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Eurozone economic sentiment signals a recession is near

The European Commission's economic sentiment indicator took a dive in July, with forward-looking indicators pointing to an economic contraction in the second half of the year. Meanwhile, inflationary pressures are starting to soften, albeit only gradually



A recession is coming

The European Commission's economic sentiment indicator plunged from 103.5 in June to 99 in July, now below its long-term average. Among the bigger member states, the ESI declined significantly in Spain (-5.0), Germany (-4.9) and Italy (-3.4), while it remained broadly stable in France (-0.1) and the Netherlands (+0.2).

Industrial confidence declined markedly (-3.5) on the back of increasing headwinds, with the worsening energy crisis most probably one of the main culprits. All forward-looking indicators now point to a contraction in the coming months. Order books have deteriorated, inventories are at too high a level and production plans have been scaled down.

Surprisingly, sentiment in the services sector also fell back significantly (-3.4). That clearly goes against the European Central Bank's assessment that third-quarter growth will still be supported

by the full reopening of the economy with people travelling more and tourism booming. Confidence in the retail sector (-1.6) and the construction sector (-0.4) declined but to a lesser extent.

It seems clear that final demand is stalling. Consumer confidence declined again (-3.2) and the outlook for the personal financial situation over the next 12 months is now at the lowest level ever. High inflation and the soaring costs of energy are, of course, major headwinds. Unfortunately, the labour market, which had been a big support for consumption also shows signs of weakening. The Employment Expectations Indicator, while still above its long-term average, fell for the fifth month in a row. In the consumer survey, unemployment expectations also increased. No wonder that the intention to make major purchases over the next 12 months is now close to an all-time low.

Inflationary pressures start to ease

The rapidly cooling economy means that inflationary pressures are starting to abate somewhat. Selling price expectations fell in all four sectors, while consumer inflation expectations remained broadly stable. It is interesting to note that in industry, the supply side issues are also easing gradually. With a recession now clearly around the corner, pricing power of companies is likely to diminish. At the same time, the underlying softening of the labour market will not be conducive to massive wage increases either.

To be sure, inflation will remain far too high in the coming quarters on the back of rising energy prices and some second-round effects that will still materialise. But underlying inflation should have peaked in the first half of 2023 at the latest.

While we still believe that the ECB will deliver an additional 50bp rate hike over the coming months, the spectre of a full-blown recession is likely to halt the tightening cycle before the end of this year.

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