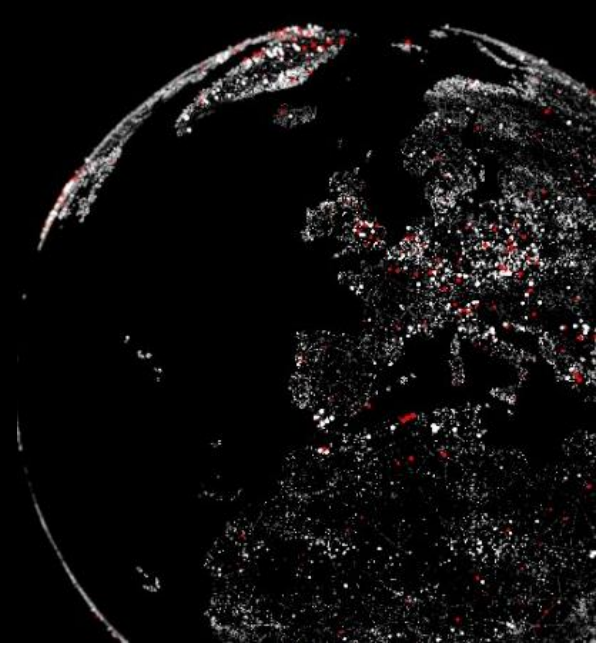


Europe Insights

Lagged effects of tight policy

March 2024

For professional clients and institutional investors only



In a nutshell:

Signs of recovery in construction sector amidst challenges

- Eurozone is experiencing varying impacts of increased energy and material costs with divergence observed in construction costs and output.
- Despite signs of stabilisation in construction costs and borrowing rates, elevated borrowing costs remain a challenge for the sector.
- While a new rate environment may stabilise construction costs by mid-2024, sustained recovery hinges on resolving elevated borrowing costs and regional disparities.

A reversal for small cap equities on the horizon?

- Despite robust earnings and sales growth, European small caps have trailed larger counterparts largely due to heightened sensitivity to tightening credit conditions and economic uncertainties. This was further compounded by small caps' lower exposure to sectors benefiting from rising rates.
- Several factors have now turned in favour of small caps and signal that a potential turnaround may be underway after the recent underperformance.

European bonds are back

- The European fixed income market is experiencing a positive performance run due to the expectation that the ECB will cut interest rates later this year.
- Consequence of this rally, yields have progressively moderated over the last few months.
- Yet, euro investment grade markets are still offering yields twice higher than their ten-year average, providing asset allocators with carry opportunities – assuming careful sector and issuer selection.

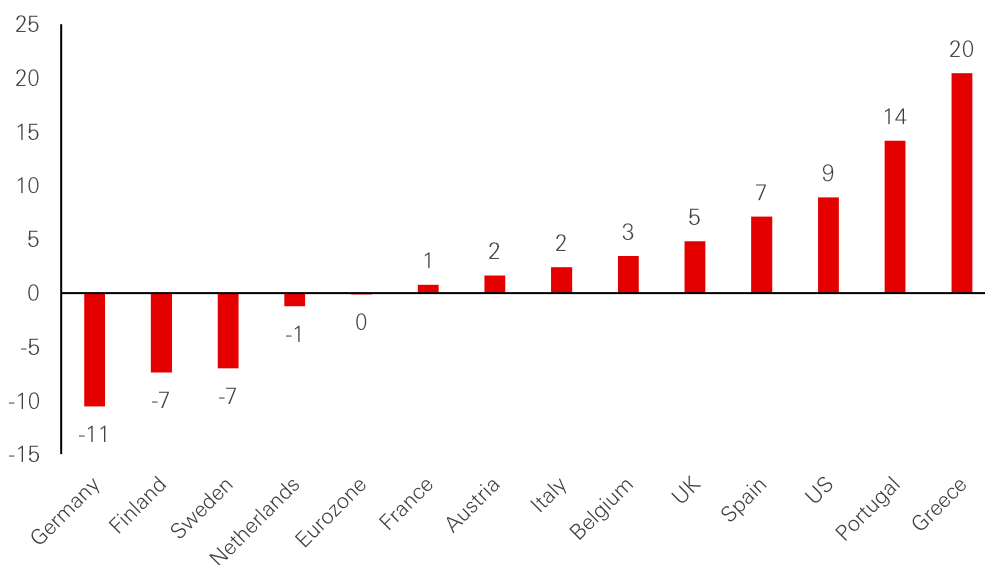
Signs of recovery in construction sector amidst challenges

The effects of two consecutive cost shocks disrupted the trajectory of construction costs in the eurozone. While the shock reverberated across eurozone economies, its impact varied significantly. House prices, for example, surged in Greece (20%) and Portugal (14%), while experiencing a moderate uptick in Spain (7%). Conversely, Germany (-11%) and Finland (-7%) witnessed declines in house prices.

Overall, from pre-pandemic levels until Q1 2022, nominal house prices surged by 18% in the eurozone, compared to a robust 37% increase in the United States. However, during the last two years, the energy, material, and financing costs have soared, weighing on the construction sector.

The effect of two consecutive cost shocks has disrupted the construction costs in eurozone leading to significant divergence within the region.

Figure 1: Nominal house prices change across the major economies since Q1 2022 (%)

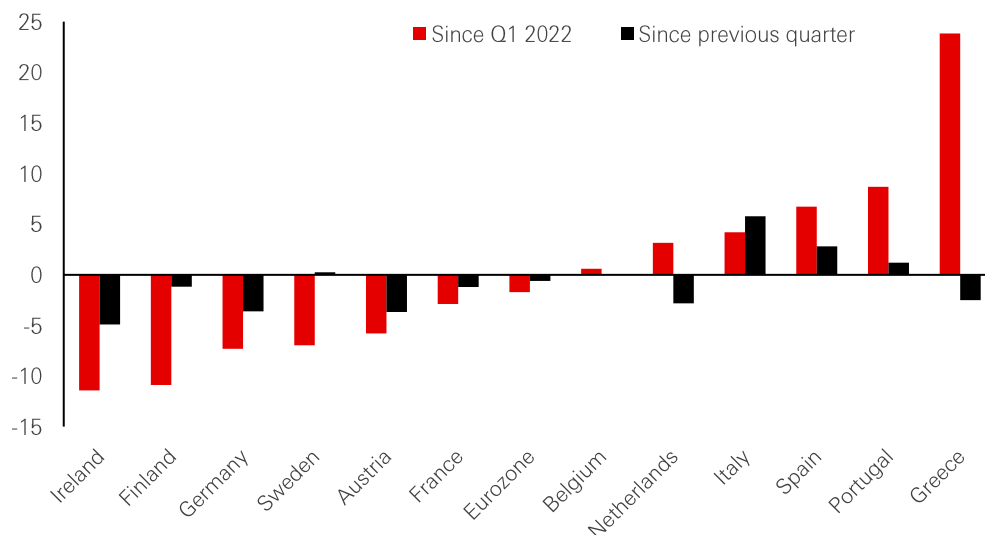


Source: Eurostat, Refinitiv – Data as of 30/09/2023

Construction output suffered a sharp downturn in Northern Europe but saw a rise in Southern countries, particularly in Greece (Figure 2). However, recent trends indicate a continued weakening of construction output across most countries, with Italy, Spain, and Portugal showing resilience (Figure 2).

Construction output continues to weaken based on the recent trends.

Figure 2: Construction output across eurozone countries – Activity change (%)



Source: OECD main indicators, Eurostat, Refinitiv – Data as of 31/12/2023

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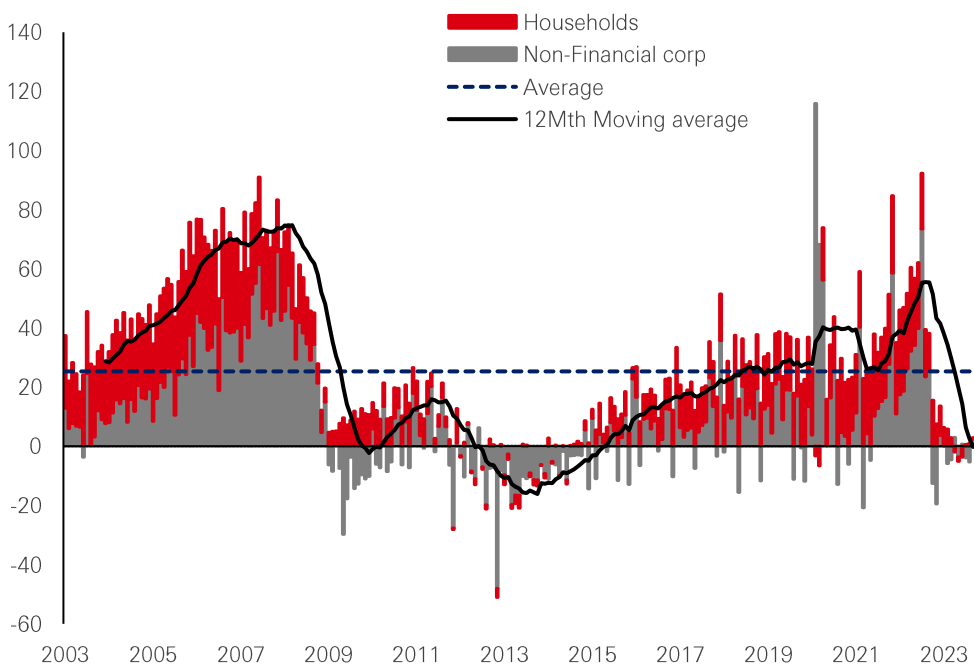
Credit flows bottoming-out

Amidst these challenges, there are glimmers of hope. Confidence survey data from the final quarter of 2023 hinted at signs of stabilization. Construction costs, which had surged by nearly 30% at the beginning of 2023, moderated to 4.5% by December. Similarly, borrowing costs on house purchases for households stabilized around 4.3% since September, while credit flows in the eurozone halted their decline (Figure 3).

However, the road to recovery remains uncertain. January's confidence surveys indicated a further deterioration in construction activity, with persistently high borrowing costs posing a significant challenge for the sector in 2024.

While construction costs have stabilised, the persistently elevated borrowing costs pose a challenge for construction activity.

Figure 3: Eurozone credit flows to households and non-financial corporations (monthly flows, € billions)



Source: Refinitiv, European Central Bank – Data as of 22/02/2024

Light at the end of the tunnel

Despite facing elevated borrowing costs, such as those exceeding 6% in countries like Greece or Portugal, the construction sector has shown resilience, particularly in Southern European countries. Counter-cyclical policies like the Recovery and Resilience Facility (RRF), which has injected €196 billion since 2021, particularly benefiting Italy, Spain, Portugal, and Greece, have provided crucial support. With 63% of the RRF yet to be disbursed until 2026, continued support for construction, especially in non-residential and civil engineering projects (roads, railway, telecommunication, water), is anticipated. Supply-side policy measures have also been introduced, such as accelerating the delivery of construction permits in the residential and non-residential sectors.

Despite elevated borrowing costs, construction activity has shown resilience in Southern Europe as policies have provided crucial support.

While elevated borrowing costs remain a concern, recent reductions in long-term yields offer a glimmer of optimism. Academic research suggests that interest rate impacts on the real economy typically manifest with a lag, typically of 12 to 18 months. With long-term yields in Europe declining towards the end of 2023, there is anticipation for stabilization in construction costs in 2024, albeit possibly not until the latter half of the year.

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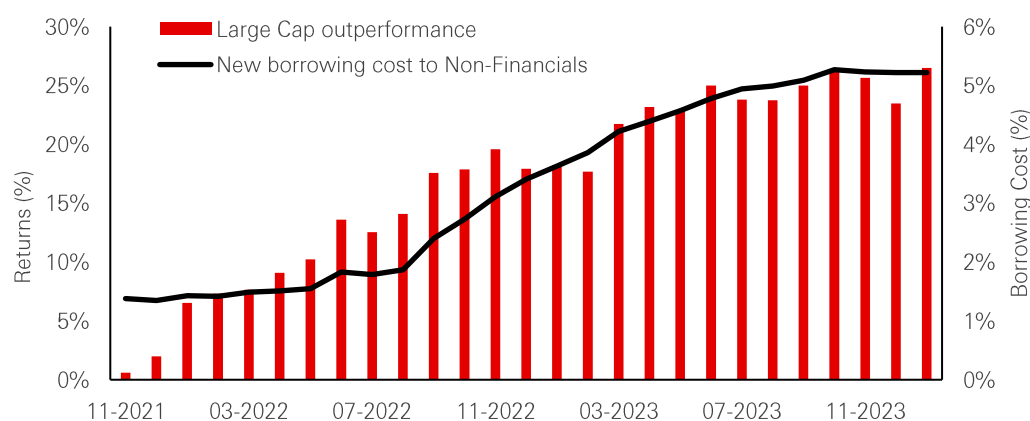
A reversal for small cap equities on the horizon?

Historically¹, small caps have outperformed large caps by over 100%. Nevertheless, the recent downturn has brought about a rare occurrence of small caps trailing behind large caps over a decade-long rolling period.

Over the course of the Covid-19 pandemic, European small-cap stocks have faced a notable setback, trailing behind their larger counterparts by approximately 25%. Indeed, this can be partially explained by their lower exposure to sectors benefiting from rising rates, such as Financials and Energy, has further contributed to their underperformance. More importantly, small caps have struggled due to investor apprehension stemming from their heightened sensitivity to tightening credit conditions and economic uncertainties. This phenomenon led to a notable correlation between the increase in net new borrowing costs for non-financial corporations in the Eurozone, rising from 1.4% at the end of 2021 to 5.2% presently and the widening performance gap between large and small caps.

Small caps have struggled due to their heightened sensitivity to tight credit conditions and economic uncertainty.

Figure 1: Difference between large cap and small cap performance versus new borrowing costs to non-financial corporates



Sources: HSBC Asset Management, Bloomberg, data as of 15/02/2024.

As per the chart above, borrowing costs have stabilized in recent months and the current disinflationary environment should support a decrease in the near future. Coupled with other factors – such as low valuations and positive earnings growth perspectives – this could lead to a potential for a reversal in small caps' underperformance relative to their larger peers.

Figure 2: Valuation, balance sheet and growth metric of Europe large versus small caps

MSCI Europe	Price to Book (2023)	Price to sales (2023)	Total Debt to Assets	Net Debt to EBITDA	EPS growth ² (2023-25)	Sales growth ² (2023-25)
Large Caps	1.9x	1.5x	23.6%	2.5x	-1.6%	+3.2%
10Y average	1.7x	1.3x	24.4%	4.2x		
Small Caps	1.3x	0.8x	26%	3.0x	+108%	+7,1%
10Y average	1.7x	1.0x	26.6%	3.7x		

Sources: HSBC AM, Bloomberg, data as of 15/02/2024.

¹ Data availability from December 1981

² Consensus earnings and sales growth, Bloomberg, <https://data.ecb.europa.eu/publications/financial-markets-and-interest-rates/3030664>

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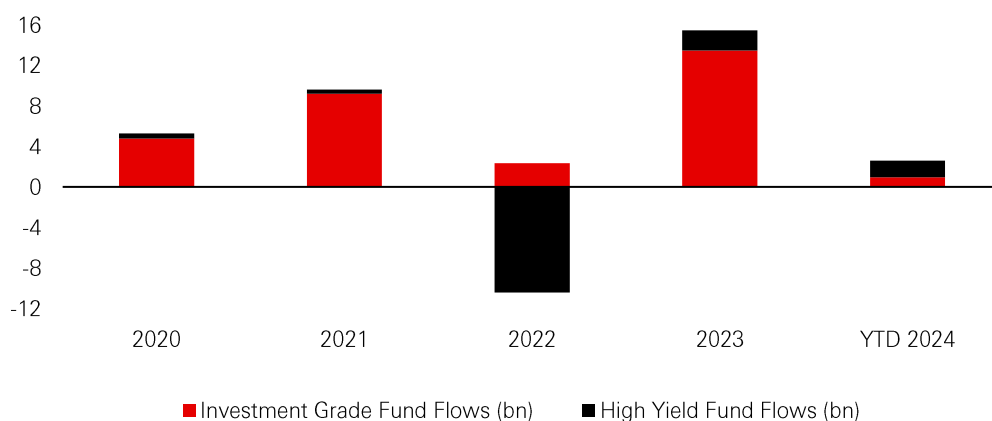
European bonds are back

Driven by the expectation that the ECB will cut interest rates later this year (as well as the fact that European corporate balance sheets remain relatively solid for now), the European fixed income market is experiencing a very positive performance run.

Over the last three months, investment grade indices have progressed by almost 2%, while their high yield peers have increased by more than 4%. Similarly, inflows into euro fixed income funds have largely progressed in 2023 and the trend doesn't seem to fade so far this year (as per the chart below). Continued inflows reflecting a search for yield among investors aligned with the prospect of companies issuing fewer bonds due to fewer merger and acquisition deals bode well for the segment this year. In addition, a normalisation of the yield curve (with shorter-term maturities issues yielding less than their long-term peers) could push investors to convert their cash positions into bonds, which would also drive significant flows into the asset class.

Despite the recent rally, euro investment grade markets are still offering yields twice higher than their ten-year average.

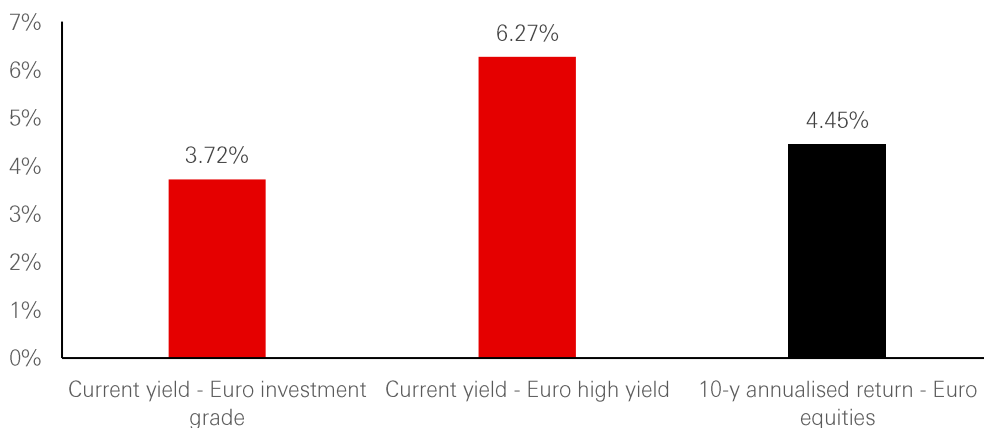
Figure 1: Flows in fixed income funds (€bn)



Source: HSBC AM, Bloomberg, March 2024.

Consequence of this rally, yields have progressively moderated over the last few months. That being said, euro investment grade markets are still offering yields twice higher than their ten-year average. Similarly, high yield bonds are still providing yields that are higher than average historical returns from stocks in the region.

Figure 2: European yields remain at historical returns from equity



Past performance is no guarantee of future returns.

Source: HSBC AM, Bloomberg, March 2024.

¹ Source: HSBC AM, Bloomberg as of end of February 2024. Bloomberg Barclays Euro High Yield and iBoxxEuro Corporate indices.

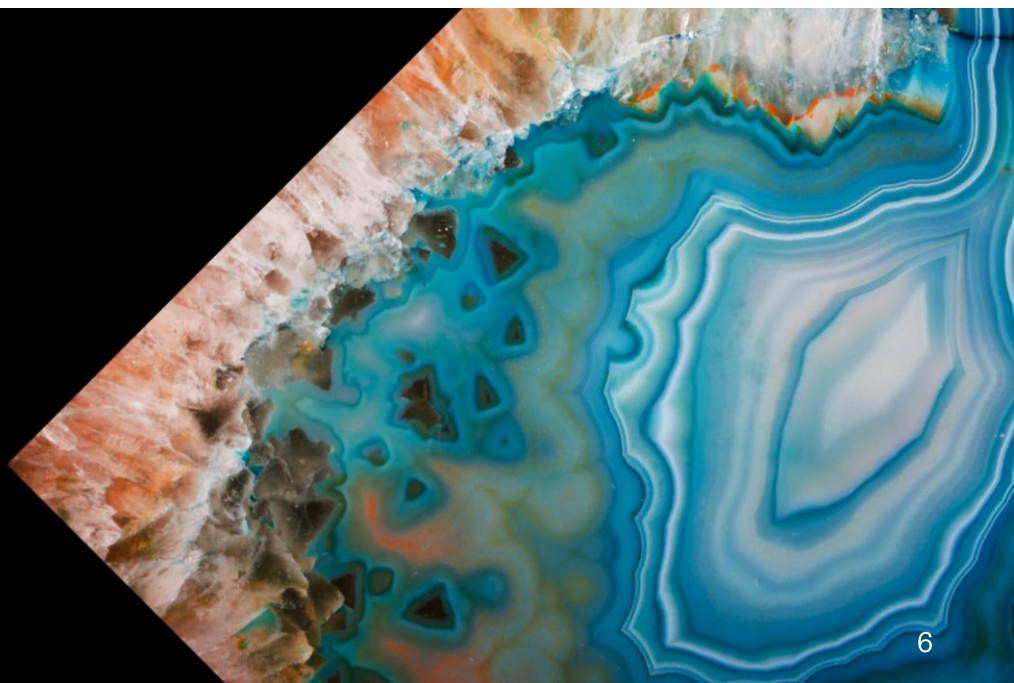
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Indeed, high yield bonds include higher default risks, meaning a selective approach is warranted, especially since growth in Europe is lowering and current credit spreads may not be sufficient to compensate for even a small pickup in defaults. More specifically, we think that BB-rated companies look to be relatively fairly priced while B-rated bonds are looking more expensive.

As we anticipate that the lagged effects of tight policy and slowed earnings growth will weigh on European companies later this year, we expect those with solid fundamentals to be able to cope with the pressure they are facing better than weaker high yield issuers. It should be noted, however, that leverage ratios of entities that may face higher refinancing needs may rapidly reach their long-term average.

Overall, investors have good reasons to be constructive on euro investment grade given carry and rolldown opportunities but careful sector and issuer selection remains key.

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Data watch

As of 26 March 2024

Eurozone growth stagnated in Q4 and the recent activity data showed weakness. Both headline and core inflation surprised slightly to the upside due to sticky services prices and annual revision of the consumption weights. Despite this, the tone of the communication by ECB provided an implicit guidance to cut rates, probably in June.

Economic Indicator	Data as of	Last data	Consensus	Previous data	Analysis
PMI composite	Mar	49.9	49.7	49.2	Eurozone PMI surveys improved slightly, on expectations that the ECB will cut interest rates soon. Germany's PMIs increased in March, driven by services, and despite another decline of the manufacturing sector. Eurozone services keeps expanding, while the manufacturing sector deteriorated again.
GDP growth qoq	Q4 2023	0.0%	0.0%	-0.1%	Eurozone stagnation in Q4 2023 reflected divergences across the region, and an overall slowdown of household consumption (+0.1% qoq after +0.3% in Q3). Eurozone GDP details showed a negative contribution from net trade and inventories which was offset by an expansion in Capex and public spending. Several countries reported economic growth: Italy (0.2%), Greece (0.2%), Belgium (0.3%), Netherlands (0.4%), Spain (0.6%), Portugal (0.8%) and Latvia (0.8%). 4Q GDP stagnated in France and Austria, and contracted in Germany (-0.3%), Finland (-0.8%) and Ireland (-3.4%).
Industrial production % yoy	Jan	-6.7%	-3.0%	0.2%	Eurozone industrial production deteriorated, driven by Germany. German export-oriented economy and its energy-intensive industry keep being penalised by a more competitive environment, the weakness of the Chinese market and the transformation of the automotive sector.
Unemployment rate	Jan	6.4%	6.4%	6.5%	The eurozone unemployment rate keeps stabilising at a record historical low level of 6.4%, but has barely moved since March 2023, and this despite economic stagnation. Labour hoarding, high rates of sick-leave, a large share of the workforce approaching retirement age may have contributed to the resilience of the unemployment rate.
Trade balance (goods, ex EMU) EUR billion (12Mth cumulative)	Mar	100.1	88	57.1	The eurozone trade balance (on a cumulative 12-month basis) increased its surplus again in January. Imports keeps contracting sharply (-15% yoy), at a faster pace than exports (-1% yoy). The fall of energy prices have significantly improved the terms of trade. The eurozone trade balance has not reached its pre-pandemic level (€208 billions in December 2019).
Retail sales % yoy	Jan	-1.0%	-1.3%	-0.5%	Eurozone retail sales have stabilised at weak levels. Consumption of goods excluding fuel keep resilient in France and Spain, rebounded in the Netherlands, and weakened in Germany and Italy.
Inflation - Headline CPI, % yoy	Feb	2.6%	2.5%	2.8%	Eurozone inflation surprised slightly to the upside, on sticky services prices (4.0% unchanged), but also owing to annual revision of the consumption weights (up from 43.6% to 45% for services). Looking ahead into 2024, disinflation is set to be bumpy in H1 2024. The 2% headline target should be broadly reached during H2 2024.
- CPI core*, % yoy	Feb	3.1%	2.9%	3.3%	Disinflation is already expected by the markets (5Y5Y Euro forward breakeven stands close to 2.2%). Country-wise, headline inflation ranged from 4.2% in Austria to 0.8% in Italy.
ECB Refinancing rate	7 Mar	4.50%	4.50%	4.50%	
Deposit rate		4.00%	4.00%	4.00%	The ECB revised its macroeconomic projections to the downside, closer to the consensus forecasts. Headline inflation is expected at 2.3% in 2024 (against 2.7% previously) amid reduced energy costs, and the anticipation of higher productivity and slowing wage growth. The ECB acknowledged that progress is being made on inflation, but a sustained downward path remains to be seen. President Lagarde mentioned that in June more key information will be available, notably wage growth and corporate profits. Overall, the tone of the communication provided an implicit guidance to cut rates, probably in June. Separately, the ECB's new operational framework will set a narrow rate corridor system to implement a gradual reduction of the excess reserves. Among other measures, the spread between the main refinancing rate (4.50%) and the deposit rate (4.0%) will be reduced on 18 September, to just 15 bps from 50bps currently.

■	Improved or better-than-expected
■	Worsened or below-expectations
■	Unchanged or in line with expectations

* Eurozone Core CPI is CPI excluding energy, food, alcohol & tobacco
Sources: Bloomberg, Refinitiv, Eurostat, HSBC Asset Management – data as of 26/03/2024

F: Final A: Advanced P: Preliminary estimate

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