

What to expect from the ECB today

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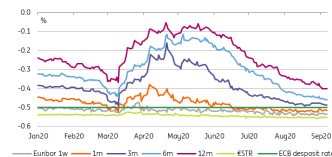
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Source: Shutterstock

Scenario analysis: How to position for Lagarde's alternatives

	Inflation outlook	Growth outlook	Interest rate, QE & PEPP	Exchange rate comments	
<i>Current stance</i>	Inflation outlook "surrounded by an exceptional degree of uncertainty"	"Activity is expected to rebound in the third quarter"	Depo at 0.50%, QE & PEPP commitments unchanged	No prior reference to the euro	EUR/USD
Very dovish	Inflation projected at 1% in 2022. ECB "highly concerned"	High degree of uncertainty and risks clearly tilted to the downside	Downside risks still present, further depo cuts on cards	EUR strength considered as "brutal"	1.1500
Dovish	Recent data suggest the CPI pick up will take longer	Recent data suggest significant levelling off	No change, but hints at eventual PEPP extension	Stronger euro weighs on growth and CPI outlooks	1.1700
ING Base Case	Downward revision to CPI forecast by 0.2% for 2021 & 22	Downside risks have started to disappear	No change, forward guidance for lower rates for longer	Exchange rate is not a target but ECB monitors closely	1.1850
Hawkish	Risks to the inflation outlook are balanced	Risks to the economic outlook are balanced	No change, current envelope for PEPP more than sufficient	EUR strength having a limited impact on econ / CPI outlooks	1.2000

All eyes on focus is on the euro comments

Were it not for the strong euro, the September European central bank meeting on Thursday would probably have been a non-event.

Growth outlook hasn't deteriorated versus the last forecast (particularly in light of the prior pessimistic ECB projections) and although the CPI forecast is likely to be revised lower, the monetary policy set up is already very loose (i.e, material asset purchase via QE and PEPP, and deeply negative rates), raising the bar for differentiating and impactful additional easing steps.

[Read Carsten Brzeski's ECB preview for more on inflation forecasts](#)

Too early for ECB to forcefully talk down the euro...

While the some of ECB Council member's comments showed an uncomfortableness with the recent EUR strength, we think it is too early for the ECB to forcefully talk down the euro this week.

We don't look for Trichet-like comments on a "brutal" EUR appreciation. Rather, President Christine Lagarde may highlight that the central bank monitors the euro closely while reiterating that the exchange rate isn't seen as a target. We also don't expect the ECB to hint at the extension of the PEPP programme beyond 2021 just yet, suggesting that EUR/USD should not be affected much by the meeting.

... and if attempted, it will be difficult to talk it down

Although the euro is on the ECB radar, we don't expect potential verbal interventions to be strong enough to send EUR/USD materially and persistently lower as (a) there is not much the ECB can do (i.e, the depo rate is already negative, asset purchases are already large, and while the PEPP extension beyond mid-2021 is a possibility, it is unlikely to come this week and is in fact already expected by the market to eventually come in one of the next ECB meetings) and; (b) the case for a structural USD bear trend remains strong, with the Fed's adoption of the Average Inflation Targeting strengthening the narrative for low US real rates for longer – which should, in our view, be the key driving force behind the USD weakness in quarters to come.

[For all our latest FX markets views, read FX Talking](#)

Speculative community has built significant net EUR/USD longs



* As of 1st September 2020 (data are reported with a lag)

Source: ING, CFTC

Into the year-end, the vigilant ECB, the risk surrounding the November US presidential elections and one-way net-long EUR/USD positioning should tame the euro upside.

But as the USD bear trend continues into mid-2021, EUR/USD is likely to push to/above the 1.25 level next year.

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ECB preview: Another communication test

Next week's ECB meeting could open the door to additional easing before the end of the year



Source: Shutterstock

When Christine Lagarde started her job as ECB president last November, the job description was mainly focused on possible normalisation of monetary policy, reviving the team spirit in the Governing Council and preparing the strategic review. Ten months later, Lagarde has gone through a sea of emotions and the worst economic crisis in decades.

Tomorrow's meeting will bring another communication test for Christine Lagarde: how to temper the euro without causing unwarranted market movements.

What to watch

In our view, there are three important issues to look for.

There is a fresh set of ECB projections, related to this lots of attention will be on the ECB's reaction to the recent strengthening of the euro and finally, with the Fed's latest announcement, there should be interest in the ECB's own strategy review.

As regards new macro projections, we expect the ECB to acknowledge the v-shaped rebound since the lifting of the lockdown measures, while at the same time still stress the high level of uncertainty. To some extent, comments by ECB officials over the last weeks suggested some slight

differences regarding the ECB's economic assessment. While Isabel Schnabel underlined that the ongoing recovery was basically in line with the ECB's own base case scenario, Philip Lane sounded somewhat more cautious, pointing to the probability of a long-lasting and only gradual recovery.

We will have a close look at the ECB's inflation projections. In June, the ECB expected an inflation rate of 1.3% for 2022. Any downward revision will increase the likelihood of additional monetary stimulus.

The recent strengthening of the euro could be one driver for such downward revisions. The stronger euro could easily lead to a downward revision of the inflation forecasts by 0.2 percentage points. However, recent ECB research stresses that the impact of exchange rate moves on inflation, as well as growth, depends on the nature of the shock and many structural factors.

Interestingly, and in our view highly policy-relevant, the ECB's research also concludes that the more credibly and effectively monetary policy counteracts external inflationary pressures, the lower the pass-through of exchange rate movements will be. An open door for more stimulus.

As regards the ECB's strategy review, the Fed's decision to move to an average inflation target has set the scene. We don't expect any insights into the ECB's strategy next week.

It is hard to believe that Christine Lagarde will want to preempt the discussion which has just started. In the end, however, we still see the ECB moving to a more symmetric target changing the definition of price stability to "around 2%".

How to talk 'euro'

Given the still high level of uncertainty surrounding any economic outlook, the ECB is highly unlikely to change its policy stance tomorrow.

The interesting part of the meeting and the press conference will be Lagarde's comments on the euro exchange rate. She knows that it is hard to reverse a trend in the fx market only with words. Words can dampen or temporarily stop a trend but can also accelerate it. However, all of this is not of the highest importance.

What will count most next week is the question of whether the stronger euro has already opened the door for more monetary stimulus in the coming months.

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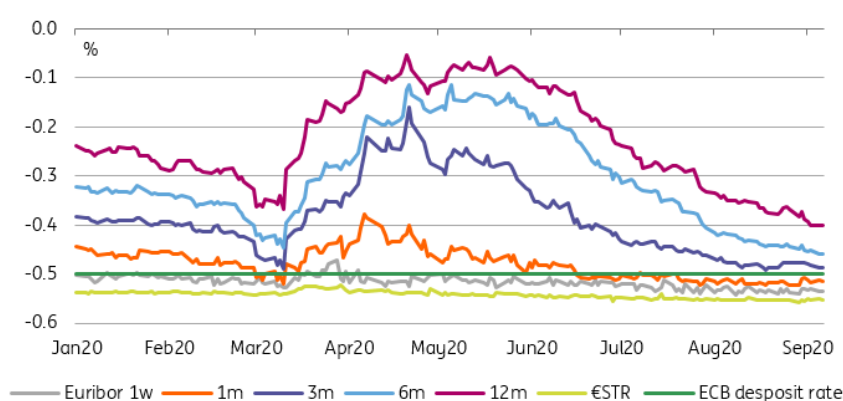
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Source: ECB, EMMI, ING

EUR rates market are normalising

When trying to decipher market behaviour around today's ECB meeting, it is worth distinguishing between near term 'knee-jerk' reaction and the longer-term trend.

Our long-term view is: rates are reflecting a protracted recovery and lasting damage to inflation. However, there is no longer a basis to reflect the same degree of market stress they did back in the spring.

This suggests to us that despite low outright rates, a normalisation of the EUR yield curve is justified. This means more upside than outright downside and a gradual re-steepening. The belly of the curve on the other hand has little room to rise if market expectations of very low inflation, preventing a policy tightening, are fulfilled.

We expect a near-term rally in rates

Nearer-term, we see odds as skewed towards lower rates around today's meeting.

The first reason has to do with macroeconomic projections. If the ECB continues to project a significant inflation shortfall compared to its target in the coming years, any display of optimism would lack credibility. This in turn could be detrimental to sentiment in our view, with markets pricing a lesser degree of central bank support, for instance by lowering the probability of a QE extension.

In short, good news can be bad news for markets, especially when it comes from a central bank.

Another factor is expectations. A Bloomberg article yesterday seemed to support Schnabel's view that the economy has progressed roughly along the lines forecasted by the ECB in June. This hardly makes the case for more easing for the time being and we think markets are expecting a cautiously optimistic tone.

This would make any dovish display more impactful from a rates point of view.

Technical tweaks as excess liquidity increases - the ECB could signal increased awareness at least

3-month Euribor hit another all-time low yesterday at -0.493%. It is closing in on the -0.5% deposit facility rate of the ECB which should in theory serve as a floor to fixings.

That is the rate at which banks can redeposit their excess liquidity at the central bank. In practice, the overnight rate €STR and 1m Euribor are already below the deposit facility rate – banks are charging those market participants without access to the facility for redepositing at the ECB and the rising excess liquidity, now approaching €3tn, is keeping the pressure on rates.

The ECB has partially alleviated the cost that the negative rate charged on the excess liquidity puts on banks by introducing tiered deposits. Six times the minimum reserve requirement is what banks are now allowed to deposit at zero charge before the -0.5% penalty rate kicks in, but that multiplier was fixed before the latest steep increase in excess liquidity.

Increasing the multiplier could thus be a technical tweak that might be considered and it could also lessen the downward pressure on Euribor rates. However, ECB officials have not signalled any urgency on that front. Furthermore, having provided banks €1.3tn in liquidity via the last TLTRO.III at a rate as low as -1% if certain requirements are met, could be viewed as an offsetting subsidy.

That said, the inclusion of a question on the multiplier in the ECB survey of monetary analysts for today's meeting signals at least an increased awareness of the issue.

Today's events: ECB, supply, industrial production numbers

Today should prove an eventful session with Italy and Ireland carrying out auctions in the morning, as European countries release industrial production numbers.

The US Treasury auctions 30-year bonds today.

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↓ USD: Taking the back seat

The dollar takes the back seat today with the sole focus on the ECB.

With the ECB unlikely to generate a EUR decline at today's meeting, we look for modest outperformance of European FX vs the dollar. With equity markets stabilising, this also points to a softer day for USD and modestly lower DXY.

↑ EUR: Difficult to talk down the euro

The ECB meeting is the key event of the day.

[As per our ECB cribsheet](#), we see a modest upside risk to EUR/USD as (a) the ECB staff projections should not show material downgrades (only a modest downgrade to CPI, but unlikely a revision in the GDP forecast lower); (b) we don't expect President Lagarde to try to forcefully talk down the euro.

The former was already leaked yesterday, with reports claiming that the ECB staff forecast will

show confidence in the eurozone growth recovery. This in turn suggests a lower need for imminent action, with the extension of PEPP unlikely to be communicated in this meeting.

On the latter, President Lagarde may mention that the Council is monitoring the exchange rate closely, but this is likely to fall short of Trichet-like comments about a “brutal” currency appreciation.

All this suggests a modest upside risk to EUR/USD, with the pair moving to or above the 1.1850 level today. However, given the leaked reports about the ECB staff forecast yesterday (and it is now being priced in), the EUR upside should be limited

📉 GBP: Little respite for sterling and more room for further weakness

GBP bad news continues to pile up, with the EU now reportedly considering legal action against the UK Internal Market Bill, while US House Speaker Nancy Pelosi warned that there will be no US-UK trade deal if the UK government action undermines the Good Friday agreement.

Despite the recent GBP fall and given the prior market complacency, we estimate that only a limited degree of risk premium is priced into the currency (just around 1% in EUR/GBP vs 5% risk premium pricing in late June), allowing for further GBP downside.

EUR/GBP to break the multi-month high of 0.9176 in coming days.

📈 CZK: ECB more important for CZK than Czech inflation

Czech August CPI should moderate to 3.2%YoY today (from 3.4%) due to weaker food prices. CPI inflation remains meaningfully above the 2% central bank target but any imminent reaction is unlikely.

The central bank stance remains neutral with potential hikes being a story for late 2021, at the earliest. Hence, look for a muted EUR/CZK reaction today, with the koruna likely to get more boost from a less dovish ECB today and EUR/CZK dipping closer to 26.40.

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