ECB preview: a welcome move towards normalisation, but what lies ahead?

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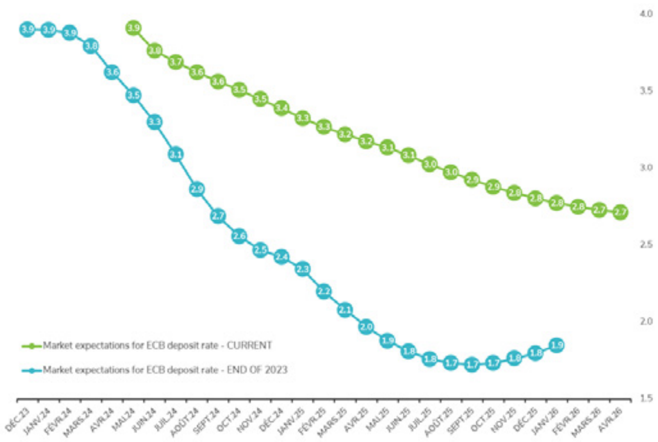
Next week, the European Central Bank (ECB) is likely to embark on a new phase of its monetary policy: normalisation. After maintaining very restrictive rates to combat higher-than-target inflation, the ECB is poised to ease this restrictiveness. The first rate cut, expected next week, comes 260 days after the first rate hike, closely aligning with the historical average between cycles. Based on recent comments from ECB members, the rate cut is almost a certainty. However, the path to the terminal rate, which should be the neutral rate—which neither stimulates nor restrains the economy—will be long and winding.

A long and sinuous path to normalisation:

Estimating the neutral rate, or R*, is challenging, especially during significant economic transitions, such as the shift from manufacturing to services or shocks like COVID-19. Currently, the consensus among central bankers, economists, and the market is that the real neutral rate is around 0.5%-1.0%, suggesting a terminal rate of about 2.5%-3.0%.

Chart 1: Projected path of European rates by the market



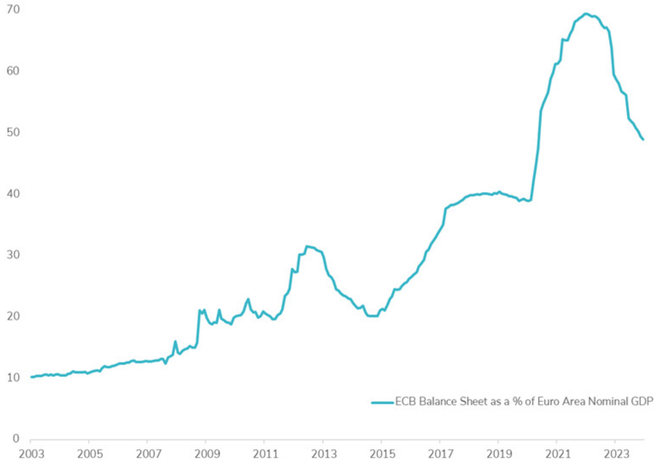
Source: CIO Office, Bloomberg

Chart 1 illustrates that the market anticipates it will take at least two years for the ECB to reach the neutral rate, indicating a prolonged period of restrictive policy. ECB Chief Economist Philip Lane's recent comments underscore this cautious approach: "We still need to be restrictive all year long." The consensus view of one rate cut per quarter points to a gradual path to normalisation. A key question for the upcoming meeting is whether the ECB will signal another rate cut in July.

The ECB balance sheet: not on the agenda this time

While the Federal Reserve announced a reduction in its quantitative tightening starting June 1st, 2024, the ECB has indicated it will consider this only in the second half of 2024. ECB executive member Isabel Schnabel recently noted that the ECB's large balance sheet "may have weakened the transmission of monetary policy during this recent tightening cycle."

Chart 2: ECB balance sheet as a percentage of European GDP



Source: CIO Office, Bloomberg

Even though ECB President Christine Lagarde stated on April 11th that "the size of our balance sheet has significantly reduced already," Chart 2 shows that the ECB balance sheet relative to European GDP is still well above pre-pandemic levels. Therefore, significant discussions or actions regarding the balance sheet are unlikely at this meeting.

The ECB and the Fed: an inescapable connection

The ECB's actions are often influenced by the Federal Reserve. A significant interest rate differential between the Eurozone and the U.S. could weaken the euro, exacerbate inflation, and negatively impact the European economy. Currently, there is a substantial gap between short-term interest rates in the U.S. and Europe. Markets expect both the Fed and the ECB to reach their terminal rates around the same time or within one quarter of each other, with the Fed's terminal rate expected to be around 4%-4.2%. We believe the ECB cannot operate independently from the Fed.

Chart 3: Impact of short-term rate differential on EUR/USD exchange rate

Source: CIO Office, Bloomberg

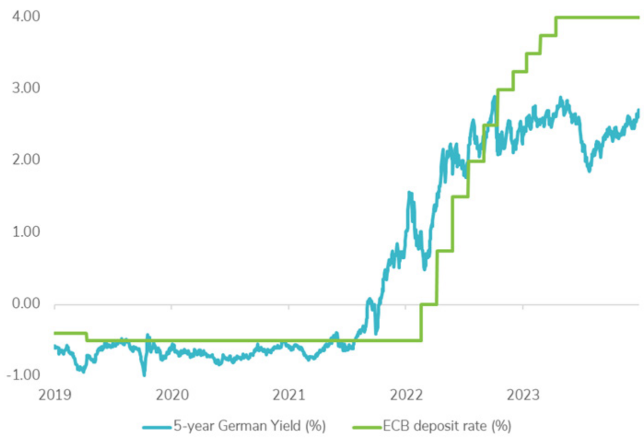
Chart 3 illustrates the current significant differential between U.S. and Eurozone short-term rates. This disparity can put downward pressure on the euro, making European exports cheaper but increasing the cost of imports priced in dollars. If the current gap remains stable, the EUR/USD exchange rate should remain relatively steady. The paths of ECB and Fed monetary policies are closely aligned according to market expectations, mitigating the risk of significant fluctuations. However, as the ECB begins to cut rates, it must carefully consider the implications of potentially widening the interest rate gap with the U.S. Too aggressive a rate-cutting cycle could lead to a sharp depreciation of the euro, undermining the ECB's inflation control efforts. Conversely, maintaining too restrictive a policy could stifle economic growth within the Eurozone.

The ECB needs to navigate this landscape carefully. While the first-rate cut is intended to reduce some of the current restrictiveness, the policy must still remain sufficiently tight to prevent the euro from depreciating too rapidly. A balanced, data-driven approach will be crucial to manage these economic forces and ensure sustainable growth while keeping inflation in check.

Implications for European fixed income

The upcoming ECB meeting is likely to provide some relief for European government bonds. However, a sharp rally in yields is unlikely unless the ECB pairs the rate cut with a firm commitment to subsequent cuts in July. As depicted in Chart 4, the market has already priced in some rate cuts.

Chart 4: ECB Deposit Rate vs. 5-year German Yield (%)



Source: CIO Office, Bloomberg

The short end of the yield curve stands to benefit the most from the ECB's anticipated actions, provided the central bank does not adopt an overly cautious tone. Recent data on European wages and inflation does not support a rapid succession of rate cuts. The long end of the curve may see limited benefits, given that the European yield curve is still inverted by 36 basis points. Additionally, European financial conditions are highly accommodative, near their peak levels according to the Bloomberg Eurozone Financial Conditions Index. The ECB is unlikely to maintain such favorable conditions indefinitely. However, if President Lagarde hints at a consistent pace of rate cuts in future meetings, the 10-year German yield could respond positively. Nonetheless, our base case scenario is that the ECB will remain highly data-dependent and cautious.

Conclusion

The upcoming ECB meeting marks the beginning of a gradual path towards normalisation. While the first rate cut is a welcome change, the journey to achieving the neutral rate will be long and cautious. The ECB's focus will remain on balancing the need to control inflation with the desire to support economic growth. The European recovery is underway, but European wages, especially in the services sector, remain at high levels. Additionally, European inflation is plateauing, adding complexity to the ECB's decision-making process.

As the ECB navigates this delicate balance, monetary policy adjustments will aim to support economic growth without destabilising the economy. If successful, these adjustments could lead to a steepening of the European yield curve, a development eagerly anticipated by investors for some time. The ECB's careful, data-driven approach will be crucial in managing these interconnected economic factors and ensuring a sustainable recovery.

For further information

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