

# ECB & EUR: Achieving the best case realistic scenario

President Draghi has done his best to limit the euro's upside



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## Draghi's Sisyphean task

It was a Sisyphean task for the ECB to prevent EUR from spiking higher and EUR/USD indeed broke above 1.20. Yet, in the context of upcoming ECB policy normalisation, preventing EUR/USD from materially spiking well above that level could be seen as a success for the ECB in its taper tiptoeing exercise. We expect EUR/USD to broadly trade around the 1.20 level in the coming months before moving to 1.25 in mid-2018, targeting 1.30 by end-2018.

The fact that the EUR comments (recent euro volatility is a “*source of uncertainty*”) made it into the opening statement (rather than being left for the Q&A session) shows the ECB does care about the recent spike in the euro and is indeed concerned about the further unwarranted EUR overshoot (as per concerns of some Governing Council members already expressed in the July Minutes, when EUR/USD was trading at 1.15). Such comments were warranted in the context of the downward revision to the ECB CPI outlook (only by 0.1% lower for 2018 and 2019) being rather mild.

## Focus switches to October meeting

The main focus now turns to the October ECB meeting, where the ECB should most likely deliver details of QE tapering (as per President Draghi's comments). While the ECB discussed the various scenarios on QE (from 2018 onwards) it did not discuss the change in the issue and issuer limit. We note that for the ECB to retain a credible threat of responding to the risk of an overly strong EUR via continuing QE in a material size for longer, it needs to ease these limits. If not, our fixed income strategists estimate that under the current set of limits on QE purchases, the ECB can only continue QE next year in the size of 30bn per month only for 9 months. This would not be a credible enough threat to prevent further EUR upside.

Given the expressed concern about the euro, we see a high probability of the ECB signalling a dovish form of QE tapering in October (i.e., monthly purchases in excess of EUR 30bn). But to keep the (tapered) QE programme open ended with a credible threat of doing more if needed, a change to the existing limits on bond purchases will have to be delivered.

With EUR/USD pushing higher, our financial fair value indicates 2.5% short term over-valuation of the cross. In other words, the upcoming ECB policy normalisation premium is being priced into the EUR//USD spot. For reference, the largest premium that was priced into EUR/USD this year was around 3% two weeks ago. Given the non-negligible short term mispricing of the EUR/USD, this suggests that either Bund yields (at the long end of the curve) need to start moving higher or USD needs to get even weaker for us to see a sustainable and meaningful push above the current EUR/USD levels.

With EUR/USD higher, CEE FX is the outperformer in the EM FX space as this is the only EM region that is lifted by higher EUR/USD. Our bullish medium term EUR/USD outlook paints a rosy picture for the CEE currencies vis-a-vis their LatAm and EM Asian peers.