MyStratWeekly
Market views and strategy

Ostrum ASSET MANAGEMENT

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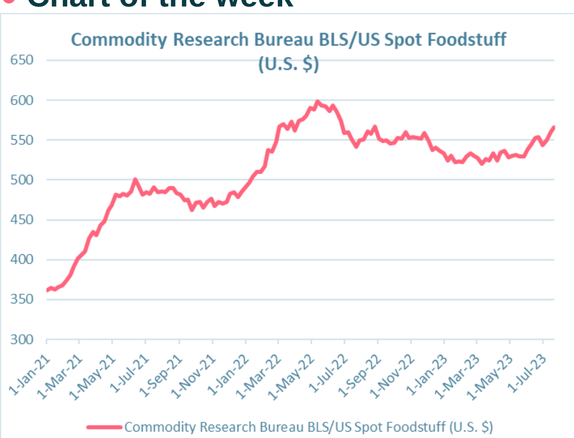
Topic of the week: Impact of TLTRO redemptions on markets

- **On June 28, European banks repaid 477 billion euros of TLTRO;**
- **The high excess liquidity and the early repayments made allowed the markets to perform well;**
- **Some tensions have however occurred on the money market;**
- **For the next repayments, the focus will be on Italian banks due to insufficient excess liquidity;**
- **They will have to resort to ECB loan facilities, borrow on the markets or reduce the size of their assets to make future repayments.**

Market review: Commodity prices bounce

- **Disinflation faced with a rebound in commodity prices;**
- **T-note yields rise back towards 3.85% ahead of the FOMC;**
- **Nasdaq index reshuffling sparks profit-taking on FAANG stocks;**
- **BTP spreads narrow as UE agrees to pay aid tranche to Italy.**

Chart of the week



Source: Bloomberg, Ostrum AM

The price of foodstuffs listed on the markets has shown a sharp rebound since the beginning of June, returning to the levels of September 2022.

Russia pulled out of the agreement allowing wheat exports via the Black Sea, which contributed to a sharp rise in cereal prices. Moreover, the resurgence of the El Nino climatic phenomenon risks disrupting agricultural production in South America, which induces an additional upside risk. India has also intervened to limit its rice exports.

These new tensions could lead to a rise in food prices for consumers within a year.

Figure of the week

18

Source : Bloomberg

18 days: this is the time it takes to sell an old house in the United States given the low stocks available. The deadline was 30 days in January 2023.

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Topic of the week

Impact of TLTRO redemptions on the markets

On June 28, European banks repaid 477 billion in targeted long-term refinancing operations (TLTROs) to the ECB. Despite the large amount, the impact on the markets was contained, due to very high excess liquidity. There are, however, disparities between countries. There are still 622 billion euros to be repaid by the end of 2024. The focus is particularly on Italy, where the excess liquidity is insufficient to meet this deadline.

The context: 180-degree turn in monetary policy

TLTRO: Quesaco?

TLTROs are targeted long-term refinancing operations carried out by the ECB. The aim is to encourage commercial banks to lend to households and businesses by offering them advantageous refinancing conditions. The ECB launched three series: TLTRO I in 2014, TLTRO II in 2016 and TLTRO III in 2019. The first two with a duration of 4 years have expired and the third, with a duration of 3 years, is ongoing (10 operations were held from September 2019 to December 2021).

Through these operations, the ECB increases the size of its balance sheet and makes its monetary policy even more accommodative. TLTROs are among the monetary policy instruments available to the Central Bank. They are added to the main instrument, which is the key rates, as well as to quantitative easing, through the purchases of securities made by the ECB, in particular sovereign bonds.

TLTRO III: Record demand in June 2020

To deal with the shock linked to the Covid 19 crisis, the ECB made its monetary policy even more accommodating. It kept the deposit rate in negative territory at -0.50% and launched a Pandemic Emergency Purchase Program (PEPP) in June 2020.

It also decided in March and April 2020 to make the conditions of TLTRO III even more attractive, so that banks continue to lend to companies and households in a context marked by an increased need for liquidity. The aim was to avoid a multiplication of bankruptcies caused by difficulties in accessing liquidity as companies suddenly ceased their activity and had to meet their current expenses.

From June 24, 2020 to June 23, 2021, the interest rate applied to TLTRO III operations was thus reduced by 50 basis points compared to the average rate applied to main refinancing operations (MRO), which was at 0%, i.e. -0.50%. In addition, if banks kept the volume of loans granted to households (excluding real estate) and businesses unchanged between March 1, 2020 and March 31, 2021, they could refinance themselves at -1%. The ECB had also temporarily relaxed the rules relating to collateral provided by banks, as well as certain prudential rules.

Given the very advantageous conditions offered by the ECB, demand from banks for the TLTRO III operation of June 18, 2020 reached a record: 1,308 billion euros. This expired on June 28, 2023 and the banks had to repay.

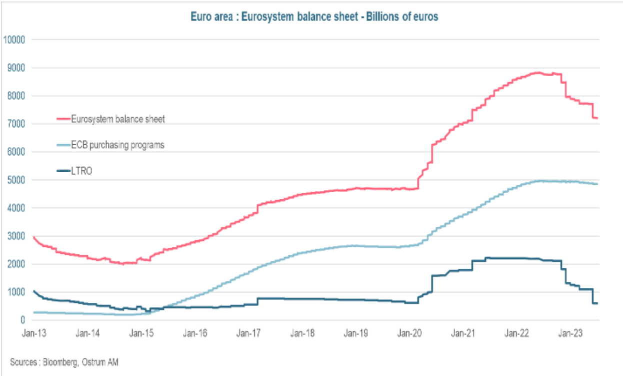
Unprecedented monetary policy tightening

This large repayment comes as the ECB is tightening its monetary policy sharply to fight against high inflation – 5.5% in June – well above the 2% target followed by the Central Bank.

The ECB has increased its key rates by 400 basis points in one year, bringing the deposit rate to 3.50%. It is expected to rise another 25 bps on Thursday. It is also reducing the size of its asset purchase program under the APP (Asset Purchase Program), making partial repayments of maturities between March and June 2023 and ending it on July 1. On the other hand, reinvestments under the PEPP continue until the end of 2024, providing some flexibility if necessary.

The ECB has also made its TLTRO III operations less attractive from November 23, 2022. The aim is to encourage banks to make early repayments (3 additional dates have been set for this purpose) and to reduce the size of the ECB's balance sheet to contribute to monetary tightening.

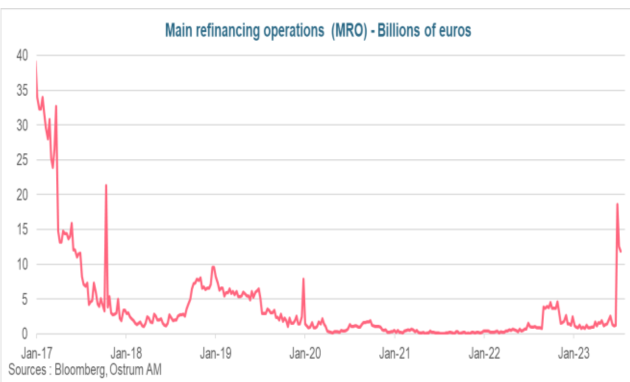
Financing conditions being much less advantageous, the banks made early repayments. Thus, only 477 billion euros remained to be reimbursed in June 2023 out of the 1,308 billion that had been requested.



Market impact

Increase in main refinancing operations (MRO)

The repayment of 477 billion euros coincided with a sharp increase in main refinancing operations (MRO). These are one-week ECB loan transactions against collateral. They reached 18.6 billion euros the June 28 week to reach their highest since October 2017. Since then, these transactions have fallen to 10 billion the July 19 week. This is a significant increase compared to the average of 1.3 billion euros of MRO since the beginning of the year but very reasonable in view of the amount of 477billion euros that the banks had to reimburse.



This shows that the vast majority of establishments had the necessary liquidity to deal with it. Some, and more particularly small banking establishments, have used the MRO to refinance themselves and this at a higher cost than the TLTRO. The rate applied is that of the main refinancing rate (refi), i.e. 4%.

Slight increase in LTROs

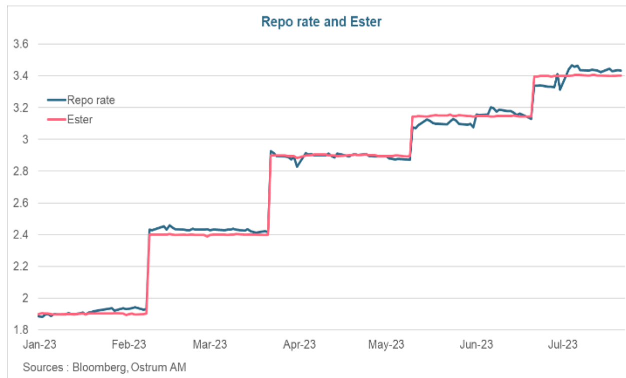
Banks slightly increased their use of long-term refinancing operations (LTRO), with a duration of 3 months, to 4.32 billion in the week of June 29. It remains limited.

Marginal lending facility

Use of the marginal lending facility remained small – €150m the June 30 week – and has since fallen back to €51m. It is a 24-hour loan facility from the ECB at the rate of 4.25%.

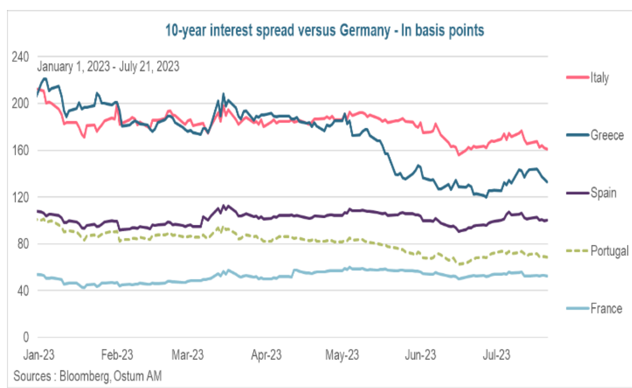
Slight tensions on the money market

Tensions took place on the money market as shown in the following chart. The Ester rate rose on June 28 to become above the repo rate. Banks resorted more to the interbank market for refinancing. In addition, issuance spreads have increased in the short term, especially for peripheral countries. This shows that some banks have thus appealed to the money market to ensure TLTRO repayments. The cost is lower than the MRO, the repo rate being at 3.4% against 4% for the refi rate.



Reaction of sovereign bond markets

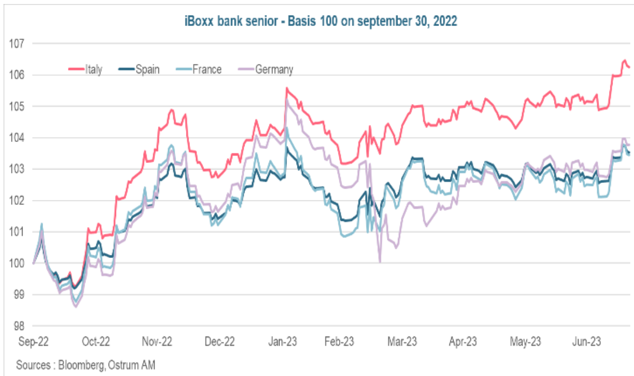
There was no specific reaction from sovereign bond markets to the redemption of TLTRO. This could indeed have generated fears about the peripheral countries, given their greater dependence on these operations.



The widening of spreads from mid-June followed a strong tightening movement and consisted mainly of profit-taking by investors. Concerning Greece, the tensions since the beginning of July result from the announcement of an early repayment of IMF loans. This was followed by a 15-year syndication and then the forthcoming issuance of a green bond, operations intended to fund part of the prepayment. Nothing to do with the TLTRO. The Greek spread remains lower than that of Italy, due to the prospect of a rapid return of Greek sovereign debt to the IG category.

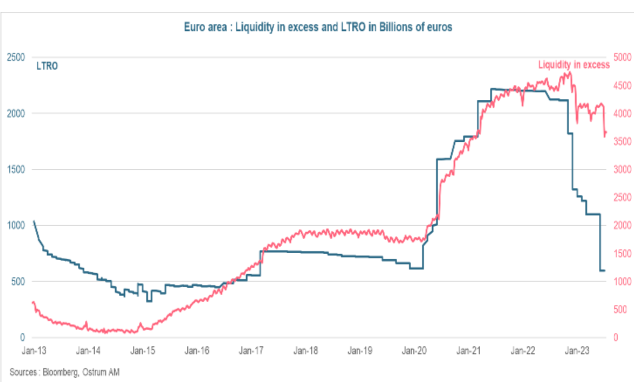
No impact on senior bank bonds

As the following chart shows, the iBoxx senior bank bond indices held up well on June 28. The Italian index even outperforms those of France, Germany and Spain.



The reason: the significant excess liquidity

The good performance of the markets in relation to the size of the repayments to be made lies in a significant excess of liquidity. Before the reimbursement of June 28, it amounted to 4,124 billion euros; today it is 3,662 billion, which remains very high. This is to be compared to an LTRO amount of 1,100 billion euros at the end of May and 578 billion at the end of June. The excess liquidity is therefore much higher than the TLTROs to be reimbursed. This is the result of the sharp increase in the ECB's balance sheet from March 2020 with more attractive TLTRO operations and the quantitative easing policy put in place to deal with the Covid-19 crisis. Added to this is the fact that the ECB continues to remunerate excess reserves, which has helped maintain high liquidity.



In addition, the banks have had enough time to prepare well for this important deadline. They thus proceeded to prepayments for nearly 64% of the initial amount, which made it possible to avoid a shock on liquidity.

And after?

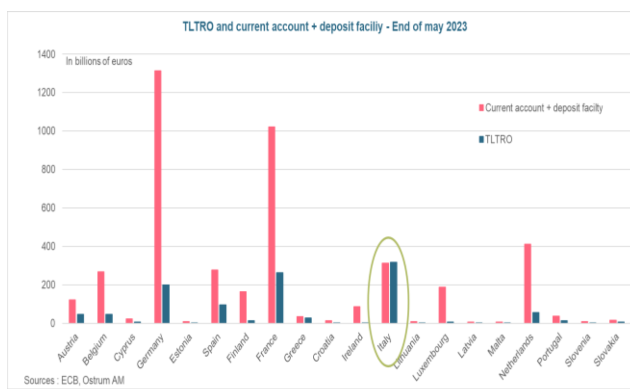
There are still 592 billion euros of TLTRO to be repaid by the end of 2024: 108 billion euros in 2023 and 484 billion in 2024. The largest deadline is March 27 with 281 billion euros.

Operation	Settlement date	Maturity date	Allotted amount	Outstanding amount	% Reimbursed
MRO	19-Jul-23	26-Jul-23	10.0	10.0	0%
LTRO	29-Jun-23	28-Sep-23	4.3	4.3	0%
LTRO	1-Jun-23	31-Aug-23	0.8	0.8	0%
LTRO	27-Apr-23	27-Jul-23	0.7	0.7	0%
TLTRO III	22-Dec-21	18-Dec-24	52.0	43.1	17%
TLTRO III	29-Sep-21	25-Sep-24	97.6	90.6	7%
TLTRO III	24-Jun-21	26-Jun-24	109.8	69.8	36%
TLTRO III	24-Mar-21	27-Mar-24	330.5	280.7	15%
TLTRO III	16-Dec-20	20-Dec-23	50.4	41.2	18%
TLTRO III	30-Sep-20	27-Sep-23	174.5	66.7	62%

MRO = Main Refinancing Operations, LTRO = Long Term Refinancing Operations, OT = other type of operation

Sources: ECB, Ostrum AM

As we have seen, excess liquidity within the Eurosystem is much higher than the amount to be repaid in aggregate. Nevertheless, there are significant disparities between countries, as shown in the following graph. Excess liquidity is approximated by the current account and the deposit facility. In Italy, the latter is less important than the LTROs remaining to be reimbursed, and this amounted to 5.7 billion euros in May 2023. The June deadline did not pose a problem, given that the excess liquidity was greater than the 130 billion euros to be reimbursed. This will no longer be the case for the next deadlines.

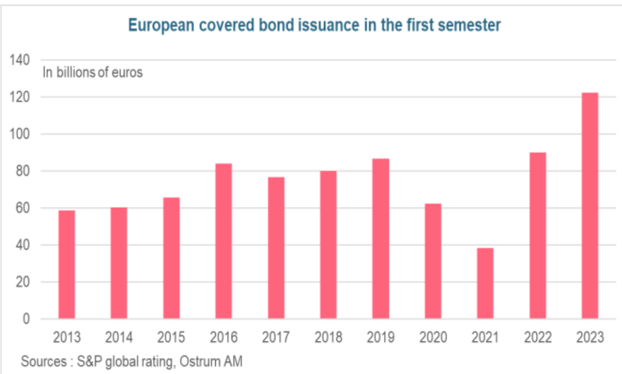


Is it a problem?

It is not: as we have seen, banks have access to other sources of financing. They can use ECB lending facilities, such as MRO and LTROs, reusing the collateral released by TLTRO repayments, at a higher cost.

In its latest financial stability report for April, the Bank of Italy indicated that if banks without sufficient excess liquidity to repay all or part of the TLTROs resorted to ECB facilities, that is just under half of the banks, the higher cost would reduce their return on equity by 350 basis points. The drop would be by 130 bps for the whole system, according to the Bank of Italy.

Banks can also finance themselves on the markets. Since the beginning of the year, bond issues guaranteed by European banks have increased sharply to reach their highest level since 2013, at just over 120 billion euros. Some banks have thus repaid TLTROs by issuing covered bonds.



In addition, institutions can reduce the size of their assets, in particular with the sale of bonds, which we do not observe. Finally, the monetary tightening carried out by the ECB has the effect of raising the cost of credit and reducing the demand for loans from households and businesses, also contributing to the decline in bank assets.

Conclusion

Banks prepared well for the large TLTRO redemption on June 28. For the remaining maturities, some banks, notably Italian ones, will have to find other sources of liquidity through the ECB's loan facilities, have recourse to the financial market or will have to reduce the size of their assets. This could generate tensions on the Italian money market, as institutions seek to refinance there, given a more advantageous rate than that of the ECB's main refinancing operation.

Aline Goupil-Raguénès

Market review

Commodity prices bounce

Rates rise at the end of the week ahead of central bank meetings against a backdrop of a rebound in commodity prices.

The blackout period observed by the members of the Fed ahead of the FOMC on July 26 is an opportunity to reshuffle portfolios for many participants. Speculative short covering of T-note future positions after last week's US CPI release faded somewhat on the back of solid economic data. In the euro area, Bunds responded positively to a downside surprise on UK inflation and the surprisingly dovish comments from Klaas Knot and Joachim Nagel, two ECB hawks, who said that the rise in September remained data dependent. This is benefiting sovereign spreads, which are narrowing, especially since Italy has reached an agreement with Brussels for the release of an aid tranche worth €18.5 billion. Corporate credit is tightening slightly thanks to financials, including real estate. High yield remains well oriented, like emerging market debt, whose spread is below 420 bp. Equity indices had very different performances last week. The overhaul of the Nasdaq index, which reduces the weight of the mega-cap Tech stocks from Monday August 24, involves portfolio reshuffling amounting to $60 billion at a time when the earnings season is in full swing. On the foreign exchange market, the U.S. dollar rebounded against the Japanese yen, which again suffered from the BoJ's sibylline communication. The Japanese currency is back above 141 against the greenback. The PBoC seems more inclined to defend the Renminbi. The euro and sterling retreat after the June UK CPI.

On the economic front, US publications remain in line with the resilience observed in the first half of the year. Retail sales rose 0.2% in June after rising 0.5% the previous month. Industrial production has fallen since May, however, but still rose by 1.5% (at annualized rate) in the second quarter. While the PhillyFed manufacturing survey remains mediocre in July, the rebound in the price received component, to its highest level since January, should be monitored. Homebuilder confidence continued to improve in July. The lack of available homes for sale reduces existing home sales to 4.13 mn (at annualized rate) in June and pushes housing prices towards previous highs (the median price on June transactions exceeded $410k). Housing starts are probably still insufficient to permanently ease the supply constraint.

In the euro area, the final estimate of the HICP stands at 5.5% as underlying inflation was rounded up to 5.5%. UK inflation came out slightly below expectations at 7.9% thanks to a 0.2 pp drop in core inflation. The RPI index, which applies to UK linkers, shows inflation at 10.7%. Retail sales rebounded in June (+0.7%) despite the relapse in household confidence and renewed upward pressure on London rents, as a result of tighter mortgage credit conditions.

Asset allocation shifts remain important to watch. Investors favor money market and bond funds. Flows to Treasuries or IG credit are nevertheless slowing to a degree. Globally, equities recorded withdrawals of around $2 billion, though Japan and sectors including technology and energy in the United States recorded inflows.

In the fixed income markets, speculative accounts, massively short T-note Futures, had started to lighten their positions before the June CPI. This trend continued until a 3.73% low on the US 10-year yield last week before good data triggered a reversal towards 3.85%. Christopher Waller, however, hinted that the rate hike in July could be enough, thus reinforcing the inversion of the yield curve which is close to -100 bp on the 2-10 year segment. Rising oil and food prices after Russia's decision to end the Black Sea wheat export deal contributed to higher inflation breakevens. The 10-year US inflation swap takes 9 bps to 2.61%. In the euro area, the Bund yield resumed rising despite a strong positive reaction to the UK CPI and to the comments from Nagel and Knot. The German 10-year yield rose back towards 2.50%, which contributed to a general narrowing of sovereign spreads. Italy reached an agreement with Brussels for the payment of €18.5 billion under the European recovery plan. This is very good news for a government faced with a significant deterioration in public finances this year. The state cash deficit reached €95 billion in the first half of 2023. The 10-year Italian BTP spread is back towards 160 bp pulling down other peripheral markets including Portugal (-3 bp), Spain (-3 bp) and Greece (-12 bp).

European credit spreads are also well oriented with a tightening of 1 bp over the week, and 3 bp for the financial sector bonds. The primary market is at a standstill in July due to earnings releases and the lower trading volume in summer. ETFs concentrate most of the demand for IG credit. European high yield remains well oriented (-7 bp) despite regular fund outflows.

The earnings season has started in the United States. The first 81 releases in the S&P 500 beat the EPS consensus by 6% on average despite less dynamic or even sharply declining turnover for basic resources or energy. A few large stocks published disappointing earnings, which amplifies sector rotations. The decline in the dollar has probably added to profits for most US companies.

Axel Botte

Main market indicators

G4 Government Bonds	24-Jul-23	1wk (bp)	1m (bp)	2023 (bp)
EUR Bunds 2y	3.03%	-16	-8	+27
EUR Bunds 10y	2.41%	-7	+6	-16
EUR Bunds 2s10s	-62.4bp	+9	+13	-42
USD Treasuries 2y	4.84%	+10	+10	+41
USD Treasuries 10y	3.82%	+1	+8	-6
USD Treasuries 2s10s	-102.4bp	-8	-1	-47
GBP Gilt 10y	4.2%	-24	-12	+52
JPY JGB 10y	0.46%	-2	-7	-23
€ Sovereign Spreads (10y)	**24-Jul-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
France	53bp	+0	-1	-1
Italy	162bp	-6	-6	-52
Spain	103bp	0	+4	-6
Inflation Break-evens (10y)	**24-Jul-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
EUR 10y Inflation Swap	2.47%	+2	-7	-7
USD 10y Inflation Swap	2.59%	+5	+6	+7
GBP 10y Inflation Swap	3.84%	+3	-6	-7
EUR Credit Indices	**24-Jul-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
EUR Corporate Credit OAS	151bp	+0	-10	-16
EUR Agencies OAS	76bp	+1	+0	-3
EUR Securitized - Covered OAS	87bp	+1	+0	+3
EUR Pan-European High Yield OAS	450bp	+7	-6	-62
EUR/USD CDS Indices 5y	**24-Jul-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
iTraxx IG	70bp	-2	-9	-21
iTraxx Crossover	392bp	-2	-31	-82
CDX IG	65bp	-1	-8	-17
CDX High Yield	419bp	-5	-47	-64
Emerging Markets	**24-Jul-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
JPM EMBI Global Div. Spread	417bp	-1	-31	-36
Currencies	**24-Jul-23**	**1wk (%)**	**1m (%)**	**2023 (%)**
EUR/USD	$1.109	-1.344	1.641	3.5
GBP/USD	$1.283	-1.851	0.928	6.2
USD/JPY	JPY 141	-1.868	1.528	-7.2
Commodity Futures	**24-Jul-23**	**-1wk ($)**	**-1m ($)**	**2023 (%)**
Crude Brent	$81.5	$3.0	$7.5	-1.9
Gold	$1 965.0	$9.9	$41.7	7.7
Equity Market Indices	**24-Jul-23**	**-1wk (%)**	**-1m (%)**	**2023 (%)**
S&P 500	4 536	0.69	4.32	18.1
EuroStoxx 50	4 381	0.56	2.57	15.5
CAC 40	7 418	1.73	3.55	14.6
Nikkei 225	32 701	0.96	-0.25	25.3
Shanghai Composite	3 164	-1.42	-1.06	2.4
VIX - Implied Volatility Index	14.19	5.27	5.58	-34.5

Source: Bloomberg, Ostrum AM

Additional notes

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