Bond Blog

PGIM FIXED INCOME

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A Dovish, But Not Necessarily Accommodative, ECB

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The ECB cut its main policy rate in April by 25 bps, to 2.25% as expected. This latest decision was a bit of a no-brainer with inflation now close to 2% and expected to stay in that range − and possibly below it − over the remainder of 2025. This puts the ECB policy stance more firmly in neutral territory, but in our mind important questions remain as to whether trade uncertainty will tip the ECB into accommodative territory later this year.

Our Take on the Meeting

The ECB cut its reference to policy restrictiveness in its latest monetary policy decision, which the market could interpret as a hawkish signal. However, new language suggesting that services inflation - a key indicator of underlying domestically generated inflation - has "eased markedly" was also added to the statement. Additionally, the statement flagged that trade tensions have led to a tightening in financial conditions. We interpret both of these statements as quite dovish and stick with our call of one more 25 bp rate cut to 2% in June.

Thereafter, we are far less convicted on further rate cuts from the ECB for 2025. Our view is that the market could be over its skis in expecting aggressive central bank rate cuts to support the real economy in the face of this latest phase of a U.S.-induced global trade shock.

Crucially, the June meeting will predate the end of the 90-day reciprocal tariff reprieve, which could muddy the waters when it comes to the inflation outlook. As a result, after the June meeting we expect the ECB to pause cuts, and only resume cutting towards year end if inflation remains subdued and the real economy weakens further on the back of tariffs. For now, however, we remain of the view that one more cut in June is pretty much in the bag.

Market Reaction

Despite the fact that the ECB decision to cut interest rates had been widely expected, the initial reaction in financial markets was consistent with a dovish read. Front-end rates fell more than low-end rates, the EUR weakened vs the USD and GBP, and measures of credit risk (e.g. CDS spreads) dropped. Admittedly, these are not large moves but they are reassuring after a turbulent start to Q2 in global markets.

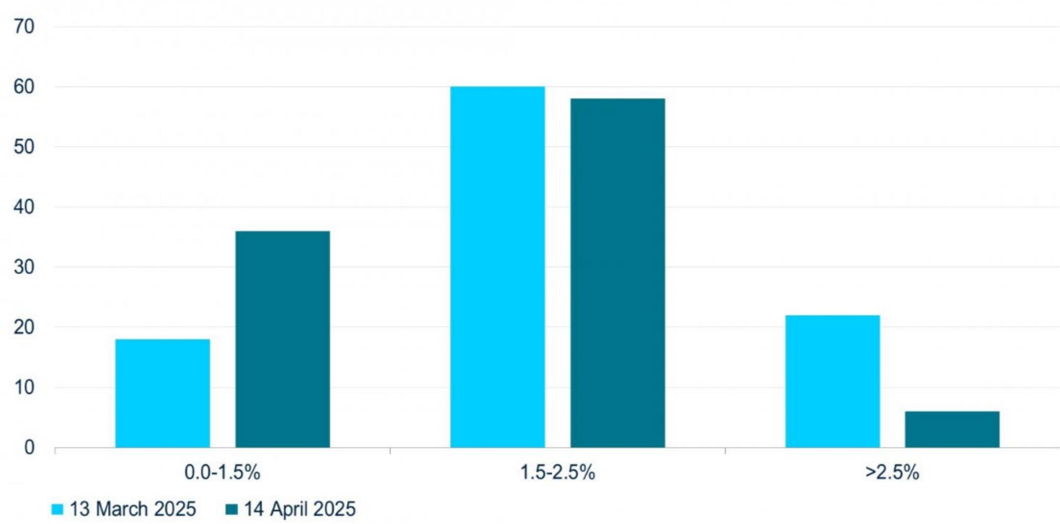
One contrast worth noting is versus U.S. monetary policy. While markets have been very comfortable pricing in cuts for the ECB, investors have been more hesitant around the U.S. policy path. This reflects the very different potential impact from tariffs, which are seen as more inflationary in the U.S. than in Europe. Figure 1, for example, shows that two-year German yields have fallen more decisively than two-year U.S. Treasury yields since the end of March.

FIGURE 1: Markets have been more comfortable with the ability of the ECB to ease policy than the Fed's (%)

Source: Bloomberg

Given the structural and cyclical (trade war risks) challenges faced by the eurozone, rates markets had already concluded that a dovish ECB tilt was likely. The probability of ECB cuts beyond neutral doubled over the past month alone, according to our market based probabilistic pricing tool (Figure 2). Our view is that the ECB's mention of increased uncertainty and tightening in financial conditions gives even more confidence to the market that a cut in June is highly likely.

FIGURE 2: Front end pricing has shifted to the dovish side for the ECB over the past month (%)



Source: PGIM Fixed Income

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