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

We take a closer look at the latest developments in the eurozone, US and UK money markets at a time when instances of tightness are becoming more apparent

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EUR Money Markets: Upward pressure from declining liquidity still gradual

Unlike the Fed or the Bank of England, the ECB looks to have more time before excess reserves reach levels where bigger shifts in banks' behaviour will become obvious. Recourse to the ECB facilities remains relatively low and upward pressure on short-term rates is still very gradual

Overall, even the higher end of estimates suggests that the ECB, unlike its US and UK peers, still has more time before a bigger shift in banks' behaviour will become obvious

ECB rates are on hold for the foreseeable future

The ECB has signalled again that it views its monetary policy as being in a “good place” with the deposit facility rate at 2% since the June meeting. There are still risks around the outlook stemming from trade uncertainties and the political developments in France and Germany, for instance, and also differing views on risks surrounding inflation. The market is still eyeing chances of further ECB easing, pricing in a roughly 25% probability of another 25bp cut within the next 12 months.

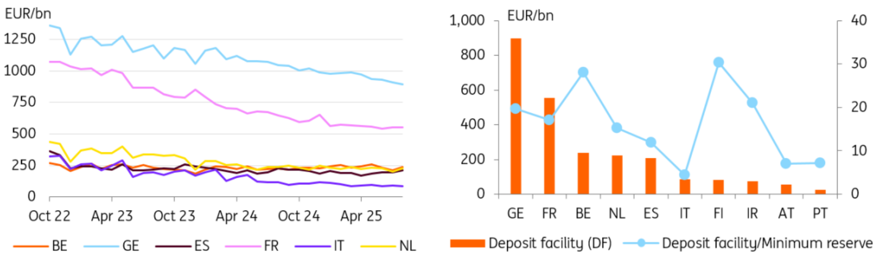
Liquidity in the system remains high, but also unequally distributed

While ECB policy rates appear to be on hold for the foreseeable future, the market is still looking at a gradual decline of excess reserves in the banking system. This stems from the ongoing roll-off of bonds from the ECB's policy securities portfolios.

The level of excess reserves in the system (i.e. reserves held by banks in the ECB accounts in excess of the minimum reserve requirement) has dropped to €2.5 trillion from around €2.9 trillion at the start of the year. It had peaked at €4.75 trillion in 2022 on the back of ECB interventions to stem the fall out of the pandemic.

Excess reserves are not distributed equally across the banking system. We still see that the bulk of it is concentrated in the banking centres of Germany and France. German banks deposited close to €900bn in reserves in the ECB's deposit facility; French banks still had around €550bn at the end of the summer. Meanwhile, Italian banks deposited only close to €100bn. Viewed as multiples of the individual countries' minimum reserve requirements, we see that Italy's banks are holding a bit more than four times the minimum reserve as excess liquidity, while the factor stands close to 20 and 17 for Germany and France, respectively.

Excess reserves are not distributed equally across the eurozone



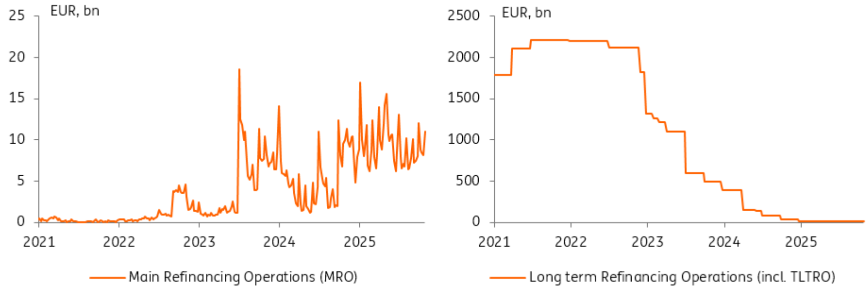
Source: ECB, ING

The ECB looks to have more time at hand than it US and UK peers

Looking ahead, the question is which level of overall reserves banks will feel comfortable with. As we near that level, we should see more pronounced pressure on market funding rates and/or recourse to the ECB's liquidity-providing operations. Estimates for that level range from €1.5tr to €2tr, but one will know for sure only once we see changes in market prices and behaviour.

Since they appear to have stabilised over the past few months, if we blindly extrapolate the level of Italian reserves in terms of minimum reserve multiples, we would arrive at an overall level even below €1tr for the system as a whole. But we also note that other countries seem to have stabilised at higher multiples of the minimum reserve, such as Spain or Ireland, which highlights that structural differences among the banking sectors can lead to different – and noticeably higher – desired reserve levels.

Banks are currently under little pressure to turn to the ECB for liquidity



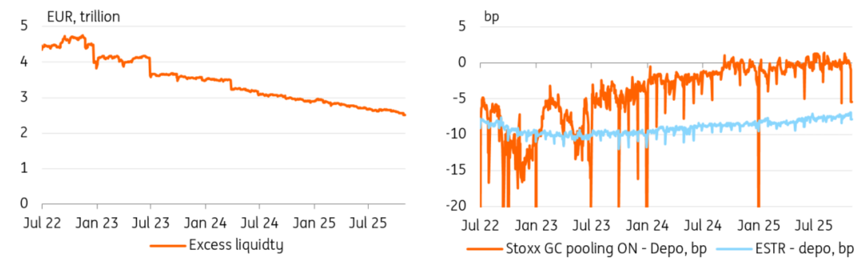
Source: ECB, ING

Overall, even the higher end of estimates suggests that the ECB, unlike its US and UK peers, still has more time before a bigger shift in banks' behaviour becomes obvious. But extrapolating the gradual decline of excess liquidity, the upper end could be reached in late 2026 already, while the €1.5tr level could be hit in early 2028.

While the ECB has already laid out its broader plans of implementing policy in the long-run, some details around the use of structural liquidity operations remain rather vague, for instance. That suggests that by the middle of next year, the ECB could think about providing more guidance around the details of its framework if it wants to prepare the market.

Keep in mind that other factors also determine the level of excess liquidity in the system, such as the evolution of banknotes in circulation, or the level of official sector deposits at the ECB.

Excess liquidity gradually declines from still-elevated levels, with only gradual impact on overnight rates so far



Source: ECB, Refinitiv, ING

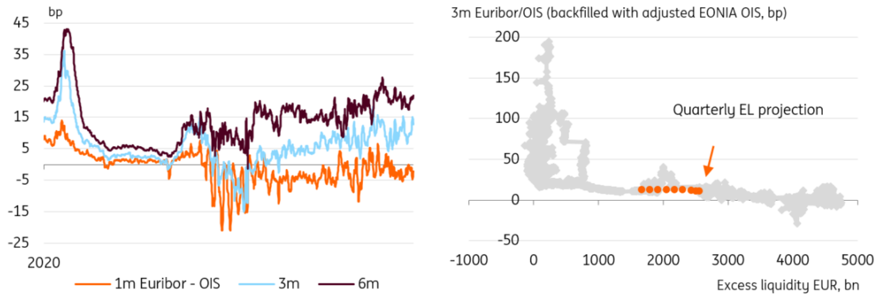
The impact on money market rates continues to be gradual, but has to be monitored

Mirroring the gradual decline of excess liquidity in the system, the upward pressure on the ECB's targeted overnight rate relative to the deposit facility rates has also been only gradual so far. Nevertheless, the ESTR fixings at around 7bp below the ECB rate ahead of October end – and now also the day after – have been the highest since 2021. A further gradual increase looks more than likely, though we are not yet looking for an acceleration of the upward dynamic, as overall liquidity still looks more than ample.

Secured overnight funding rates have already stabilised at higher levels for around a year, in an adjustment to the overall availability of collateral. The GC pooling rate, for instance, has been fluctuating a few basis points around the ECB's deposit facility for a while now. There is also very little impact from recent political turmoil in France on the distinction of repo levels between countries' government collateral.

The spread of 3m Euribor fixings relative to the overnight indexed swap still appears to trend sideways around 11bp, although in a somewhat broader range. But markets are looking for some moderate further widening. We see, for instance, that the forward spreads a year out from now implied by Euribor futures contracts have been creeping wider to above 13bp.

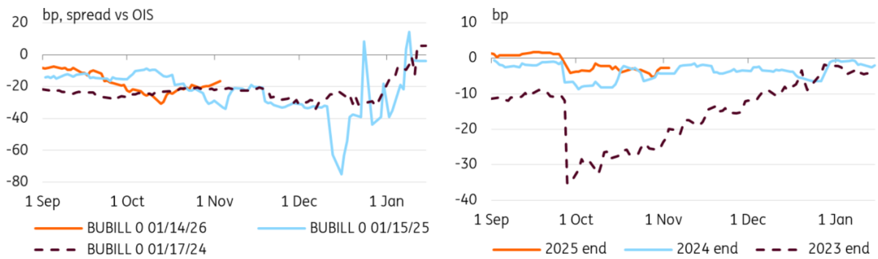
Euribor spreads also experience only mild upward pressure



Source: Refinitiv, ING

The upcoming year-end also appears to look likely to be a relatively calm affair if one compares how some of the usual funding stress indicators behave in the run-up to the turn, such as the Bubill/OIS or the cross-currency basis. But especially looking at the latter, one could argue that the pressure is now on the other end with the current tightness in US short-term funding markets.

Year-end funding tensions appear less pronounced in Bubill and 3m EUR/USD xccy markets



Source: Refinitiv, ING

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US Money Markets: Repo tight enough for the Fed to build bills

Repo has tightened, the effective funds rate has risen, and the Fed has reacted with a promise to buy T-bills. So far, heavier bills issuance has crowded out Repo longs. Ahead, expect a bigger shift into Repo. The spread from the funds rate to SOFR will remain elevated, but will ultimately ease back down. The proposed SLR adjustment would help significantly

The dollar remains soft ahead of a busy week for data and policy meetings

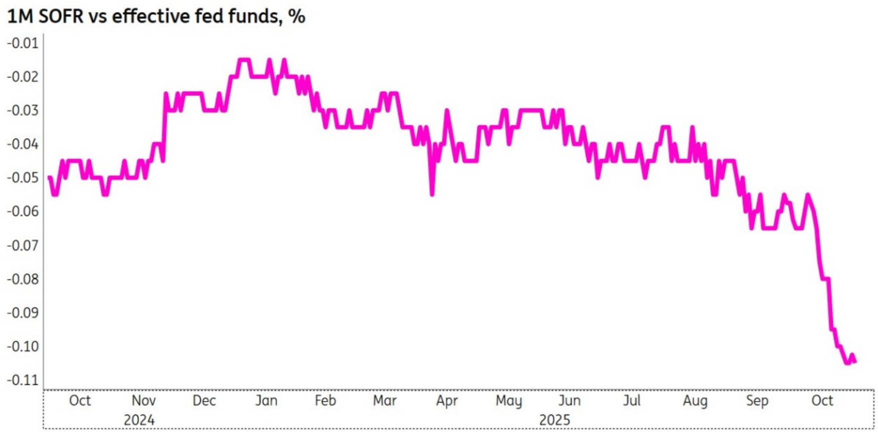
The Fed moves to using T-bill buying more actively as a means to managing reserves

The Federal Reserve now plans to buy T-bills more actively as a means of adjusting reserves. This makes sense and aligns with our thinking. Fed officials will allow the MBS roll off to continue, offset by buying T-bills, leaving the overall impact on bank reserves balanced. That also allows it to increase reserves through T-bill buying if needed, just as it did in 2019 when things got tight. There is plenty of ammunition to do so as T-bill holdings are puny right now ($195bn). MBS continues to roll off, albeit very slowly. The pace has been running at $15-20bn per month. The balancing factor here is the buying of T-bills – that's what keeps the balance sheet from shrinking.

The backstory involves prior heavy net issuance of bills, which has been affecting money market conditions. The Treasury's cash balance has continued to grow, while its 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. Additionally, not all players have access to all liquidity buckets. Ultimately, it's a relative-value trade. Upside pressure on repo – and, by extension, secured overnight financing rate (SOFR) – is presenting a tempting bucket for liquidity. The explosion of the effective funds rate to SOFR presents the clearest manifestation of this (chart below).

Spike in repo versus the funds rate is a reflection of tightness

The chart shows the spread from 1mth funds rate to SOFR (%)



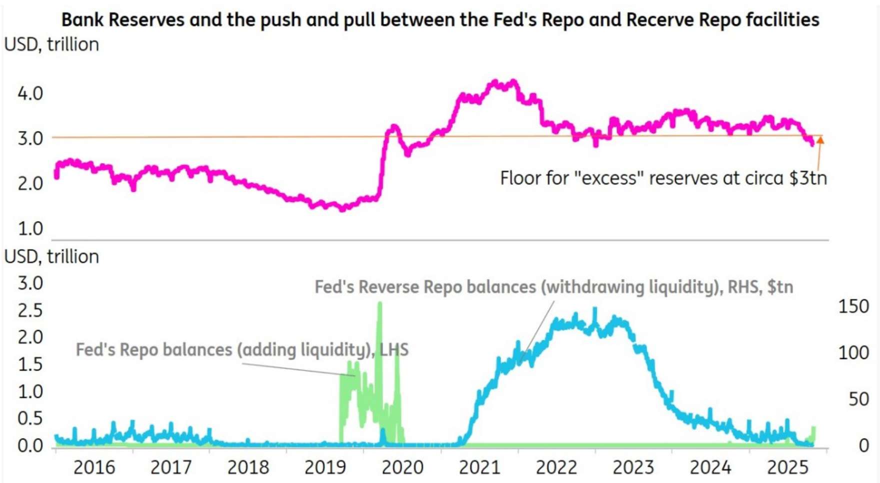
Source: Source: Macrobond, ING estimates

Bank reserves now in a balanced position, and set to rise ahead

That said, the reserves position looks broadly balanced as is. The Fed is neither providing nor withdrawing liquidity from the system to any significant extent. However, Fed Chair Powell did point to the gradually increasing use of the repo facility (where the Fed provides liquidity to the system). Not large, but the beginning of some tightness (chart below).

Bank reserves dip below $3tr, now confirmed as a line in the sand

The second chart shows how much the Fed is providing to the system and how much it's taking out. It is balanced right now



The last time the Fed actively allowed bank reserves to fall was during the quantitative easing (QE) unwind – quantitative tightening (QT) – that finally concluded in 2019. In September of that year, the Fed discovered that it had gone too far. Bank reserves had been halved to $1.4tr by then, and at that month's end, there was a severe disruption as the market struggled to deal with a dearth of liquidity, manifesting in a huge spike in repo rates. The system basically haemorrhaged, partly driven by a relatively moderate corporate tax payment need of some $120bn. So what did the Fed do in response? It proceeded to rebuild bank reserves through repos, and ultimately by purchasing T-bills. That's the recipe: rebuild reserves if they're seen to be too low. The Fed has likely learnt from this experience.

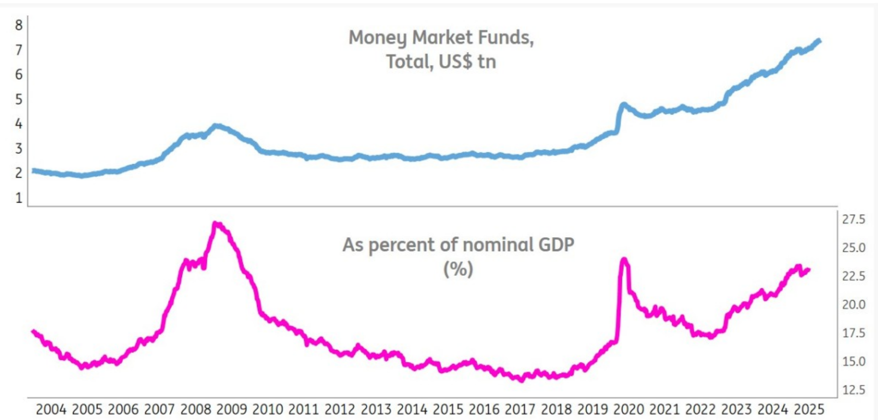
The follow-on question is what level of bank reserves are comfortable? Far from perfect, but one thing we can do is make a judgment on reserves based on a percentage of GDP. In September 2019, that percent hit a low of 6.5%. That was forced back up towards 8% as the Fed rebuilt reserves. Calibrating this to today equates to a bank reserves balance of some $2.5tr (at 8%). Then 9% reserves would be $2.8tr, while 10% would be $3.1tr. Simplistically, if 8% is a floor, then 9% offers some comfort to that floor, while 10% is likely to be very comfortable. The current level of bank reserves is $2.8tr, so we're in that semi-comfort zone of 9% to 10% of GDP. Given the upward pressure on the effective funds rate and the generally tight repo market, it's likely that this type of level represents a floor, with the Fed more likely now to build reserves at least as fast as the expansion of nominal GDP (2-5% per annum).

Money Market funds continue to attract lots of liqudity, now approaching $7.5tr

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 24%, not far off the previous high of 27% in 2009 (chart below). So far, the rate-cut narrative has not been a material issue, mostly as a return of 4% still represents a decent return on what is effectively a 'zero risk' product.

Money Market funds approaching 24% of GDP, back towards historic highs

The top chart shows the absolute dollar amount, while the lower chart illustrates the same as a percentage of GDP



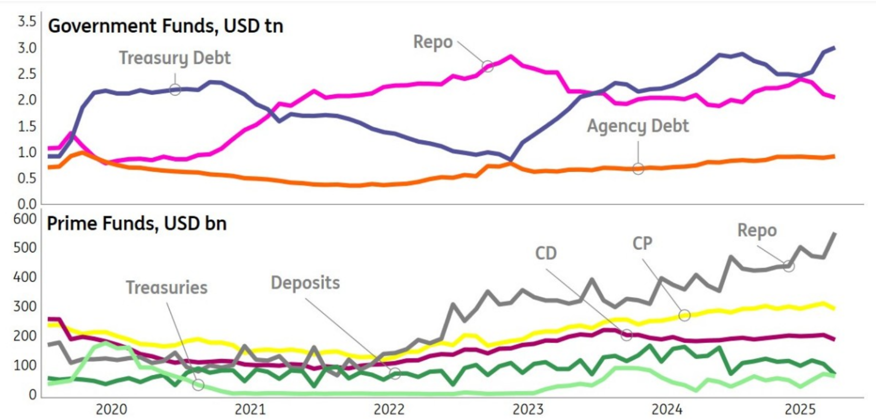
Source: Macrobond, ING estimates

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 and to build up the cash balance at the Treasury after the rise in the debt ceiling, as part of the wider 'Big Beautiful Bill'. This should help maintain a concession in bills. Repo have been downsized relative to Bills' holdings as a result.

In Prime Funds, Repo (reflecting equity repo) exposures remain elevated. 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 been on the slide, mostly because there are better terms in alternative buckets.

The composition of investments in Money Market funds

The top chart shows the breakout within government funds, while the lower chart shows how prime funds are internally apportioned.

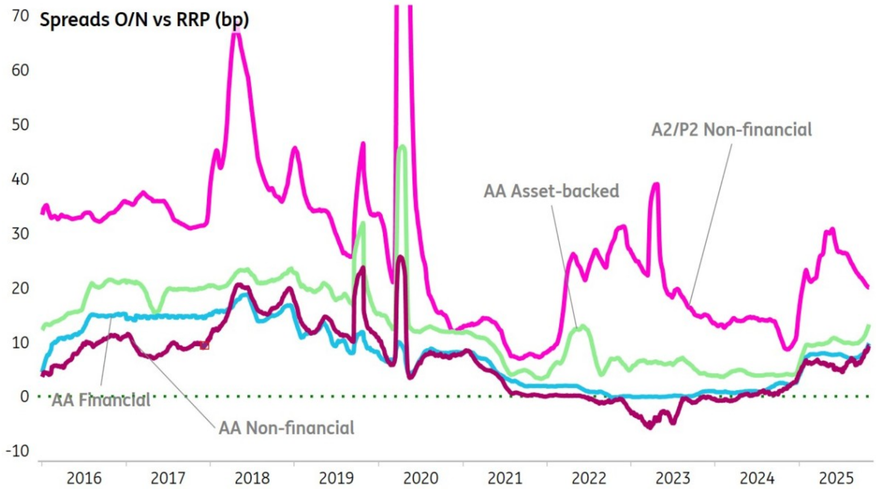


Source: Macrobond, ING estimates

Commercial paper versus the Fed's reverse repo rate

In terms of attainable rates, the entire spectrum of overnight commercial paper rates remains comfortably above the Federal Reserve's reverse repo rate. Initially, this was a reflection of the 5bp move down to the funds rate floor since the December FOMC meeting. More recently, it reflects the evolving tightness in repo, acting as an upward drag on other rates from a relative value perspective. A larger concession remains built into A2/P2 rates, but no more than the fair valuation of risk.

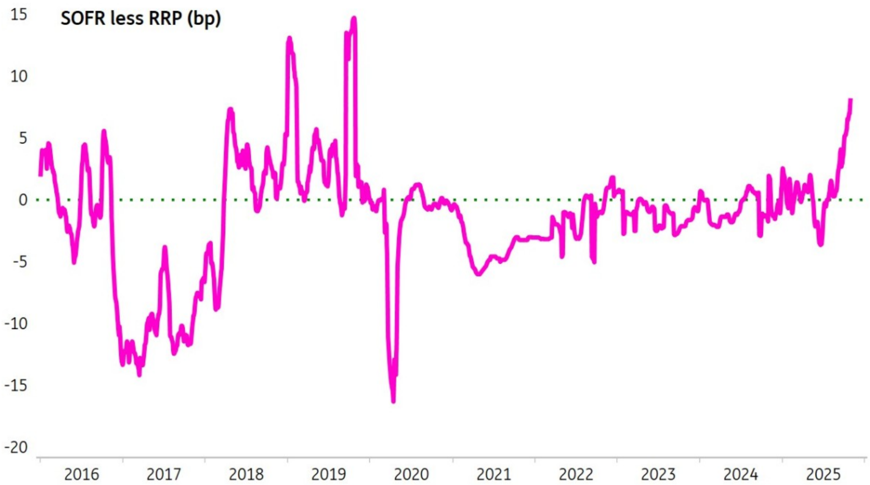
Commercial paper alternatives as spreads above the Fed's reverse repo rate



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 market. The reverse repo window will continue to be accessed primarily around quarter (and month) ends, as counterparties turn to the Fed's facility to bridge liquidity gaps driven by regulatory window dressing requirements. But effectively, this bucket has been wound down towards zero as liquidity excesses are fully unwound. An extra push of late has come from the elevation of market repo versus the Fed's reverse repo rate (chart below).

Spread from the Fed's reverse repo rate to SOFR – spike!

We expect this to calm back down, especially post the December FOMC outcome.



Source: Macrobond, ING estimates

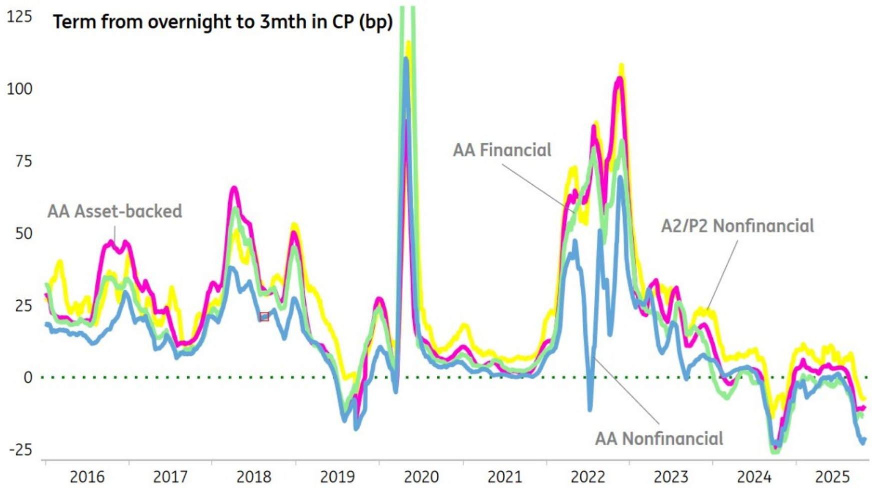
With the Fed still expected to cut, terming out comes with lower rates

With the Fed still technically in rate-cutting mode, terming out tends to net an absolute rate concession. But there is still value in terming out as a means of locking in currently attainable rate levels, which tend to underrepresent the full extent of likely cuts on a 12-month horizon.

We expect the Fed to cut by 75bp in the coming six to 12 months. A December cut is up in the air. Powell has no problem leaving the funds rate unchanged at the December meeting, if that is deemed the thing to do. It comes with residual comfort in the economy. The fact that a 4.3% unemployment rate was specifically referenced as "low" amplifies this point. Instead, there is a degree of discomfort with inflation running at 3%, and likely heading higher.

At the same time, there has not been a material change in the ultimate landing level for the funds rate. It's now slightly above 3%, but still within the 3% range. And the 5yr rate continues to trade below the straight line that can be drawn between the 2yr and 10yr rates in a steady fashion. This signals an unwavering expectation that the Fed is, in fact, far from done – it's just a matter of timing.

Terming out from Overnight to 3mth Commercial Paper



SLR adjustments in the coming months need to be monitored too

As an important aside, proposed changes to the Supplementary Leverage Ratio (SLR) for big US banks can boost demand for Treasuries and Repo. That said, banks won't rush to buy. A skew on balance sheets is more likely to be gradual. Banks are lenders first, and credit hasn't been notably constrained, especially with high reserves.

Is this impactful for Repo? We think so, yes. In fact, we suspect we need an easing in the SLR to really calm things down. Most players have easy access to liquidity, but from time to time there are liquidity shortages. It's a bit phoney as there is ample liquidity in the system. However, those holding the liquidity often don't want to, or cannot, participate. Ease the SLR and that can change.

See more here.

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GBP Money Markets: A funding reshuffle is testing liquidity plumbing

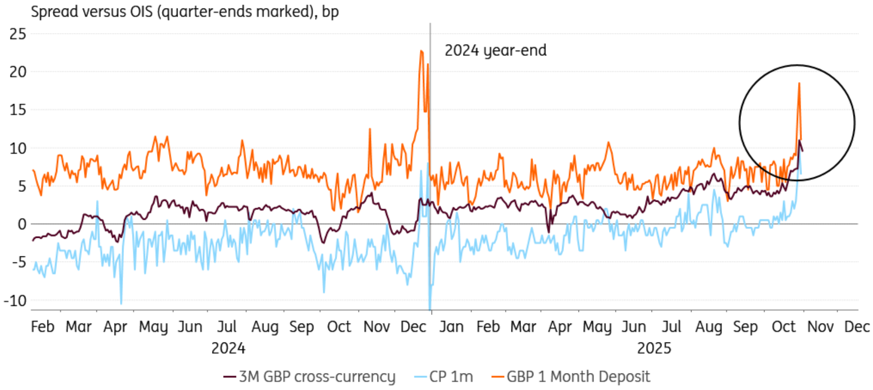
Sterling money markets showed a significant tightening in October, which can be explained by a rotation away from Covid-related funding towards the Bank of England liquidity facilities. In November, we expect conditions to ease, but year-end could see more tightening as reserves are not evenly distributed among banks

The tightening of money market conditions in October was considerable, but we argue that this was a one-off due to tweaks in the Bank of England liquidity facilities

Sudden tightening of money market conditions won't stay

The tightening of money market conditions in October was considerable, but we argue that this was a one-off due to tweaks in the Bank of England liquidity facilities. Overnight repo rates have risen significantly since mid-month, and term deposits, commercial paper and the cross-currency basis also reflected a dash for liquidity. In fact, the spread on short-dated commercial paper peaked above 2024 year-end levels.

October liquidity seemed to fare worse than 2024 year-end



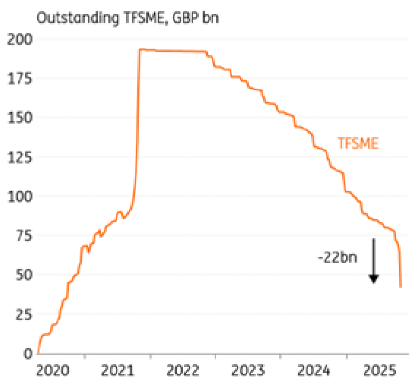
Source: ING, Macrobond

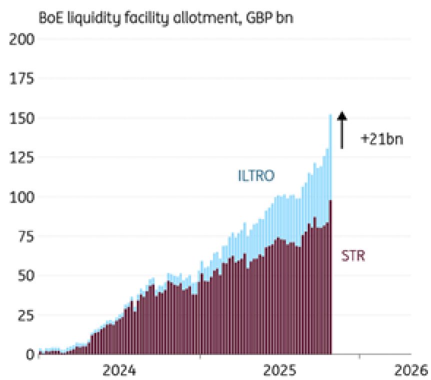
Banks rotated their Covid funding to BoE liquidity for better pricing

The sudden demand for liquidity was driven by record repayments of Covid-19 loans to encourage SME lending (TFSME). In the last week of October, banks repaid £22bn of these loans, way more than the regular amounts we've seen over the past year. The repayments almost exactly mirrored the demand for the BoE's liquidity facilities: the 1-week Short Term Repo (STR) facility and 6-month Indexed Long-Term Refinancing Operations (ILTRO). This makes the net impact on reserves negligible.

So that begs the question, why did banks decide to rotate funding from the TFSME to the Bank's liquidity facilities? The reason is that the minimum pricing of the ILTRO will increase by 3bp starting from November onwards. That would then make ILTRO funding more expensive than the terms for the TFSME loan. As such, frontloading the repayments and refinancing with a lower ILTRO cost can be beneficial for TFSME loans that mature within six months.

Banks repaid TFSME funding early and refinanced using ILTRO and STR



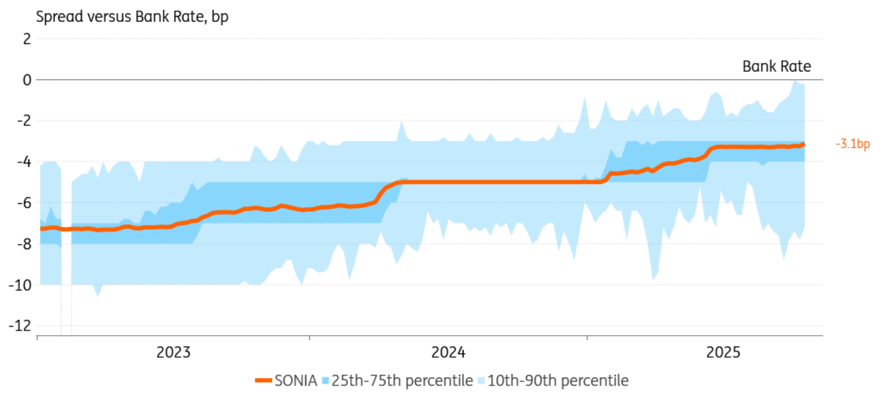


November should see some easing, but thereafter more tightening again

Because the net impact of reserves is close to zero, we don't anticipate any lasting effects and November should see better conditions. In fact, the strong pickup in the liquidity facility reflects a sound working of the liquidity plumbing set up by the BoE. The tightening in overnight markets reflects the need to bridge the gap between moving liquidity from one funding source to another with slightly different maturities. Combine that with regular month-end effects, and seeing some tightness was entirely expected.

We may, however, see more tightening again in money markets towards year-end as the level of reserves has come down drastically since last year. We can see that the SONIA rate has continued moving closer to the Bank Rate, suggesting the competition for deposits, and thus liquidity, has increased. More notable may be the distribution of the SONIA sample. The tenth-highest percentile of deposit rates was at the Bank Rate or above, whilst the tenth lowest was some 8bp below. This suggests that certain banks are much more willing to pay for reserves than others. Such effects can become more pronounced during year-end, and we could see more volatility as a result.

Dispersion in deposit rates suggest unevenly distributed reserves



Source: ING, Macrobond

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