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MACRO MORNING BRIEFING

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Services 'Strength' Cannot Sustain The Eurozone

European PMIs continue to show sectoral divergence

- Services expansion does not obviate the case for ECB easing
- Growth rates in Eurozone services converging to manufacturing
- Eurozone manufacturing at risk of scarring amid structural changes

Market reaction to Eurozone data remains highly asymmetric

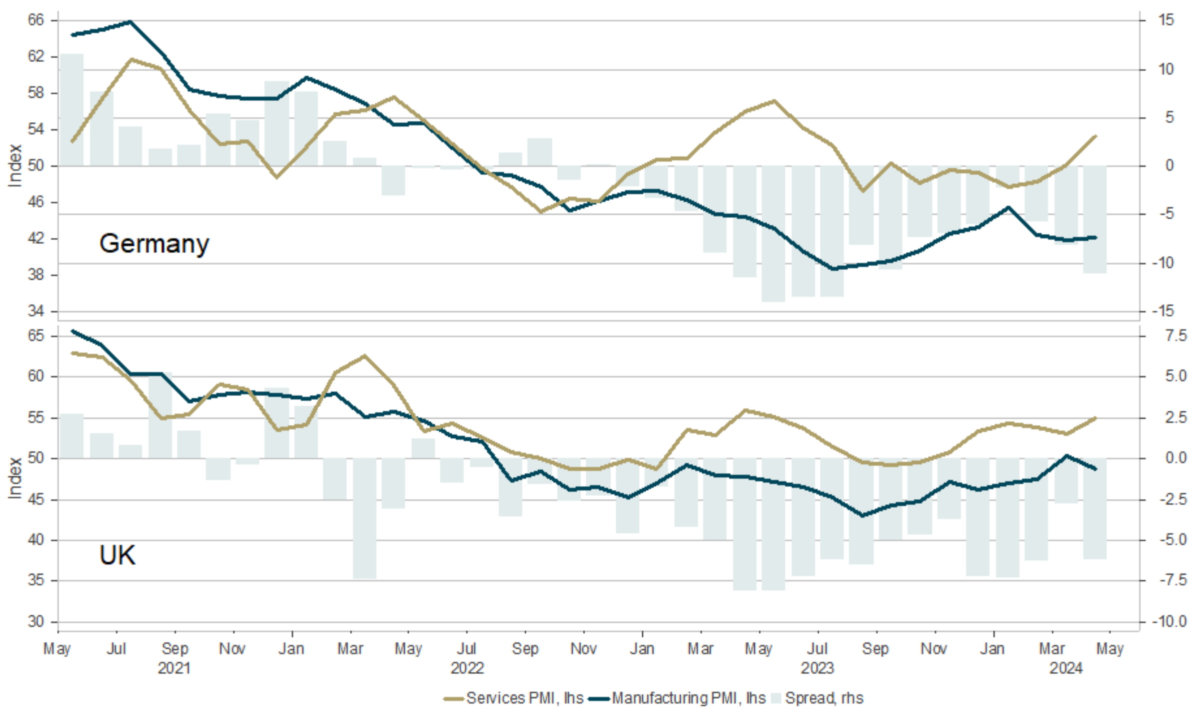
Preliminary April Purchasing Managers' Indices (PMI) released across Europe Tuesday show, on balance, exigent trends remain in place. That services continued to outperform manufacturing was largely expected, but strength in the former did surprise markets. Germany's reading, at 53.3, signals the strongest expansion in close to a year and appears to support recent comments by some European Central Bank Governing Council members that Germany and the Eurozone could look forward to expansion through Q2. With summer approaching – traditionally the strongest period for services due to an increase in hospitality investment and spending – risks to the growth from this sector appear skewed to the upside.

Although the euro's gains from the PMIs were marginal, the FX market's largesse for the Eurozone economy continues to confound. The EURUSD retreat from recent highs is largely attributable to the pullback in Fed easing expectations and some degree of risk aversion. We believe that the market is now pricing in the bare minimum of ECB easing needed. Hard data does not support the notion that services can now lead the Eurozone to a strong revival, and we remain perplexed that there is so little initiative to provide any form of policy support to counter ongoing deterioration in the Eurozone manufacturing sector.

The strength of Germany's services PMI figure coupled with the manufacturing equivalent coming in weaker than expected means that the spread between the two is now the widest since July 2023. On current evidence, a repeat of last year looks possible as a strong injection of demand over the summer months would further widen the gap between the different sectors. As opposed to ECB fears that it is simply public services keeping output and wages elevated, there may be more of a private component with respect to future demand on a seasonal basis. However, given that manufacturing has been contracting since July 2022 and very little marginal support from fiscal relief provided during the pandemic, we question whether household income from the private sector can support strong expansion.

In contrast, the UK (exhibit #1) shows far better co-movement between manufacturing and services, even though the latter is less impactful for UK growth. At least it shows that investment and growth cycles are aligned within the UK economy. Germany's divergence either heralds a restructuring of the economy in favour of services, or ongoing strength in real income growth but without any form of private sector support.

Exhibit #1: PMI Divergences Clear



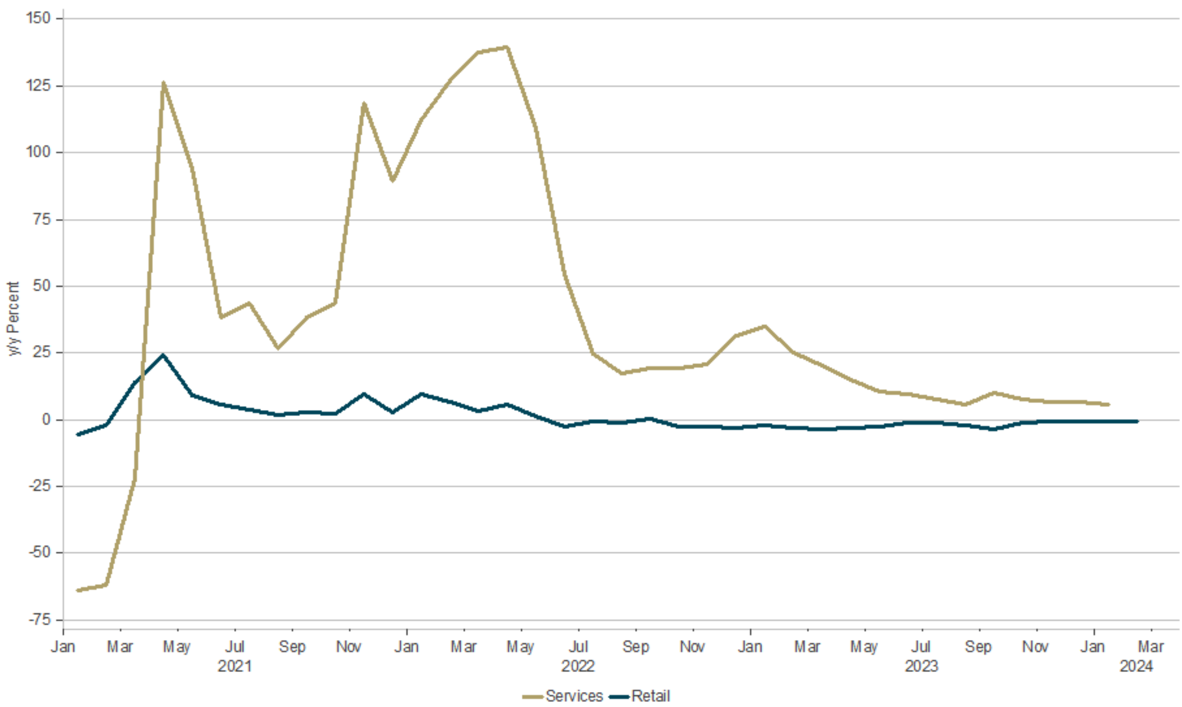
Source: Macrobond, BNY Mellon

The accompanying release to the PMI outright called the picture for manufacturing "bleak" across the Eurozone. It warned that "new business [is] continuing to decline rapidly, along with order backlogs. Weak demand for industrial products is also evident in the sharp decrease in the volume of purchased inputs and the absence of a turnaround in the inventory cycle." Structural headwinds were also mentioned, especially the emergence of China as a competitor in high-value-added industrial goods. Managing these challenges was a key mission during German Chancellor Scholz' recent visit to China. Judging by current rhetoric, however, there seems very little common ground when it comes to industrial policy.

The market's asymmetric reaction to Eurozone data, whereby positive data supports the euro much more than weaker data undermines it, perhaps underscores low expectations to begin with. As services is a sector which has been under-represented in Eurozone growth in the past, some degree of rebalancing in its favour should be considered healthy. However, we question the extent to which services alone can drive Eurozone growth given the current outlook for manufacturing. The hard data does not support this prospect.

After extremely high growth rates in services turnover in the Eurozone in 2021 and 2022 due to pandemic-related effects, growth rates have fallen to low single-digits on an annualised basis. It is easy to forget that consumption growth will also require goods spending to rise as well on a marginal basis, yet retail turnover (exhibit #2) remains anchored at close to flat growth. As such, household demand driving Eurozone growth is marginal at best and could flatline by the end of the year, while manufacturing continues to contract.

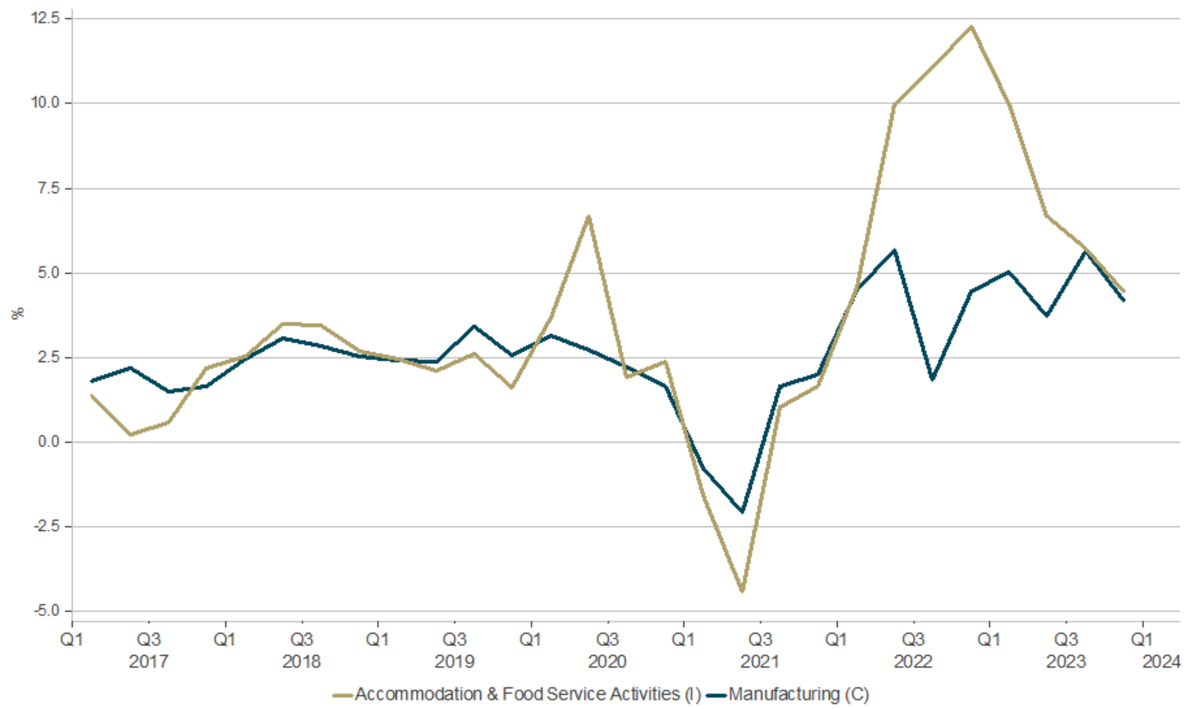
Exhibit #2: Turnover Growth Slowing Across Sectors



Source: Macrobond, BNY Mellon

As Bank of England Chief Economist Huw Pill outlined yesterday, headline inflation in the UK could fall below target in the near future, but it's persistent inflation – manifested through wage growth – which would determine the BoE's rate path. The ECB is in a similar situation, and we would advise caution with the assumption that the current recovery in services expectations can directly generate wage growth. Eurozone labour markets remain tight and the PMI release highlighted that amidst "a ten-month high rate of employment growth in the services sector...the rate of increase reached a nine-month high" for jobs growth in France, "along side a marginal return to growth in Germany and sustained solid hiring in the rest of the region". Wages directly feed into output prices but, again, there is a material divergence between services and manufacturing: rates fell for a twelfth month in the row in the latter but were climbing "at a strong pace" in the former. We can see (exhibit #3) that across the Eurozone, manufacturing wage growth has stagnated and services wage growth – using accommodation and food services activities as a proxy – has converged to manufacturing.

Exhibit #3: Wage Growth Softening In All Sectors

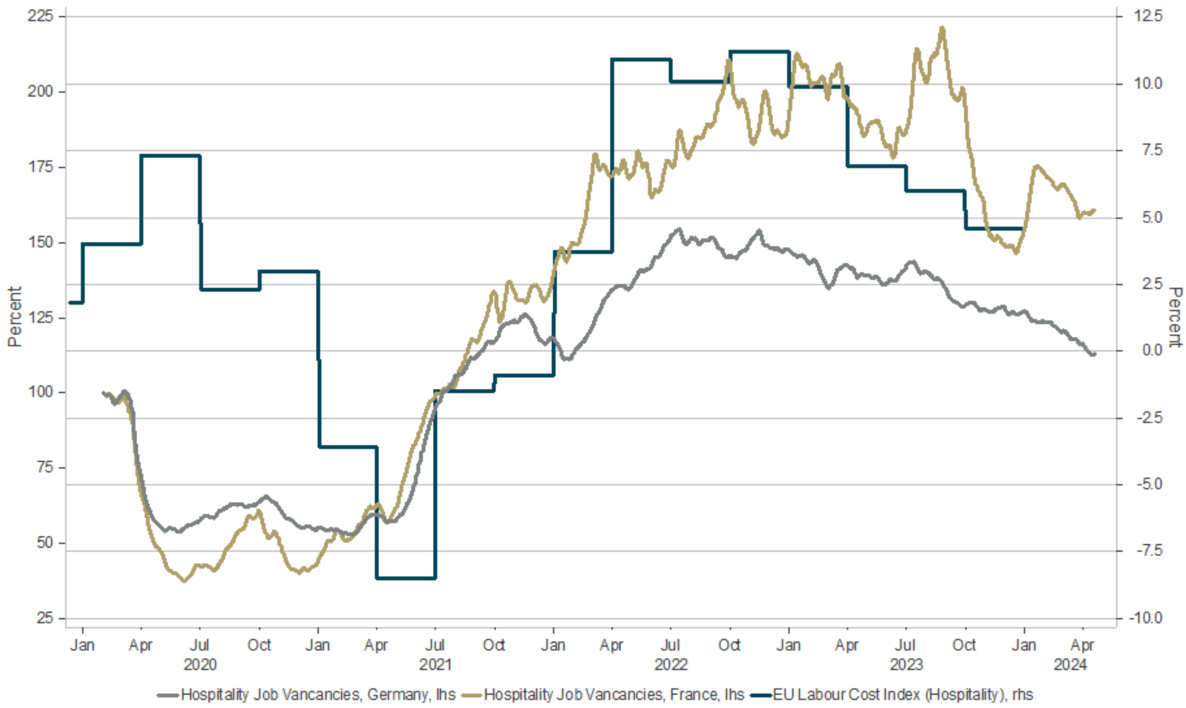


Source: Macrobond, BNY Mellon

A repeat of the divergence between 2021 and 2022 between services and manufacturing is unlikely, in our view. Instead, there is every indication that wage growth in services is now declining on a structural basis, albeit from very high levels. This summer season will be a crucial test for the hospitability industry, but vacancies in Germany and France are continuing to decline from 2022 highs (exhibit #4), and labour costs in the sector are not rising either even though the PMIs are suggesting strong inflation growth. If this summer is the last hurrah for hospitality and private services output in general, the only source of wage growth remaining across the Eurozone would likely be in the public sector.

As we highlighted earlier this week, fiscal consolidation will become more pressing, and the ECB has generally seen public sector employment as lacking in productivity growth and not supportive for wider growth, hence continuing to delay rate cuts based on an increasingly limited set of price and wage drivers – while the manufacturing sector faces secular decline and potential scarring. Unfortunately, from monetary to industrial policy, there is a clear lack of coherence on how to support the Eurozone's manufacturers. The Eurozone economy may be rebalancing in favour of services, but it is doing so from a contractionary dynamic – potentially a very painful socio-economic and politically painful process.

Exhibit #4: Hospitality Boom Is Over



Source: Macrobond, BNY Mellon

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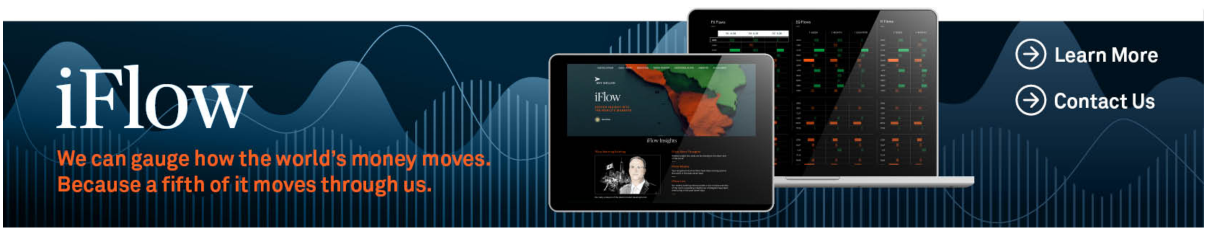

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