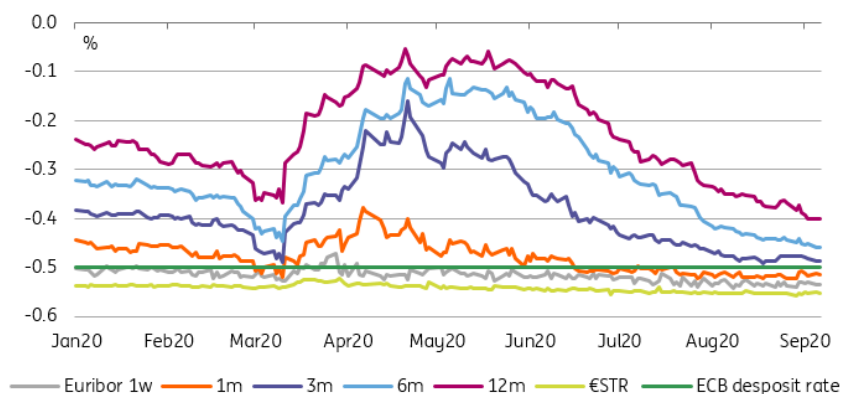


Rates Spark: What to expect from the ECB

With no policy action expected from the ECB today, all focus will be on their forecasts. We expect a near-term drop in EUR rates, to be later reversed as markets normalise. Euribor fixings keep declining, and a change in the tiering multiplier would be a wildcard in today's decision



Source: ECB, EMMI, ING

EUR rates market are normalising

When trying to decipher market behaviour around today's ECB meeting, it is worth distinguishing between near term 'knee-jerk' reaction and the longer-term trend.

Our long-term view is: rates are reflecting a protracted recovery and lasting damage to inflation. However, there is no longer a basis to reflect the same degree of market stress they did back in the spring.

This suggests to us that despite low outright rates, a normalisation of the EUR yield curve is justified. This means more upside than outright downside and a gradual re-steepening. The belly of the curve on the other hand has little room to rise if market expectations of very low inflation, preventing a policy tightening, are fulfilled.

We expect a near-term rally in rates

Nearer-term, we see odds as skewed towards lower rates around today's meeting.

The first reason has to do with macroeconomic projections. If the ECB continues to project a significant inflation shortfall compared to its target in the coming years, any display of optimism

would lack credibility. This in turn could be detrimental to sentiment in our view, with markets pricing a lesser degree of central bank support, for instance by lowering the probability of a QE extension.

In short, good news can be bad news for markets, especially when it comes from a central bank.

Another factor is expectations. A Bloomberg article yesterday seemed to support Schnabel's view that the economy has progressed roughly along the lines forecasted by the ECB in June. This hardly makes the case for more easing for the time being and we think markets are expecting a cautiously optimistic tone.

This would make any dovish display more impactful from a rates point of view.

Technical tweaks as excess liquidity increases - the ECB could signal increased awareness at least

3-month Euribor hit another all-time low yesterday at -0.493%. It is closing in on the -0.5% deposit facility rate of the ECB which should in theory serve as a floor to fixings.

That is the rate at which banks can redeposit their excess liquidity at the central bank. In practice, the overnight rate €STR and 1m Euribor are already below the deposit facility rate – banks are charging those market participants without access to the facility for redepositing at the ECB and the rising excess liquidity, now approaching €3tn, is keeping the pressure on rates.

The ECB has partially alleviated the cost that the negative rate charged on the excess liquidity puts on banks by introducing tiered deposits. Six times the minimum reserve requirement is what banks are now allowed to deposit at zero charge before the -0.5% penalty rate kicks in, but that multiplier was fixed before the latest steep increase in excess liquidity.

Increasing the multiplier could thus be a technical tweak that might be considered and it could also lessen the downward pressure on Euribor rates. However, ECB officials have not signalled any urgency on that front. Furthermore, having provided banks €1.3tn in liquidity via the last TLTRO.III at a rate as low as -1% if certain requirements are met, could be viewed as an offsetting subsidy.

That said, the inclusion of a question on the multiplier in the ECB survey of monetary analysts for today's meeting signals at least an increased awareness of the issue.

Today's events: ECB, supply, industrial production numbers

Today should prove an eventful session with Italy and Ireland carrying out auctions in the morning, as European countries release industrial production numbers.

The US Treasury auctions 30-year bonds today.

Author

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

Benjamin Schroeder

Senior Rates Strategist

benjamin.schroeder@ing.com

Antoine Bouvet

Head of European Rates Strategy

antoine.bouvet@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 www.ing.com.