Danske Bank

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Research euro area

Southern Europe to continue outperforming

- Southern Europe have witnessed strong growth in the previous years while Germany and France have struggled to recover following the pandemic. Southern countries benefit from larger service sector and lower energy price increases.
- We expect southern economies to continue outperforming as they benefit from strong services demand due to rising real incomes and strong labour markets.
- The strong macroeconomic performance has been reflected in upgrades of credit ratings as well as a very solid relative performance in the Spanish, Portuguese and Greek government bond markets. We expect continued outperformance and that the 10Y spread between France and Spain will converge to 0bp (see page 2&3).

Larger service sector and lower energy costs benefits Southern

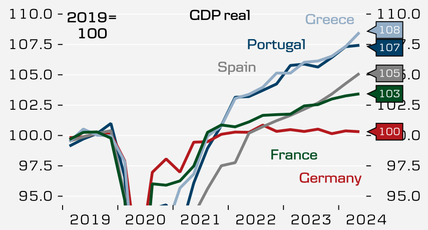
The Southern European countries have witnessed strong growth in the previous years while the traditional euro growth engines in Germany and France have struggled to recover following the pandemic. **In the second quarter of 2024 German real GDP growth was at the same level as in 2019 while Greece and Portugal had managed to grow 8% and 7%**. Most recent quarterly growth in 2024H1 has averaged 0.9% q/q in Greece, 0.8% q/q in Spain, and 0.5% q/q in Portugal while German and French growth has averaged 0.1% q/q and 0.2% q/q, respectively.

Southern European countries have benefited from a relatively larger service sector. As the service sector has been the main growth driver post-covid, this has created wedge between the South and the rest of the euro area. In Greece the service sectors accounts for 78% of the economy, in Spain 75% and Portugal 77% respectively compared to 69% in Germany. Manufacturing production in all countries except Greece is below pre-covid levels, and activity has been particularly weak in Germany and Portugal.

Another explanation for the growth divergence is differences in energy price developments. Energy price increases have been more muted in Southern Europe compared to Germany and France as the southern countries have been less reliant on Russian gas due to supply from Africa and relatively more renewable energy sources. Average electricity prices for companies in Germany and France rose by 150% and 140%, respectively, in the period 2022-2023 compared to 2019, while companies in Spain and Portugal only saw a 30% and 90% increase, respectively, in the same period.

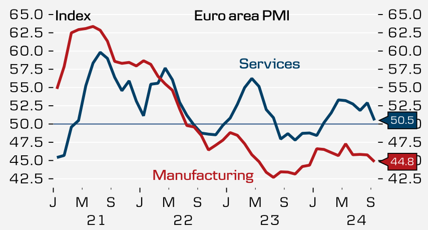
While companies in Portugal have witnessed smaller increases in energy prices compared to German competitors, production is still almost as weak. The Portuguese economy has a significantly faster pass-through of monetary policy rates to corporate and household loan rates compared to Germany, which has countered the impact of lower energy prices. In Greece, the economy has both a high pass-through of monetary policy rates and experienced a large increase in energy prices. **Despite this, manufacturing production is 25% higher compared to pre-covid thanks to a broad-based increase across sectors.** In fact, demand for labour in the industry is so high that the government has allowed companies to extend the working week to 6 days to cope with labour shortages

Growth since covid strongest in Southern Europe



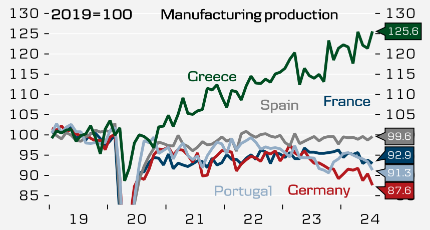
Source: Eurostat, Macrobond Financial

Service sector drives growth benefitting Southern economies



Source: S&P Global, Macrobond

Manufacturing production weak in all countries except Greece



Source: Eurostat, Macrobond Financial Bank

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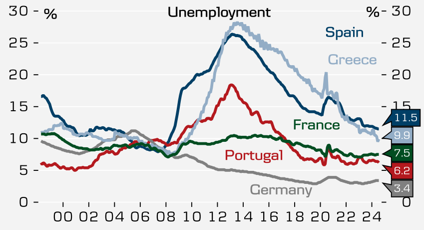
Strong labour markets to support growth

Labour market developments have been quite similar in all economies, currently experiencing record-low unemployment rates. While the unemployment rate has now stabilized in most euro area countries, it keeps declining in Greece due to high labour demand but have increased in Germany due to layoffs in the manufacturing sector. We expect the labour markets in all economies to remain strong as labour demand is high although it has come down somewhat. As real incomes are also rising significantly across countries, private consumption should support growth the coming year. For the manufacturing sector, we expect weak performance near-term and then foresee only a gradual rebound next year as financial conditions ease and the decline in energy costs feed through. **With the muted outlook for the manufacturing sector, we expect the outperformance of growth in Southern Europe to persist in the coming years.**

Strong labour markets to support growth the coming year



Source: Eurostat, Macrobond Financial

Growth outperformance expected to continue in Southern Europe

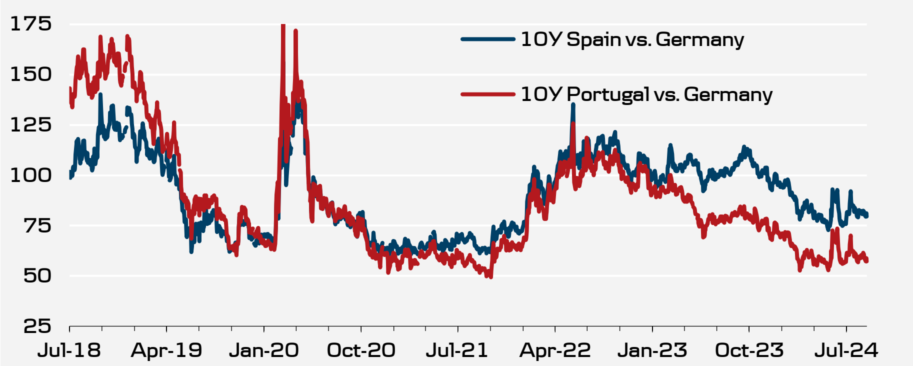
	2024	2025	2026
Gross domesic product (%y/y)			
Spain	2.6	2	1.7
Greece	1.9	2.0	2.0
Portugal	1.8	1.9	1.9
France	1.1	1.1	1.3
German	0.1	1	1.3

Source: Bloomberg consensus expectations

Peripheral government bonds supported by strong macro

The strong macroeconomic performance has been very supportive for the peripheral government bond markets, where Portugal, Spain, Greece and Italy all have made strong comebacks relative to peers. The "classic" spread between 10Y Portugal, Greece and Spain relative to Germany has tightened significantly after ECB ended reinvestments from PSPP and most recently scaled down on the reinvestments from PEPP as shown in the chart below. Hence, we are back to the levels in 2020-2021, where ECB was buying a lot of bonds through PSPP and PEPP.

Tighter spreads between the periphery and core-EU



Note: Past performance is not a reliable indicator of current or future results

Source: Danske Bank.

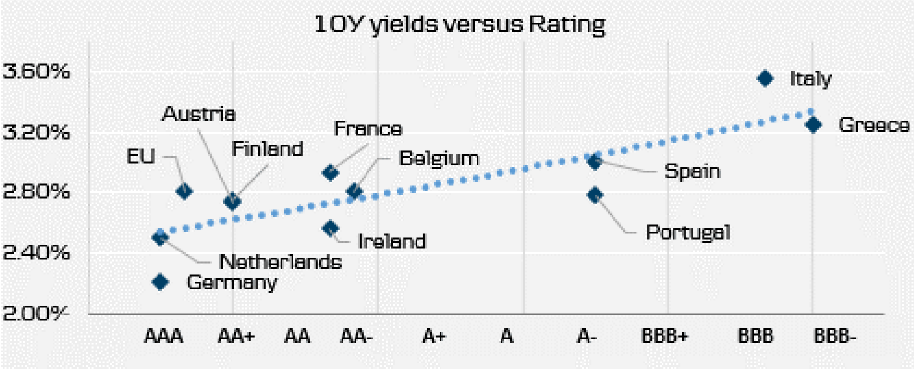
Positive rating cycle in Spain, Portugal, and France

The strong performance in the fixed income markets and the economy has led to positive rating cycle, where Portugal has been upgraded from below investment grade in 2014 to now a single-A rating. Spain has gone from BBB- to a single-A rating, while Greece has gone from a CCC-rating in 2015 to now being investment grade BBB. The upgrades are important as they reduce the risk of the countries being excluded from the various bond indices, where you need to have at least one or two investment grade ratings. If a country gets downgraded to junk as in the case with Greece, they are no longer eligible with ECB for collateral and needs a special exemption. For private investors, the higher rating is also important for collateral purposes, and it broadens the investor base when a country gets upgraded from the BBB-level towards the Single-A and AA-ratings. **Hence, the rating is important not only for the pricing but also for regulatory reasons.**

Room for further upgrades in peripheral ratings

Given that Portugal, Greece, and Spain are on positive outlook by various rating agencies, there is room for more convergence. In the chart below we look at the rating versus the level for the 10Y government bond yield. Portugal is almost priced as an 'AA-' rated country, but with a significantly lower rating, leaving room for a rating upgrade. In Spain, there is still room for more performance, and we expect a converge to France and thus a spread of 0 bp. Finally, in Greece there is also room for more convergence in yield-spreads as it gets upgraded.

The 10Y yield versus the rating



Note: Past performance is not a reliable indicator of current or future results

Source: Danske Bank.

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None

Date of first publication

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