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The ECB's Dashboard: Praet's pivot pirouette

We expect the European Central Bank to recalibrate its bond-buying programme on Thursday. But it will have to tread carefully

Scenario analysis: How to position for the ECB

	Inflation outlook	Growth outlook	Forward rate guidance	QE taper guidance	EUR/USD	2-year Schatz	10-year Bund
Current stance	"Underlying inflation is expected to rise gradually"	"The risks… to growth outlook are broadly balanced"	Rates to remain "at present levels for n extended period … well past the horizon"	QE "intended to run until end of September 2018, or beyond"			
Dovish	Downward revision to (medium-term) 2020 CPI forecast	Risks to the growth outlook **to the downside**	Announcement of reinvestments to last at least 2 years	Most inflation criteria are met and GC tasked internal committees	1.16	-5 bp	-10bp
ING Base Case	**Upward revision of CPI forecast** by 0.2pp for 2018/19	**Unchanged GDP forecasts** for 2018/19/20	No change to forward guidance and the "well past"	Extension of QE, at least until December at 10bn euro per month	1.19	+0 bp	+5 bp
Hawkish	**Upward revision** by 0.2 pp or more of 2020 CPI forecast	Upward revision of 2019/20 growth forecasts	Hinting at 6-9 months time frame for a first hike	**Announcement that QE will end in December**	1.20	+5 bp	+10 bp
Very hawkish	**"Upside risks"** to the **inflation outlook**	**Risks** to growth outlook are to the **"upside"**	Signalling a hike within 6 months	**Announcement of tapering details**	1.28	+10 bp	+15 bp

Source: ING

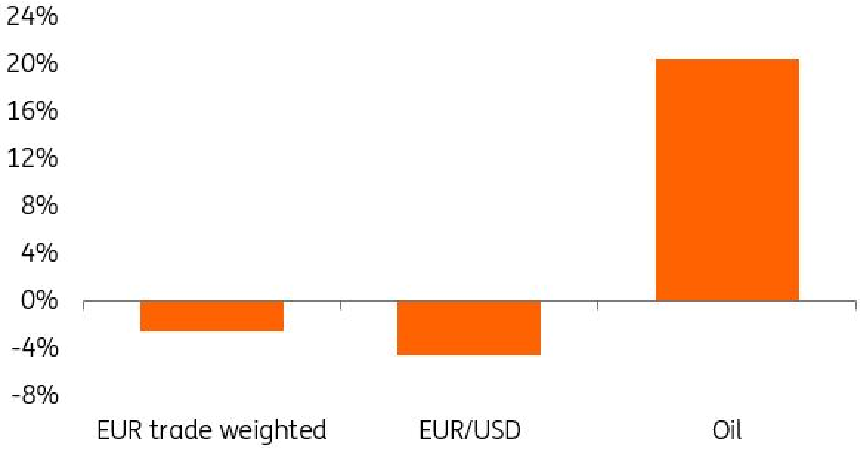
Balancing act

Despite growing uncertainty around the strength of the eurozone recovery, little underlying inflationary pressure and possible further market turmoil, the European Central Bank seems determined to focus on long-term trends.

After a speech by ECB chief economist Peter Praet last week, the only question is how much detail the ECB will be willing to present. We still don't think the central bank will easily give away flexibility and room for manoeuvre on quantitative easing in a situation where downside risks to the economic outlook have increased and political risks (be it from Italy or later this year from Brexit) could easily reemerge.

It is a close call between trying to buy more time with hawkish words and announcing explicit details. Given Praet's comments, we expect the ECB to announce another recalibration of QE, i.e. an extension of QE at a reduced pace of €10 billion per month at least until December 2018.

% increase since the ECB Meeting on 26 April 2018



(when the last ECB staff projections were presented)

Market reaction

What this means for FX markets: Slowing pace of QE to put a floor under EUR/USD.

The announcement of a lower pace of asset purchases over 4Q (from €30 billion to €10 billion) should be EUR/USD positive as (a) signalling-wise, it brings us closer to the eventual end of QE; (b) volume-wise, €10 billion per month is a limited amount.

Yet keeping the programme open-ended (i.e. the ECB will not commit to an end date) should mitigate the degree of EUR/USD upside. We thus don't expect EUR/USD to break above the 1.20 level.

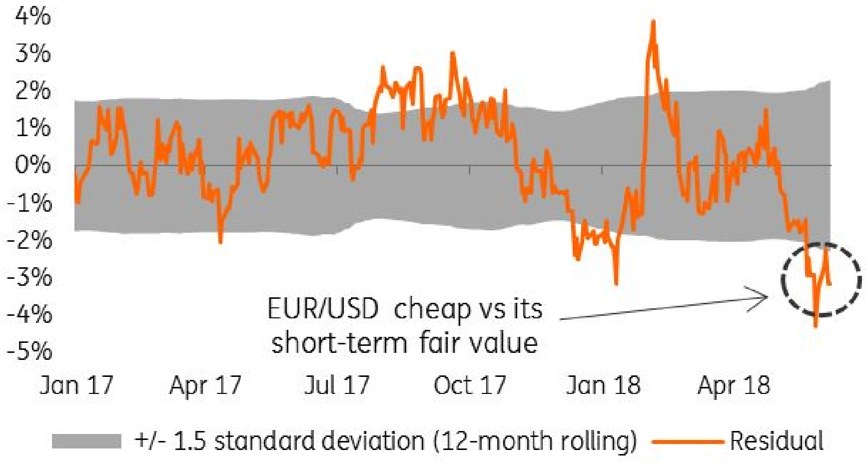
What this means for bond markets: Open-ended QE to dampen the immediate upside in rates.

Heading into the ECB meeting, rates remain depressed by lingering political risks surrounding Italy and ongoing fears of an escalation of trade tensions. Keeping net QE purchases open-ended should thus cap the immediate bearish reaction in rates.

However, a signal from the ECB that it remains undeterred in moving towards the exit should keep rates on course to rise back towards 0.70% over the summer.

Residual between EUR/USD financial fair value and spot

Large and persistent misvaluation is a sign of a risk premium (as things other than normal drivers are affecting EUR/USD)



Source: ING

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