European Views: The Path to Faster ECB Cuts (Stehn)

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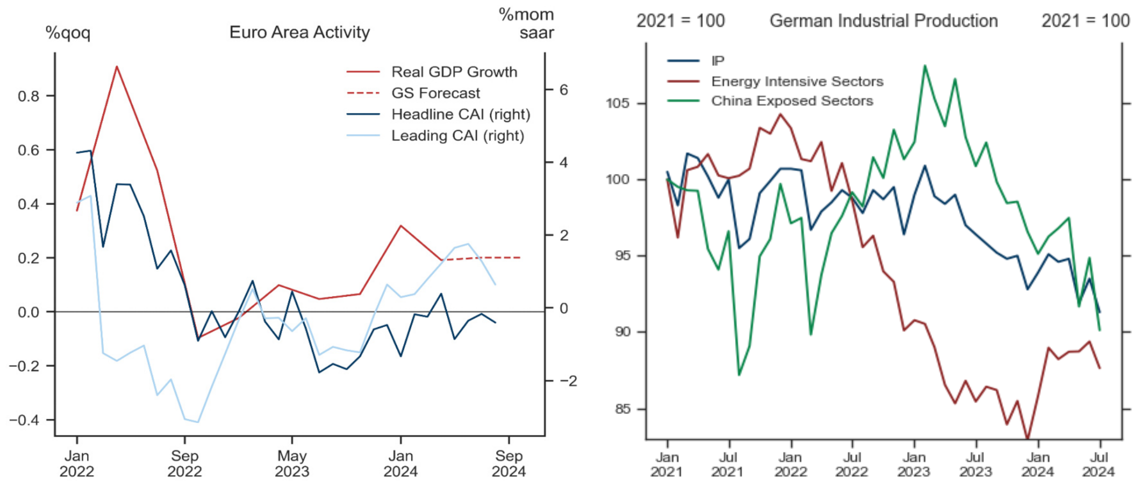
1. The incoming Euro area data strengthen our conviction that the ECB will speed up the pace of rate cuts to consecutive steps. In particular, growth has slowed further, with another step down in the September PMIs. While much of the sharp drop in the French services PMI was driven by payback from the Olympics, the release showed broad-based weakness across sectors and countries. The PMIs thus confirm other soft activity data for Q3, including industrial production (where weakness has broadened) and forward-looking surveys (such as ZEW and Sentix). As a result, our Euro area CAI has fallen further into negative territory and our leading CAI continues to unwind its Q1 bounce.

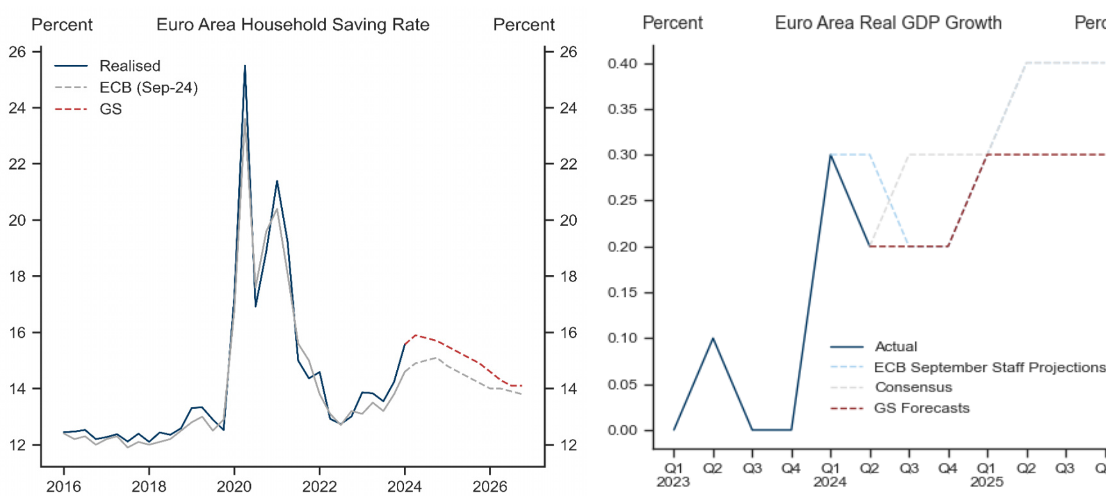
Exhibit 1: The Euro area Data Continue to Weaken



Source: Goldman Sachs Global Investment Research, Haver Analytics

2. Consistent with this, we expect growth to fall short of potential at 0.2% in Q3 and Q4. While consumer finances remain in good shape—with ongoing gains in household real incomes and very elevated saving rates—we now see more consumer caution with a flat savings rate in the remainder of the year. Moreover, the weakness in industrial production looks more persistent, as it has broadened beyond energy-intensive sectors and the Euro area, likely linked to a further loss of momentum in China. We still look for a modest pickup in growth next year to 1.1% as the saving rate eases from its very high level, but our forecast is significantly below consensus and the September ECB staff projections, with recent surveys pointing to downside risks to our forecast.

Exhibit 2: Modest Growth Ahead

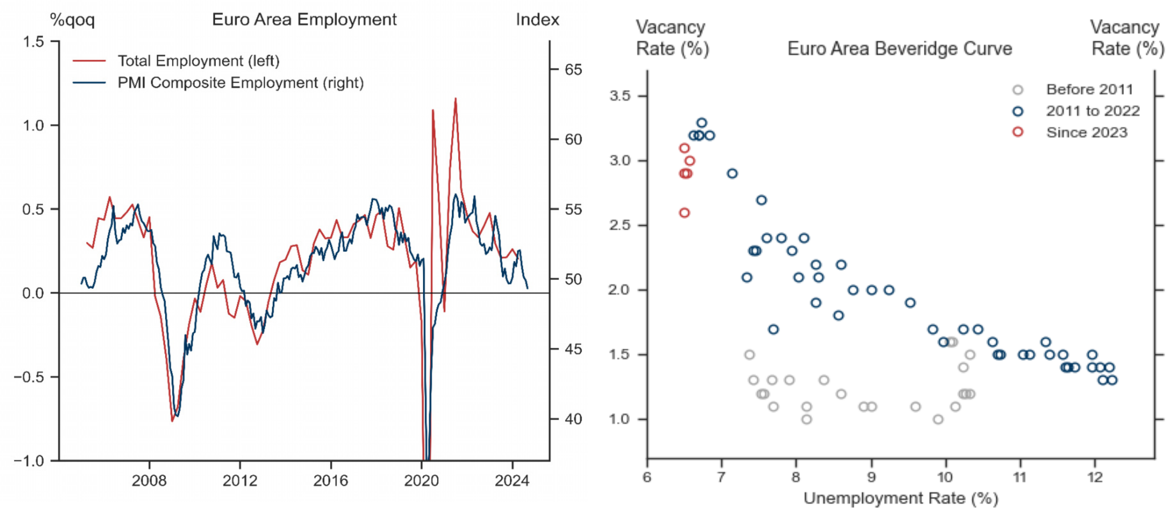


Source: Goldman Sachs Global Investment Research, Haver Analytics, Bloomberg

3. While the Euro area unemployment rate remains at an all-time low, employment growth has slowed steadily and the timelier indicators point to further cooling ahead. Area-wide employment grew by 0.2% in Q2 but surveys (including the PMI and European Commission employment components) point to stalling employment growth

in H2. Moreover, vacancy rates have declined materially and are now close to pre-covid levels, suggesting that further labour market weakness is more likely to push up unemployment, as seen in other economies (including the US).

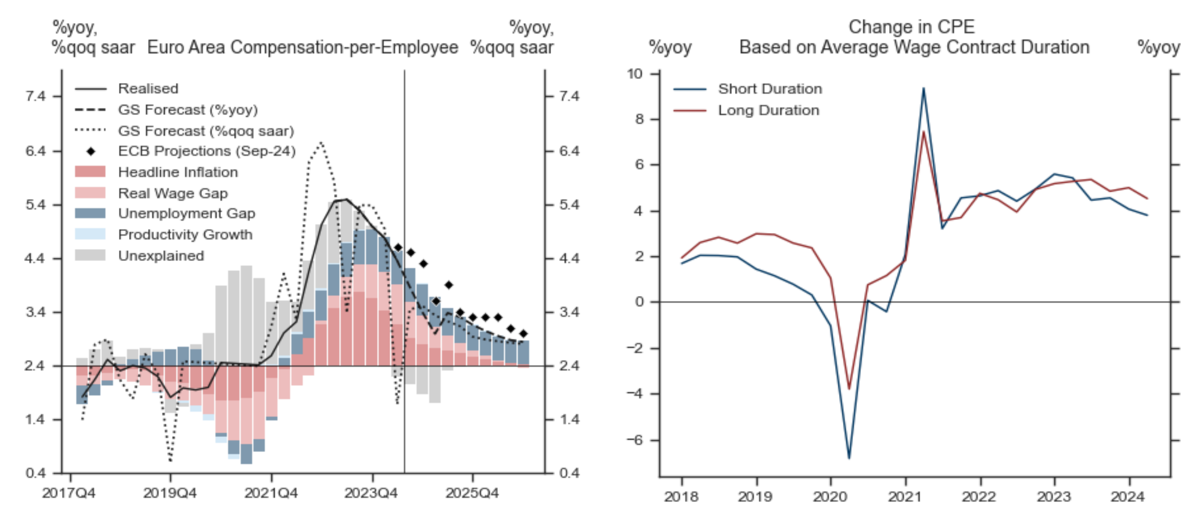
Exhibit 3: Early Signs of Labour Market Softening



Source: Goldman Sachs Global Investment Research, Haver Analytics

4. Wage growth has now cooled meaningfully, with downside surprises in all three major indicators in Q2 (including negotiated wages, compensation per employee and the Labour Cost Index). While the run-rate remains high—with our wage tracker at 4.2% in Q2—the strength looks increasingly backward-looking, with pay pressures already notably weaker in countries that have a shorter average duration of wage contracts (like France). Consistent with this, the ECB's wage surveys and our analysis point to further deceleration ahead, as the catch-up progress from high past headline inflation completes. Our forecast for compensation per employee is below the ECB staff's for Q4 at 3.4% vs 4.3%.

Exhibit 4: Cooling Wage Growth

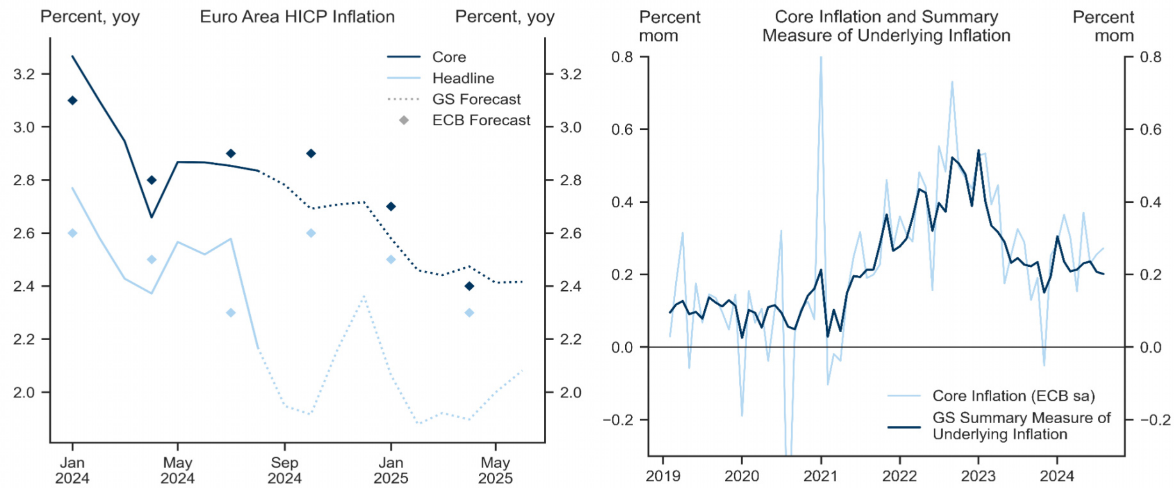


Source: Goldman Sachs Global Investment Research, Haver Analytics

5. We likewise look for more progress with disinflation in coming months than expected

in the September ECB staff projections, with headline and core inflation at 2.1% and 2.7% in Q4 (vs 2.6% and 2.9% in the staff projections), respectively. While the momentum of services inflation remains high, recent services selling price expectations surveys have softened further and our summary measure of underlying inflation has now made some progress (down to 0.20% in August from 0.24% in June). We therefore look for further cooling in sequential core inflation as we come out of the summer.

Exhibit 5: We Look for Faster Disinflation



Source: Goldman Sachs Global Investment Research, ECB

6. Recent ECB commentary, however, has signalled little urgency to accelerate the pace of cuts. President Lagarde acknowledged downside risks to growth after the September meeting but emphasised the stickiness of domestic inflation and highlighted that the October meeting is not far away. A few members have hinted at the benefits of faster policy normalisation (including governors Panetta and Centeno), while some have pushed back against expectations for an October cut (including Simkus, Kazaks and Kazimir). Others have voiced support for gradual rate cuts with the pace depending on the incoming data (including De Guindos, Lane, Villeroy, Knot and Rehn).

Exhibit 6: Cautious ECB Commentary

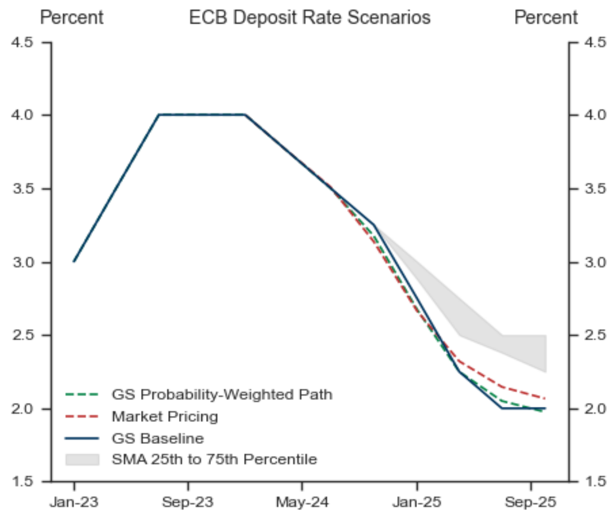
Speaker	Date	Comment
Rehn	20/09/2024	"The ECB has a clear easing direction for its monetary policy, with the pace and scope dependent on fresh economic data and analysis,"
de Guindos	20/09/2024	"It's true to say that in December, we will have more information than in October. But we have left the door totally open. We want to maintain our optionality, and that will depend on the evolution of the data."
Panetta	19/09/2024	"Maybe […] the reduction of ECB interest rates can be accelerated in the coming months."
Knot	19/09/2024	"As long as [inflation cools as projected], I'm more or less fine with market expectations of further cuts, […] Following the current path we're on is a path that gives us two-sided optionality,"
Centeno	19/09/2024	"Given the position in which we are today, in the monetary policy cycle, we have really to minimize the risk of undershooting, because that's the main risk, […] I don't think five weeks is a short period of time,"
Nagel	18/09/2024	"Depending on the incoming data, the time intervals between the potential steps may vary, […] We now need to show that we have enough staying power,"
Simkus	17/09/2024	"the likelihood of an October rate cut is very small"
Lane	16/09/2024	"A gradual approach to dialling back restrictiveness will be appropriate if the incoming data are in line with the baseline projection. At the same time, we should retain optionality about the speed of adjustment."
Kazimir	16/09/2024	"I would require a significant shift, a powerful signal, concerning the outlook to consider backing another cut in October, […] But the fact is that very little new information is in the pipeline."
Kazaks	16/09/2024	"The probability of a rate cut in October, if we look at the financial markets, isn't big, [...] if the economy feels significantly weaker than is currently expected and inflation also significantly declines, then of course we could also consider a rate cut."
Villeroy	13/09/2024	"We should continue to reduce gradually and as appropriate the degree of restriction of our monetary policy, [...] But the pace has to be highly pragmatic: we are not pre-committing to any particular rate path, and we keep our full optionality for our next meetings."

Source: Goldman Sachs Global Investment Research, ECB

7. While we maintain our baseline for sequential cuts from December (with a hold in October), we believe that an October cut is quite possible with further dovish news. First, an October move would likely require notable progress on services inflation in September (released on October 1), together with further signs of activity weakness, for example, including German unemployment and consumer confidence (Sep 27), and area-wide unemployment (Oct 2). Second, expectations for Fed policy would, in our view, need to shift further towards another 50bp step, for example, in response to a weak September employment report (Oct 4). Third, Governing Council members would need to start expressing concerns around the economic outlook, including centrist policymakers.

Exhibit 7: What's Needed for an October Cut?

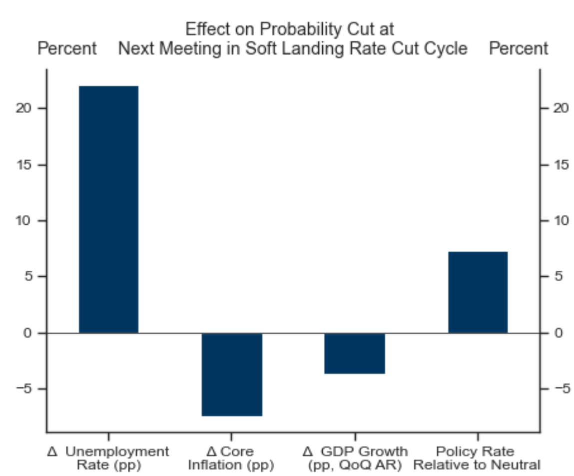
Release Date	Events/Release	Reference Period
24 Sep	Germany Ifo	Sep
27 Sep	France/Spain/Belgium CPI	Sep
27 Sep	Germany Unemployment	Sep
27 Sep	EC Survey	Sep
1 Oct	Flash HICP	Sep
2 Oct	Euro Area Unemployment	Aug
4 Oct	Euro Area Household Saving Rate	Q2
4 Oct	US Non-Farm Payrolls	Sep
7 Oct	Euro Area Sentix	Oct
8 Oct	Germany IP	Aug
15 Oct	Euro Area IP	Aug
15 Oct	Germany ZEW	Oct
17 Oct	Final HICP	Sep
17 Oct	ECB Meeting	

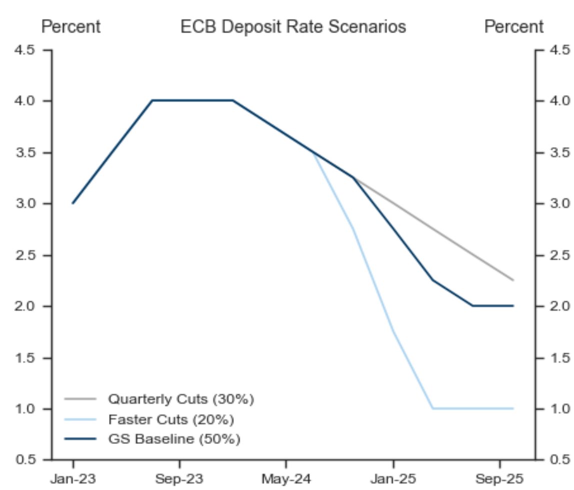


Source: Goldman Sachs Global Investment Research, Bloomberg

8. The likelihood of a 50bp ECB cut, however, remains significantly lower, in our view. Our global team has shown that labour market deterioration has historically been key to accelerate G10 central bank rate cuts, consistent with the Fed's September decision. The hurdle for large near-term increases in unemployment, however, still looks high in the Euro area, suggesting that sequential 25bp steps remain materially more likely than larger increments. Consistent with this, we place a 50% subjective probability on our baseline of sequential cuts from December (up from 40%), 30% on continued quarterly steps and 20% on 50bp steps to a much lower terminal rate. Our rate forecast is slightly below market pricing in 2025 -on a probability-adjusted basis but remains notably below the consensus.

Exhibit 8: Sequential 25bp Cuts Ahead





Source: Goldman Sachs Global Investment Research, ECB

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