

# Advanced warning of the bond sell-off spooking investors

On Monday, our global team assessed the cross-asset implications of a big Treasury sell-off. Just as well given such a turbulent week in bond markets. Also this week, we look at the increasing importance of ESG on the ratings' agencies. We examine why dairy alternatives are in the spotlight. And into Libor transition? We've got you covered there too

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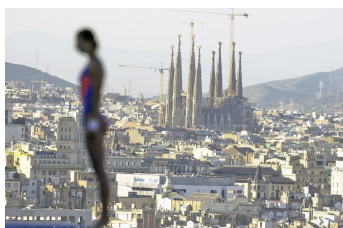
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# Timing the Tantrum: The market implications of a big Treasury sell-off

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## Memories of 2013

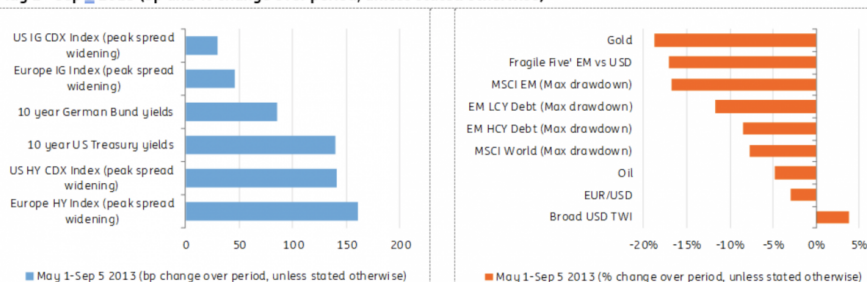
Investors are increasingly confident of a 'V' shape global recovery, so much so that the emerging concern is not growth, but inflation. This has seen the long end of bond markets come under pressure, refreshing memories of 2013. This was the year the Fed exacerbated the bond market sell-off by discussing the reduction or 'tapering' of its US Treasury debt purchases.

At the time, a sharp rise in US yields rippled through asset classes around the world, hitting equities and commodities (two heavily backed markets in 2021), widening credit spreads, and lifting the dollar.

So, we thought it would be useful to look at just when the Fed might be forced to discuss tapering this year, the likelihood of a tantrum in the US Treasury markets, and how asset markets would react were such a tantrum - let's call it a quick 50bp rise in US 10 year Treasury yields - to be seen.

## Cross-market reaction: How asset markets performed during the 2013 taper tantrum

May 1 - Sep 5 2013 (bp and % change over period, unless stated otherwise)



ING, Refinitiv

### ? When could the Fed start to communicate a taper?

At tomorrow's testimony to Congress, Jerome Powell will again insist that the Fed are not contemplating any imminent shift in their policy and stick with the "guidance" that they will continue to buy \$80bn of Treasuries and \$40bn of MBS per month "until substantial further progress has been made toward the Committee's maximum employment and price stability goals".

But what is "substantial further progress"?

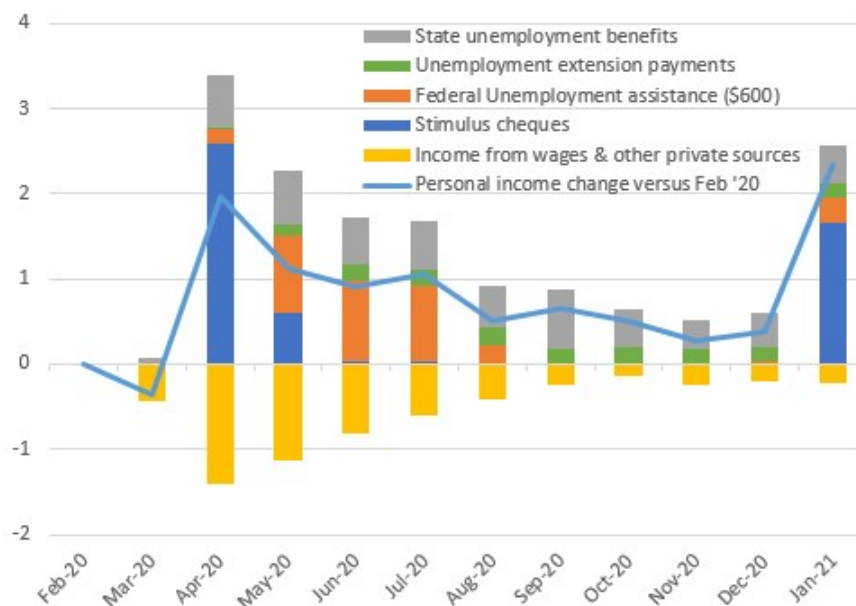
It will probably be at the point where we have a clear view that herd immunity is being reached, a re-opening is happening and price pressures are becoming apparent. All three could happen in the mid to late second quarter.

**On vaccination & herd immunity:** President Biden's Chief Medical Advisor, Anthony Fauci, suggests he thinks herd immunity is 85%-90% of Americans being vaccinated. At the current run rate of 1.6 million doses a day that puts us at herd immunity in mid-January 2022. However, more money and better management mean Biden is targeting a speedier program. There is no reason to think the US can't quickly hit 3-million (1% of its population a day) and if it can do that we get herd immunity in the States by July 2021. And should the Johnson and Johnson vaccine be approved, which only requires one dose, this would bring it forward into the second quarter.

**On re-opening:** It is neither Fauci nor Biden's call but individual state governors. For them, the electoral cycle may mean reopening before herd immunity is reached. Think 'jobs, jobs, jobs', especially if hospitalisation numbers have fallen away dramatically as we hope they should over the next two to four months.

**On the economic bounce-back:** Household savings levels have increased \$2.4tn since 3Q 2019 – that is just money in the form of cash, checking, and savings accounts – while credit card balances are at 4-year lows. Wealth gains are also felt more evenly across the income spectrum than in Europe given the stimulus cheques while expanded and uprated unemployment benefits have seen a majority of lower-income households gain income relative to before the pandemic.

## Contributions to changes in US personal income levels versus Feb 2020 (annualised \$trn)



Source: Macrobond, ING

Throw in another \$1.9tn fiscal stimulus, a wave of corporate CAPEX, and a housing construction boom and you have the recipe for very strong economic activity as soon as the doors are unlocked – hence our 5.5% GDP forecast for this year risks being on the low side.

**On inflation:** Even if we get just “benign” or “typical” 0.2%MoM readings through the rest of the year, headline inflation will rise to 3.1% by May. With rising freight costs, fuel costs, commodity prices, and unit labour costs this could be even higher, possibly in a 3.5-4% range. The key question is how sustainable inflation will be? Ordinarily, we would look at wages as the US is a service sector and labour costs are the biggest input. But with nearly ten million fewer people in jobs than a year ago, there is unlikely to be much wage pressure in the near-term. That said, vigorous demand coming up against supply constraints within many industries (bars and restaurants having gone out of business, airlines mothballing aircraft, a lack of upkeep in entertainment venues and hotels etc) could boost corporate pricing power and make inflation sticky.

**On the Fed:** By the third quarter we could see real pressure on the US Federal Reserve to justify what it's doing. 3.5% inflation, booming growth and a waning pandemic would, one would think, be compatible with “substantial further progress” – progress implies a journey, rather than an end result. Consequently, we think the Fed will taper purchases in the fourth quarter, with some shift in communication presumably coming 2Q or early 3Q.

*This suggests the June 16th FOMC meeting, where a new round of forecasts will be presented, could be the first time the Fed feels serious pressure to take its foot off the accelerator.*

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## How would we define a bond market tantrum and how likely is it?

Anyone with very young kids will understand that a tantrum needs to be left alone to take its course. Once it starts, just let it happen, as attempting to end it early will only prolong it, or make it worse, or both. The trick then is to avoid the tantrum in the first place. But as every good parent knows, taking away the cookie jar must be done at times, tantrum or not.

At some point, the Federal Reserve will have to taper. Remember, as the Fed tapers, policy is still exceptionally easy, as the Fed is still buying billions of dollars of bonds per month, just less than the previous month, and less again in subsequent months.

But the bond market won't care about that. What the bond market sees is a progression towards a point where the Fed is no longer buying bonds, and beyond that to a point where the Fed will hike rates. As rates rise, the present value of fixed coupon and redemption payments fall. New bonds need to come with larger coupons, and older bonds trade at a deeper discount to par – code for (likely) large negative total returns.

**The faster this happens, the worse is the mood of the bond market and the more intense is the tantrum; the so-called taper tantrum.**

In 2013, the size of that tantrum was 150bp, as the 10yr rose from 1.5% to 3% over the course of 5 months. Turning to the current US 10yr yield - the move from the low at 50bp to just under 1% was mostly a recovery from extremes. The subsequent break above 1% was an acknowledgement of reflation, and now we are at above 1.25%. Our end-year target is 1.75%, and along the way, there could well be a tantrum-style push. A 50bp rise in any single month would certainly be a tantrum.

Such a push could come from discomfort on inflation. The issue here for bond investors is the erosion of the real value of future coupon and principal payments that inflation implies. But remember, if the Fed does nothing into an inflation spurt, namely not bringing forward tapering, then bonds become even less protected from inflation, as it is effectively allowed to rip higher, eroding future fixed payments in real terms even further.

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### *A taper need not result in an outsized tantrum*

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This is an important nuance. A taper need not result in an outsized tantrum if it is seen as the Fed taking action to reduce the inflation risk. The tantrum would be more an inflation tantrum than a tapering one. And if the Fed chooses to “twist” the QE by reducing the size done while risk-weight-lengthening the maturity of purchases, the impact of tapering could be considerably lessened.

Either way, we likely end up with higher yields. The only uncertainty is how high. Our end-2021 target of 1.75% is in fact consistent with at least some version of tapering in anticipation of rate hikes to come (much) further down the pipe. A more extreme version of events is one where our 1.75% target gets brought forward by 3-6 months to mid-2021, and the bond market extrapolates more of the same in H2, targeting a break above 2%, and beyond. Something like a cumulative 75-100bp uplift from where we are currently in the space of a few months would smell and feel very much like 2013.

Now that is the one that risk assets really have to worry about; a not improbable risk case scenario that sees the 10yr break above 2% as a theme, not far enough out to be a fuzzy 2022/23 forecast, but in 2021 and very much with a crystal clear focus.

## ? European Rates: How far would they get dragged?

By and large, most of the drivers for the US reflation trade, aggressive fiscal policy, and new dovish central bank goals, are absent in Europe. This did not prevent European rates from reacting in kind with higher rates, greater inflation expectations, and steeper curves. This is because capital markets are more correlated than the real economy. Higher rates in the US might convince foreign investors to allocate more money there, and borrowers to borrow in EUR or GBP instead.

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*There is also a growing risk of the reflation trade becoming a duration event*

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There is also a growing risk of the reflation trade becoming a 'duration event' where the rise in rates feeds on itself. The structure of financial markets is different from one country to the next, but they share some characteristics: Investors seeing rates rise will look to reduce duration, pension managers will tend to reduce rates hedges, large rates portfolio will see their duration, and hedging needs, diminish as rates rise.

The upshot is, brace yourselves for higher EUR and GBP rates in case of a taper tantrum in the US, only to a lesser extent. We would struggle to justify 10Y EUR swaps rising above 0.2% unless the Fed loses control of the USD curve, but a further steepening of EUR 10s30s could continue to bear the brunt of the adjustment, rising back to 60bp. The GBP market has been even more impacted by the prospect of reflation, courtesy of a faster vaccine rollout and a central bank perceived to be more hawkish. 10Y swaps rising to 1.25%, from 0.90% currently, is a distinct possibility in the coming months, higher than this would sow the seeds of a sharp retracement lower.

## ? Equities: What size correction could we see?

Investors have started the year with a conviction call on a 'V' shaped recovery meaning that overweight positioning in equities and commodities is at a decade high. Clearly, a sharp rise in US Treasury yields increases the discount rate used in equity valuation models and, as the European Central Bank puts it, would trigger a 'more broad-based repricing' of risk assets.

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*Global equity investors appear to be running very overweight positions*

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The experience of 2013, triggering a maximum drawdown of 7.5% in the S&P 500 – largely seen at the most intense period of the yield rise in late June – could well be seen again. And as our earlier chart shows, EM equity indices could well see maximum drawdowns of around 15%. This especially so given that global equity investors appear to be running very overweight positions in EM equities

right now. Recall that Asian equity markets, China, Taiwan, Korea, India have some of the largest weights in global EM equity benchmarks and could be in the front-line of the adjustment.

But recall as well, summer 2013 proved barely a blip in the long-term equity bull-market and there is no reason to think that any bond tantrum-induced equity correction this summer would be more than that, just a correction.

## ? Credit: Can positive net supply trends limit the fall-out on the IG and HY market?

The technical picture remains very positive for credit in 2021 which will keep any major sell-off muted. High yield should underperform, particularly as the pool of leverage continues to grow. The rise in rates will mean higher funding levels, and in combination with the spread widening, funding costs will increase. This will be particularly worse for high yield. However, less supply is expected for 2021 vs 2020 in both EUR and USD meaning that net supply will be down at a period of rising yields. Thus net supply trends will offer some support for the credit markets.

We expect to see a more muted spread reaction in Euro compared to USD. This is due to the lack of direct central bank support in USD (compared to CSPP in Europe) and a significantly stronger EUR technical picture.

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### *The technical picture remains very positive for credit in 2021*

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ECB activity in CSPP has and will continue to be substantial, keeping spreads supported and primary markets open for refinancing. Back in 2018, CSPP purchases were falling off the edge while reinvestment levels were minimal. This time around reinvestment levels are significantly larger, meaning credit markets will remain supported for longer. That said, we do expect to see some small widening from current levels in Euro as tapering becomes a discussion and fundamental weakness starts to emerge.

Looking at synthetic credit indices, a sharp, 50bp adjustment in Treasury yields would, we expect, drive the CDX IG index higher by around 20-25bp landing around 70-75bp. CDX HY we would expect to widen more - widening 100bp-110bp to roughly 390bp-400bp. Euro synthetics would outperform against USD, but would likely still see a widening of 13bp-15bp for the iTraxx Main up to 55bp-60bp. Similarly, the crossover index would also see more severe widening by 60bp-80bp up to 300bp-320bp.

We have a conservative view in terms of our sector allocation. Higher beta and lower-rated names and sectors will be affected significantly worse by any tapering led sell-off. The Oil & Gas sector will likely underperform substantially, particularly as the supply expectations here are high, resulting in a net supply forecast of over US\$100bn. Inflows over the past year have been favouring ESG 'green bonds' and we expect ESG debt and QE eligible debt to remain firmer.

## ? Commodities – What would tapering mean for the complex?

The commodities complex has had a strong start to the year, in fact, the strongest start since 2008. Loose monetary policy, fiscal stimulus, and hopes of a strong post-Covid-19 recovery have



boosted the demand outlook for commodities. Investors have been attracted to the complex as a result of growing inflation expectations.

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*Any tapering suggestion would put further pressure on gold*

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However, the rise that we have already seen in Treasury yields so far this year has put a fair amount of pressure on gold, with it increasing the opportunity cost of holding it. Any suggestion of tapering would likely put only further selling pressure on the yellow metal.

Gold will likely not be alone, there is an abundance of speculative money in commodities at the moment, and tapering should be enough to flush out a sizeable amount of these longs from most markets. This is particularly the case when looking at the metals and agriculture space, where the dollar value of speculative positions is at multiyear highs.

While we believe oil would also come under pressure, it is better placed in terms of its fundamental outlook. Expectations of a strong demand recovery over the course of the next year, along with OPEC+ supply policy should mean it is relatively better supported.

## **? Foreign Exchange: Will we see a return of the ‘Fragile Five’?**

It has become a consensus trade, but most, including ourselves, expect a benign dollar decline in 2021 as the world gets back on its feet and the Fed allows the US economy to run a little hotter than usual consistent with its new Average Inflation Target framework.

That view is reflecting in positioning data, where speculators remain quite short dollars and both commodity and EM currencies are heavily backed as the best vehicles to express the reflation trade.

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*The high yield and commodity complex would be hit most aggressively first*

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A sharp rise in US yields, enough to trigger an equity correction, would probably see the high yield and commodity complex hit most aggressively first. Indeed, this was the case in taper tantrum 2013.

However, compared to 2013, the valuations among the EM FX high yielders are currently less stretched (Fig 1) and the current account positions (Fig 2) have also improved over the years (especially in the case of Turkey). From this perspective, the scope for a meaningful sell-off among high-yielding EM FX should be lower than 2013 - i.e. far less than that witnessed by the Fragile Five (Brazil, India, Indonesia, Turkey, S. Africa) of roughly a 17-18% decline against the dollar.

Among the high yielders, perhaps the most vulnerable in EM might be the ZAR, which has enjoyed strong gains in 2021. And given that the bulk of portfolio flows into EM since November have largely gone into equity markets, particularly Asian equity markets, we would expect the CNY,

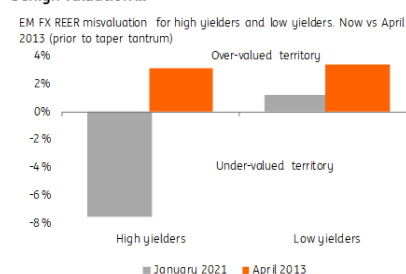
TWD, and particularly the more volatile KRW to come under pressure. Also in this space, Indonesia's current account deficit could leave the IDR exposed.

As positioning matters, the best performing EM currency during the 2013 taper tantrum (CZK) is unlikely to repeat the trend in our view and is in fact one of the most vulnerable EM currencies to a sharp spike in UST yields given the large one-way long positioning seen currently.

Positioning would also make a case for a further adjustment in EUR/USD, perhaps to the 1.17/18 area. But we would still consider this a correction rather than the start of a new trend, where a 2H global expansion would still favour cyclical currencies, including the EUR.

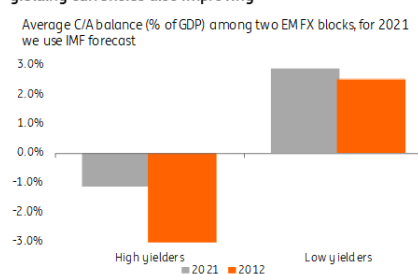
## FX: EMFX looks better positioned today than in 2013 in terms of valuation and external imbalances

**Fig 1 EM FX (high yielders in particular) show more benign valuation ...**



Source: BIS, ING

**Fig 2 ... with current account position among most high yielding currencies also improving**



Source: IMF, ING

Source: BIS, ING

## ? EM Local Currency Debt: Less vulnerable than in 2013?

The EM local currency (LCY) bond market should follow a similar script to EM FX in terms of vulnerabilities to a tantrum, with high yielding bonds understandably more vulnerable than the low yielders.

While EM LCY debt levels are mostly higher than pre-2013, the fact that the sharp rise in debt in 2020 was a global trend should give EM countries some leeway. Many EM countries have also improved their fundamental positions compared to 2013. With the EM currencies looking more sound this should provide some cushion to local bond markets.

Within the CEEMEA space, we see POLGBs as the least vulnerable bond market. This because the NBP is engaged in QE and offshore positioning in the zloty and POLGBs is not overly stretched (with the currency benefiting from the current account surplus). The latter factor, in particular, should make POLGBs less vulnerable versus CZGBs (which were in the past considered the 'quasi Bund' of the CEE region), given the meaningful long positioning in both the koruna and offshore positions in CZGBs. Needless to say, the CNB is decisively more hawkish, moving CZGBs behind POLGBs in the order of preference.

Among the high yielders, we expect TURKGBs to do much better than in 2013 given the current greater resilience of the currency and less stretched positioning. We see SAGBs as most vulnerable, in line with the currency view. In terms of OFZ, the most solid fiscal position among the high-yielding CEEMEA bonds should provide some cushion, particularly if the rise in UST yields is

accompanied by higher oil prices.

## ? EM Hard Currency Credit: Can tight spreads withstand a tantrum?

US\$-denominated EM sovereign credit has become sensitive to interest rate swings, with modified duration having risen to 8.9 years (up from 7.9 years in end-2019). Valuations are particularly stretched for investment-grade sovereigns (Z+109bp or a 2.34% yield based on Bloomberg Barclays Indices). Thus, assuming a gradual rise in UST yields and continuing portfolio inflows into EM debt, our baseline view assumes high yield sovereign credit remains attractive and is set to compress versus investment grade thanks to a higher spread buffer (Z+524bp or 6.3%).

However, there is a pain threshold: A too rapid rise in US Treasury yields over a short-term period (say 50bp in a month) would weigh on broader risk sentiment and leave EM assets vulnerable to capital outflows (reflected by US\$35bn of EM debt portfolio outflows in March 2020 following the Covid-19 induced sell-off).

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*Higher financing costs would intensify debt sustainability challenges for some*

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In such a scenario, high yield sovereigns would come under substantial pressure given the lack of market liquidity owing to a narrower investor base and scrutiny for external vulnerabilities (notably FX reserves adequacy and external/FX-denominated debt). Eventually, this would likely also translate into higher financing costs here which would intensify debt sustainability challenges for some. We identify Bahrain, Egypt, Oman, South Africa, Sri Lanka, Turkey, and Ukraine as more vulnerable among the larger sovereign Eurobond issuers.

We assume that EM corporate bonds can absorb up to 30-50bp of a US Treasury yields upward shock, based on (1) a relatively short modified duration (4.9 years based on Bloomberg Barclays Indices) and (2) still attractive yields/spreads in relative terms (Z+311bp or 3.6%). Thus, EM corporate credit might be considered as a defensive strategy.

Nonetheless, a larger shock would have different implications within the space: investment-grade corporates might hold well while HY corporate debt should come under intensified pressure. We would be especially wary of banks' subordinated and perpetual bonds as they historically have been more vulnerable during times of high market volatility.

Within CEEMEA, this would be the case for Russian and Turkish subordinated bonds, but also for higher beta senior bonds from Ukraine.

In line with this, a renewed tantrum would shake all subordinated risk assets in Russia, Turkey, and Ukraine. Prolonged volatility amid rising rates might restrict corporate access to external funding sources which, if coupled with weakened EM currencies, could result in increased liquidity and refinancing challenges.

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## Listen: Gauging the taper tantrum fallout

Federal Reserve Chairman Jerome Powell sent a message to jittery bond markets this week: calm down. But are traders and investors listening? 10-year...



In Congressional testimony this week, Fed Chair Powell stressed that the central bank has no intention of tightening monetary policy any time soon. The pandemic is far from over, inflation is not a serious threat and millions of Americans remain out of work, he said. Yet financial markets have moved quickly to price in an economic recovery, with the yield on the 10-year Treasury note rising above 1.4% on Wednesday for the first time since last February.

The speed of the move has sparked concern that financial conditions could tighten too quickly, undermining the rally in stocks and sending ripples through other asset markets around the world. [In this podcast](#), ING's Global Head of Markets Chris Turner tells Senior Editor Rebecca Byrne what a 'taper tantrum' could mean for stocks, bonds, currencies and commodities this year. Read more on this subject [here](#).

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## Plant-based milk IPO puts dairy alternatives in the spotlight

Sales of plant-based drinks have been growing at double-digit rates both in the US and Europe in recent years. For dairy companies, this means the...



Source: Shutterstock

Various vegan plant based milk alternatives and ingredients.

### Potential Oatly IPO puts dairy alternatives in the spotlight

[Press reports about a vegan milk maker's potential IPO](#) shows you that you don't necessarily need dairy milk to become big and strong.

The move itself shouldn't really come as a surprise as plant-based food has been the talk of the town in the food industry for some years now. Vegan burger maker, [Beyond Meat's IPO in 2019](#) showed investors, that plant-based alternatives can also walk the talk.

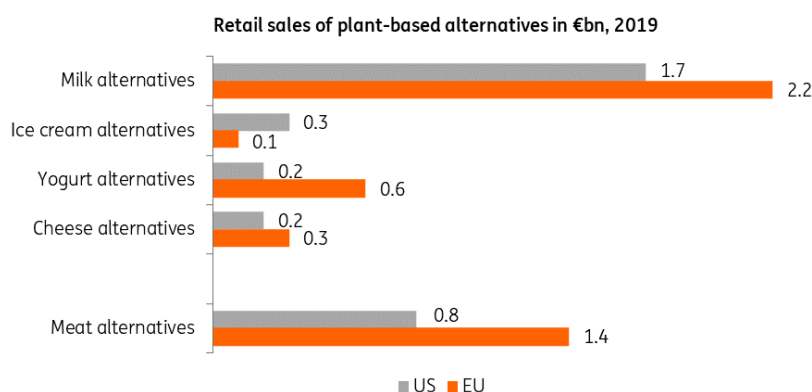
Although retail sales of plant-based dairy alternatives are bigger than those of meat alternatives, the alternative dairy space somewhat lacked a flagship company. But following strong sales growth, Oatly seems to be moving into that position. For traditional dairy companies, it means the pressure to enter the plant-based market has increased while it also heightens the importance to ramp up their efforts to improve the sustainability of their dairy products.

## Market for plant-based drinks bigger than plant-based meat

In recent years, sales of plant-based drinks have been growing at double-digit rates in both the US and Europe. Within the plant-based segment, milk alternatives stand out because they already represent a sizeable part of the overall milk market. The total share in retail value is estimated at 14% in the US and at 10% in the EU.

In comparison, meat substitutes and other dairy alternatives only have a market share of 1% or less. In the US, almond drinks are the most popular plant-based drinks while in the EU soy is the most popular. But oat-based drinks have gained ground rapidly too and have for example overtaken soy as the second most popular dairy alternative in the US.

## Milk alternatives are the biggest plant-based category in US and the EU



Source: GoodFood Institute, Euromonitor, ING Research

## Dairy alternatives can become five billion market in EU in 2025

[We have shown earlier the growth potential of plant-based dairy and meat products.](#) Still, the main challenge for plant-based producers is to bring down the price gap compared to meat and dairy products, improve aspects like taste and texture and increase availability.

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*The main challenge for plant-based producers is to bring down the price gap in comparison to meat and dairy products, improve aspects like taste and texture and increase availability*

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Many consumers in the US and the EU haven't purchased a plant-based beverage before. Household penetration for plant-based drinks in key markets in the EU ranges from 30 to 50%, which is still much lower than for milk, which is greater than 90%.

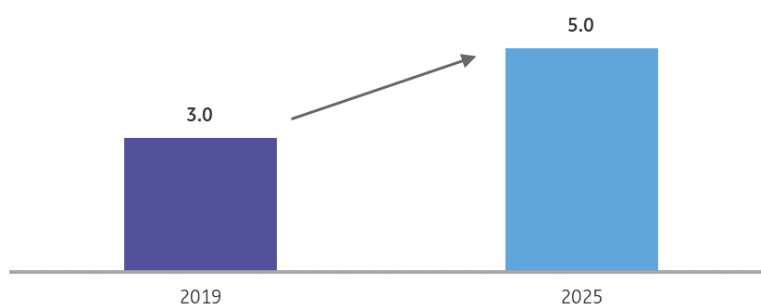
If these companies succeed, we expect the European market for dairy alternatives to develop from a 3 billion EUR market in 2019 into a 5 billion market in 2025. Both an increase in household penetration of plant-based drinks and the possibility to branch out to adjacent categories like spreads, yoghurt and ice cream are expected to support his growth.



[The growth of meat and dairy alternatives is stirring up the European food industry](#)

## Sales of dairy alternatives in EU + UK forecasted to rise to 5 billion in 2025

(value of retail sales in EU and UK, in €bn)



Source: Euromonitor, ING Research

## Many dairy companies haven't embraced plant-based alternatives.. yet

While start-ups like Oatly and fast-moving consumer goods companies like the French dairy giant Danone were building the dairy alternatives category, many dairy companies followed a wait-and-see approach. Although milk consumption in the US and EU is declining, they still experience growth in dairy products like cheese and yoghurt and exports to developing markets.

Many dairy companies in Europe have only begun trialling plant-based products over the last two years and only in some of their markets. Still if they were to enter the plant-based space on a more structural basis they do have the opportunity to build on existing knowledge of consumer preferences and can benefit from existing supply chains and contracts with retailers.

## Plant-based pressure is additional incentive for sustainability efforts in dairy sector

The decrease in milk consumption and the growth of plant-based milk alternatives show that the era of milk as an undisputed staple food lies behind us, at least in Western markets.

On many occasions, plant-based competitors position themselves as a more sustainable alternative given the lower CO<sub>2</sub> emissions per glass. The impact from these plant-based competitors also goes beyond their own operations as they provide dairy companies with an extra incentive to increase their efforts to improve the sustainability aspects of their products.

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## ESG and credit rating agencies: The pressure accelerates

As environmental, social and governance themes become increasingly relevant in today's world, accelerated by the pandemic, rating agencies are paying...



Source: Shutterstock

### Rating agencies have integrated ESG factors into their rating methodologies

As the sustainability debate comes under increasing focus for a number of corporate sectors, credit rating agencies have not been able to escape this discussion either.

The pandemic has accelerated the importance of environmental, social and governance (ESG) themes, especially the social component, due to the impact on employees and civil society. Therefore, the three most prominent rating agencies, Standard & Poor's, Moody's and Fitch Ratings have each incorporated ESG themes into their credit rating methodologies in their own way.

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*The pandemic has increased the importance of ESG further and accelerated rating agencies' thinking in this area*

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In order to fully engage with the task, S&P and Moody's have both acquired entities that have brought ESG knowledge in-house. S&P bought Trucost - a provider of carbon and environmental data and risk analysis and in November 2019 the ESG rating business from RobecoSAM. Moody's has made a few acquisitions too including Vigeo Eiris, a global leader in ESG assessments, Four Twenty Seven, a publisher and provider of market intelligence on the economic risk of climate change, and SynTao Green Finance, a provider of ESG data and analytics-based in and serving China.

During the peak of the pandemic, the 'social' factor emerged prominently as a credit determining factor when health concerns and social distancing measures were having a direct impact on business activities. Also, there is an intensified focus on institutional preparedness for global risks and environmental as well as social factors including healthcare access and economic inequality.

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*Corporates face a time horizon mismatch paradox, as they have to prepare for ESG risks in the medium-to-long-term and short-to-medium-term capex and opex*

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That being said, corporates face a time horizon mismatch paradox. While they are increasingly urged to prepare for ESG risks in the medium-to-long-term, they also need to manage their credit ratings, which involves managing short-to-medium-term capex and opex and the hit that can have on 'traditional' credit metrics.

Unless carefully managed it could turn into a case of "damned if you do and damned if you don't"

## **So far, ESG factors haven't really been a direct component of issuers' final credit ratings**

The way rating agencies have integrated ESG themes into their rating methodologies thus far has excluded these factors directly impacting credit ratings as isolated concepts.

Rather environmental, social and governance issues are considered in relation to the impact they have on corporates and their financial risk profiles. At the same time, fundamental credit factors such as financial flexibility, the strength of free cash flow generation and robust liquidity can limit or offset ESG risks, at least from a rating perspective, in particular environmental and social risks. In short, rating agencies' ESG analysis has so far complemented their overall credit rating analysis and will increasingly continue to do so.

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*Although not direct components, ESG impact on issuers' profile have led to rating actions*

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Although not standalone factors that drive issuers' credit ratings just yet, the assessment of ESG impact on the issuers' business and financial profiles have led to rating actions.

At Standard & Poor's, just above 30% of total rating actions in the corporate sector between April and December 2020 were affected by ESG factors, of which 14% were related to environmental issues. In 2019, 33% of Moody's rating actions in the private sector cited ESG factors as material credit considerations. Fitch has had around 25% of its ratings influenced by one or more high ESG impact scores of which around 3% had ESG as a key rating driver and 20% was related to governance considerations as of September 2020.

For example, S&P downgraded the credit rating of an automotive OEM company in April 2020 because of non-compliance issues with EU law on CO2 emissions targets which led to a fine and significantly reduced the issuer's financial flexibility in the middle of the pandemic. And we expect, more examples to follow.

# 33%

Private-sector rating action at Moody's in 2019 was influenced by ESG factors

of which 20% were related to social issue

The purpose of credit ratings is to assess the likelihood of a company to repay its debt. However, as ESG factors become increasingly important in the quality assessment of issuers, we believe these elements will see their importance swell over time.

## Energy sector in the spotlight

On 27 January 2021, S&P placed a number of issuers part of the oil & gas industry on CreditWatch with negative implications.

The move concerned fifteen energy companies including a mix of European, North American and Chinese oil majors, on the basis of energy transition, price volatility, and weaker profitability. Although this major step could be interpreted as a shift in methodology, the revision actually reflects the application of the rating agency's current methodology.

The rating agency revised the industry risk for the industry to "moderately high" from "intermediate" in part because of the increased environmental threat posed by greenhouse gas emissions, evolving government policies and emission standards. Beyond the assessment revision that took into consideration the "challenges and uncertainties engendered by the energy transition, including market declines due to growth of renewables", the rating agency also looked into investments levels between 2005 and 2015, lower prices since 2014, and the recent volatility in the industry risk assessment.

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*Oil & gas industry risk changed to "Moderate High" partly because of increased environmental threats*

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Standard & Poor's is likely to follow-up on the CreditWatch negative implications soon. The energy players concerned are amongst the highest rated within the industry, but the rating agency

believes these companies bear a significant increase in pressure from governments to respond to the energy transition and climate risk issues in general.

With special thanks to Julian Crush and Athanasios Smprinis, part of the ING Ratings Advisory team.

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Report | 25 February 2021

# Libor Transition: No please I insist, you go first

It's not easy taking a dive into the unknown. But like parachuters lined up for the jump, go we must. But when? There is no big bang moment for Libor...



A woman diving against Barcelona's skyline

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## Patterson on oil: There seems to be no stopping this market

ING's Head of Commodity Strategy, Warren Patterson, looks at what's really driving the price of oil higher and why \$70 a barrel for Brent is not...



### Why there's no stopping the oil price rise

There seems to be no stopping the oil market, with Brent having traded above \$65 a barrel and up around 25% so far this year. So what's behind this strength? And where are we going next? In this short video, ING's Head of Commodity Strategy, Warren Patterson, explains why he's expecting prices to trade just short of \$70 a barrel towards the end of this year

[Watch video](#)

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Article | 26 February 2021

## Now walk the talk: Monitoring the ECB's purchase programme

A concerted effort by the European Central Bank to talk rates down is clear. As this has had little impact on financial conditions, the focus now turns to...



ECB Chief Economist, Philip Lane

### If talking doesn't help, action is needed

Thursday's speech by ECB chief economist Philip Lane cast aside any doubts that there is a concerted effort by the governing council to lean against the move higher in EUR rates. Keeping "favourable financing conditions" is the ECB's main compass. Higher risk-free rates (overnight indexed swap rates) and sovereign yields, now also feeding into wider bond spreads, risk putting the ECB off course.

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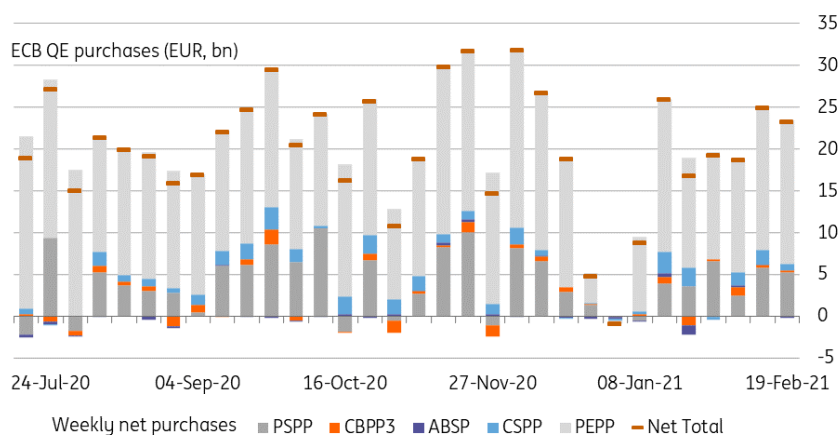
*There is limited evidence of the ECB following up verbal intervention with action*

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Lane has explicitly stated that the central bank would use the flexibility of the pandemic emergency purchase programme (PEPP) to prevent any undue tightening of financial conditions.

As of now, there has been limited evidence that the ECB is following up verbal intervention with action.

## ECB has already increased weekly volumes somewhat, but with little effect



Source: ECB, ING

## What to watch: PEPP volumes, duration and capital key deviations

The ECB presents more detailed data for its asset purchase programme at the end of each month. But since the pandemic, the PEPP is the most important one in terms of volumes and impact. Here, we get a detailed set of data only every other month. Unfortunately, the next set will only be available in April.

So we are left in the dark as to whether the ECB geared the parameters other than the volume of its most effective tool towards reining in bond yields and spreads as it did very effectively in the first phase of the pandemic. The volumes aside, we could eventually see, for instance, whether the ECB chooses to purchase further out in the maturity spectrum or relatively more in the periphery bond markets, thus again deviating more strongly from the ECB's guiding capital subscription key after a recent period of normalisation.

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*We are left in the dark as to whether the ECB geared the parameters other than the volume of its most effective tool*

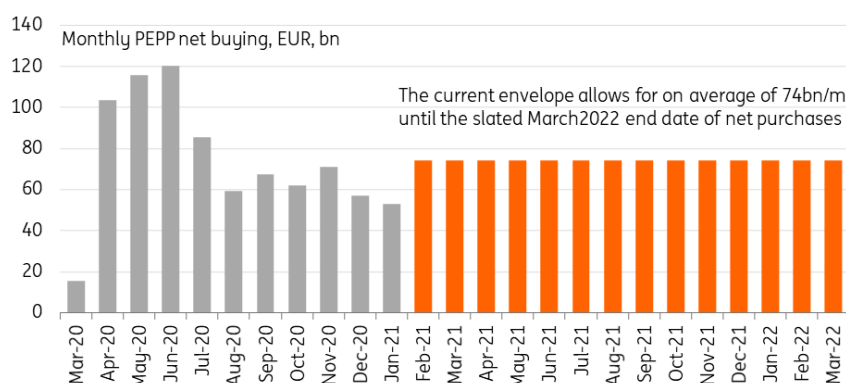
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All we can do for now, though, is look at the headline weekly and monthly volumes. And even they come with a lag. The ECB's weekly data reports settled trades. So a figure released on Monday for the portfolio size as of the previous Friday actually covers trades executed until the end of business on Wednesday.

On Monday the ECB will report its asset holdings again. Over the past two weeks, we have seen net PEPP buying of a bit more than €17bn each week, previously up from just above €13bn per week

since January. That is already a 30% increase, which however has had little impact on the trajectory of rates so far.

## Ramping up PEPP purchases above €74bn/month implies less buying later under the current envelope



Source: ECB, ING

### Bringing back the October spirit

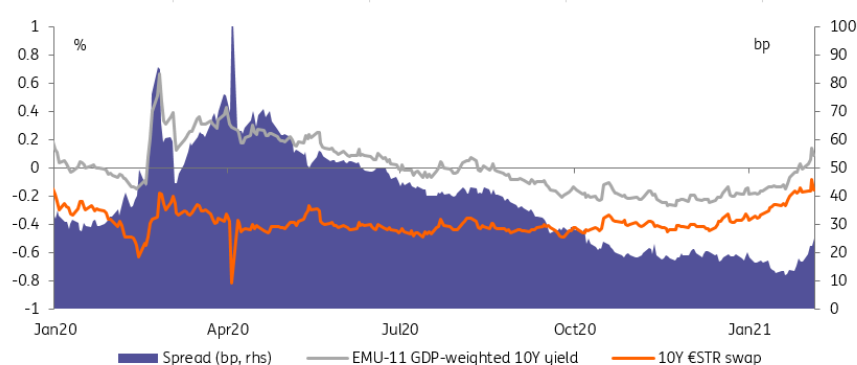
The current pace would set the PEPP on track for a monthly net buying volume of roughly €70bn in February. That is well above the sub €60bn levels of December and January and similar to those of last November. Remember, that was the effect of Joe Biden winning the US elections which put upward pressure on yields, and an emerging second virus wave in Europe putting widening pressure on bond spreads in the eurozone. And the ECB had just pledged to “recalibrate” its monetary policy toolset at the end of October, sparking speculation about an expanded PEPP envelope and driving a wedge between US and eurozone rates. Markets appear to want more of that spirit right now.

*The ECB will be judged by its impact on yields and not the purchase volumes*

In the end, the ECB will be judged by its impact on yields and not the purchase volumes. If PEPP proves effective, the volumes will tell us more about the state of the market than the ECB itself. However, if yields rise nonetheless, the volumes will tell us how far the ECB is willing to go.

The amounts that will be spent will also influence any extrapolations on how far the remaining €1tn of the envelope will last. At the latest pace of just above €17bn per week, it would continue until the end of March 2022, which is also the currently stated end date of net purchases under PEPP. That means any increase in the pace now implies a slower pace at a later stage or exhaustion of the envelope ahead of the stated end date. A renewed discussion about the sufficiency of the current envelope could be the result.

## Average EUR yields could be pushed higher by Italy without ECB intervention



Source: Refinitiv, ING

## The Italian canary in the bond market coal mine

We doubt that the recent bond market sell-off has shaken the deeply-rooted consensus that economic conditions in the eurozone do warrant low rates for longer. This is helpful. This means appetite to hedge against a USD-style rise in core EUR rates (core government bonds and swaps) will remain contained in our view.

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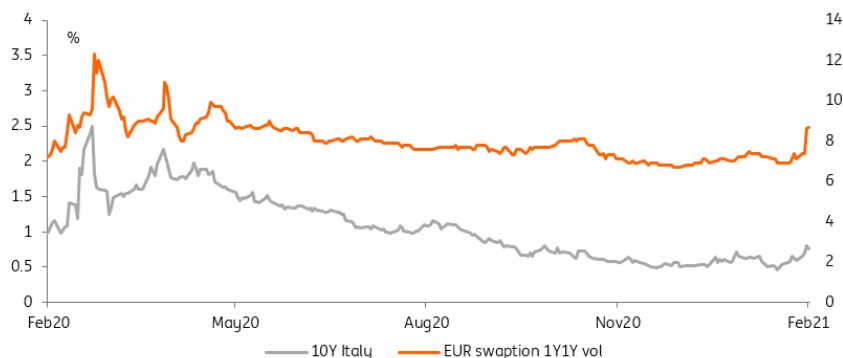
*There is still near-term upside for rates*

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Still, a number of large rates portfolios' hedging strategy is more formulaic and we suspect does require a non-negligible amount of swap paying, which means there is still near-term upside for rates.

We are more worried about the fate of carry trades in higher-beta fixed income. As with any investment, expected returns, carry here, is a function of the risk investors are taking. As a key measure of underlying risk, here rates' volatility, increases, so should the carry and thus the yield in their investments.

## Higher volatility means carry trades, such as Italian bonds, become less attractive



Source: Refinitiv, ING

## Higher Italian yield potential could spur the ECB into action

Italian bonds are a case in point. This isn't always true but, in periods of calm political developments in Italy, the correlation between rates' volatility and yields is high. As the largest sovereign bond market in Europe, and also as one of the most volatile, this would quickly push up the ECB's favourite GDP-weighted average 10Y bond yield indicator. That's why, even if market participants agree that higher core rates are just a blip, the potential for higher Italian yields could be enough to spur the ECB into action.

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