



FX & FI Daily

What if the euro view is wrong?

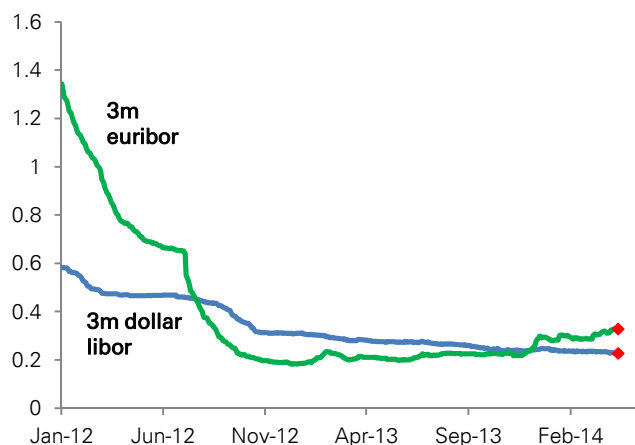
We have been arguing that EUR/USD should weaken from these levels on the back of peaking equity inflows, a turn in rate differentials and building ECB verbal intervention. But what if the view is wrong? There's three counter-arguments to our reasoning. First, even though US-EU rate differentials are busily widening across the rates structure money market rates are moving the other way. As LTRO prepayments continue and liquidity tightens, Euribor is making new highs. USD libor meanwhile is making fresh record lows as dollar liquidity keeps rising. The move should reverse over the course of the year given US curve steepness and a dovish ECB. But for now, very short-dated (<1yr) forward points have moved in favor, not against the euro.

Second, "verbal QE" could end up backfiring on the ECB. By providing an implicit put on asset prices the central bank risks encouraging more periphery inflows, without providing offsetting balance sheet expansion to weaken the euro. The most recent portfolio flow data released last week point to ongoing weakness in equity inflows in February, but that was before the last ECB meeting. The more the central bank talks up asset prices, the more counterproductive this will be for FX.

Third, the bar for upside surprises in Euro-area inflation is low. Market expectations are already significantly below ECB forecasts, suggesting that even modest upside surprises in next week's inflation numbers could reduce expectations of ECB easing. Inflation normalization should be bearish for the euro medium-term: it implies lower real rates which have done a better job of explaining EUR/USD since 2010. It could nevertheless be counterproductive in the short-term.

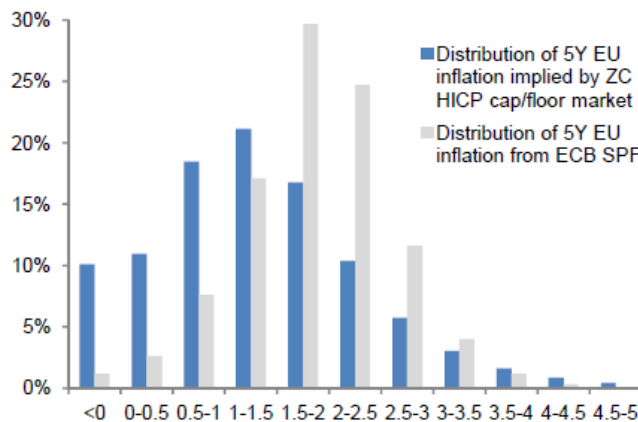
Our favourite way of monetizing "going wrong" is to place faith on the ECB. Given the strength of verbal commentary, we have a high degree of confidence that the ECB won't tolerate a large overshoot above 1.40. The most straightforward way of expressing this is to sell EUR/USD calls in the mid-1.40s and use the premium to buy downside. An alternative is to buy a European rates receiver that knocks-in only if EUR/USD appreciates: the most likely ECB reaction to the latter would be a negative depo rate and extra liquidity injections. With the market pricing only 8bp of easing and the correlation discount large, we like the idea of buying a 6m2y atm euro receiver that knocks in if EUR/USD hits 1.42. This has a cost of around 11cents - a 50% discount to the vanilla.

The ECB Shouldn't Be Letting Liquidity Tighten



Source: Deutsche Bank, Bloomberg Finance LP

Market More Negative on Inflation than ECB/Economists



Source: Deutsche Bank, Bloomberg Finance LP and DB research