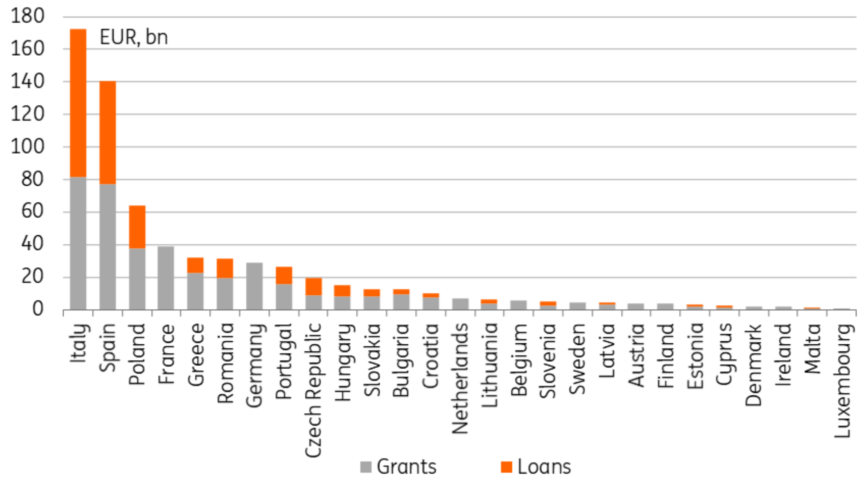
Rates Spark: small things have big beginnings

The EU recovery fund plans will not let the ECB off the hook. Behind the bold headline figures still lie relatively moderate transfers, likely to be watered down in the negotiations to come. We see increased possibility of yield curve control (YCC) in the US. In Australia it steepened the curve. All talk so far, but hotting up. We explore some options.



Source: European Commission, DPA, ING

EU plans do not let the ECB off the hook

The European Commission (EC) has presented plans for a EU recovery fund yesterday that topped expectations by going further than the €500bn 'Mercron' proposal. It was greeted by the 10Y BTP-Bund spread falling below the 200bp threshold and Bunds briefly topping -0.4%. We would argue that does not let the ECB off the hook to provide further support, as the plans do little to relieve the immediate pressure on government finances.

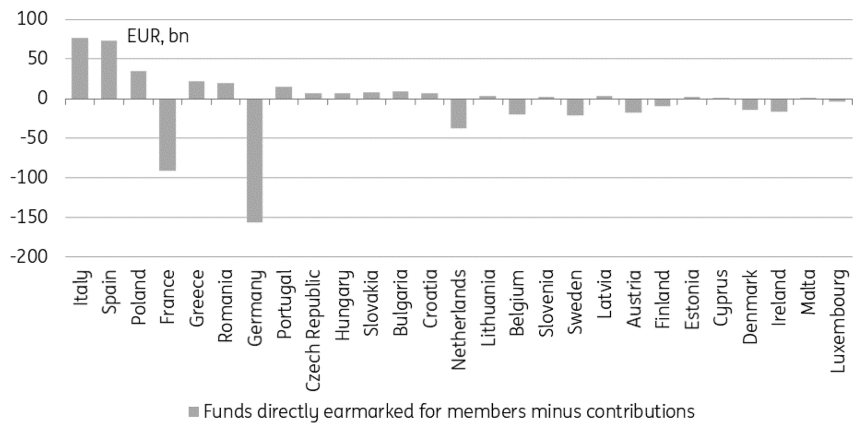
The EC aims to raise €750bn by issuing 3Y to 30Y bonds for its new recovery instrument - 'Next generation EU'. The money will only be spent on measures over the 2021 to 2024 period and comes on top of a proposed €1.1bn EU budget for 2021-2027. The debt would be repaid out of future EU budgets (aka future member state contributions or EU-wide taxes) beginning no earlier than 2028 and ending in 2058.

Out of the €750bn some €655bn, mainly via the €560bn 'Recovery and Resilience Facility', is reserved for individual EU countries and distributed according to criteria that take into account the severity of the crisis impact. €250bn is offered as loans and €405bn handed out as grants - leaving some room for redistributive effects. According to an allocation table that has circulated in the press, Italy and Spain, would be eligible for €172bn and €140bn, of which €82bn and €77bn would be in grants, respectively.

However, taking into account the countries' contributions to the recovery instrument paints a truer picture of the potential net transfers involved. In the EC's simulations Germany for instance is seen to contribute €185bn to the €750bn representing its share in the EU GDP, but looks set to receive only €29bn of the funds directly reserved for member states. Italy would still have to contribute €96bn, which would already exceed what the country could expect in the form of grants.

Spain stands to benefit on the other hand, its contribution being below funds received as grants. To be sure, favorable loan conditions would have to be taken into account as well, but at least for the large member states the transfers themselves would hardly leave a dent in the longer term debt trajectories. What remains are indirect impacts via the anticipated stimulative effects on growth given a more front loaded spending pattern.

The EU recovery funds net impact is less overwhelming



Source: EC, DPA, ING

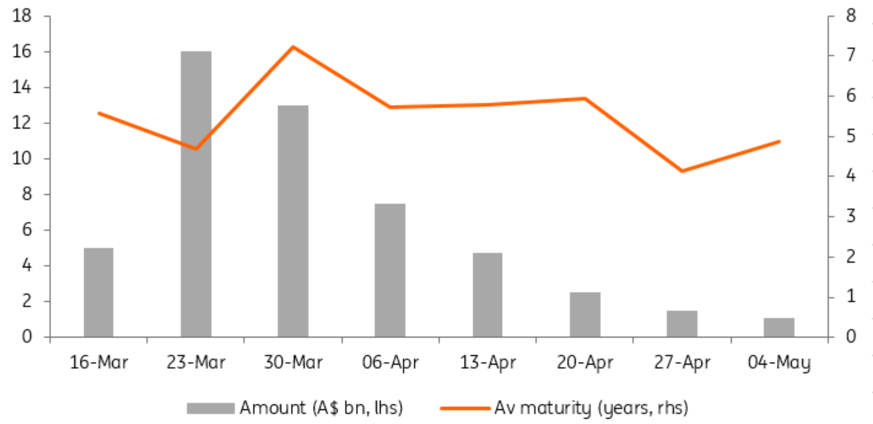
Opposition to the EC proposal has already been voiced, not just by the 'frugal four'. This suggests tough negotiations into July and in the process a watering down of the current proposal. In Lawrence fo Arabia, big things have small beginnings. In the EU, small things have big beginnings. In the end the conclusion may well be that the ECB purchasing government debt on a large scale is the easier option to stabilize the Eurozone and to keep the costs of financing the recovery low.

Yield curve control: the Australian precedent

Persistent talk of the Fed looking into Yield Curve Control (YCC) as a policy option is also getting some attention in interest rates markets. New York Fed's Williams for instance said yesterday that the tool was under consideration, and Bullard also said it should be examined. The RBA's experience has boosted the credibility of YCC a great deal and proved it could be applicable to countries that did not match Japan's specific economic and financial peculiarity.

The Australian central bank has opted for targeting interest rates at the 3Y point of the curve rather than 10Y in Japan. Despite targeting short-term interest rates, the RBA allows itself to buy bonds across the curve to enforce the 3Y yield target. The longest issue it bought had a residual maturity of over 10 years. The policy has overall been a success in anchoring 3Y ACGB yields, but also in letting supply and demand determine long-end interest rates.

Weekly RBA purchases and average maturity



Source: RBA, ING

Lots of chat on yield curve control in the US; just talk so far

We suspect Australia's smaller government bond market was one reason for the RBA to skip traditional QE and jump directly to YCC. Therein lies its relevance to the US: the Fed's current QE does not have a quantitative target which makes tapering problematic. The RBA's experience has proved that after an initial spike in purchases to enforce the target, the central bank can afford to buy less bonds. We also suspect it can then taper its asset purchases by reducing the maturity of bonds bought.

Williams described YCC as a potential complement to forward guidance. If Australia proves the template to the Fed's own version of YCC, we think USD rates markets will be tempted to mimic ACGB curve movements. Both as front-end rates are anchored, and as purchases slow, the AUD yield curve has progressively re-steepened. We think YCC combined with forward guidance in the US would contribute to reinforce the message that interest will stay low for longer and thus avoid a bear-flattening of the yield curve when conditions improve.

A repeat of the Australian model in the US would steepen the curve. But if the Fed adopted this it would expose the likes of 30yr, 15yr and 10/1 ARM (mortgage) rates to rises that could obstruct a macro recovery that would be helped by a better housing market. There is no panic to enact this policy right away as the rates market is contained; on sub-1% inflatin expectations and 2021 futures still peppering in negative territory. But it could be fast-tracked if rates did (ever) threaten to break higher, e.g. on pure supply concern.

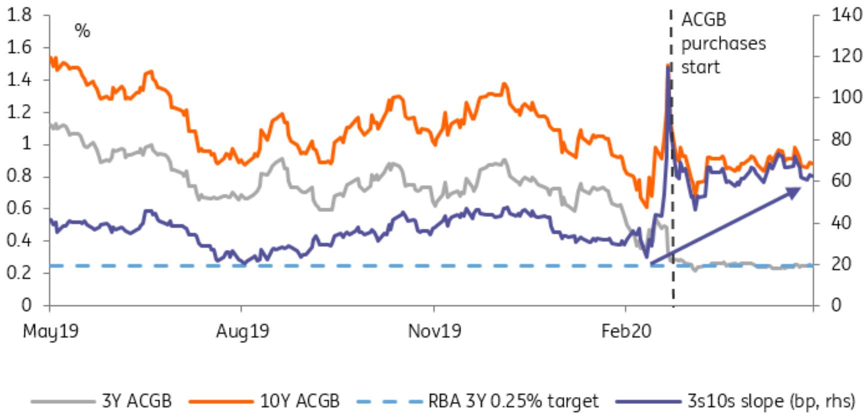
The advantage of the Australian model is it allows the 10yr (and 30yr) to find their own levels.

The counter advantage of YCC in longer tenors is a larger duration impact for every dollar spent (and theoretically less needs to be spent), with the outcome of actually holding down long-tenor rates.

The disadvantage is it artifically sets long rates, which is not the ideal central bank policy (which typically prefer to control short rates).

That said, it would be better than going negative on the fed funds rates.

AUD yields curve has re-steepened since YCC



Source: Bloomberg, ING

Events today: Williams and US Q1 GDP

Williams and Harker make up the Fed's speakers slate for today. We expect YCC comments to gain attention (see section above). The second reading of the US's Q1 GDP will also be published.

In Europe, deflationary CPI readings in German and Spain should keep bonds supported, and lend some credibility to Villeroy's comment if he choses to repeat calls for more easing.

Author

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com

Antoine Bouvet
Head of European Rates Strategy
antoine.bouvet@ing.com

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