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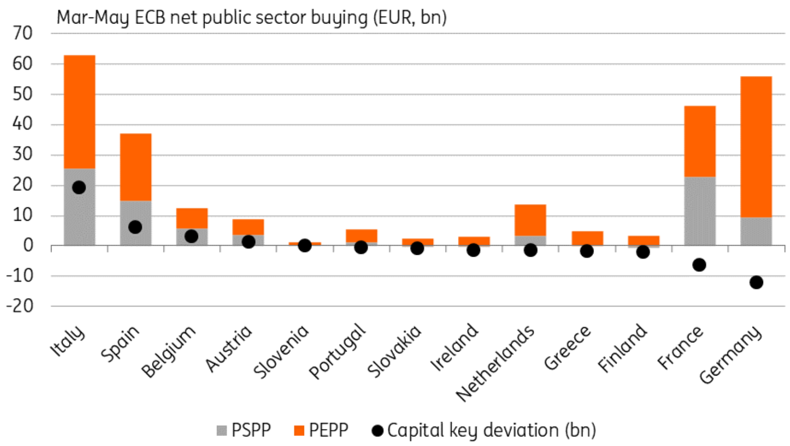
Rates Spark: the rising tide of liquidity and tighter spreads

ECB QE data suggests a willingness to tighten spreads. Rising ECB liquidity and QE will limit Euribor rises but bonds will not benefit if tiering is increased. Bigger picture there is an infectious spread tightening process ongoing, extending from high yield to emerging markets. Too much more of this and curves can be pulled steeper vs anchored front ends.



Source: ECB, ING

The ECB doused multiple fires with QE

ECB QE data released yesterday afternoon suggests a willingness to limit spread widening in the periphery. This is just as well. Our economics team sees more economic divergence between core and peripheral economies, with associated impact on debt dynamics on countries worst hit by the coronavirus epidemic.
The heavy skew of PEPP purchases towards the public sector confirms the notion that the tensions in government bond markets were at the forefront of the ECB's worries. Out of the € 235bn net PEPP purchases from March through May €186bn were executed in the public sector alone. The further breakdown into the individual countries was surprising at first glance, with €47bn bought in Germany but "only" €37bn bought in Italy. However, two important observations can be made than reconcile the headline figures and market perception.

First, the ECB revealed that the German purchases had a weighted average maturity of just 3 years as opposed to the 7 years for Italy. In risk adjusted terms that is signifcantly less for Germany and probably reflects efforts to contain upward pressure in money market rates which faced a surge in German treasury bills issuance. These efforts were flanked by the PEPP also buying €35bn in private sector commercial paper.

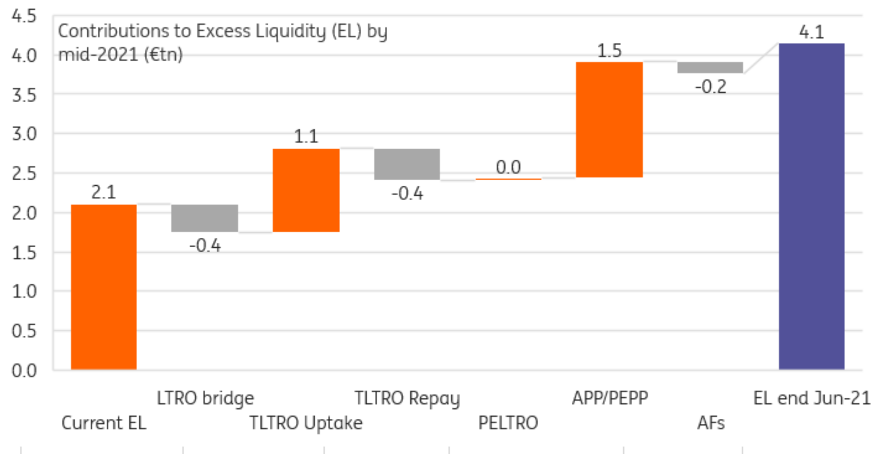
Second, we think it is more instructive to look at the PEPP and the older PSPP programme as a package, especially in the beginning when the PSPP had to pick up the slack before the new programme became operational. Taking the two together reveals an even larger skew towards Italy (see above chart) as the ECB bought €19bn more than a strict adherence to the capital subscription key would have implied. In Germany the ECB bought €12bn less.

The rising tide of ECB liquidity will keep Euribor low

Today is the last full trading session before the ECB meeting. It is also the last full trading session before we find out whether, as an MNI story suggested on Monday, expectations of easing in June are premature. Our house view is that there is no point in waiting to increase PEPP. A number of factors contribute to making an immediate decision more likely. One of the these is the loss of credibility at the hands of the German Constitutional Court ruling if no easing is enacted soon.

Another driver is that Eurozone sovereigns are still in a phase of downgrading growth forecasts, and worsening deficits. The German coalition is still locked in talks to add €80-100bn of stimulus, although not all of it may be financed with federal debt. Peter Altmaier also stessed growth forecasts should be revised lower for 2020. We've also heard from French finance and budget ministers yesterday, revealing respectively deeper recession and wider deficit forecasts for this year.

Excess Liquidity should nearly double within a year



Source: ECB, ING

Either way, rates markets are in for another wave of liquidity hitting the Eurozone's shores this or the other side of the summer. With the increase to PEPP we're expecting, excess liquidity will nearly double from €2.1tn to €4.1tn by the middle of next year (see decomposition on the chart above). Additional asset purchases, alongside the extra liquidity we think will be auctioned due to more generous TLTRO conditions, comes with benefits… and some costs.

Benefits first. Extra liquidity further supresses the part of Euribor fixings that pertains to supply and demand for liquidity. It is hard to argue that liquidity is scarce or expensive at the Eurozone level, but it might be for some financial institutions. What the ECB's facilities, in particular PELTRO, achieve is a reduction of systemic risk by providing yet another backstop for banks unable to find cheap funding.

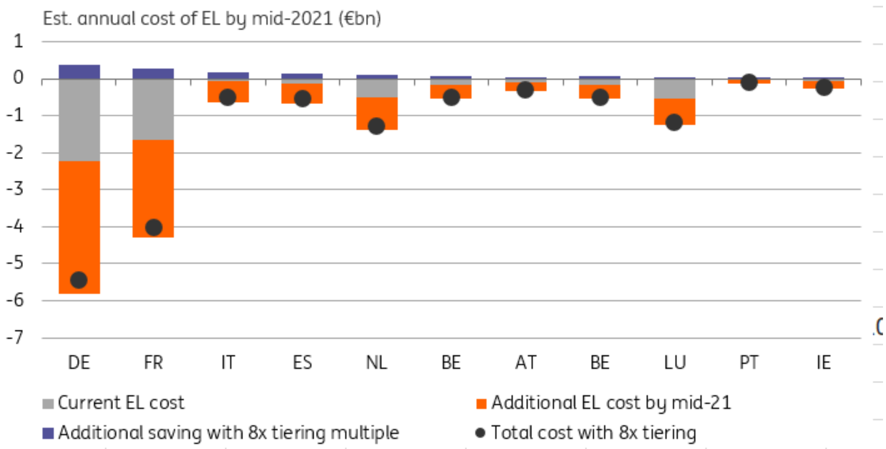
This should help reduce the number of expensive transactions used for Euribor fixings. More importantly perhaps, forceful bond purchases help reduce credit spreads and thus the theoretical funding level of banks when they have to rely on their 'expert judgement' when estimating their funding cost.

But it might not lift all boats

What of costs? On the net level the addition of liquidity means some of it should be available to buy short-dated safe assets such as government bonds. We agree, up to a point. A lot depends on whether the ECB elects to increase the tiering multiple shielding some of banks' deposits from negative rates.

When tiering was announced in September 2019, the front-end treated it as a rate hike. Conditions are slightly different now than in 2019 due to the fast increase in liquidity but a higher tiering multiple means less of it will be available for buying bonds.

An 8x tiering multiple would not save banks much money



Source: ECB, ING

This is all the more true in that to achieve a sizeable saving for Eurozone banks, the multiple would have to be increased by a lot. We show on the chart above the annualised saving achieved for Eurozone banks if the multiple is increase from 6 times to 8 times reserve requirements, which we think is where expectations are ahead of Thursday. This tends to show that if the governing council wants to shield banks from the cost of excess liquidity, it would also limit the positive impact on bonds.

Spread tightening on a global scale

The price action in risk assets forms an important backdrop for rates, and especially if it is persistent. Spread tightening in high yield has become infectious, now extending into emerging markets. The fact that the dollar has come off the boil has helped, manifesting in a lower perceived demand for ultimate safety.

So far there has not been a material effect on US Treasuries, where the impulse for global core rates is key. Some edgeing higher in rates has happened, but its been quite tame. Should the risk rally continue alongside an easing in volatility, the most likely pressure for market rates would be for some steepening from the back end.

Front ends are anchored by policy. And any Fed dip into yield curve control would begin there too (but then likely extend out the curve). At the same time, the US curve structure remains quite bullish. Hence, market rates are not naturally inclined to move higher from here; they would need to be pushed.

Today's Events: 10Y Italy and US data

Italy has mandated banks for the launch of new 10Y BTP via syndication which we think will take place today. Given that it normally launches 10Y benchmarks via auctions, we surmise the issuer wants to achieve a larger size than €5-6bn. The new issue might fare differently depending on whether the ECB decides to increase PEPP or not tomorrow. Germany will also sell bonds, at the 5Y point.

In data, US ISM non-manufacturing and factory orders will be the highlights. Especially since both are forward-looking components and as markets are focused on the speed of the recovery from its spring slump. There also is the possiblity of a surprise in peripheral PMI services this morning. On Monday, BTPs were supported by a large beat in the manufacturing index.

Author

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

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

Antoine Bouvet
Head of European Rates Strategy
antoine.bouvet@ing.com

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