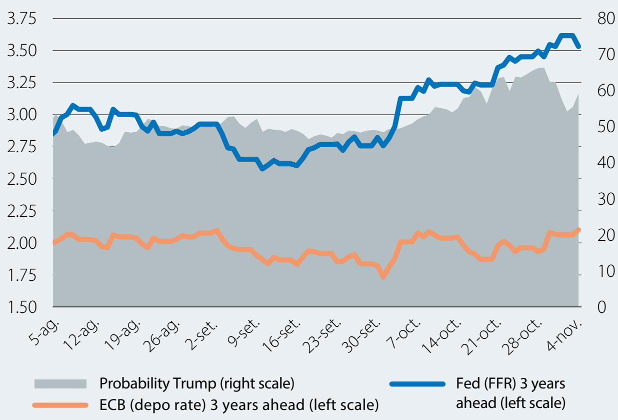
The ECB amid the reverberations of the Trump Trade

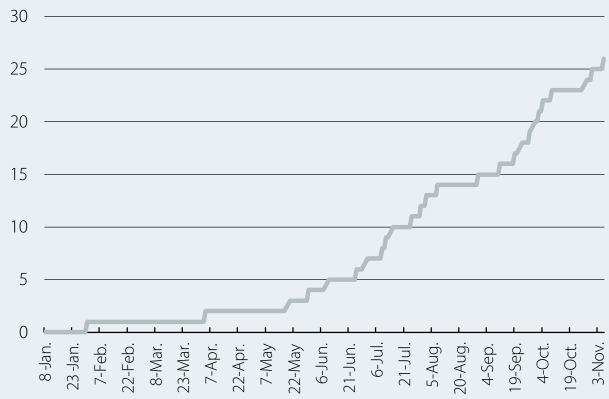
Donald Trump's victory in the US election has shifted expectations in the financial markets. Already in the first few weeks of autumn, the probability of a victory that was reflected in the betting odds was accompanied by higher interest rates, expectations of a less dovish Fed and a stronger dollar. These dynamics, which were given an additional boost by the strong macroeconomic situation in the US, were compounded by a stock market rally following the confirmation of the triple Republican victory in November (White House, Senate and House of Representatives). In Europe, however, the movements have been more moderate and expectations regarding the ECB remained particularly stable (see first chart). Does this mean that the change of US administration will not affect the outlook for the ECB?

*US: monetary policy expectations and the presidential election **



Notes: ** Monetary policy expectations correspond to estimated forwards on US and euro area OIS rate curves using the Nelson-Siegel-Svensson model. The probability of a Trump victory corresponds to the probability implied by betting odds according to Polymarket.*
Source: *CaixaBank Research, based on data from Bloomberg.*

Sessions identified as Trump Trade in 2024
Number (cumulative)



Note: *A market session is considered Trump Trade if it meets four requirements: increase in US sovereign rates, appreciation of the dollar, gains in US stock markets and an increase in the probability of a Trump victory according to bookmakers.*
Source: *CaixaBank Research, based on data from Bloomberg and Polymarket.*

Shock and transmission mechanisms

The new Trump administration's economic agenda includes an expansive fiscal policy (tax cuts), a restrictive immigration policy and barriers to international trade (tariff hikes). By stimulating demand and limiting supply in a context of maturity in the business cycle, these three pillars could trigger higher inflation in the US and, in the short term, moderately stimulate domestic economic activity. As a result of these consequences, which are consistent with the anticipatory market movements mentioned above, the combination of a stronger dollar, higher interest rates and stock market gains has become known as the «Trump Trade».

For the European economy, there are three major channels through which the new administration's agenda could end up impacting the short- and medium-term economic outlook. Firstly, the proposed tariffs would make exports from Europe to the US more expensive and would cool external demand for the euro area. The appreciation of the dollar could mitigate the negative impact on European economic activity, but at the cost of importing inflation which could be accentuated in the event of a trade war and tariff retaliation on the part of Europe. Secondly, the spillovers of a less dovish Fed (as it combats inflation) could trigger a tightening of global financial conditions, including in Europe. Thirdly, the heightened uncertainty could weigh down investor sentiment and risk appetite, potentially depressing economic activity.

The net impact of these three channels on the ECB's actions is uncertain: the euro area could suffer some degree of inflation, depending on the intensity of the policies and the reaction of asset prices, as well as the cooling of European economic activity (and its transmission to prices). In addition, there are other uncertainty factors, such as Congress' capacity for moderation given the tight Republican majority, or the question of whether the Trump administration's tariff threats are indisputable or, perhaps, a tool for trade negotiation between governments. While we await clearer visibility on all these aspects, the reaction of the financial markets can provide some initial clues.

The Trump Trade and market sensitivities

In order to get a clearer picture of the scenario that the financial markets are contemplating, we analysed the co-movement of European financial variables with their US counterparts during the trading sessions dominated by the US electoral outlook: specifically, only Trump-Trade sessions where (i) the stock market rose (S&P 500),

(ii) the dollar appreciated (vis-à-vis a basket of currencies), (iii) the 10-year US sovereign interest rate increased and (iv) the probability of a Trump victory increased (based on the bookmakers' odds).[1] As the second chart shows, these sessions are concentrated in the second half of 2024 and especially between the months of September and October.

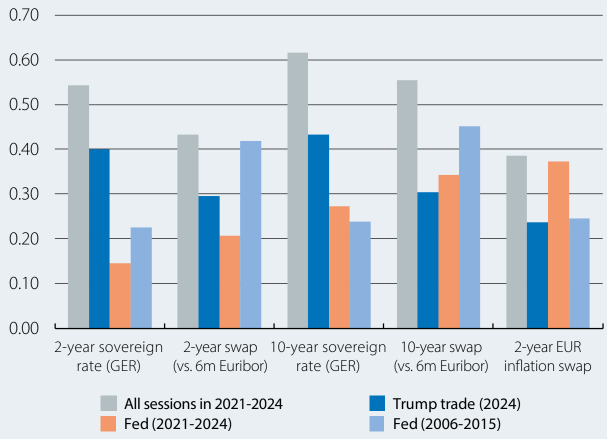
This exercise, which is summarised in the third chart, indicates that the Trump Trade has a significant spillover effect on the financial markets in the euro area, affecting both short- and long-term sovereign rates and the ECB's monetary policy expectations and inflation expectations. In all cases there is a positive co-movement with the US (i.e. although the magnitude of the impact of the Trump administration's agenda is smaller in Europe, according to the financial markets the direction of that impact is the same in both the US and Europe). However, the strongest spillover effect is found in sovereign rates, especially in the longer sections of the curve, while the spillover to inflation expectations is clearly less pronounced. As for monetary policy expectations, the exercise suggests that the markets see a knock-on effect of a moderate magnitude.

To put these market sensitivities to the Trump Trade into context, we can compare them with another important event: the meetings of the Fed.[2] The third chart shows that the Fed also generates a significant spillover effect on European financial markets.[3] However, the Trump Trade appears to have a notably more pronounced effect than the Fed in terms of sovereign interest rates, while the Fed dominates in terms of inflation expectations and both factors generate a similar effect on monetary policy expectations.

Finally, it should be noted that the co-movement on the days dominated by a Fed meeting or by the Trump Trade is less than that observed when we take all market sessions as a whole. This suggests that, on the days of Fed meetings or the Trump Trade, the idiosyncratic driver of the US (with a higher incidence on US financial variables) overpowers the global drivers (which affect all economies to a more similar degree).

Spillovers from the US to the euro area

*Regression coefficient **



Note: ** Coefficient of the regression of the European variable against its US counterpart. For example, it can be interpreted as the pp increase of the 2-year sovereign rate of Germany in response to a 1-pp increase in the 2-year sovereign rate of the US.*
Source: *CaixaBank Research, based on data from Bloomberg.*

In short, Donald Trump's victory and the Republicans' control of the Senate and the House of Representatives facilitate the implementation of an economic agenda which, in the US, may end up generating more inflation and, perhaps, a certain acceleration of economic activity in the short term. If this outlook were to materialise, then the Fed could end up taking a less dovish stance than anticipated, and all of this would have reverberations in Europe. The initial reading of the financial markets was that we should expect some spillover on the ECB and the financial conditions of the euro area. However, the outlook will also depend on what the starting point is and on where the euro area lies in the business cycle. In this regard, the latest data for the euro area show that inflation is declining towards target, while economic activity is cooling. Given its official «data-dependent» strategy, the ECB's upcoming decisions will be subject to the current signals provided by the data, although they will likely also be conditioned by expectations regarding the US economic agenda and its consequences for the future.

1. Also part of the analysis are those sessions in which the probability of victory decreased and the direction of the stock market, the exchange rate and sovereign rates is reversed accordingly.
2. We evaluated the co-movement of the same European financial variables with their US counterparts, analysing only those market sessions in which a Fed monetary policy meeting was held.
3. Although, as the comparison between the sensitivity of 2006-2015 and that of 2021-2024 suggests, in recent years this effect seems to have lost some strength. Between 2015 and 2019 there is also a lower sensitivity, which can be explained by the decoupling between the Fed, which was raising rates, and the ECB, which was delving deeper into unconventional stimulus measures, with asset purchases and negative rates.