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Interest rates do not need to rise much further in Europe

European equities | March 2023

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- **Europe acted quickly to reduce its dependence on Russian energy, and inflation has reduced – but it won't fall back to previous levels**
- **There are green shoots in Europe with significant potential demand for durable goods, but signals are mixed**
- **We do not expect the European Central Bank to raise rates by as much as the market expects, and stock prices still have upside**

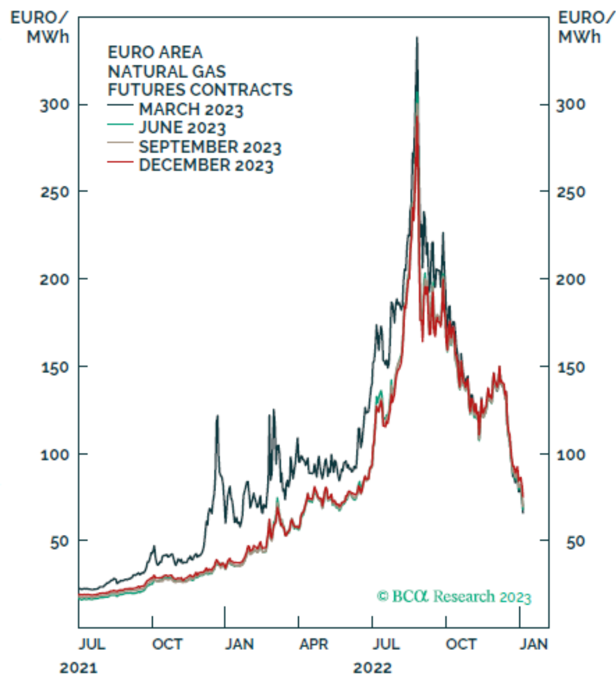
It is said that necessity is the mother of invention, and Europe has moved swiftly to defuse its dependence on Russian gas. Facing soaring prices, households cut energy consumption by turning down their thermostats, while businesses burnt less gas yet maintained production. Europe also got lucky with a mild winter. To address supply challenges, Germany has built its first five floating liquified natural gas (LNG) terminals[1] and Norwegian gas is flowing into Poland for the first time[2].

With the immediate crisis abating, gas prices have tumbled (Figure 1), bringing down inflation and lifting business sentiment – all of which is good for stocks. European inflation was the product of pandemic-related supply constraints exacerbated by the effects of the Ukraine war. We expect consumer price inflation to moderate to 3%-4% by year-end, a plus for the European economy.

[1] Reuters, Germany says fifth floating LNG terminal to be built by end of 2022, 19 July 2022

[2] Euronews, Norway-Poland gas pipeline opens in key move to cut dependency on Russia, 27 September 2022

Figure 1: Euro area natural gas prices



Source: Intercontinental Exchange, Ice Futures Limited, January 2023

Longer term, we believe inflation will not fall back to the 2% levels we have been used to for 20 years, but rather will remain closer to 4%. Reasons for this include: a shortfall of commodities after years of low capital expenditure, the reopening of China's economy as Covid subsides, Europe's ageing population, European subsidies for green transition, deglobalisation, and military tension in Europe. This will all lead to higher bond yields and more market volatility, and therefore lower PE (price to earnings) multiples than in the recent past.

Mixed signals on the strength of the economy

There are green shoots in Europe, but signals are mixed. The best leading indicator is money supply, which looks like softening further. If inflation lessens as we anticipate, demand will pick up. There is significant potential demand for durable goods in Europe, unlike in the US where demand is already higher than it was pre-Covid.

Also positive is the end of China's zero-Covid policy. With 8% of European sales going there[3], only south-east Asia sells more. As Covid infections in China fall and consumers begin to travel, they will spend more. Supply chain problems will ease, and stronger Chinese demand will reduce the pressure to devalue the renminbi. This too is positive for Europe.

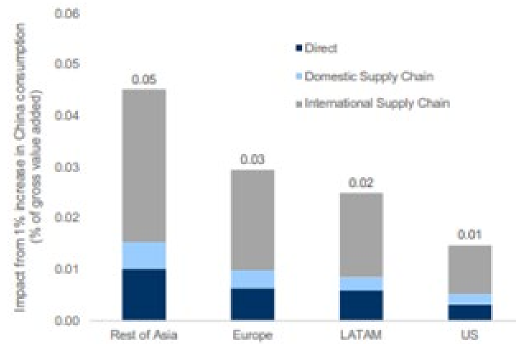
Sectors in Europe with most exposure to China are semiconductors, materials, luxury goods, energy and autos. China accounts for a quarter of semiconductor demand and 16% of luxury goods[4].

[3] Morgan Stanley research, as at June 2022

[4] Morgan Stanley research, as at June 2022

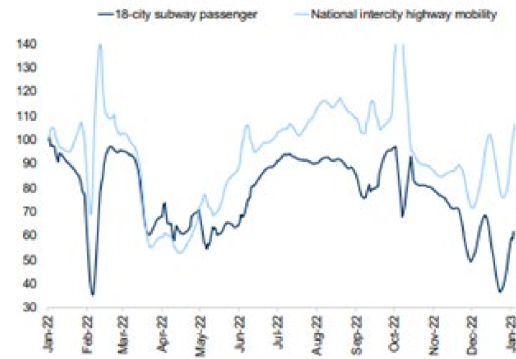
Figure 2: China in four charts

Exhibit 1: The European economy is more exposed to a China consumption recovery than other non-Asia regions



Source: WIOD, Morgan Stanley Research; Note: Gross valued added (GVA) assesses the output of an economy, based on the production approach of the national accounting system, and the sum of GVA plus taxes on products minus subsidies on products is equal to GDP.

Exhibit 2: Mobility metrics are starting to recover across China

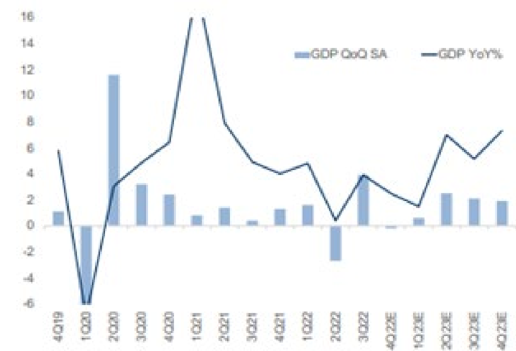


Source: CEIC, WIND, Morgan Stanley Research

Exhibit 3: We forecast a sharp recovery in China household consumption in 2023 ...

Source: NBS, Morgan Stanley Research Estimates (E)

Exhibit 4: ... with GDP growth picking up sharply from 2Q onwards



Source: NBS, Morgan Stanley Research Estimates (E)

Source: Morgan Stanley Research estimates, January 2023

Biggest ever valuation discount

Turning to equities, valuations (including Europe) look reasonable after 2022's falls. Europe is at its biggest ever discount to the US. PEs based on the next 12 months' earnings are 10x in Europe and 17x in the US[5]. US corporates may be more profitable than others, but a stronger China and weaker US dollar will boost valuations outside the US.

In the unlikely event that European stocks fall this year, it will be because of earnings compression.

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[5] Bloomberg, as at February 2023

The US is different

The neutral rate of interest is the rate of interest equivalent to the amount of investment a country makes with its savings. Anything that lowers savings or raises investment will boost the neutral interest rate. It is highest in the US, meaning the US economy can withstand higher interest rates than other countries.

In the US, the neutral rate has been low since the global financial crisis: households and companies were paying down debt, causing a savings glut which lowered the price of money. Globalisation and excess savings elsewhere in the world accentuated this. These trends are now reversing so the neutral rate of interest is rising. Ageing demographics means the dependency ratio – the proportion of non-workers relative to workers – rises. So output will fall relative to spending, and this is inflationary.

Interest costs for the US government will rise, as they will for other governments, perhaps to the levels of the early 1990s. Longer term, a higher cost of capital will reduce systemic risk in economies and capital markets as leverage and capital misallocation will be penalised. Meanwhile, the war in Ukraine should accelerate investment in renewables, boosting productivity in Europe.

In the short term, the risks to US asset prices (equities and bonds) persist as slowing inflation boosts real wages. Nominal wage growth will lag inflation given the tight US labour market. Higher real wages boost consumer spending, so the economy may overheat – a dangerous proposition since the US Federal Reserve would be forced to hike rates again and shares would not respond well.

Inflationary risks are falling

We do not expect the European Central Bank to raise rates by as much as the market expects. The neutral rate of interest in Europe is low – far lower than in the US. Europe’s economy is too fragile to weather the rate hikes seen from the Fed. The real neutral rate in Germany is around zero and Italy’s is negative. Germany might survive rates of 2.5%; Italy could not.

In summary, inflation in Europe was caused by a supply-side shock but a wage/price spiral has been averted. Rates do not need to rise that much in Europe, which means stock prices still have upside.

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