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Global

FX Flash

EUR: ECB's Extraordinary Measures in Extraordinary Times

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Targets Liquidity, Credit Channels and Monetary Transmission

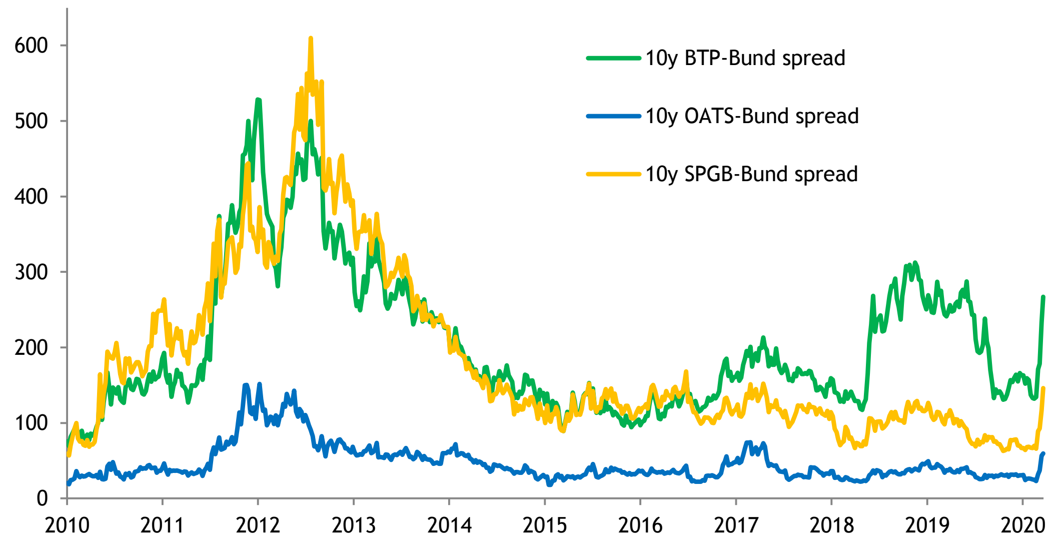
Both sets of monetary stimulus measures announced by ECB in a span of less than a week were aimed at addressing the liquidity, credit and monetary transmission mechanisms.

There was no decision to cut rates (in line with our call that there is little benefit), unlike Fed and other central banks.

ECB's latest bazooka is close to former ECB President Draghi's to do whatever it takes moment (back in 2012) as current ECB President Lagarde said extraordinary times require extraordinary action and there are no limits to ECB's actions. Policymakers remain determined to use the full potential of policy tools, within their mandate.

EUR rebounded on news of additional stimulus in attempt to support markets and anchor confidence that the ECB will expend all its policy tools. But gains petered off on broad USD demand in times of broad and immense market uncertainty. We reiterate that EUR could get worse before recovering as COVID-19 epicentre shifts from Wuhan to Italy and the currency is weighed by COVID-19 outbreak, continent lockdown and business disruptions. On the other hand, EUR somewhat trading like JPY and CHF (safe haven proxies in loose terms) could partially mitigate against its downside.

Decisive Actions Needed to Contain Spread from Widening



Source: Bloomberg, Maybank FX Research & Strategy

ECB Actions Welcomed by Markets but Too Soon to Say Worse is Over

Sovereign bond spreads have risen last week after Lagarde infamously said that “we are not here to close spreads”. 10y Italian bond yield rose sharply from 1.2% (prior to 12 Mar ECB meeting) to a high of 2.43% (18 Mar) before easing off to 1.55% (19 Mar). Price action suggests that ECB’s recent EUR750bn bazooka is welcomed by markets, at least on a preliminary assessment. ECB’s willingness to do more should somewhat help to anchor confidence but it remains too soon to tell if the worse is over – if sovereign bond market fragmentation and monetary policy transmission is successfully repaired. We do not think ECB toolbox is exhausted at this point as policymakers can still dip into (1) Outright Monetary Transactions (OMT) – introduced by Draghi in 2012 but was never activated and yet its existence served to calm the markets. Tool allows ECB to make unlimited purchases of sovereign bonds on secondary markets and put them on the balance sheet; (2) European Stability Mechanism (ESM) – EUR410bn bailout fund could be tapped to bring down borrowing cost; (3) potentially a joint debt issuance (termed euro Corona bond) – backed by Italian PM Conte, French President Macron, to be backed by ESM (still in early stages of discussion) are amongst some of the tools available.

ECB Stimulus v2.0 – Announced 18 Mar 2020

In an emergency ECB Governing Council meeting overnight, the ECB launched another **asset purchase program worth EUR750bn – Pandemic Emergency Purchase Program (PEPP)** – in response to economic and market damage caused by COVID-19. This is on top of the monetary stimulus announced at the last GC meeting last Thu.

The PEPP program will include (1) purchases of public and private sector securities to **counter the risks to monetary policy transmission mechanism** and will be conducted in “flexible manner” allowing fluctuations over time, across asset classes and among jurisdiction; (2) Eligible assets include non-financial commercial paper; (3) ECB will ease collateral standards to allow banks to raise money against more of their assets including corporate finance claims; (4) the size and composition of programs will be increased if needed; (5) program will be terminated once the Governing Council judges that the COVID-19 phase is over but not before end-2020.

In addition the ECB will also consider lifting its self-imposed limits to not buy more than 1/3 of the eligible sovereign bonds of any single country and to purchase sovereign bonds in proportion to the weight of each EU member’s investment in its capital.

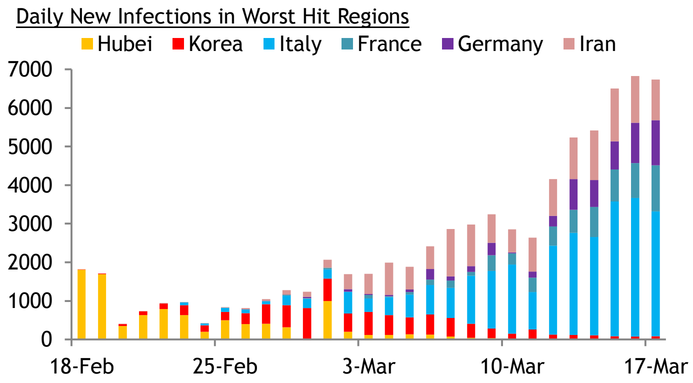
ECB Stimulus v1.0 – Announced 12 Mar 2020

ECB did not cut deposit rate, but instead delivered a calibrated and targeted package of stimulus, including QE purchases of EUR120bn through to end-2020. On top of its existing commitment to buy EUR20bn per month, more favourable terms on TLTRO, additional long-term loans for banks to provide immediate liquidity and easing of capital buffer rules for banks to keep lending going while stress test on banks have been postponed to 2021 (from 2020).

EUR Could Get Worse Before Recovering

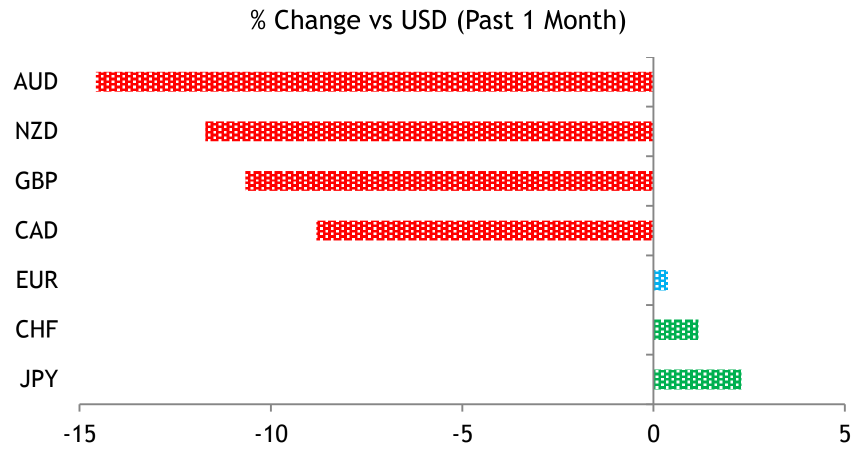
The broad downward pressure on EUR could persist as COVID-19 epicentre shifts to Europe from China, resulting in continent lockdown and business disruption. Switzerland has shut down schools, introduced border checks and closed all bars and restaurants. Germany, Austria, Hungary, Czech Republic, Poland and Lithuania have also tightened border controls and the EU has banned all nonessential inbound travellers from abroad for 30 days while major carmaker, Volkswagen is preparing to suspend production in Europe, etc. Economic fallout (amid supply chain disruption and lower Chinese demand owing to COVID-19 outbreak) is expected to impact Europe. In particular Germany's activity data, including industrial production, factory orders, retail sales and investor sentiment have already weakened even prior to COVID-19 outbreak in China. The risk of a deeper downturn in Europe (dragged by Germany) reinforces ECB's bias to remain accommodative for longer. This implies that EUR downside could persist for longer. But at the same time, we remain watchful for any rapid policy response from EU policymakers, especially on the fiscal front as that could be helpful to restore confidence. An eventual easing of USD strength could then provide support for EUR. And we shared in the next section that EUR's loosely defined "safe haven" proxy could actually help to mitigate against some of its weakness.

COVID-19 Epicentre Shifts to Europe



Sources: World Health Organization, Johns Hopkins CSSE and updated as of 19 Mar

EUR Relatively Less Hit Compared to Other Major FX

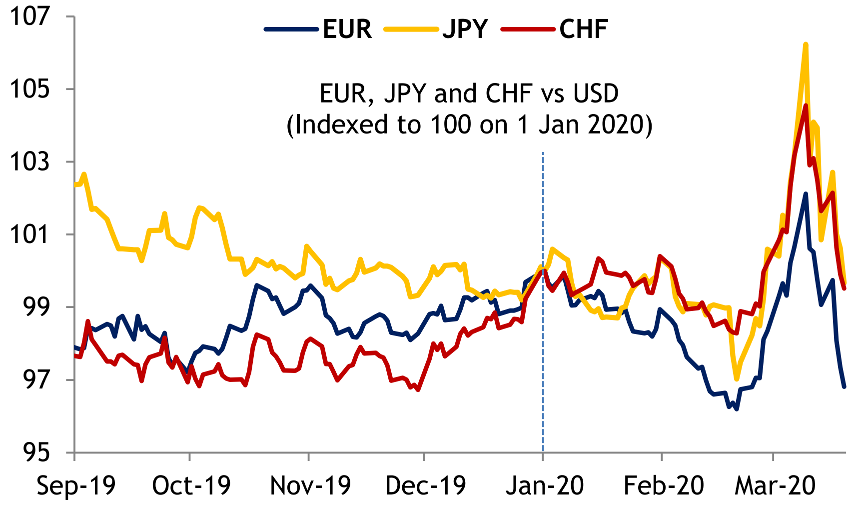


Source: Bloomberg, Maybank FX Research & Strategy

EUR Trading Like JPY and CHF

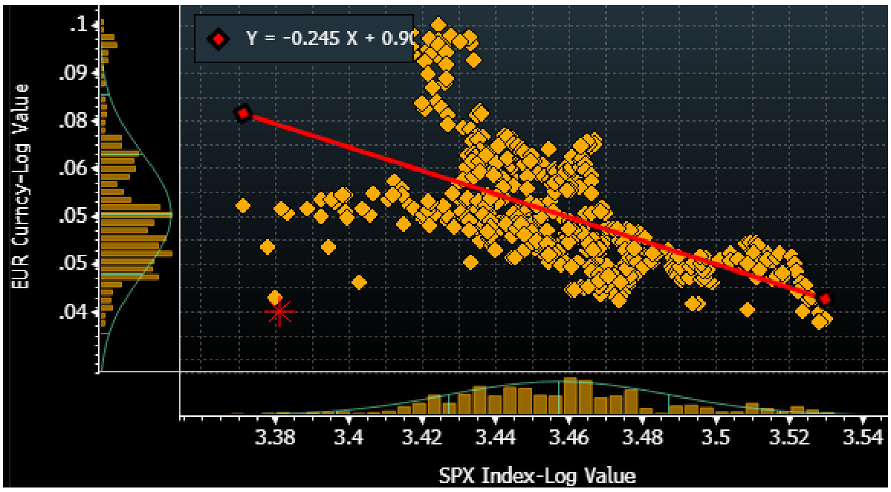
While JPY and CHF are typically safe haven proxy and funding currencies, the EUR is somewhat sharing those characteristics and is trading like one, to some extent. We had shared this thought quite a while back in 2015 that the inverse relationship between risk assets (using S&P 500) and EURUSD still stands. This can be attributed to EUR as a cheap funding currency ever since ECB embarked on unconventional policies. To some extent, EUR is inclined to trade lower in risk-on sentiment (sell funding currencies and buy risk assets) while the reverse is also (asymmetrically) true – EUR tend to trade higher in risk-off sentiment (sell risk assets and buy back funding currencies). Such characteristic could serve to mitigate EUR softness resulting from COVID-19 outbreak and negative repercussions on economy.

EUR Loosely Defined as "Safe Haven"



Source: Bloomberg, Maybank FX Research & Strategy

Negative Correlation between EURUSD and S&P 500



Source: Bloomberg, Maybank FX Research & Strategy

EURUSD: Interim Risks Still Skewed to the Downside

EUR has traded sharply lower this month, after the run-up in second half of Feb. Pair was last seen at 1.0860 levels. Bearish momentum on daily chart intact while RSI is falling. Risks remain skewed to the downside for now but we refrain from chasing lows at current levels. Immediate support at 1.0780 levels (2020 low) before 1.07 levels (downward sloping trend line support). Resistance at 1.0980, 1.1030 (50 DMA).

Source: Bloomberg, Maybank FX Research & Strategy

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