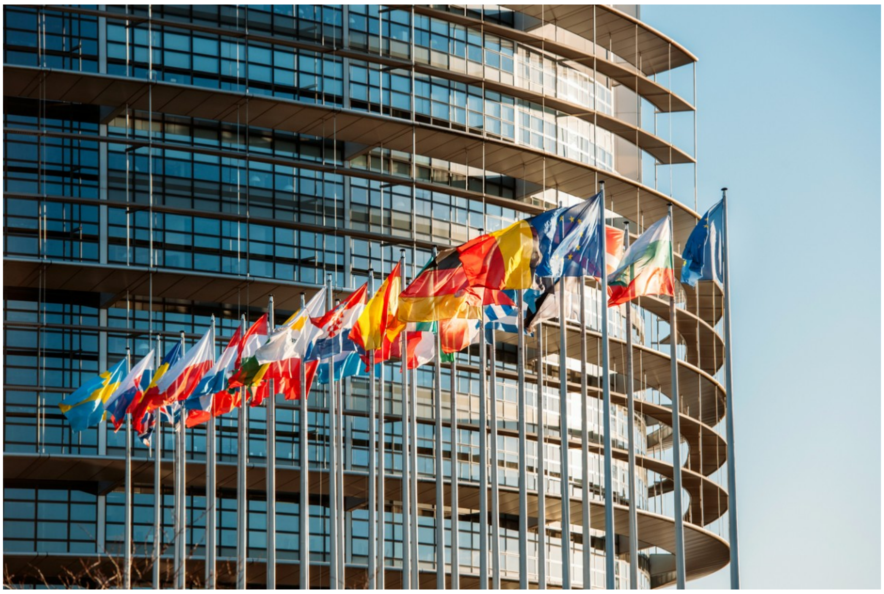
Rates Spark: Cutting to the chase

The EU has outlined the funding strategy for the Next Generation EU (NGEU). Once ratified by all member states it should start issuing in July. The ECB's PEPP buying will have slowed again by then and the focus could turn to other political factors. US focus today is on retail sales, one more indication that rates are still out of line with the recovery.



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EU funding plans are becoming more concrete ...

The EU commission has laid out its funding strategy for the EU recovery fund. The current plan is to start issuing in the summer when – and if – all member states have ratified the EU's "Own Resources" decision that backs the increased borrowing. 17 states have already ratified the decision. Among those not yet to have done so is Germany, where the constitutional court here still has to give its green light. EU Commissioner Hahn expressed confidence that this would eventually be given, not least because what held up the plans last year were the lengthy elaborations to protect the plans from any constitutional challenges by member states. That said, there is no plan B, if one member were not to ratify.

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In total the EU will raise around €800bn between now and 2026. The base case sees at least €50-55bn in issuance this year starting in July, followed by yearly issuance of around €150bn. The assumption is that the market will be able to absorb around €15-20bn of EU bond issuance per month. The complexity of the EU recovery plans will no longer make it possible for the EU to follow its usual back-to-back funding approach. Issuance activities will more closely resemble those of larger EU sovereign issuers. They will feature annual funding plans and regular auctions and syndications of bonds in 3Y-30Y maturities, conducted within a network of primary dealers. To add flexibility the EU will also launch a money market bills programme.

… and after boosting the social bond market, green is next

Under the SURE programme the EU already issues social bonds, with close to €100bn overall planned quickly dominating this segment of the sustainable bonds market. For the recovery fund, the EU plans to raise at 30% of the funding via green bonds, in total €250bn. It will be a boost to the segment, which as of now has a total volume of EUR denominated green sovereign and SSA bonds outstanding at €180bn.

A lot coming together towards the end of this year for EUR rates

Currently the ECB is still buying bonds at a faster pace via the pandemic emergency purchase programme (PEPP). Judging from latest ECB commentary, there is little desire to extend this faster buying beyond the second quarter, and by April 2022 bond markets probably won't be able to count on the further support of the PEPP.

That could keep periphery sovereigns spreads in limbo and more vulnerable should the ratification process face a longer delay or, in the (we think less probable) worst case, if the German constitutional court would not provide its green light. In core markets, our forecast of 10Y German yields converging to 0% later this year would then be at risk.

With the EU recovery fund coming online the direct bond market peers could also face pressure despite announced efforts to coordinate issuance plans. That could be the case in particular for France which then runs into the pre-election phase of what is likely to be become another contest between incumbent President Emmanuel Macron and the main challenger from the right Marine Le Pen.

Today's events and market view

The post-supply relief rally was short-lived both in US Treasuries and also eurozone bonds where the 10Y Bund yield rose past -0.26% yesterday.

Sentiment was boosted by news that Pfizer will deliver 50 million more doses in 2Q to the EU, making up for the potential suspension of the J&J vaccine. And ECB President Lagarde also acknowledged that the US stimulus would have spill-over effects for the eurozone economy: more concrete a boost of 0.3 percentage points to growth and added 0.15 percentage points to inflation in 2022.

In supply Ireland having announced an additional 20Y deal indicates that appetite for long-dated deals remains healthy from issuers, even with the approaching ECB meeting.

The Fed should be well aware that market rates need to adjust higher

In the US the Fed's Powell said that the timing of the rates lift-off would be outcome based, but highly unlikely to happen before 2022. Not ground breaking, but we sense a shift towards more optimism versus a month ago. We also think the Fed should be well aware that market rates need to adjust higher, and it should be wary of preempting a return to levels more consistent with the recovery. Remarks such as Powell's, gradually moving away from the strict "not before 2024" towards a more balanced assessment should leave more room for that adjustment to happen in an orderly manner. All the more important as today the market will probably watch another surge in the March US retail sales data which is boosted by the latest round of stimulus cheques.

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