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Rates Daily: ECB steps up to the plate

While the US official sector continues to fire fight, the off-shore crew are falling over themselves to get their hands on dollar liquidity. Bond investors were given a boost yesterday by the Bank of England and the European Central Bank boosting QE. The outlook for core and for peripheral bonds brightens as a result, despite widening deficits

Source: Shutterstock

Plumbing the works till the cows come home

Ever hear of gates and fees? US money market players know all about them. They are there as a protection for both the money market funds themselves, and to protect participants in the funds. They incur fees and limits in a scenario where there is a significant drawdown on the fund. Thing is, if these are triggered, they cause consternation and added stress. Therein lies another layer of anxiety for the official sector.

We mention that as talk of the town yesterday was that the US Treasury was mulling a backstop support for money market funds. This is a great idea, as it would allow money market funds to minimise panic liquidations in order to protect themselves in the face of outflows. It would mean less hoarding of liquidity, which is good. Thing is, it does not necessarily remove the risk for more corporate commercial paper outflows in the first place.

Despite the measures taken, we continue to identify a relative elevation of Libor as an ongoing sign of angst. And despite all the talk yesterday of a tighter basis on cross currency swaps to dollars, the basis in fact widened for very short (3 month) tenors. So the underlying narrative of dollar liquidity angst remains. Frustrating as each solution leaves other elements of risk. But the official sector should continue to fire fight as best it can.

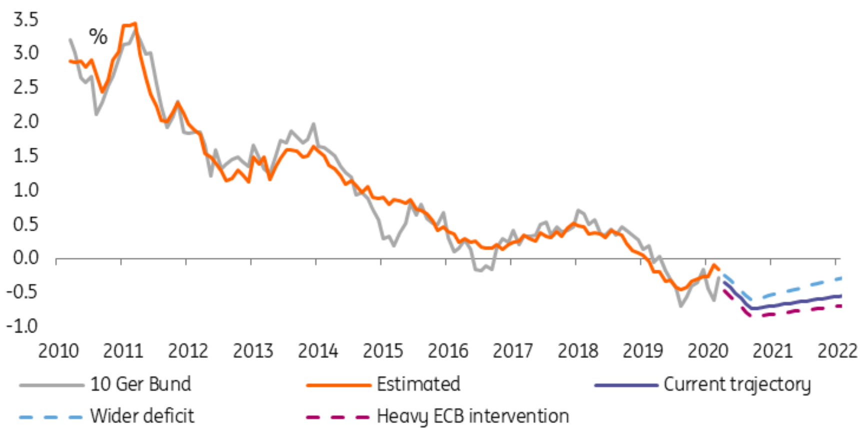
Bund valuation: crying for (ECB) help

The rise in core government bonds globally has caused much surprise and angst on the part of investors relying on them for portfolio diversification. Of the factors justifying ever lower interest rates, secular growth and inflation slowdown, hyperactive central banks, and deficient fiscal policy, the last two have been called into question in the past few days.

There is still much uncertainty as to the size of any fiscal package in the eurozone. We remain doubtful that stimulus on the scale of what is discussed in the US is applicable to Europe however. The ECB's timid response last Thursday has also been a factor in the upward move in bond yields, in core as well as in the periphery. Fortunately, the new €750 billion quantitative easing envelope (see below) unveiled yesterday has the potential to change this dynamic.

Reactivating the Outright Monetary Transactions is sub-optimal on a number of levels. One of them is that it would fail to stamp out the rise in core yields at a time when issuers are boosting issuance. The additional ECB envelope should go some way towards lowering borrowing costs but also towards restoring core bonds' status as a safe haven. In our Bund FV chart below, the new lower path now becomes the relevant one.

Even with fiscal easing, Bund yields should be lower



Source: Bloomberg, ING

How to solve a problem like Italy

The widening in Italian government bond spreads was only brought to a halt yesterday by headlines that the EU was considering activating the European Stability Mechanism bailout fund. The idea is that granting ESM credit lines to countries facing fiscal strains as they stem the COVID-19 crisis would also open up the possibility of additional bond purchases by the ECB via the OMT. The ESM's remaining lending capacity is €410bn, but the ECB's OMT comes without quantitative limits, although it is only allowed to buy in 1-3Y maturities. And slipping under the umbrella of the ESM it comes with conditionalities attached, usually in the form of budgetary and reform commitments. This is likely to face resistance from Italy itself even as the EU was reportedly considering “minimal conditionality.”

The other issue: While the OMT is without quantitative limits, the Public Sector Purchase Programme is not allowed to hold more than 33.3% of any issuer or bond. Importantly, these restrictions take into account all Eurosystem portfolio holdings. At the extreme this could mean if limits are hit, the ECB could continue purchases only in short maturities via the OMT, restricting its ability to intervene in markets in a time of need. Hence, we would pay more attention to comments such as those by ECB’s Olli Rehn who suggested that QE may need to be expanded and PSPP issuer limits removed. Alongside the stated flexibility on the capital key distribution of purchases this should provide an effective backstop to government bond spreads.

Pandemic Emergency Purchase Programme - Now we're talking

And indeed, the ECB reacted in kind by launching a new asset purchase programme dubbed the Pandemic Emergency Purchase Programme to stamp out the sell-off occuring across euro fixed income markets. The new envelope available will be €750bn to spend on the securities already eligible to the Asset Purchase Programme and non-financial commercial paper (CP) by the end of the year. The ECB included a waiver for Greek government bonds to be included in the programme but public sector securities purchases will continue to follow the capital key.

The ECB ended its statement by stressing that the size of the programme could be increased if necessary and that some of the self-imposed limits might be relaxed. The announcement came shortly after the Bank of England unveiled a commercial paper purchase programme of potentially unlimited size yesterday.

We think the nature and size of the programme is a more credible option to reign in the widening of sovereign spreads, especially Italy's. After Italy-Germany spreads touched our near-term target of 300bp yesterday, we now see scope for the spread to re-tighten all the way to 200bp. Given the commitment to the capital key, core bonds should also benefit. The amount of corporate paper purchased has the potential to 'dilute' purchases for other asset classes however.

What's up today? TLTRO, Bond auctions, IFO

The ECB announces today the liquidity allotment for the third tranche of the Targeted Longer-Term Refinancing Operation 3. Banks have announced they will repay €92bn from previous facilities and it is possible that some of the demand for liquidity has been displaced from this TLTRO tranche to the temporary LTRO available until June.

Today sees the release of a flash March IFO index. This will be one of the first indicators giving a good sense of the economic malaise. France (3y/5y/7y) and Spain (7Y/10Y/15Y) sell bonds in volatile markets. France raised this year's bond issuance target by €5bn and its bills funding target by €17.5bn yesterday.

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