

Rates Spark: Changing the rules of the game

The US curve is looking to the end fo the Fed cycle, and bank funding cost is ratcheting higher. The European Central Bank is about to change the targeted longer-term refinancing operations (TLTRO) rules after the game has started. It can save €31bn in interest but early repayments should remain modest



The US story continues to hum in a nuanced fashion

Two things have happened in the past couple of days.

First the structure of the curve has flipped toward a more bullish leaning as the 5yr has resumed an outperformance on the curve as market rates have fallen. This is typical as the market starts to converge on a likely completion of the rate hiking process.

Second, the market discount for the terminal rate itself has eased off from the highs. A few days back the fed funds strip was peppering the 5% area. Its now back down to 4.85%. That pulls down the need for the 10yr to ratchet higher.

The 10yr had been at 4.25%, and looking up. It's now closer to 4%, pulled there in part by a slew of

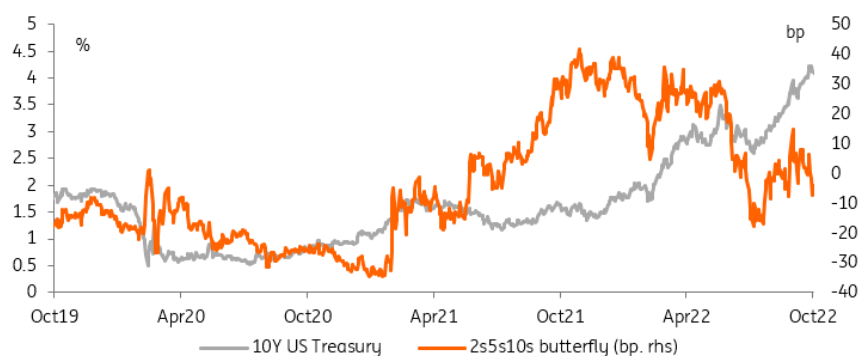
weak macro data, and talk that the Fed may be about to ease off on the size of hikes once they deliver the 75bp discounted for November. But there is something else going on too.

Sneaky item three. Bank funding costs are now creeping higher.

The 3mth commercial paper rate is up to 25bp over the risk free rate, and double that for European names. That's the beginning of signs of creaking in the system. If the Fed is going to pull back in the face of persistent inflation it is more likely to reflect this than the macro weakness that, after all, they are actively engineering. No panic yet. Just something to monitor.

Probably enough there to keep the 10yr above 4% for now, and for it to continue to be re-pressured higher in the weeks ahead. But we are also looking at 4.25% as being quite peakish ([with an outside risk to 4.5%](#)). Can't quite conclude that the 4.25% seen was in fact the high, but these are the things we are looking at.

5Y coming in on the curve indicates a peak in 10Y yield is getting more likely



Source: Refinitiv, ING

A change of TLTRO rates is now widely expected

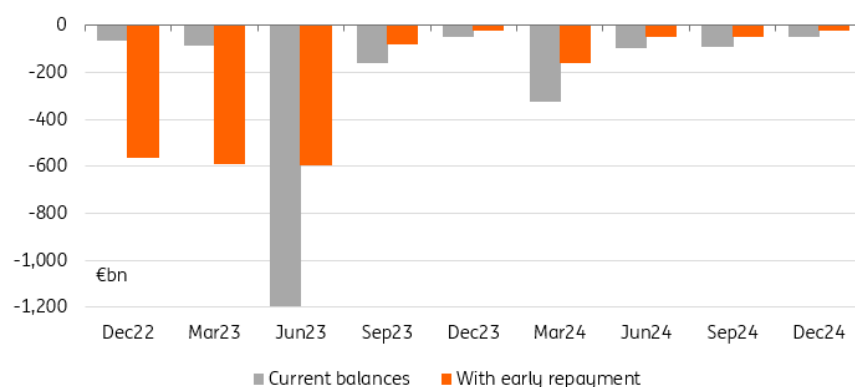
Heading into tomorrow's ECB meeting, various press reports have put changing the terms of TLTRO loans to banks as the ECB's favourite option. The goal is to nudge them to repay, and to reduce a perceived subsidy paid to banks that can currently place these funds back at the ECB at a higher interest rate than they borrowed. As we've outlined in [earlier publications](#), all options on the table are potentially disruptive but the central bank seems intent on acting before TLTRO loans fall due, the majority of them as soon as June next year. The question now is what change the ECB will implement.

The central bank seems intent on acting before TLTRO loans fall due

Changing the borrowing rate from "average interest rate on the deposit facility calculated over the life of the respective TLTRO III during the rest of the life of the same operation" to "average interest rate on the deposit facility calculated over **the rest** of the life of the respective TLTRO III during the

rest of the life of the same operation” would make the borrowing rate identical to the rate at which the proceeds are placed back at the ECB, and eliminate the carry trade opportunity.

A change to TLTRO terms would only result in partial repayments



Source: Refinitiv, ING

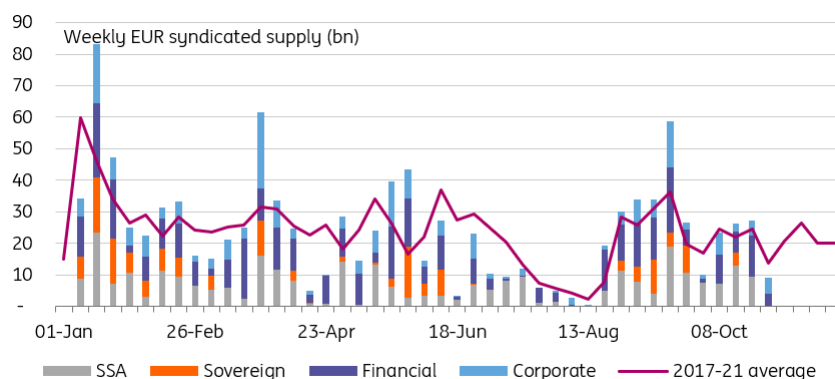
Saving the ECB money but repayments to remain more elusive

This wouldn't guarantee immediate repayment of TLTRO loans, however. Likely, these funds have been earmarked by banks for other uses already, and it is probable that some banks don't have the liquidity available to repay the ECB at the next opportunity in December 2022. Given funding difficulties over year-end some may choose to wait for March 2023 for their early repayments. Finally, we expect other banks would hold on to their TLTRO loans until their maturity given challenging funding environment currently. In the chart below, we illustrate the difference between this early repayment scenario and the original maturities of TLTRO loans.

This wouldn't guarantee immediate repayment of TLTRO loans

Of course, the ECB could be more aggressive and add a spread on top of the average interest rate on TLTRO loans to incentivise earlier repayments. This is an option it might pursue if a sharp reduction in excess liquidity is its goal but we think it is far from guaranteed to work, and would end up punishing banks with the most difficulties in accessing funding markets. The other, apparently more important, objective of getting rid of the perceived subsidy to banks, can be achieved without causing such disruptions as described above. By this simple change, up to €31bn of interest cost to the ECB disappear.

Euro syndicated supply has been above recent years' despite difficult markets



Source: Refinitiv, ING

Today's events and market view

The economic release calendar is relatively thin today, with only eurozone M3 growth to watch out of Europe, followed by mortgage application, inventories, and new home sales in the US.

Instead, the action will be on the supply front. Italy will auction 2Y bonds as well as inflation-linked debt. The US treasury will auction 2Y floating rate notes, as well as 5Y T-notes. The UK will sell 7Y bonds. This will come on top of syndicated supply which has overshot previous years' average on most weeks since the summer (see chart above for euro syndications). Despite this headwind, short-covering into tomorrow's ECB could tip price action in favour of lower rates today.

Authors

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

Benjamin Schroeder

Senior Rates Strategist

benjamin.schroeder@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss

arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.