ECB decision time: For FX, the euro's in need of a hawkish tilt as downside risks mount

The unfavourable widening of short-term rate differentials has been a major driver of EUR/USD weakness, with the euro also suffering from investors re-entering carry trades amid a recovery in risk sentiment. We would need to see a clear hawkish twist by the ECB to turn the tide for the slightly overvalued and not clearly oversold euro

Christine Lagarde was shown where to sign the euro notes when she became ECB President

Taking only the negatives from Omicron

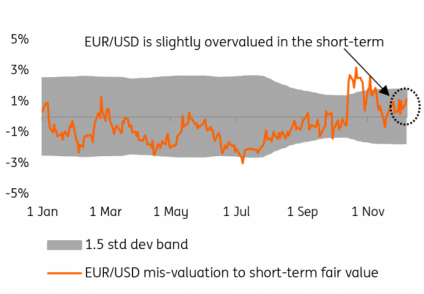
The Omicron impact on markets initially offered some support to the euro, as EUR-funded popular carry trades (short EUR/RUB is a notable example) were quickly unwound amid risk-off and falling oil prices. With markets quickly reverting their bearish bets and now looking less concerned about the new variant, EUR/USD is looking at fresh downside risks.

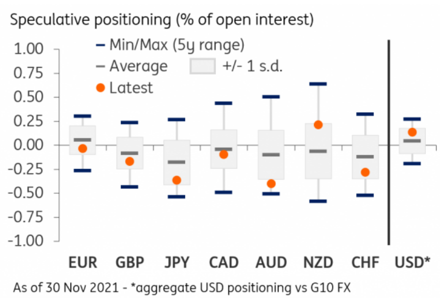
An additional factor weighing on the EUR recently is the re-rating of eurozone growth expectations due to restrictions in Germany and other EU countries. From a forward-looking perspective, markets seem to be pricing in a greater likelihood of tough containment measures in Europe than in the US and this keeps widening the US-EZ growth and monetary policy differential. The short-term rate differential has shown a high beta to EUR/USD in 2021 according to our short-term fair value model and has been a major contributor (along with relative equity performance) to the recent EUR/USD weakness.

Hard to turn the tide

This should mean that EUR/USD may prove asymmetrically more sensitive to any hawkish surprise, whether that be on the timing of unwinding asset purchases or on staff projections), compared to signs of extra cautiousness. If, instead, we see no major surprises by the ECB, and given the Fed meeting risks prompting another spike in US short-term yields, we think EUR/USD may be set for another bad week. After all EUR/USD is slightly overvalued according to our short-term fair value model, suggesting there is still room for the pair to catch up with the unfavourable widening of USD-EUR short-term rates.

From a technical perspective, net speculative positioning on the EUR has declined of late, but, unlike some other G10 currencies, it is not in over-stretched net-short territory, as you can see in our chart below.





Source: ING, CFTC, Macrobond, Refinitiv

> We think that only a hawkish turn can significantly turn the tide for the euro at the moment. Otherwise, many factors are pointing to EUR/USD weakness as we end the year. A move beneath even the 1.1200 lows is entirely possible. One potential counter-argument is the seasonal tendency of the dollar to underperform in December, although that may require much calmer markets to materialise.

Author

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

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