The ECB Signals Job Done

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The clear message from Thursday's ECB policy decision is that it is confident that domestic inflationary pressures will be in line with its 2% target over the forecast horizon. It emphasized this message despite a significant downward revision to its forecast for headline inflation from 1.9% to 1.6% in 2026. With domestic inflationary pressures in line with its inflation goal, the obvious takeaway is that there is no need for further rate cuts from here.

Our Take on the Meeting

As expected, the ECB cut interest rates by 25 bps at the June meeting, bringing the policy rate to 2.0%. That said, the tone of the statement and President Lagarde's press conference was quite hawkish. She indicated that any deviations in headline inflation from the target over the forecast horizon will be driven by external, temporary factors, such as the strengthening in the euro and lower oil prices. Wage growth is also expected to remain below 3% over the forecast and in line with the target.

Having reduced interest rates to 2%, the ECB's policy rate is now firmly in neutral territory. The view from President Lagarde is that the ECB is therefore in a good position to respond nimbly as lingering uncertainties (particularly around trade tensions) evolve.

In particular, a newly published ECB scenario analysis around tariffs suggests that a further escalation in trade tensions could lead to lower growth and inflation relative to the baseline projections. Escalating trade tensions would reduce global demand for EU exports and additionally expose the EU to dumping of excess capacity from abroad. A lower policy rate would therefore be warranted if such a scenario were to crystallise.

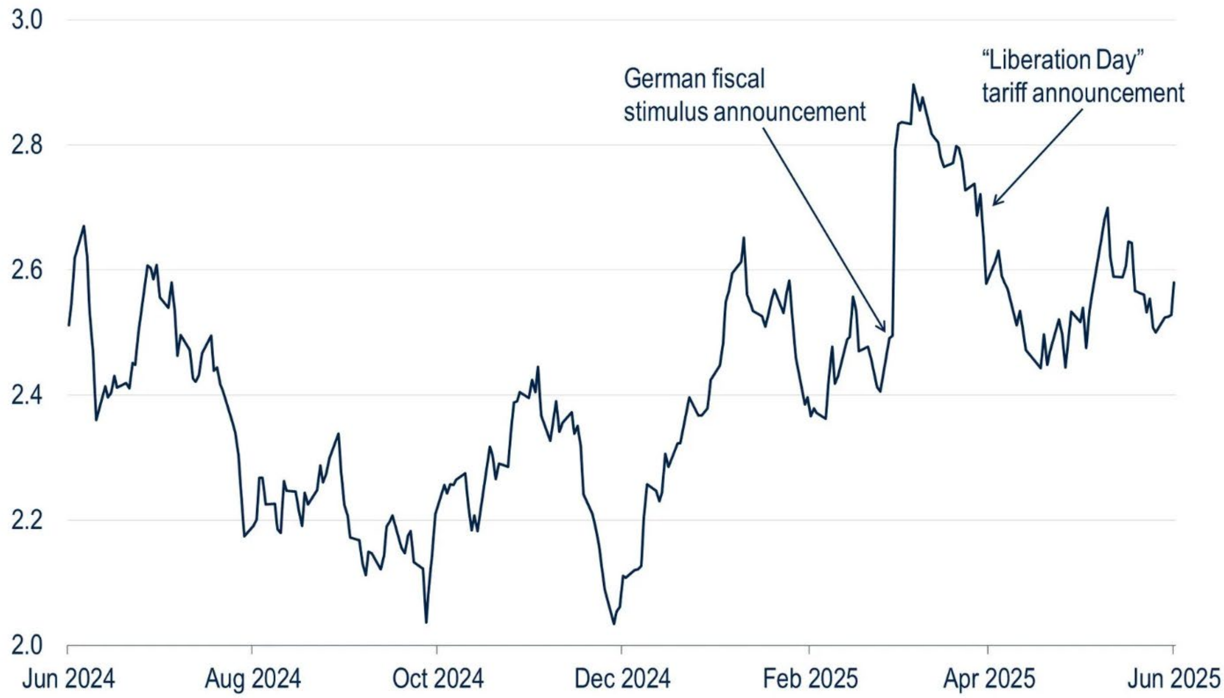
But there are near-term risks that inflationary pressures could also be higher than expected. For example, increased EU defence spending and global supply chain dislocations as a consequence of rising trade tensions could push policy rates the other way.

Bottom line, we see this latest policy decision as straight in line with our prior forecasts. The policy rate has indeed come down to 2% by June, and we expect that it will remain there for the remainder of this year.

Market Reaction

After one of the more successful cutting cycles of any central bank (totaling eight in a row), ten-year Bund yields sit near the pre-German stimulus announcement lows of 2.48% while front-end rates are still pricing in one more 25 bp rate cut over the remainder of this year. This appears to be the most palatable place for rates until there is more clarity around the impact of tariffs and fiscal stimulus.

FIGURE 1: German 10-year Bund Yield (%)



Source: Bloomberg

While incoming data will dictate the ECB's next move, the market's viewed today's press conference as hawkish, with Lagarde seeming non-committal and another committee member calling for no rate cut at today's meeting. While European rates markets have remained relatively steady amid the lingering impacts from German fiscal stimulus and U.S. tariff uncertainty, ten-year Bunds sold off 6 bps to a 2.58% yield as markets digested the ECB's hawkish message.

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