Weekly Analysis

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THE SURPRISE FALL IN INFLATION IN THE EURO ZONE RESHUFFLES THE CARDS

Entry into recession in Q4. Inflation declines faster than expected. New paradigm for ECB policy and euro bond yields. Favourable environment for securitized real estate and equities.

Key points

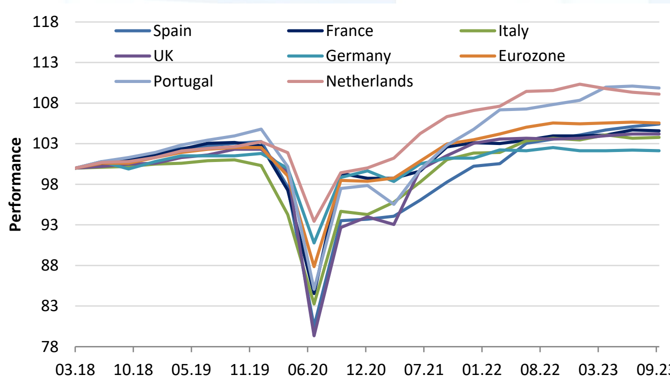
- Eurozone GDP finally slips into negative territory in Q3
- Technical recession expected in Q4 2023
- Leading indicators point to a fall in activity
- Confidence indices stabilize at low levels
- Surprisingly rapid decline in inflation
- Falling inflation is a boon for the ECB
- New paradigm for European bond markets
- Crushing yields affect the euro
- Rapid revaluation of securitized real estate
- Favorable backdrop for European equities

Eurozone GDP finally slips into negative territory

The evolution of GDP in the Eurozone in Q3 takes another step towards a probable recession in H2, with a decline of -0.1%, which should be followed in Q4 by a further contraction in GDP of -0.2%. The eurozone economy is thus closer than ever to recording two consecutive quarters of pessimistic forecasts already predicting a collapse in its momentum by early 2023. After holding up well against the headwinds at the start of the year, European economic now shows the weakness long expected. The slowdown in activity in the eurozone is thus taking shape very gradually, with a resilience that continues to surprise. Overall, there was little activity in all GDP components, but household consumption rather surprised by a new growth rate of +0.3% over the quarter, as did the +0.3% rise in public spending. In the end, it was the impact of foreign trade that seems to have pulled GDP growth slightly into negative territory, with a -1.1% fall in exports.

Year-on-year, GDP in the eurozone is now stable, after having risen by +0.5% year-on-year in the previous quarter. The difficulties faced by households are real, but they found the resources to increase their consumption levels during the quarter. Contrary to expectations, the situation in Germany, the eurozone's leading country, was not the sole cause of this negative quarterly result. Indeed, in regional comparison, the main European countries followed similar dynamics, with a limited contraction of just -0.1% in France and Germany, while the Netherlands and Portugal recorded a barely more marked decline of -0.2%. Spain (+0.3%) and Italy (+0.1%) seemed to be holding up a little better, supporting overall performance. Moreover, this contraction in Eurozone GDP is relatively similar to that of the European Union as a whole, where aggregate GDP was perfectly stable, despite the greater disparity between national performances. The spectrum of national results sees Ireland record a sharp contraction in GDP (-1.9%), while Malta (+2.4%) and Poland (+1.5%) continue the positive momentum already recorded in previous quarters. The resilience of the European economy remains surprising in the current context of serious declines in real purchasing power and rising financing costs. The European economy is staggering and is set to enter recession at the end of 2023.

Quarterly GDP growth-Europe



Sources: Bloomberg, BBGI Group SA

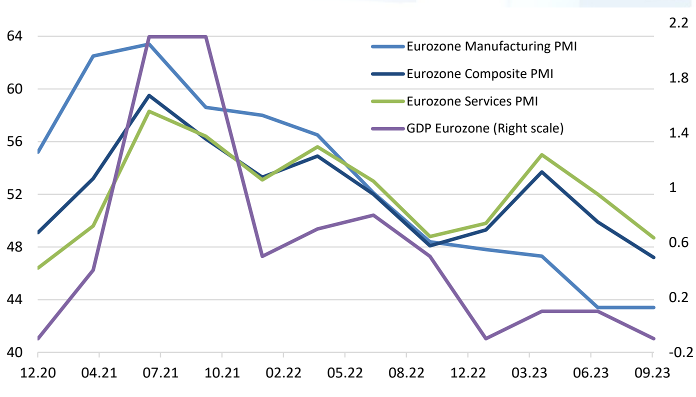
Technical recession expected in Q4 2023

Aggregate GDP growth in the eurozone is likely to be at best -0.1% in Q4, which will be enough of a tipping point to record a technical recession characterized by two consecutive quarters of GDP contraction. In this eventuality, growth for 2023 as a whole would be unlikely to exceed +0.5% by year-end. Our forecast today is only slightly different from that at the start of the year, and we still believe that the eurozone will end the year with weak GDP growth of +0.3% to +0.4%. In contrast to our outlook for an extremely moderate recession in the European economy in the 2nd half of the year, which is likely to weigh on the full-year result, the ECB's current forecasts seem more optimistic. The ECB's forecast of +0.6% in 2023 will certainly be subject to disappointment. The ECB has been steadily reducing its GDP growth forecasts, after long believing that a +1% increase was likely. Without government support, this growth forecast will struggle to materialize. However, even if a slight increase in public spending were still possible, we believe it would certainly be offset by a reduction in household spending. The service sector is likely to be more affected by the loss of household purchasing power. At the start of the 4th quarter, industrial production in the eurozone fell by a further -0.7% (October), representing a year-on-year contraction of -6.6%. Monthly data remain volatile, but this was the steepest fall seen in a very long time, with the exception of that seen in March and April 2020 at the start of the Covid pandemic. This is therefore another very weak start to the quarter, suggesting that the manufacturing sector remains fragile and could yet weigh on eurozone GDP.

Leading indicators point to a fall in activity

The latest releases of PMI leading indicators for December point more than ever to a very high risk of recession. Without registering any real collapses, the manufacturing and services indicators remain on negative trends, well below growth thresholds. They clearly suggest a slowdown in the manufacturing sector and a continued downturn in services. As a result, the composite indicator fell again in the space of a month, from 47.6 to 46, and has now been below the growth threshold for several months. This result was largely driven by the services segment, which nevertheless struggled to withstand the various pressures in December, slipping from 48.7 to 48.1.

Eurozone PMI and GDP indicators



Sources: Bloomberg, BBGI Group SA

The leading manufacturing PMI indicator for the eurozone had already reached a low point in July (42.7) before recovering slightly thereafter, but in December it remained in a worrying zone with a pessimistic reading of 44.2, well below the growth threshold of 50. The trend in the PMIs suggests that the eurozone economy will find it difficult to record growth in Q4 and the following months, as it continues to be affected by higher interest rates and credit costs. Changes in the main parameters used to assess credit conditions also suggest that they are deteriorating for both households and businesses, thereby increasing the risk of a weakening of the economy and consumption. That said, the latest positive developments observed since November on the inflation and interest rate fronts could temper negative estimates of falling demand and also support a rebound in leading indicators over the coming weeks.

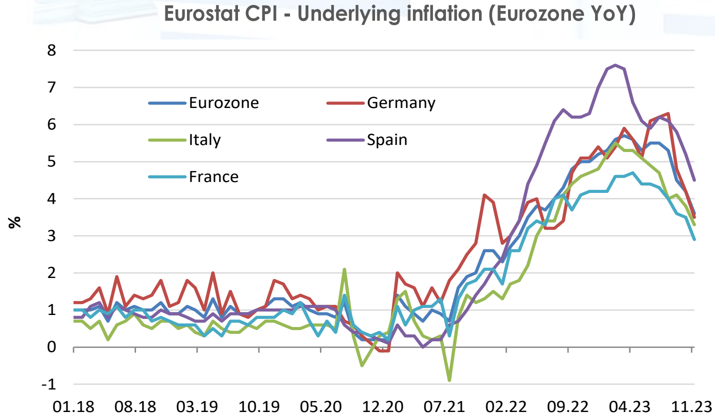
Confidence indices stabilize at low levels

Household confidence for the month of December improved slightly, certainly in the light of better inflation statistics and no doubt also thanks to the easing of interest rate tensions, but it remains relatively gloomy by historical standards. The European Commission's indicator is still worrying, despite a relative stabilization at around -16, although it has clearly recovered from its September low point (-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. Indices measuring confidence in both industry and services already seem to be looking a little further ahead, taking into account the positive prospects for a change in monetary policy in 2024. It's still far too early to see any real positive change in the degree of confidence of all economic agents, but the recent sharper decline in inflation will contribute to a forthcoming improvement in sentiment.

Surprisingly rapid decline in inflation

Inflation in the eurozone fell by -0.6% in November, thanks to an almost generalized decline in all components. On an annual basis, CPI is now up by just +2.4% after peaking at +10.7% in October 2022, and is approaching the ECB's +2% target more rapidly than expected. Excluding food and energy, the index is declining more slowly and still stands at +3.6 (+4.2% in October).

Eurostat CPI - Underlying inflation (Eurozone YoY)



Sources: Bloomberg, BBGI Group SA

Inflationary pressures eased sharply in November, with a particularly encouraging decline in the services segment, which remains the slowest to adjust. On the producer price front, the situation improved markedly in 2023, even though October saw a slight monthly increase of +0.2%. On an annual basis, prices actually fell by -9.4%, which should give companies some flexibility to adjust their sales prices downwards. The sharp decline in producer prices should therefore soon have a noticeable effect on consumer price indices. Inflation in the eurozone is likely to weaken further, particularly with the confirmation of the expected economic slowdown. The ECB's inflation forecast for the year as a whole is still +5.4%. The current situation is therefore already relatively ahead of the ECB's forecast. CPI could quickly reach the 2% threshold in early 2024, while core inflation will probably take a little longer to approach it.

Falling inflation is a boon for the ECB

The ECB was not expecting such a pleasant surprise after the summer break. Thanks to a faster-than-expected downward acceleration in price indices, the ECB can now look forward to its actions with a little more peace of mind. Only a few weeks ago, the ECB was still clearly demonstrating its determination to fight inflation and bring down price trends to +2%. With this in mind, the ECB once again raised its key rates in September for the tenth time in a row, from +0.25% to 4.5%, noting in particular that the inflation outlook was still too high and that the expected decline was indeed materializing, albeit at an insufficient pace. It emphasized that the high degree of uncertainty required a flexible policy linked to the constant evolution of available data. In other words, the ECB confirmed that it would assess the inflation outlook, taking into account a broad spectrum of economic and financial information, in order to adjust its policy. As the year draws to a close, a number of economic statistics pointing more clearly to a recession and a more rapid fall in inflation are contributing to a very marked change in the ECB's assessment of the situation. Indeed, it should be noted that key rates have recently returned to a level above both headline inflation (+2.4%) and core inflation (+3.6%). This new situation, with a gap of over 200 bps between CPI and key rates, seems to us to call for a change in monetary policy in the near future.

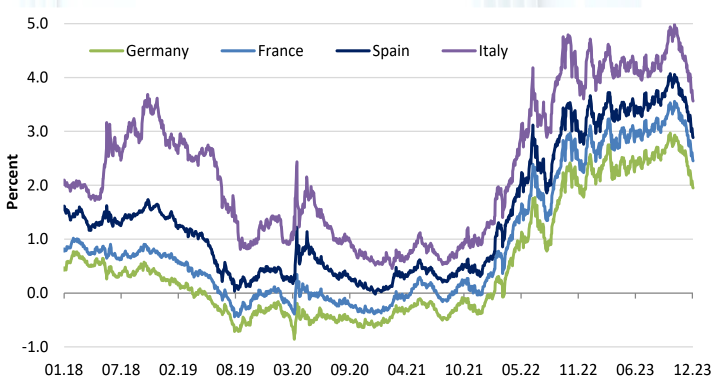
Before the surprise fall in inflation in recent weeks, we believed that the conditions for monetary easing by the ECB were not yet in place, or even conceivable in the near future. It is now likely that, following the more rapid fall in inflation, the ECB will refrain from further rate hikes, and that the peak of the rate hike cycle has therefore probably already been reached in September. In the coming months, the ECB will continue to be concerned by the slow pace of adjustment in the services sector, and is likely to favor a cautious approach characterized by a stabilization of its action. Growing signs of economic slowdown could also very quickly support new expectations of a reversal of the monetary policy trend and a cut in key rates as early as the 2nd quarter of 2024.

New paradigm for European bond markets

The faster-than-expected fall in inflation in Europe has had a major impact on investors' expectations regarding key rates and market rates. As far as key rates are concerned, the consensus is already that the ECB will have to adjust rates to 3.75% at the end of March, implying a 75 bp cut in key rates in the first three months of 2024. This seems to us to be a particularly aggressive expectation, even considering that inflation will continue to fall at a steady pace. Barring a much more severe recession than that envisaged, the ECB is unlikely to embark on a radical change in monetary policy so soon in 2024. As far as medium-and long-term bond yields are concerned, the extremely rapid fall that has taken place has adjusted ten-year German Bund yields from 3% in October to less than 2% today. A fall of 100 bps, or 33%, in ten-year bond yields has put European yields back where they were in June 2022.

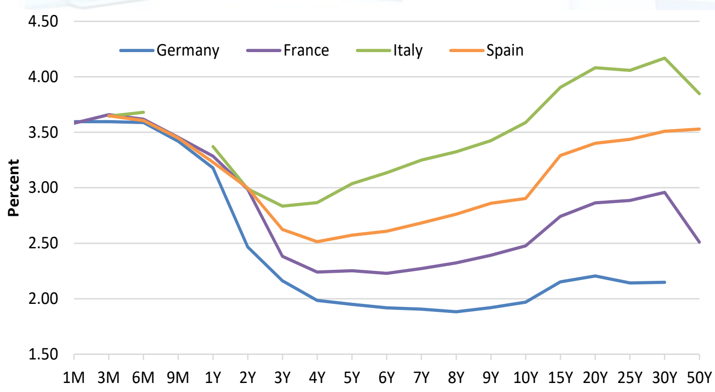
This adjustment, which has also taken place in many other market segments, may now seem excessive, even though it is supported by a downward trend in inflation and the risk of recession. Interestingly, in this new context, real yields adjusted in a matter of weeks thanks to a stronger decline in inflation. Ten-year real yields thus fell from -3% to -0.4%. Against this backdrop, the yield curve has inverted sharply, pointing more logically to a heightened risk of recession in the winter of 2023-2024. The downward trend seems to be well underway, but given the amplitude of the fluctuations observed in just a few weeks, we believe that the potential for capital gains is now reduced, in the event of a moderate recession.

10-year interest rates European countries



Sources: Bloomberg, BBGI Group SA

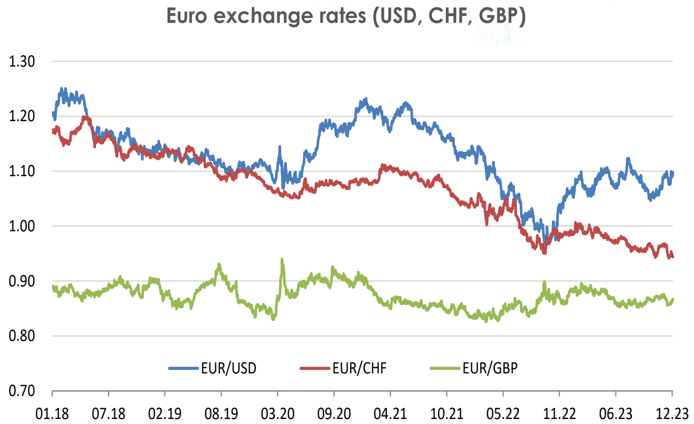
Interest rate curves



Sources: Bloomberg, BBGI Group SA

Crushing yields affect the euro

The ECB still looked set to be one of the most restrictive of the major central banks in Q4, but recent inflation trends have reshuffled the deck. It has finally joined the group of central bankers adopting a wait-and-see attitude. Investor expectations of bond yields have also changed dramatically, so that now, if short rates are unfavourable to the euro against the dollar, for example, this is even more the case for ten-year rates, whose differential has widened in recent weeks from 200 bps to 225 bps in favour of the dollar. The yield differential with Swiss ten-year rates, meanwhile, has contracted from 180 bps to 130 bps, but remains in favor of the euro. For a few months, this environment should support a slight appreciation of the euro against the franc. Conversely, the European currency should weaken slightly against the dollar.



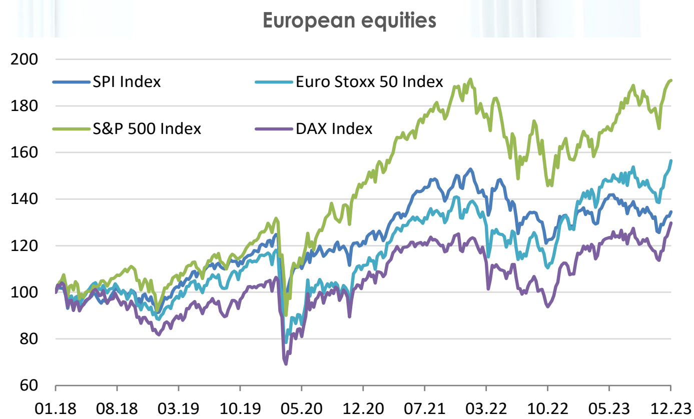
Sources: Bloomberg, BBGI Group SA

Rapid revaluation of securitized real estate

In recent weeks, securitized real estate in Europe has finally freed itself from the negative influence of inflation, the ECB's restrictive monetary policy and the interest rate pressures of the past two years. The downward acceleration in inflation in November, the general fall in interest rates and the probable end of the ECB's monetary tightening cycle have all helped to improve the outlook for listed real estate stocks. The EPRA Nareit index took advantage of this new, more favorable paradigm to rebound sharply from its October lows. In our latest weekly analysis of securitized real estate, we pointed out that the collapse in prices in Q1 2023 clearly seemed excessive, even though it offered opportunities to reposition real estate companies trading at less than 60% of their book value. At the time, we pointed out that the European real estate market offered rare investment opportunities worth considering. The recent rise of +34% comes as no surprise. It puts European securitized real estate back where it was at the end of January, with a YTD rise of +14%. The 12-month average yield of the EPRA Nareit Eurozone index remains very attractive at 5.98%, underpinning the favorable outlook for this asset class, whose price to net asset value is just 63%.

Favorable backdrop for European equities

European equities logically took into account the extremely positive aspects of the rate cut, and were able to resume their rise in line with our expectations. After a three-month decline of around -10%, European stocks have indeed benefited from lower rates since the beginning of November. The +13% rise pushed SX5E stocks to their highest level of the year, above 4,500 points. Now up +20% YTD, 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 12.7x earnings for 2024 is lower than the S&P500's PE of 21.2x. They also look attractive relative to Japanese equities (20x), Swiss equities (18.4x) and Chinese equities (11.7x). The average dividend yield in Europe (3.1%) is also attractive, well ahead of the US (1.5%) and Japan (1.8%). European equities still deserve to be favored in the 2024 perspective.



Sources: Bloomberg, BBGI Group SA

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