EUR rates

A liquidity roadmap revisited

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Markets

Summary – smoothly passing liquidity event risks

Key liquidity takes

TLTRO, ABSPP & CBPP3
The September TLTRO and the modalities of the ABS and covered bond programs represented event risks in terms of the excess liquidity path. However, liquidity has remained in range.

Autonomous factors
The tightening conditions driven by higher autonomous factors ahead of quarter-end are set to reverse as we enter Q4. Next hurdle, year-end.

Negative deposit rate
Banks still put excess liquidity at the negative rate with the ECB. Fed-placements are looking stronger for banks with such possibilities.

Conclusion: Albeit the TLTRO and purchase programs had the possibility to change the liquidity outlook, excess liquidity has remained in range and our projections don´t materially differ from our liquidity outlook in September. Our point estimate on the maximum excess liquidity (without QE), we revise down from around €580bn to €500bn.

Lower than expected TLTRO uptake increases the downside risks. The next hurdle is the year-end, which could become more volatile than usual in terms of liquidity with the December TLTRO and the maturity of the 3y LTROs in early 2015.

Key market takes

Money market
Eonia fixings are going down on average, with a new record low of -4.5bps on Friday. They have not however gone down as far and quick as the market had anticipated.

Indeed, the market has had a hard time getting it right in this regime of a negative depo-rate, and has on average firmly undershot Eonia fixings when evaluated through the pricing of 1w swaps.

Further out on the Eonia curve, the liquidity trajectory has been re-priced in forward Eonias (ECB periods or fixed swaps) which have been priced upwards. They look close to fair now, but we recommend paying when -10bps levels are nearing.

We maintain that the Eonia fixing only sporadically should go below -10bps. Euribors have turned sticky and we also maintain that the 3M fixing should go no lower than +3-4bps.

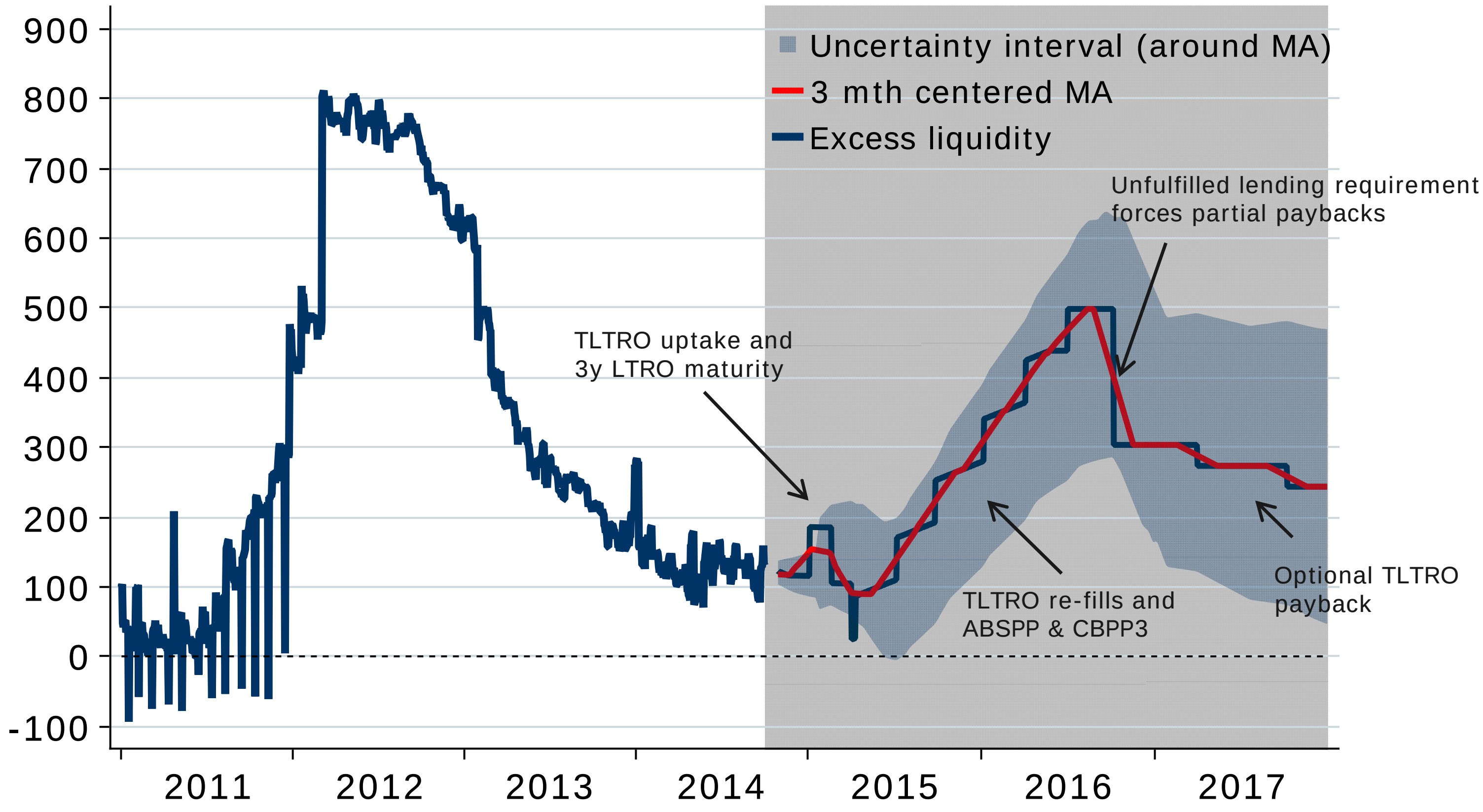
Basis swaps

The basis market has been strongly correlated with the FX market over recent months. We point out that EURUSD xCcy basis is not a surrogate for a FX view. Given the liquidity outlook presented here, along with less dovish tones from the ECB, we like more tightening here on a tactical horizon. 1Y1Y in particular is a good spot on the curve.

Part 1. The liquidity situation

Summarizing the excess liquidity trajectory

Many of the deciding factors in terms of liquidity conditions over the coming years are highly uncertain and (disregarding the QE threat) risks are tilted to the downside in the trajectory below…



Source: Nordea Markets and Macrobond

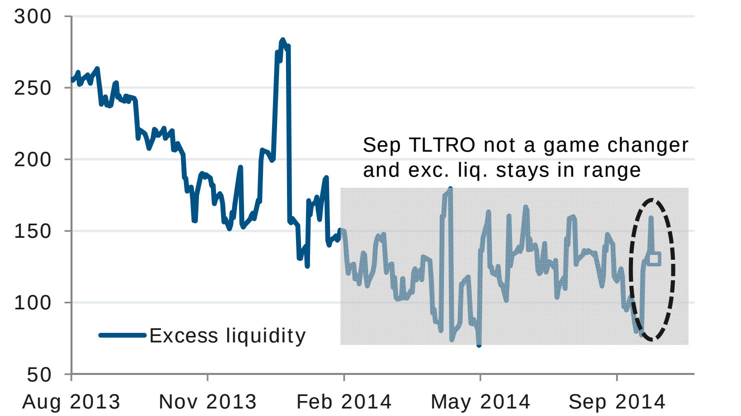
The liquidity projection requires a range of assumptions, which make the trajectory very uncertain. We have tried to pencil in the main drivers ahead, but illustrate the uncertainty through the area shaded in blue.

The TLTRO, ABSPP & CBPP3: keep calm and carry on

The September TLTRO and the modalities of the ABS and covered bond programs represented event risks in terms of the excess liquidity path. However, liquidity has remained in range…

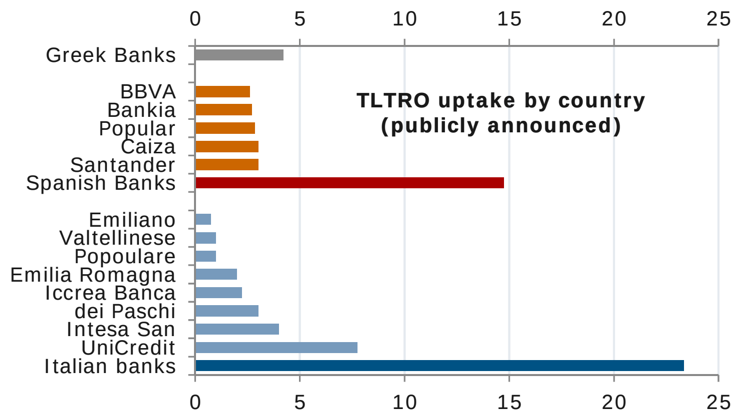
- The September TLTRO tranche must have been seen as somewhat of a disappointment for the ECB, with only a 82.6bn uptake.
- Expectations are now for a somewhat larger interest in December, but with year-end window dressing and the 3y LTRO maturities coming up, the effect on excess liquidity may not necessarily be much different than in September.
- Eventually, the net effect on excess liquidity was 50bn after the September TLTRO tranche, which is not standing out as a very large move when comparing with the volatility over the past year (Fig 1).
- Of the banks that have announced participation in the operation, Italian banks took the most (a result of the large uptake by UniCredit, Fig 2).
- In terms of the ECB´s new purchase programs, the modalities offered very little guidance in terms of changes to the liquidity situation.
- Neither volume nor pace was suggested, and our economists has kept their estimate of the programs summing up to 150-200bn.

Fig 1. TLTRO effect on exc. liq. was modest



Source:Nordea & Bloomberg

Fig 2. Italian banks largest takers of the TLTRO in Sep



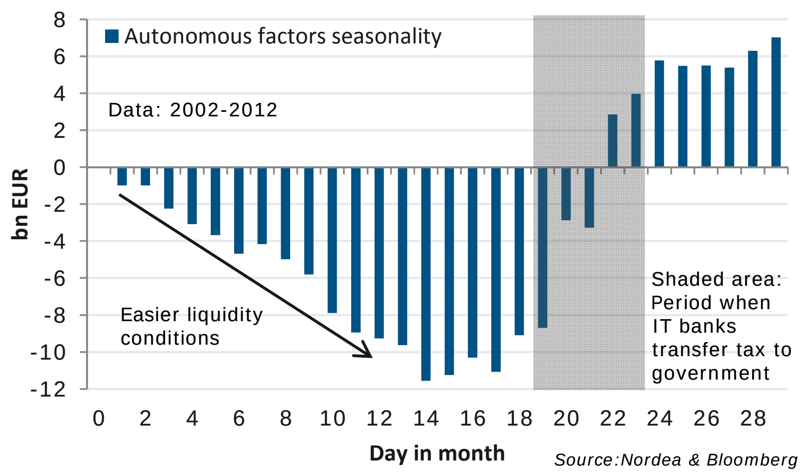
Source:Nordea & Bloomberg

Autonomous factor: month/quarter-end still matters

The tightening conditions driven by higher autonomous factors ahead of quarter-end are set to reverse as we enter Q4. Next hurdle, year-end…

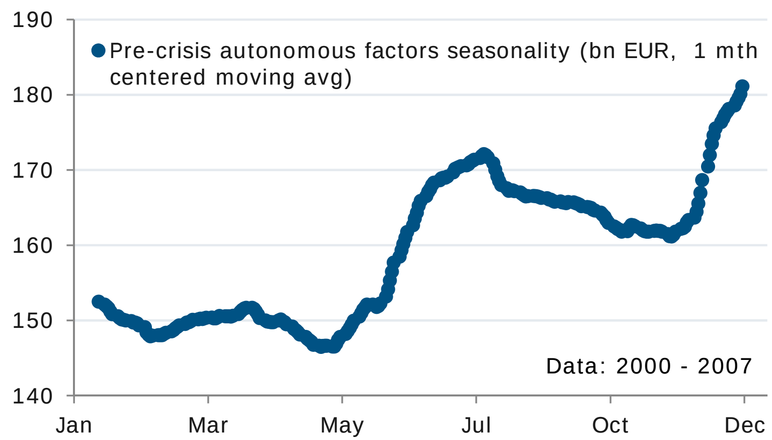
- Autonomous factors trended higher in September before falling after quarter-end.
- The somewhat tighter liquidity conditions in late September were clearly visible, with EONIA O/N remaining somewhat sticky at "high" levels and excess liquidity dropping to lows around 77bn.
- Autonomous factors however tend to decline after month-end (Fig 3), as e.g. social security and pensions are paid in the beginning of the month in some Euro zone countries. This effect tends to be more pronounced after quarter-end.
- Both banknotes in circulation and government deposits, two key sub-components of autonomous factors, have followed historical seasonality patterns and declined somewhat after the summer months, causing autonomous factors to drop since this year´s peak in June.
- Looking ahead, year-end should be the next hurdle in terms of liquidity (Fig 4), which may be more volatile than usually due to the December TLTRO and the likely increase in LTRO repayments before maturity in early 2015.

Fig 3. Aut. fact. tend to decline after month/quarter-end



Source:Nordea & Bloomberg

Fig 4. Next hurdle, year-end…



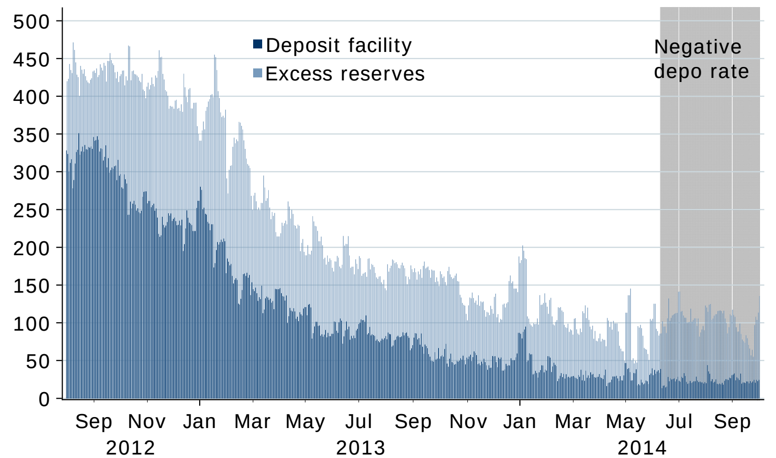
Source:Nordea & Bloomberg

Negative depo rate: Fed´s facility looks attractive

Banks still put excess liquidity at the negative rate with the ECB. In a relative metric, Fed-placement looks ever better. It has not yet however been a huge driver on liquidity markets.

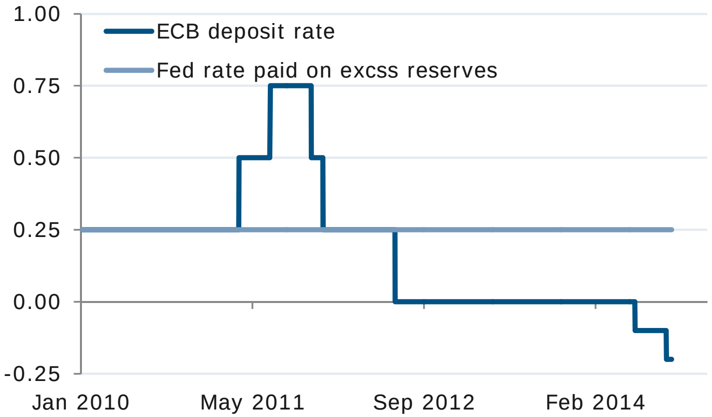
- Looking at data on excess reserves and the use of the deposit facility, it is difficult to see any significant effect of the negative deposit rate (Fig 5).
- However, that could be something that takes time, and while banks are being charged at -20bps at the ECB they are rewarded with 25bps at the Fed (Fig 6).
- The recent move tighter in basis swaps also makes it more attractive for euro banks to place their excess liquidity with the Fed (those who can), instead of with the ECB (Fig 7).
- We are not expecting this to have a material impact on the liquidity in the Euro zone, but it could at least be an incentive for some solid banks with large amounts of excess liquidity.

Fig 5. Difficult to see a real effect of negative depo rate



Source: Nordea Markets and Macrobond

Fig 6. Fed and ECB rates on excess reserves



Source:Nordea & Bloomberg

Fig 7. Incentive has improved to move money from ECB deposit

Source:Nordea & Bloomberg

Part 2. The market take

Eonia (1): market having a tough time getting it right

Excess liquidity now is less than expected months back, and there have seemed to be issues pricing both the immediate fixings AND the longer trajectory…

- There are two somewhat separate issues in play on the Eonia market currently: (1) the expected element as priced on longer swaps or forward periods, and (2) the struggle to pinpoint where fixings will actually end up right now with a depo-rate of -20bps.

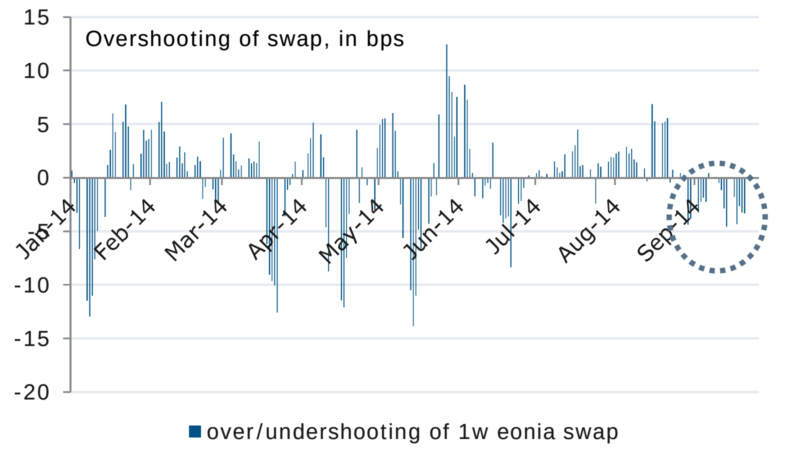
- On both counts, the market clearly seems to have overestimated the impact and consequently underestimated Eonia values, or rather have overstated how negative fixings will go.

- On the year as a whole, the accumulated over/undershooting is about zero now. Note that the two cuts have contributed substantially to the periods of undershooting.

- So what is the point of this. One thing is that stickiness below zero seems to be larger, and that a higher Eonia-Depo for a given liquidity situation should be expected.

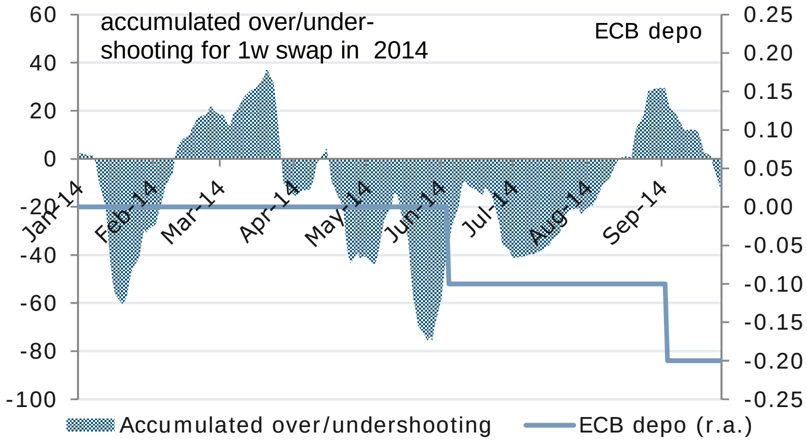
- Also, due to this, and especially coupled with a liquidity outlook that looks to be lower in excess terms than previously anticipated, **we maintain our view that fixings only sporadically will go below -10bps**, and that Eonia swaps near that level should be paid.

Fig 8. 1W swaps have recently undershot fixings



Source: Nordea Markets

Fig 9. For the year, 1W swaps are unbiased



Source: Nordea Markets

Eonia (2): forwards getting re-priced

The liquidity path is a delicate combination of projecting the existing measures and assessing the need of, and the scope of, potential new measures...

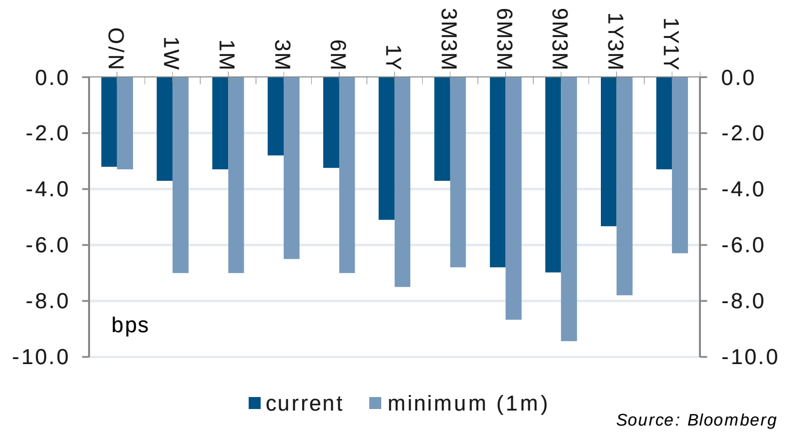
- We have long favored paying forward starting Eonia swaps at levels near -10bps. The market is priced fairer now, and is markedly up since the recent depths in early September (Fig 10).

- Similarly, the ECB runs are also being repriced as the overall take-away from last weeks meeting is not supportive of either very large excess liquidity from the current measures nor in terms of QE looming nearby.

- Regarding QE-trades, these will tend to be receiving in Eonia swaps, and obviously the recent increases mean better entries. However, as the timing of QE giving the ECB-reluctance overall (and the apparent dissent in the council), it is likely to come only as a last resort **if it** comes; as such, we find Eonia curve flatteners a better bet here.

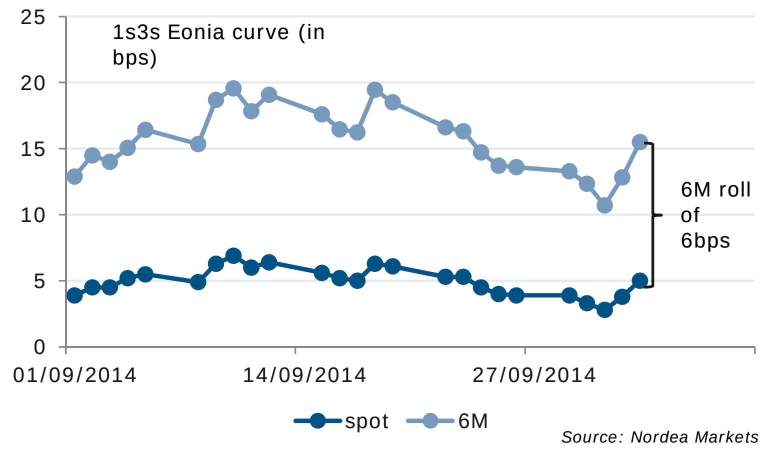
- A mitigating factor for trades such as 1s3s flatteners on the O/N curve lies with the positive roll for forward versions. QE might well not come, but neither is a sell-off likely in that part of the curve, hence the trade offers some QE-scenario exposure whilst generating profit as time passes with a gridlocked curve. 6M forward has 1bp roll per month.

Fig 10. Eonia swaps being re-priced



Source: Bloomberg

Fig 11. Low and flat, but flatteners still roll fine



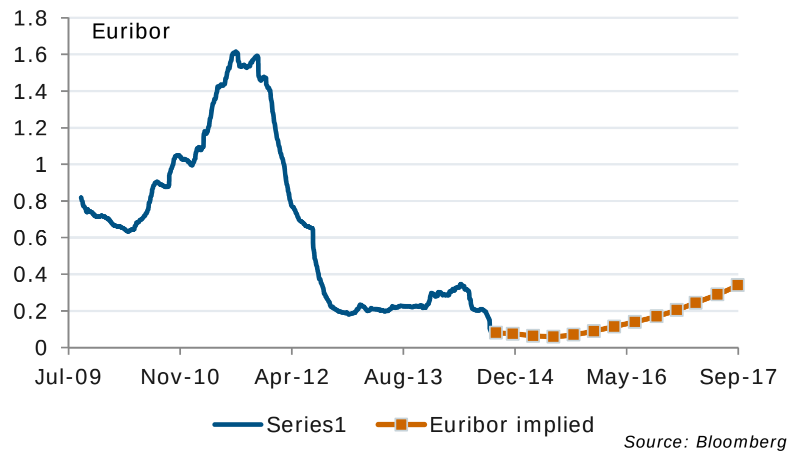
Source: Nordea Markets

Euribors and FRA/OIS

Euribors turning sticky. We maintain that negative Euribor 3M fixings will not happen. FRA/OIS market supports this rather strongly, as does Futures and options on futures.

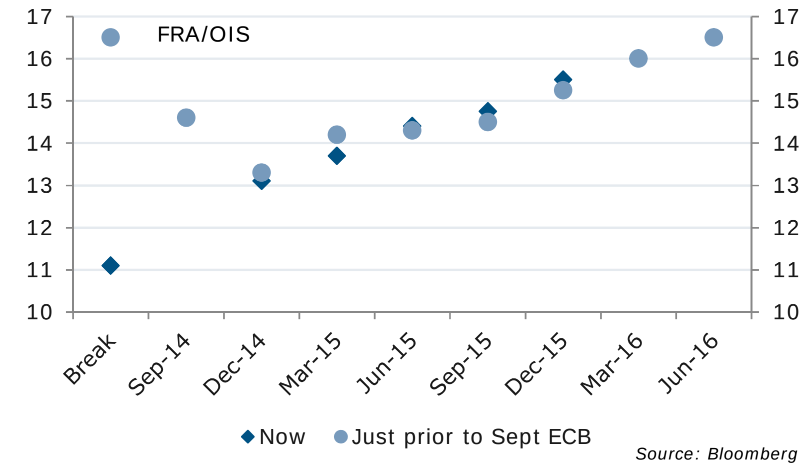
- After a quite swift movement down on the heels of the most recent cut, Euribor fixings have turned sticky recently.
- The 1M fixing has actually increased a little bit and current lies in 0.7bps whereas the 3M fixing has tailed off just above 8bps.
- Implied, the latter is priced to reach 6bps in mid 2015, a new low on the trough. How low will of course be a function of the liquidity trajectory, with a middle calculation on how low the Eonia fixings and swaps will go.
- The FRA/OIS break (Euribor 3M – Eonia 3M swap) has tanked since early September, but in future terms, this market prices the gap very stable indeed.
- **We maintain our previous assessment on the prospective lows on Euribor 3M to +3-4bps.** The average Euribor value for the next months is likely to be higher than this. Our call is based on both history (i.e. the Euribor/Eonia/Depo relation to excess liquidity) and the implied pricing of Euribor futures, FRA/OIS and option prices on Euribor futures.

Fig 12. Euribors turning sticky



Source: Bloomberg

Fig 13. FRA/OIS: "Break" down, but forwards are stable



Source: Bloomberg

xCcy basis: Tightening to continue short-term

On a tactical horizon we favor a tighter front on the EURUSD xCcy. If QE-expectations become dire, then the direction changes.

- It's not always a perfect metric, but in essence the cross currency swap spread captures the relative liquidity premiums of two economies.

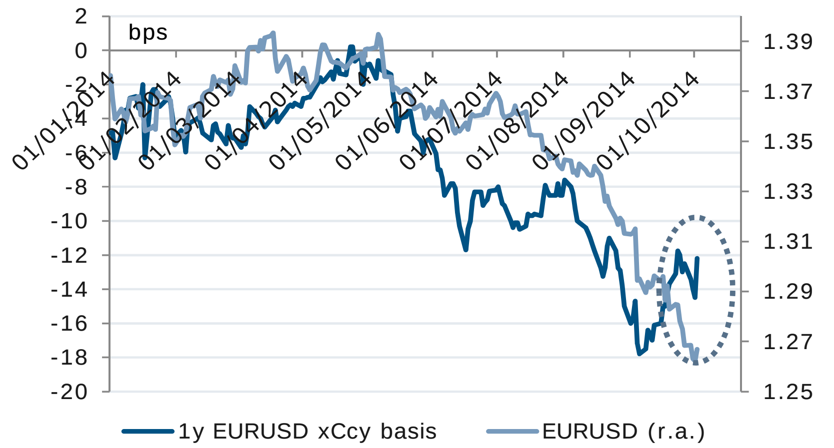
- Like the FX, EURUSD xCcy can be gauged through two lenses, the EUR side and the US side. ECB-QE or a very high trajectory on the extant measures will likely turn spreads wider.

- We're not there however, and on a short horizon, playing what looks likelier, namely a lower liquidity path than previously anticipated, is the way to go.

- The correlation to the FX spot is often strong, but also very dynamic, as evidenced in the upper chart (cf. highlight circle). **xCcy basis positions are thus not a surrogate for a EURUSD view!** Case in point: Last Friday's NFP number boosted the dollar, and left xCcy basis tighter. The thesis here is that a weaker EURUSD all else equal lifts inflation expectations, and lowers the chance of ECB-QE, and hence supports the basis.

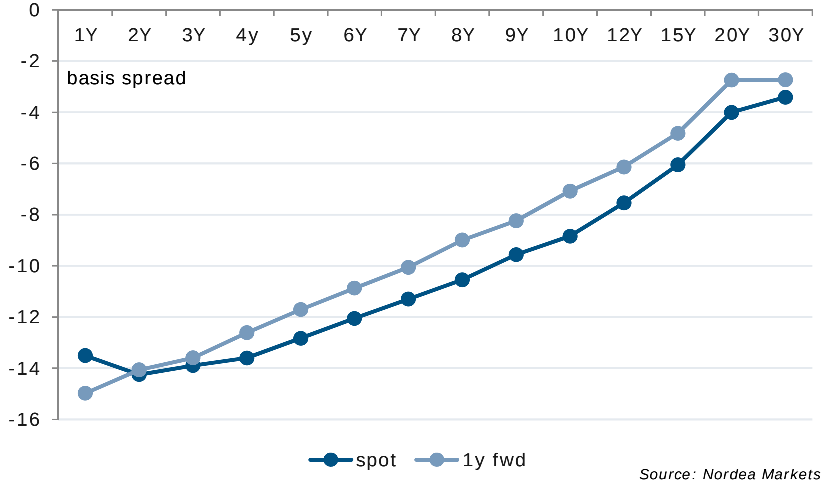
- The current curve favors taking the tightening view in forward starting swaps, and we continue to like the 1Y1Y at around -15bps (2 bps tighter than previously) which rolls positively.

Fig 14. EURUSD: Basis and FX are not substitutes



Source: Bloomberg

Fig 15. xCcy term structure favors paying 1Y1Y



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Thank you!

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