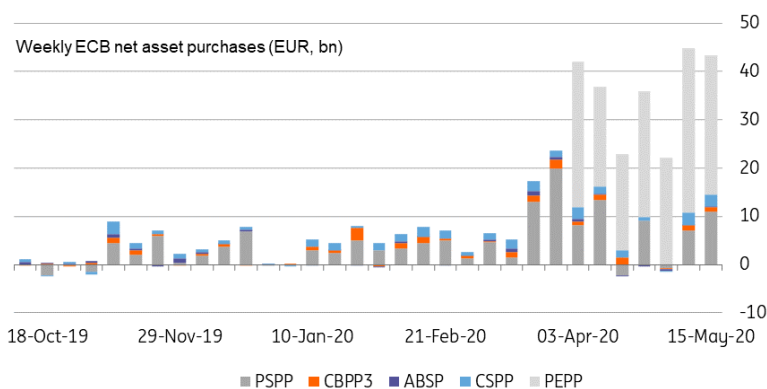


Rates Spark: EU Recovery fund, more questions than answers

Today's Ecofin should help ascertain how much substance there is behind the EU recovery fund proposal. ECB purchases continue unabated, but spreads need an assist to tighten further. A sombre Powell will testify today, egged on by a negative rates discount in 2021 futures and in contrast to the euphoria rippling through equity markets yesterday.



Source: ECB, ING

Recovery Fund: more questions than answers

Today's Ecofin video conference between EU finance and economy ministers will be an opportunity to gauge support for the [Franco-German proposal](#) of a €500bn recovery fund. Our economics team hailed it [as a potential game changer](#) but, as always, the details matter more than the headline figure being floated. The reaction of ministers to these parameters will be key for markets to gauge the overall impact, especially since the new programme's validation will be linked to the acrimonious Multiannual Financial Framework (MFF). Austria PM Kurz has already expressed skepticism about the proposal, and he is not alone.

One crucial point is whether the money disbursed will be as grants or loans. Macron assured during the press conference that grants are needed and that member states would share the burden in financing them. Whilst this sounds encouraging this requires at least two important specifications.

Firstly how much of these new monies will be in addition to the EU budget, rather than funds repackaged from other programmes. If the €500bn is indeed financed with new EU borrowing, it will be interesting to see how much support the proposal gathers among other member states. Taking the SURE employment support programme as an example, €25bn of guarantees are needed for €100bn of total borrowing capacity. The same structure for the recovery fund would imply €125bn of guarantees for a €500bn capacity.

The second question is how exactly would the burden of these grants or loans will be shared between member states, and therefore what will be the 'net' benefit for economies that need support the most. In other words, how much will the disbursement key and repayment key differ? If the funds are indeed grants, they will require financing. One option is an EU-wide tax but this could prove a stumbling block at today's Ecofin.

Another unanswered question is how much of this overall capacity will be used. Taking the ESM as an example, its new lending capacity to face the Covid emergency is €540bn when one adds up the total drawing capacity of all member states. In reality even Italy's use of it, arguably one of the countries it was created for, is uncertain.

Market reaction: banana skins

In short, these unanswered questions, and others, are as many banana skins for sentiment to slip on today. For choice we expect the rally in risk assets to continue today but remain concerned that the feelgood factor could quickly dissipate. Book building on the new BTP Italia of already over €4bn yesterday also tends to support the view that Italy can muster diversified sources of financing for its ballooning deficit but this won't matter much if the economic recovery fund proposal lacks in substance.

[In an interview](#) published late yesterday, Lagarde estimated additional government funding needs this year at €1-1.5tn and left the door open to additional stimulus. A little over two weeks before the June 4th ECB meeting, we think markets will take this as a confirmation that central banks are intent on providing rates stability in the face of the debt wave hitting primary markets. These comments, and Lane's later today, would help soften the impact on core and swap EUR rates from the recovery fund stimulus.

The fast clip of ECB purchases nurtures hopes for more

The ECB's QE portfolios grew by over €43bn over the past week. The pandemic emergency purchase programme (PEPP) alone accounted for €29bn, while lower than the week before, still well above the average of its brief history. Net purchases of public sector paper (PSPP) accounted for another €11bn. If the ECB continues to mop up assets at the current average pace, then PEPP's €750bn buying envelopes will be spent in October. This continues to nurture hopes that the ECB may expand the envelopes already at the next ECB meeting in June.

Today's Events: Powell testimony

Powell's Senate testimony is the main event today. In light of the barrage of Fed speeches in recent weeks, including from the chairman himself, we doubt there will be a lot new information revealed today. His gloomy tone, if last weekend's interview is any guide, might cause some cognitive dissonance compared to the improvement in market sentiment. That said, despite the rally in equity markets, the 2021 USD futures just about clung to a negative rates

discount yesterday (albeit pared back to a half a basis point). We also note that the belly of the curve richened versus the wings. That suggests the rates market is not ready to extrapolate yesterday's feel-good vibe, at least not yet.

We will also look out for comments from ECB chief economist Lane at a time expectations of a QE boost in June are rising. The May Zew survey will also be published.

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