

Macro Outlook

CRUISE (IN) CONTROL

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US growth remains driven by solid domestic demand. Incoming April data point to an economy operating near potential, while overheating risks remain limited. The growth-engine model is gradually shifting from consumption-led to capex-led, with AI-related investment continuing to offer further upside, while generating limited inflation repercussions thus far. Indeed, the latest core inflation dynamics remain consistent with an ongoing disinflation trend.

That said, potential overheating risks continue to warrant close monitoring, particularly in relation to income distribution dynamics. Higher-income households continue to experience stronger wage growth, although lower- and middle-income cohorts are beginning to recover. This narrowing gap is partly supported by solid labour demand, but the improvement remains tentative and requires further confirmation.

Euro Area GDP for Q1-26 was revised down to -0.2% q/q, largely driven by distortions from Ireland through net exports. Excluding Ireland, growth was more resilient at 0.3% q/q, but underlying domestic demand remained subdued, both on an EA aggregate basis and on an ex-Ireland basis. Momentum is expected to remain weak in Q2, with continued headwinds in H2 from high energy prices, though a recession is not anticipated, partly due to expansionary German fiscal policy.

Weak economic momentum should limit the pass-through of elevated energy prices to core inflation. The transmission of energy shocks to underlying inflation depends critically on initial macroeconomic conditions, with stronger pass-through typically occurring when inflation is high, demand robust, labour markets tight, and policies more expansionary — all of which are absent in the current cycle.

Our China story is unchanged. The economy continues to perform according to the old model: exports drive growth, while domestic demand remains subdued. Japanification continues: core inflation remains subdued even in a context of rising oil prices.

We have adjusted our Fed fund rate forecast to reflect the increased uncertainty under new Chair Warsh. To account for the Fed's hawkish signals, we have removed the easing bias from our central scenario and now expect the Fed to remain on hold through year-end. At the same time, we continue to believe that a rate cut remains more likely than a rate hike - although both outcomes remain tail risks. In our view, the FOMC's PCE inflation projection, particularly for core inflation, are overly aggressive. The labor market remains solid but broadly balanced, economic growth is not overheating, and core inflation continues to follow a disinflationary trend, supported by the fading impact of tariffs and limited pass-through from the prior energy shock.

We remain of the view that the ECB will refrain from embarking on an aggressive hiking cycle similar to that of 2022 amid: 1) weakening growth prospects, 2) ongoing core disinflation, and 3) the absence of second-round effects on wages. While a September move remains a 50:50 proposition at this stage, we maintain our view that the ECB will not be able to deliver the third additional rate increase currently priced in by markets for this year. We also continue to believe that, further down the road and perhaps as early as Q4 this year, the ECB will have to reverse course and deliver at least one rate cut, if not more, as downside risks to growth intensify the longer the ECB maintains its pre-emptive stance.

We anticipate that the PBoC will maintain a "moderately accommodative" monetary policy stance throughout 2026, preserving an easing bias to support growth, even after the upside surprise in Q1 activity.

GROWTH & INFLATION

US – May the potential be with U(S)

US growth remains driven by solid domestic demand. Incoming April data point to an economy operating near potential, while overheating risks remain limited. The growth-engine model is gradually shifting from consumption-led to capex-led, with AI-related investment continuing to offer further upside, while generating limited inflation repercussions thus far. Indeed, the latest core inflation dynamics remain consistent with an ongoing disinflation trend.

That said, potential overheating risks continue to warrant close monitoring, particularly in relation to income distribution dynamics. Higher-income households continue to experience stronger wage growth, although lower- and middle-income cohorts are beginning to recover. This narrowing gap is partly supported by solid labour demand, but the improvement remains tentative and requires further confirmation.

Domestic demand remains in the lead. The BEA's second estimate placed Q1 real GDP growth at 1.6% q/q SAAR, 0.4pp slower than the advance estimate. Consumer spending was marginally revised down by 0.2pp to 1.4% q/q SAAR, largely reflecting downward revisions to healthcare spending from the incorporation of Quarterly Services Survey (QSS) data. Meanwhile, discretionary services spending categories came in unrevised and remained on a healthy trajectory.

Business fixed investment growth was revised down slightly (-0.4pp) with a very solid print of +10.1% q/q SAAR - the fastest since Q2-23 - reflecting notable pickups in equipment investment and intellectual property products as hyperscalers picked up capital expenditures. On net, despite minor downward revisions, the measure of private domestic final purchases remains solid at 2.4% q/q SAAR, similar to 2025's Q4/Q4 pace.

Data for April continue to show that the economy is operating close to potential.

- In April, real PCE spending increased by 0.1% m/m, down from 0.3% in March. Looking at the expenditure breakdown, we note that the m/m deceleration was entirely driven by goods spending (from 0.8% m/m in March to -0.1% in April). In our view, this reflects a pullback two consecutive months of strong goods spending growth of 0.8% m/m, well above the average run rate over the past year. Meanwhile, real services spending rose to 0.2% m/m from 0.1% in March, driven mainly by discretionary spending categories. Indeed, we note that real PCE spending on recreation services rose to 1.0% m/m from 0.2% in March, while real PCE spending on food services increased to 0.3% m/m from 0.0% in March.
- Personal income decreased markedly in April at 0.0% m/m from 0.5% in March. However, we note that the April report was disproportionately affected by a single component, namely proprietors' income with inventory valuation (IVA) and capital consumption adjustments, which declined by 2.7% m/m due to reduced payments to farmers under the Farmer Bridge Assistance Program. This component typically experiences fairly sharp downward corrections, which are generally fully recouped in the following month. The core components of personal income, namely wages and salaries and personal income receipts on assets, remained resilient, increasing by 0.2% and 0.3%, respectively.

- With spending outpacing income growth, the personal saving rate fell to 2.6% in April. We expect the decline below 3.0% to prove temporary, as aggregate personal income is expected to rebound in the following month. On the investment side, factory orders for April remained solid, with capital goods shipments rising by 0.4% m/m, unchanged from March.

We continue to believe that overheating risks remain limited.

First, the consumer remains resilient but not overheated. Since the start of the year, the trend for real PCE spending has been running at an average pace of 1.7% (6m % chg SAAR), consistent with an economy operating close to potential. This implies a materially less overheated consumption profile compared with 2024 (3.3%) and 2025 (2.4%).

The moderation is particularly evident in more discretionary categories. For instance, the 6-month annualized growth rate (6m SAAR) of PCE recreation services has averaged 1.5% in 2026, compared with a 2024–25 average of 2.2%. Similarly, the 6m SAAR growth rate of sales at food services and drinking places stands at 1.5%, well below the 4.9% average observed over 2024–25.

Second, the US economy continues to shift from a consumer-centric to a capex-centric growth model. AI-related investments — spanning computers and peripherals, data centers, and software — contributed 1.2pp to Q1-26 GDP growth in expenditure terms, marking the largest contribution on record for these categories. Based on recent signals from monthly capital goods orders and capex guidance from hyperscalers, this contribution retains meaningful upside potential. However, this should not translate into upward inflationary pressures, given that the various measures of PCE inflation linked to AI account for only a marginal share of core PCE (around 0.2% of relative weight).

This rotation towards capex-led growth is becoming increasingly visible in the labour market. Payroll growth in the IT-related manufacturing sector (computer and electronic products) has improved markedly, with the 6-month annualized growth rate now at 0.8%, compared with an average contraction of -2.5% over 2024–25. By contrast, employment growth in leisure and hospitality sectors remains broadly unchanged.

This divergence is also reflected in wage dynamics. Average hourly earnings (AHE) in information services are currently growing at around 6.4% (6m SAAR), up from an average of 4.0% over 2024–25, whereas wage growth in leisure and hospitality remains broadly stable relative to the previous two years.

More broadly, other measures of wage pressures continue to soften. Notably, the Atlanta Fed Wage Tracker reported the slowest median wage growth among job switchers since Q2-21 in April, while unit labour costs in Q1-26 recorded their lowest reading since Q3-19.

Overall, this structural shift is unlikely to reignite inflationary pressures. The latest core inflation readings remain consistent with an ongoing disinflationary trend that still has room to extend.

That said, we continue to monitor potential sources of overheating closely. So far, the absence of overheating consumption patterns may partly reflect the uneven distribution of income dynamics, with higher-income households exhibiting stronger financial conditions relative to lower- and middle-income groups.

Using high-frequency BofA Institute credit card data, we observe that while a sizable gap remains between after-tax wage growth for higher-income households and that of lower- and middle-income cohorts, there are early signs of improvement for the latter as of May. Specifically, higher-income households recorded after-tax wage growth of 5.6% y/y in May, down from 5.9% in April, but still elevated relative to the

past three years. Growth rates for lower- and middle-income households remain lower but are gradually recovering: lower-income wage growth rose to 3.1% y/y — the highest since January 2025 — while middle-income wage growth increased to 3.5% y/y. As a result, the gap between higher- and lower-income wage growth has narrowed to its lowest level since July 2025, although it remains significant.

What is driving this rebound? In our view, part of the improvement is consistent with firmer job creation in recent months and the rise in job openings highlighted in the latest JOLTS report. However, we interpret the recent uptick in wage growth with caution, as short-term fluctuations can reflect technical factors, such as differences in the number of pay periods. Additional data will be required to confirm the durability of this trend.

Recent inflation data support our view that the US economy continues to disinflate. This reflects three key factors: (1) the late tariff pass-through feared by the Powell-led Fed has not materialised; (2) AI-related price pressures remain contained and are, in any case, limited to a small set of low-weight components within the CPI basket; and (3) the indirect effects from the oil shock have so far remained modest.

Looking more closely, core CPI momentum slowed to 0.21% m/m, down from 0.38% in April. Core goods momentum declined to -0.1% m/m, falling below both pre-COVID norms and pre-Liberation Day levels, with outright deflation observed in several tariff-sensitive categories. Excluding used cars and AI-related components, core CPI dynamics show little difference from the aggregate measure, suggesting no evidence of delayed tariff pass-through and broadly offsetting AI-related price effects.

Supercore inflation (core services excluding shelter) also moderated, declining to 0.3% m/m from 0.4% in April. Excluding more volatile components linked to oil price dynamics - particularly airfares affected by jet fuel costs - momentum eased further to 0.2% from 0.25%. Overall, supercore inflation has now normalised relative to its pre-COVID average. Finally, as expected, core shelter inflation (OER and RPR) reported a payback from April's technical quirk.

ANIMA baseline. Our growth baseline remains unchanged. We have incorporated the revision to Q1 data into our profile, and our 2026 annual growth forecast now stands at 2.1% (compared with the previous estimate of 2.2%).

For inflation, we leave our baseline unchanged. We continue to expect core CPI to average 2.5% in 2026.

In core PCE terms, bearing in mind that, as of January 2026, the core PCE-CPI inflation gap has reversed sign (resulting in core PCE inflation running above core CPI inflation) and widened to unusual levels, we continue to expect the 2026 annual average for core PCE inflation to be 2.7%

EA – Grim prospects

Area-wide GDP for Q1-26 was revised down to -0.2% q/q, largely driven by distortions from Ireland through net exports. Excluding Ireland, growth was more resilient at 0.3% q/q, but underlying domestic demand remained subdued, both on an EA aggregate basis and on an ex-Ireland basis. Momentum is expected to remain weak in Q2, with continued headwinds in H2 from high energy prices, though a recession is not anticipated, partly due to expansionary German fiscal policy.

Weak economic momentum should limit the pass-through of elevated energy prices to core inflation. The transmission of energy shocks to underlying inflation depends critically on initial macroeconomic conditions, with stronger pass-through typically occurring when inflation is high, demand robust, labour markets tight, and policies more expansionary — all of which are absent in the current cycle.

Grim prospects, with some caveats. The area-wide final GDP print for Q1-26 was downwardly revised to -0.2% q/q from the prior estimate of +0.1% q/q, and from +0.2% in Q4-25. The revision reflects a huge downward adjustment to Ireland's Q1 growth rate: Irish GDP was revised down from -2.0% (flash estimate) to -12.1% (final estimate). Ireland being 4% of the block, it ultimately weighed around 45bp on EA growth in that quarter. Irish GDP data are typically volatile due to sharp swings in the intellectual property investments component, reflecting the activity of multinationals. However, the breakdown of Irish expenditure shows that in Q1, the distortion stemmed entirely from the net trade channel (Irish exports were down 7.0% q/q in Q1, while imports were up 4.2%) and not from the usual investment channel.

Expenditure details are not encouraging. Excluding Ireland, the aggregate EA print came in at 0.3% q/q from 0.4% in Q4-25. But this is a sign that should be interpreted with caution, since both the aggregate expenditure breakdown and the Ireland-excluded breakdown indicate a slowdown in underlying demand. Our measure of final sales to domestic purchasers (Private Consumption + Government Consumption + Fixed Investments) decreased to 0.2% q/q from 0.6% (both on an aggregate basis and excluding Ireland) while final domestic demand (Private Consumption + Government Consumption + Fixed Investments + Inventories) decelerated to 0.1% q/q (EA aggregate) and 0.0% (excluding Ireland) from 0.6% in Q4-25 (with and without Ireland). Moreover, net exports dragged real GDP growth down by 0.3pp. In our view, the negative net export contribution can't be blamed for the bad Q1 print as it has been contributing negatively since Q2-25. Moreover, growth momentum for imports remained marginally positive albeit declining. In our view, this could be a further sign of weakening demand, especially now that the tariff shock has been fully factored into corporate reaction functions.

Big-2 countries are struggling.

- Real GDP growth in Germany came in at 0.3% q/q, up from 0.2% in Q4-25. However, much of the increase was driven by government final consumption (+1.1%). Private consumption stagnated and gross fixed investment contracted by 1.5% q/q. Although construction investment — due to adverse weather conditions in January and February — subtracted approximately 0.2pp from GDP growth — spending on machinery and equipment also slowed significantly, from +1.2% q/q to 0.0%, indicating that core investments struggled at the start of the year.
- Real GDP growth in France came in at -0.1% q/q from 0.2% in Q4-25. Private consumption decreased to -0.2% q/q from +0.3% in Q4-25, while gross fixed investment contracted to -0.6% q/q from +0.2% in Q4-25.

What to expect for Q2?

We remain of the view that the EA economic momentum will remain tepid in Q2. In terms of drivers, we believe that:

- 1) Ireland quarterly data are hard to predict, but we expect the rebound from net exports to be marginal in Q2. In fact, we believe that the export channel saw a downward correction in Q1 after having been pushed to exceptional levels last year in some sectors (chemical and pharmaceutical products) in the context of changes to US trade policy. In a nutshell, after frontloading exports supported Irish GDP in 2025, it is rather unlikely that we will see significant increases in net exports.
- 2) Construction investment in Germany is expected to rebound following unfavourable weather conditions in the first quarter. Monthly construction output data point in this direction.

- 3) Domestic demand remains weak. The latest retail sales data for April indicate that momentum remains weak (total retail sales down 0.4% m/m and core retail sales down 0.2%). Moreover, investment trends remain highly uncertain due to tightening credit and financial conditions and ongoing geopolitical tensions that are weighing on energy prices, this is confirmed by weak core manufacturing orders in Germany for April.

Overall, on top of weak survey data, we expect relatively muted EA growth in Q2-26, at 0.2% q/q (0.15% at 2dps): this number would reflect a soft trend of around 0.05% q/q excluding Ireland and some upside in that country (i.e., a limited correction of the large drop) contributing around 10bp to the EA figure.

Looking ahead to H2-26, we believe that the EA economy will continue to face headwinds due to the impact of energy prices, but we do not foresee a recession.

A key reason is that German fiscal policy is expanding markedly. While the rollout of the infrastructure fund is moving in the right direction, defence spending is rising rapidly and appears geared towards domestic production. As a result, activity in the German defence industry has picked up sharply, including in terms of factory orders, production and company sales. The rise in defence spending is much slower elsewhere in Europe, but we expect German fiscal policy to boost German growth by 1/2pp this year, providing a key source of resilience for the euro area as a whole.

Looking at core inflation developments with the right lens. Core inflation in May rose to 2.5% y/y (up 0.3pp from April), driven mainly by higher services inflation. However, we note that the re-acceleration in annual core inflation was in part mechanical - as negative base effects in volatile components (package holidays, accommodation and transport services) related to Easter had artificially weighed on the April services reading.

So far, we do not observe any significant pass-through of energy prices into core inflation. For instance, a closer look at the German detailed regional data shows that the m/m NSA growth rate for airfares dropped to -17% in May. In theory, airfares should be one of the core components most rapidly impacted by energy prices (through the jet fuel price channel). However, there is ample evidence to suggest that European airlines are not raising ticket prices in order to preserve demand ahead of the summer season, thanks to various hedging strategies implemented over the past few years. For instance, Ryanair reported that it has hedged 80% of its fuel needs at \$67/barrel, while Lufthansa, IAG, and easyJet have stated that they hedge approximately 70% of their fuel needs on average.

No second-round inflation effects in the pipeline. We believe that the current state of the euro area economy lacks the momentum to generate significant second-round effects on core inflation.

The 2022 script is unlikely to be repeated this time around. We believe that beyond the nature of the shock itself, the starting macro-financial environment plays a key role in the propagation of an energy shock into underlying inflation. Evidence shows that the pass-through tends to be stronger when the level of inflation is higher, demand conditions are more robust, the labour market is tighter and fiscal and monetary policies are more expansionary. Along each of these dimensions, today's starting point differs substantially from that of early 2022.

- In 2022 headline inflation was growing at between 5% and 6% y/y and was accelerating. Energy inflation had already been climbing steeply from around 15% since mid-2021 to slightly above 30% in February 2022 due to a combination of surging post-pandemic demand and Russia curtailing gas supplies ahead of the invasion. When the current shock hit in late February 2026, headline inflation stood slightly below 2% – close to the ECB's medium-

term target – with energy and core inflation momentum at moderate levels. Empirical findings report that starting from a position of inflation close to target thus reduces the risk of the initial energy price spike triggering a disproportionate reaction by price- and wage-setters.

- Domestic demand in 2022 was clearly overheating: on average, real domestic demand in 2021–2022, driven primarily by private consumption, posted a sequential growth rate of 1.1% (compared with 0.1% currently).
- The labour market remains resilient but is loosening given sluggish employment growth (at 0.1% in Q1-26), a declining vacancy/unemployment ratio and gently rising unemployment (for example, in France).
- While some forward-looking wage indicators (such as wage expectations in the ECB corporate telephone survey) have increased, they continue to show wage growth falling back into the 2.5-3.0% range that we see as consistent with inflation at target. Indeed, negotiated wage growth decelerated to 2.5% y/y in Q1-26 from 2.9% in Q4-25. That's below the 3% increase in overall wage growth considered by the ECB to be consistent with price stability, given an inflation target of 2% and long-term productivity growth of around 1%. Moreover, the Q1-26 figure for compensation per employee (the most comprehensive measure of wage growth) fell to 3.4% y/y in Q1-26 from 3.6% in Q4, and forward-looking wage trackers point to weaker pay settlements ahead.

ANIMA baseline. Our baseline for real GDP growth remains unchanged. We are mechanically factoring in the downward revision to the final Q1 figure, and as a result, our 2026 annual GDP growth forecast now stands at 0.3% (vs the prior estimate of 0.8%). In terms of sequential momentum, we continue to expect real GDP growth of 0.2% q/q in Q2-26, 0.2% in Q3-26 and 0.3% in Q4-26 (unchanged vs our prior estimates).

On inflation, our core HICP baseline reflects minor technical adjustments. In fact, we are mechanically factoring the May core HICP print, which came in slightly above our expectations. Consequently, we now expect core HICP inflation in Q2-26 to be 2.3% (vs the prior estimate of 2.2%), 2.2% in Q3-26 (vs 2.1% in the prior baseline) and 2.1% in Q4-26 (vs 2.0%). The annual average forecast remains unchanged at 2.2%.

CHINA – Neither bad, nor new

Our China story is unchanged. The economy continues to perform according to the old model: exports drive growth, while domestic demand remains subdued. Japanification continues: core inflation remains subdued even in a context of rising oil prices.

Slowing and bifurcating growth. Following a broad-based slowdown in April, May PMIs and high-frequency data suggest further weakening in growth momentum, mainly driven by softer domestic demand and some supply disruptions in the petrochemical sectors.

- China's NBS manufacturing PMI edged down to 50.0 in May from 50.3 in April. The slowdown was led by consumer goods and petrochemical-related sectors.
- Meanwhile, the RatingDog manufacturing PMI, which covers more export-oriented firms, came in at 51.8 in May, easing from a five-year high of 52.2 in April.

This is consistent with our baseline forecast of 4.7% year-over-year real GDP growth in Q2 2026, down from 5.0% in Q1.

The trade engine is still alive. China's trade growth accelerated sharply in May: exports increased by 19.4% y/y from 14.1% in April. By major destination, Chinese nominal exports to major trading partners increased sequentially in May, except for those to the EU and Latin America. By major category and in sequential terms, export value rose broadly from April to May, with tech-related products rising the most, followed by metals and housing-related products.

We expect net exports to continue to contribute about 30% of GDP growth this year (2025: 32%), adding 1.5pp to our full-year 2026 GDP growth forecast of 4.9%. The strength in exports will be led by green-tech and AI-related products.

Upstream-driven PPI, weak pass-through. May price data indicate that rising oil prices continued to drive PPI inflation and energy-related components of CPI, while core and services inflation remained largely unaffected, suggesting limited second-round effects. In terms of sequential momentum, PPI showed signs of normalization as oil prices eased slightly, though they remained elevated. Declines were recorded in oil and gas extraction, while price increases in chemicals, fibres, rubber, and plastics moderated.

The May PPI breakdown highlights the uneven price effects stemming from the Middle East conflict. Upstream segments remained the primary drivers, with raw material prices increasing by 9.2% y/y in May from 7.1% in April and mining prices rising by 15.8% from 10.6% in April. Although some manufacturing subsectors - such as electrical machinery and electronics - registered price gains, overall manufacturing inflation stayed relatively contained at 2.3% y/y. In contrast, downstream consumer goods prices continued to show deflation, indicating persistent difficulties in passing higher input costs along the value chain.

No second-round effects in sight. CPI was unchanged at 1.2% y/y in May, with energy providing greater support in May compared with April. Elsewhere, both core and services CPI edged lower, with continued weakness in housing rents and auto prices, reinforcing the view that soft domestic demand is limiting demand-driven reflation and preventing meaningful second-round effects.

ANIMA baseline. We maintain our y/y % growth forecast for the coming quarters. Our full-year projection remains at 4.9% (annual average).

On inflation, our baseline remains unchanged: our forecast for annual average headline inflation in 2026 stands at 1.0%. Upside risks remain, given the potential for further non-linear moves in energy markets.

MONETARY POLICY

Fed – Reading the tea leaves

Interpreting the Federal Reserve's reaction function has become increasingly difficult. The new Chair has made it clear that markets will have to infer the Fed's policy stance from incoming data and policymakers' actions, rather than rely on explicit forward guidance.

This was evident following the first meeting chaired by Governor Warsh. Although the statement, the updated Summary of Economic Projections (SEP), and the new dot plot were all distinctly hawkish, the FOMC left rates unchanged. Moreover, by choosing not to submit his own rate forecast, Governor Warsh signaled that the Fed's traditional communication tools, including the dot plot, may carry less informational value than they have in the past.

Against this backdrop, we have adjusted our rate forecast to reflect the increased uncertainty. To account for the Fed's hawkish signals, we have removed the easing bias from our central scenario and now expect the Fed to remain on hold through year-end. At the same time, we continue to believe that a rate cut remains more likely than a rate hike - although both outcomes remain tail risks. In our view, the FOMC's PCE inflation projection, particularly for core inflation, are overly aggressive. The labour market remains solid but broadly balanced, economic growth is not overheating, and core inflation continues to follow a disinflationary trend, supported by the fading impact of tariffs and limited pass-through from the prior energy shock.

A hawkish hold. At its first meeting under Chair Warsh, the FOMC left rates unchanged at 3.50–3.75%. While the statement, the SEP, and the dot plot all conveyed a clearly hawkish message, the Committee unanimously kept rates unchanged and, according to Chair Warsh, did not consider any alternative policy proposals, even though half of the FOMC expects at least one rate hike this year and the Committee's core inflation forecasts were revised materially higher.

End of babysitting. The statement was noticeably shorter than those issued during the Powell era, with the FOMC removing both forward guidance and any detailed explanation of its reaction function. Overall, it retained a hawkish tone, describing the economy as remaining solid and inflation as remaining elevated, partly due to supply shocks. The easing bias was also removed.

Hawkish SEP and dots. The SEP and the dot plot delivered an even more hawkish message. GDP growth forecasts were revised only slightly lower for 2026, while both headline and core PCE inflation projections were revised sharply higher (to 3.6% and 3.3%, respectively), with core inflation expected to remain above target until 2028. Against this backdrop, half of FOMC participants now expect at least one rate hike in 2026, followed by cuts in 2027 and 2028. Consistent with his skepticism about forward guidance, Warsh did not submit his own projections.

But no hike was delivered. Despite higher inflation forecasts and the upside risks surrounding them, the FOMC neither raised rates nor appears to have seriously considered doing so. This inconsistency between the Committee's inflation outlook and its policy decision remains striking.

A meaningful shift in the Fed's framework. The decision to leave rates unchanged likely reflects broader institutional changes hinted at by Chair Warsh. He announced five task forces focusing on communication, balance sheet policy, macroeconomic methodology, productivity and AI, and the inflation framework. Their conclusions, expected by year-end, could significantly reshape the Fed's policy approach.

Against this backdrop, we have adjusted our rate call to reflect the increased uncertainty. To account for the Fed's hawkish signals, we have removed the easing bias from our central scenario and now expect the Fed to remain on hold through year-end.

While the FOMC delivered a hawkish message through the statement, the SEP and the dot plot, Chair Warsh appeared reluctant to articulate his own assessment of the current monetary policy stance. Instead he described policy as "uneven", restrictive in some sectors of the economy and accommodative in others, and he argued that the work of the task forces would provide greater clarity on the Fed's stance. Barring a material change in economic outlook over the coming months, our interpretation is that Chair Warsh's preferred course of action is to keep rates on hold through the remainder of the year.

At the same time, to allow for the possibility that other factors may be influencing the new Fed's reaction function, otherwise why has it not raised rates despite more hawkish dot plan and SEP? We continue to believe a rate cut is more likely than a rate hike, although both outcomes remain tail risks.

Our view is based on four considerations:

1. We believe that the FOMC's core PCE inflation projections are overly aggressive and implicitly assume meaningful second-round effects. This is not our baseline. The labour market remains solid but broadly balanced, growth is not overheating, and core inflation continues to follow a disinflationary trend, supported by the fading impact of tariffs and limited pass-through from the previous energy shock.
2. The FOMC refrained from even discussing a rate hike despite raising its core inflation forecasts to levels last seen at the end of 2023, suggesting that the bar for tightening policy remains exceptionally high. In fact, according to the Chair, the only discussion of an alternative to holding rates unchanged concerned the possibility of cutting rates.
3. The elevated inflation projections for 2026 increase the likelihood that they will be revised lower later this year.
4. Chair Warsh has emphasized that strong growth accompanied by higher productivity is welcome. Based on our interpretation of his remarks, he does not appear to view such an outcome as inherently inflationary.

ECB – Ordinary maintenance

We continue to expect ordinary maintenance of the euro area inflation outlook from the ECB rather than the kind of extraordinary policy management seen in 2022. Accordingly, we remain of the view that the ECB will refrain from embarking on an aggressive hiking cycle similar to that of 2022 amid: 1) weakening growth prospects, 2) ongoing core disinflation, and 3) the absence of second-round effects on wages.

While a September move remains a 50:50 proposition at this stage, we maintain our view that the ECB will not be able to deliver the third additional rate increase currently priced in by markets for this year.

We also continue to believe that, further down the road and perhaps as early as Q4 this year, the ECB will have to reverse course and deliver at least one rate cut, if not more, as downside risks to growth intensify the longer the ECB maintains its pre-emptive stance.

First rate hike since September 2023. As widely expected, the ECB raised rates by 25bp, taking the deposit rate to 2.25%. The decision was unanimous, and there was no discussion of alternative options, including a larger move or no hike at all. However, President Lagarde refrained from providing guidance regarding future moves, arguing that, following the June hike, the ECB is now in a good position to navigate war-related uncertainty.

A stitch in time saves nine. Despite President Lagarde characterizing the rate hike as simply a sound monetary policy decision, given that energy price inflation is spilling over into other prices, we believe the ECB delivered what amounts to an insurance hike.

We base this assessment on the following considerations:

1. President Lagarde explained that medium-term inflation expectations remain well anchored and that there is currently no evidence of second-round effects.

However, she also noted that the longer the energy price shock persists, the greater the probability that such risks will materialise.

2. President Lagarde stated that, in the baseline scenario, compensation per employee remains contained at around 3.2% y/y throughout the forecast horizon, implying an absence of meaningful second-round effects. This is despite the baseline assumption that oil prices peak well above USD 100/bbl in Q2 2026 and remain above USD 80/bbl through H1 2027.
3. President Lagarde repeatedly stressed that the rate hike is robust across a range of scenarios, suggesting that the ECB has used this move to hedge against adverse outcomes.
4. We believe that the ECB is determined to send a clear message to markets that it will not repeat the mistake of 2022 by reacting too late to rising inflation.

The ECB remains open to another rate hike. While the ECB remains data-dependent and retains its meeting-by-meeting approach, the rhetoric during the press conference suggests that another rate hike remains on the table.

This assessment is based on the following:

1. President Lagarde argued that while risks to growth remain tilted to the downside, growth is neither absent nor seriously threatened under any scenario. Indeed, even in the adverse scenario, GDP growth remains comfortably in positive territory (Figure 1).
2. President Lagarde referred to her March speech at the “**ECB and Its Watchers**” conference to describe the ECB’s reaction function under the current baseline. At that time, she argued that if the energy price shock were to generate a significant but temporary overshoot of the inflation target, “**some measured adjustment of policy**” would be warranted. In our view, this could imply more than one additional rate hike.
3. President Lagarde refrained from commenting on whether the ECB intends to move monetary policy into restrictive territory, arguing instead that the estimates of the neutral rate are too uncertain in the presence of large shocks.

Easier said than done. That said, we believe current market pricing represents a hard ceiling for the ECB, as downside risks to economic activity continue to build, core disinflation continues to progress, and wage growth keeps moderating. Against this backdrop, we maintain our view that the ECB could deliver a second-rate hike in Q3. We continue to see September as more likely than July, although the timing will also depend on geopolitical developments in the Middle East. However, we remain of the view that the ECB will not be able to deliver a third additional rate hike this year, despite current market pricing implying otherwise. **Medium-term tenor of our call unchanged.** We also continue to believe that, further down the road and perhaps as early as Q4 this year, the ECB will have to reverse course and deliver at least one rate cut, if not more, as downside risks to growth intensify.

The likelihood of such an outcome will depend on: 1) the amount of additional tightening implemented by the ECB, and 2) geopolitical developments, including the post-war adjustment of the oil market following a potential Middle East settlement.

PBoC – No news

We anticipate that the PBoC will maintain a “moderately accommodative” monetary policy stance throughout 2026, preserving an easing bias to support growth, even after the upside surprise in Q1 activity.

Our baseline remains unchanged: we continue to expect a 10bp policy rate cut in Q3 and a cumulative 50bp reduction in the reserve requirement ratio over the course of the year.

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