NORTHERN TRUST
ASSET MANAGEMENT

FIXED INCOME COMMENTARY

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DISINFLATION PROCESS KEEPS RATES CUTS ON TRACK

The European Central Bank (ECB) Governing Council implemented a widely expected 25-basis-point (bp) rate cut to its three key interest rates, lowering the deposit rate to 2.75%.The accompanying press release and press conference struck a slightly dovish tone on the growth outlook while emphasizing a data-dependent and flexible approach to future policy decisions. The 25-bp decision was unanimous. Forward guidance was unchanged, aligning with signals from the December meeting as the Governing Council (GC) remains focused on inflation dynamics, growth risks, and potential external shocks.

The evolution of data has been consistent with the ECB's December staff projections. The GC is increasingly confident that the disinflation process is "well on track", despite a temporary rise in December due to energy base effects. However, the GC noted that while domestic inflation remains elevated due to delayed wage and price adjustments, recent data suggest wage growth is moderating. Moreover, corporate profit margins appear to be absorbing part of the cost pressures, which could further support a sustained decline toward the 2% inflation target.

During the press conference, President Lagarde noted that despite these rate cuts, financial conditions and monetary policy remain tight, reflecting the lingering effects of previous hikes. She acknowledged near-term growth and employment challenges, with the Euro Area economy facing headwinds from weak manufacturing output and high energy costs. These factors could push the ECB to cut rates below the estimated 2% neutral rate. Markets will be closely watching the upcoming ECB staff report on the natural rate of interest (R-star), set for release on February 7th. That report could provide additional guidance on the long-term policy trajectory.

Lagarde reiterated that the central bank will not pre-commit to a specific rate path, citing persistent inflationary pressures in services and domestically driven sectors. She struck a cautiously optimistic tone, nonetheless, highlighting the progress made so far.

Prior to the meeting, European sovereign rates outperformed their North American peers as growth data in the Eurozone disappointed increasing fears of downside risk to the growth outlook. Market moves post the press conference have been relatively muted, but front-end rates have outperformed with shorter-term yields edging lower causing a small yield curve steepening. Risk assets were left unphased by today's policy decision, with peripheral spread moving only marginally tighter relative to core markets.

What does this mean for portfolios we manage?

The meeting outcome and unchanged forward guidance aligned with our expectations. However, the Governing Council's subtle adjustment to its inflation language introduces some risk to the pace of future policy easing if wage growth does not moderate as anticipated. That said, the Council's confidence in achieving its inflation target suggests a shift in focus toward growth.

The Eurozone's growth outlook remains skewed to the downside, even excluding potential risks from U.S. tariffs. This should allow the ECB to maintain its measured pace of 25-bp cuts, with the policy rate expected to reach the estimated neutral level of around 2% by mid-year. In the near term, the ECB staff report on the neutral rate will attract market attention, though wage dynamics and economic growth will remain our primary focus. Given the fragility of the growth outlook and ongoing external risks, we cannot rule out the possibility of the ECB cutting rates below its estimated neutral level. While current market pricing suggests a potential slowdown in the pace of easing after the March meeting, we believe this view is premature. A reassessment would require evidence of sustained wage pressures and a meaningful pickup in consumption, neither of which are currently evident in the data.

Disclosure: Unless otherwise noted, all data is sourced from Bloomberg as of 30/1/2025.