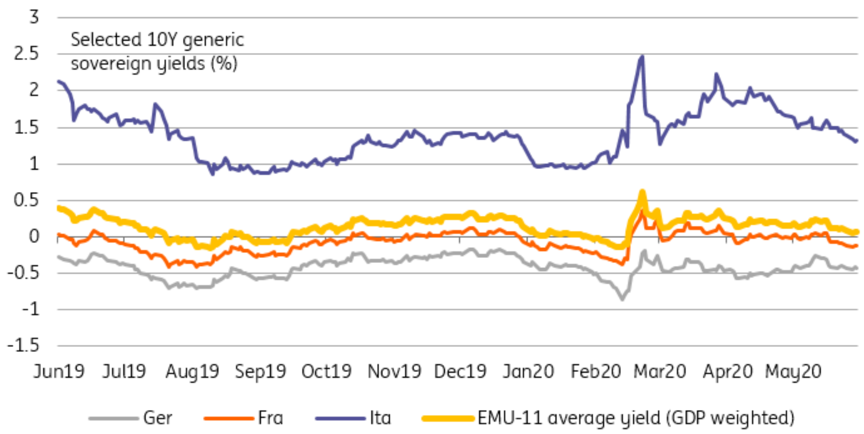
Rates Spark: can the ECB turn sentiment around?

We don't think so, but the minutes to be published today should cement the outperformance of peripheral debt. Following up on Austria's century bond, it is notable that only core issuance saw lengthening maturities on average over the past quarter, but that does not mean others won't shift their focus as the ECB pledges benign funding conditions.



Source: Bloomberg, ING

A dovish tilt is expected in today's ECB minutes

Regular readers know that we think a key reason for peripheral debt performing better than other risk markets is the ECB's intervention. In this light the minutes (called accounts) of the June 4th meeting could prove a focal point. To be clear, speakers have skewed expectations in favour of a dovish tilt, confirming the decisions taken that day. Holzmann for instance, usually understood to be part of the hawkish wing of the governing council (GC), said there was surprisingly little disagreement at the last meeting.

The ECB's chief economist Philip Lane also dedicated a lot of time to explaining the ECB decision in recent speeches and blog posts, thus reducing the potential for surprises in today's minutes. Nevertheless, an endorsement by the governing council of Lane's analysis would be an interesting takeaway for rates markets. A dovish central bank is unlikely to completely offset worries surrounding rising covid cases in our view, so lower rates and flatter curves for core countries and swaps are on the cards in the coming days.

But peripheral debt should be supported nonetheless

To summarise Lane's points most relevant to interest rates, he repeated that the ECB views PEPP as its most potent tool to fight the fallout from coronavirus. One particular focus seems to be reducing sovereign yields on (GDP-weighted) average. In our analysis, and the chief economists confirmed this point yesterday, peripheral bonds are the main contributors to this index on account of their greater volatility. This is a key plank behind our expectation that Italy-Germany spreads will continue tightening to 150bp in the coming days.

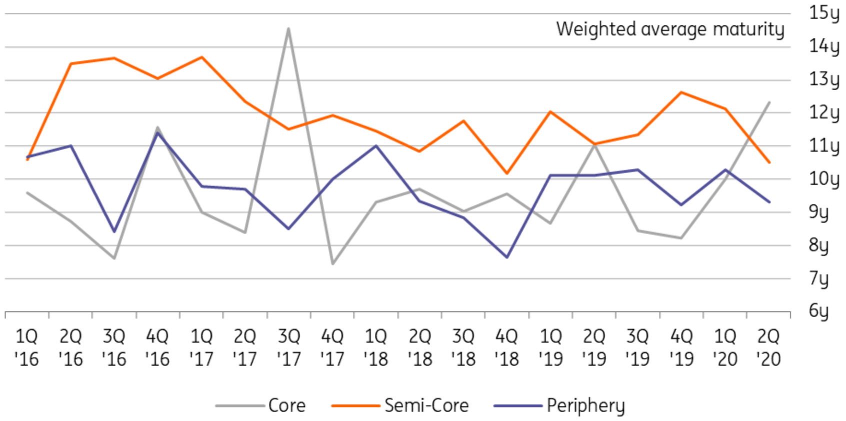
Comparatively, Lane seems to think rate cuts are a less appropriate tool than QE in this environment. It follows that EUR curve bull-flattening if the outlook deteriorates is the correct reaction, at least until the 10Y point. At the front-end, 3-months Euribor fixings seem to have reached a floor for the time being. More importantly in our view, 6-months fixings continue catching up with shorter tenors, in line with our expectations.

Only core Eurozone issuers have lengthened their bond issuance durations ...

Yesterday Austria sold €2bn in 100Y maturity bonds with an issuance yield of 0.88%. The deal saw strong demand with an order book just shy of €18bn. As investors scramble for yield one can argue that it is only prudent for an issuer to make use of the very benign funding conditions provided by the ECB's sizeable purchases and so lengthen the duration of their debt profile (even though the 100Y bond is out of scope for the purchase programmes), as was already the case in 2016.

Looking at bond issuance to date, it is notable that only the highest rated issuers in the eurozone – or core countries – have actually lengthened their issuance in 2Q on aggregate (even when excluding Austria's 100Y issue). Note that the previous peak in 2017 was when Austria issued its first century bond. The weighted average maturity of issuance in semicore countries (France and Belgium) and the periphery (Italy, Spain, Portugal and Ireland) has actually dropped in 2Q. Amid the crisis and the suddenly and substantially increased funding needs the focus has been to raise vast amounts of cash quickly in the least disruptive ways, particularly given some countries' already precarious debt ratios. In absolute volumes 2Q issuance of the periphery already now tops usual peak quarterly issuance by more than 50%. In semicore countries issuance is slighly above.

Average maturity of quarterly European government bond issuance

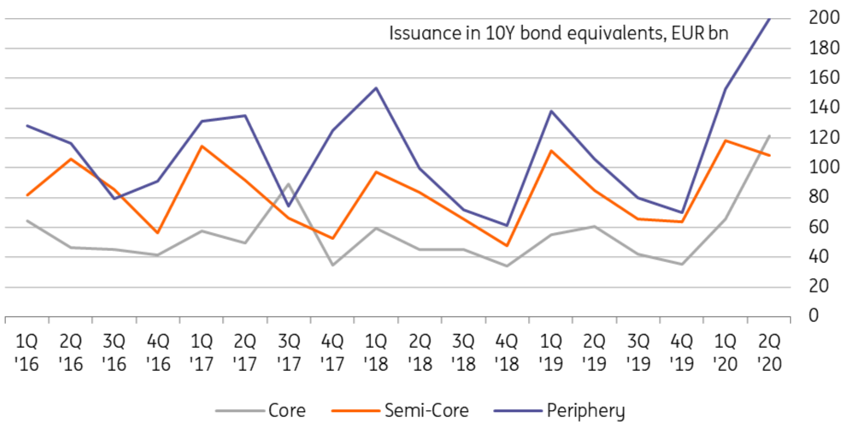


Source: Debt agencies, Bloomberg, ING

... while for the remainder the initial focus was to raise vast amounts quickly

Another way to look at the issuance is in risk adjusted terms or 10y bond equivalents, combining volume and duration into one indictator. On that metric 2Q issuance in the periphery is still above recent years' peaks, but tops it by only 30%. Still a lot of risk to digest for markets, and don't forget that the ECB also absorbs a good share. For the semicore aggregate we see issuance in risk adjusted terms still slighly below recent peaks. As we stressed recently when comparing the Eurozone sovereign issuance figures with ECB purchases, there is no end in sight yet for state deficit revisions. The latest examples to date are Italy preparing to ask parliament for additional deficit, and France extending its furlough programme for as long as 2 years.

This does not mean that countries will not lengthen their issuance at a later stage. Much of the initially ramped-up money market issuance is likely to be shifted towards bond market funding. With the ECB pledging to keep financing costs in check for the foreseeable future, there is still plenty of opportunity to do so.



Source: Debt agencies, Bloomberg, ING

Today's events: ECB minutes, US claims and durable goods orders

In European time, the main event will be the publications of the June 4th ECB meeting.Italy will also sell short-dated debt (2Y zero coupon and 6Y linker).

In the US session, jobless claims and durable goods orders are the highlights.

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