

## Can the ECB deliver, and what are the implications for EUR markets?

The European Central Bank is at an impasse having nearly exhausted its easing options. We see more downside to core rates regardless of ECB action, but we doubt sovereign spreads will find support. We see upside to EUR/USD but low risk appetite should keep EUR/CHF under pressure



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### ECB action: mostly words, for now

Last night, the ECB finally joined other major central banks' communication efforts to calm financial markets, stating that it stood ready to take "appropriate and targeted measures". The "targeted" in this statement could be key in predicting the ECB's next steps.

Under the leadership of ECB President Christine Lagarde, the bank looked less sensitive to financial market developments than it did under her predecessor Mario Draghi. Judging by recent statements, there has been a growing awareness of the adverse effects of the ECB's unconventional measures, lowering the likelihood of, or at least the willingness for, additional monetary policy easing. In our view, the ECB would still prefer to stick to its wait-and-see policy

until next week's official policy meeting and then try to steer markets with words rather than action.

## Out of ammo and ineffective tools

The ECB is facing a challenging situation in which the staff projections, which are based on the no-policy-change assumption, and the still relatively benign macro data (cut-off date for the projections was last week), will be more optimistic than the gut feeling of many ECB officials about the possible economic impact of the coronavirus. This combination of fear and uncertainty, and the root problem originating clearly outside of the ECB's reach, once again illustrates the ECB's dilemma: it has run out of ammunition.

The coronavirus and its impact on the economy, in our view, call for fiscal rather than monetary policy. Think of state guarantees, bridge loans or temporary tax relief. There is very little the ECB can do, besides calming financial markets. To be blunt, at the current juncture a vaccine would definitely help more than another rate cut.

Still, coordinated action from central banks and governments would likely involve the ECB, if only for the sake of emphasising the so-called "mutual brotherhood of central banks" and to avoid an unwarranted appreciation of the euro. This could mean a 10 or 20 basis point rate cut, combined with some tweaking of the tiering facility and some new or tweaked Targeted Longer-Term Refinancing Operations.

## EUR rates: lower... or lower?

Even with 10Y Bund yields trading around -0.60%, we continue to see downside to core EUR interest rates. Barring a sudden stop in the spread of the coronavirus, the reaction of EUR interest rates appears asymmetric to us: they are heading lower either on an easing package or on the ensuing disappointment. A risk to this view is if we see a strong fiscal policy response that boosts both the issuance of government bonds and growth expectations. We judge this unlikely. As a result, look for 10Y Bund yields to breach their all time low from September 2019, and rally to -0.75%.

Taking into account our expectation of an underwhelming ECB response, we think long-end interest rates are poised to outperform shorter ones. Even in a scenario where the ECB comes around to the idea of cutting rates, the limited space to lower the deposit rate further means the long-end would be more likely to reflect a deterioration in risk sentiment. Our curve flattening view might seem surprising in light of the strength of front-end EUR bonds of late but we attribute episodes of curve steepening to the steepening of the USD curve, [reflecting the possibility of 100 basis points of Federal Reserve rate cuts in the first half of the year.](#)

## EUR risk assets: no support

EUR risk assets, in particular peripheral sovereign bonds, appear at risk of a further correction. Clearly, the ECB adopting a more reserved tone than its peers is not going to reflect well on risk appetite in EUR financial markets. While the threat to the monetary policy transmission mechanism is a concern, the central bank is ill-equipped to ease the blow to consumers and small businesses. If the situation deteriorates further, it is possible that financial markets will price in a probability of larger asset purchases, but this means that things need to get worse before they get better. More generous TLTROs aimed at SMEs are possible but there is already ample liquidity.

Due to the lack of specific response in EUR markets, the improvement in sentiment caused by Fed easing might be short-lived. Additional TLTRO liquidity injections might help short-end credit but we doubt their effectiveness in suppressing spreads for longer tenors. The current level in Italian spreads, in particular, appears incongruous relative to the correction in other risk markets. The 10Y Italy-Germany spread [has reached our near-term target of 175bp](#). We see potential for a widening to 200bp in short order to reflect the risk of an economic slowdown affecting the eurozone's weakest member disproportionately.

## EUR/USD set to move higher

That the ECB has far less room than the Fed to lower the short-term policy rate is obvious. US short term rates therefore look to converge on those in Europe, which we think is [enough to briefly push EUR/USD to 1.15 in the second quarter](#).

Also important in the EUR space will be what happens to eurozone peripheral debt. A fresh spread widening stands to keep EUR/CHF under pressure at 1.06 and raises questions over the magnitude of the Swiss National Bank's FX intervention now that Switzerland is on the US Treasury's Monitoring List for currency manipulation. 1.05 beckons on EUR/CHF, while USD/CHF could trade down to 0.92.

### Authors

#### Carsten Brzeski

Global Head of Macro  
[carsten.brzeski@ing.de](mailto:carsten.brzeski@ing.de)

#### Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE  
[chris.turner@ing.com](mailto:chris.turner@ing.com)

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