ODDO BHF
CORPORATES & MARKETS

# Economy

## Business climate in Europe: cracks beginning to appear

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***Business climate indicators in the eurozone weakened significantly in June. In the manufacturing sector, this is due to the persistent constraints on production, with no hope of an easing in the foreseeable future given the war in Ukraine and the related energy crisis. In services, as expected, the post-Omicron reopening effect is wearing off. Current conditions are eroding moderately, particularly on the employment front, but the outlook for demand is declining sharply against a backdrop of inflationary pressures. To make matters worse, the ECB has triggered a severe tightening of financial conditions.***

### Below normal

Since the outbreak of the war in Ukraine four months ago, the interpretation of European business confidence surveys has given rise to mixed sentiment. While there were signs of weakness -the opposite would have been surprising given the suddenness and severity of the shock- they were neither diffuse enough across sectors nor strong enough to signal a significant downturn. Moreover, as this war started when morale was well above normal, it left a safety buffer before hitting critical levels. **There is no longer any ambiguity in the signals sent by eurozone businesses in June: they are all negative.**

According to the flash estimates of the PMI surveys conducted from 13 to 21 June[1], the downturn has become markedly more pronounced in all countries and sectors (table). In the manufacturing sector, purchasing managers' confidence fell for the fifth month in a row. In the services sector, which had previously found significant support in the catch-up following the abating of the Omicron wave, it is the second consecutive contraction. **In the eurozone, the business climate indices remain above the "critical threshold" for entering a recession (50 points) but all have fallen below their pre-Covid levels. This portends a slowdown in economic growth in the second half of 2022.**

**Purchasing Managers Indices (PMI)**

| | | pre-Covid 2015-2019 | 2020-2021 Trough | 2020-2021 Peak | Q1 2022 | Q2 2022 | May 2022 | **June 2022** | June 2022 vs… May | June 2022 vs… Q2 | June 2022 vs… pre-Covid |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Eurozone** | manufacturing | 53.0 | 33.4 | 63.4 | 57.8 | 54.0 | 54.6 | **52.0** | ⇩ | ⇩ | ⇩ |
| | services | 54.0 | 12.0 | 59.8 | 54.1 | 55.5 | 56.1 | **52.8** | ⇩ | ⇩ | ⇩ |
| | composite | 53.9 | 13.6 | 60.2 | 54.2 | 54.2 | 54.8 | **51.9** | ⇩ | ⇩ | ⇩ |
| **Germany** | manufacturing | 53.2 | 34.5 | 66.6 | 58.4 | 53.8 | 54.8 | **52.0** | ⇩ | ⇩ | ⇩ |
| | services | 54.3 | 16.2 | 61.8 | 54.7 | 55.0 | 55.0 | **52.4** | ⇩ | ⇩ | ⇩ |
| | composite | 54.2 | 17.4 | 62.4 | 54.8 | 53.1 | 53.7 | **51.3** | ⇩ | ⇩ | ⇩ |
| **France** | manufacturing | 52.0 | 31.5 | 59.4 | 55.8 | 53.8 | 54.6 | **51.0** | ⇩ | ⇩ | ⇩ |
| | services | 53.5 | 10.2 | 57.8 | 55.3 | 57.2 | 58.3 | **54.4** | ⇩ | ⇩ | ⇧ |
| | composite | 53.2 | 11.1 | 57.4 | 54.8 | 55.8 | 57.0 | **52.8** | ⇩ | ⇩ | ⇩ |

*for services and composite, output index.

Moreover, given the state of EU-Russia relations, the disruption of supply-chains and inflationary tensions stoked by the war in Ukraine are not about to abate. Sanctions on the one hand, and reduced gas supplies on the other, all kindle fears of shortages. **It is quite possible that European governments will have to ration energy distribution in the coming months, at least they are working on such contingency plans. In this extreme situation, there can be no doubt that this would cause a contraction of activity.** Countries with a large industrial sector are most directly exposed. Germany is in the front line in this regard[2].

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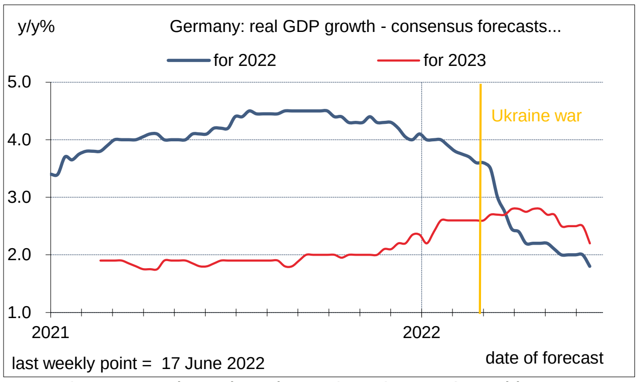
[1] *In France, the monthly INSEE survey, carried out over a longer period, from 27 May to 20 June, also indicates a deterioration of the business climate, but more moderate than the PMI survey. Could it be that the downturn in sentiment has suddenly become more pronounced in recent days, precisely at a time when everywhere there is nothing but talk of recession or the risk of recession? There are fears that may prove self-fulfilling.*
[2] *See our* Eco Flash *of 30 March 2022: "*Germany: on the brink of recession*". The Bundesbank's monthly report in April estimated that an energy embargo could cause an immediate loss of activity of 5 points of GDP, more than half of which would be due to rationing effects.*

**The energy squeeze poses a major threat to economic activity in Europe. In a more ordinary economic cycle, we are more inclined to focus on a potential rationing on employment or credit[3]. In these areas, the recent news is far less alarmist**.

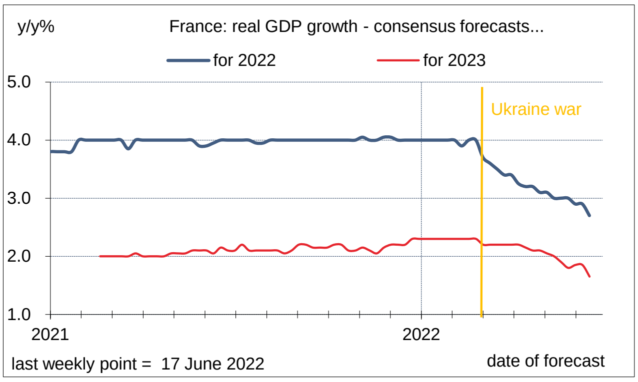
- To date, there are no indications that labour market conditions have weakened substantially. In France, for example, the hiring data in the private sector known up to May and the employment climate index up to June still point towards above-normal jobs growth. While a slowup in job creations is likely on the cards in H2 2022, there is nothing to presage a sudden collapse.
- As regards credit, the signals are bleaker. Since the spring, commercial banks have been tightening their lending standards. Also, the brisk uptick in interest rates is set to be passed onto borrowing rates and demand, particularly in the mortgage lending segment. In Germany, based on past correlations, mortgage rates tend to react on a virtually one-for-one basis and more or less immediately to Bund yields. After a rate increase of over 150bp since the start of the year, borrowing costs are set to be at their highest level since 2011. After a sustained increase of around 1% a month over the last two years, housing prices are beginning to show signs of easing.

The war in Ukraine has upended Europe's economic outlook. Since February, growth forecasts have been substantially downgraded, more so in Germany (chart lhs) than in France (chart rhs). Given the carry-over effect resulting from the strong recovery of 2021, we should have no illusions about the y-o-y averages. Consensus forecasts are now just above the brink of recession territory, in a zone of real GDP growth of 0.1% to 0.2% per quarter.

**Germany: consensus on real GDP growth**




**France: consensus on real GDP growth**




*Sources: Consensus inc. Bloomberg, ODDO BHF Securities*

**Apart from the war, the fragility of the Eurozone has been accentuated by the ECB.** Since February, in the region the most exposed to the negative repercussions of this shock, the ECB has held an increasingly aggressive stance to the point which, over this period, the tightening of financial conditions has been stronger in the eurozone than in the US. Neither the state of demand (there is no widespread excess in the eurozone), nor momentum on wages, or the deep-rooted causes of the inflation shock (supply constraints) could justify such a gap. All told, the markets did not wait for the ECB to deliver policy rate hikes to adjust and the ECB did nothing to reverse the markets' interest rate expectations. Circular logic! It required the overreaction on sovereign spreads last week for the ECB to react with the promise of an anti-fragmentation tool. **The next ECB meeting is scheduled for 21 July[4]. It is now too late to stop the process of interest-rate hikes at the ECB, but perhaps the pace could be slowed. The flash estimates for the PMI surveys for July will be published the day after this meeting. We are hoping that they will not fall below 50 points. This would be a real shame.**

[3] *See our* Eco Flash *of 19 May 2022: " Eurozone: employment is holding up, credit slightly less so".*
[4] *See our* Eco Flash *of 10 May 2022: "The ECB and the July curse".*

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