

EUR and ECB: Dovish for bonds, but not for EUR

ECB frontloading PEPP purchases isn't a negative for EUR/USD. It helps to underscore the latest market narrative of tentative stability in core bond yields, in turn taking away support from USD. EUR/USD to move above 1.25 in summer. The main winner from the subsequent stability in core bond markets is EM FX, mainly the high yielders that got hit last month



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Frontload PEPP purchases is not bad news for EUR/USD

The European Central Bank surprised with the announcement of frontloaded Pandemic Emergency Purchase Programme (PEPP) purchases (see [ECB Review](#)), but in terms of the dovish impact on underlying eurozone assets, this is more a story for the eurozone bond market than the euro itself.

As we argued in the [ECB Cribsheet](#), as long as the whole PEPP envelope is not extended, the negative impact on the euro should be limited as this only changes the pace of the bond purchases, but not the overall size. For a more meaningful (negative) impact on the euro, the size of the PEPP envelope should have to be increased. Such a potential move from the ECB is still rather far away and unlikely, in our view.

If anything, the ECB decision to lean against the rising bond yields is a positive for EUR/USD as

more bond buying helps to underscore the very latest market narrative of the tentative stability in core bond yields. This in turn is (a) negative for USD, the key beneficiary of the UST sell-off in February (largely because it triggered a positioning squeeze in G10 and EM currencies) and (b) positive for cyclical FX and also for EUR/USD.

Moreover, the fact that the ECB language is now less downbeat ("risks have become more balanced") has also helped to offset any dovish impact from frontloading the PEPP purchases on the euro.

Constructive EUR/USD outlook

We reiterate our bullish EUR/USD view. Not only does today's ECB decision help to limit the key USD tailwind of late (sharply rising UST yields), but as the eurozone economy starts to recover in the second quarter (with the pace of vaccination set to increase), EUR/USD should start moving higher, further helped by the deeply negative US front-end real rates (note: US CPI should push above 3.5% during 2Q). We thus expect EUR/USD to move above 1.2500 this summer.

EM FX the big beneficiary from ECB attempt to stabilise the bond market

The big winner from the ECB's decision to front-load PEPP purchases should be Emerging Market FX. This FX segment was under material pressure in February as the UST sold off. But now, with another hint at stability in the core bond market, EM FX will be given some more breathing room. With most of the EM currencies trading in undervalued territory and local EM bond markets selling off throughout February, this now offers good entry points – mainly for EM high yielders which got particularly exposed via the bond channel during the February sell-off.

The expected rise in EUR/USD is also a favourable factor for the low yielding Central and Eastern European FX, which should benefit from the EUR/USD overlay. We continue to see CZK as the most attractive currency in the region as the Czech National Bank remains hawkish (and should hike rates twice this year), the currency is undervalued vs EUR and the Czech current account should remain in surplus this year.

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