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Hope springs eternal for the eurozone

More signs of a bottoming out of the economy are showing up: even German industry is now growing again. The recovery should very gradually gain pace, while inflation is likely to continue its slow downtrend. The ECB is expected to start cutting rates in June, though the neutral rate has increased

Signs of spring and economic growth are appearing across the eurozone

Signs of life in German industry

With spring arriving, more economic indicators in the eurozone are turning from red to green. As such, the composite PMI rose in March above the 50 points boom-or-bust level for the first time since May 2023. Admittedly, the improvement is still essentially due to the services sector. And while confidence figures in the manufacturing sector are still weak, at least they're significantly above the low point of July 2023.

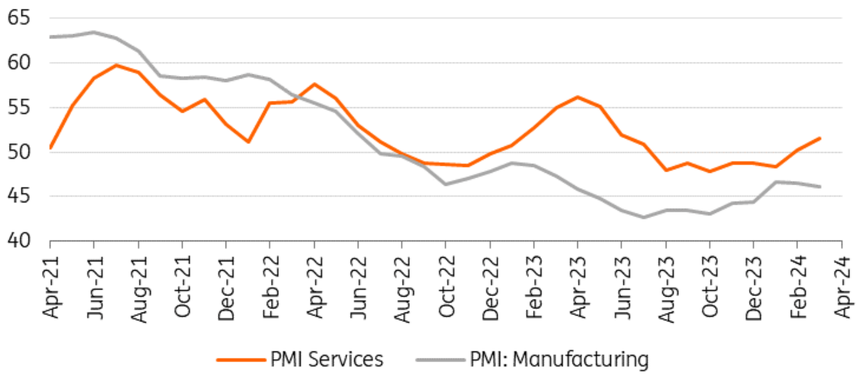
It is telling that in industrial powerhouse Germany, industrial production increased in the first two months of the year. The hope is that after two quarters of negative growth in the eurozone, the first quarter of this year might show some positive growth, even if it is somewhat subdued. Interestingly, confidence indicators in Spain, Italy, Portugal and Greece signal a more robust expansion than the eurozone average for the first quarter.

Things are improving, albeit slowly

The reasons for pencilling in a gradual recovery have not changed: cheaper natural gas and rising real household income will alleviate some of the pressure on energy-intensive industries and support household consumption. At the same time, the inventory correction in manufacturing should peter out in the coming quarters. The ECB's survey on access to finance shows that fewer firms are reporting a reduction in the availability of bank loans, a signal that the strongest impact of the monetary tightening is now probably behind us.

But we shouldn't get overexcited either. The current geopolitical climate remains a headwind for a very open economy such as the eurozone. And according to the PMI numbers, the construction sector remained firmly in contraction territory in March with weak order books not heralding an upturn in the short run. The bank lending survey also didn't show a significant improvement in credit demand yet. So, we expect rather modest growth figures in the first half of the year, leading to 0.4% average growth for 2024. 2025 should see the expansion returning towards potential, as we are pencilling in 1.4% GDP growth.

Economic temperature slowly rising



Source: LSEG Datastream

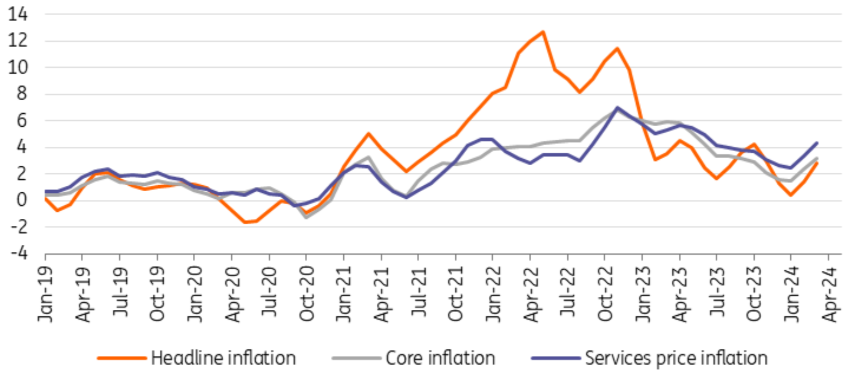
The Easter inflation effect is likely to be reversed

At 2.4%, headline Inflation came out better than expected in March, but if we compare the most recent three months with the previous three, the pace is still picking up for both the headline and core figures. This could be due to the early Easter, which typically affects hospitality and package holiday prices, which might not be captured in this year's seasonal adjustments.

So, this impact might be reversed again in April. We assume that natural gas prices will probably continue to hover around current levels, so we are reducing our estimate for average headline inflation for this year to 2.4%. For 2025, we anticipate 2.1% inflation.

Inflation deceleration temporarily interrupted

3m-on-3m annualised change in %



Source: LSEG Datastream

The door is opening for a rate cut, but higher terminal rate

With wage increases probably also over the top, the door is opening for the ECB to start cutting interest rates. We stick to our expectation of a first 25 bp rate cut in June, followed by two additional 25 bp rate cuts this year. Reading between the lines of a recent speech by Isabel Schnabel, the thinking within the ECB seems to have evolved to believe that the neutral interest rate has probably shifted upwards since the pandemic and is likely to stay higher for a while. An estimate of a nominal neutral rate between 2.25% and 2.50% now seems to be the consensus, something we subscribe to. Therefore, we continue to forecast that the deposit rate will be further reduced in 2025 to 2.5%, and subsequently remain at that level for some time to come.

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