Examining the outlook for key equity indices in the euro-zone

- July PMI surveys will probably point to a continued recovery in much of the world
- We expect a one million gain in US non-farm payrolls in July (Friday)
- Brazil’s central bank is likely to cut its policy rate by 25bp (Wednesday)

**Key Market Themes**

We suspect that MSCI’s index of German equities will stop outperforming its indices of equities in other major euro-zone countries in the coming months, even if the economy holds up better in Germany than in those places. This view rests on an assumption, however, that renewed outbreaks of coronavirus will remain under control.

The raft of euro-zone Q2 GDP data released over the past two days confirmed that, while all the major euro-zone economies experienced record falls in output, economic activity held up much better in Germany than elsewhere. Indeed, GDP fell by 10% q/q there, by 12% and 14% in Italy and France respectively, and by a staggering 18% in Spain. (See our European Data Responses for more.)

**Chart 1: Euro-zone equities & GDP**

The relative resilience of Germany’s economy has coincided with MSCI’s index of equities there outperforming its indices of equities in other major euro-zone countries during the pandemic. As Chart 1 shows, the MSCI Germany total return index is currently only ~10% lower than on 19th February, when worries about the coronavirus first hit financial markets. In contrast, the MSCI France and MSCI Italy indices are down ~20%, and the MSCI Spain ~30%.

While the strength of Germany’s domestic economy may partly explain differences in the performance of euro-zone equities indices over the past few months, we don’t think it tells the whole story. For one, companies in the main euro-zone equity indices generate a large share of their earnings abroad. Indeed, the strong economic recovery in China may have played a role in the outperformance of the MSCI Germany, and particularly of its industrial sector. Firms in Germany’s equity market generate a large share of revenues in China.

What’s more, the composition of countries’ stock markets is often very different from that of their domestic economies. And the sectoral composition of euro-zone equity indices appears to have been a key driver of their relative performance. The MSCI Germany has a higher weighting than the other main euro-zone indices in sectors such as IT and health care, which have fallen the least across euro-zone countries since 19th February. It also has a lower weighting in energy and financials, which have been the hardest hit sectors during the pandemic.

In our view, the relative performance of euro-zone equity indices in the future will depend on how the recent upturn in virus cases in several countries there will evolve. If the renewed outbreaks remain under control – which is our baseline scenario – we expect the sectors that were hit hardest during the crisis to outperform, as economic activity returns to normal. This would benefit equity indices in France, Italy and Spain. That said, we doubt that the MSCI Germany would lag much behind its euro-zone peers. In fact, we also think that China’s recovery will remain robust and that Germany’s economy will continue to hold up better than elsewhere in the euro-zone. In contrast, if the virus took a turn for the worst, we would expect Germany’s stock market to fall by less than its euro-zone peers. (Franziska Palmas)

**Selected Data & Events**

<table>
<thead>
<tr>
<th>Day</th>
<th>Country</th>
<th>Event</th>
<th>BST</th>
<th>Previous*</th>
<th>Median*</th>
<th>CE Forecasts*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tue 4th</td>
<td>Brz</td>
<td>Interest Rate Announcement</td>
<td>-</td>
<td>2.25%</td>
<td>2.00%</td>
<td>2.00%</td>
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<tr>
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<td>UK</td>
<td>Interest Rate Announcement</td>
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<tr>
<td>Fri 7th</td>
<td>US</td>
<td>Change in Non-Farm Payrolls (Jul)</td>
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<td>+4,800,000</td>
<td>+1,635,000</td>
<td>+1,000,000</td>
</tr>
</tbody>
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*m/m/y/y*: unless otherwise stated; p = provisional

Sources: Refinitiv, Capital Economics
Key Data & Events

US
The 5.2% m/m rise in real personal spending in June sets the stage for a big rebound in Q3. Even assuming much more modest monthly gains from July to September, real consumption is on track to rebound by close to 30% annualised in Q3. That would point to GDP rising at a pace of about 25%. Even so, with the resurgence in infections starting to weigh on activity, that pace of recovery is unlikely to be sustained.

Negotiations over the next fiscal package look set to continue into next week, meaning the $600 weekly unemployment insurance payments, which made up 5% of personal incomes in June, will expire, at least temporarily. But it still looks likely that politicians will eventually reach a deal. So, for now, this does not represent a major threat to the recovery. Otherwise, we expect further signs that virus concerns are weighing on the recovery, but have not yet pushed it into reverse, with non-farm payrolls rising by 1.0m and the ISM non-manufacturing index recovery, but have not yet pushed it into reverse, with non-farm

Europe
Data published on Friday confirmed an unprecedented slump in the euro-zone in Q2. GDP dropped by 12.4% q/q in Italy, by 13.8% in France, by 18.5% in Spain, and by 12.1% in the block as a whole. Parts of the economy have bounced back since April, but the damage already done, plus the risk of a renewed upturn in infections, means the recovery is likely to be painfully slow and uneven. Other data showed that headline inflation in the euro-zone edged up to 0.4% in July, from 0.3% in June. But we expect this to be reversed in August, given the breakdown suggests July’s rise was driven by temporary factors.

Next week, data are likely to show large rises in euro-zone retail sales and industrial output in Germany in June. July’s PMIs for Italy and Spain will probably be weaker than those for Germany and France. Meanwhile, we expect a relatively small drop in Sweden’s GDP in Q2. Switzerland’s inflation probably remained below zero in July, while the manufacturing PMIs for the Nordic and Swiss economies are likely to show that conditions continued to improve at the start of Q3.

The Bank of England is unlikely to expand QE further at its meeting on Thursday but may signal that more stimulus might be needed at some point. We expect it to announce a further £250bn expansion by end-2021. The UK’s final PMIs are likely to provide further signs that the recovery continued in July. But the upturn in virus cases in parts of northern England highlights the risks to that recovery. (Melanie Debono & Ruth Gregory)

Other Developed Markets
In Canada, GDP rose by a stronger-than-expected 4.5% m/m in May. Output rose in almost every sector, with the construction, retail and accommodation & food services sectors seeing particularly strong gains as the first restrictions lifted. We expect an even larger rise in GDP in June. Next week, we think that trade data will show that exports rebounded further in June, boding well for the manufacturing sector, and also expect to learn that employment rose substantially in July, by 500,000.

In Japan, the sharp drop in the number of furloughed workers and the rise in industrial production in June bodes well for the recovery in economic activity in the second half of the year. However, next week we expect to learn that wage growth fell sharply in June, as bonuses plunged.

In Australia, we expect the RBA to keep policy unchanged at its meeting on Tuesday. We also think that Australia’s trade balance improved further in June as export growth outpaced growth in imports. Finally, employment probably fell in New Zealand in Q1. (Stephen Brown, Tom Learmonth & Ben Udy)

China
The official PMIs for July published today suggest that China’s economic recovery was still going strong at the start of Q3. A rise in both the manufacturing and construction indices mostly offset a decline in the services index, leaving the composite reading just shy of the two-year high it hit in June. We expect the Caixin PMIs due next week to be equally strong, though the trade data for July may be a touch weaker. Finally, we think that China’s FX reserves rose by $40bn in July, though mainly due to valuation effects. (Julian Evans-Pritchard)

Other Emerging Markets
In Emerging Asia, while the 0.7% y/y drop in Taiwan’s GDP in Q2 was its worst performance since the Global Financial Crisis, it nonetheless suggests that Taiwan is on course to be one of the few economies to grow this year. In contrast, we expect Q2 GDP data due next week to show much larger falls in Indonesia and the Philippines. Otherwise, Thailand’s central bank is likely to leave its policy rate unchanged on Wednesday.

In Emerging Europe, the 8.4% q/q contraction in the Czech GDP was a far smaller than most had expected and compares favourably with most other countries in Europe. Authorities there managed to get the coronavirus under control quickly, enabling its lockdown to be eased earlier. Next week, we expect that inflation edged down in Turkey but was unchanged in Russia. Meanwhile, we think that the Czech central bank will keep interest rates unchanged at 0.25% on Thursday.

In Latin America, we think that Colombia’s central bank will cut its policy rate by a further 25bp, to 2.25%, later on Friday. Next week, the raft of inflation data for the region for July is likely to show that the headline rate dipped slightly in Colombia and Chile, rose in Mexico, and was unchanged in Brazil. We have also pencilled in a 10% m/m rise in Brazil’s industrial production in June, though that would still leave output well below its February peak. Finally, we think Brazil’s central bank will cut its policy rate by a further 25bp, to 2.00%, on Wednesday. That should mark the last cut in its easing cycle. (Gareth Leather, Jason Tuvey & William Jackson)

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