Rates Spark: ECB's first steps towards reducing its balance sheet

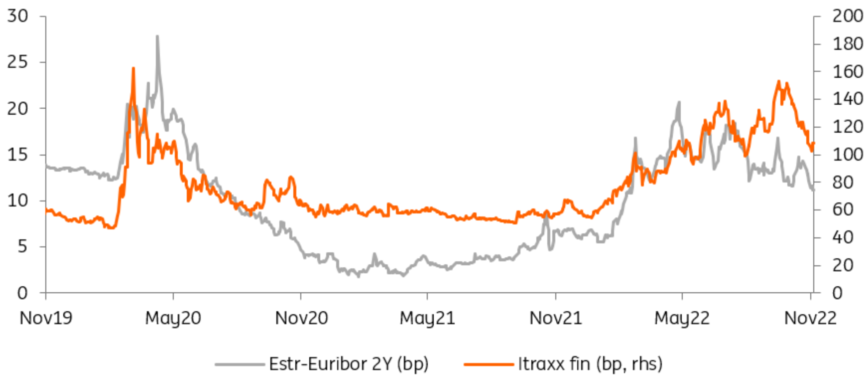
The rates rally has run into resistance as central bankers signal that their job is far from being done. In Europe the first TLTRO repayment will kick off the European Central Bank's balance sheet reduction, though the impact should at first be marginal. Over in the UK the prospect of substantial net supply has limited the downside in gilt yields

First TLTRO repayment kicks off ECB balance sheet reduction

The ECB's outstanding targeted liquidity operations (TLTRO) and the quantitative easing portfolio currently still bloat the central bank's balance sheet, a situation not deemed compatible with the ECB's overarching goal of reining in policy accommodation to tackle high inflation.

To that end the ECB had revised the terms of the TLTROs at the last meeting in October. Today the central bank will announce how much of the currently still €2.1tn outstanding banks will repay at the first additional repayment date on 23 November, the day that the new less attractive borrowing terms come into force. Some ECB officials have said they expected a sizeable repayment, though a Bloomberg survey sees estimates in a wide range anywhere from €200bn to €1500bn with a median at €600bn. At this early stage we think the risk is skewed towards a smaller repayment – we have pencilled in €400bn.

The Euribor-Estr basis will become more correlated to credit spreads after TLTRO repayments



Source: Refinitiv, ING

Given total excess reserves of €4.7tn today's repayment by itself will have a marginal impact

Officials have hope that the repayments can ease the collateral scarcity. We would caution that the collateral pledged in these operations will unlikely be of the high quality liquid type so dearly in demand. For the system as an aggregate, the repayments will imply a lower amount of excess reserves chasing this quality collateral. Considering that the overall excess reserves are still at a staggering €4.7tn, today's repayment is likely to have only a marginal impact.

Over time with further repayments and at the latest with the bulk of the TLTROs maturing by mid next year the impact should increase, however. The suppression of money market rates that was achieved by high levels of excess reserves should start to fade. The overnight rates ESTR could see fading downward pressure, allowing it to gradually return to the deposit facility rate. Credit sensitive money market rates like the Euribor fixings could become more sensitive to growing systemic risks and the looming recession.

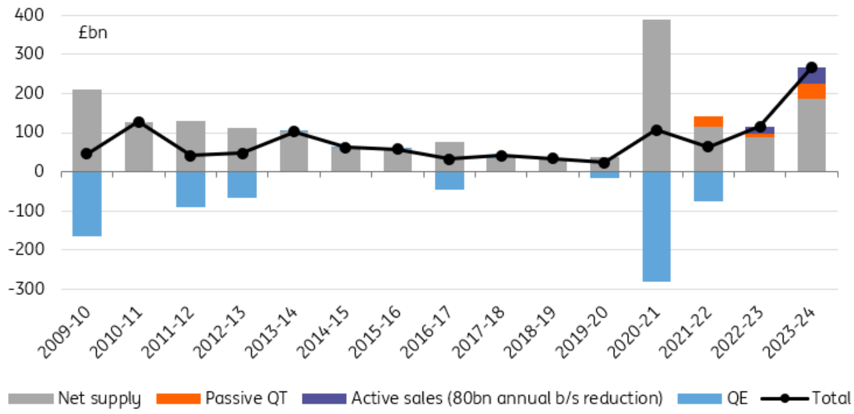
Gilt investors will have plenty of supply to absorb

The UK Chancellor has presented a plan that will stabilise the country's debt over the medium term – as much has been confirmed by the independent OBR's new projections, if only towards 2027/28. But faced with the trade-off between boosting credibility by presenting immediate plans to reduce borrowing and avoiding amplifying the forthcoming recession, the Chancellor is leaning more towards the second of those priorities – much of the fiscal tightening has been deferred to the later years.

Private investors will be required to increase their gilt exposure by at least £268bn in FY2023-24

The result is that borrowing is still elevated over the next couple of years, to the extent that gilt issuance plans have actually increased for the next fiscal year. Taking the Debt Management Office's forecast 2023-24 remit of £305bn, and the BoE's quantitative tightening programme, we estimate that private investors will be required to increase their gilt exposure by at least £268bn in FY2023-24. The previous peak was £107bn during the pandemic of FY2020-21.

The size of the gilt market will increase by a record amount next year



Source: Refinitiv, ING

Today's events and market view

The rally in rates has finally run into some resistance. With a look to the UK the higher gilt remit will have helped, but it also seems that Fed officials saw more pushback was in order, warning not to read too much into one CPI reading. Standing out was the Fed's Bullard, who signalled that he saw the terminal rate at least at 5-5.25%.

There is little on the data calendars worth mentioning apart from US existing home sales. The attention should remain on central bank speakers. In the US only the Fed's Collins is scheduled to speak on the labour market, but over in Europe we will see President Lagarde, the Bundesbank's Nagel and the Dutch central bank's Knot speaking at the European Banking Congress.

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