MACRO MORNING BRIEFING
iFlow

January 27, 2025

Europe Believing in Green Shoots

“Peak pessimism” for Europe may have passed

- US tariff risks appear manageable for now
- Data has stabilised while equities pricing is improving
- Acceleration of structural reforms needed as uncertainty will continue

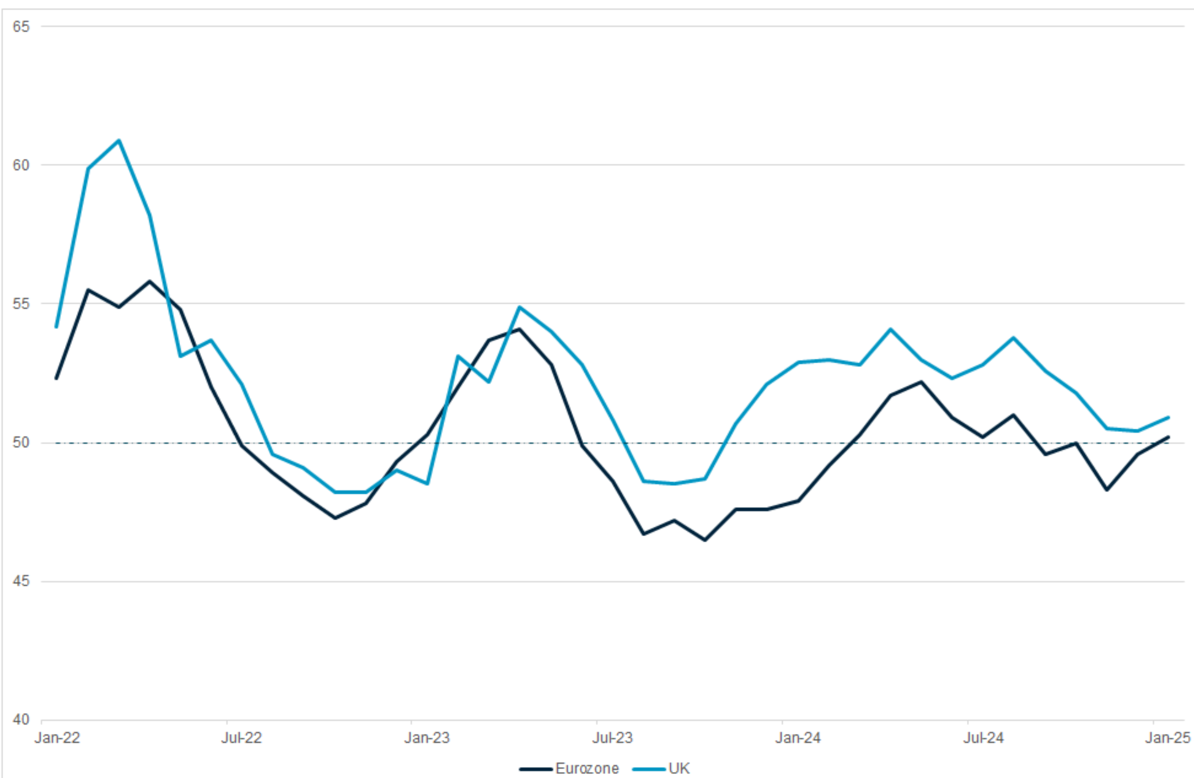
General easing of financial conditions taking effect

European currencies and asset markets enjoyed one of the best weeks in recent months this week. Just days into the Trump administration, while general tariffs and EU-specific measures have been mentioned, we suspect that there is a general sense of relief in European capitals that there are no imminent plans to impose tariffs on the EU. However, EU leaders should remain vigilant, and we are concerned that there is no unified front to respond to US tariffs. For example, ECB President Lagarde has been a leading advocate of negotiating with the US, and we expect her to reiterate this stance, if asked, at this week’s ECB policy decision. In contrast, several national leaders – who will have a more direct say in the matter – have advocated a stronger response.

We believe US risks are far from over, and any turn in events could mean the gains seen in the EUR, GBP and associated asset markets could be lost in short order. The recent experience of the Canadian dollar supports this view. However, we believe that the market should also be more attuned to some of the developments taking place in Europe on a standalone basis. In our 2025 Outlook, one of our top themes in asset allocation is the outperformance of European assets, especially equities. Normalisation in positioning would be one of the core drivers, and to some extent we are seeing this already in January as markets dial back their hedges against Europe – at the expense of the dollar and other positions associated with "US exceptionalism." Other factors supportive of Europe include stabilising data, attractive asset valuations and a push for structural reform. We will wait until after the German federal elections to take a view on reforms, but green shoots are clearly emerging.

The first round of Purchasing Manager Indices across Europe released last week do not exactly point to robust growth (Exhibit #1), but on a marginal basis trends have clearly stabilised. The composite PMI for both the Eurozone and the UK have moved back into expansion, with the former led by Germany, where the composite print is above 50 for the first time since June 2024. We acknowledge that across Europe services continue to support overall demand, and manufacturing PMIs, especially in the Eurozone, remain very depressed. Even so, there are no longer signs of marginal declines. The PMI report itself notes that in Germany, "manufacturing output is shrinking at the slowest rate since mid-2024, and the new order situation has eased a bit too. This shift towards optimism is highlighted by a much better outlook on future activity."

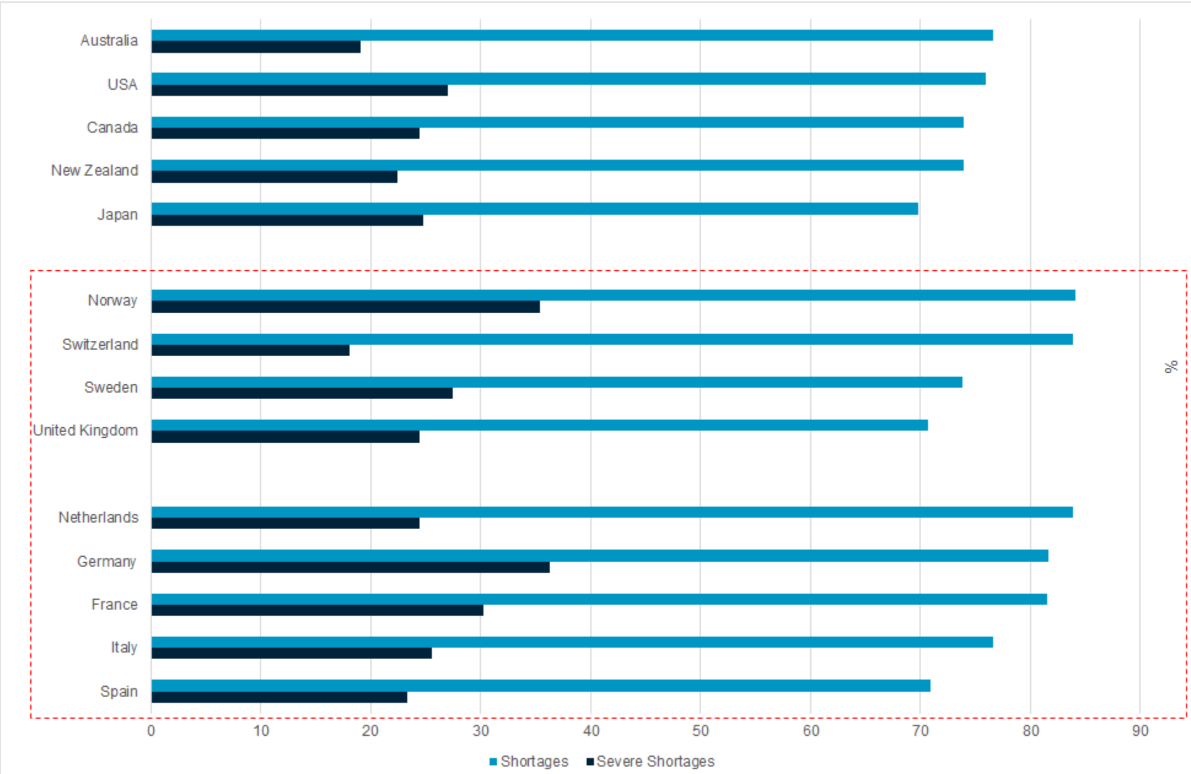
Exhibit #1: PMI Stabilisation in Europe



Source: Bloomberg, BNY

Improvement in the Eurozone's outlook may have even contributed to a small pullback in easing expectations for the ECB. We fully expect a 25bp cut on Thursday and one such cut per quarter is a pace that the ECB seems comfortable with. The improvement in the growth outlook does dampen fears over stagflation in the Eurozone (things are different in the UK), but the risks stemming from high labour-driven input costs – as the ECB has repeatedly warned – remain high. As the monetary policy calendar picks up in earnest this week, we note that dealing with labour constraints remains one of the biggest risks to the global economic outlook as it keeps financial conditions tighter for longer, at a cost to growth, and will amply any other supply shocks, especially from trade. Exhibit #2 shows that across the Eurozone and G10, general labour shortages are by far the highest in Western Europe: France, Germany, the Netherlands, Switzerland and Norway all have general shortages of above 80%, based on the Organisation for Economic Cooperation and Development (OECD) 2024 Outlook, Volume 2, published last month. Across the OECD these issues are structural, and the organisation highlighted that "job vacancy rates have nearly doubled, with particularly sharp increases in sectors like healthcare and ICT. Population ageing is exacerbating these shortages and is expected to accelerate in the coming decades." In Europe these challenges are well established, and we believe the ECB and, to a lesser extent, the BoE paid undue attention to the impact of labour constraints on inflation over the last 18 months as this is something monetary policy cannot lean effectively against. In the short term, this will help the EUR and other regional currencies against the dollar, but without commensurate productivity gains, excessively tight financial conditions through rates and currencies will prove damaging in the long term.

Exhibit #2: Labour Markets the Main Complication



Source: OECD, BNY

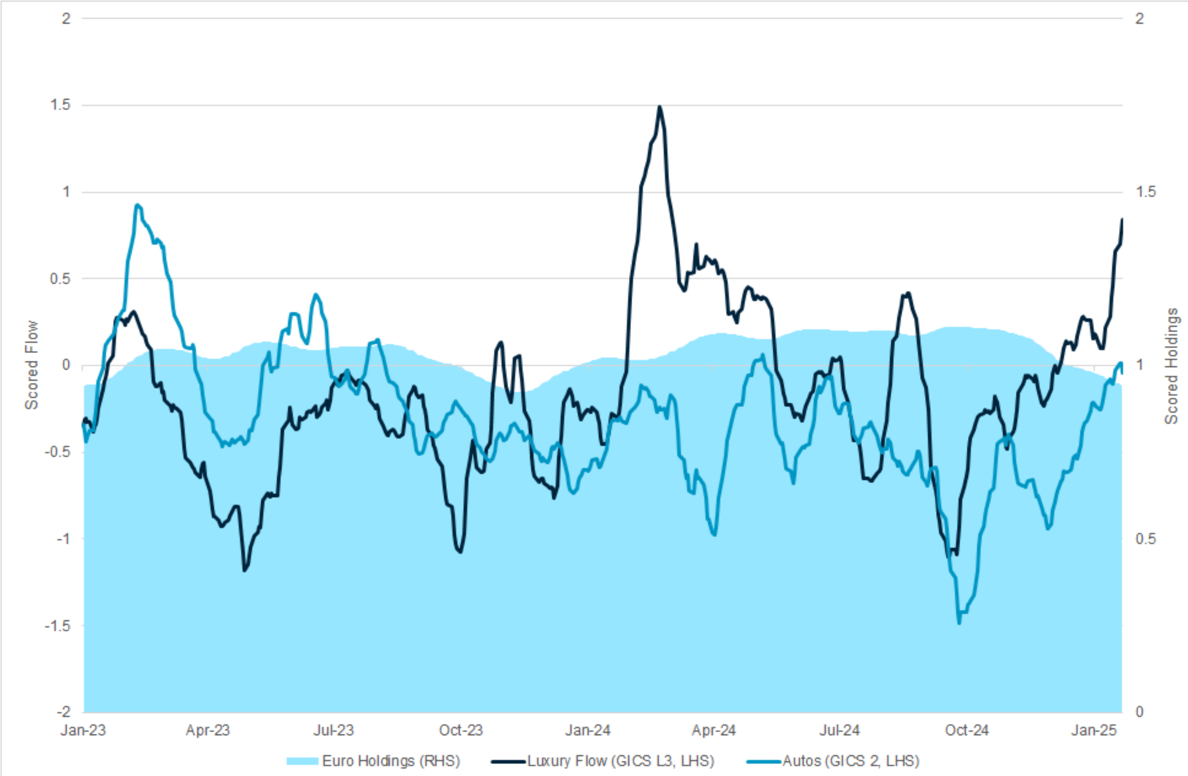
The January PMI report for Germany noted that “a much better outlook on future activity” went “hand in hand” with equity market outperformance in Germany and Europe over the US. Earnings reports have indeed surprised to the upside in key sectors, but we believe that positioning and valuations remain the core drivers for any re-rating. The EUR started the year on the back foot while GBP has also struggled of late. Eurozone and UK stock markets have high levels of overseas sales exposure and stand to benefit more from earnings translation, at least in theory. Based on the 60-day correlation between the European indices and their respective currencies, we see that the present linkages are weak, and it is only recently that the EUR has exerted a drag on overall equity performance. This is not a surprise in an environment of “US exceptionalism” but given the Q4 moves in the dollar, FX translation effects – coupled with global demand stabilisation – could now become too difficult to ignore.

Exhibit #3: FX Translation Impact Muted

Source: Bloomberg, BNY

Nowhere is this more evident in the luxury goods segment – a core segment in Europe – which has outperformed strongly amid earnings season. Europe's most valuable company is once again a luxury goods producer. On the other hand, manufacturing still has much ground to make up and the challenges remain severe. The divergence between the luxury and automotive segments in iFlow remain stark (Exhibit #4), but directionally a large underheld position is now being reversed. Green shoots from cyclical factors are clearly emerging in Europe, while headwinds from the US are not emerging yet. The onus will be on Europe to take advantage of the favourable conditions to push for secular changes to drive productivity and competitiveness.

Exhibit #4: Flows Picking Up in Core Segments



Source: Bloomberg, BNY

Please direct questions or comments to: iflow@bny.com

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