

## 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
<i>Current stance</i>	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
<b>ING Base Case</b>	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

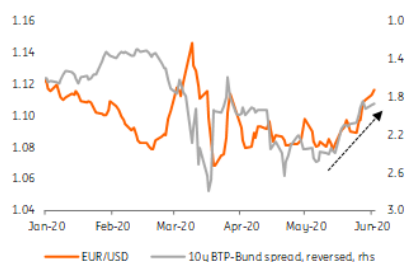
The main focus on the June ECB meeting (this Thursday) will be the expected increase in the size of the Pandemic Emergency Purchase Programme (PEPP). As per [ECB Preview](#), we expect an additional €500bn top-up, to be spent until mid-2021. As has been the case since the start of the Covid-19 crisis, 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

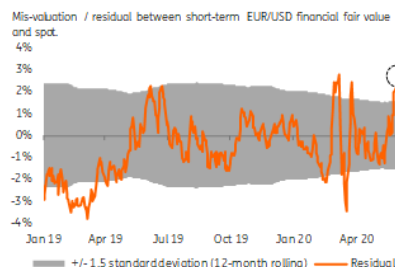
forceful PEPP response (ie, €750bn expansion vs €500bn expected).

**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

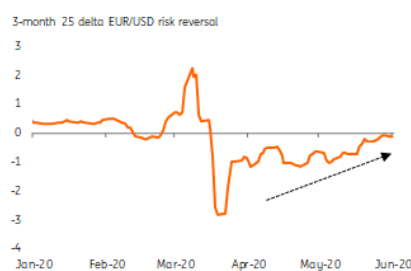
**Fig 3 EUR/USD speculative longs risen in past months**



\* 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.

## Author

### Carsten Brzeski

Global Head of Macro

[carsten.brzeski@ing.de](mailto:carsten.brzeski@ing.de)

## Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. (“ING”) solely for information purposes without regard to any particular user’s investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies)*. The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.