Macro Outlook

SEIZE THE PRESENT

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"Keep your head when all about you are losing theirs" (Rudyard Kipling)

We have let this quote from the famous poem "If" inspire our macro thoughts this month. Acknowledging that we are not geopolitical analysts and wary that we do not have the luxury of not taking a view, we have introduced into our macro baseline the assumption that the conflict in the Middle East will not escalate, thus keeping increases in energy commodity prices limited and, most importantly, temporary.

Against this backdrop, barring mechanical upgrades to our energy inflation forecasts to reflect the recent shape of the Brent crude oil futures price curve and the strengthening of the US dollar, we have left the backbone of our macro baseline unchanged, while remaining wary, though, that any escalation and/or prolongation of the situation would hit the geographies under our coverage differently.

Against conventional wisdom, we think that overheating risks have declined in the US, albeit at the margin. Under base-guesstimate that the Iran conflict will only have a limited impact on the US economy, our projected macro-outlook is largely unchanged. Incoming data continues to support our baseline that economic activity retains momentum, led by domestic demand, while core disinflation remains benign and the risk of wage acceleration has eased.

Consistent with our geopolitical base-guesstimate, we are also keeping the shape of our projected macro-outlook for the Euro Area (EA) unchanged. For the time being, the energy shock that has unfolded so far isn't enough to derail the acceleration in growth momentum we project for this year, while we allow the stress to filter through our projected inflation baseline via volatile components only, without involving core inflation.

However, acknowledging that the EA economy's tolerance to rapid and sharp increases in energy commodity prices is lower than that of the US, we warn that downside risks to the EA macro-outlook are greater and more immediate than those faced by the US. Therefore, we do not rule out that, should the conflict persist, our view on the EA economy may be downgraded more quickly than that on the US.

While the hit to EA growth would be largely linear, that on core inflation might be more complex. Initially, underlying prices could be impacted if the energy market stress persist, yet, we would not anticipate core inflation to accelerate uncontrollably as it did in 2022. Given the presence of a much less solid macro backdrop than that experienced by the EA in 2022, we believe that the related growth relapse (and any eventual miscalculated response by the European Central Bank) would tame underlying inflation further down the road.

Finally, consistent with our wait-and-see approach, we have left our projected macro-outlook for China unchanged. Middle East tensions are unlikely, for now, to alter the growth and inflation trajectory; however, risks to the latter are increasing.

GROWTH & INFLATION

US – Thinking out of the box

Against conventional wisdom, we think that overheating risks have declined in the US, albeit at the margin. Under base-guesstimate that the Iran conflict will only have a limited impact on the US economy, our projected macro-outlook is largely unchanged. Incoming data continues to support our baseline that economic activity retains momentum, led by domestic demand, while core disinflation remains benign and the risk of wage acceleration has eased.

Limited war impact so far. Our base case is that the Iran conflict will only have a limited impact on the US economy. Accordingly, our projected growth forecast remains unchanged. The reason is twofold:

1) By looking back at the last three major conflicts with direct US military involvement, there is no clear evidence of weakening in the macro data after the conflict started. At the risk of oversimplifying, the US economy tends to export economic shocks rather than importing them from abroad.
2) While large oil shocks that result in sustained energy price increases can weigh on GDP growth and boost inflation, history suggests that oil price spikes driven by geopolitical shocks can be short-lived if markets gain confidence that supply disruptions will be temporary. In addition, the US economy has significantly increased its energy production capacity over the past five years. As a result, it would be less exposed to an energy supply shock.

Outlook unchanged. Given that the evolution of military escalation in the Middle East remains fluid and there is still no clear picture of how long the conflict will last, we are not revising our outlook at this stage.

Domestic economy remains resilient. The Bureau of Economic Analysis (BEA) second estimate of Q4 real GDP came in at 0.7% q/q SAAR, decelerating from the 4.4% q/q gain in Q3. However, much of this slowdown was mechanical, amid the government shutdown, which led to a significant contraction in government spending (-5.1% q/q SAAR). Net of the government-related drop, aggregate demand continued to retain momentum through year-end, following the uneven performance in H1-25, with the bellwether real final sales to private domestic purchasers continuing to show solid growth in Q4 at 2.4% q/q SAAR, after the 2.9% increase in Q3. In this respect, the underlying drivers remain solid:

1) **Consumer spending remains resilient,** at 2.0% q/q SAAR in Q4, down from a remarkably strong gain of 3.5% q/q in Q3. The print was mainly driven by strong services spending, which continues to support consumer demand, while goods consumption declined outright amid weaker durable goods spending.
2) **CAPEX activity is accelerating**. Fixed investment increased to 1.6% q/q SAAR, with a broad-based composition: AI-related investment continued to advance, despite smaller declines in residential and structures investment. Spending in AI-sensitive categories (computers and peripherals, software, and data centres) contributed 0.8pp in the quarter.

Growth is set to remain solid in Q1. We expect growth to reach 3.1% q/q SAAR in Q1. The rebound is expected to be driven by a payback component from the government shutdown through a rebound in government spending. However, our focus remains on domestic demand. On this front, the signals coming from incoming data remain fairly positive and in line with our baseline.

1) The largely unchanged level of the ISM Manufacturing Index in February, after the prior month's surge, suggests that the domestic factory sector is benefiting from stronger global conditions tied to the AI build-out. Based on capex plans from hyperscalers, we think that the demand impetus from AI build-outs will remain firm throughout 2026. Strong outturns for core capital goods orders and shipments through December suggest that growth is set to continue in early 2026.

2) The ISM Services Index reading for February confirms that the services sector remains solid across the board: demand and production accelerated, employment improved, and price pressures became less pervasive.

3) The January reading for retail sales suggests that goods consumption started the year on a solid footing. With tax refunds running ahead of last year's averages, we should start to see cash flows materially support spending in the months ahead.

4) Card-spending data point to positive momentum in the first weeks of March.

5) The Nonfarm Payrolls (NFP) numbers for February came in weaker than expected at -92k. However, our interpretation is less dramatic than the headline would suggest, as the weakness appears to be largely due to temporary factors rather than a fundamental deterioration in employment trends.

A. In our view, much of the weakness this month represents negative payback following the positive overshoot in January. Sectors that outperformed in January slowed sharply in this month's report, most notably education and health (+132k in January, down to -34k in February) and construction (+44k in January, -11k in February). The deceleration in private payroll growth between January and February was likely amplified by the Bureau of Labor Statistics (BLS) new birth–death methodology.

B. There was also some idiosyncratic weakness this month, beyond the broad negative payback. A nurses' strike weighed on healthcare employment (around 30k workers), but it was resolved shortly after last month's NFP reference week, making a rebound in March likely.

C. Adverse weather may have distorted the data. Payroll growth in weather-sensitive industries was about 40k lower than its prior three-month average.

Leaving aside the plethora of NFP metrics, alternative indicators suggest that the labour market remains in a state of low hiring and low firing. Measures of layoffs have remained low, consistent with Initial Jobless Claims and JOLTS layoffs and discharges. On the other hand, a broad range of employment indicators has continued to demonstrate stability in recent months, including ADP private employment growth, NFIB hiring plans, and services-sector surveys.

Inflation-wise, incoming data suggest that overheating risks have declined at the margin lately, supporting our baseline that core inflation will return to target by Q4 this year:

1) Bad news is good news. From a pure inflation standpoint, February's labour-market reality check softens the overheating risks that emerged after the extraordinarily strong January print. Inflation-wise, the United States labour market is skating on thin ice. Amid severe constraints related to anti-immigration policies, any surge in labour demand would likely come with upward pressures on wages.

2) The data did the rest. In February, core CPI came in at 0.2% m/m (-0.1 pp compared with January). Weakness was broad-based. Core shelter and lodging prices decelerated markedly during the month. *Supercore* momentum eased from January as volatile components, which had boosted the prior month's print, moderated. Core goods momentum also slowed relative to January, even excluding used cars, consistent with a slow tariff pass-through rather than a late pick-up in tariff momentum.

Higher oil prices and headline inflation: a price-level shock rather than a persistent inflationary shock.

Although crude oil prices have risen by nearly 30% since end-February, retail gasoline prices have increased by a more moderate ~12%. While the two tend to co-move, the pass-through is neither one-for-one nor fully immediate, given that crude oil accounts for only around half of the final retail gasoline price, with the remainder reflecting refining, distribution, and other downstream costs. Estimates from the Federal Reserve Bank of Dallas suggest that the pass-through from crude oil to gasoline prices is well below 100%, more likely in the region of 50–60%, with most of the adjustment occurring within two to three weeks. As such, the transmission is relatively rapid, but only partial. Incorporating energy futures as of 10 March, our baseline forecast implies headline CPI inflation of 2.6% y/y. This is 0.3pp above our prior baseline and is largely explained by the latest increase in gasoline prices.

Second-round effects on core inflation appear to be limited. At this stage, the risk of meaningful second-round effects on core inflation appears limited and would likely require a larger and more persistent oil shock. Based on the evidence currently available, the conditions typically associated with broader inflation spillovers do not appear to be present. The last time oil prices moved above $100/bbl, in early 2022, the macroeconomic backdrop was materially more inflationary. At that time, global supply chains were still heavily impaired by the pandemic, while substantial fiscal support to households in the United States was sustaining demand, meaning the energy shock was layered onto an already inflationary environment, thereby contributing to the rise in core inflation.

The current price configuration of the US economy is quite different. Post-pandemic consumer overspending has moderated, excess savings have been depleted, equity gains have slowed, the level of prices is historically high, official interest rates are much higher than in the post-Covid period, and wage growth is slowing. Against that backdrop, while a renewed and extended rise in oil prices remains a clear upside risk to headline inflation, the softer underlying momentum in non-energy prices suggests that any endogenous persistence into core inflation should prove more contained in 2022.

ANIMA baseline. On growth, for Q1-26 we expect growth to pick up to 3.1% q/q SAAR (from 2.8% in the prior baseline) in Q1-26. The rebound is mainly linked to the recovery from the government-spending drag in Q4-25. For Q2, Q3 and Q4-26, we expect growth to average 2.2% q/q SAAR (unchanged from the prior baseline). This is consistent with an annual growth rate of 2.5%. In Q4/Q4 terms, our forecast stands at 2.4%.

On inflation, we now expect headline CPI to average 2.6% in 2026 (annual average), up from 2.3% in the prior baseline. For core inflation, our baseline remains unchanged. For H1-26, we expect core CPI to average 2.8%, and 2.2% in H2-26, which is consistent with an annual average of 2.6%. We expect the y/y rate to reach 2% by the end of Q3-26. In core PCE terms, for H1-26, we expect core PCE to average 2.6%, and 2.2% in H2-26, which is consistent with an annual average of 2.5%.

EA – Thinking ahead

Consistent with our geopolitical base-guesstimate, we are also keeping the shape of our projected macro-outlook for the Euro Area (EA) unchanged. For the time being, the energy shock that has unfolded so far isn't enough to derail the acceleration in *growth momentum we project for this year, while we allow the stress to filter through our projected inflation baseline via volatile components only, without involving core inflation. However, acknowledging that the EA economy's tolerance to rapid and sharp increases in energy commodity prices is lower than that of the US, we warn that downside risks to the EA macro-outlook are greater and more immediate than those faced by the US. Therefore, we do not rule out that, should the conflict persist, our view on the EA economy may be downgraded more quickly than that on the US. Initially, underlying prices could be impacted if energy market stress persists; however, we would not anticipate core inflation to accelerate uncontrollably as it did in 2022. Given the presence of a much less solid macroeconomic backdrop than that experienced by the Euro Area in 2022, we believe that the related growth relapse (and any eventual miscalculated response by the European Central Bank) would tame underlying inflation further over time.*

Backward-looking data point to decent growth at the end of 2025. The final GDP release for Q4-25 came in line with our baseline forecast, at 0.2% q/q (-0.1 pp compared with previous estimates), largely reflecting a larger-than-expected decline in Irish real GDP (-3.8% q/q). Excluding Ireland, area-wide real GDP rose by 0.4% q/q. Net of Irish volatility, the underlying expenditure details send an encouraging signal: private consumption rose by 0.5% q/q - the highest quarterly reading since Q4-24. Fixed capital formation continued to expand at a solid pace, increasing by 0.6% q/q, after an upwardly revised increase in Q3 of 1.3% q/q (0.9% q/q previously). On net, our measure of underlying domestic demand - namely final sales to domestic purchasers excluding IPP - rose to 0.6% q/q (+0.2 pp compared with Q3). Finally, both net exports and inventories made negative contributions to growth (-0.1 pp and -0.2 pp respectively).

We expect positive growth to continue in Q1-26 as well. Although incoming data for the start of the year have been mixed, we maintain our baseline forecast of a modest improvement in GDP growth in Q1-26:

A) We should not place too much weight on the hard data for January, as the first month of the year is typically highly volatile and because the upward revisions to December data were substantial.

- Area-wide retail sales edged down by -0.1% m/m in January following a +0.1% increase in December (revised up from -0.5%). The upward revision to the December print was mainly driven by Germany, where sales were revised upward from 0.1% m/m to 1.2% m/m.
- Across countries, production data for January were mixed-to-weak. In Germany, production declined by -0.5% m/m in January, following a strong upward revision to December data (+0.9 pp to -1.0%). Meanwhile, production increased in France (0.5% m/m), and the December print was also revised upward (to -0.5% m/m, from -0.7% m/m previously).

B) The latest high-frequency data for February point to a somewhat more optimistic outlook. Purchasing Managers' Index (PMI) data for February came in slightly above expectations: the composite PMI rose to 51.9 (vs 51.3 in January). The cross-sector rotation between manufacturing (51.9 vs 50.5 in January) and services (51.9 vs 51.6 in January) remains in place.

C) Our two cents on Germany remain on the table. German fiscal data for January came in rather solid. Overall spending across the main budget and the off-budget funds for the military as well as infrastructure and climate came in at EUR 60.4bn, about EUR 11.1bn higher than spending in January 2025. Spending amounted to EUR 54.8bn in the main budget in January, EUR 6.1bn higher than a year earlier. Social spending increased during the month, driven by loans to social security. The second source of strength was that, compared with last year, defence spending rose substantially (EUR +2.4bn) due to higher spending on military procurement (EUR +0.4bn) and greater assistance to Ukraine (EUR +1.8bn).

Decent figures in the off-budget funds. Spending in the off-budget military fund (implied by the fund's issuance activity) stood at EUR 0.6bn. Spending in the infrastructure fund (implied by the fund's issuance activity) came in at EUR 5.0bn. As this fund was only established last autumn, there are no comparable numbers for last year, but total spending out of this fund was notably higher than the decline in infrastructure-related items in the main budget.

Accordingly, our full-year outlook remains unchanged. We continue to expect real GDP growth in the Euro Area to remain slightly above trend in the coming quarters: we continue to project sequential growth of 0.3% in Q1/Q2 and 0.4% in the second half of the year. Our two main drivers of stronger growth momentum in 2026 continue to progress in line with our expectations: 1) German fiscal expansion continues to advance; 2) Peripheral economies continue to grow at a pace above that of the core countries.

Persistence trumps size. The most relevant channel of transmission from the war in the Middle East to Euro Area growth is the increase in energy prices, because most European countries are net oil and gas importers.

Risks. However, should energy prices and trade disruptions persist for more than a few weeks, area-wide real GDP growth would be negatively affected initially on the supply side and subsequently on the demand side. Hence, the improving growth outlook we are projecting for 2026 would be delayed at best, if not derailed.

The duration of the conflict in the Middle East poses a significant risk of a supply shock. Using European Central Bank staff sensitivity analyses, a 10% increase in the synthetic oil and gas price index would translate into a 0.1pp drag on growth over a one-year horizon. If energy prices were to remain persistently at current levels (Brent Crude Oil at $92.1/bbl at the time of writing vs $70.8/bbl at the end of February - TTF at EUR 48/MWh at the time of writing vs EUR 31/MWh at the end of February), this would translate into a drag of around 0.4pp on growth, all else equal.

First-order inflationary impact of tensions in the Middle East:

1) **Headline impact** - As with most private and public analysts, we take energy prices as exogenous inputs into our forecasting model. By incorporating the Brent crude oil and natural gas futures price curve into our model, our headline inflation forecast for 2026 changes mechanically from 2.0% to 1.8%.

2) **Core impact** - Unless the geopolitical situation deteriorates further, pushing oil and gas prices much higher, we do not expect core inflation to be materially affected.

For several reasons:

A) <u>The impact of energy prices on EA core inflation is unclear</u> – Historically, neither core goods (NEIG) nor core services inflation responds in a linear way to isolated energy shocks.

B) <u>The size of supply shocks matters</u> - Large increases are more salient for consumers and firms adjust the frequency of price resets accordingly. The current energy shock (so far) is minimal compared with that of 2022.

C) <u>Initial conditions play a key role in how supply shocks propagate</u>. Currently, inflation in EA is on a disinflationary trend, and many core HICP items have now normalised to pre-COVID levels.

D) The stability of inflation expectations is key to the transmission of supply shocks. Following a significant rise in 2022-23, long-term inflation expectations in the Euro area have re-anchored relatively well around 2%.

The disinflationary trend in core prices is still ongoing. The core HICP print for February came in at 2.4% y/y, up from 2.2% in January. We suspect that a stronger-than-expected effect from the 2026 Winter Olympic Games in Milan was the main contributor. Indeed, services inflation in Italy accelerated sharply to 3.9% from 2.7%. Restaurants, recreation and transport prices accounted for around half a percentage point of the increase. We believe that next month there will be a payback effect in Italian services inflation, which will help normalise the disinflationary trend in services. We remain of the view that services inflation should ease in the coming months, while weaker external demand, reflecting United States tariffs on European Union goods and the strong euro, is likely to reinforce disinflationary pressures over the course of the year.

ANIMA baseline. On growth, we project real GDP growth of 0.3% q/q for Q1-26 and Q2-26, and 0.4% q/q in H2 2026. This results in an annual growth forecast of 1.2% in 2026.

On inflation, we incorporate the current level of market pricing data for gas and oil into our energy HICP profile for 2026. Relative to our baseline profile, the 2026 headline HICP forecast increases by about 0.2pp. Hence, our new headline HICP forecast for 2026 now stands at 2.0% (vs 1.8% in prior baseline). On the other hand, we are only mechanically revising our baseline for core inflation, in light of a stronger-than-expected February print: we now forecast core HICP at 2.0% in 2026 (vs 1.9% in the prior baseline). In terms of quarterly profile, we forecast Q1-26 at 2.3% (vs 2.2% in the prior baseline), 2.1% in Q2-26 (vs 2.0% in the prior baseline), 1.9% in Q3-26 (unchanged), and 1.8% in Q4-26 (unchanged).

CHINA – Same same

Consistent with our wait-and-see approach, we have left our projected macro-outlook for China unchanged. Middle East tensions are unlikely, for now, to alter growth and inflation trajectory; however, risks to the latter are rising.

Incoming data remain consistent with our Q1-26 GDP forecast of 4.5%. The official NBS PMI readings were soft in February (manufacturing PMI at 49.0 and non-manufacturing PMI at 49.4), but we believe they were distorted downward by the later-than-usual Lunar New Year (LNY) this year. The unofficial RatingDog PMIs, which tend not to be materially affected by the timing of the LNY, rose significantly and exceeded expectations (manufacturing PMI at 52.1 and services PMI at 56.7). This is consistent with the signal sent by January-February activity data that broadly improved from December. Industrial production growth rose further in January-February on the back of the much stronger-than-expected exports, while retail sales growth also rebounded in January-February, with year-on-year growth in goods sales and restaurant sales revenue both improving.
Against this backdrop, we interpret this set of indicators as signalling solid growth momentum in early 2026.

The export channel continues to be the growth engine. China's trade growth accelerated sharply in January-February (exports: +21.8% y/y, imports: +19.8% y/y) and came in well above consensus expectations. Despite the strength in trade data, recent increases in energy prices linked to disruptions in the Strait of Hormuz present downside risks to the current account balance outlook through higher import costs. For now, we are leaving our forecast profile unchanged amid still-elevated uncertainty.

"Two Sessions" broadly in line with expectations. The main message form the National People's Congress ("Two Sessions") in 2026 (5-12 March) largely met expectations. The real Gross Domestic Product growth target was lowered to "4.5–5%" from "around 5%" last year.

February CPI inflation jumped due to the late Lunar New Year holiday. China's headline Consumer Price Index (CPI) rose to +1.3% y/y in February from +0.2% in January, mainly reflecting higher food prices and tourism-related services prices. This was largely driven by a later-than-usual Lunar New Year holiday. Core goods inflation likely remained broadly stable, and the CPI breakdown suggests that pass-through from higher oil prices remained limited in February. Year-over-year Producer Price Index (PPI) inflation rose to -0.9% in February from -1.4% in January, mainly due to elevated non-ferrous metal prices. The PPI breakdown suggests that pass-through from other commodities (such as crude oil) remained muted in February.

The combination of the February CPI/PPI prints and much higher energy prices due to disruptions in the Strait of Hormuz suggests higher CPI/PPI inflation at least in H1 than we had previously anticipated. Therefore, we revise upward our 2026 full-year CPI inflation forecast to 0.9% (vs 0.8% previously), driven by slightly stronger sequential price gains in Q1 and Q2.

ANIMA baseline. We leave our growth forecasts unchanged. Our annual real GDP growth forecast for 2026 stands at 4.8%. We make minor upward revisions to our headline CPI profile for 2026: we now expect inflation to average 0.9% in 2026 (vs 0.8% previously).

MONETARY POLICY

Fed - Less dovish, yet not enough

As widely expected, the Fed left the Fed funds rates unchanged at 3.50-3.75%. The statement was basically unchanged compared to January, but the tone of the meeting was less dovish, with FOMC members revising up their growth and inflation forecasts, with some members revising down the number of rate cuts expected for this year from two to one, and Chair Powell expressing some frustration about the slower-than-expected progress of core goods inflation. That said, we stick to our baseline and continue to expect three rate cuts this year, with one remaining uncertain as our inflation baseline remains less sanguine than that projected by the Fed. However, we also remain of the view that risks are skewed towards fewer cuts. While risks of overheating have declined lately, the Fed could cut less than we forecast amid 1) risks that core inflation is affected by the war-related energy stress and 2) the latest, and to some extent very curious, revised Fed expectation on the neutral rate, that could make it difficult for the Fed to go below 3-3.25% unless growth and inflation slow down significantly or, perhaps, the FOMC changes its mind under the upcoming new Fed leadership.

A slightly less dovish Fed. As widely expected, the Fed left the Fed funds rate unchanged at 3.50-3.75%. The statement was basically unchanged compared to January, and there was only one dissenter in the vote, Miran, who preferred to cut rates, while Waller, who dissented in January, was in favor of holding rates at this meeting. Overall, the tone of the meeting was less dovish than in January, with FOMC members revising up their growth and inflation forecasts, some members revising down the number of rate cuts for this year from two to one in the dot plot, and Chair Powell expressing some frustration with the slower-than-expected progress of core goods disinflation amid tariffs. The conflict in the Middle East was only mentioned as a factor adding uncertainty to the macro-outlook, with Chair Powell refraining from commenting on either on the duration nor on the potential impact on the projected growth or inflation outlook.

Upward revisions to growth (all through the horizon) and inflation (mainly this year). In the new Summary of Economic Projections (SEP), growth was revised up along the entire forecast horizon (from 2.3% to 2.4% y/y in 2026, from 2.0% to 2.3% y/y in 2027 and from 1.9% to 2.1% y/y in 2028) including long-term growth (from 1.8% to 2.0% y/y). On the other hand, PCE inflation and core PCE inflation were revised up mainly in 2026 (from 2.4% to 2.7% y/y and from 2.5% to 2.7% y/y, respectively), with only minor upward revisions in 2027 (from 2.1% to 2.2% y/y for both). Chair Powell explained that the upward revision to growth is structural, as it comes from an increase in productivity. Meanwhile, the upward revision to inflation is the result of slower-than-expected progress in core goods disinflation so far this year rather than higher oil prices, while the Fed remains confident that inflation will continue its progress towards the target in the coming years.

Unchanged dot plot. The dot plot was unchanged, with one rate cut expected this year and another in 2027. Despite the unchanged median, some members revised down the number of rate cuts for this year from two to one. Consistent with the structural upward revision in growth forecasts, FOMC members revised up the neutral rate from 3% to 3.125%.

Slower progress on disinflation. Since the January meeting, the Fed's rhetoric has become less dovish, with several members signaling that they would like to see more progress on disinflation and that holding rates for the time being is the best course of action. In that regard, the March meeting formally encapsulates a less dovish tone Fed members than seen so far this year:

1) Chair Powell reiterated that the US economy is in good shape and that the weakness in the labour market stems from the supply side, while the unemployment rate, which, according to the Chair, is more informative about the underlying state of the US economy, remains at historically low levels.

2) Chair Powell conveyed the message that the Fed is somewhat frustrated by the slow progress of core goods prices. While the Fed's baseline remains that the tariff impact on goods inflation will fade around mid-year, Chair Powell stressed that no cuts will be made without further progress on that front.

We stick to our baseline of three rate cuts, with risks tilted towards two. We think that the less dovish tone at the Fed's meeting is not enough to justify a revision of our Fed call at this stage. We therefore stick to our baseline of three rate cuts this year, taking the Fed funds rate to 2.75-3%. For the following reasons:

1) Risks of overheating in the economy have declined lately.

2) While the Fed's assessment of the labor market has not changed compared to January, and Powell did not give too much weight to the weak-ish February NFP reading, he still signaled that the Fed is carefully monitoring any sign of weakness in the labor market.

3) While our growth forecast for 2026 is in line with the new SEP, we remain much more constructive on the disinflation progress than the Fed, continuing to expect Core PCE at 2.0% in Q4 2026 (vs. 2.7% in the new SEP).

That said, we think the Fed could deliver less rate cuts compared to our baseline amid:

1) Risks that the war-related energy market stress could filter through to core inflation.

2) The latest and to some extent very curious, revised Fed expectation on the neutral rate (up to 3.125% compared to 3.0% before) could make it difficult for the Fed to cut rates below 3-3.25% unless growth and inflation slow down remarkably or the FOMC changes its mind, perhaps under the upcoming new Fed leadership.

ECB – Taking it easy

As widely expected, the ECB left policy rates unchanged. Contrary to expectations, the ECB's rhetoric was more dovish than that of the Fed and the BoE. While the revision to the staff forecasts could have justified a more hawkish stance by the ECB, President Lagarde chose to convey a balanced message. Against this backdrop, we stick to our call of one rate cut, as we think that downside risks to growth are more prominent compared to upside risks to inflation, but we now think that such a cut will not happen until Q4 without ruling out it may be postponed to Q1 next year. Unless growth slows down more significantly than expected, the ECB will want to make sure that the increase in energy prices does not lead to indirect or second-round effects on inflation (our baseline).

A balanced hold. As widely expected, the ECB left policy rates unchanged. The ECB explicitly acknowledged in the statement that the war in the Middle East creates upside risks to inflation and downside risks to growth in the near-term, as reflected in the new staff forecasts, but that its impact in the medium-term will depend on the 1) the intensity of the conflict 2) the duration of the conflict and 3) indirect and second-round effects on the economy, which the ECB will continue to monitor. Given the ECB's good starting position in terms of inflation (at target) and growth (resilient), the ECB can afford to wait and see the possible impact of the war on the euro area economy. This approach was also reflected by the unanimous vote at today's decision.

ECB staff forecasts signal higher inflation and lower growth. Contrary to past (the cut-off date for staff macroeconomic forecasts is usually three weeks ahead of the meeting), the ECB included some of the impact of the energy price shock in its forecasts, also developing adverse and severe scenarios alongside the usual baseline scenario (for which the cut-off date was 11 March). The ECB revised up its headline inflation forecasts to reflect higher energy prices (from 1.9% to 2.6% in 2026, from 1.8% to 2.0% in 2027 and from 2.0% to 2.1% in 2028) and also revised up its core inflation forecasts, on the back of a judgement-based assessment of the pass-through of energy inflation to core inflation (from 2.2% to 2.3% in 2026, from 1.9% to 2.2% in 2027 and from 2.0% to 2.1% in 2028). On the other hand, the ECB revised down its growth forecasts (from 1.2% to 0.9% in 2026 and from 1.4% to 1.3% in 2027), while leaving them unchanged at 1.4% in 2028.

A more-dovish-than expected rhetoric. Contrary to the somewhat hawkish rhetoric from the Fed and the BoE, we think that the ECB's rhetoric was more dovish than many expected, for the following reasons:

1. If the ECB wanted to be hawkish, it could have been, but it chose not to. On the surface, the recent macro backdrop could be easily interpreted to support a hawkish stance. Growth surprised to the upside in Q4, led by private consumption, core inflation accelerated in February led by services and core goods; and the unemployment rate remains close to all-time lows. The ECB could have leveraged this macro backdrop to flag risks that the economy would be strong enough to "take" the energy shock beyond its impact on volatile components, including potential spillovers to wages and/or core inflation.

2. Judging by the new staff forecasts, the ECB appears more concerned about growth than inflation. Following the incorporation of a judgment-based view on the war in the Middle East into their baseline for this year, core inflation was revised up by only 0.1pp, while growth was downgraded by 0.3pp.

3. By incorporating war risks into the inflation scenario and not signaling during the press conference that it is willing to act in response, we think the ECB has raised the bar for intervention.

4. When asked whether the current energy shock bears any similarity to that observed in 2022, President Lagarde set out several arguments supporting the view that "this time is different" when assessing the likelihood that the energy shock might feed through to core inflation, as it did in 2022, thereby forcing another strong ECB reaction. The President stressed that post-COVID pent-up demand is no longer present, the starting level of inflation is now much lower, and the labour market, while still solid, is not as tight as before. Among the upside risks, she only mentioned the possibility that inflation expectations may now be more reactive than in 2022

Against this backdrop, we stick to our call of one rate cut. Given the different starting point of the economy compared to 2022 (tighter financing conditions, depleted savings, less buoyant labour market, lower inflation), we think that downside risks to growth will feature more prominently than upside risks to inflation in the ECB's reaction function.

But we now think it may not happen until Q4 without ruling out it may be postponed to Q1 nest year. Unless growth slows down significantly before Q4, we think that the ECB will remain on hold until then, as it will have to be reasonably sure that the increase in energy prices does not lead to indirect or second-round effects on inflation (our baseline).

PBoC – No news

We still expect support measures in 2026 to remain relatively contained in aggregate, though increasingly calibrated towards the areas of greatest weakness. This view reflects the continued softness in domestic demand, with the property sector still acting as a major constraint on the broader economy.

Towards a measured easing stance. On the policy front, we continue to expect overall modest but increasingly targeted policy support in 2026, in view of the ongoing weakness in domestic demand, with the property sector remaining a significant drag. Notably, on 15 January, the PBoC announced a targeted 25bp reduction in the relending and rediscount facility rates. We maintain our current forecasts of around 40bp of policy rate cuts (7-day reverse repo-rate rate) and possibly one 50bp reduction in the RRR to support growth in 2026 on a firmer footing.

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