Yield in a low interest rate environment

One-on-one interview - Olivier Gayno

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On 5 June 2014, the European Central Bank (ECB) reduced key rates effective 11 June: the marginal lending facility rate will stand at 0.40% (previously 0.75%), the main refinancing rate at 0.15% (previously 0.25%) and the deposit facility rate at -0.10% (previously 0%). It is the first time a major central bank has set a policy rate in negative territory. The rationale for such an unusual decision is to fight against deflationary pressures which exist in parts of the Eurozone.

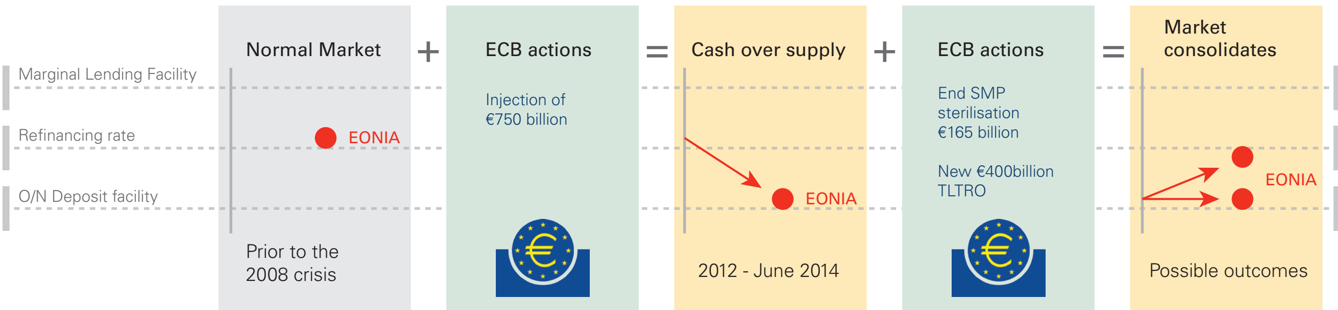
What is the likely impact of lower ECB rates on the eurozone money markets?

In addition to the rate cuts, the ECB also announced unconventional measures which should lead to higher levels of excess overnight liquidity in the coming weeks compared to the levels that have prevailed since the beginning of the year:

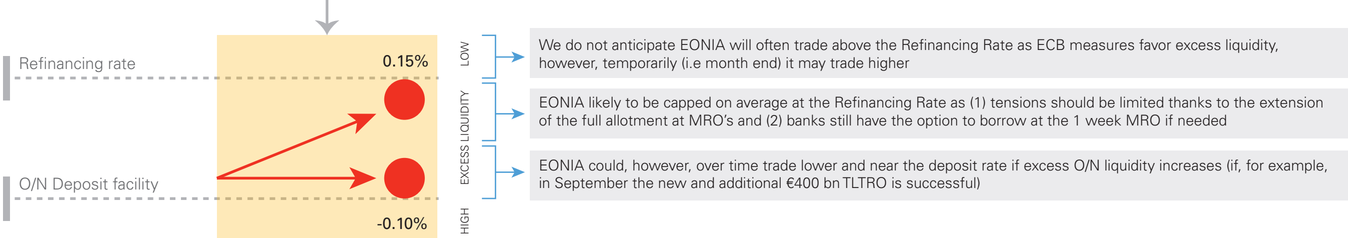
- End of the Securities Market Programme (SMP) sterilization (€165bn)
- Extension of full allotment at the Main Refinancing Operations (MRO) until at least December 2016
- As of September 2014, a €400bn 4 year Targeted Long Term Refinancing Operation (TLTRO) targeting private non-financial and non-real estate sector loans
- The ECB is also working on an Asset Backed Securities program targeting the same economic sectors

Following these actions, we expect overnight (O/N) interest rates and the EONIA to trade within a range from 0 - 0.05%. From time to time these rates could be negative. As more liquidity is injected into the system, for example in September, the ECB will start the TLTRO program aimed at providing more liquidity to the private sector which could favor a lower EONIA rate.

An illustration of the ECB's actions and EONIA levels over time (Period: prior to 2008 to June 2014)



Opinion: During the next few months there is likely to be some uncertainty in the markets as to the success of the ECB's additional measures. With the TLTRO not starting until September 2014 and uncertainty over the market reaction to the end of the sterilization of the SMP. For these reasons, it is likely that EONIA will be volatile but typically will be between the Refinancing and Deposit rates. On average, we believe it will trade closer to the Refinancing rate than the Deposit rate.



Source: HSBC Global Asset Management. As at 6 June 2014. For illustrative purposes only. Any forecast, projection or target contained in this publication is for information purposes only and is not guaranteed in any way. HSBC accepts no liability for any failure to meet such forecasts, projections or targets.

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Lower yields in the front end of the curve (overnight) is a given, but what about longer maturities?

"Short Term Money Market Funds"[1] do not only invest in overnight maturities but also extend into longer maturities of up to 397 days. As of today, the good news for investors is that there is still yield pick-up in longer maturities relative to the O/N.

How can this be explained?

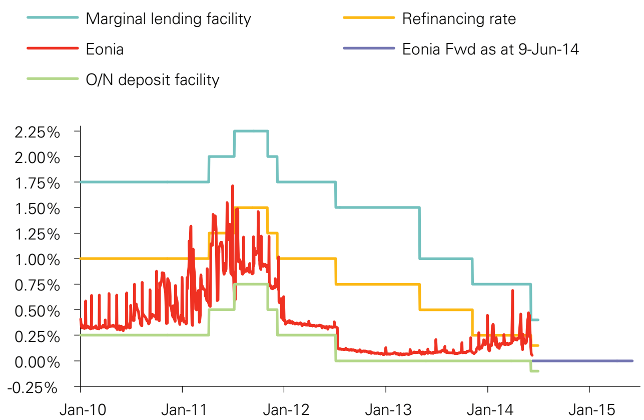
There are currently two positive aspects to highlight that support maintaining some yield in the portfolio:

1. There is some steepness in the yield curve up to 1 year meaning portfolio managers can pick-up some yield relative to maturities closer to the O/N.
2. Banks have become more eager to issue 3 and 6 month paper as they have now repaid part of the LTRO and thus started to normalise their funding and have moved back into issuing longer maturities.

The result is that the Euro money market fund portfolios will likely maintain a Weighted Average Life (WAL) that is fairly long (around 60 days) demonstrating portfolio managers are using techniques to acquire yield in the portfolio.

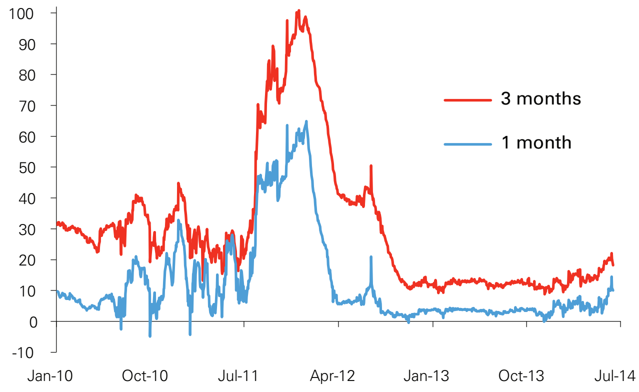
ECB key lending rates and EONIA forward swap rates

The following chart illustrates that the EONIA forward rate is anticipated close to zero and not in negative territory.



Source: Bloomberg, HSBC Global Asset Management (France) – Forward rates are based on ECB dated Eonia swaps. Data as at 9 June 2014.

Spread in bps between Euribor and EONIA Swap (in basis points)



Source: HSBC Global Asset Management. Data as at 9 June 2014. For illustrative purposes only.

Understanding the closely watched Euribor / EONIA spread

The Euribor / EONIA spread is a good way to monitor market sentiment and market liquidity. When the financial crisis hit in 2008, portfolio managers monitored the spread closely as it became a good proxy to measure stress in the euro money markets (the wider the spread the less confident banks were to lend to each other).

Over the past few years, as the ECB has flooded the market with liquidity, market participants have become more confident in the interbank market and the spread is now influenced more by issuance. As banks have been repairing balance sheets, they have started to finance in longer maturities. As a result, the Euribor / EONIA spread has widened out due to increased supply in longer maturities. This means that portfolio managers can pick-up spread by extending out longer and this helps maintain yield for investors.

[1] On 1 July 2011, asset managers implemented a new set of guidelines that were defined by ESMA for European money market funds. These guidelines were simultaneously adopted by local regulators (eg AMF in France). As of this date, money market funds were split in two categories, "short-term money market funds" and "money market funds". ESMA's objective was to improve investor protection by introducing harmonised definitions across Europe. This initiative was designed to help investors choose between funds that are tightly constrained to holding short-dated investments and those that hold longer-dated instruments. Any fund identifying itself as a money market fund must conform to the ESMA established definitions of either a "short-term money market fund" or a "money market fund".

Key money market reference rates in Europe

In Europe, there are two key benchmarks for money markets and capital markets: EONIA and Euribor. The indexes have a common characteristic in that the banks contributing to EONIA (35 banks) are largely the same panel of banks quoting for Euribor (26 banks).

Data as at 6 June 2014.
http://www.euribor-ebf.eu/euribor-eonia-org/panel-banks.html
http://www.euribor-ebf.eu/euribor-org/panel-banks.html

The EONIA (Euro OverNight Index Average) is a variable rate; changing daily. It refers to a daily average of overnight rates for unsecured interbank lending in the Eurozone (equivalent to the federal funds rate in the US). EONIA reference rates are calculated by the European Central Bank (ECB). EONIA is the reference for the OverNight rate period.

The Euro Interbank Offered Rate (or Euribor) is a rate that is revised or reset. It is a reference rate based on the average interest rates at which banks offer to lend unsecured funds to other banks in the euro wholesale money market or interbank market. Euribor is comparable to Libor for Sterling and US Dollar denominated instruments. Domestic reference rates, like Paris' PIBOR, Frankfurt's FIBOR, and Helsinki's Helibor merged into Euribor on EMU day, January 1st 1999. Euribor is the reference for 3 month rate periods.

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