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What to watch: Quarterly country and sector risk updates, transatlantic equity markets super trends and sticky services inflation v. the ECB

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In summary

- **Quarterly country and sector risk changes: Normalization in the making?** As of end-Q1 2024, we upgraded the corporate non-payment risk rating for eight countries (Brazil, Cape Verde, Egypt, Kazakhstan, Madagascar, Mauritania, Philippines and Thailand) and downgraded two (Bahrain and Israel). Seven industries got an upgrade while six industries got downgraded. Non-payment risk for automotive, machinery equipment and household equipment improved, while it deteriorated for construction, chemicals, IT services and energy. Overall, country and sector risk returned to pre-pandemic levels.

- **Equity markets going long trends on both sides of the Atlantic.** While US corporates posted a (very) decent performance throughout the Q4 earnings season, European ones recorded their third consecutive quarter of earnings and revenues declines. This trend is expected to continue during most of 2024. However, European risky assets have managed to keep up with the US bull market, joining the upward trajectory. Why? Because markets' focus is slowly shifting from short-term drivers such as monetary policy expectations to long-term trends (e.g., AI, climate, reshoring). In this context, we continue to expect 5-10% yearly returns in both 2024 and 2025 for both the US and Europe.

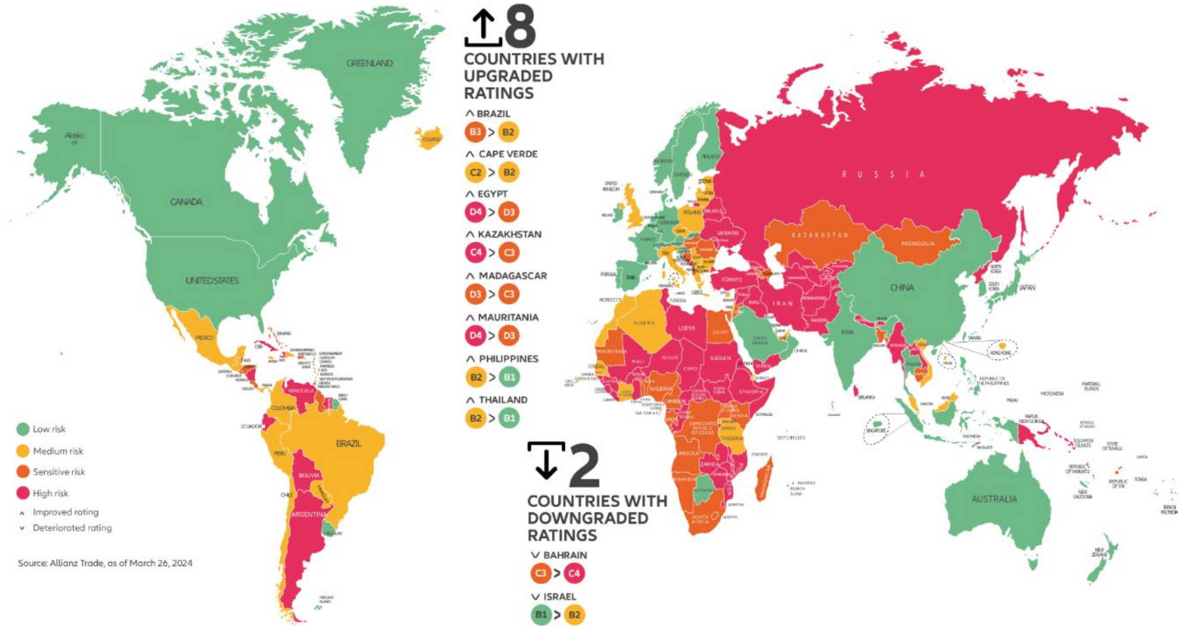
- **Sticky services inflation is the fly in the ointment for the ECB.** Eurozone inflation fell to 2.4% in March, but services inflation remains a key contributor. Labor costs, a major component of output prices in the services sector, continue to rise at a rate above historical average. Moreover, nine out of 20 countries show inflation rates above 3%. Germany and France have seen a strong slowdown in inflation while inflation in Spain and Italy is bouncing back as negative base effects from energy fade. For 2024 we continue to expect inflation at 2.4%. Disinflation will continue, albeit at a lower speed, paving the way for ECB cuts starting in July.

Quarterly country and sector risk changes: Normalization in the making?

Global country risk is returning to pre-pandemic levels. In Q1 2024, we upgraded the risk ratings of eight countries (Brazil, Cape Verde, Egypt, Kazakhstan, Madagascar, Mauritania, Philippines and Thailand) and downgraded two (Bahrain and Israel). After several signs of resilience in 2023 (see our Country Risk Atlas 2024[1]), the first quarter of the year showed more countries returning to the risk levels seen in 2019. However, our quarterly review of sub-component ratings, which include distinct risks such as those related to the business environment, exposure to climate risks, available financing for businesses or political risk, presents a more mixed trend, with 20 countries on an improving path and 19 on a deteriorating path.

Brazil's economic outlook is optimistic, driven by fiscal reforms such as the 2023 tax reform and the upcoming digital real in 2025, which are expected to enhance growth prospects. Political stability adds to this positive trajectory. **Egypt** is set to receive significant financial support, amounting to 13-15% of its GDP, from various sources, safeguarding against a balance of payments crisis despite challenges from conflicts and economic issues like devaluation and inflation. **Thailand**'s economy is gradually recovering post-Covid, with GDP having returned to pre-pandemic levels in 2023 and expected growth rates of +2.4% in 2024 and +2.9% in 2025, driven by robust private consumption and improved external conditions. The **Philippines** is experiencing improving economic momentum, with expected growth of +5.9% in 2024, supported by fiscal measures and recovering exports, though high inflation and interest rates remain challenges. Finally, **Kazakhstan** is benefiting from robust commodity prices, which have helped rebalance an earlier double deficit and pushed economic expansion above long-term trend growth. On the other hand, **Israel**'s economy is stagnating due to internal factors and conflict, leading to increased isolation and economic challenges, while **Bahrain** faces subdued growth due to declining oil revenues, fiscal challenges and geopolitical uncertainties, with a projected slowdown in 2024.

Figure 1: Country risk map as of end-March 2024



Source: Allianz Research

[1] Country Risk Atlas 2024: Assessing non-payment risk in major economies.

Looking at sectors[2], we find a balanced picture of changes, with seven moving up and six moving down. This represents the lowest number of changes from a historical perspective, following two quarters with limited changes (23 and 27 cases in Q4 2023 and Q3 2023, respectively). This prolonged 'pause' reflects the lack of noticeable improvement but also the lack of a noticeable deterioration in the outlook, even though risks are looming ahead with the potential to derail the soft-landing central scenario. Better risk ratings are mainly found in the **automotive** sector (Brazil, Greece, Kuwait and the UK) and in **machinery equipment** in Asia (Hong Kong, Philippines), where the risk rating mostly moved from sensitive to medium (Figure 2). Europe saw more downgrades as economic weakness and financing will continue to hit companies in the coming quarters, while the sectors with the most downgrades were construction (Romania and Spain) and chemicals (Mexico and the Netherlands, Fig. 2). Due to the limited number of changes, the global picture of ratings remains stable: sector ratings are mostly either medium (45%) or sensitive risk (42%) across all regions, but the overall risk dispersion is noticeable between the comparatively safest region (Asia) and the riskiest (Latin America) (Figure 2). As of Q1 2024, there are still fewer low risk sectors (9%) and more high risk (4%) sectors than before the pandemic (vs. 15% and 4% in Q4 2019, respectively). Three sectors stand out with the slowest return to pre-crisis risk levels: **automotive suppliers**, **retail** and **chemicals**, followed by transport equipment, household equipment and textiles.

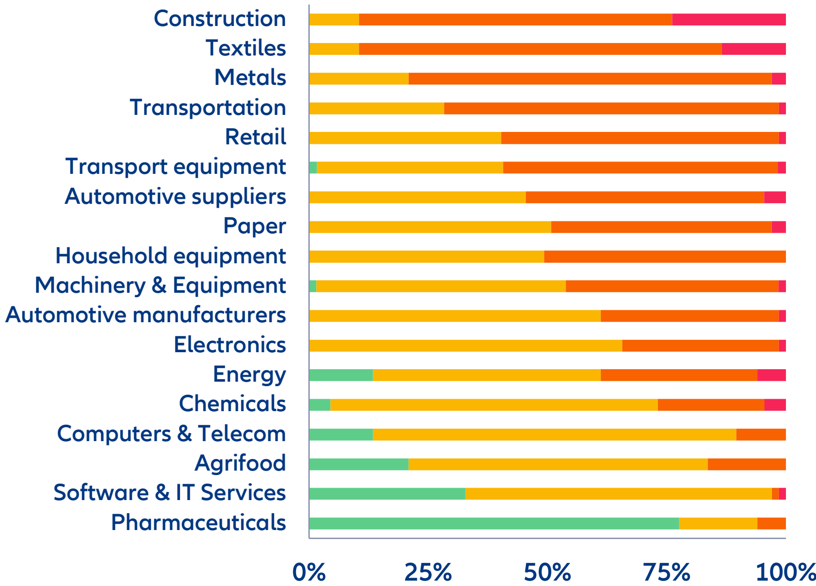
Figure 2: Q1 2024 changes in sector risk ratings

Sector	Country	Change in grade	From (Q4 23)	To (Q1 24)
Automotive manufacturers	Brazil	upgrade	red	orange
Automotive manufacturers	Greece	upgrade	orange	yellow
Automotive manufacturers	United Kingdom	upgrade	red	orange
Automotive suppliers	Kuwait	upgrade	orange	yellow
Household Equipment	South Africa	upgrade	orange	yellow
Machinery equipment	Hong Kong	upgrade	orange	yellow
Machinery equipment	Philippines	upgrade	orange	yellow
Chemicals	Mexico	downgrade	orange	red
Chemicals	Netherlands	downgrade	yellow	orange
Construction	Romania	downgrade	orange	red
Construction	Spain	downgrade	orange	red
Energy	Vietnam	downgrade	yellow	orange
IT services	Colombia	downgrade	green	yellow

Source: Allianz Research, based on the Sector Risk Methodology and the Sector Risk Map Q1 2024.

[2] *We review more than 1,200 industries (18 sectors in 67 countries).*

Figure 3: Sector risk ratings as of end-March 2024, in number of countries, by level of risk



Source: Allianz Research

The overall improving outlook for country risk and the balanced picture for sector risk support our baseline scenario[3] of a soft landing of the global economy in 2024-2025. We expect annual global real GDP growth to remain broadly unchanged from 2023, growing by less than +3% between 2024-25, and global inflation to fall steadily to 3.6% in 2025 from 6.8% in 2023.

Equity markets going long trends on both sides of the Atlantic

Clear skies over the US, clouds over Europe. US companies ended 2023 on a resilient note, with projections for a robust recovery and sustained performance through 2024 and 2025. But on the other side of the Atlantic, European companies grappled with the third consecutive quarter of declines in both earnings and revenues, a trend likely to continue in the first half of 2024 (Figures 4 and 5). Metrics of earnings breadth, which examine the ratio of earnings forecasts being upgraded to those being downgraded, reinforce the diverging trend. They indicate a swift recovery for the US, while Europe still faces downward revisions, despite the emergence of initial recovery signs. Our macro-based earnings growth models also confirm an acceleration in US earnings growth over the coming 12 months, while Eurozone earnings are set to continue their decline, potentially remaining in negative territory for an extended period (Figure 6). This suggests that American and European companies are navigating distinct phases of the business cycle. But it also highlights the differing structures of equity indices, with the US more technology centric while Europe remains more defensively biased. Moreover, US companies have long been at the forefront of new trends, the latest being artificial intelligence. The current surge in AI-driven innovations, predominantly centered among US corporates, is also contributing to an optimistic outlook for earnings growth (Figure 7).

[3] *Global Economic Outlook: It's a wrap!*

Figure 4: Revenue and earnings in the US (S&P500), y/y % terms

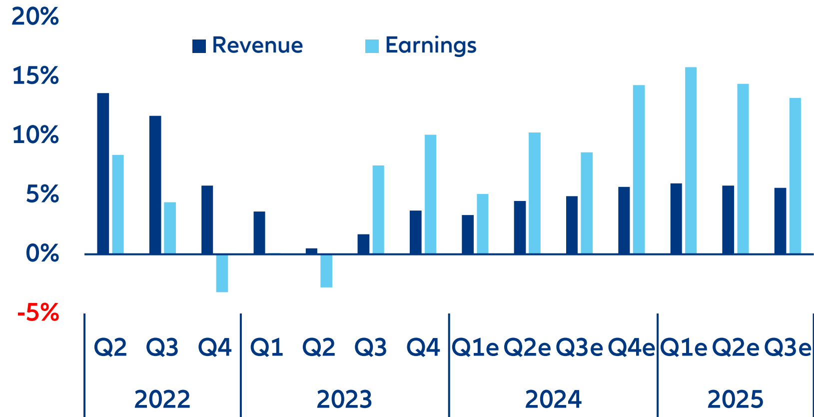
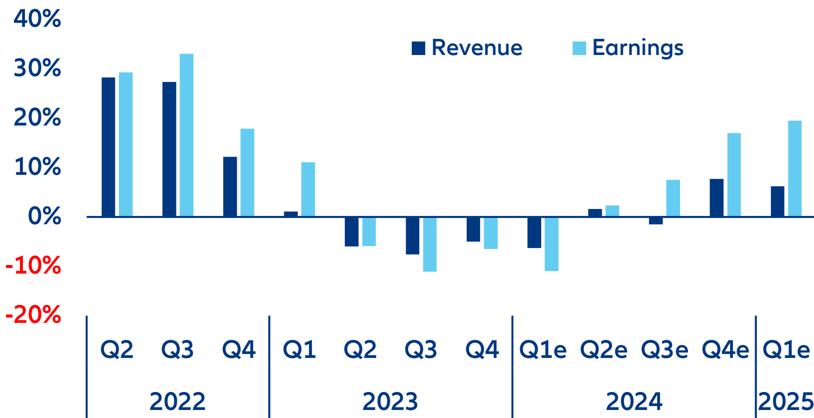
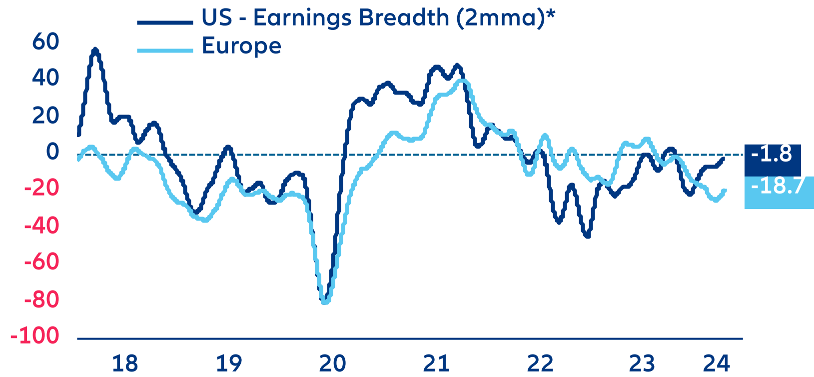


Figure 5: Revenue and earnings in Europe (Stoxx 600), y/y % terms



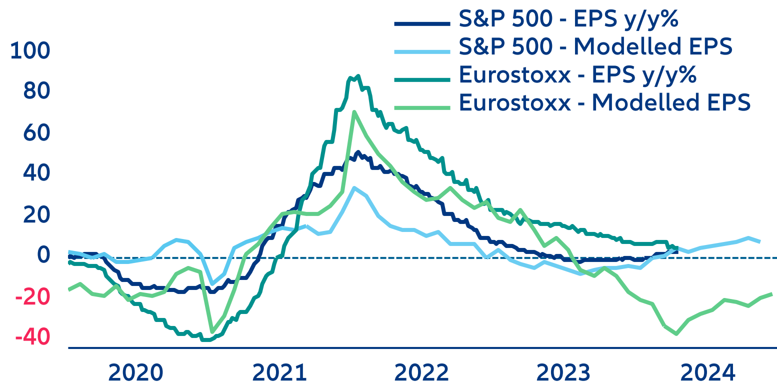
Source: LSEG Datastream, IBES, Allianz Research

Figure 6: US (S&P500) and Europe (Stoxx 600) earnings breadth (2-months moving average)



Source: LSEG Datastream, IBES, Allianz Research
Note: # of earnings projections being revised up vs # of earnings projections being revised down

Figure 7: Macro-based EPS growth models (y/y %)



Source: LSEG Datastream, IBES, Allianz Research
Note: EPS – Earnings per Share

The energy and commodity sectors are being hit the hardest as declining commodity prices affect both revenue and profits. Conversely, sectors such as financials, consumer discretionary and technology are seeing superior performance, particularly in the US, buoyed by optimistic forward-looking statements and a "reshoring" push. An exception to this trend is the European real estate sector, which is grappling with region-specific challenges, leading to underperformance in terms of market valuation and financial health (Figure 8 & 9).

Figure 8: US (S&P 500) sector revenue – earnings mapping (y/y % growth)

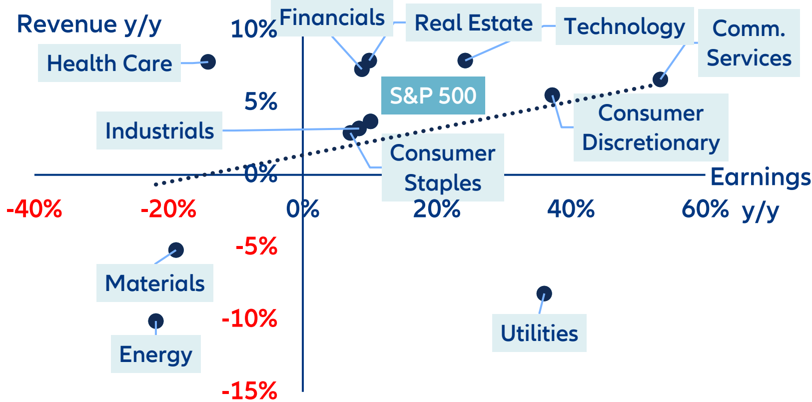
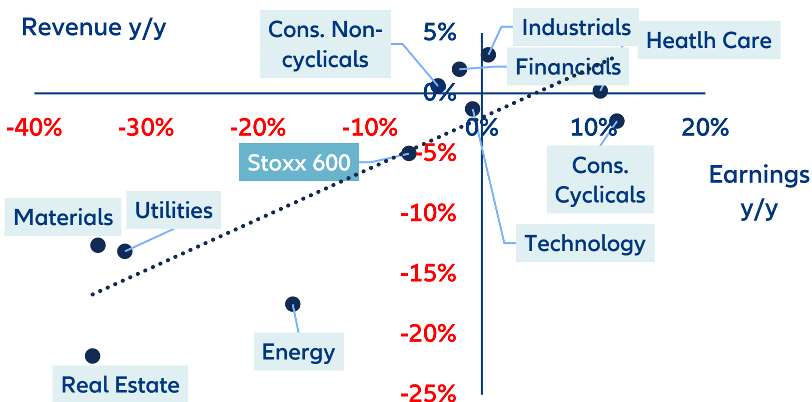


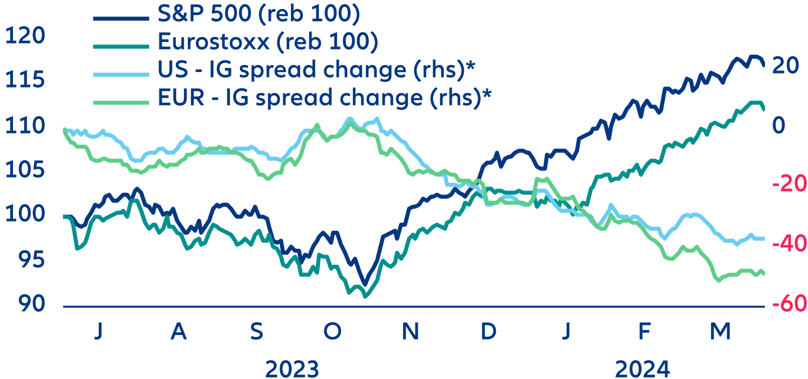
Figure 9: European (Stoxx 600) sector revenue – earnings mapping (y/y % growth)



Source: LSEG Datastream, Allianz Research

Counterintuitively, the diverging earnings trend has not held back European equity markets. European risky assets have managed to keep up with the US bull market, joining the upward trajectory (Figure 10). This suggests that markets are looking beyond immediate challenges such as earnings fluctuations, geopolitical unrest and political elections, focusing instead on the long-term trends – such as digital transformation and AI –that will primarily benefit the mega-cap companies driving major market indices. These trends promise enduring productivity enhancements and opportunities, which will lead to sustained earnings growth and synergies for corporations. Moreover, the shift towards climate-friendly solutions should also provide additional momentum for leading companies, bolstered by consistent investment flows. This perspective also encompasses factors such as demographic shifts, protectionism and reshoring, indicating a broader market inclination towards long-term strategic considerations.

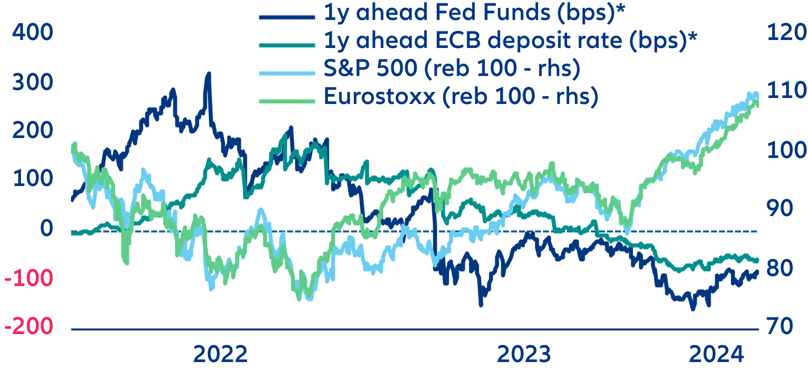
Figure 10: US and European equities vs investment grade spreads



Source: LSEG Datastream, IBES, Allianz Research
*Note: * change in Investment Grade corporate bond spreads in bps since 30/06/2023*

In this context, short-term market variables currently wield minimal influence over investor sentiment towards riskier assets. This is exemplified by the negligible impact that the recent, albeit limited, hawkish reevaluation of monetary policy trajectories has had on the performance of equity and corporate markets (Figure 11). Considering these factors, we maintain our outlook for equity markets to sustain positive momentum through both 2024 and 2025 (~5 to 10% yearly returns), with US markets anticipated to slightly outpace their European counterparts. However, the year-to-date market pace is unlikely to be sustained until year-end.

Figure 11: US and Europe monetary policy expectations and equity market performance

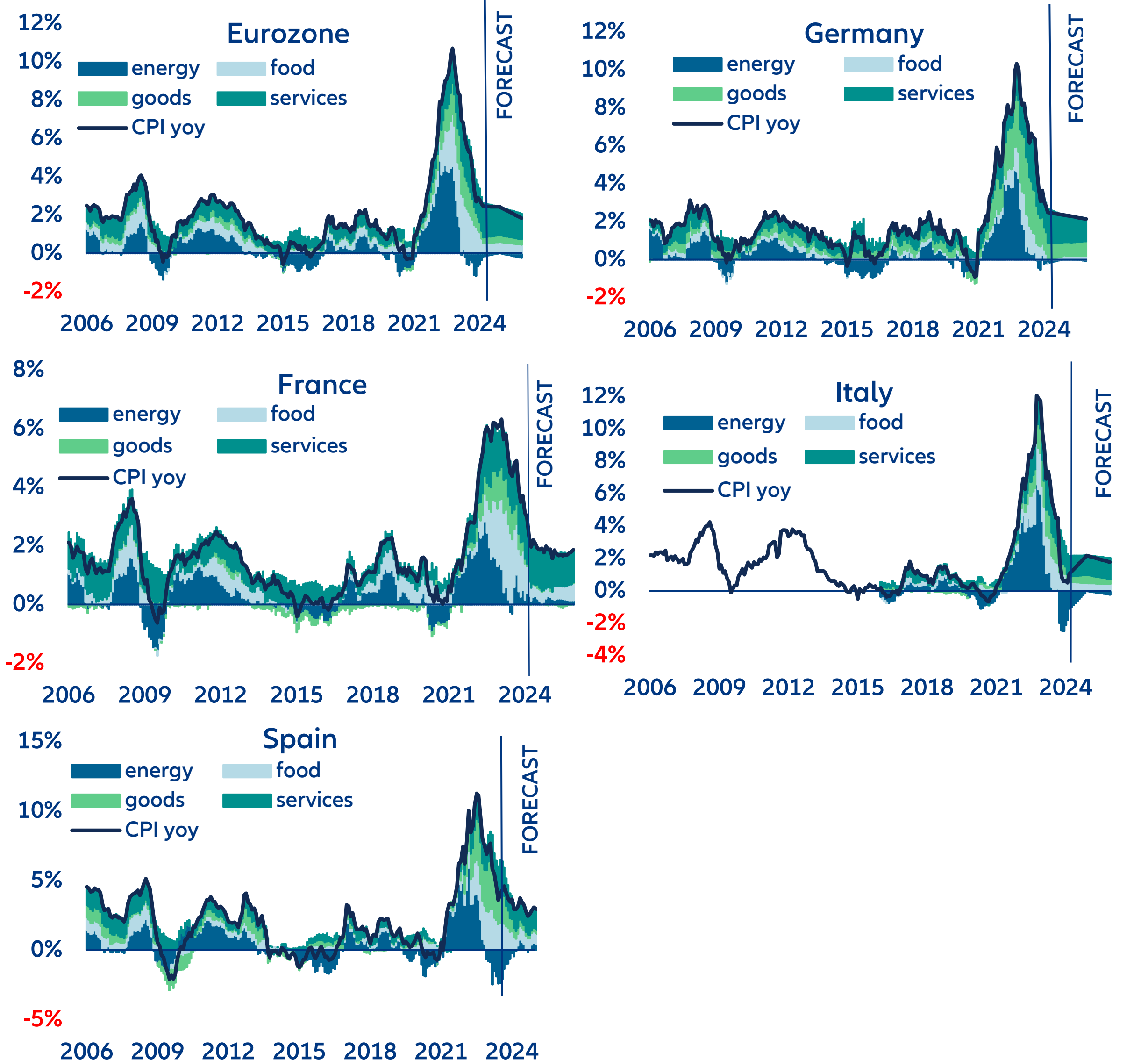


Source: LSEG Datastream, Allianz Research
*Note: * 1 year ahead market-based policy rate expectations in bps*

Sticky services inflation is the fly in the ointment for the ECB

Eurozone inflation fell to 2.4% in March, but services inflation will remain sticky going forward. This week's flash estimate revealed headline inflation in the Eurozone stood at 2.4% y/y in March, down from 2.6% in February. Notably, core inflation also dropped from 3.1% to 2.9%, marking the lowest level since early 2022. However, services inflation remains sticky and is expected to remain a key contributor to inflation going forward (Figure 12). First, prices in the services sector make up almost half of the weight in the consumer basket. Secondly, labor costs are a key component to prices in the service sector and they continue to rise at a rate above the historic average (Figure 13). Consequently, companies in the services sector still report strongly increasing output prices, according to the latest PMI surveys (Figure 14). Additionally, it is crucial to highlight that base effects continue to play a significant role. While the seasonally adjusted core CPI has stopped accelerating sequentially, its current level is above the ECB's comfort zone. Over the past three months, the annualized monthly rise in core CPI has averaged 3.8%. Services inflation has even accelerated to 5.7% – the highest pace in a year. Meanwhile, the wide dispersion between member states adds to ECB's current challenges. In the March reading, headline inflation ranged from 0.3% in Lithuania to 4.9% in Croatia. Nine out of 20 countries show inflation rates above 3%, while six have it below 2%.

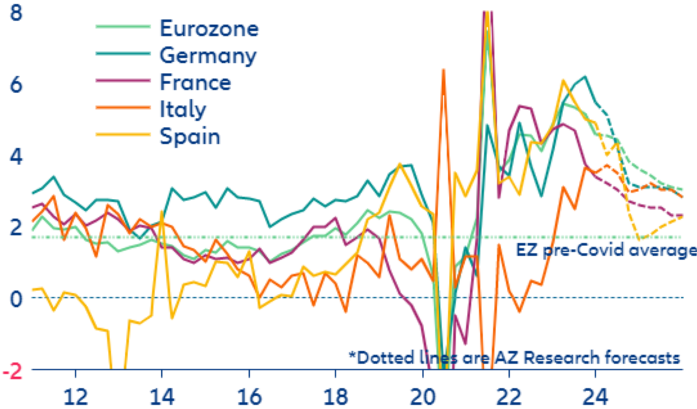
Figure 12: Inflation decomposition in the Eurozone



Source: LSEG Datastream, Destatis, Insee, Allianz Research. Note: for Italy, contributions by products are available from 2016

Reflecting the trends seen in other Eurozone economies, Germany is experiencing a slowdown in inflation pressures, although there are some potential upside risks stemming from services inflation. In March 2024, the inflation rate in Germany is projected to be 2.2%, down from 2.5% in February, driven mainly by decreasing energy and food prices. This marks the lowest figure since April 2021 (2.0%), with energy prices dropping by -2.7% and food prices by -0.2%. However, there are concerns about potential upward pressure on energy prices as the VAT on gas and direct heat is set to normalize from 7% to 19% in April, potentially leading to a temporary rise in energy costs. But overall, the energy component is likely to bring down inflation further over the forecast period. Core inflation is expected to reach 3.3%, with goods contributing only 1% while services inflation has risen from 3.4% in February to 3.7% in March. Despite expectations of falling prices among companies in consumer-related industries, retail and construction, the last mile is the hardest as inflationary pressures remain widespread across all products and are falling less sharply across the board. The services component of core inflation is proving to be particularly resilient, with labor-intensive services providers facing upward pressure on prices due to rising wage costs from strong union agreements. The broader trend suggests that services inflation will decline gradually over the next two years but remain above 3.5% in 2024 before easing towards 3% by the end of 2025. The slow pace of decline in core inflation, driven by services, is expected to keep it higher than the overall inflation rate for the near future.

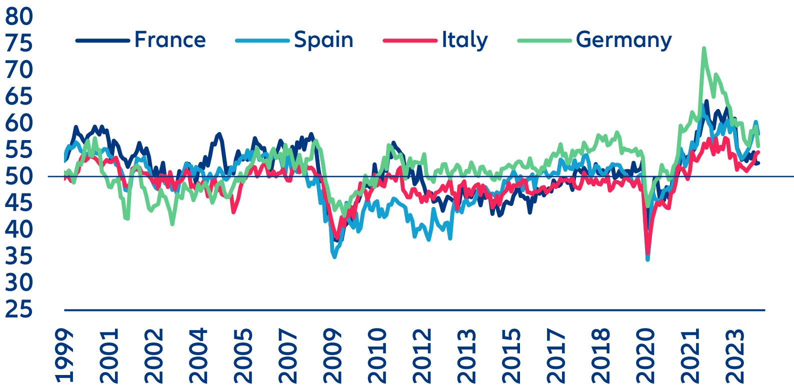
Figure 13: Nominal wage growth, quarterly y/y in %



Source: LSEG Datastream, Allianz Research

Increases in services prices will continue to explain two-thirds of inflation in France. Inflation in France came down more than expected in March to 2.3% (from 3.0% in February and compared to an expected 2.5%). Core inflation fell by -0.2pp to 2.1%, with goods inflation at 0.1% – the lowest level since 2021 – against 3% for services (-0.2pp). Food inflation fell significantly to 1.8% from 3.6% while energy inflation fell to 3.4% from 4.3%. The fall in gas prices and petroleum products was likely compensated by further rises in electricity prices. Looking ahead, we expect services inflation to slow down to 2.5% in July and plateau at those levels by year-end as wage growth remains below but close to 4% y/y. As of Q4 2023, unit labor costs were the second-largest upside driver for inflation after unit margins. These should contribute less to inflation as weak demand and high inventories continue to push many corporates in the manufacturing sector to reduce their price expectations. Advanced surveys suggest that all manufacturing sectors are either in disinflationary or deflationary phases (metals, chemicals, furniture), apart from the manufacturing of computer, electronic and optical products, which remains in the inflationary phase. In the services sector, most corporates still intend to increase prices further, mainly in areas such as food and accommodation and tourism-related services, telecommunications & information service activities, warehousing, land and air transportation. Overall, we expect inflation in France to average 2.2% in 2024 and 1.7% in 2025.

Figure 14: Services PMI, output prices (above 50 = rising prices)



Sources: Markit S&P, Allianz Research

Italy's inflation print for March remains among the lowest rates in the Eurozone, despite edging up to 1.3% y/y from 0.8% the month before. Italy's underlying price pressures are not different from the other economies. Strong negative base effects from energy prices continue to ease (-10.8% y/y from -17.8% in February), while services price growth remained quite stubborn at 3.0% y/y (from 2.9% a month earlier), with a +0.4% monthly gain. In particular, transport services' prices increased to 4.4% y/y from 3.8% in February. Although sticky services prices are still a concern, the sector's selling prices expectations, measured by the European Commission's ESI, also edged down in March (from a new record high in February since April 2023). Italy's lagging and "softer" wage growth should also help alleviate further pressures on the labor-intensive services sector. In contrast to the Eurozone's March trend, Italy's core inflation edged up to 2.4% from 2.3% y/y, reverting 12 consecutive months of improvements (from the 6.3% peak in February 2023). All in all, we expect services inflation to edge down only gradually and largely contribute to inflation this year (1.3pp), and food prices to remain above the 2% target for the entire year while energy and goods' prices drive the normalization path of inflation.

In Spain, we expect inflation to continue to moderate, in line with what has already been observed since the end of 2023. However, the gradual withdrawal of fiscal measures introduced by the government – such as VAT reductions on electricity, gas and food – will offset this underlying trend. We expect inflation to reach 3.1% in 2024, down from 3.5% in 2023. Note that services inflation should remain benign as we do not see pressure from rising wage costs. According to the Bank of Spain, available data from collective agreements show a reduction in the average wage increase agreed in collective agreements from 3.5% in December 2023 to 2.8% in January 2024.

Overall, the latest inflation data is in line with our long-held ECB call of rate cuts starting this summer. For the Eurozone aggregate, we continue to expect inflation at 2.4% for 2024 and 2.2% for 2025, with monthly inflation rates hovering between 2.0% and 2.5% until year end. The ECB has made it clear that there will not be any policy change before June. By then, they will have three more inflation prints and one quarterly wage data point at hand to confirm that disinflation continues to be on track.

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

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