Deutsche Bank
Markets Research

Global

Foreign Exchange
FX Spot

Date
7 November 2013

FX Daily

Beware the squeeze - can't get excited with ECB

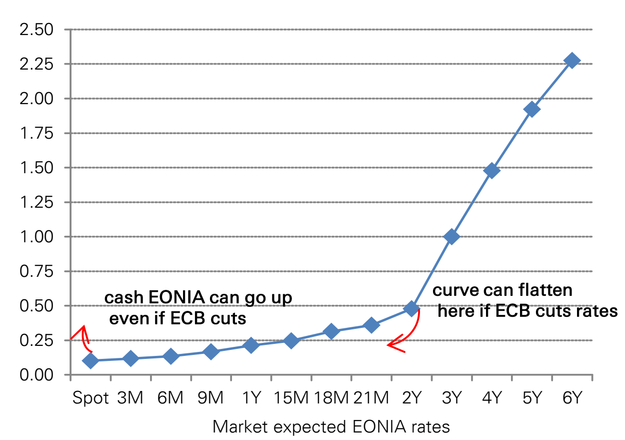
We don't think it is a big deal if the ECB cuts interest rates in December, or even today. Cash EONIA is already at 9bps, not rising to 25bps until January 2015. There is a bit of room for 2016 rate expectations to drop, but big picture two things matter more:

First, what does the ECB say about the future? Indicating that the probability of negative rates has increased would be very dovish. Shifting the balance of price stability risks to the downside would also be dovish. The trouble is that it's tough to see either materializing, not least because the data pulse remains close to the ECB baseline and negative rates are politically explosive. The risk is therefore that following a potential rate cut (if at all), the market is left concluding that the ECB easing cycle is complete rather than having more to go - typically associated with relief rallies in yields/FX not weakness.

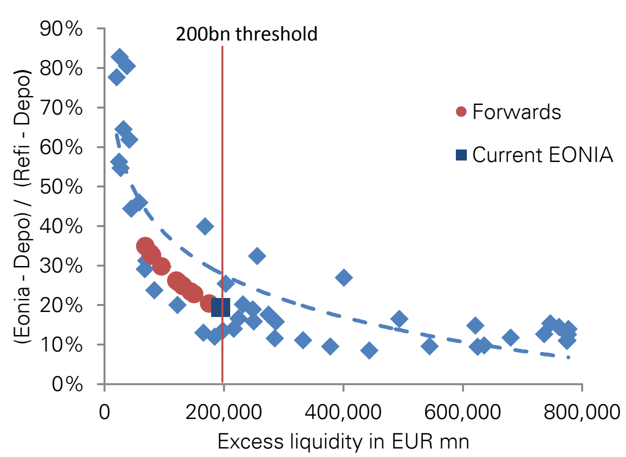
The second thing that matters is ECB liquidity policy. Even if the central bank cuts rates, cash EONIA is well below the refi target, at a time when excess liquidity in the Eurosystem has declined below the 200bn threshold level. This means that a cut notwithstanding, the risk is that short-dated euro yields grind higher. To be sure, the ECB can offer an additional LTRO to ease the pressure. The constraint is that unlike QE, an LTRO is demand-push rather than supply-push liquidity: banks will determine how much new cash is taken up. At best, we see banks rolling over their existing liquidity into a longer-dated LTRO, but this will do little to increase the overall size of the ECB balance sheet and will bear little resemblance to last years' liquidity injections.

In sum, we can't get too excited by the ECB meeting. We estimate the market is pricing around a 50% chance of a cut by December, while we think it is less, and the medium-term impact will be low. We therefore see the risks skewed towards a EUR/USD squeeze higher today. Bigger picture, the US side of the equation matters more. US short-end expectations remain very subdued, helped by increasing focus on the potential for extended forward guidance from the Fed. We see the risks as asymmetrically skewed towards higher US rates and a resumption of the stronger dollar theme as we head into next year, but unless the ECB sounds far more dovish than usual that's not a story for EUR/USD today.

ECB Rate Cut Can't Have Big Impact on Rates



Low Excess Liquidity Means Cash Rates Can Grind Up



Source: Deutsche Bank, Bloomberg Finance LP