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Market views and strategy

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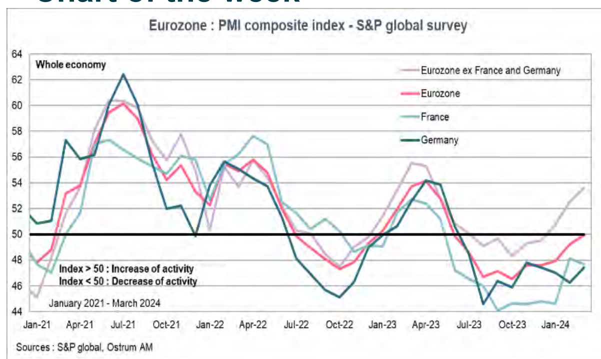
Topic of the week: A review of the ECB operational framework

- **The ECB unveiled a review of its operational framework on March 13;**
- **The central bank will continue to play a key role in the functioning of money markets for years to come;**
- **The rate corridor has narrowed with the refi rate just 15 bp above the deposit rate from September;**
- **Full-allotment refinancing operations against a broad set of collateral should reach all corners of the euro area banking system;**
- **New structural LTRO and asset purchases will help banks comply with net stable funding ratios and liquidity coverage ratios;**
- **In all, the changes should mitigate short-term volatility and contribute to lower spreads in supranational and green bonds in particular.**

Market review: Getting closer to rate cuts

- **The Fed confirms three cuts in 2024;**
- **T-note yields dip to 4.20%;**
- **Sovereign spreads widen, some tensions in high yield space;**
- **Equities remain upbeat.**

Chart of the week



Preliminary PMI surveys for March demonstrate a two-speed recovery within the economic and monetary union. Germany remains lagging behind below the threshold of 48 and the rebound of the French economy seen in February already seems to be weakening.

Conversely, the economies of southern Europe are reporting a clear improvement in the economic situation. This better growth is one of the reasons for the clear tightening of the spreads of these countries against German and French debts. strategies to work is the absence of volatility.

Figure of the week

500

Source : Bloomberg

The size of the surprise rate hike in basis points in Turkey announced on 21 March. The increase to 50% aims at steadying the Turkish Lira ahead of the elections at the end of the month.

Axel Botte
Head of Market Strategy
axel.botte@ostrum.com

Zouhoure Bousbih
Emerging countries strategist
Zouhoure.bousbih@ostrum.com

Aline Goupil-Raguénès
Developed countries strategist
aline.goupil-raguenes@ostrum.com

• Topic of the week

A review of the ECB operational framework

The ECB unveiled its new operational framework on 13 March. The ECB adapted its own framework to reflect the fundamental changes in the functioning of money markets since the great financial crisis. The ECB will continue playing a central role in the provisioning of liquidity to the financial system and the economy via new long-term loans and a structural bond portfolio.

In search of the optimal monetary framework

A brief recap of the post-GFC monetary system

Prior to the 2008 financial crisis, central bank policy was very different. The ECB had a lean balance sheet. This is because the central bank only intervened on the margin by supplying or withdrawing reserves to fine-tune market interest rates. Bank reserves were kept relatively scarce, so that broad money creation came from banking activity. In other words, the banking multiplier was the cornerstone of the financial system. The ECB's primary policy tool was the main refinancing rate (refi or MRO thereafter). The refi rate was the *minimum* interest rate at which the ECB lent a pre-determined amount at 1-week or 91-day terms. When banks' liquidity demand exceeded the auctioned amount, the effective refinancing rate would rise above the minimum rate. Deposit rates were set up to 100 bp below the current refinancing rate to foster interbank lending. Most interbank loans were unsecured.

Comes the great financial crisis: many large banking institutions were insolvent. Banks no longer trusted each other and the banking multiplier was broken. The ECB had to step in and de facto became the main counterparty for most banks. Full allotment at refinancing operations became the norm so that the refi rate is now the effective policy rate. The ECB, led by Mario Draghi, went on to vastly enhance its funding to banks. Various types of long-term loans (up to 4-year maturities) against a broad set of collateral cemented the footprint of the ECB in the money markets, well beyond marginal liquidity management. Meanwhile, rebuilding trust in the financial system required tighter regulatory liquidity and capital ratios. Unsecured interbank lending almost vanished as repo lending took off. Later on, asset purchases provided additional easing in the broader economy.

In sum, the pendulum of monetary policy has gone full swing from a scarce reserve system to trillions of euros in excess liquidity. It also shifted from relying on decentralized unsecured interbank lending and the banking multiplier before the crisis to a central-bank centric system and widespread secured interbank lending as banking regulation tightened.

Current issues with the ample reserve system

No monetary policy framework is perfect. The current operational backdrop has its own drawbacks. Ample access to ECB lending has made banks less prone to seek refinancing in the financial markets. TLTRO borrowing was substituted to commercial paper and secured and unsecured bond issuance. This is unwelcome as the EU aims at greater financial market integration over time.

Furthermore, the deposit rate is supposed to put a floor on market interest rates. But trillions of excess liquidity made the floor somewhat leaky. With market rates below the deposit rate, it is arguably harder for the ECB to retain full control of financial conditions. That said, deviations from the deposit rate remained manageable.

Asset purchases, aligned with the capital key rather than the market value, have reduced collateral availability in parts of the bond markets. A shortage of safe assets including the benchmark German Bunds often distorted market pricing. Distortions also affected credit and equities as the risk-free rates are essential inputs into fair value estimates. In addition, bond scarcity may have delayed the transmission of monetary policy by reducing lendable funds in the repo market.

The new monetary framework of the ECB

There is a lot to achieve with the revised operational framework. The new framework must ensure that policy can be implemented efficiently and flexibly in different financial and liquidity environments, whilst

reaching all corners of the financial system and taking into account risks to financial stability. Without prejudice to the price stability objective, the framework must allow the ECB to support other EU policy objectives like the transition to a greener economy.

The new framework in a nutshell.

Policy Instrument	Tenor	Interest rate	Frequency	Collateral
Main Refinancing Operations	7 days	Deposit rate + 15 bp	Weekly	Broad set
Marginal Lending Facility	overnight	Deposit rate + 40 bp	Daily	Broad set
Long-Term Refinancing Rate	91 days	Average MRO over life of LTRO	Monthly	Broad set
"Structural" LTRO	To be defined (likely >2 years)	To be defined - spread over MRO?	Quarterly?	Broad set (preferable treatment for loans?)

Source: ECB, Ostrum AM

Asset Purchases	Bond Maturity Target	Composition	Amount
Structural Bond Portfolio	Likely <5 years	Government & Credit bonds - Overweight green/EU bonds?	Linked to MRR (structural liquidity needs : nominal GDP growth?)

Source: ECB, Ostrum AM

- Soft floor on rates and a new rate corridor

As stated above, an ample reserve system may push market rates below the levels consistent with the monetary policy stance. The ECB made it clear that its reference policy rate is now the deposit facility rate (DFR). The DFR thus serves as an anchor to overnight money rates. As excess reserves decline, market rates may drift higher towards the DFR. There is even a risk that market rates will rise and that rate volatility increases. The ECB thus decided to narrow the corridor by setting the refi (MRO) rate just 15 bp above the DFR (compared with 50 bp currently) and keeping the emergency lending (MLF) rate 40 bp above the deposit rate. The adjustments to the MRO and MLF rates will come into effect on 18 September.

Bear in mind that that, as excess liquidity diminishes, repo operations will be increasingly motivated by liquidity demand (initiated by the borrower) rather than demand for collateral (initiated by the lender). Therefore, it is quite important for the ECB to be able to enforce a lower ceiling on market rates and dampen volatility.

- Refinancing operations remain important

The euro area remains a fragmented and heterogenous bank-based financial system. The refinancing operations will continue to provide on-demand liquidity and enable an effective pass-through of monetary policy decisions. Smaller banks have benefitted less from asset purchases than larger institutions. According to Isabel Schnabel, excess liquidity from asset purchases is held by just 40% of banks (mostly large/German institutions). Refi will thus help to mitigate these imbalances.

In addition, given the risk of digital bank runs as shown by the SVB event from last year, on-demand liquidity against a broad range of collateral also reinforces existing prudential liquidity requirements.

- Addressing structural liquidity needs

The ECB has not been short of monetary policy tools but new loans and asset purchases will be added to its monetary arsenal as part of the new framework.

At present, excess liquidity prevails. The autonomous factors and minimum reserve requirements are less than the amounts of cash provided through asset purchases (APP and PEPP) and other schemes. But quantitative tightening means that, at some point in time, liquidity needs will rise.

In addition to existing weekly 7-day and monthly 91-day MRO, new long-term operations will be launched to deal with banks' structural liquidity needs. The duration and pricing will match the bank's needs arising from autonomous factors and minimum reserve requirements (MRR). TLTRO borrowing has previously been used to fulfill regulatory requirements including the net stable funding ratio. For this reason, the maturity of new loans will likely be 2 years at a minimum.

Furthermore, the structural bond portfolio will build on the remaining APP and PEPP holdings after the end of quantitative tightening, which is unlikely to come before 2026. Also, the size and composition of future asset purchases will not interfere with the current stance of monetary policy to the extent possible. In all likelihood, the principles guiding asset purchases will be transparent and enable the ECB to pursue secondary objectives including climate change mitigation.

Market implications of the new operational framework

The changes announced on 13 March are unlikely to have a material impact on financial markets in the short run but there are some takeaways.

The narrower corridor to be implemented in September will effectively cap market rates and limit volatility. Selling short-term ESTR volatility makes sense in this context. In addition, the lower refi rate is a net positive for Italian banks and other institutions that have relied on MRO to refinance TLTRO maturities.

Furthermore, the ECB decided to keep the MRR at 1%. Market participants had feared that the ECB could raise the MMR to mitigate losses on its bond portfolio (since required reserves are not remunerated). With required reserves at €161 billion at present, a 1 pp increase in the MRR would have represented an opportunity cost of 6.44 billion per annum for banks (at a 4% deposit rate). This is thus a net positive for euro area bank margins.

The structural bond portfolio will represent regular flows into short-term bond markets with a tilt towards covered bonds, supranational debt (EU) and green bonds. This will lower the refinancing risk for bond issuers and provide steady liquidity whatever the stance of monetary policy. The structural bond purchases could cushion against liquidity issues in the secondary bond markets. ECB purchases should contribute to shrink asset swap spreads on covered bonds and agency bonds. At this juncture, we see no rationale for non-financial corporate bonds (except for green bonds) to be included in the future structural portfolio.

Conclusion

The new ECB policy toolkit builds on the experience of post-GFC monetary policy. The ECB will continue to play a central role in the functioning of money markets. A narrower rate corridor from September will help reduce volatility as the balance sheet continues to shrink. The ample reserve system will remain the norm with full-allotment refinancing operations. In addition, longer-term LTRO and a structural bond portfolio will provide steady liquidity injection after the end of QT. Lower interest rate volatility and downward pressure on spreads in short-term supranational and green bonds.

Axel Botte

Market review

Getting closer to rate cuts

The Fed is confirming that rate cuts are coming despite solid nominal growth. Global monetary policy will ease.

An intense week of Central Banks has just ended. The conclusion is that monetary easing is coming. The consensus in favor of three Fed rate cuts in 2024 has strengthened in the United States despite economic growth and inflation forecasts being revised upwards. The BoE is reversing the restrictive bias that still prevailed last month, in the wake of encouraging inflation data. The SNB lowered its policy rate to 1.50% in a bid to curb upward pressure on the swiss franc. On the contrary, in Japan, Ueda finally buried Kuroda's monetary policy by putting an end to negative rates and the control of long-term rates. The ambiguity lies in the BoJ's commitment to maintain an accommodative monetary stance through regular purchases of JGB to the tune of 6,000 billion yen per month. The dollar-yen exchange rate shot up above 150. In emerging countries, the Turkish Central Bank is leaning against the inflationary spiral by raising its repo rate by 500 bp. This monetary policy backdrop entails support to the equity markets. However, sovereign and credit spreads shed some of their recent performance. The US dollar remained quite strong across the board. Despite the rise in the value of the greenback, raw materials are progressing, a quiet reminder of the risks to price stability.

The Fed raised its year-over-year growth forecast for the 4th quarter to 2.1%. Forecasts for headline PCE inflation stands at 2.4% and 2.6% excluding volatile items. The 1st quarter data seems consistent with GDP growth slightly above consensus. Real estate developers have turned more confident, hence the pickup in housing starts (1.5 million at annual rate). Home resales jumped in February. Despite these promising developments, the Fed continues to believe in lasting disinflation, paving the way for a more accommodative monetary policy. The consensus within the FOMC is now converging towards a scenario of three rate cuts this year. Furthermore, the Fed indicates an upcoming adjustment to its balance sheet policy. We believe the Fed will halve the amounts not reinvested starting in May before reducing rates by 25 bps. In the United Kingdom, dissidents in favor of an increase have lined up behind a consensus favoring a future repo rate cut. The political agenda with general elections likely in October could argue for a preemptive rate cut. In the euro area, economic surveys are mixed. Disappointing PMI readings in France and Germany are contradicted by indicators from INSEE and IFO. The economies of southern Europe appear to post a stronger recovery.

The spread tightening trend faded at the end of last week. The decline in risk-free yields (4.20% on the T-note, 2.33% on the Bund) is accompanied by a widening in euro sovereign spreads of 2 to 5 bp depending on the credit quality. Profit-taking in the BTP sector thus sent the Italian spread on 10-Yr maturities above 130 bp. Swap spreads widened to some extent (+3 bp). Government bond issuance nevertheless continue to be well received by investors. For instance, the syndication of a 25-year EU bond drew €87 billion demand for just €7 billion issued.

The euro IG credit market is broadly stable in terms of asset swap spreads at 79 bps. Mutual fund flows remain supportive and transactions on the primary market are oversubscribed, although post-issuance spread tightening was limited in the secondary market. The lack of a new issue premium is the reason for subdued performance. As for high yield, investor sentiment seems to be deteriorating given several specific issues even as mutual fund inflows continued. The upbeat tone in the high yield market since the start of the year may fade as specific risks arise. More and more companies are hiring consulting firms over plans to restructuring their debts. The new iTraxx XOVER series (300 bp) ended the last week on a weaker tone. Given recent market action so far in 2024, profit-taking on high yield could result in a sudden trend reversal.

On the equity markets, the indices remain quite upbeat thanks to the announcements of Central Banks. US stock markets gained 2 to 3% last week, even as flows into funds recorded their largest outflow since December 2022. In European markets, real estate, banks and technology, in particular stocks linked to the semiconductor industry, are doing well. Nevertheless, mutual fund outflows seem unabated totaling €14 billion so far this year.

Axel Botte

Main market indicators

G4 Government Bonds	25-Mar-24	1wk (bp)	1m (bp)	2024 (bp)
EUR Bunds 2y	2.82%	-13	-3	+42
EUR Bunds 10y	2.32%	-14	-4	+30
EUR Bunds 2s10s	-50.5bp	-1	-1	-12
USD Treasuries 2y	4.6%	-13	-9	+35
USD Treasuries 10y	4.21%	-12	-4	+33
USD Treasuries 2s10s	-39.6bp	+1	+5	-2
GBP Gilt 10y	3.92%	-17	-12	+38
JPY JGB 10y	0.73%	-3	-8	-25
€ Sovereign Spreads (10y)	**25-Mar-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
France	48bp	+5	+1	-5
Italy	132bp	+11	-10	-34
Spain	84bp	+5	-4	-13
Inflation Break-evens (10y)	**25-Mar-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
EUR 10y Inflation Swap	2.21%	-4	+2	+8
USD 10y Inflation Swap	2.56%	+4	+5	+15
GBP 10y Inflation Swap	3.67%	+1	+8	+13
EUR Credit Indices	**25-Mar-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
EUR Corporate Credit OAS	114bp	+2	-5	-24
EUR Agencies OAS	60bp	+2	-2	-10
EUR Securitized - Covered OAS	66bp	+1	-3	-13
EUR Pan-European High Yield OAS	360bp	+24	+16	-39
EUR/USD CDS Indices 5y	**25-Mar-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
iTraxx IG	55bp	+3	+1	-3
iTraxx Crossover	305bp	+4	+0	-9
CDX IG	52bp	+3	+0	-4
CDX High Yield	319bp	-11	-21	-37
Emerging Markets	**25-Mar-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
JPM EMBI Global Div. Spread	346bp	-10	-30	-38
Currencies	**25-Mar-24**	**1wk (%)**	**1m (%)**	**2024 (%)**
EUR/USD	$1.082	-0.442	-0.221	-2.0
GBP/USD	$1.261	-0.904	-0.521	-1.0
USD/JPY	JPY 151	-1.408	-0.311	-6.7
Commodity Futures	**25-Mar-24**	**-1wk ($)**	**-1m ($)**	**2024 (%)**
Crude Brent	$85.8	-$1.1	$5.0	11.8
Gold	$2 167.9	$7.8	$139.1	5.1
Equity Market Indices	**25-Mar-24**	**-1wk (%)**	**-1m (%)**	**2024 (%)**
S&P 500	5 234	2.29	2.86	9.7
EuroStoxx 50	5 030	0.95	3.24	11.3
CAC 40	8 148	0.00	2.27	8.0
Nikkei 225	40 414	4.41	3.36	20.8
Shanghai Composite	3 026	-1.90	0.71	1.7
VIX - Implied Volatility Index	13.63	-4.88	-0.87	9.5

Source: Bloomberg, Ostrum AM

Additional notes

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