

The eurozone's summer tourist boom should give way to a significant slowdown

The third quarter may still be saved by tourism in the eurozone, but the latest data points to a more pronounced slowdown in the coming months. Inflation is falling, but a last interest rate hike in September is not yet off the table. The European Central Bank will be hesitant to loosen significantly in 2024, limiting the scope for a bond market rally



This outdoor classic car show in Nice, France, helped boost eurozone tourism this summer

Business sentiment in contraction territory

In spite of heatwaves and wildfires, the tourist season seems to have been strong in Europe. It has continued to support growth in the third quarter following a better-than-expected growth figure in the second quarter. However, with the end of the summer in sight, we're now beginning to see a more sobering economic outlook emerge.

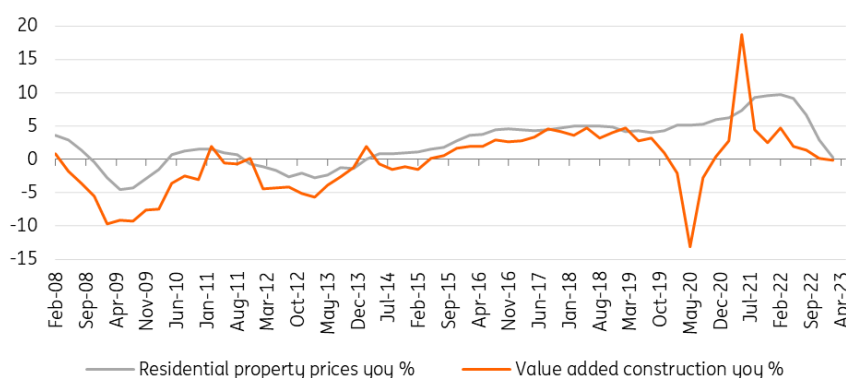
The composite PMI survey for August was certainly a cold shower, falling to the lowest level in 33 months at 47 points. While the figure has already been in contraction territory in industry for some time, it has now fallen below the boom-or-bust level in the services sector. Deteriorating

order books weighed on confidence in both the manufacturing and the services sector, which also explains why there were job losses in manufacturing while hiring plans in the services sector were put on a slow burner. This will probably stop the decline in unemployment in the eurozone.

Disappointing external demand

A softer labour market might lead to higher savings rates, thereby countering the positive impact on consumption of rising purchasing power. At the same time, the much-anticipated export boost is unlikely to materialise as the US economy eventually starts to cool while the Chinese recovery continues to disappoint. Finally, with a rapidly cooling housing market on the back of tighter monetary policy, the construction sector is also likely to see a slowdown. All of this explains why we still don't buy the European Central Bank's story that economic recovery will strengthen on the back of falling inflation, rising incomes and improving supply conditions. We expect the winter quarters to see close to 0% growth, resulting in 0.6% annual GDP growth for both this year and next year.

Cooling housing market is likely to weigh on construction activity



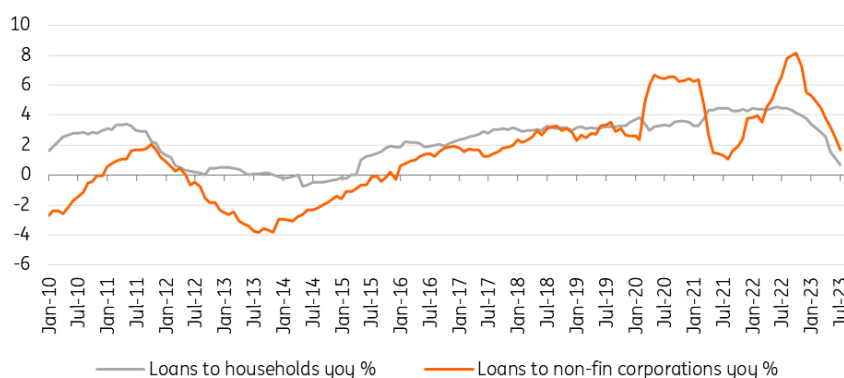
Source: LSEG Datastream

Inflation is coming down, slowly

While inflation is clearly trending down, the pace might still leave the ECB uncomfortable. Industrial goods prices have started to fall, but services prices are still growing monthly above 4% in annualised terms. Negotiated wage growth seems to have reached a plateau just below 4.5%. Still, given the slow productivity growth (with the decline in hours worked as one of the important drags), final demand will have to be very weak to prevent higher wages from feeding into higher prices.

We expect headline inflation to hit 2% by the end of 2024, but over the coming months, core inflation remains likely to hover around 5%. As the recent trend in underlying inflation is one of the key determinants of monetary policy, this would lead to an additional rate hike.

Loan growth is close to stalling



Source: LSEG Datastream

The ECB's job is almost done

With credit growth now close to a standstill and money growth negative, there remains little doubt that monetary policy is already sufficiently restrictive and that the monetary transmission mechanism is working. On top of that, the median consumer inflation expectation for the period three years ahead fell back to 2.3% in June. So, it looks as though the job is nearly done. For now, we're still pencilling in a final 25 basis point hike for the ECB's September meeting – but it's a very close call. A pause would likely mean the end of the tightening cycle, as the faltering recovery will make it harder to continue raising rates afterwards.

While we see the first rate cut by the summer of 2024, we can't imagine the central bank loosening aggressively next year. In her speech at Jackson Hole, President Christine Lagarde mentioned a number of structural changes that make the medium-term inflation outlook more uncertain, and we think that the ECB will keep short rates relatively high for some time to come. That will probably limit the potential for the bond market to rally strongly in the wake of the expected economic stagnation later this year.

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