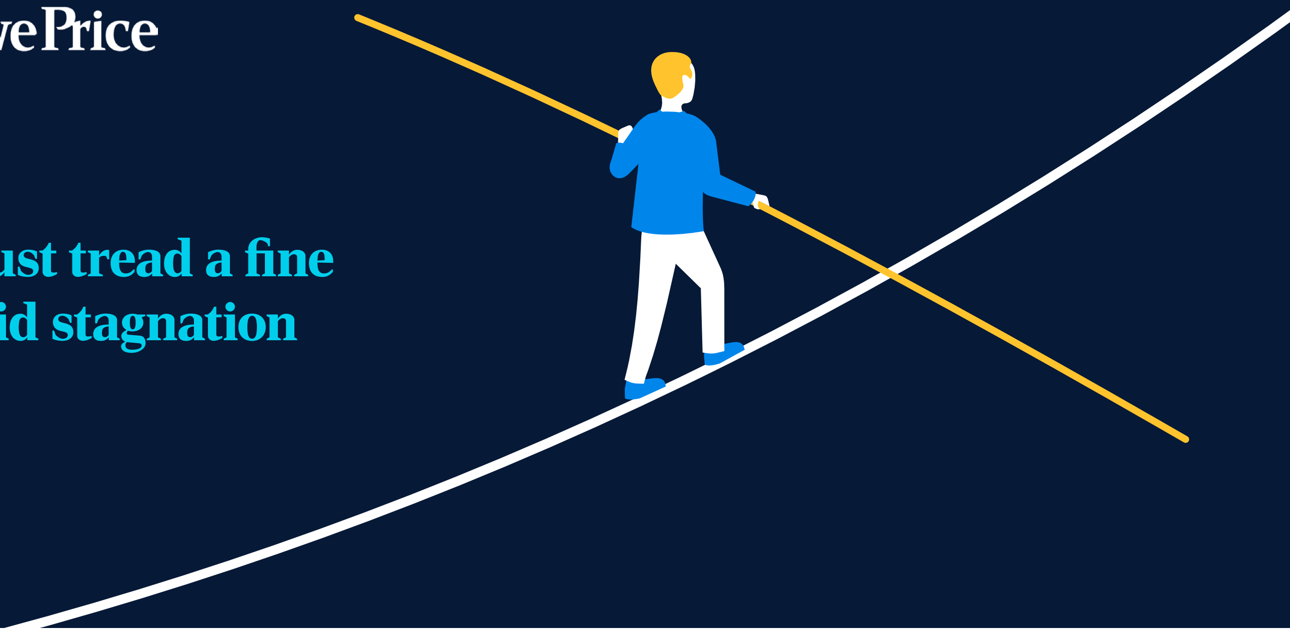


Europe must tread a fine line to avoid stagnation

From the Field
December 2023

Key Insights

- Europe looks set for a mild recession in 2024 before returning to growth, but tight financing conditions and geopolitical uncertainty could hamper the recovery.
- The key risk is a return to pre-pandemic-era stagnation, and the European Central Bank will need to calibrate policy very carefully to prevent this from occurring.
- An earlier-than-expected rate-cutting cycle would favor bunds and would likely weaken the euro against other currencies.

Tomasz Wieladek
Chief European Economist

Europe very likely faces several quarters of negative, or at least stagnating, growth in 2024. How long this period lasts will depend on several factors, but the most likely scenario is that the eurozone undergoes a mild to medium-sized recession before returning to growth toward the end of next year. However, the risk of a more prolonged period of stagnation cannot be ruled out, particularly if the European Central Bank's (ECB's) monetary policy remains too tight for too long.

A faster-than-expected drop in inflation would likely prompt the ECB to cut rates sooner rather than later. This would favor German bunds but would weaken the euro. European stocks are likely to remain muted until the recovery begins, at which point cheap valuations may provide a buying opportunity.

Demographics pose challenge for eurozone's biggest economies

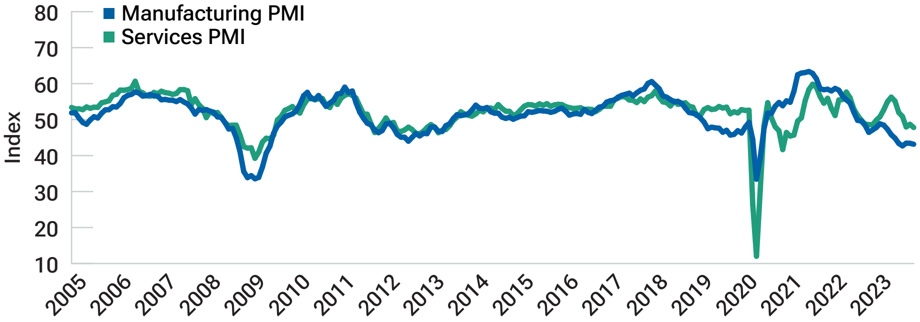
Recent Purchasing Managers' Index (PMI) surveys indicate that the European economy is already in recession. German manufacturing data are very weak, and French manufacturing PMIs have been falling to a similar level. Manufacturing PMIs in Italy and Spain have improved a little, but from very low levels. Services PMIs are weakening across the whole of the eurozone. Overall, these dynamics suggest that the currency bloc is close to the bottom of its manufacturing cycle but the deterioration in the services sector could have further to run (Figure 1).

Germany, Europe's manufacturing motor, faces multiple challenges. In the 2000s, social benefit reforms significantly raised workforce participation rates among middle-aged Germans, keeping wage levels competitive. European Union accession countries provided a further source of skilled and competitively priced labor, while Russia supplied cheap energy and Chinese just-in-time inputs allowed Germany to focus on higher value-added manufacturing.

> “European stocks are likely to remain muted until the recovery begins....

The deterioration in services likely has further to run

(Fig. 1) The manufacturing cycle may already be close to the bottom



As of October 31, 2023.
Source: S&P Global. See Additional Disclosure.

Since then, many of these tailwinds have turned into headwinds. Social benefits cannot be reformed much further, and there are fewer economic migrants. Germany needs approximately 400,000 immigrants each year to plug the gap in its workforce left by an aging population but is struggling to attract them. The economy is being slowly weaned off Russian gas, and some strategic supply chains are being reconfigured. These structural changes will keep growth in Germany subdued for several years while it transitions to a new economic model. In the past, fiscal policy would have been deployed to ease the pain during this process, but Germany's debt brake rule means this is not feasible this time.

Italy will experience similar challenges to Germany on the manufacturing side, and, given its very high debt levels, the government is similarly constrained in its use of fiscal policy. France has an active industrial and fiscal policy, which will help to cushion the transition. France is the only large country in the eurozone with sustainable demographics, which means that it should be much less affected by population aging.

Spain's economy has a much smaller share of manufacturing than the other countries. It could still be affected by a eurozone-wide services downturn, yet surveys indicate that the Spanish economy continues to be by far the most resilient.

Geopolitical tensions and rising yields weigh on growth

Geopolitical uncertainty will weigh on consumption and investment, particularly if energy prices surge again. The severity of this impact will depend on how national governments respond. If most or all of any rising prices are passed onto consumers, the resulting demand destruction will sharply reduce inflationary pressures and enable the ECB to ignore the spike in energy prices. If, however, governments respond to rising prices by cutting the fuel duty, the inflation that follows could put pressure on the ECB to tighten again.

Arguably the biggest future geopolitical risk is a trade war with China. Although some European countries are ready to impose tariffs on Chinese imports, others are more concerned about reduced access to the Chinese market. A trade war with China would hit external demand and, therefore, eurozone growth.

Key challenges for European economies in 2024

The Continent faces three strong headwinds

Demographic change

Aging populations and fewer migrant workers pose a challenge for some European economies, particularly Germany.

Geopolitics

High energy prices and a potential trade war with China could hit external demand and, therefore, growth.

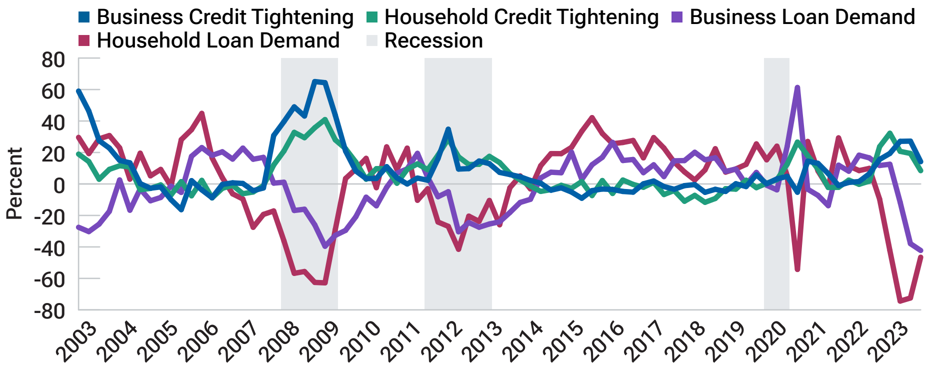
Inflation path

The ECB faces the difficult task of controlling inflation while avoiding causing stagnation.

Source: T. Rowe Price.

Tighter financing conditions often preceded a recession

(Fig. 2) Credit conditions are tightening, albeit at a slower rate



As of September 30, 2023.
Source: ECB Bank Lending Survey.

Tightening financial conditions also threaten growth (Figure 2). The ECB's monetary policy has tightened financial conditions in the eurozone significantly: According to the central bank's own bank lending survey, household and firm loan demand has fallen drastically, and credit conditions have tightened. Narrow and broad monetary aggregates have also declined outright in 2023—another indicator of a very tight monetary stance. These effects have been exacerbated by spillovers from the U.S., where concerns about higher monetary policy rates and a large amount of fiscal issuance have led to a persistent sell-off in government bond markets.

External pressures in the form of rising yields threaten to tighten financial conditions even further irrespective of any policy actions the ECB itself takes. In the worst-case scenario, a rapid externally driven tightening in financial conditions could push eurozone sovereign yields to levels that would certainly lead to a significant undershoot of the inflation target. If that happens, the ECB may decide to cut the policy rate.

Tight financing conditions not only affect consumers and firms, but also governments—the recent large rise in bond yields has made borrowing more expensive, which will constrain fiscal spending and weigh on domestic consumption and business investment. However, this will be offset to some degree by external demand, which should remain supportive, particularly if the U.S. economy remains resilient. Growth spillover effects arising from any further fiscal or monetary stimulus in China would also likely benefit Europe.

> “The biggest risk for the eurozone is a return to pre-pandemic-era stagnation.

ECB must walk a narrow path

As things stand, inflation should begin to fall in the coming months and into next year. Following the coronavirus pandemic, supply chain disruption fueled a burst of manufactured goods inflation. Supply chains have since normalized to a large extent, and manufactured goods prices are falling. In addition, the full impact of the ECB's tightening on inflation will very likely only be felt in the second half of 2024. In the absence of further commodity shocks, inflation may fall more quickly toward the ECB's 2% target than currently anticipated. In our view, the risks that inflation undershoots the ECB's 2% target are larger than currently anticipated.

The biggest risk for the eurozone is a return to pre-pandemic-era stagnation. This is a bigger risk than persistent inflation from second-round effects. Following the global financial crisis, the currency bloc became mired in a low-inflation, low-growth equilibrium. The ECB has since set an inflation target of 2%, but this was a level it struggled to reach for almost a decade prior to the pandemic despite more than EUR 1 trillion worth of quantitative easing. If the ECB tightens too quickly, it could cause inflation to plummet back below 2%, pushing the eurozone into stagnation once again.

This is not a small risk: The eurozone's manufacturing sector needs to transition away from cheap imported gas and labor, which is a major structural challenge. Normally, fiscal policy would be used to stimulate demand enough to ensure this supply adjustment occurs in an orderly fashion, but the eurozone is fiscally constrained. The ECB, therefore, faces the delicate task of carefully calibrating its monetary policy so that it is tight enough to keep inflation on a path consistent with its 2% inflation target in the medium term, but not so tight that it causes persistent stagnation. This is a narrow path to tread.

Ultimately, there are two scenarios in which the ECB is likely to initiate a rate-cutting cycle: first, if growth is weaker than expected; and second, if inflation falls back to the 2% target faster than expected. Only one of these scenarios needs to materialize for the ECB to cut rates in our view. Our preference is therefore to be long German bunds, which we expect would be the main beneficiary of rate cuts in Europe. We believe that the ECB will eventually end up cutting between 150bps and 250bps, more than markets expect. As a result, assuming our expectations are correct, the euro is likely to decline relative to a broad basket of currencies in the coming year.

In equities, corporate profit margins will remain under pressure while economic conditions remain weak. If Europe avoids stagnation and returns to growth, opportunities may arise to invest in strong companies whose valuations will likely still be relatively cheap.

Weak UK data point to early rate cut

Outside of the European Union, the Bank of England (BoE) is expecting the UK economy to flatline until early 2025 but has warned it is "much too early" to think about rate cuts. Indeed, UK inflation has turned out to be more persistent than in other economies. The official measure of wage growth continues to grow at roughly 8% year on year, which is significantly above the level required to return inflation to target in the medium term.

However, it also needs to be acknowledged that surveys on the housing market, consumer confidence, manufacturing, and services activity are all at levels that were historically consistent with a recession. The BoE's Monetary Policy Committee has a mandate to deliver inflation at 2%. But monetary policy that pushes the economy into deep recession may lead to a prolonged inflation target undershoot, which is equally undesirable to an inflation overshoot. The Bank of England, like the ECB, therefore faces a very difficult balancing act.

How this balancing act will play out really depends on the labor market. Historically, once the unemployment rate has begun to rise as it has in the past year, it has continued to rise to much higher levels. The Bank of England has predicted that the UK's unemployment rate will rise only gradually, by 0.1% per quarter to a peak of 5.1% in the fourth quarter of 2026. I believe that this is too optimistic and that the unemployment rate will rise faster than the BoE expects. If I am right, the BoE is likely to cut rates faster than the market currently anticipates.

T. Rowe Price cautions that economic estimates and forward-looking statements are subject to numerous assumptions, risks, and uncertainties, which change over time. Actual outcomes could differ materially from those anticipated in estimates and forward-looking statements, and future results could differ materially from any historical performance. The information presented herein is shown for illustrative, informational purposes only. Forecasts are based on subjective estimates about market environments that may never occur. Any historical data used as a basis for this analysis are based on information gathered by T. Rowe Price and from third-party sources and have not been independently verified. Forward-looking statements speak only as of the date they are made, and T. Rowe Price assumes no duty to and does not undertake to update forward-looking statements.

INVEST WITH CONFIDENCE™

T. Rowe Price identifies and actively invests in opportunities to help people thrive in an evolving world, bringing our dynamic perspective and meaningful partnership to clients so they can feel more confident.

DISCLOSURE CONTINUES ON THE FOLLOWING PAGE.

Important Information (cont.)

Australia—Issued by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 28, Governor Phillip Tower, 1 Farrer Place, Sydney NSW 2000, Australia. For Wholesale Clients only.

Brunei—This material can only be delivered to certain specific institutional investors for informational purpose only. Any strategy and/or any products associated with the strategy discussed herein has not been authorised for distribution in Brunei. No distribution of this material to any member of the public in Brunei is permitted.

Canada—Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc.'s investment management services are only available to Accredited Investors as defined under National Instrument 45-106. T. Rowe Price (Canada), Inc. enters into written delegation agreements with affiliates to provide investment management services.

Colombia, Chile, Mexico, Perù, Uruguay—This material is prepared by T. Rowe Price International Ltd - Warwick Court, 5 Paternoster Square, London, EC4M 7DX which is authorised and regulated by the UK Financial Conduct Authority - and issued and distributed by locally authorized distributors only. For professional investors only.

DIFC—Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd which is regulated by the Dubai Financial Services Authority as a Representative Office. For Professional Clients only.

EEA—Unless indicated otherwise this material is issued and approved by T. Rowe Price (Luxembourg) Management S.à r.l. 35 Boulevard du Prince Henri L-1724 Luxembourg which is authorised and regulated by the Luxembourg Commission de Surveillance du Secteur Financier. For Professional Clients only.

Hong Kong—Issued in Hong Kong by T. Rowe Price Hong Kong Limited, 6/F, Chater House, 8 Connaught Road Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

Indonesia—This material is intended to be used only by the designated recipient to whom T. Rowe Price delivered; it is for institutional use only. Under no circumstances should the material, in whole or in part, be copied, redistributed or shared, in any medium, without prior written consent from T. Rowe Price. No distribution of this material to members of the public in any jurisdiction is permitted.

Korea—This material is intended only to Qualified Professional Investors. Not for further distribution.

Mainland China—This material is provided to qualified investors only. No invitation to offer, or offer for, or sale of, the shares will be made in the mainland of the People's Republic of China ("Mainland China", not including the Hong Kong or Macau Special Administrative Regions or Taiwan) or by any means that would be deemed public under the laws of the Mainland China. The information relating to the strategy contained in this material has not been submitted to or approved by the China Securities Regulatory Commission or any other relevant governmental authority in the Mainland China. The strategy and/or any product associated with the strategy may only be offered or sold to investors in the Mainland China that are expressly authorized under the laws and regulations of the Mainland China to buy and sell securities denominated in a currency other than the Renminbi (or RMB), which is the official currency of the Mainland China. Potential investors who are resident in the Mainland China are responsible for obtaining the required approvals from all relevant government authorities in the Mainland China, including, but not limited to, the State Administration of Foreign Exchange, before purchasing the shares. This document further does not constitute any securities or investment advice to citizens of the Mainland China, or nationals with permanent residence in the Mainland China, or to any corporation, partnership, or other entity incorporated or established in the Mainland China.

Malaysia—This material can only be delivered to specific institutional investor. This material is solely for institutional use and for informational purposes only. This material does not provide investment advice or an offering to make, or an inducement or attempted inducement of any person to enter into or to offer to enter into, an agreement for or with a view to acquiring, disposing of, subscribing for or underwriting securities. Nothing in this material shall be considered a making available of, solicitation to buy, an offering for subscription or purchase or an invitation to subscribe for or purchase any securities, or any other product or service, to any person in any jurisdiction where such offer, solicitation, purchase or sale would be unlawful under the laws of Malaysia.

New Zealand—Issued by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 28, Governor Phillip Tower, 1 Farrer Place, Sydney NSW 2000, Australia. No Interests are offered to the public. Accordingly, the Interests may not, directly or indirectly, be offered, sold or delivered in New Zealand, nor may any offering document or advertisement in relation to any offer of the Interests be distributed in New Zealand, other than in circumstances where there is no contravention of the Financial Markets Conduct Act 2013.

Philippines—ANY STRATEGY AND/ OR ANY SECURITIES ASSOCIATED WITH THE STRATEGY BEING DISCUSSED HEREIN HAVE NOT BEEN REGISTERED WITH THE SECURITIES AND EXCHANGE COMMISSION UNDER THE SECURITIES REGULATION CODE. ANY FUTURE OFFER OR SALE OF THE STRATEGY AND/ OR ANY SECURITIES IS SUBJECT TO REGISTRATION REQUIREMENTS UNDER THE CODE, UNLESS SUCH OFFER OR SALE QUALIFIES AS AN EXEMPT TRANSACTION.

Singapore—Issued by T. Rowe Price Singapore Private Ltd. (UEN: 201021137E), 501 Orchard Rd, #10-02 Wheelock Place, Singapore 238880. T. Rowe Price Singapore Private Ltd. is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

South Africa—Issued in South Africa by T. Rowe Price International Ltd (TRPIL), Warwick Court, 5 Paternoster Square, London EC4M 7DX, is an authorised financial services provider under the Financial Advisory and Intermediary Services Act, 2002 (Financial Services Provider (FSP) Licence Number 31935), authorised to provide "intermediary services" to South African Investors. TRPIL's Complaint Handling Procedures are available to clients upon request. The Financial Advisory and Intermediary Services Act Ombud in South Africa deals with complaints from clients against FSPs in relation to the specific services rendered by FSPs. The contact details are noted below: Telephone: +27 12 762 5000, Web: www.faisombud.co.za, Email: info@faisombud.co.za

Switzerland—Issued in Switzerland by T. Rowe Price (Switzerland) GmbH, Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

Taiwan—This does not provide investment advice or recommendations. Nothing in this material shall be considered a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person in the Republic of China.

Thailand—This material has not been and will not be filed with or approved by the Securities Exchange Commission of Thailand or any other regulatory authority in Thailand. The material is provided solely to "institutional investors" as defined under relevant Thai laws and regulations. No distribution of this material to any member of the public in Thailand is permitted. Nothing in this material shall be considered a provision of service, or a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person where such provision, offer, solicitation, purchase or sale would be unlawful under relevant Thai laws and regulations.

UK—This material is issued and approved by T. Rowe Price International Ltd, Warwick Court, 5 Paternoster Square, London EC4M 7DX which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

USA—Issued in the USA by T. Rowe Price Associates, Inc., 100 East Pratt Street, Baltimore, MD, 21202, which is regulated by the U.S. Securities and Exchange Commission. For Institutional Investors only.