

## ECB turns more cautious on the outlook

The December meeting of the ECB Governing Council concluded in line with expectations, with no changes to interest rates from their present levels of 0% for the refi rate and -0.4% for the deposit rate. The ECB had previously announced back in June that it will cease net purchases under its QE programme this month.

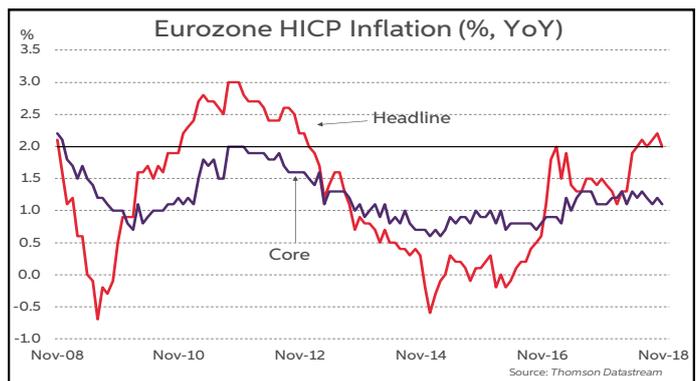
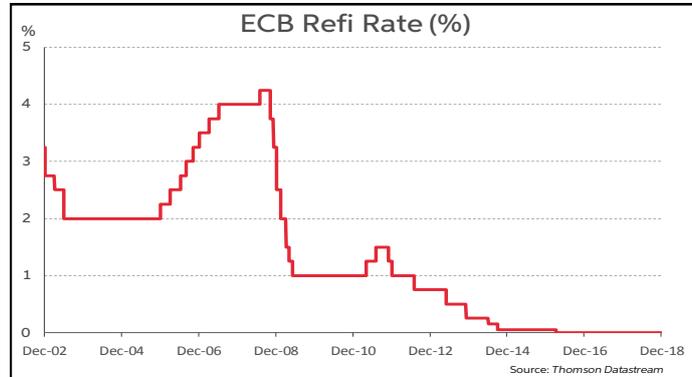
The meeting statement acknowledged the recent softer tone to Eurozone macro data, noting that incoming figures have been weaker than expected. The more challenging economic backdrop was also reflected in today's updated set of macro forecasts.

The ECB marginally downgraded its GDP growth forecasts for 2018 and 2019. It is now projecting GDP growth of 1.9% in 2018 (from 2.0%) and 1.7% in 2019 (from 1.8%). Meanwhile, the 2020 GDP forecast was left unchanged at 1.7%, whilst in its first published forecast for 2021, the ECB is anticipating growth slowing to 1.5%. It also commented that the "balance of risks" to the growth outlook is "moving to the downside".

The December update of its inflation forecasts highlight why the ECB is taking such a cautious approach to policy tightening. They show that the ECB continues to expect inflation to remain below its 2% target over the next 3 years. HICP inflation is forecast to average 1.8% in 2018, 1.6% in 2019, 1.7% in 2020 and 1.8% in 2021. Compared to its September forecasts, HICP inflation has been revised slightly up in 2018 (was 1.7%) and slightly lower for 2019 (was 1.7%).

Not surprisingly then, given this very subdued inflationary outlook, the ECB continued to emphasise that interest rates are expected to remain at their current levels "at least through the summer of 2019". Furthermore, it enhanced its forward guidance in relation to the reinvestment of maturing securities from its QE programme by stating that this would continue for an "extended period of time past the date" when the ECB starts raising interest rates.

In terms of market expectations, futures contracts suggest that 3-month Eurozone rates are not expected to turn positive until the second half of 2020. Market pricing indicates that expectations are that rates may rise by around 10bps by end 2019 and will have increased by only 40bps in total by end 2020. Looking out to the medium term, futures contracts suggest that the market is expecting rates to remain low for an extended period. Three month rates are not expected to get to 1% until around the second half of 2023. While there were no major surprises from today's ECB meeting, the euro did come under some modest downward pressure on the back of the ECB downgrading, albeit marginally, its inflation as well as its GDP growth outlook.



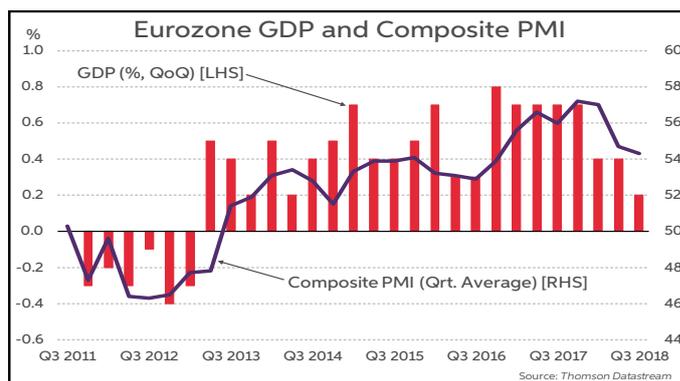
ECB Macroeconomic Forecasts for the Euro Area				
(%)	2018	2019	2020	2021
HICP	1.8	1.6	1.7	1.8
Real GDP	1.9	1.7	1.7	1.5

*Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average \$71.8 in 2018, \$67.5 in 2019, \$66.8 in 2020, and \$65.9 in 2021*

**Source: ECB December 2018**

## Eurozone growth slowed during 2018

**Quarterly growth in the Eurozone economy declined to just 0.2% in Q3.** This is down from 0.4% in both Q1 and Q2, and a rate of 0.7% recorded right through 2017. Slower growth in Q3 has been partly attributed to delays in car production associated with new EU emission standards. The underlying data shows that government expenditure, personal consumption and investment combined made only a modest contribution to growth. Meanwhile, net trade acted as a significant drag, although this was offset by an increase in inventories.

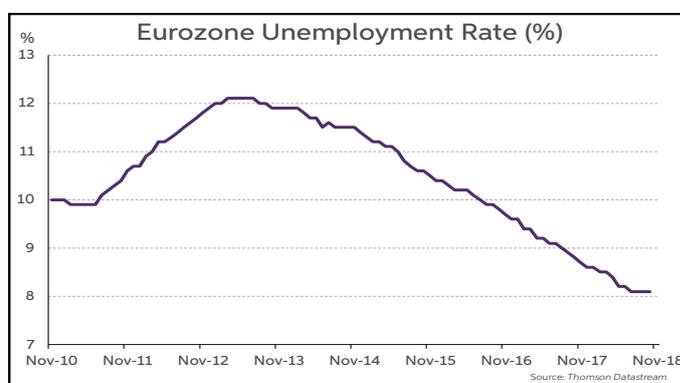


**Survey data have suggested that economic activity has so far failed to regain momentum in Q4.** The Markit composite PMI averaged 52.9 in October/November versus 54.3 in Q3. The index is on track for its worst quarterly performance since Q4 2014, with both the manufacturing and services components trending downwards. Meanwhile, the EC Eurozone Economic Sentiment index has also edged down in Q4, averaging 109.6 in October/November against 111.5 in Q3. However, it does remain at an elevated level. On a national level, both the French INSEE and German Ifo also suggest that economic activity has failed to pick up in the current quarter.

**However, the available 'hard' data for Q4 have been more positive.** Retail sales recorded a monthly increase of 0.3% in October, leaving the year-on-year growth rate at close to 2.0%. On the production side of the economy, the October reading of industrial production showed that output rose by 0.2% in the month.

**In terms of the labour market, the data have been somewhat mixed.** Employment growth weakened in Q3, rising by just 0.2%, the slowest pace since Q1 2015. Although, the year-on-year growth rate remains solid at 1.3%. Meantime, the timelier composite PMI employment sub-component averaged 54.1 in October/November versus 55.1 in Q3. The jobless rate held at 8.1% in October, a near 10-year low.

**On the inflation front, price pressures in the region remain subdued.** Headline HICP hovered around the 2.0% level in October/November, while the core rate remains very subdued at just 1.1-1.2%. This is well under the ECB's target rate of close to, but below 2%.



**The Eurozone economy continues to face some significant challenges.** Unemployment remains very high in some countries, while productivity growth is weak. On the political front, tensions between the Italian government and the European Commission are a source of worry, as is the continuing uncertainty over the nature of the UK's exit from the EU. Meanwhile, weaker external demand owing to global trade tensions, as well as increased financial market volatility, seem to be acting as a dampener on export activity.

However, there are a number of tailwinds for the economy. Positive real earnings as wage increase, a low inflation environment, mildly expansionary budgetary measures and ultra-loose monetary policy are all providing a supportive backdrop for domestic demand. These factors should help consumer spending and business investment regain momentum in the coming months. **Today's forecasts from the ECB are for the economy to grow by 1.7% in 2019 and 2020, close to the expected level of 1.9% in 2018.**

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