Europe Economic Update
August 2022

Not all doom and gloom

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Structural factors cushion downside

The impact of Russia's invasion of Ukraine continued to reverberate through global markets and economies in Q2, with sharply higher commodity prices driving inflation and market interest rates up and growth expectations and risk assets down. Despite the upheaval caused by the war in Ukraine, Europe's economies held up better than expected through the first half of 2022 as momentum from economic re-opening offset the drags of higher consumer prices and interest rates.

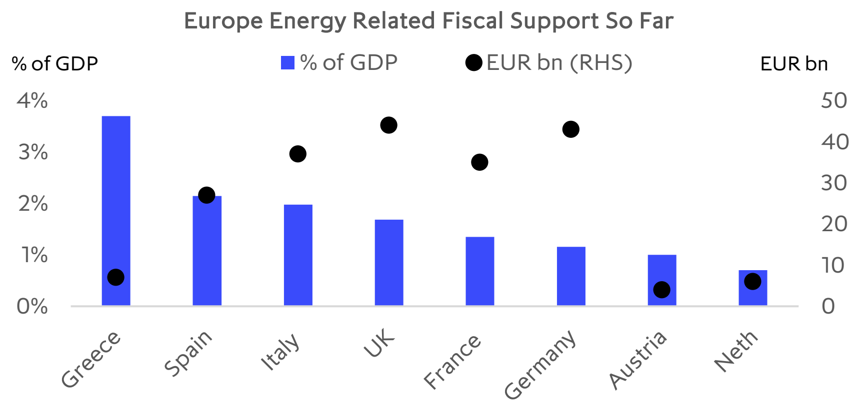
Looking forward, growth is likely to slow – with some countries likely to experience recession - as the initial burst of pent-up spending following economic re-opening fades and the energy shock and higher interest rates weigh on consumption and investment. Slowing growth and central bank tightening will likely keep market volatility high in the coming months.

While the next few quarters are likely to be difficult, it is not all doom and gloom. As we highlighted in our most recent economic update and our analysis of private company fundamentals, there are a number of factors that should limit the depth of the downturn, including strong consumer, corporate and bank balance sheets, historically low unemployment and substantial fiscal support for households and businesses. In addition, the slowdown is likely to be focused primarily in commodity and supply chain sensitive industrial sectors and consumer discretionary spending. Most businesses in the healthcare, technology, business and financial services sectors should be less affected. This should provide opportunities for investors with strong bottom-up capabilities and medium to long-term investment horizons in our view.

Overview

- **Uncertainty and public market volatility will likely remain high in the coming months** as slower economic growth, earnings downgrades, front-loading of interest rate hikes by major central banks and a likely intensified squeeze on Europe's natural gas supplies by Russia's president Putin over the winter months weigh on investor sentiment.
- **While the next few quarters are likely to be difficult, it is not all doom and gloom.** Despite the above headwinds, strong household, corporate and financial sector balance sheets, together with high levels of household savings, low unemployment and supportive fiscal policy should limit the depth of the slowdown, with a few sectors and countries taking the brunt of the hit.
- **Governments have been pro-active in providing fiscal support to buffer economies.** Already governments in Europe have acted to shield households from higher energy costs through varying combinations of energy tax cuts, subsidies, direct payments and price caps ranging from 1% to nearly 4% of GDP so far. On top of national government programs, there are still substantial funds still to be disbursed from the EU's EUR800bn Next Generation EU recovery programme.
- **The slowdown in growth is likely to be sector specific,** with healthcare, technology, business and financial services likely to be less negatively affected than energy and supply chain-sensitive heavy industry, aviation, autos, building materials and big-ticket consumer discretionary.
- **Country performance is also likely to diverge.** Germany, Italy and a number of Eastern European countries are most exposed to the risk of a cut off or substantial reduction in Russian natural gas supplies over the winter months. However, most of the Nordic countries, France, Spain, Portugal, UK and Ireland have limited direct exposure. Even within more exposed countries', the impact is likely to focused mostly in the industrial sector and big ticket consumer discretionary.
- **Disruption brings opportunity.** Market disruption and wide performance dispersion at a country, sector and sub sector level brings opportunity for investors with medium to long-term investment horizons, strong bottom-up analytical capability and detailed knowledge of local markets. With public market volatility likely to remain high and banks continuing to retrench, we think this environment will be particularly suited to private market investors.

European fiscal support programmes should help buffer growth



Source: Government websites, press reports, bank reports, Bruegel. Data to June 2022

A more difficult operating environment ahead, but a number of positive offsets

Despite the disruptions caused by Russia's invasion of Ukraine and China's zero Covid policy, Europe and the UK proved to be more resilient through H1 2022 than most headlines would indicate. While consumer sentiment has fallen sharply since the invasion as higher energy and other prices have eroded real spending power, most hard indicators of growth and employment have held up better than expected, with GDP growth in most countries maintaining positive momentum through the first half of the year.

It seems likely, however, that growth will start to slow more quickly in the coming months as the lagged impact of higher interest rates, energy and other input prices starts to be fully felt by consumers and businesses and the initial momentum from economic re-opening starts to fade.

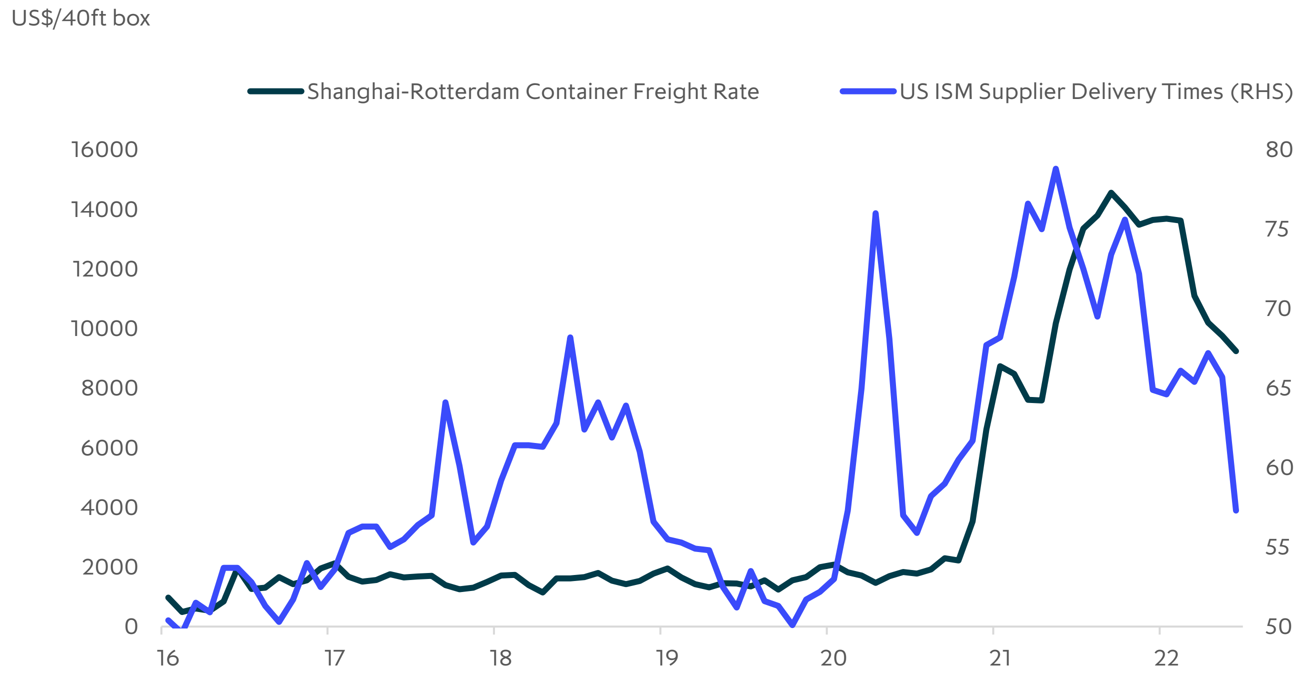
Slower economic growth, earnings downgrades, front-loading of interest rate hikes by major central banks and a likely intensified squeeze on Europe's natural gas supplies by Russia's president Putin over the winter months, will likely keep uncertainty and market volatility high in the coming months.

However, there are a number offsets that are likely to help cushion economies during this adjustment period. The first is that household balance sheets enter this period in healthy shape. The combination of generous government support packages and limited ability to spend during the worst part of the Covid-19 pandemic caused household savings to rise to record levels.

Although spending on non-essential goods – particularly big ticket consumer durables such as autos - is likely to slow as high energy, food and other prices eat into disposable income in the coming quarters, the large store of saving built up during the pandemic will likely be tapped to shore up and help smooth consumption over the period. Job markets are also strong, with unemployment rates in the US and UK close to pre-Covid lows and the unemployment rate in the Eurozone its lowest on record.

Europe's private company balance sheets, as tracked by ICG's private company database, also enter this more difficult period on strong foundations. At an aggregate level, strong EBITDA growth helped push leverage down and interest coverage up through to the end of 2022. The trend towards improved credit fundamentals through 2021 and through the first half of 2022 is corroborated by credit rating agency data. According to Moody's, Europe's speculative-grade corporate default rate was 1.7% at end of June 2022, down from a peak of 5.5% in November 2020 and 1.9% in January 2020 before the pandemic hit.

Signs supply-chain bottlenecks are easing



Source: Bloomberg. Data to June 2022

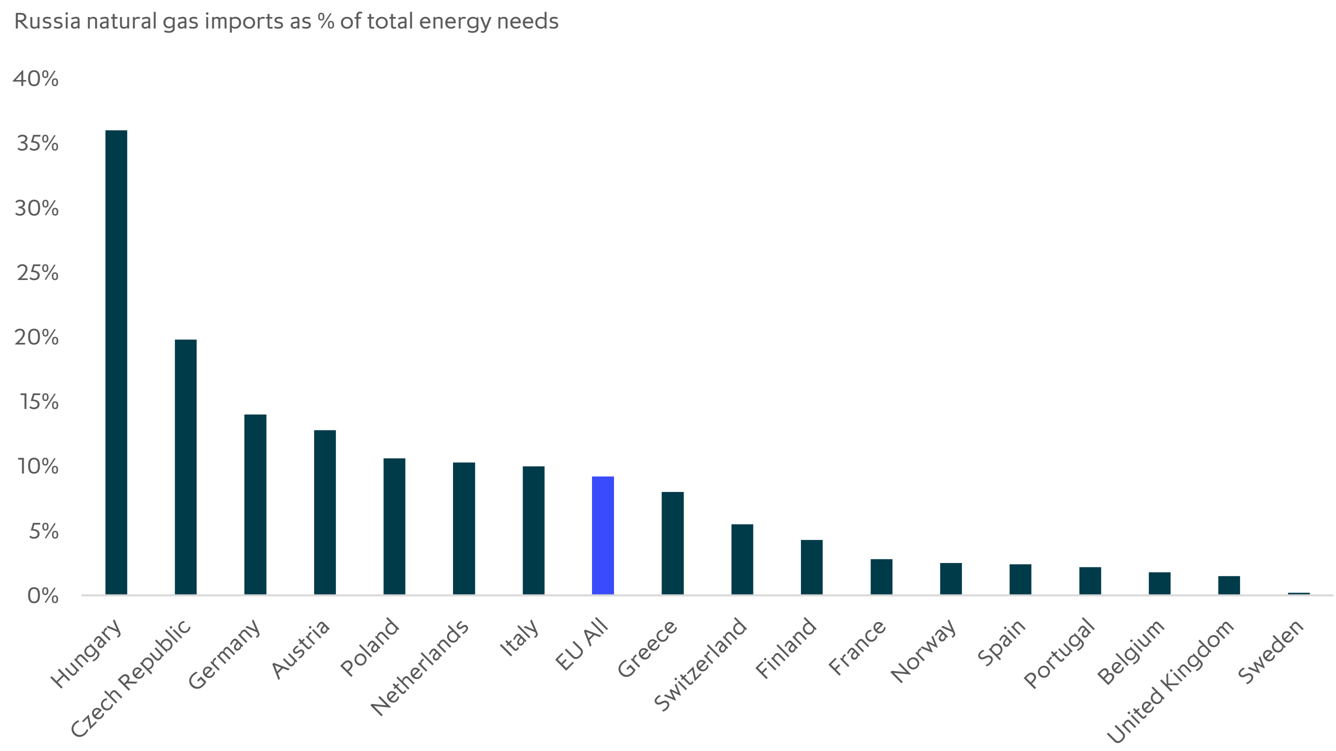
Bank balance sheets are also strong. While banks are likely to become more conservative in credit provision, their tier one capital is substantially higher than in 2008 and regular stress indicates they are well-protected against a downturn in economic growth. In addition, while the ECB is expected to continue to raise rates in the coming months, it has also made clear that through its new Transmission Protection Instrument (TPI), OMT and other market intervention instruments that it has the tools, and has the will, to do "whatever it takes" to protect against sovereign bond market stress (with Italy clearly front of mind). These factors makes a repeat of a 2008/09 or Euro style systemic financial crisis unlikely in our view.

Last, but certainly not least, governments are becoming more active in providing fiscal support to businesses and households worst hit by the rise in energy and food prices. Already the UK and a number of governments in Europe have acted to shield households from higher energy costs through varying combinations of energy tax cuts, subsidies, direct payments and price caps. Support announced so far ranges from 1.2% of GDP in Germany to 1.7% in the UK to 2.1% in Spain and 3.7% in Greece . There are also still substantial funds from the EU's EUR800 Next Generation EU recovery programme to be disbursed. More announcements on fiscal support packages to protect households from the energy and food price shock are likely in the coming months.

Later in 2023, if China starts to relax its zero Covid policy as we expect (see "When will China's zero Covid policy end?"), easing supply bottlenecks take upward pressure off input costs and interest rates, and the lagged impact of China easing starts to feed through the global economy, export-oriented Europe with its super competitive exchange rate may be in a better position than current consensus seems to believe. In the meantime, however, a difficult winter likely lies ahead.

"While growth is likely to slow quite sharply in the coming months, the weakness is likely to be concentrated in a few key sectors and countries, with a number of offsetting factors helping to limit broader economic damage."

Exposure to Russia gas supply varies widely



Source: Eurostat; UK Dept for Business, Energy and Industrial Strategy; BP. Data to June 2022

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