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GLOBAL ECONOMICS

**FLASH REPORT**

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*Market Reaction (at time of writing, 10:20ET)*

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# ECB: Neutral Lagarde Surprises Markets that Expected Push-Back

- **The ECB left all its policy levers steady today, as universally expected, but delivered a rather neutral set of communications that fell short of more hawkish expectations.**
- **Although the ECB was in no way dovish, it was also not hawkish. Lagarde did not push back, failing to make use of Middle East or wage negotiations risks to challenge the market's pricing of cuts. Accordingly, EGBs rallied across the curve in steepening fashion, markets added back some expected cuts by year-end, and the EUR lost ground against all of its peers.**
- **Today's ECB decision does not change our expectation for rate cuts to begin in June, as data have not motivated an outlook change. An April start is possible if data warrant such a move but the March decision seven weeks from today looks too soon for easing to begin. Markets pricing in 22bps in cuts by April may have got ahead of themselves.**

The ECB left all its policy levers steady today, as universally expected, but delivered a set of communications that fell short of the hawkish expectations of markets and among the median economist. Today's ECB decision does not change our expectation for rate cuts to begin in June, with 25bps, as data have not motivated an outlook change, nor does it alter our view that the first rate cut could still come in April if data warrant—but not in March, unless the Eurozone economy absolutely collapses in the seven week meeting interim.

Although the ECB was in no way dovish, it was also not hawkish. Lagarde did not push back. Neutrality at policy announcements has tended to result in rates rallies in markets that are relishing the start of rate cuts but have had to swiftly curb their enthusiasm since end-2023. Accordingly, EGBs rallied across the curve in steepening fashion, markets added back some expected cuts by year-end, and the EUR lost ground against all of its peers.

Markets had been conditioned by pre-blackout ECB speakers to expect a hawkish statement and presser at today's policy decision. They did not get that, but instead a neutral-sounding and pragmatic policy statement and a non-committal Lagarde press conference. Louder hawks do not represent the view of the average Governing Council member that Lagarde attempts to represent at the presser and this was seemingly reflected in her non-committal answers to questions. Lagarde said there was a consensus (note not unanimous as she tends to highlight) that it was premature to discuss rate cuts.

Lagarde had two themes at her disposal to highlight as upside risks to inflation that could have helped her push out the expected start of rate cuts: wage negotiations and Middle East risks/disruptions. On Middle East risks, Lagarde did note the upside risks to inflation from geopolitical tensions and their influence on energy and freight costs, but she also pointed to the negative confidence effects of global conflicts that could hurt growth.

On wages, she did not want to point to a specific data series on compensation or the outcome of wage settlements in coming months as the main thing to evaluate—going as far as highlighting that they've seen a slight decline in wage growth. This is in contrast to chief economist Lane, who **on the 13th** hand-waved that by the April meeting they won't have the most complete dataset on wages, Q1 national accounts data. Markets had interpreted this as the ECB not being ready to begin easing in April. This remains a key upside risk to inflation, despite Lagarde not making much of wage negotiations specifically.

On top of not making use of the two main upside risks to inflation to push back against markets, when questioned on the possibility of a rate cut in April she pointed to the March forecast round as key. This implies that they could be happy enough with their inflation, wages, and growth projections in March to roll out a cut at the following meeting.

The ECB made minor changes to its statement beyond the obvious ones due to the December meeting coming with new forecasts. What few changes there were, they were not hawkish. In December, the ECB said that inflation would pick up in the near term, and so it did in December data as was expected. Now, the ECB says that “aside from an energy-related upward base effect on headline inflation, the declining trend in underlying inflation has continued”. The ECB is shrugging off headline inflation noise and seems at peace with how core inflation is evolving.

The ECB removed the sentence “domestic price pressures remain elevated, primarily owing to strong growth in unit labour costs.” This may simply be due to this being a non-forecasts meeting, but strong wages growth could have easily been incorporated into the new statement as a caveat to their opinion that “the declining trend in underlying inflation has continued”. Yesterday’s S&P PMI releases noted that firms continue to be pressured by higher wage expenses but have been able to pass on these increase costs to prices charged. Lagarde simply referred to their expectation that firms’ profit margins that had driven part of past inflation will continue to adjust.

Market reaction (at writing, 15.20UK):

- From pre-statement levels, markets have added 13bps in expected ECB rate cuts by December 2024, totaling 142bps from 129bps previously (but we ended 2023 with 165bps priced in). As for the April meeting, there are now 22bps priced in versus 15bps pre-decision (7bps increase), and markets now see a full two cuts (and then some) by June, pricing in 53bps from 42bps prior (11bps increase).
- German 2yr yields have fallen about 12bps from pre-meeting, to about 2.60% at writing, with 10s down 8bps to 2.28%. The spread of Italian over German 10yr yields has also fallen about 3bps on the communications.
- The EUR has shed about 50 pips versus the USD, from trading around 1.09 this morning to around 1.0850 at writing, on track for a small 0.3% drop on the day vs the USD, and also the GBP where on a EURGBP basis it sits at 0.8525—briefly trading at its lowest point in the cross since August 2023.
- Note that the release of mixed US data between the publication of the statement and Lagarde’s presser also supported rates markets and weighed on the USD somewhat broadly. US 2s are down 6bps and 10s are down about 4bps from pre-ECB statement levels, and markets added 7bps into year-end Fed pricing that sits at ~140bps.