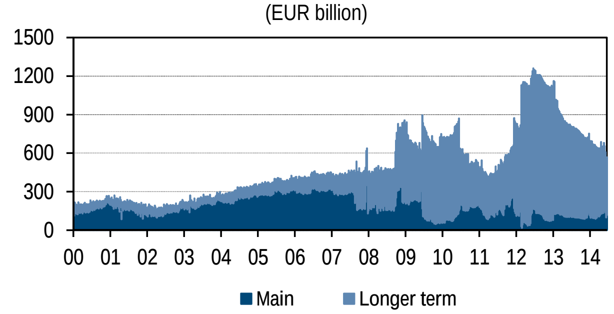
Disappointing take-up of new ECB loans

Flash note from Multi-Asset Solutions | 18 September 2014

SUMMARY

- Banks take up EUR 82.5 billion of ECB TLTROs
- Market reactions muted
- Muted interest should increase the call for more asset purchases

ECB refinancing operations
(EUR billion)



Source: ECB, BNPP IP

"Any treasurer who doesn't make use of this offer is making a big mistake"
Ewald Novotny, governor of the Austrian central bank, commenting on Bloomberg on 28 August on the ECB's TLTROs.

Today, the ECB announced how much banks will borrow under its new Targeted Longer-Term Refinancing Operations or TLTROs. The 'targeted' part is that the maximum banks can borrow is tied to banks' outstanding loan volume; next year it will even be tied to the amounts of new credit extended. The maximum banks could take up in the September and December offering is EUR 400 billion. Estimates of this month's take-up had centred around EUR 150 billion, with anything below EUR 100 billion seen as disappointing. The actual number was EUR 82.5 billion. So perhaps some people made a 'big mistake'?

WHY DID MARKETS NOT REACT NEGATIVELY?

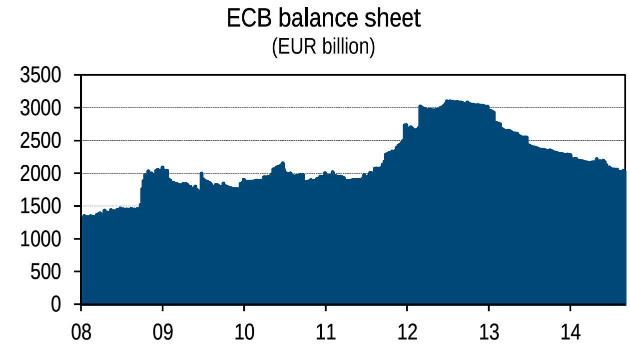
Equity markets were higher at the end of the day after what should have been disappointing news. There may be several explanations:

- Banks do not need the money. Banks, especially in the core eurozone countries, have now repaid most of the long-term loans (LTROs) the ECB provided to the banking system between 2008 and 2012. In June 2012, the Long-Term Refinance Operations peaked at above EUR 1 000 billion. At that time, the ECB's balance sheet exceeded EUR 3 000 billion. But this has shrunk now that banks have repaid the loans. Currently, there are EUR 372 billion of loans outstanding. The terms of the new loans look attractive enough. The interest rate to be paid is the refi rate plus 10bp, which amounts to just 0.15% annually until September 2018.

- The carry trade is now less attractive. Back in the summer of 2012, Italian two-year yields were at 4% and Spanish yields even at 5%. Currently, those yields are only at about 0.35%. Thus, the carry trade has become less attractive, even if banks buy longer maturity government bonds and risk a maturity mismatch.

- This is just the first tranche of the TLTROs. A second tranche tied to credit outstandings will follow in December. Perhaps banks want to wait until December, when the ECB's Asset Quality Review is done and the results are out.

- The disappointing outcome could increase the call for additional asset purchases by the ECB. At the news conference after the ECB's monetary policy meeting earlier this month, president Draghi said he wanted to expand the size of the ECB's balance sheet to EUR 3,000 billion again. This would require adding EUR 1,000 billion. The more the TLTROs come in below the ECB's assessment of up to EUR 850 billion for the quarterly tranches this year and until mid-2016, the greater could be the need for the ECB to compensate for the 'shortfall' by purchasing more assets. ECB can therefore be expected to try to convince banks to take up a bigger stake in the December tranche. With the amounts the ECB can buy in ABS and covered bonds limited to roughly EUR 500 billion in our view, the central bank might have to broaden the range of assets eligible for its purchases, e.g. to include corporate or bank bonds. Or (and this is what the hawks on the ECB's governing council oppose), it might have to start buying government bonds. Such 'fully-fledged' quantitative easing is generally seen as positive for equities.



Source: Bloomberg, BNPP IP

WHAT TO EXPECT NOW?

As we mentioned in the flash note we sent out after the ECB's monetary policy meeting on 4 September, we think that the ECB is currently particularly attuned to the macroeconomic environment with growth in particular playing a bigger role in its assessment of what is required. This will ultimately determine whether fully-blown QE comes ("if needed") or not. Recent economic data showed the eurozone has not fallen completely off the growth track, but the outlook has darkened. Although we do not think the ECB will start government bond style QE, the call is getting harder to make. After today's news market hopes will remain alive for a more extensive quantitative easing in the foreseeable future.

At the MAS TAA team, we see this as positive for Europe ex-UK assets. We have however recently closed our overweight Europe versus UK equities position due to a weaker economic outlook for the eurozone and a possible positive impact on UK equities of a Scottish vote against independence.

We are still overweight European high-yield corporate bonds. We like these for fundamental reasons, but we also think this asset class could benefit from more action by the ECB. In relative terms, it should be even more favourable for investment-grade bonds due to a ECB preference for limiting the risk transfer from the corporate sector and bank balance sheets to the ECB.

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