Rates Daily: If I had a hammer, I'd ...

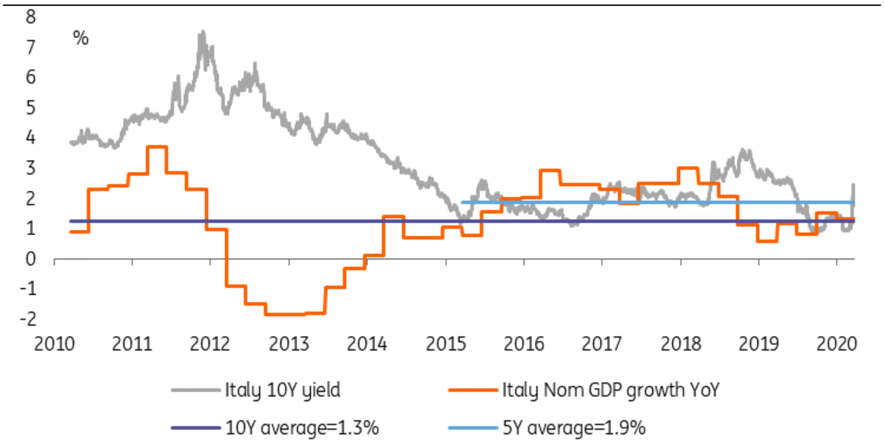
...hammer all over this land; hit each nail as it pops - central banks at play. The Fed, ECB, and BoE all upped QE. A gap will open between markets directly supported by central banks, and the rest. Government bonds will benefit from more purchases and portfolio reallocation away from non-central bank-sponsored markets. And Libor is feeling the stress

ECB: back to the drawing board

Markets have a way of forcing policy makers back to the drawing board when they get it wrong. This was nowhere more obvious than in the eurozone where last week's puny €120 billion quantitative easing was augmented with an additional €750bn 'envelope'. The announcement was successful in snapping the Italian bond losing streak. Going forward, we expect the facility will act as a less efficient and more convoluted yield curve control (YCC) tool on Italian rates. Our best guess is that the ECB will be particularly averse to yields rising above Italy's long-term nominal growth, or 2%.

The impact on core rates is less straightforward. For one thing, this was the second easing package that did not feature a rate cut. Secondly, we are unsure whether the whole 'envelope' will be spent. If the old relationship with interest rates still applies, and if the ECB follows through with the announced purchases, we see the 10Y Bund trading through -0.50% again. Indeed, a decision to raise the issue share limit above 33% would help Bunds along with the credibility of the package. The WSJ and FT reported divisions about the scale and limits attached to Pandemic Emergency Purchase Programme within the governing council.

The ECB should stop Italian yields from rising above nominal growth



Source: Bloomberg, ING

BoE and Fed also saving the bond market

How do we get there, one may ask. As central bank interventions get more foreceful, we see the risk of a gap opening between markets they are directly supporting, mostly sovereign and corporate bonds, and the rest, equities, commodities and the like. Not only do we see scope for more purchases bringing yields down, we also think central bank support will restore government bonds' status as a safe haven if/when risk assets fall further.

The latest example to date is the Bank of England pledging an additional £200bn of sovereign and corporate bond purchases. The target is greater than market expectations and comes on top of a potentially unlimited Commercial Paper (CP) purchase facility. We think this will be enough to absorb bond liquidation flow but, even if it weren't, we think cental banks have their finger pretty close to the QE button already.

The same applies to the Fed. The target amount to this week's UST purchase operations added up to $375bn. The point of front-loading purchases is very clear as the time to stamp out market stress is now. At this rate, the Fed will have fulfilled its $500bn purchase target next week however. Our US chief economist thinks at least another $900bn of purchases is a possibility, as Fed holdings are still well below their 25% of GDP peak.

How to solve a problem like Libor

Despite the solutions being thrown at the system by the official sector, 3mth Libor remains elevated. Cutting to the chase, we note that Libor today is more about where banks print commercial paper (CP) than any interbank activity. Initially, all three rates fell as the Fed cut rates. But Libor by less. Moreover, in more recent weeks Libor has been on the rise. The correlation with financials CP is clear. In fact, financial CP rates are now above Libor, whereas historically they have been below. This points to upward pressure rather than downward pressure on Libor fixings.

The Fed's Commercial Paper Funding Facility (CPFF) helps. Granted it is focused on issuers more than holders or investors. And by implication it helps corporates more than financials. The implied backstop cost is OIS+200bp at a minimum. Fine for corporates. But for financials, the corollary is that CP then prints north of 2%. And if that's the case, the panel banks would feel compelled to pitch Libor around there also. It should not happen given the plumbing done to the system, but the pressure is certainly in the direction of higher Libor prints. Another nail for the Fed to get out its hammer for.

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