06 MARCH 2025

RATES DOWN, DEFENSES UP

The European Central Bank (ECB) cut its deposit rate by 25 basis points (bps), to 2.5%. The rate cut itself was widely anticipated; the main news was in the ECB's updated macroeconomic projections and accompanying communications, which provided key insights into the monetary easing path ahead.

The ECB's latest communications pointed to a tempered outlook for the Eurozone's economic growth. The Bank downgraded its Gross Domestic Product (GDP) forecast for 2025, from 1.1% to 0.9%, and for 2026, from 1.4% to 1.2%, citing weaker exports and ongoing investment sluggishness amid trade and policy uncertainty. Inflation projections were largely unchanged, with the 2025 forecast revised slightly upward due to higher energy prices between December and March. The projection for headline inflation in 2027 was lowered from 2.1% to 2.0%, while that for core inflation remained at 1.9%, consistent with the ECB's view that disinflation is "well on track." Notably, the ECB refined its policy language, now describing its stance as "meaningfully less restrictive" as opposed to its previous language of "restrictive". We took that as confirmation that the Bank sees its rate-cutting cycle as nearing its end.

During the press conference, President Lagarde heavily emphasized that the future policy decisions will be driven by the data and, therefore, not on a predetermined rate path. She also acknowledged upside risks to inflation, particularly those associated with increased defense and infrastructure spending.

The meeting was perceived as slightly hawkish based on the bear steepening curve move post meeting. The ECB's staff's upward revision to inflation projections for 2025 coupled with the distinct change in language led investors split on a potential April skip. Market participants paired back their ECB rate cut expectations; rates sold off slightly, and the Euro (EUR) rose slightly against the dollar post the ECB's decision, up 0.28% at $1.082.

What does this mean for portfolios we manage?

Our assessment of today's meeting has to be viewed in tandem with the significant shift in German fiscal and defense policies announcements. Whilst too early to conclude the impact of the latter, it is expected to provide a positive impulse to growth- potentially outweighing any near-term negative impacts from U.S. tariff measures. Given these fiscal tailwinds, the risk that the ECB may need to cut rates below neutral has diminished. Instead, the risk balance has shifted toward the ECB being able to complete this cycle at or around neutral, which we see as close to 2%.

While the timing of the economic effects of the planned fiscal expansion is subject to considerable uncertainty, our base case assumes that the bulk of the economic effects will materialize over the medium term, with limited near-term impact on growth and inflation. As a result, we have not changed our views on the likely path of monetary policy in the euro area in coming months. Should the fiscal stimulus be implemented more rapidly than we currently expect, however, the resulting boost to growth and inflation could lead to an earlier pause in the ECB's rate-cutting cycle. This would create upside risks to rates, particularly if stronger-than-expected economic momentum delays the current disinflationary trend.

Given the high amount of uncertainty, we believe the ECB will remain cautious on front-loading its cuts. At present, the market is pricing in around 45 basis points of rate cuts by the end of the year, which is broadly in line with our own views. We continue to expect the yield curve to steepen, with the short end being pulled lower by ongoing ECB rate cuts and the long end being pressured higher by wider term premiums stemming from increased debt issuance.

Disclosure: Unless otherwise noted, all data is sourced from Bloomberg as of 6/3/2025.

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