FX Viewpoint

ECB positive rates: mixed flows so far

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G10 FX Strategy
Global

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Leaving negative rates well behind

The strong consensus last year when the ECB was about to move away from negative rates was that it would trigger strong inflows. We had expressed doubts. Looking at how EUR has performed since then, it is hard to argue for a rally looking for an explanation. The evidence is mixed, with some positive flows in some cases, but far below expectations up to now.

EPFR data: limited private inflows in EZ bonds

Private investor flows using the EPFR data do not suggest that positive ECB rates have attracted flows so far. Foreign demand for Eurozone bonds has been mixed and consistent with pre-ECB tightening trends and levels. Foreign demand for Eurozone equities also does not reflect any major shift. Domestic demand for Eurozone bonds has been slightly positive, but far too small compared with selling in previous years. Domestic demand for Eurozone equities has been mostly negative since 2012 and this remains the case. It is hard to argue for a rotation from equities into bonds.

Foreign bank claims: no rates related structural changes

BIS foreign bank claims in Eurozone countries also do not seem to be much affected by shifting to positive rates, which is also consistent with mixed evidence in the years when ECB rates were negative. They have remained broadly constant in the last two years.

BoP data: higher but timid interest from foreigners

Non-resident interest in EUR denominated fixed income is not up in commensurate terms. Over 2022, foreign interest in EUR fixed income was positive but less so (in absolute terms) than over 2019 or over 2011-2014. Non-resident transactions in financial assets different from fixed income securities have been even more negative. Data for 2023 shows non-resident transactions picking up for bonds with longer maturities while bids for bills and currency/deposits remain lacklustre. Balance of Payments data up to July shows a similar picture, with non-resident net purchasing flows picking up on EUR duration but largely unchanged for money market instruments. Euro Area residents are also increasing net purchases of foreign bonds and notes.

Euro area retail flows main demand from higher rates

Retail investors are running down bank deposits at a pace never seen before in the Euro Area and positioning in highly yielding EGB front-end. If retail investors for core and semi-core were to accelerate their participation in Euro govies, this pace of net purchases may be maintained for another five years.

IMF data: signs of higher CB demand for EUR bonds

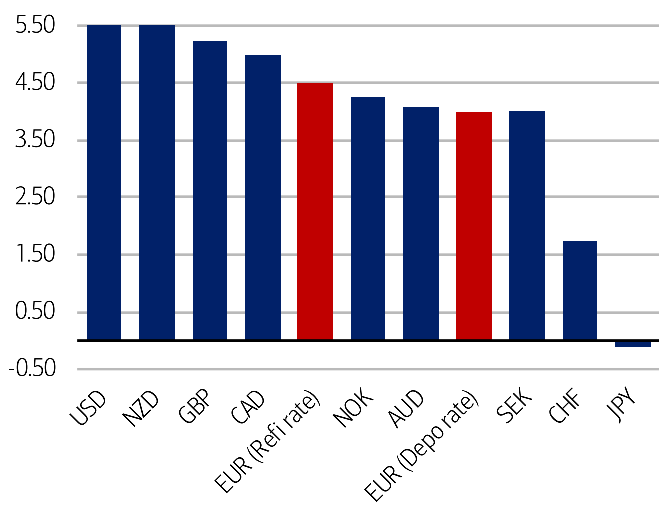
IMF data, when adjusted for FX and bond valuation changes, appears to support the thesis of renewed demand in 2022. However, while these may be early signs, we take them with caution once we consider few details.

Leaving negative rates well behind

The ECB was the last G10 central bank, with the exception of the BoJ, to start policy normalization as inflation surged last year. It stopped QE and started hiking in July 2022, bringing its depo policy rate from -0.5% to 4% today, and its main refinancing rate from 0% to 4.5%. The pace of hikes started at 50bp, accelerated to 75bp, went back to 50bp, and then 25bp. We believe the ECB is now done hiking, consistent with the message in its two last meetings and market pricing. We expect the ECB to start cutting rates in June next year, 25bp quarterly, consistent with market pricing and also our Fed call.

The ECB policy rate now compares well with the rest of G10. Looking at both the main refinancing rate and the depo rate, the ECB is somewhere in the middle of the G10 group (Exhibit 1). In real terms (using core inflation) the ECB real depo rate is back to pre-Covid levels and, although still negative, at the high end of the post-global financial crisis level (Exhibit 2).

Exhibit 1: G10 policy rates
ECB policy rate mid of G10



Source: Bloomberg, BofA Global Research

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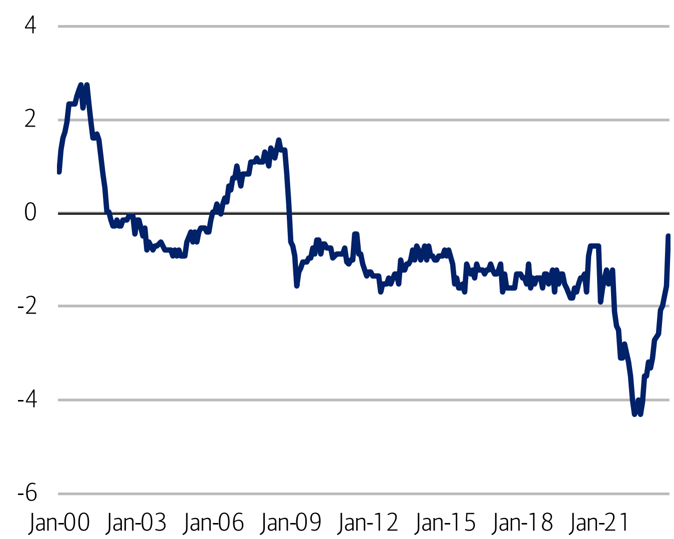
Exhibit 2: ECB real depo rate (deflated by core inflation)
ECB real depo rate back to pre-Covid levels in real terms



Source: Bloomberg, BofA Global Research

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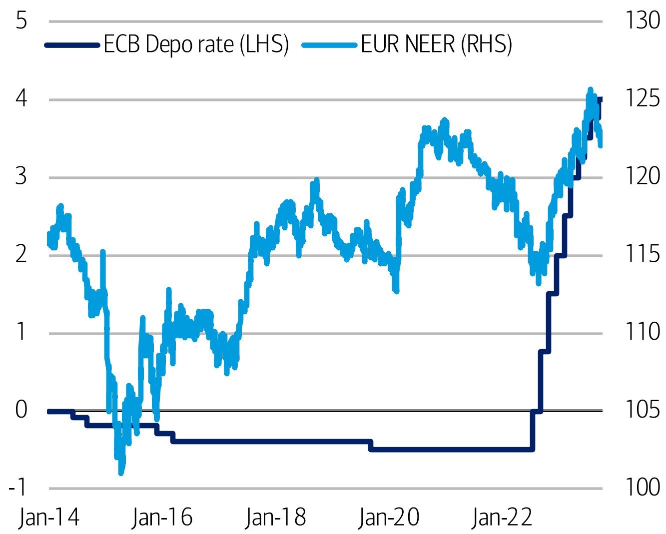
The strong consensus last year, when the ECB was about to move away from negative rates, was that it would trigger strong inflows. The expectations was for non-linear, strong flows that were pushed away by negative rates in the years before and would come back once the ECB was to cross the zero threshold. This in turn was supposed to lead to a EUR rally, from an undervalued level.

We wrote a report about such expectations in early 2022, expressing our doubts (see ECB positive rates: implications for flows 04 March 2022). Looking at various flows since the ECB moved to negative rates, we found mixed evidence, suggesting some potential inflows, but hard to quantify. In most cases, it was hard to find strong outflows when ECB rates went negative. Outflows did take place during the Eurozone crisis, but mostly recovered afterwards.

Looking at how the EUR has performed since the ECB went with positive rates and during the hiking cycle, it is hard to argue for a rally looking for an explanation. The EUR did appreciate in trade-weighted terms (NEER) once the ECB started hiking, but it had already more than recovered its losses from after the ECB went with negative rates in 2014 before the pandemic (Exhibit 3). The EUR NEER is currently historically high, but close to its early-2021 level, when the ECB still had negative rates. The evidence is even more mixed when we look at EURUSD, which remains historically weak and has not appreciated by much as the ECB has been hiking (Exhibit 4).

Exhibit 3: ECB policy rate and EUR NEER
EUR NEER (nominal effective exchange rate) has appreciated as the ECB has been hiking



Source: Bloomberg, BIS, BofA Global Research

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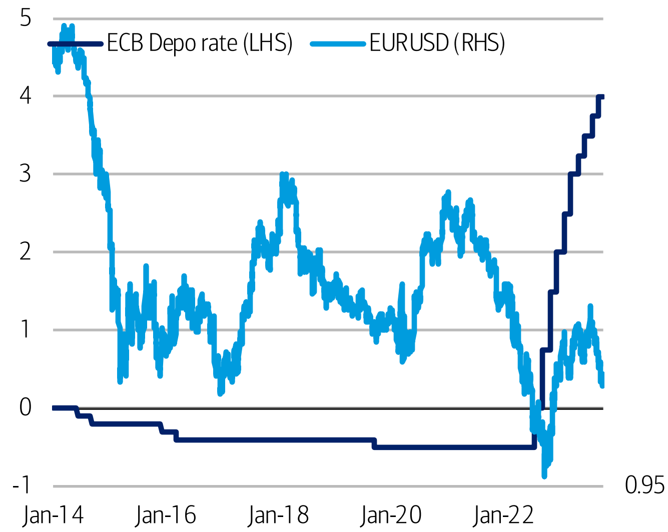
Exhibit 4: ECB policy rate and EURUSD
EURUSD reaction to ECB hikes has been mixed



Source: Bloomberg, BofA Global Research

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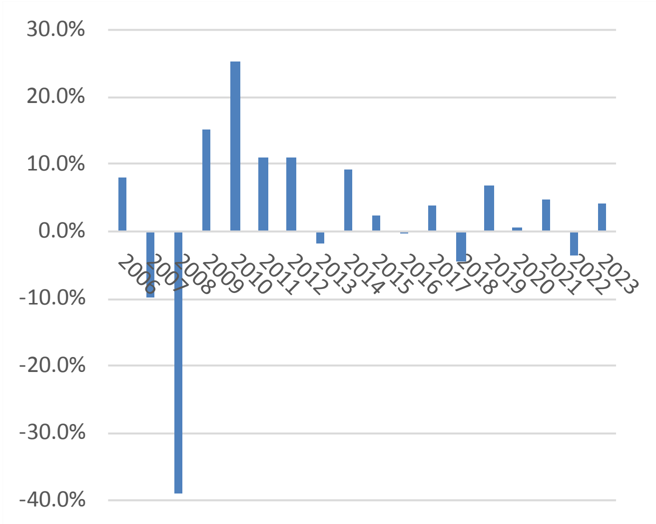
EPFR data: limited private inflows in EZ bonds

Private investor flows using the EPFR data do not suggest that positive ECB rates have attracted flows so far. As we have discussed before, this data also does not show strong outflows in the years when the ECB had negative rates.

Foreign demand for Eurozone bonds dropped but remained mostly positive in the years after the global financial crisis (Exhibit 5). It was also weaker in the years after the ECB went with negative rates, but again still mostly positive. Recent flows have been mixed, but consistent with the pre-ECB tightening trends and levels, with some inflows in 2023 offsetting outflows in 2022. It may still be early, but this evidence does not suggest any strong inflows following positive rates.

Foreign demand for Eurozone equities also does not reflect any major shift (Exhibit 6). The strongest inflows took place just before and just after the ECB went with negative rates. Flows in recent years have been mixed, with more outflows than inflows. There were outflows in 2022, but almost nothing so far in 2023. One may have expected a rotation from equities into bonds after the ECB moved rates to zero and to positive levels, but this does not seem to be the case.

Exhibit 5: Foreign demand for Eurozone bonds, % AUM
Limited foreign demand for Eurozone bonds



Source: EPFR

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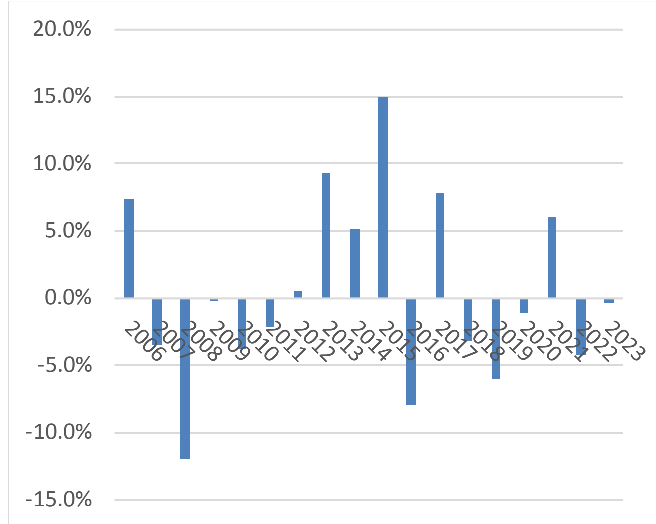
Exhibit 6: Foreign demand for Eurozone equities, % AUM
Foreign demand for Eurozone equities does not reflect a shift



Source: EPFR

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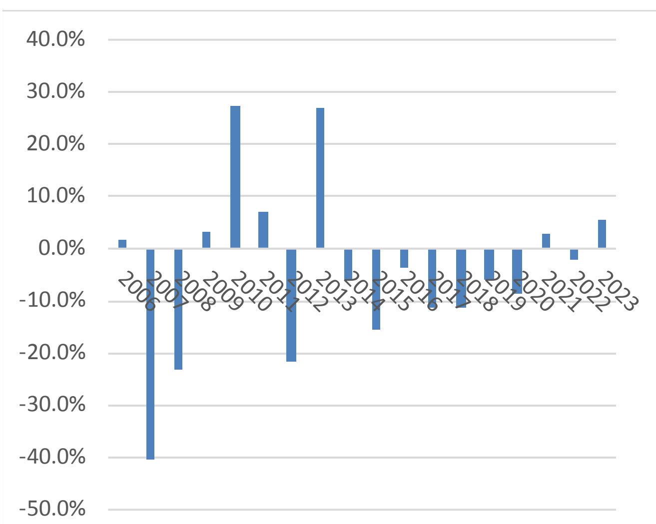
Evidence based on domestic demand of Eurozone assets is also mixed. Domestic demand for Eurozone bonds was negative for all years after the ECB went with negative rates in 2014 and until the pandemic (Exhibit 7). We have seen some demand in 2023, but it is far too small so far compared with selling in the previous years. Domestic demand for Eurozone equities has been mostly negative (selling) since 2012 (Exhibit 8). We have also seen selling so far in 2023. It is hard to argue that this evidence reflects a rotation from equities into bonds for domestic investors, given the relatively small and consistent-with-previous-trends amounts involved.

Exhibit 7: Domestic demand for Eurozone bonds, % AUM
Limited domestic demand for Eurozone bonds



Source: EPFR

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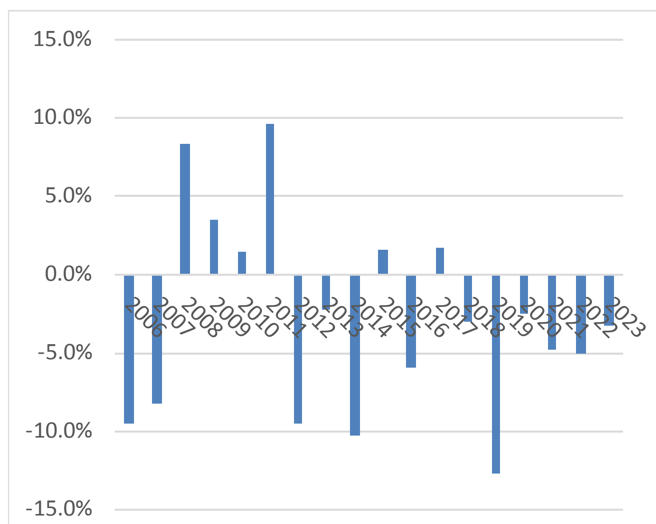
Exhibit 8: Domestic demand for Eurozone equities, % AUM
Negative domestic demand for Eurozone equities



Source: EPFR

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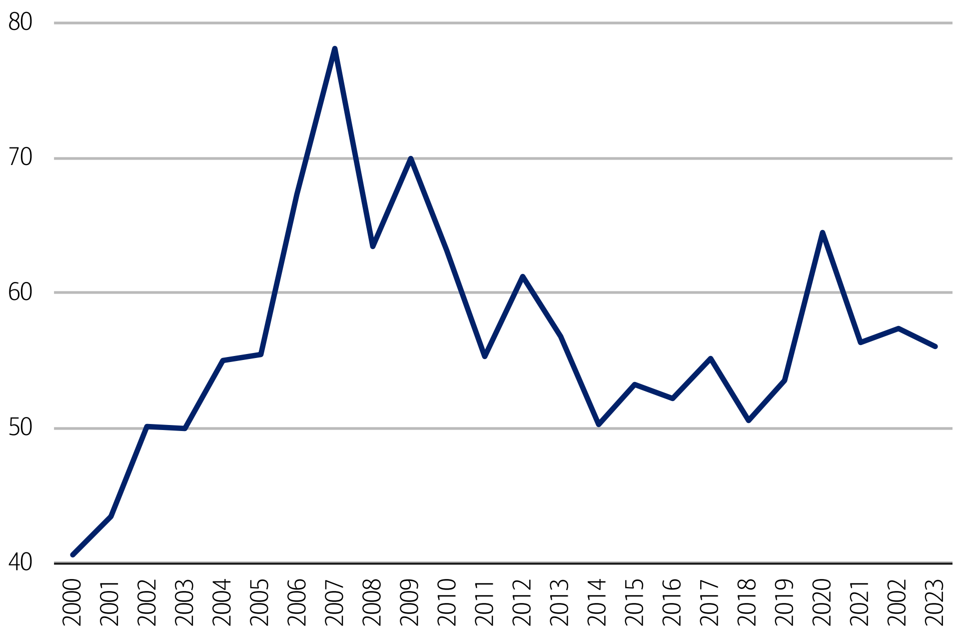
Foreign bank claims: no rates related structural changes

BIS foreign bank claims in Eurozone countries also do not seem to be much affected by shifting to positive rates (Exhibit 9). This is also consistent with mixed evidence in the years when ECB rates were negative.

After the EUR was introduced in 2000 and up until 2007, foreign bank claims increased sharply. After the global financial crisis, foreign bank claims started to drop. The decline continued as the Eurozone crisis started. From peak to trough, foreign bank claims in the Eurozone dropped from 78% of GDP in 2007 to 50% of GDP in 2014. In 2014 specifically, which is when the ECB went with negative rates, they dropped from 57% to 50%--not all of it should be attributed to negative rates. However, foreign bank claims recovered to 64% in 2020, before dropping again to 56% in 2021, most likely because of the pandemic.

Exhibit 9: Total foreign bank claims to Eurozone countries, in percent of GDP

Foreign bank claims to Eurozone do not seem to have been affected by negative rates



Source: BIS

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Foreign bank claims to the Eurozone have remained broadly constant in the last two years. They increased to 57% from 56% in 2022 but are back to 56% up to mid-2023. Again, it may be early for a change, but the consensus was expecting non-linear and relatively fast shifts. Such claims remain above the 2014 low, but this increase took place before the pandemic, while the ECB rates were still negative. Moreover, they remain well below the pre-global financial crisis peak.

BoP data: higher but timid interest from foreigners

Despite the historic increase in EUR rates seen since the summer of 2022, non-resident interest in EUR denominated fixed income is not up in commensurate terms. We look at more granular data up to 2022 first, then look at trends over 2023.

Over 2022, foreign interest in EUR fixed income was positive but less so (in absolute terms) than over 2019 or over 2011-2014 when rates were more than 2% lower. As we already said, ECB QE is a bigger determinant of foreign flows – when Quantitative Easing is in place, foreign holders are the first to sell (as you would expect from an investor community generally seen as less sticky than domestics). When QE is not in place non-resident positioning build-up can regain steam (Exhibit 10).

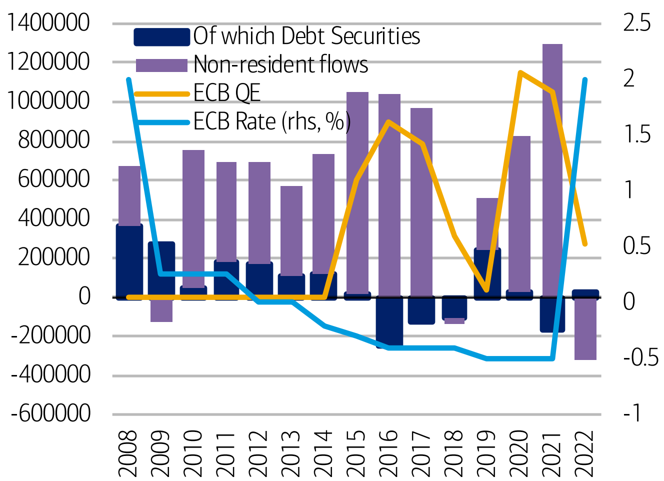
Also because of the cheap valuations (relative to the solid fundamentals, especially when compared to Euro Area peers) as a result of EU issuance, French fixed income from private and public entities retain the biggest interest from non-residents as opposed to Italy and other smaller member states (Exhibit 11).

Non-resident transactions in financial assets different from fixed income securities, over 2022, have been even more negative especially for equities, currency/deposits, loans.

Preliminary data for Q1 and Q2 2023 shows non-resident transactions picking up for bonds with longer maturities while bids for bills and currency/deposits remain lacklustre: this reinforces the view that the return of high (and positive) rates in the EUR front-end, has not necessarily attracted an amount of foreign demand commensurate to the change of the block's monetary policy over the same period.

Balance of Payments data (monthly and available up to July 2023) confirms a similar picture. Non-resident net purchasing flows have picked up on EUR duration but remain largely unchanged for money market instruments. On the other hand, Euro Area residents are also increasing net purchases of foreign bonds and notes and to a larger extent pressuring net portfolio investments upwards.

Exhibit 10: Non-resident net flows into Eurozone financial instruments and debt securities
With QT, foreign investors may return, slowly, back into EUR fixed income



Source: ECB. Values in € millions and %

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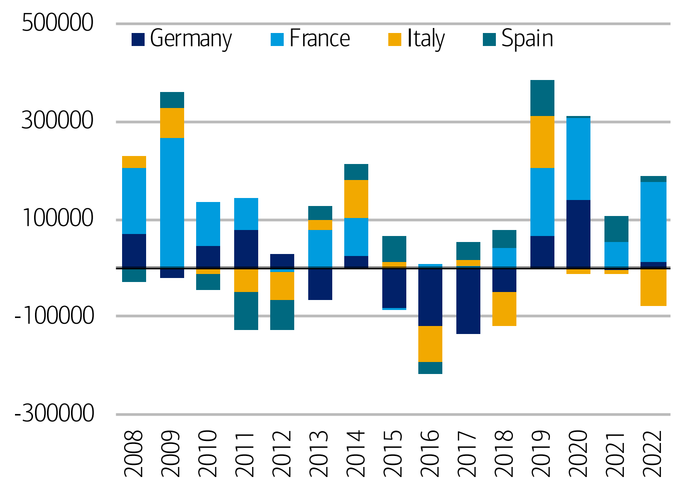
Exhibit 11: Non-resident net flows in 4 major Eurozone debt securities split by issuer geography
Flows focused on France



Source: ECB. Values in € millions

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Euro area retail flows the main source of demand from higher rates

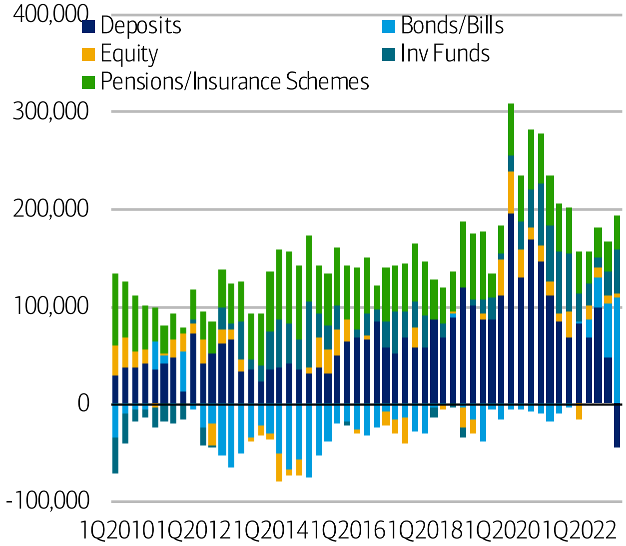
An investor category that is particularly sensitive to the outright level of rates, especially in the front-end (1-3y area) is that of retail investors.

During the age of "financial repression" Euro Area families focused savings on bank deposits and Pension/Insurance schemes. Divestments from fixed income instruments have been stable and sizeable in the aftermath of the sovereign crisis and during the QE-era alike.

We are now living the opposite of that trend with retail investors running down bank deposits at a pace never seen before in the Euro Area (especially in Italy) and positioning in highly yielding EGB front-end. Flows into EGBs from this investor community are motivated by relatively low bank deposit rates (these latter have been slow at updating rates upwards with markets given the large amounts of excess liquidity still present in the system): over Q2-2022/Q2-2023 fixed income flows are running at over €200bn, ~50% of EGB net issuance after accounting for QT over that period.

If retail investors for core and semi-core were to accelerate their participation in Euro govies, this pace of net purchases may be maintained for another five years. The driver of these flows of course will be a function of bank competition for funding and the level of rates (these investors are active in the >3% area, low maturities).

Exhibit 12: Euro Area Financial Accounts - Households
Strong pace of portfolio rebalancing towards EUR fixed income is driven by level of policy rates



Source: ECB. Numbers in EUR millions

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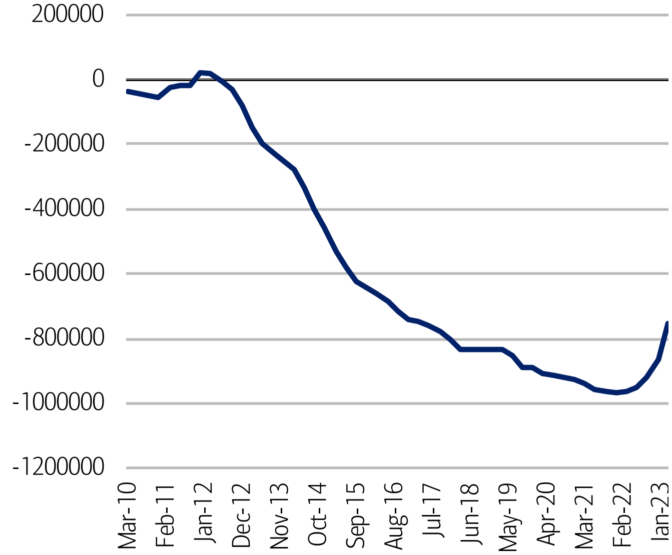
Exhibit 13: Cumulative flows into EUR Bonds/Bills from Households
Much more to go before this source of demand exhausts at current conditions



Source: ECB. Numbers in EUR millions

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IMF data: signs of higher CB demand for EUR bonds

We have long hoped that central bank reserve diversification would result in increased demand for Euro area debt securities from that investor base. In Reports of USD replacement greatly exaggerated, we argued that the 3 factors constraining reserve managers in terms of their EUR allocation were:

1. the surge in credit risk in periphery space (this has driven a collapse in allocations to Italian and Spanish bonds in 2012-15,
2. the ECB's negative interest rate policy, with many reserve managers being averse to buying negatively yielding bonds, and
3. the limited availability of EUR-denominated govt bond paper, following the start of ECB Quantitative Easing (QE).

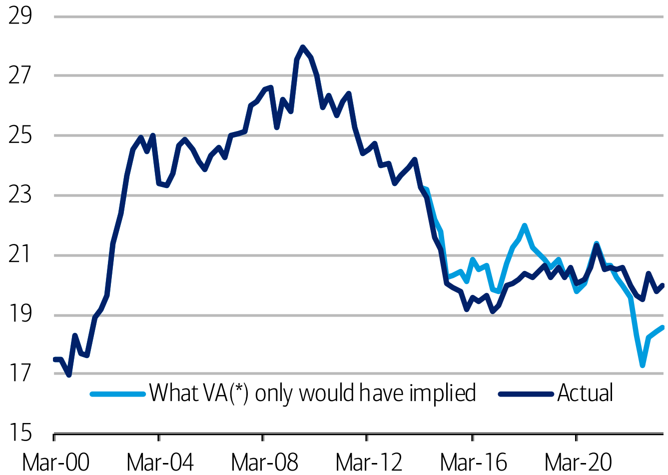
While the relevance of (1) faded as periphery spreads tightened post QE, (2) and (3) have only recently reversed, suggesting we may now finally see renewed demand for EUR bonds from foreign central banks.

Data from the IMF on the Composition of Official Foreign Exchange Reserves (COFER) and Coordinated Portfolio Investment Survey (CPIS), when adjusted for FX and bond valuation changes appears to support the thesis of renewed demand in 2022:

- The share of EUR reserves in COFER has been relatively stable at around 20%, when valuation changes in 2022 would have pointed to a mechanical decline to c.17% (Exhibit 14). More active investments in EUR may therefore have taken place.
- The CPIS data shows that the value of Euro area bond holdings of participating central banks was somewhat stable in 2022 (Exhibit 16), which would imply an increase in the face value of those holdings, given the collapse in bond (Exhibit 17).

Exhibit 14: EUR share in Global FX reserves: actual vs implied by VA*

EUR share didn't decline as much as implied by valuation adjustments in '22



Source: IMF COFER, BofA Global Research. (*) Valuation Changes: based on changes in FX, and prices of bond and equity indices

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Exhibit 15: Assumptions used for valuation adjustments

Breakdown of FX holdings by type used as assumption to derive valuation adjustments for COFER data in 2020-23

	USD	EUR	GBP	CHF
Debt securities	80%	80%	80%	60%
short term securites as % of debt securities	10%	20%	15%	10%
Equities and investment fund shares	6%	3%	9%	30%
cash	14%	17%	11%	10%

Source: BofA Global Research

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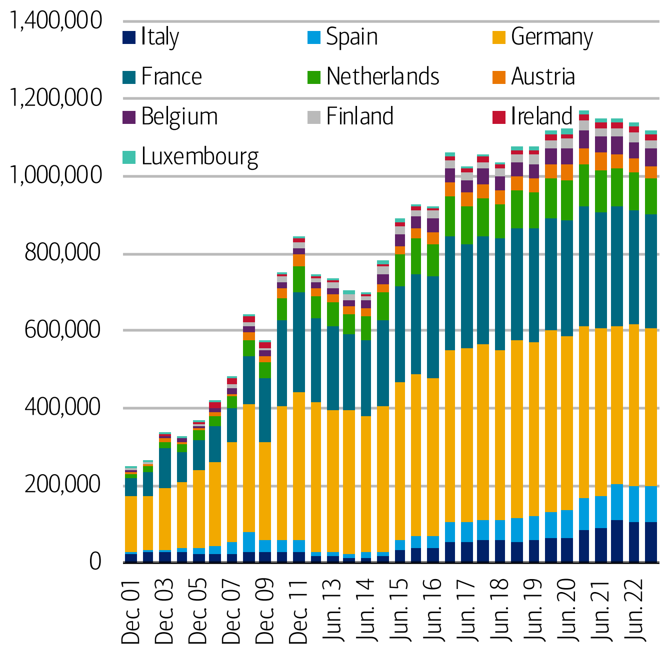
Exhibit 16: EUR market value of long term debt securities held by central banks participating in SEFER/CPIS, by country of issuer

Market value of EUR LT debt holdings was somewhat stable in 2022...



Source: IMF CPIS / SEFER database, BofA Global Research

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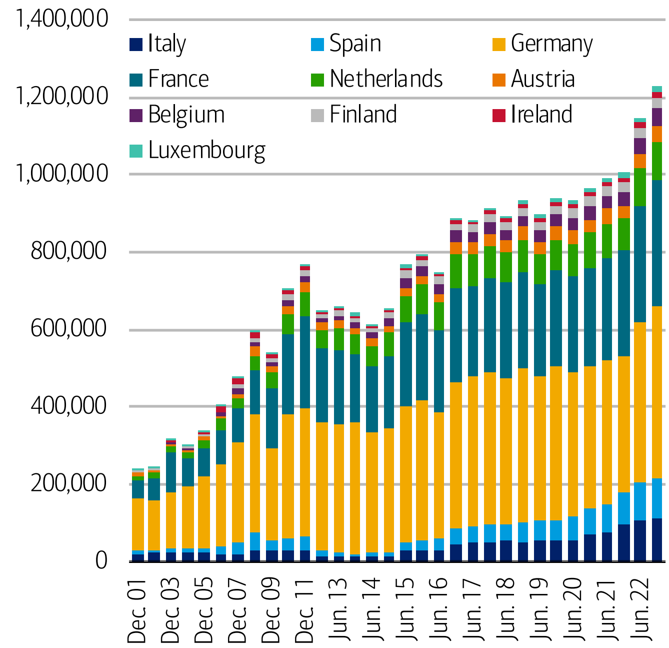
Exhibit 17: BofA est. for face value of long-term debt securities held by central banks participating in SEFER/CPIS, by country of issuer

...Implying an increase in the face value of LT debt holdings as bond prices declined in '22 (*)



Source: IMF CPIS / SEFER database, BofA Global Research

(*) We assume LT bond prices in each country move in line with the corresponding govt debt index

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However, while these may be early signs of renewed EUR attractiveness in CB reserves, we take this data with caution for a few reasons:

- The breakdown of CB reserves in terms of cash vs debt securities may have changed a lot across currencies as the global hiking cycle unfolded over the last two years (with likely a greater share being allocated to cash when central bank rates increased). However, our estimates of valuation changes in COFER are based on a static allocation in cash & equities vs debt securities (Exhibit 15).

- The raw CPIS data includes long term debt securities holdings of reporting central banks by issuing country, presented in USD market value terms. To derive the face value in Exhibit 17, we assume prices evolve in line with each European govt bond index price. However, if central banks reduced the duration of their bond holdings vs the index, it would imply a smaller increase in the face value of these holdings.

- 2022 may have been a special year as the EUR curve remained quite steep when yields rose, while the US curve was faster to invert. This could explain the greater interest in EUR long term debt securities on any reserve build up, when USD investments were probably more geared towards reverse repo.

The flattening in the EUR bond curves in 2023 may limit the interest for long-dated bonds, while the reduced rate paid by the ECB on foreign CB cash may drive demand for debt securities over cash holdings. The result of the two could be greater demand for short-dated securities and/or reverse repos.

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