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Rates Outlook 2024

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Contents

Rates outlook for 2024: Fair winds and following seas	3
The significant steepening potential on the US curve	5
The big US fiscal deficit and effect on market rates	7
Waning US liquidity pressure set to accelerate in 2024	9
EUR direction and curve	11
EUR bond supply and spreads	14
The impact of the ECB's framework review	18

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

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

Rates outlook for 2024: Fair winds and following seas

Bond markets love nothing more than the turn of the rate cycle. That's why we're bullish and anticipate an evolution towards normal-looking upward curves at lower levels. It's all sounding just a bit too normal, though. We still worry about liquidity risks, the fiscal deficit in the US, and geopolitics – and admittedly, about 2024 as a whole

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

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

The year ahead will be all about anticipation for rate cuts, and then delivery

Bond markets tend to get very excited when central banks gear up for rate cuts. So far, both the Federal Reserve and the European Central Bank (ECB) are doing their best to keep the rate hike narrative alive and well, but markets have concluded that they are done and that the next move is down. In fact, markets are discounting almost 100bp of cuts from both the Fed and the ECB in 2024. Once central banks start to cut, the discount for cumulative cuts tends to deepen further. At the beginning of the rate cut cycle, it's all about anticipation. Actual delivery is assumed, and market rates fall.

What happens to front end rates is obvious. If central banks cut, then 2yr yields will clearly gap lower. Typically, once the cuts are coming (about three months ahead), the 2yr jumps lower – often by as much as 100bp in a matter of days. The big question is what happens to longer tenor rates. The answer is they usually fall, too, right out of the curve. In fact, total returns are typically maximised in the 30yr. There is a nagging fear that the US back end might struggle to perform due to fiscal pressures. But we are of the opinion that the bond market obsession with the rate cycle should dominate, causing a bullish steepening of the curve from the front end.

But, beware of waning liquidity…

And there are concerns about liquidity conditions to consider. We've been awash with liquidity since the pandemic, but both the Fed and the ECB are – in varying degrees – engaging in (soft) quantitative tightening. It's gone under the radar so far but will become an accelerated issue through 2024. It's unusual for liquidity to get tighter as central banks cut rates, but that's the juxtaposition we're facing.

Central banks need to be careful not to overdo the liquidity withdrawal, as there is a route to hurting the functioning of the system here. Separately, liquidity in US Treasuries has already become a worry, and both bank and market repo are not as influential as they once were in driving overall liquidity. Ideally, this theme should not be overly impactful, but is still a key area to keep an eye on in 2024.

The bullish steepening expected will also be impacted by other risks and prospects for 2025

Bond markets will also be keeping an eye on prospects for 2025, as they must, given they are long-tenor products. Here, the baseline market discount for both the Fed and the ECB in terms of lows for official rates is benign. In both cases, the end game is some 100bp short of where we anticipate official rates getting to. We think the 3% area is the neutral Fed funds rate and 2% to 2.5% is neutral for the eurozone, and we anticipate getting to these levels. That assumes a convergence on neutrality for 2025, with upward sloping 2/10yr curves stacked on top, or about 100bp in the US and 50-75bp for the eurozone.

That discount can be impacted by many things, and the US supply story is one. By 2025, we could have a fresh administration to deal with following the US presidential elections,

and how that administration deals with the deficit and geopolitics will be key. In the eurozone, the prognosis with respect to Russia and Ukraine – as well as future linkages with China – will be key, and their impact on Germany will be particularly important for the region's economy. There are also significant macro uncertainties to consider. We will know more as we progress through what is expected to be a difficult 2024 in terms of macro activity.

An uncomfortable call for a return to normality

Our baseline view is that we will land in a better place as we progress beyond 2024 and into 2025. We will still be in a rate-cutting phase, but we assume that both the Fed and the ECB get rates down to normal levels and to a point where they are neither contractionary nor stimulative. In many ways, it would be the completion of a return to normal process, following a decade and a half of a post-great financial crisis legacy and a pandemic-induced jump start to inflation. What makes us uncomfortable is this is all too balmy an outcome. Our conviction is centred on the lure of government bonds as official rates fall in 2024. After that, it gets much more fuzzy.

The significant steepening potential on the US curve

The bond market's obsession with the rate cycle should blind it from fiscal deficit worries. A rate-cutting cycle typically results in positive total returns right out the curve, with the best of those in longer tenors. We're expecting that for much of 2024, but prepare for a heavier long end as we get closer to 2025 as the rate-cutting novelty fades

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

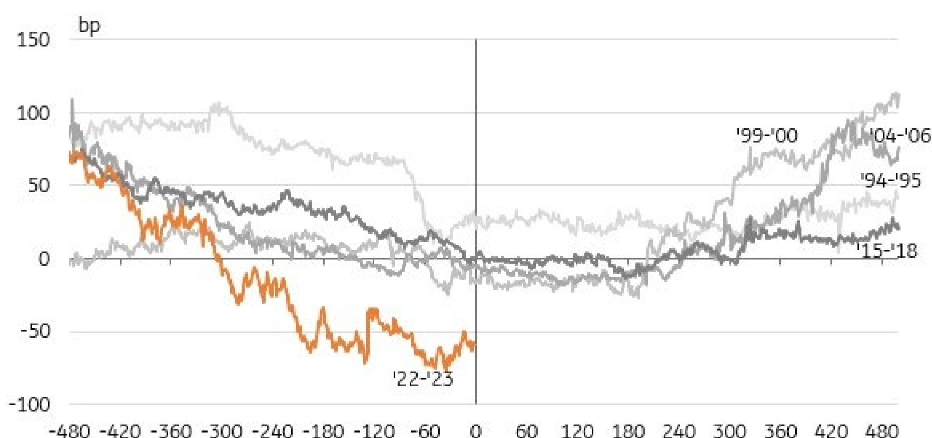
The last few rate cycles have seen different landing points for the curve once the Fed has cut rates to its new low

Recent cycles have seen the 2/10yr get to 50/75bp. This time we expect 100bp

The last few rate cycles have seen different landing points for the curve once the Fed has cut rates to its new low. If we focus on the 2/10yr spread, these curves have ranged from 50bp to 200bp, with the most recent one at the low end of this range. Could the curve stretch to 200bp this time around? Possibly, eventually. But we don't anticipate this as the impact effect of the rate-cutting cycle. A 2025 risk, but not a 2024 one.

The reason for this is the bond market's obsession with the rate cycle, and the outright need to be long interest rate exposure as the Fed is cutting. That tends to drag the whole curve lower. The theme for 2024 should be a push for lower rates right out the curve. Our baseline view is for this to co-exist with the 2/10yr getting to the 100bp area. A 200bp curve is a risk for 2025 should the deficit pressures persist, but that can also be frustrated by structural buying into the curve, preventing severe steepening. The latter has been thematic in the past few decades as pension funds and insurance companies lock in high long rates when they can.

The 2/10yr curve (number of days before and after the Fed funds peak)



Source: Macrobond, ING estimates

Different tenors will move at different paces as we get closer to rate cuts. Watch the 2yr in particular

The sequence that we envisage is as follows:

Assuming the Fed has peaked, the broad direction of travel for the 10yr yield is down. Not a dramatic gap fall, but likely a gradual one, as the elevated front end curbs the ability of long-end yields to fall by too much too soon.

The 5yr area of the curve holds on to a degree of richness on the 2/5/10yr fly, mostly reflecting a persistence in the inversion of the 2/5yr segment. The 5yr here is anticipating cuts to come, while the 2yr is held up by the elevation of the funds rate.

About three months before the Fed actually cuts, the 2yr yield gaps lower by 100bp. Now at around 5%, it heads for 4%. It eventually gets to 3%, but the second 100bp fall will be much slower than the first 100bp one, and needs actual Fed cuts.

Assuming the 2/10yr curve needs a 100bp valuation when the Fed is done at 3%, that places fair value for the 10yr at around 4%. But the lure of the rate-cutting cycle likely sees the 10yr yield overshoot to the downside, potentially getting down to 3.5%.

That 3.5% to 4% area for the 10yr is a call for 2024. For 2025, we would not be surprised to see the market price in an even steeper curve, to reflect a persistently large fiscal deficit. That pushes the 10yr back into the 4% to 5% range. But that's for much later.

The curve should stretch from 3% to 4% as we get to the bottom of the next rate cycle

The baseline view is for the 2yr to get to 3% and for the 10yr to get to 4%, with the risk for an overshoot to the downside, as a call for 2024. The 30yr likely tracks the 10yr to a point, but is unlikely to get much below 4%, resulting in net 10/30yr steepening, likely targeting 30-50bp.

The big US fiscal deficit and effect on market rates

Even though the US Treasury has taken some pressure off longer tenors by morphing new issuance towards shorter tenors, the size of the fiscal deficit still matters for the bond market. For any given Fed funds rate it means a steeper curve from the back end. We target a minimum 100bp curve along the 2/10yr segment when the Fed gets to the next cycle low

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

The US Treasury has taken pressure off the back end by morphing issuance towards the front end

Higher market rates and a steeper curve are the consequence of an excessive fiscal deficit

The US fiscal deficit in cash terms has hit US$2tn – a substantial number, equating to some 7.5% of GDP. Some unusual factors caused a shortfall on the revenue side, but there is a structural excess of government spending over receipts in the area of 6% of GDP. The baseline expectation is we are stuck with this in the coming years, at least until we see a policy overhaul. These are scary numbers that mean one key thing for bond markets – sustained supply pressure.

The question then is what this means for rates. It's difficult to be precise on these things, but an elevated fiscal deficit should place upward pressure on rates, despite Treasury Secretary Janet Yellen's recent assertion to the contrary. The key question centres on the size of this effect. The often-quoted Harvard/Bank of England 2019 study suggests that every 100bp increase in the budget deficit as a percentage of GDP adds 35bp to market rates.

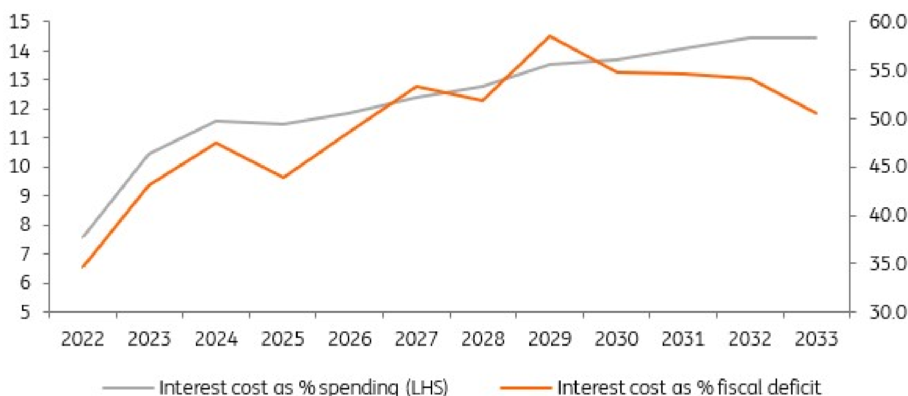
We'd overlay this by asserting that the average US fiscal deficit has tended to be in the 3% area. The current 6% deficit is 300bp above that. If the study is correct, this should add 100bp to market rates. We'd also assert that the bulk of this should be impacting the shape of the curve, so for any given funds rate we should expect to see a steeper curve (all other things being equal). And a bulk of this can come from higher real rates.

Growth will not exceed real coupon prints by enough to counter the large primary deficit

Debt dynamics are also key here. There are a few items to consider:

First, we have interest payments. These are projected at US$745bn for 2023, equating to 2.7% of GDP. That's up from 1.9% of GDP for 2022, and is projected to extend to 3.7% of GDP over time as bonds get rolled over. Absolute interest payments are projected to hit US$1tr by 2028. And interest payments as a proportion of the fiscal deficit will rise from 35% today to 60% by 2029, on unchanged policies. This data comes from the Congressional Budget Office and extends through ING estimates.

Interest rate costs are on the rise too...



Source: Macrobond, Congressional Budgetary Office, ING estimates

Second, we have debt dynamics. The US currently has a primary deficit of 3.3% of GDP (the rest of the fiscal deficit is interest payments). And the primary deficit remains in the 3% to 3.5% range in the coming years. This pushes up overall debt at this pace every year unless real GDP growth exceeds the average real coupon print by a greater amount. The current average real coupon print is around 1%, but this will head to 2% if we assume that something like the current curve remains in place. The US would have to grow by 5-6% per annum to offset the primary deficit. Based on that, the trajectory for the debt/GDP ratio sees it heading to 200% of GDP (currently around 100% of GDP) in the coming two decades.

The same Harvard/Bank of England 2019 study suggests that every 10 percentage point rise in the debt/GDP ratio also adds 35bp to market rates. Based on the current trajectory, we'll have a 10ppt increase in the US debt-to-GDP ratio by 2027. This is less impactful, as it's a slow grind effect. But the cumulative effect is still significant and places an underlying steepening effect on the curve. The US Treasury has taken pressure off the back end by morphing issuance towards the front end. But this does not take the weight of the supply issue away.

The deficit as a stand alone results in a steeper curve and higher longer term rates

Suffice it to say that US debt dynamics are troubling based on current policy. Both the size of the deficit and debt as a percent of GDP have a meaningful impact and pressure the curve steeper and long rates higher, mostly through the channel of higher real rates. These are important impulses to take into account when it comes to assessing the likely trajectory of the curve. We argue that the 2/10yr curve should be at least 100bp when the Fed gets to the bottom of the next cycle.

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Waning US liquidity pressure set to accelerate in 2024

Quantitative tightening has been humming broadly unnoticed in the background through 2023, but it will have an accelerated impact next year. While the level of rates will fall, the perception of liquidity will tighten. Bank reserves will fall in the second half of 2024, and QT will have wound down to prevent liquidity stress by year-end

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

The ongoing withdrawal of excess liquidity from the money market is also important to note

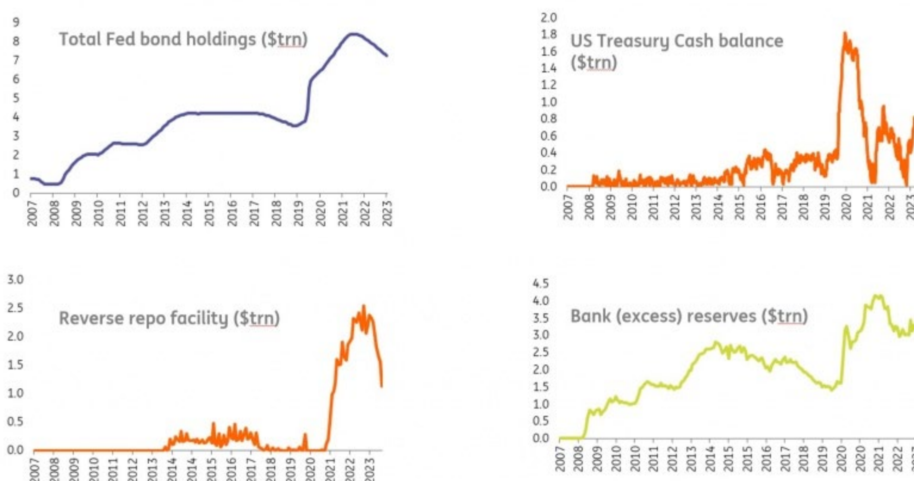
Reverse repo balances will hit zero in 2024, and then bank reserves meaningfully fall

There's no shortage of challenges on the horizon for the US rates market in 2024. Already the Treasury market has been struggling with liquidity, mostly with getting size done. This is typical when there's been an injection of impactful one-way direction. A gear switch from rate hiking to cutting typically generates jumpy price action, and this is set to be a source of volatility – which is exacerbated by a repo market that has seen better days in terms of size and liquidity. In bonds, tailed auctions, and especially in longer tenors, are another 2023 feature that could persist into 2024. Fiscal deficit-originated supply pressure is also impactful here, making the market a tad skittish, even as the pendulum switches to a rate-cutting bias next year.

The ongoing withdrawal of excess liquidity from the money market is also important to note. The genesis of this is ongoing quantitative tightening (QT) as the Federal Reserve continues to allow US$95bn per month to roll off the curve (and off their balance sheet). The most significant manifestation is to be seen in the fall in idle market cash going back to the Fed on the reverse repo facility. That peaked at around US$2.5tr and is now just below US$1tr, helped recently by a rebuild in Treasury cash balances.

The bottom line here is that these reverse repo balances will head to zero, signalling a virtual end to excess liquidity. As the US Treasury does not need to build additional cash buffers, the pace of fall in reverse repo balances should slow to something akin to the size of monthly quantitative easing – but even at that pace, it would mean the reverse repo balance hitting zero by the third quarter of 2024.

Bank reserves holding up as reverse repo balances take most of the QT pressure



Source: Macrobond, Federal Reserve, US Treasury, ING estimates

By that time, the Fed is already set to be cutting rates. So, we envisage a period during which the central bank is easing policy through rate cuts and at the same time continuing to engage in QT. While the latter could be construed as being a contrary tightening in policy, the Fed will view it more as a return to more normal conditions in terms of the balance of liquidity in the system. Once the reverse repo balance hits zero, bank (excess) reserves will come under downward pressure. The big question, though, is how far the Fed will push this. Bank reserves are currently flatlining at around US$3.3tr, but have edged higher as of late.

Quantitative tightening likely ends around the end of 2024, long after the Fed has started to cut

The last time the Fed engaged in quantitative tightening, bank reserves bottomed at a little under US$1.5tr and there was a material effect felt on the money markets. It's unlikely that we'll get anywhere near that this time around. Bank reserves will certainly get below US$3tr and likely down to US$2.5trn – but it's unlikely that we'll get much lower, especially as the bias of policy is towards easing. The Fed will want to get liquidity into better balance as a first port of call, but beyond that, it won't want to over-tighten liquidity conditions. Taking this into account, QT likely ends around the end of 2024.

The Fed could be a supplier of liquidity through the permanent repo facility by year-end

Consequently, one of the key features through 2024 will be a gradual and persistent tightening in liquidity conditions. This will become more apparent as bank reserves eventually start to ease lower. Less supply of liquidity typically goes hand in hand with a rise in the price of it, which is counterintuitive to the notion that market rates are falling. It acts to mute the extent of rate-cut euphoria which is likely to envelop markets through much of 2024.

This does not prevent market rates from falling, but it does make for more expensive funded longs at the margin. And it also reins in excessiveness that might come from a falling rates environment. It should result in higher market repo rates, well clear of the reverse repo rate offered by the Fed.

If pushed too far, it will require drawdowns from the Fed's permanent repo facility that supplies liquidity to the market. We think it'd be best for the Federal Reserve not to push on this.

EUR direction and curve

The ECB is likely already at its interest rate peak, putting the focus on the timing of a first rate cut. As cuts approach in the summer of 2024, the curve should start to disinvert via the front end. But a prospective landing zone of the depo rate at 2.75% in 2025 limits the scope of steepening and how far longer rates can rally from here

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

Central banks, including the European Central Bank (ECB), are likely at the top of their tightening cycles

Timing the turn in the ECB rate cycle

As 2024 approaches, central banks, including the European Central Bank, are likely at the end of their tightening cycles. Usually, this should also mark shifting dynamics in fixed income markets, as the focus then turns to the timing of rate cuts.

But the the inflation challenge is not yet over with a core inflation rate that is still above 4%. While not explicitly taking further hikes off the table, the ECB determined in September that rates had reached a level high enough, if held there sufficiently long, to make a substantial contribution towards bringing inflation back to the 2% target over the medium term.

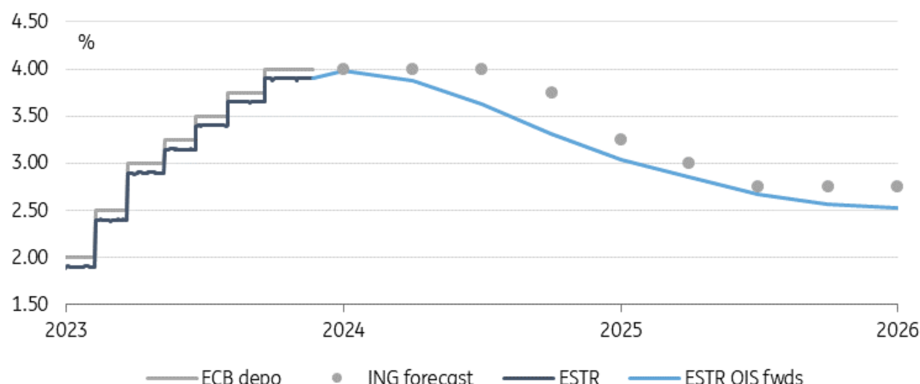
We are seeing progress being made on the inflation front but the going is likely to get slower as inflation drivers become more domestic. Inflation expectations, especially, are still seen as fragile given the potential for renewed energy shocks or weather-related food price inflation. Before any victory over inflation can be declared, the ECB wants to wait out the wage negotiation rounds through the first half of next year.

This means the ECB is still looking in the rearview mirror, although it is now starting to acknowledge that it might have been too optimistic on the growth backdrop. That is an important shift, albeit a slow one. Eurozone GDP growth turned negative in the third quarter (-0.1% quarter-on-quarter) and the latest sentiment indicators suggest that growth over the winter quarters is also likely to hover around 0%. The economy itself is not seen falling into a deeper recession but rather a broad stagnation. Our economists expect very weak GDP growth for both 2023 (0.4%) and 2024 (0.2%).

However, with progress on inflation, the ECB will eventually be in a position to cut rates next summer. Our economists expect the ECB to cut rates by 75bp over the course of

the second half of 2024 to end the year with a deposit facility rate of 3.25%, and we think it will extend the easing cycle by another 50bp in the early part of 2025

Rate cut speculation could get some pushback at first



Source: Refinitiv, ING

The factors keeping long-end rates more elevated

Our economists are looking for a 125bp reduction in ECB policy rates before mid-2025. That should also pull longer rates lower, but considering the levels we currently see in 10Y swaps – around 3.05% – and the prospective landing zone for the ECB deposit facility rate at 2.75%, the potential for longer rates to rally looks modest in our base case scenario. It is still likely that the 10Y swap rate undershoots the 3% mark into the middle of next year, but we would also expect rates to come off these lower levels again soon afterwards when markets have a better view of the ECB's shallower trajectory.

The ECB may well be on track to reach its inflation target, perhaps even hit it somewhat earlier than indicated in its own forecasts. But at the same time, there are structural factors that can keep inflation more elevated compared to pre-pandemic times which were marked by a low interest rate environment. Demographics, deglobalisation and decarbonisation argue in favour of upward pressure on price levels.

Closer at hand, fiscal policies could also be comparatively more expansive, assuming that the EU can compromise on a new set of fiscal rules that allow for more leeway than the old Stability and Growth Pact. And one important factor that could add to the term premium of longer rates and is in the hands of the ECB, is the continued roll-off of its bond portfolios. The roll-off could even be accelerated if the ECB decides on an early end to the reinvestments of the portfolio accumulated under the Pandemic Emergency Purchase Programme.

The ECB's Chief Economist Philip Lane has suggested that the long-run nominal neutral rate should be around 2%. Our economists would side with some of the more hawkish governing council members who have put that value closer to 2.5%. That would put fair value on the long-end rate at 3%, including an OIS-based term premium of around 0.5%, as estimated by the ECB.

Steepening via the front end, but don't get carried away

Initially, there may well be a period when the ECB holds out against pressure to cut rates as it wants to see more evidence of stabilising wage dynamics. This period could pose a re-flattening risk for the curve as other macro weakness materialises either domestically or abroad, especially when US growth starts to falter, as our economists expect and Treasuries begin to rally.

Eventually, the curve should start to disinvert from the front end once the potential for rate cuts moves into view. But the steepening potential is limited by the degree to which the ECB can and will cut – also considering the aforementioned structural factors

keeping inflation higher. Only towards the end of next year do we see the 2s10s curve becoming upward-sloping again. If the backdrop were to deteriorate more than we anticipate, then markets might be tempted to see the post-pandemic situation in the eurozone as not so different to pre-pandemic times after all. That could imply more rate cuts, but with the old ailments still plaguing the bloc, it would also mean longer rates could fall further.

Further curve steepening should come via the front end

Source: Refinitiv, ING

EUR bond supply and spreads

Fundamentals look weaker emerging from multiple crises, and the supply of government bonds will remain elevated when also taking into account ECB quantitative tightening. Eventually, accelerated EU investments and structural reforms could improve the trajectory, especially if paired with the prospect of ECB easing and a recovering macro backdrop

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

There is still the prospect of more spending via the NextGenerationEU to support the growth outlook and eventually spreads

Less favourable fundamentals following multiple crises and less certain ECB support

The prospect of stagnating growth, likely still high interest rates and ongoing elevated funding needs is not an ideal backdrop for sovereign bond spreads to materially tighten from here.

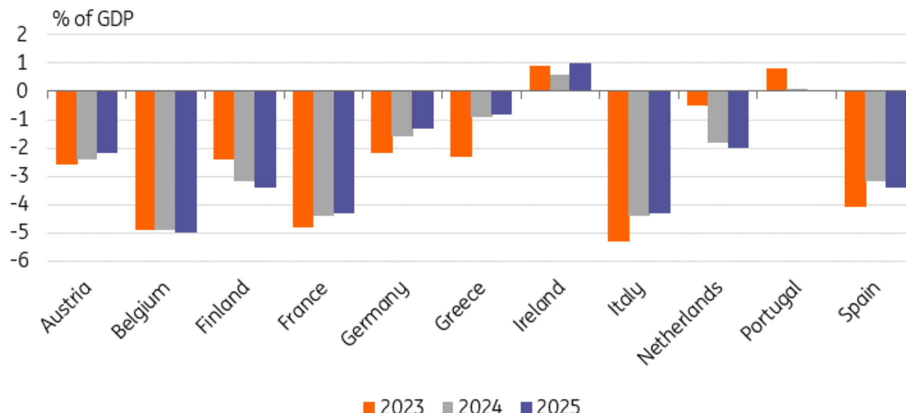
On the positive side, there is still the prospect of more spending via the NextGenerationEU to support the growth outlook and eventually, spreads. This could be the case for Italy, in particular, as the implementation of the programme has fallen behind target this year and Italy is the biggest beneficiary. But progress will be closely scrutinised, not just by markets but also by rating agencies with lingering concerns over rating downgrades.

The European Central Bank (ECB) will cut rates eventually, but it is not a fully-fledged easing cycle, rather a return of monetary policy towards a more neutral setting. Crucially, it is more likely that the ECB's balance sheet decline will continue or even accelerate. This downward trajectory means that longer rates could struggle to materially rally alongside rate cuts – direction as a driver of tighter spreads of higher beta credit could underwhelm.

The ECB's first line of defence for sovereign spreads, which is currently provided via the ECB's ability to flexibly reinvest Pandemic Emergency Purchase Programme (PEPP) maturities, could also weaken – we think reinvestments could slow around mid-year before eventually stopping by the end of 2024. There is still the ECB's Transmission Protection Mechanism, but the hurdle to activate this backstop looks rather high and markets may be unsure as to whether Italy would even qualify given the outlined conditionality of this tool.

That said, the ECB will have some discretion around weighing strict conditionality against the danger of wider systemic risks. The ECB has already proven it can act pragmatically in the past; the question is more what its pain tolerance is before getting there. In the end, the ECB may also find a way to keep its first line of defence depending on the outcome of its operational framework review. Even ECB hawks have expressed the view that it may be desirable to retain some of the flexibility that is currently provided by the PEPP reinvestment policy.

Budget deficits remain elevated in many cases



Source: EU Commission, ING

10Y Italy-Germany yield spread could stay in a 150-200bp range

The key yield spread between 10y Italian government bonds and their German counterparts has recently narrowed to 165bp (interpolated) after Moody's raised the outlook of Italy's rating to stable. Sitting at the lowest possible investment grade level, the stable outlook removed the immediate threat of non-investment grade status. Near-term, the yield spread may tighten even further as issuance slows into the end of the year.

However, issuance will pick up again and in 2024, Italy will likely face even higher gross and net bond supply compared to this year, especially when taking into account the ECB potentially also slowing PEPP reinvestments. A rewidening of spreads in the first part of next year looks possible when resuming issuance, a hawkish ECB and weak growth come together. Overall, we would look for the 10Y spread to remain in the 150-200bp area with tightening toward the latter part of next year amid policy easing and a more benign macro backdrop.

10Y Italian bonds are likely to remain in a wider range

Source: Refinitiv, ING

Eurozone net government bond issuance should moderate…

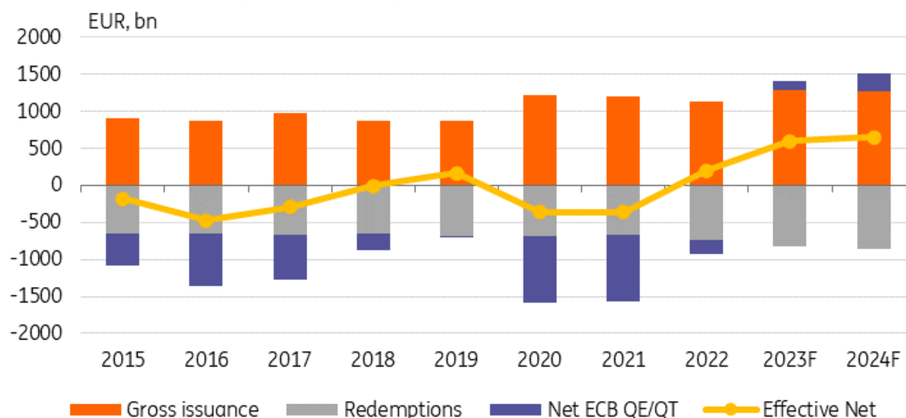
In aggregate, eurozone countries are expected to see modest deficit reductions as fiscal support is further pared back following the pandemic and energy crisis. Yet overall net lending requirements are still seen at relatively high levels in 2024 with the European Commission, for instance, having pencilled in only a reduction by €35bn to €424bn versus 2023 across the 19 eurozone nations.

What this means for eventual gross bond supply will depend on the debt that has to be rolled on top of the new borrowing and also on the choice of funding instrument by the issuers. One will not only have to consider the split between money market funding and bond funding, but also the increased reliance on retail bond issuance as seen in the case of Italy and Belgium.

Very few issuers have provided concrete issuance plans as of yet, and in the case of Germany, we are even confronted with uncertainty about overall funding needs after the constitutional court declared the retroactive repurposing of €60bn in unused pandemic emergency funds (in reality unused borrowing capacity) towards funding climate action as unconstitutional. German issuance needs have been dominated in recent years by the off-budget funding for numerous special funds rather than the government's main budget.

Taking it all together, our initial estimate for 2024 gross bond issuance stands at €1.27tr vs an estimated €1.29tr for 2023. Higher bond redemptions next year imply a somewhat larger drop in net issuance, from €470bn down towards €415bn. These are rough indications that we will refine as debt agencies present their final issuance plans over the coming months.

The ECB impact is likley to offset any moderation in issuance

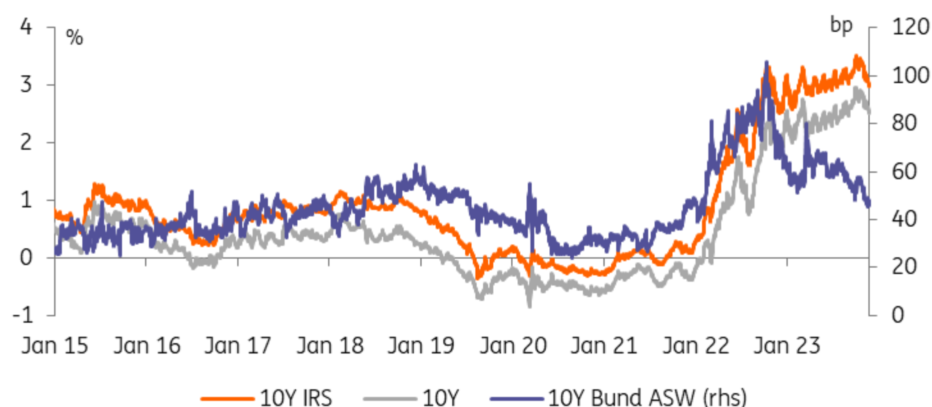


Source: Debt agencies, ECB, Refinitiv, ING

… but the ECB's portfolio roll-off could speed up

The issuance that the market will effectively have to absorb will also depend on the net impact of the ECB bond portfolios. We think that the shrinking of the ECB's balance sheet could more than offset the aforementioned decline in net issuance. 2023 had seen the ECB start with the roll-off of the Asset Purchase Programme (APP) portfolio, and 2024 could see the ECB begin to reduce its PEPP portfolio as well. In 2023, public sector holdings will have declined by €166bn, and over 2024 that volume could increase toward €300bn including slowing PEPP reinvestments. The volume impact on government bonds requires some assumptions with regard to the split of the ECB's public sector holdings, which also include Supra, agency and regional bonds.

The Bund ASW has tightened as collateral fears abate



Source: Refinitiv, ING

The past couple of months has seen a notable underperformance of Bunds versus swaps, which has narrowed the gap between the two to below 50bp and thus the tightest levels since February 2022.

Traditionally, hedging demand and risk sentiment have been key drivers of the spread. With the market turning to rate cuts, the widening pressure from structural demand to hedge interest rate risk via paying fixed rates has gone. At the same, time risk sentiment has also started to ease as markets have digested the ECB's initial tightening shock therapy. Sovereign spreads over Bunds have receded and implied volatility measures have also backed down from last year's high. Looking at a longer history, these measures still sit at somewhat elevated levels though.

More recently, however, the availability of high-quality paper has also become an important factor in driving the spread of Bunds versus swaps. This factor is more difficult to grasp and has not just been driven by pure net bond supply expectations (including the ECB's portfolio impact), but also by the central bank's tweaking of other parameters, for instance surrounding the remuneration of government deposits on its balance sheet, and also prospects around the more general decline in excess reserves.

10Y Bund ASW spread to find balance at structurally tighter levels

Our issuance outlook foresees a considerable drop in Bund net supply from just above €100bn in 2023 to €64bn next year. However, taking into account the ECB impact, we estimate that the net amount that markets will have to absorb will drop only moderately from around €135bn to around €115bn. This historically high level in effective net supply confirms the notion that collateral availability will play a less dominating role and argues for structurally tighter spreads alongside some moderate improvements in the dynamics of the other aforementioned factors.

At the same time, the longer-term issuance outlook for Germany could be somewhat less generous than previously anticipated in the wake of the German constitutional court decision regarding the government's use of special funds to effectively circumvent the constitutional debt brake. And crucially, the central bank's footprint in bond markets still remains large in absolute terms. Overall, we think the 10Y spread of Bunds to swaps (vs 6m Euribor) should start to find an equilibrium around 45bp.

The impact of the ECB's framework review

2023 has been a year of ECB balance sheet reduction, and 2024 could see the central bank accelerate the shrinking of its bond portfolio. Many further adjustments have been floated this year but postponed ahead of the outcome of the operational framework review. This could give markets a sense of how far the ECB will take policy normalisation

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

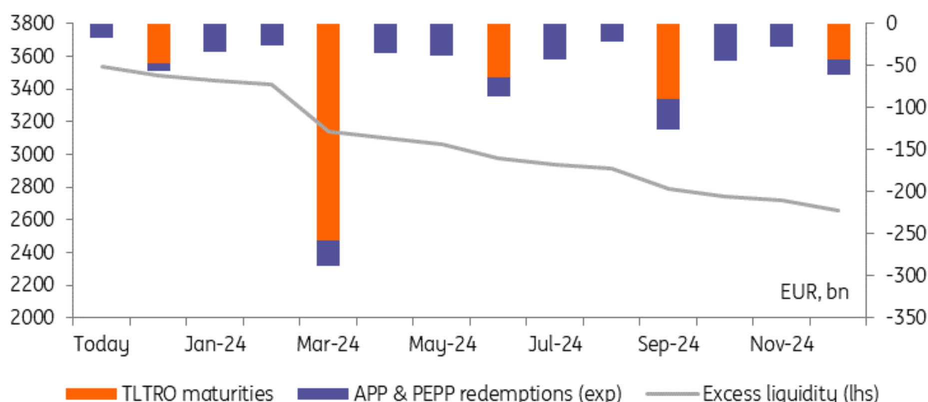
An important outcome of the ECB review will be the size and makeup of the balance sheet that it wants to operate in the future.

The ECB's operational framework review – it is all integrally interlinked

2023 has already been a year of balance sheet reduction. The largest part of the targeted longer-term refinancing operations (TLTROs) has matured by now and reinvestments of the Asset Purchase Programme (APP) portfolio were phased out with the focus now turning to the Pandemic Emergency Purchase Programme (PEPP). But the European Central Bank has also tweaked other parameters surrounding its policy implementation. The remuneration of minimum reserves was dropped to zero, as was the remuneration of government deposits at some central banks, foremost the Bundesbank. Over the past few months, the ECB had been expected to further adjust these and other policy parameters aside from key rates.

However, many of these decisions have now been pushed to the end of the year and into the early part of next year. One important reason being that the ECB does not want to pre-empt any decisions coming out of its review of the operational framework, which it still plans to complete next spring.

Excess liquidity is already set on a declining trend



Source: ECB, ING

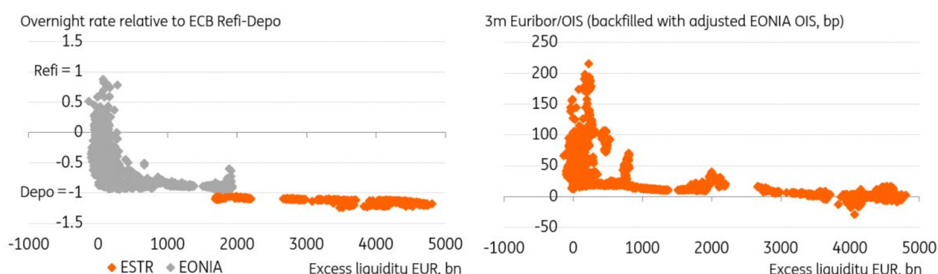
The desired size of the balance sheet and level of excess liquidity

One important outcome will be the size and makeup of the balance sheet that the ECB wants to operate in the future. The balance sheet is already set to shrink, but the choice of the future framework could give us an idea of how far the ECB will take the decline in the resulting level of excess liquidity in the system.

Considering the current level of excess liquidity, €3.5tr, there should still be some distance from the point where the level of short-term interest rates is actually impacted by changes in liquidity supply. Historically, that level has been somewhere below €1tr. However, past relationships that pre-date regulatory changes at the bank level may no longer hold, which could argue for a more cautious approach from the ECB.

The consensus is that the ECB will stick with a so-called "demand-driven floor system", where the short-term rate remains tied to the ECB's deposit facility rate rather than to the main refinancing rate. This would mean the ECB will operate with excess liquidity high enough to keep short-end rates pinned to the deposit rate.

Excess reserves are still some distance away from levels where rates and spreads are more directly affected



Source: ECB, Refinitiv, ING

Possible implications of a demand driven floor system

A "demand-driven" system also implies that banks will still have to bid for part of the liquidity via open market operations – think of the one-week main refinancing and 3-month or longer-term liquidity operations. This is to distribute liquidity further than just via asset purchases, which has kept liquidity more concentrated in certain jurisdictions and/or larger banks. To facilitate this, the ECB would likely have to narrow its interest rate corridor. Currently, the more than 50bp difference between the refinancing rate of the ECB operations and the market rates which are tied to the depo floor, means that there is a penalty and implied stigma attached to getting liquidity from the central bank.

Furthermore, an overall higher level of excess reserves with some buffer to guard against unwanted volatility would lessen the need to materially accelerate the current

pace of liquidity reductions. Considering that €491bn in TLTROs will mature by the end of 2024 and that €300bn will roll off from the APP alone, the prospect of having to remove even more liquidity by raising, for instance, the minimum reserve ratio to 10% as some policy hawks have floated, would look remote (not even considering other negative side effects).

Also, the ECB could consider injecting a base stock of liquidity via a structural bond portfolio, something that the ECB's Chief Economist Philip Lane hinted at during a recent money market conference. This could also offer the ECB an avenue to retain some of the ability to intervene in bond markets via reinvestments – a successor to the PEPP reinvestments that currently still serve as the first line of defence against market turmoil in sovereign bond markets.

Lane was the latest official to touch upon the deliberations over the ECB's policy framework and the potential size of the balance sheet going forward. His speech highlighted how choices are interlinked with many of the policy parameters that the market had become concerned about in recent months. It also suggests that there will likely be a longer transition towards a new framework.

All that argues for a rather benign market impact from the review, if not even supportive for wider bond markets and bond spreads in the longer run. That might offset some of the fears surrounding the prospect of the ECB slowing and eventually ending PEPP reinvestments. And it also does not fully exclude "minor" changes as the ECB considers its costs of conducting monetary policy such as raising minimum reserves to 2%, which could still have a negative impact on bond market sentiment via its effect on banks.

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