A Strategic take on European Macro

Introduction

For the last 12 months, Central Banks worldwide have been under the limelight as market participants tried to decipher their respective rate paths after the conclusion of the global hiking cycle. In this article we attempt to decompose the key factors that central banks take into consideration when making interest rate decisions, and how these decisive factors have shifted in the last 12 months.

We dive in depth to the European Central Bank's situation and propose a rate path that we think would be most coherent with the latest data and central bank guidance.

The European Central Bank was a late mover in the latest global hiking cycle which occurred, starting in Q2 22. Also, the ECB deposit rate was the lowest of the respective G3 rates at the peak of the cycle. This time around the ECB was the first of its G3 counterparts to start cutting rates, with its initial cut being in June 2024.

After cutting rates in June and September, the ECB promised to remain data-dependent and did not give certain answers to the future rate path, leaving market participants to infer the path based on data and sentiment. They promised to fulfill their mandate of price stability and have inflation fall to 2% between 2025-2026 in their latest projections.

In the next sections, we analyze how global factors and each of the major euro area countries in terms of the capital key might contribute to the ECB's decision. We also look at Mario Draghi's latest report and give a final overview on the current macro state. It is to be noted that the ECB also claims to operate and make deposit rate decisions on a euro-area basis, without taking into account each country idiosyncratically.

Germany

Germany's economy is projected to shrink by 0.1 percent this year, this now being the second year in a row. For 2025, projections have fallen from 1.4 percent earlier this year to around 0.8 percent. Economic growth or rather the complete lack thereof has been mainly driven by industrial woes that have manifested themselves strongly after natural gas prices spiked following the beginning of the Ukraine-Russia conflict in March of 2022. However, to attribute it completely to the gas prices would be ill-advised as there are plenty of other structural problems plaguing the former formidable powerhouse of Europe. In the following bit, we will elaborate on them as well as our view on the German general elections coming up next year.

At the beginning of 1975 East Germany started embracing Russian gas and after 1989 West Germany as well. Last year the remaining three nuclear power plants were shut down by the current Ampel coalition; German for traffic light: red being SPD; green being rather self-explanatory; and yellow the FDP. We will revisit these parties later when discussing the impressively horrendous approval rating, they currently manage to hold it at 18 percent. These high energy costs have resulted in energy-intensive production to be 15 percent lower when compared to 2021.

The car sector's malaise stems from their badly managed attempt at electric car production, general corporate mismanagement, and a seeming lack of "Progress through Technology". Germany's main advantage of their renowned internal combustion engine engineering, alongside the many jobs that the assembly thereof creates, is threatened by the push towards electric vehicles where engines are simpler require less parts and Chinese cars now are a viable threat to mass market producers. Additionally, electric vehicle sales after the abandonment of highly

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regressive subsidies have become sluggish at best. With China itself being in a substantial slowdown due to the deleveraging of its property sector, German autos' large revenue exposure is not a great outlook either. Profit outlook cuts at Mercedes-Benz led to a 7 percent share tumble last week; Volkswagen announced that it would consider ending its 30-year-old job security pact with the union; and with Audi considering plant closure in Brussels we are witnessing a precursor of what is yet to come.

BASF, the world's largest chemicals company, has announced the end of the CDon and CPon production in the first half of 2025 alongside a closure of their apidic acid production in Ludwigshafen in 2025. This alongside a slashing of the dividend by a third, and its stock having lost around the same amount since the start of the Ukraine conflict, does not bode well. BASF's scheduled operational opening around 2026 for its Zhanjiang plant is representative of German industrials. They seemingly double down on China whilst the United States as well as the European Union as a whole wants to decouple.

The much-discussed constitutional debt brake, limiting deficit spending to 0.35 percent of GDP with an escape clause for extraordinary times, could be seen as a refreshing breath of fiscal prudence. The existence of it in a time where France and the US seemingly want to redefine how much one can borrow is remarkable, if it were not for the dire circumstances of its economy. We hold the view that discussing the macroeconomic implication of it being removed is ridiculous at worst and naïve at best given 61 percent of Germans are opposed to loosening it. The per-party view with the highest approval rating for abandoning being with the Greens at 67 percent, 55 percent for the SPD, compared to 31 at FDP, 20 at CDU/CSU, and finally 14 at AfD. Given the Greens' recent abysmal performance in the Brandenburg election accompanied by the resignation of their party leaders, we choose to ignore their view deliberately. We firmly hold the view that it is here to stay for the future.

Politically Germany has been experiencing a right-wing surge surprisingly on both sides of the political spectrum, with the right-ward shift of Merz' CDU/CSU, the surge in polls as well as elections for the AfD, and the emergence of BSW. AfD's successes in Lower Saxony, Thuringia, and Brandenburg, alongside terror attacks in the summer, have led to an immigration stance within CDU/CSU that is unrecognizable with Merkel's "Wir schaffen das!", we will make this in 2015 during the refugee crisis. A few years ago, with Fridays for Future, one would have said that the political future is green. However, the tides seem to have turned blue. AfD's grip on the younger population, exemplified by around 33 percent of under 59-year-olds voting compared to 29 percent overall in the Brandenburg election, has been achieved through their remarkably efficient use of social media such as TikTok and Instagram to attract potential voters. This generation is generally not consuming traditional media and thereby not being communicated the unsavory details of the far-right party as much. Moreover, it has begun a purge of the more extreme members of its party to be more palatable to the public. One of the oddballs of German politics currently is BSW, short for Bündnis Sarah Wagenknecht, a party founded by the former die Linke Bundestag member. Her being the former leader of the Communist Platform explains her party's recent success in East Germany alongside their interesting mix of seemingly opposing views, at least opposing considered by this century's standards. The party's ideology is, in our view, best described as DDR reminiscent with hardline stances on immigration and near communist economic policies, accompanied by a nearing AfD-like pro-Russia stance with an exceptional amount of Euroscepticism.

With Germany's 2025 general elections being a year away from this publishing date, we will provide the reader with a short take on what we believe is to come ahead. Current polling indicates ~32 percent for CDU/CSU, ~18 percent for Afd, followed by 15 for SPD, 11 for the Greens and 8 for BSW on a national basis. We hold the view that SPD is highly likely to bleed support to BSW to get it above 10 percent, and CDU/CSU to lose substantial amounts to the AfD given that economic conditions in our eyes will likely turn out to be worse than projected, and the 0.8 percent of growth projection for 2025 being aspirational at best. Although CDU/CSU currently vows

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to not form a coalition with the AfD, we hold the view that given enough bleeding of support their views will change once reality has set in whether one likes it or not.

France

Turning to the king of Germany's yang within the EU, Berlin's current sparring partner in Brussels, France. Following the Rassemblement national's ~31 percent result in the European Parliament election, more than double of Macron's ensemble, Macron naively called out elections attributing the RN's success more to a vote to show discontent rather than an accurate reflection of who the public would vote for in general elections. Teaming up with the NFP and using France's two-stage election system to its fullest extent, the NFP ended up with 180, Ensemble with 159, and RN with 142 seats. The fact that the distribution of seat percentage within the parliament is far removed from the popular vote in the second vote with RN getting 37 percent of the popular vote but only around 25 percent of seats, and its implications for the functioning of democracy we will gloss over. Leaving the new prime minister undecided for the Olympic games and well past that, France's new prime minister Michel Barnier, vowed to tackle France's deficit spending.

French borrowing costs have continued surging since the election was announced with OAT Bund spreads currently being the same as BONO Bund spreads at 78 bps. The French deficit is expected to exceed 5.6 percent of GDP in 2024, around 16 times the amount Germany's debt brake allows for reference. This budget deficit will be financed through medium- and long-term government debt issuance program in the amount of €285bn, short-term government securities for €7.7bn, and €6.5bn of Covid debt redemption. France's government spending is 59 percent of GDP currently taking first place in the OECD ranking and well above EU averages. It is approaching US deficit spending which is at projected to be at 7 percent this year. It is not even that the budget deficit arises due to France being a tax haven with low personal income tax, VAT, and CIT, but rather all three being above OECD averages.

Naturally, the question arises on how a country manages to spend that much. Long answer short: Social Spending. France currently spends around 34 percent of its GDP on social spending, in comparison, Germany and Spain spend ~27 and ~28 percent, respectively (2022 data), and the OECD average is ~21 percent. Ronald Reagan would have likely suffered from a heart attack from seeing these numbers. Although cries for a reigning in of the spending mania have erupted in Macron's Ensemble, with what we see as a political stalemate with the far-left NFP on its left, and RN on its right side, we do not view an effective way of reducing deficit spending as probable. The large divergence between the various parties in policies, and French politics' history of being incapable of coming to concessions, especially around such drastic measures that would be needed to rein in spending, we believe the deficit will continue well into the future.

Italy

Growth in Italy is projected to be quite muted at 0.9% for 2024, and 1.2% in 2025. These forecasts have remained stable throughout the year despite the slowdown in global trade.

The picture is quite grim when considering this growth is projected to come mainly from previous ECB stimulus for the post-pandemic period. Another factor contributing to positive growth is trade surplus, which is at 3-year highs, despite the mentioned global trade woes. Consumption is still very low, despite its increase since mid-2023, which will continue to contribute to the country's below-target inflation, which has materialised across the whole of 2024. The latest reading of this figure was 1.1% in August 2024, down from 1.3% in July.

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With other indicators like Industry sales decreasing, and Manufacturing confidence being at 4 year lows, we expect Italian growth to keep being very muted for the foreseeable future, putting a very dovish pressure on the ECB's rate decisions coming forward. Another problem which will continue to place downward pressure on Italian growth is the growing deficit, which has been closely monitored by the ECB for decades. Under the pressures of the EU's Excessive Deficit Procedure, deficits will have to be kept below 3% in coming years, further hampering potential growth.

The labor market does bring some good news as it continues to be steady with unemployment falling over the past 12 months, although these numbers are affected by a very large increase in self-employed individuals, which stems from the favorable tax regime. Wage growth is already outpacing inflation, putting even more dovish pressures on the ECB to cut to a neutral rate or r* in quick fashion.

Overall the economic outlook for Italy in the next 2 years is sluggish at best, and with Italy being the third largest country in terms of capital key, we expect this to be a major driving force behind the ECB's future decisions.

Spain

Spain is Europe's fourth largest country in terms of Capital key and appears to have a completely different macro landscape than those analysed above.

The latest ECB projections see the Spanish economy growing an average of 2% in 2024 and 2025, well above the figures from the previously analyzed countries. The Spanish governments have forecasts of 2.7% GDP growth now, up from their original 2.4% estimate What's more encouraging is that this should come from a continuing rise in private consumption and improvement of the labour market's conditions. Personal consumption is mainly up due to a reduction in household savings rate. The downward risks in growth mainly lie in slowing demand from export partners, but this is a minor concern. Unemployment is steadily decreasing due to strong job creation, albeit from high double-digit levels. The Spanish government forecasts unemployment to reach the 9.7% level during 2026

Spain's hawkish influence on the euro area macro picture is further strengthened by its inflation numbers. The latest projections by the ECB have YoY inflation at 3.1% and 2.3% in 2024 and 2025 respectively, clearly a slower path to target inflation than key euro area counterparts. Wage growth however remains marginally above inflation despite this.

Government deficits are expected to continue their decreasing path in the next 2 years as many subsidies to energy prices will start phasing out. This is somewhat mitigated by higher expenditure on social benefits. The other side of the coin is that the fiscal easing will likely result in upward pressures to the already sticky inflation in the short term, further strengthening Spain's hawkish influence on the euro area macro picture.

Draghi's Report

This month Mario Draghi revealed his plan for "The future of European competitiveness" commissioned by the European Commission, unsurprisingly it called for more EU spending. One of by the media more celebrated conclusions of the report was the call for around €800bn a year in investment through combined borrowing in order to bridge the gap to the US in terms of GDP growth as well as fiscal deficits. One criticism of his indirectly targeted at van der Leyen herself is the vastness of the EU regulatory landscape, it is growing larger and faster than the pace at which the EU has since its inception. The report also has been met with criticism from central and eastern European countries with Latvia, Poland, and the Czech Republic speaking out against his reliance on the

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"old EU", with a Czech official stating "Draghi didn't travel". The Latvian economy minister agreed on Draghi's stance on regulation albeit their exclusion from the creation of the report by saying that it "come[s] directly from the core of the EU, the old traditions, the 'old Europe' countries, which should be the first to change". Although a more in-depth analysis of the plan would be interesting, we believe it is unwarranted given that the German government has been quick to dismiss the spending part and red tape is what the European Parliament creates "best". We do not believe that MEPs will want to lose the area where Europe is truly innovative albeit self-sabotaging its future growth. Draghi also cautioned of a too-hasty decarbonization effort led by the EU that does not include good enough industrial policy and time with it.

We hold the view that it is not a great macroeconomic sign if the most glowing part of the press conference from the last ECB meeting was Christine Lagarde's disco ball-resembling outfit. The economic outlook gave albeit mostly dovish referenced Draghi's report with an emphasis on needed fiscal policy and structural changes. On the inflationary side most of the emphasis was placed on the effects of wage growth, with the overall look more dovish than the previous statement. Risk assessment was unsurprisingly on the more hawkish side citing the Ukraine and Middle East conflicts thus remained unchanged from the July meeting. The messaging in the financial and monetary conditions remained dovish. The Q&A part was somewhat more insightful with Lagarde stating that: "the peak has been reached in relation to GDP", and that there will be continued downward-sloping effects which is indicative of a dovish stance on economic conditions overall.

Global Factors

Other Central bank's activity can influence the ECB in a range of ways. For example, excessive deviation from the rates of important currency pairs can impact the price of the Euro, and hence euro area inflation.

In times of high economic distress, or crisis, central bank correlations tend to be very high as seen in the 2022 hiking cycle, however we expect correlations between central banks to be lower in this current cutting cycle as different nations exhibit very different macro-economic conditions. For exmaple, during the global hiking cycle, the ECB was accused of following the FED's activities, hence delaying its intervention.

This time around, the FED had rates at a presumably more restrictive territory than that of the ECB, at the peak of their cycles, and started cutting rates later than the ECB due to the USA's strong growth numbers, despite some wobbles in labour data in early August.

We expect this decrease between central bank correlation to continue as worldwide economic outlooks continue to differ, and do not show imminent signs of alignment.

Conclusion

In conclusion, we find that the European macro landscape is markedly grim, especially in the euro area's top 3 largest economies. Markets are pricing euro area inflation to be below target by January, while the ECB has inflation at a target during Q4 of 2025. We share the view that the ECB is behind the curve and that with around 16bps and 47bps priced for the October and December meeting, we think the most coherent rate path given the current data would be to cut 25bps at the 2 remaining meetings of 2024. Because it is clear that there is still some room before r* is reached, we believe that pausing in October and going for 25 or 50bps, which is what the market is pricing as of now, would be quite counterintuitive as the short-term narrative clearly points into one direction for the euro area.

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We do keep in mind that the October meeting comes in quick succession to September's, however, we are confident in our view that the latest economic data and sentiment warrant steady easing in Europe if a soft landing is to be achieved. With the well-known lags present in monetary policy implementation, it is likely we still have not seen the full effects of the hiking cycle, and that we will not see the full effect of this cutting cycle for years. This further supports the view that cuts should be coming in both meetings left in this calendar year

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