

EUR & ECB: Big dovish surprise today, but a lot is priced in by now

The ECB surprised both in the strength and the scope of pre-commitment to Dec easing. While a clear short-term EUR negative, given the build-up in expectations, the extension of asset purchases as well as TLTROs terms on their own, and in the absence of rate cuts, may not cause a more permanent damage to EUR – particularly if USD outlook for 2021 is challenging



The ECB surprising both in strength and scope

While markets braced themselves for European Central Bank easing in December, where President Lagarde surprised on the dovish side today was the strength and the scope of the signalled easing. On the former, Lagarde by and large pre-committed to easing in December (saying there is little doubt that circumstances will warrant the recalibration of the current package in December). On the latter, Lagarde clarified that the ECB is looking at all instruments – which by definition does not rule out a possible rate cut. While we continue to think the bar for a cut is still high, this is a stronger and more dovish message than anticipated.

That's why EUR underperformed most of the G10 currencies (with the exception of higher beta and

the EZ growth de-rating battered NOK and SEK) with the euro starting to lag once President Lagarde clarified the definition of the "recalibration" (ie, all instruments under review, which by extension also mean possible rate cuts).

But a lot is priced in by now, limiting eventual EUR downside

While the surprisingly dovish ECB bias is a clear short-term negative for EUR, as expectations for a forceful response in December are being built (the market brought forward rate cut expectations, now fully pricing a 10bp cut by June next year), the ECB needs to truly deliver in December to make more permanent damage to the euro. The likely extension of asset purchases (by some EUR 500bn and more, as per [ECB Review](#)) and targeted longer-term refinancing operations terms on their own, and in the absence of rate cuts, may not do it. While six weeks is a long time in the current environment, we don't think a rate cut is on the cards.

Silver lining from reduced risk premium

There may be also some silver lining for the euro stemming from the responsive ahead-of-the-curve ECB. The central bank, by signalling a strong willingness to act, should (a) partly reduce the scale of the downside to the pandemic-hit EZ economy (of course, fiscal responses must go hand-in-hand with it); and (b) reduce downside to EZ risk assets (EZ equity markets are up and BTP benefits since the ECB meeting) and thus keep the potential EUR risk premium in check, both of which should help the euro.

Reluctant to embrace medium-term bearish EUR/USD view

This is why we are reluctant to embrace a medium-term bearish EUR/USD view. Today's forceful ECB commitment to easing is a short-term euro negative but equally it raises the bar for the central bank to surprise meaningfully in December (in other words, a lot got priced in today). Moreover, the anticipated forces behind the USD weakness remain intact (the Fed being the curve, USD to suffer from negative rates, global and the EZ economic recovery after the challenging winter that should benefit EUR more than USD). Despite the challenging outlook for the euro into the year-end, the path for EUR/USD for the next year still look upwards, towards the 1.25 level.

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