ECB meeting: Angry Birds

At today's ECB meeting, we expect no hint of when QE could end, but we'll be watching the language closely. The subtle change in words should give a good indication of who is currently on top in the ECB's in-house bird fight. However, ECB members shouldn't forget when real bird fights, everyone loses some feathers

Scenario analysis: How to position for Draghi's alternatives

	Inflation outlook	Growth outlook	Reference to the EUR level	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"	"Volatility in exchange rate is source of uncertainty ..."	ECB "stands ready to increase" QE "in size and/or the duration"			
Very dovish	**Downward revision** to (medium-term) 2020 CPI forecast	Risks to the growth outlook **to the downside**	**Unwarranted tightening** of monetary conditions	The **"size and/or the duration"** reference unchanged	1.21	-5 bp	-10bp
ING Base Case	**Unchanged CPI** forecast for 2018/19/20	**Upward revision to** 2018 GDP to 2.4%; 2019/20 unchanged	Volatility in the exchange rate represents **a source of uncertainty**	Ready to **use all tools available** (i.e., the QE ref. omitted)	1.26	+0 bp	+5 bp
Hawkish	**Upward revision** by 0.1% for 2018/19/20 CPI	2019/20 growth forecasts also **revised higher**	The EUR level is a **full reflection of fundamentals**	**No reference to QE** purchases or **available tools**	1.27	+5 bp	+10 bp
Very hawkish	**"Upside risks"** to the inflation outlook	Risks to growth outlook are to the **"upside"**	The EUR level **not a concern** to the Governing Council	**Asset purchases to end** by Sep 2018	1.29	+10 bp	+15 bp

In this bundle

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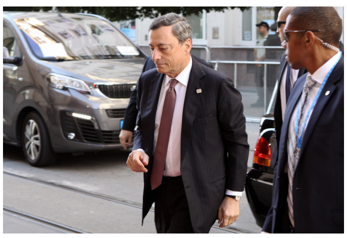
By Carsten Brzeski



FX

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By Carsten Brzeski and Benjamin Schroeder

Article | 8 March 2018

ECB preview: Angry birds

The tension between a small but vocal minority of hawks and the still large majority of doves seems to be increasing. Today's ECB meeting will offer some new insights on who is currently on top in this bird fight

Source: Shutterstock

For months, the macroeconomic situation faced by the ECB has hardly changed. The Eurozone is enjoying a strong recovery, which if anything has gained momentum over the last few months. At the same time, inflationary pressures remain low. For now, the expected inflation pick-up on the back of a strong cyclical recovery is more wish than reality. The latest announcement of possible trade sanctions from the US should have increased the ECB's vigilance.

Some relief from market developments

The market rout of recent weeks should not have impacted the ECB's assessment. On the contrary, financial market developments since the January meeting should have brought some relief to the ECB. Volatility in stock markets is something that hardly interests the bank, given the small impact that these developments have on confidence in the Eurozone. It is rather the development of bond yields, oil prices and the euro exchange rate which interest the Eurozone's monetary policymakers. And in fact, oil price and exchange rate developments since December argue in favour of a slight downward revision of the inflation forecasts (was 1.4% for 2018 and 1.5% for 2019).

Despite little inflationary pressure, the end of QE is getting closer. The risk of deflation is clearly behind us and the only question is how to moderate and implement this exit. Judging from the minutes of the last two ECB meetings and regular public statements, it is clear that there is a growing divide within the ECB on how and when to exit QE.

Watch the language

At today's meeting, we expect no hint of when QE could end but a subtle change in the ECB's language to signal that it is already en route to the exit. The broader majority in the Governing Council still seem to favour no change at all to avoid an unwarranted tightening in monetary and financial conditions, particularly now that the euro strengthening has come to a (temporary) halt.

However, even though small in number, the hawks have become more vocal. Therefore, a communication change could occur in the so-called forward guidance. According to the minutes of the last meeting, some ECB members had already called for dropping the easing bias on QE. Currently, the option for an extension or expansion of QE is linked to shocks to the economy and/or financial conditions. It is too early to drop the entire easing bias. Instead, the ECB could introduce a new concept that the full set of policy instruments would be used were the outlook for growth and inflation to worsen.

As subtle as the change in words might be, any simple change could easily revamp market speculation about a surprisingly hawkish ECB, strengthen the euro exchange rate and add to unrest in bond markets. Also, as soon as the ECB puts an end date on its QE programme, speculation about the timing of the first rate hike will start to heat up, leading to a further tightening of monetary and financial conditions in the Eurozone. Therefore, it will be a very delicate balancing act. A balancing act caused by the growing divide between a small but vocal minority of hawks and the still large majority of doves.

Bird fight

The ECB meeting should mark another cautious and very subtle next step towards the QE exit. It will also give a good indication of who is currently on top in the ECB's in-house bird fight. ECB members, however, should not forget that when real bird fights, everybody loses some feathers.

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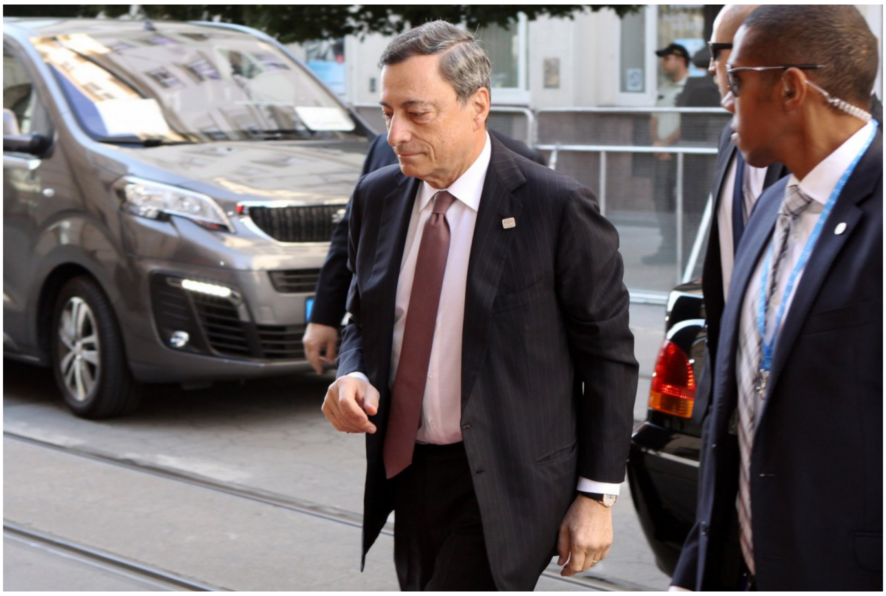
ECB positives may equate to a high-flying euro

For ECB President Mario Draghi, today is all about managing expectations. Here's what we think he'll say and how markets are likely to react



Source: Andrej Klizan

EUR: Series of small ECB positives may equate to a punchy move higher

- The ECB meeting today will take place at a time when global markets are at a pivotal juncture, which could make for a fairly interesting (or entertaining) press conference with President Mario Draghi. From the ECB chief's perspective, it'll all be about managing expectations and sending nuanced signals. For markets, we'll be looking to infer what role the global external environment (ie stock market volatility and US protectionism) is playing in the ECB's policy reaction function.
- We expect the following combination of developments from the ECB meeting today to be broadly supportive for the EUR: (1) a subtle change in the ECB's forward guidance to keep markets on their toes over the potential end to QE asset purchases this year; (2) no attempts by President Draghi to actively talk down the euro; and (3) an upward revision to the ECB's growth profile (2018 GDP nudged up to 2.4%), while no change to the CPI profile (2018 at 1.4%).

- While we don't expect any explicit QE end date to be announced today, the ECB dropping its willingness to "increase QE in size and/or duration" would be an implicit step forward towards the end of asset purchases – and might just be enough to appease the dissenting hawks within the Governing Council.
- On the currency front, expect "volatility" in the euro to be cited as a "source of uncertainty" – although this is merely a matter of fact within the context of central bank policymaking. Only direct concerns over the level of the FX – for which we think there are little grounds for justification (pointing to the flat-ish trade-weighted EUR since Feb) – would actually spook EUR investors.
- Looking ahead, markets remain relatively underprepared for the next stages of ECB policy normalisation. The short-term 3-year forward EZ OIS rate is still around 50bps below its level when the ECB began easing in summer 2014. A re-pricing here this summer will set EUR/USD on a path towards 1.30 in 2018.

With the US dollar trading soft, these small positives could amount to a fairly punchy move higher in EUR/USD today – with a potential test of 1.25 on the cards (key resistance levels to monitor are first 1.2435/45 – and then 1.2505/15).

SEK: Spectre of US protectionism warrants a near-term bearish krona outlook

We have been somewhat prompted to turn bearish on the Swedish krona – with the spectre of US protectionism and a 'trade war risk premium' weighing on the FX of small-open economies like Sweden. In addition, SEK has all but lost its relative current account surplus advantage versus the EUR – making the currency increasingly vulnerable to global risk factors. Finally, recent SEK weakness is unlikely to see a significant inflation overshoot, thus is unlikely to warrant any Riksbank response. These factors mean we now expect EUR/SEK to hit 10.30 in the coming months.

USD: Uncertainty over Trump tariff objectives lends itself to choppy trading

Various US media reports overnight state that President Trump may or may not sign a Presidential Proclamation on steel and aluminium import tariffs today, while Canada and Mexico may or may not be exempt from any measures. Such ever-changing US trade policy lends itself to a choppy trading environment – with the USD broadly on the back foot given the general White House chaos (see our note from yesterday Trade Wars – Episode II: Attack of the Cohns). The Canadian dollar saw a partial relief rally on news of tariff exemptions; CAD/MXN downside looks overdone in 2018 (-7.5%) especially given the local economic and political risks.

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Growing dissent among ECB hawks

All eyes are on the ECB's forward guidance. We don't expect any hints at when QE could end, but as always, will be looking for a subtle change in language that signals it is already en route to the exit. Expect more EUR/USD upside

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