

Eurozone inventory cycle – a silver lining for industry

The eurozone inventory cycle shows signs of turning, boosting manufacturing prospects despite headwinds from the trade war. However, it's too early to call this a full inflection point for the eurozone economy as the effect is most pronounced in Germany and also driven by US frontloading



Easing inventory burden adds to growth optimism

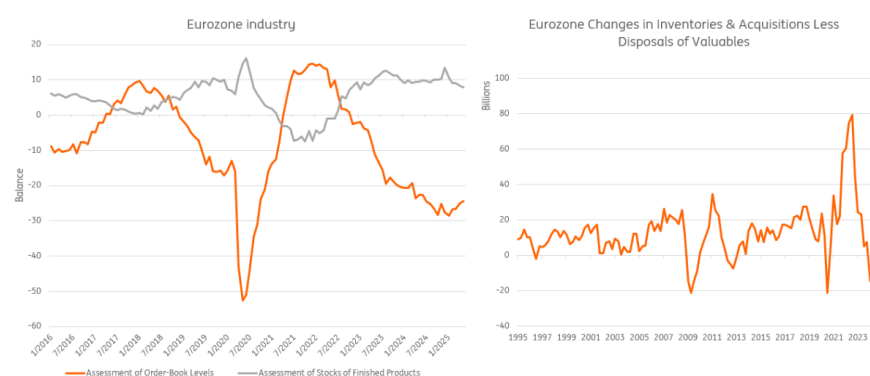
Eurozone manufacturing had a whopper of a first quarter. Growth in industrial production for the quarter was 4.7%, the highest since the start of the time series in the early 1990s, except for the post-lockdown rebound. After a long period of declining output for manufacturing which started in 3Q 2022, this was a remarkable jump, mainly driven by significant American frontloading of eurozone goods ahead of higher tariffs.

But even when taking frontloading out of the mix, it looks like eurozone manufacturing has been bottoming out. Recent surveys indicate more optimism about future production and better order books. Lower energy prices will surely help the more energy-intensive producers and announced German fiscal stimulus as well as European defence spending have both added to order books and general optimism. But there's more. After huge stockpiling in 2021 and 2022 and high inventories

limiting production since then, the inventory cycle is showing the first signs of turning again. Normally, it is the combination of inventory reduction and improving order books that will boost production in the future.

The relationship between stock levels and new orders has been disrupted in recent years. Due to substantial inventory accumulation during periods of supply chain strain, many businesses held off placing new orders, as their existing stock remained excessively high. That buffer has come down as inventories have been reduced. The number of businesses indicating that their stock of finished products is too large has fallen to the lowest level since March 2022, albeit still elevated compared to pre-Covid levels. And since this year, the rundown of inventories has been accompanied again by increasing order books. The relationship between orders and stocks seems to have been restored now that more normal levels of stocks have been reached.

Order books improve as inventories fall from record highs



Source: Eurostat, European Commission DG ECFIN

Data are seasonally and calendar adjusted. Right-hand chart shows the balance of European Commission survey answers on how order books are filled and how businesses perceive stocks (too large, too small).

Uncertain start to turn in inventory cycle

The overall eurozone picture is clear, but a closer look at individual member countries shows that a turn in the inventory cycle has not yet taken hold across the entire region. The relationship between stocks and order books is most pronounced in Germany. Other countries have also seen large inventory build-ups according to the national accounts measure, but the most recent developments and signals sent from survey data are less clear, so far. Given that Germany is the most important eurozone manufacturer, this is good news, but the direction of travel across the eurozone remains unclear so far. It's therefore premature to be overly optimistic, though we note the developments as an upside risk to manufacturing at this point.

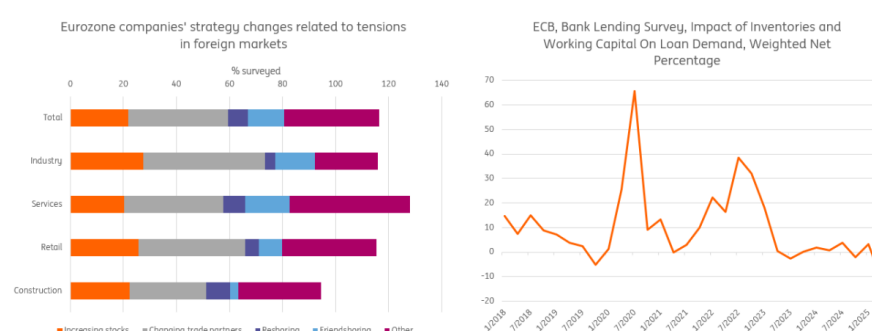
From just-in-time to just-in-case changes inventory behaviour

As mentioned above, there are clear signs of a turn in the inventory cycle. However, the next few months will show how much of this shift is structural and how much has been temporary due to the US frontloading. More generally speaking, it could also be that any inventory reduction will be less pronounced than in the past. As uncertainty rises and supply chain disruptions escalate, the European Commission reports that nearly half of manufacturers and about a quarter of retailers are adapting—or planning to adapt—their strategies in response to trade war developments. Of those intending to adjust, more than a quarter of manufacturers and retailers intend to increase

stocks to prepare for possible disruptions. This means that businesses are willing to hold more inventory, which theoretically wouldn't impact new production and orders too negatively.

But while businesses may want to increase inventories, this comes at a price, which is why the just-in-time model continues to be favoured by businesses over just-in-case. The extra costs of holding inventory and impact on working capital mean that many businesses prefer to take the risk of supply chain vulnerability. While some higher inventory levels could materialise over the coming quarters, eurozone banks have yet to see a financial impact. The European Central Bank lending survey shows that, in the first quarter, businesses were actually borrowing less for working capital and inventory needs.

Businesses seem keen to increase inventories structurally but this comes at a cost



Source: European Commission, ECB

Right-hand chart shows a survey answer from February/March by EU firms on their strategic response to tensions in foreign markets, multiple answers are possible.

The manufacturing outlook is bleak, but don't miss the bright spots

The outlook for eurozone manufacturing is incredibly uncertain despite a strong first quarter. Frontloading from the US could well result in a reversal of that effect in the second quarter. But while the trade war significantly dampens the prospects of a recovery in eurozone manufacturing, lingering cyclical effects remain a factor as well. Signs of a turn in the inventory cycle may support manufacturing significantly in the coming quarters, which provides an upside risk to a very uncertain outlook for eurozone industry. A silver lining in an uncertain global environment.

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