EUR & ECB crib sheet: Lifting the euro is a hard task

A 25bp rate hike and openness to a 50bp move in September may fall slightly short of market expectations and add some pressure to the euro this week. The European Central Bank is unhappy with a weak euro, but its ability to offer sustainable support to the currency may continue to prove limited

What to expect on Thursday

As discussed in our July ECB preview, we expect policymakers in Frankfurt to deliver the previously announced 25bp rate hike on Thursday and leave the door open for a 50bp increase in September. The overnight index swaps market is pricing in 30bp for this week and nearly 200bp of tightening by June 2023. We suspect that the Bank's message may fall slightly below market expectations, and trigger some dovish re-pricing across the EUR curve.

The deployment of the anti-fragmentation tool will be all the more interesting as the recent Italian political crisis (which we analysed in detail here) has increased the chances of a sharp re-widening of Italian sovereign spreads. Here, the details about the conditionality to access the anti-spread tool will be key and may drive part of the market's reaction.

We identify four different scenarios (with the second being our base case) ahead of this week's ECB policy announcement, and we include our estimated impact on EUR/USD and German 10Y yields.

Scenario analysis: How to position for Lagarde's alternatives

	Inflation outlook	Growth outlook	Interest rates	Quantitative easing	EUR/USD (1.01)	10Y Bund (1.18%)
Current stance	Headline inflation slightly above target at the end of projection horizon	Some factors keep weighing on outlook, but growth to pick up again	Depo at -0.50%. September hike can be larger than 25bp. Gradual hiking after	APP and PEPP in reinvestment phase. But PEPP flexible if fragmentation		
Dovish	Upside risks in near term, but medium-term infl. will return to target	Stagflation risk has risen significantly	25bp hike. Worsening outlook suggests no more than 25bp in Sept.	Fragmentation tool putting limited conditionality. Unlimited.	0.99	1.00%
ING Base Case (neutral)	Infl. to remain high, decline to slightly above target in medium-term.	Mounting downside risks, but conditions still in place for growth.	25bp hike. Signalling 50bp option on the table for Sept.	Fragmentation tool with some conditionality. Few details.	1.00	1.15%
Hawkish	Medium-term inflation outlook even higher than June projections.	Same downside risks, but conditions in place for growth.	50bp hike. 50bp more in September highly likely.	Fragmentation tool with some conditionality. Size limited	1.02	1.25%
Very hawkish	Inflation seen persistently above target in the projection period	Stressing that downside risks are temporary, outlook strong beyond that	50bp hike, 50bp or 75bp in September.	Fragmentation tool with very strict conditionality. Size limited.	1.03	1.30%

Source: ING

Fighting a weak euro is not easy

There is no doubt that the ECB is unhappy with the recent weakness of the euro – not only against the dollar, but on a trade-weighted basis. Recent hawkish surprises by the ECB have, however, failed to offer sustained support to the euro, and we suspect that a larger-than-expected move (a 50bp rate hike) or more hawkish-than-expected forward-looking language may fail to generate enough lift to the euro.

This is especially due to the mounting downside risks in the eurozone, mostly related to the threat of a gas supply crunch in the coming months (or during winter) and more recently about Italy falling back into political uncertainty.

> Our base case for EUR/USD is that it can re-test parity this week – with the ECB potentially being a trigger – and that it may only come back to levels above 1.0300 once the dollar loses some momentum (which would require some stabilisation in risk sentiment) and markets feel somewhat comfortable with the magnitude of the economic downturn priced into European assets.

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