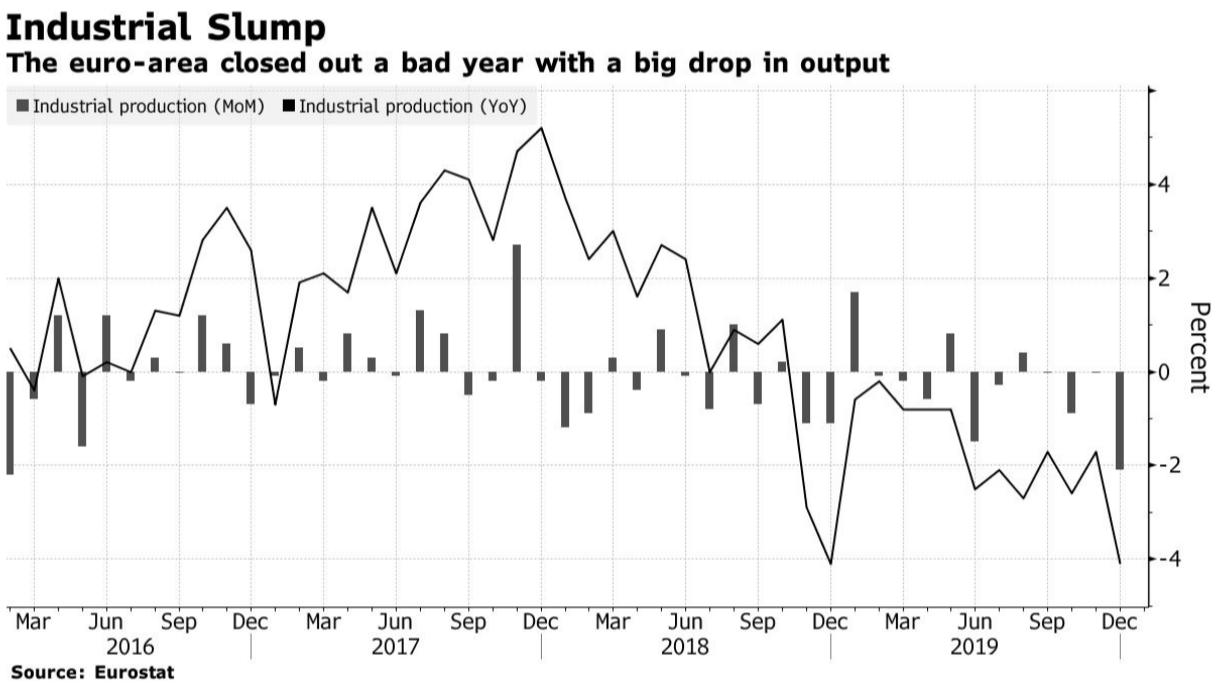
Market Update: 13th February 2020

Coronavirus Outbreak Threatens Eurozone Recovery

Against a challenging economic backdrop in 2019, key Eurozone economies struggled to offset declining industrial activity over the year, led by a significant decline in German manufacturing. While bright spots have begun to appear in the economic data in recent months suggesting that a recovery within the bloc is underway, industrial output data released this week has prompted doubts over a meaningful rebound in momentum. At the same time, coronavirus fears have dented the short-term Eurozone outlook, with uncertainty impacting investor sentiment as we wait to see the economic impact of the Wuhan outbreak.

The Recovery so far

So far this year, European PMIs have been rising and demand has been picking up, however the situation remains fragile. After optimism over a rebound in activity in December as key risks were removed regarding US-China trade and Brexit, IHS Markit's latest manufacturing PMI data from around the world show that the situation is fragile, with manufacturing continuing to shrink in Germany, Italy, Spain and the Netherlands despite European activity overall picking up. Recent figures show that industrial weakness continued over the month of December, with a 2.1% drop in Eurozone industrial output over the month. The deep slump in Euro-area industrial output towards the end of the year highlights the scale of the challenge the sector will face in 2020.



- *It should be noted that some of the slump in the December data can be attributed to temporary factors. France was hit by strikes and protests that month, while Germany's plunge is partly linked to the impact of holidays on construction. Additionally, despite the optimism in mid-December over trade and Brexit, the impact of improved sentiment is unlikely to have fed through into the December data, particularly given the impact of the holiday period.*

Despite continued weakness in the industrial sector, final figures for Eurozone PMIs in January were rather positive, driven by better developments in services. This confirms that despite signs of easing growth, the domestic demand-oriented services sector remained robust, while industry continued to gradually bottom out, driven by Germany. This eased concerns that manufacturing gloom may spill over into domestic demand.

Overall, current data is consistent with very feeble growth in the bloc, indicating that a gradual recovery is underway. At the same time, the recent coronavirus outbreak has dented the short-term outlook, as its negative impact on sentiment could push companies to further postpone investment plans, capping the global demand recovery. As a result, economists will be watching the situation in China very closely to determine any near-term impact on the Eurozone outlook.

Coronavirus Impact

While some risks to the outlook diminished as the US and China agreed to the phase one trade deal and the UK left the EU last month without much disruption, the novel coronavirus outbreak has thrown a spanner into works regarding the Q1 recovery, with economists indicating concern over the level of disruption the recent outbreak will have on the global economy after companies shut factories and shops, and warned of disruption to supply chains and profits.

This week's slight decline in February's Sentix indicator is relatively positive news for the Eurozone, as it suggests that the outbreak has only had a limited impact on the bloc's investor confidence so far, however we still need to wait for activity data to gauge the real impact of the Wuhan outbreak. The longer the coronavirus curtails China's factory output, the bigger the risk of disruption elsewhere.

Despite concerns that the Coronavirus outbreak could derail a Eurozone recovery via trade and business disruption, there are reasons to believe that the Eurozone industry will be able to contain some of the impact. Given the timing of the outbreak, the industry may be able to accommodate some early supply chain bottlenecks, as it has budgeted for the Chinese New Year holiday. Additionally, a larger part of the impact is likely to be on the services sector (the area which has proved to be relatively robust in recent months) while trade in goods is likely to be relatively less affected. This suggests that should any economic impact be relatively short lived, the Eurozone could escape with little change to the outlook.

Potential Stimulus

In reaction to concerns over growth, head of the European Central Bank Christine Lagarde announced this week that policymakers are watching the situation closely for any broader economic impact as a result of the virus outbreak. Despite the next ECB meeting not being for another four weeks, speculation has started that policymakers may consider easing policy to stimulate the economy, depending on how much impact recent virus fears have had on the economy. Prior to the outbreak, Eurozone growth was expected to come in at a relatively muted 1.1% in 2020, with the ECB expected to update this in March. Should the economy feel a pinch from the coronavirus outbreak, it is likely that we would see further stimulus to maintain this growth goal.

Our Positioning

Overall, while we expect that markets will continue to demonstrate high levels of volatility in the near term, our view remains that any impact of the coronavirus outbreak on growth and markets is likely to be relatively short-lived. In line with this, once this dark cloud has passed, as the outlook brightens again on improving economic fundamentals, the global economy is likely to resume its recovery, building on recent upward momentum. For this reason, with our medium to long term outlook remaining unchanged, we have taken the recent drop back in equity markets as a buy in opportunity to re-enter certain areas of equity markets at lower valuations.