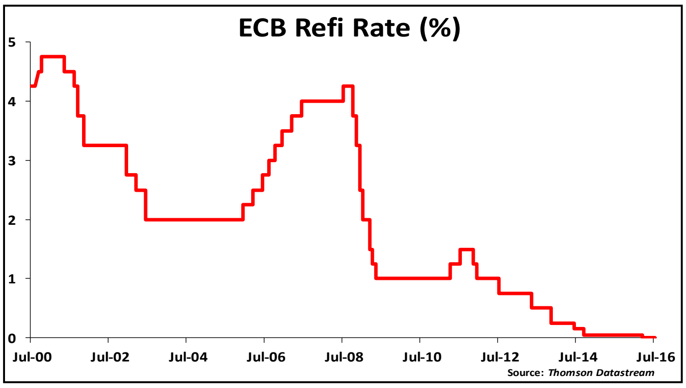
ECB ready to do more, if required

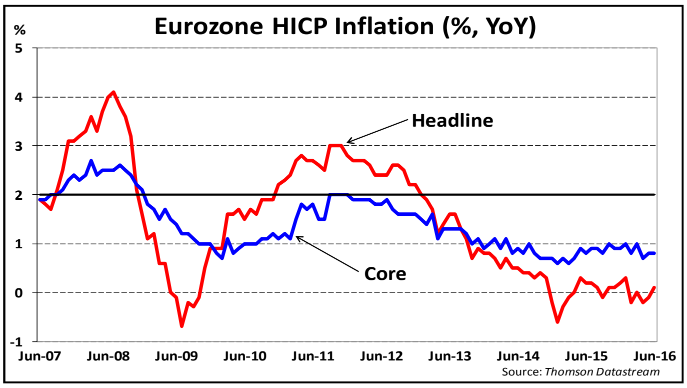
As expected, today's meeting of the ECB's Governing Council concluded with no changes to monetary policy. The Central Bank "decided to keep the key interest rates unchanged" at –0.4% for the deposit rate and at 0% for the refi rate. It also repeated its commitment that "the monthly asset purchases of €80 billion are intended to run until the end of March 2017, or beyond, if necessary".



Not surprising, the meeting statement made reference to the outcome of the recent referendum in the UK. The ECB commented that "euro area financial markets have weathered the spike in uncertainty and volatility with encouraging resilience".

However, the Governing Council also noted that "given the prevailing uncertainties" it will continue to "monitor economic and financial market developments very closely". It stated that over the next few months it will have more information to hand and therefore will be in a "better position to reassess the underlying macroeconomic conditions" and risks to its growth and inflation outlook. **It re-affirmed its easing bias, by saying that if required, it "will act by using all the instruments available within its mandate".**

In terms of the economic outlook, the **ECB continues to "expect the economic recovery to proceed at a moderate pace".** At the same time, the Central Bank remains cognisant of the "headwinds to the economic recovery". These include the outcome of the Brexit vote in the UK, which President Draghi described as a "risk that has mobilised". However, it also referenced the other challenges facing the Eurozone economy, including "other geopolitical uncertainties", slower growth in emerging markets, the "necessary balance sheet adjustments in a number of sectors and a sluggish pace of implementation of structural reforms".



As a result, the ECB continues to view that the "risks to the euro area growth outlook remain tilted to the downside". The most recent ECB staff projections, which were released at its June meeting showed a GDP growth forecast for this year of 1.6%, while it envisages that growth will remain moderate but steady at 1.7% in both 2017 and 2018.

Meanwhile on the inflation front, the Governing Council continues to expect that "inflation rates are likely to remain very low in the next few months before starting to pick up later in 2016". Inflation rates are projected to "increase further in 2017 and 2018". This view is reflected in the June staff forecasts, with inflation of just 0.2% being pencilled in for this year, picking up to 1.3% in 2017 and at 1.6% in 2018.

Overall, the ECB retains a bias to ease policy again if warranted. Indeed, in the press conference, President Draghi emphasised the Central Bank's "readiness, willingness, [and] ability" to act if economic and financial market conditions warrant it. Although, the ECB President also stated that "no attention was really given to discuss specific instruments at this point in time". Given that today's meeting outcome and tone were very much in line with expectations, there has been limited impact on markets.

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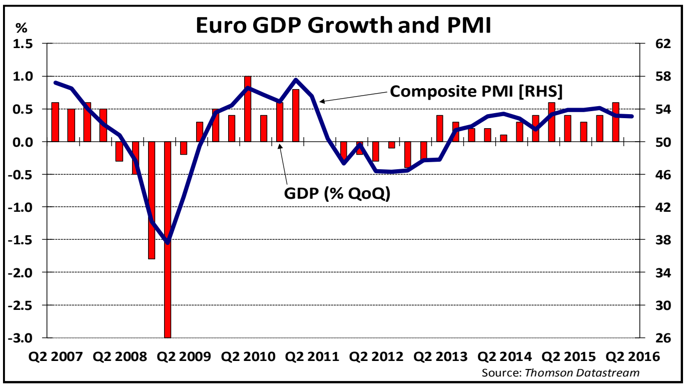
Growth remains modest

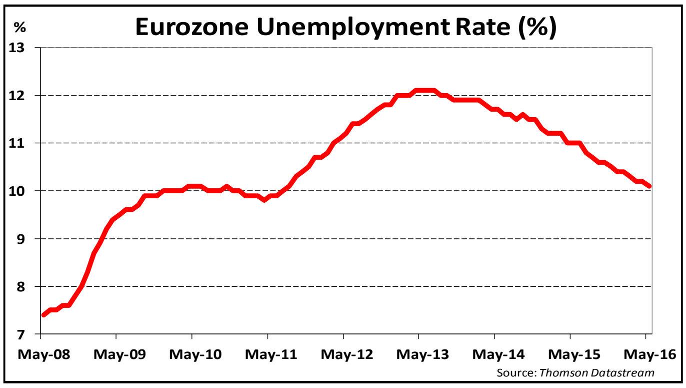
The Eurozone economy grew by 0.6% in Q1, after growing by 0.4% in Q4'15. Year-on-year growth remained at 1.7% in the first quarter. The underlying data show that consumption (+0.3 percentage points) and investment (+0.2 p.p.) were the main contributors to GDP. Meanwhile, net trade remained a slight drag (-0.1 p.p.) in Q1.



In terms of the performance of the economy in Q2, leading indicators of activity pointed to a stable pace of growth. The key Eurozone composite PMI averaged 53.1 in Q2, broadly unchanged from Q1's 53.2 average. Likewise, the EC measure of Eurozone economic sentiment averaged 104.3, compared to 104.

Hard data, though, have been more mixed. For example, retail sales rose by just 0.1% in April/May compared to the 0.4% increase seen in Q1. Industrial production weakened, declining by 0.2% in April/May compared to Q1, when it rose by a solid 0.8%. In terms of external trade, monthly goods trade data saw some improvement in April/May, suggesting the sector may have made a positive contribution to growth in Q2. Growth in M3 money supply has been at 4.8% (3mth/3mth YoY) in recent months.

Meantime, the labour market continues to register improvement. The unemployment rate fell to 10.1% in May, a near 5-year low. While this figure hides a significant dichotomy—German unemployment rate at 4.2%, versus 9.9% in France and 19.8% in Spain—the gap between Eurozone countries has narrowed.



At the same time, **year-on-year growth in employment has continued to accelerate, reaching an 8-year high of 1.4% in Q1** (from 1.3% in Q4'15). The timelier Eurozone composite employment PMI index averaged 52.3 in Q2, a slight improvement on Q1's 51.9 performance. This suggests that employment continued to grow at a steady pace in the quarter.

The economy continues to face some significant challenges, including high levels of unemployment in many countries, a lack of structural reforms in some economies, the negative impact from a slowdown in growth in emerging markets (especially China) and related global risk aversion.

The heightened level of uncertainty related to the UK's vote to leave the EU also poses an additional significant downside risk. Early indicators of activity following the referendum, such as the EC measure of consumer confidence or the German ZEW index have shown a weakening in sentiment. Brexit could weigh on investment and employment, particularly in countries and sectors with strong trade links with the UK. It also has the potential to act as a headwind to consumer spending.

However, there are also positives for the economy, including the favourable impact from lower commodity prices, the relatively weaker euro and the impact of monetary policy easing, with interest rates likely to remain at very accommodative levels for the next few years.

Overall, **the Eurozone economy is expected to continue to grow at a moderate pace.** This week's updated IMF forecasts saw growth for this year revised up slightly to 1.6%, based on the stronger than anticipated performance in H1, while growth in 2017 was revised down modestly to 1.4% (from 1.6%) "in light of the potential impact of increased uncertainty".