One ECB hand giveth, the other taketh away

The European Central Bank's dovish guidance on interest rates and a further escalation in the US-China trade war will keep the euro on the backfoot

Source: Andrej Klizan

EUR: ECB's curveball means the skew around the euro tilted to the downside

It is safe to say that the ECB threw a massive curveball yesterday. The decision to more or less announce the end of QE – albeit in a tapered fashion until end-2018 – was buffered by the caveat that the central bank will keep rates on hold "at least through the summer of 2019". This could be described as a 'give with one hand and take away with the other' ECB exit from unconventional policy – although the hand taking away feels more like a knockout blow for the euro.
While we have seen a material shakeout in ECB rate hike bets (with the implied probability of a 10 basis point increase in June 2019 falling from 63% to 27%), we think policy expectations will ultimately be a function of forthcoming eurozone data. So at best, this will be a one-off adjustment to the ECB's new forward guidance.

Yet, there are subtle implications for the euro going forward; the strict rate hike pledge reduces the sensitivity of short-term eurozone rates – and by extension the euro – to incoming economic data. Put alternatively, we may need to see some amazing hard data out of Europe to convince the ECB to hike earlier than they've specified. As such, the skew around market expectations over ECB rate hikes will be tilted to the downside. The same can be said for our euro outlook.

While the ECB's dovish guidance itself isn't a reason to chase EUR/USD lower, we envisage an even shallower EUR/USD move up towards 1.23 by year-end. But for now, expect to trade within a narrow 1.15-1.18 range – as we remain stuck in a 'Trade War trap' (which increases the risk of a EUR/USD correction).

It's worth considering the implications of the ECB's rate hike pledge on the other major central banks within Europe. The Riksbank and Swiss National Bank tend to show greater policy synchronicity with the ECB, while Norges Bank and the Bank of England less so. We could see the Norwegian krone and the pound tactically outperform Swedish krona and Swiss franc this summer.

USD: 'Trade War trap' means global markets will lack direction this summer

After a lot of huffing and puffing, it looks as though the White House will follow through on Chinese tariffs today – with reports stating that the administration will unveil a new list of Chinese exports that will be subject to a 25% tariff. One would expect this to be met with retaliation by Chinese authorities. But to truly gauge the long-run market impact, one should look to how President Trump chooses to absorb any retaliation from China (ie, either counter-retaliate or take it on the chin). The likelihood of more protectionist threats means that global asset prices will remain stuck in a 'Trade War trap' and lack any clear direction.

JPY: US and China 'tariff' cries usually mean that it's time to buy the yen

The status quo from the Bank of Japan has put the yen slightly on the back foot. But with US and China tariffs on the horizon, expect USD/JPY topside to run out of steam.

CAD: Going from bad to worse as external dynamics shift into reverse

External dynamics are starting to shift into reverse for the Canadian dollar – with both US-Canada trade tensions and lower oil prices weighing on the loonie. The former is set to be a perennial threat to CAD this summer – with Foreign Affairs Minister Chrystia Freeland noting that Nafta talks will continue despite both countries pressing ahead with bilateral tariffs on selected goods. On the oil side, the OPEC semi-annual meeting (22 June) could see a gradual easing of production cuts and as such, the likelihood is that we've seen a short-term peak in oil prices. Risks of a dovish Bank of Canada policy re-pricing means USD/CAD could run even higher up to 1.32.