CIO Memo

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ECB delivers expected easing

Key takeaways

- As expected and priced in by the financial markets in advance, the European Central Bank (ECB) lowered key interest rates by 25 basis points each at its meeting today.
- The ECB has also revised its short-term growth and inflation forecasts for 2024 and 2025 slightly downwards, but still expects an economic recovery in coming years.
- We still expect four rate cuts by the end of 2025 of 25 basis points and thus a final deposit rate of 2.0%. By contrast, markets are pricing in five such adjustments.

1. What happened?

As expected, the ECB's Governing Council unanimously decided at its meeting today to cut the key interest rates by 25 basis points (bp) each, effective December 18. This means that the deposit rate will be 3.00%, the main refinancing rate 3.15% and the marginal lending rate 3.40%.

In the accompanying statement, the monetary authorities point to good progress in bringing down inflation and, as part of their updated macroeconomic projections, revise the expected short-term inflation path downwards by 0.1 percentage points compared to their September forecast. An average headline inflation rate of 2.4% and 2.1% is now expected for 2024 and 2025, respectively, while the forecast for 2026 remains unchanged at 1.9%. For 2027, the final year included in the forecast period, the ECB expects a slight increase in headline inflation to 2.1% due to higher prices in CO_2 certificate trading.

With regards to core inflation, most parameters indicate that the underlying price pressures will make it settle around the target level of 2% in the medium term. Rates of 1.9% are forecast for 2026 and 2027 respectively. Average core rates of 2.9% and 2.3% are still expected for 2024 and 2025.

Despite the slight economic improvement in the third quarter, the ECB expects growth to slow in the current quarter, given overall weaker leading indicators. Against this background, it expects a slower recovery than it did in September, which is reflected in slightly downwardly revised growth expectations for the forecast period. Specifically, GDP growth is now expected to reach 0.7% in 2024, recover to 1.1% in 2025 and pick up further to 1.4% in 2026, stabilising at around this level at 1.3% in 2027.

2. How did markets react?

The widely anticipated rate decision initially triggered a muted market reaction. In afternoon trading, stronger than expected producer price data from the U.S. caused yields to rise in the bond markets.

At the time of writing, two- and ten-year German government bonds are yielding 2.01% and 2.19% respectively, both six basis points higher than at the start of trading.

After some volatility, the euro was little changed at EUR/USD 1.051. European equities are slightly up.

3. What does it mean for investors?

Particular attention was paid in the press conference's Q&A session to the fact that, contrary to previous statements, the clause that the Governing Council would "keep key interest rates sufficiently restrictive for as long as necessary" to achieve a rapid return of inflation to the medium-term objective of 2% was dropped. However, this should not be understood as an indication of a future major rate cut of 50 basis points, explained ECB President Christine Lagarde, with her underlining once again the data dependence of future decisions by the Monetary Policy Council.

While Lagarde stressed that risks to growth forecasts remain tilted to the downside, she noted that uncertainties about future U.S. trade policy and developments in some EU member states (a reference to France and Germany) are expected to diminish in the coming months. This is also reflected in the ECB's growth forecasts, which continue to assume a slow economic recovery. In addition to positive real wage growth, which should benefit private consumption, we think that expected successive key interest rate cuts in the coming quarters should also strengthen economic activity in the euro area.

The markets are currently pricing in an ECB deposit rate of less than 1.75% by the end of 2025. The associated easing path seems too aggressive to us from today's perspective. We continue to expect four key interest rate cuts of 25 bps each over the next four quarters, which would bring the deposit rate to 2.0%.

We maintain our view that the interest rate structure will further normalize over the next 12 months.

Glossary

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

Bunds is the name for federal bonds, i.e. German government bonds.

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

Disinflation: This means a reduction in the increase in the price level, i.e. the pace of price increases is decreasing.

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

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

EUR is the currency code for the euro.

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

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

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

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

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

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

Monetary policy: Monetary policy is a summary of all economic policy measures that a central bank takes to achieve its objectives.

USD is the currency code for the US dollar.

Performance	11.12.2019 - 11.12.2020	11.12.2020 - 11.12.2021	11.12.2021 - 11.12.2022	11.12.2022 - 11.12.2023	11.12.2023 - 11.12.2024
30-Year German Bund	13.3%	-5.1%	-38.2%	-17.5%	1.2%
10-Year German Bund	3.3%	-2.2%	-17.7%	-0.1%	3.7%
2-Year German Bund	-0.5%	-0.8%	-3.7%	1.6%	3.1%
EURUSD	9.2%	-6.6%	-6.8%	1.9%	-2.4%

Source: LSEG Datastream, Deutsche Bank AG. Date of December, 11 2024.

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