

## Our guide to July's ECB meeting

This week's ECB meeting may be low on action, but it will be big on words. We highlight and explain the key things you should listen out for in Draghi's speech and what it will all mean for markets.

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By Carsten Brzeski



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By Benjamin Schroeder

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### Verbal acrobatic skills

How will the ECB get round a pretty basic conundrum? On the one hand, the ECB wants to prepare financial markets for tapering, without creating a ‘taper tantrum’. On the other hand, in a world without inflationary pressure, the ECB will have to substantiate the tapering preparation with economic arguments that do not leave market participants completely stumped: a balancing act that requires all of Draghi’s verbal acrobatic skills.

### Growth without inflation

The general macro picture in the Eurozone has not changed since the ECB’s early June meeting. Confidence indicators remain strong, despite some recent downward corrections. Activity has picked up further, but inflationary pressures are almost impossible to find. If anything, the drop in oil prices, the pickup in bond yields and the strengthening of the euro have further (at least technically) deteriorated the ECB’s inflation outlook.

### ECB Bull-Bear

	Bull ↓	Bear ↑	ING →
<b>Monetary stance</b>	There has been little change to the monetary stance over the last few weeks.	Cyclical upswing argues in favour of some withdrawal of monetary accommodation.	→ Economic data argues for a wait-and-see stance.
<b>Inflation</b>	Low headline inflation and core inflation being close to 1% could still argue in favour of further easing.	With deflationary risks having disappeared, some might argue in favour of less monetary stimulus.	→ Deflationary risks have disappeared, but no inflationary risks are in sight.
<b>Economic growth</b>	Although growth in the Eurozone has been positive for several quarters in a row, structural problems are capping the upside potential.	Weak growth rates need more structural reforms and fiscal stimulus, but no additional monetary easing.	→ The Eurozone economy continues to grow, without producing inflationary pressure.
<b>Exchange rate and asset prices</b>	Further monetary easing could lead to a weaker euro and support exports as a result.	A further strengthening of the euro exchange rate is currently not an option for the ECB.	→ Despite the recent strengthening, the euro exchange rate remains favourable for Eurozone exports.
<b>Politics and fiscal policy</b>	Political uncertainty and the lack of fiscal stimulus argue in favour of more monetary easing.	Loose monetary policies undermine the incentive to implement structural reforms.	→ With interest rates at record low levels, any changes would only have a marginal impact on fiscal policies.

## Disinflationary without deflation

More generally speaking, the ECB will continue facing very little home-made inflationary pressures.

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*There are reasons to believe that wage growth in the Eurozone is bound to stay lacklustre.*

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Slack in the labour market and sectoral and technological changes all argue against a fast pick-up in Eurozone wage growth, even with GDP growth above trend growth. In addition, digitalisation, as long as it continues to increase in importance in B2B and B2C, is likely to apply downward pressure on consumer prices due to higher price transparency and more competition, now also in services.

## Preparing without distorting

Evidently, given bond market developments of the last two weeks, the ECB's macro assessment will not be the main item on next week's meeting agenda. A possible unwinding, or tapering, of QE is on the top of the mind of every market participant and ECB watcher. We believe that, given the cyclical upswing, the disappearance of deflationary risks, opposition to QE from some ECB members and the bond supply scarcity issue, the ECB wants to move towards tapering. However, the ECB ideally would like to prepare markets without distorting them.

## Tapering without inflation

In this process of moving towards tapering, the absence of any inflationary pressure makes the narrative a bit complicated. This is why Draghi tried to adjust the official communication and line of argumentation away from inflation and towards a new concept of a monetary policy 'speed limit'. In this context, the key phrase in Sintra, Portugal, was: *"As the economy continues to recover, a constant policy stance will become more accommodative, and the central bank can accompany the recovery by adjusting the parameters of its policy instruments – not in order to tighten the policy stance, but to keep it broadly unchanged"*; the ideal new narrative for the ECB to prepare to taper.

## Verbal acrobatics without action

In our view, the ECB's 'tiptoeing' towards tapering will continue and we expect Draghi to repeat the key messages from the Sintra speech next week. Particularly, however, the reaction of bond markets over the last two weeks was a good reminder of how thin the line is between preparing markets and distorting them. Though some steepening of the yield curve is fine, a real 'taper tantrum' is not. This is why some dovish remarks by Draghi should not be excluded. The best way to do this would be by stressing the sequencing, ie, by dropping clear hints that a first interest rate hike will not come before the end of QE.

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Source: Shutterstock

### Fully justified EUR/USD strength – break above 1.1500 is on the cards

We see the two-step post-French elections EUR/USD rally as fully justified starting with a build-up of QE taper expectations, amplified by Draghi's Sintra speech, mainly driven by steeper German yield curve. It seems it will only be a matter of time before EUR/USD breaks through 1.15 (as bund yields nudge up), with an overshoot around the ECB September meeting.

### Materially lower EZ yields not necessarily desirable at this point

We see limited scope for lower Eurozone sovereign yields. While the ECB wants to avoid a taper tantrum bund sell-off, it also seeks to pre-prepare the market for eventual QE tapering via gradually higher yields. Thus, a dovish surprise and sharp decline in bund yields is not desirable. The likely retention of the QE easing bias (the threat of an increase in QE duration and size) may push German 10-year yields lower, but don't expect a material move below 0.55%. We could see German yields rise hit 0.65% later this year.

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

	Inflation outlook	Growth outlook	Forward rate guidance	QE taper guidance	EUR/USD	Short end	Long end
	Inflation measures "continue to remain subdued"	"The risks... to growth outlook are considered to be broadly balanced"	Rates to stay "at present levels for an extended period"	QE "to run until the end of December, or beyond, if necessary"			
Dovish	Outlook for inflation has further deteriorated	Reintroduction of downside risks	Reintroduce "...at present or lower levels..."	"Need for unordinary high monetary stimulus"	1.11	-5 bp	-15 bp
ING Base Case	Inflationary pressures remain subdued	Distribution of risks unchanged	No change to the wording; <b>emphasise sequencing</b>	No hint at timing of the QE tapering; <b>QE easing bias kept</b>	1.14	flat	-5 bp
Modestly Hawkish	Current low inflation is transitory	Distribution of risks unchanged	Wording unchanged; <b>lack of sequencing talk</b>	Drop QE easing bias: threat of increase of duration, <b>NOT size</b>	1.16	+5 bp	+5 bp
Very Hawkish	"First signs of inflation pressures building up"	"Upside risks to growth outlook"	Remove "present", idea of sequencing <b>scrapped</b>	ECB "already looking" at QE tapering options	1.18	+10 bp	+15 bp

Source: ING

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