27 August 2014

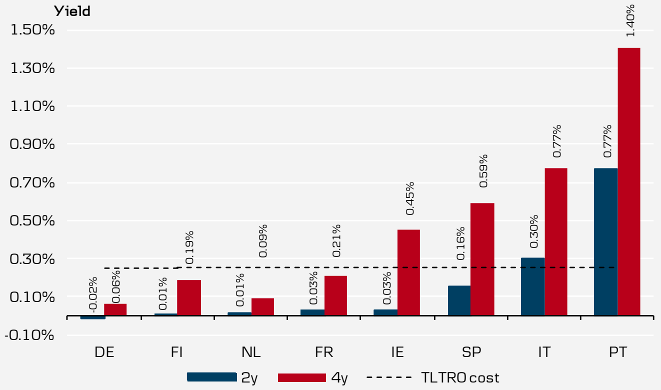
ECB delivered – will it work? #3

Carry trades and 'hot potato' effect

- **There are no penalties attached to the TLTRO borrowing that prevent banks from using the funding for government bond carry trades. This should be positive for banks' willingness to take on the TLTRO.**
- **Although it is possible to use the funds for carry trades, it is much less attractive to do so today compared to when the LTROs were introduced. This could reduce banks' demand for the liquidity, but from a funding perspective the TLTROs are still very attractive and should reduce banks' costs.**
- **We have for some time been arguing that adopting a negative deposit rate would be a game changer in the rate markets and create a 'hot potato' effect – this is confirmed in market behaviour since the deposit rate was cut to -0.10%.**
- **We have yet to see the big increase in liquidity from the TLTROs but evidence shows improved liquidity conditions in the euro system. Eonia has consequently fixed lower in the corridor than our previous estimated relationship to excess liquidity would suggest.**
- **Furthermore, other parts of the fixed income sphere confirm this picture with the impressive rally in peripheral bonds as the best evidence.**

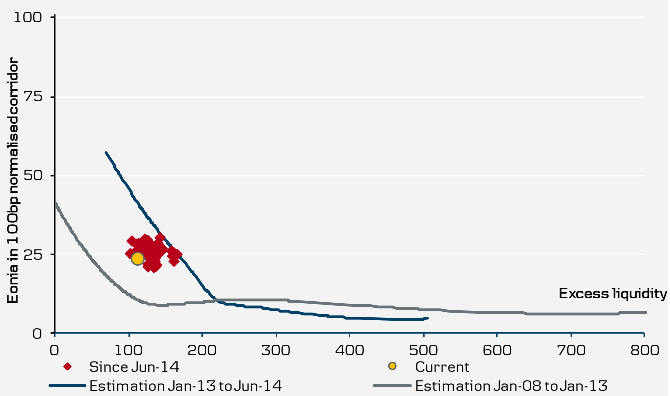
ECB delivered – will it work?

Less potential for carry trades



Source : Bloomberg, Danske Bank Markets

Improved money market conditions since negative rates



Source : Bloomberg, Danske Bank Markets

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Still possible to do carry trades – but less attractive than earlier

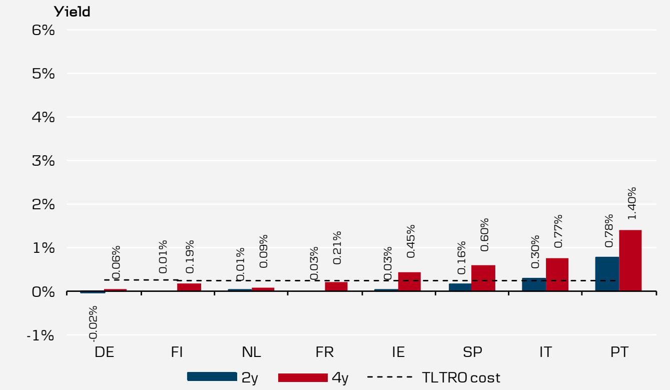
The ECB's TLTROs are targeted in the way that the potential amount of liquidity depends on future net lending compared to banks' benchmark. However, there are no penalties attached to the borrowing that prevent banks from using the funding for government bond carry trades. This holds for the entire lifetime of the borrowing, but if banks' net lending is below the benchmark in April 2016, they must repay early in September 2016 instead of having the funding until maturity in September 2018, see paper #1 *ECB's easing measures revisited*.

The setup implies that bank treasury managers can keep the TLTRO funds at least until September 2016 regardless of the developments in net lending. Furthermore, the fixed rate of 25bp (the current MRO plus 10bp) on the operation makes it even more attractive from a funding perspective than the LTRO from 2011/12. These loans were introduced when the MRO was 1% and the future cost of borrowing was unknown, as the rate was set as the average MRO over the life of the operation.

We have previously mentioned these conditions and the attractiveness resulting in great incentive for banks to take on the TLTROs. However, the risk is that the funding from the TLTRO will not feed through to credit growth and support the recovery as it can be used for government bond carry trades. It seemed that banks used the funding from the previous LTRO to buy bonds as banks holding of euro government bonds and especially periphery bonds increased with the introduction of the LTROs (see the right chart on the next page).

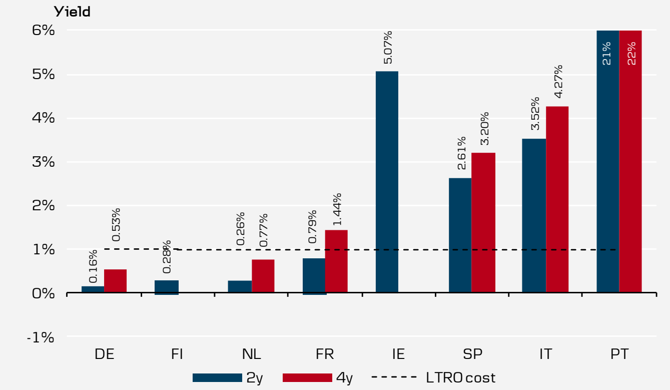
Nevertheless, the government bonds yields are much lower today and the gains from carry trades are expected to be much less profitable, although the funding costs are lower. Considering the current 2Y government bonds it is only the Italian and Portuguese which should give a positive gain as they yield higher than 25bp. The respective gains are nevertheless only 5bp and 53bp. Compared to the 3Y LTRO in 2011/12 the yields on Italian and Portuguese 2Y bonds were 3.52% and 21%, respectively. Additionally, the Spanish and Irish 2Y bonds also yielded above the costs of the LTRO. Hence, it is much less profitable for banks to do government bond carry trades today than it was in 2011/12. In our upcoming paper, we will consider the potential for a pass-through to the real economy.

Current 2y and 4y government bond yields



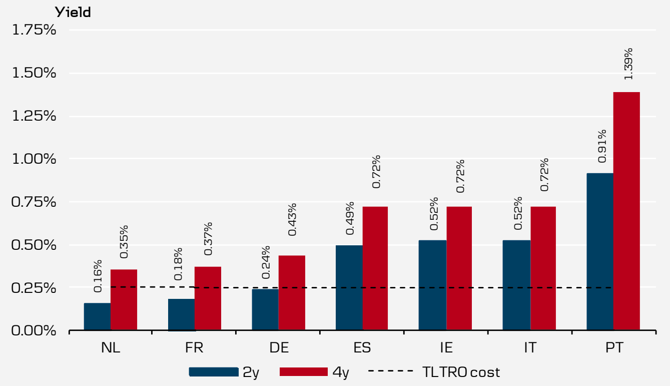
Source : Bloomberg, Danske Bank Markets

2y and 4y government bond yields on 31 January 2012



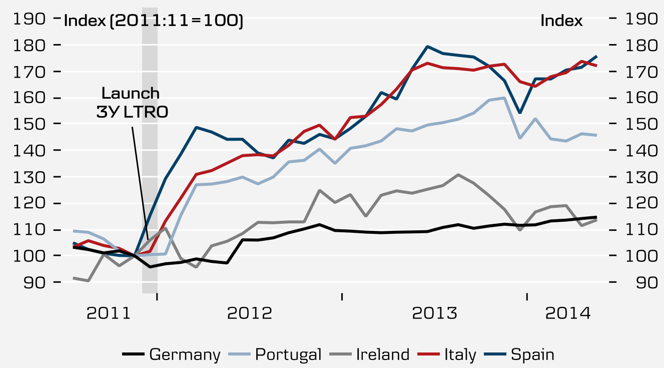
Source : Bloomberg, Danske Bank Markets

Generic 2y and 4y yields on euro zone bank covered bonds



Source : Bloomberg, Danske Bank Markets

Big rise in banks' holding of government bonds from 3Y LTRO



Source: ECB, Danske Bank Markets

The lower expected gains from government bond carry trades could suggest that banks would be less willing to take on the TLTRO, but taking the funding perspective a step further it appears that it is still very attractive as a source of cheap funding for participating banks. In the left chart above, we show generic 2y and 4y yields on banks' covered bond programmes across euro zone countries. We note that most banks cannot issue at a cost below the current cost of the TLTRO of 25bp and as we have only taken averages from the prime banks within each country, we should expect the TLTRO funding also to be attractive for less creditworthy banks in the core countries and even more attractive for such banks in the periphery.

All in all, we conclude that although the perspective for carry trades is less favourable compared to the 2011/12 LTROs due to much lower yields on government bonds, we expect solid participation from banks as funding comes at very attractive price levels.

The first three months of negative rates – signs of the 'hot potato'

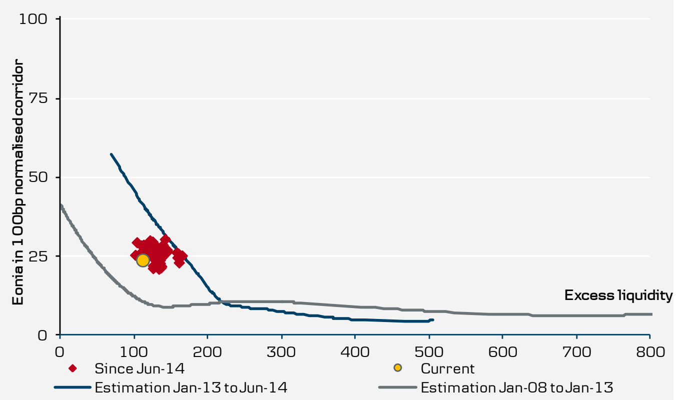
Added to the upcoming TLTROs the ECB lowered its policy rates, bringing the deposit rate into negative territory, while liquidity was increased through a halt of the SMP sterilisation.

The lower policy rates and the initial boost to liquidity have already resulted in record low Eonia fixings, while periphery spreads have tightened further in particular in the 5y segment. We have for some time been arguing that adopting a negative deposit rate would be a game changer in the rate markets and create a 'hot potato' effect, see *Implications of negative rates – the Danish experiences*. Below, we look at the actual evidence since the rate cut in June.

Money markets have improved from negative deposit rate

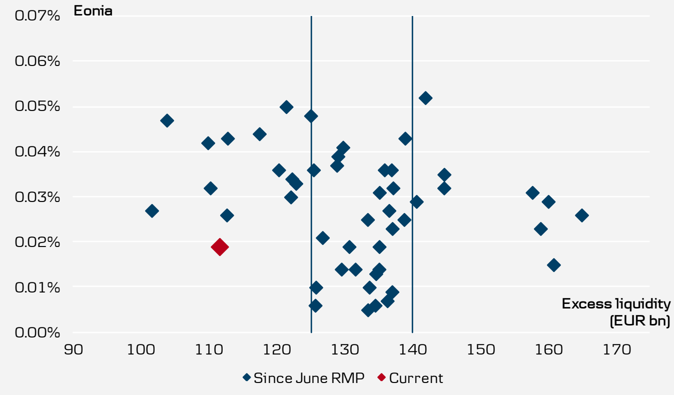
Since the negative deposit rate came into force in the June Reserve Maintenance Period (RMP) starting 13 June, Eonia has fixed in a very tight level of 0-6bp (disregarding month-end turns). This has happened in an environment where excess liquidity has been EUR130bn on average, and we have thus not seen a significant liquidity boost from halting the SMP drain auctions, as less demand at one-week MRO auctions and higher autonomous factors have countered the liquidity injection. However, although we wait for the liquidity injection from the TLTROs, it is noteworthy that Eonia still has fixed relatively low in the corridor, which our estimated relationship between the Eonia rate and the amount of excess liquidity also confirms (see paper #2 *Liquidity and money market rates* for details).

Eonia has fixed lower than our model estimation suggests...



Source: Bloomberg, Danske Bank Markets

... and has been rather inelastic to levels of excess liquidity



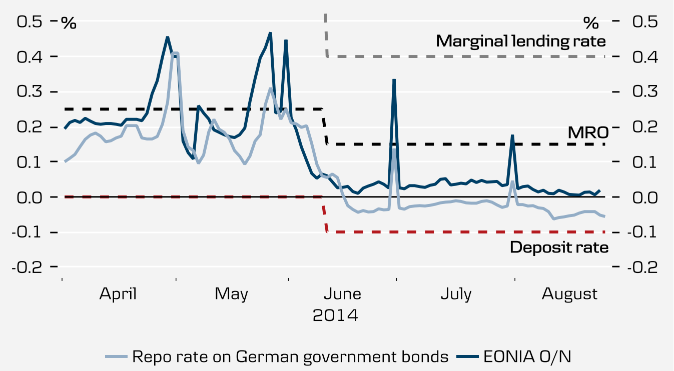
Source: Bloomberg, Danske Bank Markets

The two lines in the left hand chart above show our estimations, with the blue line representing the environment before the June cut to negative and Eonia fixings in the corridor since June in the red dots. We see that Eonia has consequently fixed below what our estimation would suggest and the right chart above shows that Eonia has been rather inelastic to the level of excess liquidity. It is interesting to note that Eonia fixing has been down to 0.5bp at liquidity levels around EUR130bn. In April and May these levels of liquidity resulted in Eonia being close to (or even above) the MRO rate and averages from January to May RMPs have Eonia at 20bp (just 5bp below the MRO rate at 25bp) with excess liquidity averaging EUR128bn. We interpret this as a positive side-effect from the June rate cut and that a negative deposit rate is slowly starting to reduce fragmentation in the overnight liquidity market.

Also evidence of 'hot potato effect' in other parts of the fixed income sphere

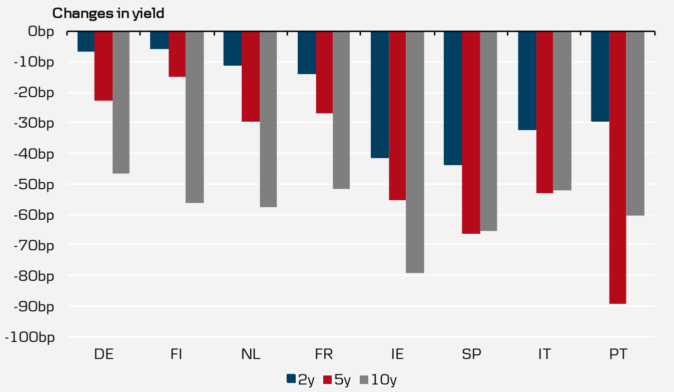
Evidence of the 'hot potato effect' is also seen in other fixed income products. Even though we have not witnessed a negative Eonia fixing yet (we are confident the TLTRO liquidity boost will do the trick), we have negative repo rates on German government bonds. This rate reflects less counterparty risk than unsecured overnight borrowing as repo transactions by nature are secured lending. The most significant changes, however, have been in the peripheral markets, where especially the 5Y segment has outperformed. Naturally, with yields in core countries being close to 0.00% or even slightly negative, bond investors are pushed further out in maturity and down in credit quality.

ECB corridor, Eonia and German GC repo rates



Source: Bloomberg, Danske Bank Markets

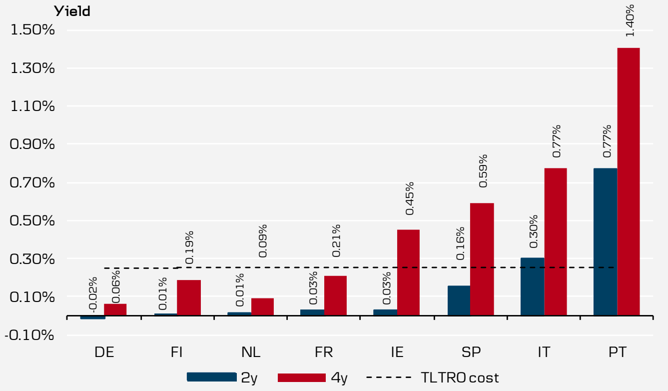
Change in yields since June ECB meeting



Source: Bloomberg, Danske Bank Markets

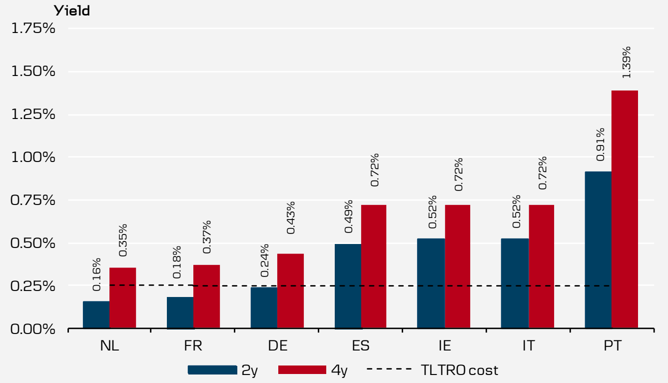
What to watch?

Current 2y and 4y government bond yields



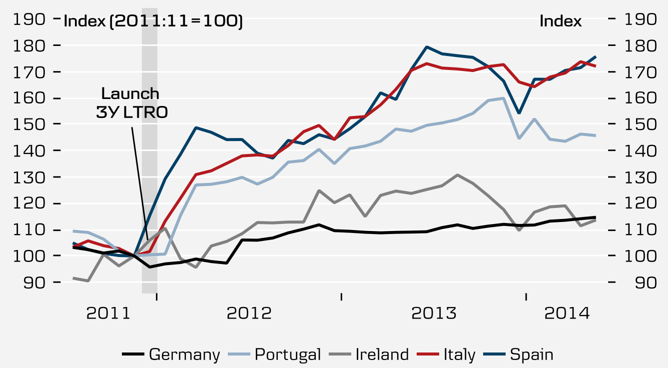
Source : Bloomberg, Danske Bank Markets

Generic 2y and 4y yields on euro zone bank covered bonds



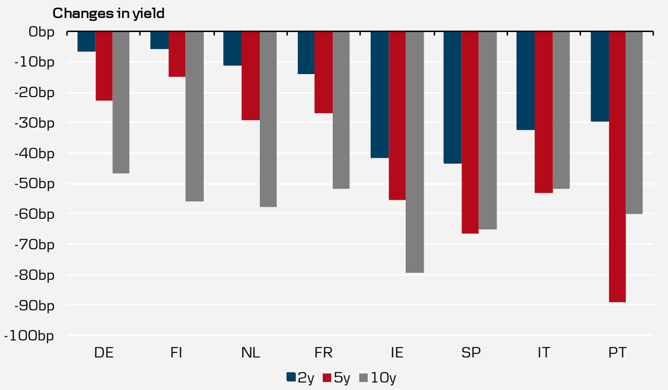
Source : Bloomberg, Danske Bank Markets

Changes in banks' holding of government bonds



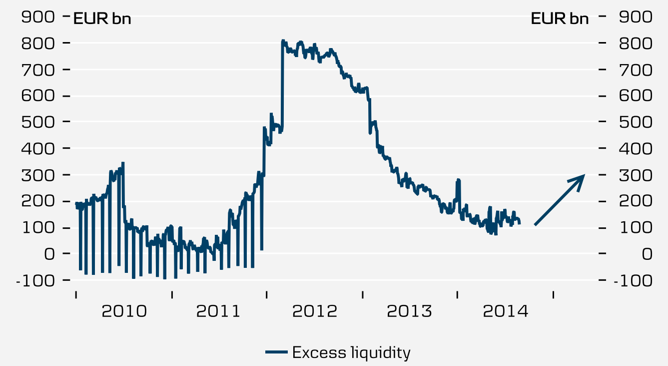
Source: ECB, Danske Bank Markets

Change in yields since June ECB meeting



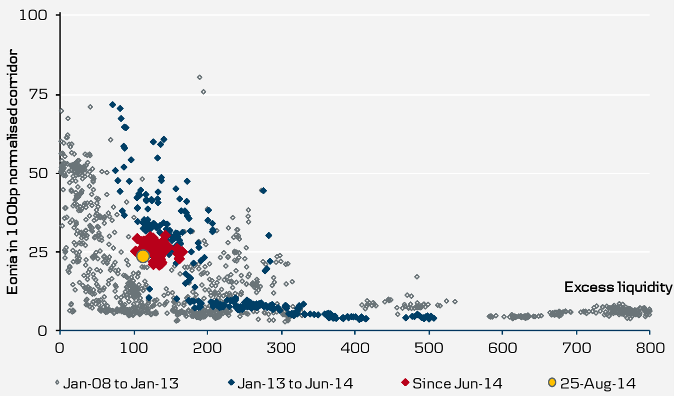
Source: Bloomberg, Danske Bank Markets

Developments in excess liquidity



Source: Bloomberg, Danske Bank Markets

How the liquidity pushes down Eonia in the corridor



Source: Bloomberg, Danske Bank Markets

Disclosure

This research report has been prepared by Danske Bank Markets, a division of Danske Bank A/S ('Danske Bank'). The authors of the research report is Anders Vestergård Fischer, Analyst, and Pernille Bomholdt Nielsen, Senior Analyst.

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