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Eurozone: A rate cut is coming

Just when it seemed that the eurozone economy was starting to improve, the escalation of the trade war between the US and China soured the mood once more. We believe that a 10bp rate cut from the European Central Bank is now on the cards in the second half of 2019

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Just when things were looking up...

Just when it seemed that the eurozone economy was starting to improve, the escalation of the trade war between the US and China soured the mood once more. We mustn't forget that Europe and especially Germany is very exposed to international trade. Any trade slowdown will leave its mark on the eurozone economy. While some might argue that Europe could benefit from the US-China conflict through trade diversion, we think that the overall negative effect on world growth will be more important. What's more, Europe itself is likely to be in the line of fire itself if President Trump decides to impose import tariffs on cars later this year. No wonder that the European Central Bank (ECB) has introduced an easing bias in its monetary policy statement.

We have marginally downgraded our GDP outlook both for this year and next year to 1.0%

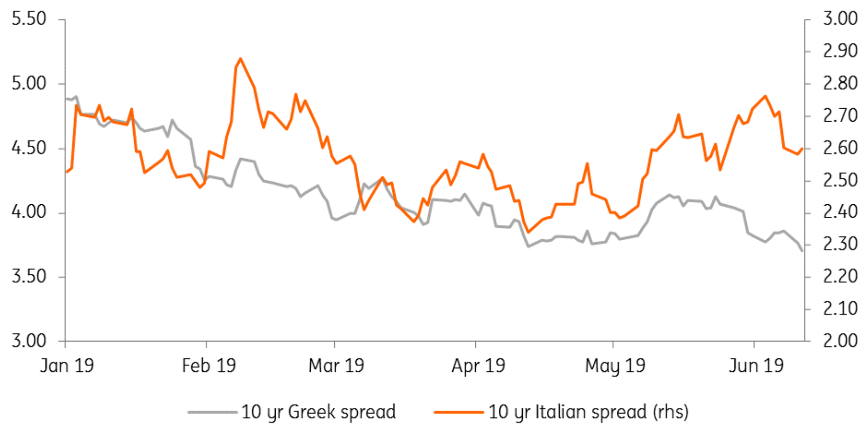
The strong drop in German exports in April was a testament to international trade troubles, even before President Trump decided to tweet about additional import tariffs. However, the weakness was probably exaggerated because of the end of stockpiling in the UK in the wake of Brexit. To be sure, domestic demand has done rather well on the back of a strong service sector and decent construction activity. Economic sentiment in the eurozone actually rose from 103.9 to 105.1 in May and lending picked up in April. So there is no reason to expect an economic standstill in the near term. However, forward-looking indicators like new orders point to slowing growth. There is also the fear that weakness in manufacturing might spread to the rest of the economy. We have marginally downgraded our GDP outlook both for this year and next year to 1.0%.

Political uncertainty is rising in Italy and Greece

While the European elections results were not really a shocker, there were some interesting local results, with the most direct consequence the announcement of a snap election in Greece. To be sure, political uncertainty has not disappeared. Brexit is far from resolved and the story is likely to linger on for a while, potentially weighing on business investment.

At the same time, things are heating up again in Italy, now that the European Commission has recommended starting an excessive deficit procedure against the country. A final decision on this matter is likely to be taken at the Ecofin meeting on the 9th of July, which is sure to create tensions within the Italian government if this necessitates the scrapping of a number of election promises. Therefore, we think that the likelihood of early elections in September has increased significantly, especially now that Lega strongman Matteo Salvini might be keen to capitalise on his very strong result in the European elections.

Bond markets getting nervous (again) about Italy

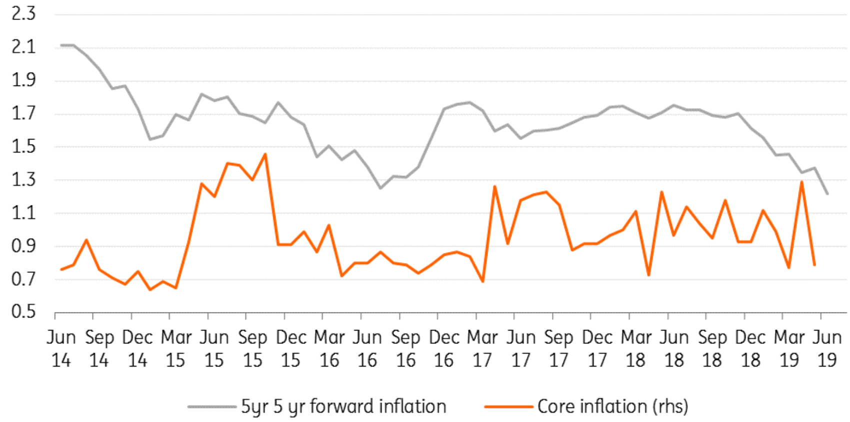


Source: Thomson Reuters Datastream

We have reduced our inflation forecasts

After the artificially higher inflation readings for April because of late Easter holidays, inflation fell back in May. Underlying inflation actually declined to only 0.8% in May with the closely followed 5yr 5yr forward break-even inflation rate now at the lowest level in years. With oil prices having declined lately, headline inflation is also likely to fall again in the coming months. We, therefore, reduced our headline inflation forecast to 1.2% for 2019 and 1.4% for 2020.

Both inflation and inflation expectations fell



Source: Thomson Reuters Datastream

A 10bp rate cut is now on the cards for later this year

With inflation remaining stubbornly low and the economic expansion threatened by external shocks, the ECB had little choice than to suggest an easing bias. The targeted longer-term refinancing operations (TLTROs) were announced with a rather generous (though conditional) interest rate of deposit rate +10bp. At the same time, the forward guidance of keeping interest unchanged was lengthened through the first half of 2020.

A rate cut from the ECB could come as soon as the September meeting

ECB president Mario Draghi also suggested the possibility of a further rate cut. We, therefore, believe that a 10bp cut is now on the cards in the second half of this year and could come as soon as the September meeting. Given that a lower negative deposit rate for a longer time will increasingly become a burden on bank profitability, a tiering system for excess liquidity is likely to be introduced in due course. And we wouldn't be surprised if the ECB suggests the potential of restarting net asset purchases, though it is unlikely that the maximum threshold on sovereign exposure would be altered.

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