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Increased bond market tensions likely to weigh on eurozone growth

Eurozone growth likely remained solid in the third quarter, but higher energy prices, rising long-term interest rates and sovereign bond tensions will weigh on activity. Inflation is still too high, pointing to another ECB rate hike, although quantitative tightening could be halted



Higher energy and borrowing costs continue to weigh on the eurozone economic outlook

October is the cruellest month

October is budget season in Europe, when cash-strapped member states must show they can put their finances in order. France's minority government has proposed a budget that curbs expenditure growth but would still fail to stabilise the debt ratio next year. With presidential elections due in April and May 2027 and street protests mounting, few parties are willing to back austerity. We still expect the government to invoke Article 49.3 to pass the budget without parliamentary approval, but tensions may rise first.

As for the rest of the eurozone, contagion has already widened bond spreads in other highly indebted member states, tightening eurozone financial conditions. This will increase pressure on governments to adopt austerity measures, resulting in a less accommodative fiscal stance in 2027.

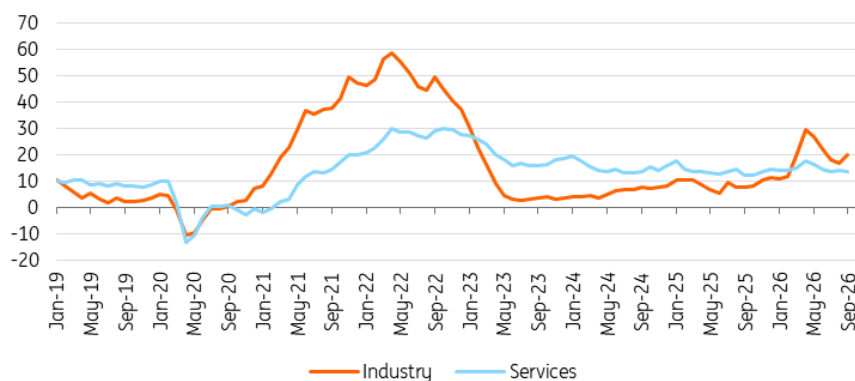
Growth likely to slow temporarily

Energy prices remain relatively high, while wage growth is failing to keep pace with inflation. Households drew on savings in the second quarter and may need to do so again to support spending. Yet signs of a weakening labour market and renewed falls in consumer confidence point to softer consumption growth in the coming quarters.

Residential construction may also gradually feel the impact of higher bond yields. Business sentiment suggests GDP growth remained moderate in the third quarter, but strengthening headwinds are likely to weaken the fourth quarter and the first quarter of next year. Following a very strong second quarter, artificially boosted by Irish GDP figures, we now expect average growth of 1.0% in 2026. Assuming energy prices normalise in 2027, growth should average 1.2% next year.

Second round effects remain more moderate than in 2022-23

Survey on selling price expectations



Source: LSEG Datastream

Second-round inflation effects remain moderate

The eurozone's harmonised index of consumer prices (HICP) inflation rose to 3.8% in September, with underlying inflation at 2.5%. Energy prices are likely to lift the headline rate further in the coming months, while food prices, which are highly sensitive to energy costs, are also trending higher. Inflation is therefore likely to end the year above 4%.

At the same time, second-round effects remain muted. They may still emerge, but we do not expect a repeat of the full-blown inflation wave of 2022-23. Business surveys show that selling-price expectations have risen less than they did four years ago, suggesting firms have less pricing power as consumers turn more cautious. We expect inflation to fall back to an average of 2.5% next year.

One last rate hike?

We still expect one more European Central Bank rate hike, although higher bond yields are already doing much of the ECB's work. Markets have moved towards our view, scaling back expectations from almost four increases to around one. Given the bond market unrest, we also expect the ECB to halt quantitative tightening before year-end, echoing earlier moves by the Federal Reserve and the Bank of England.

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