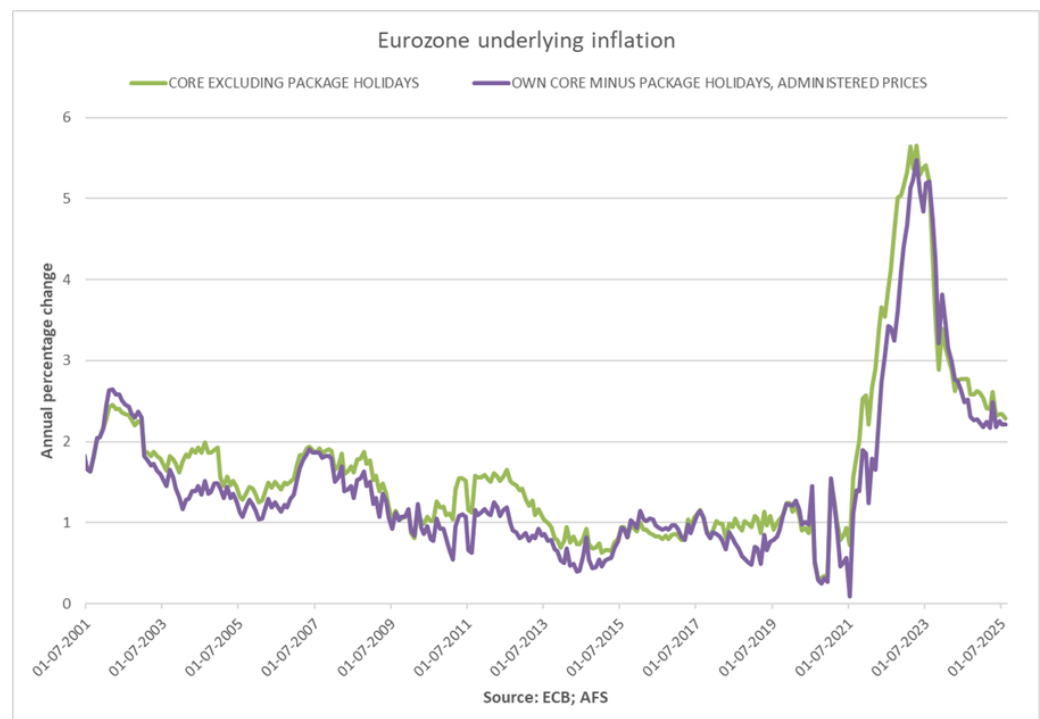


Research

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Yes, with stockings and all, knee-deep in s***

- **They say low expectations are the key to happiness.** Or in a similar vein: setting the bar low and then claiming success. Both apply to the ECB. President Lagarde and our other central bank overlords in Frankfurt pride themselves on getting inflation down without triggering a recession. And having exited the nightmarish world of negative nominal interest rates and seemingly endless bond buying without a market meltdown. But that's another matter. In any case, I take a more measured view of the ECB's successes on growth and inflation.
- **Take inflation.** I look at core inflation excluding package holidays, which are infamously volatile and completely useless for gauging the underlying trend in prices. Sometimes I also exclude government administered prices, which one could argue do not have such a direct relationship with the business cycle. If I am honest, I am on the fence with regards to including or excluding administered prices. So, let's do both. Here's a chart showing my two measures of core inflation:

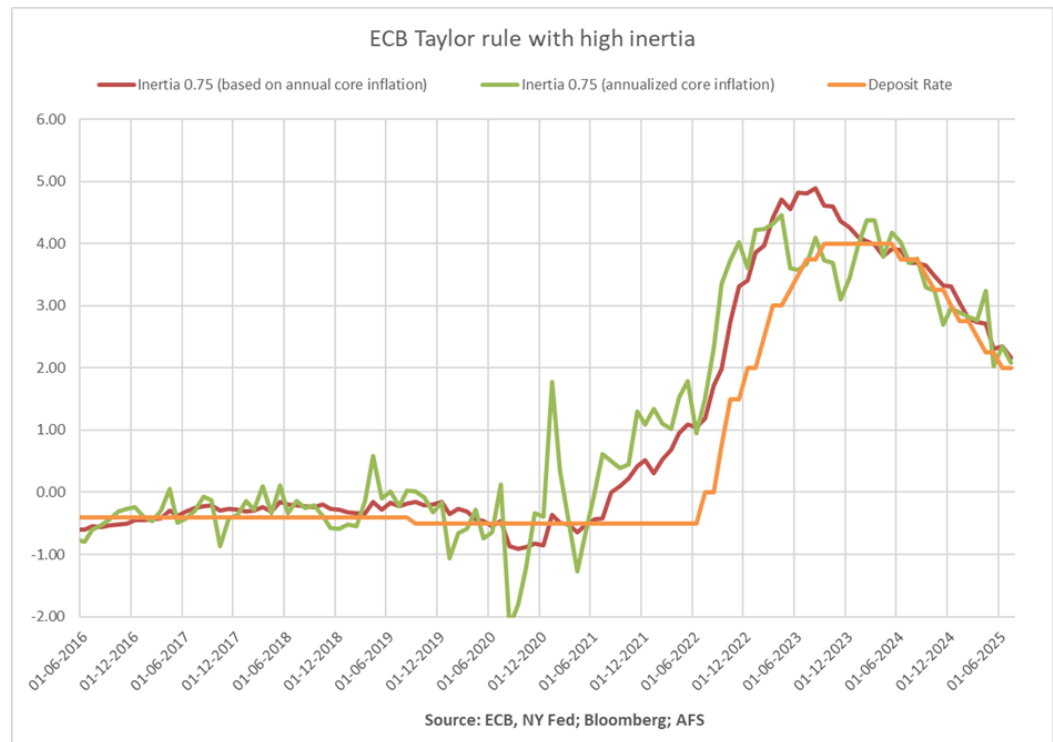


- **When administered prices are excluded too, underlying inflation bottomed out at 2.2 percent in January and has been moving sideways ever since.** When administered prices are included, the optical pattern appears to be one of falling inflation. But a closer look at the data in the table below (apologies for the many decimals) shows that core excluding only package holidays has been unchanged at 2.3 percent since last May:

Column	CORE EXCLUDING PACKAGE HOLIDAYS	OWN CORE MINUS PACKAGE HOLIDAYS, ADMINISTERED PI
30-09-2024	2.581693984	2.304198389
31-10-2024	2.585823922	2.268008102
30-11-2024	2.626411083	2.277792146
31-12-2024	2.596873571	2.232602893
31-01-2025	2.541116097	2.177584748
28-02-2025	2.414004366	2.245407752
31-03-2025	2.398795283	2.172530752
30-04-2025	2.611671463	2.482467779
31-05-2025	2.313086802	2.181948531
30-06-2025	2.341694123	2.250872495
31-07-2025	2.337670957	2.213352758
31-08-2025	2.288013983	2.209301815

- **Now, any sane person will point out that the central bank cannot micro-manage inflation by two or three decimals.** And let's not forget about measuring errors – we're talking about man-made consumer price baskets, not physics. True indeed. In any case, the ECB did what most people expected it would do: hit its target from above. Meaning that inflation would likely end up modestly above target.
- **The problem with hitting your target from above is that it's hard to cut interest rates further to, say, boost demand.** Because this is where the ECB has 'failed': demand. Now, demand – economic growth to you and me – is not the ECB's primary target. But it matters a lot, suffice to say.
- **The quarterly rate of annual real GDP growth excluding Ireland averaged¹ 0.85 percent in the past year and a half.** Growth was of the 'wrong kind' in the sense that employment growth was about equal to real GDP growth. Put differently, there was no productivity growth at all. Granted, my employment measure – persons instead of hours works – is less precise. Still, there's no getting away from the fact that there's barely any productivity growth. If you thought that the 2010s were bad for the Euro Area because of low growth rates for both GDP and labor productivity, this decade is even worse.
- **The bottom line is that the ECB best cool it with giving itself an A+ for its monetary policy performance.** The pandemic inflation was a direct result of its crazy easy policies and belated tightening. And bringing inflation down has not been costless – there is no free lunch as Milton Friedman often quipped – re the terrible growth performance.
- **Polemics aside, when I use a simple Taylor rule to gauge ECB rates, we are priced to perfection so to say:**

¹ Irish GDP is what package holidays are to the inflation basket: noise.



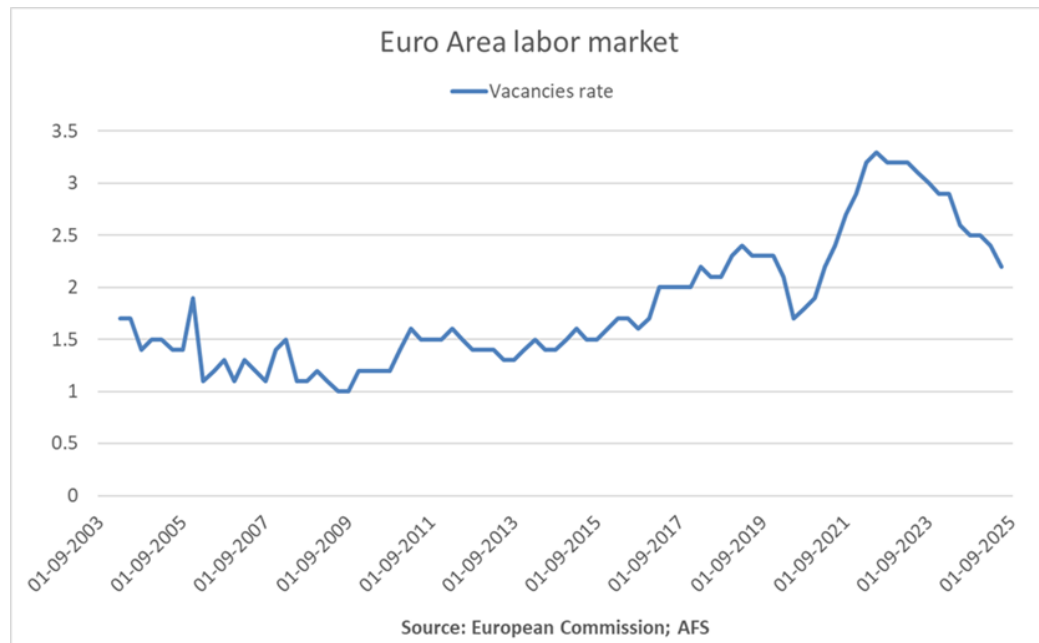
- **The ECB was royally late with raising rates.** But ever since the rate hike cycle was completed the deposit rate has been spot on. Even when I try to make the Taylor rule a bit forward-looking by changing the annual rate in core inflation with the *annualized* rate, the deposit rate is basically where it should be. Concurring, if you expect more of the same – weak growth and inflation marginally above target – then the ECB will be on hold for perhaps a very long time. Say, a twelve-month period, which where my comfort zone for forecasting ends.
- **Of course, we can think of very different scenarios.** One where the next step is a hike, and one where the next step is a resumption of cuts. Having bearish inclinations, my preference is the latter over the former. However, beyond ingrained prejudices, there is in fact a case to be made for a resumption of cuts. That case rests on the assumption that economic growth, which has been dismal for quite some time, will weaken. Economic slack, and a slacker labor market in particular, will drag inflation below two percent. Or risk dragging it below two percent without rate cuts.
- **Here's employment growth, measured as the percentage change in employment in persons compared to the same quarter a year ago:**



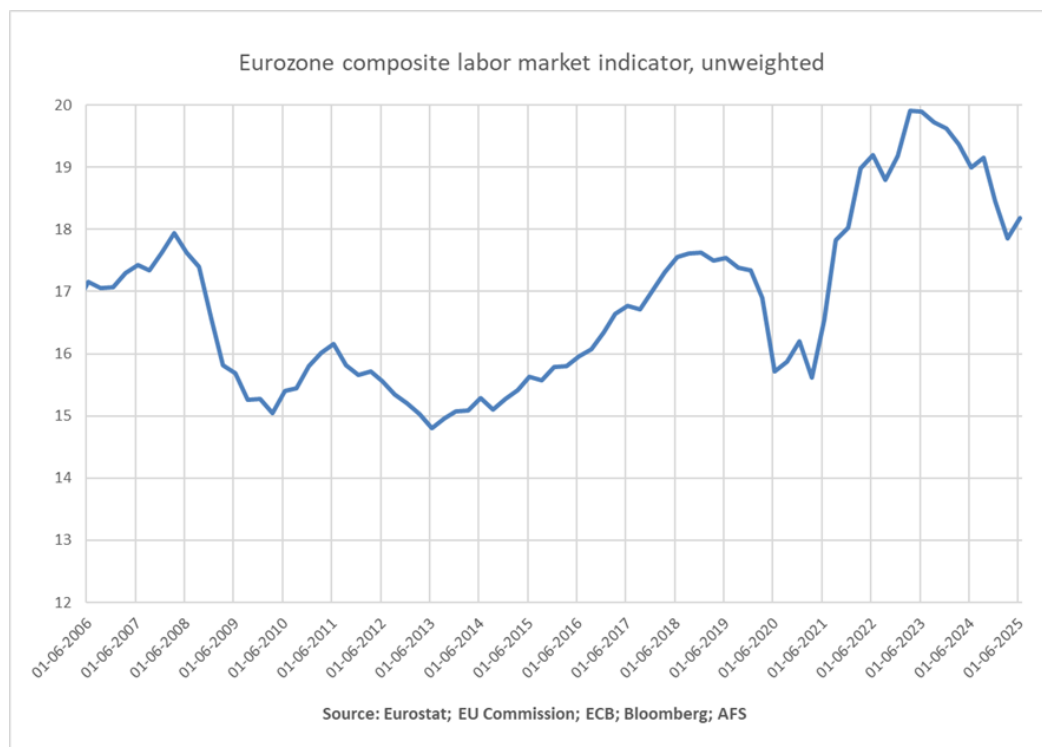
- **Employment growth has weakened quarter after quarter.** With dismal and barely existent productivity growth, GDP growth has suffered.
- **The few publicly forward-looking available labor market indicators point to the labor market slowing further.** Take, for example, the EU Commission's monthly business survey, which includes questions on firms' hiring plans.



- **The chart shows the net percentage of firms expecting hiring to increase (when positive) or decline (when negative).** Recent net percentage readings are at historically depressed levels, though the manufacturing sector appears to be bottoming out.
- **Next, we have the vacancies rate, which is defined as job vacancies as a percentage of the sum of employment (in persons) and vacancies.**

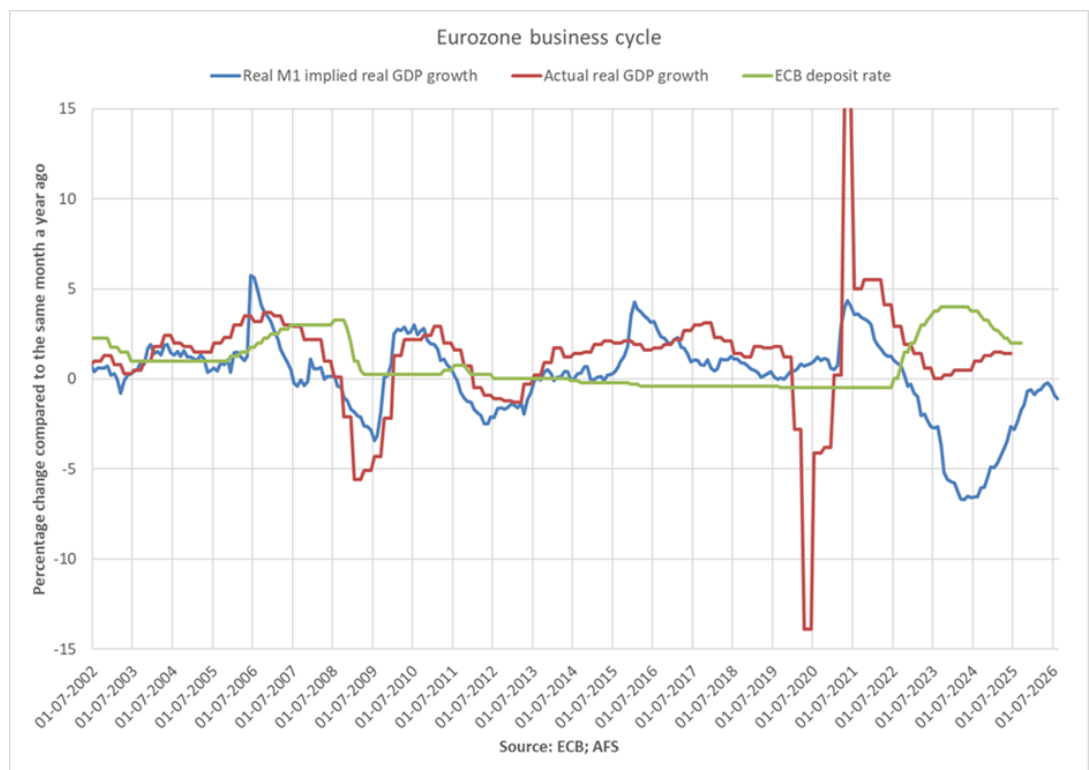


- **The vacancies rate has retreated to late 2010s ‘good times’ levels.** Of course, if you’re a glass is half full type, you will say that the labor market is becoming less tight, not loose. True indeed. Furthermore, remarkably similar to the US situation, workers are not losing their jobs – unemployment has been basically steady for the past year or so. Still, when I combine the hotchpotch of Eurozone labor market data² into a single unweighted indicator, the slowdown picture is unmistakable:



² Included are various measure of wages, labor costs, vacancies, hiring plans, unemployment, and employment growth.

- The chart shows where my hotch-potch of labor market indicators are relative to their historical range: at the low or high end of their respective historical ranges, and anything in between.³ Be aware that the bounce in Q2 2025 was a function of a one-off bounce in wage growth, not an improvement in labor demand as measured by vacancies and hiring plans. In any case, we're looking at a picture of a cooling but not weak labor market.
- **A further slowdown of the labor market should translate to slower economic growth.** Remember: with negligible productivity growth, GDP growth is simply a function of employment growth. That begs the question, what are the implications of an employment slowdown for inflation? If wage growth eases more strongly than output growth – which it has been doing since the summer of 2023 – inflation should lessen through lower unit labor costs. Inflation can also ease if output growth doesn't drop because of a (miraculous) revival in productivity growth. In any case, I am rooting for further softening of wages and/or a recovery in productivity, however marginal.
- **That's the labor market side of things.** My case for a resumption of cuts also depends on typical sell-side trickery. Real M1 money growth, the leading indicator for turning points in the Euro Area business cycle twelve months ahead, flags just that: a turning point. A turn for the worse, in fact:



Real M1 never missed flagging the business cycle heading south a year in advance except during the pandemic shutdown, which had nothing to do with the 'traditional' endogenous causes of a recession.

³ The composite index consists of eleven indicators. When the indicator is at the highest point of its historical range, a '2' is assigned. Conversely, a '1' is assigned when the indicator is at a record low. Theoretically, the composite index could be as low as 11 or as high as 22. However, the labor market never got that weak – not even after the 2008 crisis – that all indicators were at the low end of their historical range.

- **In any case, I expect the labor market to slow further, and to manifest itself in inflation finally taking a leg down over the course of the first half of the year.** I assume that easier fiscal policy in Germany doesn't matter. Significant fiscal easing will not materialize because of bureaucracy. Or it is offset by tighter fiscal policy in France and/or a lower contribution from net trade (demand leaking away to China, the drag from tariffs). Or, to use the 'angst of the month', the AI bubble popping, dragging down the US economy and its export-reliant partners (the Euro Area) with it. For the doves, this is fertile ground. They will successfully push for a couple of 25bps cuts. The ECB being the ECB, that will entail cuts at the March and June meeting, when we get the staff forecasts.
- **We can also make the dovish scenario a worst-case scenario. Think of France spiraling out of control and into a full-blown balance of payments crisis.** Or recession in the US finally arrives. Alas, the stuff that a simpleton cannot forecast in advance. So, I won't even try.
- **I might very well be epically wrong about my call for a resumption of rate cuts.** To my credit: at least it is not consensus hugging. Furthermore, it's easy to imagine a starkly different scenario, whereby the Eurozone economy does pick up steam. Perhaps on the back of fiscal easing in Germany, or manufacturers regaining their footing following the tariffs shock. Or the Fed engineering yet another soft landing, the AI bubble not popping (or maybe it's not a bubble, who am I to judge).
- **Eurozone growth picking up is consensus.** Here's a snippet from the ECB's quarterly Survey of Professional Forecasters (SPF):

2025 Q3 real GDP growth forecasts

	2025	2026	2027	2026 Q1	2027 Q1	2030
Mean point estimate	1.1	1.1	1.4	0.7	1.4	1.3
Standard deviation	0.2	0.2	0.2	0.4	0.2	0.3
Number of replies	53	53	43	46	34	38

- **Look at the annual growth rate for 2027 Q1.** That is Q1 2027 compared to Q1 2026. It's not the average annual growth rate over a calendar year that is highly susceptible to base effects. We're looking at a 1.4 percent growth rate. That's double the current growth rate (2026 Q1). Some optimistic economists indeed.
- **I have a hard time figuring out where this optimism comes from.** Maybe it's hopes that fiscal easing is the silver bullet for the Euro Area growth quagmire – I have my doubts. As per the Q3 ECB staff forecasts, the fiscal impulse in 2026 is 0.3 percent of GDP (difference between the 2025 and 2026 structural primary budget balance, or what the budget balance excluding interest payments on the debt would be if the economy is at full employment):

Table 4
Fiscal outlook for the euro area

(percentage of GDP; revisions in percentage points)

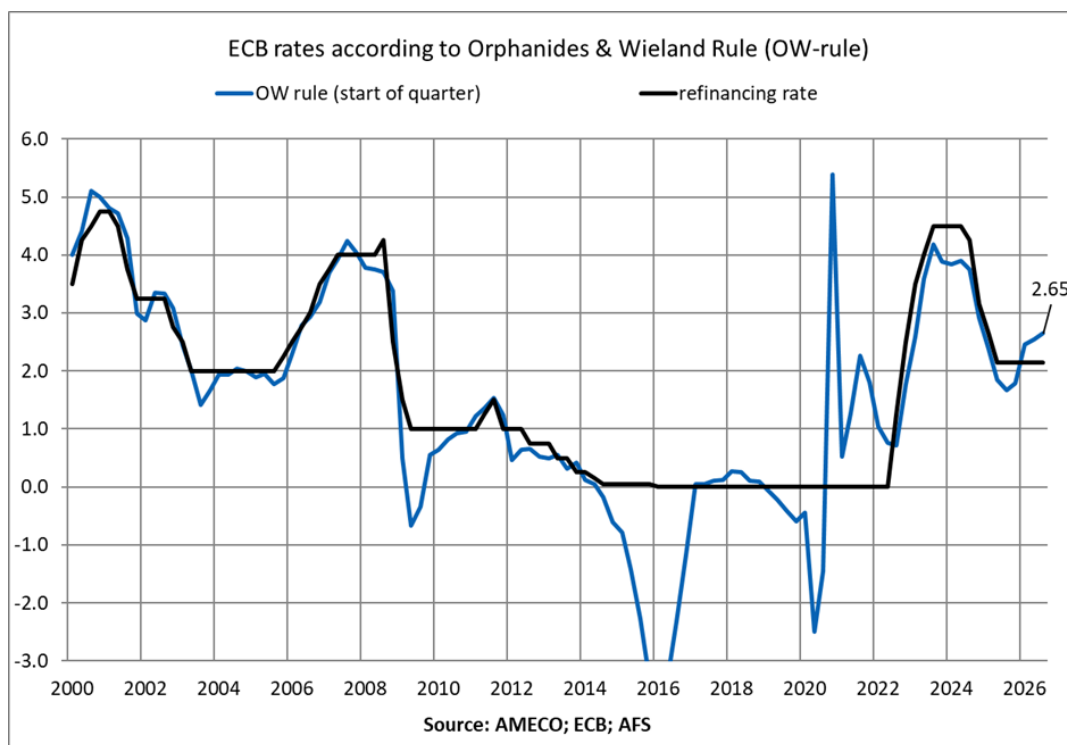
	September 2025				Revisions vs June 2025			
	2024	2025	2026	2027	2024	2025	2026	2027
Fiscal stance¹⁾	1.0	0.1	-0.2	0.4	0.1	0.1	0.1	-0.1
General government budget balance	-3.1	-2.9	-3.2	-3.4	0.0	0.1	0.2	0.1
Structural budget balance ²⁾	-3.0	-2.9	-3.1	-3.3	0.1	0.1	0.2	0.2
General government gross debt	87.4	88.0	89.1	89.8	-0.1	-0.5	-0.5	-0.4

Notes: Revisions are based on unrounded figures.

1) The **fiscal stance** is measured as the change in the cyclically adjusted primary balance net of government support to the financial sector. The figures shown are also adjusted for grants under the Next Generation EU (NGEU) programme, which do not have an impact on the economy on the revenue side. A negative (positive) figure implies a loosening (tightening) of the **fiscal stance**.

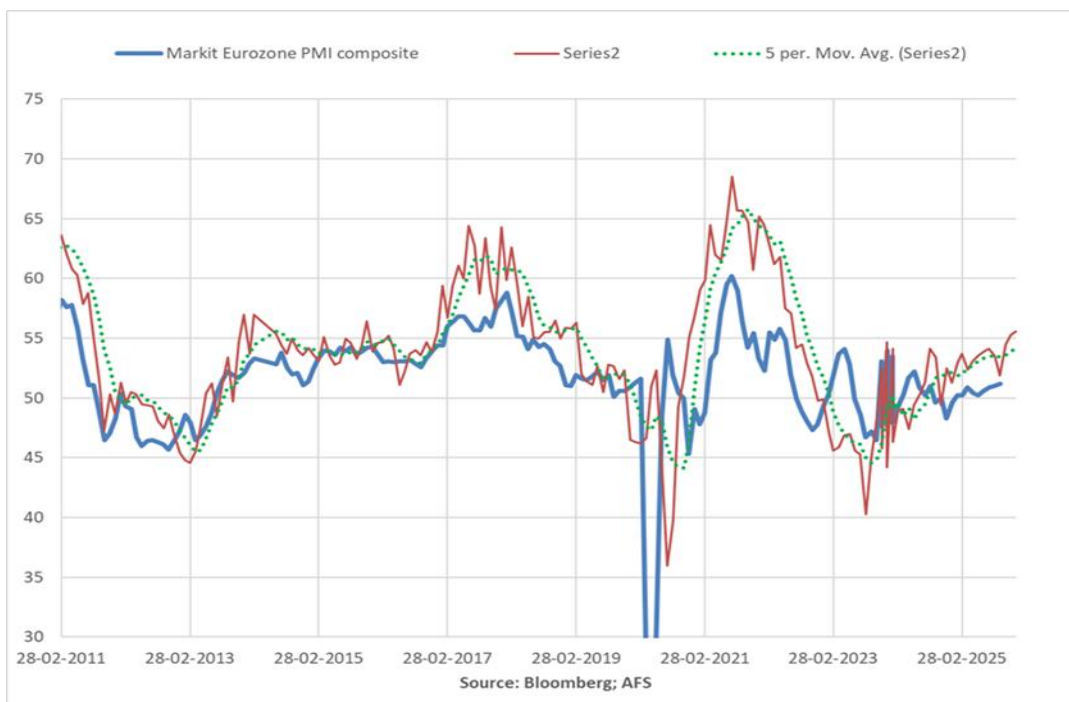
2) The structural budget balance is calculated as the government balance net of transitory effects of the economic cycle (or the cyclically adjusted primary balance, referenced above, plus interest payments) and net of measures classified under the European System of Central Banks definition as temporary.

- **Three tenths of a percent is a measurement error in my book.** One also wonders what the multiplier is in a low productivity, high employment economy. Probably less than one.
- **In any case, the ECB SPF is used as the input for that other model that us analysts use to forecast ECB rates: the Orphanides and Wieland rule.** Named after long-time German ECB watcher Volker Wieland and the former head of the Cypriot central bank and academic Athanasios Orphanides.
- **The model, which has an excellent track record, flags a couple of quarter point ECB hikes next year on the back of those buoyant GDP forecasts:**

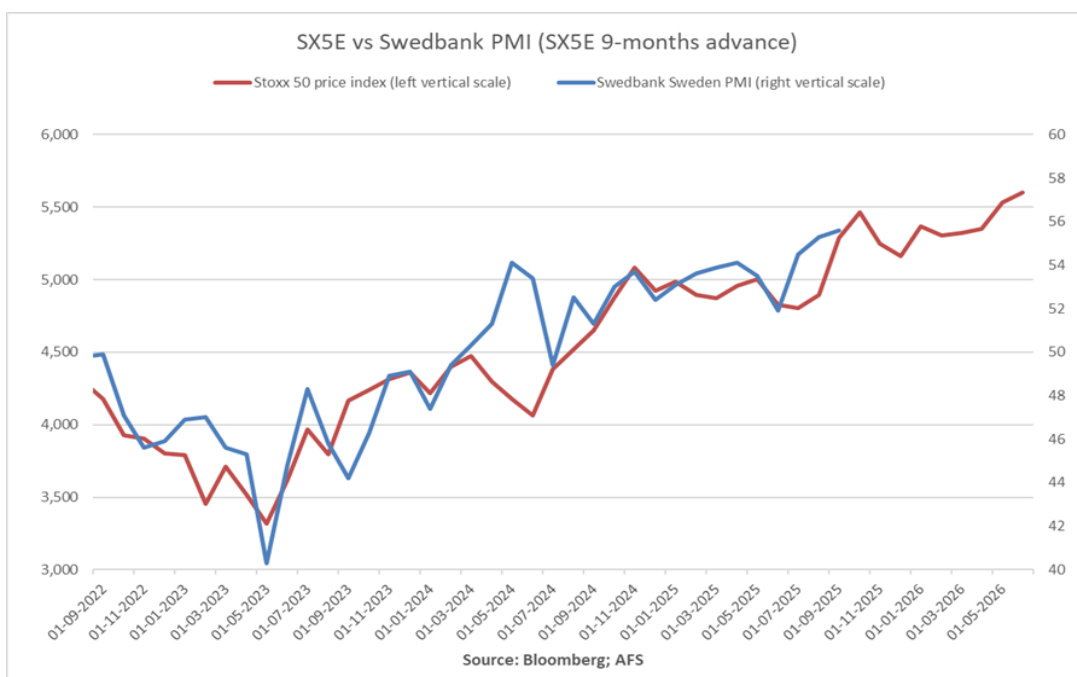


Optimism indeed.

- **The equity market is on board with the rosy-rosy scenario of the Eurozone economy, with market pricing consistent with further improvements in business surveys.** Below I've charted the Swedbank Sweden PMI. That's a proxy for the Eurozone PMI, but the former tends to advance the latter by several months. Plus, it's freely available on Bloomberg, unlike the Eurozone PMI:



- **I can use more sell-side trickery – horizontal and vertical axis manipulation – and overlay the Swedbank PMI with the Eurostoxx 50, with the latter leading the former:**



- **Eyeballing the two charts above suggest that the equity market thinks that the Eurozone PMI will rise to 55 or thereabout.** That's consistent with solid growth rates and an end to the years' long slow-growth quagmire. With little economic slack – remember, unemployment is at historically very low levels – a growth upturn will prove to be modestly inflationary. That will demand a modestly restrictive stance. Think of two rate hikes over the course of the year: June and September, for example.
- **So, to conclude, we have three scenarios in front of us with regards to ECB-policy in the next twelve months: no change, cut, or hike.** In the case of no change, the facts on the ground stay the same: meagre growth, inflation steady at a wee bit above two percent. In the case of cuts, my preferred scenario, a further weakening of the labor market will spur the ECB into action, cutting rates a couple of times in H1 2026. Finally, in the upside scenario and much dreamed-about in that ivory tower in Frankfurt, growth will pick up on the back of home-grown growth: fiscal easing in Germany. Don't expect anything spectacular except a few cuts over the course of the year. This is the Eurozone after all. Curb your enthusiasm.

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