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There's no denying it anymore: the eurozone is in recession

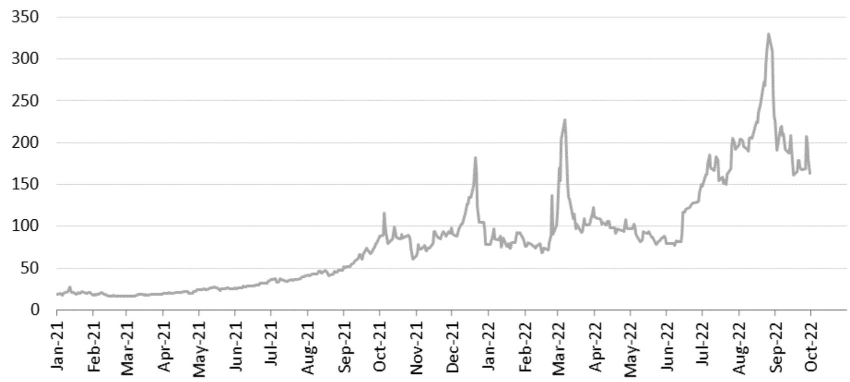
After a deceleration in economic growth over the summer months, eurozone indicators strongly deteriorated in September, suggesting the start of a recession. Meanwhile, inflation has reached double-digit figures, setting the European Central Bank on a more aggressive tightening path

According to the latest weather analyses, the risk of a cold winter has risen

Headwinds intensify

The challenges that the eurozone economy has been facing over the last few months have not disappeared. If anything, they have got worse. The war in Ukraine seems to be far from over with Russia deciding on a partial mobilisation after a rather successful Ukrainian counter-offensive. Natural gas exports from Russia to the European Union have been cut further and the sabotage of the Nord Stream 1 and 2 pipelines has created some fears regarding the safety of the gas pipelines from Norway. Unfortunately, according to the latest weather analyses, the risk of a cold winter has risen. We continue to expect very tight natural gas markets over the winter months, keeping prices at uncomfortably high levels. Moreover, because of the lack of natural gas imports from Russia, prices are not likely to fall significantly in 2023. This will hurt the supply side of the economy, with a growing number of European companies reducing production. And while governments have stepped up their support for households and businesses, we still believe that consumption will contract. At the same time, increasingly tight financial conditions are another headwind for growth.

European natural gas prices are likely to remain at historically high levels



Source: Refinitiv Datastream

Negative growth in 2023

While the deceleration of economic activity seemed to be limited during the holiday season, the September data now clearly screams recession. The Composite PMI indicator stood at 48.2 in September, clearly below the 50 boom-or-bust-level. With inventories building on the back of slowing sales, eurozone manufacturers reduced their purchases of inputs for the third month in a row. Consumer confidence fell in September to the lowest level since the survey started, with households especially worried about their financial situation over the next 12 months.

The ECB's assessment that households will reduce their savings to maintain their level of consumption looks illusory to us, as European consumers tend to save more in times of great uncertainty. The Eurocoin indicator, a gauge of the underlying growth pace, perfectly illustrates the strong deterioration of the economic environment in September: it fell from 0.23% to -0.73%. We therefore stand with our forecast of a small negative growth figure for the third quarter of 2022 and a deeper downturn over the winter months. With the ECB in a tightening mode, we also anticipate a more subdued recovery over the course of 2023. For next year, we now anticipate a 0.8% GDP contraction, after a 2.9% expansion in 2022.

Eurozone consumer confidence falls to a very low level

Source: Refinitiv Datastream

Double-digit inflation

Meanwhile, the inflation rate has hit double-digit figures: it rose to 10% in September. Energy prices remain the main culprit, but core inflation also rose to 4.8%. However, according to the models of the national central banks, the indirect effects of higher energy costs are currently contributing around one-third to core inflation. This means that once energy prices stabilise, core inflation will also come down. That said, this is likely to be a very gradual process. We still expect 5.6% headline inflation for 2023 and we believe it will take until the second half of 2024 before inflation reaches the ECB's 2% target.

A more hawkish ECB

Since the Jackson Hole conference in August, the ECB has become more aggressive. As it seems to have lost confidence in its medium-term inflation forecast, it is now focusing much more on current inflation. Quite a change! That explains why the bank now wants to get rates back to neutral as fast as possible and is even willing to go a bit further, as long as the recession is not creating too much unemployment. We therefore see a 75bp hike in October, followed by 50bp in December and 25bp in February 2023, bringing the deposit rate to 2.25%. The ECB might also decide to stop the reinvestment of its asset purchase programme (APP) portfolio somewhere in the first half of next year. However, the pandemic emergency purchase programme (PEPP) portfolio is likely to be reinvested until the end of 2024. As for bond yields, some further limited upward potential is still on the cards, but around the turn of the year, the yield curve is very likely to invert in the wake of the significant economic downturn.

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