EUR & ECB Crib Sheet

The expected €500bn top-up to the ECB's PEPP should have a further stabilising effect on EUR, keeping the currency's risk premium in check. But with EUR/USD trading modestly overvalued on a short-term basis, more is needed to push EUR/USD meaningfully higher. The main driver of further EUR/USD gains should be the unfolding dollar bear trend

Scenario analysis: How to position for Lagarde's alternatives

	Inflation outlook	Growth outlook	Interest rate & QE decision	PEPP programme	EUR/USD
Current stance	inflation outlook "surrounded by high uncertainty "	"Duration of ... recession and ... recovery are difficult predict"	Deposit rate at 0.50%, regular EUR 20bn QE pm & temporary EUR 120bn until year end	An overall envelope of EUR 750 billion until end-2020	
Rise in risk premium	Inflation pick up far too slow to bring CPI to the target	Recent data don't suggest a sustained easing of risks	Downside risks still present, further depo cuts on cards	No PEPP top up intended as BTP-bund spread stable	**1.1000**
ING Base Case	Recent data suggest the **CPI pick up will take longer**	Recent data suggest **significant** slowdown in activity	**No change**, forward guidance for lower rates for longer	**PEPP top up by EUR 500bn** & extended until mid-2021	**1.1200**
Decline in risk premium	Confident that underlying inflation will pick up	Downside risks have started to disappear	No change, forward guidance for lower rates for longer	PEPP top up by EUR 500bn, ECB buying fallen angels	**1.1250**
Large decline in risk premium	Risks to the inflation outlook are balanced	Risks to the economic outlook are balanced	No change, easing of TLTRO conditions, but lower bound of rates	EUR 750bn top up, bank bonds / fallen angels buying	**1.1300**

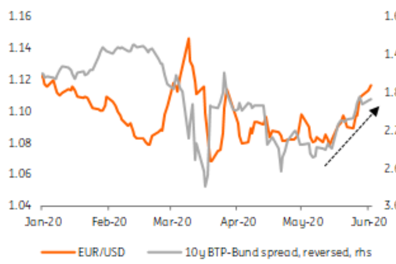
The top-up to the PEPP programme the main factor for the euro

The main focus on the June ECB meeting (this Thursday) will be the expected increase in the size of the Pandemic Emergency Purchase Programme (PEPP). As per ECB Preview, we expect an additional €500bn top-up, to be spent until mid-2021. As has been the case since the start of the Covid-19 crisis, the ECB balance sheet expansion has not been seen as negative for EUR as the accompanying asset purchases and the subsequent stabilising effect on peripheral bonds has had a reducing risk premium effect on EUR, in turn benefiting the currency (Fig 1). The same should be the case this week.

EUR trading on the expensive side vs USD on a short-term basis

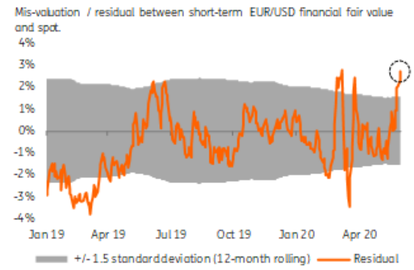
The €500bn PEPP top-up is the consensus expectation, meaning that its impact on EUR/USD should be limited. The prime upside risk stems from a possible larger top-up (ie, €750bn +) but this is not our base case. We also note that following (a) the ECB risk premium stabilising steps and the generous EC proposal on the Next Generation EU plan, and (b) the broad-based USD weakness of late, the EUR/USD trades in an overvalued territory based on our short-term financial fair value model (Fig 2). This may tamper a meaningful EUR/USD upside even if the ECB surprises with a more forceful PEPP response (ie, €750bn expansion vs €500bn expected).

Fig 1 The decline in EZ fiscal concerns helped the euro



Source: ING, Bloomberg

Fig 2 EUR/USD trading rich vs its short-term fair value



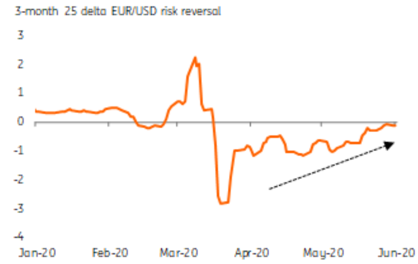
Source: ING

Fig 3 EUR/USD speculative longs risen in past months

* As of 26th May 2020 (data are reported with a lag)

Source: ING, Bloomberg

Fig 4 EUR/USD risk reversals normalizing



Source: ING, Bloomberg

Positioning and the option market show an improved sentiment towards the euro

The improvement in sentiment towards the euro is also apparent in the speculative positioning, which has increased sharply since the peak of the Covid-19 crisis (Fig 3) as the speculative community has pre-positioned for the USD bear trend. The option market also shows an improved sentiment towards EUR as EUR/USD risk reversal continues grinding higher (Fig 4) since the peak of the USD funding squeeze in mid-March.

USD bear trend the key driver for further EUR/USD gains

Still, with the ECB firmly containing risk premium in both the euro and peripheral bonds (the current level of 10y BTP being the case in point), this should allow for an ongoing move in EUR/USD higher in months to come as the USD bear trend extends further. The broader USD weakness already unfolded in recent weeks (see USD: Wake up and smell the (bearish) coffee) and with the USD no longer benefiting from its key advantage of past years (the vanished interest rate differential), more weakness is to come in 2H20.

But unlike the profound EUR/USD rally in 2017, this time the cross' upside should be driven by the weak USD dynamics, rather than strong EUR. The ECB keeping the euro risk premium in check is a necessary condition for higher EUR/USD, but on its own it won't lead to a meaningful appreciation of the cross in the absence of the ECB policy normalisation (which is highly unlikely any time soon). The weak dollar environment must do its part and we see EUR/USD breaking above 1.15 this summer.

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