ECB: Will it spend the 'envelope'?

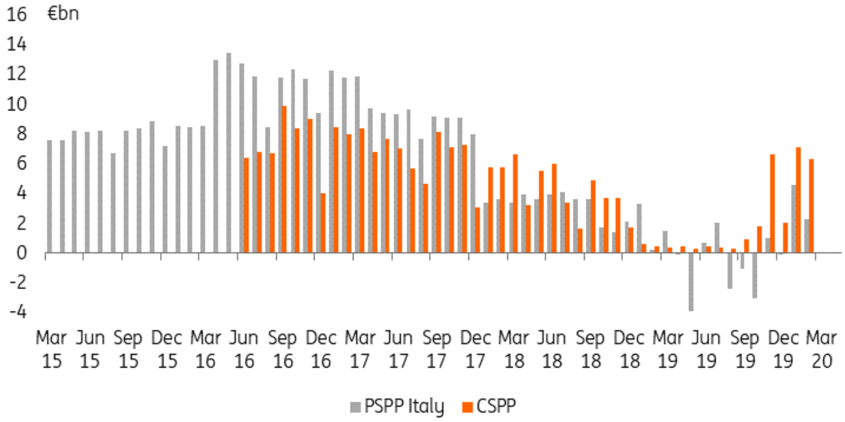
The European Central Bank has finally heard the bond market's cry for help and upped its Asset Purchase Programme (APP) 'envelope' by another €750 billion. We provided an overview of the programme in our Rates Daily this morning, here we look into its market implications

More room to buy sovereign bonds: good for Italy

A €120bn envelope with a greater emphasis on corporate bonds does not leave much space to cap Italian yields. Assuming half of this amount is spent on corporates, this would leave only €60bn to buy sovereign bonds. For reference, Italy's alone are over €1.8 trillion in size.

It is difficult to estimate how much of the new €750bn envelope will be available for sovereigns. For instance, the amount of corporate Commercial Paper (CP) purchases is unknown. Given the smaller size of non-sovereign APP eligible bond markets however, most of the additional purchases will target sovereigns. This is great news for Italy but how much will they actually buy?

ECB Corporate and Italian Sovereign bond purchases so far



Source: Bloomberg, ING

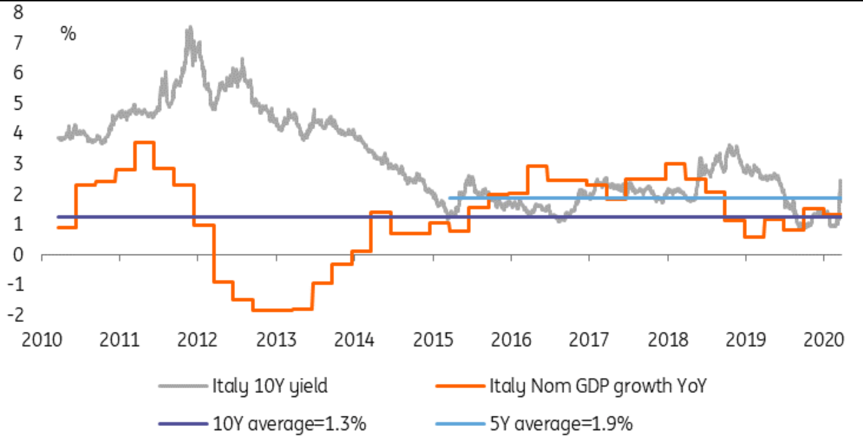
Will they spend all of it?

The wording of the announcement is nagging us. The term ‘envelope’ suggests there is no commitment to spend the entire amount. This would be a departure from previous programmes. We see a material execution risk in the first weeks of the new programme. Arguably, the need for ECB intervention is most pressing now. If the ECB does not purchase a greater amount of bonds than the roughly €18bn weekly run rate of the new programme, its credibility will come into question.

For this reason, we see the newly minted Pandemic Emergency Purchase Programme (PEPP) as more of a backstop than as classic Quantitative Easing (QE). In effect, PEPP is a less efficient version of the yield curve control (YCC) enacted by the Bank of Japan and Reserve Bank of Australia to cap bond yields. The implication for euro bond valuation is that there is an upper limit to yields that the ECB will now enforce. Unlike the BOJ and RBA, these levels are not advertised by the ECB however. Whilst inevitable due to fragmentation of the European bond market, this creates an asymmetry of information between market participants.

In the case of Italy, we can still venture a guess as to where the cap may be. We surmise that the ECB’s motivation was to prevent Italian bonds falling into a vicious spiral where rising yields would worsen debt dynamics, then causing a further rise in yields. Using a simplistic metric, we would assume the ECB wants to prevent yields rising materially above Italy’s long-run nominal growth rate. To us, this means preventing Italy’s yields rising above 2% (see chart below). In practice, we suspect that if it is to get anywhere near the €18bn/week PEPP benchmark, the ECB will have to buy bonds even when yields are lower than this.

10Y Italian bond yields vs nominal growth



Source: Bloomberg, ING

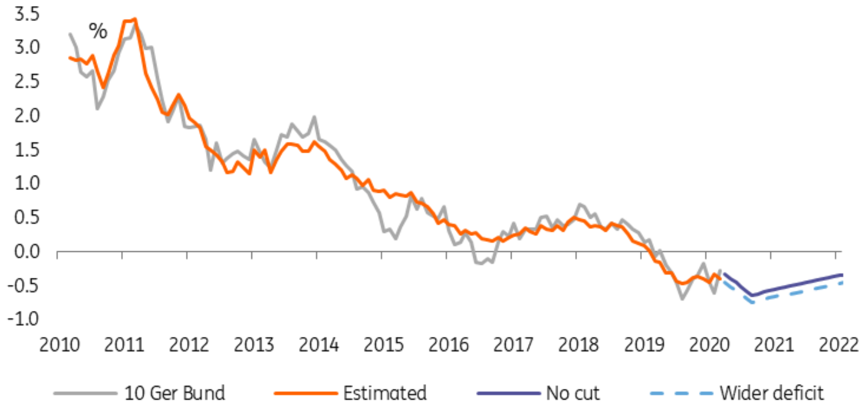
What about Bunds? Still crying for help

One key sentence in the PEPP announcement is, “For the purchases of public sector securities, the benchmark allocation across jurisdictions will continue to be the capital key of the national central banks”. In plain English, the capital key distribution still applies even if flexibility is possible, and this limit may be relaxed if it proves a hindrance in the execution of the programme. This means that for each €1 spent on Italian debt, the ECB should spend €1.55 on German debt. This, of course, will bring ECB holdings closer to the 33% issue share limit.

Now, this should normally be good news for Bund but as we wrote above, we doubt the whole 'envelope' will be spent. Another worry is that the ECB failed to cut the depo rate last week and did not mention cuts this week. This reinforces the impression that the ECB is reluctant to use interest rate policy. We do not blame them, but this removes a factor driving Bund yields lower. Putting it all together, we see Bund fair value (FV) at -0.55% if the ECB doesn’t cut rates, if it does cut by 20 basis points, FV moves to -0.65%.

One under-appreciated impacts of PEPP is that it should allow core bonds to regain their status as a safe-haven. There is still much uncertainty about the length of the economic disruption caused by the coronavirus, and thus more downside to risk assets not directly supported by central banks. We expect the 10Y Bund to benefit from any further deterioration of risk sentiment and to return to its fair value.

More downside to Bund yields if old relationships apply



CP: expanding the shopping list

The ECB has expanded the pool of assets. It can now buy non-financial commercial paper of sufficient credit quality under the Corporate Sector Purchase Programme (CSPP). The short-term European paper STEP market has more than €400bn outstanding currently, of which more than 60% are in EURs. Non-financial corporations only accounted for around €38bn of the outstanding paper however, according to the ECB.

The USD funding squeeze that led to a widening of Libor/OIS and cross currency bases also had roots in CP markets, or rather its traditional investors. As money market funds (MMFs) started hoarding liquidity to prepare for potential outflows amid the crisis, CP issuers where losing a crucial funding source. While the respective EUR spread measures have been relatively contained so far, including corporate paper in ECB purchases going forward should be geared at pre-empting a similar situation.

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