GENERALI ASSET MANAGEMENT

FOCAL POINT

How much do we need to be concerned about euro area activity?

Author: Martin Wolburg

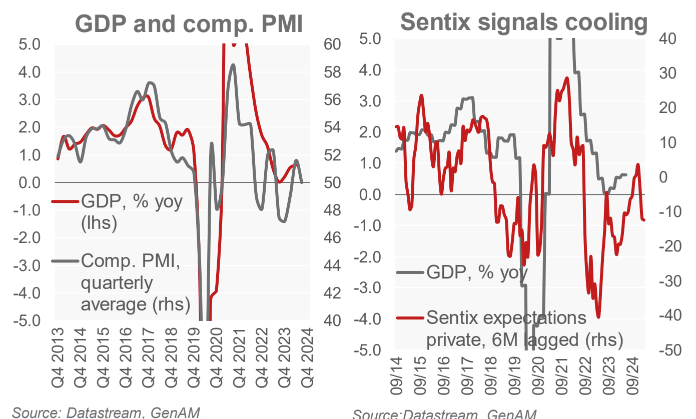
October 4, 2024

Our Focal Point series explores topical issues on macro, markets and investment

- **Weakening economic indicators over the summer amid US recession fears and political tensions in France and Germany have sparked concerns about euro area growth.**
- **Moreover, fiscal consolidation will likely continue to drag on activity also in 2025 with the risks skewed towards an even more pronounced consolidation. And the very export-oriented largest euro area economy, Germany, has also come structurally under pressure, especially in the car industry.**
- **That said, ongoing disinflation will lift real purchasing power and consumers will likely start to reduce their excess savings. ECB policy easing will support the turn in the credit cycle and we now forecast a frontloading of policy easing amid an October rate cut. We also expect strong US growth and a policy boost from China.**
- **All in all, we look for a period of muted quarterly growth rates of around 0.2% qoq in the second half of 2024 but see some rebound towards 0.3% qoq at the beginning of 2025. While we do not see a recession, the weak set of September sentiment indicators highlights the risk of stalling activity.**

High flying expectations about the euro area recovery in spring morphed into growth concerns with recession risks being increasingly mentioned again. Following a good start into the year, Q2 GDP growth surprisingly moderated (to 0.2% qoq, from 0.3% qoq) as investment spending shrank strongly and consumption activity receded somewhat.

Looking ahead, sentiment indicators like the composite PMI fell to levels consistent with contraction in September. Do we have to write-off the euro area recovery, or will it just be postponed? We tend to lean towards the latter possibility and will discuss the key activity drivers in what follows.



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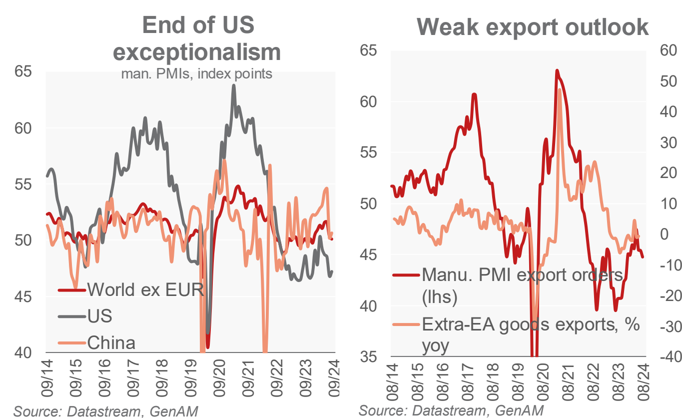
A weak global environment

Over the coming months global growth is set to rather stay muted. We expect US growth to step down from the exceptionally strong 3.1% annualised pace seen in Q2, to something slightly lower than 2%. Lacklustre credit growth and a housing sector still in the doldrums highlights downside risks to overall muted Chinese activity.



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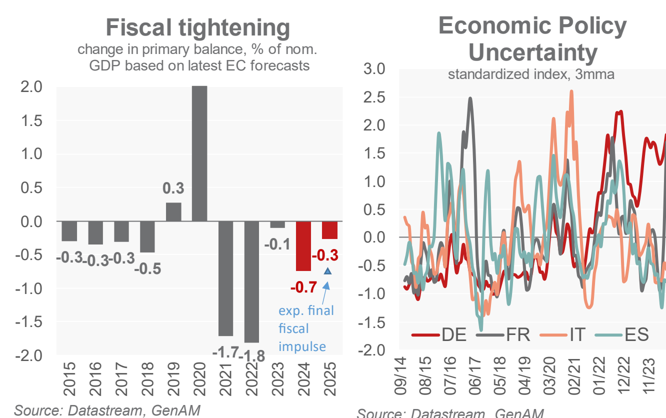
The global environment is currently a drag for euro area activity. Global manufacturing activity outside the euro area is almost stagnating in Q3, according to the PMI survey, translating into weaker export activity in the months to come. Also, manufacturing firms will see less of a need to re-stock inventories for the time being. That said, recently the Chinese central bank announced a number of stimulus measures and thereafter the Politburo stated that it would launch a bold fiscal plan aiming at achieve the 2024 growth target of 5.0% (we currently have 4.8% in our books).

Political uncertainty and fiscal drags

Headwinds to euro area activity also come from the domestic side. As the suspension of the Stability and Growth Pact (SGP) is over consolidation had to be resumed. According to the latest EC projection the fiscal impulse is at -0.7 pp in 2024 translating into a drag on growth of almost 0.2 pp on quarterly growth (assuming an average normal fiscal multiplier of one). In 2025 the fiscal drag is set to recede to -0.3 pp. However, we think that this too conservative. On July 8 the European Commission launched excessive deficit procedures (EDP) against countries with high expected 2025 deficits according to the latest EC forecast, namely the Belgium (-4.7%), France (-5.0%), Italy (-4.7%), Malta (-3.9%) and Slovakia (-5.4%), representing about 40% of euro area GDP. While the new SGP offers more flexibility it nevertheless requires still significant consolidation efforts. This concerns especially France with persistently high deficits and high public expenditure (57.3 % of GDP in 2023), driven by high social spending. With the new SGP focusing on net expenditures as a key target variable we think that significantly more tightening will be needed. At unchanged policies, the 2027 public deficit is now forecast at 6.5% of GDP versus 2.9% target presented in stability plan from April 2024. New Prime Minister Barnier announced on October 1 its consolidation plans which would amount to € 60 bn or about 2% of GDP in 2025. The French government will still need to present and align its (multiannual) plan with the EC. But we think that the ultimately agreed consolidation path will not imply a softer fiscal stance in 2025. But also in Germany, which is not subject to an EDP the need to comply with the domestic debt brake will trigger additional tightening measures. While there is considerable uncertainty about the details, we conjecture that updated projections in autumn after the member states have submitted their budgets will show for 2025 at least a similar degree of fiscal headwind as in 2024.



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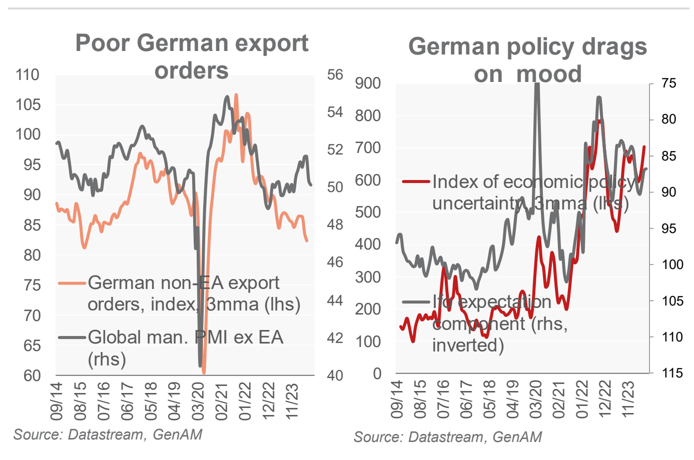
Furthermore, economic activity suffers from political uncertainty, especially in France and Germany. It rose significantly in France after the inconclusive July snap election outcome. President Macron has no possibility to form a coalition from centre-parties so that its technocratic Barnier government might have to rely on majorities with help of the far-left. In any case, this rather fragile constellation gives rise to huge uncertainty about political stability, fiscal policy and also the potential unwinding of important measures to ensure debt sustainability such as the recent pension reform. In Germany political uncertainty, the badly managed and communicated transition towards renewable energies along persistently high tensions within the ruling three-party coalition amid a struggling economy are key drivers. The risks of a government breakup and snap elections rose as of late. We do not expect these uncertainties to abate, at least not before the September 2025 forthcoming general election.

Germany to keep red lantern also for domestic reasons

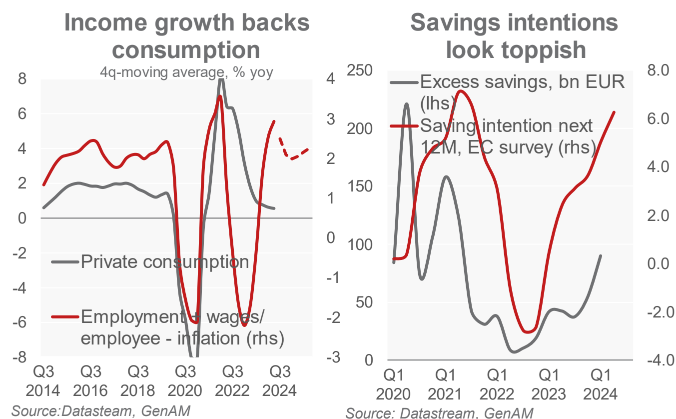
With a share of almost 30% in GDP, the weakness of the German economy significantly holds back activity in the euro area. Short-term the muted global environment is an important factor. Over the past four quarters countries with a high share of goods exports in GDP like Germany (0.39) and the Netherlands (0.59) experienced weaker growth than

countries with a low share like Greece (0.19) and Spain (0.23). Once the global economy is gaining some momentum again the export-oriented economies will benefit most. That said, we think that this will support Germany less than in the past because of structural problems. There are two main structural headwinds: energy costs and the crisis of the automotive sector. On the first we agree with Ifo's diagnosis that it is related to the de-carbonisation of the relatively energy-intensive economy, especially in manufacturing. European energy prices rose sharply, and the German ones for non-household consumers are above the euro area average. Moreover, increased competition in the car industry by Chinese firms together with the transition toward electric vehicles will continue to drag on activity. The decision of the majority of EU member states to allow the EC to levy tariffs of up to 35.3% on Chinese EVs can easily result in a trade war adding to the headwinds of the European car industry, especially the German one. Automotive is the country's most important industry, with a gross value added of 4.7% of GDP before the crisis. Directly and indirectly around 4% of employment (or 1.75mn people) has been related to the car industry before the pandemic according to the German Statistical Office. Employment is currently$ being reduced (by about 30k since 2020) according to the German Economic Ministry and that clearly spills over to the whole economy and has not finished yet. E.g. VW recently announced plans to heavily reduce employment. Fiscal policy is unlikely to come to the rescue as the government is committed to comply with the ambitious national debt brake leaving hardly any room to boost demand or to conduct urgently needed infrastructure investments. Therefore, we think that Germany will keep the red lantern for the time being thereby dragging on euro area activity.

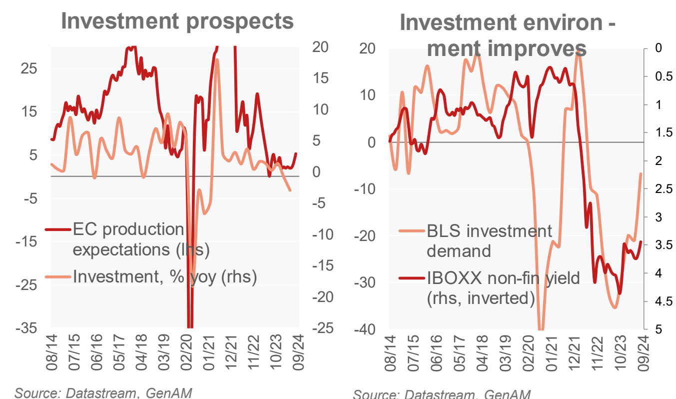


Domestic demand strong enough to sustain growth

Notwithstanding a poor global environment, fiscal headwinds, and political uncertainty, we think that domestic activity will be strong enough to sustain growth. We see it gaining momentum in the quarters to come. Consumption is backed by the recovery of real income growth. Wage growth currently shows signs of moderation, but we expect it to stay strong. Compensation per employee for instance was at 4.3% yoy in Q2/24 and the Indeed wage tracker which focuses on new wage agreements was up 3.9% yoy in 08/24. But with inflation set to fall further we expect solid real income growth to persist (see left-hand graph below). In September consumer confidence further advanced on the euro area level, despite faltering sentiment in Germany. Against this backdrop private consumption growth could easily recover towards its long-term average of 0.4% qoq or above, from -0.1% qoq in Q2/24.



Likewise, we see potential for investment activity to gain momentum. In Q2 it was likely held down by weaker construction as well as equipment investment. However, indicators like production expectations already now imply notwithstanding high uncertainty a positive investment dynamic. In the recent Bank Lending Survey the investment-driven credit demand further rose. And loan growth for firms (as well as households) gained momentum again increasing to the highest since July 2023 (October 2023). According to President Lagarde, the peak of policy restriction has been reached, implying that going forward the monetary policy drag will ease. Moreover, after having cut its key rate to 3.5% in September, we expect the ECB to keep on easing financing conditions further and lower the key rate to 2.25% by year-end 2025. Against the recent string of disappointing data we



now expect the ECB to bring forward its policy easing. While a still a very close call, we now deem it more likely that not that the ECB already cuts in October. We see rate cuts at each of the following meetings from December onwards until our 2025 year-end target of 2.25% has been reached (by April). We see the risks rather tilted towards more rather than less policy easing.

No recession but risk of stalling activity

All in all, we caution to write off the euro area recovery. The above-mentioned domestic forces should be strong enough to maintain output growth positive. In our baseline scenario we look for quarterly growth rates of about 0.2% qoq in the second half of 2024 and some strengthening in 2025. This would translate into annual growth rates of 0.7% in 2024 and 1.1% in 2025.

Crucial for this constructive view is the labour market. It remained so far very resilient with the unemployment rate fluctuating around 6.5%, close to the low of 6.4%. Going forward employment growth (of 0.2% qoq in Q2/24) will likely come to a halt or even recede somewhat, as indicated by the employment component of the composite PMI in Aug./Sep. However, we do not look for a period of strong net layoffs as demographically driven shortages are likely to give rise to some labor hoarding. And not least due to demographic reasons, also wage growth is set to remain strong to solid. In as much as the labour market deteriorates more strongly the risks to our constructive stance on activity increases. Likewise, a further rise in political uncertainties, e.g. due to the breakdown of the German government coalition, would induce additional headwinds.

Regarding geopolitics, an escalation of the situation in Middle East towards direct involvement of Iran into war seems to the highest risk, primarily via sky-rocketing oil prices. All in all, we see risks to growth clearly skewed to the downside.

A Trump victory in the November US election would dampen the growth outlook but more in the medium-term. According to our simulations the full implementation of the proposed trade measures would start towards the end of 2025 only and shave off at least 0.4 pp cumulative growth of the euro area in the 2025-29 period.

Imprint

Issued by:	**Generali Asset Management S.p.A.** **Società di gestione del risparmio, Research Department**
Head of Research:	**Vincent Chaigneau**
Head of Macro & Market Research:	**Dr. Thomas Hempell, CFA**
Team:	**Elisabeth Assmuth |** Research Operations **Elisa Belgacem |** Senior Credit Strategist **Radomír Jáč |** GI CEE Chief Economist **Jakub Krátký |** GI CEE Financial Analyst **Michele Morganti |** Head of Insurance & AM Research, Senior Equity Strategist **Vladimir Oleinikov, CFA |** Senior Quantitative Analyst **Dr. Thorsten Runde |** Senior Quantitative Analyst **Dr. Christoph Siepmann |** Senior Economist **Dr. Florian Späte, CIIA |** Senior Bond Strategist **Guillaume Tresca |** Senior Emerging Market Strategist **Dr. Martin Wolburg, CIIA |** Senior Economist **Paolo Zanghieri, PhD |** Senior Economist

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