



Global Macro Research

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#Europe

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#Growth

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#Monetary Policy

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What's gone wrong with the Eurozone recovery?

The Eurozone recovery seems to be losing speed. Further ECB easing and still strong wage growth should help prevent a recession, even if a slowdown looks hard to stop. ECB officials are still primarily focused on the final mile of inflation, but headwinds to the growth outlook mean risks around our monetary policy forecasts are to the downside.

Key Takeaways

- In the first half of 2024 the Eurozone had its best two quarters of growth in two years. But forward-looking data suggest this recovery is now losing steam.
- Despite strong real disposable income growth and the start of interest rate cuts, the European consumer is becoming a bit more hesitant. Still high borrowing costs, lingering pessimism about earnings prospects, a less tight labour market, falling home prices, and possible long-term "belief scarring" following the pandemic may all be limiting the propensity to spend.
- And the industrial recovery faces structural headwinds, particularly in Germany, while fixed asset investment remains tepid.
- All that said, we don't expect a recession. But growth over the second half of 2024 is likely to be slower than in the first. Trend growth in the Eurozone is probably capped around 1.2%.
- If we're right that the economy is set to slowly expand, ECB officials will continue to look primarily to the inflation outlook when setting policy.
- This means the ECB will continue with its cautious approach to the cutting cycle. We forecast two more cuts this year and three in 2025, and think current market pricing may have slightly overshot the extent of easing.
- However, with growth concerns building, risks of a more rapid easing cycle are increasing.

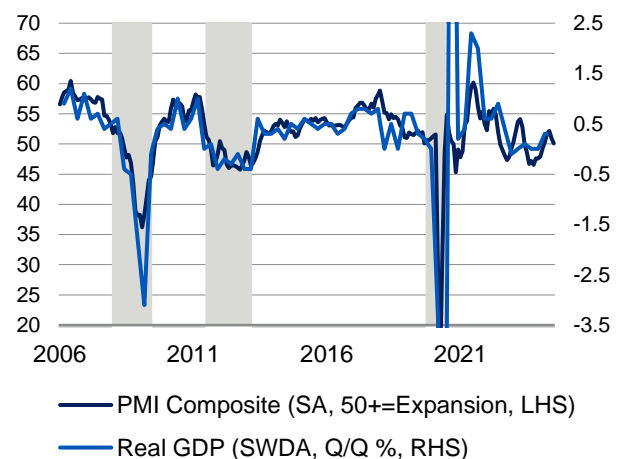
The Eurozone recovery is losing steam

The Eurozone economy grew by 0.3% in each of the first two quarters of 2024. This looks fairly strong in the context of the bloc's recent history, representing the fastest expansion since mid-2022, when the economy was still recovering from the pandemic.

However, given the tailwinds from the significant boost to real disposable incomes amid declining inflation, and the fading impact of past European Central Bank (ECB) rate hikes, policymakers may have been hoping for more.

Moreover, recent data suggest the recovery is now losing some steam heading into the second half of the year (see Figure 1).

Figure 1: PMIs suggest growth is set to slow



Source: Haver, abrdrn, August 2024

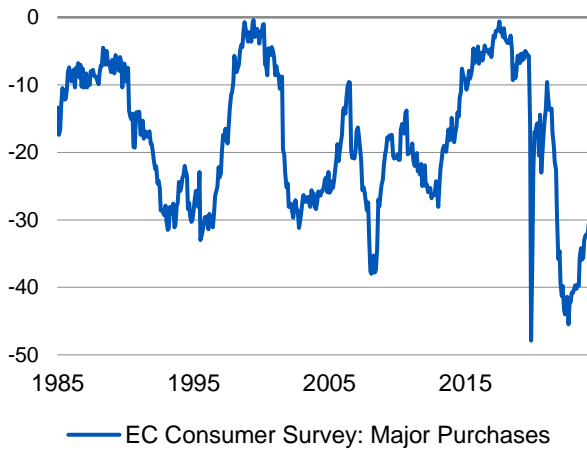


Why are European consumers so cautious?

One puzzling aspect of the Eurozone recovery is consumer caution given strongly growing disposable income.

Still-tight monetary policy goes some way in explaining this phenomenon. Consumers report being more reluctant to make major purchases on credit while interest rates are elevated (see Figure 2). And the incentive to save is commensurably higher.

Figure 2: Consumers think conditions are unfavourable for making major purchases



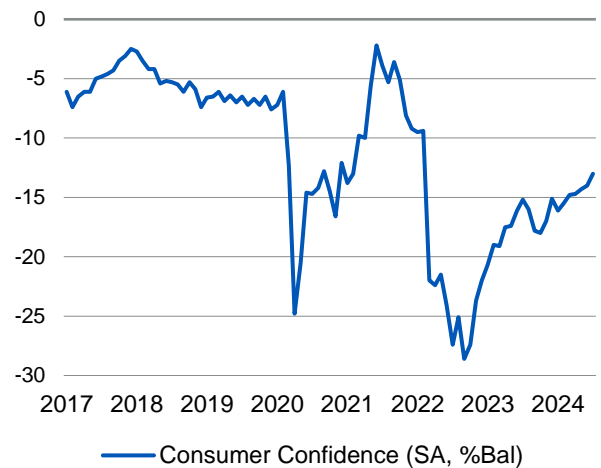
Source: Haver, abrdrn, August 2024

But this can't be the whole explanation. If reticence to spend was entirely driven by high interest rates, we might expect to see confidence improving – not deteriorating – now that the ECB has begun its cutting cycle.

That could yet happen – but we think there are additional factors weighing on the propensity of households to spend.

First, consumers seem to be pessimistic about their own earnings prospects, even as real wages continue to rise (see Figure 3). They may therefore be deferring consumption and building up savings to insulate spending power against future shocks.

Figure 3: Though improving, consumer confidence remains depressed

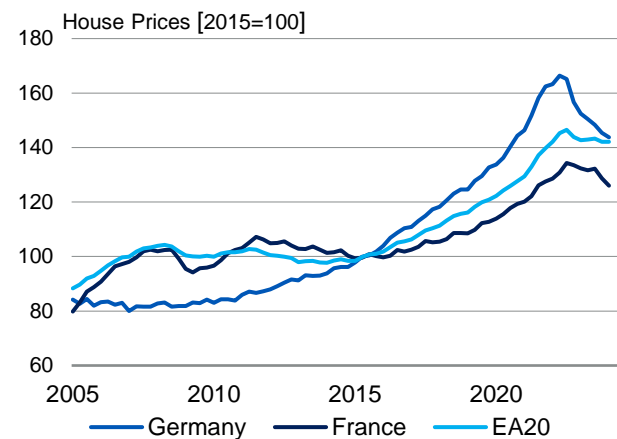


Source: Haver, abrdrn, August 2024

Second, there is some evidence to suggest that the long-awaited rollover in the Eurozone labour market has arrived. Unemployment ticked up to 6.5% in June. And, with nominal wage growth beginning to moderate and inflation stable, the pace of real disposable income growth has slowed a little. This may also help to explain the pessimism around earnings expectations, with households extrapolating from the early signs of weakness.

Third, the passthrough of tight monetary policy to the housing market seems to be affecting consumer behaviour in France and Germany in particular through a negative wealth effect (see Figure 4).

Figure 4: Falling house prices mean homeowners' spending power is hit through the wealth channel

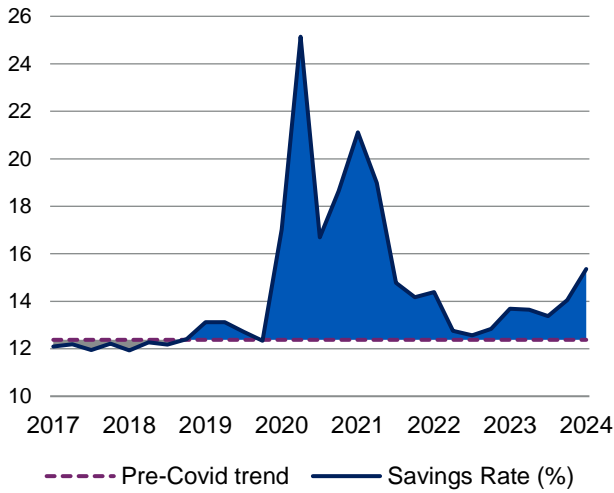


Source: Haver, abrdrn, August 2024

Finally, the European consumer may have become more risk averse following the major economic shocks of the pandemic and the increase in energy prices. These experiences may weigh heavily on households' expectations about the future, making them systematically more risk averse. Long-term "belief scarring" could explain the apparent structural break in the household savings rate (see Figure 5).



Figure 5: Households still aren't running down their pandemic-era savings stockpile



Source: Haver, abrdrn, August 2024

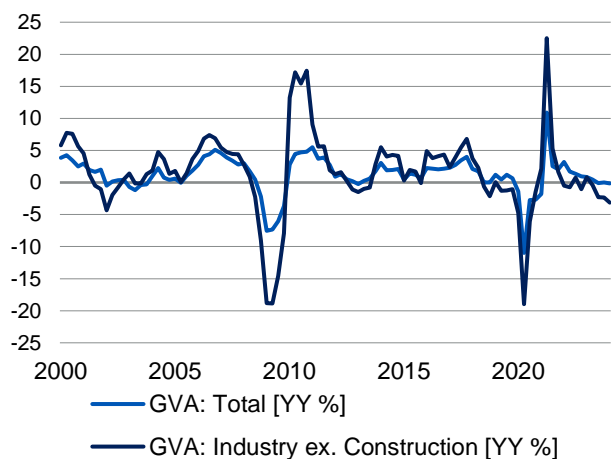
Still waiting on an industrial recovery

Even amid Q2's decent Eurozone-wide growth, there was weakness in some countries with relatively large industrial sectors.

Germany in particular weighed on the bloc's performance, with the country's GDP actually contracting slightly. This is the fifth quarterly decline in the previous nine quarters, with Germany so far managing to avoid a technical recession but clearly mired in weakness.

German industry faces a number of structural headwinds, in addition to cyclical weakness. This is reflected in the sector-level growth data, which shows industrial contraction weighing on aggregate activity (see Figure 6).

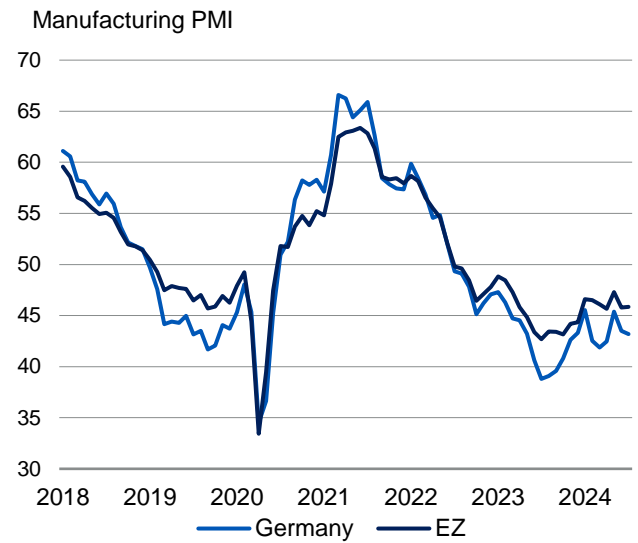
Figure 6: German industry has underperformed the economy as a whole



Source: Haver, abrdrn, August 2024

And forward-looking data including manufacturing PMIs and German factory orders suggest that industrial weakness is set to continue (see Figure 7).

Figure 7: German manufacturing PMIs do not point towards an imminent industrial recovery

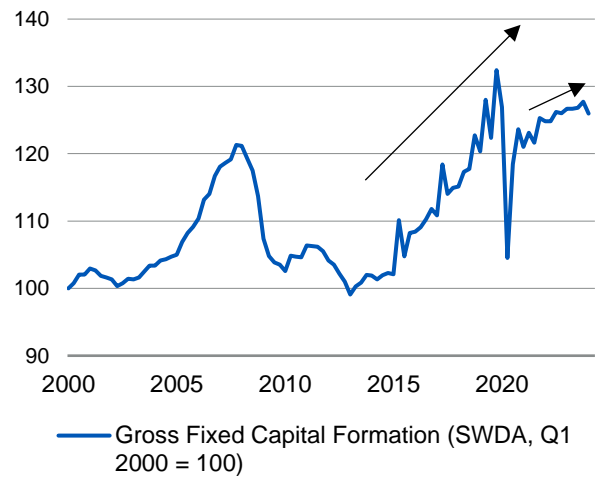


Source: Haver, abrdrn, August 2024

Investment spending remains tepid

The recovery in Eurozone fixed asset investment has also been underwhelming, primarily because monetary easing has yet to get underway in earnest (see Figure 8).

Figure 8: Fixed asset formation remains well below its pre-pandemic trend



Source: Haver, abrdrn, August 2024

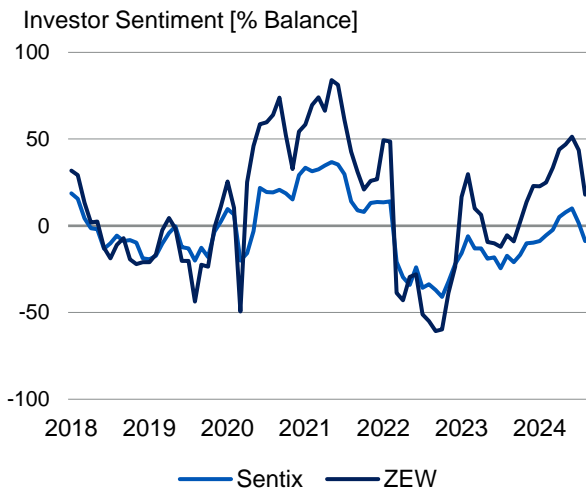
But, much like industrial activity, the sector also faces structural headwinds.

These challenges are particularly acute in the case of construction, where a significant regulatory burden weighs on developers. In addition, governmental rental price controls discourage investments in some jurisdictions.

Investors are also losing confidence in the economic outlook (see Figure 9).



Figure 9: Investor expectations have fallen recently



Source: Haver, abrdrn, August 2024

Can the recovery get back on track?

All this being said, the Eurozone recovery will increasingly feel the benefits of further ECB rate cuts in coming quarters and years. And, with household balance sheets strong, consumers shouldn't need to retrench even as real income growth moderates.

Therefore, a slide into recession is not our base case. However, it looks increasingly likely that the pace of Eurozone recovery will recede in H2.

Once interest rates fall closer to a more neutral level, structural, rather than cyclical factors, will become the binding constraint on growth. We think Eurozone trend growth is around 1-1.2%.

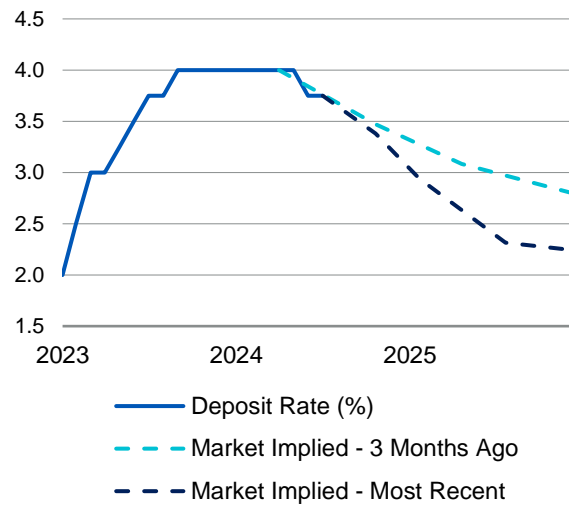
Will the ECB come to the rescue?

Soft activity data and spillovers from changing US interest rate expectations have seen markets price in a more aggressive easing cycle by the ECB (see Figure 10).

Author

Felix Feather

Figure 10: The market is now pricing a rapid and deep cutting cycle from the ECB



Source: Haver, Bloomberg, abrdrn, August 2024

However, there's little sign the Governing Council's more influential members have shifted their focus from inflation to activity just yet.

Our proprietary model of the ECB's reaction function suggests that, while policymakers are sensitive to *forward-looking* expectations of inflation, they are more likely to react to *backward-looking* surprises in activity data. So, history suggests that the ECB is likely to wait for official growth or unemployment data to disappoint before adjusting policy settings accordingly.

As such, we continue to expect two further deposit rate cuts this year, three cuts through 2025, and a final one in 2026 to take the deposit rate to 2.25%.

Market pricing has likely therefore overshot somewhat, although we think there is a risk of more rapid easing if the activity data deteriorate much further.



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