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Economy Macro Update

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"When there are clouds on the horizon, the captain stays on the ship."

ECB President Christine Lagarde

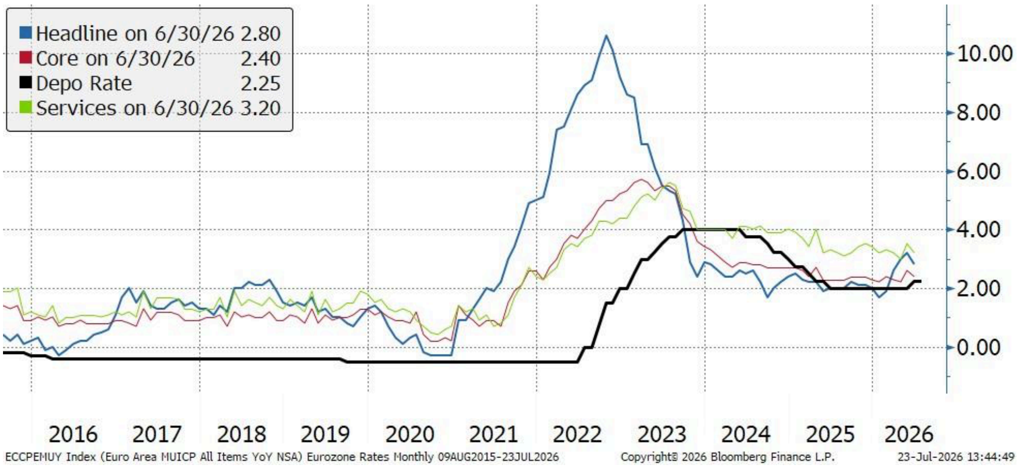
The European Central Bank delivered the expected hold. After it started a tightening cycle at the June meeting with a 25 bp hike, a pause was in order. In this piece, we discuss why the ECB is likely to follow up with a 25 bp hike at the next meeting September 9-10 and also discuss where we probably are right now in the ECB's scenario analysis.

The Decision

After keeping rates steady at 2.25%, the bank stated that "The outlook for energy prices, while highly volatile, currently stands close to the baseline of the June Eurosystem staff projections and well above the levels recorded prior to the conflict in the Middle East. Uncertainty remains high and the full inflationary impact of the energy shock has yet to play out. The Governing Council is therefore closely monitoring the intensity and duration of the shock, as well as its indirect and second-round effects."

With regards to future policy, the bank basically repeated the June statement verbatim that "With today's decision, the Governing Council remains well positioned to navigate the uncertainty caused by the conflict. It will follow a data-dependent and meeting-by-meeting approach to determining the appropriate monetary policy stance."

ECB Rates



The Press Conference

President Lagarde said the decision was unanimous but added that "There were some governors who asked themselves whether we should not consider a hike." She added that "We were positioned adequately to wait and be very attentive in the next few weeks to the development of the situation and to the data that we will be receiving in the next few weeks."

Lagarde said that the risks to the growth outlook are to the downside and noted that the "more balanced" assessment from Sintra had been removed. This is a bit more realistic than her rather optimistic June assessment that growth was "not under significant threat." Lagarde added that risks to the inflation outlook are to the upside and that headline inflation was likely to remain above the 2% target through H1 2027 due to high energy prices. However, she noted that so far the bank is not seeing any second round effects. Lagarde said recent developments in the Gulf were "alarming" but added that the bank will have a lot more data available in September.

The Leaks

As usual, reports emerged right after the decision that ECB officials were prepared to hike rates in September unless the inflation outlook improves "markedly." However, the officials stressed that nothing has been decided and that the situation can change quickly in both directions.

The Scenario Outlook

President Lagarde acknowledged that the milder scenario now looks "quite unlikely" and that "We're back to the baseline." Recall that the ECB introduced the milder scenario at the June meeting, when it looked like oil prices were headed back towards pre-conflict levels. From the ECB: "In the milder scenario, the oil price drops to USD 88 per barrel and gas prices to €41 per MWh in the third quarter of 2026 and they are around 15-20% below the baseline levels throughout the horizon. This projected path likely reflects investors' expectations that the conflict could be resolved very swiftly, leading to a rapid normalization of global oil and gas markets and a return of prices to their pre-war levels by the end of 2026." This is clearly no longer the case.

If we are indeed back to the baseline scenario, this means that we now have to think about when the adverse scenario becomes likely. From the ECB: “In the adverse scenario, the oil price increases to USD 122 per barrel and gas prices to €60 per MWh in the third quarter and they remain around 20-30% above the baseline levels throughout the horizon, likely reflecting market expectations of a more prolonged conflict than assumed in the baseline scenario.” With Brent oil currently around $100, there is still quite a bit of cushion before the adverse scenario is triggered.

Lastly, the severe scenario is even further away. From the ECB: “In the severe scenario, relative to the baseline, oil prices rise by around 60% and gas prices double, reaching USD 166 per barrel and €98 per MWh respectively in the third quarter. The shocks are also highly persistent, with deviations from the baseline still being of a similar magnitude at the end of the projection horizon. This persistence partly reflects greater uncertainty at longer horizons, which widens option-implied densities. It may also reflect market expectations of a prolonged conflict coupled with significant damage to regional oil and gas production infrastructure, keeping energy prices elevated over an extended period.”

Note that the ECB will update its scenario assumptions and macro forecasts at the September meeting.

ECB Baseline Scenario June 2026 (March)

	2026	2027	2028
GDP Growth	0.8% (0.9%)	1.2% (1.3%)	1.5% (1.4%)
CPI Inflation	3.0% (2.6%)	2.3% (2.0%)	2.0% (2.1%)
Core Inflation	2.5% (2.3%)	2.5% (2.2%)	2.2% (2.1%)

The Leadership Outlook

Recall that reports emerged this February that Lagarde would step down before her term ends in October 2027. This was subsequently denied by Lagarde. When asked about when her term as President might end, Lagarde said "You are not going to see the back of me before 2027." She stressed that she wouldn't exit under adverse conditions and noted that "When there are clouds on the horizon, the captain stays on the ship." If you read between the lines, that was not really a pledge to complete her term.

Indeed, markets should be prepared for the possibility of an early exit for the same political considerations as why Villeroy resigned early from the Bank of France. That's because each member country has the opportunity to nominate candidates for the Executive Board.

The first round of the presidential election will be held in April 2027; if no candidate wins a majority, the top two contenders go to a runoff in May 2027. Polls currently point to Marine Le Pen as the likely winner and that is why we believe Lagarde may step down early to allow President Macron to nominate her replacement. Just as Villeroy successfully blocked the path of a less orthodox Bank of France Governor to replace him, so too is Lagarde likely to try and prevent such a nominee to the Executive Board by Le Pen.

Besides President Lagarde, there will be several other openings coming up on the Executive Board. Chief Economist Philip Lane's term ends in May 2027, Executive Council member Isabel Schnabel's term ends in December 2027, and Executive Council member Frank Elderson's term ends in November 2028. Given the dispersed nature of the ECB's Governing Council, it would be very difficult for any one country to impact ECB monetary policy. However, the rotation of so many senior bank officials in such a short time is noteworthy and suggests that staggered terms (like the Fed Board of Governors) should perhaps be considered.

The Monetary Policy Outlook

In her press conference, President Lagarde echoed Fed Chair Warsh when she stressed "We're not giving forward guidance." However, she noted that the ECB's reaction function is "very well understood" by the markets. This suggests to us that she is validating market pricing for a September hike. Looking ahead, the swaps market is pricing in nearly 75 bp of total tightening over the next twelve months. We had been highly skeptical in the past of such aggressive tightening but if oil stays above $100 for an extended period of time, then all bets are off. As we have noted before, the longer the energy shock persists, the greater the risks that second round effects appear and that is what central banks try to choke off and so a second cut in September is likely a done deal now.

The Euro Outlook

Despite the prospects for more aggressive ECB tightening, the euro continues to weaken and is trading just above the late June low near $1.1325. A break below $1.1325 sets up a test of the May 2025 low near $1.1065. Much of this recent weakness is due to broad-based dollar strength rather than idiosyncratic euro weakness. Brent crude is the highest since late May, which in turn has led UST yields higher. The 10-year yield hit a new cycle high near 4.71% while the 30-year yield is nearing the May high near 5.20%. The higher yields and risk off impulses are giving the dollar a boost and we see these trends continuing as long as the Iran conflict is running hot.