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What to watch: Unlocking Eurozone consumer confidence, the ECB's next rate cut and the CORE problem for Europe's auto sector

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In summary

Eurozone: Confidence is key (to unlock consumption). Private consumption is still lagging behind economic growth, despite declining interest rates and recovering real wages. In fact, savings rates are on the rise – unlike in the US – and savings intentions are also at historic highs. Inflation has eroded financial asset gains and led to the lower interest rates that have dragged down house prices. Net financial assets of French households grew by just +1.5% since the end of 2019, while in Germany this figure is +6.0% and in Italy and Spain +7.4% and +11.8%, respectively. Meanwhile, US households have seen net financial assets grow by +10.7% in the same period. With persistent uncertainty, especially over the upcoming German election and ongoing French political turmoil, alongside an impending fiscal consolidation and a normalization of wage growth, savings intentions are unlikely to come down in Europe. Against this backdrop, Eurozone policymakers and political leaders need to push a credible plan to address the cyclical and structural challenges.

ECB: Rate cut number four ahead amid gloomy outlook. At its next meeting on 12 December, we expect the ECB to cut the deposit rate for a fourth time this year to 3.00%. Recent economic data has surprised to the downside, with leading indicators struggling against the backdrop of a weak German economy and looming US tariffs from the incoming Trump administration. Given the dim outlook, which will hit consumer and business confidence, we have once again lowered our expectations for the terminal rate to 2.0% and sped up the cutting path to a meeting-by-meeting approach. Meanwhile, inflation concerns have taken a back seat: The second uptick to 2.3% y/y in November can largely be attributed to base effects while services inflation – long regarded as a sticky problem – has sequentially fallen to the lowest value since 2021.

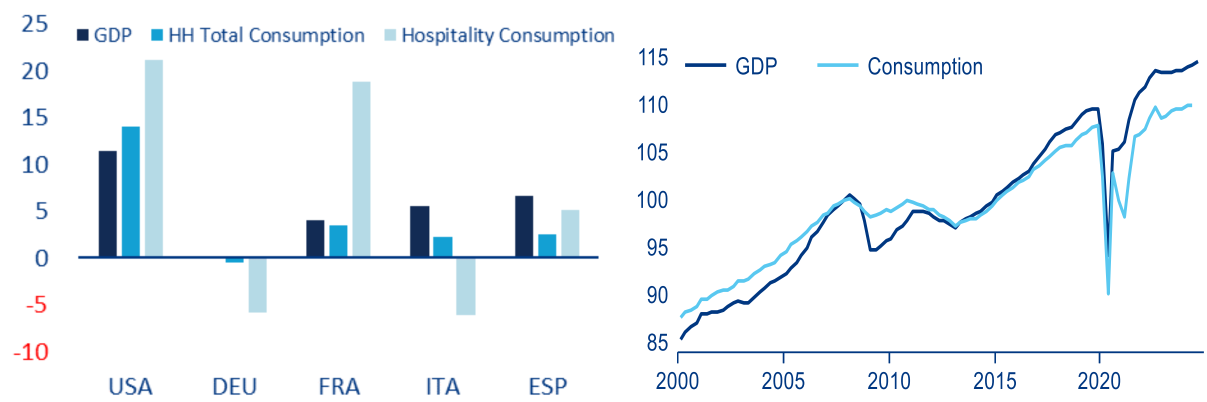
The CORE problem for European automakers (consumption, oversupply, revenue, energy transition). In recent weeks, the auto sector has been in the news for all the wrong reasons. Some of the largest original equipment manufacturers (OEMs) are facing a serious profitability squeeze (-20-40% this year) as market demand for new vehicles has stagnated (+1%) and Chinese competition has intensified in the premium market. But the list of problems is even longer, covering production capacity and product mix (German OEMs have 2x more inventories than peers); low competitiveness in electric vehicles; ineffective pricing and geographic dependency. Green regulation is also looming, with the risk of heavy sanctions if carmakers do not reduce emissions by -15%, and a new wave of protectionism could put roughly 20% of estimated EBITDA at risk for the biggest OEMs in 2025.

Eurozone: Confidence is key (to unlock consumption)

Household consumption in the Eurozone has not kept pace with the post-pandemic economic recovery and expectations. By the end of Q2 2024, private spending was just 2% above end-2019 levels, even as GDP had rebounded to +4.2%. Despite declining interest rates and rising real wages, which have helped improve purchasing power, European households have chosen to bolster their savings rather than increase spending. This cautious behavior can be attributed to several factors, including persistent uncertainty over the macroeconomic outlook, the lingering effects of high inflation between 2022 and 2023 on consumer sentiment and geopolitical events closer to the EU than to the US, where private consumption is 1.2 times economic output and, in turn, 11% above pre-Covid levels (Figure 1).

Figure 1: a) Change in GDP and consumption between 2019 and Q3 2024 and b) Eurozone GDP and consumption (index 2007=100)

a) b)



Sources: LSEG Workspace, BEA, Allianz Research

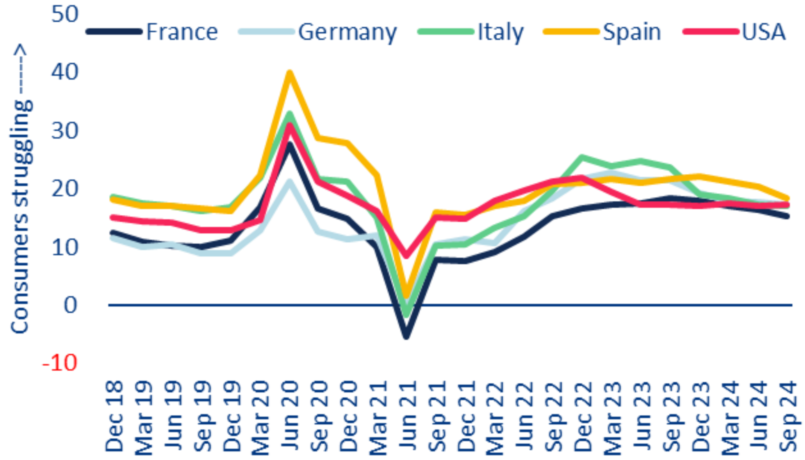
Savings intentions have also reached historic highs. During the pandemic, consumers' coffers benefited from the reallocation of public resources in advanced economies to support households, while the limited spending opportunities led to involuntary savings. But the return of inflation and a tighter labor market have eroded these savings, while the outbreak of war in Ukraine has ramped up uncertainty (Figure 2). In this context, savings intentions have been increasing and are now at historic highs.

Figure 2: World economic policy uncertainty index

Sources: LSEG Refinitiv, Allianz Research

Inflation is a big culprit – but growing disposable income in the US has outpaced rising debt. To compare consumer sentiment in the four largest economies in Europe to that of the US, we add unemployment rates, inflation rates, short-term bank lending rates as well as mortgage rates to Okun's misery index[1] and subtracted economic growth per capita. Although economic growth in the US has outpaced that of the other European economies, inflation rates are still above the Fed's target, mortgage rates are still higher than their pre-pandemic normal and the household mortgage balance stands at USD12.59trn. Credit-card debt in the US just surpassed the milestone figure of one trillion, currently standing at USD1.17trn. However, households' disposable income has grown even faster and their debt-to-income ratio is now below pre-pandemic levels (82% v. 86%). These factors serve as an equalizer for American consumer welfare compared to their European peers.

Figure 3: Adjusted misery index = unemployment rate + cpi + short-term bank lending rates + mortgage rates – gdp growth per capita

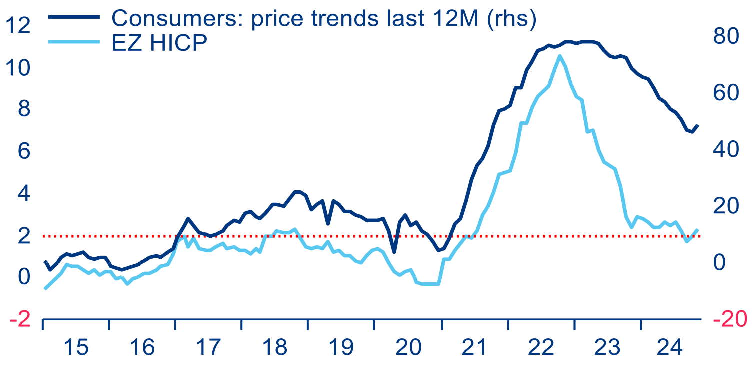


Sources: LSEG Refinitiv, Allianz Research

In the Eurozone, inflation has slowed down and is now on the path to the medium-term target of 2% but **households' perceptions of price trends has diverged and remained high (Figure 4).** Food and housing prices, which represent a large part of household spending, are now declining but still 15% and 26% above pre-pandemic levels, respectively. Meanwhile, the easing cycle has spilled over to consumer bank lending rates, which have also relaxed after reaching their peak in November 2023. But economic growth has been very heterogeneous in these four economies: muted or inexistent in Germany, France and Italy, while still solid and boosted by strong exports of services in Spain. While activity is slowing across the board, unemployment is well below pre-pandemic levels in France, Italy and Spain. But unemployment in Germany remains above the pre-pandemic norm as industry struggles. Although the grievances are different on both sides of the Atlantic, consumers have yet to feel at ease in the new normal of political tensions, both abroad and domestically, which has dampened sentiment and, in Europe, increased precautionary savings.

1 The misery index is an economic indicator, created by economist Arthur Okun. The index helps determine how the average citizen is doing economically and is calculated by adding the seasonally adjusted unemployment rate to the annual inflation rate.

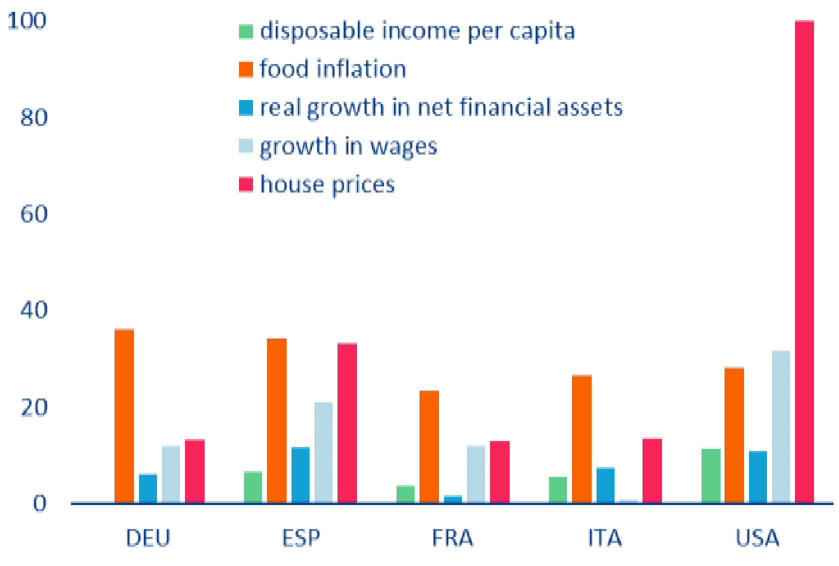
Figure 4: Eurozone perceived and actual inflation (% y/y and balance)



Sources: LSEG Refinitiv, Allianz Research

There is another side to the story: the erosion of household wealth due to high inflation and restrictive monetary policy. French households have been hit the hardest. Their net financial assets have grown by just +1.5% since the end of 2019. In Germany this figure is +6.0% and in Italy and Spain +7.4% and 11.8%, respectively. In the US, households have seen real growth of their net financial assets has been +10.7%. Moreover on the income side, inflation outpaced wage growth more frequently in Germany and Italy, where, for example, hospitality consumption has not recovered when compared to the other countries. Additionally, wage growth outpaced disposable income per capita by a factor of three in France, Spain and the US. However, their households' disposable income growth is not solely dependent on it as it is in Italy, where wages and salaries are carrying the growth in disposable income. In Germany, it is the growth in wages and salaries that is compensating for loses elsewhere as disposable income for capita has stayed the same when compared to pre-pandemic levels

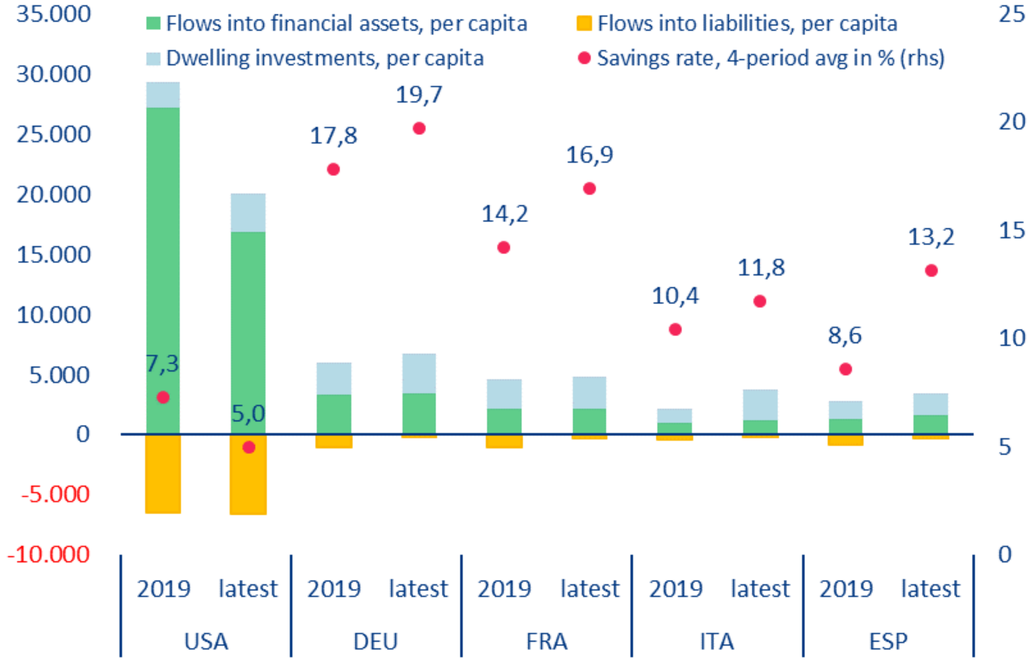
Figure 5: Consumer 'vibecession' – delta 2019 to Q3 2024, in pp



Sources: LSEG Refinitiv, Eurostat, Allianz Research

Furthermore, the sharp increase in interest rates that started in mid-2022 caused a fall in housing prices and dwelling investments to increase slightly. Figure 6 shows that savings rates remain far above their pre-pandemic normal in Europe, while in the US, they have fallen below. If we take a closer look at the decomposition of the savings rate, flows into financial assets have grown in Europe when compared to pre-pandemic flows, while in the US the massive change has been in the flows into liabilities. Europeans are mostly paying off debt, and in all markets we see an increasing share of financial transactions in dwelling investments.

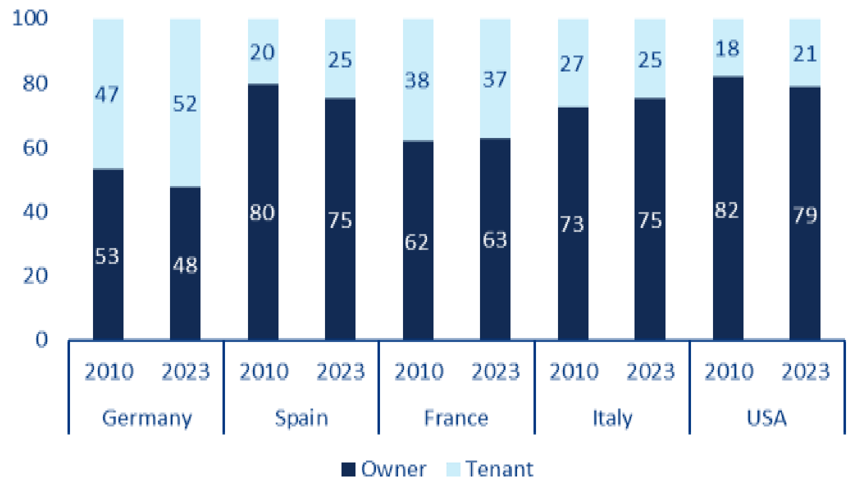
Figure 6: Deconstruction of savings: Four period flow of funds, investment in dwellings and average savings rate, in EUR per capita and %



Sources: LSEG Refinitiv, Eurostat, Allianz Research

Going forward, there is a better outlook for the housing market: increased mortgage demand and growth of house price inflation. Two scenarios may come into play: housing investment may crowd out private consumption, with households saving more to invest in the housing market. Alternatively, the fall in interest rates may create a positive income effect on interest generating savings, pushing up both housing investment and private consumption in other goods and services. Moreover, as house prices increases, the perception of accumulated wealth for homeowners might improve sentiment, especially in countries like the US where homeownership is ingrained in the culture. In Germany, homeownership is not as widespread as in other European countries (see Figure 7) so consumers are more sensitive to rental prices or housing shortages in certain regions. If previous economic crises serve as a blueprint, we might see consumption and sentiment slightly recover as the easing cycle continues.

Figure 7: Home ownership rates, in %



Sources: LSEG Workspace, Eurostat, Allianz Research

However, we do not expect a trend reversal in savings habits as the reduction in interest rates should provide only a moderate support to the consumption outlook. Mounting headwinds are expected to weigh on household spending, from governments embarking fiscal consolidation measures to normalizing wage growth. Consumer confidence is also under pressure from both domestic political uncertainty (the upcoming election in Germany and political turmoil in France) as well as international geopolitics.

In Germany and Italy, where social protection is normally generous, the combination of a fiscal consolidation regime with a simultaneous tightening of the labor market is prompting consumers to save more to preserve their financial standing. Ageing populations will only aggravate this trend in the long run. Against this backdrop, policymakers will have to project a sensible and credible plan for the cyclical and structural struggles that the Eurozone is facing to promote consumption and investment.

ECB: Rate cut number four ahead amid gloomy outlook

The ECB is set to deliver its fourth rate cut this year as **the Eurozone's** economic outlook darkens. At its next meeting on 12 December, the ECB is expected to lower the deposit rate again by 25bps to 3.0%. As economic data has surprised to the downside lately and inflation is becoming less of a concern, easing the monetary policy stance is widely expected by markets, with even slightly more than one cut being priced in currently. Recent central bank statements reveal a divergence in views, with board member Isabel Schnabel pointing out that the neutral nominal rate, which she expects to be between 2-3%, will soon be reached and should not be undershot. On the other hand, ECB chief economist Philip Lane indicated that the ECB should start looking at "upcoming risks" rather than past data. Indeed, the amount of risks ahead has increased since the last meeting in October, including a looming trade war, the break-up of the German government and political woes in France, just to name three.

Figure 8: Eurozone headline and core inflation, y/y and sequentially in %

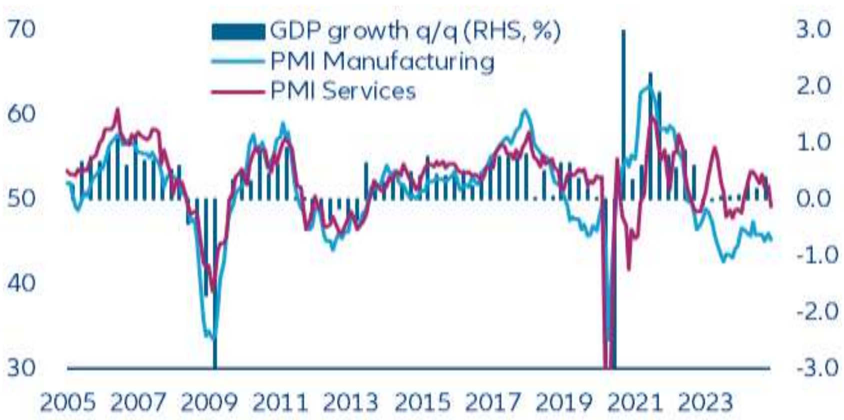
Sources: LSEG Datastream, Allianz Research. Note: Scales are cut off at -4% and +8% for better visibility. saar= seasonal adjusted annualized rate

While headline inflation inched up on base effects in the last two months to 2.3% y/y, underlying inflation trends are easing faster than expected. Core inflation moved sideways and stood at 2.7% y/y in November. However, looking at sequential price developments, which take out base effects, we find a strong softening of price pressures, with the annualized three-month average change of core prices having dropped to 1.2% seasonally adjusted, clearly below the central bank target (Figure 8). By the same measure, services inflation – long regarded as a sticky problem – has fallen to -0.1% (compared to 3.9% y/y), which is the lowest reading since 2021. As base effects will soon drop out, we expect headline inflation to retreat again from January onwards and undershoot the inflation target, at least in the first half of 2025. Meanwhile, the weaker euro should not be an issue. As we pointed out earlier, a 4% depreciation of the euro would increase inflation by less than 0.2pp ceteris paribus[2]. However, with oil prices (in USD) receding in lockstep with the euro lately, the impact from energy inflation should be even less. There are

[2] *See our report 2024_04_11_what_to_watch.pdf*

also positive signals from wages, with the most up-to-date indeed wage tracker having fallen to around +3% y/y growth down from around +5% in 2023.

Figure 9: Eurozone GDP growth and PMIs, index, %



Sources: LSEG Datastream, S&P Global, Allianz Research

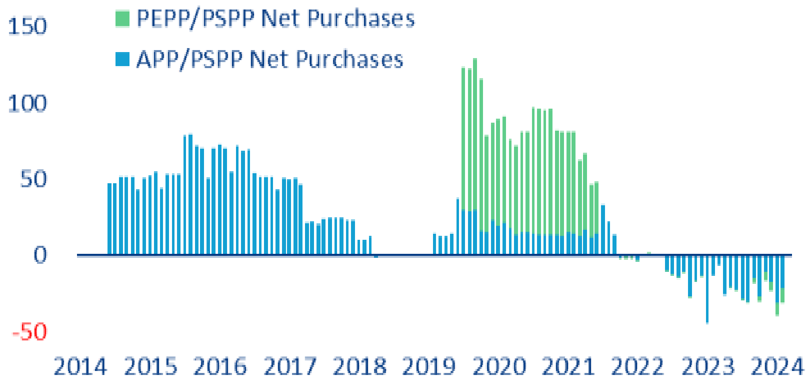
At the same time, economic headwinds are increasing. The latest batch of purchasing manager indices (PMI) shows a deterioration of the services sector back into contractionary territory, with a reading of 49.2 (values below 50 indicate contraction). The manufacturing PMI also slipped and remains in the red zone (45.2, Figure 9). This drop might also be a reflection of rising uncertainty after the US presidential election, with a looming trade war now becoming the baseline scenario. While the labor market is still fairly stable, with the unemployment rate staying at a record low of 6.3%, the vacancy rate continues to inch up, indicating that labor market tightness is falling. A weaker economic outlook as well as a faster disinflation process will likely be reflected in the updated ECB staff expectations to be published at this meeting.

Figure 10: Eurozone policy rate and neutral rate, %

Sources: LSEG Datastream, Allianz Research. Note: Dots represent Allianz Research forecast.

Going forward, we expect a continuous meeting-by-meeting cutting cycle, with a terminal rate of 2% to be reached by June 2025. Given the economic headwinds and a faster-than-expected disinflation process, we have accelerated our expectations for the rate-cutting cycle to a meeting-by-meeting approach from the previous quarter-by-quarter approach. Despite our downward revision of the terminal rate by 25bps to 2.0%, there are additional downside risks. A full-scale trade war could derail the global economy further and would foster more rate cuts by the ECB. Moreover, the 2% terminal rate implies a real neutral rate around 0% (Figure 10), which would be a historically high level for the Eurozone, so downside risks also persist from this perspective.

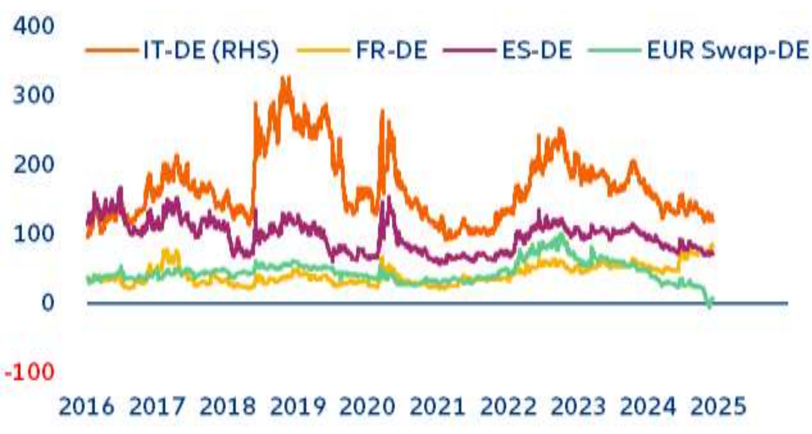
Figure 11: ECB quantitative easing and tightening, EUR billion per month



Sources: LSEG Datastream, Allianz Research

Despite widening government bond spreads in France, we do not expect any change to the ongoing quantitative tightening (QT) process as government bond yields in general are falling. The forthcoming meeting will also be the anniversary of the last adjustment of the QT process. In December 2023, the ECB announced it would partially stop the reinvestment of the holdings in the Pandemic emergency purchase programme (PEPP) from June this year, and allow for a full run-off from January 2025 (Figure 11). So far, this has not led to any issues. In fact, the scarcity of German government bonds has diminished, which is reflected in a falling euro swap spread, while government bond spreads have continued to narrow – with the exception of France (Figure 12). The widening of the German-French 10y spread to around 80bps can be attributed to local fiscal issues and government instability and has neither lead to a Eurozone wide contagion nor has it caused any disruptions in the French government bond market as spreads are still comparatively low and yields are falling in general (Figure 13). This should comfort the ECB in proceeding with QT as planned, especially since government bond holdings are still very high.

Figure 12: Eurozone government bond and swap spread against Germany, bps



Sources: Bloomberg, Allianz Research

Figure 13: Eurozone government bond yields, %

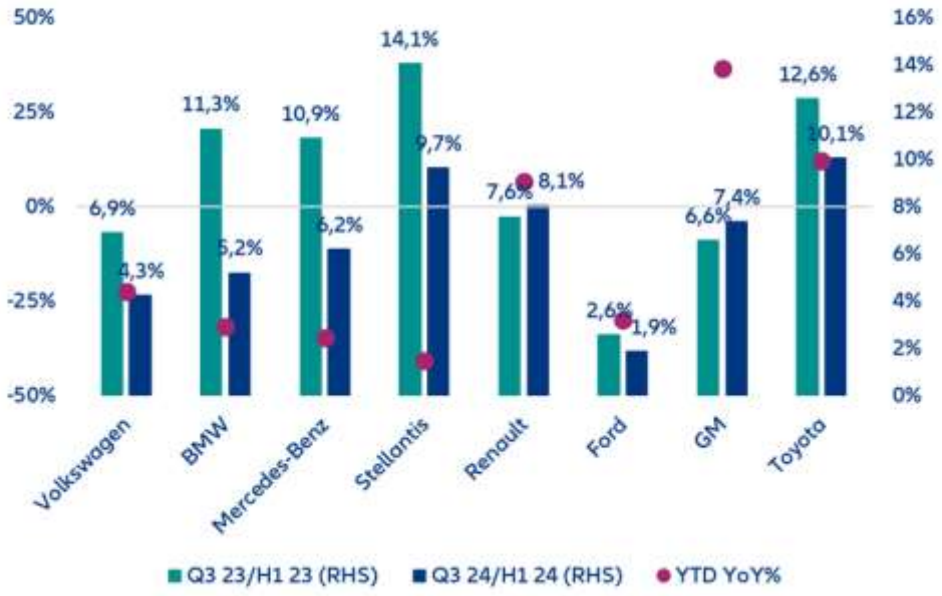
Sources: Bloomberg, Allianz Research

The CORE problem for European automakers (consumption, oversupply, revenue, energy transition)

Winter has come early for the automotive sector, which has been in the news for all the wrong reasons. After a disappointing Q3 earnings season, European carmakers have announced even more bad news, including broad-based cost-cutting plans, layoffs, plant shutdowns and also board reshufflings. The recent departures of the CFO of Nissan, and more surprisingly the CEO from Stellantis one year before the end of his term, illustrate the challenges plaguing the sector, which recorded outstanding performance just one year ago.

Weaker demand is just one of many bumps in the road. The nightmare for the European automative sector began with the unexpected weakening of global demand at the start of the year, and intensified with the slowdown of both the Japanese and Chinese economies. At the same time, sales of electric vehicles have stagnated. As a result, on a year-to-date basis, the cumulated registrations of new vehicles in big markets (Eurozone, US, UK, Japan, China, Brazil and India) has slightly decreased by over -1% compared to last year. But there's more to the story of the auto sector's bumpy ride. A closer look at the quarterly or biannual financial reports points out a bigger issue: a dramatic decrease of profitability, notably for German and US-oriented manufacturers. After ending last year with double-digit margins, mostly driven by strong pricing power and a vigorous growth of the EV segment, carmakers are struggling now to contain the slide in profitability. On a YTD basis, the operating profit for a representative sample of five large European and US automakers has collapsed by -20-40% compared to last year, far beyond the -5% drop in vehicle sales for these manufacturers.

Figure 14: EBIT margin from main automakers in Europe

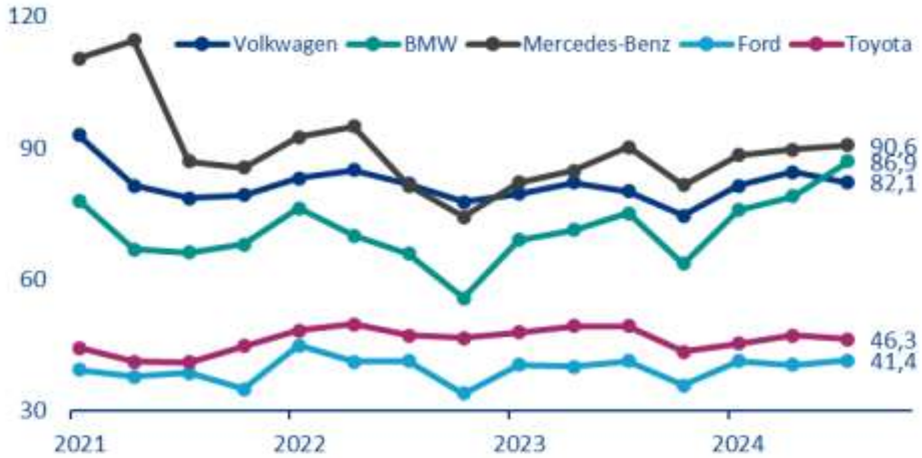


Sources: LSEG Datastream, Allianz Research

Oversupply is a sizeable problem – especially in Germany. Nothing illustrates the oversupply conditions in Europe better than the image published recently of 6,000 vehicles parked in the German city of Essen. Indeed, despite weaker demand, German carmakers continue to produce at a high pace – for example, VW produces 40,000 vehicles each day and roughly 10mn per year – and have to manage the resulting skyrocketing inventory costs. Large groups with multiple brands in their portfolios are more subject to oversupply issues due to a lack of agility to quickly and efficiently reorient their supply chains to meet demand. Volkswagen is the most impacted among European carmakers and holds inventories equivalent to 80-90 days of turnover, a sharp increase since the low point recorded at the end of last year, and above all twice more than peers such as Renault, Toyota or GM (40-45 days). While stiffer competition from Chinese brands in Asia could explain surging inventories, Japanese manufacturers are not facing the same profitability pressure. Looking ahead, things could get worse before they get better as the industry will need to adjust to a new business environment, not only with more competitors, but also with changing consumer behavior as fewer households prioritize buying a car and/or keep their cars longer. The most recent data suggest that the life span of a car in Europe increased by +11% between 2017 and 2022 to reach a peak of 12.3 years, while it reached 12.5 years for US households in 2022. In this context, German automakers will need to address the inefficiency of their plants and downsize their output capacity.

The auto industry also has to tread carefully when it comes to relying on automation and digitalization to increase productivity and cut costs. Accounting for 6% of total employment in the EU, and with roughly 1% of German labor working in the manufacturing of motor vehicles, the automotive sector has to deal with powerful labor unions, as seen recently in Germany. The employment decisions made by large manufacturers will have sizable snowball effects across the industry, affecting direct and indirect suppliers via a tremendous decrease of backlogs in the sector. This could then force them in turn to proceed with substantial cuts in costs and staff.

Figure 15: Average inventory days (trailing twelve months)



Sources: LSEG Datastream, Allianz Research

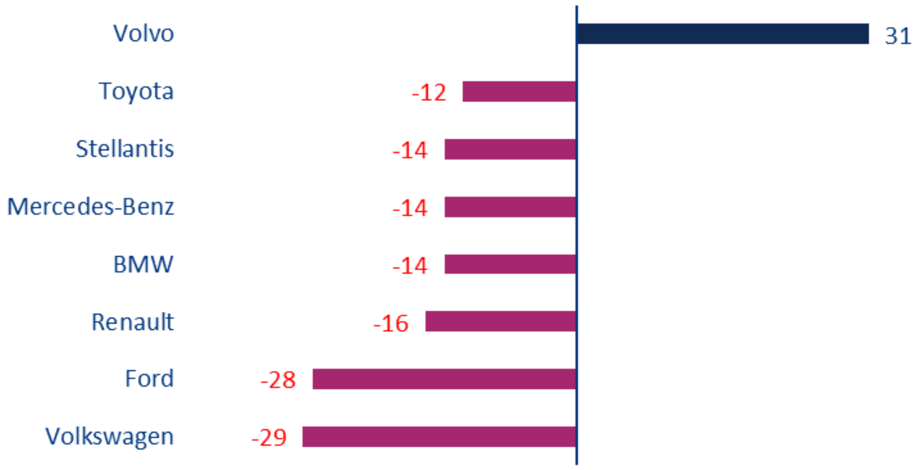
This year also highlighted the lack of competitiveness of European carmakers compared to their American, Japanese and Chinese peers. After the pandemic and energy crisis, policy measures such as an incentive scheme for electric vehicles and a cap on regulated electricity prices worked wonders to boost sales of electric vehicles. But things have taken a U-turn this year as the first measure has been scrapped and the threshold for electricity prices increased. For consumers, European and especially German electric vehicles are considered too expensive or not as technologically advanced as those sold by competitors. With inflation effects still perceptible among lower-income households that cannot afford to pay a green premium without state support, and the absence of second-hand market for electrical vehicles, pricing policy has been a real deal-breaker. This explains in part the low penetration of German EV vehicles in Europe, while in China a low-perceived price-to-technology ratio is the reason of the declining market share on domestic market where none of the big three brands is ranked in the top 10 of sellers in BEV segment (Tesla is the only foreign brand that appears in that ranking). The technology deficit is primarily because European carmakers lack control over the supply chain (so weaker control on costs when adjustments need to be done), which remains heavily dependent on China for batteries. The recent administrative bankruptcy under US law of the Swedish company Northvolt, the biggest European manufacturer of batteries for the automotive sector, illustrates how Europe is behind the curve on this technology. Moreover, carmakers also need to cope with a trust deficit regarding the efficiency and durability of battery-powered cars, and the high insurance costs resulting from the lack of cheap alternatives to repair a defective battery.

Figure 16: What are the top five concerns from Europeans who do not own battery electric vehicles?

Sources: McKinsey, Allianz Research

Automakers need to align further with green regulation to avoid sanctions. Europe's ambitious green targets will force carmakers to gradually decrease their carbon emissions to reach the neutrality target set up for 2035 or face severe sanctions. The CAFE regulation (Corporate Average Fuel Economy) foresees a -15% decrease of the average carbon limitation from 95 gCo2/km to 81 gCo2/km as of 01 January 2025. But as of mid-2024, only Volvo was aligned with that standard. While the regulation will strictly apply to 2025 sales, carmakers with lower penetration in the electric vehicle segment are likely to struggle, with current average carbon emissions (as of end-June 2024) roughly 30g above the 2025 target. These companies would need to reach close to 25% in the electric vehicle segment (and as much in hybrid segment) to align with carbon regulations and avoid sanctions. While European manufacturers are lobbying to delay the implementation of the new threshold, this is unlikely to succeed. Even if it does, it will only postpone the matter for some months. The first sanctions, if any, will not come into effect before 2026 as they will apply on annual sales volume. A modest demand recovery could help to offset the effects and lift up margins.

Figure 17: How well are European automakers positioned for the 2025 carbon regulation?
Average carbon emissions vs. EU 2025 threshold (81 gCO2/km)



Sources: Transport & Environment, Allianz Research

Tariff risk is no free lunch for OEMs, even though they look better prepared. President-elect Trump could kick off a new wave of protectionism, especially targeting imports from Canada and Mexico where many automotive manufacturing plants are located to service the US market. While European OEMs may not be the first target, they are not entirely safe from US retaliatory measures. Recent research from S&P suggests that European manufacturers are more resilient to tariff threats today, compared to Trump's first mandate, with the average earnings impact of a potential 20% tariff on European imports likely to be 8% of 2025 EBITDA for the top six biggest manufacturers, against 15% in 2019 under a 25% tariff assumption. The biggest German manufacturers look quite resilient against trade friction risks at this stage due to their lower exposure to the US market and/or for some of them low capacity production localized in Canada and Mexico but some European OEMs could see up to 30% of their estimated 2025 EBITDA at risk[3].

[3] *Auto Industry Buckles Up For Trump's Proposed Tariffs On Car Imports | S&P Global Ratings*

All in all, Europe's automotive sector is at the crossroads of what could be its biggest structural revolution. The share prices of some of the largest European OEMs have decreased by around -30/40% on year-to-date basis as investors sanction bad operating results. At the same time, social anger against large cost-cutting plans is on the rise across Europe. In this context, the multiple issues highlighted above set the stage for a mountain of a challenge for Europe's automotive sector.

These assessments are, as always, subject to the disclaimer provided below.

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