EUR and ECB Cribsheet

With trade weighed EUR below its 6-month average and the ECB already announcing new easing measures in December, little suggests that the January ECB meeting should affect the euro much. We don't expect a meaningful shift in verbal intervention. As the USD decline is expected to resurface in the coming months, EUR/USD should move to 1.30 by the year-end

Scenario analysis: How to position for Lagarde's alternatives

	Inflation outlook	Growth outlook	Interest rate, QE & PEPP	Exchange rate comments	EUR/USD
Current stance	"Underlying price pressures are expected to remain subdued"	"Risks to the economic outlook tilted to the downside"	Depo at 0.50%, PEPP at €1,850bn until March 2022 & APP at €20bn pm	The GC "monitors developments in the exchange rate"	
Very dovish	ECB is "highly concerned" about 2022 inflation	High degree of uncertainty and risks clearly tilted to the downside	Hint at a **possible rate cut** to -0.60% as EUR weighs on the macro outlook	Strong EUR **forcing** the ECB to **adjust policy instruments**	1.1900
Dovish	Recent data suggest **only a gradual increase in CPI**	**Recovery will gain momentum** over the summer but high uncertainty	No change	EUR not a target but the **recent EUR moves monitored extremely carefully**	1.2050
ING Base Case (neutral)	"Somewhat higher inflation this year on back of one-off factors"	"Recent data confirm base case of gradual recovery"	No change	EUR is not a target but the **ECB monitors it very carefully**	1.2100
Hawkish	Risks to the inflation outlook are balanced	Risks to the economic outlook are balanced	GC assessment of a **declining future need to ease policy** further	EUR strength having **a limited impact** on econ / CPI outlooks	1.2250

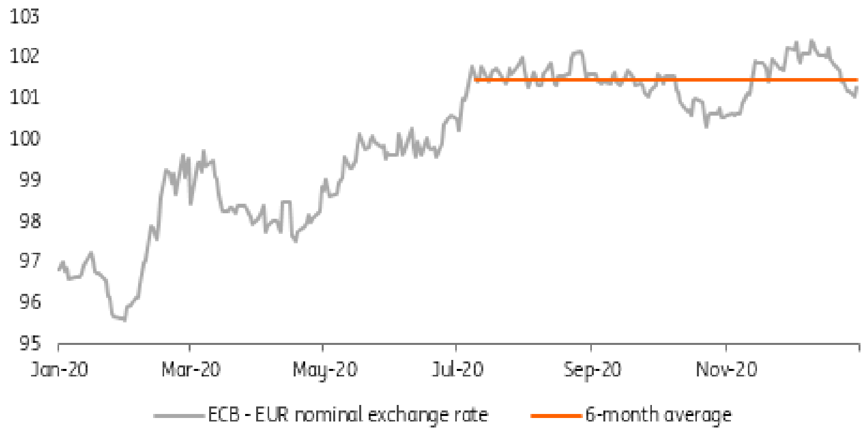
No ECB fireworks expected in January

As we've already discussed in our ECB Preview, we don't expect many fireworks from the European Central Bank meeting tomorrow as the material adjustment to the monetary policy set-up was already made in the December meeting. With the new round of easing measures fully in place and no new forecasts to be presented tomorrow, it should be a fairly uneventful day for the euro.

The trade weighted euro currently below its 6-month average

Still, the level of the exchange rate and any possible ECB comments are likely to be in focus. However, given that both the trade-weighted euro and EUR/USD have corrected lower in the past two weeks, the need for imminent verbal intervention is lower. Indeed, as Figure 1 shows, the trade-weighted euro is currently modestly below its 6-month average, which coincided with the first verbal intervention from ECB officials in summer last year that helped to halt the rise in the euro. Hence, purely from the level of the exchange rate today, there is no need for the ECB to overreact during the January meeting.

Figure 1: Trade weighted euro dipped below its 6-month average



Source: ING, Refinitiv

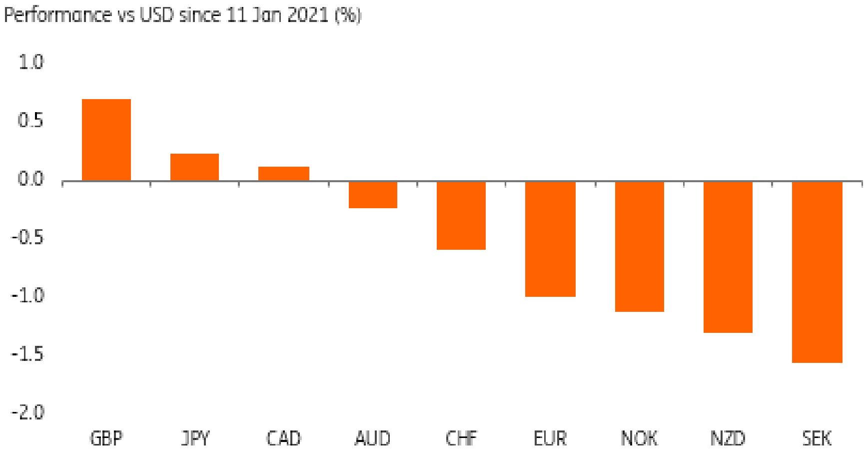
The ECB doesn't have to react

Still, the ECB should reiterate that it monitors the exchange rate carefully, but for now, we don't expect any tweak to the wording. Coupled with the change to policy instruments during the December meeting and what we see as a modest upside risk to the current ECB inflation forecast (which has, in turn, reduced an imminent need for the ECB to act), the scope for a surprise, which could meaningfully affect the euro, is limited in our view.

More upside to EUR/USD this year as the dollar remains soft

As we noted in our January FX Talking, we have upgraded our year-end EUR/USD forecast to 1.30. While the idiosyncratic euro story remains unexciting (the eurozone (EZ) will not outperform the US economy this year and any ECB policy normalisation is a very distant story), we expect the bearish dollar dynamics to dominate as the USD will suffer from the mix of negative rates, a non-reacting Fed to rising inflation and the global economic recovery. Under these conditions, the dollar should remain on a broad-based decline, and in turn push EUR/USD higher.

Figure 2: EUR not a negative outlier



Source: ING, Refinitiv

No clear negative impact on the euro from eurozone politics

Although we acknowledge the risks associated with eurozone politics, as was very clear during the past two weeks (notably, the Italian political saga) these risks are currently not sufficient enough to cause material damage to the euro. Over the past two weeks, EUR was neither a negative outlier within the G10 FX space (as Figure 2 shows, it was in the middle of the G10 FX pack since 11 January) nor did we observe any risk premium build-up in the currency (EUR/USD currently trades in line with our short-term financial fair value measure). As we've already noted, the dollar side of the equation should remain a dominant driver of the EUR/USD and we expect it to drive the cross higher – probably from the second quarter onwards when clarity on the relaxation of lockdown measures begins to emerge.

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