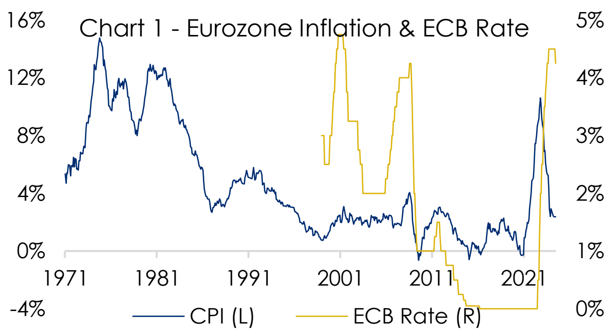
Market Snapshot

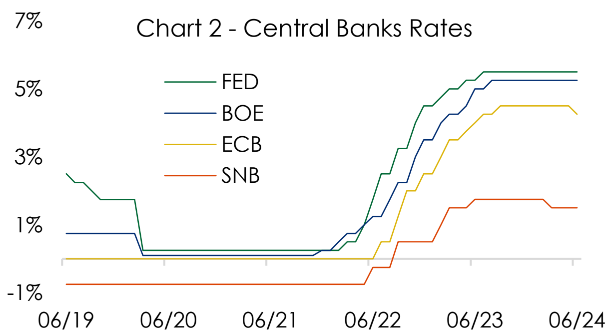
JUNE 2024

EUROPEAN CENTRAL BANK RATE CUT DECISION

The European Central Bank (ECB) cut its main refinancing rate as expected by 25bps to 4.25%, after over 2 years of tightening conditions to fight the highest Eurozone inflation recorded in decades and first desynchronization with the US Federal Reserve.

The ECB, whose stated objective is prices stability, started discussions to fight inflation in late 2021. Its first action was to reduce the pace of net asset purchases, which was halted by mid-2022. The general level of consumer prices in member states rose with the recovery from the COVID-19 crisis, and accelerated with the Russian invasion of Ukraine, peaking above 10% before slowing to 2.4% in April 2024, closer to the ECB's 2% annual target inflation.



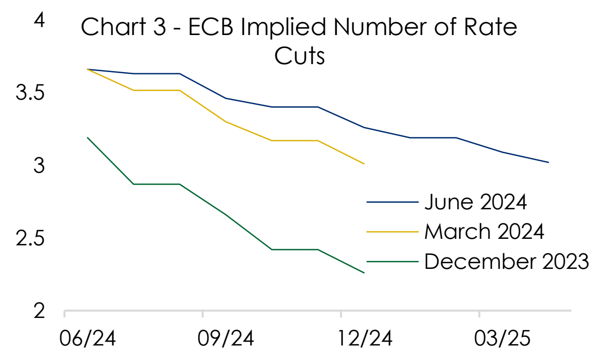


The ECB initiated its rate hikes cycle in July 2022, marking the end of an over 6-year period of zero rates and its first hike since the quickly aborted rate hike cycle of 2011 in response to the eurozone sovereign debt crisis. Chart 2 shows that the ECB was the last major central bank to hike its rate (the Bank of Japan left it unchanged in 2022); 7 months after the Bank of England (BOE), 4 after the US Federal Reserve (FED) and 1 after the Swiss National Bank (SNB), which was the first to cut in March 2024 by surprise. This initial ECB rate hike was 50 basis points, followed by 9 increases to combat rising inflation.

The ECB did not hike its key rates as quickly as its peers because it did not cut them during the pandemic, unlike most others, and the first step for tightening financial conditions was to unwind its quantitative easing program. The ECB was also facing a dilemma in setting the same key rates for all member states. Significant economic health differences could have damaged the equilibrium of the Union.

The fastest rate hike cycle of the ECB's short history has not caused a Eurozone recession as it is expected to grow 0.7% in 2024 and 1.4% in 2025. The future will tell whether the ECB's monetary policy was a success. Although the ECB officials do not give guidance for the future path of interest rates, additional rates cuts are expected. Indeed, Euro overnight index swaps futures are pricing about 2 more cuts in 2024 (in September and December) to 3.3%, before establishing around 3% in the medium term. First market reaction post the decision was higher yields given the ECB's raised inflation forecast. The euro generally appreciated.

Graph 3 shows that expectations for future ECB rates cuts have changed over time. In the end of 2023, markets were pricing in 7 cuts for 2024. In March, it was 4.



Further rate cuts are mostly priced in by markets, but some areas of the economy will benefit from lower rates as financing will become cheaper. It will ease pressure on the real estate market and other leveraged sectors. Lower rates are generally supportive for equities and fixed income instruments. The net impact on the European currency is difficult to assess as other central banks actions must also be considered.

Sources: ECB, Bloomberg

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