Bundle | 6 July 2026 RATES

Money Market Outlook: Our latest for the eurozone, US and UK

We favour terming out as markets are too hawkish on terminal rates. Meanwhile, the Fed's bill-buying and Bank of England s liquidity facilities have helped their bank reserves stabilise. The eurozone's reserves are still coming down, along with subtle signs of tighter liquidity conditions

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We don't expect an ECB rate hike in July but higher reserve requirements should see an uneven tightening impact

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By Michiel Tukker

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EUR Money Markets: Some signs of tightening conditions

Easing energy prices have taken a July European Central Bank rate hike off the table, but September remains in play. Liquidity still looks ample, but there are some signs of increasing tightness. A doubling of the reserve requirement as mulled by the ECB risks an uneven tightening impact

ECB policy outlook: Easing back from the energy shock

The 60-day ceasefire in the Middle East has seen oil prices drop close to pre-war levels. This has clearly eased inflation concerns, not just in the market but also among central bank officials.

ECB officials have been cautious not to sound too dovish, however. Clearly, a hike in July has become unlikely, but the idea of further policy tightening down the road has been kept alive. For one, there are clear risks around the deal in the Middle East and a re-escalation with another spike in energy prices remains a possibility. Secondly, the ECB will still want to monitor how the energy situation percolates through the economy before committing to any path.

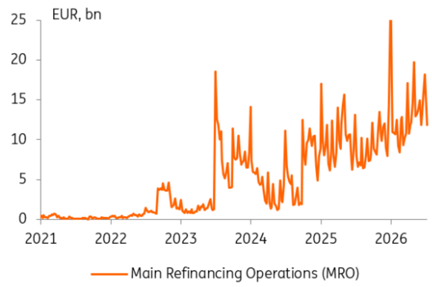
Markets have already made up their minds. A hike in July is off the table, while September looks to be a coin toss. If anything, we think the ECB will act before the end of the year, and looking further along the curve, the market is just shy of fully discounting another hike from the ECB.

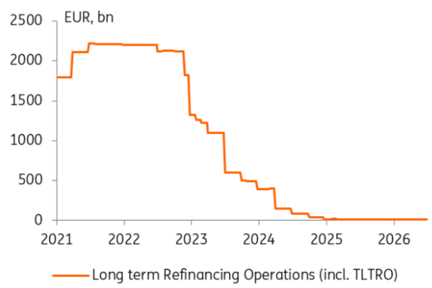
We think the market can maintain its dovish bias for front-end rates if, on average, energy prices stay at benign levels and inflation does not surprise to the upside due to second-round effects. But it will be a slow process, as such risks will be priced out over time as data materialises and ECB officials gradually shift to a more balanced tone. But for now, our economists are keeping a second rate hike in play.

Liquidity and funding conditions: Still ample, but some signs of tightening conditions

Excess liquidity in the banking system continues to contract as the ECB rolls off its bond holdings. The current level of €2.2tr still appears ample, and that view is corroborated by the still very muted uptake in the ECB's regular liquidity providing operations. Banks are picking up €12bn in the weekly operation and another €13bn via the three 3m longer-term operations.

Banks' pick up of liquidity from the ECB is rising only slowly

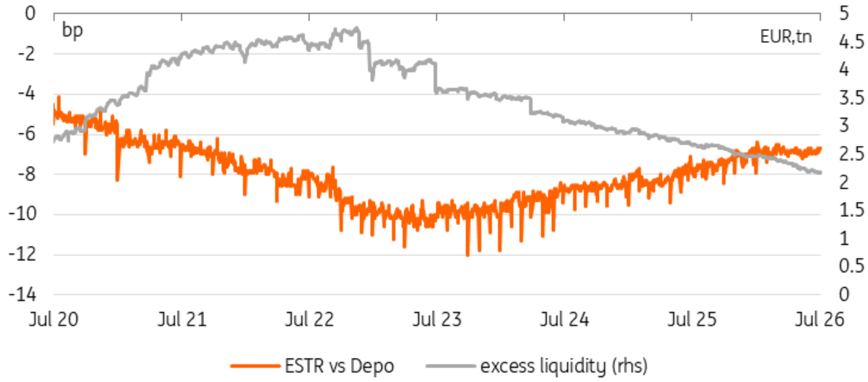




Source: ECB, ING

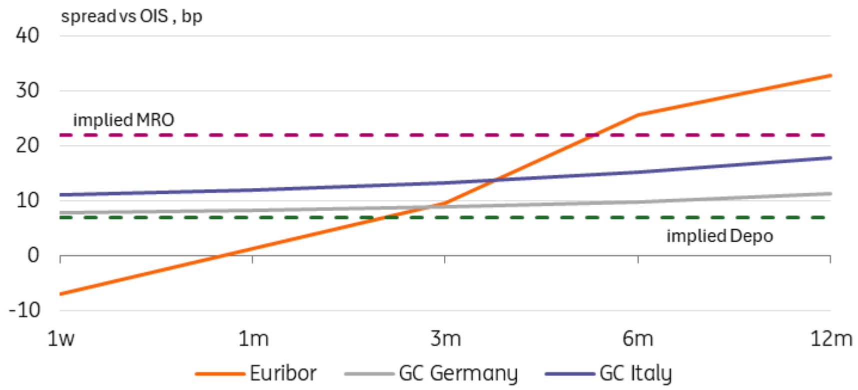
That said, there are also signs that funding conditions are gradually turning tighter, especially around quarter-ends. For instance, banks had picked up a slightly higher €18bn in the weekly operation, and we had seen somewhat higher recourse to the marginal lending facility into the turn of the quarter – just below €1bn still, but an increase in volumes compared to previous turns.

Excess reserves continue to trend lower, but the rise in ESTR as stalled



Repo markets have seen a more pronounced increase in general collateral (GC) rates over the turn of the quarter. Overnight Repo fund GC rates for Germany rose 3.5bp above prior levels and by more than 5bp for Italy, although the broader GC pooling basket only saw a relatively muted uptick. Overall, we are still facing excess liquidity levels where the reaction of short-term funding rates to any smaller changes remains limited, resulting in the slow updrift witnessed over the past years. Of late, that updrift seems to have stalled somewhat.

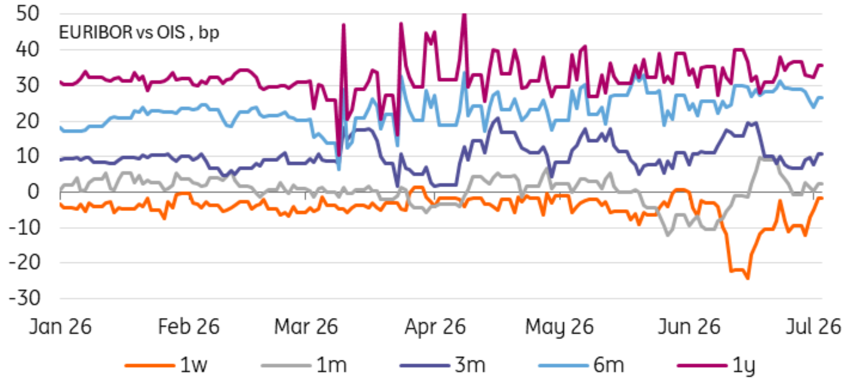
Repo rates remain within ECB rate channel, unsecured steepened



Source: Refinitiv, ING repo desk, ING

If we look further out the funding curve we see the usual relative steepness of the Euribor curve. With the onset of the Middle East crisis, front-end rates have become more volatile in general, which has also been reflected in the spread volatility. While things have normalised somewhat, the 6m and 1y term spreads, especially, remain at wider levels.

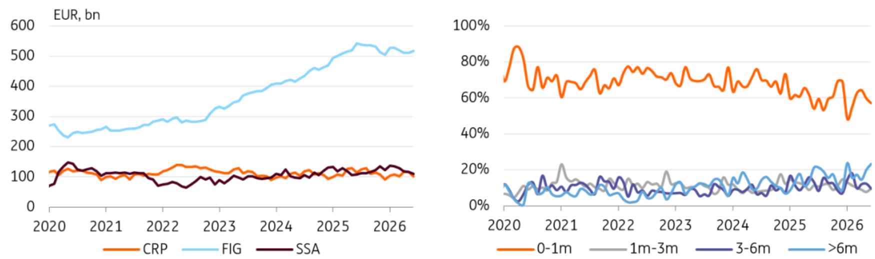
The Euribor/OIS structure has become steeper and more volatile



Source: Refinitiv, ING

EUR funding volumes by banks (FIG) in the commercial paper (CP) market are up marginally from the end of last year. Looking at the maturity composition of banks' unsecured CP funding since the Middle East crisis began, one can observe first a focus on short maturities, and then, as funding moved further out again, a focus on the 6m and longer tenors over the course of June.

Outstanding CP/CD and banks' CP issuance by maturity bucket



Source: CMD, ING

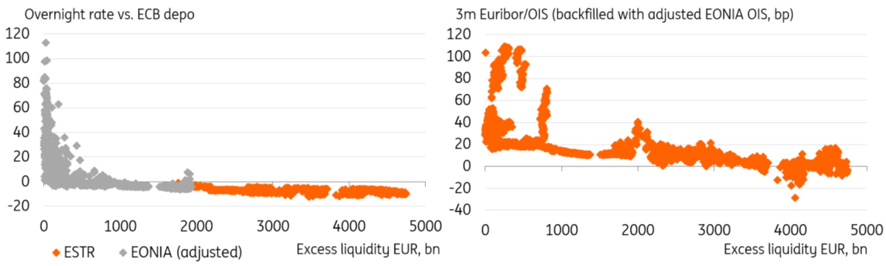
The ECB has revived the minimum reserves discussion to cut its losses

Reuters reported last week that the ECB was considering raising the amount of reserves banks are required to hold at the ECB on average – not immediately, but potentially in the autumn. Crucially, this Minimum Reserve Requirement (MRR) is not remunerated, unlike reserves parked at the deposit facility, which currently earns banks 2.25% in interest. Doubling the MRR is estimated to save the ECB close to €4bn annually, and more if interest rates were to be increased further.

The original purpose of the MRR was to create a liquidity deficit in a system where the ECB is the sole supplier of liquidity – via this monopoly, the ECB had a means to implement its monetary policy stance in the market via its liquidity operations. But the MRR no longer serves that purpose in a time when the ECB has injected multiples of the MRR as excess liquidity into the banking system via quantitative easing. Market rates are determined by the interest earned in the deposit facility, where banks park their excess liquidity.

With excess liquidity currently at €2.2tr, the impact of a €174bn one-off reduction, which the doubling of the MRR would effectively result in, could be expected to be marginal. It would push us closer to a level of excess liquidity where funding rates are anticipated to react more sensitively to any changes, though. We have seen market expectations of Euribor/OIS spreads already nudge slightly higher on the back of the headlines.

The system is closing in on reserve levels where rates react more sensitively



Source: Refinitiv, ECB, ING

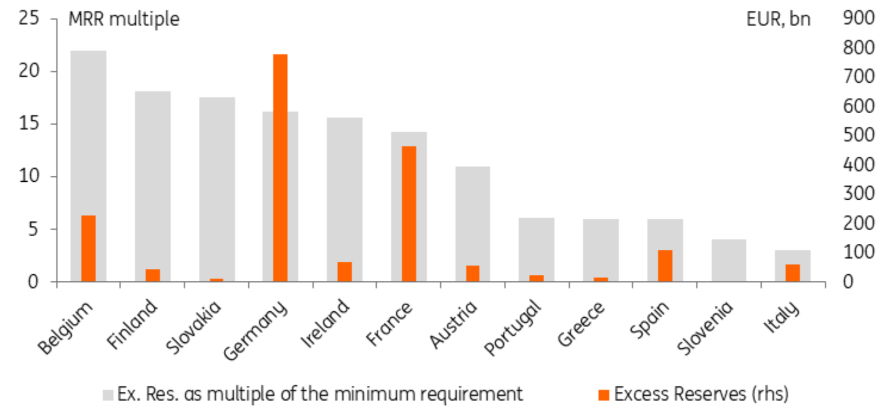
Looking deeper into potential knock-on effects, it is important to note that required reserves do not count towards banks' Liquidity Coverage Ratios. And that excess liquidity is not distributed equally.

On a country level, we can see that Italy, Spain and Portugal hold excess liquidity to the tune of 3 to 6 times their respective MRR, whereas we are looking for multiples close to 15 for e.g. France and Germany. One could argue that redistribution of liquidity within the Eurosystem is currently happening relatively smoothly, but certainly some jurisdictions would feel a greater squeeze.

Liquidity is also not distributed proportionally across banks, as had been pointed out in the discussions when the ECB first floated the idea of increasing the MRR, back then by even more than just doubling it. Crucially, those banks that hold the excess liquidity are not necessarily the ones holding deposits, which ultimately serve as a basis for the calculation of a bank's MRR. And those banks holding disproportionally larger deposits tend to be smaller banks that would then be penalised.

Looking at who taps into the ECB's liquidity operations currently – as seen above at still very moderate levels on aggregate – it is mainly Italy, and surprisingly, also Germany. The former reflects the already low levels of excess reserves in Italy, whereas the latter likely points to the situation of smaller banks.

Excess reserves are not distributed equally across countries and banks



Source: ECB, ING

The ECB's endgame remains to get to an environment where the banking system operates with lower levels of excess reserves, at levels determined by banks themselves in a self-balancing manner, with the ECB liquidity operations seen becoming an integral part of banks' liquidity planning. The result is higher short-term market funding rates closer to the MRO as we see more reliance on the ECB's liquidity operations. The more structural liquidity needs would be covered by long-term liquidity operations and a bond portfolio (but substantially smaller than now).

The desire to cut losses and get to that situation more quickly is understandable. This year there will be a review of the operational framework changes that were introduced in 2024, which can explain the timing of the headlines. But we doubt it is worth the risks of disrupting the gradual path toward the envisaged way of conducting monetary policy that the ECB has worked so hard to keep in the background.

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US Money Markets: Circumstances auger for terming out

Repo has calmed as a consequence of the Fed's bill-buying programme, which in turn has helped stabilise bank reserves in the $3tr area. Even the effective funds rate has finally managed to dip a tad. We like terming out here, as the market is discounting rate hikes, and we don't think the Fed will deliver hikes, on the view that inflation comes down

The US Federal Reserve, currently under construction

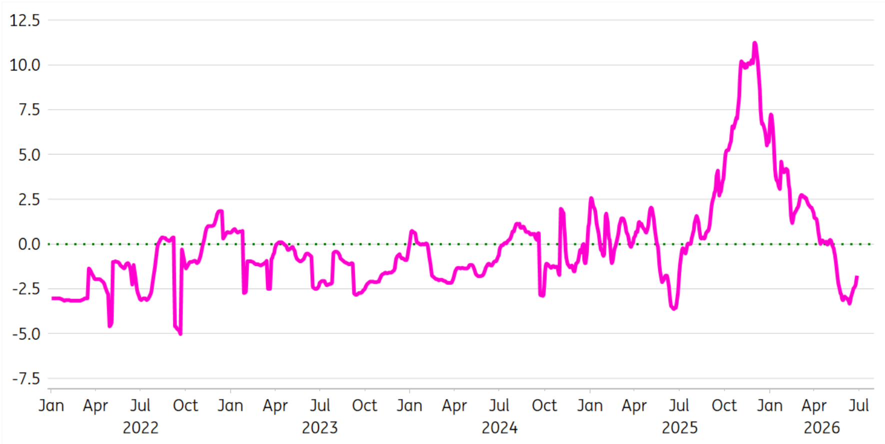
The Fed to hold for the rest of 2026

It is a very close call whether the Fed will hike rates this year, but on balance, we think it will instead choose to look through a near-term energy spike and hold rates steady for an extended period. The low-hire, low-fire economy means weak wage growth, with real household disposable income having fallen for three consecutive months.

Consequently, elevated energy costs risk demand destruction that should help to dampen core inflation in time. Consumer and market inflation expectations remain in tolerable ranges, and slowing housing rents, weak wage growth, a waning influence from tariffs and energy price falls mean that inflation should undershoot the target in the second half of 2027. This environment should give the Fed room to resume moving policy rates back to neutral in 2027.

Fed funds rates versus the SOFR rate

SOFR *minus* effective Fed funds rate)



Source: Macrobond, ING estimates

The effective funds rate versus SOFR

The effective funds rate used to trade just 8bp above the funds rate floor. The ratchet higher to 14bp in September/October 2025 prompted the policy of renewed T-bill buying. The backstory saw bank reserves dip below US$3tr, and repo had shown a marked tendency to tighten, with bank reserves at sub-$3tr. That repo tightness, in a relative value sense, was the genesis of the relative rise in the effective funds rate.

Since then, the effective funds rate has dipped back down to 3.62% and is now back up at the 3.63% level. And by the way, that's just 2bp below the rate paid on reserves (3.65%). It's actually tough to get to 3.65%, as then eligible counterparties have a choice between two windows (reserves vs funds rate). It should not go above, though.

The other competition for avenues for market liquidity is repo, as encapsulated by the SOFR rate (basically an amalgamation of repo rates). Different players in the market with varying rights in the reserves bucket or the reverse repo bucket will see SOFR as an alternative rate that gets deployed from a relative value perspective. This is important for framing where the effective funds rate actually sits. SOFR should, in theory, trade below the effective funds rate, as it is a collateralised rate.

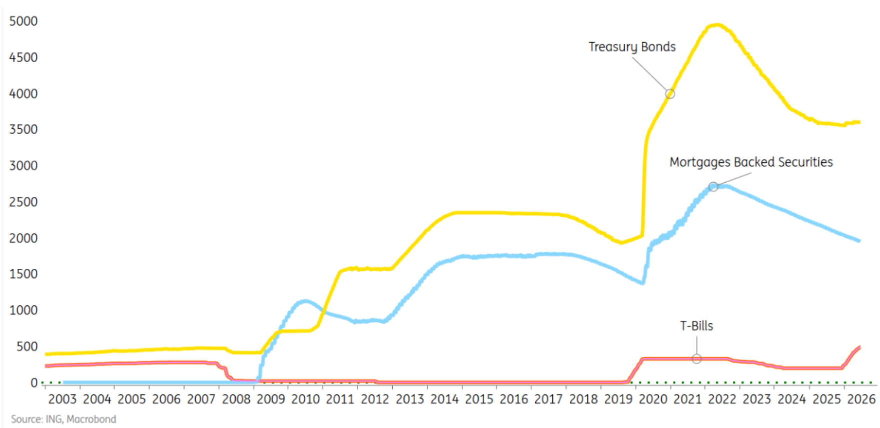
And in the funds market, we also need to account for the Federal Home Loan Banks (FHLBs).

They provide funds to typically smaller banks. The FHLBs cannot post in the Fed's reserves bucket, but they can post at the Fed funds rate. In fact, they tend to be dominant players in the current funds rate market, especially as the commercial banks will prefer to post at the higher excess reserves rate. Bottom line, they are effective funds rate influencers.

The latest impulses show repo trading far easier than it was. SOFR, in consequence, has shown a tendency to trade through the effective funds rate. That is a symbol of relative stability in money markets, apart from month-end, but even then there has been reduced volatility. We expect more of the same ahead based on the current policy of maintaining reserves at or above $3tr, alongside ongoing buying of T-bills, as an offset to the roll-off of mortgage-backed securities (while the Fed's holdings of Treasuries remain unchanged).

The Fed's bond and bills holdings

USD, billions



Source: Macrobond, ING estimates

Since the Fed recommenced T-bill buying in mid-December 2025, it has bought a cumulative $290bn. Overall, the Fed's holdings of all securities (including bills) are up $210bn, to almost $6.35tr. That has coincided with a rise in bank reserves holdings to over $3tr.

New Fed Chair Kevin Warsh came into the job in the wake of various suggestions that the Fed should reduce the size of its balance sheet. We covered the issue here, and noted that at the end of 2005, the Fed's balance sheet was about 5.5% of GDP. Roll on 20 years, in and out of the global financial crisis and pandemic, and it's now 21% of GDP (quadrupled). The driver was bond buying. Total bonds held by the Fed were around 5.5% of GDP 20 years ago. That now equates to 20% of GDP (almost quadruple). Bank reserves were purely regulatory in nature and a puny 0.1% of GDP 20 years ago. Today's bank reserves are closer to 10% of GDP (100-fold).

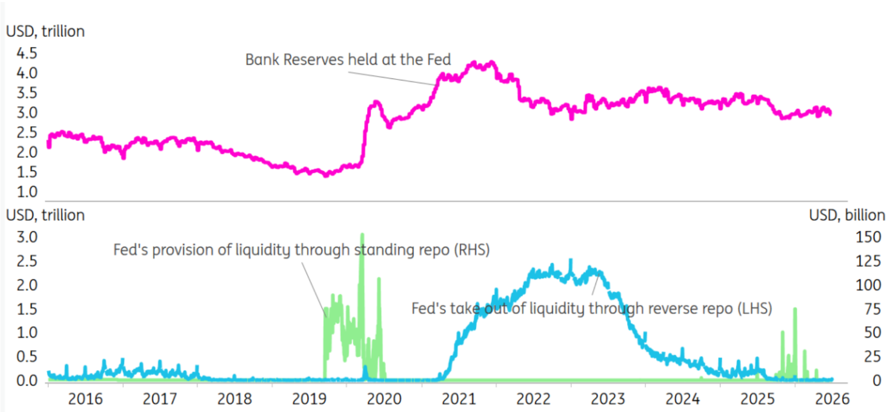
Kevin Warsh wants to 'fix it', it seems. The technicalities could require the sale of all mortgage-backed bonds ($2tr) and at least half of the Treasury bonds (c.$2.5tr). So that's some $4.5tr in total, and would bring Fed bond holdings back down to around 5.5% of GDP (pre-GFC proportions). That in itself is big, and raises questions about a doable pace.

On the other side of the balance sheet there is the complication of transitioning from the current excess bank reserves environment back potentially towards a scarce regulatory bank reserves environment. On the former, a Congress-legislated special purpose vehicle tasked with taking the bonds off the Fed's balance sheet has been mooted (so they would not be "sold"). On the latter, an easing in bank liquidity ratios would be required.

For now, it's all quite speculative. But what we do know is Warsh can't simply sell bonds and stop there. He would need to address both sides of the balance sheet, and make regulatory changes to bank liquidity requirements.

Bank reserves at the Federal Reserve

Alongside the Fed's repo (adding liquidity) and reverse repo facilities (taking out liquidity)



Source: Macrobond, ING estimates

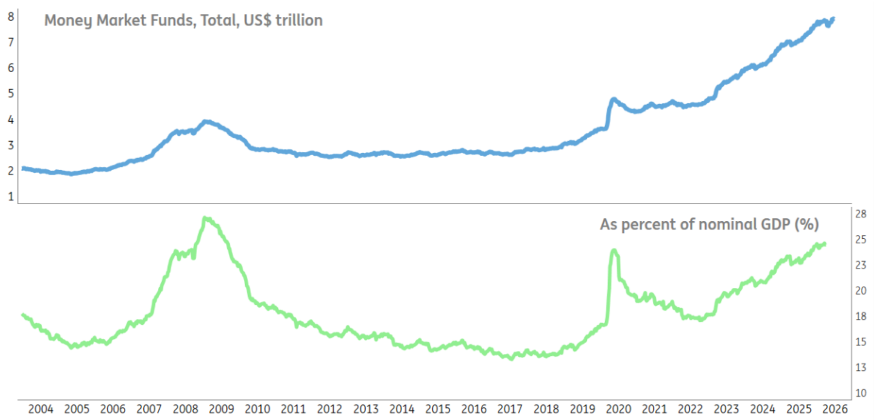
Then there is the complication of a transition from the current excess reserves environment, potentially back towards a "scarce reserves" environment, as indicated by Warsh (but without specifics). Selling the bonds is relatively straightforward; far less straightforward is how to get back to the prior regime for reserves management and how the funds rate is set, along the way, and in the future.

One aspect that can help here is the revision to the leverage ratio requirements as of 1 April 2026. The fact that the larger banks will, as a result, have more capacity to buy Treasuries and/or engage in repo is potentially a huge benefit. The weak link in the current structure has been the capacity for tightness in repo to bully the effective funds rate higher, primarily on a relative-value play. Larger banks in the game could and should tame the tendency for repo to over-tighten at times.

There is a link here with reserves, too, as the Federal Reserve has reverse-engineered a logic that repo tightness was associated with the fall in excess reserves to a level that exacerbated repo tightness. While a clear link between the two is not necessarily obvious, one does exist. We saw the same when the Fed went through its first quantitative tightening exercise in 2019, which culminated in a brief but severe repo tantrum. It was calmed through the Fed's decision to buy bills from December 2026, and that policy continues as we head into the second half of 2026.

Money market funds remain on the rise

Also on the rise as per cent of nominal GDP

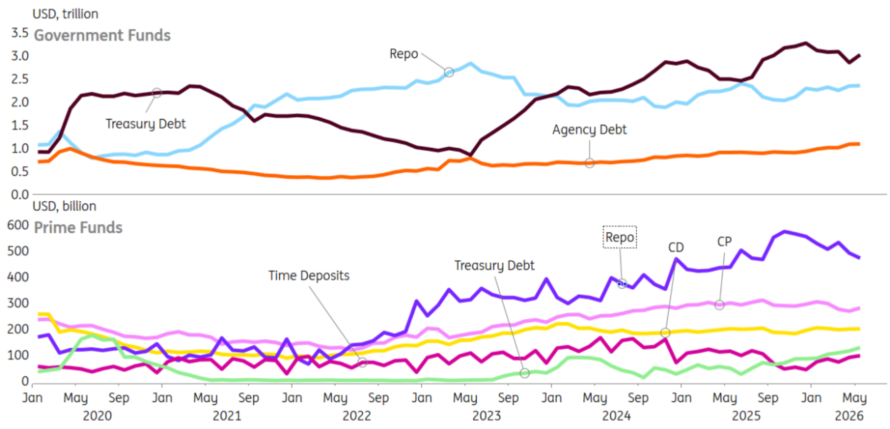


Source: Macrobond, ING estimates

Inflows to money market funds remain firm, with both institutional and retail participating. Prime funds continue to see their fair share of the increase. As a percentage of GDP, total money market funds are now approaching 25%, not far off the previous high of 27% in 2009. So far, the rate level has not been a material issue, mostly as a return of 3-4% still represents a decent return on what is effectively a 'zero risk' product. The latest data shows money market funds holding steady, while large bank deposits have seen some decent inflows.

Money market fund holdings

Government Funds on top, and Prime Funds on the bottom

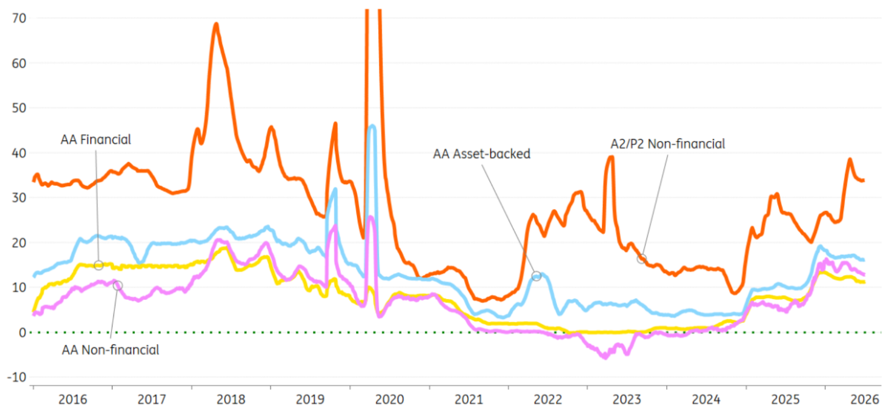


In terms of specific exposures, Government Funds have seen a renewed rise in holdings of Treasury Debt (effectively bills). Extra bills are being issued to take pressure off coupon issuance. This should help maintain a concession in bills. Repo has been downsized relative to bills' holdings as a result, although repo has been on the rise recently.

In Prime Funds, repo (reflecting equity repo) exposures remain elevated, albeit off prior highs. Exposure to commercial paper (CP) has been gradually rising, while certificates of deposit (CD) and ordinary deposits have been steadier to a tad lower. Bank deposits have seen resumed rises, mostly into the larger banks (less so into the small banks).

Commercial paper alternatives

As spreads above the Fed's reverse repo rate (bp)



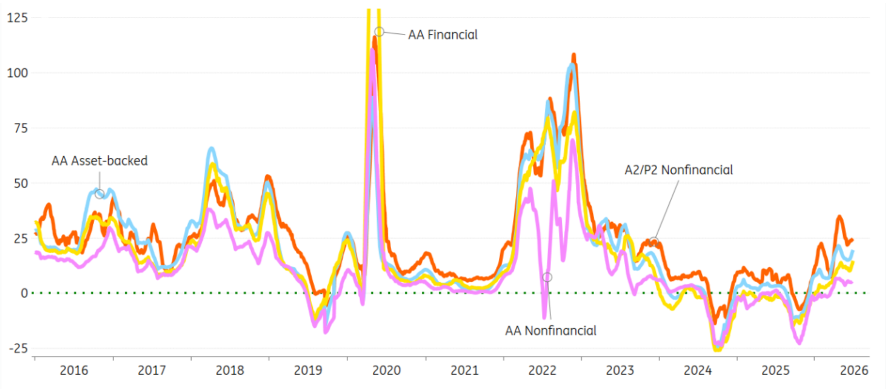
Source: Macrobond, ING estimates

In terms of attainable rates, the entire spectrum of overnight commercial paper rates remains comfortably above the Federal Reserve's reverse repo rate. This has reflected past relative tightness in repo, which has acted as an upward drag on other rates from a relative-value perspective, and on a concessionary T-bills environment. That has tamed in recent months.

The market is discounting rate hikes, which has built concessions. If we are correct that the Fed does not hike, and ultimately the next move is down, then terming out in spread products at current levels could be seen as a decent play.

Terming out

From overnight (o/n) to three months (3mths), bp



Source: Macrobond, ING estimates

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GBP Money Markets: Bank of England is supporting liquidity

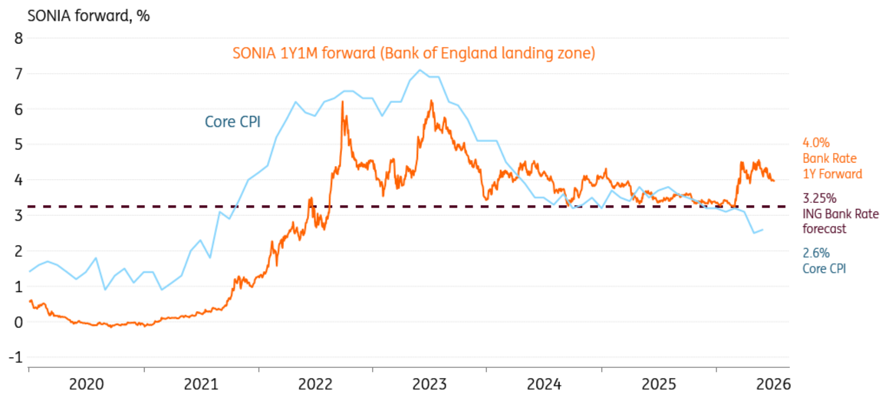
Liquidity conditions look very healthy, and stable bank reserves are helping money markets. We think the terminal rate priced in by markets is too high and prefer positioning further out the curve. Tweaks to the Discount Window Facility increase the system's resilience against liquidity shocks

Stable reserves – thanks to the Bank of England's liquidity facilities – are supporting money market conditions

High Bank of England terminal rate favours terming out

Money market curves are still positioned for a Bank of England hike later this year, but the sharp decline in oil prices has turned sentiment more dovish. Only around 20bp of hikes are priced in for this year, and this could still go lower once the risks of second-round inflation effects are better understood. Whilst we still acknowledge the chance of another hike, we disagree with markets' perceived terminal rate of 4%. We expect price pressures to ease in 2027, allowing the BoE to cut the policy rate to 3.25%. As such, we see more value further out the curve.

We think markets are pricing in a too high terminal Bank Rate

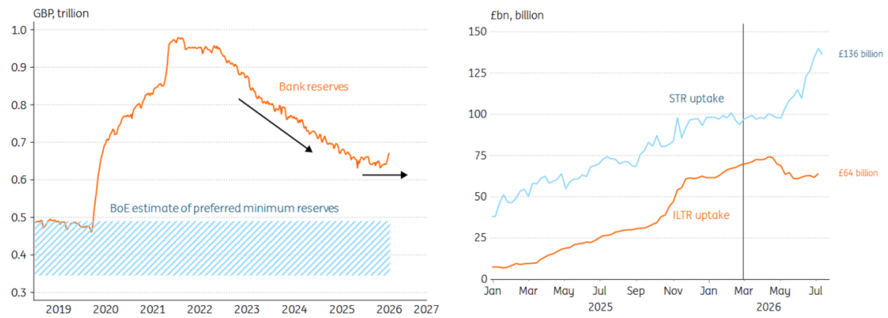


Source: ING, Macrobond

Liquidity conditions benefit from stable reserves

Despite the increased volatility in rates, liquidity conditions have remained very healthy. Overall bank reserves have actually increased thanks to a strong pickup in the Bank of England's liquidity facilities. The uptake of the Short-Term Repo (STR) increased to £134bn, almost double that in July last year.

Pickup in BoE liquidity facilities helped reserves stabilise for now



Source: ING, Bank of England, Macrobond

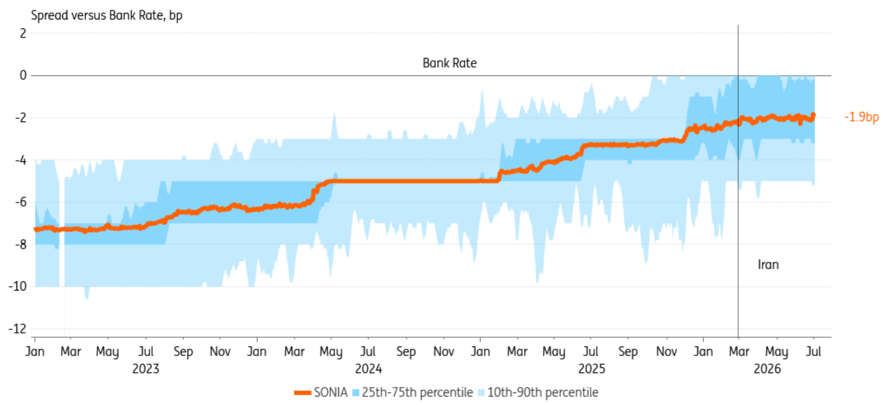
We've previously signalled that the upward pressure on gilt yields might trigger a review of the Bank of England's pace of quantitative tightening in September. Right now, the BoE targets £70bn of unwinding annually, which, all else equal, would reduce reserves by a similar amount. If this number gets reduced to say £50bn, the withdrawal of bank reserves from the system would proceed at a slower pace. In effect, this would further support liquidity conditions going forward.

Overnight deposit rates are comfortable at current levels

SONIA is now trading at just 2bp below the Bank Rate and could remain there for longer. The Bank Rate provides a soft ceiling which limits further upside. Around 25% of banks are now offering the Bank Rate for attracting deposits, but we also see around 10% of banks offering around 5bp below the Bank Rate. As reserves stay around current levels, we shouldn't see much movement in the pricing of SONIA.

Having said that, in the future, banks could start paying more than the Bank Rate to attract reserves. SONIA is based on unsecured borrowing between financial institutions. In contrast, obtaining liquidity from the Bank of England facilities requires collateral. The Short Term Repo facility, for example, requires high-quality collateral like gilts. So even though the STR is priced at the Bank Rate, obtaining funding through the market might still be preferred when possible.

SONIA seems comfortable around 2bp below the Bank Rate



Source: ING, Macrobond

The system is made more resilient against unexpected liquidity shocks

The Bank of England's efforts to keep liquidity risks to a minimum are also reflected in the latest tweaks to the Discount Window Facility. In contrast to the STR and ILTR, this window also allows for intra-week and intra-day liquidity. To discourage structural use, the Bank of England sets the pricing of this facility at a relatively high spread versus the Bank Rate. But the latest changes have reduced this premium. Where initially the facility would cost up to 150bp above the Bank Rate (for lowest collateral quality), this has been reduced to just 50bp. For the highest level of collateral quality, the spread is now just 15bp.

In effect, the Bank of England has strengthened the system against unexpected liquidity shocks. The new pricing of the DWF is less punitive than before, which should hopefully also reduce the stigma surrounding its use. These changes are also in line with the broader strategy to make central bank liquidity a more integral part of banks' liquidity planning. Easier and cheaper access to BoE liquidity allows banks to operate at lower reserve levels.

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