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Rates Spark: Another helping

Dovish risks dominate in today's ECB decision, especially in case of a longer-than-expected extension of certain measures. Given already low market rates, the most noticeable impact going forward will be low volatility and an inability to follow USD rates higher, The same goes for Euribor fixings. We expect peripheral debt to be the most likely winner.

Overnight: new deadline

EU commission von der Leyen and UK PM Johnson agreed that Brexit talks will continue until Sunday 13th December and that a 'firm decision' will have to be taken by then. No breakthrough was made at the dinner meeting.

On the other political saga that has been keeping EU leaders up at night, the implementation of the EU recovery fund, Poland confirmed a preliminary agreement has been reached. The deal should be signed off at the EU summit starting today. This last hurdle being cleared adds more weight to the already overwhelming case for peripheral spread tighteners.

In light of those mixed messages, rates decided to see the glass half-empty in overnight trading. Besides political news, we surmise that the proximity of ECB meeting (for EUR) and the still rising number of covid cases (in the US) were the key factors

ECB: smoothing out the noise

If politics threatened to eclipse the ECB meeting as the main market driver this week, the proximity of another easing package announcement manifested itself in fairly muted market volatility. This was not for lack of important developments. Progress towards finding a consensus on the rule-of-law rules governing the EU recovery fund yesterday should have been hailed by at least a temporary jump in rates.

Looking forward, we expect the most noticeable effect of today's package to be what EUR rates do not do in the coming months: rise alongside their USD counterparts. Compared to consensus, we see dovish risks dominating today's decision. In our view, the most likely non-consensus outcome is for a longer extension of TLTRO (cheap loans to banks) and PEPP (asset purchases). The resulting impact would be supressed rates volatility for much of 2021, and an inability to follow rates in other currencies higher.

With EUR rates where they are, we expect the immediate reaction to a dovish surprise to be limited in scope, at most a handful of basis points rally in core rates (eg swap rates and German yields). Instead, we would look to asset classes that would benefit from persistently low rates volatility. Peripheral debt seems best placed to gain from an environment where investors seek to improve their portfolio returns, and where stable markets remove one of the key deterrents for taking on additional credit risk.

We detail our expectations and market consensus on the plethora of policy levels the ECB can act on today in the table below. The third column shows our assessment of what the 'risk scenarios' are, defined as non-consensus outcomes rate markets are not prepared for.

ECB easing comes in many flavors

Easing measure	ING	Bloomberg median	Risk scenario
Interest rates			
- Deposit facility rate	unch. at -0.50%	unch. at -0.50%	10bp cut
- Forward guidance	unch.	unch.	
Asset Purchase Programme (APP)			
- Monthly net purchase target	double to +€40bn/m	unch at +€20bn/m	double to +€40bn/m
Pandemic Emergency Purchase Programme (PEPP)			
- Overall size (current: €1.35trn)	+€500bn	+€500bn	balanced
- Duration	at least until Dec-21	Dec-21	until Jun-22
- Commitment to spend full size	Optional	N/A	Optional
- Reinvestment	at least until Dec-22	N/A	Jun-23
- Other	include "Fallen angels"	N/A	APP limits applied
Targeted Long Term Refinancing Operations (TLTRO)			
- Preferential interest rate period	ext. to Dec21 at least	N/A	ext. to Jun-22
- Number of tranches	3 more to Dec21	4 more to Mar-22	6 more to Sep-22
- Maturity	unch at 3Y	lengthened	ext. to 5Y
- Conditionality	unch. but extended	lower lend. threshold	balanced
Banks' excess reserves exempted from penalty rate ("tiered deposits")			
- Tiering multiplier (current: 6x)	increased to 8x	unch.	increased to 10x

Source: Bloomberg, ING

TLTROs tweaks should cement low funding rates for longer

Obviously the communication on the possibility of rate cuts remains an important driver of front-end rates. Speculation has receded on the back of ECB officials' reserved comments on the matter, but a 1y1y €STR at -0.65% versus current fixings of just below -0.55% still discounts a rate cut over the next year. The ECB is unlikely to forego the possibility of a future cut, but we still think it is low on the agenda.

Money markets will be eying today's decisions surrounding the targeted liquidity operations (TLTROs) and the tiering of deposits. The two issues are interconnected: If preferential rates are extended and made easier to attain, then the need to provide relief on the excess liquidity front via tiering is further lessened. Already now the subsidy provided via the -1% TLTRO rate more than offsets the -0.5% penalty invoked on excess liquidity held in ECB accounts (assuming all banks fulfil the necessary conditions). Still, the ECB could decide to send a signal in support of banks by increasing the multiplier, but we expect it to be in a way that does not inject unwanted volatility into the short-term funding market.

That said, the TLTROs have been instrumental in the decline of Euribor fixings. Out to the 6m tenor they are already below the deposit facility rate having reached new lows just yesterday as today's meeting loomed; the 3m fixed at -0.545%, just over 3bp above the respective €STR swap. In the absence of a term premium the latter should serve as a floor to Euribors meaning the scope for further drop is waning. But both an extension of the TLTRO's preferential interest period and the number of operations will extend the effects currently at work. Depressed Euribor rates are set to remain a feature of rates markets for longer.

Today's Events: ECB, EU summit, periphery supply

Ahead of its policy decision the ECB will announce the allotment of the 6th TLTRO.III tranche. We don't anticipate a high volume in this transaction, as any changes which would incentivize and allow banks to take on more funds will only be made public after the allotment.

Spain and Italy will auction bonds today. Spain in its final supply for the year sells up to €2.25bn in its 10Y benchmark and an inflation linked bond. Italy sells up to €5.75bn in 3Y and 7Y bonds.

The two-days EU summit starts today, of the two most pressing issues at hand, it seems that an agreemtn on the EU multiannual budget and recovery fund is in the offing. Brexit should take longer, potentially requiring leaders to meet once more by year-end, o whenever a trade deal is finally reached.

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