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MACRO MORNING BRIEFING

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Messages from the Eurozone Supply Chain

Eurozone “Supply Chain” Central Banks Diverging from ECB

- Swedish, Swiss and Czech central banks not aligning well with ECB
- Divergence in inflation outlook particularly acute
- Eurozone growth risks not core risk in key trading partners yet

ECB being given benefit of doubt by the region for now

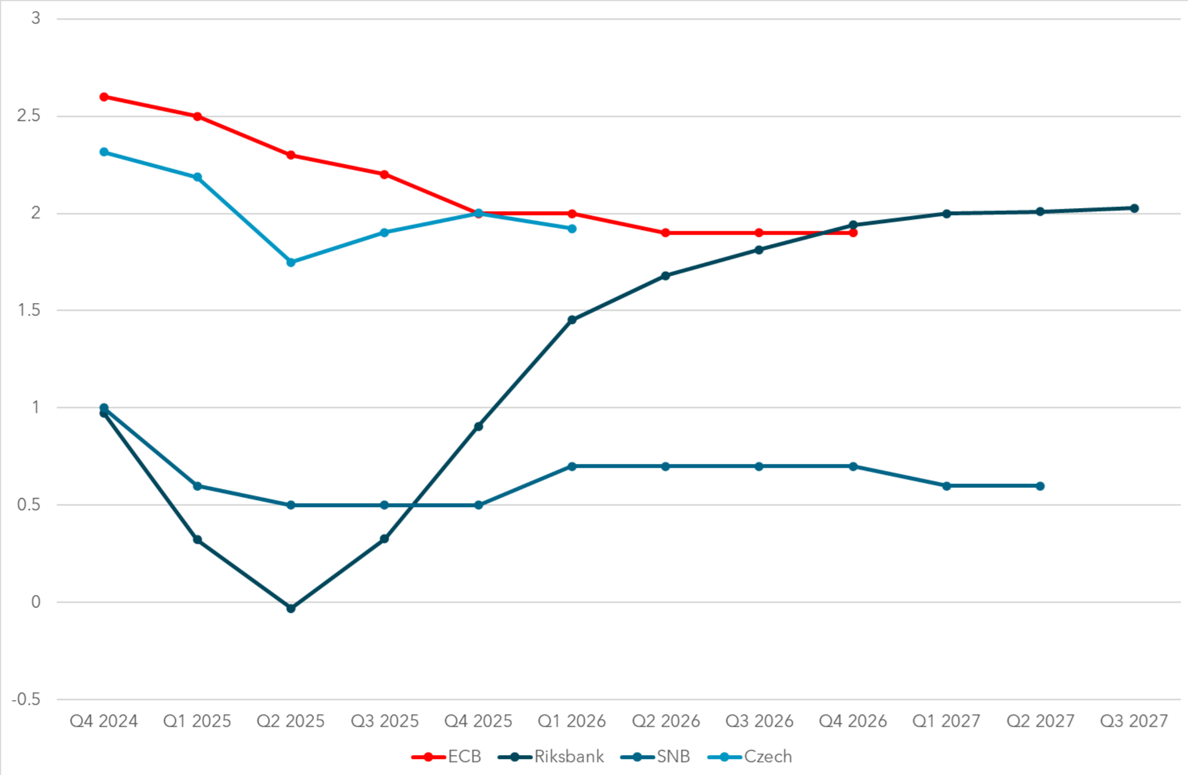
China may have occupied the majority of market attention this week and if the news regarding stimulus is correct, then every single market to which China is exposed will benefit from a demand injection. Despite increased trade tensions and competition in high value-added sectors, the Eurozone is China’s biggest single-economy trading partner. The European Central Bank (ECB) will feel even more justified that their relatively robust outlook on the economy is correct, especially if the export sector now begins to pick up on top of what remains a firm services sector.

However, we believe it is perhaps more important for the ECB to look closer to home for cues on the medium-term outlook. The Riksbank, Czech National Bank (CNB) and Swiss National Bank (SNB) all made policy decisions this week. All three cut rates by 25bp and to varying degrees cited the Eurozone’s current outlook as a potential drag on their own economies. This is no surprise: all three economies are largely export-driven and enjoy current account surpluses. The Eurozone represents 35% of Swedish exports and 43% of Swiss exports, while 40% of Czech exports go to Germany and Slovakia alone. More importantly, intermediate goods represent a material proportion of overall exports to the Eurozone, where finished goods are subsequently produced. The bottom line is that these three economies are the Eurozone’s “input economies” and can even serve as a leading indicator for the

Eurozone’s future outcomes.

Based on the outlooks released this week by the Riksbank, CNB and SNB, the forward inflation outlook is where we see the biggest mismatch (Exhibit #1). The picture is not uniform across the three, but for the next five quarters the Eurozone is expected to have higher headline inflation. Swiss and Swedish inflation is expected to fall well below 1%, while Czech inflation is expected to fall below 2% by Q2 next year. The ECB is not expected to see sub-2% inflation by Q2 2026. Furthermore, we stress that all four central banks are focused more on domestic services-based inflation rather than the usual export-related income, so it is not simply a matter of external demand. The main divergence therefore is the role of the public sector. We have highlighted frequently in the past how Eurozone wage inflation is being heavily supported by government spending, a point highlighted by ECB President Lagarde since 2023. The CNB’s statement this week highlighted similar risks, stating that “increased wage demands in the private and public sector are an inflationary risk. Potential excessive growth in total public sector spending would also lead to a risk of the state budget having an inflationary effect.” However, the main downside risk cited is “weaker German economic output” and this is where the manufacturing aspect comes through as well. As such, the ECB (and CNB) should recognize that if public spending starts to tail off, irrespective of the cause, the inflation trajectory will likely resemble Sweden and Switzerland’s far more, as these countries have different fiscal trajectories. Furthermore, we note that even Czech inflation indicates some front-loading of downside risk, and this has been the case in Sweden and Switzerland through the year. This means a sharp revision in the inflation path is possible in upcoming ECB projections.

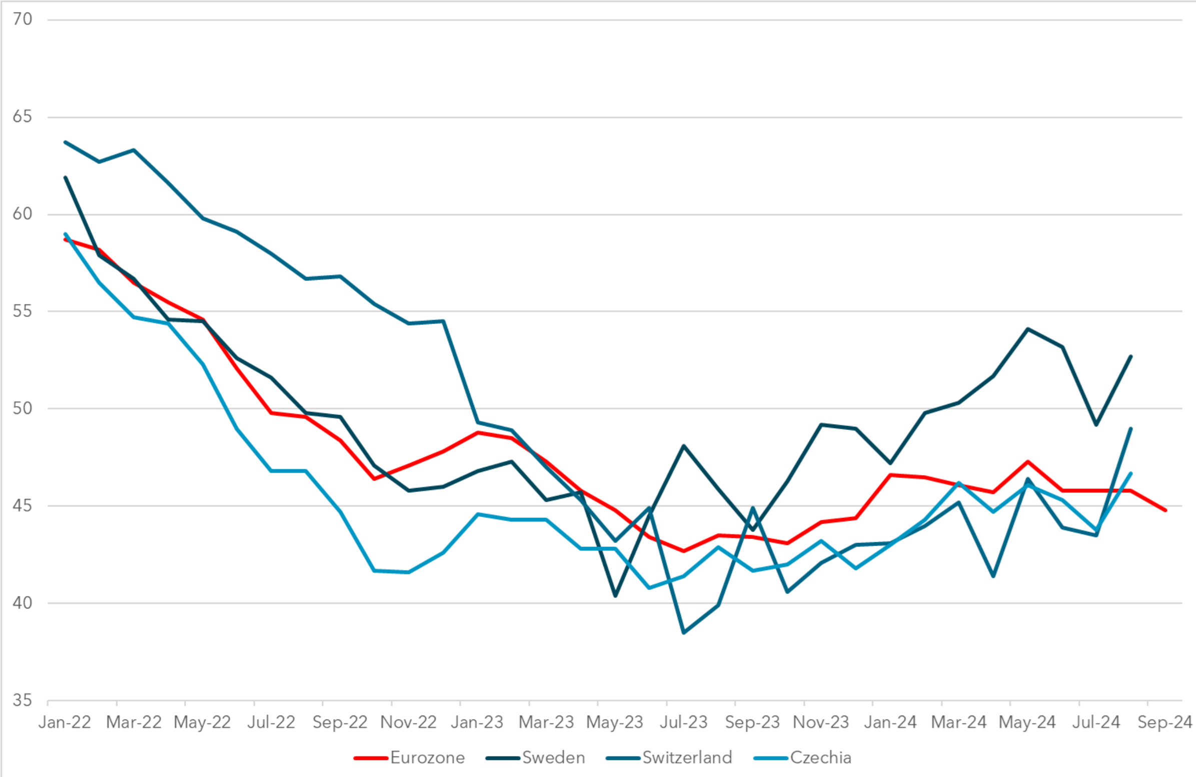
Exhibit #1: ECB, Riksbank, CNB and SNB Inflation Forecasts



Source: Riksbank, Czech National Bank, European Central Bank, Swiss National Bank, BNY

Looking at the manufacturing output picture, there is perhaps some scope to move away from excessive pessimism, but only insofar as contraction may not get worse. The August PMI figures which showed improvement for Sweden, Switzerland and Czechia could indicate improvement in the Eurozone outlook ahead as orders for intermediate goods are improving. Chinese stimulus would certainly help proceedings further, but one quarter's worth of marginal demand boost cannot compensate for almost two years of contraction. Furthermore, only Swedish manufacturing PMI is showing any sign of expansion and admittedly has been doing so for several months now and the others are only contracting less. Given the coincidental nature of these indices, we would expect Eurozone manufacturing to remain under pressure.

Exhibit #2: European PMI Comparisons



Source: Bloomberg, BNY

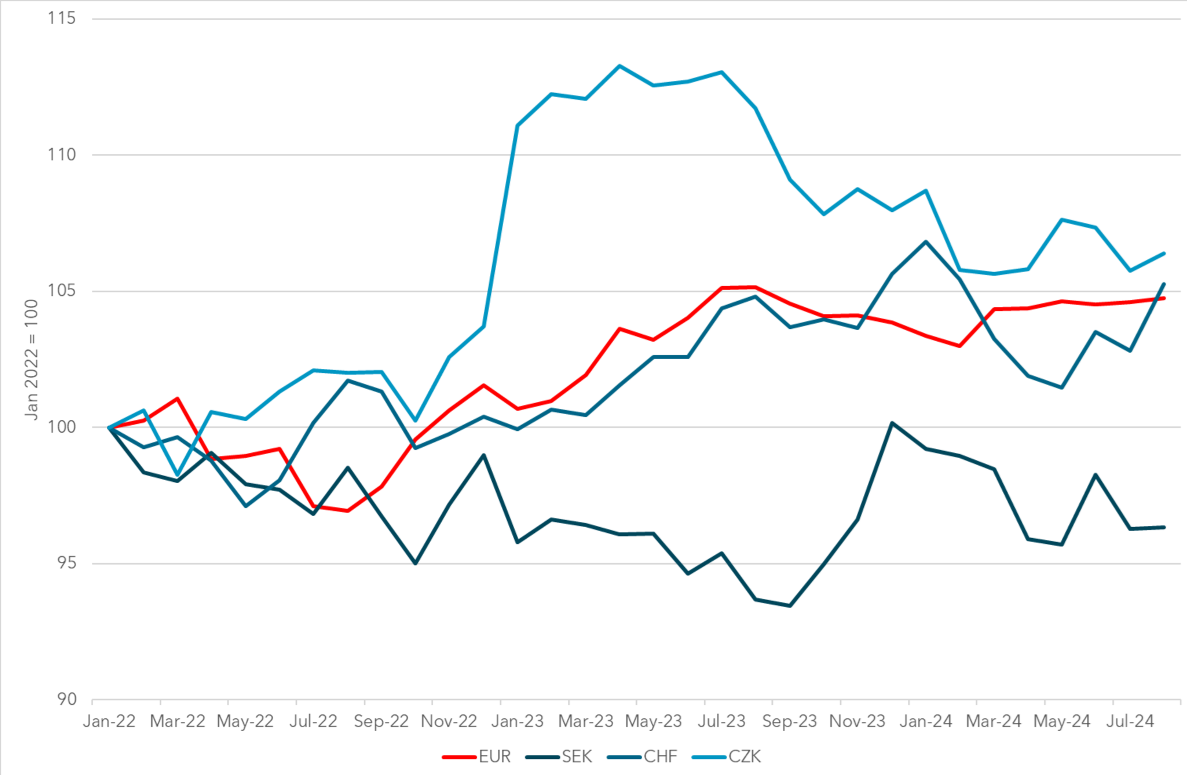
When measured by hard data, the outlook is also troubling. International Monetary Fund trade statistics show that Czech and Swedish exports to the Eurozone have been contracting since the end of 2023, though Swiss exports have been expanding for nearly a year. More analysis is needed on the precise breakdown of goods to indicate whether it is indeed intermediate inputs which are performing well, and we can see that export growth to the Eurozone for these three countries is far less coincidental compared to PMI figures. The SNB's outlook – as opposed to the CNB's – did not cite Eurozone growth as a significant downside risk, and nor was that the case for global trade in general. Nonetheless, we highly doubt that Swiss export growth to the Eurozone – especially with a strengthening franc – can diverge from peers for long. If the SNB's tune on Eurozone risks starts to change, then the ECB should really take notice.

Exhibit #3: Export Growth to Eurozone

Source: Bloomberg, BNY

The Riksbank and SNB have succeeded in moving policy expectations in an even more dovish direction, while there is still some room for maneuver for the CNB, which reflects the varying degrees of alignment between their inflation views. Even though the euro has not been very sensitive to changes in the ECB's outlook this year, it means that even current easing is not adequately reflected in currency valuations (Exhibit #4). Now that the Fed's outlook has been settled, the risk to EUR performance is clearly to the downside if the ECB's stance changes. EUR and CZK performance in real terms since 2022 has been strongly supported by inflation differentials, but if easing is now needed, then the nominal will need to start adjusting, especially if the demand drag from manufacturing finally begins to push down wage growth if services cannot grow at a strong enough pace to compensate. Furthermore, unlike the CHF, the EUR tends not to benefit from safety properties during cyclical downturns and global policy easing phases, so CHF performance despite SNB cuts is not the right template. Policymakers in the Eurozone's "input economies" are currently giving the ECB's forecasts the benefit of the doubt, but the front-loading of rate cuts and disinflation outcomes in their respective forecasts should give Frankfurt pause for thought. With the EUR at valuation highs, Eurozone price evolution could follow a similar path without sufficient policy offsets.

Exhibit #4: REER Change



Source: Bloomberg, BNY

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