

European Rates Watch

EUR FX-Sofr basis at crosscurrent

ECB and Fed to part ways on balance sheet...

The ECB will accelerate QT via commencing passive QT in its PEPP portfolio in 2H 2024. Meanwhile, our US colleagues expect the Fed to taper QT in March and end QT mid-year although they acknowledge risks of the Fed simply lowering the UST redemption cap in March to \$30b and allowing for a longer period of QT (see [US Rates Watch, 8 January 2024](#)) (Exhibit 1). This means the Fed's balance sheet will begin to stabilise while the Eurosystem's balance sheet will decline at a faster rate.

... but this is not reflected in FX swaps

Divergent balance sheet trajectory theoretically means growing premium of euros over dollars from a liquidity supply standpoint and would be reflected in EUR FX-Sofr basis tightening (more positive). But the market is pricing in gradual basis widening (more negative), signalling growing dollar premium vs euros (Exhibit 2).

EUR FX-Sofr basis now better explained by pickups...

Basis widening expectations may be better explained by more demand short-dated USD assets over euro equivalents. USD T-bills and repo now offer a positive pickup over their German counterparts on a FX hedged basis (Exhibit 3): 3M T-bills offer c. 20bp pickup vs 3M Bubills on a FX hedged basis. But forward pricing is consistent with demand shifting to T-bills and away from Bubills and such attractive pickup diminishing (Exhibit 4).

... partly supported by the Bubill outlook

The current attractiveness of short-dated USD assets over German equivalents may be supported by the Bubill outlook in 2024: 1) net Bubill supply is set to decline from € +10bn in 2023 to € -37bn; 2) expected remuneration changes by the ECB following its operational framework review may also prompt a search for yield in short-dated assets.

Delay in potential new lending operations a risk...

Another reason for the market not pricing in basis tightening may also be expectations of the ECB providing new lending operations to help banks satiate their reserve demand as it continues to reduce its balance sheet. Such operations could limit potential euro funding pressures. But details of any such operations will need to be agreed upon in the ECB's operational framework review scheduled to conclude in spring.

... that could trigger further basis tightening

In our view, if the ECB fails to address the growing demand-supply reserve imbalance in a timely manner, euro funding pressures may rise significantly as competition among banks for reserves intensify. This may trigger further tightening in the EUR FX-Sofr basis, despite the large tightening recorded in 2H 2023 (Exhibit 5). The difficulty for the market is when the inflection point of demand exceeding supply is unknown: our estimates suggest it is probable that this point could be reached as soon as this year (Exhibit 6, see [European Rates Viewpoint, 21 November 2023](#)).

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ECB: European central bank

Fed: Federal Reserve

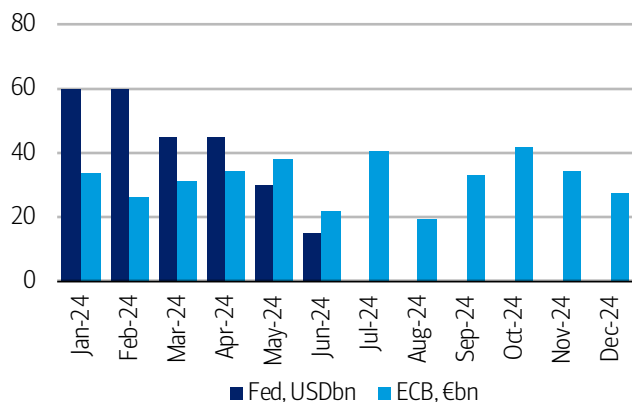
PEPP: pandemic emergency purchase
programme

Sofr: secured overnight financing
rate

QT: quantitative tightening

Exhibit 1: ECB and Fed QT 2024 outlook

Fed expected to end QT by mid-year while ECB set to accelerate QT

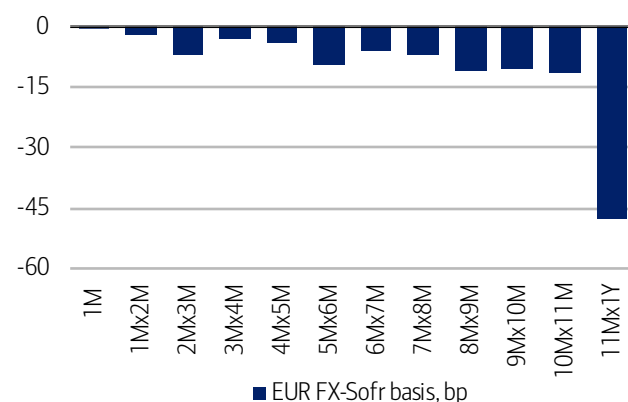


Source: BofA Global Research, ECB, Fed

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Exhibit 2: EUR FX-SoFr basis

Market pricing in widening in EUR FX-SoFr basis despite QT outlook

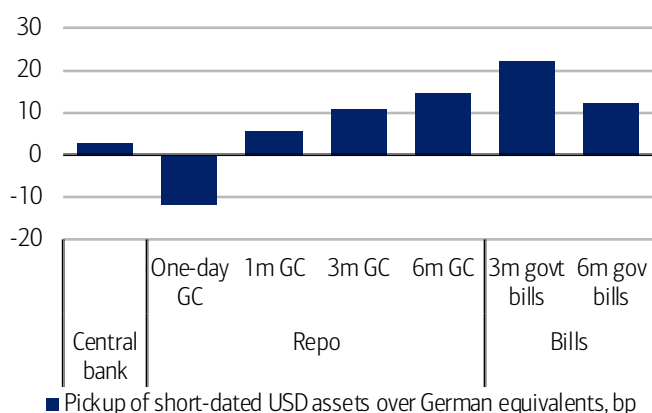


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Exhibit 3: Pickup of short-dated USD assets over German equivalents

FX-hedged pickup from USD assets tends to be more attractive

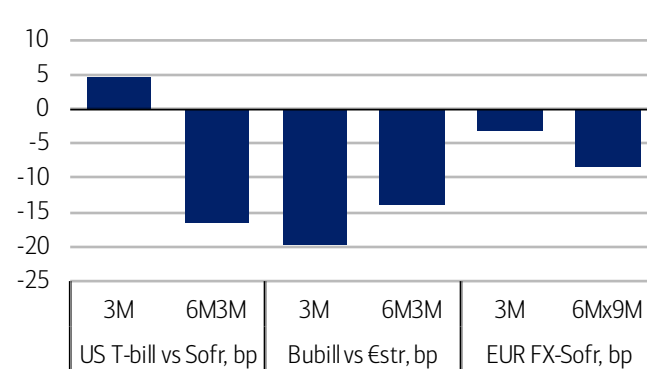


Source: BofA Global Research, Bloomberg, CME Group. For central bank and one-day GC we use the 1M EUR FX swap to compute FX hedging. The maturity of FX hedging is matched for other assets.

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Exhibit 4: Bill spread and EUR FX-SoFr basis

Forward pricing consistent with demand shifting towards T-bills



Source: BofA Global Research, Bloomberg

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Exhibit 5: 1Y EUR FX-SoFr basis

EUR funding pressures could support further tightening

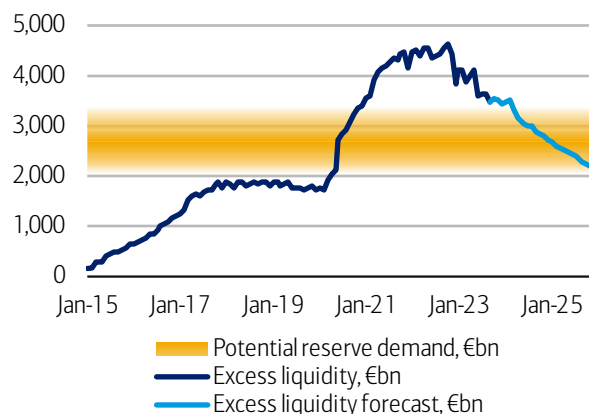


Source: BofA Global Research

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Exhibit 6: Reserve demand and excess liquidity in the euro area

We believe demand could exceed supply in 2024



Source: BofA Global Research, Bloomberg

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