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ECB sticking to its guns…but shift seen in June

ECB Communication: Dovish minutes and Draghi speech – The account of the ECB's March meeting suggested that there was a strong consensus to keep the forward guidance – including the option of cutting rates or stepping up QE - unchanged. It notes that 'there was broad agreement among members that the current monetary policy stance remained appropriate', this meant 'keeping the ECB's policy rates unchanged, as well as confirming both the intended pace and horizon of APP purchases and the Governing Council's forward guidance on policy rates and the APP'. This reflected that 'underlying inflation pressures had remained subdued and signs of a convincing upward trend were still lacking'. In addition, 'changes in the formulation (of the forward guidance) at the current juncture could lead to an undue upward shift in market interest rates and tighten financial conditions to an extent that was not warranted by the prevailing outlook for price stability'. Although in a sign that the tide was slowly starting to turn, the account notes that the 'recourse to (the) options for providing further accommodation was becoming less likely'. Meanwhile, earlier today, ECB President Mario Draghi struck a dovish tone in a speech to 'The ECB and Its Watchers' conference. He said that there was 'scant evidence' that inflation was stabilising around the central bank's price stability objective. He concluded that he did not see cause to 'deviate' from the forward guidance from 'today's standpoint'. Finally, he underlined the 'logical basis' for tapering QE before raising interest rates. (Nick Kounis)

ECB View: Guidance to stay in April but change in June – Although the hawks in the Governing Council appeared to raise the issue of changing the forward guidance in March, there appears to have been little support for such a change according to the meeting minutes. In addition, ECB President Mario Draghi's comments suggest that the next Governing Council meeting (on 27 April) may also come too soon to see such a change. However, we do expect to see a shift at the Governing Council meeting after that (8 June). The guidance will likely become more neutral, dropping the explicit possibility of cutting rates or stepping up QE. We then expect the ECB to set out its plan for tapering in September of this year. We think the ECB will start to reduce the monthly purchasing pace from January of next year onwards, in steps of EUR 10bn a month. That would lead to an end of the QE programme by June 2018. The central bank is seen subsequently following with a 10bp increase in its deposit rate in September of that year. The pace of the ECB's exit in our base scenario is a somewhat faster than what would be justified by the likely slow build-up of underlying inflationary pressures. This reflects that the ECB will be unable to extend its asset purchase programme further given it will hit the issue(r) limits for most countries by the end of 2017. We think it can use the ongoing economic recovery and falling unemployment to justify a gradual shift towards the exit in coming quarters. (Nick Kounis)

Global FX: Yen set to strengthen versus the euro – The risk of a sharp appreciation of the yen against the euro is increasing substantially. First, the FOMC minutes signalled that the start the process of reducing the Fed's balance sheet is on the cards for later this year. This led to a deterioration in investor sentiment on financial markets. The yen is a global safe haven currency, which rallies if investor sentiment deteriorates. Demand for the yen has clearly increased. Moreover, currency markets have set their focus on the French Presidential elections. The first and second rounds of these elections now fall within the 1-month tenor in the currency options markets. Investors have decided to hedge for potential euro downside in case the result of the French Presidential elections is not favourable for the eurozone. As a result, the costs to hedge against a lower euro versus US dollar, sterling and Japanese yen have risen substantially. This is because option volatility moved up and demand for euro puts has increased. The 1-month preference for euro puts versus the US dollar, sterling and Japanese yen is approaching crisis levels (but liquidity is thin), while volatility has further room to increase. What does this mean? In the coming weeks the downward pressure on the euro versus US dollar, yen and sterling will likely increase. We expect EUR/JPY to be the most vulnerable. EUR/USD could be relatively stable as both the US dollar and the euro are out of favour. Sterling could benefit from euro weakness if the risks related to Brexit do not escalate further. (Georgette Boele)