Mizuho Market Comment

12 June, 2024

Colin Asher
Senior Economist
colin.asher@mhcb.co.uk | +44 20 7012 5262

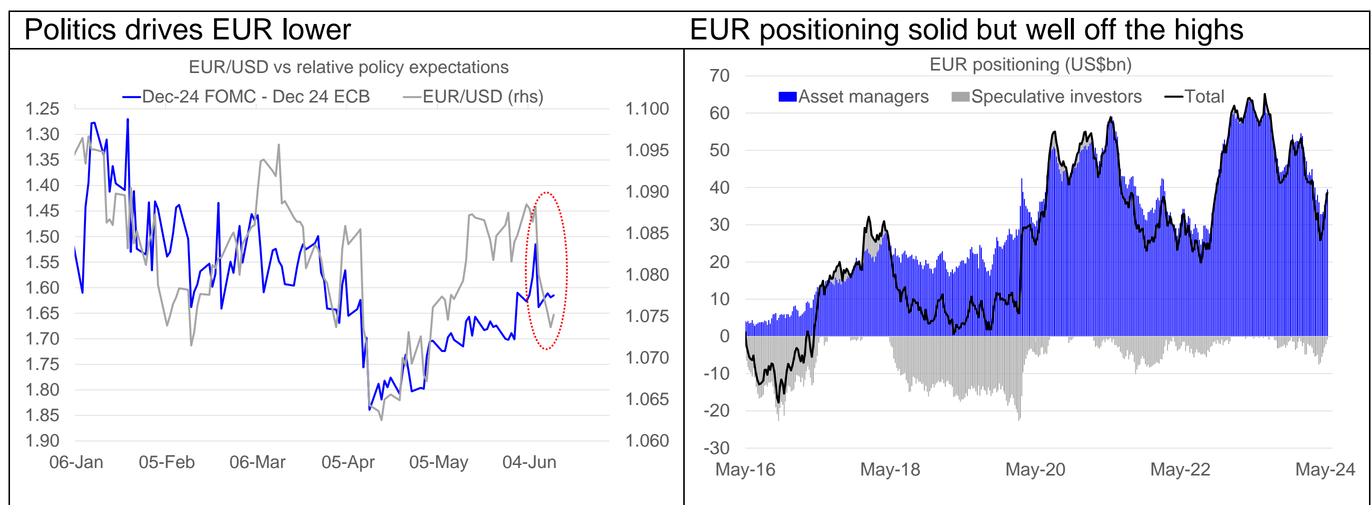
EUR outlook – mildly less dovish ECB vs French election drag

- **ECB cut 25bp as expected but offered limited guidance on further action**
- **Reading between the lines we expect the ECB to proceed slowly, cutting at 25bp/quarter**
- **Macron's snap election boosts political risks which will weigh on EUR …**
- **…but the near-term downside due to political risks for EUR is limited. Fr-exit is not on the agenda**

ECB kicks off easing cycle with 25bp cut as expected, limited forward guidance
Last week, the ECB cut rates by 25bp as almost universally expected. That said, it was keen not to give much guidance on future rate cuts. The statement concluded "*The Governing Council will continue to follow a data-dependent and meeting-by-meeting approach to determining the appropriate level and duration of restriction. In particular, its interest rate decisions will be based on its assessment of the inflation outlook in light of the incoming economic and financial data, the dynamics of underlying inflation and the strength of monetary policy transmission. The Governing Council is not pre-committing to a particular rate path*."

The statement had a slightly hawkish bias noting "*despite the progress over recent quarters, domestic price pressures remain strong as wage growth is elevated, and inflation is likely to stay above target well into next year. The latest Eurosystem staff projections for both headline and core inflation have been revised up for 2024 and 2025 compared with the March projections*." 2024 CPI was seen at 2.5% (+0.2pp), 2025 CPI at 2.2% (+0.2pp) while 2026 CPI was unchanged at 1.9%. The upward revisions to core CPI were of similar magnitude.

We detect some caution on the inflation/wage outlook that implies proceeding slowly…
The stress on "*markedly*" higher service prices and "*elevated*" wages in the press conference hint that the ECB will proceed with caution in regard to further cuts. The tone of the press conference suggests to us that there will be little support for a July move. Lagarde noted that near-term activity risks seemed more balanced suggesting that it will need a large downside surprise in activity or inflation to result in a July rate cut. The longer-term risks were more biased to the downside and were mostly geopolitical in nature. Lagarde spoke at length about wages. She acknowledged that they were high but said that the ECB's wage tracker suggested a downward drift in coming quarters. We have the impression that this expectation needs to be confirmed before further easing is forthcoming. Given that the compensation per employee data and unit profits are produced quarterly, this also hints at a modest pace of action. Unit profits are also something the ECB is tracking closely.



Source: Bloomberg

…with the ECB cutting 25bp/quarter at least through spring 2025
We continue to expect that the ECB will ease gradually with cuts each quarter until the depo rate reaches 2.75% in summer next year. This would see the ECB depo rate at 3.25% at end 2024.

Eurozone elections more or less as expected…
The EU elections were more or less in line with the polls. The centre right held, the disparate far-right groups gained and the greens lost ground. The centre right (EPP) remains the largest group and their leader Von der Leyen is most likely to remain EU President. The EU's Green Deal will take a hit but broad policy continuity seems the most likely outcome.

…but Macron's gamble boosts uncertainty, downside for OATs
However, late on Sunday French President Macron called a snap election for the Lower House, over two years before it was due. This has significantly boosted political uncertainty in France. Macron's motivations are uncertain. The two most likely are 1) challenging the electorate to vote for a far-right party in elections that really matter (the RN usually does much better in EU elections that are seen as less important) or 2) acknowledging the fact that he will lose and hoping the 2 years in power is enough to expose the RN as a force unfit to govern, which would allow his party to retain the presidency in 2027. Macron will have to stand down in 2027, having already served 2 terms. The first few polls suggest that the RN will be a) the largest party by far and 2) close to a majority. Both the left and the right are discussing forming alliances but with the first round of voting just a few weeks away on 30 June, lengthy negotiations are not possible. The second round run-off will be one week later on 7 July. The republicans look likely to split over plans to support RN. The left has agreed to field only one set of candidates but the agreement may yet unravel. Macron's hope of peeling off left and right votes for his centrist coalition looks difficult to bring about. Either France is in for a period of uncomfortable cohabitation with the RN running the government and Macron as President or there will be highly unstable anti-RN coalition in government. Neither is an appealing prospect. Both suggest to us difficulty in passing reforms that keep fiscal spending under better control. The former is probably worse for the fiscal outlook as the RN have made many unfunded promises such as abolishing income tax for the under 30s, cutting VAT on electricity and gas bills, increasing healthcare spending and lowering the retirement age. Consequently, the sell off in OATs looks justified and may have further to run, especially considering the worse fiscal position now vs 2017.

…but EUR outlook is less impacted
A more fiscally fragile EU is not supportive of EUR but we note that the 2017 presidential election and the upcoming elections are very different. The 2017 election was fought against the backdrop of the UK's 2016 Brexit referendum, where the UK voted to leave the EU. There was widespread fear that others might follow in 2017. It was the first time since 2002 that a far-right candidate had made the run-off. Leaving the EU was a core part of the National Front (NF) platform. Thus back in 2017 the sell off in OAT yields and the weak EUR were part of the same Fr-exit trade.

In the current situation we see a much looser link between OATs and EUR, with OATs bearing the brunt of any adjustment thanks to likely fiscal deterioration in France. The NF has been rebranded as RN and it no longer seeks to remove France from the EU. It may be hostile to much of the EU's federalist agenda but it is not seeking to leave. Unlike Italy (where Meloni's government has proved surprisingly co-operative with the EU agenda), France is a (mild) net contributor to the EU and as such has less incentive to get on well with the EU, so EU management would likely be more difficult. While an RN government in France would make life more difficult for the EU, the EU elections have already shifted the EU in that direction anyway. So while there may be scope for more underperformance in French bonds in coming weeks, we suspect that EUR depreciation driven by a pick-up in political risks is near its limit. In addition, unlike the 2017 election, the risks do not end with the election. The political dysfunction will be a feature of the French economy for at least the next 2 years. The market disruptions do not have a clean end-point as they did back in 2017 (assuming, as we do, that Macron's party cannot win a majority).

EUR "political discount" likely already in the price, further downside limited in the near term
If the RN was to become the leading party in France, its lack of empathy for an ever closer union may mean that in a crisis, it struggles to find the political will to find a way, especially if other EU countries similarly struggle and no-one wants to make the required sacrifices to hold the EU together. However, such a crisis is most likely in an economic downturn. With the eurozone already recovering from the H2-23 recession and the ECB easing cycle underway, the macro backdrop is likely to be relatively upbeat in coming quarters, keeping these risks low in the near term.

The rise in French political risks has come as a surprise to us. We think that a slightly weaker EUR forecast is now justified but there are limits. France is not the eurozone and politics is not the only driver of a currency. We note that the drop in EUR/USD so far this week is less than the drop on Friday, in the wake of the strong US payrolls data. Ahead of the EU elections our EUR/USD forecasts for end Q3-24 and end Q4-24 were 1.11 and 1.10, respectively. We trim these to 1.10 and 1.09, in the wake of the up-tick in French political risks. We continue to see the US presidential election as much more consequential for the global outlook.

Important Information

This publication has been prepared by Mizuho Bank, Ltd. ("Mizuho") and represents the views of the author. It has not been prepared by an independent research department and it has not been prepared in accordance with legal requirements in any country or jurisdiction designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research.

Disclaimer

Unless otherwise stated, all views or opinions herein are solely those of the author(s) as of the date of this publication and are not to be relied upon as authoritative or taken in substitution for the exercise of judgement by any recipient, and are subject to change without notice.

This publication has been prepared by Mizuho solely from publicly available information. Information contained herein and the data underlying it have been obtained from, or based upon, sources believed by us to be reliable, but no assurance can be given that the information, data or any computations based thereon are accurate or complete. This publication provides general background information only. It is information in summary form and does not purport to be complete. This publication has been prepared for information purposes only and is not intended by Mizuho or its affiliates to constitute investment, legal, accounting, tax or other advice of any kind and all recipients of this publication are advised to contact independent advisors in order to evaluate the publication, including, without limitation, the suitability of any security, commodity, futures contract or instrument or related derivative (hereinafter, a "financial instrument"), product or strategy herein described. This publication is not intended to be relied upon as advice to investors or potential investors and does not take into account investment objectives, financial situation or needs of any particular investor. It is not intended for persons who are Retail Clients within the meaning of the United Kingdom's Financial Conduct Authority rules nor for persons who are restricted in accordance with US, Japanese or any other applicable securities laws.

This publication has been prepared for information purposes only and is not intended by Mizuho to market any financial instrument, product or service or serve as a recommendation to take or refrain from taking any particular course of action or participate in any trading or other strategy. This publication is not an offer to buy or sell or a solicitation of any offer to buy or sell any security or any of the assets, businesses or undertakings described herein, or any other financial instrument, nor is it an offer to participate in any trading or other strategy, nor a disclosure document under applicable laws, rules, regulations or guidelines. Nothing contained herein is in any way intended by Mizuho or its affiliates to offer, solicit and/or market any financial instrument, product or service, or to act as any inducement to enter into any contract or commitment whatsoever. Neither the author, Mizuho nor any affiliate accepts any liability whatsoever with respect to the use of this report or its contents.

Mizuho and its affiliates, connected companies, employees or clients may take the other side of any order by you, enter into transactions contrary to any recommendations contained herein or have positions or make markets or act as principal or agent in transactions in any securities mentioned herein or derivative transactions relating thereto or perform or seek financial or advisory services for the issuers of those securities or financial instruments.
All of the information contained in this publication is subject to further modification without prior notice and any and all opinions, forecasts, projections or forward-looking statements contained herein shall not be relied upon as facts nor relied upon as any indication of future results. Opinions stated in this report are subject to change without notice. Future results may results may materially vary from such opinions, forecasts, projections or forward-looking statements. The information may not be current due to, among other things, changes in the financial markets or economic environment. Past performance is not indicative of future performance.

United Kingdom / European Economic Area: Mizuho is authorised and regulated by the Financial Services Agency of Japan. In the UK, Mizuho is authorised by the Prudential Regulation Authority and subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of MHBK's regulation by the Prudential Regulation Authority are available upon request. This publication may also be distributed by Mizuho International plc. ("MHI"). MHI is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority.

United States: This publication is not a "research report" as defined in Commodity Futures Trading Commission ("CFTC") Regulations 1.71 and 23.605. The content of publications distributed by Mizuho Securities USA Inc. ("MSUSA") is the responsibility of MSUSA. The content of publications distributed directly to US customers by Mizuho is the responsibility of Mizuho. US investors must effect any order for a security that is the subject of this report through MSUSA.
This publication is available free of charge to clients. However, if you no longer wish to receive it then please specifically request to unsubscribe from the distribution list.

© 2020 Mizuho Bank, Ltd