Rates Spark: QE legality, massive US issuance and corporate “QE-lite”

US Treasury issuance for Q2 is now set at an eye-watering $3trn. Meanwhile, the Fed's corporate support programmes are imminent. Not ECB-style QE though. The German Constitutional Court ruling on the legality of sovereign purchases should amount to a small additional headwind to Bunds, but is actually a bigger threat to sovereign spreads.

Curve bear-steepening to continue on supply

We expect the technical retracement of last week’s bull flattening to continue today. Supply pressure in particular should weigh on fixed income markets after the Fed and ECB-induced hiatus last week. In addition to large deals from financial and corporate issuers (like yesterday’s 4-tranche Apple deal) the US quarterly refinancing announcement for Q2 is a timely reminder of how much issuance the bond market will be required to take down.

A remarkable $3bn of US issuance is now planned for Q2. That compares with an upwardly revised $477bn borrowed in Q1. The good news is that the US Treasury is effectively doing this as a one-shot-one-quarter solution, as borrowing drops to $677bn for Q3. But still, these are massive numbers, although no huge surprise given the CBO's prior estimate of a $3.7trn deficit. This compares with typical annual issuance at around $1trn, before Covid-19.

At the same time our uneasiness about risk assets' valuation remains. We see a material risk of a correction brought about by the realisation that a state of quasi-permanent lockdown will characterise the coming months, or that an end to the epidemic would reduce the need for unprecedented central bank support.

Fed's "quasi-QE" in corporates is close

On the one hand the US Treasury has unleashed extra issuance ambitions, on the other the Fed's SPV is close to starting its corporate credit secondary market facility. It is remarkable that the Fed has not had to buy a single corporate bond during the recent convergence in credit spreads. At the same time, the high yield spread remains elevated, and might the Fed support high yield ETFs as a first stage support play? There is less leverage (versus equity) available in the high yield space, so the cash amounts would be less than in investemnt grade per unit of equity, but the biggest impact would be in high yield ETFs.

The target here is to start with the primary market facility, although that comes at a cost of 100bp, and may be less needed given how busy the primary market has been. Then the secondary market facility would be ready to go. The Fed as a start target of "early May", which suggests intiation is imminent. This of course is not technically QE, but it would feel like that for trading desks that get to see a big bid from a big semi-official player (if or when that comes).

On the corprate credit primary credit facility, we note that the 100bp fee plus the extra due dilligence necessary to have the Fed involved will likely act as a deterant for significant use of the facility. Only those players that really can't access the primary market would likely employ it. On many fronts these primary and secondary market facilities are quite different from the ECB's outright corporate QE and widespread participation in new issuance books. The Fed is playing quite a different game. This was never meant to be QE, and it won't feel like it until or unless it is really needs to be employed in size (up to $750bn available).

Don't underestimate it though, as it still provides an important backstop should conditions deteriorate. For that reason we expect the Fed to save it's power here until it's really needed. Some focussed high yield ETF buying that makes the headlines would likely suffice for now.

Constitutional court ruling: a threat to spreads

The German constitutional court (BVerfG) is due to rule on the legality of the ECB’s PSPP this morning. In short, the court should establish whether PSPP constitutes monetary financing of governments and if the programme breaches the ECB’s mandate.

Our understanding is that consensus is for the BVerfG to rubber stamp the ECB’s decision, as the European Court of Justice did when ruling on the same question, but that it could add some inconvenient constrains to the programme. The ruling could also express reservations about the ECB’s approach, as it has since added PEPP to its armoury and has weakened some of the restrictions on sovereign bond buying.

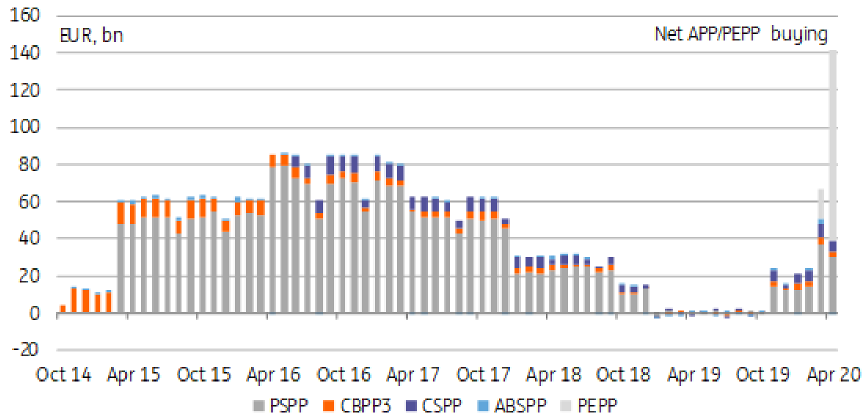
Given that few expect the court to curtail PSPP altogether, we should see only a modest relief sell-off in Bund when the decision is published. Worse, we see room for a temporary widening of sovereign spreads if it adds restrictions on bond purchases. To be sure, the court does not have jurisdiction beyond Germany but its ruling cannot be ignored by the ECB. An adverse ruling could also fan opposition to what is now the only tool preventing long-term economic divergence between member states turning into a short term liquidity crisis.

April ECB QE: what it takes to save the Euro, monthly

ECB purchase data for April published yesterday make for a perfect illustration of that point. It took a record €142bn of net purchases, the greatest monthly tally since ECB QE started, to keep spreads in check. Worse, it necessitated bending the PSPP capital key allocation rule even further by purchasing 41% of Italian bonds, compared to 35% in March, and to a target of 16%. We surmise that the 'Italian bias' is comparable in PEPP purchases.

In our opinion, the results are a mixed bag. Italy-Germany sovereign spreads are still less than 50bp shy of their pre-PEPP peak but activity is slowly returning to Commercial Paper markets and Euribor fixings have declined. This suggests heavy market intervention should continue in the coming months and the prospect of the QE portfolios converging with the capital key allocation is an ever more distant prospect.

April saw record ECB net purchases



Source: ECB, ING

Today's events: court ruling and ISM

The focus in the European session is likely to be very much on supply (syndicated deals, Austrian and German auctions), and on the German constitutional court ruling at 10am CET (see preview above). In the afternoon, the US ISM non-manufacturing will be the highlight.

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