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The Eurozone economy: business activity surprises on the upside but a challenging winter lies ahead



Data released this week showed that business activity in the eurozone was more resilient than expected through November. However, as winter tightens her noose around the northern hemisphere, dovetailing factors such as rising Covid infections, high energy costs and supply chain dislocations suggest conditions are set to become more challenging.

The Eurozone flash composite purchasing managers' index (PMI), a monthly survey compiled by IHS Markit that takes the pulse of business sentiment, rose for the first time in four months to

55.8 in November, up from 54.2 in October, defying economist expectations for a drop to 53.2.

For the third month running, services outperformed manufacturing with the latter still held back by supply chain issues, especially in the auto sector (a heavyweight inside of the European manufacturing industry). The silver lining is that robust demand for IT equipment, household goods, and food and beverages persists.

Even if the November picture was better-than-expected, the survey also revealed that the months ahead could present an uphill struggle.

Firstly, price pressures are intensifying. Costs that businesses have to pay for goods and services are rising at the fastest pace since the PMI survey began in 1998 as a result of shortages, elevated energy costs and higher shipping costs. Selling price inflation also accelerated at a record pace as companies seek to protect their margins and pass these higher costs on to customers, most notably in Germany. This fact is echoed in inflation data, published earlier in the month by Eurostat: Headline eurozone inflation rose to 4.1% in October, the fastest pace since the creation of the currency union, and almost double the ECB's 2% target.

Secondly, the continent faces a resurgence in Covid infection levels, compelling some countries to enact full lockdowns (Austria), while others (Germany) have said such measures cannot be ruled out. While vaccination rates limit the burden on the health care system, rising fear of the virus could make consumers apprehensive to go out and spend (particularly on services).

While further economic momentum in the Eurozone is likely to be delayed, stronger-thanexpected business activity at least confirms that the recovery has not been derailed.

The key risk to growth in our view, remains to be inflation. Lately, markets have been losing faith in the "transitory" narrative, but central banks are holding the line. In our opinon, once volatile energy prices soften and Covid-related supply chain issues are ironed out, price pressures should begin to alleviate. It is also worth noting that the German VAT increase has added around 0.6 percentage points to eurozone inflation, an effect that will disappear in January 2022.

However, there is a danger that before these factors subside, a self-fulfilling feedback loop kicks in with regard to inflation dynamics; inflation drivers are already broadening out and starting to look stickier than originally thought. If this trend continues, it could ultimately impact monetary policy decisions.

For now, the ECB is advocating patience. The Chair, Christine Lagarde, has actively pushed back on market bets on an interest rate hike as soon as next October, saying it was "very unlikely" such a move would happen in 2022. But there are some sounds emanating from other policymakers which suggest that the ECB is eyeing every new inflation reading with caution.

European yields took a lurch upwards this week after Schnabel and Knot both downplayed the impact from possible new Covid restrictions on the economy and thus on monetary policy. Schnabel added that the ECB shouldn't pre-commit for an overly extended timespan and that risks to inflation are tilted to the upside. Schnabel, Villeroy and Knot have also indicated that asset purchases beyond the end of the Pandemic Emergency Purchase Program (PEPP) in March might be more modest than some market participants hoped for.

The market now eagerly awaits the ECB's next monetary policy committee on 16th December, as well as the November flash inflation print, which will be available this Tuesday (30th).

The full PMI report is available <u>here</u>.

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