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EUR and ECB Cribsheet

With euro strength no longer a pressing issue and higher bond yields in focus instead, the ECB meeting should not be a risk event for the euro. The latest EUR/USD fall was exaggerated by a positioning squeeze, translating into non-negligible EUR undervaluation. As the economy recovers in 2Q and US front-end rates remain negative, EUR/USD should rebound

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 too low 2022 inflation	High degree of uncertainty and risks clearly tilted to the downside	ECB increasing the PEPP envelope	The level of EUR **forcing** the ECB to **adjust policy instruments**	1.1700
Dovish	Recent data suggest **only a gradual increase in CPI**	**Recovery will gain momentum** over summer but high uncertainty	No change, but **intention to increase the PEPP** size communicated	Recent EUR correction not enough to reduce risks to CPI outlook	1.1800
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. The PEPP size to increase if necessary	**No change**	1.1900
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	Exchange rate no longer warrants monitoring	1.2000

Less need for the ECB to lean against the euro

Compared to prior occasions, the European Central Bank meeting on Thursday should not be a risk event for euro. The recent declines in the trade-weighted euro and the EUR/USD suggest there is no need to lean against the currency strength. Instead, the prime ECB focus has recently shifted to rising bond yields. While the ECB may talk about the unwarranted increase in yields and the tightening of financial conditions, more forceful action that would weigh on the single currency (i.e. an increase in the Pandemic Emergency Purchase Programme's 'envelope' – be it an announcement or outright signalling) is highly unlikely. The new set of economic forecasts should not be surprising either (a downward revision of the growth forecasts in 2021 and an upward revision of the inflation forecasts for 2021 and 2022 – see the ECB Preview). All this means that EUR/USD should continue to be driven by global / US related factors for now (the direction of US Treasury yields and the strength of the US dollar) with the euro-specific drivers taking a back seat.

Unless extended in size, PEPP modifications won't have a big impact on EUR

Even if the ECB were to suggest a front-loading of PEPP purchases (to contain rising bond yields), the impact on the euro should be limited, as long as the whole PEPP envelope is not extended. If markets are disappointed by the ECB's level of support via PEPP and eurozone local bond yields rise further, the impact on the euro should be negligible so long as the move is driven by global factors (ie, higher US Treasury yields, the global reflation theme) and not by domestic risk premiums (i.e. as was the case with BTPs last year – though this still had a limited negative spillover into the euro). Indeed, this was the case after the last two weekly reports on ECB bond buying, with numbers disappointing somewhat on the lower side, yet the spill over into the euro was rather limited.

EUR/USD now screening cheap

We also note that based on our short-term financial fair value model, EUR/USD trades around 2% cheap vs its fair value. This is a non-negligible under-valuation and based on the experience of past quarters, an undervaluation of 2% or higher has been rare and short-lived. This should also add some support to the currency in terms of the potential downside from here.

EUR/USD constructive outlook for 2Q remains intact

As per our March FX Talking, we continue to retain a constructive view on EUR/USD. Some of the recent EUR/USD decline was exaggerated by positioning (with the speculative community being heavily long EUR/USD going into the UST sell-off in February). As the eurozone economy starts to recover in the second quarter (with the pace of vaccination set to increase) and the rise in UST yields becomes more orderly, the EUR/USD should start moving higher, further helped by the deeply negative US front-end real rates (note the US CPI should push above 3.5% during 2Q). We thus expect EUR/USD to move above 1.2500 this summer.

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