9 February 2018
FX and Economics

ECB's Sisyphean task…

…to credibly talk down the euro

Despite recent attempts, **we don't believe the ECB will be able to credibly talk down the euro**. We look for more EUR/USD upside in quarters to come, targeting 1.30 this year.

There are **three key hurdles** why the ECB won't be able to credibly lean against the EUR:

1) Despite recent ECB officials' comments, the **euro is in fact not strong**. While EUR/USD is up by 4% over the past 6 months, **the trade weighted euro** (which matters for the ECB) is in fact largely flat.

2) The potential disinflationary effects of a stronger euro are likely to be mitigated by the rise in the oil price.

3) **Drivers of exchange rate moves matter**. Given the latest strengthening of the euro is **also partly a function of solid EZ economic growth**, such a strengthening should do less harm to the economy.

If the **recent rise in EUR is unlikely to have a detrimental effect on both EZ inflation and the economic outlook,** it should not lead to a downgrade of the ECB staff inflation and growth projections at the next ECB meeting on 8 March.

This in turn means that **President Draghi won't be able to credibly talk down the euro** and credibly threaten a looser policy stance. This would be hard to justify in the absence of deteriorating inflation and growth outlooks (within ECB staff projections).

All this means that **more 'brutal' and broad-based EUR strength from here is needed for the ECB to act**. How to define 'brutal'? In our view, the ECB would consider as brutal such a move in the trade weighted euro that would knock 0.3% off its 2020 CPI forecast (currently 1.7%) thereby undermining the ECB's hope for sustainably higher inflation.

We estimate that for the 2020 CPI forecast to be revised lower by 0.3%, other things being equal, we would have to see a **4% rise in the trade-weighted EUR between now and early March.** This would then cause a meaningful downward revision of the ECB staff inflation forecast and in turn justify a more dovish ECB stance.

While another (and fast) 4% rise in the trade-weighted euro may be the pain threshold for the ECB that could prompt a credible backlash, we note **that the pain threshold for EUR/USD may be much higher** and will very much **depend on the driver behind EUR/USD strength.**

If the general USD weakness continues to be one of the prime drivers behind EUR/USD strength, then the 'headline' EUR/USD gains don't have to fully spill over into trade-weighted EUR gains. This is because: (a) **USD forms only 17% of the euro basket**; (b) **EUR does not have to necessarily appreciate against the European FX** part of the euro trade-weighted basket; and (c) **EUR does not have to record as large gains against the USD-bloc currencies** as it does against USD as the broad-based USD weakness is also in play against the likes of CNY.

Indeed **it may well be that EUR/USD has to strengthen materially in excess of 4% before the trade-weighted euro is actually up 4%.**

On a valuation basis, we note that the recent **EUR/USD rise did not bring the EUR/USD into extreme territory** and the **cross still looks undervalued on a long-term basis**.

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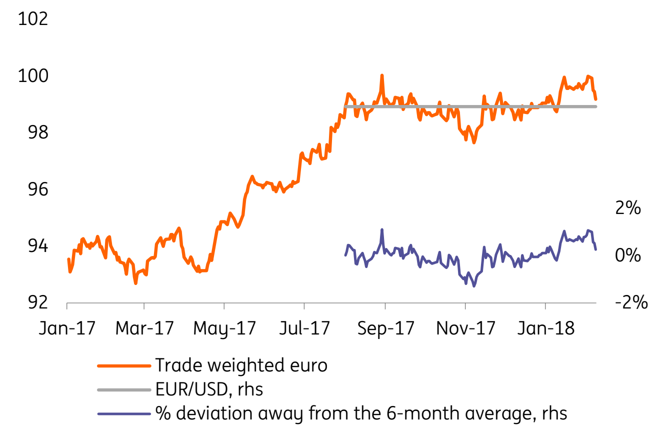
ECB's Sisyphean task

Following the recent comments from President Draghi and other officials concerned about the strengthening of the euro and its volatility, we ask ourselves whether the ECB can, at this point, credibly lean against the 'perceived' EUR strength. In our view, the bar for the ECB to credibly talk down the EUR is set rather high at this point. This is largely due to three hurdles.

Three hurdles...

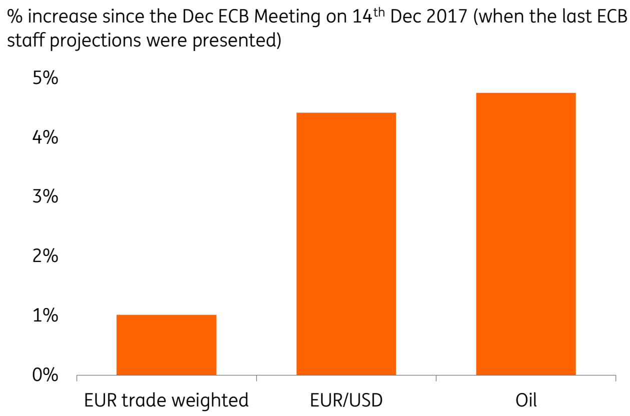
1) While the headline news focuses on the EUR/USD rise (the cross recently reached its highest level since December 2014) **the trade-weighted euro** (ultimately the euro that matters for the ECB) is largely flat this year (vs the close to 2% rise in EUR/USD) and is not much above its 6-month average (Figure 1). From this perspective, concerns about recent EUR strength seem exaggerated as the trade-weighted EUR actually did not strengthen much recently (as opposed to the April–August 2017 strength, as shown in Figure 1, when the ECB QE taper market expectations adjustment occurred). Hence, there is in fact not much to complain about or lean against.

Fig 1 Trade weighted EUR has been flattish for months



Source: ING, Bloomberg

Fig 2 Higher EUR/USD offset by the higher oil price



Source: ING, Bloomberg

2) Looking at the effects of the stronger euro, we note that its potential **disinflationary effect** is likely to be **mitigated by the rise in the oil price**. Since the December ECB meeting (when the last ECB staff projections were published), oil prices have increased by c.5%. This is largely equal to the rise in the EUR/USD, while the trade-weighted EUR is up less than 1% over the same time period - Figure 2. Since the start of 2017, oil prices have increased by 15% in dollar terms, but are flat when denominated in euro. As the higher oil price will offset a higher EUR, ceteris paribus, this suggests limited potential for the next ECB staff projections (to be released in March) to show a lower CPI profile (particularly when adding that Eurozone economic data have been surprising to the upside). Without any oil price movements, the euro appreciation since December could shave less than 0.1ppt off the ECB's inflation forecasts. However, at the same time, the increase in oil prices could lead to additional inflationary pressure of a higher magnitude, still leaving the risk of an upward, not downward, revision of the ECB's 2018 inflation projections.

3) According to the ECB the impact of a stronger currency on economic activity has weakened in recent years. ECB research (ECB Economic Bulletin Issue 7, 2016) shows that the **drivers of exchange rate moves matter**. Given that – in the eyes of the ECB – the latest strengthening of the euro has to a large extent been the result of the strong Eurozone recovery and is a sign of regained economic strength, such a

strengthening should do less harm to the economy. In addition, we note that the rise in **EUR invoicing and hedging activities in recent years have reduced the impact from currency movements on growth** (as well as inflation) and generally reduced sensitivity of the economy to exchange rate movements in general.

...making a credible threat of a dovish stance not justified at this point

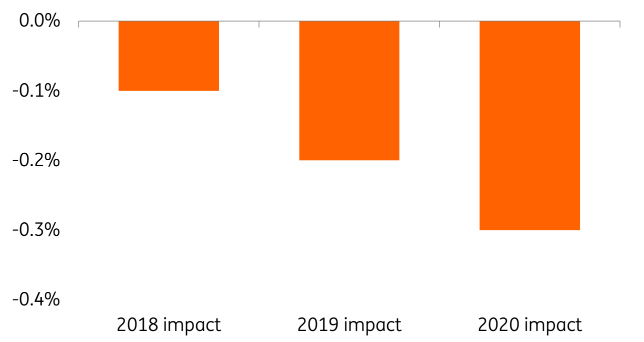
The last two points are important in terms of gauging the degree of credibility with which the ECB can lean against the stronger EUR. If the recent rise in EUR is unlikely to have a detrimental effect on both the EZ inflation and economic outlook (which, for the reasons above, is unlikely in our view) it should not lead to a downgrade of ECB staff inflation and growth projections to be unveiled at the March meeting.

If the ECB staff projections are not downgraded, it will be hard for President Draghi to credibly threaten prolonged QE (ie, beyond 2018) particularly in the context of the rising opposition among ECB board members to the current ultra-loose monetary stance.

The above means that at this point and at current EUR levels, the ECB does not have hard economic arguments to deliver either: (a) a credible threat of a shift towards a more dovish stance; or (b) actually loosening its policy stance (by increasing the amount of monthly QE purchases, extending the QE programme or even cutting the depo rate).

Fig 3 Stronger EUR has the main impact on long term CPI

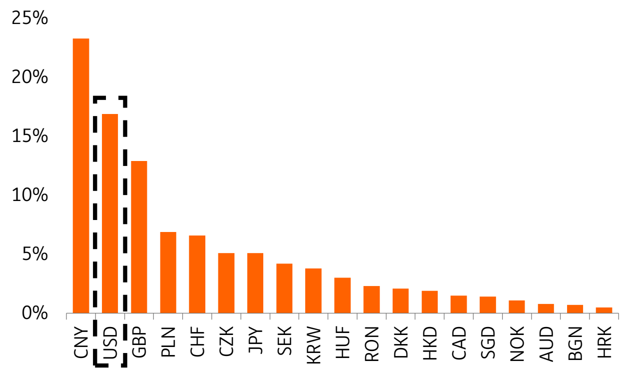
The estimated scale of a downward revision of the ECB staff EZ inflation forecast for 2018, 2019 and 2020 stemming from a 4% rise in trade weighted euro (other things being equal)



Source: ING

Fig 4 USD forms only 17% of the trade weighted basket

% share in the euro trade weighted basket (EER-19 index)



Source: ING, ECB

More 'brutal' and broad-based EUR strength needed for the ECB to act...

In our view, the trade-weighted euro and EUR/USD would have to strengthen materially more from here to offset the impact of higher oil price as well as improved economic activity and actually lead to downward revisions of inflation projections, which could in turn lead to a credible threat of a looser policy stance (ie, prolonged QE for longer).

For example, should the oil price remain unchanged at current levels, the trade-weighted EUR would have to rise by another 4% between now and early March (which would represent a significant acceleration of EUR strength) for the ECB staff inflation forecast for 2018 to be downgraded by 0.1ppt. However, it is not the 2018 forecast but rather the 2019 and 2020 forecasts which would be more sensitive to a stronger euro. In our view, another 4% strengthening of the trade-weighted euro (with unchanged oil prices) could lead to a downward revision of the 2019 and 2020 inflation forecasts by c.0.2-0.3ppt (Figure 3). Such a move could indeed be considered as brutal and lead to the ECB's credible pushback. However, we are still some distance from these levels.

...but the trade-weighted euro (not necessarily EUR/USD) is key to watch

While another (and fast) 4% rise in the trade-weighted euro might be the pain threshold for the ECB that could prompt a credible backlash, we note that the pain threshold for EUR/USD might be much higher and will very much depend on the driver behind the

EUR/USD strength. If general USD weakness continues to be one of the prime drivers behind EUR/USD strength (as was the case this year until the stock market sell-off) it may well be that EUR/USD has to strengthen materially in excess of 4% before the trade weighted euro is actually up 4% (which could be the pain threshold for the ECB in terms of its implications for the EZ inflation and growth outlook).

This is largely because of three factors:

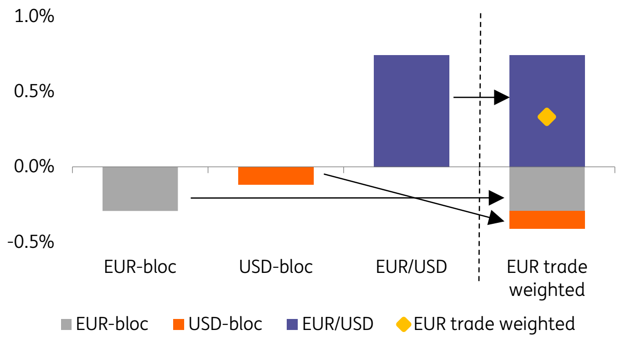
1) USD forms 'only' 17% of the euro trade-weighed basket (Figure 4). This partly limits the impact of the headline EUR/USD gains on the trade weighted euro.

2) If general USD weakness is the prime reason behind a higher EUR/USD, the euro does not have to necessarily appreciate against the European FX part of the basket (forming 45% of the trade weighted euro basket) as this is not directly influenced by the EUR/USD cross.

3) EUR does not have to record as large gains against the USD-block currencies as it does against USD as the broad-based USD weakness is also in play against the likes of CNY, meaning that these currencies don't depreciate against the euro as much as the euro appreciates against the dollar.

Fig 5 Rise in EUR/USD offset by EUR weakness elsewhere

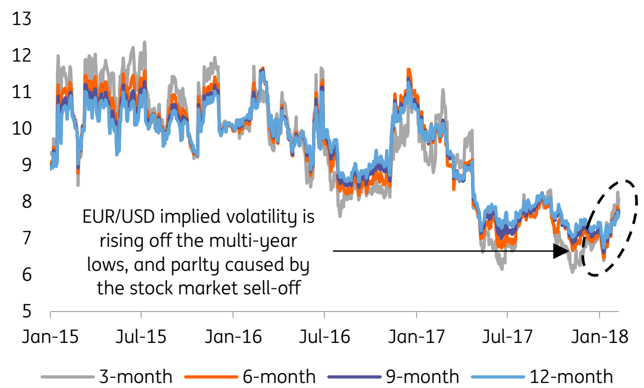
Contributing factors to the trade weighted euro over the last six months. Divided into EUR-bloc and USD-bloc currencies and EUR/USD. Contribution scaled by the currencies' / blocs' weights



Source: ING

Fig 6 Volatility remains historically low

EUR/USD implied volatility (at the money), various tenors



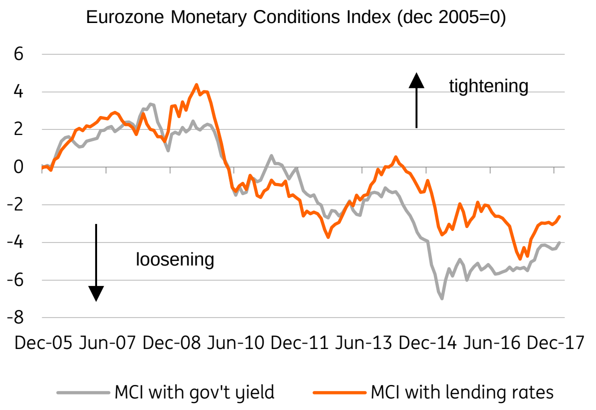
Source: ING, Bloomberg

The above three points are reflected in Figure 5, showing the contributing factors to the trade weighted euro over the past six months which coincide with the 4.5% EUR/USD rally (from 1.175 to 1.227 currently). First, while EUR/USD has been up 4.5%, the fact that USD only forms 17% of the euro basket means that its contribution to trade weighted euro strength was less than 1% (the blue bar). Second, EUR has been down against the European currency bloc (the grey bar). Third, EUR actually modestly depreciated against the USD-bloc currencies (consisting of the likes of CNY or JPY or CAD, but ex USD) vs its strength against USD (the orange and blue bars respectively). All this means that the trade weighted euro is up c.0.3% over the past 6 months (the yellow dot) vs the 4.5% rally in the EUR/USD.

From this perspective, EUR/USD can be at 1.30 in 2H18 and still does not have to necessarily lead to an overly dovish response from the ECB as long as the overall gains in the trade weighted euro and thus the impact on inflation outlook are rather muted (as has been the case so far – see above).

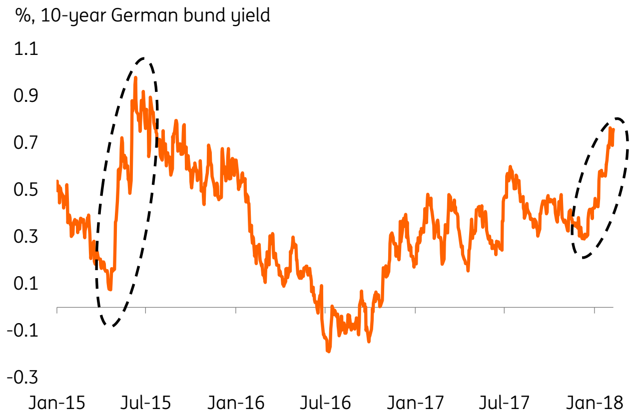
At this point, the only thing the ECB can do is to express concerns about currency volatility ('creating uncertainty') or less accommodative monetary and financial conditions rather than euro strength (as such strength is in fact not necessarily present – as per above). Yet, even looking at EUR volatility, its recent increase is not alarming (particularly when rising from historically low levels – as per Figure 6).

Fig 7 EZ financial conditions remain loose



Source: Thomon Reuters, ING estimates

Fig 8 Move in bund more muted vs the 2015 sell-off



Source: ING, Bloomberg

We also point to EZ firms' view of the recent EUR strength. In the latest business survey (conducted in January), it was noted that "managers' assessment of their competitive position on foreign markets outside the EU over the past three months remained virtually flat." This also suggests that the recent EUR gains (muted in trade-weighted terms and rather more visible in the bilateral EUR/USD exchange rate) are not necessarily a clear negative for the competitiveness of eurozone firms and can so be tolerated.

Tightening of financial conditions due to higher yields not a pure EZ phenomenon

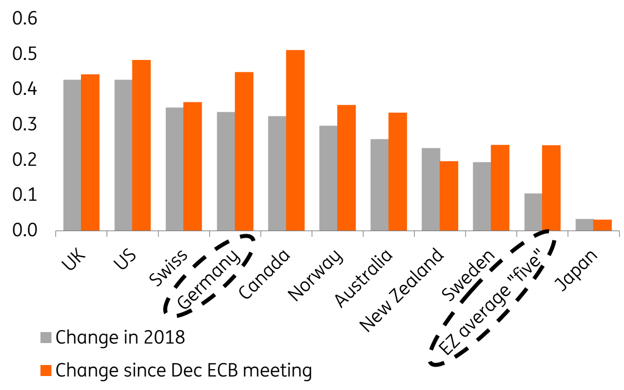
Rather than the EUR itself, it might be the higher Eurozone bond yields that provide the ECB with more credible ammunition to keep the threat of a looser policy for longer in place. As per Figure 7, financial conditions have tightened due in part to rising bond yields. Since the December ECB meeting, German 10y bond yields have increased by 40-50bp. Currently, the stronger euro and higher bond yields are a small double whammy for the ECB. Monetary and financial conditions have become less accommodative in recent months, but the overall level remains low.

However, with the ECB coming close to the end of the QE, the adjustment at the long end of the Eurozone bond curve is natural as this segment was heavily distorted by the ECB asset purchase programme. Still, and compared to the big bund sell-off in 1H15 (Figure 8), the latest adjustment in EZ yields is more orderly and, importantly, was in large part driven by the global rise in yields, rather than any specific ECB policy re-pricing.

The latter is evident in Figure 9 which shows that the rise in Bund yields is not a purely German market specific event. From this perspective and to the extent of which it is driven by higher long dated yields, not a dissimilar degree of financial conditions tightening should be happening elsewhere and not only in the Eurozone. Hence, the higher long dated bund yields are not a global outlier – rather they are a global norm.

Fig 9 Long end yields rising across the globe

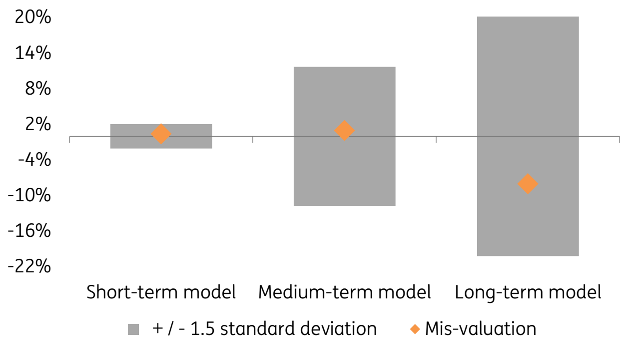
Change in levels of the global 10-y sovereign yields



Source: ING, Bloomberg

Fig 10 Valuation not an issue for the euro

Mis-valuation of EUR/USD away from various iterations of its fair value (short-term financial fair value, medium-term BEER fair value and long-term PPP fair value)



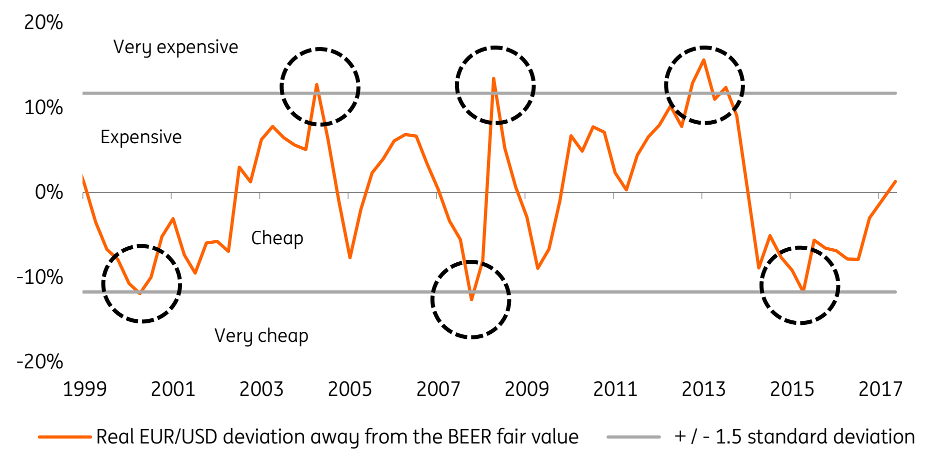
Source: ING

Valuation not an issue for the euro

On the valuation side, we note that the recent EUR/USD rise did not bring the EUR/USD into extreme territory. As Figure 10 shows, EUR/USD looks fairly valued on a short-term and medium-term basis and still meaningfully undervalued on a long term basis.

Even if the EUR/USD looks fairly valued on a medium-term basis, this should not be a cause for concern in terms of scope for further cross upside, given that: (a) currencies tend to over- or undershoot fair value; (b) EUR/USD medium-term fair value is likely to gradually increase as the EZ economy catches up with the US economy, which is now in a more mature stage of the cycle. Point: (a) is depicted in Figure 11. All this suggests plenty of breathing room for multi-quarter EUR/USD upside, in line with our forecast of 1.30 by the end of this year and 1.35 next year.

Fig 11 EUR/USD tend to under- and over-shoot its medium-term BEER fair value



Source: ING

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