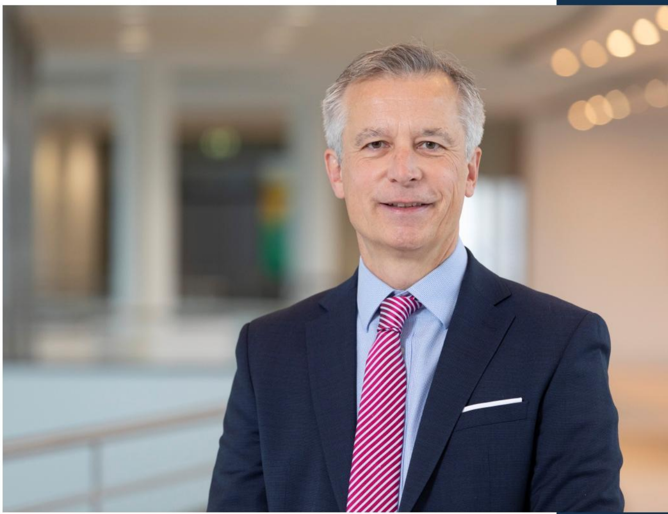

LB≡BW Bereit für Neues

To the point!

Cross-Asset- and Strategy-Research

ECB's mission accom-plished – for now

Moritz Kraemer -- Chief Economist
LBBWResearch@LBBW.de

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After the rate cut, the ECB is now on a summer break

Yesterday, the ECB cut its key interest rates for the first time since 2019. The deposit stands now at 3.75%. This was universally anticipated, including by LBBW Research. But what seems like one small step for the ECB – it only reversed one-eighteenth of the cumulative rate hikes since 2022 – is in fact a giant leap for the capital market, as it marks a beginning. From this point, key interest rates are expected to head only in one direction for the foreseeable future: downwards.

Descent from interest rate peak has begun

The stubborn beast has not been vanquished yet

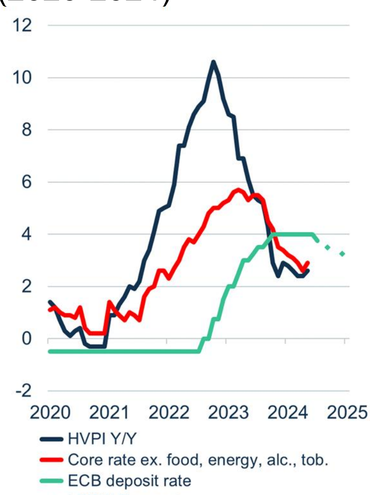
Recently, the hope for a swift descent from the interest rate peak was once again unsettled: Many market participants were startled as inflation rose more sharply than expected in May for the first time in 2024 (see figure). It had been foreseeable that the journey on the last mile could become somewhat rugged. Not least because the benign so-called "base effects" have ended.

While price increases for energy and food have largely dissipated, the persistent high price pressure in services (4.1%) is likely causing concern for Christine Lagarde & Co. This can be partly explained by the recently observed acceleration in wage cost increases. Services often require a lot of manpower. Hence, higher labor costs have a significant impact.

Overreaction in the bond market

The yield on the ten-year federal bond spiked after the inflation news, briefly approaching the 2.7% mark. This is the highest yield seen this year! Such a reaction seems exaggerated. Because over a decade, it hardly makes a difference whether the ECB cuts rates three times this year or maybe just twice. Don't forget: Since the inflation peak of 10.6% in October 2022, more

Euro area: Inflation rates and ECB deposit rate (2020-2024)



Source: Eurostat, ECB, LBBW Research

than 90% of the inflation exceeding the 2% target has already been trimmed. Yes, the last mile is the hardest, but as the long-distance runners among you know: Even with tired legs on the last kilometer, the finish line is within reach. This is encouraging.

The 2% target: So close and yet so far!

Christine is no clairvoyant

The rate cut was the right move. Even with a deposit rate of 3.75%, monetary policy remains tight. At the press conference, Lagarde resisted the temptation to commit to future rate moves. She simply couldn't. To do so, she would need to be able to see the future and already know the inflation trends of the coming months.

The ECB has slightly raised its own inflation forecasts for 2025. However, staff continues to expect that wage growth will slow and that companies will partially absorb the wage cost increases within their margins, rather than passing them on to consumers. This is a plausible scenario. But is just one of several possibilities. Therefore, the ECB is wise to proceed with caution and not rush anything. Further rate cuts in July have been effectively ruled out by numerous members of the central bank council in interviews and speeches. And rightly so.

LBBW Research expects two more rate cuts by the end of the year, in September and then again at the end of the year. This makes us slightly more optimistic than the consensus. But we draw encouragement from the fact that since the rate pivot in the summer of 2022, we have correctly anticipated every single ECB rate move.

Two more rate cuts by the end of the year

Please keep your fingers crossed that this streak continues!