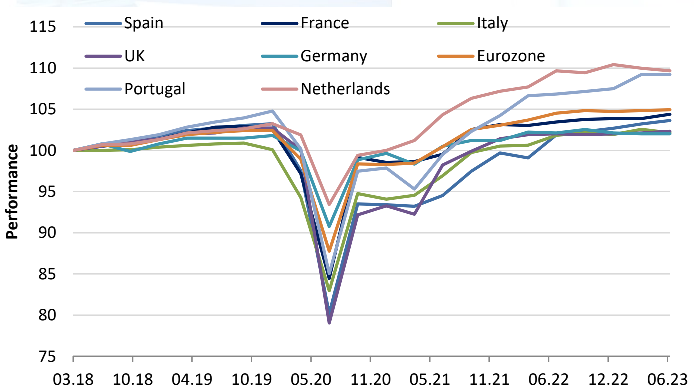
Eurozone economy avoids recession with +0.1% growth in Q2

Eurozone GDP growth in Q2 was exactly in line with our forecast of a barely positive +0.1%. However, this was significantly weaker than the consensus forecast of +0.3%. We were predicting a very weak Q2, but it's interesting to note that even modest momentum is resisting headwinds. After several quarters of negative expectations from economists predicting a recession in the eurozone, their recent optimism has once again proved excessive. The slowdown in activity in the eurozone is clear, but the economy's performance is slowly deteriorating. It has to be said that the eurozone economy has once again thwarted negative expectations, recording another quarter of relative GDP stagnation rather than a collapse in economic momentum. Overall, there was very little activity in any of the GDP components, with household consumption recording a result of 0% and +0.2% year-on-year, government spending also stagnating and rising by just +0.2% year-on-year, and the only notable increase coming from capital goods investment, which rose by +0.3% for a result of just +1.1% year-on-year. The only notable increase came from capital goods investment, which rose by +0.3%, for a result of just +1.1% year-on-year. Eurozone GDP advanced by +0.5% year-on-year. The -0.7% drop in exports over the quarter weighed on the overall result and is a cause for concern. The difficulties encountered by households are therefore very real, even though the evolution of their spending has simply stagnated. Contrary to expectations, it is not the situation in Germany, the eurozone's leading country, that is at the root of this economic stagnation.

Germany's economic momentum (0%) was nil, and it was rather the negative contributions of Holland (-0.3%), Italy (-0.4%) and Austria (-0.7%) that dragged down the Eurozone's performance, while France (+0.5%) and Spain (+0.4%) managed to record increases in their national GDPs. This stagnation in Eurozone GDP is relatively similar to that of the European Union as a whole, where aggregate GDP was perfectly stable.

The resilience of the European economy remains surprising. In the current context, serious declines in real purchasing power are being caused by rising inflation. The European economy is faltering and approaching a new danger zone in the second half of the year. We believe that rising interest rates and financing costs are only just beginning to affect consumption and investment.

Quarterly GDP growth — Europe



Source: Bloomberg, BBGI Group SA

Further stagnation in quarterly GDP in Q3 and Q4

Eurozone aggregate GDP growth is likely to be 0% at best in Q3 and Q4. In this event, annual growth should hardly rise above +0.5%. Our forecast today is scarcely different from that at the start of the year, and we still believe that the eurozone will barely avoid a recession, ending the year with weak GDP growth of +0.3% to +0.4%. In contrast to our outlook for stagnation in the European economy over the coming months, which is likely to weigh on the full-year result, the ECB's adjusted forecasts seem more optimistic and certainly subject to disappointment. The ECB still believes that GDP growth for the year as a whole could be close to +0.7%, after long believing that an increase of +1% was likely. Without government support, this growth forecast will struggle to materialize. However, even if a slight increase were possible, we believe it would certainly be offset by a fall in household spending. The services sector will undoubtedly be more affected by the loss of household purchasing power.

In the short term, we are already seeing a further decline in industrial production in the eurozone of -1.1% in July, following a slight upturn in April and June. Monthly data remain volatile and do not yet reveal any real trend, but the upturn will have been short-lived. Another very weak start to the quarter suggests that the manufacturing sector remains fragile and could yet weigh on eurozone GDP. The same trends can be seen at the start of Q3 as in the Q2 national GDP data, with German and Italian industrial output weakening, while that of France and Spain is rising.

Leading indicators point to recession

The latest releases of PMI leading indicators for August failed to live up to economists' expectations, and clearly suggest a probable slowdown in the manufacturing sector and reduced momentum in services. The composite indicator fell in one month from 47 to 46.7, and has thus been above the growth threshold for several months. This result is largely underpinned by the services segment, which nonetheless struggled to withstand the various pressures in August, slipping from 48.3 to 47.9.

The leading manufacturing PMI indicator for the eurozone continues its decline in the contraction zone, falling in August from 43.7 to 43.5. He approach his more low level reached at the deeper pandemic of the 1st half 2020. The trend in the PMIs suggests that the eurozone economy will find it difficult to record growth in the 3rd quarter and subsequent months, as it continues to be affected by higher interest rates and credit costs. Trends in the main parameters used to assess credit conditions also suggest that they are deteriorating for both households and businesses, thus increasing the risk of a weakening in the economy and consumption.

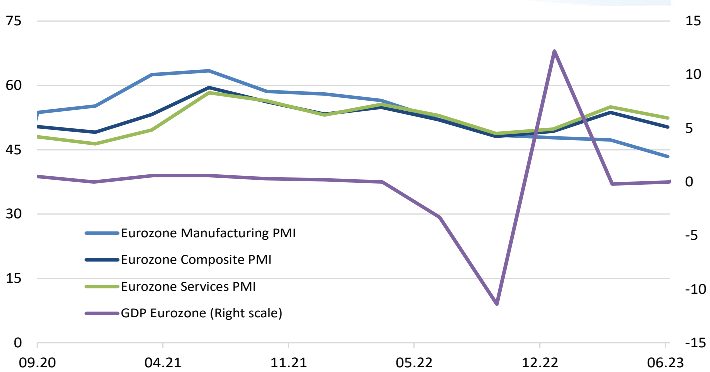
Confidence indices fall again

Household confidence for August was relatively unchanged, stabilizing after nine months of improvement, despite rising financing costs and declining purchasing power. The European Commission's indicator remains gloomy, however, with a reading of -16.0, albeit a marked recovery from September's low of -28.7. The main concern remains price trends, which are having a dramatic impact on household purchasing power. Households are still concerned about CPI trends, despite a marked decline in this measure since its peak in October 2022. Confidence indices for both industry and services sank further into negative territory. On the contrary, they continued their decline in June, sliding to their lowest level since August 2020 for the former and May 2021 for services. These persistently low levels of confidence are likely to influence economic performance in the 3rd and 4th quarters.

Falling inflation still insufficient for ECB

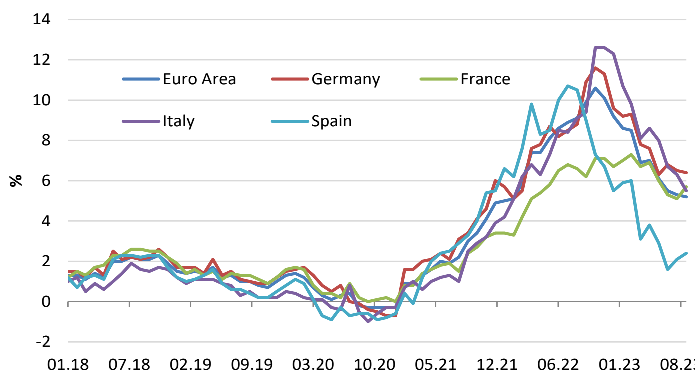
Eurozone inflation rebounded by +0.6% in August, thus halting the downward trend observed in recent months. On an annual basis, the decline in inflation is still very encouraging, despite stabilizing at +5.3% in August. It is now well below the peak level of +10.7% reached in October 2022. After ten months of declining prices, inflation is still logically a key concern for households, but it may already be declining sufficiently to help reduce their uncertainty. The energy/food segment had initially made a marked contribution to the volatility of the CPI index, and has also recently contributed to the decline in inflation measured by the overall index. The index excluding food and energy now registers an identical rise of +5.3%, and appears to be in a trend-lowering phase.

Eurozone PMI and GDP indicators



Source: Bloomberg, BBGI Group SA

Eurostat CPI — All items (Eurozone YoY)



Source: Bloomberg, BBGI Group SA

On the producer price front, the situation has improved considerably, with a final decline of -0.5% in August confirming the downward trend in prices. On an annual basis, prices have even fallen by -7.6%, which should give companies some flexibility to adjust their selling prices downwards. The sharp decline in producer prices should therefore soon have a noticeable effect on consumer price indices. However, inflation in the eurozone remains too high, even if signs of a slowdown should contribute to a further decline in inflationary pressures. The ECB's inflation forecast for the year as a whole is still +5.6%. The current situation is therefore already relatively ahead of the ECB's forecast.

ECB to raise key interest rates to 5%

Despite a fall in inflation to +5.3% year-on-year in August, and an ECB estimate of +5.6% for 2023 as a whole, the ECB does not 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 and bring price trends down to +2%. With this in mind, the ECB once again raised its key rates in September for the tenth consecutive time by +0.25%, noting in particular that the inflation outlook was still too high and that the expected decline was indeed materializing, but at an insufficient pace. She 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 assess the inflation outlook by taking into account a broad spectrum of economic and financial information in order to adjust its policy.

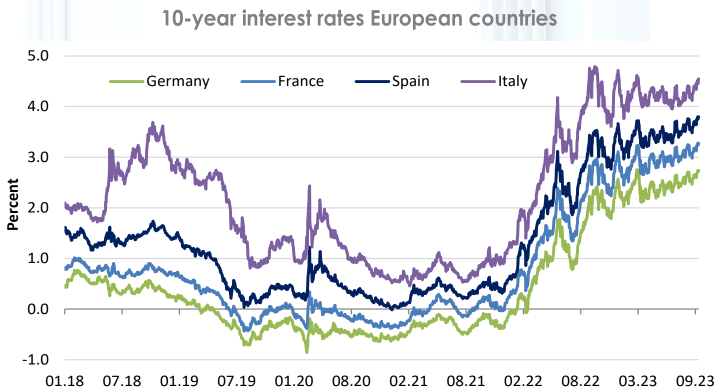
Key rates are now at 4.50%, but still well below annual inflation. Consensus still seems to be expecting the monetary tightening cycle to end soon, partly due to forecasts of an economic slowdown, whereas they were already expecting the cycle to end at around 4.5%. In our view, however, this remains unlikely, unless the CPI accelerates sharply downwards over the next few months, which we do not consider likely. 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 her 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 into account differing national trends, and in particular the persistent higher inflationary pressures 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 sufficient impact on prices to achieve its objective.

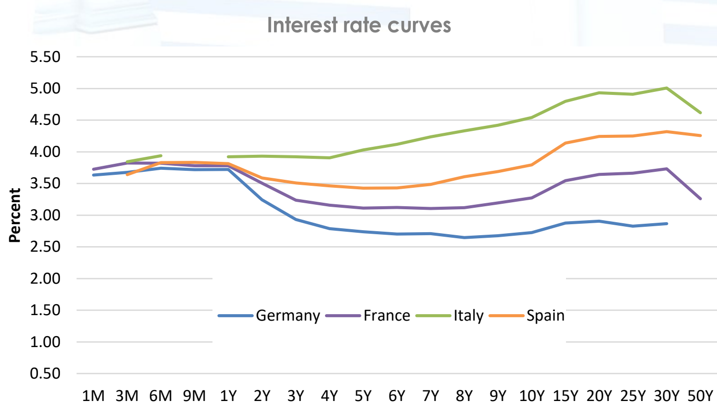
Despite the recent change in the expected projection of these rates, we believe that the ECB will proceed with two further key rate hikes while economic growth shows more significant signs of deceleration.

Economic slowdown will not prevent euro bond yields from rising

The decorrelation in interest rates between the European and US bond markets is set to intensify over the coming months. While monetary policy is in a pause phase in the US, and key rates (5.75%) are above inflation (3.7%), in Europe, ECB rates (4.5%) are still much lower, and should rise further above 5.5% to be above inflation rates. US medium-term government bond yields (4.25%) are also higher than current US inflation levels. In Europe, ten-year government yields are just 2.6%, almost 300 basis points below the CPI index of +5.6%. Against this backdrop, it seems extremely unlikely to us that European bond yields will stabilize at these levels in the immediate future. Ten-year German government yields (+2.6) need to tighten significantly simply to close the gap with the inflation rate, especially as German inflation is still at +6.1%. Since October 2022, German ten-year government 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 start to rise again. Against this backdrop, an increase of one hundred basis points is not out of the question on all German government maturities, while the yield curve is virtually flat between the two-year and ten-year maturities. Now is not the time for yield pick-up strategies, but for managing the risk of capital losses.



Source: Bloomberg, BBGI Group SA

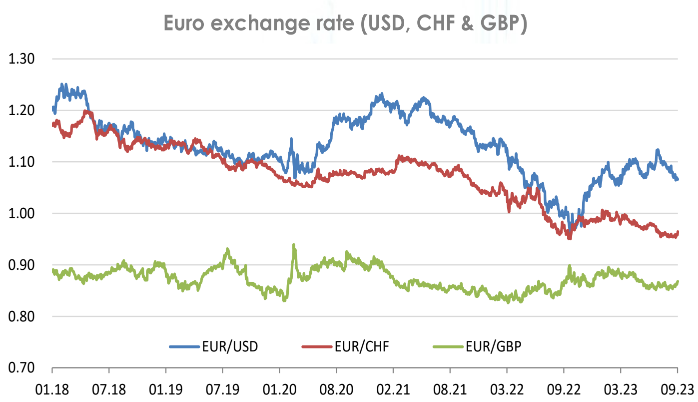


Source: Bloomberg, BBGI Group SA

The European capital market presents very significant risks which may also have major consequences for Italian (3.9%), Spanish (3.2%), Portuguese (2.9%) and Greek (3.5%) government bonds, which will not be spared by the expected adjustment, despite higher yield levels.

Decoupling of monetary policies in favor of the euro

Over the coming months, the ECB is likely to 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 next few months, but our six-month expectations seem to favour an increase in the yield spread with Swiss and Japanese rates in favour of the euro, as well as a decrease in the spread with dollar rates, which will also potentially support an appreciation of the European currency. For a few months, this environment should support a euro appreciation of around +5% against the dollar and the franc. Our outlook for the next quarter is therefore favorable for the European currency.



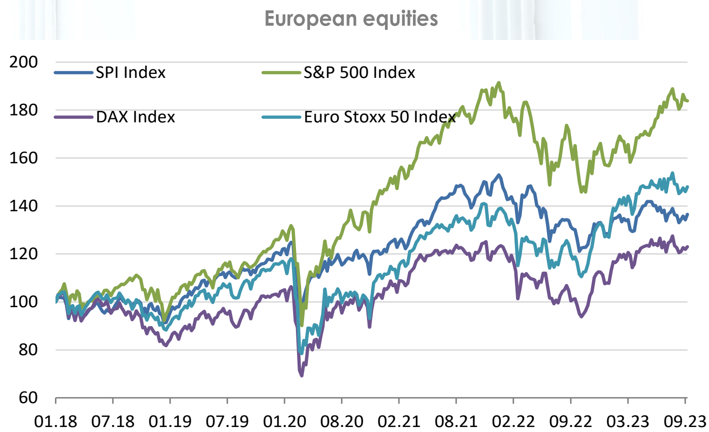
Source: Bloomberg, BBGI Group SA

Ongoing revaluation of securitized real estate

Securitized real estate in Europe is still suffering from the effects of inflation, the ECB's restrictive monetary policy and the interest-rate pressures of the past two years. However, the last quarter has finally brought some calm to the outlook for listed real estate. The EPRA Nareit index has rebounded sharply after a 25% fall between February and March, and still presents opportunities after a collapse in prices which we feel was clearly excessive, even in the context of the continued rise in interest rates mentioned above. At less than 60% of their book value, some securities 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.

Equities rise again after eight months of consolidation

After eight months of horizontal consolidation, European equities should be able to ride out the impending rate hikes and participate in the uptrend of international equity markets. European equities remain attractive in terms of historical valuation and relative to their peers. They still offer a significant discount to US stocks. Their valuation of 12x earnings for 2024 is lower than the S&P500's PE of 20.3x. They also look attractive relative to Japanese (18.8x) and Swiss (17x) equities, and are on a par with Chinese stocks (12.3x). The average dividend yield in Europe (3.4%) is also attractive, far outstripping that of the USA (1.5%) and Japan (1.8%) in particular. Now underperforming the S&P500 by 5% since the start of the year, European equities still deserve to be favored for 2023-2024, unless the ECB's next rate hikes end up disrupting investors' appreciation of risks and opportunities.



Source: Bloomberg, BBGI Group SA

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