BNY

iFlow

MACRO MORNING BRIEFING

July 4, 2024

Chips Sole Bright Spot in European Industry

No end in sight for European manufacturing contraction

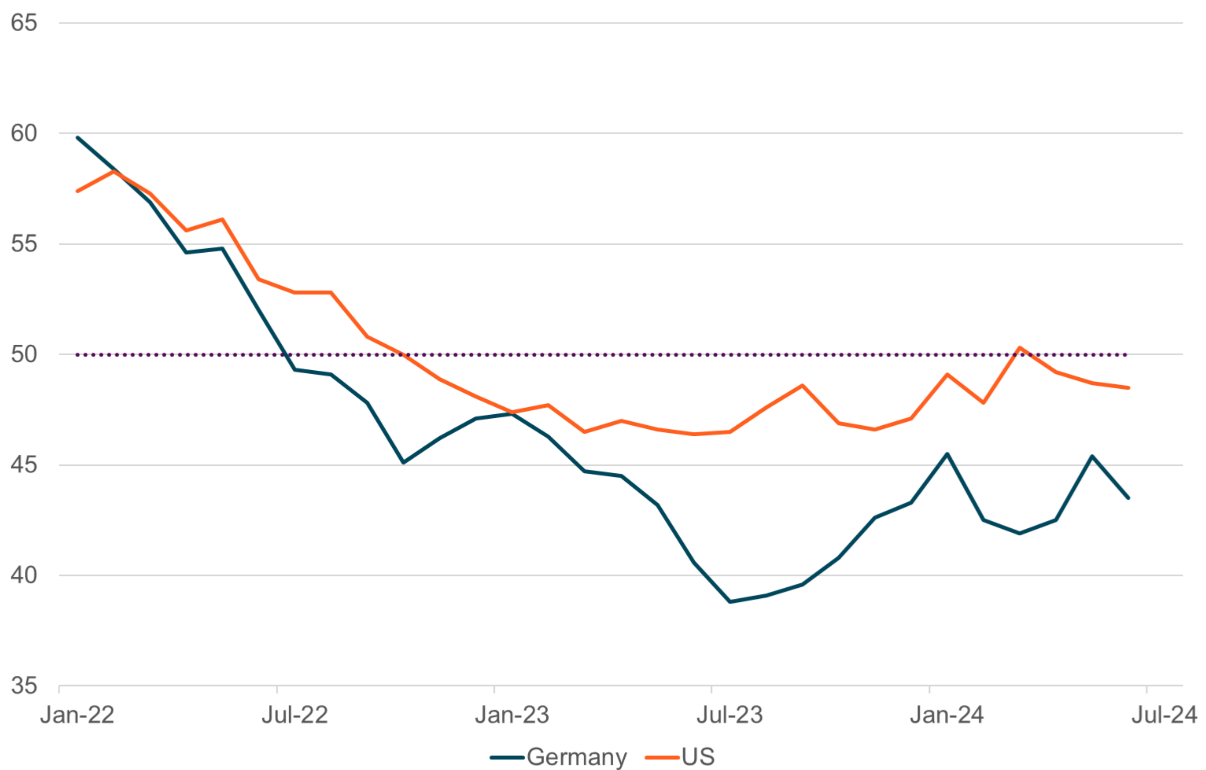
- June contraction rekindles fears of structural declines
- Smaller exporters globally seeing better expansion
- Microchip economies experiencing expansion and attracting flows

Specialization helps buck PMI trends

For euro bears such as ourselves, the 2024 Sintra round of policy speeches are disappointing as there is no sign of bearish deviations from their central scenarios in the near future. The situation in France may have cast a shadow over bond markets, but we would not overplay the implications for monetary policy as Eurozone sovereign bond markets are generally well-behaved and do not require any form of ECB intervention, be it through activating existing or new facilities.

Our central case for the need for more cuts lies in the state of the manufacturing sector and the structural challenges faced by the European Union. Germany's performance is particularly weak and there are additional risks regarding trade relations with China and the US. While many of the issues are well beyond the remit of the ECB, data indicate that the sector's contraction has continued unabated. Admittedly, this is a global trend and the equivalent figures for the US are not much better (Exhibit 1), but the Eurozone's GDP is far more dependent on manufacturing for value-added growth, and we don't view the situation as sustainable over the longer-term as there will be a downward drag on aggregate demand.

Exhibit #1: German and US manufacturing PMI

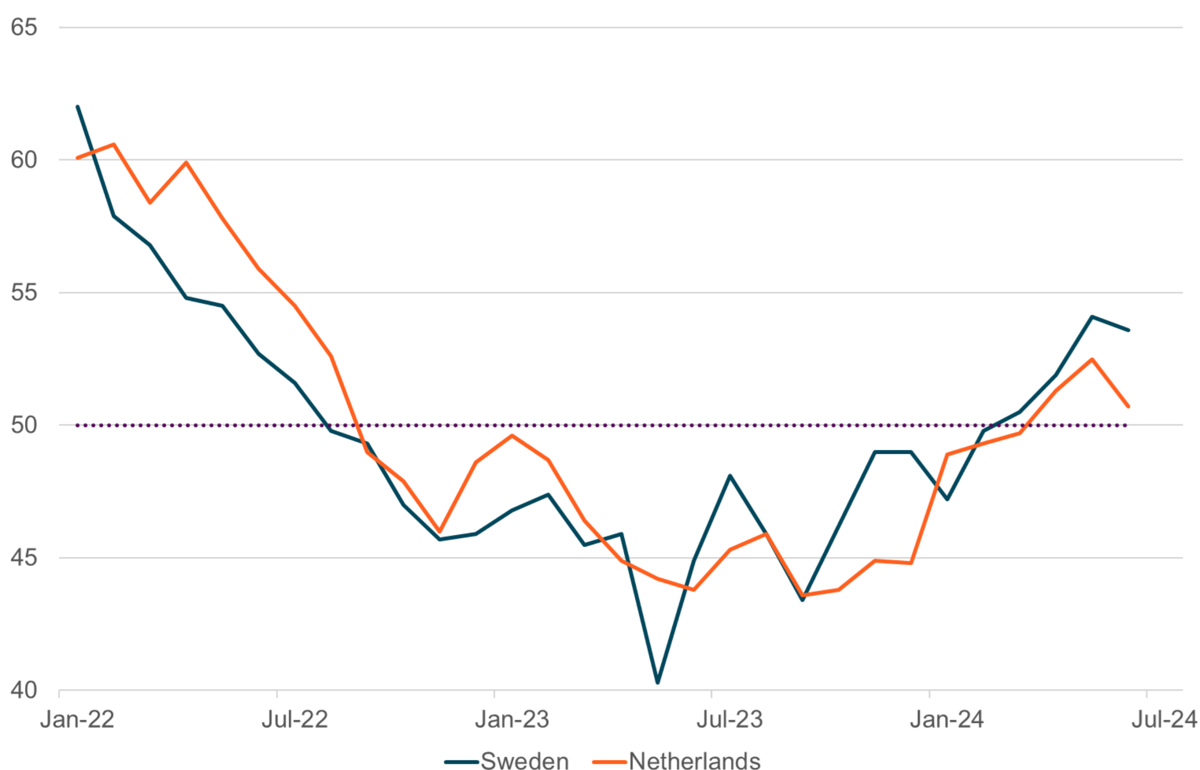


Source: Bloomberg, BNY

Consequently, we fear that inflation in the low value-added but more inflationary segments of the economy will hollow out manufacturing due to the ECB's inflation mandate. This was the thrust of President Lagarde's Sintra speech last year, but the tone on Monday was somewhat different. Calling the current cycle "unusual," the focus of her speech was squarely on inflation risks rather than the real economy. This is perhaps a realization that she is mandate-constrained, but only by bringing down inflation and the cost of living can political leaders – especially in such a febrile environment – adopt what will likely be painful structural reform to boost competitiveness. Ultimately, she noted that although growth had softened and "soft landings" were usually elusive, the "labor market has been exceptionally benign," while unemployment is not rising thanks to the ability of firms to "hoard more labor." Lagarde did not address sectoral differences at all: there was almost no need given that total unemployment remains at "historic lows."

The ECB may also be making the calculation that Germany's growth situation is no longer the be-all and end-all for Eurozone dynamics. For example, services performance across the Eurozone, but particularly in Southern Europe, has been exceptional, to the extent that Greece is able to repay ESM loans early and Portuguese government bond yields recently traded under France, though it was more a case of the latter rising due to fiscal risk rather than additional Portuguese outperformance. Furthermore, we can see that there is also divergence in the manufacturing outlook between Germany and export-led economies, which normally would be considered producers of intermediate goods that feed into Germany's

supply chain. Central and Eastern Europe certainly fit this bill: Polish and Czech manufacturing PMIs have been in contraction for two years. However, Dutch and Swedish PMIs are moving in the opposite direction (Exhibit 2). Swedish and Dutch manufacturing PMIs returned to positive territory in Q1 and are still holding up well. More importantly, the trend has been one of recovery since June. One reason is that relative to prior baselines, trade with emerging markets is hampering Germany even more: Swedish and Dutch export exposures to advanced economies stand at 78% and 86%, respectively (2023 data), whereas the German figure is 71%. High real rates and fiscal restraint across emerging markets are making their impact felt in this regard for finished goods manufacturers and exporters.



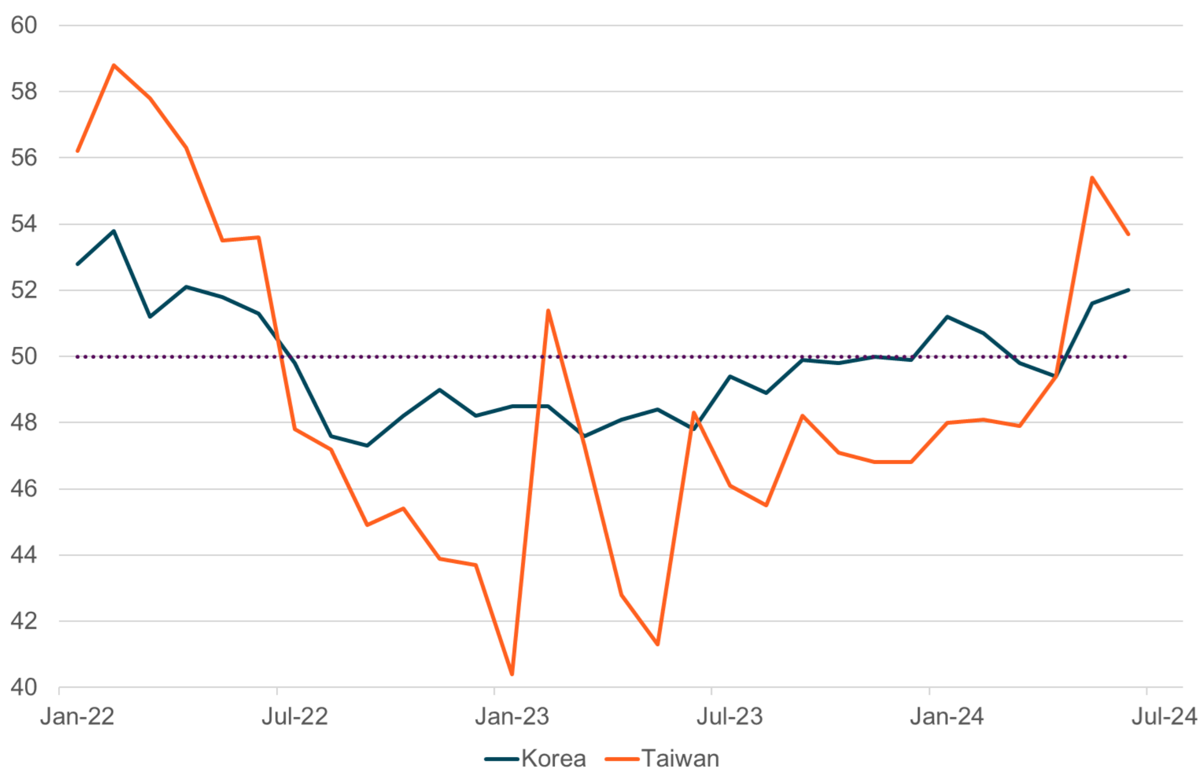
Source: Bloomberg, BNY

The strong manufacturing performance of the Netherlands may also have much to do with its position in the global microchip supply chain, particularly lithography machines where the country's monopolistic position is unlikely to be challenged soon due to the complexities of the supply chain. We are often loath to attribute a country's performance to one particular company, but this does happen in Europe from time to time. We recently highlighted parallels in Denmark and the dominant economic position of pharmaceutical companies. Global competition for microchips and key fabrication inputs has also generated serious anomalies in trade flows. For example, Chinese imports from the Netherlands are up 36%y/y as of May, and annualized growth rates have been at above 25%y/y for over a year. In contrast, Chinese

imports from Germany and France are running at -10%y/y and -8%y/y, respectively. Given the current level of investment intent for artificial intelligence and the fact that strengthening microchip supply chains has taken on material geopolitical connotations, demand is likely to be inelastic – we could easily foresee a situation where the Netherlands is the only Eurozone economy maintaining outright manufacturing expansion, even if it is single-industry driven.

The microchip theme is even more pertinent globally for economies that can specialize in the industry. Chinese and Japanese PMIs are relatively moribund, but we can see that Korean and Taiwanese PMI prints are back in expansion territory (Exhibit 3) and the trend has also been one of improvement over the past few months. China is obviously trying to move into this space as well, but progress will likely be slow. Furthermore, outside of the chip industry, if the upcoming series of meetings in Beijing results in additional reflation tailwinds through fiscal and monetary stimulus, the risk to the export trade in the region is clearly to the upside as well. Given the industrial overlaps between Asia and Europe, diverging manufacturing cycles will pose a serious risk to regional competitiveness. Yet, as shown earlier this week, the reflexive action in European capitals to competition remains one of tariff investigations.

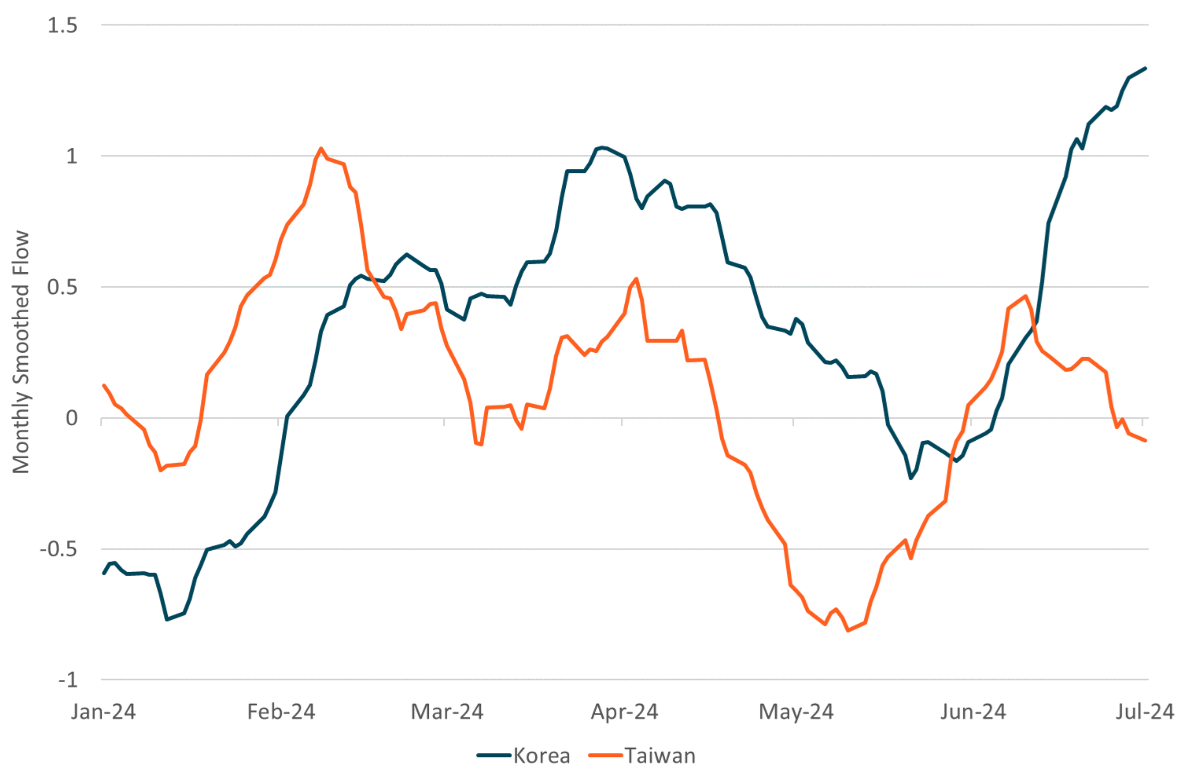
Exhibit #3: Korean and Taiwanese manufacturing PMI



Source: Bloomberg, BNY

Asset allocation decisions will also start to assert themselves in time. Recent developments in France have led to material outflows from Europe, but specialist manufacturers in APAC

are seeing the opposite. iFlow shows very strong demand for Korean and Taiwanese equities (Exhibit 4) though demand for the latter has tailed off in recent weeks. Hampered by the lack of a more comprehensive industrial policy and process deficiencies, Europe stands to continue to lose ground on the global high value-added manufacturing and technology investment cycle. That ECB President Lagarde failed to repeat her acknowledgement of such risks in her Sintra update this year only adds to concerns over the future of European manufacturing. Tariffs aside, there is simply no policy help forthcoming for the industry.



Source: BNY

Disclaimer & Disclosures

Please direct questions or comments to: iFlow@BNYMellon.com

Geoff Yu

EMEA MACRO STRATEGIST

CONTACT GEOFF

Can't see the email? View online

We take our data protection and privacy responsibilities seriously and our privacy notice explains how we collect, use, and share personal information in the course of our business activities. It can be accessed here.

This email was sent to WeeKhoon.Chong@bnymellon.com, and was sent by The Bank of New York Mellon 240 Greenwich Street, New York NY 10286.

Your privacy is important to us. You can opt out from receiving future Newsletters by unsubscribing via this link at any time. You can also select the topics that you want to receive by managing your preferences.

This message was sent from an unmonitored email box. Please do not reply to this message.

Contact Us | iflow@bnymellon.com

© 2024 The Bank of New York Mellon Corporation. All rights reserved.

This message was sent from an unmonitored email box. Please do not reply to this message.

.