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Rates Spark: Tighter spreads

The ECB quiet period leaves the stage free for the EU recovery fund to be a driver of rates. We doubt its long-term significance but warm words would tighten sovereign spreads. It remains a spread tightening theme in the US too, with the Fed intimating a potential wind-down of its corporate buying programme. Main Street is where the real issue is now.

Federal Reserve

Source: Shutterstock

Fed signals a pullback in corporate bond buying

The Fed has confirmed that corporate bond purchases have slowed from USD300m to USD 200m per day, while also confirming that latest purchases have all been in bonds, as opposed to ETFs. While noting that they could re-elevate purchases should it be required, the underlying tone is in the other direction. In fact, they have now intimated that they could wind down the program early, and especially should conditions continue to improve.

It seems the Fed is quite happy with how the US corporate bond market is now functioning, which should come as little surprise given the depth seen on the primary market in recent months. The impressive tightening of USD corporate ASW spreads is indicative of this. This also chimes with the wind down in support for money market funds, global central banks, and the US repo market.

Systemic pressures have certainly eased.

Instead it is the Paycheck Protection programs and new kid on the block - Mainstreet Lending program - which has the focus of the Fed. The Fed's balance sheet has been allowed to shrink as help to Wall Street has been needed less. But help to Mainstreet remains a top theme. This in turn is reflective of a body of investors that have piled into long dated US Treasuries, with a handle well in excess of 1% seen as generous in some quarters.

The dichotomoy between the rates discount versus the risk asset continues, especislly as equities kicked higher again into the US close yesterday. In contrast the rates discount remains benign, and the curve refuses to steepen out in any material fashion; in fact the pressure remains in the other direction. We'll need more upbeat macro and health evidence before a material reflection discount occurs.

And there is little in Fed speakers' tone of late that would justify a less benign discount. Bostic urged the Fed to consider more easing in light of softening economic data. Rosengren also acknowledged that the economy is disappointing, whilst Mester said it is taking a turn for the worst.

Focus on the EU recovery fund

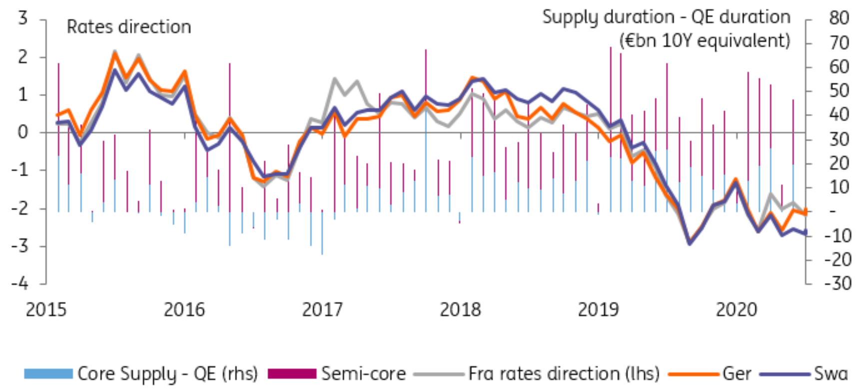
The ECB enters its self-imposed quiet period of one week prior to the July meeting. This means monetary policy goes down the order of potential market movers until next Thursday. Comparatively speaking, news on the progress of the EU recovery fund debate will gain in importance, especially since member states' budget stance and the EC's economic projections will be discussed by the Eurogroup today.

Whilst there is still much uncertainty about the shape of a future agreement, any public declaration of support would be cheered by sovereign spreads extending their tightening trend. The issue is that, barring a breakthrough today, it makes sense for officials to downplay the odds of an agreement ahead of next week's EU summit. Firstly so that a failure to reach an agreement does not reflect too poorly on participants, and secondly to strengthen their negotiating position into crunch talks.This was definitely the tone of overnight comments from Merkel, and yesterday from Orban.

QE now, more borrowing later

In the grand scheme of things, we think rates market have paid too much attention to the EU recovery fund rather than not enough. We are not debating the political importance of an agreement, nor its significance for the long-term EU integration, much less its economic impact. We are simply highlighting that the payments will be spread over many years (see for example European Council President Michel's proposal to delay some of the disbursements to after 2023) and that the greatest net benefit as a percent of GDP will in all likelihood be for smaller CEE countries.

EUR rates should revert higher thanks to supply



Source: Bloomberg, ING

Regular readers know that we think of QE as a much more potent, € for €, driver of interest rates. This being said, the implementation of the EUR recovery fund would fit the trajectory we have in mind for interest rates. First the downward impact of QE as the ECB front-loads it purchases and gives markets a precise amount, and only later a rise in rates due to still rising borrowing targets and issuers progressively increasing the maturity of their borrowing.

More clarity on Italy's TLTRO borrowing - a decent buffer for BTPs

Today the Bank of Italy will release its national "Bank and Money" statistics. They should also include a figure of how much exactly Italian banks borrowed in the latest tranche of the 3Y TLTROIII that saw a total allotment of €1.3tn. Data already released earlier this week showed that longer term refinancing from the central bank increased by €54bn to €345bn over the course of June. We know that Italian banks have around €68bn outstanding in earlier TLTROIII tranches and taking into account that some of the prior TLTROIIs may not be fully repaid yet we think a figure of around €260bn for the latest tranche looks plausible - that would be 20% of the total allotment.

Note that the generous rates of down to minus -1% over the next year if certain lending criteria are met apply to all TLTROIII tranches. That means Italian banks alone have quite a sizeable amount availbale for potential carry trades in BTPs. While some caution is warranted with regards to BTP spreads given a potential disappointment in the upcoming summit on the EU recovery fund, the TLTRO constitutes a decent liquidity buffer that should dampen the fallout. The fact that Italy is open to using the ESM, if needed, also provides markets with a buffer of confidence.

Today's Events: Ireland auction

Events today (if we can call them that) mostly consist of a 7Y/10Y/30Y Ireland auction, and US jobless claims. Hernandez and Bostic, respectively of the ECB and the Fed, are the central bank speakers scheduled today.

A press conference is scheduled for 6pm CET following today's Eurogroup meeting.

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