Corporate & Investment Banking

BBVA Sovereign Bonds Strategy

Discussion topics on euro money markets developments

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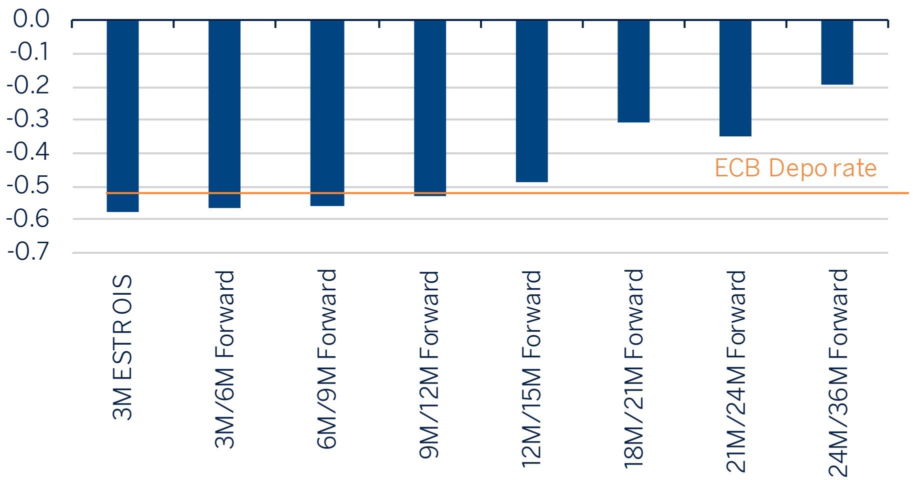
EONIA/ESTR transition: spot trends and market expectations

In the spot realm, EONIA references have been gradually moving out of the picture to the benefit of ESTR-linked contracts. The recent CCPs full migration to ESTR in mid-October should lead to their final disappearance. The transition from the former to the latter doesn't seem to have prompted any distortion either in spot or forward pricing.

As of now ESTR forwards remain fairly anchored up to 12M. Thereafter the curve is discounting some uptick.

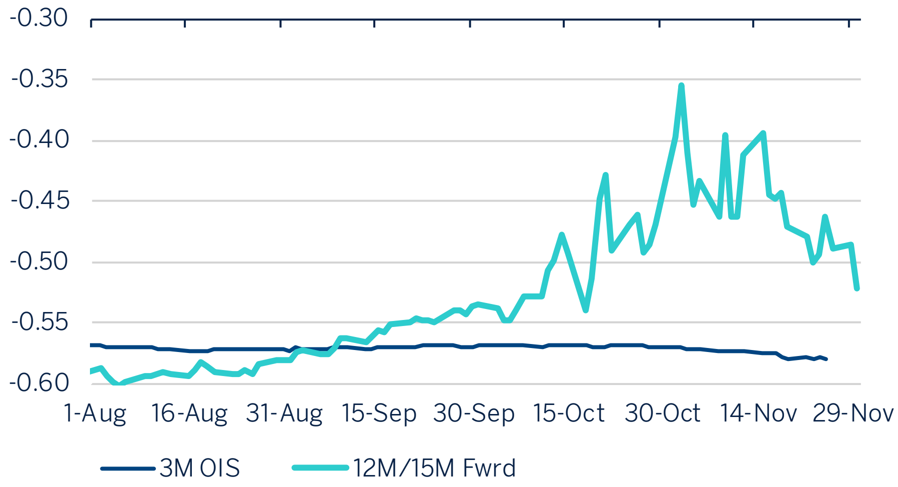
ESTR OIS spot & forwards as of 31 November (%)

Source: BBVA Global Markets Strategy based on Bloomberg



ESTR OIS spot vs. 12/15M forward (bp)

Source: BBVA Global Markets Strategy based on Bloomberg



2 Oct 20- €STR kicks off
First operations related to €STR

EONIA calculation methodology changes to €STR+8.5bp

2H20
CCPs start using €STR as the discount and remuneration curves

15-16 Oct 21
LCH, EUREX, CME transition to €STR goes-live
Significant increase in €STR values as EONIA, in practical terms, is discontinued

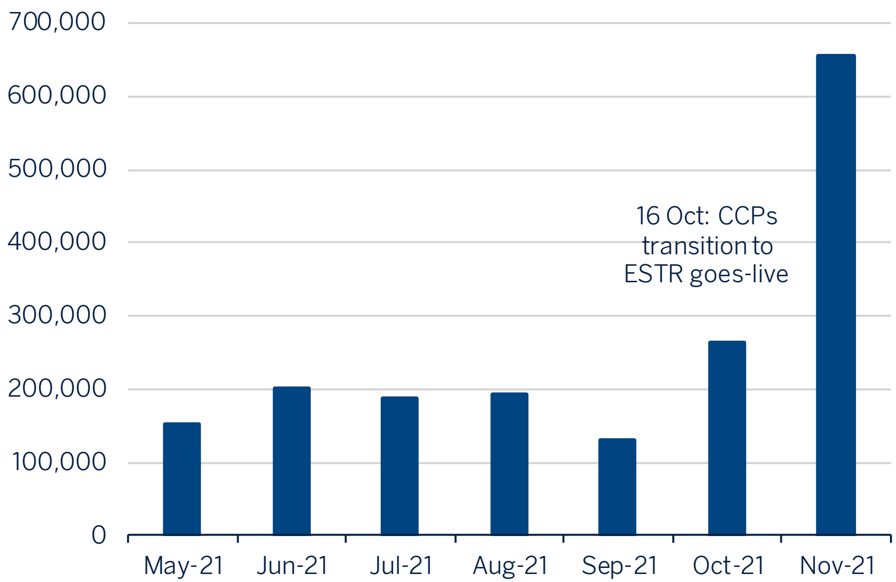
January 2022
Discontinuation of EONIA – slight increase in trading volumes

EONIA/ESTR transition: rising volumes but concentrated in the short area

ESTR activity in swap markets has risen significantly since the migration of CCPs from EONIA to ESTR on 16 October. However, most of the activity remains concentrated in 1Y and 2Y with little flows in longer tenors.

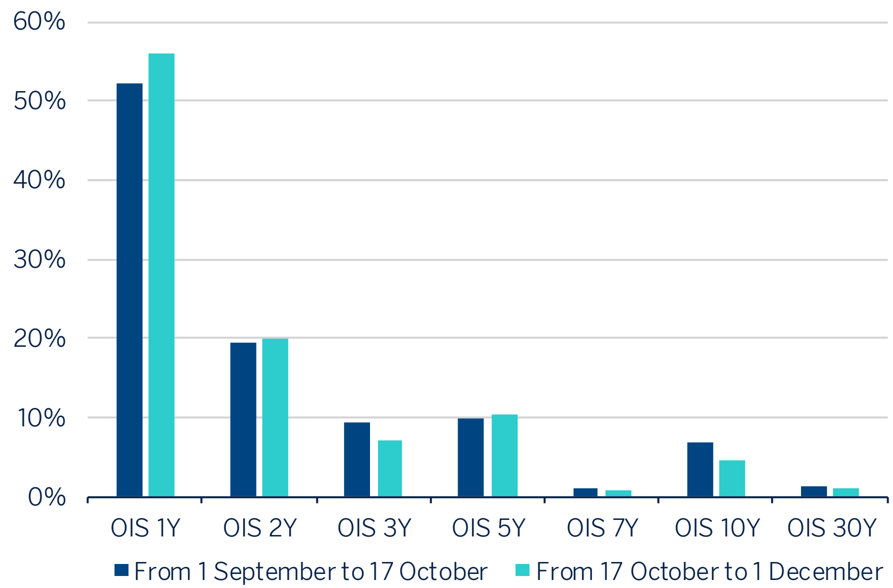
ESTR OIS swap volume (EUR bn)

Source: BBVA Global Markets Strategy based on Bloomberg swap data repository trade activity



ESTR OIS swap distribution by tenor (%)

Source: BBVA Global Markets Strategy based on Bloomberg swap data repository trade activity



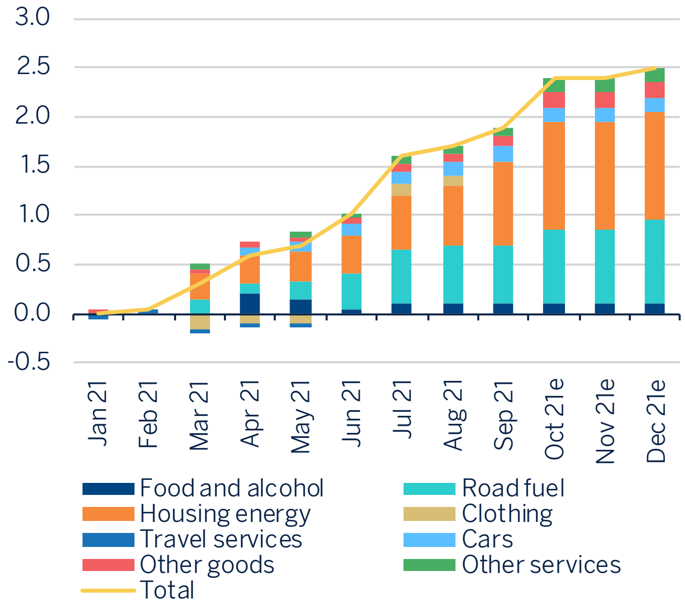
Market expectations: inflation, how much of a concern is it for the money markets?

Although the acceleration process in inflation may not be close to exhaustion, two elements continue to support the "mainly transitory" feature of this phenomenon:

1. most of the upward surprise in actual inflation data reflects a very specific (exogenous) set of factors;
2. second round effects have so far proved rather limited in both absolute and comparative terms.

EMU inflation: deviation from Jan 2021 consensus forecasts and contribution by components (pp of YoY change)

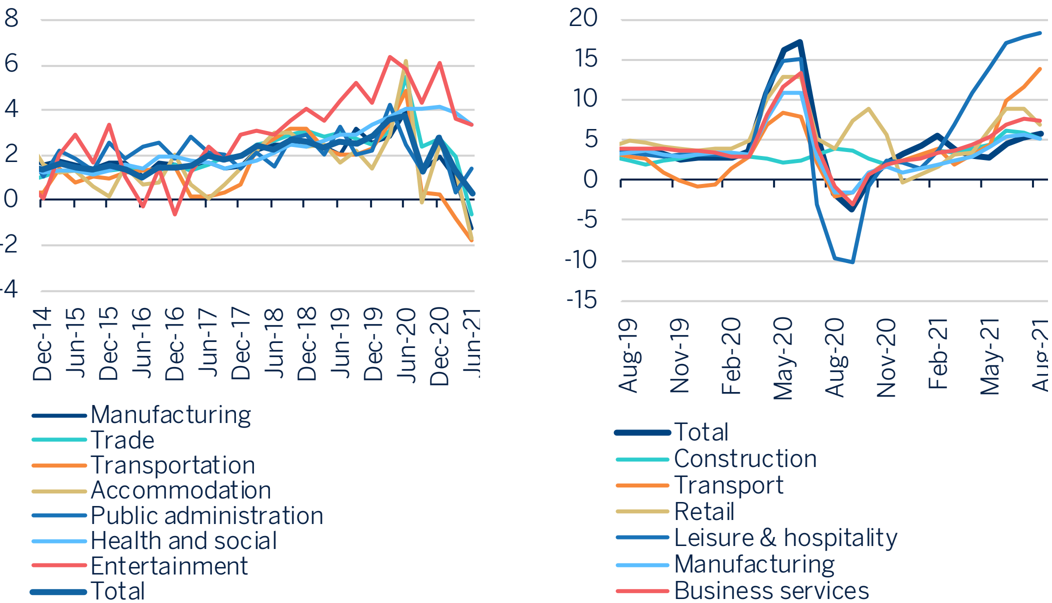
Source: BBVA Global Markets Strategy based on Bloomberg



EMU and US labour costs* (% YoY)

* EMU: Labour cost index. US Average hourly earnings

Source: BBVA Global Markets Strategy based on Eurostat and Bureau of Labour Statistics

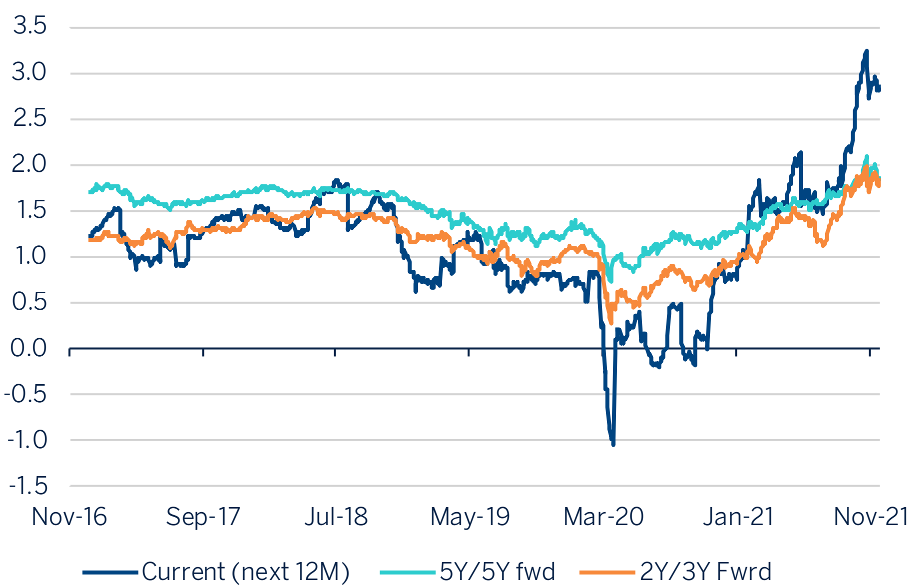


Market expectations: Inflation, how much of a concern is it for the money markets?

Despite reflecting the short-term risk of inflation spikes, both market-based and expert-view inflation gauge indicators reflect a medium-term perspective that inflation will reverse to a range below the target. Recent inflation figures do not appear to have overwhelmed the ECB and should not trigger any bold change to its monetary policy approach

Euro implicit annual inflation expectations (% YoY)

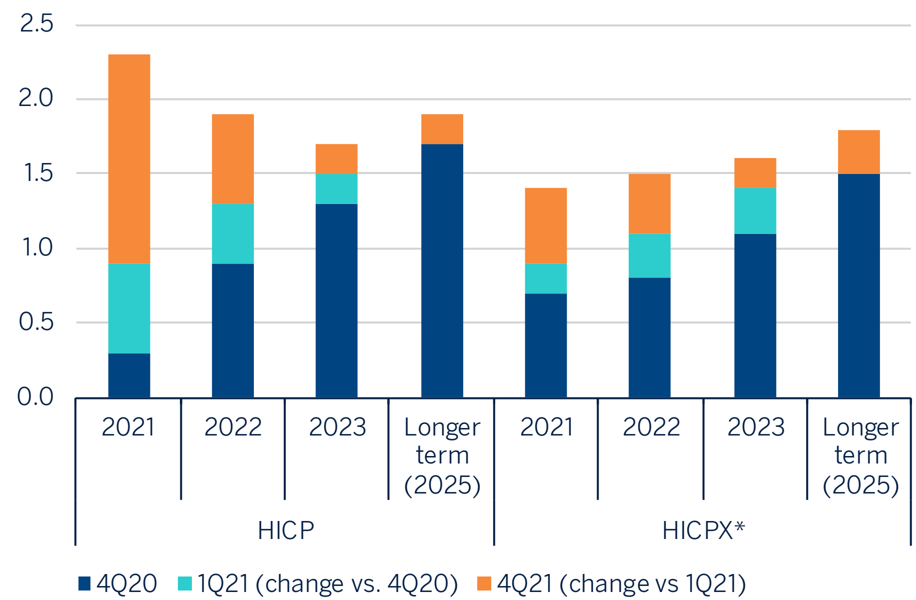
Source: BBVA Global Markets Strategy based on Bloomberg



EMU annual inflation expectations by professional forecasters (% YoY)

*HICP inflation ex energy, fresh food and tobacco

Source: BBVA Global Markets Strategy based on ECB

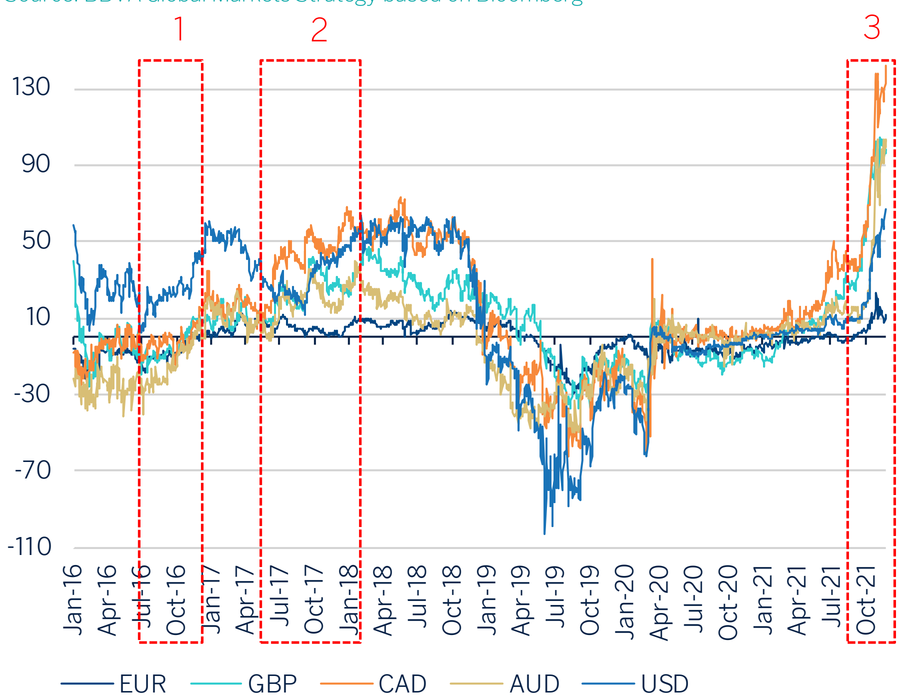


Spikes in ESTR forwards: 1.- how much is due to domestic factors vs. a contagion effect from other CBs?

The spike in the ESTR forward rates observed in October, relevant as it is, has been more contained than in the rest of curves. In our opinion, this spike did not materialised until there was a generalised and intense repricing of hawkish expectations all across the CBs. This “contagion effect” did also take place (albeit with less intensity) in late 2H16 and 2H17 (kick off and extension of the last Fed tightening cycle).

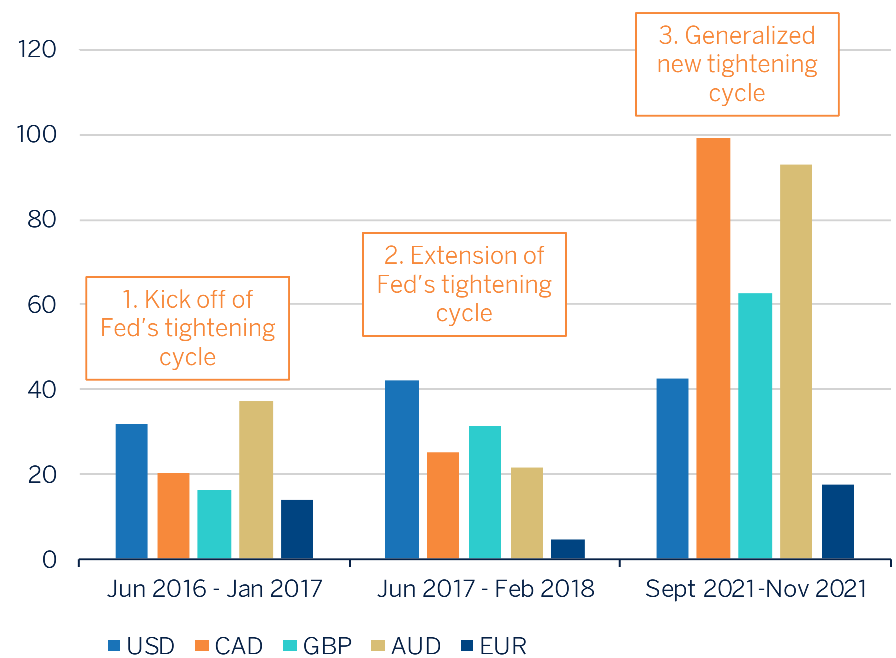
3M OIS spot vs. 12/15M forward spread (bp)

Source: BBVA Global Markets Strategy based on Bloomberg



Change in the 3M OIS spot vs. 12/15M forward in selected periods (bp)

Source: BBVA Global Markets Strategy based on Bloomberg



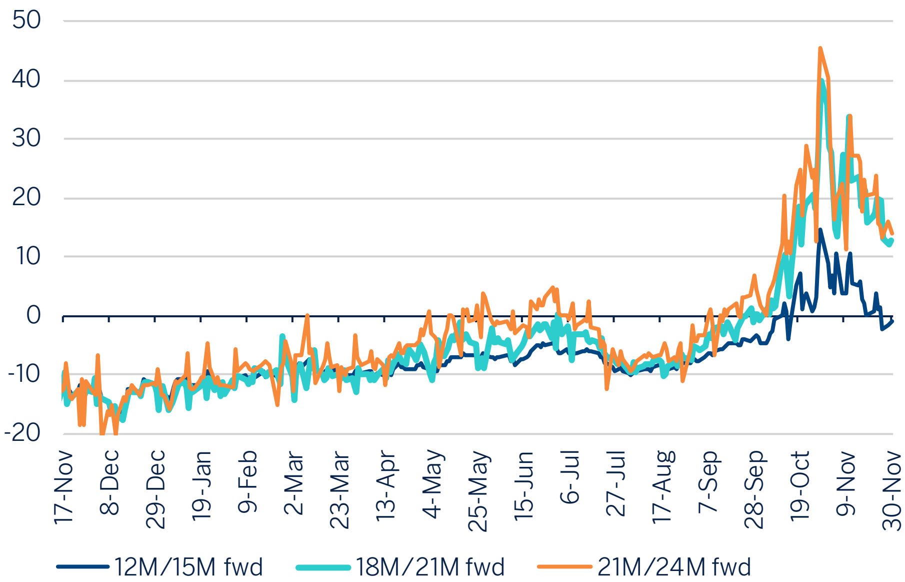
Spikes in ESTR forwards: 2.- reflecting pure ECB rate expectations or eventual changes in the liquidity realm?

ESTR forward rates may not only be reflecting expectations about the ECB's future rate policy but also eventual changes ahead in the liquidity realm. There are two elements to highlight in this context:

1. although short-term forward ESTR rates have reversed a great part of the pervious spikes, long forwards remain relatively high;
2. ESTR-Euribor spreads (which do not reflect rate expectations but rather the outlook on the abundance of liquidity and its cost) are now at significantly higher levels.

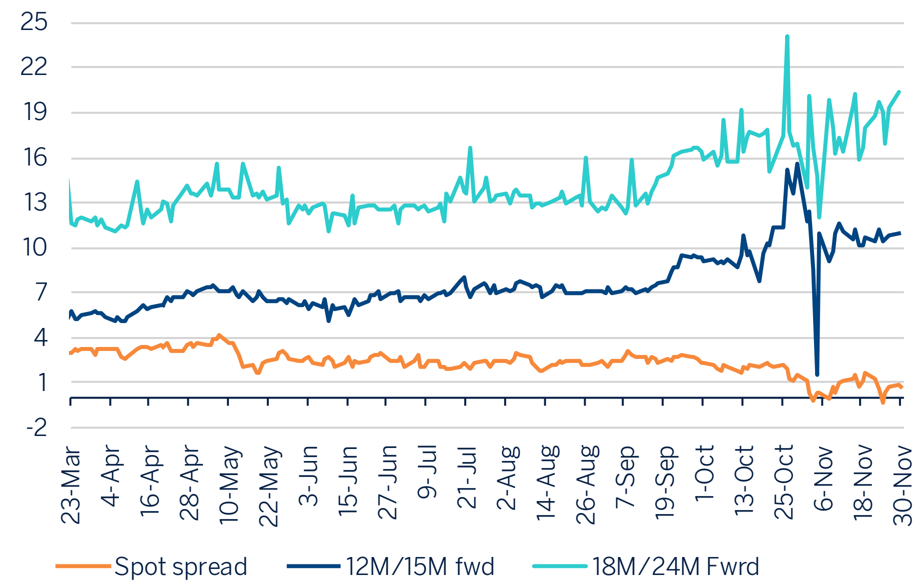
Spread between 3M ESTR OIS forwards and ECB depo rate (bp)

Source: BBVA Global Markets Strategy based on Bloomberg



3M Euribor-3M ESTR OIS spread (bp)

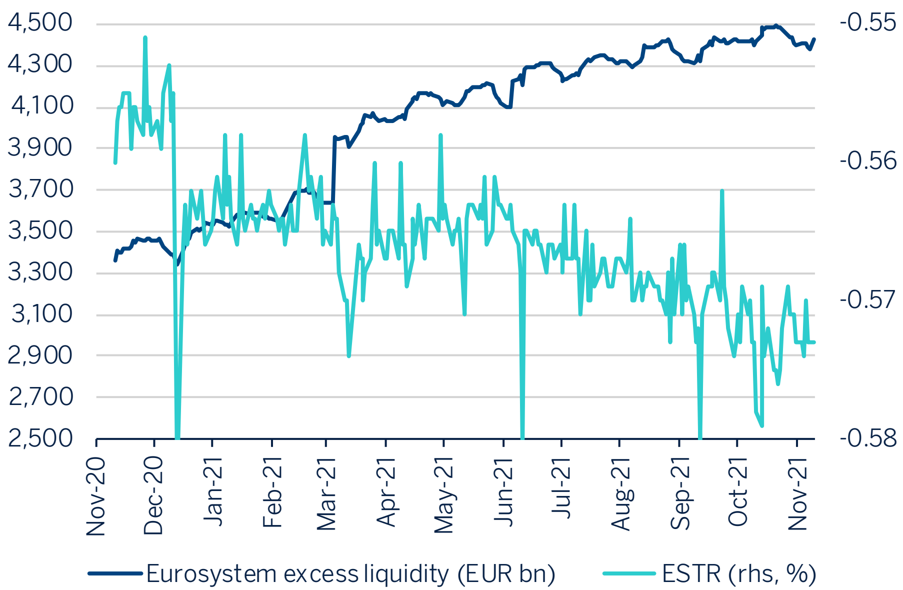
Source: BBVA Global Markets Strategy based on Bloomberg



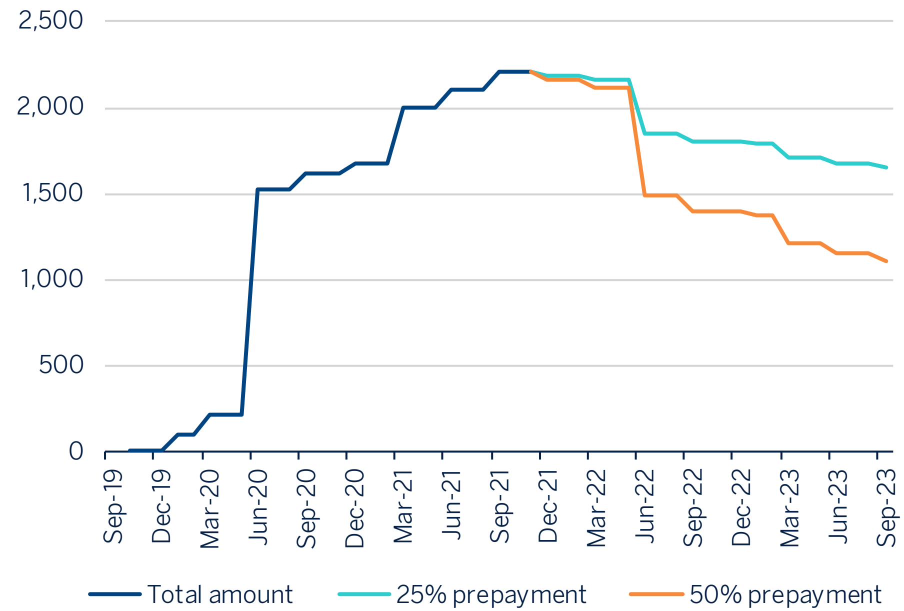
Maintaining the abundant liquidity scenario after 2022 may become somewhat more challenging

Market's expectations about the amount of excess liquidity could weigh on ESTR rates. In this regard, banks may start finding some incentives to make early repayments after 2H22 (at least those for which the NSFR assessment may represent an issue).

ESTR (%) vs. Eurosystem excess liquidity (EUR bn)
Source: BBVA Global Markets Strategy based on Bloomberg



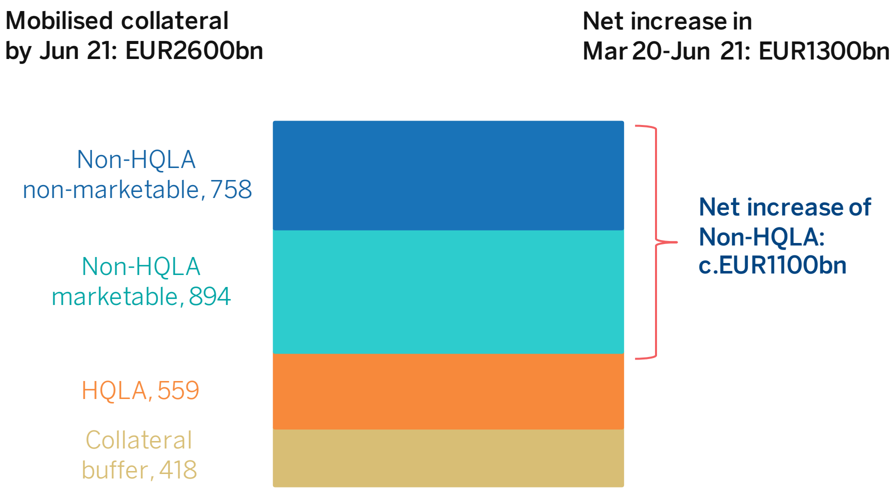
TLTRO III potential reduction risk scenarios* (EUR bn)
* Assuming that from June 2022 onwards TLTRO operations starting to have less than one year of remaining duration are prepaid
Source: BBVA Global Markets Strategy based on Bloomberg



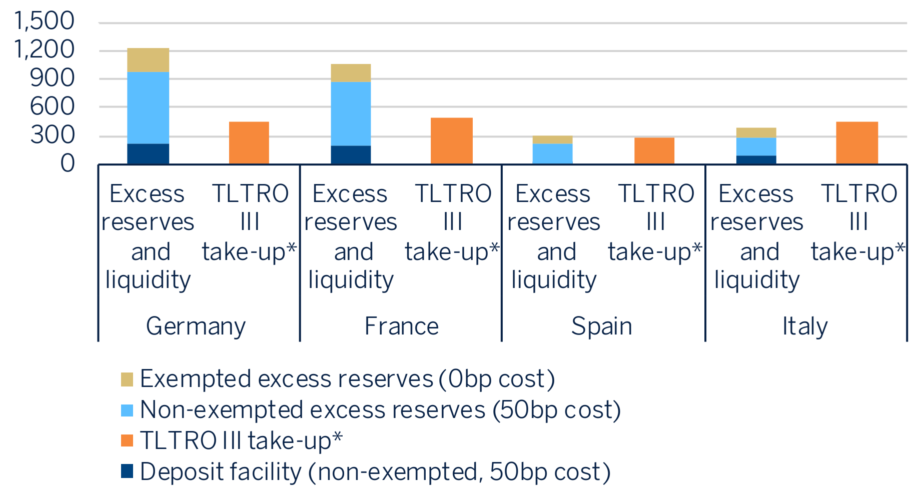
TLTRO III + collateral easing measures: a highly effective (and still warranted) instrument

Apart from their bank-lending fostering role, the combination of TLTRO III operations + easing of collateral rules: i) has proved highly effective in "mobilising" a sizeable volume of assets; and ii) has served as a way to compensate for the ECB's "depo rate cost" to those banks with a high volume of non-exempted excess reserves (a proxy for Tiering?)

TLTRO III collateral encumbrance (total outstanding as of June 2021 and change from Mar 2020, EUR bn)
Source: BBVA Global Markets Strategy based on Bloomberg and ECB



Excess reserves and TLRO III take up in selected countries (EUR bn)
*TLTRO III operations offer a net margin of +50bp if the lending target is met
Source BBVA Global Markets Strategy based on Bloomberg and ECB



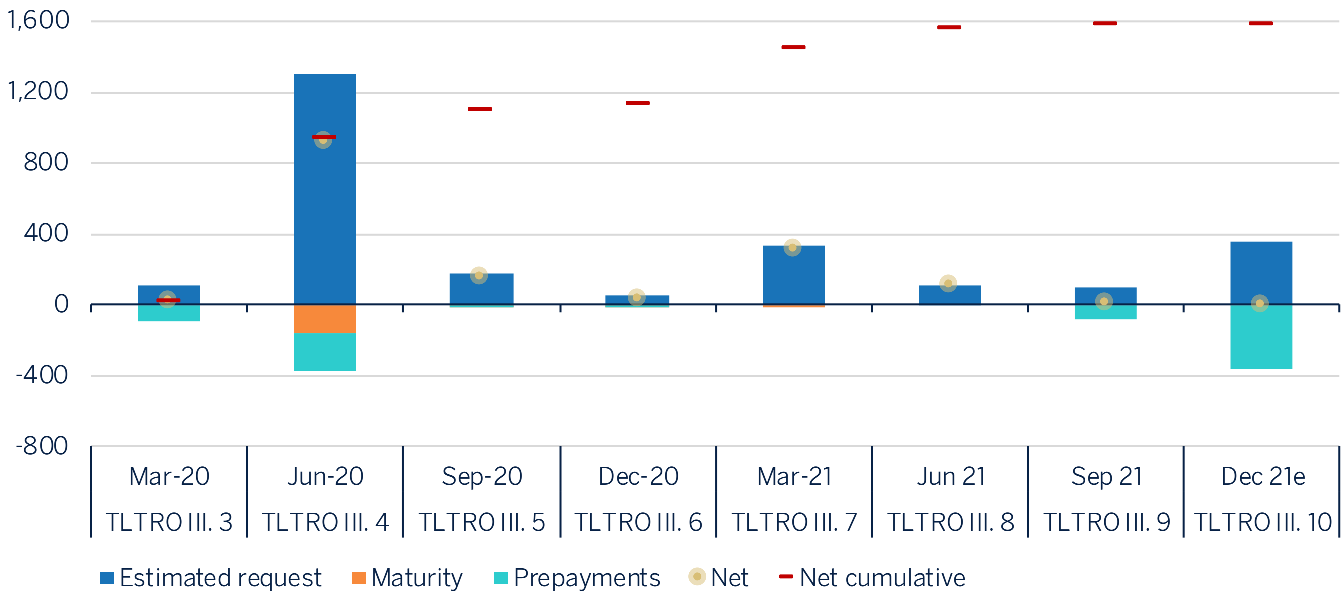
Pure price effect: collateral easing measures have increased the value of collateral by c. EUR240bn (c.EUR180bn in credit claims)

Incentivising effect: wider acceptability and lower haircuts of non-High Quality Liquid Assets (HQLA) have fostered c.EUR1.6trn of collateral mobilisation of these assets (c.EUR1.1trn increase from pre-pandemic levels)

We do not expect a large rollover of the liquidity taken up in the TLTRO III.1 to .6 into the TLTRO III.10

TLTRO III: scheduled operations and estimated take-up (EUR bn)

Source: BBVA Global Markets Strategy based on Bloomberg



We believe that the "implicit cost" of the early repayments will discourage the "repay to rollover" strategies in the TLTRO III.10 (tentatively only c.20% of rollover, c.EUR350/380bn).

Some proposals on discussion topics about where the liquidity policy should focus

What is now in force?

Collateral easing measures implemented since March 2020

..on credit claims collateral

Less stringent reporting requirements

Removal of minimum eligible size

Eligibility expansion of additional credit claims

...on Eurosystem risk tolerance

Lower haircuts

Waiver on Greek sovereign bonds

Increase in concentration limit for unsecured bank bonds

Extraordinary features in the TLTRO III

Cost: up to June 2022, a 50bp positive margin is applied to the gross liquidity take up if lending targets are met and 0% thereafter.

Volume: maximum borrowing capacity raised from 30% to 55% of eligible loans

Standard rates policy

Refi rate at 0%, Deposit facility rate at -0.50%

Tiering (6x minimum reserve requirement)

A tentative approach to what can and cannot be fine tuned in the current or potentially new TLTRO programmes from our point of view

Not a major game changer in the event it is wound down

Still a key (highly warranted) element to foster collateral mobilisation

Not a major game changer in the event it is wound down

Discouraging early repayments after June 2022 and/or incentivise fresh take in eventual new instruments in 2022

The early repayment of the TLTRO III.1 to .6 before June 2022 has an embedded "cost". This may disincentivise "repay to rollover" strategies.

The period when the 50bp margin is applied can be extended beyond June 2022 (this could include new lending targets).

No need to widen the net margin of 50bp

A new funding for lending programme might be convenient in 2022

No need to intervene on the standard rates. The dual rate policy can be fine-tuned through the TLTRO effective cost

No need to tweak the tiering unless the deposit rate is altered

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