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How well is the Eurozone doing?

Market Comment, June 2023

In light of the many special factors that have influenced economic activity in the Eurozone over recent months and the fact that some of these are by no means over, the question arises as to just how well the Eurozone is actually doing? We would answer this question as follows: not as badly as feared, but with increasing risks. This is because both the currency situation (a stronger euro once more is acting as a burden) and the weakening sales market in China have a significance for the development of the Eurozone economy that should not be underestimated. The greater cyclical vulnerability of the Eurozone equity index means that we favour the more defensive Swiss equity market over other European equities.

Despite the Ukraine war, the Eurozone managed to post economic growth, albeit modest, throughout 2022 thanks to the mild autumn and winter and the early preparations made to tackle a potential energy shortage. This growth was particularly supported by the service sectors, which were able to benefit from pent up demand for entertainment and tourism that had built up during the coronavirus crisis. It is for precisely this reason, however, that weaker economic growth is likely in the second half of 2023, as the relatively high level of spending on services in the summer and autumn of 2022 has created a so-called base effect. While this is unlikely to make further increases impossible in 2023, it will make them more difficult to achieve. Incidentally, the same effect stemming from a high base in 2022 is also likely to lead to a decline in the year-on-year percentage increase in headline inflation over the months ahead. Nevertheless, consumer prices remain at above-average levels by historical standards and core inflation, which does not take account of food and energy prices, is still far removed from the 2% level targeted by the European Central Bank, meaning that further interest rate hikes are possible.

An important consequence of historically high consumer prices is a decline in inflation-adjusted incomes or "real" wages. This is due to the fact that the increase in prices that have to be paid exceeds the increase in incomes. It can therefore be expected that people's propensity to save will gradually increase where this is possible. According to a study by the European Commission, people's wealth situation has generally also tended to worsen against the backdrop of the decline in equity and bond prices in 2022 and, in some cases, a fall in real estate values.

In 2023, there will also be the impact of higher interest rates and tighter credit conditions as banks become more restrictive in their lending activities – similar to the situation in the US. This is likely not only to hit consumption, but also business investment. Due to the base effect described above and the particularly high level of commodity prices during the second and third quarters of 2022, headline inflation will decrease on a year-on-year basis during the course of 2023. However, the passing on of higher business costs to customers could keep core inflation, which does not include energy and food prices, relatively high, especially if wage costs rise.

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The task of quantifying inflation is now being complicated by exchange rates. This means that while the decline in the euro had a particularly inflationary effect in 2022, the impact in 2023 is not clear. On the other hand, it is foreseeable that prices for services are likely to remain at historically high levels, as the pressure of higher wages in service industries such as hospitality, public services and healthcare will increase. It would only be possible for this to change if unemployment were to rise significantly. However, this would clearly increase the risks of a more marked recession. A stronger euro overall relative to last year could also put the brakes on exports.

The situation as regards public finances could also remain tight over the coming quarters. The support packages aimed at easing the burden on the population in many Eurozone countries against the backdrop of high energy prices have tended to further increase debt levels in the Eurozone and are weighing on household budgets.

In conclusion, it would come as no surprise to us if we were to see an economic slowdown in the Eurozone towards the end of 2023 with inflation remaining at above-average levels by historical standards. Due to its sector composition, the European equity market, and especially the Eurozone equity index, is more cyclical than the Swiss equity market. The Swiss equity index has a higher weighting of defensive companies, i.e. firms that are less dependent on economic developments. We therefore currently favour the Swiss equity market over the Eurozone equity market.

Gérard Piasko

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