

Special Coverage:

ECB delivers first cut, but will need more confidence for the next one

Key takeaways

- ◆ The ECB delivered its first rate cut in almost five years, and did not wait for the Fed to act first. The move comes 9 months after the last hike was delivered which had marked the end of 4.5% of cumulative hikes delivered in the space of approximately 1.5 years. The ECB became the fourth major Developed Market central bank to ease rates, after similar moves earlier from the central banks in Switzerland, Sweden and Canada.
- ◆ Markets were ultimately fully pricing in the move and focus on any clues of the future pace and timing of cuts. The explicit easing bias was removed from the press statement. Inflation projections were raised for 2024 and 2025, though Ms Lagarde avoided to make any speculation on the timing of future moves.
- ◆ Our base case remains for two cuts in 2024 but data dependency and revised language from the ECB create risk for a more moderate pace. The start of the cutting cycle reinforces our view that a ceiling in yields has been reached, so any volatility can be seen as an opportunity for investors to put cash to work in quality bonds. We remain neutral on Europe ex-UK equities and prefer to gain exposure in European companies that are global market leaders with high levels of profitability and product innovation in their sector.



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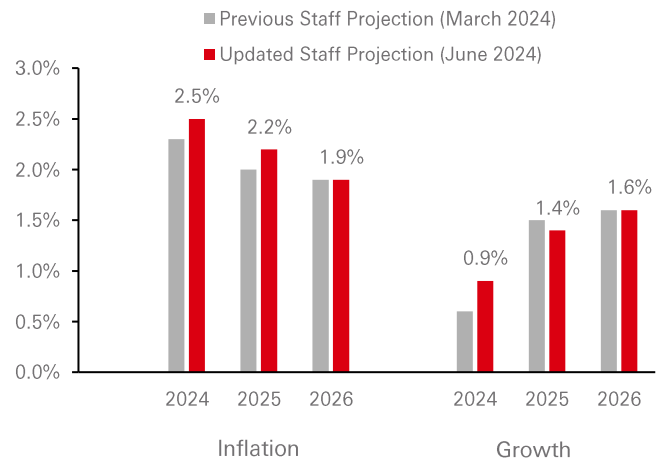
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What happened?

- The ECB announced a 0.25% cut in its key policy rate to 3.75%, a move that was fully priced in swaps markets heading into the meeting. This makes the ECB the fourth major Developed Market central bank to cut rates, after the central banks in Switzerland, Sweden and Canada undertook similar moves recently. Moreover, it is the first time the ECB has cut rates before the Fed.
- It marks the first cut in policy rates since 2019. It is also the first reduction from the 4.5% record high that was reached 9 months ago, when an aggressive 4.5% cumulative rate hiking cycle, that started in July 2022, came to an end in September 2023.
- The rate cut comes despite higher inflation forecasts for 2024 and 2025. The ECB defended its (almost unanimous) decision to cut rates by citing the substantial progress in inflation that has been delivered in recent years. The ECB assumes wages will remain elevated, however its trackers point towards some moderation ahead. Ultimately, interest rates remain restrictive after the recent cut, and there is still some way to go until the neutral rate according to Ms Lagarde's response to the cut.
- The ECB Governor refrained from speculating on the timing of future cuts. She did, however, acknowledge that the quarterly meetings typically offer more information compared to other months which could embolden expectations for a move in September, particularly if price data over the summer does not surprise to the upside. After all, Ms Lagarde highlighted an improvement in "the reliability of (ECB) forecasts" and that "overall confidence in the path ahead has been increasing."

- Although the small uptick in the May inflation data did nothing to alter expectations for June, the market had already dialled down its expectations for a second consecutive rate cut. The updated staff projections seem to make a July rate cut possibility rather remote, however, a September move remains firmly on the table with a 94% probability. A total of 0.44% is priced in from now until year-end, suggesting a 56% chance of a further cut in December.
- The repricing of interest rate swaps led to a rise in European yields with 2-year bonds rising 0.04-0.05% across both core and peripheral markets, and 10-year bonds rising by 0.05-0.06%.
- European equities trimmed their gains after the ECB meeting, with the Stoxx 600 up 0.6%. Tech, healthcare and financials led gains with all three sectors up by at least 1% on the day, whereas utilities, real estate and communication services were in the red.

The ECB refrained from any guidance on future cuts, as inflation forecasts were revised higher for 2025



Source: Bloomberg, HSBC Global Private Banking and Wealth as at 6 June 2024. Forecasts are subject to change.

Investment implications

- Bond investors should not be worried from the knee-jerk rise in European yields. After all, policy rates came down and the ECB expressed growing confidence in the reliability of its forecasts, stating that we are already in restrictive territory and have further room to go to the neutral rate.
- The removal of an explicit easing bias from the policy statement could inject some volatility, particularly around key inflation and wage data releases. But overall, we believe a ceiling in European bond yields has been reached and therefore view this as an opportunity to put cash to work in quality bonds, preferably investment grade rated corporates in the region as spreads in high yield are on the tighter end of historical averages.
- It is encouraging to see that economic growth in Europe bottomed out in H2 2023, and future indicators suggest some further economic upside in the near term despite the lingering geopolitical and trade headwinds. Ms Lagarde also highlighted that the recovery is expected to continue in the near term, thanks to improved real wages and better terms of trade. The latest round of PMI data confirmed the forward-looking indicators such as new orders and new export orders.
- Following the conclusion of the Q1 earnings season, the earnings revision ratio has turned comfortably above the 50% mark. While growth indicators are picking up, it will not be until later in H2 2024 that we expect a rebound in equity earnings to reflect this (EPS growth for FTSE Europe forecasted at approximately 6% y-o-y for FY'24 and 10% for FY'25).
- We remain neutral on Europe ex-UK equities and prefer to gain exposure in European companies that are global market leaders with high levels of profitability and product innovation in their sector.
- The recovery in EUR has been spurred from improved risk sentiment, cyclical strength and the latest upward surprise in European wage and inflation data. We expect EUR/USD to soften in H2. Our latest forecasts call for one Fed cut in September, meaning that absolute and relative interest rate differentials should still favour USD.

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