Global Views

1 July 2010

The View Ahead: ECB liquidity tightens up

So it is not the end of the world, as European banks only borrowed EUR132b for three months at 1% from the ECB, down from the EUR442b borrowed for a one-year term twelve months ago. The number of banks involved was also only 171 compared to 1,121 a year ago. Many analysts, including my London colleagues, were expecting a liquidity injection of around double this amount. The size of the injection was viewed as an indicator of banking stress since banks were not limited in how much they could borrow provided they posted collateral.

Still, borrowing at 1% for three months represents a penalty that only banks experiencing funding stress should be prepared to pay since 3M EUR LIBOR is quoted at 0.77%. One year ago, when the first big 12-month term LTRO was allotted at 1%, 12M EUR LIBOR was 1.50% and 2-year Bund yields were 1.36%, so accessing ECB funds was a no-brainer opportunity. Banks piled in whether they needed the funds or not and used the excess money to buy low-risk assets.

Nevertheless, the market is viewing the Wednesday outcome as better than expected, although clearly it does still reveal significant funding stress. It appears that the liquidity in the system will be reduced significantly, although there are a variety of other factors that will affect daily liquidity, including a special 6-day operation tomorrow. Understanding the fine detail of ECB liquidity operations is not straightforward. I refer you to the comment from Nick Matthews (Higher risk of a temporary back-up in EONIA).

There is some risk that the lower level of excess liquidity will place upward pressure on money market rates in the Eurozone. In fact, that has happened in the lead-up to this LTRO. This has contributed to higher yields across the front of the curve in the Eurozone for LIBOR, swaps and bunds. The result is a high cost of carry for short EUR positions. It is unlikely that the ECB will allow rates to continue to rise against the other majors, but in effect policy has been tightened in the last month, and this is a factor that may be supporting the EUR.

However, tighter ECB policy will be viewed as inappropriate and the market will view higher rates in EUR as reflective of higher risk. As such, the positive impact on the EUR should be muted. The EUR rose following the ECB LTRO, but it failed to rise much above 1.23, and fell back to be only modestly firmer. The news that Moody's has Spain under review for a possible downgrade reminded the market of the sovereign debt problems.

Lower yields in the US on fears of weak job growth are helping keep EUR up against the USD. Perhaps for the near term we should expect the EUR to mark time. The market is also waiting to see the result of the European bank stress tests expected in late July.

Research Team
Global Strategy

We continue to see bigger problems in the EUR banking system and Government debt markets than other majors and this will ultimately involve capital leaking out of the region and more liquidity support and asset purchases by the ECB. As such we are biased towards shorting the EUR.

We continue to look for relatively safe alternatives, such as the CHF and SEK, which are untroubled by tight credit conditions and are experiencing stronger domestic demand growth. In this respect I am watching with more interest than normal the Riksbank rate decision Thursday, where a 25bp hike to ½% is expected. **Greg Gibbs**

Ahead today

UK PMI, Jun (08:30 GMT): The PMI should ease a touch to 57.5.

US ISM, Jun (14:00 GMT): In June, the ISM gauge may have been little changed at 59.5, suggesting little loss of momentum in the factory sector.

Central banks: 08:30 GMT BoE's Credit Conditions Survey; 15:00 GMT ECB's Stark speaks

G10 data calendar
EM data calendar

Overnight news

China PMI, Jun: The official PMI was below expectations, falling from 53.9 to 52.1, which put it broadly back at its February level. The HSBC PMI was weaker, falling from 52.7 to 50.4.

Japan Tankan, Q2: The Tankan beat expectations, rising from -14 to 1 for manufacturing on broad-based improvement. This reduces pressure on the BoJ to ease policy further, although the Government will still press for more action.

South Korea PMI, Jun: Manufacturing eased to 53.3. Separate data showed exports up 32% over the year to June, easily beating expectations.

Australia retail trade, May: Sales matched expectations with a 0.2% rise, with the more reliable large store series up 0.7%.

Australia building approvals, May: Approvals were unexpectedly down 6.6% due to a sharp drop in the volatile approvals for apartments category.

Today's views

US rates: Buy dips and extend is still the larger view. Look at the 10s-30s curve at 101bp or wider as a potential curve point to do this. Shorter term, it is not unreasonable to see some consolidation outright into the data with short term momentum overbought.

Japan rates: 10Y JGB yields breached 1.1%, which was another important resistance level, falling to 1.08%. The collapse in equity prices, combined with accelerated buying in the global bonds, has created strong tailwinds for JGBs, particularly the long end. Month-end buying from pension funds added fuel to the fire. JGB-friendly factors such as mounting worries about the global economy and further falls in the overseas bonds should drive JGB yields down towards 1%, but watch whether domestic investors sell on strength early in the new quarter after the rally of recent weeks.

FX: Canadian economic reports have lost momentum. In the last week, retail sales and GDP for April were weaker than expected. Rate hike expectations for the year ahead have been whittled back by around 40bp to 75bp. As global growth expectations are revised lower, the higher-yielding commodity currencies have seen significant falls in their yield advantage against the major currencies that have less room to adjust rates. Perversely, EUR rates have risen against the global trend, but it remains to be seen if this will support EUR. We might expect risk aversion trading to continue to dominate as we head into payrolls, boosting the JPY and CHF. It will be interesting to see how the ECB special six-day liquidity operation goes today and whether the Riksbank has the chutzpah to hike rates.

Emerging markets

NJA: The CNY has appreciated by 0.65% against the USD after the PBoC's policy shift. The pace appears unsustainable and we expect more two-way moves post the US Treasury report. Adding to market jitters was the poor China PMI data. The KRW weakened despite record June exports and easing inflation. We expect it to start outperforming once the BOK raises rates embarks on its tightening path. Long-end SGS continued to rally with the bullish sentiment underpinned by flush overnight liquidity and the ongoing rally in USTs. While there could be a retracement in the near term, further performance in long-end SGS can be expected. Our UST strategist has a 2.75% target on 10Y USTs and should that level be hit, long-end SGS fall a further 10-15bp. The RBI will announce later this week plans to raise the foreign investment limit in Government and corporate bonds to encourage capital inflows. Currently, foreign investors can own up to USD5b of Government bonds and USD15bn of corporate bonds. This is a positive for the Government bond market, but the impact should be more pronounced in the FX space.

Latam: In Argentina, we are revising upwards our GDP forecast for 2010 to 7% from 4.4%. As authorities perceive that they have a fighting chance in next year's elections, they are likely to keep fuelling the consumption boom. This policy stance is aided by benign weather conditions and strong car demand from Brazil. This "full throttle" growth strategy is likely to exacerbate distortions in the economy, leaving problems for the next Administration. In Colombia, we have had a bullish credit view on expectations of renewed economic reform from the incoming Santos Administration and the subsequent dual investment grade rating. We have recommended the convergence of Colombia to its high-grade peers with the most value on the long end of the curve. Recent comments from Moody's suggest convergence within 3-6 months. The USDCOP rallied on the news and a positive credit shock supports further currency strength in the medium term even after recent gains (we forecast the USDCOP to reach 1,700-1,800 in next 6 months). Together, structural flows into the oil sector and a conservative FX intervention policy leaves the downside open for the USDCOP. In the short-term, the COP is hostage to the external environment, together with the rest of LatAm.

Media

[EU agrees tough new bonus guidelines - FT] http://strategy.rbsm.com/disclosures - View this page for additional Important Disclosure Information for Research Recommendations including Recommendation history.