MAERKI BAUMANN & CO. AG

PRIVATBANK

An update on the Eurozone

Market Comment, February 2024

In light of the many special factors that have influenced economic activity in the Eurozone over recent quarters and the fact that some of these are by no means over, the question arises as to just how well Europe's single-currency area is actually doing? Our view: not too badly, but with increasing risks. Politically speaking, the Eurozone appears more stable internally than was the case before. At a geopolitical level, however, it is vulnerable. This is because both Russia and, above all, China are more important for its economy than they are for the health of the economy on the other side of the Atlantic. The greater economic vulnerability of the single-currency bloc owing to the war in Ukraine and its partial dependence on China means that we currently favour the clearly defensive and less cyclically sensitive Swiss equity market over its Eurozone counterpart.

Economic activity in Europe's single-currency area has tended to deteriorate in recent times. There is no clear recession, but rather a state of stagnation, as the labour market has been subdued up to now. For several months, however, unemployment has been on the rise again in Germany, the Eurozone's most important economy. The employment situation across the euro area as a whole is likely to cool further over the coming months, as it can be assumed that economic growth in the countries that make up the bloc will tend to weaken against the backdrop of the significant rise in interest rates.

The downtrend in inflation due to lower demand pressure is positive. In light of the situation in the Middle East, however, there are still uncertainties as regards energy price developments, especially in the case of oil and gas. It is therefore likely that the European Central Bank will hold off on changing its key interest rates for the time being.

The situation in Italy, which has often influenced the ECB's interest rate policy in the past, is also playing a role here. The fiscal situation in Italy has failed to improve and could have a negative impact on the tightening of credit conditions for the European economy. This is in view of the increase in Italy's budget deficit, which is set to increase the country's national debt.

European wage trends not only represent a significant source of uncertainty for the European Central Bank, but also for the financial markets. Should wage growth come down significantly rather than just slightly, this would represent a lower cost factor for company earnings and increase the probability of potential interest rate cuts. Up to now, however, wage growth has been rising.

> "Financing conditions for households and companies have tightened once more."
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> Gérard Piasko, Chief Investment Officer

The fiscal and government situation in the Eurozone is likely to provide less economic support than has been the case in recent years, especially due to the deficit problem in Germany. This means that government spending in the single-currency bloc is likely to have a less stimulating effect on the economy than was the case between 2020 and 2023.

In terms of economic momentum in the euro area, the manufacturing industries are exhibiting greater weakness than the service sectors. The enormous competition for the German car industry coming from Chinese electric car producers, which are heavily subsidised by the Chinese government and steadily securing a greater market share in the Eurozone, is playing a significant role here.

The EU economy's dependence on Asia in general and China in particular remains an issue, as this reliance is much greater than that of the US economy. If China's economy continues to perform at an unsatisfactory level, this could be a considerable negative factor not only for Germany, but for the Eurozone as a whole.

What is more, financing conditions for households, governments and companies have not improved owing to the huge interest rate hikes seen since 2023. A decline in credit volume growth therefore seems increasingly likely. It would thus come as no surprise if financial institutions were to build up higher reserves for potential loan defaults.

In this environment, it would likewise be no shock for particularly cyclical companies to post a below-average performance. For this reason, focussing on quality stocks with stable profitability and relatively low levels of debt could also be appropriate in more difficult economic times.

Gérard Piasko

Gérard Piasko is Chief Investment Officer and head of the investment committee of private bank Maerki Baumann. Before he was for many years Chief Investment Officer of Julius Baer, Sal. Oppenheim and Deutsche Bank.

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