Europe's investment outlook clouded by Ukraine, inflation shocks

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The recovery in Eurozone economies from the COVID-19 pandemic has given way to concerns about inflation, higher interest rates and the impact of the war in Ukraine. Reliance on Russian oil and gas has highlighted Europe's energy security concerns and delivered significant increases in living costs to households. In other circumstances, the European Central Bank might have been willing to let the post-pandemic recovery take hold before adjusting monetary policy. However, with Eurozone inflation running at 7.5% year-on-year in April, it looks as though the central bank is readying to quickly move away from its negative interest rate policy. Money market expectations for a hike in the deposit rate in July have strengthened and the deposit rate is projected to be back in positive territory by the third quarter of this year.

For investors, the outlook has deteriorated markedly. Europe is bearing the brunt of the energy shock coming from the conflict in Ukraine and the sanctions imposed on Russia. The Bloomberg consensus economic growth forecast for 2022 is now at 2.8% but this has been revised down in recent months. Lower growth rates are forecast for 2023 and 2024. The risks of a more pronounced slowdown are clear given the squeeze on household incomes. In the markets, bond yields have risen significantly with the benchmark German 10-year government bond now yielding 1.0% compared to a low of -0.5% last summer.[1] The corporate bond market has delivered negative returns to investors, driven by higher underlying yields and a widening of credit spreads – the additional yield required to hold riskier corporate debt. The deteriorating growth outlook and the prospect of tighter monetary conditions are driving this credit risk premium higher. The average yield on a representative investment grade debt index has risen by over 2% in less than a year.

While interest rates and borrowing costs remain low by historical standards, the direction of movement is clear and further increases are likely until there are signs of inflation peaking. In the meantime, there are fresh concerns growing around sovereign debt sustainability. Unlike the situation a decade ago, there is no systemic fear over the future of the euro and the single currency area. The fear this time is higher rates and what that does to government borrowing costs. For example, the yield on Italian government debt has increased by 100 basis points more than the increase in German yields – pushing 10-year Italian government bond yields to just shy of 3%. Again, this is low, historically speaking, but the higher yields get, the worse Italy's fiscal position becomes. The consensus growth rate for Italy for this year and next is 2.8% and 1.9% – already lower than current yields. Slower growth and higher yields will force governments to rein in fiscal support just as the economy needs it.

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For equity investors in Europe the outlook is mixed. Compared to the US equity market, Europe trades at more attractive valuations with the price-earnings ratio for the Euro Stoxx index right in the middle of its 20-year range. A weak euro, while adding to inflation concerns, is good for those European companies with significant international revenues. Overall, profit growth is easing but remains positive and forecasts are for modest gains in earnings over the next two years.

An end to the war in Ukraine and relief from higher energy prices would clearly be very positive for the Eurozone economy. Such a scenario would allow the ECB to be more measured in its tightening of monetary policy and its termination of asset purchases. Negative interest rates are doing no good for the Eurozone economy and remain a technical inconvenience in the banking sector, so normalising rates in positive territory would be welcome. If lower inflation also limits the extent to which bond yields rise, this will cap some of the concerns around fiscal stability in the periphery. The EU is helping mitigate the impact of transitioning away from Russian energy supplies alongside efforts to accelerate investment in renewable energy sources and improve energy efficiency. Over the long term this should deliver cheaper and more stable energy supplies. That will be beneficial to economic growth.

FOOTNOTE

1 All market data sourced to Bloomberg 5 May 2022

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