EUR & ECB: Facilitating the downside to the euro

The ECB is just about likely to stay on hold this week. We expect the dovish press conference, with guidance on a September rate cut and talk about QE, to weigh on the euro. The evolution of market expectations on ECB QE should be the prime euro-negative factor in the coming months

Figure 1: The ECB's Dashboard

Scenario analysis: How to position for Draghi's alternatives

	Inflation outlook	Growth outlook	Forward rate guidance	*QE discussion*	EUR/USD	2-year Schatz	10-year Bund
Current stance	"Underlying inflation is expected to increase over the medium term"	"The risks... to growth outlook remain tilted to the downside"	Rates to remain "at their present levels at least through the summer of 2019"	None at this point.			
Very dovish	**Symmetricity** of CPI target **under the consideration**	Recent data suggest **slowdown in activity**	**20bp interest rate cut** & dovish rate guidance	Forward guidance on the start of the QE in September	1.09	-5 bp	-10bp
Dovish	Recent data suggest the **CPI pick up will take longer**	Recent data suggest **slowdown in activity**	**10bp interest rate cut** & dovish rate guidance	The Council **"has tasked relevant committees"**	1.10	-2.5 bp	-5 bp
ING Base Case	No language change given no new staff projections	No change given no new staff projections	Change to forward guidance: "present or **lower** levels"	Hint at **the re-start of QE should it be necessary**	1.11	+2.5 bp	+5 bp
Hawkish	No language change given no new staff projections	No change given no new staff projections	No change to forward guidance	Talk on QE seen as "premature"	1.14	+10 bp	+15 bp

Source: ING

FX: More downside to EUR...

Despite the market already pricing a 40% probability of a 10bp cut this week, more than one 10bp cut by September and close to 20bp overall easing by the end of this year, we see a downside risk to EUR/USD coming from the ECB meeting this Thursday. This is because:

(a) The ECB is likely to change the forward guidance and signal the upcoming cuts (in September and potentially beyond), thus cementing the markets' dovish expectations, and

(b) President Draghi is likely to deliver a dovish press conference, with a potential hint at QE (see ECB Preview for more details).

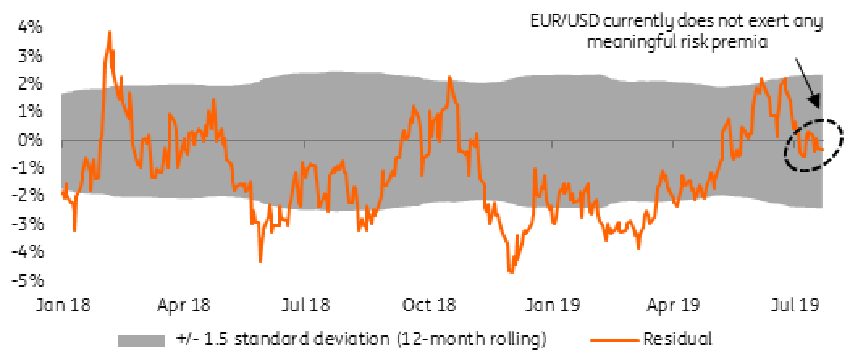
The latter in particular should be a negative factor for EUR over the coming months as the expectations for ECB QE will continue to build.

... as technicals are not stretched

On a short term basis, EUR/USD currently does not exert any meaningful risk premia (as per Fig 2, the cross is fairly valued based on our short term financial fair value model). Coupled with the fairly light short EUR/USD positioning (Fig 3), there is scope for EUR/USD downside stemming from the dovish press conference (the short-term effect – coming days) and a further build-up of ECB QE expectations (the medium-term effect – coming months). In Figure 1, we provide a scenario analysis around the possible ECB July meeting outcomes.

Figure 2: No material risk premium priced into the euro

Residual between EUR/USD financial fair value and spot. Large and persistent mis-valuation is a sign of a risk premium (as other things than normal drivers are affecting EUR/USD)

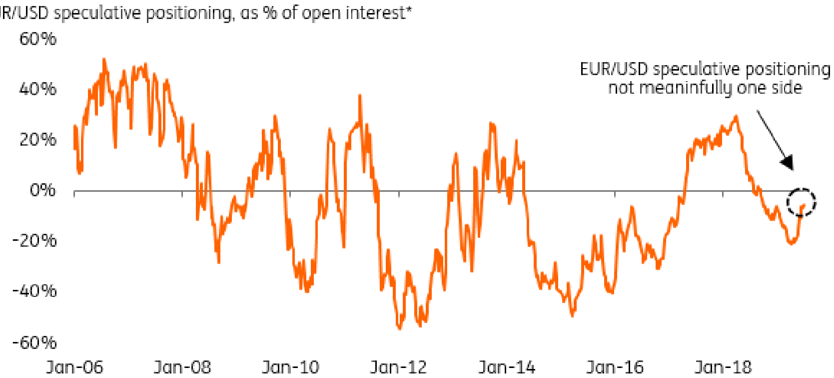


The ECB is more likely to over-deliver than the Fed

With the market pricing almost three full 25bp Fed rate cuts this year (vs our economists' call for two cuts), from the monetary policy perspective the downside to the USD seems more limited vs the downside to EUR as, in our view, it is the ECB that will over-deliver this year (likely on the QE side). As per FX intervention: Does President Trump have the means, motive and opportunity?, at this point we see the main downside risk to USD stemming for the possible FX interventions (should the US administration frustration with the low EUR/USD rate grow) rather than an overly dovish Fed (given the still solid US data points).

Figure 3: EUR/USD speculative positioning not materially one-sided

EUR/USD speculative positioning, as % of open interest*



* As of 16th July 2019 (data are reported with a lag)

Source: ING, CFTC

Bond markets: Longer-dated rates at risk of disappointment

An adjustment of the forward guidance to incorporate the possibility of lower rates would set the central bank on a clear path to cut rates in coming months. This should put the focus on the front end of the curve as markets also gauge where the new lower bound in policy rates will be. The absence of an immediate cut this time around would probably mark only a minor and in our view a temporary disappointment.

Longer-dated yields should be at greater risk of a temporary disappointment if the ECB were to remain vague on the possibility of restarting QE, and given well-advanced market expectations of a dovish press conference some profit-taking cannot be excluded.

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