

Severe tapering added to credit cocktail

Tapering of the CSPP and CBPP3 is the next ingredient in the credit cocktail and is more severe than expected. Markets reacted to yesterday's ECB event with a mix of higher rates and a widening of CDS spreads. Credit spreads remained steady, but what will dominate? Is this a bear trap or will the bulls swim in higher yields?



Faster tapering than previously expected

Tapering reinvestments of the asset purchase programme (APP) will begin in March 2023, thus we will see lower reinvestments under the corporate sector purchase programme (CSPP) and third covered bond purchase programme (CBPP3). The tapering will be in the form of a decline of €15bn per month as of March until the end of the second quarter, with the subsequent pace to be determined later. Many details, such as the breakdown of which programme will see what decline in reinvestments, and the choices between bonds, have been left very unclear, but more information will come in February.

The €15bn reduction in holdings is a much faster tapering than previously expected, averaging at just 50% of reinvestments. On the back of this, we have seen some small spread widening, but nothing substantial. The big moves in rates have made yields more attractive with many buyers stepping in. However, this may be the setup of a bear trap, as fundamentally credit is looking slightly weaker.

The hawkish stance of the European Central Bank (ECB) makes it clear that it is still concerned about inflation, so we could see inflation putting more pressure on corporates and ultimately credit markets in 2023. Combined with the more severe tapering, we could see some spread widening from these levels. Although long term, any widening will add more value to credit in our view, adding more magic into the credit markets, as we remain constructive on credit for the full year 2023.

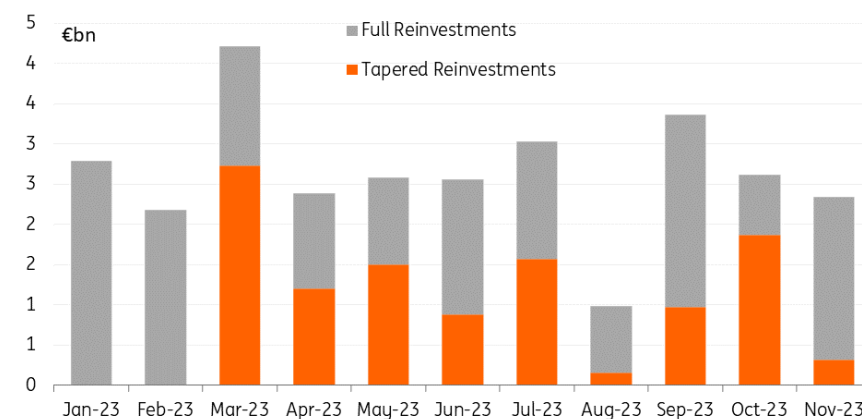
This of course will also be added to the list of risks and drivers of increased volatility in credit, alongside the recessionary environment, high inflation, the Russia/Ukraine war, the energy crisis and supply chain shortages. Covered bonds may be under a bit more pressure from this tapering if Bund asset swap spreads normalise further, as they are still relatively tight to begin with.

As we highlighted in our report '[Tapering could be the next ingredient in the credit cocktail](#)'. We foresee the following:

- The lower level of support will add to the turbulence and increase volatility, as well as reprice spreads wider, ultimately adding more value to credit.
- More pressure and spread widening in the case of an even faster tapering come July or an abrupt stop as the market becomes more exposed, with a large number of participants no longer active at all. Selling of holdings will have much more negative implications on spreads.
- Based on current oversubscription levels, deals can still get done even with lower CSPP participation. Thus, primary market activity shouldn't struggle to price, meaning less pressure on spread widening.
- An indirect implication may be supply indigestion, as many corporates may push to issue earlier in the year for a better chance of having the ECB involved in the deal (this may mostly be seen in January). This will add some extra volatility and perhaps underperformance.

The tapered CSPP reinvestment levels in the chart below illustrate how low reinvestments will likely be assuming an equal ratio of tapering for each programme, and assuming a continuation of a €15bn reduction. Initially, reinvestments would pick up in 2023 and support with between €2-4bn per month. Now reinvestments will be notably lower between €1-2bn per month, offering very little support from March onward. Therefore, if the ECB continues to reduce the holdings by €15bn per month, CSPP reinvestments will total no more than €11bn for the year.

Forecasted CSPP reinvestments



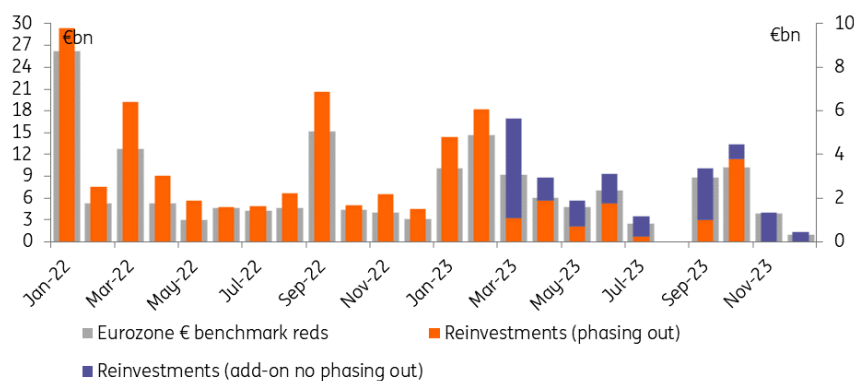
Source: ING, ECB

A pro-rata distribution of the lower reinvestments of redemptions across the different purchase programmes under the APP means that the CSPP3 will only reinvest €21bn in 2023 instead of €35bn in the event of full reinvestments. We assume here that the €15bn will remain stable from March until year-end. If reinvestments were to drop to 0 after June, CSPP3 reinvestments will sum to €16bn in the first half of 2023.

At our estimate of €118bn supply in 2023 by eurozone issuers, €21bn represents 18% of the total supply by eurozone banks expected for next year. Most reinvestments are centred in the first quarter of the year when most supply is also expected. Nonetheless, reinvestments will still make up about a quarter of the amount of eligible covered bonds we expect to be brought to the market in that quarter. If 40% is reinvested via the primary market, the order size of the CBPP3 in the primary could still be around 15% in that quarter. It will likely decline to 5-10% from 2Q23 onwards.

The impact on spreads will consequently likely become more meaningful from the second quarter onwards. The biggest impact on covered bonds will still come from the indirect effect on sovereign asset swap spread levels, more so than from the direct effect of the CBPP3 being less present in the primary and secondary markets.

CBPP3 reinvestments of redemptions (at €15bn lower APP reinvestments divided pro-rata per programme for Mar-Dec '23)



Source: ING, ECB

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