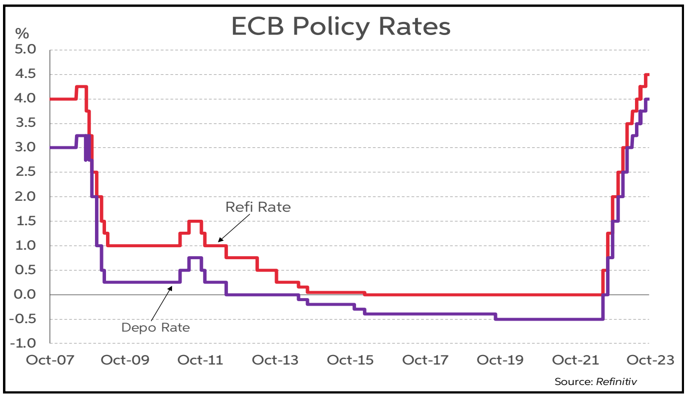
26th October 2023

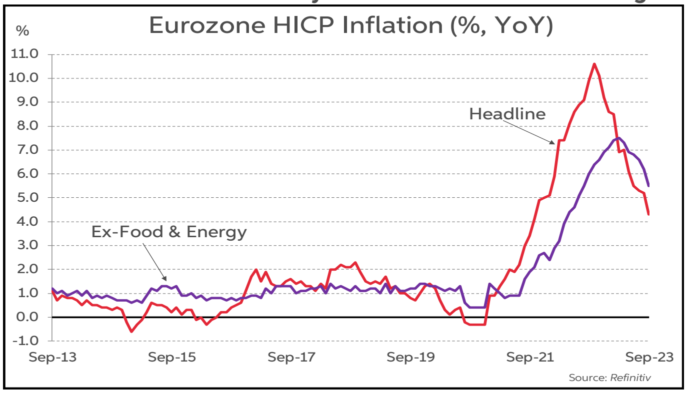
Markets expect rate cuts in 2024 as recession risks rise

The October meeting of the ECB's Governing Council saw the Central Bank maintain its key deposit rate at 4%, which was very much in line with expectations. It represented the first policy meeting that the ECB has not hiked rates since it began tightening policy in July 2022. In total, it has increased rates by 450bps in this cycle. The ECB's decision to keep rates unchanged at 4% was unanimous.



The ECB hiked rate by 25bps at its last policy meeting in September. However, the text of that meeting statement and President Lagarde's subsequent press conference **comments suggested that it had come to the end of its rate hiking campaign.** The ECB guided that it considered its key interest rates had reached levels, that if maintained for a sufficiently long time horizon would have a substantial impact on reaching its 2% inflation target in a timely manner**.**

It repeated this message today and said it will ensure that rates will be set at sufficiently restrictive levels for as long as necessary to restore price stability, suggesting it intends to keep policy on hold for a considerable period of time. It noted also that while inflation has declined, it is still expected to remain too high for too long, and domestic price pressures remain strong, reflecting higher wage inflation in particular. The ECB repeated that it will continue to follow a data-dependent approach in making future monetary policy decisions.



The ECB's latest staff quarterly macro forecasts were published at the September meeting. These saw a significant lowering of its growth forecasts amid the increasing impact of monetary policy tightening on domestic demand and the weakening in global trade. The ECB forecast GDP growth at 0.7% (was 0.9% previously) this year, 1.0% (was 1.5%) in 2024 and 1.5% (was 1.6%) in 2025. Furthermore, the ECB also commented that the risks to the economic outlook remain tilted to the downside. Meanwhile, it continues to believe it will take some time for inflation to fall back to target, with both headline and core HICP inflation seen averaging slightly above 2% in 2025.

Against the backdrop of subdued growth and declining inflation, **futures contracts indicate that the market is not only of the view that ECB rates have peaked, but that they will start to be lowered from around mid-2024.** They see the first 25bps cut in June, with two more to follow in the second half of 2024 and another 25bps cut in 2025, taking rates down to 3%**. Market expectations for significant rate cuts next year would not seem to be in tune with the ECB firm focus on maintaining a restrictive policy** for as long as necessary in the face of still high inflation.

ECB Macroeconomic Forecasts for the Euro Area

(%)	2022	2023	2024	2025
HICP	8.4	5.6	3.2	2.1
Real GDP	3.4	0.7	1.0	1.5

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average $82.7 in 2023, $81.8 in 2024 and $77.9 in 2025

Source: ECB September 2023

In this regard, though, the ECB's macro forecasts envisage a pick up in the pace of activity next year and in 2025. However, the **available hard data for the third quarter have been very weak as were the flash PMI readings for October. They suggest that the economy is continuing to lose momentum and may even enter recession in H2 2023.** This could be expected to add to the downward momentum on inflation via a softening in both demand and labour market conditions, paving the way for rate cuts by next summer.

Today's ECB meeting outcome prompted little reaction on markets, which is not surprising given an early change to monetary policy is not anticipated. ECB policy is very much on hold in the near-term and it is very unlikely to signal anytime soon that policy easing could be on the agenda next year. Indeed, President Lagarde said today any talk of rate cuts is totally premature.

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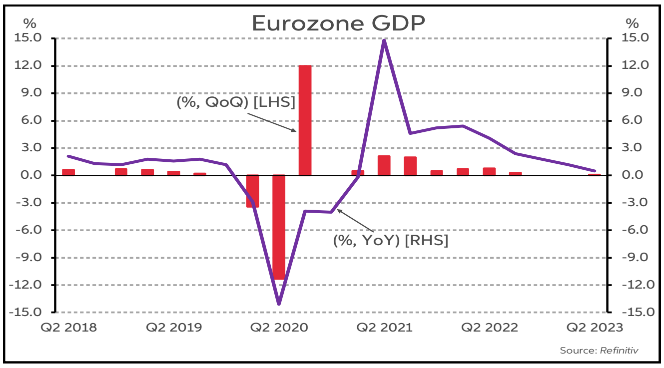
Eurozone economy on verge of recession

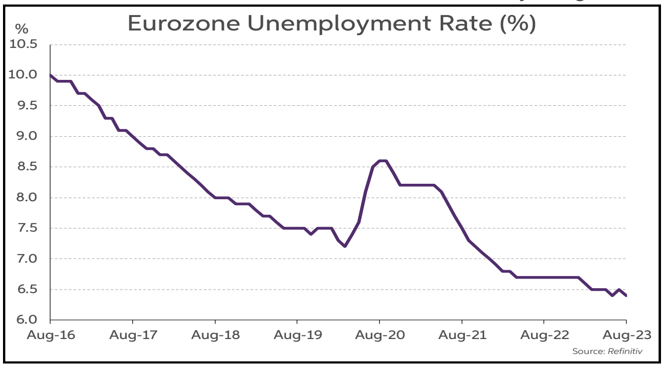


Having flat-lined in the previous two quarters, the Eurozone economy expanded by a meagre 0.1% in Q2 2023. The underlying breakdown of Q2 GDP growth shows that consumption stagnated, as the squeeze on real incomes from higher inflation and interest rates weighed on spending. Investment rose marginally by 0.1% in the quarter. Meanwhile, a slight increase in government expenditure contributed 0.1 percentage points (p.p.) to growth. Elsewhere, a fall in exports meant net trade knocked 0.4 p.p. from GDP, but this was completely offset by higher inventories. Overall then, the Eurozone has narrowly avoided entering a technical recession, with the economy broadly stagnant since Q3 2022.

Meantime, the available hard data have been quite weak so far in the third quarter of this year. Retail sales fell sharply by 1.3% in August, having edged 0.1% lower in July. The decline in August, was broad-based with food and non-food products contracting by 1.2% and 0.9%, respectively. Furthermore, retail sales were circa 2.1% lower in year-on-year terms in August. Meanwhile, industrial production rebounded by 0.6% in August, after contracting by 1.1% in July. Annually though, industrial output was 5.1% lower in August. Monetary aggregates also continued to weaken in September, with M3 money supply falling by 1.2% and credit growth to households slowing to 0.8% y/y.

Survey data also suggest the Eurozone economy weakened further in Q3. The services PMI averaged 54.4 in Q2, but just 49.2 in Q3. The Aug/Sept readings fell below the key 50 level for the first time since last December, and marked the quickest pace of contraction in the sector since February 2021. Meantime, the manufacturing PMI which was already struggling, averaged 43.2 in Q3, down from 44.7 in Q2. Meanwhile, the EC economic sentiment index, which has been trending lower since the start of the year, continued to do so in Q3, falling to 93.3 in September, its lowest level since November 2020. **The ECB bank lending survey also showed that credit conditions have tightened and loan demand fell sharply in Q3,** as higher rates weighed on activity. **The limited amount of survey data available for October suggest the economy continues to weaken.** The Eurozone flash PMIs moved lower across the board in October, while consumer confidence deteriorated for the third month running, from already low levels.

In terms of the labour market, conditions remain tight. The unemployment rate has trended lower throughout this year, and fell to an all-time low of 6.4% in August. At the same time, employment was up by 0.2% in Q2, and overall, it is estimated that there are five million more people in employment now, than before the pandemic. Tight conditions are contributing to increased labour costs. The most recent official data show that hourly wages and salaries increased by 4.6% y/y in Q2.



Regarding inflation, the headline rate has fallen sharply from its peak of 10.6% last October. It declined to 4.3% in September, its lowest level since October 2021. Encouragingly, core inflation has also started to move lower recently. The core rate that excludes energy, food, alcohol and tobacco, had been in a narrow 5.0-5.7% range since last October, and stood at 5.3% in August. However, it fell to 4.5% in September, its lowest level since August 2022. **ECB staff projections are for headline inflation to average 5.6% this year and to fall to 3.2% in 2024, and to 2.1% in 2025.**

Overall, the Eurozone economy has been virtually stagnant over the past number of quarters in the face of, increased uncertainty stemming from the War in Ukraine, high inflation and rising rates, as well as, weaker global growth. The German economy, the largest in the Eurozone, has performed particularly poorly, falling into recession in Q1, before flat-lining in Q2. The Bundesbank believes the economy likely contracted again in Q3. However, it is worth noting that the Eurozone labour market remains strong, and there has been a marked fall in inflation since last autumn, although, it still remains elevated. **The IMF is forecasting Eurozone GDP growth of 0.9% in 2023, and 1.5% in 2024. The ECB is projecting the economy will expand by 0.7% this year and by 1.0% in 2024. However, given the recent weak trends in the data, the risks are tilted to the downside of these projections. Indeed, the economy may well enter recession in the second half of this year, with growth much lower than forecast in 2024.**