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Rates outlook 2021 Money for nothing

Padhraic Garvey

Regional Head of Research, Americas
New York +1 646 424 7837
padhraic.garvey@ing.com

Benjamin Schroeder

Senior Rates Strategist
Amsterdam +31 20 563 8955
benjamin.schroeder@ing.com

Antoine Bouvet

Senior Rates Strategist
London +44 20 7767 6279
antoine.bouvet@ing.com



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Watch: Padhraic Garvey on what to expect from Rates in 2021



Padhraic Garvey

Regional Head of Research, Americas
New York +1 646 424 7837
padhraic.garvey@ing.com

Benjamin Schroeder

Senior Rates Strategist
Amsterdam +31 20 563 8955
benjamin.schroeder@ing.com

Antoine Bouvet

Senior Rates Strategist
London +44 20 7767 6279
antoine.bouvet@ing.com

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Rates outlook 2021

Our outlook for rates in 2021 is relatively optimistic. That said, there are numerous drags that will contain market rates. A large debt overhang is one. Pushing in the other direction is re-pricing from heavy supply and a potentially jumpy inflation dynamic. Our base forecasts are below followed by a closer look at the many drivers in play

Bond yield forecasts 2021

	Curr 18-Nov	4Q20F	1Q21F	2Q21F	3Q21F	4Q21F
USD bond yields						
2Y US Treasury	0.17	0.15	0.25	0.25	0.25	0.40
5Y US Treasury	0.38	0.30	0.55	0.55	0.55	0.75
10Y US Treasury	0.84	0.75	1.00	1.00	1.00	1.25
30Y US Treasury	1.58	1.60	1.90	1.95	2.00	2.20
USD yield curves (bp)						
2Y/10Y US Treasury	67	60	75	75	75	85
10Y/30Y US Treasury	74	85	90	95	100	95
EUR bond yields						
2Y German Schatz	-0.74	-0.75	-0.75	-0.70	-0.65	-0.65
5Y German Bobl	-0.75	-0.75	-0.70	-0.60	-0.50	-0.50
10Y German Bund	-0.57	-0.60	-0.50	-0.40	-0.25	-0.25
30Y German Bund	-0.17	-0.20	-0.10	0.05	0.25	0.30
EUR yield curves (bp)						
2Y/10Y Bund	17	15	25	30	40	40
10Y/30Y Bund	40	40	40	45	50	55
Eurozone Spreads (bp)						
10Y Italy/Germany	119	115	105	100	95	90

Source: Bloomberg, ING

Swap rate forecast 2021

	Curr 18-Nov	1Q20F	1Q21F	2Q21F	3Q21F	4Q21F
USD interest rates						
Fed funds rate (lower bound)	0.00	0.00	0.00	0.00	0.00	0.00
USD Libor 3m	0.22	0.25	0.25	0.25	0.30	0.30
2Y USD IRS	0.26	0.25	0.35	0.35	0.35	0.50
5Y USD IRS	0.44	0.35	0.60	0.60	0.60	0.80
10Y USD IRS	0.84	0.75	1.00	1.00	1.00	1.25
30Y USD IRS	1.26	1.25	1.55	1.60	1.65	1.85
USD swap curves						
2Y/10Y USD IRS	58	50	65	65	65	75
10Y/30Y USD IRS	42	50	55	60	65	60
EUR swap rates (vs 6m)						
ECB deposit facility rate	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50
Euribor 3m	-0.52	-0.50	-0.50	-0.50	-0.45	-0.45
2Y EUR IRS	-0.52	-0.55	-0.55	-0.50	-0.45	-0.45
5Y EUR IRS	-0.45	-0.45	-0.40	-0.30	-0.20	-0.20
10Y EUR IRS	-0.24	-0.25	-0.20	-0.10	0.05	0.05
30Y EUR IRS	0.02	-0.05	0.00	0.15	0.35	0.40
EUR swap curves						
2Y/10Y EUR IRS	28	30	35	40	50	50
10Y/30Y EUR IRS	26	20	20	25	30	35

Source: Bloomberg, ING

USD supply: No need to worry, yet

The US deficit is eye-watering. And it needs to be financed. Such are the sizes involved that it is not difficult to see how this could be a problem. That said, for as long as there is offsetting demand it does not need to be a determining factor the bond market. So far, and through 2021, we see demand for bonds holding up. But this issue will not go away



Padhraic Garvey

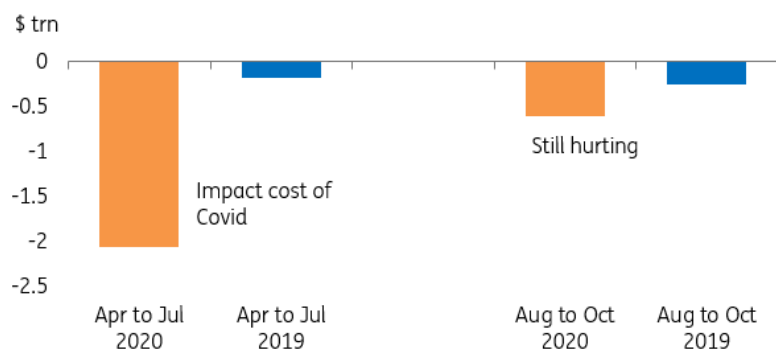
Regional Head of Research, Americas
New York +1 646 424 7837
padhraic.garvey@ing.com



The US deficit shoots to the skies, and now must be financed

As Covid-19 struck and the economy came to a government-induced shudder, the cost of covering that hole began to explode. As a consequence, the build of the US fiscal deficit in 2020 has been nothing short of astonishing. From April to October 2020, the US ran a deficit of \$2.7trn. That compares with a deficit of about \$0.4trn over the same period of 2019, an eye-boggling excess of \$2.3trn. That excess alone amounts to about 11% of the size of the US economy. In total over the Covid-struck twelve months spanning from April 2020, the deficit is likely to be at a running rate of close to 20% of GDP.

US deficit rocketed higher to finance stimulus, and the pain continues



Source: Macrobond

Deficits need to be financed. The first port of call was the bills market. Very quickly, bills issuance began to fill the required funding needs, and indeed the Treasury added to that

by building a cash balance to around \$1.5trn. And the cash balance remains at about that level, partly in anticipation of immediate requirements but also as a new stimulus package has been expected. The fact that this has not come to fruition (yet) has taken some pressure off. It has also meant a halving of targetted bond issuance in the next number of months.

However, the deficit financing pressure remains. First, as some of the bills' issuance will be slowly rolled out the curve into more longer-dated issuance. And second, as there will likely be a stimulus package coming, with at least a \$1trn handle on it.

Time to get worried about the deficit? Yes, but no need to panic just yet

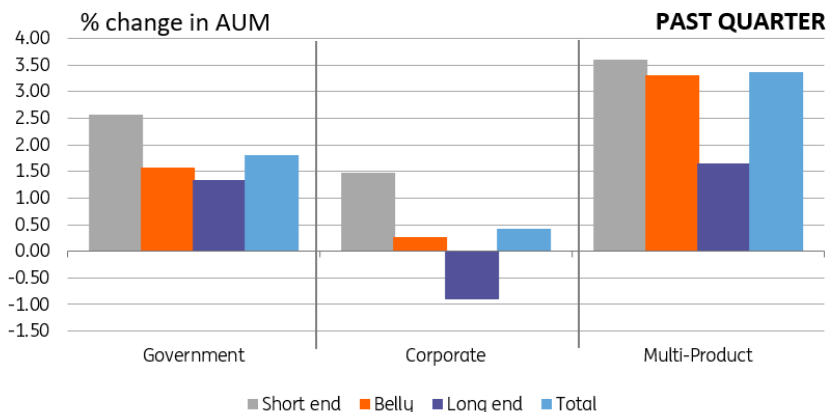
Supply can be a swing factor if there is inadequate demand. So far, demand has been impressive. Flows into government bonds remain robust, and the expectation ahead is for this to remain the case. Money market funds however have seen fewer inflows, and in fact, prime funds have seen outflows as a theme. The market capitalisation of commercial paper has also been falling. There is still decent demand for government bills, but it is not a route that should be aggressively tapped on through 2021. Rather the onus will be on supply and demand in longer tenors.

“Provided the average coupon print is below the nominal GDP growth rate debt dynamics can be contained”

Then there is the question of debt dynamics, and whether we should be concerned about that from a US perspective. Generally speaking, provided the average coupon print is below the nominal GDP growth rate, debt dynamics can

be contained. This can be complicated by the size of the primary positive and the debt/GDP ratio itself, but these are not key determining factors for the US. And the other big issue is the Federal Reserve. For as long as the Fed is there buying paper and willing to buy more, there is little to fear on the weight of debt front. Overall flows into Treasuries remain a supportive factor.

Flows into core government bonds have remained impressive despite the low (but rising) yields



Source: Macrobond

That is not to suggest there are no risks here. There are. But we see this as a bigger worry for further along 2021 and into 2022. The roll-over of debt will be an ongoing factor to take into consideration then, and especially if it coincides with some build of inflation (most likely from the service side of the economy). For now though, we think supply will be met by demand.

And by the way, the Federal Reserve has played a good game, and is still in the game

On top of the support from the Treasury, a whole litany of exceptional help has been provided by the Federal Reserve in an effort to protect both the financial system and the economy. These have been successful. The exceptionally low level of 3mth Libor is one measure of this. The other is the only moderate discount on the EUR leg of a cross-currency swap versus USD. Typically, or at least in prior crises, a significant build in a USD premium would build as players scrambled for USD, manifesting in a large EUR discount.

The actions of the Federal Reserve have helped to prevent this, and have helped ease any perception of liquidity constraints into the turn of the year. It looks at this stage that the Federal Reserve will not need to beef up support for money markets, credit markets, commercial paper markets or USD lines. But the Fed will keep policy easy and keep that QE programme humming through 2021.

USD: The glory of a 1-handle

We are upbeat for 2021. Hence the call for the US 10yr to get to the 1 to 1.25% range. If the stars align, we could go higher. But there are drags coming from Europe. And also the structure of the curve is not looking very bearish for bonds. The rich 5yr valuation tells us that market rates are still vulnerable to the downside, and Covid-19 could take us there first



Padhraic Garvey

Regional Head of Research, Americas
New York +1 646 424 7837
padhraic.garvey@ing.com



Why we target a 1-handle for the 10yr in 2021, but we go lower first

Now that we hopefully have a coronavirus vaccine, the world has a more certain prognosis. By the middle of 2021, the application of that vaccine and recovery from a likely double-dip in the first quarter mean we could see US growth in the 5% area.

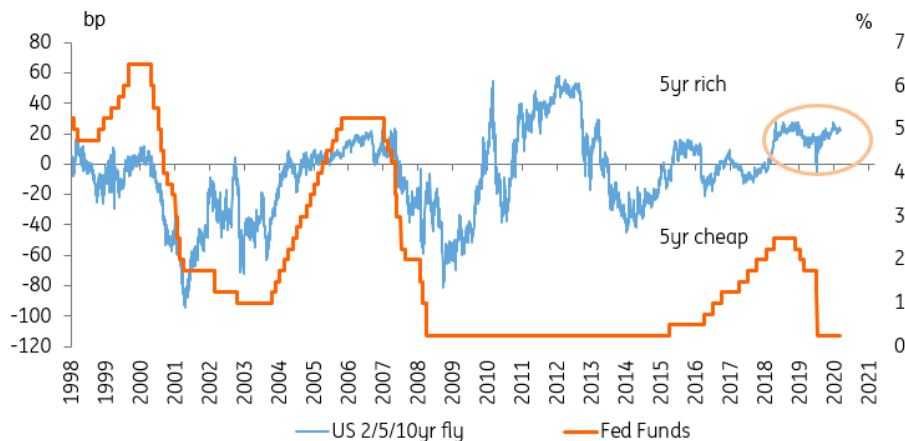
“The 1-handle is a key level, as we return to describing yield in percentage rates rather than in basis points”

This will not go on forever of course, but such an outcome would act to narrow the output gap, and there is not an inconceivable outcome which includes the buildup of inflation in the vitally important service sector. This is what

underpins the targeting of a 1-handle on the 10yr Treasury yield. This would be structural in the sense that we would likely remain at 1% or higher. We view 1.25% as achievable.

The 1-handle is a key level, as it returns us back to the notion of describing yield in percentage rates rather than in basis points. It also by implication points to the targeting of key levels above 1%. But not too far above. We don't see a 2% 10yr yield as a likely scenario for 2021 for example. A move from 1% to 2% would undoubtedly be a bear market for bonds in 2021, but this is not a bear market for bonds.

US 2//5/10 year fly v Fed funds



Source: Macrobond

The richness of the 5yr mutes any ambition to term this a bear market for bonds

Our go-to here is the 2/5/10yr fly, which tells us that the 5yr remains exceptionally rich to the curve. When this has been the case historically, the bond market has been a bullish one and/or the Federal Reserve has been easing policy.

This is also a warning shot for the bond market bears, and nearer-term the set-up is for a double-dip in the economy as the third wave of Covid-19 strikes with lockdown implications. The re-elevation in macro angst over the turn of the year and well into the first quarter of next year will act as a drag on market rates. We doubt there would be enough there to pull the 10yr down to 50bp, but a pullback to the 75bp area is conceivable.

So it is 75bp to 1% for Q4 2020 through Q1 2021, and then a 1-handle for the rest of 2021, ultimately converging on the 1.25% area.

USD: That stretchy feeling for the curve

The shape of the curve is all about direction in 2021. By 2022 that will likely change as the debate on possible Fed hikes by 2023 will be live, unnerving the jumpy 2yr. But for now, even the vaccine moment did not radically impact the fed funds strip, and by extension the 2yr. Given that, watch the 2/10yr curve stretch to 100bp, driven by back end direction



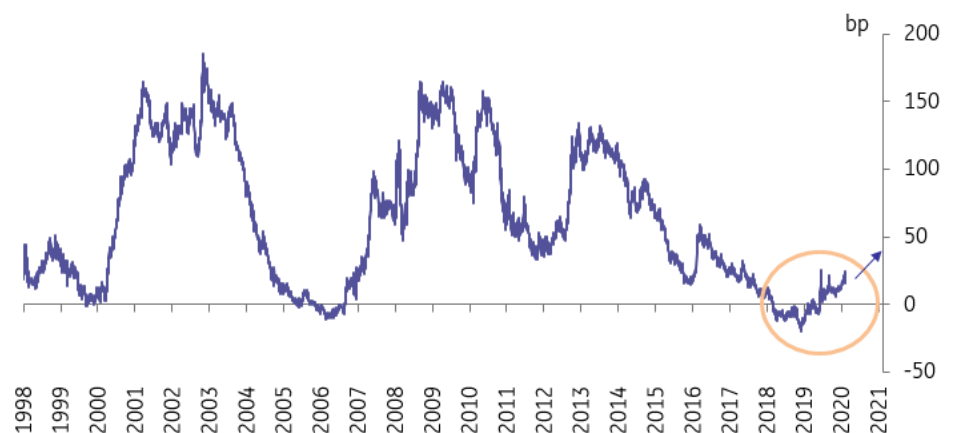
Padhraic Garvey
Regional Head of Research, Americas
New York +1 646 424 7837
padhraic.garvey@ing.com



It's a directional curve for 2021 with the front end anchored

We'll see the reflation discount in the shape of the curve; it should steepen. Watch the US curve here more than the eurozone one, as the latter has a strange front end that can go as deeply negative as it likes it seems, bringing long end rates with it. The US curve is more anchored at zero. When it stretches steeper, it means something.

US 2-5 yr spread



Source: Macrobond

The 2/5yr anticipated a recession back in 2019, but now it is stretching steeper; a reflation story

As it does stretch steeper, it further moves clear of the inversion episode seen in mid-2019. Remarkably back then the curve was already discounting a recession. Well, we got one. And we'll likely get a Covid-induced a double-dip. Beyond that, a steepening bias

should dominate as a theme for 2021. As the 10yr marks a 1-handle, we'd see the 2yr remaining in sub-25bp territory. Hence a 100bp 2/10yr curve targets the 10yr in the 1% to 1.25% range.

The debate on the Fed hiking rates will be a live one by the time we get to 2022

Even in the wake of the vaccine announcement, there was very little shift in the Fed funds strip. Implied rates in 2021 and 2022 did ease higher a tad, but not significantly so. This maintains a firm footing for the 2yr to remain anchored in 2021. That said, the debate on the Fed thinking about hiking rates will be a live one by the time we get to 2022 - any sense that the Fed could hike in 2023 would be reflected in the 2yr by 2022.

For 2021 though, there should be less discussion on Fed hikes as a live issue. In fact, this is one of the reasons underpinning the rich valuation attached to the 5yr on the curve. That is highly correlated with the money market curve and by extension rate expectations; these remain dampened down, and will likely remain so for the bulk of 2021.

USD: Slow export of reflation must widen the Treasury-Bund spread

A widening in the Treasury-Bund spread is a classic recovery outcome. It reflects a scenario where the US takes the lead role in pulling developed markets out of slowdowns and recessions. This has started to happen, which is good. And there is more to come in 2021. Watch for a 175bp spread as a target. A 200bp spread would be super positive and not impossible



Padhraic Garvey

Regional Head of Research, Americas
New York +1 646 424 7837
padhraic.garvey@ing.com



US market rates tend to be more volatile and a lead for European ones - hence the wider spread

We see 2021 as a year in which the spread between the German and the US 10yr continues to re-widen. This is a classic reflation/recovery type occurrence. US rates volatility is typically higher than that of eurozone rates, and during periods of rising markets rates, the US tends to do most of the heavy lifting to begin with, which would result in a wider spread between US market rates and eurozone ones.

“While negative rates have served the purpose of providing ultra-low financing conditions, they are also not a desired outcome”

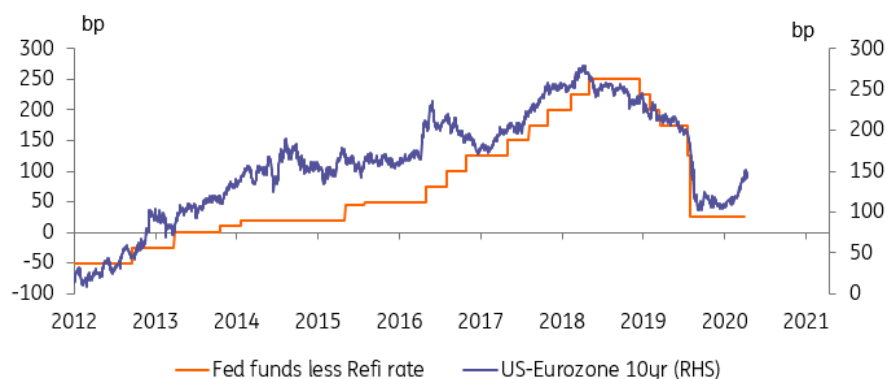
And this is important for eurozone yields, as higher US yields can help to pull the eurozone ones up too; which is a good thing. The German 10yr yield at -50bp does not paint a positive picture for the eurozone medium-term outlook. In contrast to that, the ambition for the US 10yr

to nudge above 1% takes it clear of the depths that German yields find themselves in.

While negative rates have served the purpose of providing ultra-low financing conditions, they are also not a desired outcome as higher yields usually mean better things in terms of underlying macro circumstances.

We don't see this as being a consequence of more supply. That might come. But for now, the dominant pull on market yields is a reflationary 2021.

Treasury-Bund spread



Source: Macrobond

A wider Treasury-Bund spread will mean that US rates help to pull up German ones, eventually

While this reflation mood can coax eurozone yields up too, the dominant impulse is to widen the Treasury-Bund spread. Pre-crisis this was at 2%-plus. It dipped to the 1% area as Covid-19 struck, which saw the Fed cut by 150bp. Fair value would be around 2%. We will get there provided we remain on track. But our intermediate call is to get to 175bp, with the US 10yr likely at 1.25%.

This would leave the German 10yr yield in the -50bp area, but the discussion then would be centred on the US heading for 1.5% while the German 10yr slowly moves out of deeply negative territory. A lot of positive things need to happen first, but 2021, hopefully with a vaccine, will stack up in a positive fashion.

USD: Ultra-low Libor must rise

Libor rates are trading in very close proximity to risk-free rates, which suggests a minimal credit risk premium in the rate. There is a clear risk that Libor comes under rising pressure through 2021. This will in part be a relative valuation move, but it can also reflect residual stress as Covid-19 induced sticking plasters come off



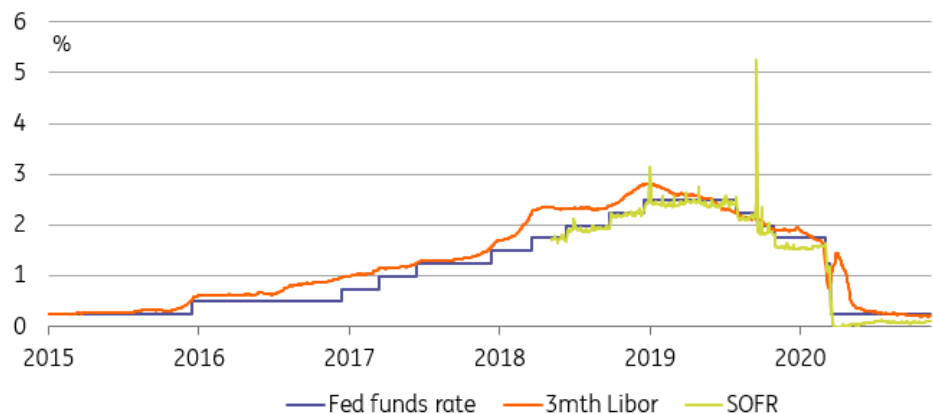
Padhraic Garvey
Regional Head of Research, Americas
New York +1 646 424 7837
padhraic.garvey@ing.com



Libor rates are ultra-low. Great, but can that last? Unlikely we think

Libor will live out its final days in market centres through 2021, but it is strutting through 2020 with quite a bit of attitude. One of the issues with Libor is the implied bank risk that it contains, which proved exceptionally volatile during crises (most notably through the great financial one). But as we head towards the end of 2020, Libor is on the floor. USD Libor at 20bp is some 5bp below the Fed funds ceiling - not much implied bank credit risk there. Libor is trading like a premium product here, sitting adjacent to risk-free rates.

Fed Funds rates, 3m Libor and SOFR



Source: Macrobond

The likelihood in 2021 is that this changes. We think that USD Libor should be some 10bp higher than it is currently, and we'd assert similar for lbors in most other centres. For example and remarkably, 3mth Euribor is currently flat to the ultra-safe ECB's deposit rate. While this can be rationalised on account of advantageous bank funding conditions, it still looks anomalous. The low valuation attached to Libor is reflective of a

lack of systemic stresses, which is a good thing. And by extension, there is an implied positivity imputed on the banking system. This is a valid point of positivity, but the question is whether it can persist.

A rise in Libor could also come from rising defaults as they impact the system negatively

So while central banks may not do an awful lot in 2021 in terms of policy changes, we would expect to see lbor rates drift higher from current levels. An important ancillary rationale here centres on the likelihood that risk attributed to banks and the system ratchet higher again, especially as default risk gets re-elevated.

“The end of Covid-19 is a clear positive, but it also means the Band-Aids come off”

The end of Covid is a clear positive for humanity and future growth, but it also means the Band-Aids come off. This in many cases will leave ghastly unhealed wounds that will result

in numerous uncomfortable shutdown stories, even as economies begin to structurally rebound.

We feel that Libor bottoms out here, and the most likely move in the period ahead would be to test higher, we think by 10bp. And that is without any change in central bank policy. A nudge higher in Libor would not be a bad thing by the way for transition away from Libor, as it would bring the spread from SOFR to Libor back up to a more normalized level, and in fact closer to the 5yr median being employed by ISDA for transition to fall back rates (see the next section for more on this).

Libor transition: Goodbye Libor

This is it! The final year for USD Libor is 2021. No looking back, and many decisions to be made ahead. Complications galore feature. Many loans will have a different convention to derivatives from 2022, and in 2021 there is a huge legacy transition exercise to be done. Players must estimate suitable spreads to be applied to SOFR for continuation. Lots to do!



Padhraic Garvey

Regional Head of Research, Americas
New York +1 646 424 7837
padhraic.garvey@ing.com



We enter a regime of dominant risk free rates - far from a risk free process

Actually, there is no such thing as a risk-free rate. All rates have risk. The transition here is from Libor, which contains a bank credit risk, to overnight rates that minimise both credit and counterparty risk. Transition must happen in 2021, as there (likely) will be no e.g. USD Libor in 2022. Initial resistance to change has morphed to inertia, as players await first movers. And there has not been a huge movement so far, to say the least. One Federal Reserve spokesperson likened the process to herding cats; very apt.

“A build-up in volumes would allow for derivatives referencing risk-free rates to begin to dominate Libor”

Still today the vast majority of derivatives trades are set with reference to Libor, and not to, for example in the US, the Secured Overnight Financing Rate (SOFR). Many are awaiting a build in volumes before switching.

We expect to see a material build in such volumes through Q2 2021, and we view it as being a simultaneous process, as volume in all product builds at the same time. This is vital. Such a build-up in volumes would allow for derivatives referencing risk-free rates to begin to dominate Libor. While not a flick of a switch, we do feel that transition to the use of the new rates can be swift; happening over a matter of weeks.

That, in turn, would facilitate the mapping out of term rates in SOFR in particular, for example, a 3mth rate in advance (and not in arrears). A decent rump of players in the loans market globally is calling for this as a must-have. We expect SOFR term rates to be in place by early Q3, and this is a critical call for a smooth transition. The official sector had an early preference for risk-free rates to be purely set in arrears, but pressure from the loan market, in particular, has ultimately called for term rates. Now they need to be delivered in the US, as they (virtually) have been in the UK.

A world of different conventions makes for complications at the margin - in arrears versus in advance for starters

“Complications will arise to the extent that (some) loans in the future will be set with reference to term rates while derivative overlays will be set in arrears.”

As it is, the bulk of derivatives will be based off SOFR in arrears. As for loans, SOFR daily simply appears to be the preference, effectively using rolling daily rates for the period in question. Mathematically the difference between the two is quite mild, especially to the extent that rates

are broadly unchanged, both in the rear-view mirror and as mapped out by futures. But still, it's not the same.

Here are the complications

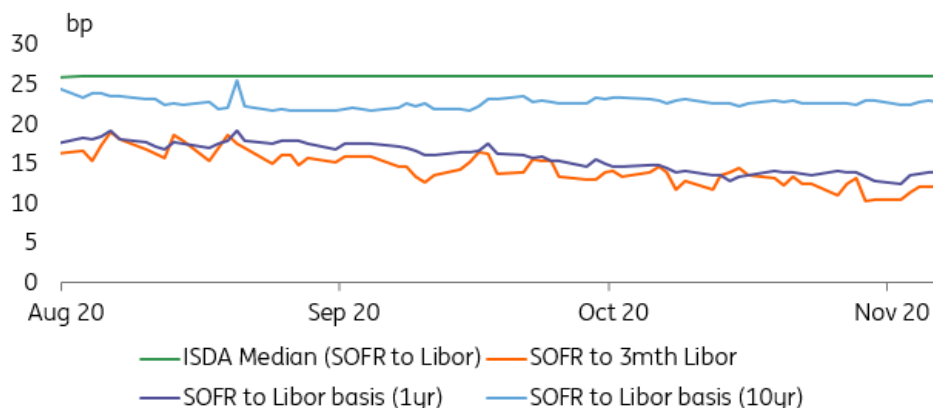
Complications will arise to the extent that (some) loans in the future will be set with reference to term rates while derivative overlays will be set in arrears. Over the counter solutions will be available to solve this, but this is still an extra step, a complication.

The other issue is how to deal with legacy Libor products, and especially loans. Here, bi-lateral conversations will have to be had, effectively on suitable spreads that translate from Libor to risk-free rates (plus an adjustment spread). There are traded market spreads that can help as a reference, but they move. Not easy. Also not easy as Libor is so low now that the market spread is below average, which makes the discussion that bit more complicated.

The ISDA protocol is convenient, but higher Libor rates would make it more appealing

And this is why there is some scrutiny on the ISDA protocol terms, as the calculated median spread adjustment is well above the current spread between SOFR and Libor, implying a fallback rate that is over 10bp above the legacy Libor rate. The basis between SOFR and Libor is traded in the market. The 10yr spread (22bp) is only a few basis points below the ISDA median (26bp), so the long term story is not too deviant from the ISDA spread. However, the 1yr spread (15bp) is much closer to the cash difference between SOFR and Libor (12bp). You can see the dilemma here – go for a convenient long-term solution, or pay closer attention to short term valuation differences.

Note the difference between the ISDA spread, the 10yr spread and the 1yr spread.



Source: Macrobond

The ISDA protocol is undoubtedly convenient and a decent long term solution. But at the same time, players are within their rights not to use it, but instead to derive some other measure of the adjustment spread. That takes time and effort and can get quite complicated. Wide application of the protocol would be the best case solution and especially if applied to the transition of legacy loans. Our gut tells us that we will get all of the above. It can get really very messy; get ready for it as best you can.

EUR: Still constrained

We forecast 10Y EUR swap rates to rise to only 0.05% next year, equivalent to -0.25% for 10Y Germany. Inflation is going nowhere fast, ECB demand for bonds continues to grow, and fiscal stimulus is insufficient to boost long-term growth expectations



Antoine Bouvet
Senior Rates Strategist
London +44 20 7767 6279
antoine.bouvet@ing.com

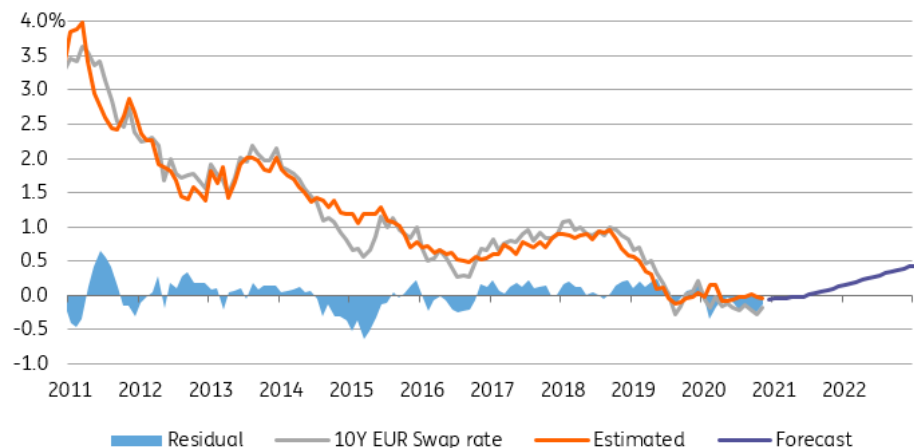


Inflation and growth: no need for (much) higher rates

It should come as no surprise that even in a period of vaccine-induced optimism, our EUR rates outlook remains heavily constrained by fundamentals, namely the very shallow path for inflation in the coming years (the ECB forecasts core inflation reaching only 1.3% in 2022). This in turn justifies no great need for higher inflation compensation further up the curve.

On the growth front, the lingering drag from higher unemployment rates and structural damage to the economic fabric of the worst affected eurozone member states still argues for depressed interest rates.

10Y swap rate to recover only slowly from its Covid slump



Source: Bloomberg, ING

Demand for safe assets is still rising

On the technical front, the European Central Bank will continue removing large amounts of duration from the debt market next year. Not only will its quantitative easing (QE) portfolio growth remain positive for the whole of 2021, we expect a reduction is unlikely before 2023 at the earliest.

“10Y EUR swap to rise to only 0.05% next year”

We would add to this official sector demand an ever-growing pool of private sector liquidity chasing yields. A large section of this demand, for example, bank liquidity portfolios, is limited

to all but the safest type of assets. This structural demand for bonds means EUR rates will fail to achieve much upward momentum in case of a recovery. It also means that if the outlook worsens, rates could easily drop below their 2020 lows (at -0.30% for 10Y swaps).

Fiscal policy better but not expansionary

Besides dealing another blow to growth and inflation expectations in Europe, the coronavirus pandemic has also brought the hope of a change in its approach to fiscal policy. A temporary suspension of the EU fiscal rules was a welcome development but did not prevent European economies from recording some of the worst growth figures worldwide.

The question investors would want to answer is, will fiscal policy become structurally expansionary beyond 2021? We wouldn't hold our breath. Even if this were the case, assuming better long-term growth prospects on that basis is a leap of faith that we are not prepared to make.

EUR: More liquidity, more compression

Money markets will remain under the spell of high excess liquidity levels. This means ever lower Euribor fixings and commercial paper rates. We do not anticipate the ECB will cut its policy rate, but cheaper liquidity injections are on the cards



Benjamin Schroeder

Senior Rates Strategist
Amsterdam +31 20 563 8955
benjamin.schroeder@ing.com



A still rising tide of excess liquidity amid QE and TLTROs

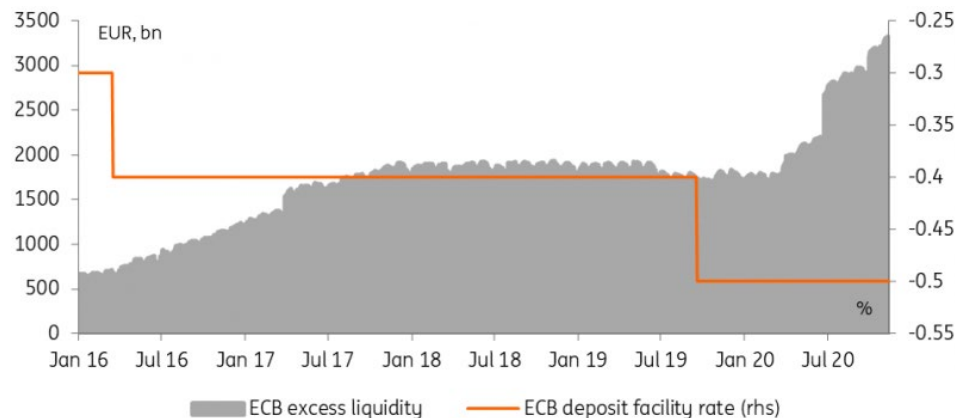
The ECB's pledge "to recalibrate" its instruments in December, with all of them on the table, was widely interpreted as a pre-commitment to act decisively. If it takes the shape our economists anticipate, high and rising excess liquidity levels will remain a dominant feature in 2021. ECB President Christine Lagarde hinted as much at her latest speech at the Central Banking Forum, highlighting that the TLTRO (liquidity injections to banks) and PEPP (asset purchases) would likely remain important tools to bridge the gap until a wider vaccine rollout opens a path back to normalcy later in 2021.

"Depressed rates will remain a feature for longer than anticipated"

Indeed, we see little to be gained from an even lower deposit facility rate. And the market is already anticipating yet more quantitative easing. Given that borrowing from the ECB is

likely to become even more attractive, banks' financing needs from the markets, at least in the short term, should decline further. This substitution has been instrumental in the decline of unsecured rates such as Euribor fixings and commercial paper rates in our view. The corollary to an extension of the TLTRO's low-interest rates terms, and higher take up, would be that depressed rates remain a feature of markets for longer than anticipated. This should push Euribor forward rates, relating to 2021 and 2022, lower.

The ECB is likely to remain focused on instruments that drive excess liquidity higher



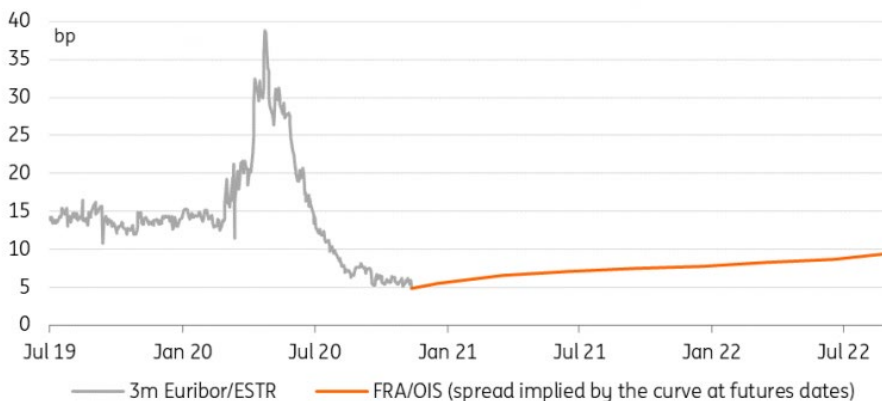
Source: ECB, ING

No cuts, no hikes, but tighter spreads

That said, 3M Euribor fixings are now below the deposit facility rate of -0.5%. We believe that the overnight €STR rate currently fixing around -0.56% should mark the lower bound for Euribors in the absence of ECB rate cut speculation, as it reflects what banks charge for the service of redepositing at the ECB. Being aware that the negative rate charged on ever-higher excess liquidity is a cost to banks, there is a chance that the ECB will allow them to redeposit a larger portion of their liquidity at 0%. This tiering multiplier could be increased, but not to a degree that would materially change money market dynamics. It remains that the marginal cost for any added euro of excess liquidity, i.e. the deposit facility rate - should determine the market rate.

Rate cut speculation is probably the main determinant of outright money market rate movements. At the moment, the market attaches a non-negligible chance that the ECB will lower the deposit facility further. €STR forwards rates for the end of next year are at -0.61%. This implies that if we are right that the ECB will not follow through with cuts, these rates are still prone to correct higher. Albeit only moderately so - the economic outlook for sure does not warrant a rate hike within the next couple of years - we thus believe the pressure exerted by excess liquidity and the TLTROs on rates is more likely to manifest itself in a further compression of money market spreads such as the difference between Euribor and €STR.

Money market spreads should remain under tightening pressure



Source: Bloomberg, ING

Fireworks in December? What to expect at the crucial ECB meeting.

While the ECB held policy steady at its October meeting, it sent a clear signal that fireworks are in the offing for December. Our economists expect an additional €500 billion in quantitative easing (QE), possibly announced as a monthly instalment and continuing for as long as needed. To keep financing costs low, the preferential TLTRO rates, allowing banks to fund cheaply if they don't shrink their loan portfolio, are probably going to be extended until the summer of 2022.

“We expect an additional €500 billion in QE”

Exempting a bigger chunk of bank liquidity from the negative deposit rate is possible. Just like the Federal Reserve, the ECB might also decide to incorporate companies that lost their investment-grade rating this year in its corporate bond purchase programme. While a deposit rate cut cannot be excluded, it is probably not the ECB's preferred policy measure right now.

EUR: The new (flatter) normal

Given the shallow rise in EUR interest rates we are forecasting for 2021, we expect curve dynamics to remain equally muted. EUR 2s10s will steepen more than 10s30s



Antoine Bouvet
Senior Rates Strategist
London +44 20 7767 6279
antoine.bouvet@ing.com



30Y richness is structural, EUR 2s10s to steepen more than 10s30s

We've detailed in a previous section the fundamental reasons why we expect the hunt for yield to be a prevalent factor in keeping rates low. The question for the shape of the curve is where exactly this demand will be directed.

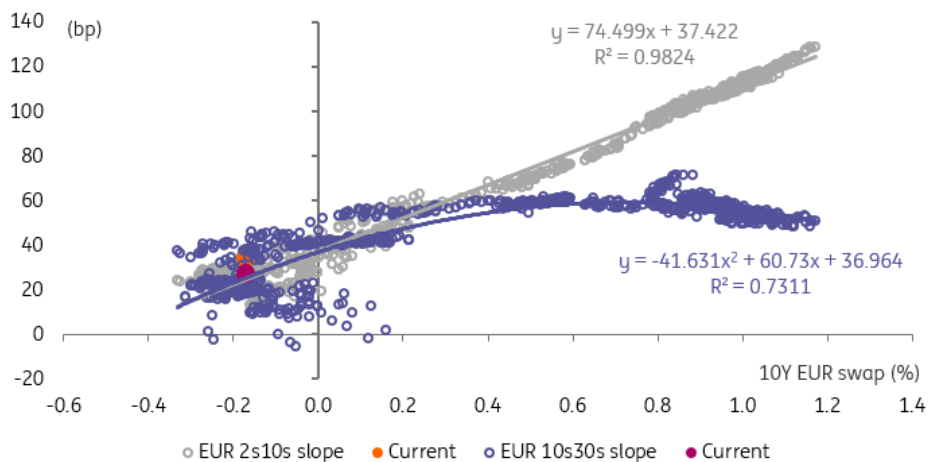
“The richness of 30Y reflects a structural shift”

In recent years, in particular 2019, maturity extension demand has made the 30Y the most directional part of the curve. We do not expect

that dynamic to go into reverse. To an extent, the richness of the 30Y reflects a structural shift in growth and inflation expectations and the fact that the main European Central Bank policy lever is to remove duration risk from the market to support the economy.

Absent any concrete hope of rate hikes over the coming years, we thus expect the 2s10s segment to be the most sensitive to direction. This should result in a faster steepening of EUR swap 2s10s, of around 17bp, than the 10s30s, of around 10bp, and so in a cheapening of the 10Y sector of the curve.

EUR 2s10s should steepen as rates rise (slowly), 10s30s not so much



Source: Bloomberg, ING

Termining out and ECB mandate change: muted risks

There are two risks to this view. The first one is if governments pursue an aggressive debt maturity extension policy beyond the 10Y point. This is a possibility, but we suspect such an increase would be mostly demand-led and so of little market impact.

Another risk is if the ECB's policy review opted for a Fed-style average inflation targeting (effectively aiming for an overshoot to the 2% inflation target). Not only is this unlikely, we think the credibility of such commitment would require radical, and sustained, fiscal support for the economy, something we are not prepared to assume.

EUR: The carry sweet spot

ECB and EU support, exceeding governments' funding needs in most cases, will continue to drive sovereign spreads tighter in 2021; in the case of Italy to 90bp, its tightest level in a decade. Spain and France have less scope to perform



Antoine Bouvet
Senior Rates Strategist
London +44 20 7767 6279
antoine.bouvet@ing.com



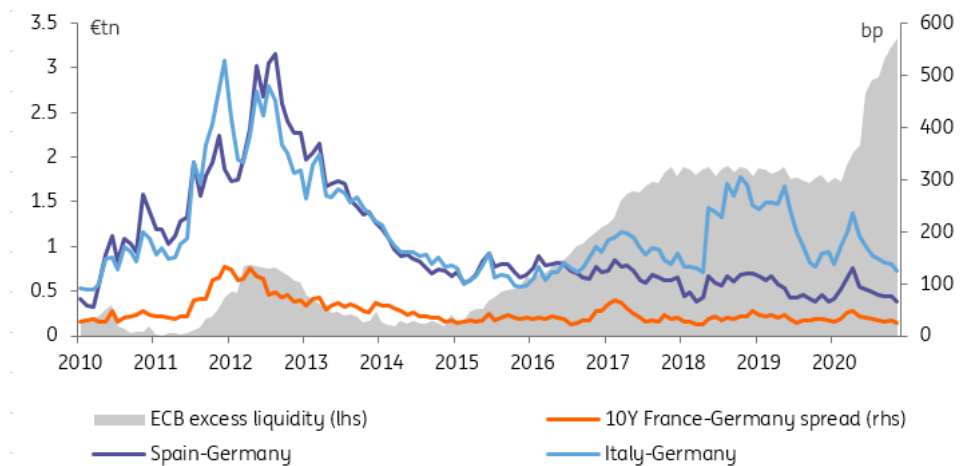
Benjamin Schroeder
Senior Rates Strategist
Amsterdam +31 20 563 8955
benjamin.schroeder@ing.com



ECB and EU support to remain the key drivers of spreads

Another, hopefully, lasting consequence of the Covid-19 pandemic was the joint EU fiscal response. The programme, dubbed NGeu (Next Generation EU), includes €350bn of cross border transfers over several years. If the annual disbursed amounts over the life of the programme are relatively modest compared to the size of the eurozone economy as a whole, its impact on smaller peripheral economies, Greece for instance, is nothing short of a game changer. Even for larger peripheral countries, the combination of supply reduction, fiscal stimulus, and monitoring is sending a positive signal to investors.

ECB intervention to steamroll spreads further



Source: Bloomberg, ECB, ING

If NGeu helps address the reasons for intra-eurozone sovereign spreads, namely diverging growth and fiscal paths, it doesn't solve them entirely. In that respect, the ECB

is once again proving instrumental in suppressing peripheral borrowing costs and preventing further divergence. It is also the prospect of sustained central bank support that pushes private investors into chasing yields lower.

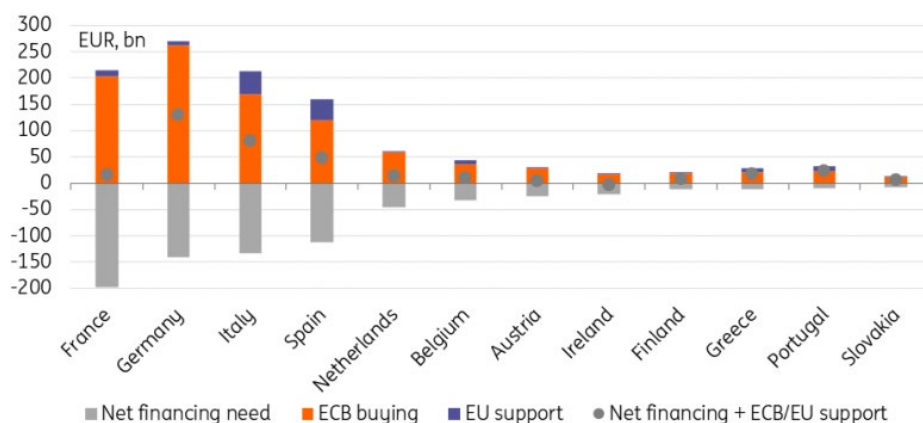
Higher yields on the front foot

We see no major impediment to this dynamic continuing next year. On the contrary, still sizeable central bank support, some degree of fiscal solidarity between states, and too shallow a recovery to question either, will serve carry trades well. As more investors are drawn to peripheral debt, we expect the 10Y spread between Germany and Italy to narrow to 90bp by the end of 2021. This would be its tightest level since the onset of the sovereign debt crisis over a decade ago. To arrive at this forecast, we assume that Italian political risk will remain in check, with no general election before 2022, but most likely in 2023.

90bp The Italy-Germany 10Y spread (end-2021 forecast) tightest level in a decade

Safer sovereigns, France and Spain for instance, will fare comparatively less well. This is in part due to competition for investor demand stemming from EU debt issuance, and in part because of the economic damage wrought by the pandemic.

Net financing needs versus ECB buying and EU financial support



Source: ECB, EU, Commission forecasts, ING

Countries' crisis costs are more than absorbed by ECB and EU support

The European Commission forecasts net new financing needs of €760bn for eurozone countries in 2021, less than the €982bn anticipated for 2020, but still more than the €74bn in 2019.

However, the ECB stands to largely cover the pandemic's financial cost. Add EU support to this - for the chart below we consider the EU loans to support employment (SURE) and the grants from the EU recovery fund (NGeu) - and the overall financing balance looks decidedly more encouraging.

“On aggregate, over €1.1 trillion in ECB and EU support far outweighs €760bn in net financing needs.”

Crucially, the support extended to Italy and Spain is likely to exceed their 2021 net financing needs. This provides a substantial buffer in times of heightened uncertainty, especially if one considers the added possibility of pandemic emergency loans via the ESM (European Stability Mechanism) and loans from the EU recovery funds.

Germany stands to benefit substantially as well, thanks to the ECB buying bonds in proportion to each country's economy (the famed capital key). For a short period of time, the ECB has the flexibility needed to intervene where necessary. When this is the case, realignment of its portfolio holdings is postponed until market conditions allow it.

One caveat remains. The EU will have to finance its support in the market via bond issuance, in 2021 that could amount to €165bn of supply that will likely compete for the same investor base as core- and semi-core government borrowing. One more reason for higher yields in the periphery to outperform.

EUR: Diverging trajectories

Supply remains the main driver of swap spreads, but 2021 will be uneventful on this front. Instead, technical factors should cheapen long-dated swap spreads relative to shorter ones



Antoine Bouvet
Senior Rates Strategist
London +44 20 7767 6279
antoine.bouvet@ing.com



Benjamin Schroeder
Senior Rates Strategist
Amsterdam +31 20 563 8955
benjamin.schroeder@ing.com



Supply is still the main factor, but is largely played out

The cheapening of German government bonds relative to Euribor swaps continued in 2020.

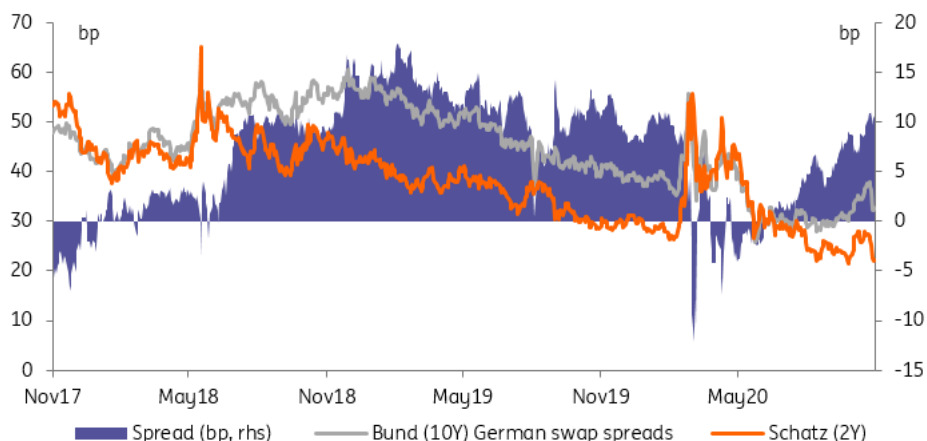
If one can point to the structurally higher government borrowing needs in 2020 as a driver, the same cannot be said for 2019, when the move in swap spreads was even sharper. This narrative remains nonetheless valid; we see the cheapening of government bonds relative to swaps in recent years as marking the end of an era, that of ever wider German fiscal surpluses.

The same holds true for 2021, although we think the 'supply-driven' swap spreads' re-pricing has now fully played out. Instead, we anticipate the 2021 regime will be dominated by changes in risk premia (typically richening bonds against swaps in times of stress and vice versa). We take an uncharacteristically upbeat view of the risk environment in 2021, and thus see no reason to expect an unwind of the recent richening.

Diverging fate at the short and long end

Money market conditions conspire to a roughly unchanged state of play. With the extension of easy TLTRO (Targeted Longer-Term Refinancing Operations) terms that we're anticipating in December - effectively cheaper liquidity to banks - the contribution from the Euribor-€STR spread should be minimal. On the other hand, some degree of richening could come from less government reliance on money market instruments, and so from lower repo rates.

We expect 10Y swap spreads to cheapen relative to 2Y



Source: Bloomberg, ING

The first quarter of 2021 should see a further unwinding of the supply-related richening of long-dated swap spreads seen in the last quarter of 2020. In addition, governments ‘terming out’ their borrowing (relying less on T-bills and more on longer-dated bonds) should contribute to a stabilisation of the cheapening of short-dated swap spreads. This should result in a flattening of the swap spreads’ term structure (cheaper long-end and richer front-end).

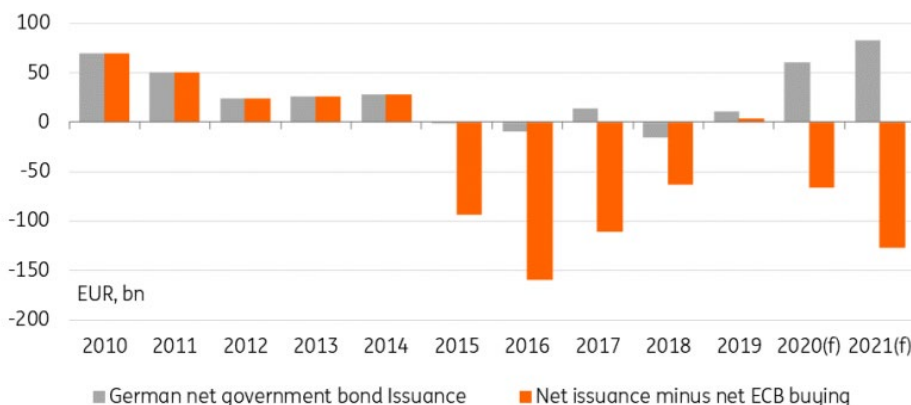
German supply/demand balance again flipped

Debt agencies have indicated so far that gross debt issuance is unlikely to fall materially next year. We still see it in the ballpark of €1.2 trillion for the entire eurozone after an estimated €1.26 trillion this year. In net terms that is a move from more than €560bn to below €530bn as redemptions fall to a smaller degree.

On the demand side, the ECB has become a dominant factor since it launched the Pandemic Emergency Purchase Programme (PEPP). Here alone €700bn of firepower is still left, and the ECB may add substantially to its purchase volume at the upcoming December meeting – our economists reckon €500bn.

Old and new programmes combined, the ECB could buy just shy of €1 trillion (net) in government bonds in 2021.

German net issuance after QE to turn even more negative again



Source: Deutsche Finanzagentur, ECB, ING

The supply and demand balance is especially lopsided for Germany, the eurozone's benchmark issuer. The 2021 budget plan suggests bond issuance will remain in the region of €235bn next year; after redemptions that leaves a net of €83bn. Given how the ECB splits its purchases, we estimate it should buy more than €200bn (net) over the course of next year in German government bonds alone. Of this already scarce 'commodity' – a highly liquid risk-free asset – the ECB is set to drain €120bn.

The crucial difference with the previous episode of bond scarcity in 2016 is that the ECB's tools have since evolved. The PEPP can now buy money market instruments. Add to this that the ECB can lend securities it has bought, and the price distortions should be less severe.

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