

October's ECB Cheat Sheet: Anything but guidance

We expect the European Central Bank to pause this week after inflation slowed, rates spiked and new geopolitical risks emerged. The Governing Council may limit offering rate guidance to markets and shift the focus to non-rate monetary policy tools. Ultimately, the market impact is set to be relatively contained

Scenario analysis: How to position for Lagarde's alternatives

	Inflation outlook	Growth outlook	Interest rates	Other monetary tools	EUR/USD (1.06)	10Y Bund (2.93%)
Current stance	Inflation declining, but projected to remain too high for too long	Economic activity subdued in coming months, but should pick up over time	Depo at 4.00%. Data-dependent approach to future decisions	PEPP reinvested at least till end '24. Managed to avoid policy interference		
Dovish	Medium-term infl. may return to target earlier than previously thought	Evidence of more sustained slowdown in the economic outlook	No hike. Peak in rates has likely been hit given high yields	No intention of adjusting PEPP guidance	1.045	2.80%
Moderately dovish ING base-case	Core still resilient, inflation coming down but upside risk for 2024/5	Unchanged. Economy to remain in subdued growth environment	No hike. Data-dependent, repeat rates are at level to bring infl. to target	Discussion about non-interest rate policy tools	1.055	2.90%
Moderately hawkish	Projection for 2% inflation in 2025 at risk	Unchanged. Economy to recover in course of 2024	No hike. Data-dependent, stressing possibility of another hike	Signal intention to faster shrink the balance sheet and excess liquidity	1.07	3.00%
Very hawkish	High chances that 2% target will only be hit in 2026	Stressing the rebound potential of economic activity	25bp hike. Data dependency for future decisions	Shortening of the PEPP reinvestment period. MRR raise	1.08	3.05%

Source: ING

The European Central Bank will, for once, face almost a no-brainer this month and keep rates unchanged, as we discuss in our [preview](#). Inflation slowed more than expected in September, bond yields have jumped, and new sources of geopolitical risk will weigh on the growth outlook. Higher oil prices may delay the return to 2% inflation beyond the end of 2025, but that is likely a concern for December when new staff projections will be released.

A dovish tilt in the ECB's communication already happened, at least in the eyes of the market, at the September policy meeting. However, in the days after that meeting, ECB officials tried to sound more hawkish, stressing that the end of rate hikes had not necessarily been reached. Next week, President Christine Lagarde and her Governing Council (GC) members will have to take stock of the market's repricing of rate expectations as well as recent geopolitical events and data - both dovish arguments - this month.

The ECB, like other central banks, is in a position where its rate cycle is probably over. But it's still in its interest, barring a substantial dovish shift in the GC equilibrium, to keep bond yields elevated, so allowing the additional tightening to put further pressure on prices. That requires a hawkish tone to be reiterated at this meeting and could also motivate the ECB to hint at an earlier end to reinvestments under the PEPP.

However, missteps have not been uncommon in recent attempts by the bank to provide rate guidance to markets and this time, the Governing Council and President Lagarde may prefer to shift the focus to the discussion on non-rate policy tools, refraining from offering any further detailed guidance on the path of interest rates. These tools include minimum reserves, reversed tiering, and a possible earlier unwinding of the PEPP bond purchase programme.

Ultimately, a "less is more" approach when it comes to discussing rates may be the preferred – and more efficient – path for the ECB this time.

Rates: Preparing to move on from the rates tool to increase policy reach

Markets have largely embraced the ECB's message that policy rates have reached sufficiently high levels to bring inflation back to target if held long for enough.

The market is discounting only a roughly 10% chance for another hike around the end of 2023 and is fully discounting a 25bp rate cut for July next year. Clearly, the danger is that energy prices have raised the upside risks to the projected inflation path, and some hawkish ECB members might even think a summer rate cut is too early; recall Klaas Knot assumes rates will likely stay at current levels for a year.

Bringing the focus of discussions back to the ECB's balance sheet might be a possibility to maintain a hawkish posture and prevent the market from pricing cuts too early. However, this will also have to be balanced against the growing concerns surrounding sovereign spreads and Italy in particular. Taken by itself, the ECB continuing to attach greater weight to inflation upside risks rather than downside risks to growth could mean a bear-flattering impetus, especially in a generally more fragile risk environment.

That said, the ECB operates in an environment with greater spill-over effects in markets from a surprisingly resilient US economy. When the ECB assesses current financial conditions, it will likely note that while shorter-dated real rates have fallen below their average since July, longer real rates are still at relatively high levels, given the upward pull from US rates. Less resilient and now more exposed to geopolitical risks, the EUR curve might hold less steepening potential than its counterpart. That's something we also see in the widening of the 10Y UST/Bund spread to around 200bp.

FX: Data remains more important than ECB communication

EUR/USD has continued to find good support despite US 10-year yields reaching 5% and risk sentiment staying unstable. The EUR-USD 2-year swap rate differential has remained wide, at -120bp, on the back of delayed prospects of Fed easing. The impact of ECB communication on this differential is generally less significant compared to that of the Fed, and given our expectations for a cautious tone at this meeting with limited guidance provided, we don't expect material spillovers into FX this month.

We suspect that a good portion of recent EUR/USD resilience is due to the dollar's overbought status and some positioning readjustments. The pair appears to be trading on the expensive side, considering hyper-attractive USD rates, growth differentials and geopolitical risks. While it's true that markets have priced out ECB tightening, we discuss above how a hawkish surprise won't be easy to achieve in the current environment. A rebound in eurozone data would do much more than an attempt to signal more tightening by the ECB, but that is not our base case for now.

We expect EUR/USD to hover around 1.05/1.06 into and after the ECB meeting. The dollar leg and geopolitical events may well have a bigger say in guiding any short-term trend.

Authors

Francesco Pesole

FX Strategist

francesco.pesole@ing.com

Benjamin Schroeder

Senior Rates Strategist

benjamin.schroeder@ing.com

Carsten Brzeski

Global Head of Macro

carsten.brzeski@ing.de

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.