

ECB decision time: Everything you need to know about today's meeting

Today's European Central Bank meeting is crucial. The emergence of the Omicron variant is putting more downward pressure on European economies. With inflation on the rise, we look at Christine Lagarde's biggest challenges. Note, this is a resend of our coverage from last week

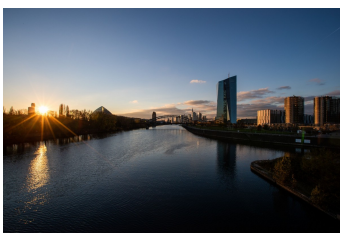
In this bundle



ECB decision time: For Europe's central bank, crucial decisions need to be taken

The fourth wave of the pandemic and the new Omicron variant have complicated the European Central Bank's already not so easy life in the run-up to...

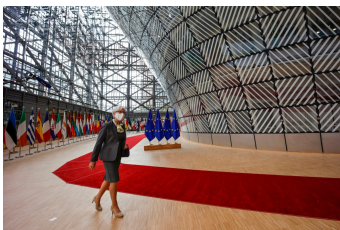
By Carsten Brzeski



Financial Institutions

ECB decision time: For banks, more deposit tiering as low TLTRO rate ends

By June 2022, the favourable borrowing rate on the Eurosystem's TLTRO operations will end and we do not expect an extension. To somewhat mitigate...



ECB decision time: For rates, QE helps but it's hikes that really matter

How rate markets react to this ECB meeting depends in part on the tone of Lagarde's statement, but the more lasting impact will be based on a cold...



ECB decision time: For FX, the euro's in need of a hawkish tilt as downside risks mount

The unfavourable widening of short-term rate differentials has been a major driver of EUR/USD weakness, with the euro also suffering from investors...

By Francesco Pesole

Article | 16 December 2021

ECB decision time: For Europe's central bank, crucial decisions need to be taken

The fourth wave of the pandemic and the new Omicron variant have complicated the European Central Bank's already not so easy life in the run-up to what is supposed to be a big bang meeting today



ECB President, Christine Lagarde, is facing many challenges

A lot has been said, analysed and speculated about the ECB's crucial meeting on 16 November. Most leading indicators are pointing to a loss of economic momentum in the fourth quarter, and the current fourth wave of the pandemic and the new Omicron variant will add further downward pressure to the eurozone economy, particularly to private consumption. At the same time, headline inflation has continued to accelerate and even "team transitory" has had to admit that inflationary pressure will last longer than previously anticipated. Against this backdrop, the ECB will have to decide on how to proceed with its emergency measures in particular and how much monetary stimulus the eurozone economy still needs in general.

Fresh round of staff projections

An important element for the discussions will be the next round of ECB staff macro projections. However, we don't expect any significant changes here. Back in September, the ECB had forecast GDP growth to come in at 5.0%, 4.6% and 2.1% in 2021, 2022 and 2023, respectively. Inflation was expected at 2.2%, 1.7% and 1.5%. Traditionally, the ECB's inflation forecasts have been highly

affected by the so-called technical assumptions on oil prices and the exchange rate, and these have hardly changed. Luckily for the ECB, the surge in oil prices after the September meeting recently came to an end, suggesting little additional pressure on the ECB's headline inflation projections.

The 2024 inflation forecast needs to be watched closely

The weakening of the exchange rate has been too insignificant to drastically change the inflation projections. As the ECB's inflation models seem to underestimate the current pass-through from higher producer prices to consumer prices and will also hardly capture any post-pandemic wage bargaining, we don't expect any significant change to the inflation projections. Instead, what needs to be watched closely is the inflation forecast for 2024.

Even if the inflation discussions between 'team transitory' and 'team permanent' become more heated, we don't see them being concluded any time soon. In fact, these talks could easily continue at least until the summer of next year. Consequently, with no fundamental changes to the inflation outlook, save for some stretching of the term 'transitory', the ECB's discussion will not focus on any tightening but simply on how to proceed with the Pandemic Emergency Purchase Programme (PEPP), the ongoing Asset Purchase Programme (APP) and Targeted Long-Term Refinancing Operations (TLTROs) for banks.

What's next for the Pandemic Emergency Purchase Programme?

Regarding the PEPP, President Christine Lagarde put the entire ECB in a corner when she – probably unintentionally – said at the last press conference that the programme would end as expected in March 2022. While the current fourth wave of the pandemic may be a good reason for the ECB to extend PEPP by one quarter, this option is unlikely given comments by Lagarde and others. The central bank could officially confirm the end next week but might want to play it safe and simply postpone a decision until the early February meeting.

The problem with ending the PEPP is the 'cliff edge' effect, as it currently runs at some €60b per month. An abrupt halt would bring total monthly net asset purchases by the ECB down from €80b to €20b (the size of the APP). Of course, the ECB could decide to simply stop PEPP and to just use reinvestments as a means to smooth the transition but we think that this would not be taken well by market participants. Instead, we think that the Bank will have to present a more powerful transition tool, which offers the same flexibility as the current emergency purchase programme.

Extending PEPP could be the easiest way out but could damage Lagarde's credibility

To maintain this flexibility, the ECB could simply extend PEPP, adjust the terms of the 'old' QE programme (APP) or introduce a new third programme. Extending PEPP could be the easiest way out but could damage Lagarde's credibility in communicating with financial markets. Adjusting the terms of the APP to give the same flexibility is possible but could lead to new lawsuits in Germany

as sticking to the capital key was one of the requirements for the German Constitutional Court to give the green light to it. This leaves the start of a new programme as an attractive option. In our view, the ECB could start a Post-Pandemic Transition Purchase Programme (PPTPP), with an envelope of €300b in order to provide a smooth transition after March 2022, while offering the same flexibility as the PEPP.

Words and action

ECB Executive Board member Isabel Schnabel was the first ECB official to say recently that “risks to inflation are skewed to the upside”, while also making the point that there could be “certain structural factors” pushing up energy price inflation in the coming years; the most notable being the green transition. If this wording is echoed in next week’s official ECB communication, it would mark a significant U-turn towards a much more hawkish ECB. However, we still think that the Bank might not yet be willing to fully go down this road.

Therefore, we expect the ECB to continue to sound cautious about the economic outlook, acknowledging the risk of higher inflation while sticking to the view that inflation is transitory and will eventually return to 2%. In order to gradually start the exit from ultra-loose monetary policy without giving up flexibility amid a fourth wave of the pandemic, we expect the ECB to confirm the end of PEPP in March 2022 and to introduce a third asset purchase programme to smooth the transition. TLTROs will not be extended at their current favourable conditions but instead, the tiering multiplier will be increased from 6 to 10.

Cautious recalibration

Given that the Fed has retired the word ‘transitory’, it would be wise for the ECB to prepare for outcomes other than inflation eventually falling back to below 2%. Therefore, a gradual recalibration of all emergency measures to prepare for the possibility of more permanent inflation is a very logical step and good risk management at the current juncture.

Author

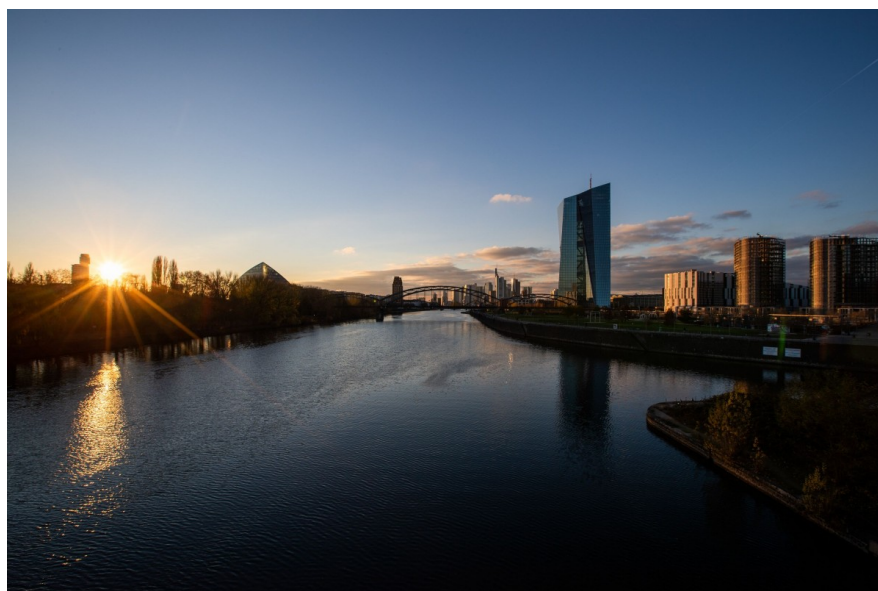
Carsten Brzeski

Global Head of Macro

carsten.brzeski@ing.de

ECB decision time: For banks, more deposit tiering as low TLTRO rate ends

By June 2022, the favourable borrowing rate on the Eurosystem's TLTRO operations will end and we do not expect an extension. To somewhat mitigate the considerable impact on eurozone banks, we expect the ECB to tweak the deposit tiering multiplier until policy rate hikes arrive in 2023



The ECB headquarters in Frankfurt

The end of TLTRO favourable rates is moving into view

What's to become of the TLTROs, the [Targeted Longer-term Refinancing Operations](#)? They're likely to be on the table at the 'big bang' meeting and the Eurosystem will particularly be looking at the expiry of the -100bp favourable rate on 23 June 2022. To mitigate the impact of this expiry on banks, we expect an increase to the deposit tiering multiplier (set at the initial value of 6 in September 2019, and not modified since), until the deposit facility rate returns to zero (which we expect to happen in late 2023), removing the need for such measures.

This is a rather complicated story, so bear with us. The rate on banks' TLTRO borrowing from the ECB has been made dependent on their lending to the real economy, in particular to businesses. If lending exceeds a benchmark, banks qualify for a borrowing rate as favourable as -100bp. The last favourable rate period runs from July 2021 to June 2022. Unless the ECB announces new

modifications to TLTRO conditions (which we do not expect), the borrowing rate will increase to, at best, the deposit facility rate which is currently -50bp.

The end of the favourable TLTRO rate would lower Eurozone banks' negative rate revenues by about €950m per month

Banks have, especially over the past 1.5 years, borrowed significant amounts under the TLTRO. The ECB currently has €2287bn of TLTRO loans outstanding (note that the tenth and last tranche is concluded next week, with allotment announced on 16 December; [we expect this to be one of the smaller tranches](#)). The end of the favourable TLTRO rate would lower TLTRO negative rate revenues for eurozone banks by about €950m every month. That significant change in itself might already be a reason for the Eurosystem to take a look.

But there's more. Ending the TLTRO favourable rates brings back another issue: the considerable negative rate costs imposed on the banking system by the Eurosystem's asset purchases. This requires some explanation.

? How Eurosystem asset purchases cause reserves that banks cannot avoid

Both ECB TLTRO loans and ECB asset purchases necessarily lead to increased deposits (or "reserves") held by commercial banks at the ECB. This is a simple consequence of double-entry bookkeeping: both TLTRO loans and asset purchases increase the Eurosystem's assets, and increased deposits are the corresponding Eurosystem liability that increases in tandem. These Eurosystem deposit liabilities, or bank reserves, have carried a negative deposit facility rate charge of -50bp since September 2019.

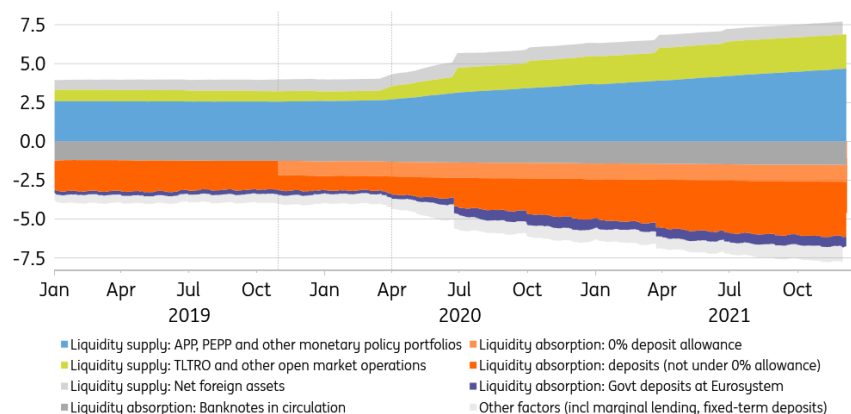
Insofar as Eurosystem deposit liabilities are caused by asset purchases, the banking sector has no way to avoid them. An individual bank may try and reduce its reserves, for instance by substituting into bonds. But this will only offload reserves to another bank. Total reserves in the system are a given for banks. The collective banking sector cannot avoid or reduce these reserves, because the Eurosystem drives them with their asset purchases.

The unavoidable nature of reserves does not apply to those reserves that are created by TLTROs. In those cases, banks deliberately choose to take out a TLTRO loan. The associated reserves may and do however end up at other banks.

Back in 2019, the ECB acknowledged that imposing a negative rate on reserves that the banking sector cannot avoid may not be fair. Hence the ECB implemented a "deposit tiering multiplier". Initially set at 6, this means that since late 2019, an amount of 6 times required reserves, plus required reserves themselves, are exempt from negative deposit facility rate charges. When this tiering came into force, it reduced the negative rate cost of bank reserves by about €350m each month. See the light orange area in the chart below, and [this article](#) for more on involuntary

reserves and deposit tiering.

Eurosystem liquidity supply and absorption (€ trillion)



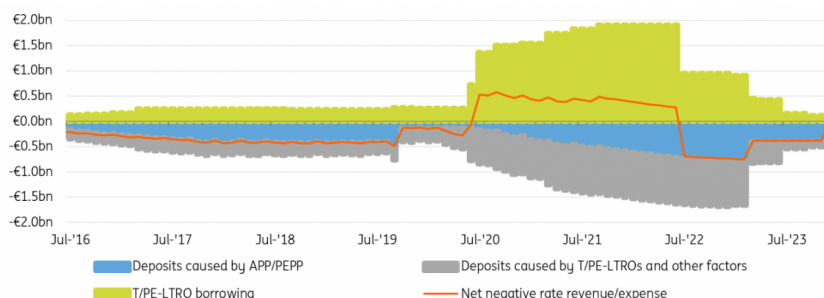
Since late 2019, both Eurosystem asset purchases and TLTRO lending have increased dramatically. Bank reserves have increased with them by an eye-watering 145%, from about €1850bn in October 2019 to over €4500bn today (see the orange area in chart). The increased reserves have driven up negative rate expenses for banks. Yet these are, in aggregate, more than compensated by the favourable 100bp borrowing rate that most banks will qualify for. The ECB did not, therefore, think it necessary to revisit the deposit tiering calibration, even though the aggregate numbers hide substantial redistributive effects between eurozone banks, as both TLTRO borrowing and reserve holdings differ (we describe the redistributive effects [here](#)).

Moreover, this constellation of policies did muddy TLTRO goals: apart from their official goal to “[preserve favourable borrowing conditions for banks and stimulate bank lending to the real economy](#)”, TLTROs have simultaneously become an instrument to mitigate the negative rate costs imposed on banks as a result of asset purchases.

From a €300m monthly net gain to a €700m monthly net loss in July 2022

The mixing of TLTRO policy goals becomes a problem when, in July 2022, the favourable TLTRO borrowing rate ends. Extending the favourable rate may not be needed to stimulate bank lending, but what about the hugely increased asset purchases and the much higher negative rate cost the associated reserves impose on banks? These have gone from a monthly €120m after tiering was enacted in late 2019, to over €500m per month now, and may surpass €700m/month in July 2022. That's shown in the blue area in the chart below. The chart also shows the other negative rate revenues and expenses for the eurozone banking sector, under our base scenario of tapering after March 2022, and a first deposit facility rate increase in the first quarter of 2023, and furthermore assuming no net changes to TLTRO holdings compared to today (except for redemption at maturity).

Eurozone banks' monthly negative rate expenses and revenues on ECB reserves and TLTROs



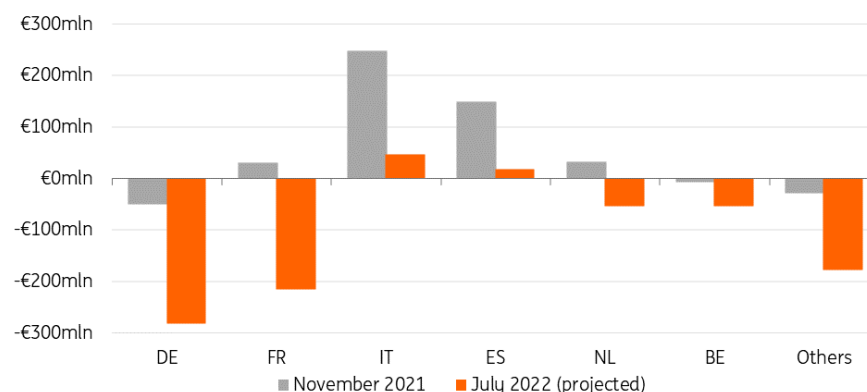
Source: ECB, ING-calculations

The monthly negative rate costs of reserves (the blue plus grey areas in our chart) are currently more than compensated by TLTRO borrowing rate revenues which are shown in the green area. This results in a projected monthly net negative rate revenue of €300m in June 2022 (the orange line). When the TLTRO favourable rate ends and no other measures are taken, the net monthly result abruptly turns negative to the tune of -€700m.

Some banks will be hit harder than others

Given the uneven distribution of TLTROs borrowing and reserve holdings over eurozone countries, some banks will be hit harder than others. The Italian and Spanish banking sectors manage to just keep net positive negative rate revenues, while banking sectors in Germany, France, Netherlands Belgium and elsewhere start to incur negative rate net costs again. Upon our assumed 25bp increase in the deposit facility rate in the first quarter of 2023, net negative rate costs halve.

Monthly net negative rate revenue/expense per country



Source: ECB, ING-calculations

What the ECB could do to dampen the impact in July 2022

We made some further calculations to see what changes to the deposit tiering framework would

be needed to mitigate the impact of the end of the -100bp favourable TLTRO rate on banks. The change in the multiplier needed to fully undo the aggregated impact would not qualify as just a tweak. Even doubling the multiplier, from the current 6 to 12 times required reserves being exempt from negative rates, would leave banks barely in a better position than where they were in September 2019. Note that the ECB should not be satisfied by just restoring the September 2019 situation in terms of costs imposed on the banking sector, because that is when the ECB decided to start deposit tiering in the first place.

Even under a multiplier of 15, some banks would continue to incur significant net negative rate costs

We can also calculate the multiplier that would reduce negative rate costs to what they were in the last quarter of 2019 under the assumption the ECB considered them satisfactory. These amounted to €125m/month. To get there, the tiering multiplier would need to be cranked up to 15. That sounds like a lot, and it is, but it would still exempt only half of ECB reserves of negative rates. It is also important to note that this tiering would reduce, but not eliminate the redistributive effects of the negative deposit rate. Even under a multiplier of 15, banks in e.g. Germany and France would continue to incur significant net negative rate costs, while those in Italy, Spain, Portugal and Greece would continue to make net negative rate revenues. This is due to the fact that banks in the latter group would continue to receive the full -50bp negative rate on their TLTRO borrowing, while some of the corresponding reserves have ended up with the former group, absorbing the -50bp deposit rate. There is little that generic deposit tiering can do about this.

A tweak to the deposit tiering multiplier as a temporary fix

As the favourable TLTRO rate expires in June 2022, eurozone banks face a strong hike in negative rate costs. This will last until the deposit facility rate is increased to zero, which we pencil in for the end of 2023. In the meantime, we don't expect a prolongation of the favourable TLTRO borrowing rate. The deposit tiering multiplier is the easiest tool for the ECB to turn to, but it has its shortcomings. For one, it would need to be increased very significantly to fully compensate banks. It would also leave the sizeable redistribution among eurozone banks unaddressed as some of the funds borrowed under TLTROs have been flowing from southern Europe towards the north. This will self-correct when TLTRO funds are repaid which will take time (the last TLTROs are scheduled to mature in 2024).

With deposit facility rate increases emerging on the horizon, the negative rate costs imposed on banks by the ECB's asset purchases will be of a temporary nature. We, therefore, expect the ECB to settle for a modest deposit tiering multiplier increase only, from 6 to 10. This will fall far short of compensating the increase in net negative rate costs many banks will experience, but will at least remove the sharpest edges. It would lower negative rate costs for northern eurozone banks by about 25%, compared to the no-multiplier-tweak scenario depicted in the chart above.

Author

Amrita Naik Nimbalkar

Junior Economist, Global Macro

amrita.naik.nimbalkar@ing.com

Alissa Lefebre

Economist

alissa.lefebvre@ing.com

Deepali Bhargava

Regional Head of Research, Asia-Pacific

Deepali.Bhargava@ing.com

Ruben Dewitte

Economist

+32495364780

ruben.dewitte@ing.com

Kinga Havasi

Economic research trainee

kinga.havasi@ing.com

Marten van Garderen

Consumer Economist, Netherlands

marten.van.garderen@ing.com

David Havrlant

Chief Economist, Czech Republic

420 770 321 486

david.havrlant@ing.com

Sander Burgers

Senior Economist, Dutch Housing

sander.burgers@ing.com

Lynn Song

Chief Economist, Greater China

lynn.song@asia.ing.com

Michiel Tukker

Senior European Rates Strategist

michiel.tukker@ing.com

Michal Rubaszek

Senior Economist, Poland

michal.rubaszek@ing.pl

This is a test author

Stefan Posea

Economist, Romania

tiberiu-stefan.posea@ing.com

Marine Leleux

Sector Strategist, Financials

marine.leleux2@ing.com

Jesse Norcross

Senior Sector Strategist, Real Estate

jesse.norcross@ing.com

Teise Stellema

Research Assistant, Energy Transition

teise.stellema@ing.com

Diederik Stadig

Sector Economist, TMT & Healthcare

diederik.stadig@ing.com

Diogo Gouveia

Sector Economist

diogo.duarte.vieira.de.gouveia@ing.com

Marine Leleux

Sector Strategist, Financials

marine.leleux2@ing.com

Ewa Manthey

Commodities Strategist

ewa.manthey@ing.com

ING Analysts

James Wilson

EM Sovereign Strategist

James.wilson@ing.com

Sophie Smith

Digital Editor

sophie.smith@ing.com

Frantisek Taborsky

EMEA FX & FI Strategist

frantisek.taborsky@ing.com

Adam Antoniak

Senior Economist, Poland

adam.antoniak@ing.pl

Min Joo Kang

Senior Economist, South Korea and Japan

min.joo.kang@asia.ing.com

Coco Zhang

ESG Research

coco.zhang@ing.com

Jan Frederik Slijkerman

Senior Sector Strategist, TMT

jan.frederik.slijkerman@ing.com

Katinka Jongkind

Senior Economist, Services and Leisure

Katinka.Jongkind@ing.com

Marina Le Blanc

Sector Strategist, Financials

Marina.Le.Blanc@ing.com

Samuel Abettan

Junior Economist

samuel.abettan@ing.com

Franziska Biehl

Senior Economist, Germany

Franziska.Marie.Biehl@ing.de

Rebecca Byrne

Senior Editor and Supervisory Analyst

rebecca.byrne@ing.com

Mirjam Bani

Sector Economist, Commercial Real Estate & Public Sector (Netherlands)

mirjam.bani@ing.com

Timothy Rahill

Credit Strategist

timothy.rahill@ing.com

Leszek Kasek

Senior Economist, Poland

leszek.kasek@ing.pl

Oleksiy Soroka, CFA

Senior High Yield Credit Strategist

oleksiy.soroka@ing.com

Antoine Bouvet

Head of European Rates Strategy

antoine.bouvet@ing.com

Jeroen van den Broek

Global Head of Sector Research

jeroen.van.den.broek@ing.com

Edse Dantuma

Senior Sector Economist, Industry and Healthcare

edse.dantuma@ing.com

Francesco Pesole

FX Strategist

francesco.pesole@ing.com

Rico Luman

Senior Sector Economist, Transport and Logistics

Rico.Luman@ing.com

Jurjen Witteveen

Sector Economist

jurjen.witteveen@ing.com

Dmitry Dolgin

Chief Economist, CIS

dmitry.dolgin@ing.de

Nicholas Mapa

Senior Economist, Philippines

nicholas.antonio.mapa@asia.ing.com

Egor Fedorov

Senior Credit Analyst

egor.fedorov@ing.com

Sebastian Franke

Consumer Economist

sebastian.franke@ing.de

Gerben Hieminga

Senior Sector Economist, Energy

gerben.hieminga@ing.com

Nadège Tillier

Head of Corporates Sector Strategy

nadege.tillier@ing.com

Charlotte de Montpellier

Senior Economist, France and Switzerland

charlotte.de.montpellier@ing.com

Laura Straeter

Behavioural Scientist

+31(0)611172684

laura.Straeter@ing.com

Valentin Tataru

Chief Economist, Romania

valentin.tataru@ing.com

James Smith

Developed Markets Economist, UK

james.smith@ing.com

Suvi Platerink Kosonen

Senior Sector Strategist, Financials

suvi.platerink-kosonen@ing.com

Thijs Geijer

Senior Sector Economist, Food & Agri

thijs.geijer@ing.com

Maurice van Sante

Senior Economist Construction & Team Lead Sectors

maurice.van.sante@ing.com

Marcel Klokk

Senior Economist, Netherlands

marcel.klokk@ing.com

Piotr Poplawski

Senior Economist, Poland

piotr.poplawski@ing.pl

Paolo Pizzoli

Senior Economist, Italy, Greece

paolo.pizzoli@ing.com

Marieke Blom

Chief Economist and Global Head of Research
marieke.blom@ing.com

Raoul Leering
Senior Macro Economist
raoul.leering@ing.com

Maarten Leen
Head of Global IFRS9 ME Scenarios
maarten.leen@ing.com

Maureen Schuller
Head of Financials Sector Strategy
Maureen.Schuller@ing.com

Warren Patterson
Head of Commodities Strategy
Warren.Patterson@asia.ing.com

Rafal Benecki
Chief Economist, Poland
rafal.benecki@ing.pl

Philippe Ledent
Senior Economist, Belgium, Luxembourg
philippe.ledent@ing.com

Peter Virovacz
Senior Economist, Hungary
peter.virovacz@ing.com

Inga Fechner
Senior Economist, Germany, Global Trade
inga.fechner@ing.de

Dimitry Fleming
Senior Data Analyst, Netherlands
Dimitry.Fleming@ing.com

Ciprian Dascalu
Chief Economist, Romania
+40 31 406 8990
ciprian.dascalu@ing.com

Muhammet Mercan
Chief Economist, Turkey
muhammet.mercan@ingbank.com.tr

Iris Pang

Chief Economist, Greater China

iris.pang@asia.ing.com

Sophie Freeman

Writer, Group Research

+44 20 7767 6209

Sophie.Freeman@uk.ing.com

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

James Knightley

Chief International Economist, US

james.knightley@ing.com

Tim Condon

Asia Chief Economist

+65 6232-6020

Martin van Vliet

Senior Interest Rate Strategist

+31 20 563 8801

martin.van.vliet@ing.com

Karol Pogorzelski

Senior Economist, Poland

Karol.Pogorzelski@ing.pl

Carsten Brzeski

Global Head of Macro

carsten.brzeski@ing.de

Viraj Patel

Foreign Exchange Strategist

+44 20 7767 6405

viraj.patel@ing.com

Owen Thomas

Global Head of Editorial Content

+44 (0) 207 767 5331

owen.thomas@ing.com

Bert Colijn

Chief Economist, Netherlands

bert.colijn@ing.com

Peter Vanden Houte

Chief Economist, Belgium, Luxembourg, Eurozone

peter.vandenhoute@ing.com

Benjamin Schroeder

Senior Rates Strategist

benjamin.schroeder@ing.com

Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE

chris.turner@ing.com

Gustavo Rangel

Chief Economist, LATAM

+1 646 424 6464

gustavo.rangel@ing.com

Carlo Cocuzzo

Economist, Digital Finance

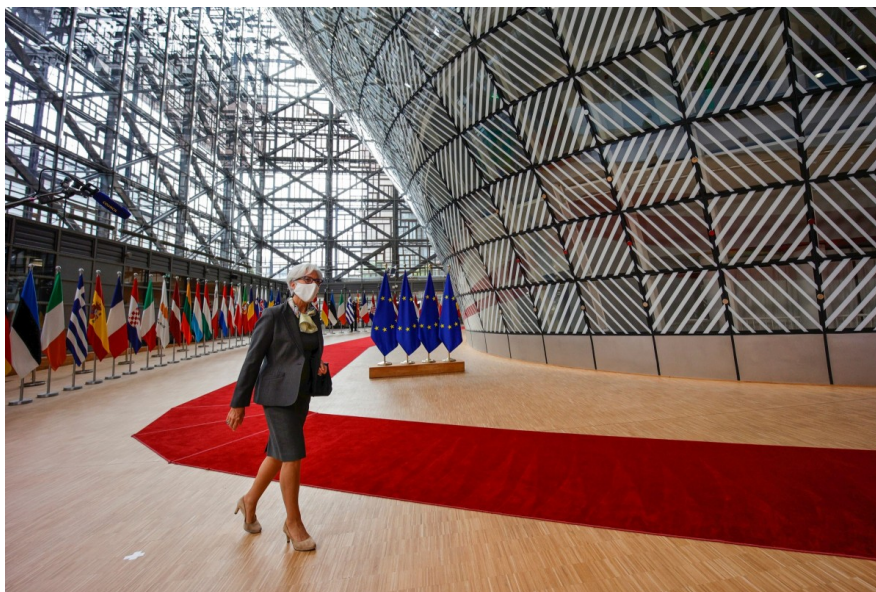
+44 20 7767 5306

carlo.cocuzzo@ing.com

Article | 9 December 2021

ECB decision time: For rates, QE helps but it's hikes that really matter

How rate markets react to this ECB meeting depends in part on the tone of Lagarde's statement, but the more lasting impact will be based on a cold hard fact: what is the ECB's inflation forecast? Eventually, markets will draw the logical conclusion for a central bank that has reached its target: exceptional support measures need to be removed



Christine Lagarde at the European Council building in Brussels earlier this year

Cold turkey or not, bond scarcity is here to stay

Among all the exceptional measures we've seen, the decision on the future of asset purchases isn't the most important thing, at least for EUR swap rates and core yields even though they're often most talked about. Bond scarcity, a key plank of current rate valuations will remain a fact of life. The stock of sovereign and supranational bonds available for private investors to buy is set to increase by only €160bn next year after ECB purchases are taken into account.

Inflation fear had the 2Y fall out of bed in October; this could happen again



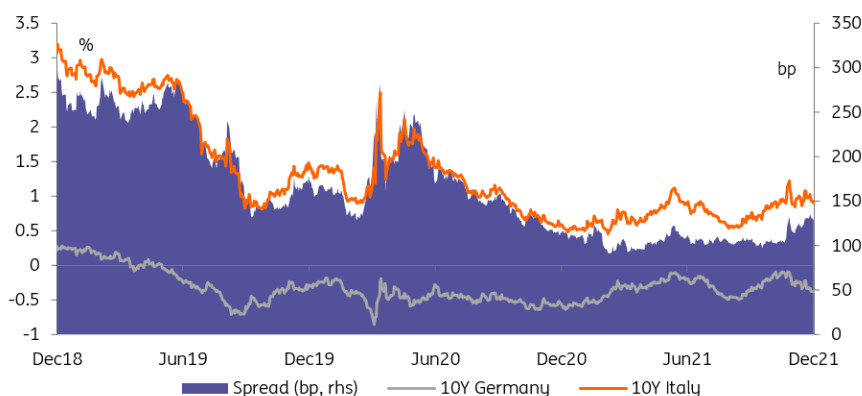
Source: Refinitiv, ING

This could change of course. Should the ECB decide to let markets go cold turkey at the end of PEPP in March, with only the €20bn/month APP net purchases for the rest of the year, that figure would grow to €330bn. Not a sea change, but a forewarning that private investors will need to step up in the future, provided they are compensated with higher rates.

Taper is really about hikes, in the market's mind

Instead, it is the signal about the timing and the extent, of the coming rate hikes that will matter the most. It has the potential to send 10Y core rates, for instance, Germany and swaps, higher by more than 50bp next year. The Covid-19 uncertainty, and an economic slowdown in late 2021/early 2022 means this is a debate for the latter half of next year. Here too, risks are skewed towards a more hawkish reaction, however. If Lagarde overemphasises inflation worries, rates will jump the gun and price-in imminent hikes again, as they did in late October.

Italian spreads are starting to price waning monetary support



Source: Refinitiv, ING

Our benign view for this meeting doesn't apply to higher beta fixed income, notably peripheral sovereign bonds. With valuations largely riding on ECB support, the degree of inflation worries will

have a direct impact on spreads. An improvement in fiscal fundamentals is a threat as much as an opportunity. They are a factor helping muffle bond volatility but we hope that this won't lull the ECB into a false sense of security. The bond market is on the mend, but it still requires crutches to walk.

Italian spreads, a spike to 150bp

With political background noise increasing next year, and in an environment characterised by less monetary support, our high confidence call is for sovereign spreads to widen at the start of 2022. In the case of the 10Y Italy-Germany spread, we think this will translate into a spike above 150bp in the first quarter. As with any attempt to forecast a spike in volatility, there isn't much certainty about its timing. Much will depend on how the ECB manages the policy change, starting at this meeting.

Author

Antoine Bouvet

Head of European Rates Strategy

antoine.bouvet@ing.com

Article | 16 December 2021

ECB decision time: For FX, the euro's in need of a hawkish tilt as downside risks mount

The unfavourable widening of short-term rate differentials has been a major driver of EUR/USD weakness, with the euro also suffering from investors re-entering carry trades amid a recovery in risk sentiment. We would need to see a clear hawkish twist by the ECB to turn the tide for the slightly overvalued and not clearly oversold euro



Christine Lagarde was shown where to sign the euro notes when she became ECB President

Taking only the negatives from Omicron

The Omicron impact on markets initially offered some support to the euro, as EUR-funded popular carry trades (short EUR/RUB is a notable example) were quickly unwound amid risk-off and falling oil prices. With markets quickly reverting their bearish bets and now looking less concerned about the new variant, EUR/USD is looking at fresh downside risks.

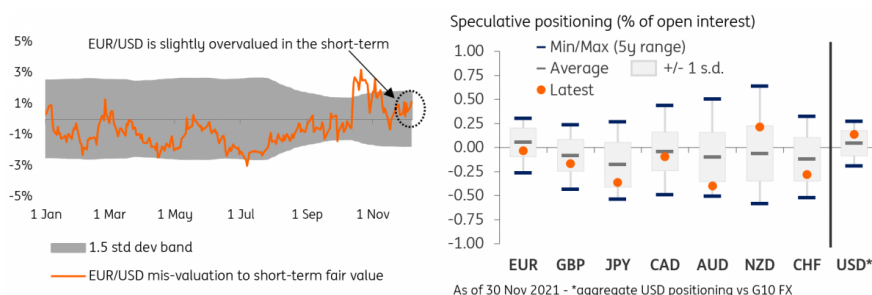
An additional factor weighing on the EUR recently is the re-rating of eurozone growth expectations due to restrictions in Germany and other EU countries. From a forward-looking perspective, markets seem to be pricing in a greater likelihood of tough containment measures in Europe than

in the US and this keeps widening the US-EZ growth and monetary policy differential. The short-term rate differential has shown a high beta to EUR/USD in 2021 according to our short-term fair value model and has been a major contributor (along with relative equity performance) to the recent EUR/USD weakness.

Hard to turn the tide

This should mean that EUR/USD may prove asymmetrically more sensitive to any hawkish surprise, whether that be on the timing of unwinding asset purchases or on staff projections), compared to signs of extra cautiousness. If, instead, we see no major surprises by the ECB, and given the Fed meeting risks prompting another spike in US short-term yields, we think EUR/USD may be set for another bad week. After all EUR/USD is slightly overvalued according to our short-term fair value model, suggesting there is still room for the pair to catch up with the unfavourable widening of USD-EUR short-term rates.

From a technical perspective, net speculative positioning on the EUR has declined of late, but, unlike some other G10 currencies, it is not in over-stretched net-short territory, as you can see in our chart below.



Source: ING, CFTC, Macrobond, Refinitiv

We think that only a hawkish turn can significantly turn the tide for the euro at the moment. Otherwise, many factors are pointing to EUR/USD weakness as we end the year. A move beneath even the 1.1200 lows is entirely possible. One potential counter-argument is the seasonal tendency of the dollar to underperform in December, although that may require much calmer markets to materialise.

Author

Francesco Pesole

FX Strategist

francesco.pesole@ing.com

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 www.ing.com.