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MACRO MORNING BRIEFING

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ECB Preview: June Rate Cut To Be Reaffirmed

ECB needs to put clear distance between it and the Fed

- Eurozone and US cycles not synchronised
- Eurozone labour market still loosening, albeit slowly
- Southern Europe performing well but cannot compensate for core weakness

Meeting should be considered 'live', but June consensus will stand

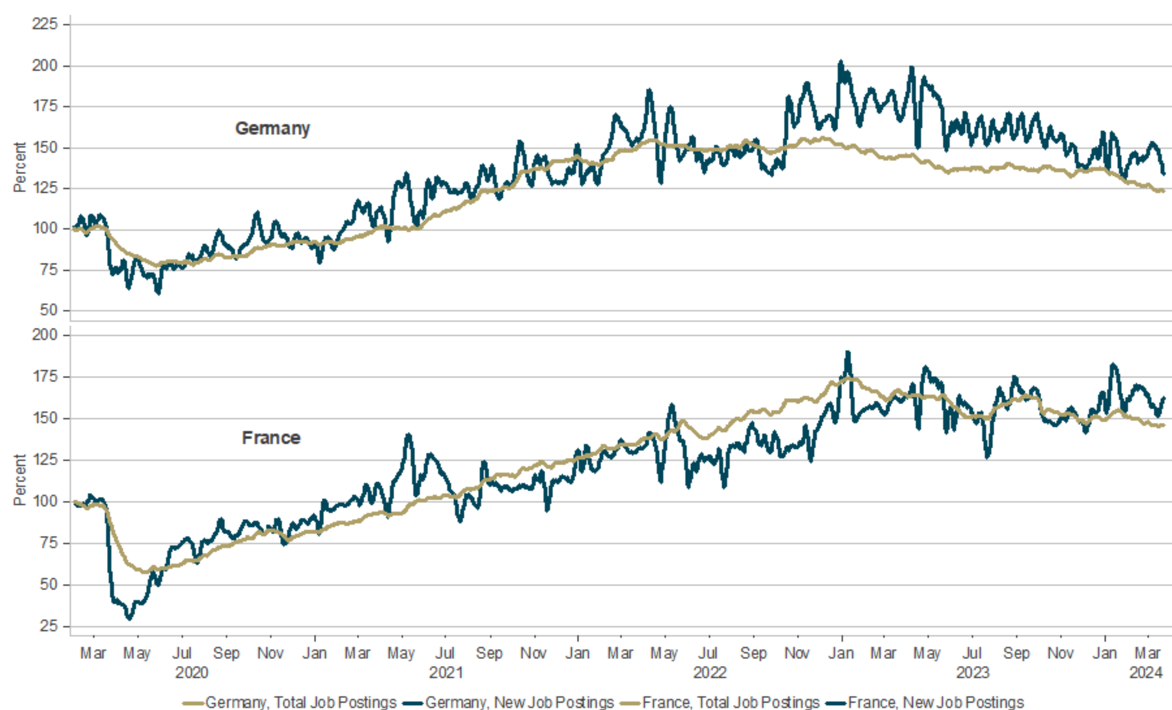
As much as the market might worry about what ‘no landing’ for the US economy could mean for the Federal Reserve's policy path, we think investors need to resist the temptation of extrapolating the Fed's policy communication and the broader US cycle into conclusions for other central banks. In our Monday preview of this week's central bank decisions, we expressed concerns around the synchronisation of policy cycles between the Fed and the European Central Bank. We think the latter’s decision on Thursday represents an opportunity for President Lagarde to highlight the differences.

If anything, the ECB's April Bank Lending Survey (press release) suggests that financial conditions in the Eurozone are too tight already. Loan demand saw a “substantial decline… [which] contrasted with banks’ prior expectations of stabilisation”, and the “positive income effect from rate hikes [were] fading”. The survey hardly paints a picture of rude health in an expanding economy. Moreover, the Eurozone lacks the credit-augmentation mechanisms available in the US, such as strong levels of private equity and private credit.

We would not be surprised to see calls for rate cuts this week. After all, the Swiss National Bank's surprise in March means every European central bank decision henceforth should be considered 'live'. The only delay we see is due to the persistence of hawkish Governing Council members in emphasising upside risks to prices and demand through the labour channel. On this factor alone they may have a case, as high-frequency labour openings data in Germany and France (exhibit #1) have clearly stabilised. To borrow a phrase from the

Bank of England's February policy decision (but dropped in March), "the labour market was still relatively tight…[and] the pace of loosening had been slow." Yet, the ECB's peers have been forthright in stating that the direction of travel matters, and there was no need to wait until inflation had fallen to target (or the labour market had loosened in a manner consistent with such) before acting, especially if other areas of the economy require support.

Exhibit #1: No Collapse In Job Openings



Source: Macrobond, BNY Mellon

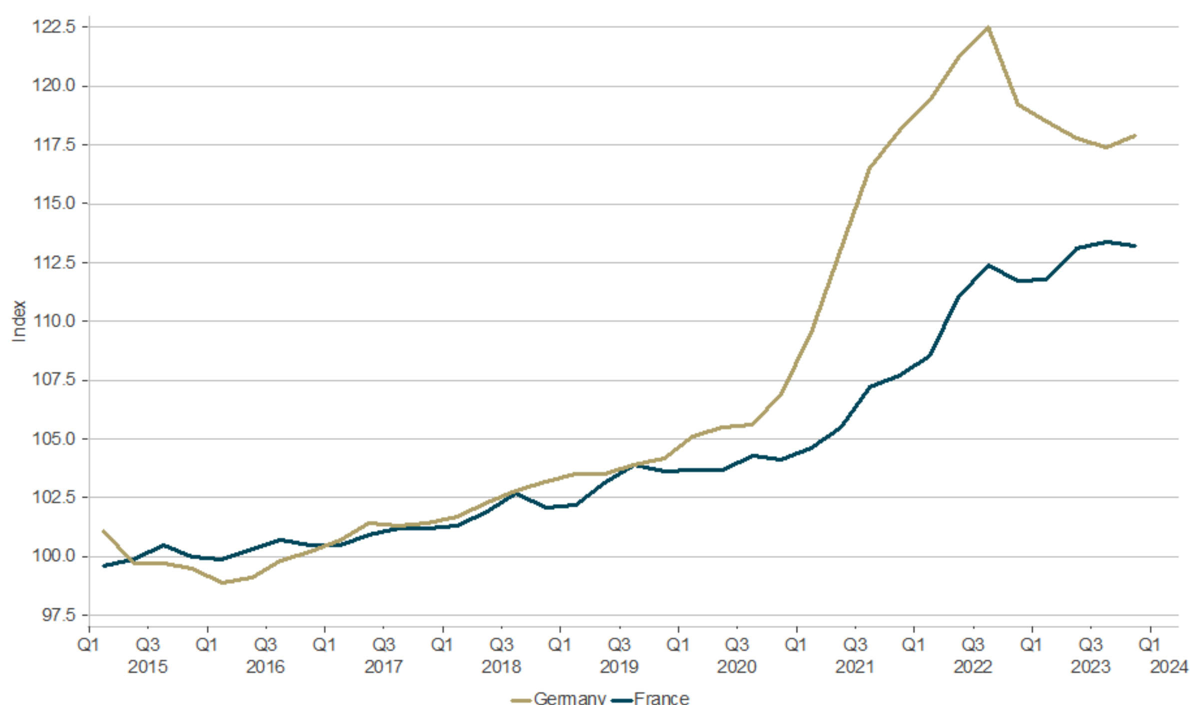
The lack of declines in wage growth due to rising public spending and low productivity growth has been a core view for the ECB since at least President Lagarde's Sintra speech last year. If activity and survey data across financial (e.g., loans and credit) and activity channels (e.g., PMIs, industrial production) continue to indicate contraction over the last two quarters at least, we believe the ECB will need to acknowledge the state of the cycle and give the strongest possible signal of easing to stabilise expectations. Core inflation and loan demand surprising expectations to the downside clearly point to underlying weakness.

Even if wages are holding up well, the lack of confidence in economic expectations will translate into higher savings rather than stronger demand – a matter the Bank of Japan has struggled for decades to overcome. For example, we can see that services prices (exhibit #2) are no longer growing – and in Germany's case have come off materially from the highs over the past quarter. Considering that the wage component will likely continue to contribute positively to services, the lack of services price growth suggests the demand channel is weakening, and this is contributing to the rapid declines in core inflation.

Over the past quarter, the hawks on the Governing Council have appeared willing to concede that the status quo for financial conditions is not sustainable and are no longer pushing back

against the need for easing. However, there are renewed risks to headline inflation emerging from the recovery in energy prices. The March technical assumptions had oil prices below $80/bbl before falling further through their forecast horizon. In the name of anchoring inflation expectations and avoiding a wage/inflation spiral, some quarters of the Governing Council may call for greater vigilance. We would beg to differ, however, given that the supply factors relative to demand are not comparable to 2022. Maintaining tight financial conditions with precious little growth impulse would threaten further stagflation, in our view.

Exhibit #2: Services Prices Starting To Struggle



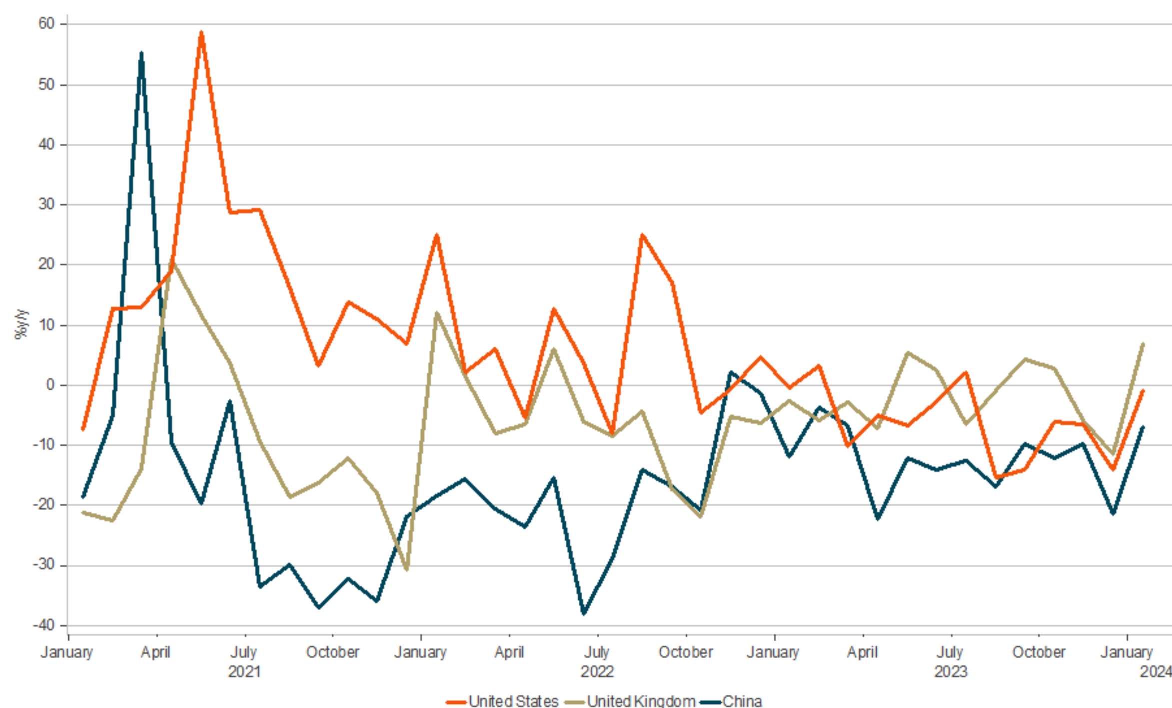
Source: Macrobond, BNY Mellon

It is not just domestic factors to which the ECB should be attuned. Justified or not, China's industrial capacity is now at the top of the European and US political agendas and has generated fears of a downward price spiral for high value-added manufactured goods. The ECB should also be concerned that Eurozone exports are showing clear signs of stagnation. Annualised German export growth (exhibit #3) to the US and China has registered only a handful of positive months over the past year – in China's case only one since April 2021. Furthermore, the structural changes in China's economy on its quest to achieve supply-chain resilience could also mean that a return to the strong growth of the past is unlikely.

Crucially, German export growth to a supposedly booming US economy is also contracting. Not dissimilar to China, US industrial policy is accelerating a shift in production to onshore or nearshore. Several Asian semiconductor companies have announced over $50bn in investments (outright or subsidy-based) in the US over the past week alone. Given the incentives, we see no reason European peers shouldn't follow. To be clear, this is not an argument for the ECB to cut rates to bring down the euro. These are structural changes, and

the lack of a comprehensive EU-based industrial policy is beyond the ECB’s control. Rather, the ECB should be prepared for further downside surprises in growth via the corporate income channel, and that would likely require a response through financial conditions.

Exhibit #3: Export Weakness Remains Pronounced



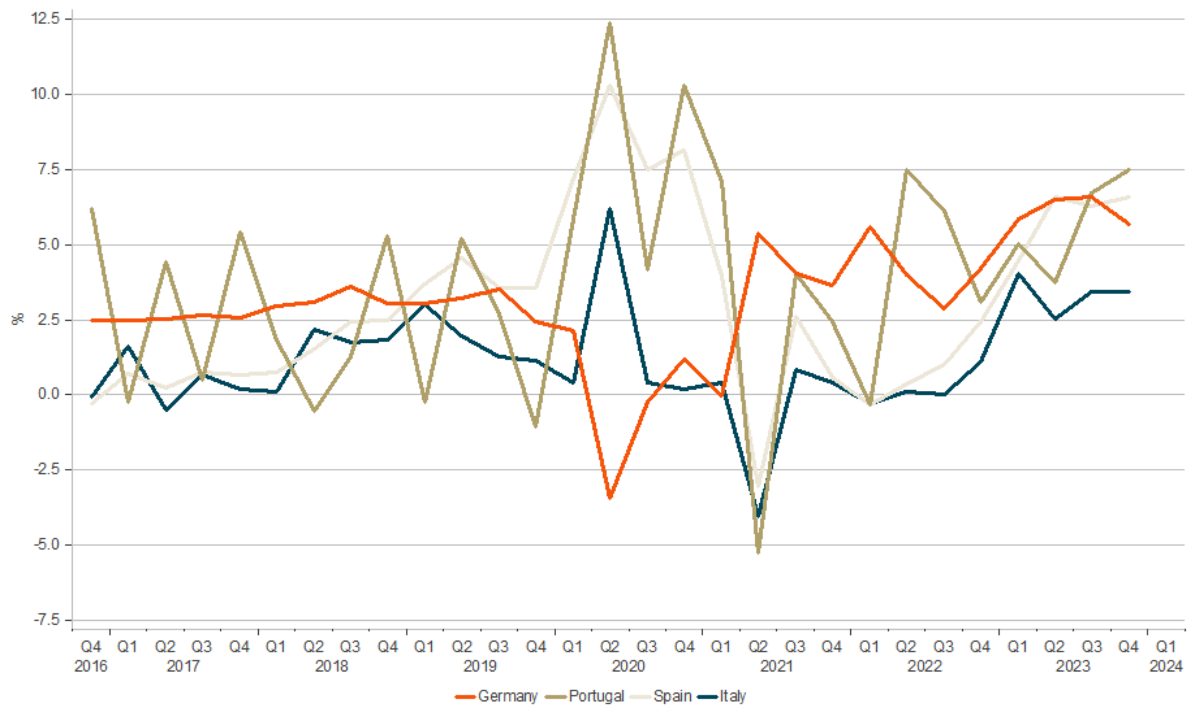
Source: Macrobond, BNY Mellon

We note that a recent argument against aggressive easing has emerged, this apparently resting on the strong performance of Southern European economies (formerly known as ‘the periphery') thanks to the strong performance of services demand over the last two years. In the past, these countries with structurally low growth rates supposedly would be the first to demand ECB support. While the current Eurozone cycle does defy conventional ‘North vs. South’ economic stereotypes, we would not over-emphasize the positivity either in a policy context. Ultimately, if the Governing Council is fixated on wages, then this is where comparisons should be made, rather than heavily lagged and volatile GDP numbers.

Total wage growth in Portugal and Spain is running higher than in the German equivalent, but this is the exception. We can see throughout much of 2022 and 2023 (exhibit #4), Germany wage growth outperformed the South – and will continue to be the dominant factor in aggregate Eurozone figures, especially with Italy wage growth continuing to trend much lower. Admittedly, absolute levels of wage growth in Southern Europe are the highest in several years and so have removed some of the urgency to ease rates. However, if this is indeed largely attributable to services demand growth, by President Lagarde’s own admission, the value-added component will be limited and such trends only make a stronger case for further stagflation – hardly a positive development for Eurozone assets, as seen in

2022. In fairness, Southern Europe Governing Council members are largely supportive of early easing. In any case, we don't see the broader direction of travel for policy disrupted.

Exhibit #4: Southern Outperformance Exaggerated



Source: Macrobond, BNY Mellon

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