

## Conflicting forces lead to subdued growth for the eurozone

While lower natural gas prices continue to act as a tailwind to the eurozone economy, tighter monetary policy is likely to slow down the expansion from the second half of 2023 onwards. That means subpar growth, both in 2023 and 2024. Inflation is past the peak, though stickier core inflation will push the European Central Bank to hike twice more by 25bp a piece



Meeting of the European Council, Brussels, Belgium - 24 Mar 2023

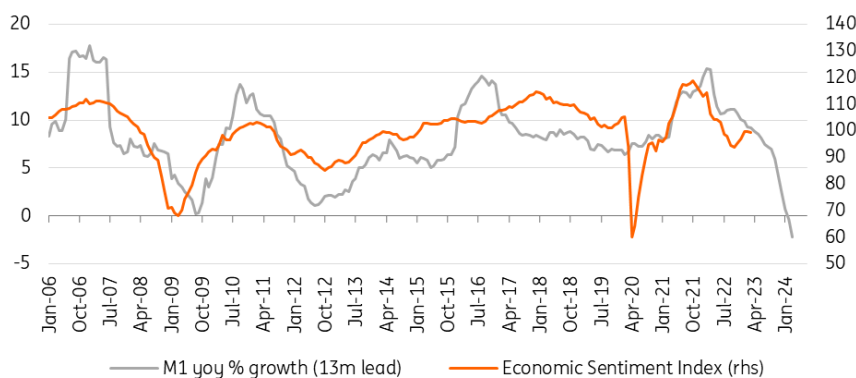
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### A foggy outlook

Most sentiment indicators in the eurozone continued to improve in the eurozone in March. However, we shouldn't forget that in recent months, confidence indicators have not had the best track record in nowcasting eurozone growth. More importantly, various conflicting forces are impacting the economy, which makes the outlook even more difficult than usual. While much lower energy prices than six months ago are clearly a boon to industry, an inventory overhang and weak orders are at the same time restraining activity. China's reopening might gradually offer some support, but for the time being there is not much pick-up in export orders. Services seem to be benefiting from stronger consumer demand, though the improvement in services sentiment is

still more explained by higher expectations than by current business. However, consumer confidence has remained weak and retail sales have hardly picked up so far. At the same time, tighter monetary policy is increasingly acting as a headwind to the expansion. Credit dynamics clearly weakened in February, a trend that might be exacerbated by the recent unrest in the banking sector. Order books in the interest rate-sensitive construction sector weakened for the third month in a row in March, heralding further weakness in building activity. The first quarter might still see a small positive growth figure. The question is, what happens afterwards?

## Contracting money growth bodes ill for the economic expansion

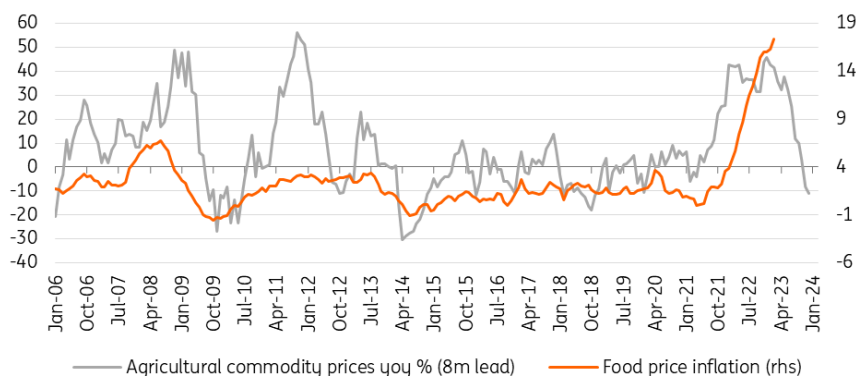


Source: Refinitiv Datastream

## Monetary contraction

The optimists will argue that despite the high level of uncertainty, the labour market remains very well supported, with the unemployment rate stabilising at 6.6% in February and consumer labour market expectations improving for the fifth consecutive month in March. This might be due to adverse demographic trends, which could lead to labour hoarding, even in a less buoyant business environment. Whatever the reason, in combination with higher wages and gradually falling inflation, the strong labour market remains supportive for purchasing power and consumption. At the same time, the easing of supply chain pressures should underpin production. This speaks to some acceleration in growth over the course of the year. However, we remain convinced that tighter monetary conditions and the withdrawal of fiscal stimulus will stop this trend in the third quarter. Even though there is a lot of uncertainty about the level of the neutral interest rate in the eurozone, the current level of short rates is in restrictive territory, according to most estimates. The most liquid part of money, M1, which proved to be a good leading indicator in the past, is now showing negative year-on-year growth for the first time since the start of the Monetary Union. Bottom line: we now have a 0.9% GDP growth estimate for the year, on the back of an “OKish” first half, but we continue to see the economy coming close to a standstill by the turn of the year. That would result in only 0.7% growth in 2024, clearly lower than what the ECB is currently pencilling in.

## Falling agricultural commodity prices will push down food inflation



Source: Refinitiv Datastream

### Disinflationary forces

Negative energy inflation is now pushing overall inflation down, with the headline figure falling to 6.9% in March. However, core inflation reached a new peak (5.7%) in the same month. Apart from energy, we believe that goods inflation is now also past the peak (with high inventory pricing power coming down), while lower agricultural commodity prices should, with some delay, also start to push down food inflation. Services inflation might prove to be stickier, but even then, we believe that the peak in core inflation has been reached. However, any drop in core inflation will be slow and at 5% in the second quarter, core inflation will still be too high for the ECB. Several ECB board members suggested that a bit more tightening might be necessary, which leaves us comfortable with our call of a 25bp rate hike both in May and June. After that, the deposit rate is likely to remain at 3.5% for a long period of time. Bond yields have been very volatile in the wake of financial market turbulence. We see them fluctuating in a range for most of the year, with slightly higher yields in the coming months, but a modest bond rally starting around the summer months.

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