The eurozone is still heading for a slowdown

Despite stronger-than-expected first-quarter growth, the eurozone's economic outlook remains bleak. While inflation figures for April disappointed, falling energy prices are still likely to push headline inflation to 2% before the end of the year, allowing the ECB to cut rates two more times

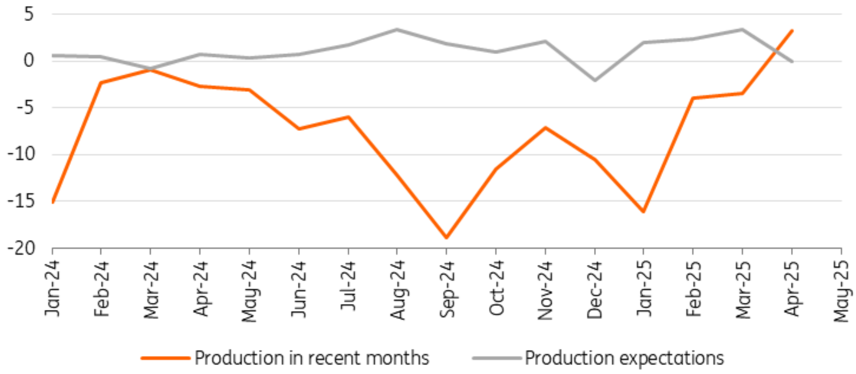
A man walks past a store having a sale in Paris

Surprisingly strong growth in the first quarter

Eurozone growth surprised in the first quarter with a 0.4% quarter-on-quarter expansion. We don't yet know all the details of the GDP component, but stronger exports ahead of the US import tariffs were the likely key driver. However, this unusual boost in the first quarter may lead to weaker performance in the subsequent ones. This is already evident in the European Commission's business and consumer survey, where production expectations in manufacturing fell significantly in April after three consecutive months of increases.

Additionally, as long as uncertainty regarding tariffs persists, companies might delay investment and hiring decisions. Households are also likely to postpone spending on big-ticket items due to increased geopolitical uncertainty. The sharp drop in consumer confidence in April supports this view.

Industry survey signals weaker production growth ahead



Source: LSEG Datastream

Lower energy prices offer welcome support

On the positive side, the drop in energy prices provides welcome support for both businesses and households, offsetting some of the negative impact of the trade war. While we previously downplayed the impact of increased defence spending on GDP growth due to high import leakage and offsetting expenditure cuts, this view has strengthened as some countries attempt to reclassify existing public spending as defence spending.

The German infrastructure package is likely to be a stronger tailwind, though its impact will probably only be felt from 2026 onwards. Overall, we continue to expect economic stagnation in the coming quarters, though a full-blown recession seems unlikely. Due to the stronger carry-over effect from the first quarter, we now project 0.7% growth in 2025. Next year's growth forecast remains at 1.1%.

Mixed inflation data

April's inflation data has been mixed. While headline inflation fell to 2.1%, underlying inflation increased to 2.7%. Although the late Easter holidays may have distorted the figures, the jump in core inflation cannot be entirely dismissed. Indeed, the three-month annualised growth of services prices remains at 4.1%, and selling price expectations stayed high in the European Commission's April survey.

That said, the economic slowdown will likely temper underlying inflationary pressures, while the significant decrease in energy prices will continue to exert downward pressure on the headline numbers. We now forecast 2.1% inflation in 2025 and 2.0% in 2026, a slight downward revision.

Two more rate cuts

With energy prices declining, the European Central Bank still has some room to cut rates further. However, it's now more aware of the risk of easing monetary policy too much. As Dutch central bank governor Klaas Knot stated, "*In the short term, it's 100 percent clear that the demand shock will dominate, so inflation will go down*." At the same time, he warned that in the longer term, the risks of supply chain disruptions and fiscal stimulus pose upward risks to inflation.

Therefore, we believe that two additional 25bp rate cuts are still highly likely, but thereafter the

ECB will probably keep short rates stable at 1.75% at least until the end of 2026.

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