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RATES

EUR Money Markets: Stirred, not shaken

The Iran conflict and energy price surge have shaken ECB rate expectations, causing market uncertainty and shifts to safer assets. Money and funding markets show limited stress, but as overall activity focuses more on very short dates, longer Euribor spreads, in particular, have seen higher volatility



Euro rates have shown resilience in the face of the Middle East conflict and higher inflation

Oil price spike pushes ECB out of its 'good place'

The short ends of the interest rate curves have been the most impacted by the Iran conflict and the energy price spike, as fears of a 2022 repeat swept through the market. A rate-cutting bias has morphed into expectations of as many as three European Central Bank (ECB) rate hikes by the end of the year. While a ceasefire has calmed the situation, the ECB signalling a readiness to act on any signs of second-round effects taking hold, keeps the possibility of a first rate hike as early as April still in play.

We think that the additional information that the ECB will have at that point will be rather limited, arguing for a wait at least until June. If we follow our base case scenario, we think the ECB will continue to signal vigilance, but will eventually manage to keep rates steady. But we also have to acknowledge that at this stage, ECB policymaking is more about managing expectations. For now, the picture presented by longer-term inflation swaps remains relatively benign. But this can still change as the crisis evolves.

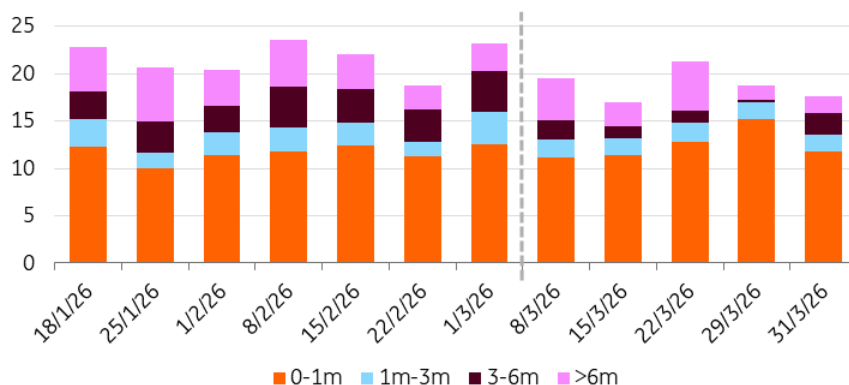
Uncertainty leaves its marks in money markets, but no signs of stress

The overall uncertainty and risk aversion in the market have also left their mark on money markets. We have seen the 2y German Schatz start to outperform more noticeably versus swaps as the conflict escalated further. That is a classic sign of flight-to-quality, although there was also a directional component to it over the past month.

There has been a shift to shorter maturities amid the uncertainty around the crisis and the ECB's policy response. Signs of actual strains in money markets and the functioning of funding markets, however, remain limited.

In repo markets, the overnight GC pooling rates had dipped back to the ECB deposit facility rate for the latter part of March, having previously sat around 1-2bp above. The quarter-end itself, however, appeared more driven by liquidity demand this time around, as the rate did not show the usual spike lower that we had observed around previous month and quarter-ends. German government GC is now back to basically flat with the depo rate again after quarter-end, after having dipped to slightly below before. Italian GC briefly widened towards 5bp above the depo rate at the beginning of March and again at the start of April, but for the most part it sat around 2bp, which is even at the low end of the range just prior to the conflict.

European banks' weekly CP/CD issuance volumes shifted to shorter tenors



Source: CMD, ING

In unsecured markets, we have also observed that for commercial paper, volumes from banks shifted to predominantly tenors of 1m and shorter, reflecting the change in investor appetite.

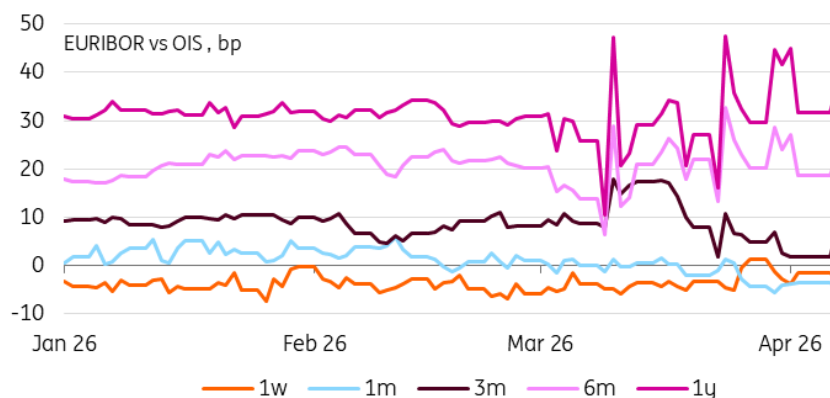
Ahead of quarter-end, the 1m Euribor fixing dropped even more noticeably below ESTR OIS, reflecting low desire to take on funding that does not add to fulfilling regulatory ratios but only expands the balance sheet.

There was a brief widening of the 3m Euribor OIS spot spread, but this was more related to the technicalities of the fixing and its fallback calculations rather than a change in credit perceptions. The spike reversed quickly, and the spot spread even reached its lowest print since the end of 2024.

However, the volatility in the spread over OIS is most striking in the longer tenors, where the 12m Euribor OIS spread has been anywhere from 10bp to 45bp since the onset of the conflict. Prior, the spread had been hovering in a range of 30bp to 35bp since last September.

Away from the spot fixings, FRA/OIS spreads briefly widened as an impact reaction, but also pared a good part of that widening. They do remain a tad wider by about a basis point, but one has to keep in mind that the FRA/OIS strip previously had shown a very gradual widening trend. This reflects the underlying ECB run-down of its balance sheet and the resulting decline in excess reserves in the banking system.

EURIBOR spread volatility in longer tenors



Source: Refinitiv, ING

To recap, Euribor fixings represent the rate at which banks can borrow in the unsecured money market. To ensure 'robustness' and 'representativeness', the calculation of the fixing is grounded to the extent possible in actual transaction data.

For that purpose, a hybrid methodology using a waterfall structure has been developed. At the first level, actual transactions are used to calculate the fixing. If a contributing bank does not have enough transactions to support this Level 1 calculation, it can resort to a Level 2 calculation that progressively employs anything from interpolation from adjacent tenors to using prior-day contributions alongside market adjustment factors.

The drawbacks, especially in more volatile times, become clear when looking at the transparent data that the benchmark administrator supplies with some lag. In

February, for instance, a transaction volume of over €130bn underpinned the 1-week fixing. But in the tenors of 1m to 12m, volumes amounted to only €5bn to €10bn that month. This meant that for the 1-week, Level 1 calculations were used 65% of the time, while the 3m fixing saw Level type calculation using prior dates being employed in 70% of cases.

ECB liquidity recourse see no fundamental change amid geopolitical turmoil

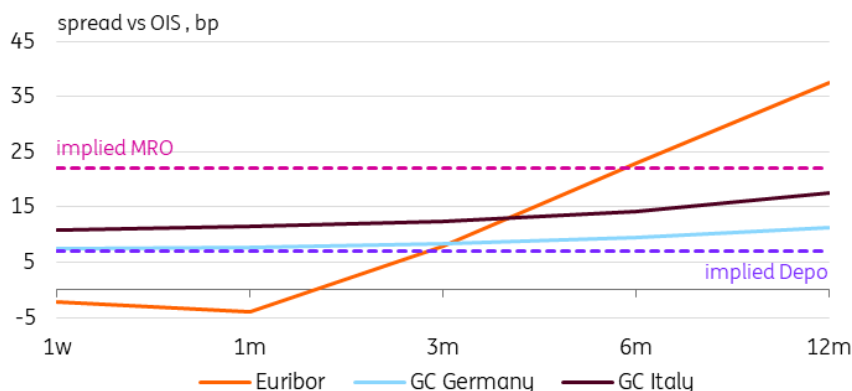
Banks' actual recourse to the ECB liquidity operations has briefly spiked to a still modest €17bn, but even this was more related to the quarter-end than anything else, and volumes subsequently returned to the €11bn area we have become accustomed to.

If the fallout from the war in the Middle East were to become more severe, there is also a scenario where the ECB might have to rethink its current balance sheet reduction on autopilot. For instance, a more forceful policy response in key rates could adversely impact European government bond spreads. In light of an uneven transmission of monetary policy, it could then be an option to at least pause the process of quantitative tightening.

For now, bond spreads have been relatively well-behaved. And while we have seen some widening on the back of spiking volatility, the overall levels remain not too far off from where last year ended. The hardest hit so far has been Italy, but even the 10y BTP spread over Bunds is currently only a bit more than 10bp above levels from last December following the more optimistic news out of the Mid East.

In a recent blog post looking at how banks have adjusted to the gradual decline of excess reserves, the ECB concluded that money markets were functioning smoothly and liquidity was redistributed efficiently even as a greater share of banks were operating closer to desired reserve levels. As that share is set to increase further, there will also be more upward pressure on funding rates. Eventually, this will also lead to a structural increase in the recourse to ECB liquidity operations, but for now, market funding remains mostly cheaper than going to the central bank.

Market funding still cheaper than the ECB



Source: Refinitiv, ING

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