Rates Spark: Fed and ECB in a good place

In the US, buying T-bills is of no benefit to longer bonds as a stand-alone measure. And MBS bonds confirmed as still rolling off. Also, longer tenors react poorly to muted anticipation of a Federal Reserve rate cut in December from Chair Powell. The European Central Bank, meanwhile, seems in a good place. Let's see

EUR rates and risk sentiment find themselves back in a good place, mirroring the ECB's stance since June

The Fed moves to using T-bill buying more actively as a means to managing reserves

The Federal Reserve now plans to buy T-bills more actively as a means of adjusting reserves. This makes sense and is in line with our thinking. They will allow the MBS roll off to continue, offset by buying T-bills, leaving the overall impact on bank reserves balanced. That enables the Fed to increase reserves through buying T-bills if needed, just as it did in 2019 when things got tight. There is plenty of ammunition to do so as T-bills holdings are puny right now. Effectively, MBS bonds will still roll off the curve. Technically, then, the Fed is not actually stopping quantitative tightening (QT). It's stopping the shrinkage of its balance sheet. The balancing factor here is the buying of T-bills, which keeps the balance sheet from shrinking. MBS continues to roll off, albeit very slowly. The pace has been running at $15–20 billion per month.

The backstory is one of prior heavy net issuance of bills, which has been affecting money market

conditions. The Treasury cash balance has continued to grow, while reserves declined. Repo has been tightening up, and the funds rate has risen, partly due to competition among the various places where players can place cash. In the end, it's a relative-value trade. Upside pressure on repo — and, by extension, the secured overnight financing rate (SOFR) — presents a tempting bucket for liquidity. That said, the reserves position looks broadly balanced as is. And the Fed is neither providing nor withdrawing liquidity from the system to any great extent. However, Chair Powell noted the gradual increase in the use of the repo facility (where the Fed provides liquidity to the system). Not large, but the beginning of some tightness.

Long-end rates did not react well to all of this. T-bill buying is of no benefit to longer bonds as a stand-alone measure. MBS bonds confirmed as still rolling off. Also, longer tenors reacted to muted anticipation of a Fed cut in December from Chair Powell. The US 10yr yield had been hugging the 4% area. But after the various announcements, it is back up at 4.05% and looking up rather than down for a change.

The ECB is unlikely to give away much as still finds itself in a "good place"

Markets are heading into the European Central Bank's rate decision with virtually no probability of a policy change being priced in. The ECB signalled before that it sees itself in a “good place” with the deposit facility at 2%. For markets, the meeting could prove unexciting, as the ECB will not provide updated forecasts. To be fair, even the ECB will likely conclude that there has been very little data to work with since the last meeting. Some important data is actually released on meeting day – including third-quarter GDP and the first country inflation readings for October.

Hence, the meeting will boil down to ECB communication and expectations management. It should focus on the balance of risks looking ahead. Perhaps journalists will be able to tease out more about the ECB’s reaction function given lingering risks.

The market’s working assumption is a mild easing bias. Perhaps too mild. Market pricing sees a 50% probability of the ECB delivering one 25bp cut within the next 12 months. We would note that if the ECB sees the need to ease, be it because of a delayed adverse impact of US tariffs, a stronger euro exchange rate, French politics or a delay in Germany’s fiscal stimulus, it is unlikely to stop at one more cut.

With a view to its balance sheet, the ECB should have more time before the issue of declining excess reserves becomes a more pressing one. As excess reserves in the banking system still amount to more than €2.5tn, the euro short-term rate (ESTR) remains set below the deposit facility rate. Although the latest fixing at 7bp below is the highest in relative terms since 2021, overall the upward pressure on short-end rates as the reserves come down still looks to be more gradual. There is also no material uptick in banks' demand for the ECB’s regular liquidity providing open-market operations. The weekly main refinancing operation stands at €13.5bn while the long-term operations total €10bn.

Thursday’s events and market view

The ECB meeting is the obvious highlight, but the data could be more important in shaping markets' outlook. The eurozone will publish the advanced third-quarter GDP data, as well as economic confidence indicators and the unemployment rate. On top, we will get the first

October inflation readings from Germany and Spain.

US data releases continue to be impacted by the shutdown, meaning delays in the third-quarter GDP data and jobless claims. Focus will therefore be on Fed comments in the wake of the latest Federal Open Market Committee meeting, with Governor Bowman and Dallas Fed President Logan scheduled to speak.

In terms of issuance, Italy is auctioning a new 10y benchmark as well as reopening existing 5y bonds and floating rate notes, overall for a total of up to €9.5bn. The UK will tender 5y gilts for £1.5bn.

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