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The eurozone's cyclical upturn continues

Despite renewed geopolitical uncertainty, most economic data shows a continuing modest recovery in the eurozone, even though structural problems are still not fully addressed. Inflation is still likely to hover around 2% this year, but a significant undershoot has become less likely. The ECB has no intention of changing interest rates this year



Despite renewed geopolitical uncertainty, things appear to be brightening up across the eurozone economy

The EU's difficult pursuit of new trade agreements

Geopolitics took centre stage again in January as the Greenland story raised tensions between the European Union and the US, with President Donald Trump also threatening to impose additional import tariffs on several EU member states. This seems to have cooled down for now, which should open the door for the approval of the EU-US trade deal in the still-hesitating European Parliament.

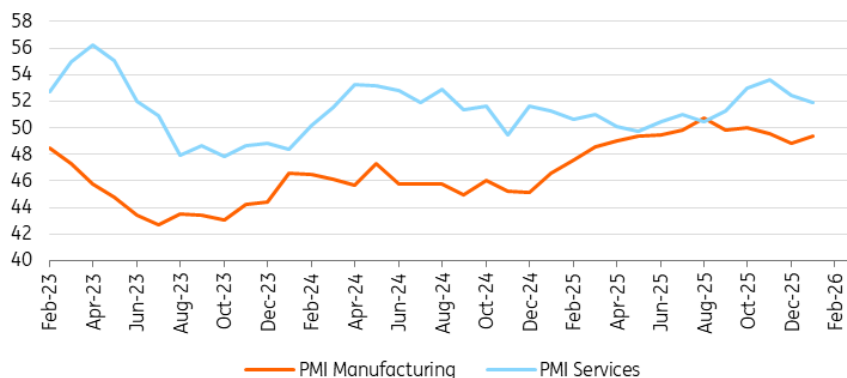
Meanwhile, the EU's aim to diversify away from the US by forging trade agreements with other nations suffered a blow as the European Parliament called on the European Court of Justice to assess whether the EU-Mercosur agreement conforms with the EU treaties. This will significantly delay ratification. Similar obstacles may affect the India trade deal as well, though

the exclusion of most agricultural products could reduce resistance. We can only notice that after the wake-up call Europe received from the America First Trump policies, it still seems very hard to sell the case for more integration and reform within the European Union.

The cyclical recovery continues

Despite only limited progress on Europe's structural challenges, the economy appears to be entering a cyclical upswing. The services sector continues to expand, while manufacturing is slowly emerging from its slump. In January, the PMI manufacturing output component rose above the boom-or-bust threshold, accompanied by a notable drop in inventories. Business sentiment regarding the outlook has strengthened, reaching its highest level in nearly four years. Confidence in France has also improved, likely helped by reduced political uncertainty following agreement on the 2026 budget, even though it still targets only a modest reduction of the deficit to 5% of GDP. Germany exited its downturn with 0.2% growth in the fourth quarter of 2025, and the rollout of its expansionary budget should support a further pickup in growth during the year. Still, due to a smaller carry-over effect, eurozone growth in 2026 is expected to reach about 1.2%, down from 1.4% in 2025.

PMIs show continuing modest recovery



Source: LSEG Datastream

Inflation likely to remain around 2%

December's final HICP reading came in at 1.9%, with core inflation at 2.3%. Wage growth is slowing, though not as quickly as the European Central Bank anticipated, while the recent rise in energy prices is likely to limit downward pressure on inflation in the near term. The PMI survey also reported the fastest increase in services-sector selling price expectations in 11 months. Assuming the energy price rise proves temporary, average headline inflation may still land just below 2% this year, but core inflation is unlikely to follow suit. Therefore, the case for a significant undershoot of inflation this year seems to have weakened.

The ECB remains stuck in a good place

Against this backdrop, the ECB has little incentive to adjust monetary policy. As Chief Economist Philip Lane put it in a recent interview: "In these circumstances, there is no near-term interest rate debate. The current level of the interest rate delivers the baseline for the next several years." We therefore anticipate stable short-term rates throughout 2026 and likely 2027. With market forwards hovering around 2% over the next two years, significant movements in bond yields also seem unlikely, though we still expect a small upward move.

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