CIO Memo

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Authors:
Dr.Ulrich Stephan
Chief Investment Officer Germany

Dr. Dirk Steffen
Chief Investment Officer EMEA

Michael Blumenroth
Senior Investment Strategist

ECB presses pause button

Key takeaways

- As firmly expected by financial markets and already indicated in advance by the European Central Bank (ECB), the ECB left key interest rates unchanged at its meeting today.
- ECB President Lagarde again emphasised the data dependence of monetary policy, but believes the ECB is well on its way to achieving the inflation target sustainably over the course of the coming year.
- Further interest rate cuts in September and December have been priced in on the interest rate futures markets. This is in line with our expectations.

1. What happened?

In line with market expectations, the ECB left its three key interest rates unchanged today. The rate for bank deposits at the ECB therefore remains at 3.75%.

In recent weeks, the ECB has increasingly given indications that it will be cautious about further interest rate cuts in the near term. "The strong labour market means that we can take time to gather new information," said ECB President Lagarde at the ECB Forum in Sintra (Portugal), referring to unemployment in the Eurozone. In May, unemployment was at a record low of 6.4%. However, one must also be aware of the fact that the growth outlook remains uncertain.

During the press conference today, Lagarde pointed out that the ECB sees risks for the economic development of the Eurozone in the second half of 2024. After a quarter-on-quarter increase in GDP of 0.3% in Q1 2024 (vs. Q4 2023), the ECB does not expect a more dynamic upturn in economic output in the following quarters. Lagarde explicitly emphasised the risks that could arise from potentially higher tariffs on goods exports from the Eurozone to the U.S., should these actually be introduced in the wake of the U.S. presidential elections.

Based on various ECB models, Lagarde forecasted that the Eurozone labour markets would soon ease and that wage pressure would therefore decrease. This is one of the reasons why the ECB remains optimistic that it will be able to achieve its inflation target of 2.0% in 2025.

According to Christine Lagarde, a rate cut in September is anything but certain, but rather completely open. She again pointed out that the ECB's decisions are data dependent.

2. How did markets react?

It had already been clearly communicated in advance that interest rates would remain unchanged. As expected, the data dependence of future decisions was emphasised again. Overnight index swaps therefore continue to price in around 48 basis points (bps) of interest rate cuts by December 2024, i.e. almost two more of 25 bps each. Lagarde's statement that the risks to economic development were pointing downward triggered minor to moderate market reactions. Yields on two- and ten-year Eurozone government bonds fell slightly, and the EUR depreciated moderately against the USD. The Eurostoxx 50 traded around 0.4% higher.

3. What does it mean for investors?

Lagarde gave no forward guidance regarding a rate cut in September. During the press conference, when asked whether a cut could be expected if the data developed as the ECB expected, she said: "The question of September and what we will do then is completely open and will be decided on the basis of the data available at that time." When asked whether her confidence in the expected decline in inflation had increased or decreased compared to June, she said: "If additional data were to confirm the ongoing disinflation process, then that would strengthen our confidence."

The fact that the ECB sees increasing risks of a weakening economy argues in favour of an interest rate cut in September. The ECB also played down the fact that both the core inflation rate and the services inflation rate remained well above the ECB's target in June. New inflation data and data on wage developments will be published twice before the September meeting. If these fall significantly short of expectations, significant market movements are likely to be the result.

The ECB meeting today had little impact on prices in financial markets. The meeting of the U.S. Federal Reserve on July 31 and possibly also developments of a (geo-)political nature, particularly in the context of the U.S. elections in November, are likely to have greater relevance for market prices.

However, further interest rate cuts by the ECB in September and December remain likely. Although these are largely priced in, government bond yields could still have moderate downward potential for short maturities. Stock markets are supported by the prospect of further interest rate hikes. The EUR/USD rate is only likely to move more strongly if expectations of a parallel development in the monetary policy of the Fed or the ECB change.

Glossary

2% target: In the medium term, the ECB is aiming for an inflation rate of 2%.

GDP: The gross domestic product (abbreviation: GDP) indicates the total value of all goods, i.e. goods and services, produced within the national borders of an economy within one year after deducting all intermediate consumption.

Deposit rate: The deposit rate specifies the amount of interest that banks receive if they deposit money with the central bank by the next business day.

EUR is the currency code for the euro.

Euro Stoxx 50: The EURO STOXX 50 is a share index comprising 50 large listed companies in the eurozone.

Eurozone: Comprises the 20 EU countries in which the euro is legal tender: Austria, Belgium, Croatia, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain.

ECB: The European Central Bank is an institution of the European Union. It is the common monetary authority of the member states of the European Monetary Union, founded in 1998, and forms the European System of Central Banks (ESCB) together with the national central banks (NCBs) of the EU member states.

Monetary policy: In summary, monetary policy refers to all economic policy measures taken by a central bank to achieve its objectives.

Main refinancing rate: The main refinancing rate is the interest rate at which banks can borrow money from the ECB for one week.

Inflation: Inflation describes a sustained increase in an average price.

Core inflation: Core inflation is an economic concept for measuring inflation that does not take into account the price changes of certain goods. The core inflation rate excludes prices for food and the energy sector from the calculation, as these are subject to greater fluctuations, the causes of which are not to be found within the economy under consideration.

Key interest rate: The key interest rate is the interest rate unilaterally set by a central bank as part of its monetary policy, at which it concludes transactions with its affiliated credit institutions.

Marginal lending facility: The marginal lending facility is the interest rate at which banks can borrow money from the ECB until the next business day.

In finance, a swap is the English term for derivative financial instruments whose common feature is the exchange of future payment flows.

Transmission: The effect of central bank policy on the economy.

USD is the currency code for the US dollar.

Performance	7.18.2019 - 7.18.2020	7.18.2020 - 7.18.2021	7.18.2021 - 7.18.2022	7.18.2022 - 7.18.2023	7.18.2023 - 7.18.2024
Eurostoxx 50	-3.4%	19.9%	-13.0%	24.4%	11.9%
10-year german gov. bonds	1.5%	-0.4%	-12.9%	-7.5%	2.3%

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