The ECB and FX: balancing Draghi bluff with market bust

- ECB rate decision due January 21st at 12:45 GMT (07:45 EDT); press conference follows at 13:30 (08:30)
- Our economists think it’s too soon for the ECB to ease again given the close proximity to the December meeting
- Risk-off and poor liquidity have made it difficult for FX investors to express dovish ECB views in recent weeks
- The short-euro trade isn’t over-crowded and investors need to wait for risk appetite to improve before selling euros
- The ECB is unlikely to send the euro sharply lower yet, but it doesn’t want it much higher either

At the crossroads (again)

The recent turmoil in global financial markets has left the ECB in a moderate dilemma. Financial conditions in the Eurozone are tighter over the past month, but overall the domestic picture still looks decent. The ECB also just eased policy in December. Nevertheless, FX markets and risk appetite are in an environment where they can react negatively to policy inertia. The ECB must therefore avoid contributing to financial distress while not acting as too much of a crutch to financial markets at the same time.

We think that Draghi will attempt that balancing act this week. For the euro, this means accepting that the currency will probably remain strong in the near-term. However, the ECB can slow the move down by providing some support to risk appetite. There are a number of options, but perhaps the best way to do this would be to provide a transparent diagnosis of current financial conditions, discuss what the ECB can do about them and what it has already done, and paint a moderately preemptive picture around the March rate decision. We view this as a relatively low-cost/low-risk option, because Draghi can walk back any bluffs later if market conditions improve.

Figure 1 and Figure 2 below highlight the necessity of striking this balancing act. As demonstrated in Figure 1, Eurozone financial conditions have tightened moderately over the past month, with the stronger euro directly contributing. Yet tighter financial conditions also look somewhat justified, given the signals from lending, consumer confidence, and other pro-cyclical variables (Figure 2). ECB policy must aim to smooth the movements in the needle, but not prevent the needle from moving when it needs to.
Exchange rates are a sensitive issue at the global level

The fact that China and its exchange rate are currently at the centre of market attention will also be a key consideration for the ECB at this juncture. If Europe wants China to avoid a currency war, Europe needs to set a peaceful example in the build-up to the G20 Finance Ministers and Central Bank Governor’s meeting in Shanghai in late February. ECB actions which send the euro sharply lower now will cause a tightening of financial conditions in the Eurozone’s largest trading partners.

With the last devaluation of the RMB being so recent, a big ECB-induced decline in the euro now might also feed concerns that the ECB is looking to directly engage in a series of competitive devaluations, as other central banks look for ways to cap their own currencies. As such, we think Draghi will be limited to verbal options and vague preemptive promises (Draghi bluff) at this week’s press conference.

Market positioning & FX responses

Many FX investors lost money on December 3rd, when the ECB refrained from cutting the deposit rate by a larger amount. Afterwards, the majority of polls concerning ECB policy indicated that most economists and investors did not expect the ECB to further increase the pace of asset purchases in 2016. We suspect that the balance of opinion has shifted more towards the “ease further” camp in recent weeks. However, price action in the euro has not been favourable enough for FX investors to put related trades on in size. In an environment where risk tolerance is low, poor liquidity and euro resilience have made bets on additional ECB easing difficult to express. In nominal trade-weighted terms, the euro has appreciated by roughly 2.0% year-to-date and nearly 5.0% since the recent low on December 2nd.

Our best estimate is that long-horizon leveraged and real money investors are still short euros. However, these investors would probably only panic if the recent market rout intensified enough to send EURUSD spiking to the 1.12/1.13 range or above as a result.

At the same time, our best estimate is that short-euro is not a crowded trade amongst short-horizon FX investors. If anything, FX investors looking to make money from risk-off have been busy getting long of euros via the euro crosses in recent weeks. Using the logic that IMM positioning data is a more reliable indicator of how FX investors are behaving when there are sizeable shifts occurring, it is worth noting that the USD value of leveraged EURUSD short positions declined from $26 billion on December 2nd to under $20 billion on January 12th.

Our conclusion is that the ECB doesn’t have a crowded short-euro trade to worry about this week. At the same time, the implied odds of a further 10bp cut in the deposit rate by mid-year have jumped since end-2015. That’s a useful development that the ECB is unlikely to want to fully counter. Therefore, we expect the ECB to offer good arguments for investors to continue selling euros once risk appetite improves. The wild card for this Thursday will be the extent to which risk appetite improves or deteriorates, as this will help dictate how the euro performs.

### Press conference & rate decision scenarios

<table>
<thead>
<tr>
<th>Probability</th>
<th>EURUSD</th>
<th>EURGBP</th>
<th>EURJPY</th>
<th>EURCAD</th>
<th>EURUSD (1wk)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Immediate rate cut/QE increase/change in QE composition, ECB sees financial market tensions as more than a temporary phenomenon</td>
<td>10%</td>
<td>-2.0%</td>
<td>-1.50%</td>
<td>-1.50%</td>
<td>-2.25%</td>
</tr>
<tr>
<td>Market tensions viewed as downside risk to growth, March a key policy date, emphasis on macro pru (not rates) for controlling financial stability risks</td>
<td>40%</td>
<td>-1.20%</td>
<td>-0.90%</td>
<td>-1.00%</td>
<td>-1.75%</td>
</tr>
<tr>
<td>Market tensions viewed as temporary, past ECB responses are working through, ready to ease further but few strong arguments to do it soon</td>
<td>40%</td>
<td>0.50%</td>
<td>0.33%</td>
<td>0.75%</td>
<td>0.75%</td>
</tr>
<tr>
<td>Growing concerned about credit and some asset price developments, worried about some financial instability risks, highlights limits and dangers of loose policy</td>
<td>10%</td>
<td>1.10%</td>
<td>0.73%</td>
<td>1.20%</td>
<td>1.30%</td>
</tr>
</tbody>
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Spot references respectively on 20/01/2016: 1.0910, 0.7680, 127.03, 1.5895
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