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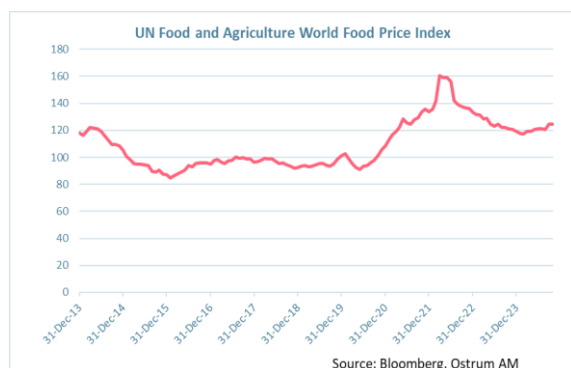
● **Topic of the week: The EU automotive sector in turmoil**
by Aline Goupil-Raguénès

- New car sales are sharply declining in the EU, and the outlook has significantly worsened. While cyclical factors are at play, structural factors are becoming increasingly significant;
- The automotive industry is undergoing its most significant structural transformation: by 2035, new cars must achieve carbon neutrality;
- EU manufacturers are lagging behind in the electric vehicle sector, particularly in terms of innovation;
- The EU is facing intensified competition from China, which has become the leader in this field. To protect itself from cheap Chinese imports, the EU has raised its customs tariffs;
- To remain a major player on the international stage, the automotive sector needs to quickly adapt to this new competitive environment. Mario Draghi's report specifically recommends developing a coordinated industrial action plan for the automotive industry at the EU level, covering all stages of the value chain.

● **Market review: ECB accelerates rate action**
by Axel Botte

- The ECB cuts rates by 25 bps as expected as Christine Lagarde paints a gloomy picture of euro area activity;
- US retail sales point to 3%+ GDP growth in the third quarter;
- Credit and sovereign spreads weather the rebound in risk-free bond yields;
- US stocks up on bank earnings, European earnings hit by China and semiconductor industry outlook.

● **Chart of the week**



The FAO Food Price Index (FFPI) is a measure of the monthly change in international prices of a basket of food commodities. It consists of the average of five commodity group price indices weighted by the average export shares of each of the groups over 2014-2016. Heavy rains and drought have taken a toll on crop yields in several regions of the world. Prices have also increased due to a recent pickup in fertilizer prices in the US. Tentative signs of an upturn in food prices must be monitored as regards the inflation outlook.

● **Figure of the week**

420

Global chip stocks erase \$420 billion in market capitalization after ASML sales warning. The magnitude of ASML forecast cut was a major surprise for investors.

Source: Bloomberg

- **Topic of the week**

The EU automotive sector in turmoil

The European Union's automotive sector is in crisis. Car sales are declining amid sluggish growth in the Eurozone and reduced demand from China, which is a significant market. Furthermore, the automotive industry is undergoing its greatest structural transformation. By 2035, new vehicles must be zero-emission. However, the EU is lagging in battery electric vehicles, particularly in terms of innovation. Additionally, it faces intensified competition from China, which has become the leader in this field.

Crisis in the European Union Automotive Sector

The automotive industry represents 6.1% of total employment in the EU and 8% of the value added in the manufacturing sector.

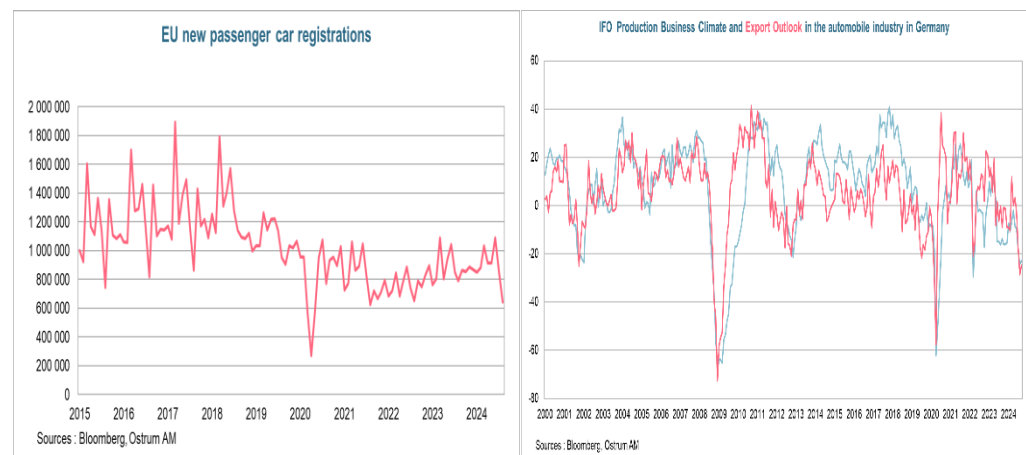
The automotive sector plays a significant role in the economy of the European Union. It is a major provider of employment, with 13.8 million direct and indirect jobs within the EU, accounting for 6.1% of total employment. The automotive industry contributes 8% to the value added of the EU's manufacturing sector. The sector is also an important source of demand for inputs from upstream industries, such as steel, chemicals, and textiles, as well as for downstream industries like information and communication technologies, repair, and mobility services. The weight of the automotive industry represents more than 10% of production in Slovakia, Romania, Sweden, the Czech Republic, Hungary, and Germany, and 7% in France, in particular.

It is the sector with the highest R&D expenditures.

The EU automotive sector has historically held a privileged international position. Among the 10 largest automotive companies in the world by revenue, 4 are headquartered in the EU. The EU single market has particularly allowed the sector to benefit from highly integrated European supply chains. It is also the sector with the highest R&D spending, which accounts for 15% of the value added in the automotive industry and one-third of the R&D expenditure in the EU industry.

New car sales contracted by nearly 20% year-on-year in August, and the outlook has significantly worsened.

The EU automotive sector is currently in crisis. Car sales are declining, as shown in the graph on the left. Registrations of new passenger vehicles contracted by 18.4% year-on-year in August. Significant declines were recorded in Germany (-27.8%), France (-24.3%), and Italy (-13.4%). Sales of battery electric vehicles dropped by 43.9% year-on-year, with dramatic declines in France (33.1%) and Germany (68.8%).



The outlook is not promising, as evidenced by the IFO business climate index for the German automotive sector (right graph). The business climate in the automotive sector has deteriorated sharply, reaching its lowest point since March 2022. This is largely related to the drop in export orders, which are at their lowest since April 2020. Announcements of "profit warnings" have increased, leading manufacturers to announce cost-cutting measures. Some major German manufacturers have even announced factory closures and layoffs in Germany. In light of the sharp decline in electric car sales, the European Automobile Manufacturers Association (ACEA) has called on European institutions to propose urgent measures before the new CO₂ targets for cars and vans come into effect in 2025. They also urged the European Commission to bring forward the CO₂ regulation reviews to 2025, instead of the currently scheduled 2026 and 2027.

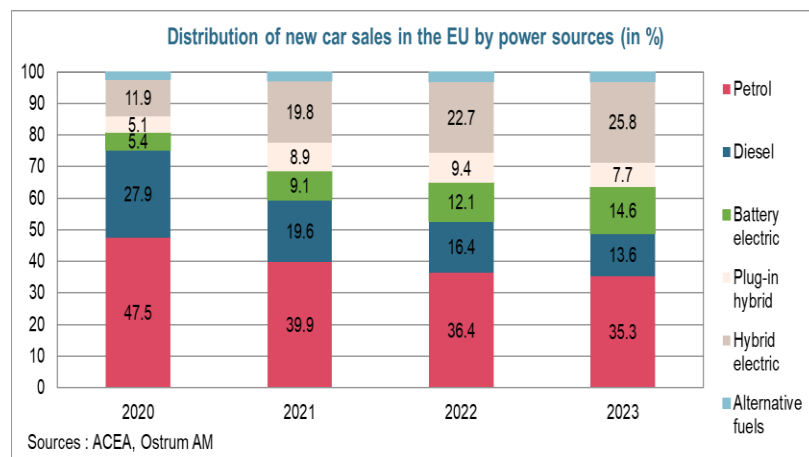
While cyclical factors are weighing on it, the automotive sector is also undergoing its greatest structural transformation.

The automotive sector is partly affected by cyclical factors related to sluggish household consumption, the slowdown in China, which is Germany's main market, and the impact of the significant monetary tightening by the ECB. Structural factors are also at play, such as lower productivity growth compared to the United States and higher energy costs in the EU compared to the U.S., since Russia's invasion of Ukraine. Furthermore, the automotive sector is undergoing its greatest structural transformation.

By 2035, new vehicles must be zero-emission

Electric car sales have nearly tripled since 2020 in the EU, but this remains insufficient compared to the established targets.

The EU has set a goal to achieve carbon neutrality by 2050 and aims for carbon neutrality for new cars by 2035 (this provision will be reviewed in 2026). Although electric car sales in the EU have nearly tripled since 2020, rising from 5.4% of new car sales to 14.6% in 2023, they are still insufficient compared to the established targets. Households currently prefer to shift towards hybrid car sales, which are less expensive than electric cars.



European manufacturers are lagging behind in the field of electric vehicles.

Electric cars are much simpler to assemble than combustion engine vehicles, leading to the emergence of new companies in the battery and technology sectors that have entered the market and even outpaced traditional European manufacturers. As a result, European manufacturers are lagging behind in the electric vehicle sector. Additionally, electric cars are more expensive than internal combustion vehicles, primarily due to the costs associated with

batteries. Cars are also becoming more connected, capable of exchanging information with other vehicles and their environment, and more autonomous. Vehicles are turning into "computers on wheels," increasingly integrating chips and software.

China has become a leader in the field of electric vehicles

Since 2009, China has created an incentive-driven environment (subsidies, research support, capital injection, etc.) to develop the electric vehicle industry. The primary reason for this initiative was to reduce its heavy reliance on oil imports, but it was also linked to the failure of its strategy regarding internal combustion vehicles.

China has moved upmarket and is competing with manufacturers from developed countries in the electric vehicle sector.

Additionally, it has a significant advantage in processing critical materials necessary for the energy transition.

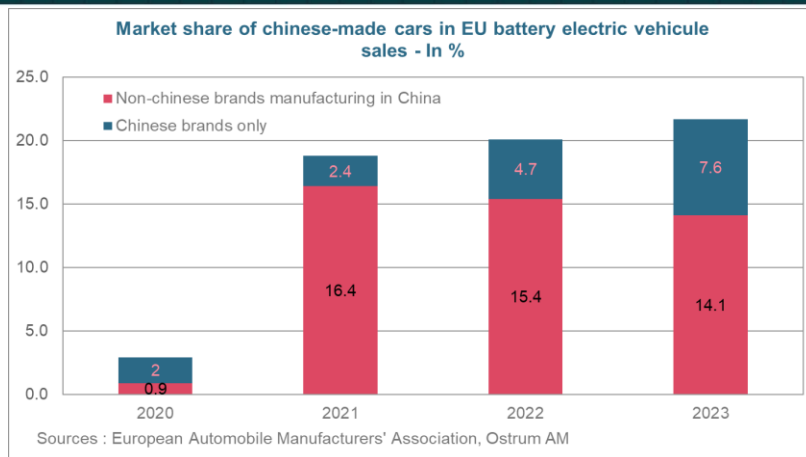
German manufacturers established in China are bearing the brunt of this competition.

China, being the largest market in the world for cars, has attracted foreign companies to establish themselves closer to demand (including German, American, and Japanese manufacturers). The development of the Chinese industry occurred through joint ventures, allowing China to benefit from technology transfers from foreign companies. Additionally, China has been ahead across the entire production chain. As a result, it has become the global leader in electric vehicles. It has specialized in entry-level and mid-range electric cars at unbeatable prices. Chinese labor is cheaper than in Europe, companies have received substantial subsidies, and China has a significant advantage in processing critical materials necessary for manufacturing electric batteries. The EU, on the other hand, is heavily dependent on a few suppliers in Asia, particularly in China, for the supply of semiconductors and batteries, which poses a risk, especially in the event of rising geopolitical tensions. China has thus moved upmarket and is competing with manufacturers from developed countries. Additionally, Chinese electric cars are proving to be superior to those of foreign competitors in terms of software and available options, and they better meet the demands of Chinese customers.

German manufacturers are particularly affected due to their strong presence in China, their main export market. While German automakers still hold 15% of the Chinese market, this is down from 25% before the pandemic, and their market share for electric vehicles is only 10%. Unlike some competitors who have chosen to withdraw, German manufacturers remain in China due to the massive investments made and the size of the Chinese market, which is still growing, in contrast to the saturated American market and the European market, which has likely peaked.

Sharp increase in imports of Chinese cars

Imports of cars from China have surged significantly (+40% between 2022 and 2023), accounting for 20% of total car imports in the EU. In just four years, China has become the leading supplier of electric vehicles to the EU by far. The market share of electric cars from China in EU electric vehicle sales has increased dramatically, rising from 2.9% in 2020 to 21.7% in 2023. However, the share of Chinese brands remains smaller: 7.6% in 2023, but showing strong growth (up from 2% in 2020).



China is making significant investments in production and transportation to increase its export capacity and put pressure on prices.

This trend is expected to intensify in the coming years. China is making significant investments in production and transportation to increase its export capacity. As a result, China has substantially increased orders for new ships to transport cars. Projections suggest an increase in the number of electric vehicles intended for export to 1.7 million per year by 2026, according to Rhodium. This can be compared to 2.5 million electric vehicles sold in the EU in 2023. The sharp rise in export volumes puts pressure on prices and affects the competitiveness of European manufacturers.

China's massive subsidies distort competition

The subsidies granted by Chinese authorities to the industry are much larger than those in other countries. According to the Center for Strategic and International Studies, the share of industrial policy measures as a percentage of GDP is four times higher in China than in Germany and the United States, among others. These massive subsidies have enabled Chinese companies to quickly move upmarket and directly compete with European producers in high-value-added products.

Increase in EU tariffs on imports of Chinese electric cars

This increased competition threatens European manufacturers, who are lagging in the development of electric vehicles, even though this is a crucial issue for enhancing the industry's productivity and competitiveness. In response, the European Commission launched an anti-subsidy investigation into Chinese electric vehicles in October 2023. The findings indicate that Chinese manufacturers benefit from unfair subsidies from Chinese authorities, posing a threat to the European industry.

The EU has increased its tariffs on Chinese electric vehicles, raising them from 10% to an average of 45%, due to unfair competition.

On October 4, 2024, EU members voted to implement additional tariffs on Chinese electric vehicles for a period of 5 years. The tariffs are, on average, raised to 45%, up from 10% previously. The increase in tariffs varies according to the manufacturers' brands and their level of cooperation with the investigation. Specifically, it is 35.3% for SAIC, 18.8% for Geely, 17% for BYD, 7.8% for Tesla, 20.7% for other producers who cooperated with the investigation, and 35.3% for those who did not cooperate. Nevertheless, China and the EU continue to work on an alternative solution to the tariffs, which could take the form of a complex mechanism for controlling prices and import volumes.

The risk for the EU is that of retaliatory measures from China. China has threatened to raise

Manufacturers fear retaliation from China. It has threatened to raise tariffs on imports of large-engine vehicles by 25%.

tariffs by 25% on large-engine vehicles, which would primarily affect German manufacturers. This is why Germany, along with Slovakia, Slovenia, Hungary, and Malta, voted against the tariff increase. Twelve countries abstained, including Spain, and ten countries voted in favor: France, Italy, the Netherlands, Ireland, Poland, Bulgaria, Latvia, Lithuania, Estonia, and Denmark.

China has little interest in adopting excessively strong retaliatory measures against the EU, as the EU is its largest export market. Furthermore, the United States and Canada have closed their markets to Chinese cars by imposing 100% tariffs on electric vehicle imports. For the moment, China has responded to the EU tariffs by adopting anti-dumping measures on imports of brandy (including Cognac), which primarily affects France.

Conclusion

Thanks to its move upmarket, facilitated notably by joint ventures with foreign manufacturers and massive state subsidies, China has become a leader in the battery electric vehicle market. It now competes with major EU manufacturers both on the European continent and within China, where European manufacturers, particularly Germany, are present. Chinese electric cars are highly competitive and offer superior performance in terms of software and available options. To protect its market and buy time to become competitive in this segment, especially in the entry-level and mid-range, the EU has raised its tariffs on imports of Chinese electric vehicles to 45%. To remain a major player on the international stage, the automotive sector needs to quickly adapt to this new competitive environment. The Draghi Report specifically recommends developing a coordinated EU-level industrial action plan for the automotive industry, covering all stages of the value chain. Massive investments are also needed, driven by the public sector, to finance important new projects of common European interest in highly innovative areas such as electric vehicles and to develop charging infrastructure.

Aline Goupil-Raguénès

- **Market review**

ECB accelerates rate action

Christine Lagarde highlights downside risks to economic activity, justifying a 25-basis point rate cut. Equity markets responded positively, buoyed by robust U.S. growth.

The European Central Bank (ECB) has stepped up its pace in line with market expectations, announcing a 25-basis point reduction in policy rates to 3.25%. This decision is primarily driven by concerns over a potential slowdown in euro area activity, coupled with inflation easing to 1.7% in September. The monetary easing serves as a catalyst for risk assets, further supported by favorable economic data from the United States and a glimmer of optimism from China at the end of Q3. Upward pressure on long-term bond yields have not adversely impacted sovereign or private credit spreads; There are nevertheless some signs of stress as gold surges past \$2,700 an ounce for the first time and yen weakness resumes, as the dollar-yen exchange rate approaches 150.

U.S. GDP growth likely exceeded 3% in the third quarter, with retail sales experiencing significant gains between July and September without negatively affecting the trade balance. Equipment investment remains robust, and employment has only moderately slowed. However, industrial production has been impacted by strikes at Boeing and two hurricanes. In the euro area, inflation has settled at 1.7% in September, thanks to declining energy prices, while service prices are up 3.9% year-on-year. In China, growth is slowly rebounding in Q3, registering a 0.9% quarterly increase (4.6% year-on-year), driven by improvements in industrial output and retail sales, although housing prices continue to decline.

The ECB's rate cut has led to increased receiving demand in swap markets, while the balance sheet reduction exerts upward pressure on bond yields. Swap spreads have narrowed to 20 basis points. The Bund has climbed above 2.20%, reflecting the ECB's stance and the rising U.S. yields, with the T-note moving beyond 4.10%. Speculation surrounding a potential Trump victory in November is driving equity flows at the expense of US Treasury securities. Meanwhile, the greenback remains strong amid concerns over widespread tariff increases.

The overall credit trend remains favorable. Sovereign spreads are tightening, particularly for Italian BTPs (120 basis points over Bunds), buoyed by fiscal consolidation efforts ahead of rating agency decisions on Friday. OATs are benefiting from this positive sentiment, despite Fitch's recent downgrade of France's outlook. Investment-grade credit is trading around 82 basis points over swaps, while high-yield bonds also show a positive trajectory. Strong bank earnings are pushing U.S. markets to new heights, with the S&P approaching 5,850 points. In Europe, exposure to China is weighing on luxury stocks, while the automotive sector rebounded last week, contrasting with ASML's disappointing outlook, which has negatively impacted tech shares.

Axel Botte

● Main market indicators

G4 Government Bonds	21-Oct-24	1 wk (bp)	1m (bp)	2024 (bp)
EUR Bunds 2y	2.18%	-8	-5	-23
EUR Bunds 10y	2.28%	+0	+7	+25
EUR Bunds 2s10s	9.5bp	+8	+12	+48
USD Treasuries 2y	4%	+5	+41	-25
USD Treasuries 10y	4.15%	+5	+41	+27
USD Treasuries 2s10s	14.4bp	+0	0	+52
GBP Gilt 10y	4.12%	-12	+22	+58
JPY JGB 10y	0.96%	+1	+8	-44
€ Sovereign Spreads (10y)	21-Oct-24	1 wk (bp)	1m (bp)	2024 (bp)
France	72bp	-4	-7	+19
Italy	121bp	-6	-12	-46
Spain	71bp	-3	-10	-25
Inflation Break-evens (10y)	21-Oct-24	1 wk (bp)	1m (bp)	2024 (bp)
EUR 10y Inflation Swap	2%	-5	+6	-13
USD 10y Inflation Swap	2.52%	-1	+14	+11
GBP 10y Inflation Swap	3.58%	-5	+11	+4
EUR Credit Indices	21-Oct-24	1 wk (bp)	1m (bp)	2024 (bp)
EUR Corporate Credit OAS	105bp	-4	-13	-33
EUR Agencies OAS	62bp	-3	-4	-8
EUR Securitized - Covered OAS	57bp	-3	-3	-21
EUR Pan-European High Yield OAS	347bp	-1	-22	-52
EUR/USD CDS Indices 5y	21-Oct-24	1 wk (bp)	1m (bp)	2024 (bp)
iTraxx IG	56bp	0	-3	-3
iTraxx Crossover	303bp	-1	-11	-11
CDX IG	52bp	0	-1	-5
CDX High Yield	324bp	-4	+13	-32
Emerging Markets	21-Oct-24	1 wk (bp)	1m (bp)	2024 (bp)
JPM EMBI Global Div. Spread	337bp	-14	-34	-47
Currencies	21-Oct-24	1wk (%)	1m (%)	2024 (%)
EUR/USD	\$1.085	-0.578	-2.385	-1.7
GBP/USD	\$1.302	-0.276	-2.428	2.3
USD/JPY	JPY 150	-0.247	-4.343	-6.1
Commodity Futures	21-Oct-24	-1 wk (\$)	-1m (\$)	2024 (%)
Crude Brent	\$74.4	-\$3.1	\$0.7	-0.9
Gold	\$2 738.5	\$89.9	\$109.8	32.7
Equity Market Indices	21-Oct-24	-1wk (%)	-1m (%)	2024 (%)
S&P 500	5 857	-0.05	2.71	22.8
EuroStoxx 50	4 960	-1.60	1.83	9.7
CAC 40	7 578	-0.32	1.04	0.5
Nikkei 225	38 955	-1.64	3.26	16.4
Shanghai Composite	3 268	-0.49	19.41	9.9
VIX - Implied Volatility Index	18.93	-3.91	17.21	52.0

Source: Bloomberg, Ostrum AM

Additional notes

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