Bundle | 22 July 2021

It's ECB day: What you need to know

Here's the latest from ING on what to expect from today's ECB meeting. We were expecting a 'non-event'. Not anymore

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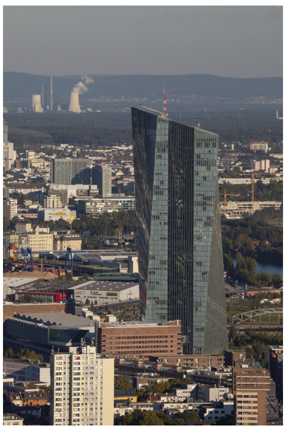

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	Inflation outlook	Growth outlook	Interest rate, QE & PEPP	Exchange rate comments	EUR/USD
Current stance	"Price pressures to remain subdued overall"	"Risks surrounding the growth outlook broadly balanced"	Depo at -0.50%, PEPP at €1,850bn until March 2022 & APP at €20bn pm	The GC monitors developments in the exchange rate	
Very dovish	ECB is "highly concerned" about too low 2023 inflation	High degree of uncertainty and risks clearly tilted to the downside	No change. GC signaling no tapering this year and early next year	The level of EUR to **force** the ECB to **adjust policy instruments**	1.1600
ING Base Case (Dovish)	Recent data suggest **a return to too low core inflation in 2022**	**Recovery will gain momentum** over summer but high uncertainty	No change, but **total reduction in QE in 2022** to be **less than expected**	**No change**	1.1700
Hawkish	Somewhat higher inflation this year on back of **one-off factors**	"Economic recovery in H2 could be stronger than anticipated"	**ECB strategic review to have no impact** on total QE reduction in 2022	**No change**	1.1850
Very hawkish	Vigilant about possible second round effects	Recent data that confirm that medium-term risks are tilted to upside	Decision to taper PEPP from Q4 onwards	Exchange rate no longer warrants monitoring	1.2100

Source: ING

What was supposed to be a non-event ECB July meeting has turned into a key focus point of the week following the release of the ECB's strategic review.

With the ECB shifting the inflation target from 'below, but close to 2%' to '2%' with a commitment to symmetry, the new strategy can be interpreted as either a formalisation of what it has been doing over the last few years anyway or a step towards more dovishness, as 2% implies a more resolute effort (see ECB Preview for more details).

This means the distribution of probabilities is skewed to lower EUR/USD. No change in the ECB bias is unlikely to be enough to send the euro higher as the ECB will remain cautious, and the Fed is much closer to starting the monetary policy normalisation process (both on the QE side and the interest rate side). At the same time, any ECB shift towards the dovish interpretation of the strategic review would underscore the recent downward EUR/USD trend.

> While not a discussion for this week, the ECB dovish bias would suggest that the total reduction of the monthly purchases in 2022 will be less than previously expected.
>
> This would further underscore the diverging trend between the ECB and the Federal Reserve and put a lid on any EUR/USD upside while exposing EUR/USD on the downside next year when the Fed should be moving closer to the interest rate hikes.

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Article | 15 July 2021

ECB preview: Clarification of the clarification

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Source: Shutterstock
Christine Lagarde, president of the European central bank

Until a week or so ago, today's ECB meeting was set to be a non-event; an intermediate meeting to bridge the time until the 9 September meeting. However, with the release of the ECB's strategy review last week, any ECB watcher hoping for early summer vacation had to change their plans. Now it's suddenly become very interesting as it should bring more clarity around how the ECB wants to implement its new strategy.

New strategy - new questions

Remember, the new strategy has set the inflation target from 'below, but close to 2%' to '2%' with a commitment to symmetry, meaning that 'the Governing Council considers negative and positive deviations from this target as equally undesirable', however, temporary or transitory deviations from the target will be tolerated. Particularly the latter can be seen as a reconfirmation of the current stance of looking through the period of higher inflation, mainly driven by one-off factors.

The new strategy can be interpreted in two ways: it is either just an official formalisation of what the ECB has been doing over the last few years anyway or it is a step towards more dovishness as 2% implies a more resolute effort, leaving less flexibility than 'below but close to'. If the latter is the case, the ECB's own inflation projection of 1.4% in 2023 would forbid any tapering in the coming months. It would even not allow for an end of the front-loading of the asset purchases under the Pandemic Emergency Purchase Programme (PEPP), which currently runs until March next year. In fact, a strict interpretation of the strategy might even suggest paving the way for more but definitely not less asset purchases.

We don't think the ECB will go as far as actually stepping up its bond purchases given the hawks at the ECB were already suggesting a reduction of the asset purchases at the June meeting. But given that the delta variant and new waves of Covid-19 in several eurozone countries cast enough uncertainty for the hawks to keep silent until the September meeting but stepping up bond purchases would clearly be a step too far.

New forward guidance

After the presentation of the strategy review, ECB president Christine Lagarde suggested changes to the ECB's forward guidance at next week's meeting. But what could this be?

Currently, the ECB has basically three kinds of forwards guidance: on rates, on the PEPP and the Asset Purchase Programme (APP). Interest rates are expected to remain at their current or lower levels until the inflation outlook has 'robustly' converged to the ECB's target. PEPP will last until the end of March 2022 or 'until the Governing Council judges that the coronavirus crisis phase is 'over'. Forward guidance on APP is probably the vaguest as it is expected 'to run for as long as necessary to reinforce our policy rates' accommodative impact and end before the first rate hike.

> *The new strategy and more dovishness suggest that the total reduction of the monthly purchases in 2022 will be less than previously expected*

In our view, there is little to change in the forward guidance on rates. Instead, the ECB could prepare its own operation twist, linking the APP closer to the inflation target, which would open the door for reduced PEPP purchases and, at the same time, increases of the APP purchases. Another important point could be clarifying the ECB's definition of the end of the 'coronavirus crisis'. Is the pandemic over when the eurozone has reached herd immunity, or when the economy has reached its pre-crisis level or when the ECB's own inflation projections are back to where they were in late-2019?

All of this makes next week's ECB meeting an exciting meeting, and we expect a very heated debate behind the scenes. On top of the new strategy, the ECB is also facing a new inflation reality, in which views on the risks of second-round effects and the pass-through from higher producer prices to consumer prices clearly differ, to say the least.

We still think that eventually, the ECB will reduce the PEPP purchases and increase the APP purchases. However, the new strategy and more dovishness suggest that the total reduction of the monthly purchases in 2022 will be less than previously expected. The ECB's new strategy is meant to clarify and simplify the conduct of monetary policy.

To get there, we definitely need another round of clarifications, hopefully, next week.

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Source: Shutterstock
ECB President Christine Lagarde in Brussels

USD: All about the ECB today

The ECB meeting today is largely seen as the main event in a week where major FX currencies have not shown large moves.

Still, defensive trades have generally dominated the FX market, leaving the dollar supported against all pro-cyclical G10 currencies except for the loonie, which appears to be benefitting from a delayed positive impact from last week's BoC tapering announcement (which in our view suggests asset purchases in Canada will end by the end of 2021). The data flow in the US remains very light and looks unlikely to drive market expectations ahead of next weeks Federal Reserve meeting in one direction or another.

EUR: Dovish ECB unlikely to help the euro

Last week's comments by Christine Lagarde and the recently published strategy review raised the stakes for today's ECB policy meeting.

As discussed in our "EUR & ECB Cribsheet", we think the distribution of probabilities for EUR/USD are skewed to the downside today. The main reason is that we see a non-negligible risk that the clarifications following the strategy review will lead markets to think that the Bank will increase purchases under the APP while unwinding the PEPP, which ultimately suggests that the pace of tapering for 2022 may well be smaller than previously expected. In addition, we think that any clarification about the new symmetrical inflation targeting will underscore how this will imply a more dovish stance.

Despite President Lagarde announcing last week how there will be a change in the ECB guidance today, our economists do not think this will be in the sphere of rates forward guidance, which should remain anchored to the lower-bound, but instead on the mix between PEPP and APP, which, as mentioned, could imply a lower net reduction of purchases in 2022. This should underpin the notion that the ECB is not following the Fed in its hawkish trend, and encourage markets to stay broadly bearish the EUR/USD for today when we could see a decisive move into the lower half of the 1.1700-1.1800 area.

Still, we expect the ECB-Fed policy divergence to fully emerge in 2022 when we expect EUR/USD to give up the gains we still forecast to see in 2H21.

GBP: Re-aligning with short-term fair value

EUR/GBP corrected lower and is trading below 0.8600 this morning. According to our fair value model, the recent spike in the pair has led it to reach a short-term overvaluation.

In line with our view that the ECB meeting may have a negative impact on the EUR, EUR/GBP may continue retracting today. However, any sustained downtrend in the pair may have to face the Brexit-related news flow, which is once again signalling the political divergence between the UK and the EU as the latter reiterated that re-negotiating the Northern Ireland Protocol is not an option.

ZAR: SARB unlikely to be rushed into hikes

South Africa's central bank – or SARB – meets today to set interest rates and is widely expected to keep the policy rate at 3.50%. Unlike peers in Russia, Brazil and Mexico, the SARB is not being rushed into rate hikes since inflation remains remarkably contained in South Africa. Headline and core are just 4.9% and 3.2% YoY respectively – well within the SARB's target of 4.5% +/- 1.5%.

The SARB does note upside risks to inflation – largely through wages or energy prices – but it looks too early for the SARB to conclude anything from the recent widespread riots – e.g. South Africa's largest oil refinery recently had to shut due to public safety concerns.

The riots will impact growth, however, though again it may be too early for the SARB to revise lower its 4.2% GDP projection for 2021 – a forecast only recently revised higher.

What does all this mean for the ZAR? The SARB in May felt that the ZAR was near its long run equilibrium level – USD/ZAR was trading 14.00 at the time. While strong terms of trade, high trade surpluses and 5% implied yields all make the ZAR look attractive, we doubt USD/ZAR can make it below 14.00 on a sustainable basis anymore. And were the SARB to sound a little hawkish today (cementing the two hikes expected by the market by year-end), we suspect the 14.25/35 area may be the best levels for the ZAR, before USD/ZAR heads through 15 later this year.

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ECB: lots of noise and a dovish message

Today, the ECB has the first opportunity to revise its forward guidance, the promise not to unwind asset purchases and raise rates until inflation picks up, to reflect its new inflation target announced two weeks ago. To many, the symmetric inflation wording and promises of more forceful action when it undershoots sound familiar from past ECB communication. Perhaps the greatest change was the fact that the new wording was endorsed by the entire governing council.

It is fair to say that a change in forward guidance will prove more controversial. However, we are led to believe, through president Christine Lagarde's public comments, and through 'EC sources' stories in the press, that it too will receive an update. The aim to make forward guidance clearer is laudable but we doubt it is achievable, as long as the ECB stops short of quantitative targets. The inclusion of words such as 'forceful' and 'persistence' would convey urgency but leave significant room for interpretation.

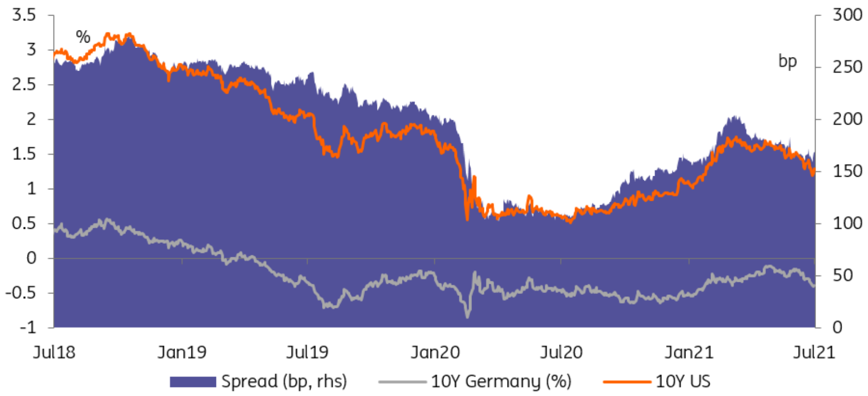
Rates markets will want to know how the new wording will translate into asset purchase amounts

What is clearer is that the aim of any change is to send a more dovish message. Rates markets will want to know how the new wording will translate into asset purchase amounts, and timing of rates hikes. We are unsure the ECB will go as far as spelling these out but, at a push, we think markets will understand new forward guidance as sign that APP (one of the two asset purchase programmes with PEPP) will receive a boost when PEPP is stopped in March next year. We already expected this but more dovish ECB comments should help more to come around to our view.

Market reaction: QE as far as the eye can see

Market reaction should be fairly straightforward, rates need to price purchases continuing for longer and outstripping supply for at least another year. The magnitude of the move will depend on how specific the ECB is in its forward guidance, and how explicit it is in flagging more APP purchases. With 10Y Bund yield flirting with 0.40%, only 10bp above the deposit rate, one can easily see that downside is limited. But what today's meeting should achieve is reduce EUR rates' ability to rise in tandem with their USD peers when the current gloom finally dissipates.

German yields are already low but the ECB could reduce their ability to rise alongside US rates



Source: Refinitiv, ING

The alternative scenario is one where the ECB fails to agree on any change, or where these changes are so woolly that the market fails to draw any conclusion. This outcome would be slightly detrimental to risk assets in our view, as it would imply lower central bank support due to divisions. In the near-term, we also see this as a reason for EUR rates to remain pinned down, but this could leave them more leeway to rise when the economy picks up.

Today's events and market view

The ECB policy decision and press conference are the main events today. In the US, the release of jobless claims and existing home sales will be the main focus. We expect a slight rebound in EUR yields after their July drop, as profit taking on tactical longs dominate price action. Markets can take a while to fully digest central bank decisions, especially when it comes to ambiguous forward guidance, but we expect lower and flatter curves in most scenarios (see above).

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Market mumbo jumbo

Any hint of looser monetary policy and bond yields rise? Is this what we've come to?

If this is the new normal, give me the old one back

Attempting to make market sense of the economic newsflow has been a 28-year struggle, though it is usually achievable, at least after the fact. But this morning's attempt to try to explain a 6.7bp increase in 10Y US Treasury bonds has taken me to a place I didn't think I'd ever go. In recent months, it has been possible to explain the decline in US Treasury yields as a reversal of tighter policy trades, which you can see in terms of the decline in USD OIS implied yields. Basically, if you take a very rough and ready approach to forecasting bond yields, you can make a case that the 10Y should bear some relation to peak Fed funds in a business cycle, adjusted for time preference and so on. That sort of works...It's a variant of the envelope theory of interest rates if that rings any bells with any of you?

Today, while the newsflow from the US, on the whole, looks fairly supportive for the bond market - a failed Senate infrastructure vote and rising Covid cases, what seems to be driving the outsize move up in Treasury yields is a rumour that Fed Chair Powell has the nod for a second term as Fed chairman. This, the reasoning goes, means that the Fed will be more likely to maintain its dovish stance, and keeps hawks like Bullard and Kaplan in check. A prolonged dovish policy will help to keep growth hopes alive, and allows for higher bond yields through both a higher real yield and higher inflation expectations.

If this doesn't sit comfortably with you, here's why you might be struggling to digest this. And it is probably because it implies that any deviation from current zero interest rates will quickly start to undermine the growth story. If so, then the US economy is in a far more delicate state than it would appear. With growth tipped to achieve about 7% this year and close to 5% next, this is a hard story to swallow. And that's without even thinking about inflation.

It also suggests that the current stance of policy is actually providing some genuine support to the economy, other than through lifting financial asset valuations. And though this was probably the case at some point, I'm just not sure that the monetary stance is all that relevant for the growth outlook now. Personally, I would find a shifting fiscal stance a far more reasonable cause for a change of market outlook. Show's what I know...!

Watch the EURUSD today

Today's other main source of market interest is the ECB meeting. With the ECB strategy review already out of the way, the time has come to see how strategic change will affect policy, if at all.

The linked crib sheet from Carsten Brzeski and Petr Krpata shows the likely scenarios for the alternatives we think are most likely, and their take is that it is a question of how (little) asset purchases will be reduced in net terms once the Pandemic Emergency Purchase Programme (PEPP) ends next year. In other words, it should move EURUSD down. I'll just throw in the newswire take on this to play devil's advocate, as they are asserting that the EUR is oversold right now, and are weighting their bias to a EUR rally. I think our guys would see that result as a failure of communication on the ECB's part if that happened. Anyway, read their piece and make your own mind up.

Asia still dominated by Covid

As well as the ebb and flow of global financial markets, closer to home, Asian markets still seem to be being dominated by Covid, with what I am terming the Covid-3 of MYR, THB and IDR all at the softer-end of the FX spectrum yesterday. At the other end of the pack, the CNH made further gains.

For newsflow today, we have further announcements of tightening of movement restrictions in Java and Bali, which seems to fly in the face of yesterday's suggestion from President Jokowi that measures may be eased by July 26. As we stated yesterday, we are still alarmed by the combination of high (though falling) daily cases and a high and rising death tally. It doesn't feel to me that this is the time to be easing up on movement constraints in those countries where death rates are still accelerating.

Bank Indonesia meets today, Nicky Mapa in Manila writes, "Governor Warjiyo is widely expected to keep rates steady today to provide support for the economy. With the country hard hit by a surge in Covid-19 infections, monetary authorities will likely provide support for as long as possible although additional rate cuts are likely off the table given the recent pressure on IDR. With options limited for Governor Warjiyo, we expect the central bank to resort to other programs to help jumpstart bank lending such as incentives for loans to particular sectors of the economy".

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