Eurozone: Desperately seeking guidance

The eurozone economy is still desperately seeking guidance and support. Confidence indicators have started to deteriorate again, and a rate cut is now a question of 'when' rather than 'if'. It's a close call, but barring further deterioration in the data before the July meeting, we think the ECB is more likely to wait until September

Incoming European Central Bank President, Christine Lagarde with Mario Draghi

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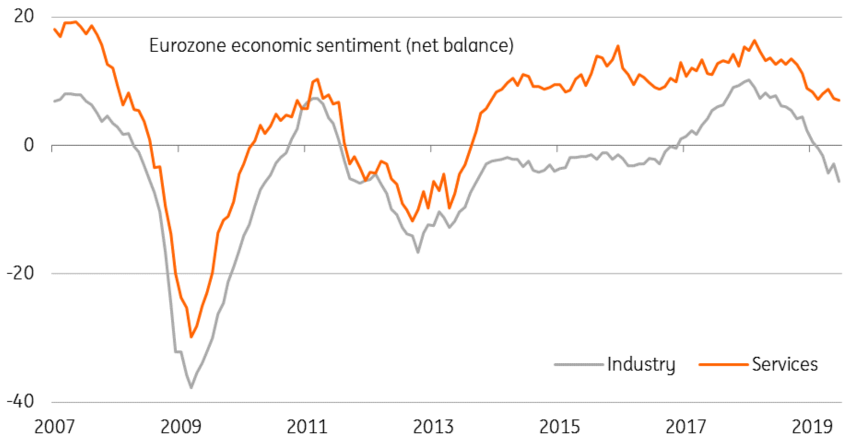
Risk of negative sentiment loop increases

The eurozone economy is still desperately seeking guidance and support. After some bottoming out at the end of the first quarter, confidence indicators have started to deteriorate again on the back of continued trade uncertainty. Up to now, the slowdown of the eurozone economy has mainly been driven by the manufacturing sector, while domestic demand has held up reasonably well. The latest drops in confidence indicators can still be labelled as a bottoming out. However, with every single month that confidence weakens, the risk of a negative sentiment loop increases.

With increased and prolonged uncertainty, the fate of the eurozone economy will mainly depend on two major questions: (1) can domestic demand continue to defy the manufacturing downswing or will it start to budge and (2) will global uncertainties eventually be resolved or are they here to stay? As regards the former, some fiscal stimulus, marginally increasing real wages and private sector investments, still argues against any recession scenario. At the same time, however, the latest German data shows a clear loss of positive momentum in the labour market and dropping retail sales for two months in a row. These are tentative signs and warnings that the current decoupling of domestic and external demand should not be taken for granted. As regards the external uncertainties, our base case on trade remains one in which things will first get worse before they get better.

Eurozone sentiment has fallen



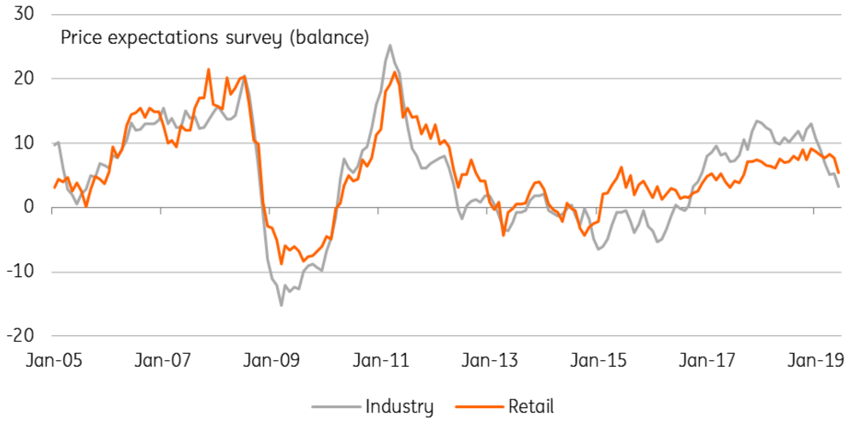
Source: Thomson Reuters Datastream

The ECB has joined the choir of dovish central banks

All of this means that the eurozone economy is likely to float steadily with low but positive growth rates towards the end of the year, regularly flirting with recession. Against this background, it was no surprise that the ECB joined the choir of major central banks, hinting at fresh rounds of monetary easing.

For the ECB, at least until Mario Draghi's term ends in October, there are two main factors driving its action: the price stability mandate and showing determination to act. In the eyes of the ECB, there is nothing worse than a central bank admitting it has run out of ammunition. Consequently, as long as inflation expectations and the ECB's own inflation projections for the next few years remain clearly below 2%, the ECB will fire on all cylinders, regardless of whether additional stimulus actually reaches the real economy. This explains Mario Draghi's dovishness at Sintra.

Eurozone price expectations



Source: Thomson Reuters Datastream

We think the ECB will wait until September before delivering easing

The Sintra speech made clear that the question regarding the short-term outlook is no longer "what negative surprise is needed for the ECB to cut rates" but rather "what positive surprise could actually prevent the ECB from cutting rates". Predicting the exact timing is somewhat more complicated though. In fact, traditional ECB watchers argue in favour of compiling more data, waiting for the release of 2Q GDP in mid-August and the next ECB staff projections and taking a decision only at the September meeting. Draghi's track record in overdelivering and trying to be ahead of the curve, however, could bring a rate cut already at the ECB's July meeting. In our view a very close call.

> *We think that the ECB will wait until the September meeting to deliver a 10bp rate cut*

Unless the days leading up to the July meeting bring more disappointing macro data, we think the ECB will wait until the September meeting to deliver a 10bp rate cut in the deposit facility, combined with a clear commitment to restarting quantitative easing. The reason not to use all ammunition at once is the UK's impending exit from the European Union and the need to have some policy measures left in case of a disorderly Brexit. Given that a lower negative deposit rate for a longer time to come will increasingly become a burden on bank profitability, a tiering system for excess liquidity is likely to be introduced as well.

Amongst the likely options, a new corporate bond purchase programme would seem a sure bet, potentially including senior bank bonds as well. As for sovereign bonds, the headroom looks limited given the 33% issuer limits. We believe the ECB would be more likely to diverge from the capital key, no longer buying in jurisdictions where it has already reached the threshold.

Change of guard from Draghi to Lagarde will hardly change anything

The nomination of Christine Lagarde as the new ECB president provides little to no change for the ECB's monetary policy over the coming months. In fact, extended forward guidance, new dovishness and probably a new round of QE before she enters office have tied Lagarde to the Draghi chains going into 2020.

Let's hope that the eurozone economy has found some stability by then so that Lagarde's willingness to do "whatever it takes" doesn't have to be tested any time soon.

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