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# Not as bad as it looks?

## *Eurozone economic update*

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## Summary

- A slew of (significantly) weaker-than-expected PMI surveys in the Eurozone in the past two months has injected fresh uncertainty about the strength of the economic recovery.
- The services sector seems to be 'catching down' to the struggling industrial sector.
- Is industrial weakness spilling over or is the services sector facing challenges of its own?
- Our analysis does not point towards negative spillover effects from industry to services, but to underlying weakness in consumer demand.
- Although near-term risks to growth appear to be to the downside, we retain a (mildly) optimistic outlook on consumer demand.

## Uncertainty creeping in - again

A slew of (significantly) weaker-than-expected PMI surveys in the Eurozone in the past several months has injected fresh uncertainty about the strength of the economic recovery. Instead of just pointing the finger at the industrial sector, which is not only suffering from headwinds due to a lack of structural competitiveness but also from slower global growth, it is the unexpected weakness in the services sector that has highlighted the possibility of deeper issues. This could be a case of weaker industrial activity spilling over to other sectors. But it could also be due to a situation where domestic demand is depressed by high interest rates, inflation, and/or (geopolitical) uncertainty. In this latter case the risk of persistent weakness is higher.

To zoom in on this we asked ourselves whether the EC business confidence survey, which has a broad range of sectors across industry and services, shows such spillover effects. But, for starters, we note that the PMI surveys – which tend to signal a trend change in activity a few months earlier than the European Commission's survey – have been quite 'erratic' in recent years. In fact, since the Covid-19 shock, a repeating pattern seems to have crept in[1]. From peak (April/May) to trough (Dec/Jan) this effect may be as large as 6 points on the level of the PMI Services index (figure 1). For September, we estimate it at around -2.5 points and – if we are correct – we could see levels as low as 48/49 for the services PMI over the next few months without any real change in underlying activity. This implies that the market, reacting sharply to September's much weaker PMIs (the 2y swap rate fell by nearly 15bp in two days), was, to some extent, misled.

Since early October, markets have largely pared those moves, pricing in fewer and slower ECB cuts than at the end of September. This, however, appears to be driven mostly by US interest rate curve shifts on the back of a strong labor market report for September followed by a stronger-than-expected uptick in US (core inflation) inflation rather than better data from the Eurozone.

[1] Figure 1 shows the residual of a regression analysis of the PMI survey on the EC services balance. One interesting observation to make is that the index of services sector *production*, as published by Eurostat, also shows similar repeating patterns in several sub sectors since 2021. Rather than this just being the result of a Covid-19 distortion to the seasonal adjustment method, it could also point at a true shift in seasonal patterns, which the seasonal adjustment algorithm hasn't fully picked up yet as that there is only a few years of reliable data since 2021.


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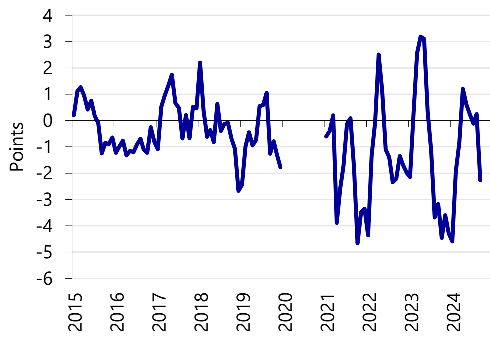
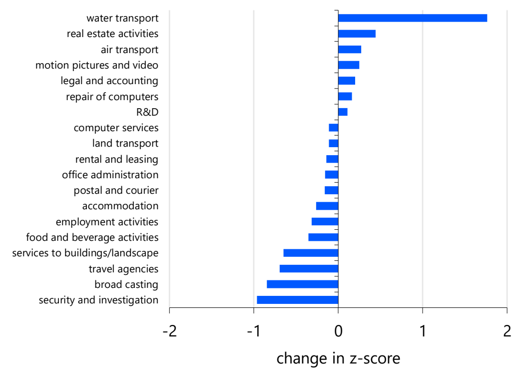
### Figure 1: A repeat pattern to the Services PMI has crept in (pts. deviation from model)




Source: Macrobond, RaboResearch

### Figure 2: EC survey: sectors improving and deteriorating compared to 2024H1




Source: Macrobond, RaboResearch

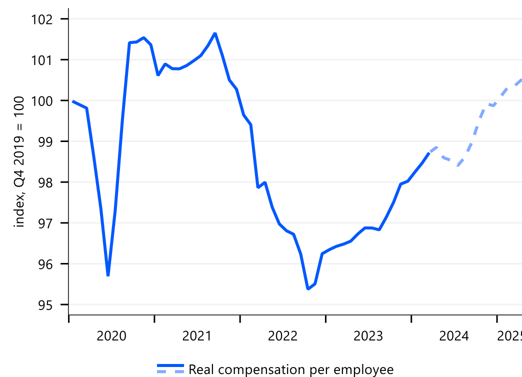
The EC services sector survey fell from an average level of around 6.7 in the first half of 2024 to 5.1 in July, but then crept up to 6.7 again in September. When we zoom in on the sub-sectors it is hard to discern a clear pattern. Security and broadcasting services, food and beverages and tourism-related activities have weakened a bit, whereas selected professional business, real estate services and water (+air) transport saw an improvement (shown in figure 2 are the differences in normalized z-scores for each sector in September compared to the average z-score for 2024H1). A similar analysis of industrial sectors points to more weakness in downstream activities but a (relative) improvement in upstream activities (not shown here).

**If anything, these observations do not point to negative spillover effects from industry-related weakness, but underlying weakness in consumer demand. The latter has – indeed – remained surprisingly subdued since 2023.**

## Consumption outlook improves

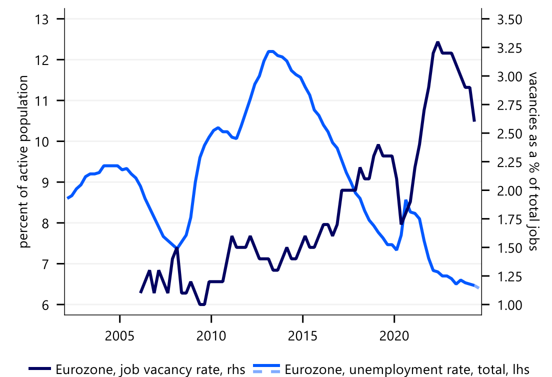
Taking a forward-looking approach, we would argue that the prospects for a modest (consumer/domestic) demand recovery remain in place. The recent fall in inflation supports a further improvement in real wages, even though nominal wage growth has been slowing down gradually. Growth of compensation per employee stood at 4.3% y/y in June, versus 1.8% for headline inflation in September. Unemployment fell to a fresh record low in July and although vacancy rates have eased back to 2.6%, that is still slightly above pre-pandemic peak levels.

### Figure 3: Real compensation growth should support consumption in the coming year




Source: Macrobond, RaboResearch

### Figure 4: Record-low unemployment combined with falling but still quite high vacancy rate




Source: Macrobond, RaboResearch

In a recent publication, we explained that we expect employment growth to stagnate, more or less, in the coming years. In other words, while we don't expect an employment boom that would result in large gross income growth, we do not expect a substantial increase in unemployment



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and hence a decline in wage income either. Stagnating employment combined with positive real wage growth should underpin positive real disposable income growth on balance.

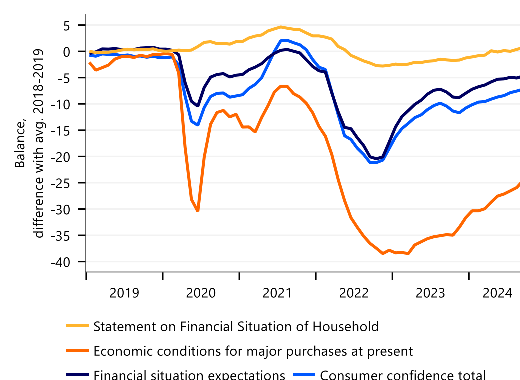
## Confidence up, saving rate down?

Meanwhile, consumers are still more pessimistic than before the pandemic and arguably in no hurry to spend on big-ticket items (figure 5). But, consumer confidence has continued to recover since the energy crisis and currently stands at a post-energy crisis high. **What's interesting is that households are becoming less pessimistic about their financial outlook.**

From the onset of the cost-of-living crisis, consumers have been very pessimistic about the outlook for their financial situation. At the same time, however, the share of consumers indicating that they have had to draw on savings or run into debt to get by has been small from a historical perspective. Excluding the pandemic period, when people couldn't spend but did receive income (support), households have never indicated more strongly that they were able to get by or save than it this moment.

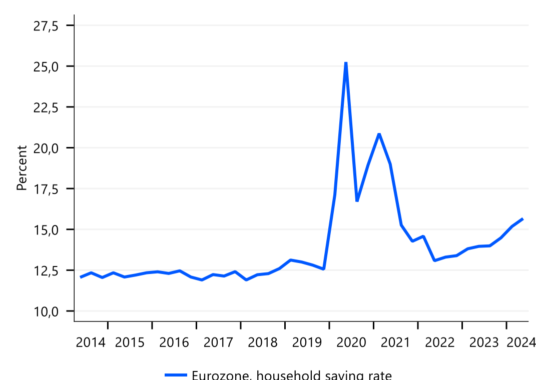
The trajectory in the surveys matches well with past years' increase in the household saving rate (figure 6). Significant – and probably faster and more than expected – real disposable income growth has likely been an important driver thereof. Uncertainty about the outlook has probably also done its part. With households becoming less pessimistic, there is scope for the above-average saving rates to come down. In other words, there is scope for higher consumption spending out of income. Especially now interest rates, and hence remuneration of interest-bearing savings, are coming down again.

**Figure 5: Consumer confidence is steadily improving**




Source: Macrobond, RaboResearch

**Figure 6: Consumption would be supported if saving rates move back to historical averages**

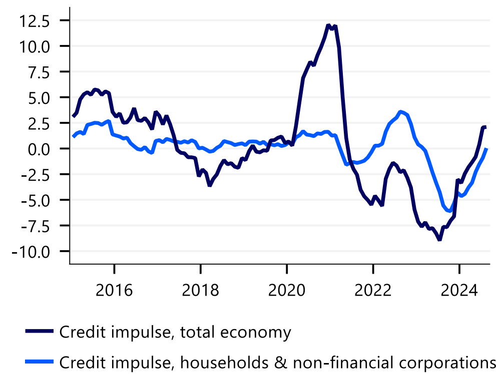



Source: Macrobond, RaboResearch

Looking at financial conditions, we note that although the ECB's policy rate still finds itself in restrictive territory, market rates, especially at the front-end of the curve have declined considerably in anticipation of further rate cuts. The 2y swap rate now stands at 2.3%, down from 3.4% in May. This should lower interest costs on both outstanding and new loans, increasing discretionary income of indebted households, and slowly start supporting investment. Especially housing investment is expected to benefit rather quickly – business investment is still being held back by low capacity utilization rates in industry. Indeed, our credit impulse indicator returned to positive territory in August, suggesting that credit is no longer a drag on the economy. Last but, not least, the Eurostoxx 50 share price index remains close to its all-time high. Hence reason to caution against pessimism.

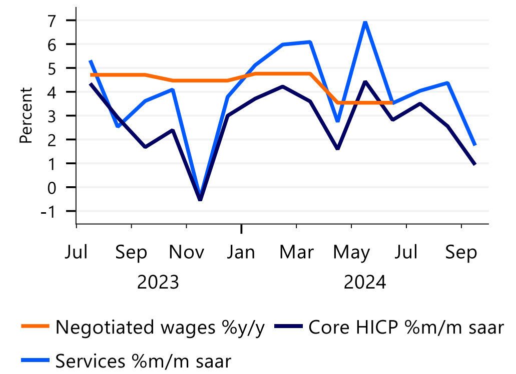
Of course this does not rule out that ongoing weakness in China – which announced a slew of support measures over the past two weeks to address this – and slower growth in the US economy could be spilling over to the Eurozone.

**Figure 7: Credit impulse has turned positive again; no longer a drag on economy**




Source: Macrobond, RaboResearch

**Figure 8: September HICP finally signalling room for decline in domestic inflation pressures?**




Source: Consensus, Macrobond

**Altogether, the risks to our Q3/Q4 growth projections are tilted to the downside, but the hard evidence for a more persistent cyclical slowdown in the services sector is missing.**

The problems in the manufacturing sector, meanwhile, are likely to be more of a structural nature. High energy and regulatory costs, a lack of innovation and R&D, an unlevel international playing field, etc. Those issues were also highlighted in the recent Draghi report. As our ECB watcher Bas van Geffen notes, *"The ECB is clearly growing more concerned about the growth outlook, but much of the sluggish growth is due to structural issues. That's not something monetary policy can fix, and the ECB should only act on the cyclical weakness."*

## Inflation revision

We see good reasons for a downward revision in our inflation forecast, though. The latest data for September point to a significant and unexpectedly sharp decline in core inflation (in particular seasonally adjusted monthly change in services prices). Lower services sector inflation could be stemming from the forementioned weakness in consumer demand. Secondly, our energy analysts are more bearish on energy prices, particularly of oil. Although it goes without saying that the geopolitical situation in the world is only pointing at elevated risk of commodity price shocks and supply-chain disruptions, in absence of such shocks the inflation trend is clearly pointing downward. We reduced our inflation projection for both 2024 and 2025 by 0.2%-points, but we add that our forecasts are still somewhat above the consensus (notably in 2026) because we still assume a 'Trump victory' in our baseline projections. This is expected to lead to more protectionism and some spillover effects from higher US inflation on Eurozone inflation.

**Table 1: Economic forecast**

| | *2024* | *2025* | *2026* | *Q3/24* | *Q4/24* | *Q1.25* | *Q2/25* |
|---|---|---|---|---|---|---|---|
| GDP | 0.7 | 1.3 | 1.2 | 0.2 | 0.3 | 0.4 | 0.4 |
| Consumption | 0.6 | 1.4 | 1.2 | 0.2 | 0.2 | 0.4 | 0.4 |
| Investment | -2.5 | 0.9 | 1.7 | 0.3 | 0.4 | 0.4 | 0.4 |
| Government | 1.5 | 0.8 | 0.9 | -0.1 | 0.1 | 0.3 | 0.2 |
| Trade (net contrib.) | 1.2 | 0.1 | -0.1 | 0.1 | 0.1 | 0.0 | -0.1 |
| Inventories | -0.6 | 0.1 | 0.1 | 0.0 | 0.0 | 0.0 | 0.0 |
| CPI (%y-o-y) | 2.3 | 2.2 | 2.3 | 2.2 | 2.1 | 1.9 | 2.1 |
| Unemployment (%) | 6.5 | 6.4 | 6.3 | 6.4 | 6.5 | 6.5 | 6.4 |

Source: Rabobank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