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ECB Watch: time to take out that insurance rate cut

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Research

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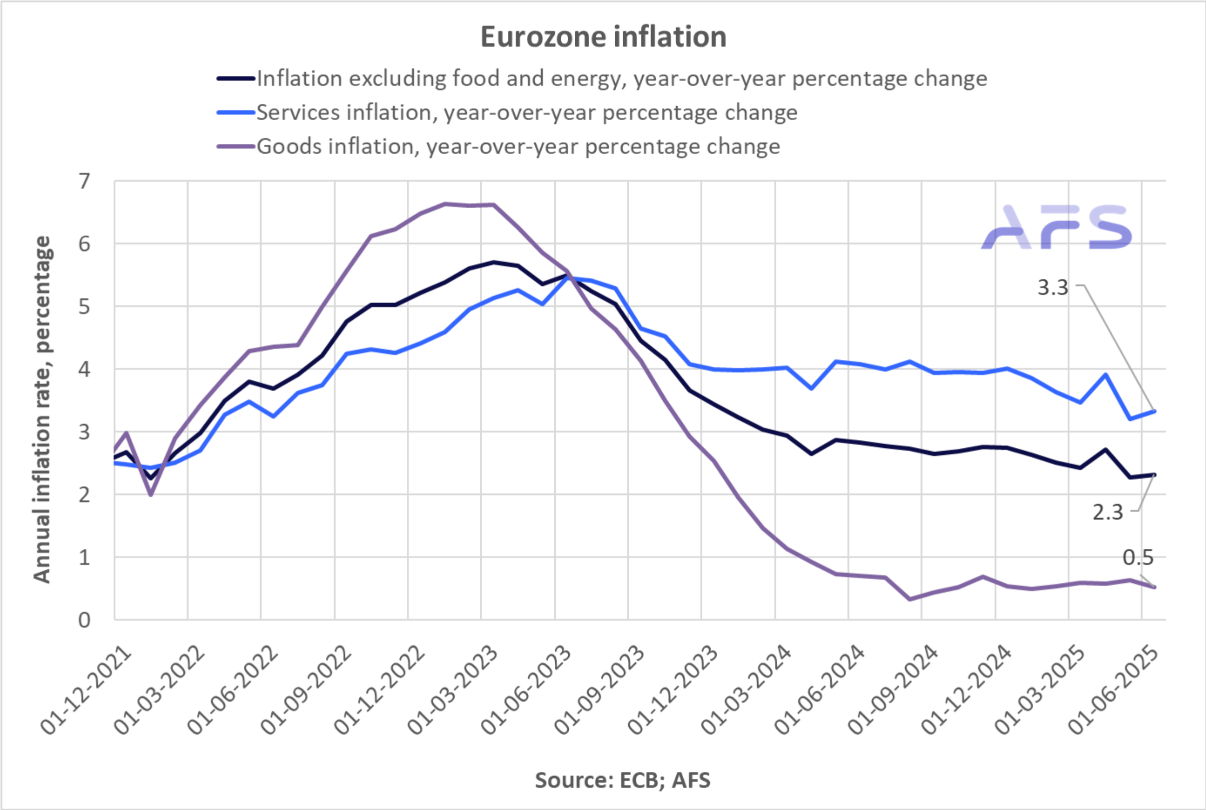
Just when I thought I was out…

- **… They pulled me back in.** That's the famous line uttered by Michael Corleone in the Godfather Part III. Which was so eloquently imitated in The Sopranos more than a decade later in the earlier 2000s. Yeah, those were the days.
- **The I-have-no-choice-I-must-get-back-to-the-nitty-gritty-business also applies to ECB interest rates.** You see, the ECB likes nice round numbers. That's the reason why the ECB cut the deposit rate to exactly two percent. And subsequently set the bar very high for further rate cuts (my own words in the June ECB post-mortem). Our central bank overlords in Frankfurt thought they were done cutting rates for some time. Could finally sit down, lean back, and relax.
- **Now I call for another 25bps cut, namely at the September meeting. I changed my mind because the facts changed, right**? Actually, no. The facts haven't changed, and that's exactly the problem. As I explain further down below, there is no end in sight for the sclerotic conditions the Eurozone economy is experiencing.
- **A rate cut taking the ECB deposit rate below two percent has long since been priced in**. So, what's the fuzz about an analyst embracing market pricing? It just confirms that analysts are a lagging indicator, right? Maybe, but my thinking is bit more complicated.
- **If the ECB delivers on rate cut pricing, then market should price in another cut.** ESTR (forward) rates should reflect the ECB's dovish bias, which is not written down in the Governing Council statement, by the way. Instead, it's best captured by a remark made by the Belgian central bank chief Pierre Wunsch. Here's the money shot dated July 3:

  > Wunsch, referring to ESTR forwards: *"I don't want to reinforce these expectations, but I don't feel uncomfortable about it either."*

  Note that Croatian central bank chief Vujcic remarkably espoused the same views on forwards as Wunsch a week later.
- **I think Wunsch's view on forwards is more than plain-old benign neglect**. Given the outlook for the Eurozone economy (yes, more on that below), if the deposit rate was at 1.75 percent, he would be just as fine with an inverted forward curve. More importantly, when the market believes the ECB is indeed done cutting rates, the inversion in the forward curve being priced out would almost certainly put more pressure on the long end. Which the ECB, with a view on fiscal sustainability, will certainly not welcome.

- **Now, the ECB doesn't target (nominal) economic growth, it targets two percent inflation.** But with the risks for both growth and inflation to the downside compared to the June forecasts, the rapid appreciation of the euro (which has become too much of a good thing), the ECB better take out insurance with another 25bps cut in September. Yes, September and not July. After reading the tea leaves – ECB-speak that is – one can only conclude that the doves aren't pushing for a move this month anyway. July will be a 'taking stocking meeting.' So, a complete non-event.
- **If the ECB cuts again in September, Lagarde & Co will definitely stick with their max-optionality approach**. Rates can move (or not move) in any direction. But the implicit bias towards another cut will stay. The problems of meagre growth, trade tensions, and too much disinflation will not be solved with a 25bps cut. Markets will duly price in another cut, which most ECB-speakers wouldn't mind given the circumstances.
- **So, what about raison d'etre of another cut – the economic data?** Can we find any excuses for the ECB to cut rates? A smoking gun perhaps? No smoking guns, but circumstantial evidence instead.
- **Here's the annual percentage change in core inflation, services inflation, and non-energy goods inflation**. Underlying inflation has finally started to drop very close to target on the back of easing services inflation:

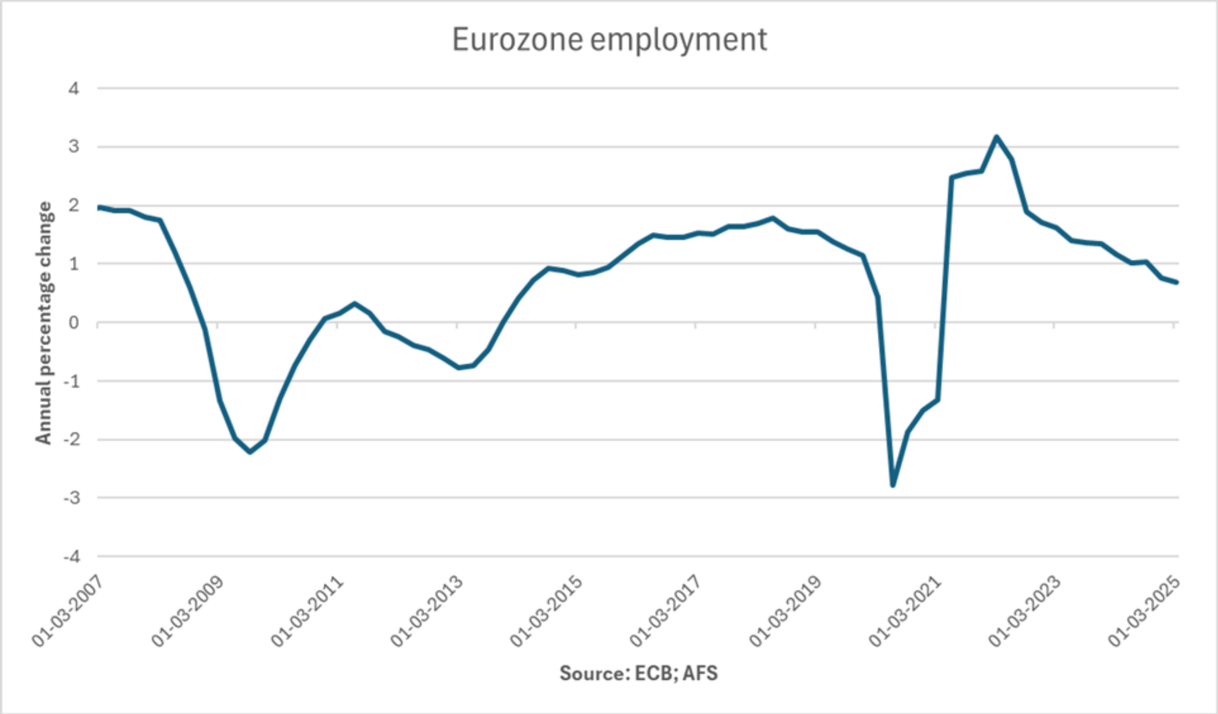


- **When the detailed inflation figures are finally published later this month, I can perhaps massage core inflation lower by taking out those erratic package holidays and perhaps administered prices (which I prefer to keep in).** In any case, the ECB in its baseline forecasts has penciled in 2.4 core inflation this year and 1.9 percent in 2016. According to the ECB's own models, euro exchange rate appreciation can shave off a few tenths from these forecasts.

- **When I cross-reference inflation data with business survey data on prices, the same familiar dichotomy between the manufacturing sector and services sector emerges**. According to the June PMI, manufacturers' input and output prices fell further in June, while the opposite was the case in the services sector. Tariffs now represent a deflationary shock to manufacturers, thus worsening the outlook for prices.
- **At the same time, expectations for price increases in the larger services sector remain above their long-term average**. However, the net percentage of firms expecting prices to increase fell to its lowest level since the pandemic last month according to the EU Commission's own monthly business survey:

Which is good news for the doves on the Governing Council, who are now clearly pushing for another cut as per recent ECB-speak.

- **On the economic growth side of things, the situation can best be described as ongoing sclerosis**. Better said: eurosclerosis. Since 2023 growth has been very meagre and with little hopes for improvement. Fiscal expansion is on the horizon, but isn't that offset by the drag from trade?
- **I find the decline in employment growth particularly worrying.** Here is the annual percentage change in employment according to the quarterly national accounts. Yes, the Eurozone continues to lack timely employment data:



- **With the unfriendly trend in employment, the ECB's hopes of GDP growth picking up this year rest on a recovery in productivity growth to 0.4 percent while it was negative last year**. I'd say: good luck with that.
- **Finally, when I take the pulse of the economy by using regression analysis on the PMIs, I arrive at measly quarterly growth rates of barely a tenth of a percent**. Though perhaps the PMIs understate activity somewhat.
- **To conclude, with underlying inflation slowing further and expected to drop below two percent, I expect the doves to take the lead as their long-standing frustration about the economy mounts.** I expect that the doves will convince the moderates, who are still sitting on the fence, to join them in supporting a cut at the September meeting. That will be a resumption of cuts, or a continuation depending on your view.