

Higher Bund yields: The complete picture

What are the implications of higher Bund yields; it's what we're expecting this year. In this collection of articles, we look at the market implications. Tapering is in focus for eurozone sovereign spreads. Emerging Market sovereigns are looking pretty resilient. And corporate spreads shouldn't widen too much due to strong technicals

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By Timothy Rahill and Jeroen van den Broek

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A woman walks over a bridge in Frankfurt with the ECB headquarters in the distance

Unstoppable Bund, but the ceiling isn't high

One development that hasn't escaped European investors is the almost parabolic rise, at least by historical standards, in the German Bund. At around -0.1%, [our 0% target for 10Y Bund yields](#) looks eminently achievable this quarter. More is to come but, first, how did we get here?

Our 0% target for 10Y Bund yields looks eminently achievable this quarter

With the benefit of hindsight, the rise in Bund yields from their pandemic-induced depth looks like the logical consequence of the strengthening European economic recovery and concerns relating to an adjustment in monetary policy. Neither was inevitable, however. On the first point, it is fair to

say that sentiment indicators have jumped ahead of the widespread reopening on the back of an accelerated vaccination programme. In fact, when EUR rates markets turned this year, much of Europe was actually tightening restrictions due to another wave of Covid-19 cases.

On the second point, the ECB at its March meeting has actually tried to stamp out a rise in yields it considered unjustified by economic conditions. It did so by accelerating bond purchases under the Pandemic Emergency Purchase Programme without changing its eventual size, €1.85tn. As the announcement in effect mostly brought purchases forward, its impact could only have been transitory. And indeed, yields stabilised for a few weeks before resuming their rise.

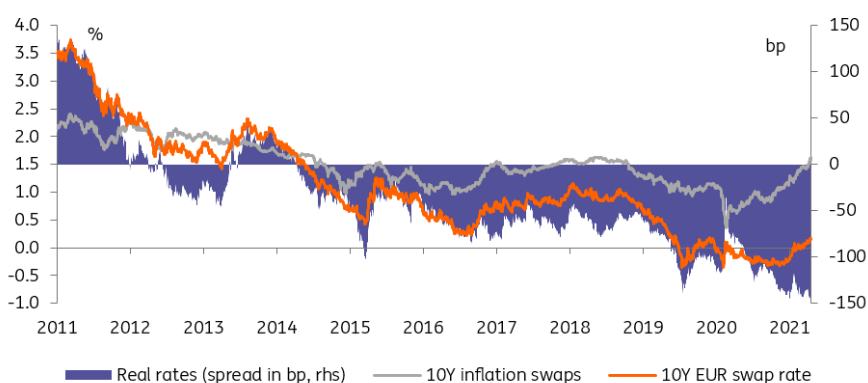
More upside than downside for yields

We expect both these factors will continue to drive Bund yields higher, to 0.2% this year. On the economic front, hard economic data should validate the recent improvement in sentiment, but risks abound. A failure to stamp out Covid-19 outbreaks could harm the all-important tourism sector this summer. Signs of overheating and rising prices could also derail a fragile recovery.

The real wildcard is the ECB

Casting those concerns aside for a moment, the real wildcard is the European Central Bank. The wisdom of hammering yields down in March was debatable. Continuing PEPP purchases at an accelerated rate beyond June will be harder to justify. All hinges on whether the tightening of financial conditions - a fluffy concept to describe borrowing terms from sovereigns to households - is justified by the economic recovery. There are many ways to assess them, and the ECB has done a good job at muddying the waters.

A few steps back: Real rates are as low as ever, hardly a case for more purchases



Source: Refinitiv, ING

One way to measure this is by comparing nominal rates (bond yields and swap rates) to inflation expectations. By that, admittedly restrictive, measure, conditions are as easy as ever.

Real rates are consistent with an unjustifiable degree of macro angst

There is no doubt in our mind that the ECB has a much broader set of indicators at its disposal, some of which we will address in the next sections, but this one suggests the need for intervention is low.

Incidentally, it doubles up as a handy fair value indicator for rates. Where they are, real rates are consistent with an unjustifiable degree of macro angst. We conclude that there is little impediment to moderately higher Bund yields.

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ECB President, Christine Lagarde

Sovereign spreads: The other financial conditions indicator

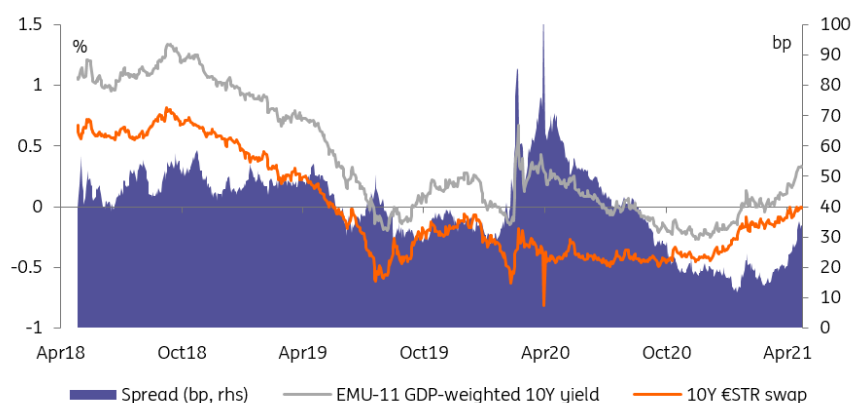
An additional indicator of how much tighter financial conditions are is the dispersion of borrowing costs among eurozone sovereigns. There is more than one way to measure this but we refer to the GDP-weighted average yield on 10Y European Government Bonds (EGBs), and the difference with swap rates. By that measure, sovereign spreads have widened significantly since the through touched in February to levels last prevailing in November 2020.

The problem is that markets have had a tendency to force the ECB's hand

In the grand scheme of things, we are tempted to say that the ~25bp or so of widening is acceptable, provided it doesn't snowball into something more significant.

The problem is that markets have had a tendency to force the ECB's hand in the past. Sovereign spreads, Italy's in particular, have been the main conduit of that pressure. We could see yet more widening into the June 10th ECB meeting.

Sovereign yields have risen faster than swaps, a sign of tapering angst



Source: Refinitiv, ING

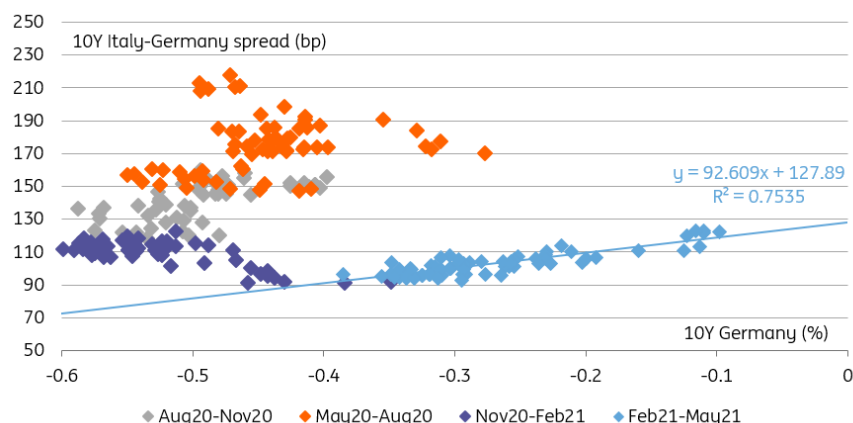
Tapering angst

It is easy to pin the blame on PEPP angst. After all, the programme invests almost the entirety of its \$80bn/month in sovereign and supranational bonds. Replacing it with smaller APP purchases, say from €20bn/month to €40bn/month, can't completely replace that. There is a silver lining though. The Asset Purchase Programme is linked to inflation returning to target, PEPP to the 'pandemic crisis phase'. As the latter comes to an end, the former is far from certain. In short, APP purchases could be with us for much longer.

The widening of sovereign spreads has been an almost mechanical effect of higher rates

It will take time for that message to sink in, unfortunately. The widening of sovereign spreads this year has been an almost mechanical effect of higher rates. As we expect further Bund rises, wider spreads should ensue. Our best guess is that this relationship will ultimately be broken by ECB communication. This is all the more true given that fundamentals conspire to tighten sovereign spreads. Namely, the simultaneous recovery, [greater fiscal spending at the EU level](#), and the prospect for more of both, and we've written about that [here](#).

Only the ECB can break the mechanical link between higher rates and wider sovereign spreads



Source: Refinitiv, ING

The Italian bond market is most vulnerable

Italy is a case in point. Its bond market is one of the most vulnerable on account of the just €380bn of debt it needs to sell this year. Fears of a lack of demand are misguided though. After accounting for bond redemptions and ECB purchases, we estimate Italy doesn't need to find new buyers for its debt.

Based on the current relationship, our Bund yield forecast would imply another ~25bp of widening in the 10Y Italy-Germany spread.

€380bn

Italy's gross bond supply 2021

Most will be offset by redemptions and ECB purchases

We think cooler heads will prevail before, either thanks to ECB rhetoric or as the [economic implications of Draghi's ambitious recovery package](#) sink in. This will in time bring that spread to 100bp, although we haven't seen the end of the widening near-term.

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Hungary is one emerging market country ripe for more credit upgrades

EM sovereign spreads shrug off eurozone troubles

Rising core rates have weighed on total returns for Emerging Market sovereign hard currency bonds this year. Here, EM EUR sovereign bonds (-1.8% YTD total return based on Bloomberg Barclays EM Pan Euro Aggregate: Sovereign Index) have fared somewhat better than their USD peers (-2.8% for Bloomberg Barclays EM Sovereign Index Unhedged EUR) due to the more modest rise in German Bund yields vs US Treasuries and a shorter duration of the EM EUR sovereign space (modified duration of 7.9yrs vs 8.8yrs for the respective indices).

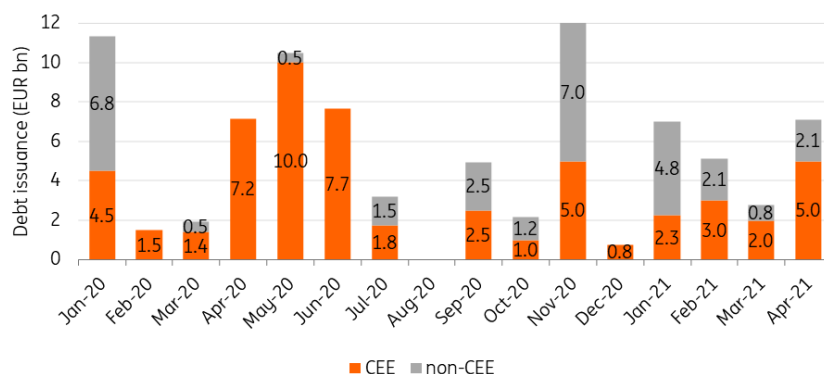
Appetite for EM debt remains strong

However, appetite for EM debt remains strong, with the Institute of International Finance (IIF) reporting US\$87bn of portfolio flows between January and April this year. This has supported EM

EUR sovereign credit spreads which have largely shrugged off the recent rise in Bund yields and the sell-off in eurozone government bonds (EGBs) with the EM Pan Euro Aggregate: Sovereign Index spread having narrowed by 7bp year-to-date.

Importantly, two key drivers behind the recent EGB sell-off have played less of a role for EM, notably the uncertainty about PEPP which should only weigh on eligible eurozone bonds and secondly, primary market supply which picked up in April but is not exceptionally high, as you can see in the chart below.

EM EUR debt issuance (€bn)



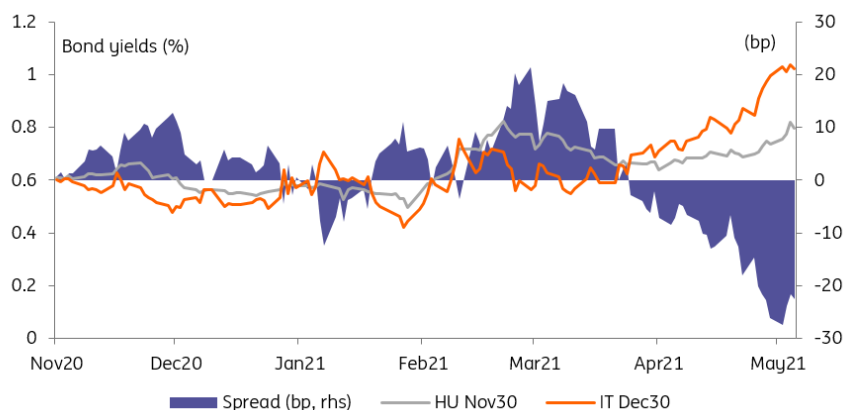
Source: Source: Bond Radar, ING – CEE includes Albania, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Montenegro, North Macedonia, Poland, Romania, Serbia, Slovakia, Slovenia

Bund curve steepening and relative valuations warrant caution but long-term outlook is favourable

That said, in client conversations, we note there is a lack of appetite for longer maturity bonds due to the curve steepening pressure in Bunds. Moreover, some EM EUR, particularly CEE bonds, screen rich in a historical relative value context against EGBs owing to the latter's underperformance, with Croatian euro-denominated sovereign bonds (CROATI) currently trading at flattish yields to Italian BTPS (vs 30/35bp wider in mid-March) and Hungarian bonds (REPHUN) trading 20-25bp inside BTPS (compared to 0bp on average over the last six months).

REPHUN bonds also trade close to all-time tight vs Portuguese PGBs (REPHUN 0.5% 30 trade 25bp wider vs PGB 0.475% 30 vs 50bp 6-month average). All in all, this could put some pressure on EM EUR spreads in the near term. With liquidity proving more challenging in EM EUR, we also see the risk of price discoveries leading to gaps in pricing.

BTPS 1.65% 30 vs REPHUN 0.5% 30



Source: Refinitiv, ING

However, based on our rates strategist view that the sell-off should be front-loaded and contained (the ING view is for the 10yr Bund at 0.20% in the fourth quarter of 2021), we believe that demand for carry in EM EUR is here to stay and therefore we only expect a limited spread widening.

We also consider the fundamentals of CEE issuers, the dominant region in EM EUR, as favourable, further supported by the NextGen EU recovery fund prospects. Indeed they are serial upgrade candidates; S&P and Fitch upgraded Hungary to BBB in 2019 and Moody's Baa3 rating has a positive outlook, Croatia gained investment-grade status in 2019, and Fitch placed Bulgaria's BBB rating on a positive outlook in February.

Net primary supply (issuance minus redemptions) by CEE issuers should be limited; we expect c.€11bn equivalent in 2021 vs €21bn in 2020.

Higher Bund yields: Strong technicals to subdue corporate spreads from widening

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Source: Shutterstock

Strong technicals from less supply, inflows and ECB asset purchases

The strong technical environment in place for 2021 is driven by a large drop in net supply. There is a notable increase in redemptions this year totalling €214bn. And we forecast supply will fall to €350bn - still a sizeable amount but significantly lower than €440bn last year and €390bn in 2019.

Read more on ESG fund flows [here](#).

€350bn Euro corporate supply

Forecast for 2021

Furthermore, the technical picture includes mutual fund inflows for 2021. We expect inflows into the Euro investment grade space will be marginal but positive nonetheless. Interestingly, ESG funds have seen the vast majority of inflows over the past year. Over the last two years, a whopping 85% of assets under management (AuM) have flowed into these funds. Non-ESG funds have seen only marginal inflows, amounting to just 3% of AuM over the past two years. And since August of 2020, non-ESG funds have seen mostly outflows.

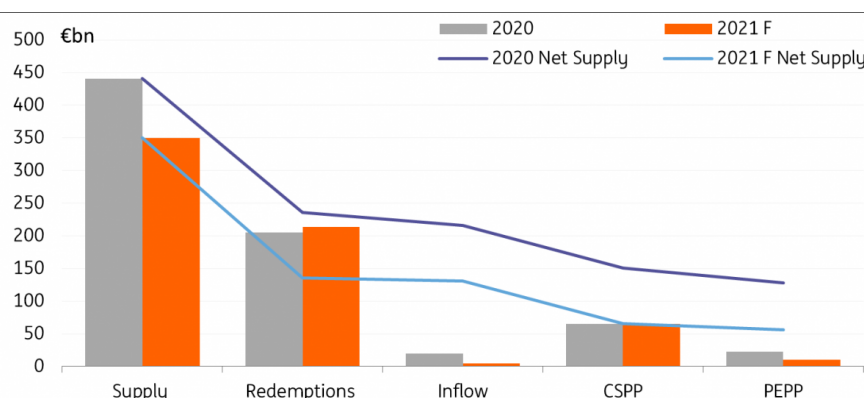
The ECB will continue its reinvestment even after it stops actively purchasing, muting any potential taper tantrum

The European Central Bank, meanwhile, is playing a significant role in supporting credit markets, with both the Corporate Sector Purchase Programme and corporate purchases under the Pandemic Emergency Purchase Programme. With reduced supply, the ECB is forced to concentrate purchases in the secondary market. This is further supportive for spreads.

Even if purchases under PEPP begin to slow and eventually cease, the CSPP will likely remain in full flow, pencilling in at least €65bn of net purchases for the year (gross purchases of €80bn). Additionally, the ECB will continue its reinvestment even after it stops actively purchasing, which will mute any potential taper tantrum.

As a result of lower supply and increased demand, we forecast net supply to fall from around €150bn to just €50bn, as you can see in the chart below.

Corporate net supply is lower in 2021



Source: ING, Dealogic, ECB, EPFR

Strong technicals will keep widening subdued

This strong technical picture will remain supportive for spreads and keep any widening subdued, however, widening from current levels is still expected as rates rise and PEPP tapering talks come to the forefront.

The long end will underperform causing credit curves to steepen

This is in line with our view for a more bearish outlook for the second half of this year, and in particular, our view for the long end to underperform, causing (as expected) credit curves to steepen.

We do take a more conservative stance for the second half of the year, whereby we prefer more defensive sectors such as Utilities and Telecoms and we prefer ESG debt.

No substantial detrimental effects expected

As rates rise, we do not expect any substantial detrimental effect to funding levels as a whole or to credit metrics. The rise in Bunds of 30bp, even when matched with, for example, a 20bp widening in credit spreads is nothing too extraordinary for the short end.

The expectation of the 10-year swap rate to reach 0.55 by the end of the year, up from -0.25% in January, and the rising Bund and likely widening of credit spreads at the longer end, in particular (albeit nothing substantial), will affect the funding levels for higher beta debt at the long end. The cost of funding could rise by around 1%, in which case, it is likely we may see significant pre-funding for longer issues. This will put further pressure on the long end, pushing curves steeper.

However, this will likely leave the technical picture unaffected as, after particularly low supply in May; year-to-date supply thus far is sitting at just €144bn, which is slightly short of our expectations.

As the search for yield becomes easier in the longer term, the attraction for the high yield market will decrease, as investors will not need to take higher credit risk for relatively little yield.

We do not expect any major widening of credit spreads on the back of rising Bund yields

Therefore, we may eventually see outflows in the high yield space at that point. But this, too, should not be of any major concern as it is more a technical issue as opposed to any worsening of the underlying metrics. In any case, this will be seen more in the US in the long term.

All in all, we do not expect any major widening of credit spreads on the back of rising Bund yields, as technicals will keep any widening subdued. However, some widening is still expected, particularly at the long end of the curve, as PEPP tapering talks come to the forefront. As bund

yields, 10yr swap rates and spreads all rise (at the longer end) this will increase funding costs for issuers. As a result, we may see prefunding in the form of longer-dated bonds. In any case, we remain conservative for the second half of the year.

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