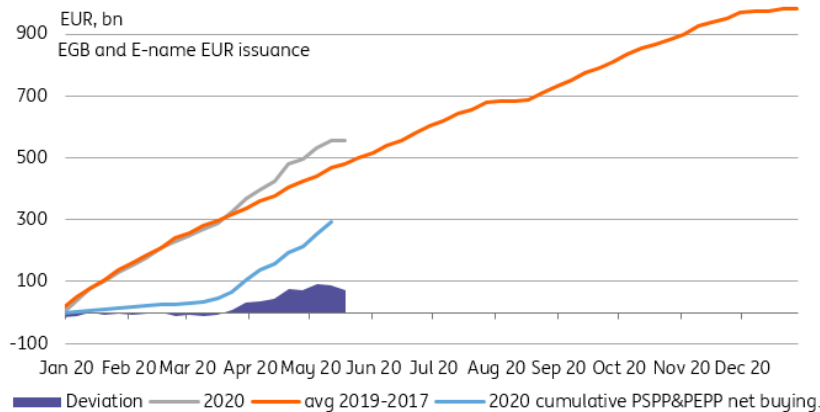


Rates Spark: It takes 2(7) to tango

The prospect of EU cross-border fiscal stimulus should have raised interest rates. It didn't. We think expectations of more QE in June are to blame. In the US, a new 20yr today rolls back the years. Treasury Secretary Mnuchin was asked yesterday whether a 100yr could be contemplated. Probably not he said; but we would not rule it out - we explain.



Source: ECB, DMOs, ING

ECB QE vs EU recovery fund

Since the onset of the coronavirus epidemic in Europe and the US, and the aggressive monetary and fiscal policy responses it triggered, EUR and USD rates have been facing two opposite forces: the prospect of additional central bank bond purchases and of additional government issuance, both in record amounts. Our view is that the impact of central bank intervention is likely to outweigh that of additional supply.

This is far from a foregone conclusion: Lagarde said in an interview earlier this week that the ECB expects an additional €1-1.5tn of Euro government debt issuance this year. This should in theory outweigh the roughly €1tn of ECB purchases spread across asset classes.

The interplay between market reaction to EU recovery fund proposals, and positioning into the June 4th ECB meeting is a great opportunity to test our view that central bank purchases are more impactful. The recovery fund proposed by Germany and France entails €500bn of extra debt issuance. According to a [Reuters poll](#) published last week, the median estimate for QE increase in June is €375bn. Since not all this should be spent on government bonds or SSA, the additional net

debt issuance should in theory have raised EUR interest rates.

What is priced in EUR rates

One potential explanation for EUR rates failing to rise is that markets are assigning a lower probability to the recovery fund plan coming into fruition than to additional QE. This would indeed be wise [in light of the large number of unknowns at this stage](#), but we think this reflects something more fundamental: there seems to be a widespread scepticism that both fiscal and monetary policy measures will succeed in boosting long-term growth and inflation.

A look at Italian rates also yields some interesting insights. Unlike core (eg German, French) bond yields and swap rates, Italian yields should be affected the same way by additional ECB QE and by a large EU recovery fund: they should drop. There has been some spread tightening in recent sessions but not nearly what we should get from the combination of additional ECB purchases (especially if weighted, as we expect, towards the periphery), and some degree of fiscal transfer.

It takes 2(7) to tango

The obvious call should thus be that Italian yields will continue to converge lower into the ECB meeting. The way to tighter spreads is littered with banana skins however. The main obstacle in our view is that between now and when the recovery fund is finally launched, more holes are going to be poked into the proposal. For instance, we await with interest Austria's counter-proposal to the German-French plan. On the other hand, Conte has requested a larger recovery fund to the EU commission. Another risk is the upcoming confidence vote in the Italian justice minister.

Yesterday's market reaction to Le Maire saying the funds will likely be available only in 2021 is telling: one could have inferred that from the choice to chain EU recovery funds at the leg to the Multiannual Financial Framework. From here, we expect more tightening of sovereign spreads, but warn this is unlikely to be as smooth a ride as policy measures would suggest. Core and swap rates on the other hand should remain stable as long as ECB QE expectations are being built-up, most likely into early June.

Today's events: Inflation and consumer sentiment data, BTP Italia on course for a double-digit billion sale

Although statisticians will have faced difficulties in the collection of data, UK inflation is likely to have slowed in April on the back of lower energy prices. Similar issues will affect today's final euro area inflation data. Consumer confidence data for the area may offer more insights, as it could point the way forward for the retail sector.

The first tranche of the newly-minted ECB PELTRO is being allotted today. We view the facility as more of a backstop to banks that have already exhausted their TLTRO borrowing ability, or didn't have any in the first place (specialist lenders, small banks etc.). For larger banks, the new reduced-rate TLTRO is more attractive. We thus expect a modest allotment today, in the low double digit billions. A larger number would send a signal that more banks are scrambling for funds than thought. Whilst secured, PELTRO funding should also help cap the upside to Euribor fixings (based on unsecured funding).

In primary government bond markets Germany will tap it's 10Y benchmark for €4bn. France will reopen bonds in the 3y to 6Y area for up to €10bn and issue another €1.25bn in inflation linked

bonds. In Italy the sale of the BTP Italia enters its third day, having so far collected €8.8bn in orders from retail investors. Tomorrow the sale will be opened to institutional investors. The already healthy demand from individual investors indicates that Italy is able to tap into new funding sources, helping to support the improved sentiment regarding Italian risks.

A new US 20yr to be launched today. Anyone for a 100yr?

And in the US, history gets re-made today as the Treasury launches a new 20yr bond. In 1981, the first 20yr was auctioned, replacing the 15yr. The 30yr had been introduced four years before that. Then, in 1986, 20yr auctions were eliminated, leaving the 10yr and 30yr as the longer maturity options on the nominal curve for the subsequent three-and-a-half decades. Until today - when \$20bn will be auctioned in a new 20yr; adding that benchmark point back to the curve.

Questions on possible future 50yr and 100yr issuance options were tabled to, but discarded by, Treasury Secretary Mnuchin yesterday. We would not be so hasty to rule these out, as times like these call for as many options on the issuance front as possible to help finance a massive fiscal deficit that is getting larger by the day. It is not so much a matter of a lack of demand (as Mnuchin suggested), but rather the requirement to find the right price to help draw that demand.

As an aside, while there was nothing earth-shattering from Fed Chair Powell yesterday, it is worth remarking that the negative rates discount on the future strip did finally manage to dissipate - we were surprised it hung in there during the risk-on session seen on Monday. If we were ever to see negative rates we'd have to go to a non-vaccine environment that threatened an L-shaped recovery for the economy, where massive debt build-up could require a big discount on the cost of funds.

That is an environment where a 100yr could be contemplated - it would feel like an ultra-low coupon perpetual; a dream for issuers. But let's hope that does not happen. Far better to keep the funds rate in positive territory, something more akin to an elongated "r" (as hand written) for the economy, and keep the 30yr as the long bond.

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