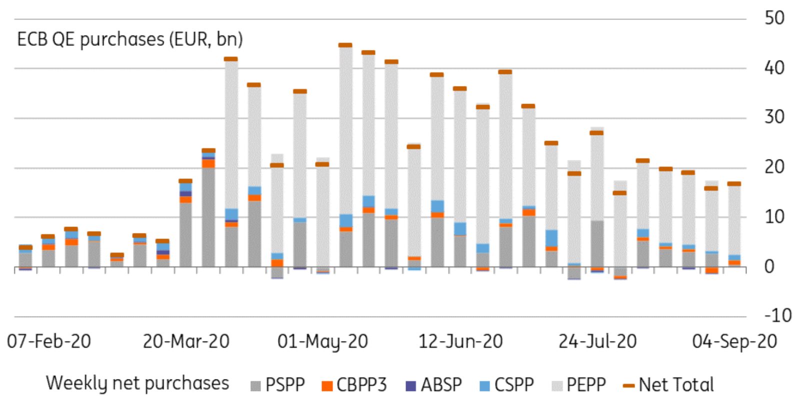
Article | 8 September 2020

Rates Spark: Spread doldrums

The long-term case for tighter sovereign spreads remains, but an uncertain ECB outlook and higher rates volatility has taken the wind out of their sails. This means they are more sensitive to supply, rates volatility, and ECB policy indecision in the near term.



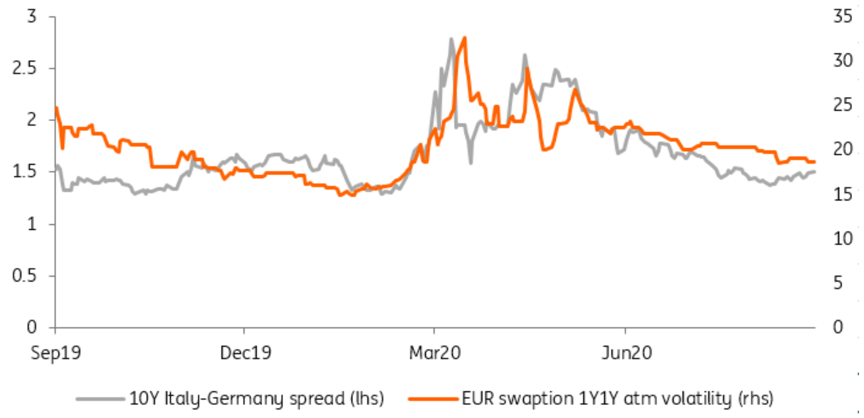
Source: ECB, ING

Peripheral debt: entering the dodrums

Our conviction for the month of September is that price action will be messy to read. Yesterday was a case in point. In spite of the decent performance in risk assets, peripheral bonds were on the back foot. The culprit, supply, is easy to identify. Italian bonds face a double challenge this week in the form of the 20Y syndication we're expecting today, and of a 3Y/7Y auction. More fundamentally, doubts about the ECB's dovish stance, and the pick-up in rates volatility have weakened buyers' resolve.

On the former, despite apparent divergence of views between governing council members, we would be surprised if the central bank allowed markets to doubt its resolve in maintaining benign market conditions. There are headline risks however. An ECB too relaxed about the inflation shortfall in its forecast this week, or about EUR strength, would mean peripheral spreads stay stuck in the doldrums until later in the year, when our economics team thinks the case for more easing will be clearer.

Near-term, peripheral spreads are vulnerable to a rise in rates volatility



Source: Bloomberg, ING

Long-term, the direction of travel is clear: tighter

Another headline risk is the weekly PEPP purchase data (see next section for our analysis of the numbers published yesterday afternoon). Should purchases fall below the roughly €20bn weekly run rate implied in the ECB's 'envelopes' in the coming weeks, we see a danger of markets inferring that the central bank is keeping its powder dry to respond to potential episodes of market volatility.

These could lead to temporary spikes in sovereign spreads, although we doubt they will prove lasting. We expect the trend towards tighter spreads to resume in the autumn, when the case for more easing becomes clearer. Eventually, we see 10Y Italy-Germany spreads tightening to 125bp in early 2021 as a result. It could also be that when adding the carry into year-end, dip-buyers in peripheral bonds still achieve better total returns than in core however.

ECB net purchases to pick up again, but by how much?

The ECB has delivered the purchase data for August, showing that overall net purchases across all programmes amounted to €78.6bn, just about 73% of July's volume. The pandemic emergency programme (PEPP) accounted for the lion's share with €59.4bn.

ECB net purchases in the week ended 4 September amounted to €17bn, slightly more than the €16bn recorded the week before where net purchases under PEPP were marginally higher at €14.4bn, thus still close to their lowest weekly volumes on record. The meagre volume of €0.5bn for the public sector programme (PSPP) should also be due to the larger redemptions at the start of September.

The recent figures do not signal an intention to get purchases back to their pre-summer speed. Indeed, ECB's Schnabel had indicated in an interview last week that more benign market conditions should also be reflected in a reduced need for the ECB to intervene, and thus lower volumes. Taking her expectation that the entire PEPP envelope should be spent under a baseline scenario, that would imply weekly average PEPP purchases of almost €20bn per week until the middle of next year, likely a threshold the market will be looking out for next week. Such volumes would be only slightly higher than those observed in July, but don't forget PSPP still comes on top..Looking just at September, higher bond redemptions this month also imply higher reinvestment needs by the ECB, meaning that the actual gross flow could be more supportive of the market.

Events today

The main event for EUR rates markets today will be the 20Y Italian syndication. The Netherlands will auction 8Y debt, and Austria 10Y and 14Y bonds. In GBP rates, the DMO will sell 15Y Gilt via syndication.

Data-wise, the Eurozone Q2 GDP is a second reading. US NFIB optimism will be the highlight in the afternoon.

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