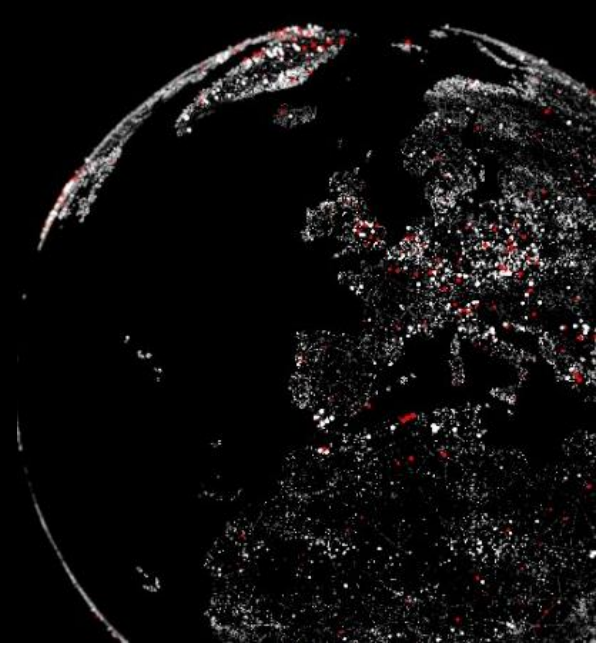


Europe Insights

The First Cut Is the Deepest

July 2024

For professional clients and institutional investors only



In a nutshell:

Eurozone fiscal stability and future adjustments

- Pent-up demand, high inflation, and increased nominal growth have boosted income and tax revenues, driving improvement in debt ratios, with the Eurozone's debt-to-GDP ratio coming down from 99% to 90% in 2023.
- Significant fiscal tightening is still needed to return to pre-pandemic debt levels. Under the new EU fiscal framework, seven countries will have an Excessive Deficit Procedure (EDP) imposed, implying a sharper fiscal adjustment than their current 2024 budget plans.
- Looking ahead, despite potential fiscal challenges, sovereign bond spreads should stay contained, supported by a relatively benign macro-environment, including low gas prices, ongoing disinflation, rising real income and further ECB rate cuts.

European equities: lessons from the past

- The current soft-landing scenario environment resembles the mid-1990s. Both Fed and European policy conditions mirrored today's environment.
- The significant difference now is the valuation gap between US and European markets. In 1995, US valuations were on par with Europe, but today, the US enjoys an unprecedented premium.
- US valuations are at levels comparable to late 1997-early 1998 (just before the internet crash), while Europe trades like it's still 1995.

European bonds are back (part 2)

- Investment grade euro bond issuance (corporates and financials) has increased by over 16% compared to a year ago, and high yield issuance this year has already surpassed the entire volume in 2023.
- Current spread levels reflect the market's confidence in corporates' fundamentals, and despite a slight widening in June, spreads remain on their compression trend.
- A low level of volatility observed on both bond and FX markets may also explain why 17% of investment grade euro-denominated emissions have been initiated by US companies.

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Eurozone fiscal stability and future adjustments

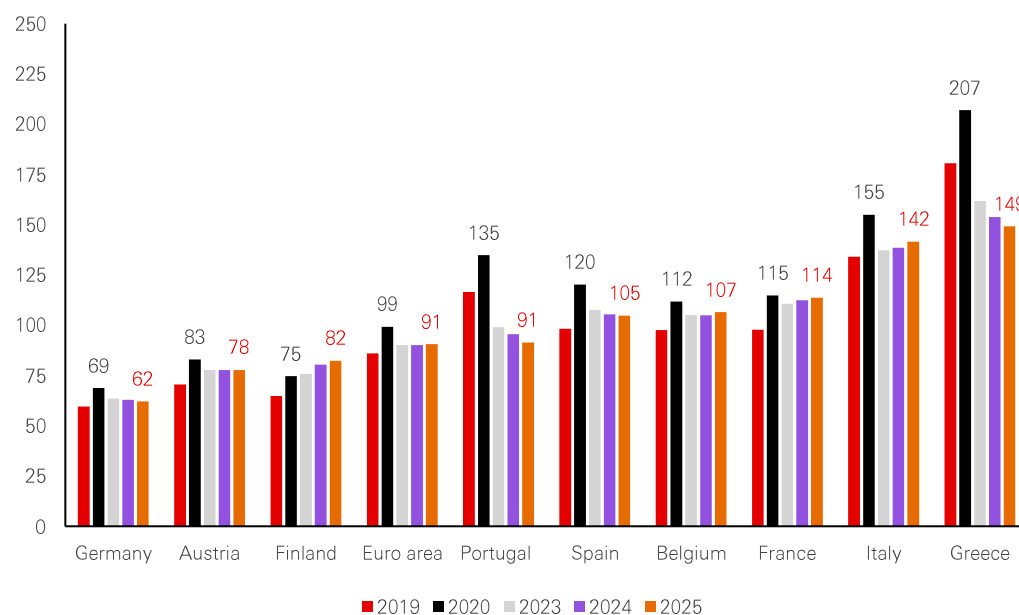
Since its peak in 2020, the eurozone's public finances have improved significantly. The debt-to-GDP ratio, which reached 99% in 2020, decreased to 90% in 2023 (Figure 1). This recovery has been driven by pent-up demand, high inflation, and increased nominal growth, which boosted income and tax revenues. Despite the 2022 energy crisis and extensive measures to protect businesses and households from extreme gas prices, debt ratios have stabilised. In 2023, the phase-out of energy support measures began, and although interest rates have risen, governments' borrowing costs have only slowly adjusted to the new rate environment. The reduction of eurozone debt ratios has been quite effortless, and despite a headline budget deficit of 3.6%, a positive snowball effect resulted in a nominal GDP growth of 5.8% in 2023, which is higher than interest costs of 1.7%.

Debt ratios have stabilised despite the energy crisis and the extensive measures taken to protect against extreme gas prices.

2024 Budget plans: The beginning of fiscal adjustment

According to EU Commission estimates, by 2025, the eurozone debt trajectory will stabilise rather than decrease. This means that returning to pre-pandemic debt levels will require more significant fiscal tightening. The reduction efforts will be measured by the structural primary fiscal adjustment¹, a key metric in the EU fiscal framework. This metric evaluates whether a country is making the necessary efforts to reduce its debt ratio beyond the effects of the economic cycle.

Figure 1: Debt-to-GDP ratios have decreased since the 2020 peaks, but except for Greece or Portugal, are not expected to improve significantly – As % of GDP



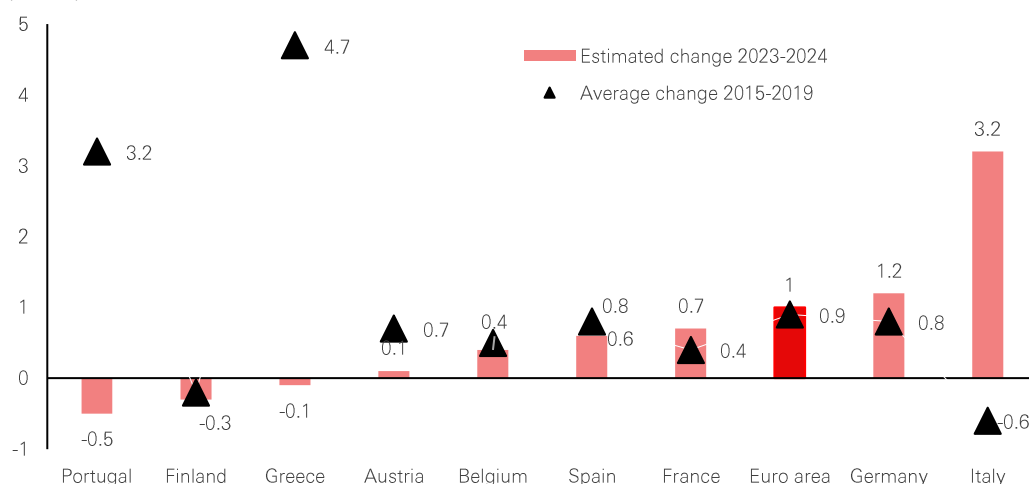
Source: European Commission Spring projections – Data as of May 2024

The planned fiscal adjustment varies by country, with Italy and Germany projected to lead the efforts, while other countries will see less than a 1% of fiscal tightening (Figure 2). Compared to the five-year pre-pandemic period (2015-2019), only Italy, and to a lesser extent Germany and France would provide a larger tightening effort. Elsewhere, in Portugal, Finland, Greece, Austria, or Spain, the fiscal effort seems milder.

Significant fiscal tightening will be needed to return to pre-pandemic debt levels, with Italy and Germany projected to lead the efforts.

¹ The structural primary adjustment measures the variation of a country's structural primary budget balance. This takes off interest costs, exceptional and cyclical components. For instance, the sale of a government entity is excluded from the calculation. Cyclical components include the extra revenues (taxes) or expenses (social welfare) when the economy runs above or below its potential.

Figure 2: Fiscal adjustment across eurozone countries as measured by the annual variation of the structural primary balance – As % of GDP



Source: Refinitiv, European Central Bank – Data as of 22/02/2024

Compliance with the new EU fiscal framework

The new EU fiscal framework² will be fully introduced in 2025. Due to the late approval of the revised framework, governments have until September 20 to submit their three-year stability and reform programs, now called medium-term fiscal structural plans. The EU Commission also decided to open an Excessive Deficit Procedure (EDP) on countries which do not fulfil the deficit criterion of budget deficit higher than 3% or a debt criterion of debt-to-GDP ratio above 60%. Under the EDP, the EU Commission will estimate the ‘technical trajectories’ for each country implying a sharper fiscal adjustment than current 2024 budget plans.

Currently, seven countries including France, Italy, Belgium, Hungary, Malta, Poland, and Slovakia are planning budget deficits above 3% of GDP both in 2024 and in 2025 and are now under an EDP to set a corrective action. In France, the structural primary adjustment projected by the incumbent government was set at around 0.6% of GDP in 2024, followed by further efforts to meet the 3% deficit target in 2027. The Cour des Comptes, the independent body in charge of assessing France’s public finances, estimated that the additional savings would imply further major spending cuts across ministries and government agencies. This level of consolidation has never been experienced in France and would significantly alter the French social model, with public spending, currently at 57% of GDP, compared to the eurozone average of 49%. The EU commission³ recently estimated that significant effort could be made to cut tax expenditures, or ‘rentes’ which amounted to €88 billion (3.3% of GDP).

In contrast, Italy's adjustment effort is already higher than the rest of the eurozone due to ending of the Superbonus scheme for housing green renovation. The budget cost of this scheme was around 10% of GDP over the past three years. The government will also end energy support measures, resulting in a total structural primary adjustment expected to reach 3.2% in 2024, followed by 0.7% in 2025. Despite these adjustments, the overall impact on growth is likely to be limited. However, the €100 billion (5% of GDP) EU NextGeneration funds and additional €100 billion disbursements expected by the end of 2026 should have a significant impact on Italy’s growth.

An Excessive Deficit Procedure will be used to estimate the ‘technical trajectories’ for countries with budget deficit above 3% and debt level above 60%.

² Technical trajectories for the net primary expenditure (nationally financed government expenditure net of cyclical spending for unemployment and discretionary revenue measures and one-offs) will require limiting deficits to 1.5% of GDP and bringing debt ratios on downward trajectories towards 60% of GDP, but at least reduce the debt pile by 1% per year. Countries will have 4 years to reach the targets or up to 7 years if they also implement structural reforms.

³ EU Council recommendation – June 2024 : 465 listed tax expenditures in 2022, in particular the tax credit on research (crédit d’impôt recherche, some €7 billion), the tax credit for home employees (crédit d’impôt pour l’emploi d’un salarié à domicile, €5.7 billion), the 10% allowance on pensions and retirement arrangements (abattement de 10 % sur les pensions et retraites, €4.4 billion) and the 10% rate for improvement, conversion, fitting-out and maintenance works, (€4.3 billion) were the largest ones in the 2023 budget law.

Policy action under scrutiny

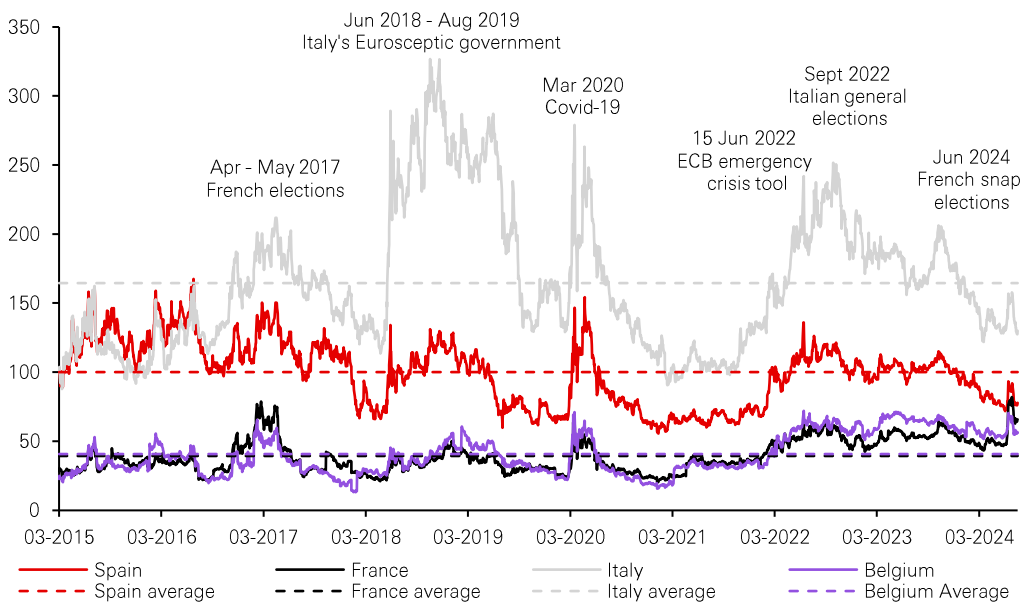
While additional cost-saving measures may weigh on economic growth in France and the rest of the eurozone, public investments in green transition, digital, defence projects, and cross-country energy and transport infrastructure will be preserved to leverage private funding, generate jobs, and raise potential growth in the medium to long term.

Credit agencies have highlighted risks around the necessary fiscal and reform path. The recent political developments in France have exacerbated uncertainties over the future policy action: a fragmented parliament may delay the required effort to comply with the EU fiscal rules. While fragmented parliaments have progressed in the region, notably Spain, Belgium, the Netherlands, Germany, or Finland, these do not imply lack of market discipline. An EDP for France and Italy, provided governments maintain a cooperative stance, should not further impact market confidence. In the meantime, the ECB's Transmission Protection Instrument (TPI) could be activated in case of major cross-national volatility in sovereign borrowing costs.

Despite the expected decreases in budget deficits on aggregate in the region, sovereign bond supply may not be significantly supportive due to rising bond redemptions. Also, the end of the reinvestments from the ECB pandemic purchase programme in the second half of this year should increase the free float to be absorbed by private investors.

Year-to-date, with the end of the rate-hiking cycle, private investors have returned to the euro bond market. The very recent political developments in France have however brought some volatility (Figure 3). Looking ahead, despite potential fiscal challenges, euro sovereign bond spreads should keep contained, supported by a relatively benign macro-environment, including low gas prices, ongoing disinflation, rising real income and further ECB rate cuts.

Figure 3: 10-Year Sovereign bond spreads to Germany (bps)



Source: Bloomberg – Data as of 17/07/2024

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European equities: lessons from the past

When the Fed announced its pivot last December, the ECB erred on the side of caution. However, the ECB announced a 25bps rate cut for the first time since 2019, pre-empting the Fed. The shift is driven by continued strength in US macro data contrasted with mixed signals from Europe, with an ongoing contraction in manufacturing PMIs but an expansion in services. Corporate earnings revisions in Europe have been negative year-to-date, but in the last three months, they have improved by approximately 10%. The consensus forecast is predicting upper-single-digit growth for 2024. Interestingly, countries in Europe ex-UK, such as Sweden, Switzerland, Austria, and Norway, have experienced a higher percentage of analyst upgrades over the past three months than the US. This trend could reverse if the US enters a recession, as Europe's relatively low market valuation and limited US revenue exposure (20%) offer little cushion in a US downturn.

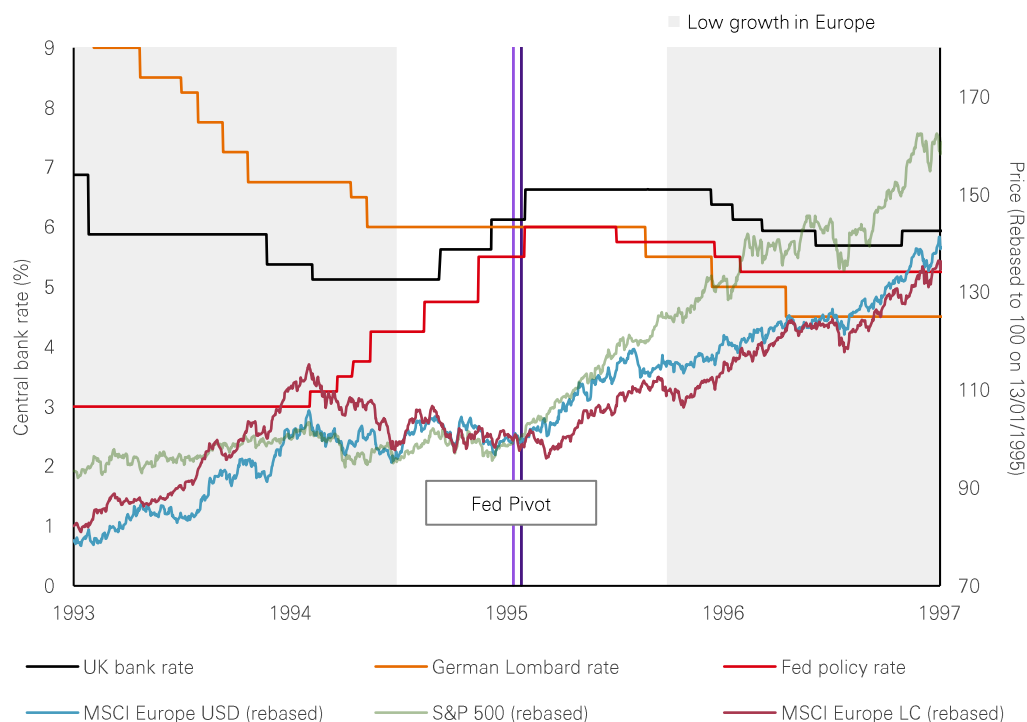
While both Fed and European policy conditions today mirrors that in 1995, there is a significant difference in the valuation gap between US and European markets.

Lessons from the past

Reflecting on historical precedents, the soft-landing scenario following the Fed's pivot in 1995 offers valuable insights. At that time, both Fed and European policy conditions mirrored today's environment. Despite signs of a US slowdown, the Fed's cautious approach did not prevent market gains. Fears of recession eventually dissipated as a soft landing materialised. European market valuations, which started at comparable levels, re-rated on the prospect of lower rates.

The significant difference now is the valuation gap between US and European markets. In 1995, US valuations were on par with Europe, but today, the US enjoys an unprecedented premium. US valuations are at levels comparable to late 1997-early 1998, just before the internet crash, while Europe trades like it's still 1995.

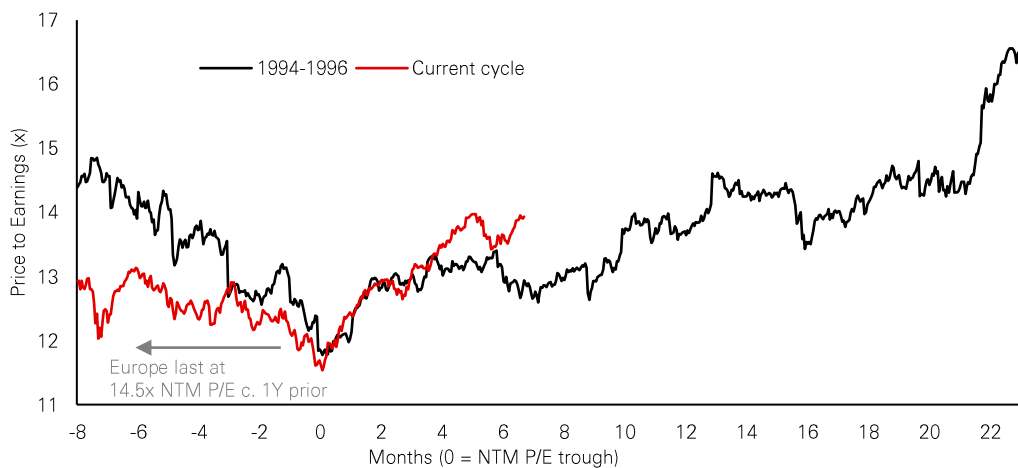
Figure 1: US / Euro policy rate pivot and cuts versus market returns



Sources: Datastream, Factset, Morgan Stanley research, data as of 31 May 2024.

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Figure 2: MSCI Europe PE during FED pivots (1995 versus 2023)



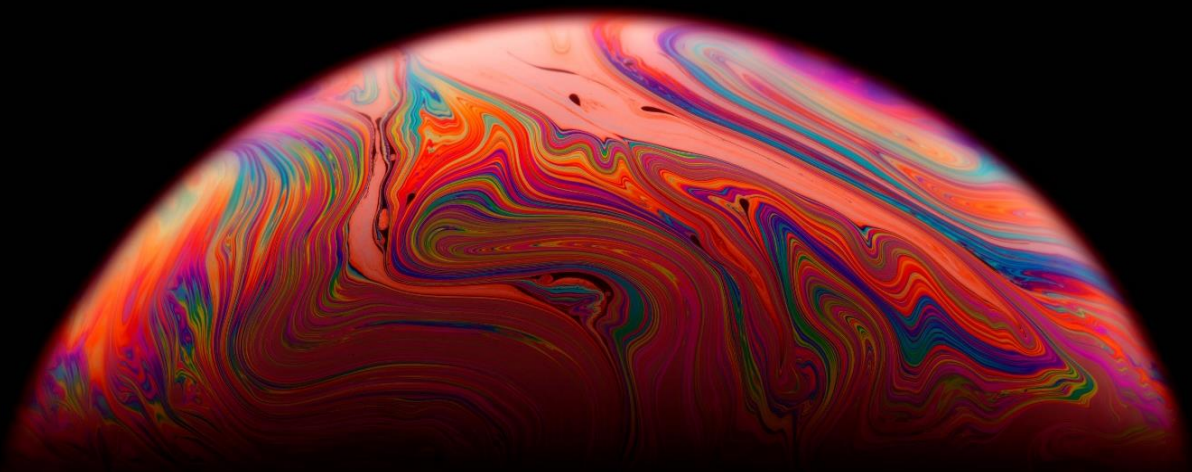
Sources: HSBC AM, MSCI, IBES, Morgan Stanley research, data as of 31/05/2024.

A new era?

Today's environment also resembles the mid-1990s in other ways. Just as the internet revolution was in its early stages then, AI is now in its infancy. The market may still have significant potential, especially early in the easing cycle. Not all interest rate-sensitive sectors have benefitted yet. Utilities, real estate, and materials are lagging, and renewables, a strong potential beneficiary of rate cuts, is down over 10% this year. This year's gains are concentrated in low interest rate-sensitive sectors such as technology, banks, healthcare, and food retail.

Historically, the second leg of a rally typically begins post-rate cuts. With global money market funds at record levels—25% higher than early 2020—some of this capital could flow back into undervalued risk assets like high yielders, value stocks, and small caps.

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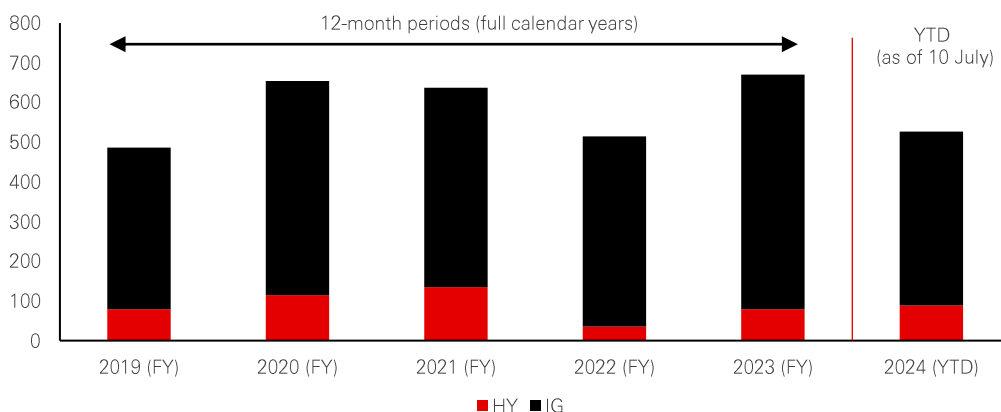


European bonds are back (part 2)

In the previous edition of [Europe Insights](#), we discussed how the European credit markets were experiencing a positive performance run thanks to ECB's pivot on rates. Another illustration of the market anticipating and welcoming this reversal in monetary policy can be found in the volume of bond issuance on the primary market. With over €430 billion issued so far this year, investment grade issuance (from both corporates and financials) has jumped by over 16% when compared to a year ago. Similarly, high yield issuance so far this year – almost €90 billion – is already above the entire volume in 2023.

The European primary bond markets is experiencing a resurgence this year, with corporates and financials issuing over 520 billion so far

Figure 1: Corporate and financial issuance on the primary market (€bn)



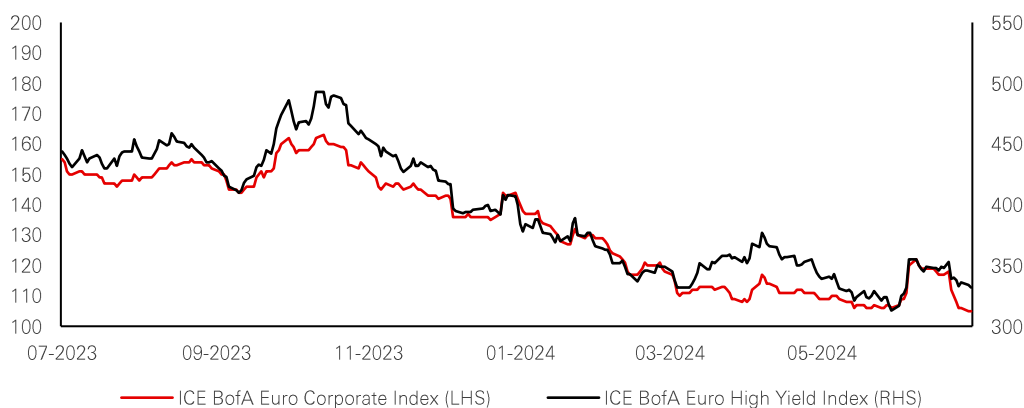
Source: HSBC AM, Bloomberg data, July 2024.

Rates and spreads as strong drivers

The ECB announcing a 25bps rate cut played a crucial role in this boom in issuance from European corporates. Increased visibility on ECB rate policy smoothed volatility on fixed income markets and encouraged corporates to issue more on the primary market and anticipate the roll-out of bonds issued during the pandemic (and that will reach maturity in the next two years).

The phenomenon has also benefited from some other factors. Historically low spreads is one of them. Since their peak in October last year, investment grade and high yield corporate spreads have compressed by over 60%. This translates to markets' confidence in corporates' fundamentals, and despite the recent elections across the region resulting in a slight widening in June, spreads have re-engaged on their compression trend.

Figure 2: European corporate spreads



Source: HSBC AM, Bloomberg data, July 2024.

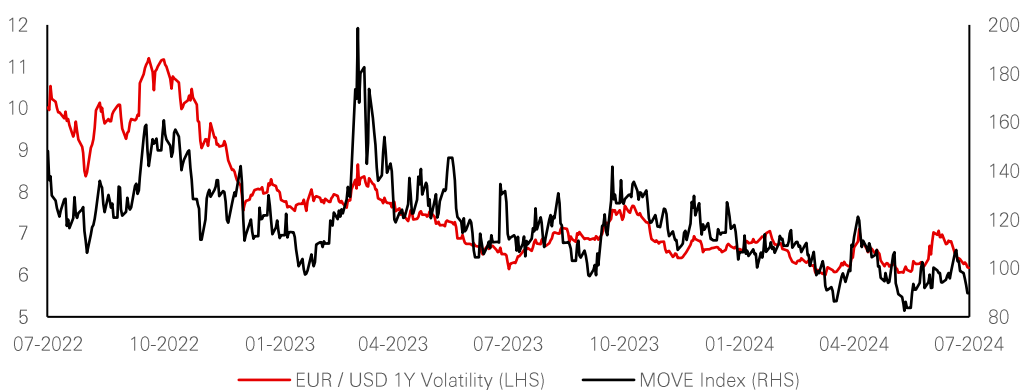
¹ Source: HSBC AM, Bloomberg data as of end of 10 July 2024.

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The less usual suspects

In addition to rate and spread levels, the low level of volatility observed on both bond and FX markets may also play a role in this dramatic increase of issuance volumes this year. Intuitively, the latter may sound more anecdotal, but it might partially explain why 17% of investment grade euro-denominated emissions have been initiated by US companies aiming to issue at lower rates than on their local markets. It makes US companies the most prolific on the euro primary market (followed by France and Germany). Overall, this is over 40% that have been issued by corporates and financials based outside the Eurozone.

Figure 3: Bonds and currency volatility



Source: HSBC AM, Refinitiv data, July 2024.

Indeed, such an increase in issuance volumes from both local and foreign companies also couldn't materialise without a solid investor appetite for the asset class. So far this year, they have clearly demonstrated that they didn't want to miss the opportunity to capture 'all-in' yields at historically high levels, to take advantage of the reversal in monetary policy and the normalisation of the inverted yield curve.

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Data watch

As of 16 July 2024

Eurozone recovery initiated in Q1 is slowing down. While headline edged down as per expectations, core inflation remained unchanged as prices of services and core goods remained stable. The ECB eased the policy rate by 25bps but also revised its projections for inflation and GDP to the upside.

Economic Indicator	Data as of	Last data	Consensus	Previous data	Analysis
PMI composite	Jun	50.9	52.5	52.2	The eurozone PMI surprised to the downside, signalling a slowdown of the recovery initiated in the first quarter. This came from a fall in new orders and rising input costs, due to trade tensions, geopolitical issues and France's political uncertainties. The manufacturing PMI pointed to a renewed contraction in that sector. The services PMI decreased from its April peak, pointing to a deceleration into the summer. Country-wise, the PMIs signalled a contraction in France, and a moderation elsewhere, with continued outperformance, notably in Spain and to a lesser extent in Italy.
GDP growth qoq	Q1 2024	0.3%	0.0%	-0.1%	Eurozone GDP growth came in better than expected. Eurozone household consumption rose at a moderate pace (0.2% qoq). The main contributions to Q1 GDP growth came from a positive net trade and higher government spending, while de-stocking by firms continued. Country wise, Q1 2024 GDP surprised to the upside, notably in Germany (+0.2% qoq against -0.5% in Q4), Italy (+0.3% qoq after +0.1% in Q4). France's GDP increased as expected (0.2% qoq). Spain and Portugal (GDP +0.8% qoq) continued to outperform the rest of the region.
Industrial production % yoy	May	-2.9%	-3.6%	-3.1%	Industrial production fell again in May, led by a contraction in car and machinery output. The eurozone manufacturing sector remains very deteriorated compared to pre-pandemic levels, due to its exposure to energy-intensive industries, the automotive sector transformation and the continued slowdown of China, the eurozone fourth largest goods' export market, behind the non-EU countries, the US and the UK. Note that the Irish output (owning of production facilities outside the country and patent transfers) usually adds significant volatility to the eurozone monthly releases. Also, the calendar-adjustment release may have underestimated the unusually large number of public holidays in May this year.
Unemployment rate	May	6.4%	6.4%	6.4%	The eurozone unemployment rate remains at a record historical low level, and has barely moved since March 2023. Labour hoarding, high rates of sick-leave, a large share of the workforce approaching retirement age may have contributed to the resilience of the unemployment rate. The unemployment rate keeps the highest in Spain (11.7%), compared to Germany (3.3%) or Italy (6.8%) and France (7.4%).
Trade balance (goods, ex EMU) EUR billion (12Mth cumulative)	Apr	154.7	153	129.0	The eurozone trade balance (on a cumulative 12-month basis) keeps increasing, on the back of a sharp contraction of imports (-15% yoy), compared to exports (-2% yoy). The drop of energy prices has significantly improved the terms of trade. The eurozone trade balance has not reached its pre-pandemic level (EUR 208 billions in December 2019).
Retail sales % yoy	May	0.3%	0.2%	0.6%	Eurozone retail sales surprised to the upside in May, with an upward revision of the April release. As of Q1, household savings kept rising, reflecting a precautionary behaviour. But the 3-month trend up to May seems to show an improvement of household consumption. The ongoing disinflation together with a resilient labour market and a rising real income should keep supporting private consumption.
Inflation - Headline CPI, % yoy	Jun	2.5%	2.5%	2.6%	Eurozone headline inflation edged down in line with the consensus, but core inflation was unexpectedly unchanged, with stable prices of services (4.1% yoy) and of core goods (0.7% yoy). At 2.9% yoy, eurozone core inflation stands above the ECB June staff forecasts, while headline inflation as expected. Country-wise, headline inflation ranges from 0.6% in Finland to 5.5% in Belgium.
- CPI core*, % yoy	Jun	2.9%	2.8%	2.9%	
ECB Refinancing rate	6 June	4.25%	4.25%	4.50%	The ECB cut its policy rates by 25 basis points as expected even though inflation projections were revised to the upside (up 0.2 basis points to 2.5% in 2024 and 2.2% in 2025), and GDP growth (up 0.3 basis points to 0.9% in 2024). These upward revisions were driven by higher energy and commodity prices, the recent upside surprises on core inflation, higher wage growth and a more cautious outlook for productivity growth. The ECB expects inflation to move sideways in the near term, moderating close to the 2% target in 2025.
Deposit rate		3.75%	3.75%	4.00%	

■	Improved or better-than-expected
■	Worsened or below-expectations
■	Unchanged or in line with expectations

* Eurozone Core CPI is CPI excluding energy, food, alcohol & tobacco
Sources: Bloomberg, Refinitiv, Eurostat, HSBC Asset Management – data as of 16/07/2024

F: Final A: Advanced P: Preliminary estimate

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