

MARKET COMMENTARY

ECB navigating through the trade war with a dovish policy stance

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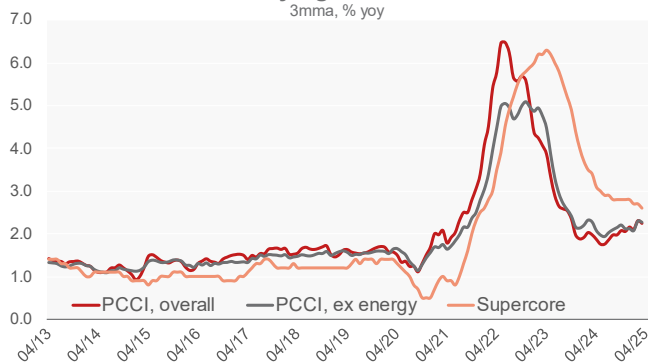
- At today's meeting the ECB's Governing Council (GC) again decided to cut its key rate by 25 bps (depo rate to 2.25%), in line with latest market expectations.
- The GC saw the inflation development as in line with its projections. The key rationale for today's cut was the expected adverse fallout of the rising trade tensions on growth via tightening financial conditions.
- The current "*exceptional uncertainty*" was emphasized and in the Q&A President Lagarde mentioned readiness and agility to cope with it. The ECB no longer characterised its policy stance as "restrictive" not only due to the further cut but also since the benchmarking vs. hypothetical neutral rates only worked in a shock-free world.
- While the trade tensions were clearly seen as negative for growth the fallout on inflation is still not clear to the GC. Also, the implementation of the German fiscal boost will be important and Mrs Lagarde suggested that the updated macro projections at the next meeting will give more of needed evidence.
- We think that in the end further rate cuts are still in the offing and see 25 bps cuts in June and July bringing the key rate down to 1.75%. We see the risk even tilted to lower rates, largely depending on the evolution of the trade war.

ECB cut by 25 bps today: At today's meeting the GC cut its key rate, the deposit rate, for the seventh consecutive time to 2.25%. It continues with fully non-reinvestments of its APP and PEPP purchases.

Inflation on track but huge uncertainty from the trade war: The expectation of a sustained return towards target is fueled by receding domestic inflation amid moderating wage growth while measures of longer-term inflation were around 2%. Looking

ECB's underlying inflation measures

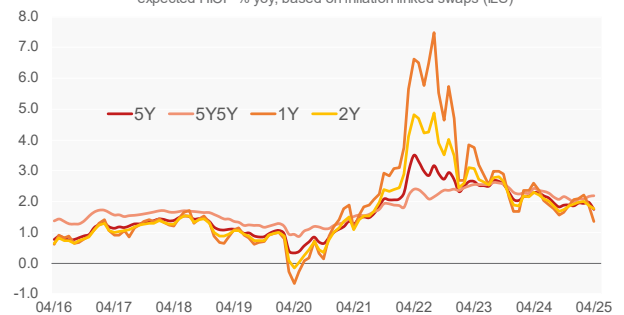
3mma, % yoy



Source: Datastream, ECB

Market inflation expectations

expected HICP % yoy, based on inflation linked swaps (LS)



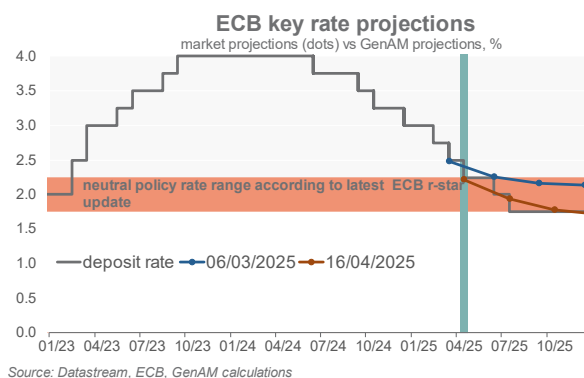
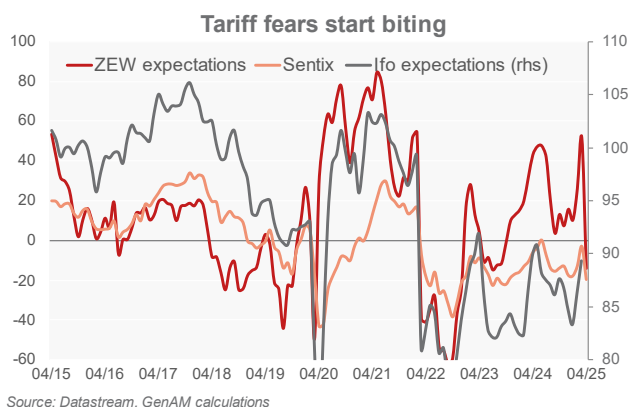
Source: Datastream, ECB, GenAM calculations

ahead, the elephant in the room are US import tariffs and the question whether they will in the end be fully implemented triggering also the implementation of retaliation measures or whether a full-blown trade war can be avoided. Over the past weeks GC members consistently stressed the emerging huge uncertainty, something also hammered at today's press conference by President Lagarde. While there was no doubt about increased downside risks to activity, the wording on the inflation outlook emphasized higher uncertainty. On the one hand lower growth, a stronger euro and the re-routing of global exports could in the end dampen inflation while on the other hand a fragmentation of global supply chains and the envisaged fiscal boost on defence and infrastructure spending could lift inflation. She also pointed out that the net impact from the current trade tensions on inflation would only become visible through time.

Appropriate policy stance also becomes uncertain: Unlike to previous meetings, the GC restrained from characterizing its policy stance as "restrictive" not only due to the further cut but also since the benchmarking vs. hypothetical neutral rates only worked in a shock-free world. That said, with the reading of 2.25% the deposit rate is at the upper bound of the neutral policy range (1.75% to 2.25%) derived from the ECB's proprietary [neutral policy rate estimates](#). In which direction and how far the ECB will need to go will hence depend primarily on the materialization of risks. In the Q&A it became clear that data-dependency and meeting-by-meeting approach remain the ECB's mantra in these times. Along this line, at today's meeting the concept of readiness to the development of new shocks and action was introduced.

Updated June macro projections to include trade war: At the forthcoming June 5 meeting we will know more about the trade war and data might also give some indication about the ultimate effect on inflation. At this meeting the ECB staff will also update its macro projections and, as Mrs Lagarde stated, run several scenarios. We think that it will be an important ingredient for the GC of how to navigate through the trade war.

We see further rate cuts still in the pipeline: We continue to think that on balance forecast changes will be disinflationary due to a negative activity effect from tariffs, the recent appreciation of the EUR and that the EU will manage to keep the inflationary effects of its potential retaliation measures low, e.g. by focusing on US services. According to Mrs Lagarde, today's cut was an unanimous decision and we see this in line with our assumption that the GC wants to cushion the euro area economy against the trade war fallout as much as possible. We therefore already adjusted our ECB landing rate down to 1.75%, from 2.0% before, and expect the ECB to cut by another 25 bps at the June as well as July meeting. We even see the risk that strong global fallout of the tariff war (e.g. pushing US into recession, diminishing Chinese growth strongly) might in the end force the ECB to cut into outright expansionary territory.



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