# ECB: Will Draghi's dovish words alone be enough?

The main question today is whether the ECB can afford to wait six more weeks. It's a very close call but we reckon they'll change their forward guidance, but the risk to this call is that Mario Draghi tries to surprise financial markets. The dovish bias suggests EUR/USD breaking the 1.1100 level

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# ECB preview: One final talk before walking the walk

It's a very close call but we expect the European Central Bank to change its forward guidance next week and effectively pre-announce a package of new...

ECB President Mario Draghi delivers a speech at the European Parliament in Strasbourg back in January

A dovish press conference after the June meeting, an even more dovish speech by Mario Draghi in Sintra and very little evidence that the economic outlook is about to improve any time soon.

Against this backdrop it will be very hard for the European Central Bank to send a sufficiently dovish message without actually delivering at next week's meeting. In our view, the discussion within the ECB's Governing Council will be an exciting and heated one.

## Dovish, more dovish, most dovish or simply action?

In fact, Draghi's Sintra speech has made clear that the question regarding the short-term outlook for the ECB is no longer "what negative surprise is needed for the ECB to cut rates" but rather "what positive surprise could actually prevent the ECB from cutting rates". This is how we read Draghi's comments that - absent economic improvements - more stimulus will be needed.

Economic data out of the eurozone, as well as the Fed's de facto announcement of a July rate cut, have clearly pushed the ECB closer towards July action, rather than waiting until September. After some tentative signs of stabilisation at the end of the first quarter, the eurozone economy seems to have slipped once again. What is also worrying is that there are signs the solid domestic part of the economy may be faltering as well. In particular, German data is worrisome with an increase in short-term work schemes, fading momentum in the labour market and falling retail sales.

Consequently, for next week's meeting, the main question is whether the ECB can afford to wait six more weeks before delivering new monetary stimulus or whether it should surprise financial markets by frontloading new measures. In fact, traditional ECB watching argues in favour of compiling more data, waiting for the release of 2Q GDP in mid-August and the next ECB staff projections and only then taking a decision at the September meeting. Draghi's track record of over-delivering and trying to be ahead of the curve, however, could bring new ECB action at the ECB's July meeting. It's a very close call, which will only be decided during the meeting next week.

## What we expect the ECB to do next week

To keep a somewhat friendly balance between the doves and hawks, a typical European way out would be to step up the dovishness once again. And to be frank, it will be the very last time the ECB can talk the talk without walking the walk. In this regard, the only way out is to change the forward guidance to say that interest rates will "remain at their present or lower levels…". A pre-announcement of a rate cut in September and a clear hint that the bank is once again considering quantitative easing.

This approach would allow the ECB to collect more data and, in case macro data continues to disappoint, cut the deposit rate by 20 basis points in September, introduce a tiering system for the deposit facility and (possibly) even restart QE.

While in the past, we often believed that the ECB preferred to deliver new stimulus in small steps and in sequences, this view has changed. In Philip Lane's first encompassing speech on monetary policy as ECB chief economist, he clearly pointed to a package of measures rather than a sequencing of smaller individual steps. This means that instead of incremental moves, the ECB appears to be shifting towards bolder, bundled action.

If we are wrong and the ECB wants to frontload new monetary stimulus, next week's meeting could bring rate cuts and a clear indication that QE could restart in September.

## One final talk before walking the walk

In our view, the latest disappointing macro data, tentative signs that the resilience of the domestic economy is faltering, a potential rate cut by the Fed and continued dovish communication from ECB officials since Sintra, have all pushed the ECB to the point of no return. In fact, the ECB and Mario Draghi have taken the genie of more monetary action out of the bottle and it will be hard to get it back in. The only question is whether words alone, as dovish as they might be, will be enough. It seems as if the ECB will try to talk a very final talk before walking the walk in September. However, the risk to this call remains that Mario Draghi will try to surprise financial markets. It would not be the first time.

## Author

**Carsten Brzeski**
Global Head of Macro
carsten.brzeski@ing.de

Article | 22 July 2019 FX

# EUR & ECB: Facilitating the downside to the euro

The ECB is just about likely to stay on hold this week. We expect the dovish press conference, with guidance on a September rate cut and talk about QE, to...

## Figure 1: The ECB's Dashboard

**Scenario analysis:** How to position for Draghi's alternatives

| | Inflation outlook | Growth outlook | Forward rate guidance | *QE discussion* | EUR/USD | 2-year Schatz | 10-year Bund |
|---|---|---|---|---|---|---|---|
| *Current stance* | "Underlying inflation is expected to increase over the medium term" | "The risks… to growth outlook remain tilted to the downside" | Rates to remain "at their present levels at least through the summer of 2019" | None at this point. | | | |
| Very dovish | **Symmetricity** of CPI target **under the consideration** | Recent data suggest **slowdown in activity** | **20bp interest rate cut** & dovish rate guidance | Forward guidance on the start of the QE in September | 1.09 | -5 bp | -10bp |
| Dovish | Recent data suggest the **CPI pick up will take longer** | Recent data suggest **slowdown in activity** | **10bp interest rate cut** & dovish rate guidance | The Council **"has tasked relevant committees"** | 1.10 | -2.5 bp | -5 bp |
| ING Base Case | No language change given no new staff projections | No change given no new staff projections | Change to forward guidance: "present or **lower** levels" | Hint at **the re-start of QE should it be necessary** | 1.11 | +2.5 bp | +5 bp |
| Hawkish | No language change given no new staff projections | No change given no new staff projections | No change to forward guidance | Talk on QE seen as "premature" | 1.14 | +10 bp | +15 bp |

Source: ING

## FX: More downside to EUR...

Despite the market already pricing a 40% probability of a 10bp cut this week, more than one 10bp cut by September and close to 20bp overall easing by the end of this year, we see a downside risk to EUR/USD coming from the ECB meeting this Thursday. This is because:

(a) The ECB is likely to change the forward guidance and signal the upcoming cuts (in September and potentially beyond), thus cementing the markets' dovish expectations, and

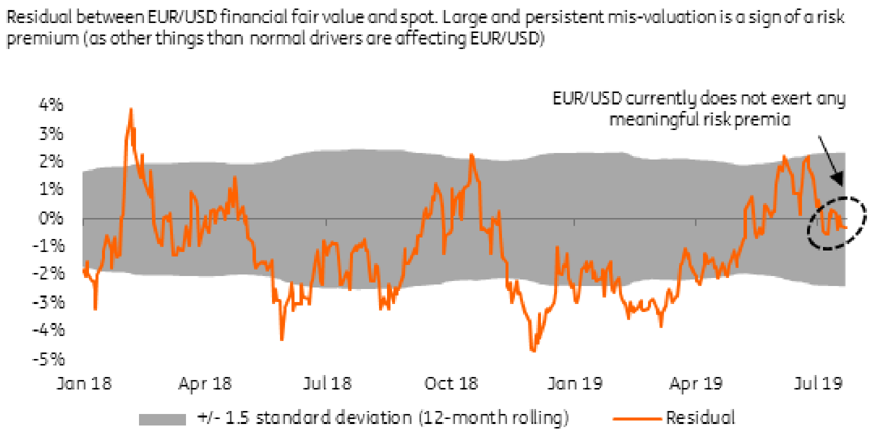
(b) President Draghi is likely to deliver a dovish press conference, with a potential hint at QE (see ECB Preview for more details).

The latter in particular should be a negative factor for EUR over the coming months as the expectations for ECB QE will continue to build.

## ... as technicals are not stretched

On a short term basis, EUR/USD currently does not exert any meaningful risk premia (as per Fig 2, the cross is fairly valued based on our short term financial fair value model). Coupled with the fairly light short EUR/USD positioning (Fig 3), there is scope for EUR/USD downside stemming from the dovish press conference (the short-term effect – coming days) and a further build-up of ECB QE expectations (the medium-term effect – coming months). In Figure 1, we provide a scenario analysis around the possible ECB July meeting outcomes.

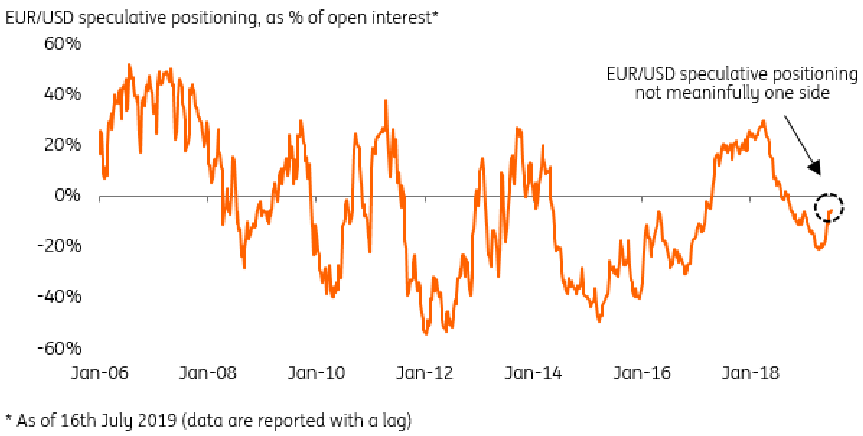
## Figure 2: No material risk premium priced into the euro




## The ECB is more likely to over-deliver than the Fed

With the market pricing almost three full 25bp Fed rate cuts this year (vs our economists' call for two cuts), from the monetary policy perspective the downside to the USD seems more limited vs the downside to EUR as, in our view, it is the ECB that will over-deliver this year (likely on the QE side). As per FX intervention: Does President Trump have the means, motive and opportunity?, at this point we see the main downside risk to USD stemming for the possible FX interventions (should the US administration frustration with the low EUR/USD rate grow) rather than an overly dovish Fed (given the still solid US data points).

## Figure 3: EUR/USD speculative positioning not materially one-sided




Source: ING, CFTC

## Bond markets: Longer-dated rates at risk of disappointment

An adjustment of the forward guidance to incorporate the possibility of lower rates would set the central bank on a clear path to cut rates in coming months. This should put the focus on the front end of the curve as markets also gauge where the new lower bound in policy rates will be. The absence of an immediate cut this time around would probably mark only a minor and in our view a temporary disappointment.

Longer-dated yields should be at greater risk of a temporary disappointment if the ECB were to remain vague on the possibility of restarting QE, and given well-advanced market expectations of a dovish press conference some profit-taking cannot be excluded.

## Authors

**Carsten Brzeski**
Global Head of Macro
carsten.brzeski@ing.de

**Benjamin Schroeder**
Senior Rates Strategist
benjamin.schroder@ing.com

Snap | 24 July 2019

# Declining eurozone PMI: More ammunition for ECB doves

The Eurozone PMI declined from 52.2 to 51.5 in July, thanks to deepening manufacturing contraction. If the European Central Bank takes this release...

Source: Shutterstock

Has the ECB already made its mind up about the course of action or can the July PMI still change things? Difficult to say, but surely governing council members will take note of it. As the second quarter has likely come in weak, this is an important first look at how the third quarter has kicked off and it does not look good.

## Growth concerns remain significant

The economy is still growing, but the pace remains weak in the third quarter. With manufacturing dropping sharply according to the PMI (drop from 48.5 to 47), concerns about the growth environment remain significant. Even though service sector activity remains strong for now, the question is how long that can be maintained when industrial production experiences a prolonged decline.

The strong service sector performance is in part driven by the surprising performance of the Eurozone labour market. As long as job and wage growth remains solid, the service sector will benefit from improving household consumption. The PMI indicates weakness in employment growth though, with manufacturing employment in Germany dropping sharply according to the indicator and falling for the third month in a row for the Eurozone as a whole. That foreshadows moderation in the service sector, making a swift recovery of growth unlikely.

Finally, the PMI signals a weakening inflation outlook with easing input prices on the industrial side. This has its impact on selling prices as businesses indicate slower inflation from both the industry and service sector side. As inflation pressures decline, the inflation outlook seems to be weakening if anything at the moment. All in all, the PMI paints a picture of an economy that is flirting more with the downside than with swift recovery. More ECB stimulus seems to be a done deal, but the timing remains an exciting question. If the ECB has yet to decide whether it is already tomorrow or September when it will act, this PMI has given the doves on the governing council even more ammunition.

## Author

**Bert Colijn**
Senior Economist, Eurozone
bert.colijn@ing.com