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Temperature Check

by Richard Stutley, CFA Portfolio Manager

I wanted to provide a quick update on the Euro-zone economy. It's good practice to step behind the headlines, which as we know are written with the aim of being interesting, rather than painting a complete picture of any topic. While we firmly believe that a good macroeconomic outcome is neither sufficient nor necessary for good investment returns (although it does help, particularly in the short term!), we nevertheless need to be aware of the macro when managing portfolios.

Consumption, which translated means day-to-day spending by individuals, rightly makes up the majority of total spending in the region – around 52% according to Eurostat[1]. Hence we're primarily interested in household finances (current and prospective) when taking the temperature of the Euro-zone economy.

Gross Domestic Product grew by 0.2% quarter-on-quarter in Q3, a bit below its 10-year average of 0.37% but well within the norm, with adjustment for the effects of the pandemic[2]. Hence real incomes continue to expand and coming into the start of this year households had approximately 12% excess savings tucked away[3]. From a debt perspective, household debt to disposable income is comfortably within its recent range and approximately 50% lower than around the time of the Great Financial Crisis[4].

That's the good news. Debt mostly in the form of mortgages is sensitive to rising interest rates and hence, as we look forward, today's good starting point begins to look less rosy. While the widening gap between US and Euro-zone short-term interest rates[5] may seem strange, one needs to understand that the transmission mechanism of central bank policy to the real economy is much weaker in the States, due to the predominance of 30-year fixed-rate mortgages far longer than anything generally seen in Europe. This means that rising interest rates will start eating into the disposable income of Euro-zone households much more quickly than their American cousins.

Unemployment in the Eurozone is low[6], and unlike in the US isn't flattered by a falling participation rate post-pandemic.

According to data from the World Bank[7], one of the clearest signals from this inflationary period is that more Americans need to find their way back to the labour market – there are too few workers to deliver the goods and services the US needs. As with household debt, the employment picture looks set to deteriorate, with hiring intentions slowing and likely to turn negative resulting in a fall in new orders reported by companies[8].

The main issue the region faces isn't poor balance sheets, but huge distortions in the price of goods and services. Stripping out the effects of energy price rises only makes sense when prices fall back quickly. Power prices in the Euro-zone's industrial heartland Germany remain in a range some five times higher than their pre-pandemic level[9]. This has led to a huge redirecting of spending towards energy, and away from all other goods and services. On this basis, the outlook for many businesses is tough, and the redistribution of profits from energy producers via windfall taxes seems appropriate.

Overall, the Euro-zone looks like it is in for a tough time, made only slightly easier by the healthy state of household balance sheets. However, the significance of that conclusion shouldn't be overstated, to repeat what I said at the outset, we are macro-aware rather than macro-driven. Economies are self-righting over time and even bad policymaking can't upset them for long, the UK's recent experience being a case in point. Despite the weak macroeconomic outlook, we are neutral European equities, given signs of some good valuation opportunities emerging.

Sources
1 Euro Area Household & NPISH Final Consumption Expenditure as a percentage of Euro Area Gross Domestic, as seen on Bloomberg Finance L.P.
2 Euro Area Gross Domestic Product Chained 2010 Prices QoQ, Eurostat
3 Euro Area (17 Countries) Gross Household Saving Rate, Eurostat
4 Eurozone Household Debt to Disposable Income Ratio, Bloomberg Finance L.P.
5 US Federal Funds Effective Rate less the ECB Main Refinancing Operations Announcement Rate
6 Eurozone Annual Unemployment Rate (%), Bloomberg Finance L.P.
7 Euro area Labor force participation rate ages 15-64, World Bank Group
8 S&P Global Flash Eurozone PMI, 24/10/2022
9 EXAA Germany Day Ahead Baseload Electricity Spot Price

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For more information, please contact your adviser or alternatively contact:

Belvest Investment Services Limited
研富投資服務有限公司
9th Floor, Centre Mark II
305-313 Queen's Road Central
Sheung Wan, Hong Kong

Tel +852 2827 1199
Fax +852 2827 0270
belvest@bis.hk
www.bis.hk

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