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Eurozone recovery facing serious headwinds

The trade war is dashing hopes for a robust eurozone recovery, with GDP expected to stagnate over the next two quarters. Inflationary pressures are likely to ease in the second half, and that will provide the European Central Bank ample opportunity to implement three additional 25bp rate cuts this year

Expect three more rate cuts from the ECB this year

Ever-changing moods

When it comes to the challenge of predicting the eurozone's growth outlook, Crowded House's classic "Four Seasons in One Day" comes to mind – it perfectly sums up the constant state of flux we're seeing in the economic environment at the moment.

Germany's fiscal U-turn and the promise of increased defence spending across Europe had raised hopes for accelerated growth starting next year. This optimism was reflected in improved confidence indicators, particularly in the expectations component. However, the announcement of blanket US import tariffs of 20% on the European Union, with even higher rates for specific sectors, drastically altered the mood. To be sure, on the back of the ensuing financial market turmoil, President Trump decided on a 90-day delay for the "reciprocal" tariffs, but in the meantime the "standard" tariff of 10% has been introduced for European goods and the higher tariffs for specific sectors, like cars, still stand. Things can, of course, shift quickly – but if the tariffs remain in place this year, the impact will be sizeable.

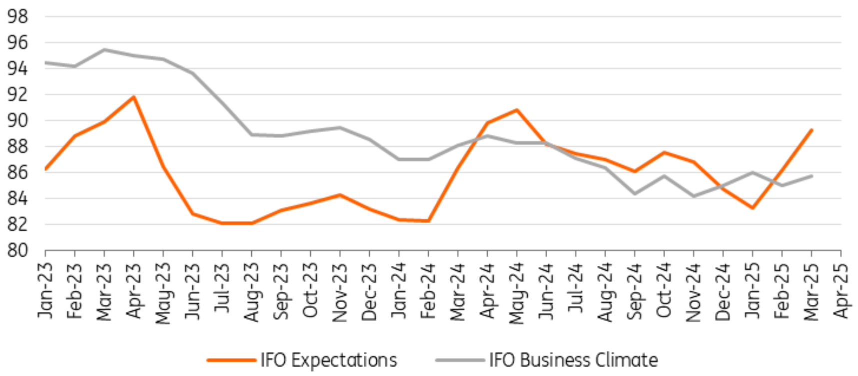
Economy coming to a standstill

The composite PMI rose for the third consecutive month in March, driven by increased sales. This may have been temporarily influenced by US companies replenishing stocks in anticipation of higher import tariffs. Consequently, growth in the first quarter was likely positive, with the eurocoin indicator – a measure of the underlying growth trend – reaching its highest level since 2022 in the first quarter.

However, recent tariff announcements have altered the landscape. We estimate the direct negative impact on exports to be between 0.1% and 0.3% of GDP, consistent with earlier estimates from the European Central Bank. The ongoing uncertainty is also expected to negatively affect business investments, and consumers are likely to become more cautious due to international tensions. There may be a small negative wealth effect on consumption (-0.1% to -0.2%) due to tanking stock markets.

Overall, we now expect the economy to stagnate in the second and third quarters of this year, resulting in 0.5% GDP growth for the year. With Germany's planned expansionary budget, improvement is still likely in 2026, but due to a weaker carry-over effect, we have also reduced next year's growth forecast to 1.1% (down from 1.4%). It is important to note that these forecasts are highly uncertain as the trade situation may swiftly change again.

The improvement in German business sentiment was mainly due to expectations



Source: LSEG Datastream

Trade war is rather deflationary

Eurozone HICP inflation fell to 2.2% in March, with core inflation at 2.4%. The decline was welcomed by financial markets, but the month-on-month figures didn't show much deceleration in services prices. The late Easter could also push services inflation up again in April.

Even so, we think the unfolding trade war is more likely to have a deflationary rather than an inflationary impact on the eurozone. Even if the European Commission retaliates with tariffs on US imports, it is important to remember that these only account for a tenth of total imports. Meanwhile, energy prices have already fallen due to expectations of a global economic slowdown.

What's more, with China facing much steeper US import tariffs, it is likely to redirect some of its excess capacity to Europe, exerting downward pressure on prices. These factors, along with weaker growth in the eurozone, are likely to keep inflation in check in the second half of the year.

Forecast for terminal ECB rate lowered to 1.75% (again)

The ECB, which was less dovish during the March meeting, is likely to change its tone again in April if Trump's tariff plans remain in place. Following the announcement of Germany's fiscal plans, concerns rose of an increase in medium-term inflation, prompting us to raise the terminal ECB interest rate to 2.25%. However, the short-term recessionary risk may now necessitate a temporarily more accommodative policy, bringing us back to our call from the pre-fiscal stimulus era. We now anticipate two 25bp rate cuts in the second quarter and a final one in the third quarter.

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