September's ECB Cheat Sheet: Buy the data, sell the cut

The European Central Bank will likely cut rates by 25bp this Thursday. We present four scenarios and the estimated impact on FX and rates. We also discuss the possible implications of a technical" 60bp refinancing rate cut. Our base case is no new forward guidance, and some hawkish repricing in EUR front-end rates as well as a moderately higher EUR/USD

Scenario analysis: How to position for Lagarde's alternatives

	Inflation outlook	Growth outlook	Interest rates	Other monetary tools	EUR/USD (1.105)	10Y Bund (2.20%)
Current stance	Inflation to fluctuate this year, decline towards target in 2H25	Economic activity to be supported by real income rising. Risks to the downside	Depo at 3.75%. Data-dependent, meeting-by-meeting approach	PEPP reinvestment will end with 2025		
Dovish	Risks of inflation undershooting target in 2025 and beyond	Recessionary risks have increased. No longer expecting a recovery	**25bp cut.** If infl. profile in line with projections, rates should be cut in Oct	ECB has all tools at its disposal	1.095	2.10%
Moderately dovish	Inflation revised lower. Greater confidence on target met in 2025	Growth revised lower, downside risks have increased	**25bp cut.** Hints that rates will be lowered again before year-end	Portfolio run-off is independent of rates decisions	1.100	2.15%
Neutral **ING base-case**	Minor changes to projections. Target only met in 2026. Balanced risk to infl.	Still expecting a recovery, minor revisions. Downside risks linger	**25bp cut.** Strict data-dependent approach, no forward guidance	Portfolio run-off is independent of rates decisions	1.110	2.20%
Hawkish	Inflation revised higher. Risks tilted to the upside	Disregarding recent indicators, growth revised higher, no extra downside risk	**25bp cut.** Growing probability of unchanged rates for longer	Balance sheet normalization could still be sped up if needed	1.115	2.30%

Source: ING

This article is companion to our macro team's September ECB Preview.

Markets are fully pricing in a 25bp rate cut from the ECB this week. The question markets seek an answer to is what follows next. For October, the market forward rates imply a 40% chance of a further 25bp cut, and it is more than fully priced for December when the ECB will have its next forecast update.

Room for some hawkish repricing

We think there is some upside risk to front end rates if the ECB reiterates the importance of forecasts for its decision making. Downplaying the chance of an October cut and confining itself to quarterly steps on rates at least for now should act as a brake on the potential pace of easing, less on the end point of the easing cycle. The EUR curve has potential to bear flatten on such communication.

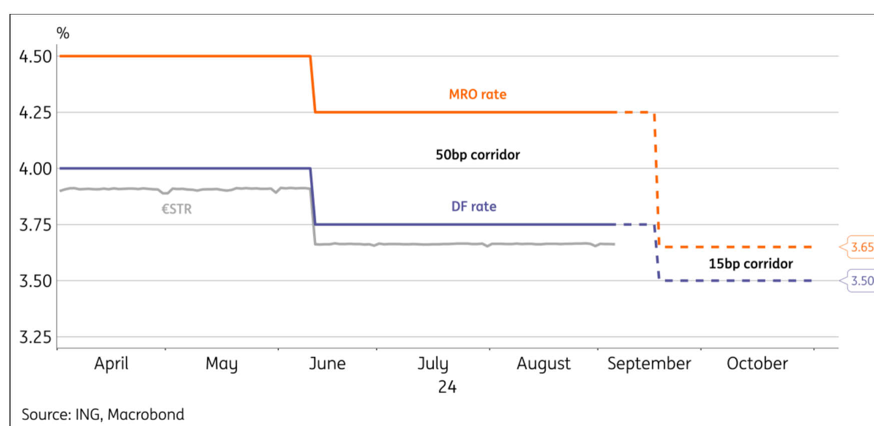
Overall, markets see the ECB reaching a deposit facility rate of around 2 to 2.25% by mid-next year. This is slightly ahead of our updated forecast for the ECB, which sees accelerated and front-loaded cuts over the first half of 2025. To some degree, this market view is probably more inspired by the more aggressive pricing in the US than being solely down to the eurozone backdrop. Near term market rates will remain closely tied to the dynamics in the US with the USD-EUR spread remaining very directional.

A "technical" 60bp cut

From 18 September, the ECB will lower the main refinancing rate (MRO) to 15bp above the deposit facility rate. This had been announced as one of the outcomes of the ECB review of the operational framework. This also means that if the ECB decides to cut the deposit rate by 25bp this week, the main refinancing rate will drop by 60bp.

For markets, the main refinancing rate is not the relevant rate at the moment. High excess reserves of still just above €3tn within the banking system mean that the effective overnight rate is still closely tied to the deposit facility rate, which is where banks can park liquidity at the ECB. And since it is only banks that have access to the deposit facility, overnight unsecured lending rates (i.e. €STR) are still almost 10bp even below the deposit facility rate.

MRO-DF rate corridor to shrink



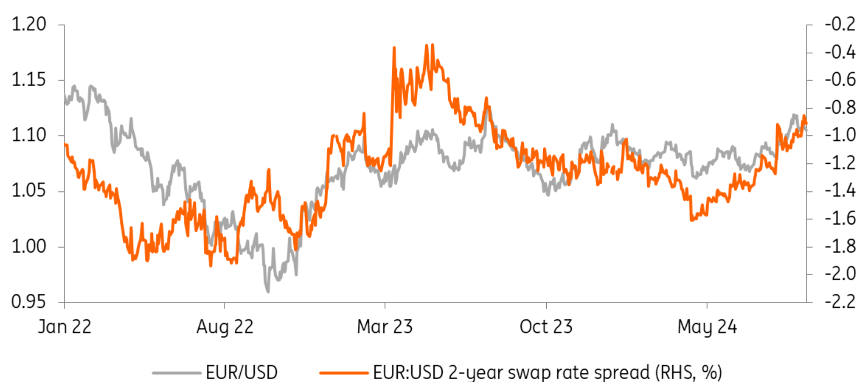
Source: ING, Macrobond

Currently, banks pick up only €11.6bn at the MRO rate via weekly and three-month operations. For now, ECB operations are only a backstop for some banks. A lower spread over the deposit rate might act as a cap to market rates and funding spreads now but it is only once excess reserves decline more significantly that the MRO rate will become more relevant for the market, i.e. when ECB funding is seen as a viable alternative to market funding in terms of pricing. We see that happening only in a matter of years rather than months given the trajectory of excess reserves.

EUR/USD can find more support into the Fed

As shown in the chart below, EUR/USD continues to be supported by its most important short-term market diver, the tightening USD:EUR rate spread. Next week's FOMC meeting will put the vast dovish rerating of the Fed cycle to the test, but we believe that Thursday's ECB meeting could add to the tightening momentum and offer more support to the euro.

EUR/USD and short-term rate spread



Source: ING, Refinitiv

Crucially, this could be one of the last chances for a clean", eurozone-led EUR/USD rally. After this, the Fed, positioning ahead of the US election, and a likely turbulent EU budget season suggest volatility could steer direction in the pair.

The 1.120 August high may only be reached with some help from the Fed next week, but a return to the 1.11 area is possible if the ECB triggers some hawkish repricing.

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