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Western Europe

European Credit Weekly

A negative deposit rate – Would it matter for credit?

- **The theory** – a negative deposit rate should discourage banks from hoarding excess liquidity with the ECB, encouraging lending. The penalty rate for holding €-denominated assets should tend to weaken the €.
- **The reality?** We doubt the lack of lending in Europe has much to do with liquidity. Rather we suspect that the most discernible impact may be further demand for higher-yielding assets, including credit.
- **Well supported** – While markets have become more volatile over the last couple of sessions, this reinforces our view that spreads remain very well supported even at these tight levels. We still expect the iBoxx index to trade in a range between 85-95bp over the next month or two

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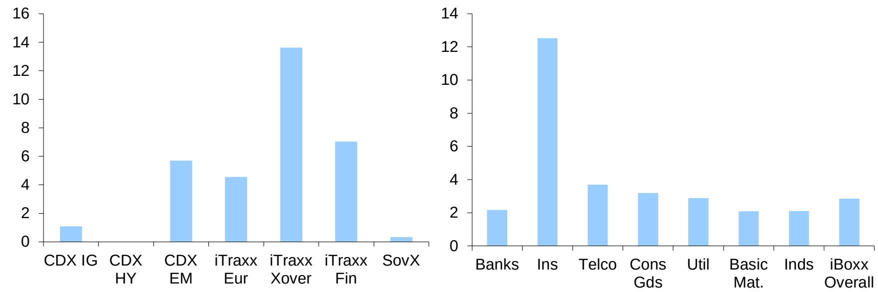
Figure 1. CDS and € iBoxx Cash Index Weekly Spread Changes, bp



Source: Markit, Citi Research.

Does a negative deposit rate impact credit?

The relentless grind tighter has finally hit a speed-bump. Aside from the reaction to the weak Eurozone data and the noise (now denied) around a retroactive capital gains tax in Greece, supply has picked up even faster than we anticipated. The last week has seen more than €22.5bn of issuance – which, depending on issuance today, may make it the biggest week of the year. And once again European credit spreads are proving susceptible. With dealers and others caught long, the de-risking may have a bit further to run.

Yet we reckon those hoping for a better entry point resulting from a more significant backup in spreads will end up disappointed. As we see it, the market remains very well underpinned, and we still expect the iBoxx index to trade in a range between 85-95bp over the next month or two.

The recent slippage in the Eurozone data, as reflected in our economic surprises index, might seem like a cause for concern, but credit is in one of those phases where bad news is ultimately good news: the weaker the data, the greater the chance of ECB intervention.

We've already discussed the impact of potential ECB QE, but more imminently there is the prospect of a cut taking the deposit rate negative at the upcoming meeting on 5 June, where the Governing Council will have updated forecasts.

The ECB certainly seemed to leave the door wide open at the last press conference. Monitoring of the money market was elevated to the front of the forward-looking paragraph. That looked like a thinly-veiled hint, following Draghi's recent observation that the appropriate response to an unwarranted tightening in policy emanating from money markets or a stronger currency would be conventional tools like a narrowing in the interest rate corridor, a cut in the deposit rate or further liquidity injections. Our economists expect that the June meeting will bring a cut in the refi rate to 10bp and a cut in the deposit rate to -10bp.[1]

How would that impact credit?

In the simplest of terms, the purpose of a negative deposit rate would be three-fold. The first would be to discourage banks from parking excess liquidity with the ECB.[2] The second would be to encourage consumer spending. Thirdly, it would weaken, or at least discourage a further rise in, the euro.

The impact on banks: While excess liquidity will always in aggregate be reflected in deposits at the ECB under normal circumstances,[3] the individual institution is encouraged to recycle excess liquidity in the banking system rather than with the ECB. In theory at least, that ought to increase transactions in the interbank market to the benefit of weaker banks that pay a premium for liquidity. Mid-tier banks in the periphery ought to be among the principal beneficiaries.

One offset is the impact on margins, if banks are unable to pass on the negative deposit rate to depositors. The experience from negative deposit rates in Denmark suggests that banks are more likely to start charging for having an account open or by raising lending rates than actually setting the interest rate below zero.

A more widely held concern is the prospect that a negative deposit rate would prompt stronger banks with excess liquidity to shrink their balance sheet rather than increase lending. However, in that regard it is important to remember that the

[1] Implying a narrowing in the interest rate corridor of 5bp.

[2] Presumably, the negative deposit rate would come with a cap on the current account.

[3] Obviously, when the deposit rate is sufficiently negative, it would lead to cash hoarding instead.

excess reserves held at the ECB have already dropped dramatically over the last couple of years, largely as a result of LTRO repayments, with little impact on broader markets. Use of the ECB's deposit facility, which peaked at more than €800bn in 2012, is now down to a mere €34bn currently.[4]

However, the more serious issue may be the impact on liquidity. We suspect that the reluctance to lend cash at negative rates will reduce the liquidity in repo and money markets. High-quality collateral, like Bunds, should be most impacted, while periphery collateral may benefit. But overall, EONIA fixings may become more volatile as a result.

To offset those two issues, our economists anticipate that the ECB will (partially) suspend its sterilisation of the SMP programme, which currently amounts €167bn, or do another MRO/LTRO of some form. In so doing, it would again pump up excess liquidity in the system.[5]

The impact on corporates and consumers: The ECB may also be hoping that it will encourage lending to cash-starved SMEs. We remain skeptical. Rather than a lack of liquidity, we think the principal causes of the high SME real interest rates are a combination of high capital charges and comparatively poor loan performance.

If banks pass on negative deposit rates to consumers, it would also be a disincentive to save and an encouragement for spending. However, with a deposit rate of just -10bp, we think that is unlikely to happen in practice.

The impact on the euro: The ECB refrains from taking an explicit stance on the level of the euro. Yet Draghi's recent comments that its recent appreciation has had an impact on price stability, requiring further monetary stimulus, demonstrates growing unease about the currency’s strength. The ECB estimates that euro appreciation has shaved around half a percentage point off inflation over the last couple of years – not a welcome development when actual inflation is less than half of target.

In theory, lowering the deposit rate would increase the interest differential to other currencies, discouraging investors from holding €-denominated assets. Some people believe that the mere idea of receiving a negative interest rate will be enough to trigger substantial outflows. In practice, we doubt a mere 10bp move will be sufficient to move the needle meaningfully. With all the major central banks having rates close to zero, currencies have seemed better correlated with relative balance sheet sizes over the past few years – meaning it may take QE to really turn things around.

Unintended, but beneficial, side effects?

So we are sceptical that the deposit rate cut will actually have much of an impact through the intended channels. But perversely, we suspect that it may be somewhat bullish for spreads nonetheless. Rather than boosting lending or leading to deposit outflows from Europe, we suspect that the most discernible impact of a negative deposit rate in the broader financial markets may well be an intensification in the hunt for yield.

It isn't too far-fetched to imagine that bank treasuries with excess liquidity will be seeking to park more of it in corporate credit – especially if the deposit rate cut is coupled with an end to SMP sterilization or some other initiative that ends up

[4] Though some excess liquidity is also parked on the current account.

[5] Although that would invalidate Trichet's original distinction between SMP and outright QE.

flooding markets with liquidity again. We also suspect periph spreads would face renewed compression, with repo lenders balking at the prospect of negative rates on lending against Bunds.

A 10bp move is, in isolation, not all that dramatic. But it is an implicit acknowledgement that the ECB will have to do more to lift the trajectory for inflation towards its target. And that is in itself a significant step.

The week ahead (Joseph Faith)

Next week looks set to be fairly quiet, with only a few companies still reporting earnings and mostly second-tier data releases due out.

On Wednesday, the FOMC will release the minutes of its April meeting. These will be watched closely for confirmation that the FOMC is committed to the dovish line Yellen has been projecting, especially in light of recent data disappointments. The BoE's MPC will release the minutes of its May meeting on the same day, and these may give some insight into the disagreements between Committee members over the degree of spare capacity in the UK economy, following the Inflation Report's statement that the Committee has a "range of views" on the issue.

Also on Wednesday, the BoJ will announce its policy decision, with no change expected. Given recent upbeat comments from BoJ officials, our economists have moved their forecasts for further easing back to the autumn from June/July previously.

Eurozone Consumer Confidence, out on Thursday, is expected to show a slight increase, to -8.0, up from -8.6, in a continuation of the recovery from February's drop.

Elections for the European Parliament will begin on the same day in the Netherlands and UK, three days before most of the rest of the EU. Anti-European parties are likely to make a strong showing in both countries, although the results will only be out once the elections are completed throughout the EU on May 25th. While they probably won't make for pleasant reading for the incumbent parties, we doubt there will be much of a market impact.

After a reported rise in Chinese loan-defaults to the highest level since 2005 this week, the preliminary reading for the HSBC Manufacturing PMI, also out on Thursday, will give investors another indication of how severe the slowdown in growth has become. The consensus expects it to rise slightly, to 48.3 from 48.1 last month, albeit still firmly in negative territory. We find it interesting that the increase in negative news reports out of China recently does not yet really seem to have had much of an effect on China CDS or other potentially exposed assets.

The April number for US existing home sales, out on the same day, is forecast to have climbed to its highest level this year, following signs of stabilisation in the residential real estate market. On the other hand, the consensus forecasts a drop in US Leading Indicators to 0.3%, its lowest level since January. Following the unexpectedly weak PMI figure this week, this would provide further evidence of a slowdown in the pace of growth, confounding hopes that the US economy had shaken off all the early-year weakness.

There will be a batch of sovereign rating updates on Friday. Moody's will provide an update on France and the UK, Fitch will give an update on Greece and S&P will do the same for Netherlands and Spain.

Key Economic Indicators (19 May – 23 May 2014)

Tuesday 20 May	Consensus Forecast	Last
Wednesday 21 May	Consensus Forecast	Last
Eurozone Consumer Confidence	-8.0	-8.6
Thursday 22 May	Consensus Forecast	Last
Eurozone Manufacturing PMI	53.2	53.4
Eurozone Services PMI	53.1	53.1
Eurozone Composite PMI	54.1	54.0
HSBC China Manufacturing PMI	48.3	48.1
US Existing Home Sales	4.68M	4.59M
US Leading Indicators	0.3%	0.8%
UK Retail Sales MoM	0.4%	-0.4%
Friday 23 May	Consensus Forecast	Last

Source: Bloomberg

Earnings Releases (19 May – 23 May 2014)

Monday 19 May
Kabel Deutschland, Campbell Soup
Tuesday 20 May
Vodafone, Marks & Spencer, Home Depot, Staples
Wednesday 21 May
Weibo, Target, Lowe's, Eaton Vance, Lenovo
Thursday 22 May
Raiffeisen, SABMiller, Schmolz + Bickenbach, Investec, RBC, Gap Hewlett-Packard, Royal Mail
Friday 23 May
Sears

Source: Bloomberg

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European Credit Sector Recommendations: When the surreal becomes everyday…	Teresa Cascino	April 29, 2014
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Source: Citi Research

Appendix A-1

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