We find the 'excitement' from Thursday's ECB announcement

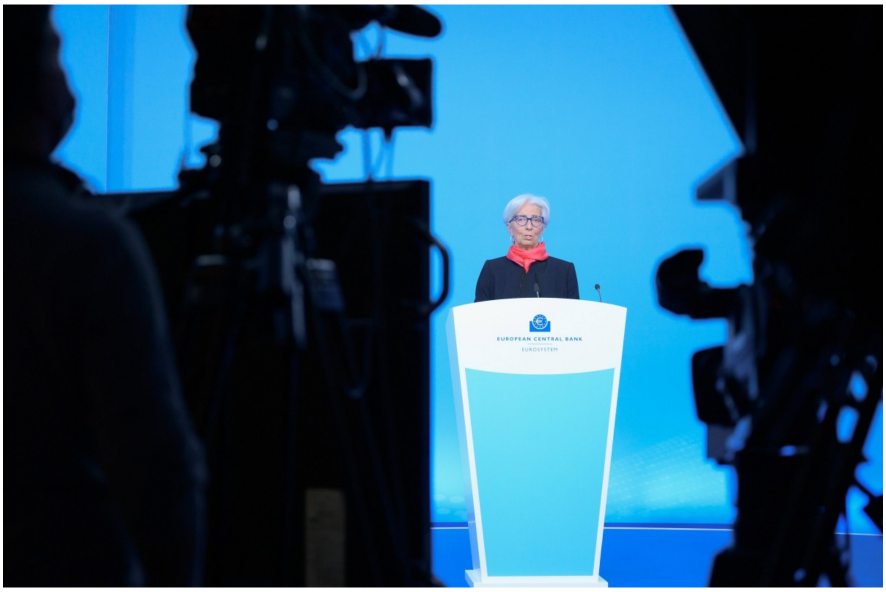
The European Central Bank kept everything unchanged today, on paper. Carsten Brzeski has his take on the initial 'news' and switches his attention to the more interesting press conference. Francesco Pesole says the downside risks for the euro have decreased and EUR/USD can find a new range. Here's our full roundup from today

In this bundle

Snap | 3 February 2022

ECB chooses copy-paste

No changes from the ECB. Just a copy-paste of the December decisions. Now let's wait for the press conference to see whether ECB president Lagarde...



ECB President, Christine Lagarde, pictured last month

The ECB just hit the copy-paste keys and kept everything unchanged. As expected, all monetary policy instruments were left unchanged and even the wording was a verbatim copy of the December decisions. No one could have seriously expected the ECB to act today as there is simply nothing the ECB can do to bring down inflation immediately. In fact, there is nothing the ECB can or could do to bring down energy prices. Only governments could act by, for example, lowering taxes and by providing financial support to compensate for households' high energy bills. Maybe this is also another conundrum of the pandemic: governments are needed to bring down energy inflation, while central banks (and low interest rates) are needed to support fiscal stimulus.

Anyway, all eyes will now be on the ECB press conference starting at 2.30pm CET. We expect the ECB to buy more time and to push any changes in monetary policy to the March meeting when a fresh set of macroeconomic forecasts will be available. Today, it will be all about the tone and words. If ECB president Christine Lagarde confirms previous statements that "it is very unlikely that we will raise interest rates in the year 2022", she would unnecessarily paint the ECB into a corner. Instead, keeping the doors open for a faster reduction of asset purchases and even a rate hike this year would be a wiser strategy to take.

Author

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

Article | 3 February 2022

ECB performs hawkish backward roll

In today's meeting, the European Central Bank made a remarkable hawkish backward roll. While there were no changes in the ECB's action, the...

Christine Lagarde, president of the European Central Bank

Regarding actual decisions, the European Central Bank (ECB) hit the copy-paste keys and kept everything unchanged. As expected, all monetary policy instruments were left unchanged and even the wording was a verbatim copy of the December decisions. The ECB only took out the words “in either direction” when confirming that the Governing Council stood ready to adjust all of its instruments. As the ECB confirmed that interest rates would remain “at present levels or lower levels”, this small change in communication does not signal a change in the ECB's stance.

It was the press conference and the official introductory statement that brought the excitement today. The ECB still expects a strong economic recovery over the coming months and pointed to strong labour market developments. At the same time, the risks to the economic outlook were still labelled as "broadly balanced" but the ECB stressed more downside factors than it has previously. Regarding the inflation assessment, the ECB was much less outspoken about the expected inflation trajectory than it has been. Even more interestingly, the ECB for the first time in years reintroduced the phrase that “risks to the inflation outlook are tilted to the upside”. If we remember correctly, this risk assessment had disappeared from the ECB's introductory statements when quantitative easing (QE) was started. While this phrase had been absent from official ECB communication for almost a decade, funnily the well-known hawks Klaas Knot and Jens Weidmann actually used this exact phrase in speeches and comments in September and October last year.

Another crucial element signalling the ECB's hawkish backward roll today was President Christine Lagarde's refusal to confirm her earlier statement (that she made several times before) that "it is very unlikely that we will raise interest rates in the year 2022". The door to a rate hike is wide open, even though Lagarde stressed that the principle of sequencing, i.e ending net asset purchases first before hiking rates, was still in place.

Hawkish push to the March meeting

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All in all, today's ECB meeting marks an important hawkish shift. For some, it even looks like the late revenge of the hawks. In any case, the ECB postponed taking any next steps until the March meeting when a fresh round of macro, and particularly inflation forecasts, will be available. Lagarde opened the door to a speeding up of asset purchase reductions and a rate hike this year. Taking all this into consideration and assuming that energy prices do not dive over the next four weeks, we expect the ECB to speed up the reduction of net asset purchases and to bring them to an end in September, allowing the ECB to hike the deposit rate at least once before the end of the year.

Author

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

Article | 3 February 2022 **FX**

EUR/USD: A new range after the ECB meeting

With the ECB dropping its forward guidance and markets heavily speculating on 2022 tightening, EUR/USD may find consolidation within the 1.13-1.15 range...

A big shake-up after Lagarde's hawkish shift

As discussed in our economics team's ECB meeting review, President Christine Lagarde's press conference fell quite clearly on the hawkish side of the spectrum today. The stance on inflation has continued to mutate into a more alarmed one, as risks to prices are now seen as tilted to the upside despite lingering expectations that inflation will ease later this year. Most importantly, the explicit guidance for rates to be kept unchanged in 2022 was dropped, and Lagarde seemed to put a lot of focus on the March meeting, when an updated forward guidance may well be released along with the new staff projections.

After the press conference, it was also reported that the ECB is indeed gearing up for a policy shift in March, and now agrees it is sensible not to exclude a 2022 hike.

All this has clearly paved the way for markets to speculate quite freely on a change in forward guidance in March (i.e. explicitly signalling the chance of a 2022 hike) and by extension on the pace, size and timing of ECB tightening. The market reaction saw eurozone bonds sell off sharply, the December 2023 Euribor dropping by around 20 ticks, markets moving to price in a first 10bp rate hike in June 2022 (and around 50bp of tightening by year-end), and EUR/USD jumping to the 1.1400 level.

EUR/USD to consolidate within 1.13-1.15 into the March ECB meeting

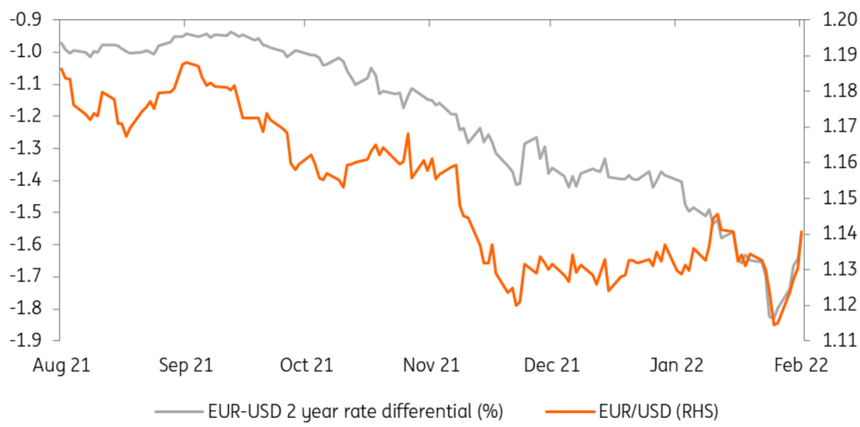
Today's spike in EUR/USD followed a strong rebound from last week's 1.1130 2-year lows, which was fuelled by a combination of EUR strength after the high inflation numbers on Monday and a generalised weak dollar environment caused by soft US data and some position-squaring. We suspect the dollar will have to process the fall-out of a likely subdued January jobs report tomorrow before finding some fresh support, which should help EUR/USD hold on to post-ECB gains for now.

Incidentally, a market that is aggressively speculating on an ECB hawkish shift in March and a start the tightening cycle by the summer should continue to offer some idiosyncratic support to the euro in the coming weeks. After all, even if the market's hawkish bets are overdone, they may not be strongly challenged until the 10 March meeting itself.

> We think that the post-FOMC 1.11-1.13 range in EUR/USD has now given way to a 1.13-1.15 range, which may hold into the March ECB meeting.

The longer-term: Less downside risks, but upside room remains limited

Last week's 1.1130 lows in EUR/USD were embedding a wide divergence in the Fed-ECB monetary outlook: as shown in the chart below, the differential between US and German 2-year yields had reached 180bp after the Fed's hawkish message, the highest since March 2020.



Source: ING, Refinitiv

With the ECB having now dropped its dovish forward guidance and markets pricing in multiple hikes this year, it's not unreasonable to conclude that the peak of the Fed-ECB policy divergence is past us. Accordingly, and given the relevance of rate differentials as a driver of EUR/USD in the current market environment, it can't be excluded that the pair touched a cyclical bottom last week.

Still, we remain reluctant to shift to a medium-term bullish view on EUR/USD, as even though a 2022 rate hike in the eurozone now appears increasingly likely, we doubt it will be delivered before 4Q, and we therefore expect some re-pricing of the current aggressive ECB rate expectations further down the road this year. On the contrary, the market's pricing on Fed tightening (five hikes in 2022) is in line with our economists' call, and objectively not as aggressive as the ECB pricing considering the much higher inflation outlook and three hikes already included in the FOMC Dot Plot.

> With this in mind, we continue to see some moderate downside risk for EUR/USD for the remainder of the year, although we acknowledge that sub-1.10 levels now look too extreme, and instead favour a flatter profile around 1.12-1.13 into year-end.

Author

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

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