A Fresh Source of Risk Materializes

- The eurozone outlook has deteriorated further
- Yet a fresh threat to its stability has materialized
- Markets are clearly wary of its wider ramifications

A week ago, we argued that along with Brexit, uncertainty surrounding global trade relations has compounded the risks facing a eurozone economy ill-placed to mitigate a developing slowdown.

The evidence in the intervening days would appear to suggest that the market is increasingly conscious of those risks and their wider ramifications.

On Tuesday, the IMF lowered its 2019 global growth forecasts for the third time in six months and unveiled particularly steep (0.5% point) downgrades for Italy and Germany, which contributed to a 0.3% downgrade for the eurozone as a whole to 1.3%.

Still, despite its downgrades, the IMF remains a tad more optimistic about 2019 than the ECB; and what was remarkable about the Bank’s 0.6% point forecast downgrade to 1.1% last month, was Mario Draghi’s insistence that risks were “still tilted to the downside”.

On the spectrum of customary nuances now fundamental to
Indeed, the ECB President reiterated this point Wednesday, but what was remarkable about Mr Draghi’s press conference this time was his endorsement of the market reaction to his prior suggestion that rate hikes could be delayed further if necessary.

On the spectrum of customary nuances now fundamental to central bank policy communication, the ECB President’s comments were blunt: on the day Mr Draghi alluded to delay - March 27 - 10-year Bund yields dropped 7bps further into negative territory in their second largest drop this year.

Little wonder then that as Mr Draghi concluded Wednesday’s press conference, Eonia futures were pricing-in a higher chance of a 10bp rate cut by year end (c20%) than when he started (c15%).

So, returning to where we began, the eurozone is hardly in the position to readily absorb further shocks, yet this precise possibility has materialized this week and the market is conspicuously aware of its potential ramifications for the globe.

Yet this precise possibility has materialised this week and the market is conspicuously aware of its potential ramifications for the globe.

On Tuesday, both Dow E-mini futures and the USD came under pressure amid reports that the Trump administration was preparing to impose tariffs on billions of dollars’ worth of imports from Europe, in retaliation for what it – and a WTO report - calls unfair subsidies of Airbus jets.

A rather more pronounced move in the USD, equity futures and Treasury yields emerged at the start of the US trading day.
day, however, as President Trump tweeted that: “The EU has taken advantage of the US on trade for many years. It will soon stop!”

Twenty four hours later, and these same instruments came under fresh pressure - something which, certainly with the benefit of hindsight, appeared both directly and indirectly related to the same story on trade.

Indeed, the pressure materialized immediately after Mario Draghi’s allusion to a spate of weak eurozone data; and the deterioration in sentiment became all the more pronounced as the ECB President depicted Mr Trump’s threat of tariffs as another blow to confidence, which was, he said, without question one of the reasons for the eurozone’s general weakness.

Undoubtedly, the market’s focus has been squarely on Brexit and the US/China trade story of late; but perhaps the real risk right now is the growing threat of a US/EU trade war materializing just as the eurozone economy toys with recessionary conditions.

Please direct questions or comments to:

AerialView@BNYMellon.com