What is unwarranted

EUR liquidity and short rates

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- Short EUR rates are on the rise once again, only unlike the December movements, there's nothing obvious in the calendar to reverse it.
- The ECB was firmer than usual, but still vague in terms of pre-commitment. However, unwarranted increases in short rates were explicitly highlighted by Mr. Draghi last week.
- The Euribor 3M fixing now prints 30.2bps - the highest since August 2012 – and the 1M EONIA swap traded just 3bps below the refi earlier today.

Receive the short end EONIA's now. We see the chance for a reduction in short term rates likely. It could stem from several sources. Firstly, organically by banks taking more on 1W (Tuesday) / 3M operations and repaying less on 3Y operations, or ECB partially failing to sterilize SMP holdings. Secondly, by the ECB taking action: The most likely tools here are a refi-rate cut, or end sterilizing SMP-holdings.

The easing bias

We have long seen the ECB as having a strong easing bias. The likelihood for impending action is certainly on the rise. Last Thursday Draghi was in rare form:

Two explicit action-prompting variables

"….we think that there are two scenarios that would cause us to act: one is unwarranted tightening of the short-term money markets, and the other is a worsening of our medium-term outlook for inflation…"

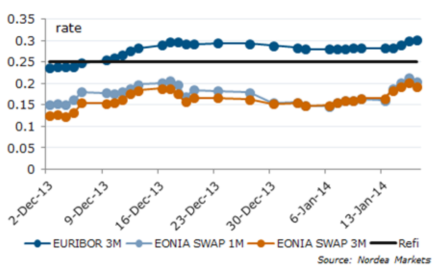
In the ECB world, this is immensely firm, even though there's no definition of what *unwarranted* exactly means.

Since then, we have seen both Euribor and EONIA fixings moving up rather starkly, the 3M EURUSD xCcy basis re-entering positive territory, and excess liquidity dropping quickly. The result of it all looks like a squeeze.

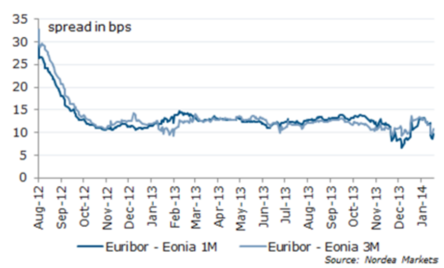
Recent market pricing and implications

The charts below show firstly the recent moves in the 3M Euribor fixing and the 1M and 3M EONIA swaps, and secondly gives the spreads of short EONIA swaps vs. the Euribor 3M fixing going back to Draghi's "whatever it takes".

1. Recent short rate history



2. Euribor v EONIA since *the speech*



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As illustrated in chart 1, Euribor 3M now trades higher than in December (and is at a year and a half high). Further, short EONIA swaps also trade higher. The 1M EONIA swap got as high as 22bps earlier today, an extremely tight level relative to the refi-rate.

Short EONIA swap rates are near their "cap".

Both the 1M and 3M rates are (risk-adjusted) expectations of the O/N fixings spanning the respective periods. While the O/N fixings often exceed the refi, due to period-ending reasons (it printed 44.6bps on 31/12 for instance), averages of them don't, and indeed wouldn't make sense. Therefore, both 1M and 3M rates are effectively capped by 25bps. [1 2] It is notable for short EUR FRA/OIS' that the Euribor rate "is free" to move north. However, such a move is implied in forwards already, cf. chart 6.

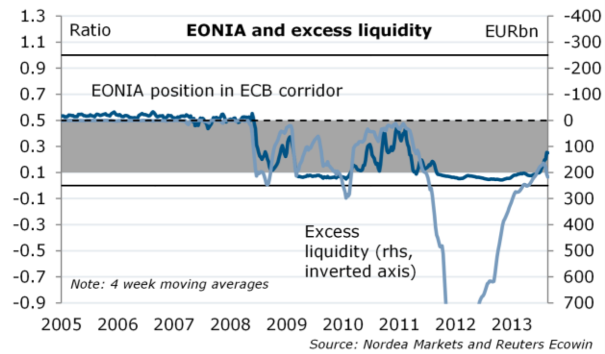
The downward trajectory in chart 2 is not surprising of course. Most potently perhaps, the Eurozone excess liquidity was in Aug12 around 750bn against 131bn per 16/1/2014. Note however the pace of redemptions seems to be waning: Very strong in late 2013, today's early redemption figure was just 990.5m, the lowest since October. Still, a wildcard here is the times where the two 3Y LTROs have less than 1Y remaining, and that time is coming up later this month for the first of the two.

What is unwarranted to the ECB?

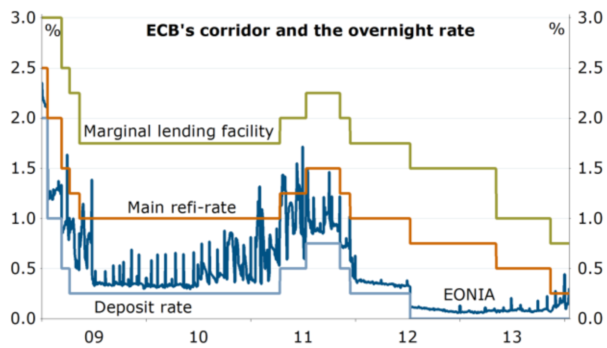
We believe the ECB is concerned with the recent tightening of monetary conditions, as mentioned by Mr. Draghi at the January Governing Council meeting. Still, the exact phrase used toward monetary conditions at the press conference was *monitor closely* rather than *very* closely, which suggests that the ECB can live with the current money market conditions, but not further tightening.

Monetary conditions include the money market rates, which have increased around 10 bps as mentioned above, but also the EUR, which is in the high end of the recent trading band vs the USD. Thresholds to watch – though the ECB has explicitly said that their tolerance towards tighter monetary conditions will depend on the circumstances – could be 32-33 bp for 3M

3. Lower excess liquidity and higher EONIA…



4. … makes the refi rate more effective



Source: Nordea Markets and Reuters Ecowin

[1] The shorter swaps can exceed the refi. The 1W swap rate did so in December for instance. A special situation needs to be present, e.g. four close to end of year dates, and the final day of the year.
[2] This "cap" is for a sizeable excess liquidity. If there was no excess liquidity and no full allotment on standard liquidity operations, it's another matter. Pre-Lehman, EONIA traded about 5-7bps above the refi.

Euribor and 1.3835 in EUR/USD.

Inflation falling below the October low of 0.7% y/y in the coming months is another factor that could trigger more ECB easing. The most likely easing step from the ECB is a refi rate cut, in our view. The refi rate has become more important, as the EONIA has moved higher in the ECB's corridor and excess liquidity has dropped.

A refi cut now will unlike those in 2013 have a closer to 1:1 impact on EONIA rates

A 10 bp cut in the refi rate would most likely take the EONIA down by close to 10 bp at this point, whereas the effect was much more limited when the refi rate was cut in May and in November 2013.The next step for the ECB, say if the EUR continues to strengthen even after a refi rate cut, could be to cut the deposit rate by 10 bp. The deposit rate is less important now than during most of 2013, as the EONIA is trading in the high end of the ECB's corridor and excess liquidity has dropped. Moreover, the ECB would probably set limits for the use of the current account facility with zero interest rate in a way that makes it able to control the exact amount of excess liquidity eligible for negative deposit rate.

Still, a cut in the deposit rate is likely to lead to somewhat lower EONIA and will have a strong signaling value. Thus, by taking the deposit rate to negative territory the ECB would once again prove its willingness to take unprecedented steps to facilitate a recovery in the Euro area and would clearly indicate that policy rates will remain low for very long.

Apart from a refi-cut, lack of SMP-sterilization is a likely pragmatic tool

Apart from the standard tools, the ECB may judge – perhaps with the assistance of the Money Market Contact Group – that the current level of excess liquidity is not high enough to have fully functioning money markets given the fragmentation in the Euro area. In that case, the ECB could decide to add more liquidity by not sterilizing its SMP holdings (freeing up 179bn of excess liquidity) or cutting reserve requirements (freeing up 103bn of excess liquidity).

In term of immediate action from the ECB these latter options, along with refi-rate cut, are the most likely. **All will impact EONIA fixings and short EONIA swaps downwards.**

"Here and now" recommendations

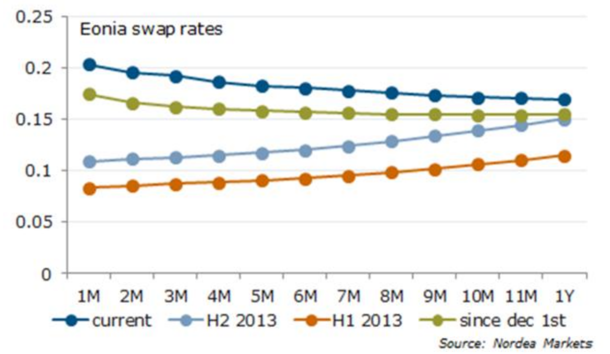
We recommend receiving in short EONIA swaps

We recommend receiving in short EONIA swaps at current levels. The risk/reward is asymmetric in that the downside is limited to the distance to the refi (or marginally above). A solution to the current squeeze can take an organic form, through the actions of market participants, e.g. by higher uptakes on the extant liquidity operations, and it can also come from the ECB easing if things are deemed unwarranted. Finally, it can come in between, as a result of a less than full SMP-sterilization. In many senses this is actually a very likely pragmatic outcome.

1M EONIA swaps should not trade this close to the refi, and we recommend receiving 1M @20.5bps.

Given the stickiness of Euribors, we also see some potential in FRA/OIS wideners, which especially should perform if the ECB cuts the refi-rate by 10-15bps and leaves the deposit rate unchanged at zero.

5. EONIA term structures – higher and flatter



6. EUR FRA/OIS term structure