# In Europe, the growth/interest rate differential remains favourable

27 May 2024

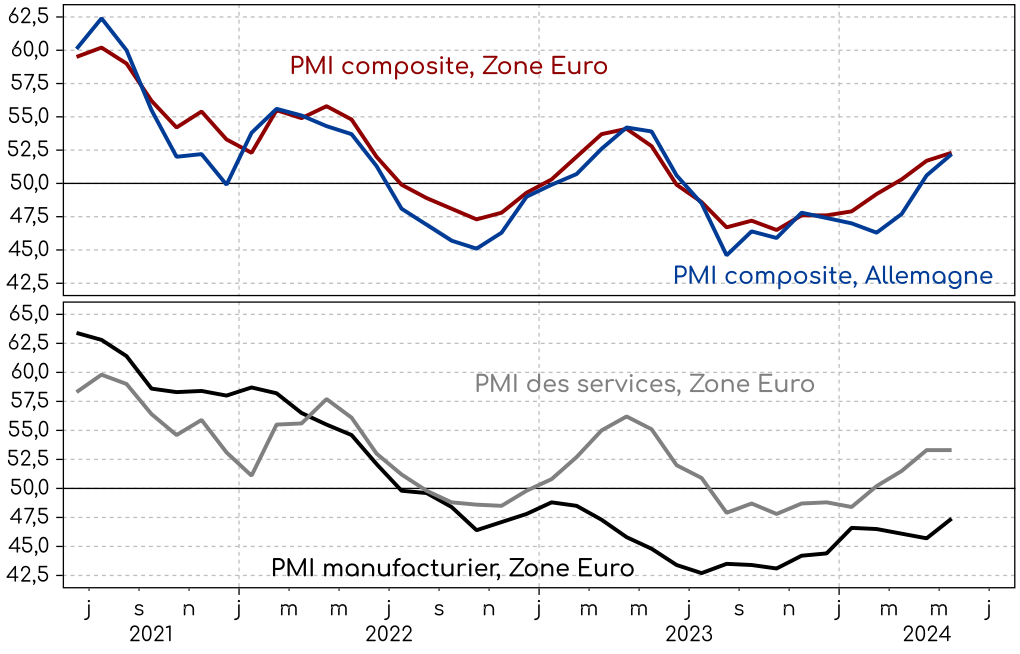
Dear Clients and Partners,

The latest European statistics support the scenario of a return to growth in Europe, including in Germany. This good economic news reduces the ECB's potential for rate cuts, but not to the point of undermining the fundamentals of the European financial markets.

After the welcome surprises of GDP growth in the eurozone in the first quarter of 2024 (+0.3% compared with the consensus expectation of +0.1%), the momentum of recovery is being sustained in the second quarter. May saw a marked rise in PMIs in the eurozone, both for the manufacturing sector and for the German economy (Chart 1). According to S&P Global, which compiles these surveys, new orders to companies are rising at their highest rate for more than a year, and this time it is internal demand that is driving the recovery.

The recovery of the business climate in Europe has spread to Germany and the manufacturing sector

Le redressement du climat des affaires en Europe se diffuse à l'Allemagne et au secteur manufacturier

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- *Composite PMI, eurozone / Composite PMI, Germany / Services PMI, eurozone / Manufacturing PMI, Germany*

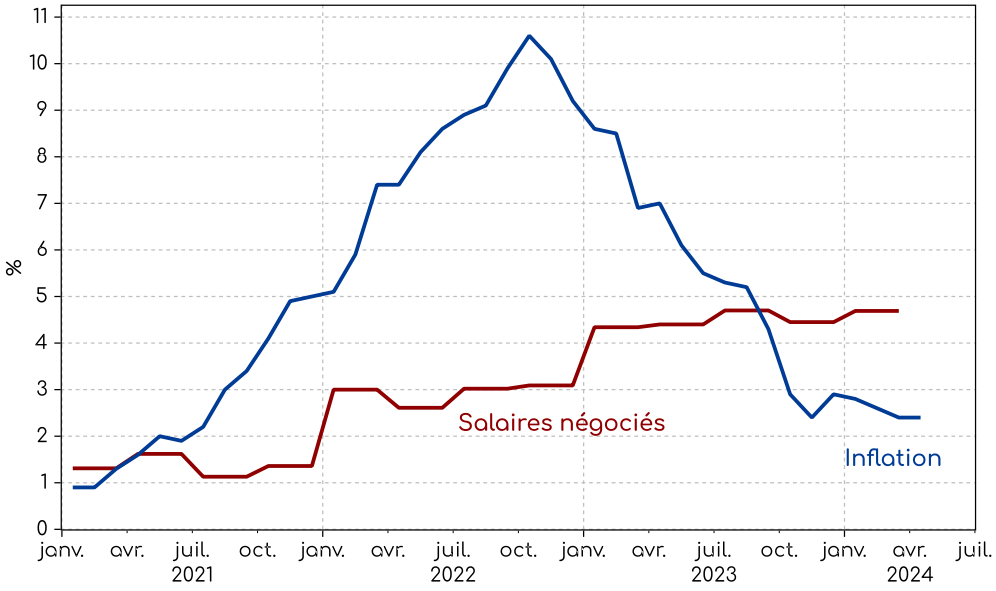
These good figures provide a measure of validation for the growing optimism among investors with regard to Europe in recent months. However, they also raise questions about the outlook for interest rates. The ECB will certainly cut its rates for the first time on 6 June, but the pressure to lower rates quickly this year is weakening against a backdrop of a return to growth. Partial data on wage growth for the first quarter also shows a resilience that will add to the ECB's caution, even though wages are very likely a lagging indicator of inflation. The latest PMI surveys also reveal that companies are raising their selling prices less and less quickly, especially in services. On the other hand, it is true that with wages rising faster than prices, households are regaining some of the purchasing power lost in 2021–2023 (Chart 2). This trend supports the eurozone's growth prospects, thus reducing the need to lower interest rates quickly.

Rising wages do not prevent inflation from falling, but they do allow an increase in household purchasing power

Rise of negotiated wages and consumer prices in the eurozone

La hausse des salaires n'empêche pas la baisse de l'inflation, mais elle permet la remontée du pouvoir d'achat des ménages

Hausse des salaires négociés et des prix à la consommation en Zone Euro

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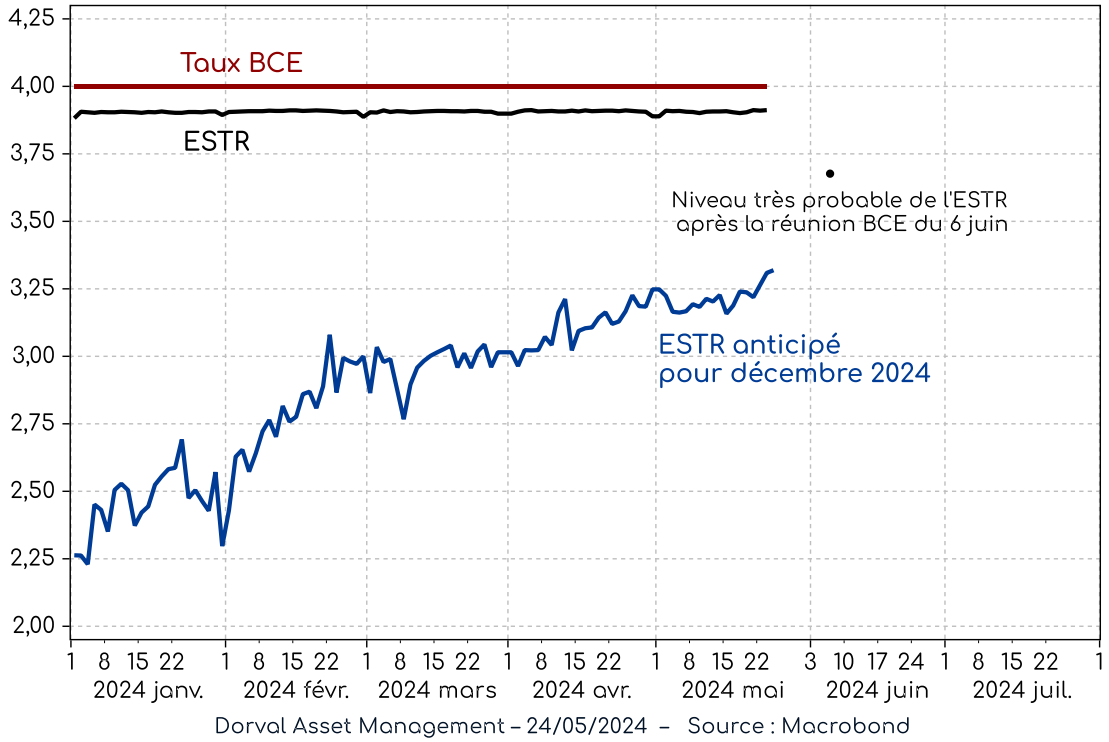
- *Negotiated wages / Inflation*

But should we not go even further and ask ourselves whether, with the return of growth in Europe, the ECB really needs to lower its rates? This question, which echoes the similar one raised by some members of the US Federal Reserve, is not entirely absurd. However, the striking differences between the two regions must be highlighted. While the US economy has never weakened since the end of COVID, Europe is only now beginning to emerge from a period of stagnation lasting almost 18 months. Its core inflation rate now appears to be very close to the 2% target, and its monetary policy has become significantly less accommodative. In many countries, the real estate sector also remains traumatised by the speed of the rate hikes in 2022–2023.

The balance between the outlook for growth – which is improving – and the outlook for ECB interest rates – which is declining more or less sharply depending on the scenario – therefore remains broadly favourable to the financial markets. In the very short term, this does not prevent tactical profit-taking on the equity markets, which have become more optimistic. However, we note that the bond markets have already significantly moderated their expectations of ECB rate reductions (two to three cuts by the end of the year, one of which is already a virtual fait accompli, Chart 3), and this should help limit the risks.

The markets are anticipating fewer rate cuts this year, thus reducing the risk of disappointment

Les marchés anticipent moins de baisse des taux cette année, ce qui réduit les risques de déception

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- *Jan. 2024 Feb. 2024 Mar. 2024 Apr. 2024 May 2024 June 2024 July 2024*
- *ECB rate / ESTR*
- *Highly likely ESTR level after the ECB meeting of 6 June*
- *Anticipated ESTR for December 2024*

Our exposure rates are as follows:

- **Dorval Convictions:** The equity exposure rate is 70%.

Dorval Asset Management

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