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Rates: PEPP reinvestments alone may not be enough to contain spreads

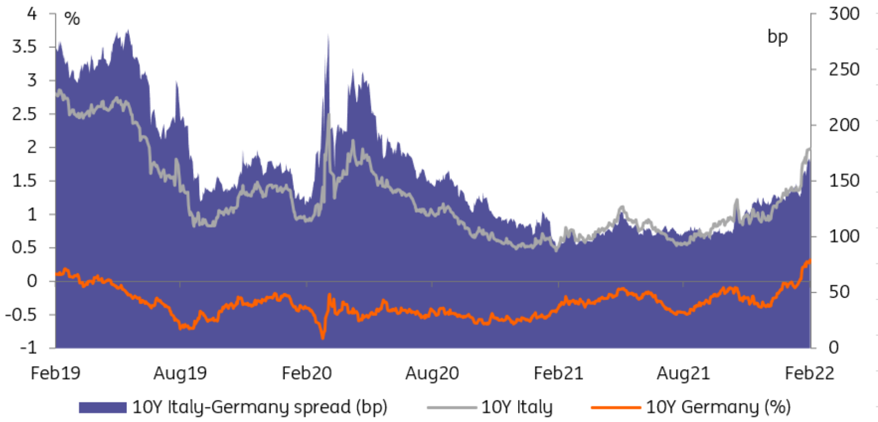
For now, the European Central Bank is playing down the need to tackle rising sovereign spreads. But accelerated tightening timelines imply that the periphery is quickly losing an important support pillar as net-QE is brought to an end. Merely reshuffling pandemic emergency purchase programme reinvestments may lack the volumes to contain spreads

High inflation is putting the ECB under pressure to tighten monetary policy. Given the pledge to stick to a sequenced exit, this implies net asset purchases will be wound down first. In sovereign bond markets that means periphery bond markets are losing one important pillar of support. That prospect is one important reason why sovereign spreads have widened in recent weeks as markets priced in an accelerated tightening timeline.

For now the ECB is not too worried about the magnitude of widening

For now the ECB has said it is not too worried about the current magnitude of widening, even as 10Y Italian government bonds now trade at above 160bp over German Bunds, up from levels closer to 100bp around mid-2021.

By ending QE early, the ECB has removed a cap on peripheral spreads



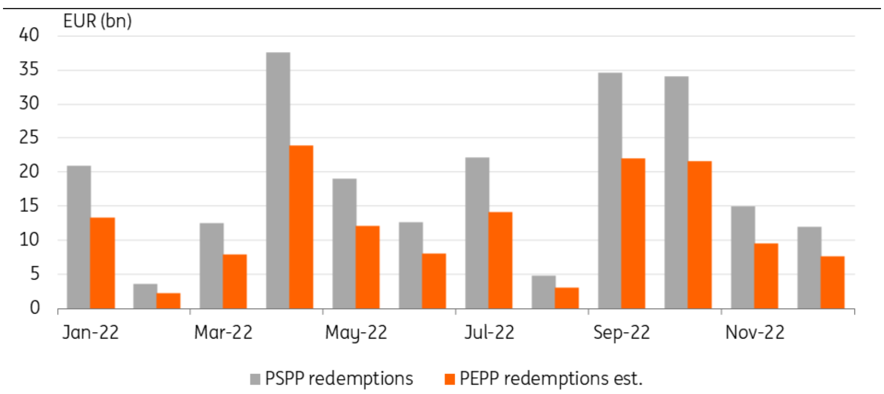
Source: Refinitiv, ING

Scoping out the limits of potential PEPP reinvestment support

The ECB seems bent on ending net asset purchases this year. And it is pinning its hopes on the stock of bonds it already owns to dampen upward pressure on yields, and more specifically, that the flexibility of PEPP reinvestments going forward will be enough to contain spreads.

The question is, just how much firepower does that flexibility in PEPP reinvestments potentially offer to support the periphery markets? Currently the ECB only publishes aggregate redemptions for its public sector purchase programme one year out. To answer the question one simple approach would be to scale down this PSPP redemption profile to the size of the PEPP portfolio. That can give a first idea of the volumes in play, a caveat of course being that it disregards differences that stem for instance from the wider maturity spectrum which PEPP buying has entailed.

Redemption profiles of the ECB's public sector portfolios



Source: ECB, ING

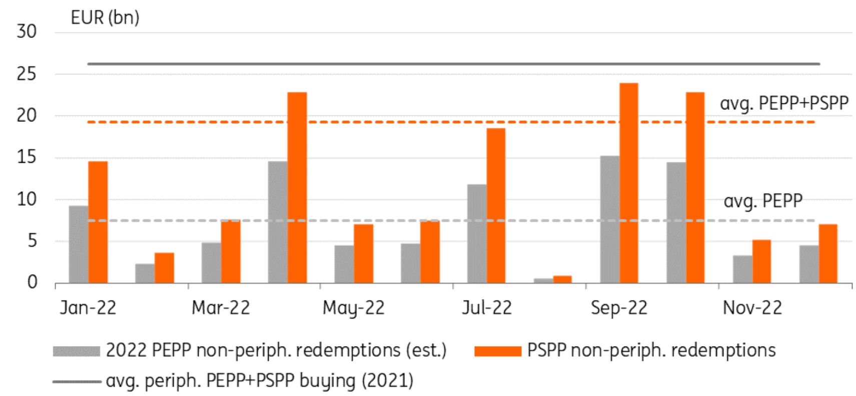
The next step would be to split up the estimated PEPP redemption profile into a periphery and non-periphery market share. The idea is that only the latter, if geared towards the periphery, would then constitute an additional net central bank buying in support of spreads, though even pure reinvestments may already offer some support, in particular if duration is lengthened. For the sake of simplicity we apply the known split of overall market redemptions.

> *Shifting PEPP reinvestments can only provide a fraction of the net buying support seen in the past year*

This simple approach indicates that shifting PEPP reinvestments alone can only provide a fraction of the support that net buying has provided in the past year. Even if assuming non-periphery redemptions are "repurposed" in their entirety, one would arrive at less than a third of the ECB's periphery net buying volume in 2021 (PSPP and PEPP combined). The ECB will also have to cope with non-periphery redemptions not necessarily coinciding with the need to intervene in the periphery. A more active management of redemptions – reinvesting non-periphery redemptions in short dated bills – may create more flexibility in that regard but will have other undesired effects as duration is then shortened in these markets.

It does not bode well for the periphery. Of course, the first half of 2022 will still see positive net-QE, but the above calculations give a sense of what lies beyond as redemption profiles may not look too differently next year.

Lacking oomph - shifting non-periphery PEPP redemptions into the periphery



Source: ECB, ING

What options does the ECB have if it becomes clear flexible PEPP reinvestments alone are not enough? Changing the sequencing of the exit would offer immediate support, but it is probably the most contentious solution as the ECB has already invested a lot of credibility in communicating a path that would see net purchases ending before rates are hiked. The extension of the PEPP's reinvestment flexibility to PSPP reinvestments could more than double the ECB's potential firepower, but could potentially also expose it to renewed legal challenges. Having to deal with the German constitutional court again is something the ECB should be keen to avoid. A dedicated contingency buying programme that would only intervene when financing conditions deteriorated too much also remains an option.

For now, the ECB is playing down the need to tackle rising sovereign spreads. Our impression is that the bar is high for the ECB to become more proactive with regards to sovereign spreads. This means more widening may have to be seen before it gets better again. We would not exclude the 10Y Italian spread revisiting 200bp first.

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