Article | 25 September 2020

Rates Spark: Diminishing returns

Expectations of central bank easing are riding high in the EUR and GBP-zones. We argue that the marginal impact of further dovish talk should be diminishing. Similarly, the additional TLTRO III liquidity is large, but of little marginal impact on already low money market rates.

Shaky sentiment and flattening curves

Deteriorating sentiment and dovish central bank speak have put yield curves in a bull-flattening trend that can mostly be reversed with a lifting of the political uncertainty in the US, or with good news on the covid front. The former is unlikely before November and should provide an uneasy backdrop to the latter. A flattening of epidemic curves is not to be excluded, and progress on vaccines would be greeted with relief by investors, but, as things stand, we expect further unwind of risk-on trades.

Central bank watchers are in for a slow day today, relative to the rest of this week at least. We would argue that further central bank speak will have a harder job moving markets going forward. This is particularly true at the ECB where a large number of officials have left the door open to more easing in recent weeks. In all likelihood, no action is forthcoming before December, and easing is now priced with a non-negligible probability. In this context, we think economic data, for instance next week's Eurozone inflation, has more market-moving potential.

TLTRO III: adding liquidity to the liquidity

The ECB alloted €174.5bn in its latest iteration of the TLTRO.III, i.e. at the higher end of market expectations and also substantially more than we had anticipated. More clarity on whether banks are able to meet the required lending target to enjoy the generous -1% rate may have allowed banks to now make use of their full allowances. With 388 banks participating the average amount drawn is relatively small at €0.45bn, which might give a hint with regards to the counterparties involved this time around.

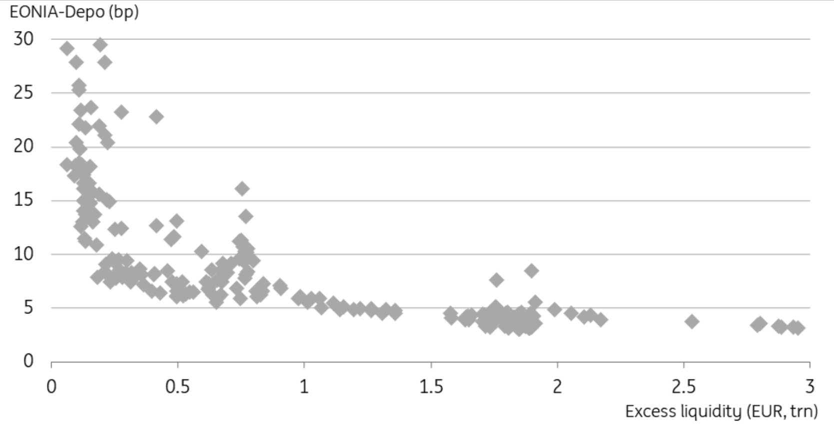
The direct impact on excess liquidty in the banking system will be a net addition of €165bn once the operation settles and the pre-announced repayments are made on 30 September. Total excess liquidity currently idling around €2.9tn is therefore quite likely to surpass the €3tn mark next week.

€175bn of TLTRO III funds allotted to banks yesterday

The larger allotment should be supportive for risk assets as it signals easier financial conditions. Near-term the net addition to liquidity adds a bullish element to EUR money markets, and in particular should entrench the dynamics seen in the Euribor fixings over recent weeks. But more volatility could be in store as the underlying market activity is further crowded out, as evidenced in commercial paper markets for instance. That said, in the context of already ample liquidty and Euribor levels close to the €STR the impact of the operation itself might still be marginal, especially as far as €STR itself is concerned relation to the depo rate.

At €3tn more excess liquidity should do little in terms of nudging the MM rates floor lower

EONIA spread over the deposit facility rate (10 day averages) plotted against excess liquidity in the banking system. As of October last year EONIA is defined as €STR + 8.5bp.



Source: ECB, ING

Today's events: US durable goods orders

The central bank speaker slate is (relatively) light today with 'only' Hernandez and Villeroy speaking from the ECB. From the Fed, Williams is due to speak.

The main release of note will be US durable goods orders.

Authors

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com