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The ECB and FX: looking for the dovish catch

- The ECB rate decision and press conference are on June 8 at 07:45 and 08:30 EDT respectively
- The EUR is already priced for 'hawkish' tweaks given the 2.0% appreciation of the TWI since the April decision
- FX leveraged money positioning and the inflation outlook suggest moderate-to-high disappointment risk
- We expect a move lower in the EUR on Thursday and we like selling EURUSD rallies into the 1.14/1.15 area (2-3M)

Moderate growth

The Eurozone economy is expanding at a moderate pace, but the outlook for underlying inflation and wage pressures remains subdued. Moreover, the prospect for early (autumn) elections in Italy has increased in recent weeks, so Italy's 10-year credit spread with Germany is near its widest level for the cycle (200bps). If anything, EURUSD trades on the expensive side of the level implied by the bloc's GDP-weighted 10-year credit spread with Germany. The very sluggish pace of structural reforms in a number of Eurozone countries is weighing on the medium-term outlook for growth.

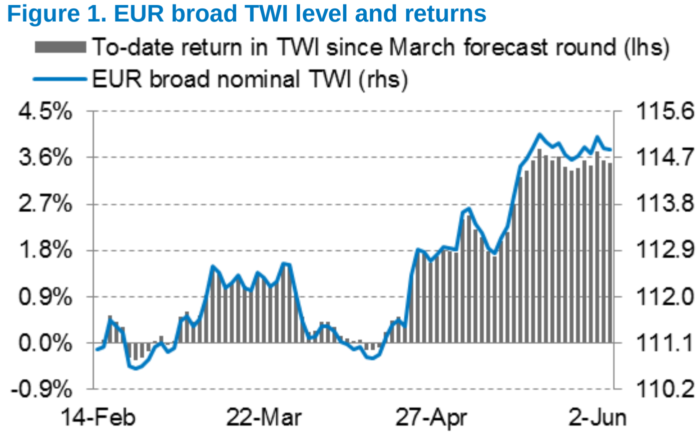
Market over-interpretation risk is high

The broad trade-weighted EUR (TWI) has appreciated by 3.5% since the cut-off date for the March ECB staff forecast round in mid-February (**Figure 1**). We interpret the bulk of this EUR strength as the FX market acting in anticipation of an ECB policy shift. IMM leveraged funds have flipped to long-EUR for the first time since May 2014. The reduction of short-EUR hedges and inbound portfolio investment flows have also been responsible for the move in the EUR TWI.

We think the ECB has to be very cautious regarding the risks of FX overshoot and the over-interpretation of verbal shifts in the forward guidance. Market perceptions of an overly hawkish ECB could unleash waves of EUR buying, especially with a number of major central banks still capping strength in their own currencies via balance sheet expansion.

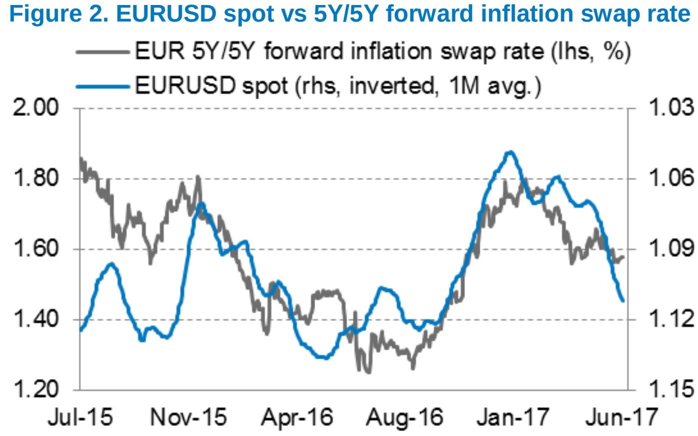
As demonstrated in **Figure 2**, EUR strength has the potential to sustain disinflationary forces and weigh on market-based inflation expectations. By our calculations, EURUSD is already trading above the levels implied by swap rate differentials across the curve. Given these dynamics, we think the ECB will want prevent further EUR overshoot.

Figure 1. EUR broad TWI level and returns



Sources: Bloomberg, BMO FX Strategy

Figure 2. EURUSD spot vs 5Y/5Y forward inflation swap rate



Sources: Bloomberg, BMO FX Strategy

Expected FX reactions to the rate decision and press conference

The broad tenets of our base case scenario for this Thursday's rate decision and press conference are 1) 'hawkish' shifts in the ECB's forward guidance but 2) no pre-commitment to a sequential QE taper. Our expectations for the performance of the EUR is dependent on what we think is already priced in to the currency. Our judgement is that the EUR is currently priced for an unqualified 'hawkish' tweak to the forward guidance. We would even go as far as saying that recent EUR price action reflects the partial pricing in of a sequential QE taper.

Given the need for the ECB to manage market over-interpretation risks, we think the press conference Q&A will be used to counteract the hawkish elements of the rate/QE decision and introductory statement. Draghi has repeatedly proven that he is a master of doing this. Like most of the ECB's recent press conferences, we think there will be a balanced mix of 'hawkish' and 'dovish' elements between the wording of the ECB's opening statement and the Q&A portion.

As of last Tuesday, long-EUR was one of the largest leveraged-fund futures positions in G10 FX relative to its 3-year average at (163% of the 3Y average). We therefore think the market is vulnerable to being surprised by the dovish elements and a lack of ECB commitment to tighten policy. As a result, we expect the net reaction in EURUSD on Thursday to be a moderate move lower (**Table 1**).

In our base case, we expect the ECB to modify the phrase 'at present or lower levels' from March (the March statement said the ECB expects interest rates to remain 'at present or lower levels for an extended period of time'). Our conviction level on this change is quite high, but we are less convinced that the ECB will moderate the 'extended period' phrase with something less 'dovish' (i.e. substantial or fairly long). However, we would interpret both changes as EUR-neutral, given the recent performance of the EUR and EUR positioning.

We think one or both of the alterations noted immediately above will necessitate the ECB moving its growth risk assessment to 'balanced' from 'tilted to the downside', but we also think expectations of this shift are already reflected in the value of the EUR. By and large, we expect these EUR-neutral shifts to be more than offset by other language within the statement and Draghi's tone within the Q&A portion.

We look for ECB to say that interest rates will remain low 'well past the horizon' of its QE programme. However, an important variation could occur if the Governing Council wishes to communicate the prospect of an extension to the current QE programme. If it does, the ECB may choose to eliminate 'well past the horizon' to incorporate the risk of a small 2018 rate hike. Nevertheless, we would expect hints from Draghi of a QE timeline extension to act as an offset and weigh on the EUR.

We also expect the opening statement to emphasize that 1) the ECB can still increase its monthly QE purchase rate if conditions warrant, 2) a very substantial degree of monetary accommodation is still required, and 3) inflation has yet to show a convincing upward trend. We expect the 2019 forecast for real GDP growth to remain around 1.5% due to structural factors. We look for the 2017, 2018 and 2019 CPI inflation forecasts to remain in the 1.6-1.8% range, but we think the risk of a change is on the downside. We would view all of these developments as EUR-negative.

FX responses & scenarios

Table 1. Press conference tone & rate decision scenarios

			Expected kneejerk reactions in euro pairs			
	Overall press conference tone and rate decision scenarios	**Probability**	**EURUSD**	**EURGBP**	**EURJPY**	**EURCAD**
A.	Announces a further €5-10 bln reduction in QE purchase rate (taper) alongside an extension of the programme timeline and hawkish tweaks to forward guidance	15%	+0.80%	+0.53%	+0.95%	+0.80%
B.	Removes 'at present or lower levels', growth risks 'balanced', retains preemptive language on QE, minimal forecast tweaks, inflation subdued, no commitment to sequential taper	70%	-0.68%	-0.45%	-0.50%	-0.68%
C.	Retains verbatim wording of March fwd guidance ('at present or lower levels for an extended period'), growth risks 'balanced' or 'tilted to the downside', reduces CPI forecasts	15%	-0.95%	-0.63%	-0.65%	-0.95%
	Weighted expected outcome in EURUSD		-0.50%			

Source: BMO FX Strategy, spot references on 06/06/2017 respectively: 1.1255, 0.8723, 123.12, 1.5174

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