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What to watch: ECB easing begins, taking stock of NGEU, no turbulence for the airline industry's bottom line

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Executive summary

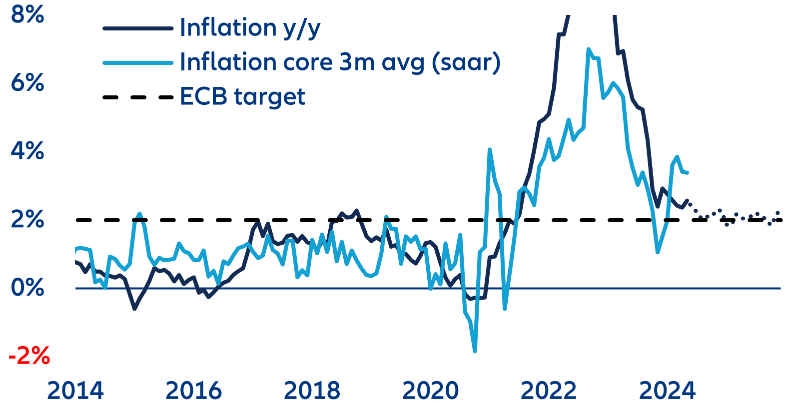
This week we look at three critical issues:

- **ECB: Kicking off a cautious easing cycle.** At the 6 June meeting, we expect the ECB to initiate a cautious easing cycle by lowering the deposit rate by 25bps to 3.75%, its first rate cut since the Covid-19 pandemic in 2020. This decision comes despite recent upside surprises in inflation and wage data, which will compel policymakers to take a hawkish tone, stressing data dependency and a meeting-by-meeting approach going forward. To not deviate too much from the Fed, which is expected to keep policy rates higher for longer, we maintain our long-held view of only two cuts in 2024 and a terminal rate of 2.5% to be reached in the course of 2025.
- **NGEU: The secret to Southern Europe's economic success?** At the halfway point for the disbursement window of the Next Generation EU (NGEU) funds, we find that Southern European countries have best managed to harness this European mane even if disbursements range from 24% in Spain to 52% in Italy. While Southern Europe has seen its economies boosted by booming tourism and country-specific fiscal support measures such as Italy's Superbonus tax credit, the NGEU funds may have contributed a significant amount to economic growth as well: In the case of Italy, as much as 2pp of cumulative growth over 2021-2023 can be attributed to NGEU, with a similar impact observed for Greece, and somewhat less for Spain and Portugal.
- **Airlines: All the way up.** Despite sticky services inflation and an economic slowdown, consumers continue to spend on travel. In 2023, 1.3bn people travelled internationally (+33% y/y), while in Q1 2024, international tourism reached more than 285mn travelers (97% of pre-pandemic levels). As airlines continue to face capacity constraints sparked by supply-chain disruptions, safety incidents and the retirement of old aircraft, air ticket prices are expected to remain high. Nevertheless, airlines expect demand to reach an all-time high this year, with global air passengers anticipated to rise by +10.4% y/y and passenger yields to strengthen by +3.2%. This should lead to revenue growth of +6.5% y/y (to USD967bn) and a net profit of USD30.5bn.

ECB: Kicking off a cautious easing cycle

The ECB is about to kick-off a cautious easing cycle with an initial 25bps cut. The ECB is set to ease its highly restrictive monetary policy by implementing the first rate cut since the Covid-19 pandemic in 2020. Having maintained the deposit rate at a record high for nine months, the ECB is expected to cut it by 25bps to 3.75% (MLF: 4.50%, MRO: 4.25%). Despite recent upside surprises in inflation and wages, the strong pre-commitment from various Governing Council members over recent weeks has made this move almost certain and it has been fully priced in by markets. However, the ECB will most certainly stress data dependence and a meeting-by-meeting approach going forward. With this initial cut, the ECB joins other European central banks in Switzerland, Sweden, the Czech Republic and Hungary, which have already started their easing cycles in recent months, showing that a transatlantic policy divergence is possible. Despite the easing of policy rates, the ECB's quantitative tightening will intensify, increasing from an average of EUR29bn per month over the past year to approximately EUR36bn per month. This acceleration follows last December's announcement that the ECB will reduce reinvestments in its EUR1.6trn PEPP program from July onwards, in addition to the ongoing passive run-off of the APP program, which as a result has already shrunk from its maximum of EUR3.3trn in 2022 to currently EUR2.9trn.

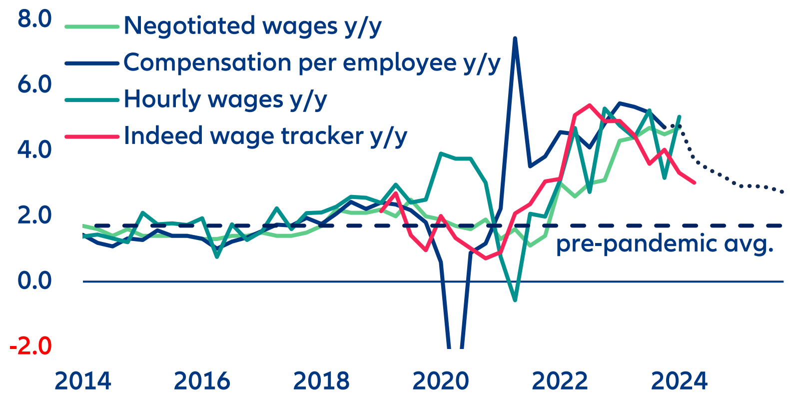
Figure 1: Eurozone headline inflation and sequential core inflation, in %



Sources: LSEG Datastream, Allianz Research.
Note: The dotted line shows Allianz Research forecast for headline inflation.

Updated staff projections will be watched closely as inflation and wage data surprised on the upside lately. The ECB will also release its quarterly update of staff projections for inflation and economic growth, which financial markets will scrutinize amid global economic and geopolitical uncertainties. Since the last update in March, conflicting new data make it uncertain how these forecasts will be adjusted. A key change is the significantly tighter monetary policy environment as staff estimates are based on market-based policy rate expectations. Whereas in March about five cuts were priced in for 2024, this has now shrunk to only two. This revision is likely to exert downward pressure on both inflation and growth forecasts. On the other hand, upside surprises in inflation and wage data as well as improving forward-looking indicators such as PMIs should mitigate these downward pressures. Headline inflation reaccelerated to 2.6% y/y in May, up from 2.4% in April. Stripping out base effects and volatile items, the three-month moving average core inflation stood at 3.4% annualized, which is clearly above the ECB's 2% target and significantly above the long-term pre-pandemic average of 1.1% (Figure 1). Core inflation is now largely driven by domestic price pressures in the services sector. These pressures may persist for several months, given that wages are still growing much faster than the long-term trend. The key measure of the ECB, compensation per employee for Q1, will only be published after the ECB meeting, but country-level data indicate a similar upside surprise as with negotiated wages two weeks ago, which jumped back to 4.7% y/y – the record high previously reached in Q3 last year. However, the best leading indicator for wages, the monthly Indeed wage tracker, decelerated to 3.0% y/y in April, the lowest reading since 2022 (Figure 2).

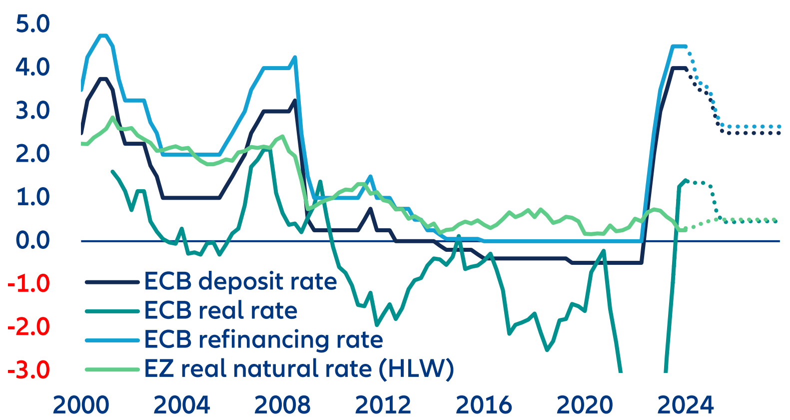
Figure 2: Eurozone wage indicators, in %



Sources: LSEG Datastream, Allianz Research.
Notes: The dotted line shows Allianz Research forecast for headline inflation. The dashed line shows the average growth rate of compensation per employee from 2010-2019.

We stick to our long-held view of two rate cuts in 2024 and a terminal rate of 2.5% to be reached in 2025. Given the latest upward surprises in inflation, the ECB will likely pause in July and deliver another rate cut in September. By then headline inflation will likely touch the inflation target of 2%, thanks to favorable base effects. After that, geopolitical uncertainty surrounding the US election, higher inflation rates given unfavorable base effects and the risk of increasing transatlantic policy divergence will force the ECB to postpone the rest of the easing cycle to Q1 2025. Continuous easing in 2025 with four more cuts will lead to a terminal rate of 2.5%, which assumes a real neutral rate of around 0.5% (Figure 3).

Figure 3: ECB policy rates nominal and real, in %

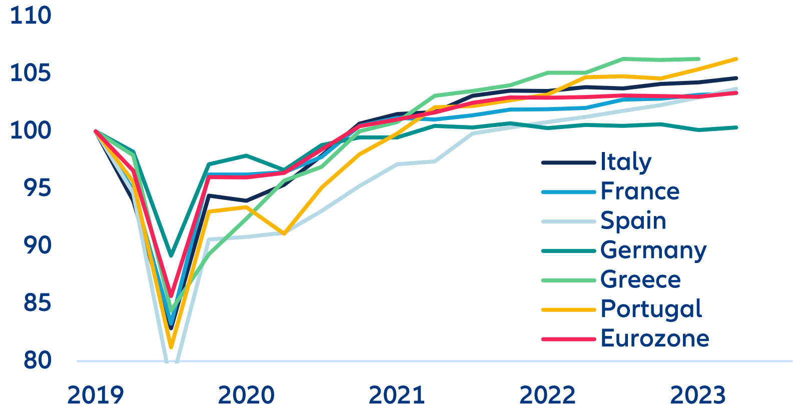


Sources: LSEG Datastream, Allianz Research.
Notes: The dotted line shows Allianz Research forecasts. The real rate is an approximation by subtracting current inflation in y/y terms from the deposit rate (refinancing rate before 2014). Note that from 18 September 2024, the ECB will lower the gap between the deposit and refinancing rates mechanically to 15bps.

NGEU: The secret to Southern Europe's economic success?

Southern European economies are outpacing the Eurozone average in terms of growth, boosted in part by booming tourism activity. At the end of the first quarter of 2024, economic activity in Italy, Spain, Portugal and Greece was between 3.7% and 6.3% above end-2019 levels (compared to 3.5% for the Eurozone overall), proving resilient against global challenges (Figure 4). In particular, the post-pandemic mechanical rebound has been augmented by tourism activity booming after the pandemic hit, along with some country-specific fiscal support measures (eg. Italy's Superbonus tax credit). Tourism contributes significantly to Mediterranean economies and accounts for a large share of their labor forces. Croatia records the highest share of direct gross value added from tourism to total gross value (11.3%), followed by Portugal (8.1%), Spain (6.9%) and Italy (6.2%). In comparison, the EU average is estimated at 4.5 %[1].

Figure 4: GDP (2019=100)



Sources: LSEG Datastream, Allianz Research

But these countries have also benefited from the significant economic impact of investments and reforms linked to the Next Generation EU funds (NGEU), available to European countries since 2021. At the halfway point of the disbursement window (2021-2026), beneficiary countries have made good progress on the implementation of NGEU. Italy has received more than 50% of the allocated funds, followed by Greece (42%) and Portugal (35%), while Spain lags quite behind, having received only 24% of the funds disbursed (Figure 5). Notably, disbursements slowed down in the first half of 2023 as countries were revising their national plans and including the RePower EU chapters[2] (under which an additional EUR60bn has been dedicated to speeding up the green transition), before resuming pace later in the year. The different absorption pace clearly helps in explaining part of the relative past performance. Given that at the EU level 65% of NGEU funds are still expected to flow in the coming quarters, some catch-up effects and positive spillovers should follow by 2026. Looking at the disbursements profile of Italy[3], the instrument is likely to have been responsible for between 1.5pp and 2.0pp of Italy's cumulative real growth over the period 2021-2023.[4]

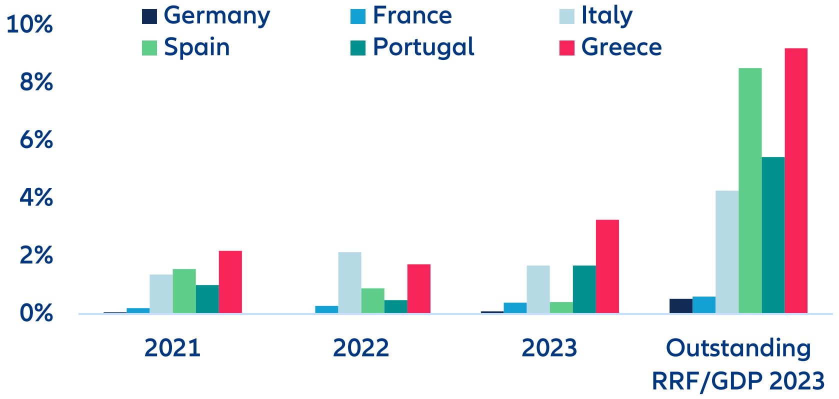
[1] *Tourism Satellite Accounts. Data missing for Greece.*

[2] *In March 2023, the amended RRF Regulation entered into force, requiring members states to introduce REPowerEU chapters in their RRFs. These include reforms and investment that will help save energy, contribute to renewable energy production and reduce dependency on Russian fossil fuels.*

[3] *Fourth report to Parliamenton the implementation status of the National Recovery and Resilience Plan*

[4] *This assumes 43% of the disbursed funds (totaling 5.2% of nominal GDP between 2021-2023) have been spent in the payment year and a fiscal multiplier between 0.7 and 1.1 in the best case scenario. The calculation also takes into account the cumulative GDP deflator of 10% in that period.*

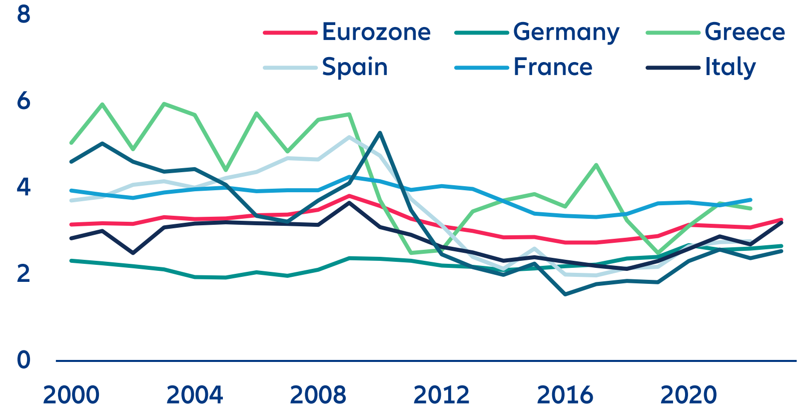
Figure 5: NGEU disbursements (% of GDP)



Sources: LSEG Datastream, European Commission, Allianz Research

Overall, European Commission estimates show that the NGEU has the potential to increase EU real GDP by up to 1.4% in 2026, in the range of other simulations done by the IMF and the ECB. In fostering economic convergence, the economic impact will be different across countries (i.e. it should reach around 4.5% in Greece in 2026). Also, estimates show that half of the increase in public investment between 2019 and 2025 has been financed by the EU budget, in particular the NGEU (Figure 6). Government investment is expected to increase further by 2025, from 3.3% of GDP in 2023, and is already 0.3% higher than in pre-pandemic times.

Figure 6: Public investment (% GDP)



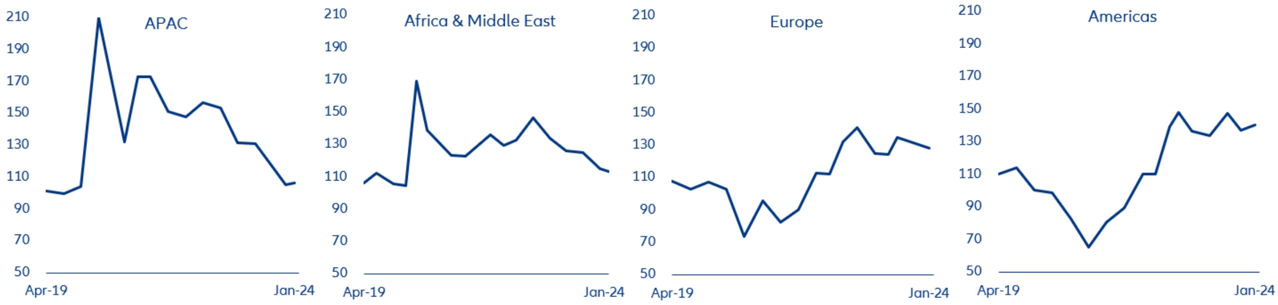
Sources: LSEG Datastream, Allianz Research

More importantly, and although to different degrees, the instrument seems to have been pivotal in revitalising long-delayed reforms vital to a longer-term sustained growth, much needed to gain competitiveness especially in the Southern European countries. The results-based design, linked to milestones and targets, helps in setting up a methodical planning and an efficient implementation. The success of the NGEU and the efficient and timely use of resources – linked to the fulfilment of country specific conditions – could give Europe a reason to establish or repeat central fiscal capacity, in this case by issuing EU common debt, to absorb common shocks or finance joint and urgent objectives (i.e. defence and the green transition).

Airlines: All the way up

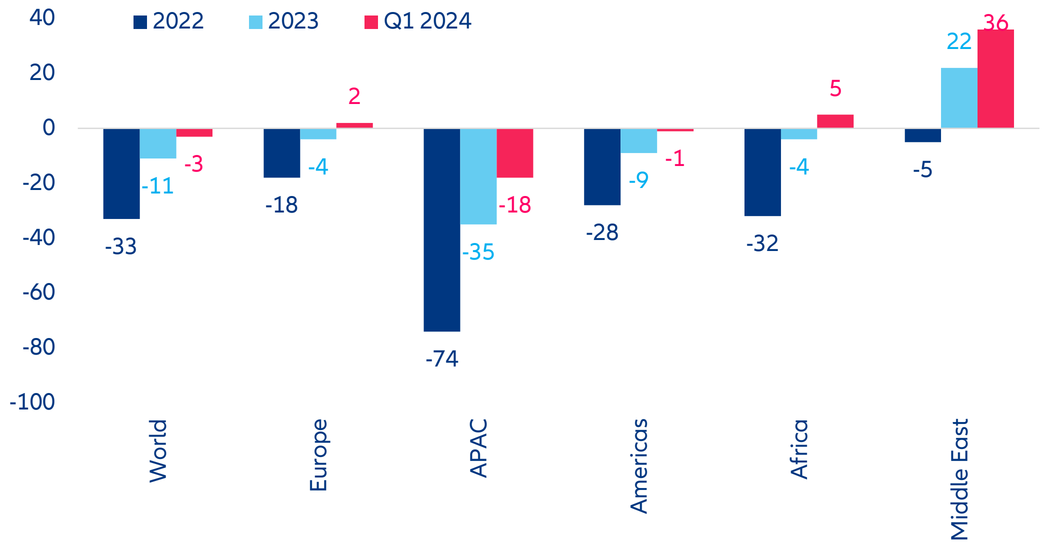
Travel has become the one thing consumers will not stop spending on. Unlike in past recessions, inflation and the economic slowdown have not deterred consumers from spending on tourism. In fact, demand for hospitality and transportation services continues to grow in all regions despite the fact that Revenue per Available Room (RevPAR) and airline ticket prices remain high (Figure 7), making it harder to moderate services inflation on both sides of the Atlantic. While global GDP grew only by +3.2% in 2023, 1.3bn people traveled internationally last year, a y/y increase of +33%. According to the World Tourism Organization (UN Tourism), in the first quarter of 2024, international tourism reached more than 285mn travelers, +20% more than in Q1 2023, and representing 97% of pre-pandemic levels (Q1 2019), with Europe, Africa and the Middle East already surpassing 2019 volumes (Figure 8). This suggests that travel is increasingly being considered a 'staple' in household budgets, with consumers willing to pay a higher price for the experience, undeterred even by recent safety incidents. Trends such as the rise of working from home – which was expected to curb business travel – and the flight-shame movement have also not dented the demand for travel, though domestic travel traffic bounced back to pre-pandemic levels quicker than international travel. This year, the volume of global air passengers, is expected to hit an all-time high (+10.4% y/y), with Asia-Pacific and North America in the lead (Figure 3), while Africa and Latin America lag behind.

Figure 7: Airfare price changes between Q1 2019 and Q1 2024, by region



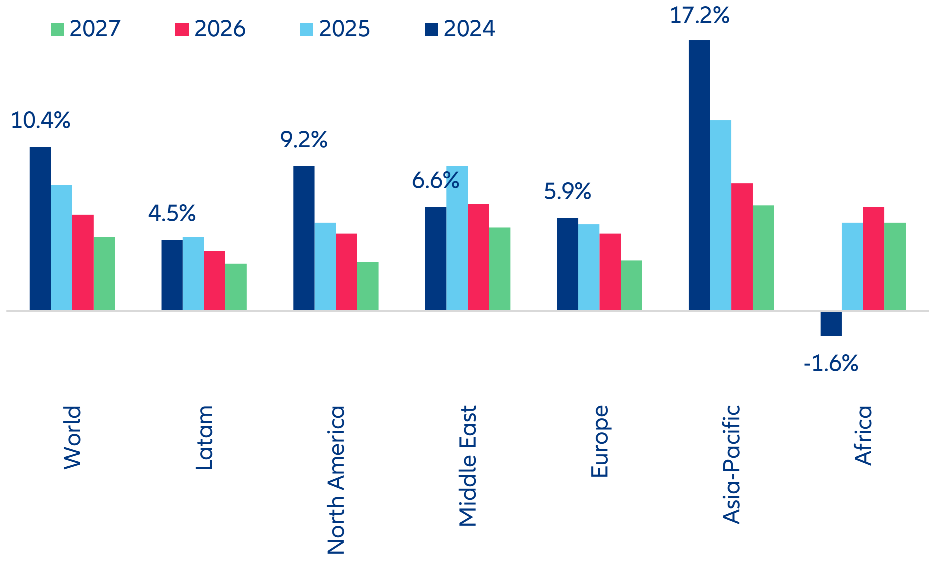
Sources: Reuters, ForwardKeys, Allianz Research. Average fares were indexed (Q1 2019 = 100)

Figure 8: International tourist arrivals, % change over 2019



Sources: UN World Tourism Organization, Allianz Research

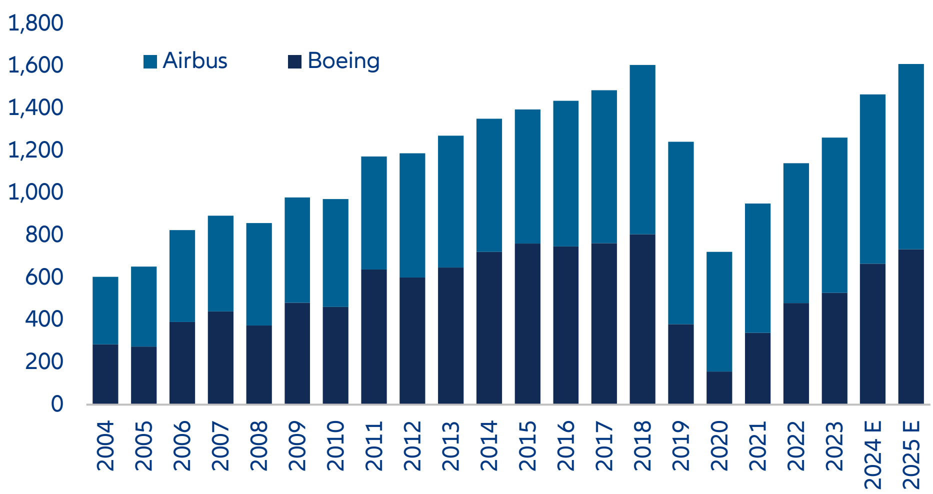
Figure 9: Regional and global y/y growth rates for air passengers



Sources: IATA, Allianz Research

As long as airlines continue to face a supply shortage, air ticket prices will remain high. Several factors have been putting pressure on airline capacity, the most significant being the shortage of aircrafts that started with the pandemic's supply-chain bottlenecks. This has been exacerbated by Boeing's recent safety issues, which have prompted the company to slow down manufacturing capacity to improve production quality (Figure 4). In parallel, with the clock ticking on reducing carbon emissions and building a more energy-efficient fleet, companies have begun to get rid of old aircraft, which has significantly reduced the sector's capacity. The average age at which planes are retired from the market has gone from 27 years before the pandemic to 23 years in 2023. As a result, capacity growth has been and will continue to be constrained in the short-term, not reaching even the pre-Covid high until 2025.

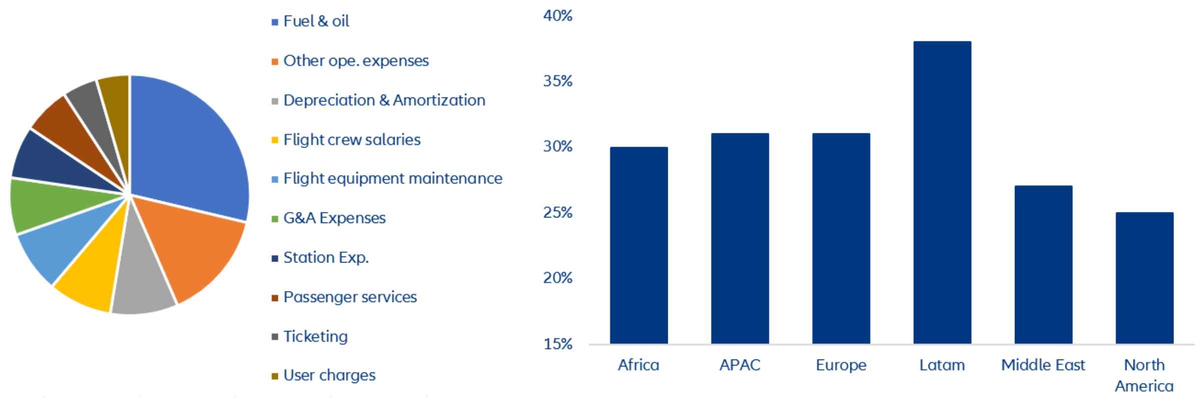
Figure 10: Commercial aircraft deliveries, units



Sources: Bloomberg, Allianz Research

In this context, the aviation industry is the only sector whose recovery shows no sign of slowing down despite the weakened global economic outlook. Passenger yields, i.e. the average amount paid by a passenger to fly one kilometer (revenue per RPK), are expected to strengthen by +3.2% y/y this year, setting the stage for overall revenue growth of around +6.5% y/y, totaling USD967bn (from USD838bn in 2019). With higher traffic anticipated this year, labor costs under control and the jet fuel crack spread expected to narrow, the International Air Transport Association (IATA) raised the industry's net profit forecast for 2024 to USD30.5bn from an already upwardly revised USD27.4bn in 2023. This was already +3.9% higher than the 2019 level. However, profitability will not look the same across regions, due to geopolitics. Aircraft fuel oil is the biggest operating cost for airlines (Figure 11) and although jet prices have remained moderated year to date, this input cost is one of the most volatile since supply and therefore prices are conditional on geopolitical matters and regional capacity. Figure 12 shows that fueling costs change significantly from one region to another, with Latin American airlines being more exposed to kerosene price changes.

Figure 11 & 12: Airlines' costs breakdown (left) and aircraft fuel & oil cost weight by region (right)



Sources: IATA, Bloomberg, Allianz Research

All in all, with still-high demand and capacity constraints, the summer 2024 holiday season will be more expensive than usual. The northern hemisphere should see strong demand benefiting all tourism-linked industries, from hotels and restaurants to transportation, leisure and consumer services businesses. In fact, the latest data for the UN Tourism Confidence Index (which goes from 0 to 200) show a positive score of 130 for the period May-August 2024, beating the sentiment at the beginning of the year. Europe in particular should benefit as it will host two major sporting events, the Paris Olympics and the UEFA Euro. As the appetite for travel has proven to be stronger than ever, consumers are likely to overcome elevated prices by travelling closer to home, opting for destinations where the exchange rate is very favorable to theirs or by shortening their holidays, but they are very unlikely to cancel their travel plans.

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