Eurozone: A step in the right direction for peripheral bonds

The ECB is finally taking the measure of financial fragmentation risk in the eurozone. In addition to existing tools, it is working on a new instrument to prevent further widening of sovereign spreads. We'll await more details but the announcement has likely changed the trajectory of spreads. Positive implications for the euro should, however, be modest

Source: Shutterstock

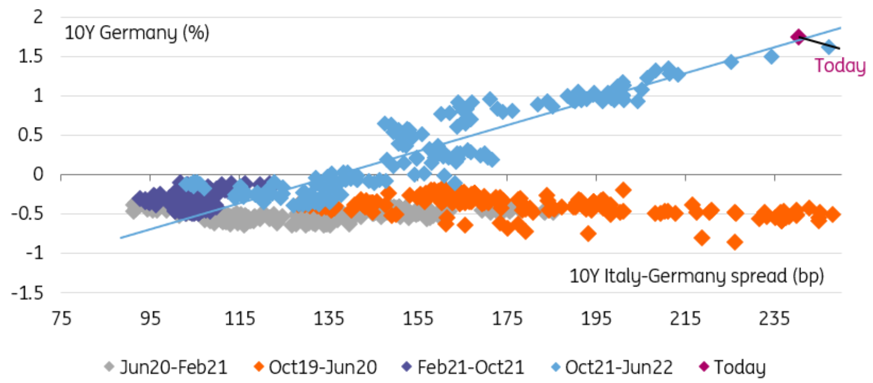
A much needed sense of urgency

The European Central Bank's Governing Council held an emergency meeting today to discuss market developments, and in particular the widening of sovereign spreads. The gathering took place less than one week after a regular monetary policy meeting where it failed to address the financial fragmentation risk posed by its upcoming tightening cycle.

> *The ECB finally takes the situation seriously*

The very unusual step to meet outside of their regular meeting cycle is an encouraging sign that the ECB finally takes the situation seriously. Unfortunately, the announcement was light on details. In a nutshell, it confirmed that it will use pandemic emergency purchase programme (PEPP) reinvestments to lean against spread widening. More importantly, it also confirmed that internal committees are working on an additional instrument.

Italian spreads have widened as core yields rose



Source: Refinitiv, ING

Light on details but a step in the right direction

In our view, PEPP reinvestments alone are insufficient to cap sovereign spread widening in a global monetary tightening cycle. In that respect, the fact that the ECB acted today ahead of a likely 75bp Fed hike is good news. Details on this new facility are still unknown but the mere fact that one is in the works is encouraging news to peripheral bond holders, and will likely slow the selling flow.

Details of the facility will likely transpire in the coming days and weeks as they are being ironed out. In our view, the most important questions to answer are:

- Conditionality: do countries that will see their sovereign bonds purchase have to fulfil any conditions, eg, adhering to the Stability and Growth Pact.
- Size: what amount the ECB would be allowed to purchase via this instrument
- Maturity: what is the maturity of the bonds the ECB would be purchasing
- Purchases breakdown: will the ECB have leeway to buy bonds only in some jurisdiction

We wrote recently that we expected Italy-Germany 10Y spreads to test 250bp barring an ECB intervention. They peaked at 242bp yesterday and we think today's announcement makes it less likely that these levels will be revisited any time soon.

Wider sovereign spreads are consistent with other markets

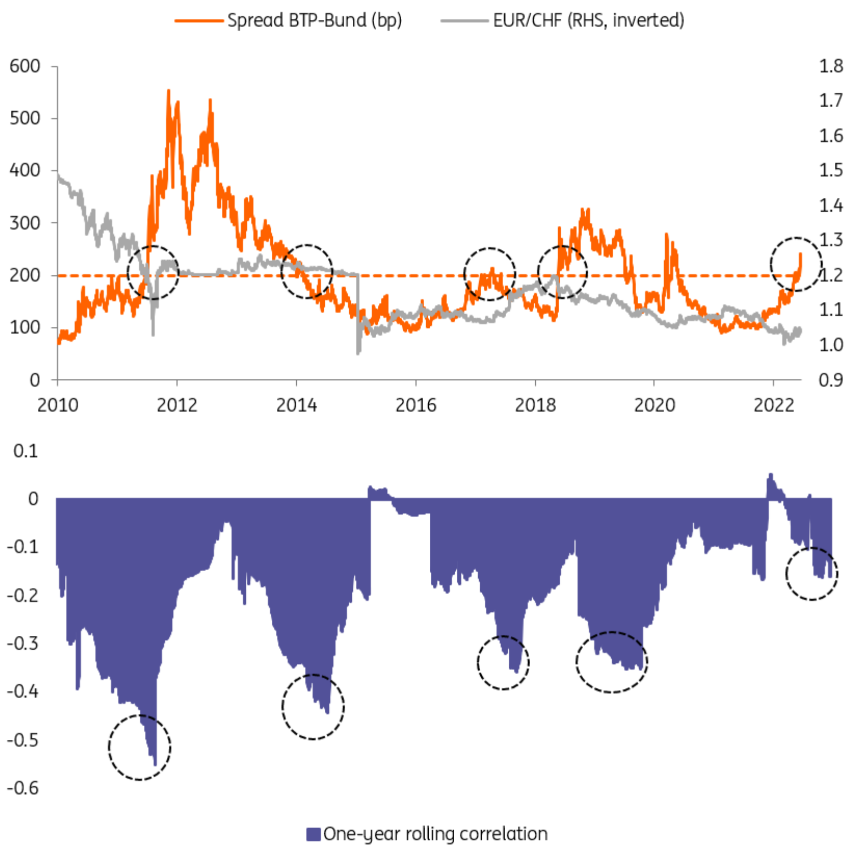
Source: Refinitiv, ING

FX: Not a game-changer for the euro

The rise in sovereign spreads in the past week was one of the reasons why the euro blatantly failed to benefit from the ECB's hawkish tone and openness to a 50bp September hike. In this sense, the new anti-fragmentation tools by the ECB successfully are probably good news for the euro should they successfully keep spreads checked as the ECB tightens policy.

However, the risks to the EUR outlook are not limited to sovereign spreads – EUR is down today despite tightening spreads – as the worsening economic outlook in the eurozone may generate a widening growth differential with the US that may negatively impact equity flows into the region. Incidentally, EUR/USD may continue to see limited upside potential on the back of dollar strength, which is being fuelled by aggressive Fed tightening, global economic woes and turbulent equity markets. Overall, the positive impact on spreads from the announcement of new tools does not change our view that EUR/USD will stay anchored around 1.0500 during the summer months.

EUR/CHF would normally be a better mirror of how peripheral spreads impact the FX market. Historically, the correlation between EUR/CHF and the 10Y BTP-Bund spread tends to peak when the spread breaks the 200bp level (chart below), as markets see debt-sustainability risks rise. We have seen some stronger correlation lately but not as marked as in previous instances.



Source: ING, Refinitiv

This may be due to the quite unique situation where high inflation is pushing not only the ECB to hike rates, but also the Swiss National Bank. On this topic, it will be interesting to keep an eye on tomorrow's (16 June) SNB meeting. None of the 20 economists surveyed by Bloomberg expect any adjustment in the SNB's -0.75% policy rate. An early rate hike would therefore be a massive surprise and confirm that that the SNB would be conforming literally to its mandate of keeping CPI below 2% year-on-year (last 2.9%), presumably backed by a higher inflation forecast over its horizon. Whether the SNB hikes or not, we now favour EUR/CHF lower over the next year (target 1.00) as the SNB keeps the real CHF stable by engineering nominal CHF appreciation – probably at around 4% per annum to offset Switzerland's low inflation relative to trading partners.

Author

Antoine Bouvet
Head of European Rates Strategy
antoine.bouvet@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

Disclaimer