The start of a recession?

Eurozone economy contracts modestly in Q3

RaboResearch
Global Economics & Markets
mr.rabobank.com

Erik-Jan van Harn
Macro Strategist
+316 300 209 36

Maartje Wijffelaars
Senior Economist
+316 225 705 69

Contents

Summary

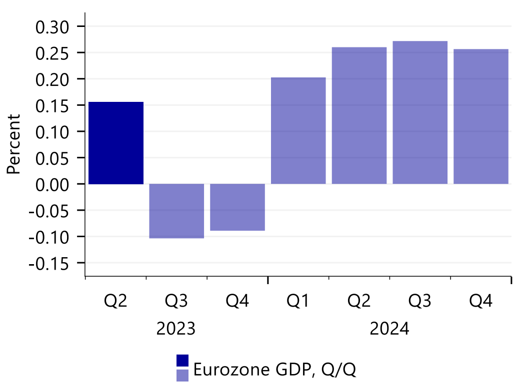
- The Eurozone economy contracted by 0.1% in the second quarter, with a wide variation among member states.
- A sizeable share of companies still indicates that the tight labour market hinders their production. On balance, companies don't expect their headcount to shrink soon.
- We expect some loosening of the labour market going forward, but don't expect a steep rise in unemployment. This will put a floor under the economic contraction, especially since we expect real wages to rise soon, but will also continue to hinder activity in several sectors.
- We expect another modest decline in GDP in Q4 followed by a slow recovery. The war in the Middle-East is a clear downside risk to our outlook, however.

The start of a recession?

In the third quarter the Eurozone economy contracted by 0.1% compared to the second quarter, in line with our projections. There is wide dispersion in the growth figures published so far for individual member states, ranging from -2.5% q/q in Lithuania to +0.5% q/q in Belgium. Among the largest member states, Spain (+0.3% q/q) and France (+0.1 q/q) managed to grow, while Germany and Italy posted a minor contraction of 0.1% q/q.

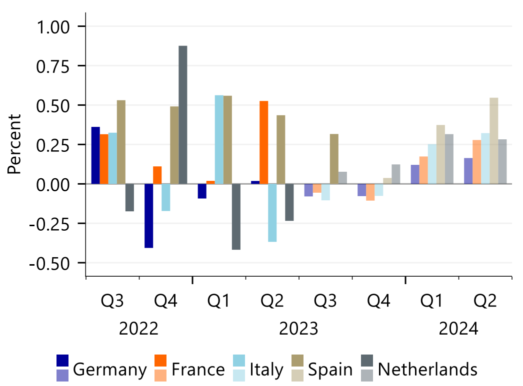
The breakdown of the Eurozone figures is still unknown, and country data available so far presents a rather mixed picture. Household consumption, for example, declined in Germany and Austria, but grew in both France and Spain. Exports seem to have acted as a drag and also developments in the construction sector were mostly weak, especially on behalf of housing investment. On an upbeat note, business investment in machinery and equipment seems to have increased, despite increased interest rates. We believe that it will take longer before the pain of higher interest fully materializes, as indicated by the ECB's bank lending survey for example.

Figure 1: A modest recession is on the horizon



Source: Macrobond, Eurostat, RaboResearch

Figure 2: Weak growth ahead for France and Germany



Source: Macrobond, Eurostat, RaboResearch

This morning, Eurostat also published a preliminary estimate for inflation in the euro area in October. As expected, inflation dropped substantially, from 4.3% in September to 2.9%. The slowdown was broad based, though unsurprisingly, energy inflation came down the sharpest falling to -11.1% y/y. This reflects downward pressures in the 'pipeline' and favourable base effects. Meanwhile, food and non-energy industrial goods also saw inflation decrease in October – to 7.5% y/y and 3.5% y/y respectively. Services inflation fell just a touch (0.1%-pts to 4.6% y/y), highlighting that labour-intensive sectors are unlikely to change course as quickly as commodity-intensive sectors have been doing in recent months. Core inflation slowed to 4.2% from 4.5%, which was a sharper drop than we had pencilled in. The combination of falling yet still high core inflation underscores our view that, barring any shocks, the ECB is done hiking but won't start cutting rates anytime soon – not before the second half of next year that is.

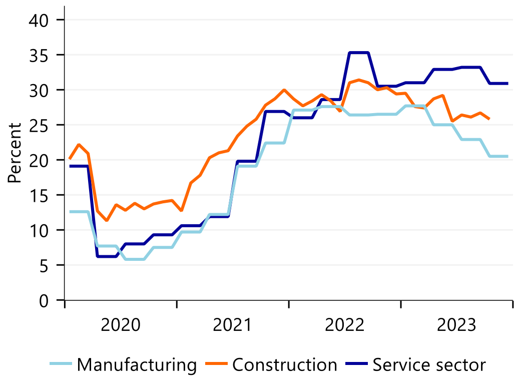
The labour market is finally loosening. Minimally.

Along with economic growth, the labour market is cooling. The vacancy rate has peaked at a historic high early 2022, and the number of unemployed people is slowly rising in some European countries, including Germany -which has arguably one of the tightest labour markets. Forward-looking indicators, such as the purchase managers indices, also indicate that European firms cut employment in September, the first drop in headcount since the early 2021 lockdowns.

Given the economic headwinds, the consensus is that the labour market will loosen. However, the real question is, by how much? Will businesses hoard labour as they have done over the past 1.5 years because they expect the downturn to be short-lived and labour markets to remain structurally tight? Or will falling profits ultimately force them they lay people off?

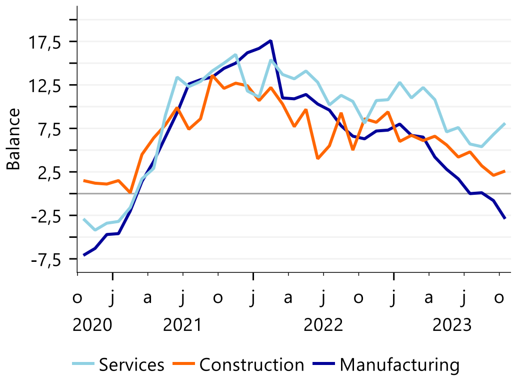
Even though we expect hiring will become somewhat easier, a sizeable share of companies, particularly in Northern and Western Europe, still indicate that they struggle to find skilled workers, after reaching a record-high in the summer of 2022 (Figure 3). Since then, the issue has faded only slightly and is still far larger than the historical average.

Figure 3: Many companies still indicate that the tight labour market hinders their production



Source: Macrobond, Eurostat

Figure 4: The employment outlook is still mildly positive, albeit with wide sectoral variances



Source: Macrobond, Eurostat

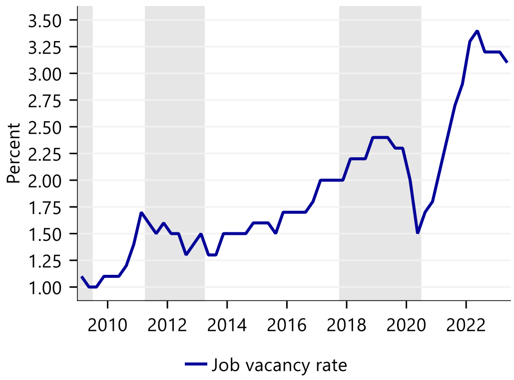
Moreover, businesses do not yet indicate a willingness to let go of their employees (Figure 4). Even in the manufacturing sector, companies indicated that they intended to retain staff over the past months, despite the steep fall in production. Going forward, manufacturing companies expect the headcount to fall slightly. The majority of companies in the services and construction sectors on the contrary, expect their headcount to grow. We can explain this from the fact that expectations for demand are positive, but there's also a degree of labour hoarding included.

To some extent, this isn't an uncommon phenomena in this stage of business cycle. As long as companies don't have the expectation that the economic downturn will be especially long or painful, they have a clear incentive to retain workers. Still, we expect that the effect will be stronger this time around because of the exceptionally tight labour market conditions.

As a result, we do not expect the unemployment rate to rise rapidly. This is further supported by the fact that the current high level of vacancies serves as a buffer. The vacancy rate is currently slightly above 3%, which is significantly higher than the pre-pandemic average. This can be explained by several factors. For example, demographics are becoming an ever more constraining factor. For one because the working age population is shrinking in many European countries, plus older people also tend to work less hours. Furthermore, the higher vacancy rate may also indicate that there is a greater mismatch between the skills that employers seek and the skills that workers possess and are willing to put to use. We suspect that this is true to some extent because, for example, the pandemic has changed workers' preferences. Additionally, the demand for labour to facilitate the energy transition has increased much faster than the supply. Yet likely the most important factor is that it is a cyclical effect. If this is true, the vacancy stock serves as a buffer, as firms will likely cut vacancies before they lay off employees.

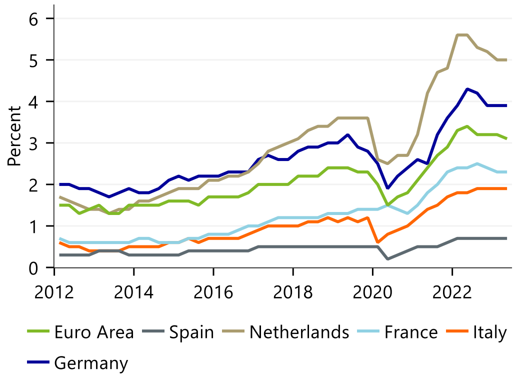
The buffer varies greatly between countries, however. The vacancy rate is particularly high in countries with a tight labour market, such as the Netherlands and Germany (even though it has already started to fall). In countries such as Spain, the vacancy rate has barely changed compared to the pre-pandemic average. As a result, we anticipate that an economic slowdown in these countries will have a greater impact on employment – note, however, that for Spain, we project a much smaller downturn than in most of its peers.

Figure 5: Is this what a buffer looks like?



Note: Shaded area represents a recession
Source: Macrobond, Eurostat

Figure 6: The buffer differs from country to country



Source: Macrobond, Eurostat

Outlook

We expect that the Eurozone will enter a mild recession, followed by a period of sluggish growth. Although it is rather difficult to precisely estimate the exact effect, undoubtedly, higher interest costs should put a lid on growth. Meanwhile, the labour market will likely loosen somewhat, but we expect that it remains structurally tight. This both puts a floor under an economic contraction (since consumers can uphold their consumption) and a lid on economic growth as companies struggle to find qualified workers. Foreign demand is unlikely to be able to substantially lift the Eurozone growth figure, as we expect a struggling Chinese economy and a US recession in 23Q4-24Q1.

We do see some serious risks to this rather benign outlook however. The most obvious one being a further escalation of the war in the Middle-East, which could lead to seriously higher energy prices (as we argued in an earlier piece). The economic impact of higher energy prices could be bigger than it was last time around. Governments no longer have the same fiscal firepower to cushion the blow, due to the increased cost of borrowing, whilst at the same time most consumers can't rely anymore on a glut of pandemic savings. Indeed, in most countries, household savings adjusted for inflation are close to their pre-pandemic level.

Meanwhile, companies are also in a worse position to handle a new energy price shock. They already face (or are about to face) significantly higher financing costs and increasing labour costs, whilst the slowing economy likely means that they can’t fully charge those higher costs to their customers. The economic price of a renewed energy shock could therefore be larger.

RaboResearch
Global Economics & Markets
mr.rabobank.com

Global Head

Jan Lambregts
+44 20 7664 9669
Jan.Lambregts@Rabobank.com

Macro Strategy

Global

Michael Every
Senior Macro Strategist
Michael.Every@Rabobank.com

Europe

Elwin de Groot
Head Macro Strategy
Eurozone, ECB
+31 30 712 1322
Elwin.de.Groot@Rabobank.com

Bas van Geffen
Senior Macro Strategist
ECB, Eurozone
+31 30 712 1046
Bas.van.Geffen@Rabobank.com

Stefan Koopman
Senior Macro Strategist
UK, Eurozone
+31 30 712 1328
Stefan.Koopman@Rabobank.com

Erik-Jan van Harn
Macro Strategist
Germany, France
+31 6 300 20 936
Erik-Jan.van.Harn@Rabobank.nl

Maartje Wijffelaars
Senior Economist
Italy, Spain, Portugal, Greece
+31 88 721 8329
Maartje.Wijffelaars@Rabobank.nl

Americas

Philip Marey
Senior Macro Strategist
United States, Fed
+31 30 712 1437
Philip.Marey@Rabobank.com

Christian Lawrence
Senior Cross-Asset Strategist
Canada, Mexico
+1 212 808 6923
Christian.Lawrence@Rabobank.com

Mauricio Une
Senior Macro Strategist
Brazil, Chile, Peru
+55 11 5503 7347
Mauricio.Une@Rabobank.com

Renan Alves
Macro Strategist
Brazil
+55 11 5503 7288
Renan.Alves@Rabobank.com

Molly Schwartz
Cross-Asset Strategist
+1 516 640 7372
Molly.Schwartz@Rabobank.com

Asia, Australia & New Zealand

Teeuwe Mevissen
Senior Macro Strategist
China
+31 30 712 1509
Teeuwe.Mevissen@Rabobank.com

Benjamin Picton
Senior Macro Strategist
Australia, New Zealand
+61 2 8115 3123
Benjamin.Picton@Rabobank.com

FX Strategy

Jane Foley
Head FX Strategy
G10 FX
+44 20 7809 4776
Jane.Foley@Rabobank.com

Rates Strategy

Richard McGuire
Head Rates Strategy
+44 20 7664 9730
Richard.McGuire@Rabobank.com

Lyn Graham-Taylor
Senior Rates Strategist
+44 20 7664 9732
Lyn.Graham-Taylor@Rabobank.com

Credit Strategy & Regulation

Matt Cairns
Head Credit Strategy & Regulation
Covered Bonds, SSAs
+44 20 7664 9502
Matt.Cairns@Rabobank.com

Bas van Zanden
Senior Analyst
Pension funds, Regulation
+31 30 712 1869
Bas.van.Zanden@Rabobank.com

Paul van der Westhuizen
Senior Analyst
Financials
+31 88 721 7374
Paul.van.der.Westhuizen@Rabobank.com

Cas Bonsema
Senior Analyst
ABS, Covered Bonds
+31 6 127 66 642
Cas.Bonsema@Rabobank.com

Agri Commodity Markets

Carlos Mera
Head of ACMR
+44 20 7664 9512
Carlos.Mera@Rabobank.com

Michael Magdovitz
Senior Commodity Analyst
+44 20 7664 9969
Michael.Magdovitz@Rabobank.com

Paul Joules
Commodity Analyst
+44 20 7887 824436
Paul.Joules@Rabobank.com

Energy Markets

Joe DeLaura
Senior Energy Strategist
+1 212 916 7874
Joe.DeLaura@Rabobank.com

Client coverage

Wholesale Corporate Clients

Martijn Sorber	Global Head	+31 30 712 3578	Martijn.Sorber@Rabobank.com
Hans Deusing	Europe	+31 30 216 9045	Hans.Deusing@Rabobank.com
Neil Williamson	North America	+1 212 808 6966	Neil.Williamson@Rabobank.com
Adam Vanderstelt	Australia, New Zealand	+61 2 8115 3102	Adam.Vanderstelt@rabobank.com
Ethan Sheng	Asia	+852 2103 2688	Ethan.Sheng@Rabobank.com
Ricardo Rosa	Brazil	+55 11 5503 7150	Ricardo.Rosa@Rabobank.com

Financial Institutions

Short-term Interest Rates

Marcel de Bever	Global Head	+31 30 216 9740	Marcel.de.Bever@Rabobank.com

Bonds & Interest Rate Derivatives

Henk Rozendaal	Global Head Fixed Income	+31 30 216 9423	Henk.Rozendaal@Rabobank.com

Solutions

Sjoerd van Peer	Global Head	+31 30 216 9072	Sjoerd.van.Peer@Rabobank.com

Relationship Management

Rogier Everwijn	Global Head	+31 30 712 2440	Rogier.Everwijn@Rabobank.com
Rob Eilering	Banks	+31 30 712 2162	Rob.Eilering@Rabobank.com
Petra Schuchard	Insurers		Petra.Schuchard@Rabobank.com
Frank Dekkers	Asset Managers		Frank.Dekkers@Rabobank.com
Javier Alvarez de Eerens	MDB	+31 30 712 1015	Javier.Alvarez@Rabobank.com
Christel Kleinhaarhuis	Fintech		Christel.Klein.Haarhuis@Rabobank.com

Capital Markets

Laura Bijl	Global Head	+31 88 726 3254	Laura.Bijl@Rabobank.com
Christopher Hartofilis	Capital Markets USA	+1 212 808 6890	Christopher.Hartofilis@Rabobank.com
Ian Baggott	Capital Markets Asia	+852 2103 2629	Ian.Baggott@Rabobank.com
Willem Kröner	Global Head ECM	+31 30 712 4783	Willem.Kroner@Rabobank.com
Harman Dhami	DCM Syndicate	+44 20 7664 9738	Harman.Dhami@Rabobank.com
Crispijn Kooijmans	DCM FIs & SSAs	+31 30 216 9028	Crispijn.Kooijmans@Rabobank.com
Bjorn Alink	DCM Securitisation & Covered Bonds	+31 30 216 9393	Bjorn.Alink@Rabobank.com
Othmar ter Waarbeek	DCM Corporate Bonds	+31 30 216 9022	Othmar.ter.Waarbeek@Rabobank.com
Joris Reijnders	DCM Corporate Loans	+31 30 216 9510	Joris.Reijnders@Rabobank.com
Brian Percival	DCM Leveraged Finance	+44 20 7809 3156	Brian.Percival@Rabobank.com

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