Swedbank

What's up Europe?

Landing is getting harder

- Manufacturing weakness is spilling over to the rest of the economy
- Core inflation finally starts dropping
- ECB hiking is done, cuts on the horizon

In Europe, disappointing data continued pouring throughout the summer and into the fourth quarter. Manufacturing continued to be a drag on growth throughout the year. New orders have been plunging for a while, and output was held up by large backlogs of unfulfilled orders; nevertheless, purchasing managers' index (PMI) surveys indicate that companies' stock of orders is declining, and inventories are being run down. Although the pace of contraction in manufacturing is decelerating somewhat, global demand is weak, and recovery is not yet in the cards.

Services activity indicators also weakened substantially in the third quarter. Admittedly, there seems to be a new post-pandemic seasonal pattern emerging that overstates the strength of services in spring and understates it in autumn. Nonetheless, the current level of PMI and other data available is pointing to a -0.2% (q/q) GDP contraction in the third quarter

The labour market remains a bright spot of the European economy. The unemployment rate holds at an all-time low of 6.4%. In addition, due to the combination of retreating inflation and slightly accelerated wage growth, purchasing power stopped falling in the second quarter. Likely, real wages resumed expanding in the third quarter. Strong employment and better real income trends should boost household consumption over the coming quarters.

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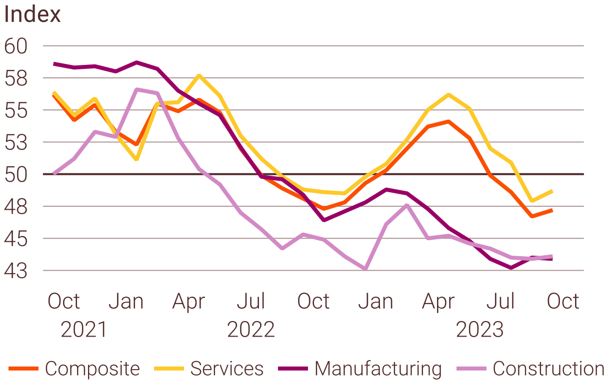
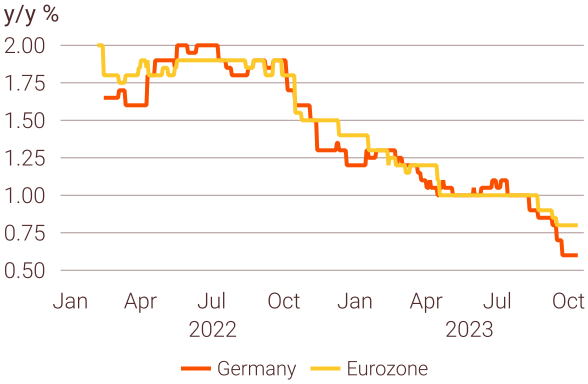
Euro area PMIs - weakness across the board



Sources: Swedbank Research & Macrobond

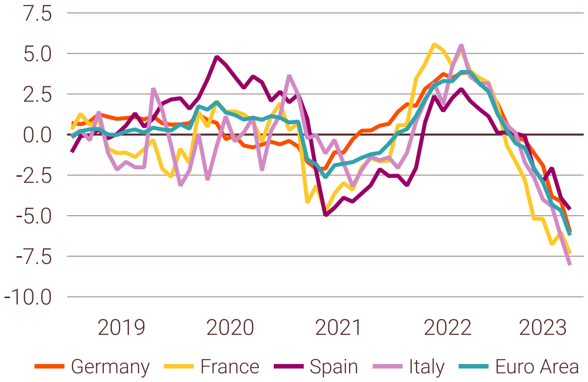
2024 Bloomberg consensus GDP growth



Sources: Swedbank Research & Macrobond

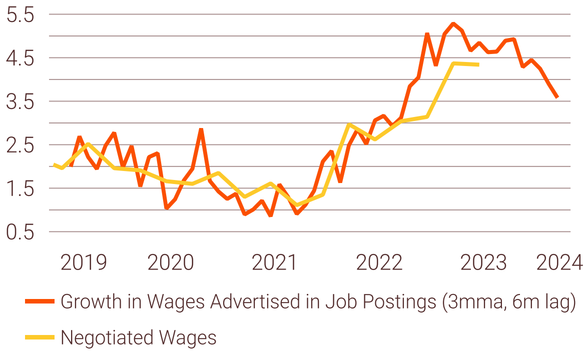
So far, there are few reasons to be optimistic about the European economy. Monetary policy is exerting a massive drag via the credit channel, new credit has dried up, and the broad money supply already fell by1.1% in August. Fiscal policy is likely turning from neutral to contractionary next year - the fiscal impulse (change in the fiscal balance) is planned to be 0.6 percentage points (pp) in euro area. Foreign demand seems unlikely to recover soon and bring relief to the exporting sectors. We expect the European economy to expand up to half a percent this year and the next. However, given the numerous risks, it is very easy to picture Europe slipping into recession.

Annual change in loan portfolio growth, pp



Sources: Swedbank Research & Macrobond

Wages are decelerating



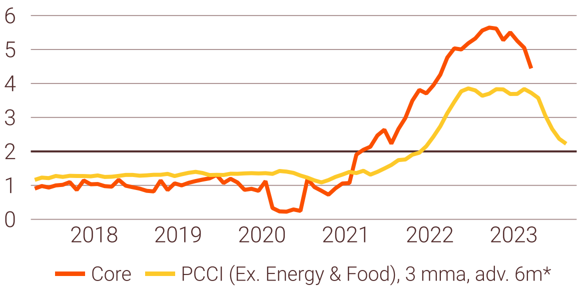
Sources: Swedbank Research & Macrobond

Inflation retreating faster than expected

Over the summer, core inflation in Europe held above 5% and maintained the hawkish bias for the ECB. While leading indicators were for some time pointing to an easing in core inflation, lags and one-offs in administered prices held core inflation elevated. In September, the long-awaited negative surprise to core inflation finally arrived. Annual core inflation eased by 0.8 pp to 4.5%. Disinflation of goods has been obvious for several months now, but services prices are also becoming more encouraging. Judging from upstream prices, food and energy commodities, producer price indices, and disinflation ought to continue in the upcoming months.

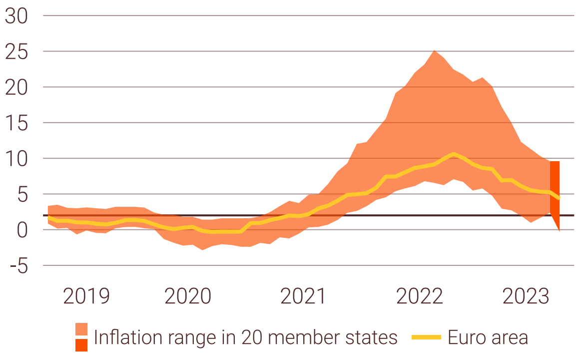
Energy price volatility might result in a temporary spike of headline inflation; however, given the tightness of monetary policy, the spillovers to broader prices would be much more limited. Overall, energy markets seem more resilient and less likely to be the source of negative surprises this winter. Last year, soaring gas prices caused electricity prices to soar and affected every sector of the economy. Now, with storage nearly full and the French nuclear fleet running smoothly, a repeat of energy-driven inflation is a way more remote risk. Admittedly, an apparent sabotage against the Baltic connector underwater natural gas pipeline between Estonia and Finland, which will take five months to repair, illustrates that European energy infrastructure remains a target for hybrid attacks.

Measures of underlying inflation



* The Principal common component of inflation (PCCI) is one of the indicators published by the ECB. It is an attempt to isolate common inflationary force across products and countries
Sources: Swedbank Research & Macrobond

Headline inflation



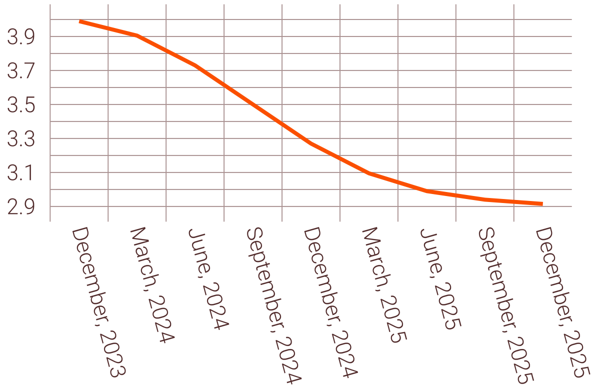
Sources: Swedbank Research & Macrobond

The ECB is likely to cut sooner and faster than the markets expect

As expected, the ECB increased all rates by anther 25 basis points in September, and this, most likely, was the final push during the hiking cycle. More unexpected were the revised macroeconomic projections, where the ECB has revised upwards its inflation expectations for 2024 and now expects headline inflation at 3.2% (mainly due to energy and food prices) and core inflation at 2.9%. We forecast both headline and core inflation to be some 0.5 percentage point below the ECB's forecast. Wage growth in the euro area remains roughly two times faster than on average during the last decade, but forward-looking indicators (e.g., Indeed wage tracker) are indicating a slowdown during the next six months. Furthermore, a large share of excessive inflation last year was caused by wider profit margins, which can be adjusted downwards easily and are likely to shrink in the face of weaker demand.

Market expectations have become more dovish during the recent weeks and are now pricing in a first cut in the summer of 2024 and another cut in the second half of next year. We remain less worried about inflation (see above) and more wary about the underlying economic developments, which will be further dampened by the negative credit impulse. We maintain our forecast that the ECB will cut rates in April, and by the end of 2024 the deposit rate will be approaching 2%.

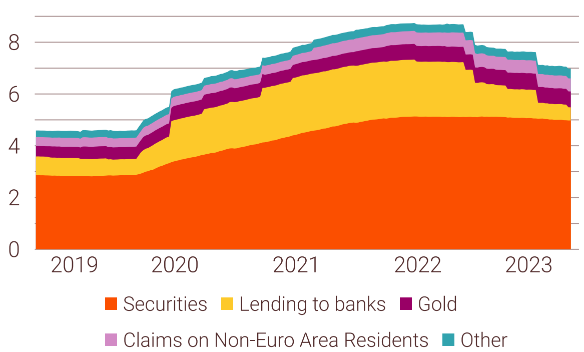
3 month euribor futures, %



Sources: Swedbank Research & Macrobond

ECB Balance sheet

trillion eur



Sources: Swedbank Research & Macrobond

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