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What to watch: ECB rate cut round two, Chinese equities feeling the heat and cooling commodity prices

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In summary

This week we look at three critical issues:

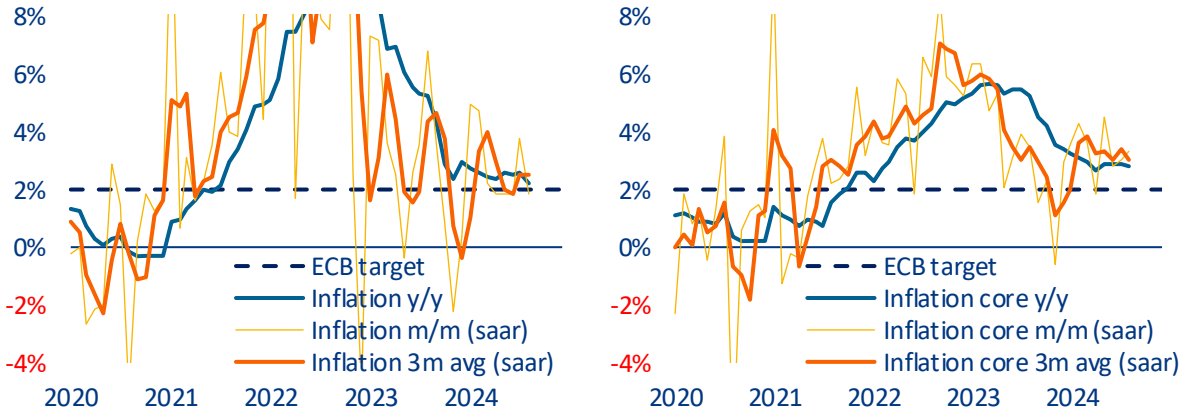
- **ECB: rate cut round two.** At its next meeting on 12 September, we expect the ECB to lower the deposit rate for the second time this year to 3.50% after a pause in July. With inflation dropping to 2.2% y/y in August, loosening the restrictive stance is justified. Going forward, the ECB will follow a gradual cutting cycle, reaching a terminal rate of 2.5% in mid-2025. However, with record low unemployment, strong wage growth and sticky core inflation, the ECB is not in a rush and is likely to emphasize a careful data-dependent approach.
- **Chinese equities: reaching for rock bottom.** China's earnings growth and equity markets have struggled in 2023 and 2024, hindered by weak consumer demand, the still-present real estate crisis and geopolitical tensions. Despite government efforts to stabilize the economy, over 50% of companies missed earnings and revenue expectations in Q2, particularly in key sectors such as consumer staples and technology. Capital outflows and reduced transparency on foreign investments have further dampened market sentiment. However, economic stabilization paired with the accelerating earnings rebound is likely to keep Chinese equity returns in the green for both 2024 and 2025, supported by continued policy measures, rate cuts and fiscal spending. With further economic stabilization expected in 2026, Chinese equities could see stronger double-digit returns in the future, presenting long-term opportunities despite the short-term risks.
- **Commodity prices: cooling down but not for power, especially in Europe.** Despite alarming headlines across the globe, most commodity prices are on the mend either because supply is strong (grains) or because the demand outlook is weaker (oil, metals). Some outliers remain, such as coffee or cocoa, but they do not pose a significant inflationary risk. Going forward, we expect prices to continue to consolidate for most commodities. In particular, we expect oil to continue to trade in the 75-85 USD/bbl range. Natural gas prices in Europe, and consequently power prices, remain an issue for inflation. Concerns over supply and weather conditions ahead of winter are making markets nervous, despite plenty gas in storage (above 90% of capacity). Nevertheless, we expect retail power prices to remain broadly stable. Indeed, we believe either governments (which are under fiscal pressure) may take advantage of lower wholesale prices to recoup some of revenues lost over 2022-2023 by increasing taxes and levies to pre-2022 levels or they may keep them low at current levels in case of a market accident, all of which would be rather neutral for consumer prices.

ECB: cutting again with inflation target in sight

The ECB is about to deliver its second rate cut this year as the inflation target comes into sight. At its next meeting on 12 September, the ECB is likely to lower the deposit rate by 25bps to 3.50%, the second rate cut in this cycle following a pause in July. Note that the rate for Main Refinancing Operations (MRO) and the Marginal Lending Facility (MLF) will even drop by 60bps to 3.65% and 3.90% for technical reasons, albeit without any economic impact yet.¹

With inflation dropping to a reassuring 2.2% y/y in August, loosening the restrictive stance is justified. But there are some caveats. Inflation in the Eurozone fell from 2.6% y/y to 2.2% in August, the lowest reading since 2021. However, this was largely driven by base effects and a drop in the energy component. Core inflation only inched down from 2.9% y/y to 2.8%. Even more concerning, the monthly change in core prices even accelerated to 0.3% m/m. So while at first glance the inflation target appears to be within reach of the ECB target, sequentially core inflation has remained stubbornly above 3% for six months now (Figure 1). This continues to be driven by services inflation, which even inched up to the highest reading in almost a year (4.2% y/y) albeit slowing down sequentially. Services inflation is still being driven by historically high wage growth. While a slowdown in wages continues to be expected, and subsequently should be transmitted into a deceleration of services prices along with lower demand, there is currently no sign in the hard data yet. On a positive note, survey-based indicators show signs of easing, with the PMI Services input prices subcomponent (largely driven by wages) having dropped to 58.0 in August, the lowest level since 2021 (Figure 2). In this context, all eyes will be on ECB staff expectations. These are updated every quarter but we do not expect any substantial changes.

Figure 1: Headline and core inflation measures, %



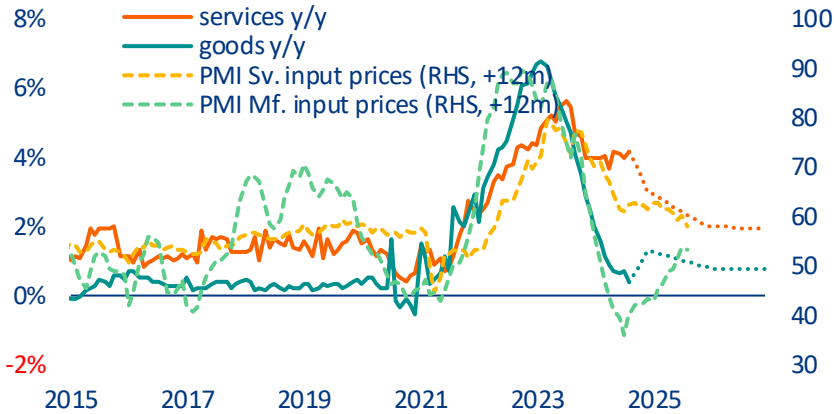
Sources: LSEG Datastream, Allianz Research

Going forward, we expect one more cut in 2024 and a terminal rate of 2.5% to be reached by mid-2025. Though unfavorable base effects will push headline inflation up close to 3% again towards the end of this year (Figure 1), we believe the ECB will look through these statistical anomalies and continue with a gradual easing cycle. Having said that, we now expect the rate-cutting cycle to come forward, shifting one cut from 2025 to 2024. With the US economy showing increasing signs of weakness, and correspondingly more cuts expected by the Fed until year-end compared to a couple of months ago, the risk of a transatlantic policy divergence is fading. This cancels out one of the arguments favoring a prolonged pause by the ECB. And though core inflation is still strong and economic growth is recovering, the current ECB stance is still highly restrictive. Real policy rates are even becoming more restrictive amid disinflation. Against this backdrop, further easing is indeed justified. We continue to expect a terminal rate of

¹ This is a consequence of the [Review of the Operational Framework](#) published in March, which announced that the spread of MRO and MLF will be lowered and fixed to 15bps and 40bps, respectively, against the deposit rate from September onwards. This will have no economic impact and is a rather technical adjustment for the future. With still plenty of excess reserves, hardly any bank currently borrows money from the ECB, making the MRO and MLF rates currently non-binding.

2.5% to be reached by mid-2025, when inflation is expected to reach the target on a sustainable basis. With this outlook, we are still on the hawkish side compared to market expectations, which are currently pricing in roughly two and half more rate cuts this year, and a terminal rate of around 2.2% to be reached in the second half of next year.

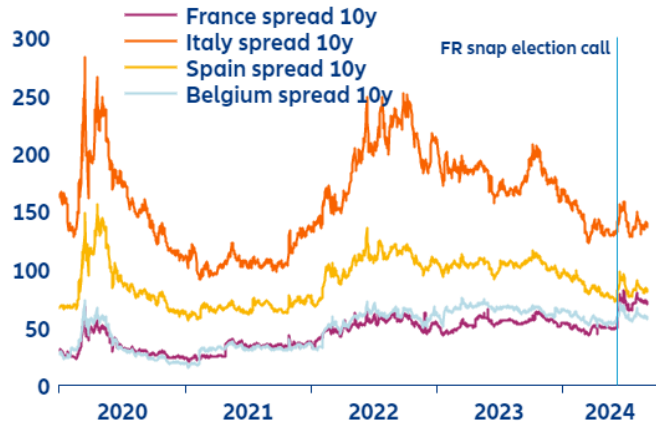
Figure 2: PMI input prices and core inflation components forecast, %, index



Sources: LSEG Datastream, Allianz Research. Note: Dotted lines refer to Allianz Research forecast. PMI Services and Manufacturing Input prices are moved forward by twelve months.

With Eurozone spreads stabilizing, the ECB can accelerate its quantitative tightening as expected and discussions around the Transmission Protection Instrument (TPI) have moved to the background again. In line with our baseline assumptions, the turmoil surrounding the French election and the subsequent political deadlock marred the outlook for France but did turn into a Euro-wide risk contagion. As a result, government bond spreads in the Eurozone have largely recovered, although the market now views French investment attractiveness close to par with that of Spain (Figure 3). Quantitative tightening has accelerated in July as already announced in December last year by the ECB, with an additional EUR7.5bln roll-off per month from the PEPP program, on top of the EUR30bln monthly roll-off on average from the APP program. Also, the remaining EUR85bln (of once more than EUR2trn) of outstanding TLTROs will be paid back until the end of the year, finally ending another chapter of unconventional monetary policy (for now).

Figure 3: Eurozone government bond spreads, bps

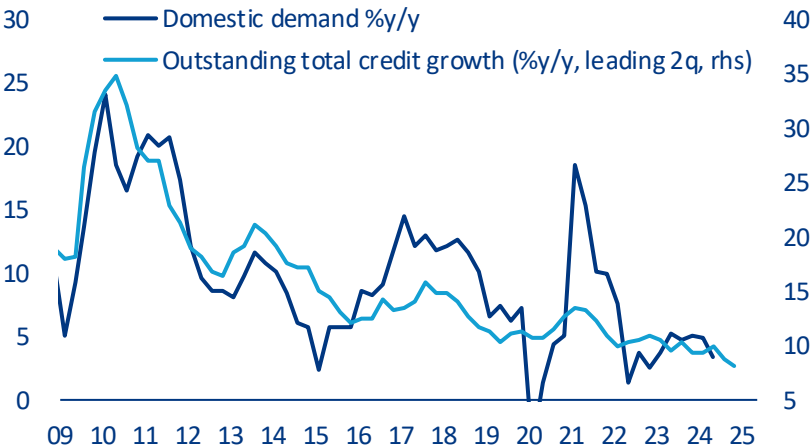


Sources: LSEG Datastream, Allianz Research

Chinese equities: reaching for rock bottom

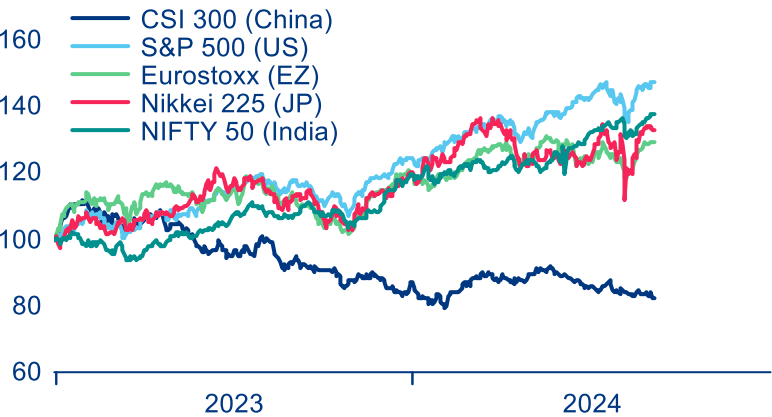
Chinese equity markets are facing the perfect storm of economic and geopolitical challenges. China's post-pandemic recovery has been slower than expected, weighed down by the ongoing real estate crisis, with collapsing construction activity and slowly declining prices keeping consumer confidence and government finances under pressure. While exports were one of the very few bright spots so far this year (thus supporting manufacturing activity), the stabilization in domestic demand is stumbling. We estimate it slowed to +3.4% y/y in Q2 2024, after +4.9% the previous quarter and +4.7% on average in 2023 (Figure 4). The policy mix has remained accommodative but so far proved insufficient to engineer a sustainable and widespread stabilization of the economy. This macroeconomic context has severely impacted investor confidence, which is also reeling from recent regulatory crackdowns, especially in the technology and real estate sectors, and geopolitical tensions, particularly with the US. The result: capital outflows and reduced foreign investment. Since June 2024, international investors have removed over USD12bn from Chinese equities, reversing the positive inflows seen earlier in the year. As a result, net flows for the year have turned negative, raising concerns that 2024 could become the first year of net outflows since 2014 (Figure 6).

Figure 4: China domestic demand and credit growth



Sources: national sources, Allianz Research

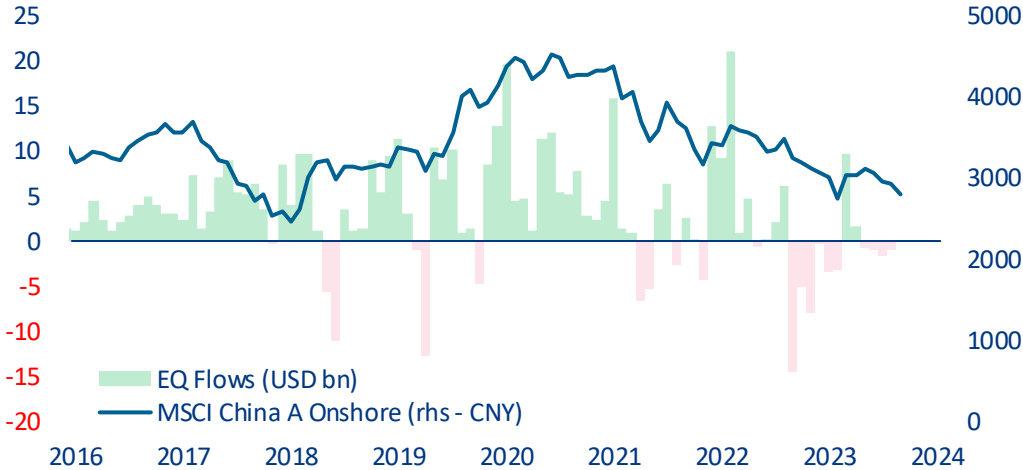
Figure 5: Global equity indices (rebased to 100 – in USD)



Sources: LSEG Datastream, Allianz Research

New restrictions on access to data on foreign investment are not helping. In an effort to address the ongoing decline and prevent the structural capital outflows that have persisted since 2023, Chinese authorities have recently imposed restrictions on access to daily data on foreign investment in mainland China's stock market via the Stock Connect trading link with Hong Kong, releasing it only on a quarterly basis. Although the goal is to prevent a snowball effect of capital outflows by restricting access to daily international flow data, this lack of transparency is likely to heighten concerns, potentially further discouraging foreign investment in an already difficult market environment. Overall, the economic slowdown, absence of a clear economic or market bottom, questionable effectiveness of policy decisions and increasing market opacity are prompting investors to increasingly exclude China from their emerging markets portfolios (Figure 6).

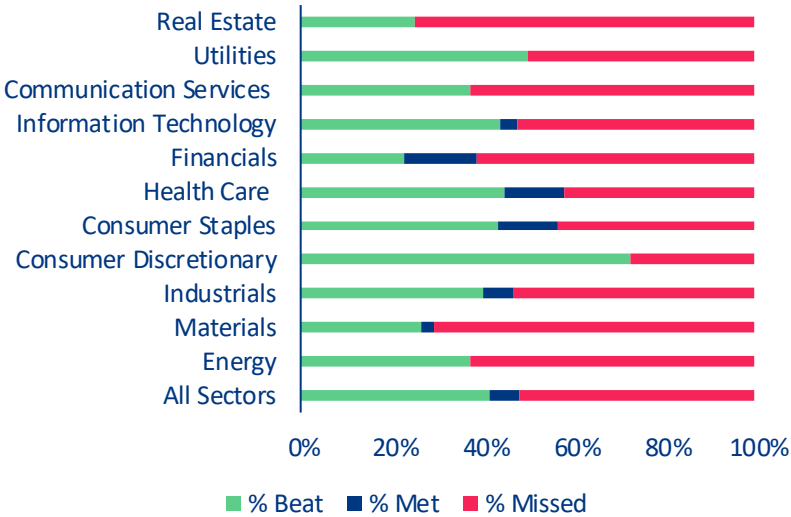
Figure 6: China Equity flows and MSCI China



Sources: LSEG Datastream, IIF, Allianz Research

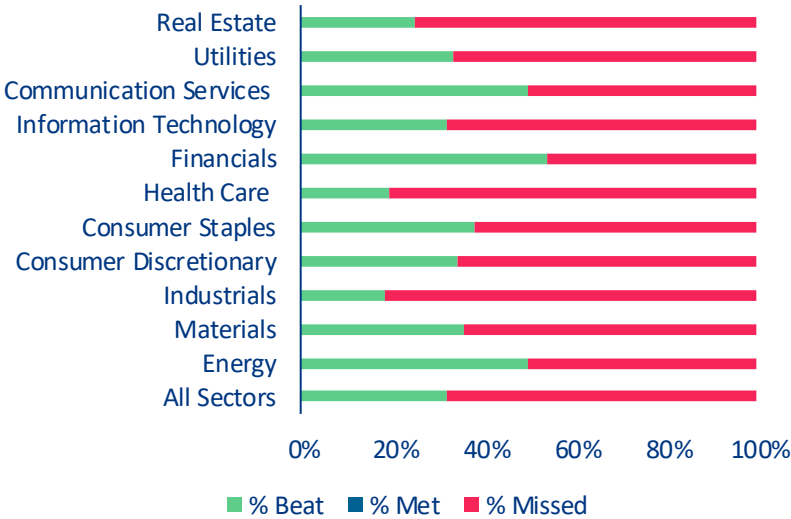
Meanwhile, the latest earnings season showed that corporate growth engines are still stalling. In Q2 2024, both revenues and earnings largely fell short of market expectations, with more than 50% of companies missing both top-line (revenues) and bottom-line (earnings) targets. This trend, which has persisted since 2023, has led analysts to repeatedly lower their revenue and earnings forecasts. However, this quarter even the sectors closely watched by analysts and investors for potential signals of an economic rebound continued to underperform. This includes consumer staples and discretionary, which capture consumer behavior, and technology, a key beneficiary of the global AI boom. Both have seen earnings and revenue misses in the range of 50% to 70%. This suggests that the much-anticipated market and economic trough, as well as the expected rebound, may still be some time away (Figures 7 and 8). This narrative not only influences market expectations but, more significantly, is evident in concrete data. As shown in Figure 9, most sectors fall within quadrants II to IV, indicating that either the top line, the bottom line or both are experiencing a year-over-year earnings/revenue recession. This confirms concerns that a market and economic recovery may take longer than anticipated, suggesting that the effects of fiscal and monetary support measures have not yet fully materialized or that additional stimulus may be required to revive the Chinese economy. Additionally, it confirms the deep contraction in the real estate sector, which continues to struggle.

Figure 7: Q2 earnings beat-miss mapping



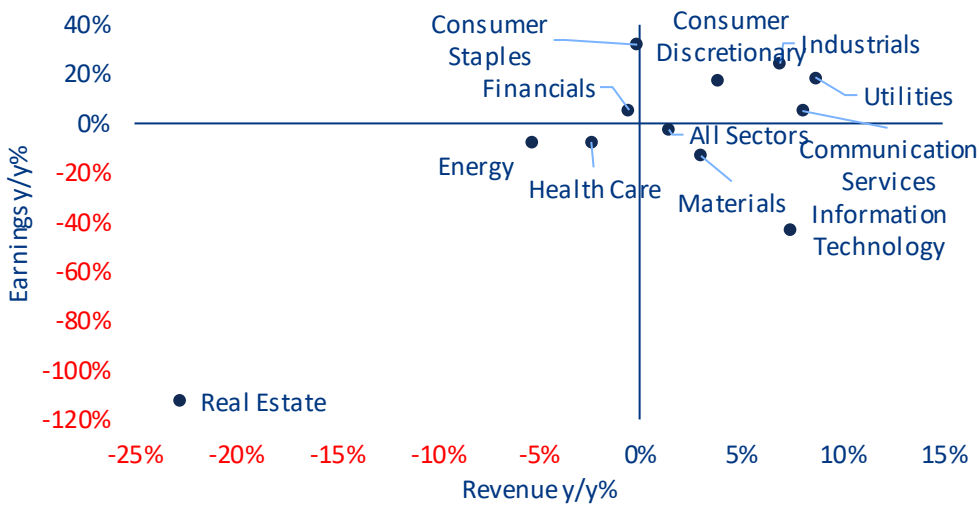
Sources: LSEG Workspace, Allianz Research

Figure 8: Q2 revenues beat-miss mapping



Sources: LSEG Workspace, Allianz Research

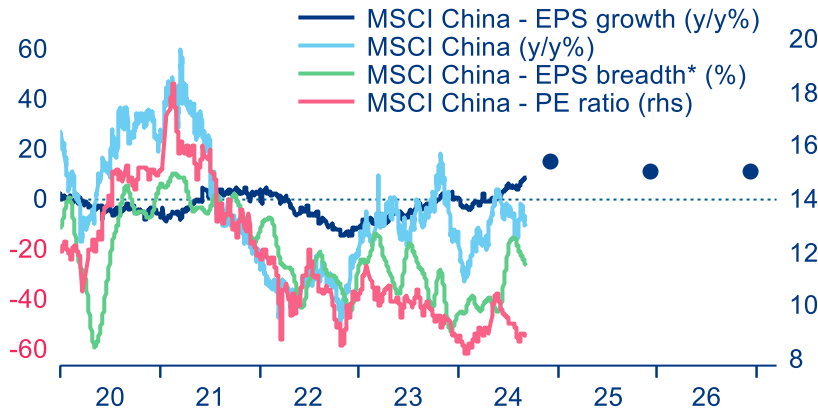
Figure 9: Q2 2024 earnings-revenue yearly changes



Sources: LSEG Workspace, Allianz Research

Nevertheless, we still expect a rebound in earnings and revenue is for 2025 and 2026 as economic growth stabilizes and policy measures start to benefit Chinese consumers and the broader economy. The PBOC is likely to cut policy rates once more in Q4 2024 to shore up confidence, while fiscal spending will step up on accelerating bond issuance by local governments. Overall, we expect GDP growth to reach +5.0% in 2024 (after +5.2% in 2023), followed by +4.3% in 2025 and +4.0% in 2026. The lower growth numbers come in part from lower contributions from net trade and the continued real estate crisis, while domestic consumption stabilizes. Based on these expectations, and considering the extremely low valuations of Chinese equities, we project a total return for Chinese equities in the range of 0% to 5% by the end of 2024, followed by a stronger double-digit growth rate by 2026. That said, caution remains warranted from an investment standpoint as there is a possibility that Chinese markets and the economy may not have bottomed out yet (Figure 10), and regulatory policy risk (especially targeting specific sectors) remains.

Figure 10: MSCI China EPS - PE

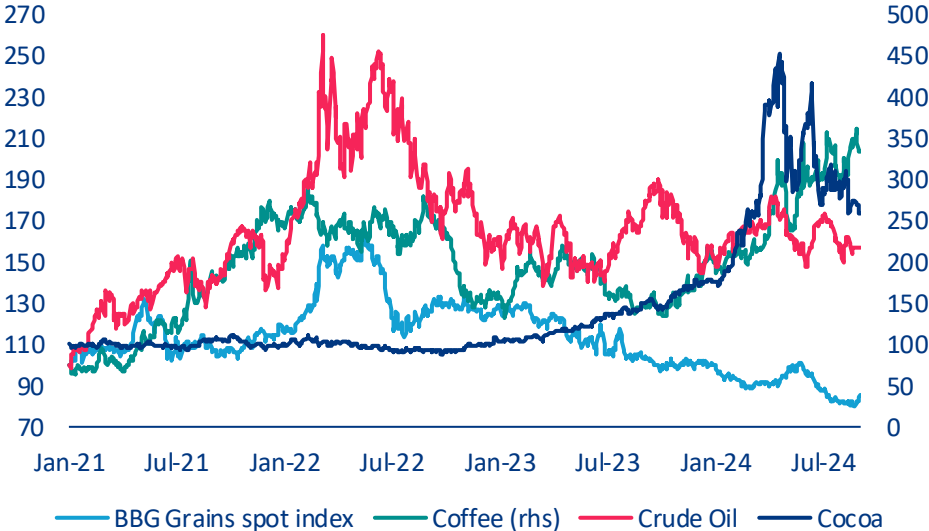


Sources: LSEG Workspace, Allianz Research. *breadth: number of EPS estimates revised up vs revised down.

Commodity prices: cooling down but not for power, especially in Europe

Despite the scary headlines, most commodity prices are cooling. From tensions in the Middle East to floods, wildfires and droughts to Ukrainian military operations on Russian soil, the sudden stop in Libyan oil exports and tankers being attacked in the Red Sea, the tumultuous news flow would suggest major shocks for global commodities, along with significant price increases. Instead, most commodity prices have been trending downward recently. First of all, key agricultural commodities and especially grains (corn, wheat etc.) have seen very good harvests, which have led their respective prices to collapse. This should bring relief to consumers and food manufacturers, albeit bad news for farmers. In the agricultural space, some exceptions remain, namely coffee and cocoa, and some fresh vegetables also remain very expensive (see Figure 11). For coffee and cocoa, this is mostly down to disappointing production leading to limited supply. Indeed, the El Niño phenomenon led to drier conditions in South East Asia, which is home to key coffee producer Vietnam, and in West Africa, where most of the world's cocoa is grown. Meanwhile fresh vegetables are still being impacted by higher wages, especially those that are harvested by hand, and expensive energy.

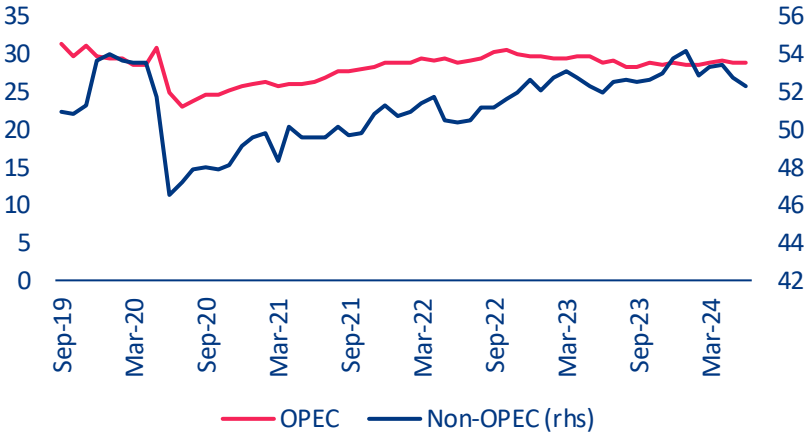
Figure 11: Commodity prices (Jan. 2021=100)



Sources: LSEG Eikon, Allianz Research

OPEC+ is struggling with falling prices and only a major geopolitical shock could trigger bumper crude prices. Crude oil was trading below 75 USD/bbl as of early September, erasing all of the price increases seen in the first half of 2024 when it averaged about 85 USD/bbl. Recent market dynamics suggest that traders are more concerned with weak demand than by supply-related news. Indeed, negative news regarding sluggish oil consumption, lower crude imports from China and inventories building up have trumped news regarding tensions in the Middle East and supply-chain issues (operations halted in Russian export ports and more recently in Libya). OPEC+ announced in June that production will gradually increase from October; considering the weak demand outlook, this has weighed on prices. Recently, the cartel hinted that it could opt out of the planned increases with very little impact on the market as traders remain convinced that OPEC+ countries need oil revenues and are facing continued growth in oil production from non-OPEC countries, especially from the US (see Figure 12). We believe that only a major geopolitical event such as widespread conflict in the Middle East or a severe escalation in the Russia-Ukraine war would lead to a major price surge in oil prices as demand-supply fundamentals plead for Brent prices to stay in the 75-85 USD/bbl price range.

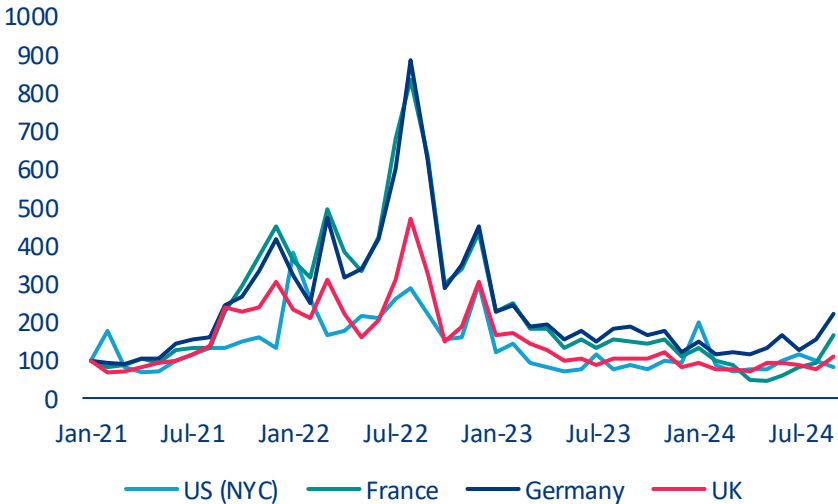
Figure 12: Oil production (million barrels per day)



Sources: LSEG Eikon, Allianz Research

Power prices continue to pose a threat to European consumers and (energy intensive) firms. Early in the summer, European natural gas prices were trading at about 25 EUR/MWh, which was the lowest since late 2021 and “only” 25% above the pre-pandemic average. However, as the summer months went on, markets grew worried because of a number of factors, from the slow delivery of LNG to planned maintenance in Norwegian export sites to negative weather forecasts for the winter to developments in the Russia-Ukraine war. As a result, natural gas prices were trading at about 35 EUR/MWh in early September, although European storage levels are at 91-92% - close to full storage and plenty enough in “normal” times. Beyond concerns on natural gas, wind energy production has been disappointing recently in most European countries and solar production, despite some peaks here and there, has been trending downward over the last few weeks. As a result, power prices have started to pick up, though this remains a very European issue as power prices in the US are rather stable (Figure 13).

Figure 13: Wholesale power prices (Jan.21 = 100)

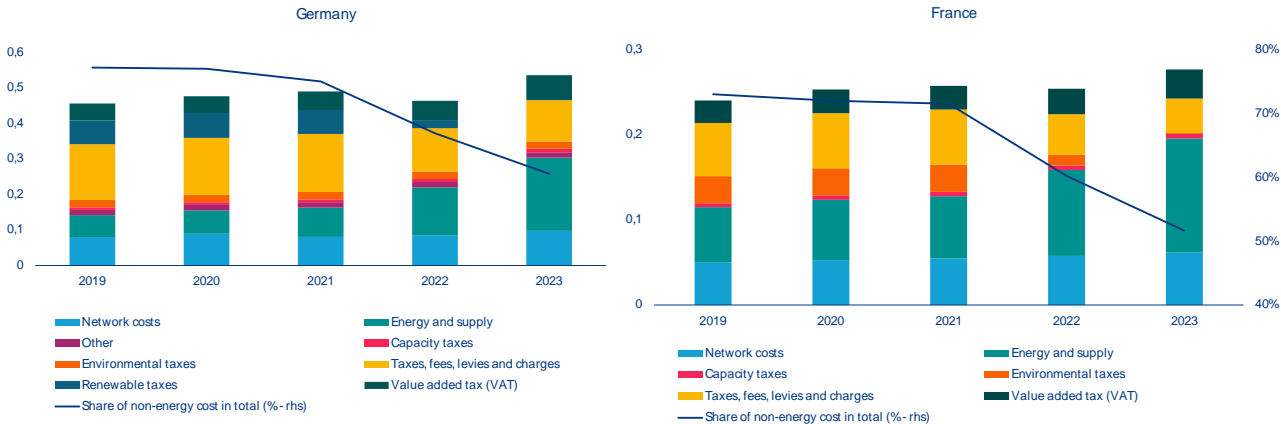


Sources: LSEG Datastream, Allianz Research

The impact on retail power prices will ultimately depend on government action. Retail power prices in Europe are formed through a mix of wholesale market dynamics, government taxes and levies, as well as network tariffs,

and are often controlled/set by a regulatory body. The underlying pricing mechanism primarily follows a mechanism where the wholesale electricity price is set by the marginal cost of the last power plant needed to meet demand – in Europe, this power plant is often a gas-fired one, hence the importance of gas prices for the continent. This system has been under pressure due to gas market volatility since Russia's invasion of Ukraine, significantly affecting retail electricity prices across the continent. However, governments play a significant role in determining the final prices consumers pay. Taxes and network charges can account for well above 50% of a household's electricity bill in Europe, with the rest coming from wholesale prices and supply costs (Figure 14). These taxes and levies, from environmental levies to carbon pricing to network tariffs, were widely used by European governments to shield households and firms from the energy shock in 2022-2023. Indeed, beyond subsidies, many countries have implemented tax reductions or price caps to protect consumers from the market spikes. However, while these measures ease the burden on consumers, they often mean higher fiscal burdens on governments. In a context of growing fiscal pressure for many European countries, it will likely be difficult for governments to provide strong support once more, and they could also take advantage of lower wholesale prices to slightly increase taxes to boost revenues. Even though some countries, such as France, have already announced lower retail power prices for 2025, the fiscal reality or higher market prices might kick in down the road.

Figure 14: Household power prices breakdown (EUR/KWh)



Sources: Bruegel, Allianz Research

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