CUSTOMER TREASURY SERVICES
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ECB may need to cut aggressively as growth weakens

As we head into the last month of the year, from an interest rate perspective, 2024 has been characterised by a pivot in global monetary policy. The year started with central banks on hold after undertaking an aggressive pace of rate hikes between 2022- 2023. The expectation at the start of this year was that the coming 12 months would see a significant reduction in interest rates. Investors in early January were pricing in rate cuts in the magnitude of 125-150bps from the ECB, Fed and BoE amid signs that inflation was on a downward trajectory.

However, central banks took a more cautious approach to easing interest rates, meaning that the extent of rate cuts that the market had been expecting did not materialise. Instead, during the first half of the year, monetary policymakers waited for further signs that underlying inflation was on a sustained downward trajectory before they contemplated cutting rates. As a result, amid this 'data dependent' approach, it was not until the summer that some of the main central banks started to ease interest rates.

The ECB started its easing cycle in June, with a 25bps rate cut. This was followed by two more 25bps cuts in September and October, lowering the Deposit rate to 3.25%. Another cut is expected in December, which would see the Depo rate end the year at 3.00%. Next year, the market is anticipating 125bps of easing, with the Depo rate reaching a terminal level of 1.75%. In the US, the Fed commenced its cutting cycle with a 50bps cut in September. It cut rates again in November, with the Fed funds rate reduced by 25bps to 4.50-4.75%. In the near term, the market is attaching around a 60% probability to a 25bps cut in December. The market is envisaging US official rates hitting a low of 3.75-4.00% next year. The BoE got its easing cycle underway with a 25bps cut in August. Like the Fed, it cut rates again in November, lowering Bank rate to 4.75%. Futures contracts suggest the market is not expecting another cut from the BoE until March'25, with official rates seen levelling off at around 4% by end-2025.

Clearly, markets expect a much more aggressive pace of easing from the ECB in 2025 compared to the Fed and BoE. As I have highlighted in the recent past, significant rate cuts may be warranted in the Eurozone next year given the ECB expects inflation to hit 2% sustainably, while at the same time growth is likely to remain muted. It is worth noting though, that Eurozone rates are now nearing estimates of the neutral rate (somewhere between 2-3%). Therefore, a key discussion amongst the Governing Council in 2025 may be on whether policy needs to be brought into accommodative territory to support the economy. This seems to be the market view, as evidenced by current futures pricing for a terminal rate below 2%. However, influential ECB Governing Council member Isabel Schnabel recently stated that a move into accommodative territory "would not be appropriate" at present. Thus, there remains a risk that for a second year running, in 2025, official Eurozone rates may not be cut by as much as anticipated by markets. At the same time, the market may be underestimating the extent of rate cuts from the BoE and Fed. The incoming data will be the determining factor for the magnitude of rate cuts from the respective central banks, meaning 'data-watching' will remain very much in vogue for market participants in 2025.

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