FX Comment
The euro trap

FX
Global

Short term downside
The market consensus may expect the ECB to disappoint. This would appear to be a very reasonable position in our view, as there would seem to be little if any room for the ECB to surprise on the upside given the hyped-up expectations contrasting with institutional and operational realities. However, we would caution against underestimating the power of President Draghi's rhetoric and the credible threat of further negative steps as well as QE.

Limited longer term impact
We do not expect asset markets to sell off on the back of the ECB decision and instead would argue that they might even enjoy further support, at least marginally. For the euro, the situation might be trickier as apart from negative rates none of the possible ECB measures seem unambiguously currency bearish.

Hoping for the Fed
We stick to our 1.35 short term target, expecting a strong threat of deeper negative rates and QE to make an impression on the market. At the same time, however, we continue to believe that the ECB alone will be unable to engineer a further drop and that instead a change in Fed tone would be needed for that. If this is not forthcoming then we might well climb toward 1.40 once again.

Macro investors continue to struggle making money this year, particularly on rates and currencies. The euro has been one important reason for weak performances as many had started to finally become more positive at just the wrong moment, i.e. before the May ECB decision. Many were thus caught on the wrong foot and have now fallen back on their long held bearish views and, as a result, the market overall seems somewhat short. This might be true particularly on the slower real money side though positioning generally is thin and unconvinced as a reflection of the low volatility environment lacking any clear trends. However, on the more speculative side the prevailing consensus seems to expect the ECB to disappoint, with many traders preparing a 'buy-the-rumour-sell-the-fact' strategy. Some of this seemed to play out yesterday when a weak CPI flash estimate of just 0.5%yoy pushed the euro higher following an initial very short-lived drop. This attitude makes a lot of sense, in our view: It is hard to see the ECB surprising on the upside given the hyped-up expectations contrasting with institutional and operational realities. A symmetrical 10-15bp rate cut is arguably now fully priced in and has pushed the euro from close to 1.40 to around 1.36. In other words, 10-15bp of negative rates have bought the ECB around 5-6 big figures on EURUSD, assuming we would have gone to 1.41 or 1.42 without President Draghi telegraphing the move last month (UBS FX Comment: ECB – Taboos, packages and red lines, 27 May 2014) [1] . Equally in the money market the Eonia curve has dropped substantially with the 3m swap now trading at almost 10bp from around 17bp prior to the May decision.

Short term downside

Back in early April we had argued that given the remarkably dovish turn in Draghi's communication our 1.35 target had finally come into view (UBS FX Comment: Decisive Central Bank Moments, 4 April 2014). We continue to think that a short term bearish euro position makes sense going into the ECB meeting as we do not expect the ECB to disappoint substantially. This is not because we expect any fireworks in terms of new policy action. Indeed, the move into negative rates would still not be an easy one for many members of the Governing Council. The market may have moved on but for policymakers it is hard to take such an unprecedented step and right away deliver even more complex measures at the same time - be they on targeted lending programmes or asset purchases. We thus do not expect formal announcements of any such programmes. However, we do expect President Draghi to retain an ultra-dovish tone and exhaustively stress 1) the threat of further rates action and 2) the threat of QE. If the decision was to cut 10bp, then he could very credibly claim that at least two more such steps would be possible. He could also emphasise the strong willingness to embark on a broad based asset purchase programme, i.e. QE, if inflation concerns were to escalate. Finally, he could indicate his confidence that both a credit easing programme as well as an ABS purchase programme would be launched over the next few months. All of this together may be enough to, at worst, prevent a meaningful sell off in asset markets and, at best, provide additional fuel for the recent rally.

Hoping for the Fed

The euro reaction might be trickier to predict. The problem is, as we have often pointed out, that most fundamental forces are currency positive, including still growing external surpluses, ongoing financial sector deleveraging, heavy capital

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[1] See also UBS Macro Keys: Lifting the lid on the ECB's toolbox, 23 May; UBS Fixed Income Strategy Comment: How to play the June ECB meeting, 2 Jun

inflows and global reserve manager demand. A further marginal widening of the interest differential will hardly change the trend. Equally, any credit easing and ABS purchase schemes might well be helpful economically, but in our view are unlikely to become balance sheet, and thus currency, relevant. And even outright QE might not be unambiguously euro negative as it might simply attract yet more capital inflows as European bond and equity markets would become even more attractive. As a result, the ECB will be under no illusion that it has the ability to sustainably weaken the euro (UBS FX Comment: Can the ECB weaken the euro? 6 May 2014). Instead, it might be satisfied to limit the appreciation until the time when the Fed would more actively push towards policy normalisation and thereby, hopefully, boost the dollar. Indeed, a frustration with the lack of policy normalisation at the Fed and the resulting dollar weakness might well be the single most important reason why the ECB has adopted a very considerably more dovish tone over recent months and is now willing to take measures that until quite recently might have been seen as questionable at best and dangerous at worst. Monetary policy in an open system is always relative, meaning that there is more than an element of competition between central banks. If the Fed remains exceptionally accommodative, then we think the ECB needs to keep up if it wants to prevent a stronger exchange rate, even if many might be of the view that the trough in inflation has now been reached, that deflation is not a real risk and that in any case monetary policy cannot fix the many structural issues in the system.

Conclusion

The market consensus may expect the ECB to disappoint. This is a very reasonable position in our view, as there would seem to be little if any room for the ECB to surprise on the upside given the hyped-up expectations contrasting with institutional and operational realities. However, we would caution against underestimating the power of President Draghi's rhetoric and the credible threat of further negative steps as well as QE.

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