

Money market outlook 2025

Money market funds are experiencing falling reserves across the US, eurozone, and UK. We look at what 2025 has in store

In this bundle



Money market outlook 2025: trends and dynamics in the eurozone, US, and UK

We go deep into money market developments for 2025, focusing on the US, UK and eurozone

By Padhraic Garvey, CFA, Benjamin Schroeder and Michiel Tukker



EUR money market faces gradual tightening from ECB's shrinking balance sheet

We see a structural tightening trend lingering in the background as the ECB shrinks its balance sheet and drains reserves

By Benjamin Schroeder

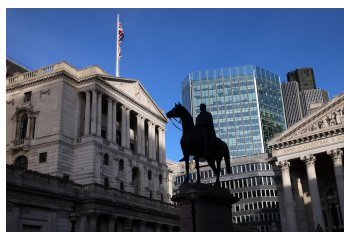


United States

Term and Repo in vogue in US money markets

Absolute rates continue to be a key draw and could stay this way even if the Fed implements further cuts

By Padhraic Garvey, CFA



United Kingdom

UK money markets transitioning to a new monetary policy regime

Overall liquidity conditions should remain good, with revamped central bank facilities giving access to liquidity at attractive pricing

By Michiel Tukker

Article | 18 February 2025

Money market outlook 2025: trends and dynamics in the eurozone, US, and UK

We delve into the world of money market funds. Distinct dynamics are at play in the US, eurozone, and UK. In the US, repo rates are more attractive, and bills are expected to appreciate. It's also worth noting that the Fed might cut rates more than anticipated, similar to the UK. In the eurozone, unsecured rates remain elevated



Eurozone: A gradual tightening from the ECB's shrinking balance sheet

There remains a structural tightening trend as the European Central Bank (ECB) shrinks its balance sheet and drains reserves. Up to now liquidity conditions have been ample, and the impact has been mainly felt in repo markets where rates have drifted towards the ECB's deposit facility rate.

Unsecured overnight rates are still fixed noticeably below the depo rate, and thus, counterintuitively, below secured rates – market fragmentation is part of the reason. The minimum level of reserves at which banks want to operate is still some distance off.

US: Term and Repo more in vogue

Absolute rates attainable in the money market funds space remain attractive and will stay this way even if the Fed cuts some more (we think two 25bp cuts in the second half of 2025). Money curves have generally dis-inverted, which generates the opportunity to term out where feasible, to

get today's rates (or at least close to them) for longer. The Fed's reserve repurchase agreement facility will increasingly be used just at turns, broadly ending routine usage. Market repo is more attractive here in relative value terms.

As quantitative tightening concludes by mid-year, idle liquidity is expected to decrease, potentially pushing generic money market rates higher. Although these changes are marginal, they create a more natural environment compared to the peak period in 2022-23, when approximately \$2.5tr was directed to the Fed's reverse repo facility.

UK: Transitioning to a new monetary policy regime

The Bank of England is pursuing a relatively rapid pace of quantitative tightening compared to its peers, but is also focused on assuring adequate liquidity conditions in the system at the right places. A recalibration of the Indexed Long Term Repo facility, for instance, offers relatively attractive liquidity to banks over six-month horizons.

In the meantime, money market rates are mirroring the normalisation of monetary policy and are performing as expected. Overnight deposit rates could, however, remain relatively low-yielding due to market segmentation. The steepening of curves will continue to incentivise investors to move out of money market funds and allocate cash to longer tenors. While overnight rates may still look attractive at first sight, we are already inclined to move further out the curve for better value.

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EUR money market faces gradual tightening from ECB's shrinking balance sheet

The European Central Bank remains in rate-cutting mode and could take the policy rate just into accommodative territory. In the background, however, remains a structural tightening trend as the ECB shrinks its balance sheet and drains reserves. So far liquidity conditions are still ample and the impact has been mainly felt in repo markets



The European Central Bank in Frankfurt am Main, Germany

ECB to continue cutting rates, possibly more than markets are pricing

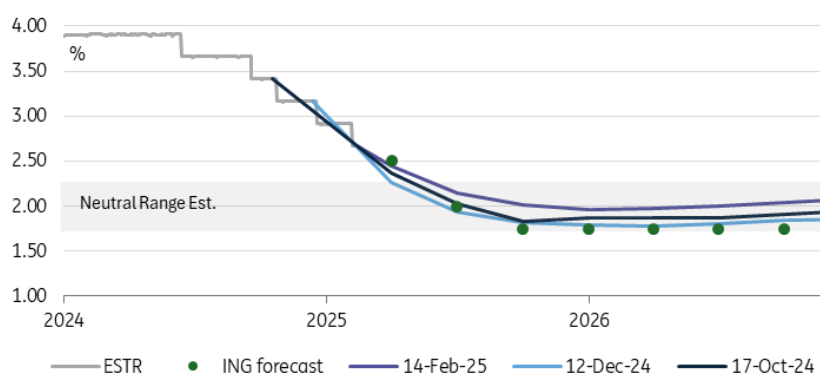
Our economists still think the European Central Bank (ECB) could end this cycle with a terminal rate at 1.75%, ending up in slightly accommodative territory compared to neutral interest rate estimates ranging mostly from 1.75% to 2.25%. We think that, in the near term, a combination of adverse headlines and data disappointments could push market pricing temporarily even closer to a terminal rate of 1.5%.

Markets are only now starting to lean in the direction of our economists' prediction given the

growing list of downside risks to the economic outlook. Overall macro indicators continue to show weakness. January's composite PMI barely made it above the boom-or-bust level, while the manufacturing PMIs have remained mired in contractionary territory for more than two years now. The prospect for fiscal stimulus also looks distant. There might be some stimulus coming through out of Germany after the elections, but several countries are under excessive deficit procedures, forcing them to maintain tighter budgets. Our economists anticipate stagnation over the winter months, followed by a modest recovery, resulting in only 0.7% GDP growth in 2025.

At the same time, the ECB seems more confident of reaching its inflation goals in line with forecasts, even as monthly inflation prints are showing ticks higher for the fourth time since headline inflation normalised from record highs. We sense that a growing number of officials have become more geared towards supporting growth. Indeed we think the ECB will have to be more nimble amid the influence of policies abroad, which might leave it picking up the pieces as domestic politics remain largely incapacitated.

The ECB is in rate cutting mode



Source: Refinitiv, ING

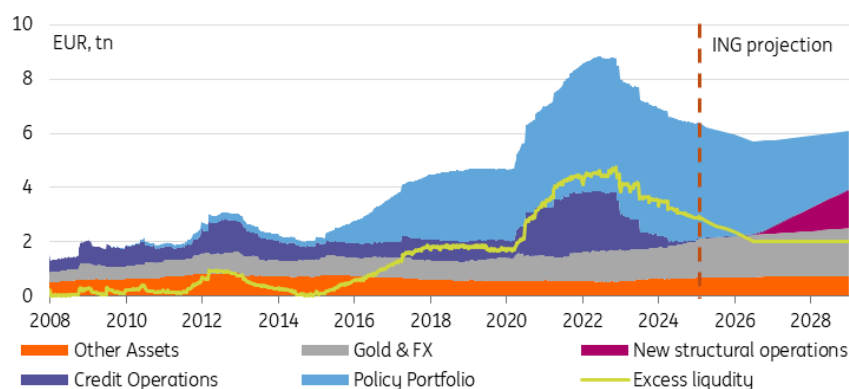
Excess liquidity will remain ample in 2025 despite the ECB's balance sheet unwind

Looking at the operational aspects of monetary policy implementation, one of the ECB's main goals at the moment is the normalisation of its balance sheet. The central bank wants to have less of a footprint in overall markets outside of setting interest rates. At least part of the reason for this is regaining policy space and “restocking” the tool box.

By now, all targeted liquidity refinancing operations (TLTROs) are matured, but the ECB's asset portfolio still holds €4.3tr in bonds, contributing to around €3tr of excess reserves in the banking system. €510bn will roll off over the course of 2025 and will – all else equal – reduce excess liquidity by the same amount.

The overall sense is that the banking system is still operating at levels of excess reserves well above those that would trigger a stronger rise in money market rates and spreads. That level, depending on literature, is estimated to be around €1.5tr to €2tr. Approaching that level, the expectation is that the system will then start to rely more on the ECB again as a provider of liquidity via its open market operations, offsetting the impact of quantitative tightening and stabilising the overall level of reserves in the system.

ECB balance sheet is still to decline over the next years



Source: ECB, ING

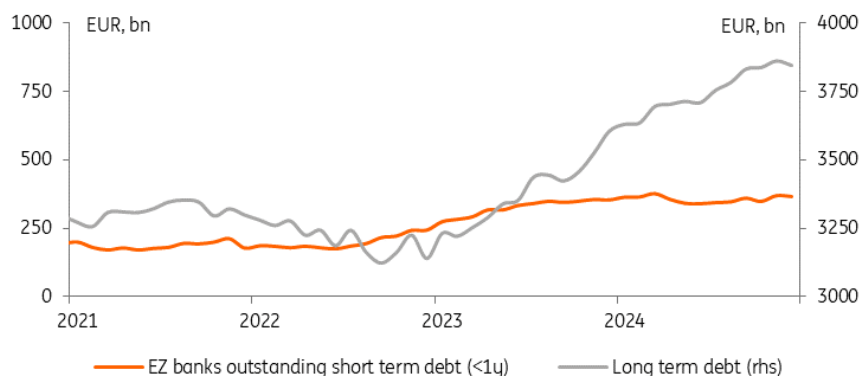
Banks' demand for reserves will determine when the point of market tightness is reached

By the end of the year, excess reserves in the banking system are expected to have reached a level of around €2.5tr. The exact level from where on money market conditions would start to tighten and impact spreads to a greater degree, will largely depend on the desired level of cash reserves banks want to operate with.

Liquidity is not only needed to fulfil the minimum reserve requirement set by the ECB – by definition NOT as part of the excess reserves – but beyond that, demand is also determined by operational needs and buffers, e.g., anticipated cash flow settlements. Another important role is played by regulatory requirements where cash reserves can form part of the high quality liquid assets (HQLA) portfolio to meet the liquidity coverage ratio (LCR, which requires banks to hold a sufficient stock of high-quality liquid assets, HQLA, that can be converted into cash easily and immediately to survive a period of significant liquidity stress lasting 30 calendar days).

Banks' LCR ratios remain relatively high overall all at 159% in third quarter 2024, according to ECB data for the weighted average of “significant institutions”. Any reduction of this ratio is likely to be only very gradual, not least due to the signalling effect and peer pressure. For now, banks have also been able to cover the need for cash reserves with other sources of market funding, also via unsecured commercial paper, bond or covered bond issuance.

Banks have already increased their market funding as the ECB withdraws

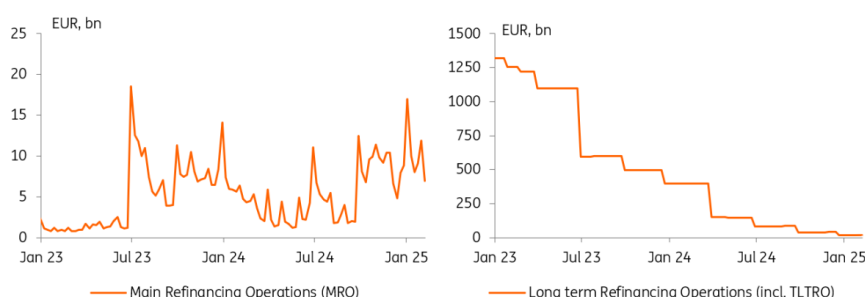


Source: ECB, ING

This implies HQLA portfolios are remaining larger for now, but within those portfolios banks can, of course, substitute declining reserves with high quality bonds. And they have indeed done so when the TLTROs matured and excess liquidity levels declined, the added incentive now being that bonds have a higher return. With (ASW) curves steepening, bonds could become even more attractive in relative terms. But then also credit risks and limits to the amount, for example, of sovereign bonds a bank may hold have to be kept in mind.

In theory these bond holdings can also always serve as collateral to be used in the collateralised ECB liquidity operations (the weekly MRO and three-month LTROs) to convert them to cash reserves, especially when the price differential between market repo and the MRO rate is very small. The ECB had lowered the MRO rate to 15bp above the deposit facility rate last December to make the ECB's operations more attractive and, in turn, also a more effective back-stop for the money market in general.

Banks' recourse to ECB liquidity operations remains relatively low



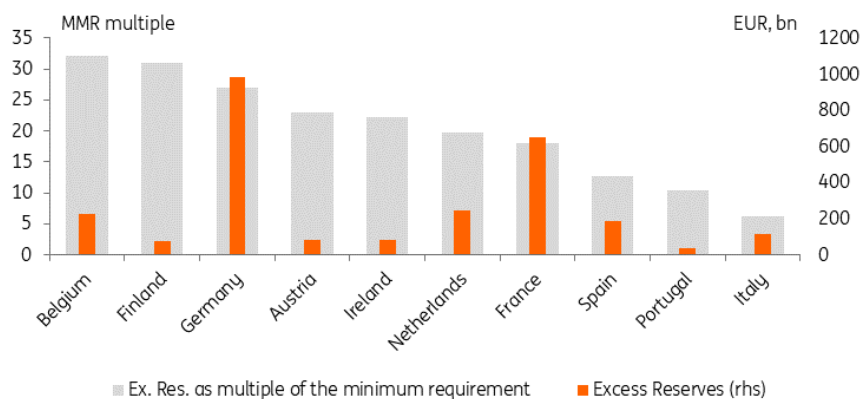
Source: ECB, ING

But a lingering stigma effect appears to still surround the ECB operations. No bank would want to be seen as having to resort to these operations in larger size. It could be interpreted as not having access to regular market funding to cover cash needs. The relative attractiveness to market rates will likely have to grow in order to draw in wider participation to overcome the perceived "first-

mover disadvantage”.

For now, banks' liquidity take-up in the ECB's MROs has been muted and is mainly attributable to banks in Italy, and to a lesser degree (likely smaller) banks in Germany and Greece. More generally, one would expect to witness a more noticeable pickup first in jurisdictions where the excess reserves cushion above the minimum requirement is relatively low.

Excess liquidity is not distributed evenly in the banking system



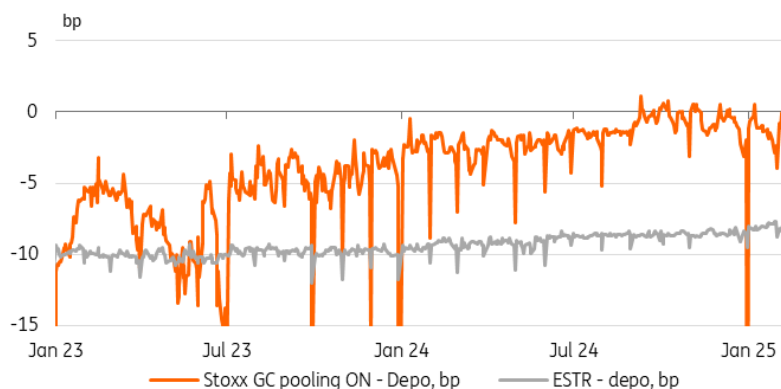
Source: ECB, ING

Market segmentation contributes to unsecured rates staying below secured rates

For now, the impact on spreads stemming from the ECB's shrinking balance sheet has been mainly felt in the realm of secured transactions. Rates on repurchase agreements ('repo') were feeling the largest impact and have risen versus €STR and OIS, mainly as collateral has become more abundant – not just as ECB holdings roll off, but also as the net funding needs of issuers remain at elevated levels.

We are at a point where the ECB facilities are starting to cap or at least noticeably slow the dynamics. Repo rates are now in the range of just 1bp below (German collateral) to 2bp above (Italian collateral) the ECB's deposit facility rate. The intuition is that at repo rates above the deposit facility rate banks should start shifting out of ECB deposits and place cash into market reverse repos, earning the additional interest.

Repo rates have moved towards the ECB's depo rate, but €STR lags noticeably



Source: Refinitiv, ING

In theory, non-banks could also shift out of bank deposits into repos. Ultimately it could be one channel to cheapen also the unsecured overnight rate (€STR) relative to the deposit facility rate. However, €STR has remained more anchored and still sits around 8bp below the deposit facility rate, having moved upwards only very marginally. Counterintuitively, that means the *unsecured* rate is well below the *secured* rate. The ECB's Isabel Schnabel has discussed several factors contributing to this effect:

For one, the short-term funding market is still very segmented. On the lending side many participants are only active in either one of the markets, repo or €STR, and very few are present in both. The hurdles to participating in the (cleared) repo market remain especially high. For banks themselves, though, repo markets are more attractive due to regulatory reasons where secured lending is treated preferentially. Also on the borrowing side, central clearing of repos allows for the netting of borrowing and lending which can also reduce regulatory/balance sheet cost.

The result is that the unsecured market is mainly used to channel excess liquidity from non-bank(s) to the ECB via the banks that have access to the central bank facilities – with banks applying the charges for the balance sheet costs in the form of a negative depo spread.

Money market funds have seen inflows alongside inverted rate curves

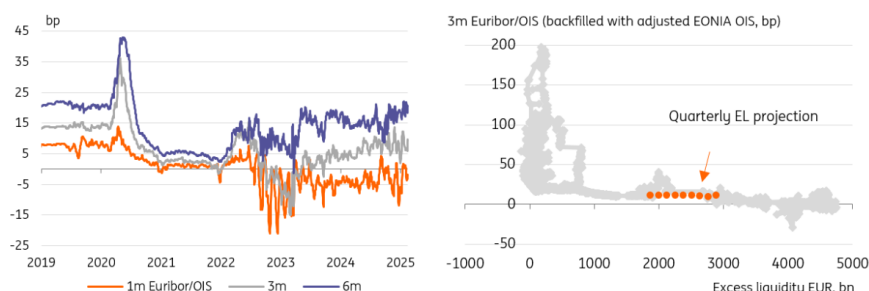


Source: EPFR, Refinitiv, ING

For now, there is no end in sight for non-banks needing to place cash in the deposit market, from money market funds, for instance, that only make use of repos to some extent due to intra-day liquidity needs. The interest rate curve is likely to stay inverted, directing flows towards money market funds – that is at least until summer when the ECB comes close to the end of its cutting cycle. But even thereafter, a notable resteeptening is not ensured. At the same time that also means even smaller banks without repo access do not feel a greater need to borrow with liquidity conditions still comfortable.

The upward pressure on unsecured rates may remain muted in the near term. If it were to rise then it should likely be felt in rising Euribor-OIS spreads first, i.e., in the terms beyond one month that have more regulatory value for banks.

Unsecured rates have yet to feel more upside pressure



Source: Refinitiv, ECB, ING

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Term and Repo in vogue in US money markets

Invested volumes are impressive and expected to stay that way. The rising trend in Bills over Repo may subside should a debt ceiling saga really kick off. There is more term now than before, and while not overly generous offers value on the expectation that the Fed cuts rates later in 2025. QT is set to end by mid-year, and RRP usage to only spike at turns



Treasury Secretary Scott Bessent has implied that coupon issuance is set to remain broadly unchanged in the coming quarters

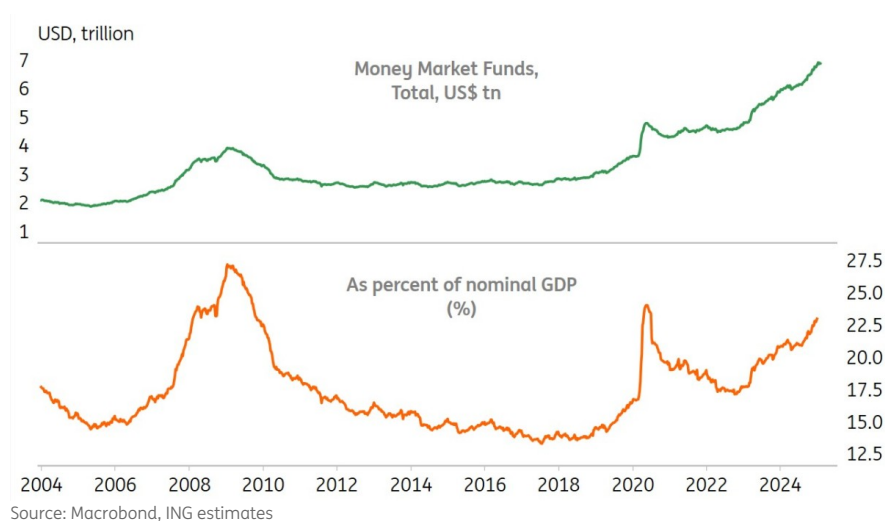
Money market funds remain a valid investment choice, even if the Fed cuts some more

Money market funds have seen a seemingly relentless rise in assets under management in the past five or six years. The first phase of this occurred during the first year or so of the pandemic, bolstered by corporates beefing up cash buffers. On some measures, the proportion of institutional money market funds held by corporates rose from sub-40% to more than 60%. It has since settled in the 50-60% area. The second phase coincided with the Fed's rate hike cycle, as absolute rates rose. And as money market exposure is 'price risk-free', it has offered an attractive foil to bond or risk asset alternatives. Even with the Fed cutting rates, absolute rates in the 4.25%+ area remain

attractive.

For 2025, there will be a tolerance for a few more cuts from the Fed before players begin to question the absolute levels attainable. A 4%+ handle remains very attractive. A break below 4% would not necessarily cause severe liquidation. We suspect such conversations will begin if the Fed gets below 3%, as we see the 3% area as a neutral valuation for the funds rate (so rates below that should be viewed as sub-optimal). That said, corporates have evolved into large holders of money market funds, and such holdings are liable to prove quite sticky. We'll see the US\$7tr area held for the foreseeable, as the Fed is unlikely to get anywhere near the 3% area.

Money market fund holdings outright, and as a proportion of GDP

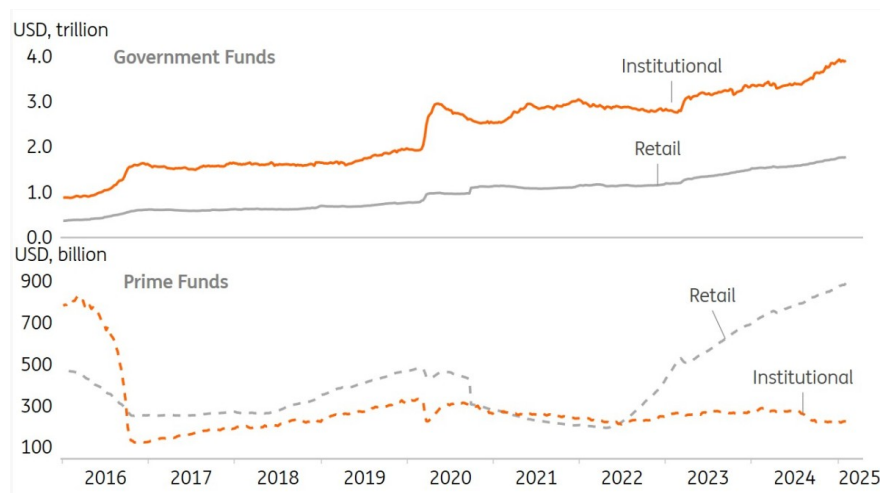


As a percentage of the value of GDP, money market fund holdings were even higher before the Great Financial Crisis. Several regulatory changes since then saw holdings fall from a high of 27% of GDP in 2008 to a low of sub-14% of GDP some 10 years later. Then the pandemic hit. And now money market funds are back up to a little over 23% of GDP. Looking ahead, it is more likely that money market funds trend in line with GDP, rather than faster than GDP.

Breakout of funds by investor type and product shows some stark individual movements

Institutional players have edged their Prime Fund holding lower post-recent rule changes. But this has been offset by ongoing significant rises in money market investment by retail players. Additional institutional cash is predominantly biased toward Government Funds where liquidity requirements are higher and "gates and fees" are less of an issue (compared to Prime funds).

Institutional cash still biased to Government Funds, while retail growth is in Prime Funds



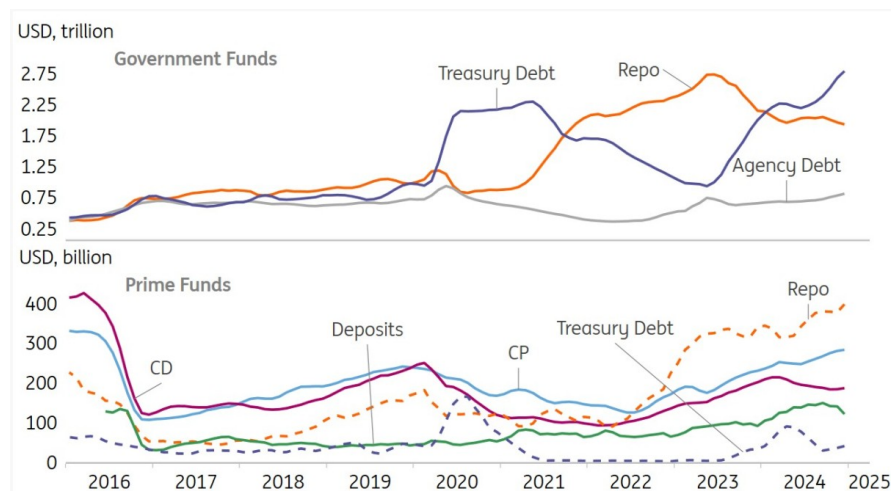
Source: Source: Macrobond, ING estimates

In terms of portfolio breakdown, Government Funds are seeing an ongoing rise in holdings of Treasury Debt (effectively bills). In the wider market setting, Bills now represent some 22% of overall government debt financing, up from the 15% area in 2022/23, implying that extra Bills issuance is being employed to take pressure off coupon issuance.

Exposure to Repo is steadier now in Government Funds, but still well down from the highs seen in 2023. The preferred value play here has been in Bills. For now, the high net Bills issuance environment remains in play. However, as we get deeper into debt ceiling control measures there will be more pressure to reduce net Bills issuance, which can add a premium to prices. That can result in more cash moving back into Repo.

In Prime Funds, Repo (reflecting equity repo) exposures remain on the increase, as is exposure to commercial paper (CP), while certificates of deposit (CD) and ordinary deposits have been steadier to a tad lower. This is in part correlated to the quantitative tightening (QT) process.

Big moves in holdings of Repo vs Bills in Government Funds, and CP plus Equity Repo in Prime Funds



Source: Source: Macrobond, ING estimates

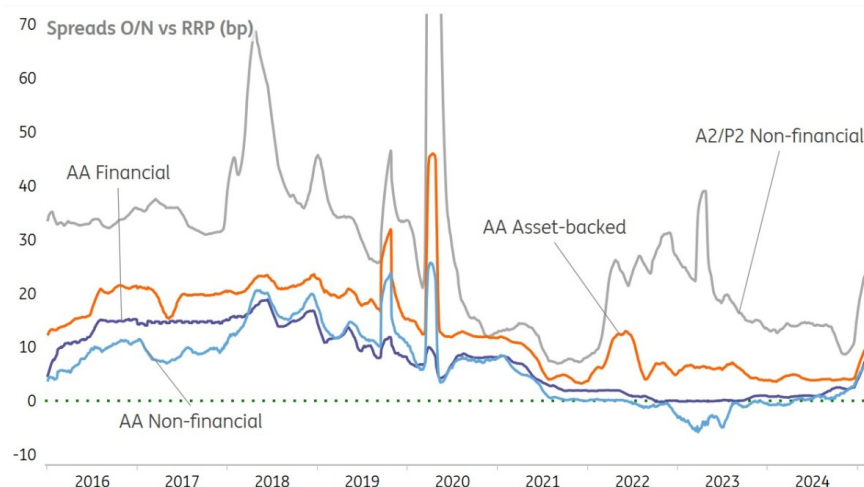
As shown in the chart above, the breakdown of money market fund portfolio holdings shows Treasuries, Agency debt and Repo dominate in Government Funds. Most of the rest is in commercial paper and certificates of deposit (in Prime Funds).

Breakdown of attainable rates and spread to the Fed's reverse repo facility (RRP) rate

In terms of attainable rates, the entire spectrum of overnight CP rates has shifted to comfortably above the Fed's reverse repo rate, which itself was moved down 5bp to the funds rate floor at the December FOMC meeting. This reduces the attractiveness of the Fed's reverse repo facility, and should increase the relative attractiveness of market Repo.

At the same time, CP spreads are not yet quite as wide as they were during the pre-pandemic years, but they are edging towards these types of levels, as shown in the chart below.

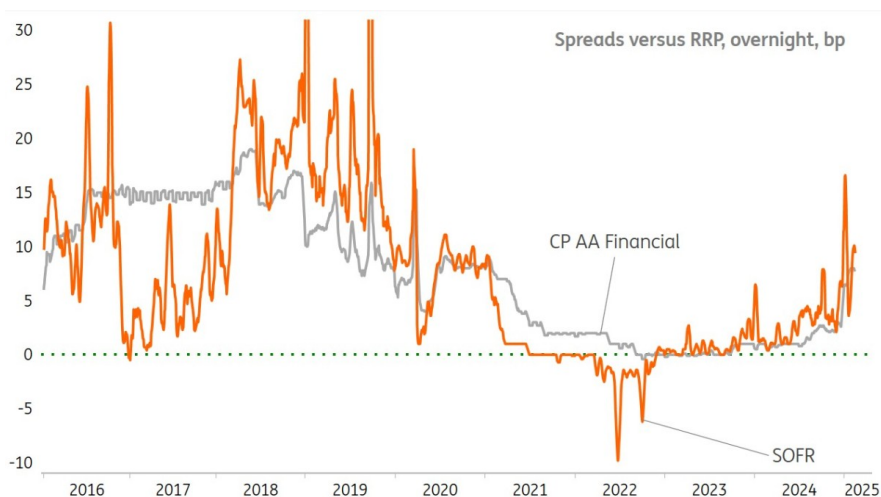
Spectrum of Overnight CP spreads versus the Fed's RRP – some widening of late...



Source: Source: Macrobond, ING estimates

Repo is liable to prove more attractive looking ahead. The relevance of the Fed's reverse repo facility has been downsized significantly from a relative value perspective, as better Repo terms are now typically attainable on the private market. Increasingly we'd see the reverse repo window accessed around quarter (and month) ends when the Fed's facility is used to get past gaps left by counterparties needing to window dress for regulatory reasons.

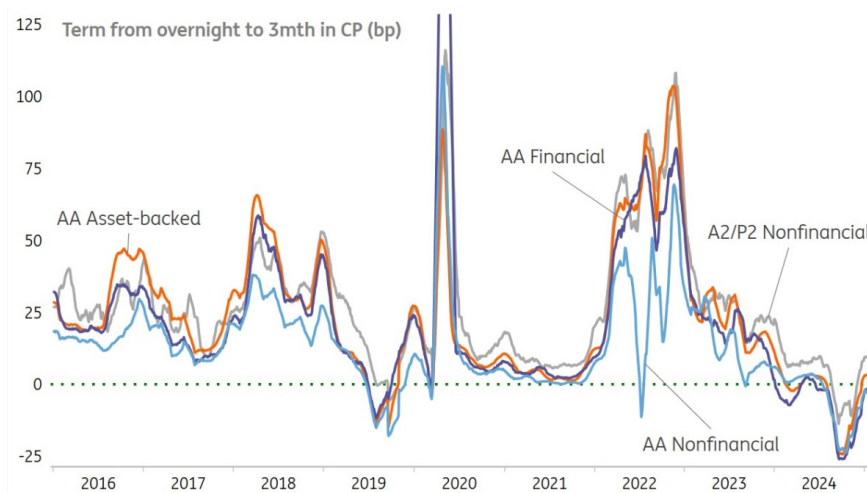
GC presenting better value versus RRP, and AA Financial CP better still



The shift in the Federal Reserve's policy narrative is extending the term on the commercial paper (CP) curve, reversing the inversion that occurred when the Fed started its rate-cutting agenda. Still, three-month AA Financial CP is trading broadly flat to overnight rates. In the A2/P2 nonfinancial and AA-asset backed the evolution of some terms is more pronounced.

With the Fed still technically in cutting mode, terms will tend to be contained. While we'll need to get to the end of the rate-cutting cycle with some degree of certainty before terms can really open up, there is still value in terming out as a means to locking in current levels of rates. This will prove to be a good play should the Fed cut rates later in the year (we think there'll be two more 25bp cuts) in the second half of 2025 (September and December meetings).

Commercial paper term from O/N to 3mth has dis-inverted, and more to go ahead...

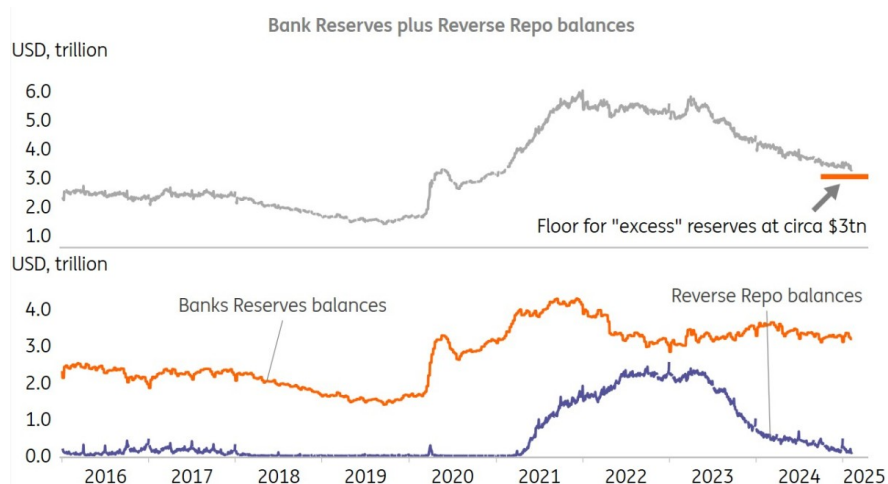


Reserves set to hit a notional floor at around \$3tr by mid year, necessitating an end to QT

Having peaked at around US\$2.5tr at the end of 2022, the volumes going into the Fed's reverse repo facility have persistently fallen, now at below US\$100bn. Our baseline view is for this to settle much closer to zero. We continue to view such balances going back to the Fed as a manifestation of excess liquidity, which should broadly evaporate by mid-2025. From here, reductions in excess liquidity due to quantitative tightening (QT) are more likely to be felt through falls in Bank Reserves.

The Fed needs to be careful here as in 2019 the QT process pushed Bank Reserves down to the US\$1.5tr area, which caused some severe tightness. Back then, the value of US GDP was around US\$20tr. So, Bank Reserves hit around 7.5% of GDP. The thinking ahead is this needs to be closer to 10% of GDP. With the value of US GDP running at around US\$30tr, that implies a floor for Bank Reserves at around US\$3tr.

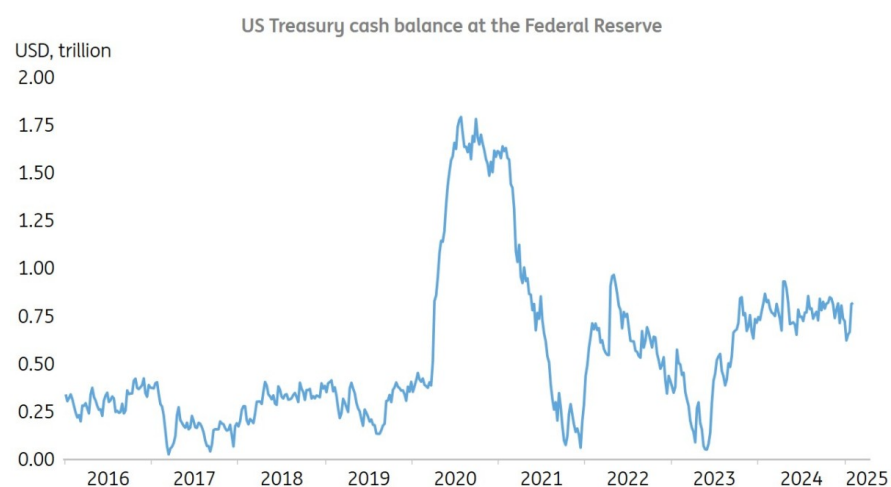
Fed's reverse repo volumes are practically at zero, while overall reserves edging towards the notional \$3tr floor



Currently, Bank Reserves are running at some US\$3.3tr. Adding the cushion of almost US\$100bn at the Fed's reverse repo facility, there is an overall "excess" liquidity balance of some \$3.4tr. Meanwhile, QT is running at around US\$60bn per month and acts to reduce excess liquidity at that pace. Based on this, within the coming half year, the US\$3tr Bank Reserves floor will be hit. Consequently, the Fed will likely bring its QT programme to a halt by the middle of the year.

A complicating factor right now is the debt ceiling. This was automatically re-instated on 2 January 2025, and the biggest implication of this for liquidity circumstances comes from the requirement for the US Treasury to spend down its cash balances (as a cushion for the inability to engage in higher net issuance). Currently, the Treasury has a cash balance of around US\$840bn. As we progress towards the middle of the year, the US Treasury will be in payout mode, and in that sense will tend to bolster Bank Reserves.

US Treasury has built a decent cash reserve that it can ease lower should an early summer debt ceiling saga unfold



Source: Source: Macrobond, ING estimates

It is, however, probable that net bills issuance is an area that could see some shrinkage, certainly as debt ceiling management intensifies (by early summer at the latest), assuming no adjustment to coupon issuance sizes. Treasury Secretary Scott Bessent has indeed intimated that coupon issuance is set to remain broadly unchanged in the coming quarters.

For now, the increased net issuance of bills has added value to that sector. However, this value may diminish if bill issuance needs to be temporarily reduced. The debt ceiling issue could also be efficiently proactively resolved by Congress, but that remains to be seen.

Bottom line, there is net opportunity in this space

Looking through the various pushes and pulls, there are a few key takeaways. First, the absolute rate attainable in the money market funds space remains attractive and will remain so even if the Fed cuts some more.

Money curves have generally dis-inverted, which generates an opportunity to term out where feasible, to get today's rates (or at least close to them) for longer.

The Fed's RRP facility will increasingly be used just at turns, broadly ending routine usage. Market repo is more attractive here in relative value terms.

As QT comes to an end by mid-year, idle liquidity is expected to decrease, potentially pushing generic money market rates higher. Although these changes are marginal, they create a more natural environment compared to the peak period in 2022-23, when around \$2.5tr was directed to the Fed's reverse repo facility.

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UK money markets transitioning to a new monetary policy regime

With the Bank of England in easing mode, overnight rates will gradually become less attractive. Already we see value further out the curve as we see more room for policy rate cuts than markets. Overall liquidity conditions should remain good, with revamped central bank facilities giving access to liquidity at attractive pricing, also in times of stress

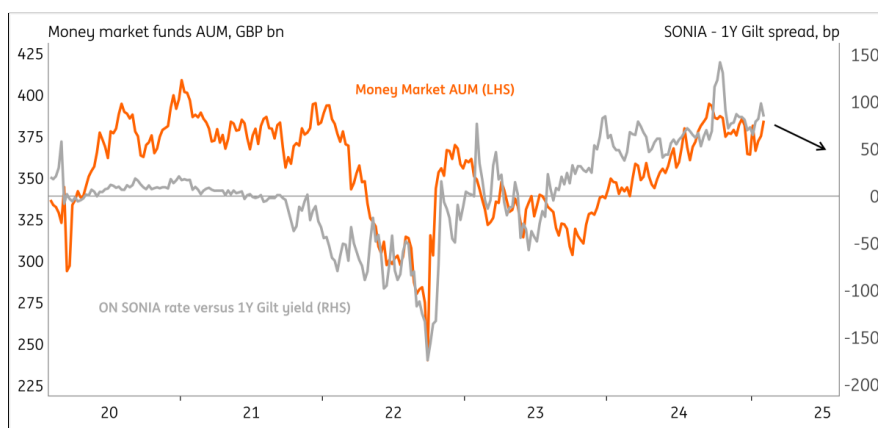


The Bank of England in London, UK

Money market funds benefit from inverted curve

Since the turn of the monetary policy cycle in 2023, money market funds have seen significant inflows, but we think the peak has been reached. The difference between storing money overnight and investing in a 1Y UK government bond is now 100bp, but this will decline as the Bank of England (BoE) continues to cut. A resteepling of the curve makes it more attractive to fix rates at longer tenors, outside of money market funds.

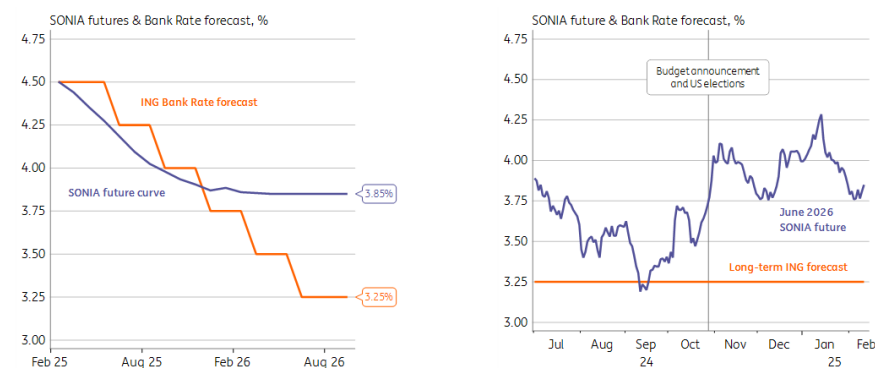
Steeper curves will see outflows from money market funds



Source: ING, Macrobond, EPFR

Markets currently price just 60bp of cuts from the BoE in 2025, which is still more dovish than at the start of the year. And although we also reduced the number of cuts in our forecast for 2025, we believe markets are underestimating the easing potential. We think 75bp of cuts is more likely, with another 25bp cut in 2026, with the risk tilted towards even more cuts. As such, we continue to see better value further out on the money market curve.

SONIA futures suggest just three more 25bp cuts, significantly less than our forecast

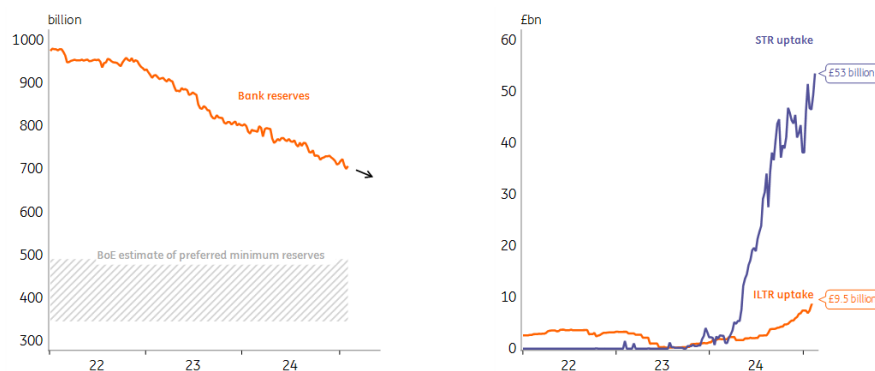


Source: ING, Macrobond

Bank of England facilities help offset falling bank reserves

As part of the broader policy normalisation process, the Bank of England continues unwinding its bond portfolio at a rate of £100bn per year, further withdrawing bank reserves from the system. Since early 2024, the Short-Term Repo (STR) facility has already seen increased uptake, supplying banks with reserves over weekly horizons. Now the BoE is also making a push to increase the use of the Indexed Long-Term Repo (ILTR), which offers reserves over a period of six months against various types of collateral.

ILTR and STR will help with liquidity while BoE unwinds bond portfolio



Source: ING, Bank of England, Macrobond

To stimulate the use of the ILTR, the BoE will tweak the pricing of the liquidity facility in the first half of 2025. As part of the monetary policy normalisation efforts, the BoE sees the ILTR as an important supplier of bank reserves. So far banks have made little use of the facility, but as reserves become more scarce and the pricing is made more attractive, we expect the ILTR to see significantly more uptake later this year. In effect, this reduces the pace at which bank reserves will diminish.

New Contingent Non-Bank Lending Facility introduced for times of liquidity stress

Furthermore, the BoE introduced the new Contingent Non-Bank Lending Facility on 28 January, which offers non-banks access to liquidity against gilts collateral. The facility will only be opened during times of stress in the gilt market and the pricing and terms are at the discretion of the BoE. As such, this backstop should prevent liquidity squeezes spilling over to gilt markets, as seen during mini-budget episode in October 2022.

Back then, former UK prime minister Liz Truss triggered a gilt sell-off in the pensions sector due to a need for liquidity to serve margin calls on interest rate derivatives. With this new facility, pension funds would have access to liquidity directly from the central bank, thereby preventing a broader sell-off in gilts. Overall, this facility should make the gilt market more resilient during times of stress, but the impact on money markets pricing is negligible.

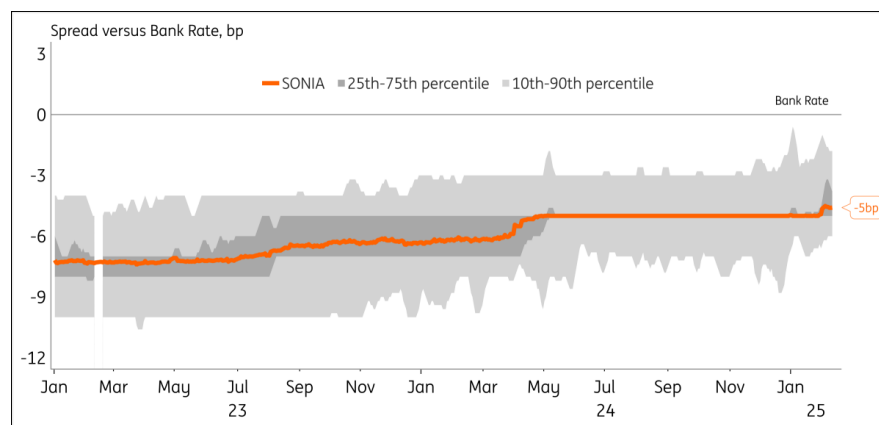
Overnight rates already reflect a tightening of liquidity

The reduction in bank reserves is already being expressed in higher overnight deposit rates, but the upside is limited. The Sterling Overnight Index Average (SONIA) is now around 5bp below the Bank Rate and since the start of 2025 it has been nudging up again. Also when looking at the underlying distribution, the dispersion increased, suggesting some banks are increasing the interest rate they are willing to pay to attract deposits.

SONIA is an unsecured rate, which should in theory compensate lenders with a higher interest rate

than secured funding (e.g., through repo). Yet due to market segmentation, money markets are not fully efficient. Only banks and a small subset of other financials can use the BoE's deposit facility. As such, the SONIA rate can remain below the Bank Rate. Over time, lower bank reserves will increase the competition for deposits among banks, thereby pulling SONIA closer to the Bank Rate. Since banks can obtain (secured) funding from the BoE at the Bank Rate or at a small spread above it, SONIA is unlikely to drift far above the Bank Rate.

SONIA will drift closer to Bank Rate, but upside limited



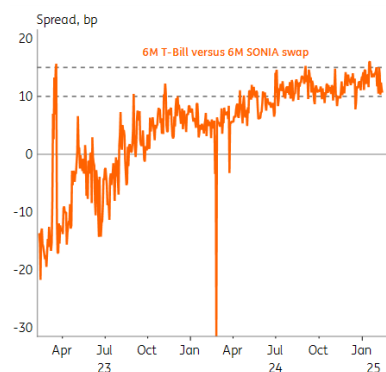
Source: ING, Bank of England, Macrobond

Rates further out the curve are also showing signs of normalisation

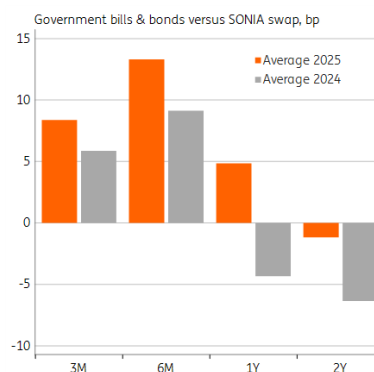
Even though the BoE intends to keep the market impact at a minimum, the ILTR helps provide a soft cap on term rates. The pricing for the facility starts as low as the Bank Rate for high quality collateral (i.e., gilts) and can therefore offer an attractive alternative to market funding. Having said that, the BoE raises the price when the auction demand for the ILTR increases and money markets should therefore remain the main source of liquidity. But overall, the facility will help keep money market rates close to the policy rate.

Since 2023, the 6-month treasury bill trades at a higher rate than the equivalent SONIA swap, but we don't expect that the widening can go much further. The ILTR offers repo funding over six month periods, which in theory caps the 6-month bill to the Bank Rate. In practice, one needs to add a spread to account for the associated balance sheet costs and the remaining stigma from using a BoE facility. The 6-month bill can therefore continue to trade in the recent range of 10-15bp above SONIA.

Funding costs are normalising and BoE facilities like ILTR provide soft cap



Source: ING, Macrobond



The yields on government bills seem to have stabilised in recent months around 10bp above the SONIA swap, but for 1Y and 2Y tenors, there is scope for further widening. The 2Y spread was still negative for most of this year, but we can expect this to drift higher as the year progresses. If anything, the 2Y gilt may even settle at a spread above those of shorter tenors, as the 10Y spread further out the curve is already much higher at 50bp.

Overnight is attractive, but value in longer tenors

A key takeaway from all of this is that overnight rates still provide the highest return in an absolute sense, but this advantage should fade going forward. In relative terms, we think longer tenors provide better value, as we see more room for the Bank of England to cut than markets are pricing in. When looking at the cross-section of treasury bill rates, the sweet spot seems to be in 6-month tenors, where spreads versus SONIA swaps are widest. The ongoing tightening of liquidity conditions could still widen spreads further, especially at tenors beyond 1-year, but the BoE's liquidity facilities should prevent sharp moves.

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