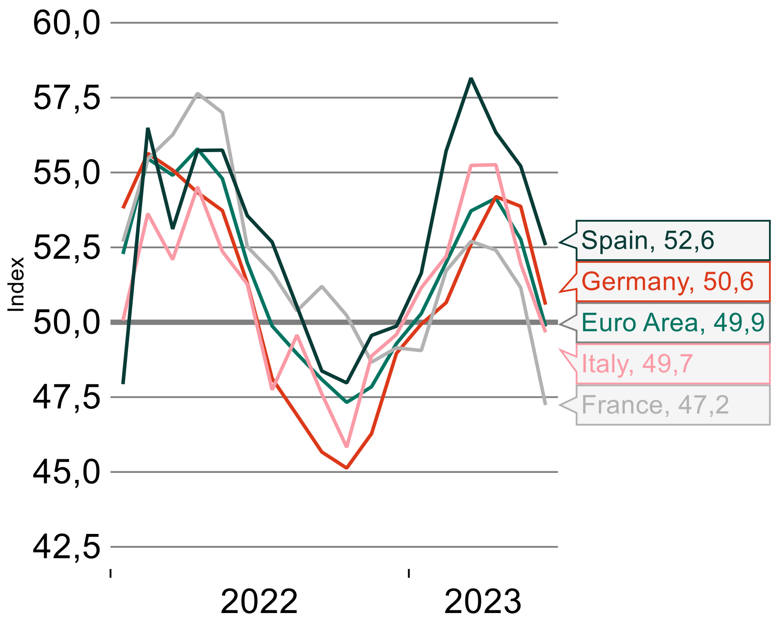
Downturn reaches services sector

HCOB Composite PMI, Output Index (Jun 2023)



Source: Macrobond, HCOB Economics, S&P Global

Content

In the eurozone, the situation has clouded over significantly. Despite the officially confirmed recession - GDP fell in Q4 2022 and Q1 2023 - activity in the services sector had increased from a low level in the first months of the year, and in the manufacturing sector companies were continuing to work off their high order backlogs. Even construction, which has been weakening for some time, experienced a small interim peak in the first quarter, due to mild weather. Now, however, all sectors are pointing downward. In the construction sector, it is safe to say that the recession which began last year is continuing. In manufacturing, the downturn that began in the first quarter is likely to have continued. The inventory cycle observed there is in full swing and will probably not come to an end until the end of the year. After a few months of recovery, the services sector is obviously running out of steam again, although growth can still be observed here in most euro zone countries. As a result, the HCOB Composite PMI has fallen below the 50 mark for the first time this year, signaling a difficult second half of the year.

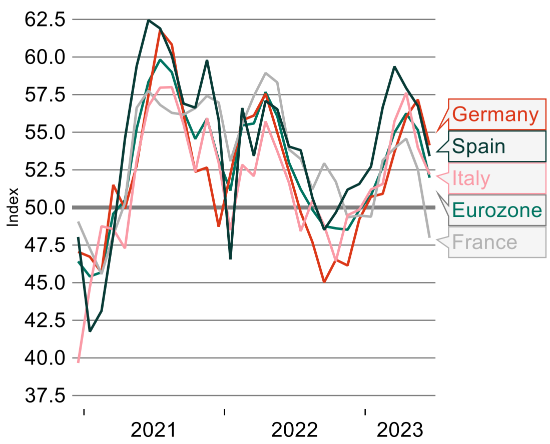
Eurozone

Growth in services sector slows down

In the services sector, which after a **weak final quarter** had picked up speed at the beginning of the year, growth in all major euro countries has again lost **considerable momentum**. The slowdown in growth is accompanied by less new business, lower price increases and a decline in business expectations. However, employment growth last month remained roughly as solid as in the previous month. Overall, there is much to suggest that the slowdown in growth will continue in the coming months.

Among the four major eurozone countries, the **slump in growth momentum** was not only most pronounced in **France**, it is also the only country in which the companies surveyed reduced their activity compared to the previous month. In addition to general factors such as tougher financing conditions and a weaker demand situation, the **protests and strikes** of recent months are likely to have taken their toll here.

HCOB PMI Services Business Activity Index (Jun 2023)



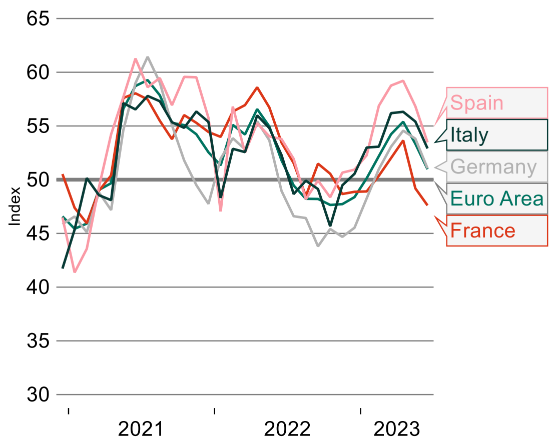
Source: Macrobond, HCOB Economics, S&P Global

Germany stands out in that companies increased their staff even more than in May. This contrasts with France, Italy and Spain, where **employment** growth has slowed.

Everywhere, however, people are still being hired, a factor which is **supporting private consumption** and thus the economy or making the downturn milder.

Price pressure in the services sector, to which the European Central Bank (ECB) is paying particular attention, has eased somewhat, but **input costs are still rising**, according to the companies surveyed, and firms are also still in a position to pass on at least some of these cost increases, some of which are due to higher wages, to end customers. This is reflected in stubbornly **high core inflation**, which is why the ECB is likely to continue to **hike policy rates**.

HCOB Eurozone Services PMI, New Business (Jun 2023)

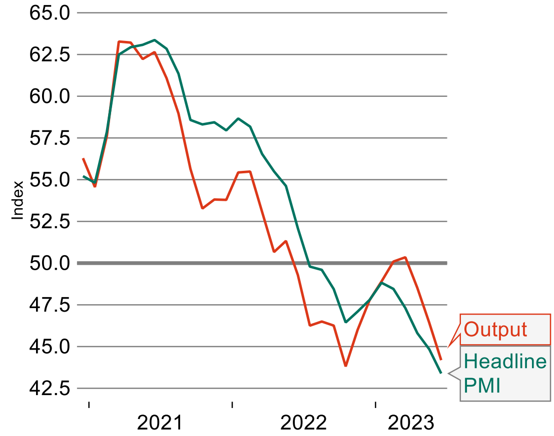


Source: Macrobond, HCOB Economics, S&P Global

Recession looms in eurozone's manufacturing sector

In the eurozone manufacturing sector, **industrial production contracted** for the third month in a row in June, according to the PMI output index, and the main index, which has been signaling falling demand since the middle of last year, has now fallen for the fifth month in a row. **New orders**, in particular, are falling. Overall, this increases the likelihood that industrial production, which contracted by 0.9 % month-on-month in the first quarter according to Eurostat, will fall again in the second quarter.

HCOB Eurozone PMI Manufacturing (Jun 2023)

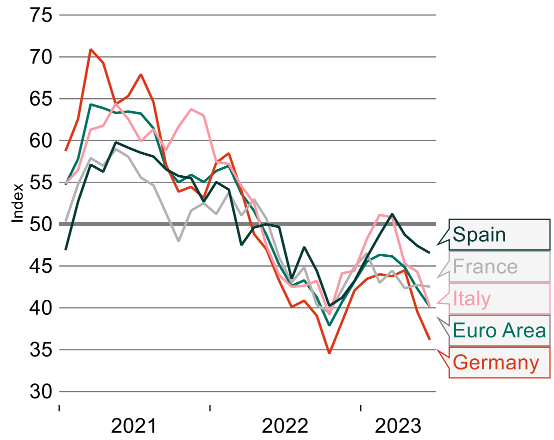


Source: Macrobond, HCOB Economics, S&P Global

The fact that the capital-intensive and thus **interest rates sensitive industrial sector** is reacting negatively to the ECB's interest rate hikes is also reflected in the fact that the companies surveyed reduced their headcount for the first time since January 2021 and they **cut their sales prices** for the second time in a row, thus reacting to falling input prices with a certain delay.

The **downturn is visible** across the board geographically. In all four major eurozone countries, the index signals contraction.

HCOB Eurozone PMI Manufacturing, New Orders (Jun 2023)

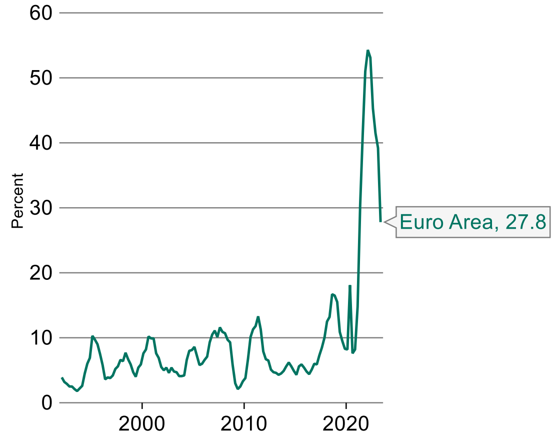


Source: Macrobond, HCOB Economics, S&P Global

Measured in terms of **new orders**, the weakness in demand is most pronounced in Germany, followed by Italy and France.

The **supply chain** situation is continuing to normalize, with the delivery times index signaling since February that companies in the currency union are receiving their goods more quickly than in the previous month. However, we are not back to normality, yet. According to DG ECFIN, for example, around 28% of companies in the eurozone complained of a **shortage of materials** in the second quarter - by 2019, this figure had averaged just under 7%.

Euro Area, Factors Limiting the Production, Equipment, SA



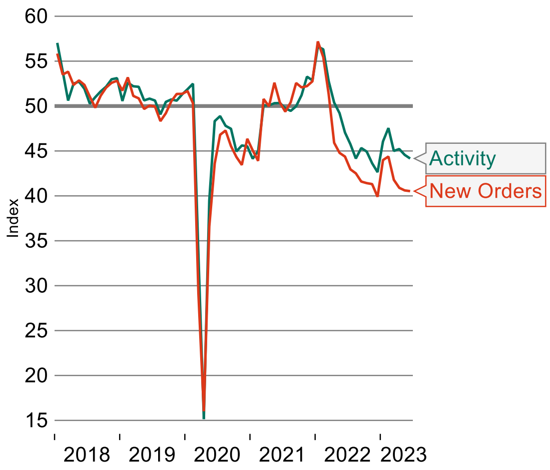
Source: Macrobond, HCOB Economics, DG ECFIN

Germany has made significant progress in this regard in recent months, as underlined by the current PMI **delivery time** index of around 70. However, supply chain problems were also by far the greatest here, with almost 38% of companies continuing to complain of delays in the supply of goods, compared with just 15% in Spain.

Weakness in construction continues

The construction sector in the eurozone remains under **heavy pressure** and is unlikely to recover in the coming months. The HCOB PMI for the construction sector has fallen again from an **already low level** and the same applies to new orders. The lack of confidence is confirmed by the corresponding PMI expectations as well as an **accelerated reduction in employment**. Activity in the residential construction sector has fallen particularly sharply, while civil engineering is the most relatively stable, as it generally benefits from orders from the public sector.

HCOB Eurozone Construction PMI (Jun 2023)

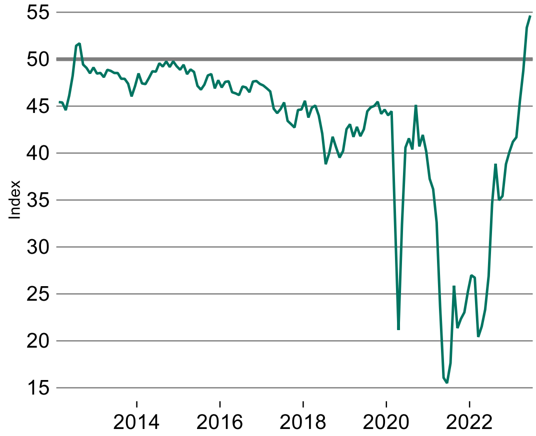


Source: Macrobond, HCOB Economics, S&P Global

In this environment, delivery times are returning gradually to normal and the availability of subcontractors has also been improving for several months. The **easing** is also bit by bit making itself felt in **prices**. Input prices, for example, have been rising at a much slower rate, and the prices charged by subcontractors have also been showing a decline in their bargaining power for more than a year.

Looking at the three largest economies in the eurozone, the **downturn** is deepest and longest in progress in Germany, followed by France. By contrast, Italy still looks the most stable and, according to official data, has not yet experienced a recession in this sector in the past twelve months, unlike Germany and France.

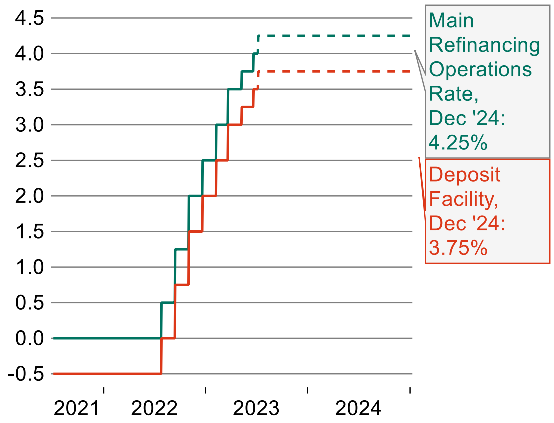
HCOB Eurozone Construction PMI, supplier delivery times (Jun 2023)



Source: Macrobond, HCOB Economics, S&P Global

An end to the downturn can probably be expected at the earliest when it is clear that the European Central Bank (ECB) will not raise its key interest rates any further and that long-term yields will also stop rising. While the ECB is approaching its **terminal rate**, there is still room for loftier long-term yields given the relatively high inflation rate. **Higher interest rates** have been cited as an important **burdening factor** by some of the companies surveyed for many months now.

ECB policy rates and forecasts of HCOB Economics



Source: Macrobond, HCOB Economics, <Property Source not found.>

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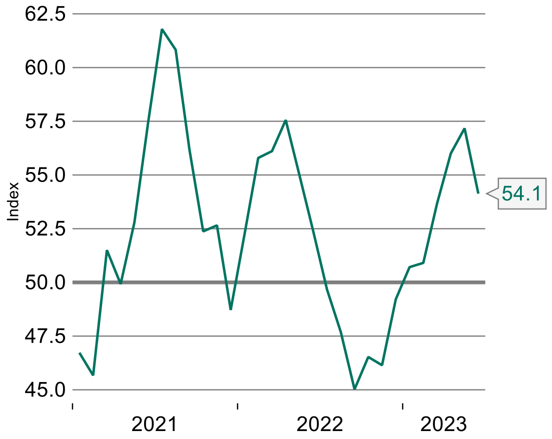
Germany

Services sector follows the industry

Is this now the turning point in the services sector that has been expected for some time? After the HCOB PMI services business activity index had risen for the first five months of the year, signalling a sustained acceleration in growth, the rate of expansion is now slowing. In parallel, growth in **new business** has also **softened**.

HCOB Germany Services PMI Business Activity Index (Jun 2023)

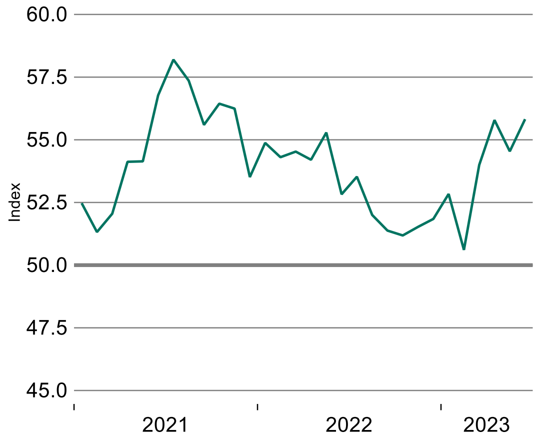


Source: Macrobond, HCOB Economics, S&P Global

This development comes as no surprise, as the **loss of momentum** in France, Italy and Spain had already begun a month earlier. It was also inevitable that the decline in demand in the manufacturing sector, which began in the middle of last year, would have to leave its mark on the **services sector** at some point.

However, it is not the case that the sector is now gripped by a deep sense of malaise. On average, companies continue to expect growth in the future, even if they are somewhat less optimistic in this respect than in May. At the same time, companies have hired slightly more staff than in the previous month, which also expresses a degree of confidence.

HCOB Germany Services PMI, Employment (Jun 2023)



Source: Macrobond, HCOB Economics, S&P Global

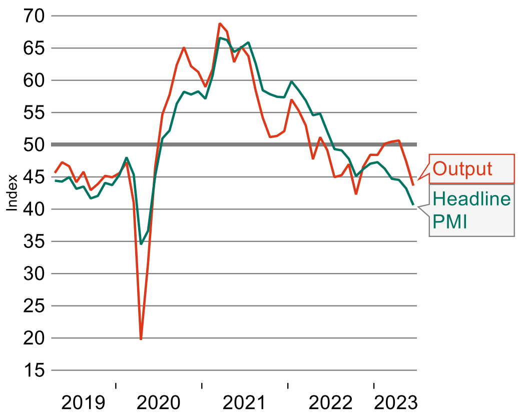
Sectorally, according to the Ifo-Institute, the situation in tourism-related services - this applies to travel agencies and the hotel industry, for example - and also the advertising business remains quite good, while the **transport and logistics** sector in particular is **losing considerable momentum**.

Germany will probably escape a continuation of the recession that set in during the fourth quarter of last year. This can be deduced from the composite PMI, which on average **signalled solid growth** in the overall economy in the second quarter, but in June was only just above the expansion threshold. However, the risk of the economy **slipping into recession** again in the second half of the year has increased.

Manufacturing: no crash

Conditions in the manufacturing sector have undoubtedly worsened, but this is not a crash and we may not see anything of the likes. The HCOB PMI for the manufacturing sector does show that demand for industrial goods is falling sharply and **production is declining** significantly, especially for intermediate and consumer goods and, for the first time in five months, for capital goods. However, we would not call it a collapse. It's important to remember that new orders began falling from very high levels and manufacturers haven't resorted to job cuts yet, the increase in employment merely slowed in June. A look at the toll index recorded by Destatis, which correlates somewhat with industrial production and where data are available until May, supports the view that we are not heading towards the abyss.

HCOB Germany PMI Manufacturing (Jun 2023)

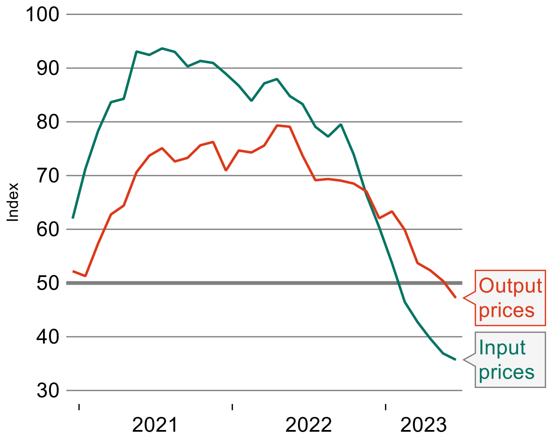


Source: Macrobond, HCOB Economics, S&P Global

Despite the decline in demand that began early last year, companies only started to cut their **selling prices** in June, according to the PMI data, while input prices have already been falling for several months. The most important reason for this certain serenity observed among companies is likely to be the order backlog, which, although declining, is still significantly higher than the historical average according to Destatis data.

The low headline PMI figure is also somewhat put into perspective by the fact that improved delivery times are negatively included in the overall index as a **sign of weak demand**. However, the fact is that while delivery times have fallen significantly, this follows a period of unprecedented delays in recent years meaning that we are apparently not back to normal yet, confirmed for example by statistics of the EU commission on material shortages of companies.

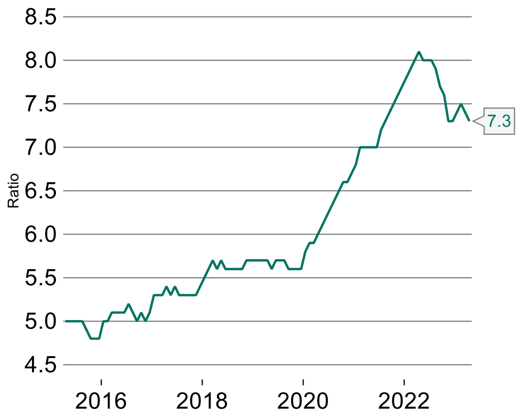
HCOB Germany PMI Manufacturing, prices (Jun 2023)



Source: Macrobond, HCOB Economics, S&P Global

Overall, the PMI data for manufacturing show that a **recession** in this sector, which was still expanding in the first quarter according to GDP statistics, has become much more likely. However, the signs are still pointing more to a mild downturn in production and the survey results therefore by no means suggest panic among companies.

Germany, Stock of Orders, Manufacturing, Range, Total, in months (Apr 2023)

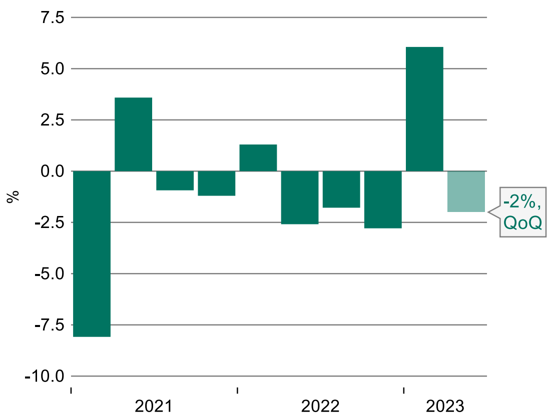


Source: Macrobond, HCOB Economics, DESTATIS

Construction: recession is not over

Activity in the construction sector in Germany declined at an accelerated rate in all sectors in June. Our HCOB nowcast model for gross value added in the construction sector, which takes into account the PMI values, now indicates a significant slump for the second quarter of around 2%.

Germany, National Accounts, Gross Value Added, Construction, QoQ, Nowcast for 2023 Q2

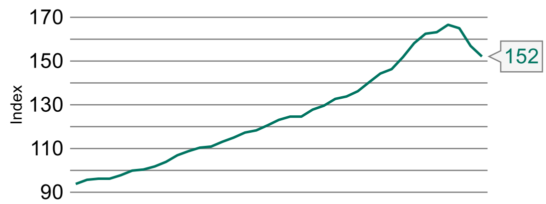


Source: Macrobond, HCOB Economics, DESTATIS

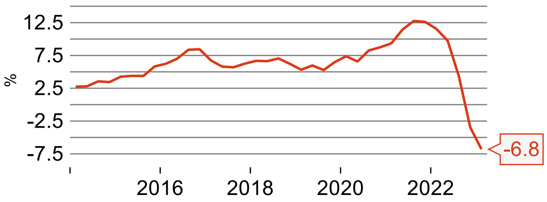
According to the PMI survey, the **decline in construction activity** has deepened especially in the residential construction sector, but also in commercial real estate and civil engineering. It now seems definitively clear that the surprising growth in this sector reported by Destatis for Q1 was just a weather-related outlier, and that the construction recession that started in Q2 2022 has not ended.

There is nothing to suggest that the situation will improve in the near future. For example, new orders declined at an accelerated pace in June and layoffs have also increased. In line with this, construction companies are purchasing less material, purchase prices have fallen at an accelerated rate and delivery times have shortened further. In view of the weak demand situation, residential property prices have fallen continuously since the middle of last year, according to Destatis, and in Q1 were down 6.8% year-on-year.

Germany, Residential Real Estate, Price Index



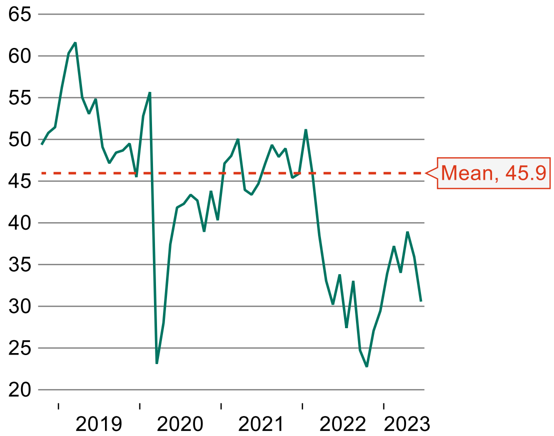
Germany, Residential Real Estate, Price Index, YoY



Source: Macrobond, HCOB Economics, DESTATIS

In this environment, it is not surprising that even more companies than in the previous month expect less construction activity in a year's time, suggesting the weak phase may continue for a while. All in all, everything points toa longer lean period, especially as it is still unclear whether the European Central Bank will raise interest rates once, twice or even more times.

HCOB Germany Construction PMI, Future Business (Jun 2023)



Source: Macrobond, HCOB Economics, S&P Global

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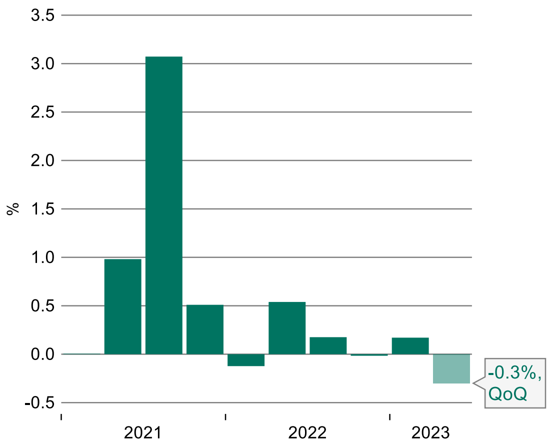
France

Services-PMIs fall significantly

After four months of continuous growth, the HCOB PMIs for June report a contraction in the services sector. It could well be that **economic growth** in France **turned negative** in the second quarter, as the services sector accounts for the largest share of French economic output. Our nowcast for France's GDP, given the composite PMI of 47.2 points, indicates a **0.3% decline** in economic output in the second quarter with both the manufacturing and services sector shrinking.

France, National Accounts, Gross Domestic Product, Total, QoQ, Nowcast for 2023 Q2

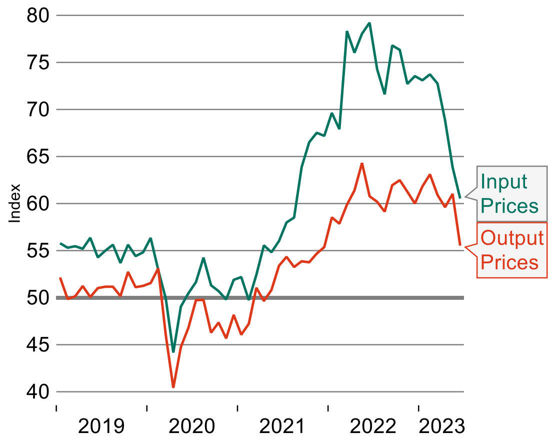


Source: Macrobond, HCOB Economics, INSEE

The service companies surveyed complained of both **declining new orders** at home and abroad, as well as a falling order backlog, which was slightly reduced by weaker demand, according to the companies surveyed. The decline in new domestic orders was mainly attributed to **inflationary pressures**, higher borrowing costs and greater difficulty in securing loans. Although business expectations for the coming twelve months remain above the critical level of 50, the corresponding HCOB PMI has fallen by over 4 points and may indicate that the services sector will come under further pressure in the coming months.

There is no overly encouraging news from the price front. While both input and output prices in the manufacturing sector declined in June, they continued to rise with **weakening momentum** in the services sector, according to the corresponding HCOB PMIs. The companies surveyed see the increase in input prices as being caused primarily by higher wages, which is also reflected in the latest data. **Negotiated wage growth** had amounted to 4.9% YoY in the first quarter of 2023, and according to companies in the services, this level could be maintained in the second quarter.

HCOB France Services PMI, Prices, June 2023



Source: Macrobond, HCOB Economics, S&P Global

Higher supplier costs were another reason for the increase in input prices. However, the pace at which they have risen has slowed significantly. The corresponding PMI has fallen by around 3 points and is at its lowest level in 22 months.

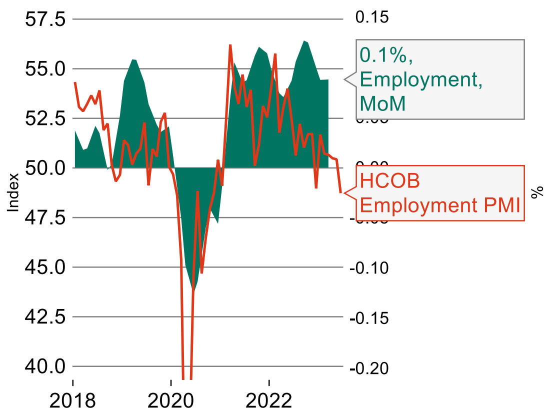
Manufacturing fails to break out of recession

For the fifth month in a row, things are not looking good for the manufacturing sector in France. According to the HCOB PMIs, production continues to decline, new orders at home and abroad are falling and business expectations have also deteriorated significantly. According to INSEE, the manufacturing sector grew in the first quarter, but this will most probably not continue in the second quarter of 2023.

After today's PMI figures, our **nowcast model** now signals a **2.4% quarterly contraction** in manufacturing for the second quarter, slightly more negative than our previous estimate. Capital goods are the main contributor to the contraction, according to our model.

For the first time this year, **employment in manufacturing declined**, with the corresponding HCOB PMI at its lowest level since November 2020. The companies surveyed said that expiring fixed-term contracts were not renewed and jobs were eliminated without replacement. Employment increased in the consumer goods segment, but decreased again in the capital goods segment.

HCOB France Manufacturing PMI, Employment PMI vs. Employment in Manufacturing, Jun 2023



Source: Macrobond, HCOB Economics, INSEE, S&P Global

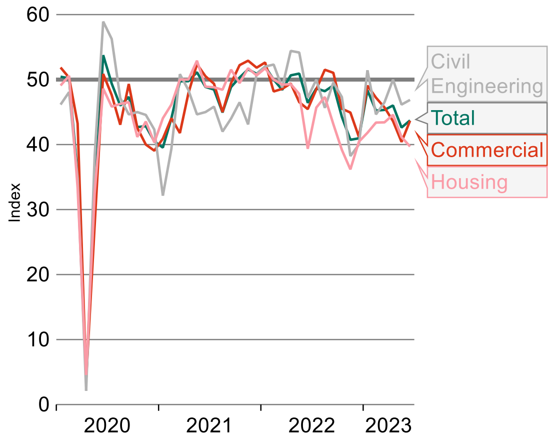
Fundamentally, **encouraging signals** are being sent from the **price front**. After the HCOB PMI for input prices in May signaled a decline in prices for the first time since July 2020, the corresponding HCOB PMI for selling prices now follows in June. However, a distinction must be made here according to goods categories. Thus, prices are declining exclusively for intermediate goods. For consumer and capital goods, selling prices continued to rise in June, although the pace at which prices have risen has slowed down.

Construction also fails to turn the corner

Things continue to look bad for the French construction sector, as shown by the June HCOB PMI survey. The sector has been in recession for three quarters, according to official data from INSEE, and according to the HCOB PMIs, this will have continued for the second quarter of 2023.

Activity is down in all three sectors - commercial, civil engineering and housing. The weakness of the housing sector is particularly noticeable, where the corresponding HCOB PMI has fallen below the 40 level. Commercial and civil engineering have managed to slow the pace of declining construction activity, although the corresponding PMIs here also remain below 50.

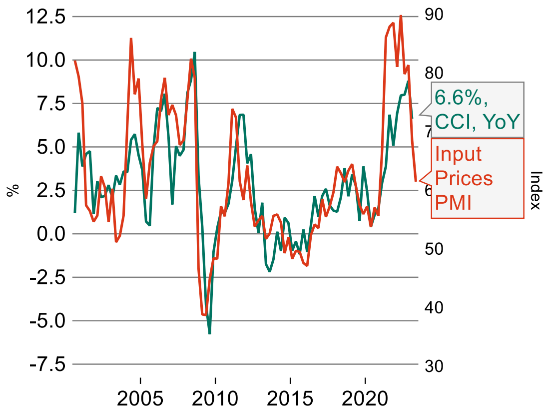
HCOB France Construction PMI, Activity, Jun 2023



Source: Macrobond, HCOB Economics, S&P Global

The HCOB PMI for **input prices** signals a further increase, with the pace at which they have been rising slowing bit by bit. As a result, Insee's **Construction Cost Index** (CCI), which measures producer prices in construction, is likely to have continued to rise in the second quarter of 2023, but possibly at a slower pace than it did in the first quarter (+1.1% QoQ).

HCOB France Construction Input Prices PMI (Jun 2023) vs. Insee's Cost-of-Construction Index (CCI, 2023 Q1), YoY



Source: Macrobond, HCOB Economics, INSEE, S&P Global

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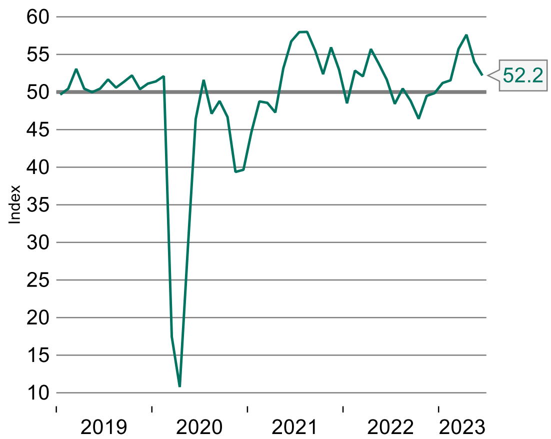
Italy

Services sector loses momentum

Two things are particularly clear in the June figures for the HCOB PMIs for the Italian services sector: on the one hand, the Italian services sector is growing for the sixth month in a row, painting an overall positive picture for the southern European economy. Secondly, the pace at which the sector is growing is slowing for the second month in a row and now stands at 52.5 points. It could well be that the pace will continue to slow in the coming months, as **recession fears** are also gradually spreading in Italy's tertiary sector - according to reports from individual companies. Higher interest rates are also cited as a burdening factor.

If one disregards a **"dip"** in the final quarter of last year, Italy's services sector has shown a robust rate of expansion since 2022. HCOB PMIs documenting slower growth not only in output but also, for example, in downsizing and new business, making it more likely that Italy is headed for **stagnation** or even contraction in this sector in the second half of the year.

HCOB Italy Services PMI, Business Activity, (June 2023)



Source: Macrobond, HCOB Economics, S&P Global

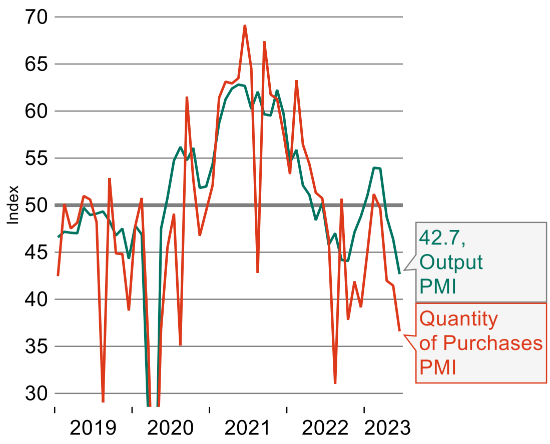
Unlike in manufacturing, **input prices** in the services sector **continued to rise**, according to the HCOB PMIs. Even though the pace has slowed again, the corresponding HCOB PMI is well above 50. The companies surveyed cited **higher wages** and increased supplier costs as the main reasons for the price increases.

Manufacturing: Recession seems to be deepening

The recession in Italian industry, which the sector entered in the second half of 2022, seems to be deepening. With an index value of 43.8 for June, the HCOB PMI for the manufacturing sector is as low as during the outbreak of the Corona pandemic in spring 2020. Together with the figures for industrial production in April this points to an even sharper slump in the sector in the current quarter.

This statement is also supported by the HCOB PMI sub-indices for output and quantity of purchases, which also fell sharply. A major reason for the weakness of this capital-intensive sector is likely to be the sharp rise in borrowing costs as a result of the ECB's **interest rate hikes**.

HCOB Italy PMI Manufacturing, Output vs. Quantity of Purchases (Jun 2023)

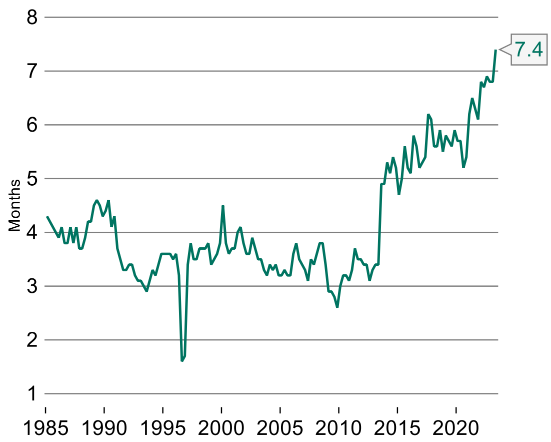


Source: Macrobond, HCOB Economics, S&P Global

The enthusiasm for falling input prices and **backlogs of work** is likely to be muted because it has become primarily an expression of a pronounced weakness in demand. The accelerated decline in output prices over the past four months points in the same direction, indicating a weakening of companies' pricing power.

Not only the present but also a look into the future is not convincing. **Domestic and foreign orders declined** in June and are now shrinking substantially, with the manufacturing sector broadly supported only by existing orders. The duration of production secured by the current order backlog according to the DG ECFIN Survey is still just under 7.5 months, which is, however, very high by historical standards. In the coming months, the industry could, however, be supported by funds under the **Next Generation EU** program, which are currently awaiting release due to disagreements between Rome and Brussels.

Italy, Duration of Production Assured by Current Order-Book Levels, in months

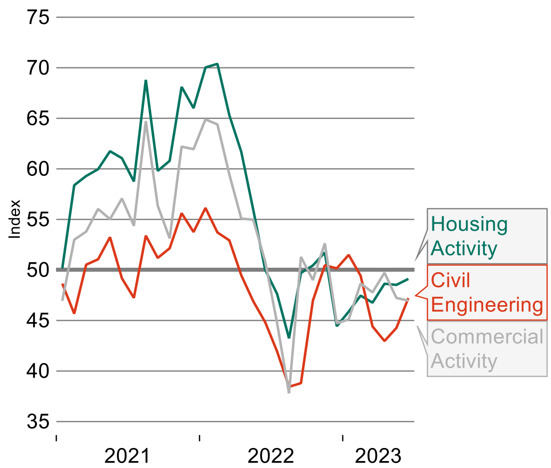


Source: Macrobond, HCOB Economics, DG ECFIN

Construction: contraction continues

The weakness of the Italian construction sector continued in June, according to the HCOB PMI. An index reading below 50 points signals that the construction sector's contraction, which according to ISTAT amounted to 3.8% MoM in April, has continued in May and June.

HCOB Italy PMI, Construction, June 2023

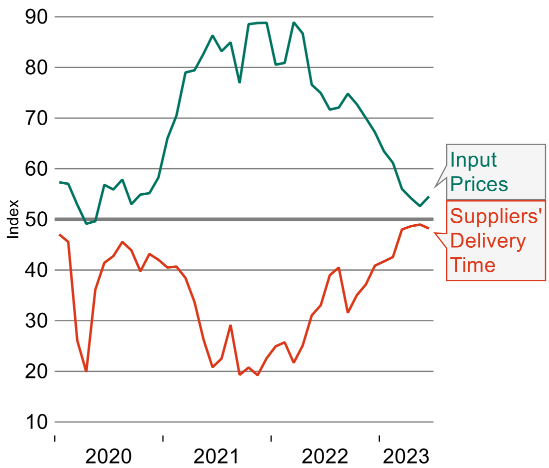


Source: Macrobond, HCOB Economics, S&P Global

The weakness of the construction sector, which expanded by just 1.4% from Q1 2022 to Q1 2023, remains comprehensive. None of the important subsectors (housing, commercial real estate, and civil engineering) succeeds in breaking free this month. The contraction in commercial real estate construction activity even marginally intensified in June compared with the previous month.

Notably, the construction sector is still struggling more with rising input prices and longer delivery times than other sectors in Italy. However, given declining construction activity, we believe it is only a matter of time before signs of easing become more noticeable on these fronts.

HCOB PMI Italy, Construction, June 2023



Source: Macrobond, HCOB Economics, S&P Global

The outlook for the coming months is rather subdued. Although **new orders** increased slightly in June, they have experienced a continuous contraction between December last year to May. The construction industry continues to hire but significantly reduced the pace of hiring last month. And a look at the demand for residential loans, as tracked by the Bank of Italy, suggests that construction activity will continue to decline in this segment.

State aid from the **Italian government** is currently not on the horizon, as it must reduce its **budget deficit to below 3% of GDP** by 2026 in line with EU requirements. Only the issuance of the outstanding tranche under the **EU Next Generation** program could spark greater optimism.

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Spain

Services sector continues to grow

The Spanish service sector, which has shown a very robust rate of expansion in recent months, is gradually losing momentum, but is still quite solid with a PMI value of 53.4 points.

HCOB Spain Services PMI, Business Activity (Jun 2023)

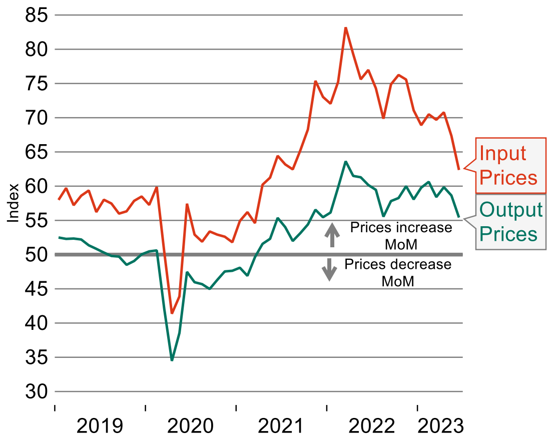
Source: Macrobond, HCOB Economics, S&P Global

GDP growth is likely to be **supported** by the good state of the **services sector** in the second quarter, while the impact of this sector on economic growth was neutral in the first quarter.

The PMIs show, that the expansion may continue in the coming months, as new business has also risen - at a declining rate - and the order backlog has even increased slightly more than in the previous month. Looking further ahead, even more companies than in the previous month believe that the volume of business will be greater in a year's time than at present. All this fits in with the fact that the Spanish central bank recently raised its **growth forecast to 2.3%**, an above-average figure compared with the eurozone as a whole.

Price pressure is easing somewhat according to the PMI price indices, which is in principle good news if you want inflation to come down. However, companies are still in a position to pass on at least part of the input price increases to end customers. In fact, according to the Spanish statistics authority, the **core rate of inflation**, which excludes energy and food, is declining only very hesitantly from a relatively high level.

HCOB Spain Services PMI, Price Indexes (Jun 2023)



Source: Macrobond, HCOB Economics, S&P Global

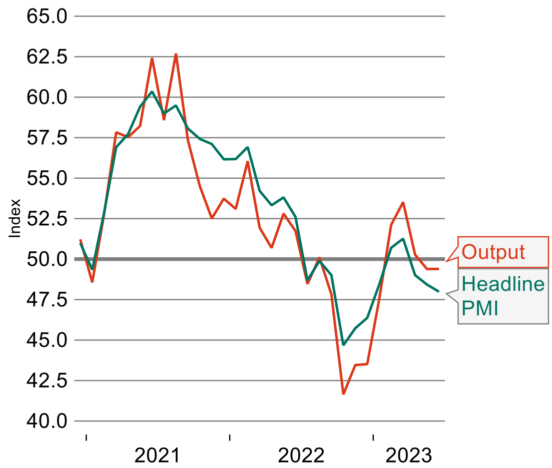
The regional elections that have already been held, as well as the general elections that will be held in Spain at the end of July, have been cited by some companies as one of the reasons why the pace of expansion has slowed. Uncertainty about the plans of a future government is likely to play an important role here.

Manufacturing under pressure

In Spain, there are signs of a mild recession for the manufacturing sector, or perhaps just stagnation. For example, the HCOB PMI production index is slightly in contractionary territory for the second time in a row, and companies are purchasing fewer goods than in the previous month, without the contraction having accelerated here.

In sectoral terms, the decline in output is once again concentrated in particular on intermediate goods, which many companies had apparently stocked up on to a somewhat exaggerated extent for fear of supply chain bottlenecks, which are now normalizing. However, output is being stabilized by **capital goods**, benefiting from stronger demand from projects financed by the **EU Next Generation Fund**, among other things. And things are likely to remain stable here, as the order situation has improved in this subsector.

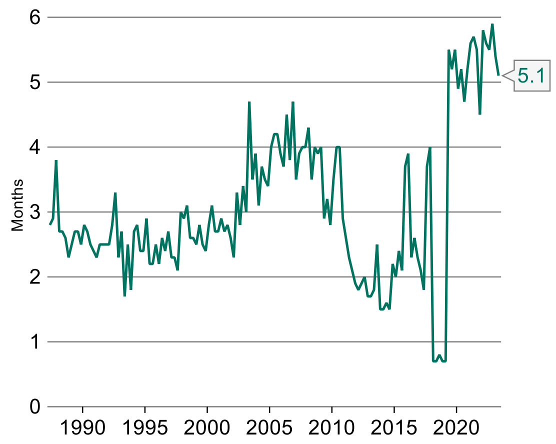
HCOB Spain PMI Manufacturing (Jun 2023)



Source: Macrobond, HCOB Economics, S&P Global

The **weakness in the manufacturing sector** is likely to continue for a few more months, as new orders overall fell for the third month in a row. The fact that this **downturn** is unlikely to be particularly deep can also be seen from the fact that the companies surveyed - after a dip in the second half of 2022 - are only now starting to cut staff and the corresponding index value of slightly below 50 points does not signal strong downward momentum. Some stability is also provided by **order backlogs**, which, according to DG ECFIN, fell in the second quarter but remain at a relatively high level in historical terms with a range of over five months.

Spain, Duration of Production Assured by Current Order-Book Levels, in months



Source: Macrobond, HCOB Economics, DG ECFIN

On the **price front**, companies have already been cutting their **selling prices** for three months. Indeed, Spain's inflation is currently among the lowest in the eurozone. However, this should not obscure the fact that the **core rate of inflation**, which excludes energy and food, is broadly in the middle within the monetary union at 6.0% and is significantly influenced by prices in the **services sector**, which is growing robustly providing companies with pricing power.

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