September 12, 2024

A(nother) Cautious ECB Cut Amidst Uneasy Stability

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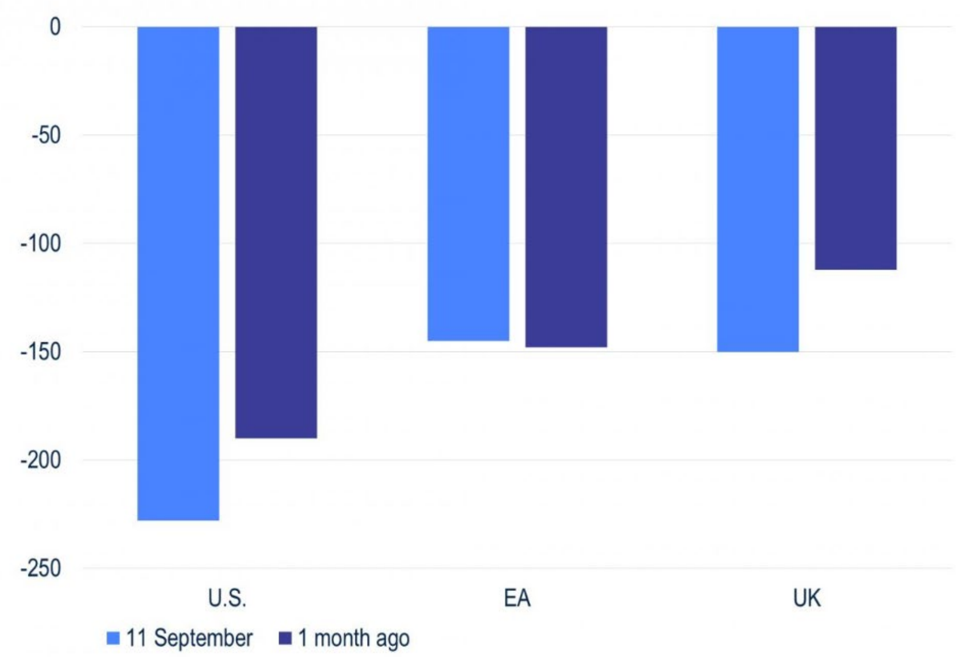
The ECB unanimously decided to cut its main policy rate to 3.5% at its September meeting. Despite an unchanged projection for headline inflation and downward revisions to growth, the ECB remains cautious when it comes to policy easing. The key factor underpinning that hesitancy is undoubtedly the continued resilience of domestically generated inflation. Until there are clear signs that easing wage growth is translating into materially lower services price inflation, we expect the ECB to remain on a gradual and limited path when it comes to further rate cuts, at least until the end of this year.

Our Take on the Meeting

In line with consensus expectations, the ECB reduced its main policy rate by 25 bps at Thursday's meeting, marking the second rate cut of its nascent easing cycle. Our view on the policy outlook is that it remains remarkably stable (see Figure 1 and our Market Insights below). For example, Euro Area rate-cut expectations have shifted only slightly over the last month relative to those in the U.S. and the UK.

FIGURE 1: The ECB's policy path is remarkable in its stability relative to the U.S., UK (cuts priced in over 12m)



Source: Bloomberg

As has been the case for some time, the ECB is expected to keep rates on hold in October before cutting again by 25 bps in December, bringing the policy rate to 3.25% by the end of this year. This stable and gradual near-term outlook belies the shift in macro undercurrents and the growing risk that inflation could undershoot the 2% target.

Contrary to expectations of a cyclical upswing, Euro Area growth came in weaker than expected in Q2, mainly due to weak domestic demand. Moreover, near-term prospects do not look encouraging, given weakening household and business sentiment. At 3.5%, current ECB policy rates remain significantly restrictive at 100-150 bps above neutral, according to the ECB's own estimates. Indeed, the ECB's latest forecast once again shows inflation below its 2% target by the end of the forecast projection.

Regardless of those risks, our view is that the bar for a rate cut in October remains relatively high. That said, we see growing signs of a policy pivot towards aggressive easing after the December meeting, triggered either by a marked slowing in the labour market or evidence that services inflation is indeed beginning to cool.

Market Insights

From a markets perspective, the ECB achieved something quite rare - a market with stable expectations for rate cuts, which coalesced around today's decision ahead of another potential cut in December. This narrow and stable path for rate expectations persisted despite a move to central bank data dependence, risk asset selloffs, and resurfacing fears of an economic hard landing.

The 10-year bund yield ended the day higher, selling off around 6 bps. However, in a further nod to the relative stability in regional conditions, this was mostly driven by U.S. inflation and jobs-related data, which, most recently, have not supported outsized cuts from the Federal Reserve.

With today's rate cut, the slow ECB easing cycle that the market priced in is coming to fruition. However, while the market sees a clear path for a continuation of rate cuts, the ultimate destination remains uncertain, but certainly warrants monitoring in terms of how it may relate to future portfolio positioning.

Source(s) of data (unless otherwise noted): PGIM Fixed Income, September 12, 2024
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2024-7090

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PGIMJ111682
3856687-20240913