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Authors:
Dr. Ulrich Stephan
Chief Investment Officer Germany

Dr. Dirk Steffen
Chief Investment Officer EMEA

Michael Blumenroth
Senior Investment Strategist

ECB hints at interest rate reversal in June

Key takeaways

- As expected by all market players in advance, the European Central Bank (ECB) left key interest rates unchanged at its meeting today.
- The ECB expects the inflation rate to return to the target level of 2.0% next year.
- ECB President Lagarde once again emphasised the data dependency of monetary policy, particularly with regard to the development of wages in the first quarter. The fact that "significantly more" would be known about this at the meeting after next in June opens the door for a probable interest rate cut in early summer.

1. What happened?

As unanimously expected, the ECB left key interest rates unchanged at its meeting today. Of greater interest was the question of how much the extent the ECB staff projections for inflation have changed and whether ECB President Christine Lagarde would provide indications at the press conference as to when the first interest rate cut might be expected.

The ECB's economic staff have lowered their projections for inflation and economic growth in the current year, but have left them at almost the same level as the December forecast for the following years. Consumer prices are now expected to rise by 2.3% in 2024 (December forecast: 2.7%). The projections for 2025 and 2026 are 2.0% (2.1%) and 1.9% (1.9%) respectively. Core inflation adjusted for energy and food prices is forecast at 2.6% (2.7%) for 2024, 2.1% (2.3%) for 2025 and 2.0% (2.1%) for 2026. This would see the monetary authorities' target level for consumer price inflation of 2.0% reached in 2025.

In her press conference, ECB President Lagarde did not explicitly address the fact that although inflation rates fell in February 2024, to 2.9% and a core rate of 3.1%, they were above analysts' estimates. Instead she emphasized her satisfaction with the disinflationary process and expressed confidence that it would continue.

According to Lagarde, the ECB has not yet specifically addressed the possibility of interest rate cuts in the Eurozone. In fact, the Council had only just begun to debate the dialling-back of its restrictive monetary policy.

However, she then became relatively specific: "We need a lot more information in the coming months to be sufficiently confident." Lagarde made it clear that "a little more" would be known at the next interest rate meeting in April. However, “a lot more" would be known by the next but one meeting in June.

2. How did markets react?

On the swap markets, the potential extent of the ECB's interest rate cuts in 2024 was priced in somewhat higher immediately after the statement was published. Overnight index swaps had priced in short-term interest rate cuts of more than 100 basis points by the end of the year, compared with 84 basis points in the morning. Yields on two- and ten-year Eurozone government bonds fell by a few basis points, while the EUR depreciated slightly against the USD. Following Lagarde's press conference, however, these movements were reversed and the EUR even rose to an intraday high. The Eurostoxx 50 gained more than 1% in what remained a risk-on environment.

3. What does it mean for investors?

In principle, the ECB delivered exactly the message that had been expected on the financial markets in advance, which is why there were no strong market movements. According to Christine Lagarde, interest rate cuts were not discussed today either. However, there was one new message: the Council has now begun to debate the dialling-back of its restrictive monetary policy.

Lagarde also emphasised the downside risks for the Eurozone economy, which are also reflected in the fact that the ECB has lowered its GDP growth projection for the Eurozone for 2024 from 0.8% to 0.6%. She expressed confidence that the disinflationary process would continue, which should lead to an easing of monetary policy in the near future.

Lagarde's probably decisive statement in the press conference indicates that this should be the case in three months' time. The ECB still needs a lot more data before there is a turnaround in interest rates. We will know "a little more" at the next interest rate meeting in April, but “a lot more" at the next but one meeting in June.

Of course, the data in the coming months could still throw a spanner in the works of the interest rate turnaround. However, monetary policy is very likely to remain restrictive until June, provided the economy does not deteriorate unexpectedly or geopolitical crises escalate before then. This was and is currently priced in on the futures markets, which is why market movements were not very pronounced today. Whether the ECB initiates a turnaround in interest rates shortly before or after the Fed is unlikely to be relevant. Only a significant time gap between the respective interest rate turnarounds would have a noticeable impact on yield differentials and the EUR/USD exchange rate. The prospect of an imminent turnaround in interest rates should continue to provide the equity markets with a slight tailwind.

Glossary

2% target: In the medium term, the ECB is aiming for an inflation rate of 2%.

GDP: The gross domestic product (abbreviation: GDP) indicates the total value of all goods, i.e. goods and services, produced within the national borders of an economy within one year after deducting all intermediate consumption.

Deposit rate: The deposit rate specifies the amount of interest that banks receive if they deposit money with the central bank by the next business day.

EUR is the currency code for the euro.

Euro Stoxx 50: The EURO STOXX 50 is a share index comprising 50 large listed companies in the eurozone.

Eurozone: Comprises the 20 EU countries in which the euro is legal tender: Austria, Belgium, Croatia, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain.

ECB: The European Central Bank is an institution of the European Union. It is the common monetary authority of the member states of the European Monetary Union, founded in 1998, and forms the European System of Central Banks (ESCB) together with the national central banks (NCBs) of the EU member states.

Monetary policy: In summary, monetary policy refers to all economic policy measures taken by a central bank to achieve its objectives.

Main refinancing rate: The main refinancing rate is the interest rate at which banks can borrow money from the ECB for one week.

Inflation: Inflation describes a sustained increase in an average price.

Core inflation: Core inflation is an economic concept for measuring inflation that does not take into account the price changes of certain goods. The core inflation rate excludes prices for food and the energy sector from the calculation, as these are subject to greater fluctuations, the causes of which are not to be found within the economy under consideration.

Key interest rate: The key interest rate is the interest rate unilaterally set by a central bank as part of its monetary policy, at which it concludes transactions with its affiliated credit institutions.

Marginal lending facility: The marginal lending facility is the interest rate at which banks can borrow money from the ECB until the next business day.

In finance, a swap is the English term for derivative financial instruments whose common feature is the exchange of future payment flows.

Transmission: The effect of central bank policy on the economy.

USD is the currency code for the US dollar.

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