

## In case you missed it: First tentative steps towards normalisation

As some countries take the first cautious steps to reopen their economies, we look at the risks of an uneven recovery. The ECB announced it would buy junk bonds too while some other central banks continue to cut rates. As for oil, our podcast indicates the worst may not still be over but prices will eventually trend higher over the second half of the year

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Article | 22 April 2020

# Eurozone lockdown live: The risk of an asymmetric recovery

Judging from mobility data, the lockdown measures in the eurozone seem to have different impacts across the countries. With some countries easing the lockdown measures, while others remain locked down for longer, the risk of an asymmetric recovery has increased



Source: Shutterstock

## Eurozone lockdowns are not all alike

While the French need to do paperwork to walk their dog, the Dutch can still do some shopping. The lockdown measures in the eurozone are similar but definitely not the same. Countries did not only react differently in terms of the timing of the lockdown measures, but also in terms of their strictness.

As Italy was the first severely affected country in Europe, it also started the lockdown measures earlier than the rest. Most other countries followed in the second half of March. However, the announced measures differed significantly in terms of the strictness and scope. Some started off with prohibiting public gatherings, others immediately decided on a shutdown. The countries which started off relatively mildly often stepped up the measures quickly afterwards, so that by end-March almost all eurozone countries were in a de facto full lockdown.

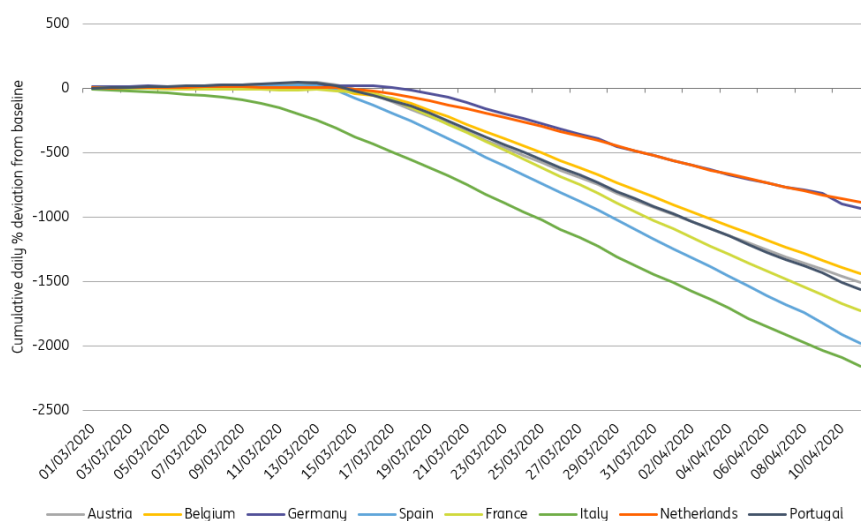
To get a sense of how much of public life has been interrupted, we look at Google's COVID-19

Community Mobility Reports. Google publishes data showing the percent change in visits to certain places like grocery stores, workplaces, and retail shops compared to a baseline (ie. the average of visits for the same day of the week between January 3 and February 6). While categorization may differ between countries, this data does provide an interesting first peek at how significantly public lives have been affected by the softer and harder lockdowns.

## Lockdown impact on economic activity

Looking at the cumulative deviation from the baseline for an average of the Google categories 'grocery stores', 'workplace' and 'retail shops' should give an interesting first proxy of how the lockdown measures could affect the different eurozone economies. It does not really come as a surprise that Italy saw a much quicker deviation from the baseline than other countries and has the largest cumulative impact at the moment. Spain has been closing in though and France ranks third in terms of restricted activity. The Netherlands, Finland and Germany are near the bottom of the list in terms of the severity of the lockdown in practice. Greece, Belgium, Austria and Ireland are in the middle of the pack. This suggests that the direct economic impact is likely larger in the Southern eurozone economies and France than in the Northern countries where the lockdown has been lighter.

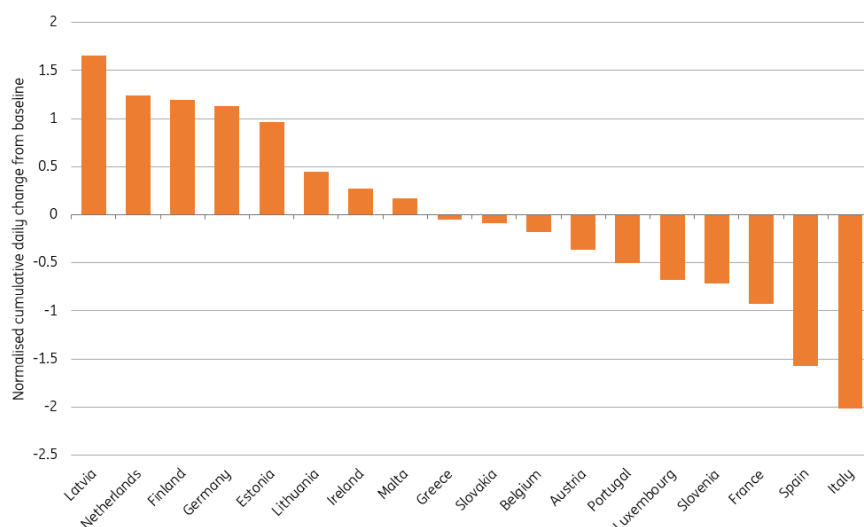
## The cumulative lockdown impact shows which countries have seen daily life most interrupted



Source: Google COVID-19 Community Mobility Reports, ING Research

Note: data from Google COVID-19 Community Mobility Reports, simple average taken of the categories "retail and recreation", "grocery and pharmacy" and "workplace" and cumulated the daily percent deviation from the neutral baseline.

## The impact on Southern eurozone economies has been more severe than in most Northern economies



Source: Google COVID-19 Community Mobility Reports, ING Research










Note: data from Google COVID-19 Community Mobility Reports, simple average taken of the categories "retail and recreation", "grocery and pharmacy" and "workplace" and cumulated the daily percent deviation from the neutral baseline.

## Which way to the exit?

Now that the new number of Covid-19 cases is dropping across the eurozone, the first plans for exits from the lockdown have been put into place. One overarching theme is clear: there is no sudden return to pre-Covid 19 daily life. A gradual return to normalcy is par for the course as concerns about a quick return of the virus and another spike in hospital admissions leads governments to be very cautious about the endgame.

Austria leads the way here as small businesses and DIY and garden centers have been allowed to re-open after Easter. Austria had one of the stricter lockdowns in place from a retail perspective and is now trying to alleviate the impact a little as progress has been made in containing the virus. A gradual opening of hotels and restaurants and also schools are planned for the month of May. Public events are not permitted until July. In Germany, something similar has been announced, with smaller retail businesses open as of April 20 and schools opening gradually. Hotels and restaurants, however, remain closed. Large gatherings have been prohibited until the end of August. Other countries have actually lengthened measures. France, for example, which already has one of the more severe lockdowns in terms of impact on daily life and the economy, has announced an extension of the measures until May 11.

## What are the current lockdown restrictions and when will they be lifted or re-evaluated?

									
Latest deadline for (most) lockdown measures	3 May	11 May	3 May	26 April	20 May	3 May	1 May	2 May	5 May
Leave home without permit	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Retail stores open	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Public gatherings, big events	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Schools open	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Source: ING Research

## Lockdown and exit measures likely to increase divergence

Covid-19 is often labelled as a symmetric shock hitting the eurozone economy. While this is correct regarding the nature of the shock, differences in the length and depth of the lockdown measures seem to have a rather asymmetric impact on the eurozone economy. Currently, a pattern seems to be emerging that the eurozone countries which experienced the sharpest impact on public (and economic) life will be the last countries exiting the lockdown measures. Add to this significant differences across countries regarding the size of the fiscal reaction and there is a clear risk of an asymmetric recovery in the eurozone.

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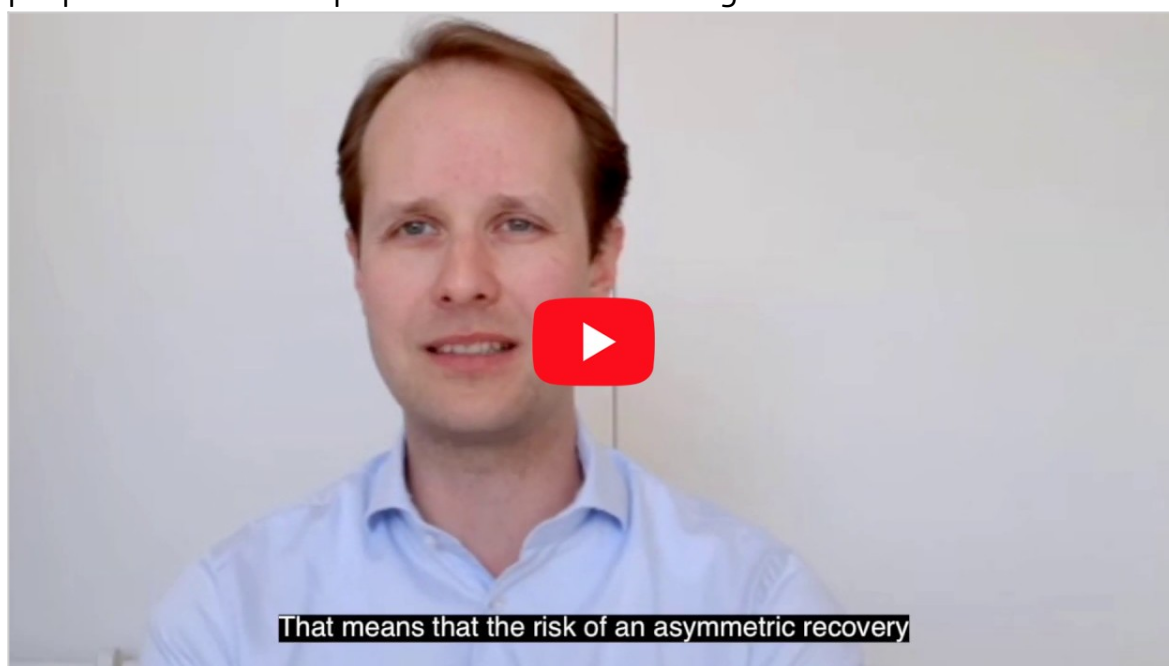
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## Watch: Europe's uneven coronavirus recovery

Europe is facing an asymmetrical recovery from Covid-19 as countries prepare the first steps to economic recovery



### Europe's uneven recovery

We're seeing the smallest steps towards normalisation in countries worst hit by the coronavirus crisis. But there's a concern that any normalisation is starting to happen more quickly in northern economies rather than those particularly hit in southern Europe, notably Spain and Italy. ING's Bert Colijn has been looking at Google activity data and warns about the dangers of an asymmetric recovery.

[Watch video](#)

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## ECB add fallen angels: More could follow

The ECB is to expand its collateral eligibility to fallen angels and we believe potentially all BB debt down the line. As long as a fallen angel was investment grade on 7 April, and remains at BB rating or above, they will be collateral eligible. We think this should benefit spreads and importantly financing possibilities for € high yield



The ECB's inflation forecasts, in particular, suggest the current neutral stance on policy is the right one

The European central bank held a call last night to discuss whether or not to include junk bonds in its collateral framework. It was a very general discussion, which has 'Italy' written all over it. Markets expect S&P to come up with an updated rating for Italy later this week, and there is a risk that Italian debt could start its slide to junk status. This discussion comes a week ahead of the next ECB meeting on 30 April and has increased speculation about additional measures the central bank could take to limit an 'unwarranted' widening of spreads.

The precedent set last week by the Federal Reserve when it included 'fallen angels' bonds (an investment-grade issuer downgraded to high yield) in its purchase programmes and the inclusion of Greece as eligible collateral has created a clear direction for the ECB. Hence, we believe the ECB would add fallen angels to its corporate debt programmes (CSPP and PEPP asset purchase programmes). The Fed went a step further to add high yield ETFs to the purchase list. The ECB is not likely to take that route and also buy ETFs because of its more extensive QE (relative size and longer maturity). However, next Thursday we could well see collateral eligibility expansion to include all BB debt including eligible corporate and thus really support (lower-rated) BBB debt and € high yield market. Please see our report published last week [here](#).

*We believe the ECB would add fallen angels to its corporate debt programmes but won't go as far as the Fed and buy ETFs*

Prior to this the collateral accepted in the credit space needed to be investment grade (one rating agency suffices) and includes financial debt (although this is not CSPP eligible - in the past we have frequently discussed the ECB perhaps including preferred debt).

Adding fallen angels is of paramount importance, as the financing conundrum for investment-grade corporates offers far more opportunities compared to high yield. Often commercial paper programmes, bond purchasing programmes, primary bond markets themselves and an array of government support all favours lower leveraged investment-grade corporates, leaving financing for high yield issuers as a real challenge. Even under our relatively positive Covid-19 base case, we estimate up to 10% of BBB debt will fall to high yield over the next 12-18 months. That is almost €70bn. One source of relief would be this move by the ECB and that thankfully that most investors (including the ECB) can hold onto fallen angels after a downgrade so as not to become forced sellers.

We continue to prefer eligible debt but given current market retracement, demand for credit in the long-end of the curve and this programme, we would not be too worried about adding to BBB and potential fallen angel debt exposure. We also think the BBB to BB spread difference can fall to 150bp consequently. Besides, the move is also beneficial to Italian corporate eligible debt, which hence we would expect to see tighten irrespective of whether it's only a fallen angel collateral expansion or broader BB debt inclusion.

[The Fed fuels fallen angels: Forecasting credit spreads on ING's Covid-19 scenarios](#)

**Fig 1: BBB & BB universe breakdown**

BBB Universe			BB Universe		
	€bn	%		€bn	%
Outstanding	664		Outstanding	156	0
BBB+	310	47	BB+	95	61
BBB	229	34	BB	35	23
BBB-	97	15	BB-	19	12
0-3	181	27	0-3	28	18
3-6	193	29	3-6	62	39
6-9	137	21	6-9	28	18
9-12	55	8	9-12	2	1
12+	55	8	12+	11	7

Source: ING, Dealogic

**Fig 2: BBB & BB universe per sector**

	BBB Universe		BB Universe	
	€bn	%	€bn	%
TMT	101	15	28	18
Consumers	138	21	35	23
Food & Bev	63	9	2	1
Energy	34	5	5	3
Insurance & REIT	72	11	7	5
Healthcare	44	7	17	11
Industrials	86	13	48	30
Utilities	125	19	14	9

Source: ING, Dealogic

There has already been a significant rise in downgrades over the past two years, as illustrated in Figure 3. Therefore, we are likely to see a higher negative rating migration, and continued downgrade dominance. The significant liquidity financing by corporates at the moment, paired with reduced earnings, will be detrimental to leverage ratios, which will, in turn, lead to a higher level of downgrades. We believe many corporates will happily take the risk of a downgrade in return for shoring up liquidity to ensure longterm survival. We believe this financing in BBB debt will gain further traction now the ECB will start purchasing falling angels.

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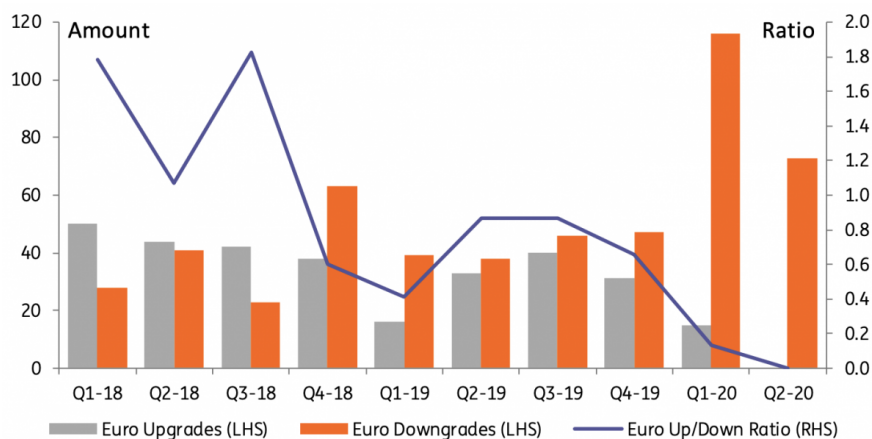
*There has already been a significant rise in downgrades over the past two years, and we are likely to see a higher negative rating migration, and continued downgrade dominance*

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As mentioned, we believe up to 10% of the BBB universe could fall into high yield. This means, as identified in Figure 1, that up to €66bn worth of BBB debt could be downgraded as a fallen angel. Although it is potentially more likely to have BBB- debt fall to junk, it is still very much possible for BBB+ issuers to fall. As it stands, close to 50% of the BBB universe is at the higher end of the rating (BBB+). Similarly, in the BB universe, BB+ accounts for over 60%. Of course, this is based on ING's base case scenario of a gradual recovery, whereby we hit a 10% default level. If we were to see a prolonged lockdown, we expect fallen angels to reach up to 20% of the BBB universe, as there will be considerably more downgrades and defaults across the board.

Consumers, which includes all autos, hold the most substantial amount of BBB debt. Indeed, this sector has been hit somewhat severely in this crisis, and as a result, we may see significant fallen angels here.

**Fig 3: European Rating Migrations**



Source: ING, S&P

Now the occurrence of high yield support from the ECB, we expect performance of BB spreads. As seen in Figure 4, the differential between BBB spreads and BB spreads has risen considerably in 2020. The differential has only recently started to retrace a little, currently at about 200bp, and looking at earlier peaks, a target around the 120-140bp mark seems achievable. In terms of the BBB curve more steepness would be expected and as such we would look for the short end here to really perform.

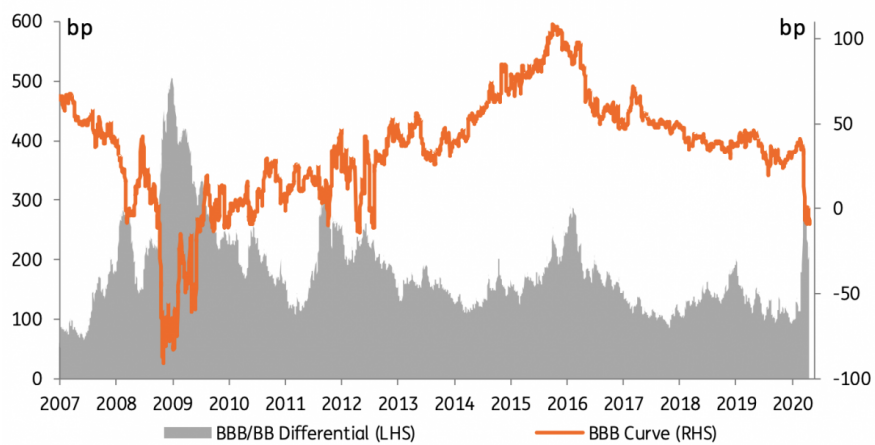
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*What is interesting about this is that the recent peak in the differential levels was close to those of the sovereign debt crisis in 2011 and the oil crisis in 2016 but did not come close to the levels seen in the global financial crisis in 2008*

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On a more cautious note, what is interesting about this is that the recent peak in the differential levels was close to those of the sovereign debt crisis in 2011 and the oil crisis in 2016 but did not come close to the levels seen in the global financial crisis in 2008, where we also saw far more substantially inverted curves in BBB. Hence there is a significant downside here, under a considerably worsening Covid-19 scenario, matched with lack of further support for high yield, so we might expect the differential to climb once more reaching the levels hit in 2008.

**Fig 4: BBB BB Differential and BBB Curve**



Source: ING, ICE

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Opinion | 21 April 2020

## What does negative oil mean for Asia?

The impact of negative oil means different things for different Asian economies - but if you have to generalise, it isn't great news



Source: Shutterstock

**-\$37.63/bbl** WTI oil  
May contract  
Lower than expected

### There are some winners and some losers, but mainly losers

I've covered this subject in some detail, not that long ago, so I won't labour these points too hard today.

WTI's May contract traded at minus (yes that's right) \$37 yesterday, and using some old and inappropriate yardsticks, we should all be revising our GDP forecasts higher. Right?

Wrong.

For starters, this is just the May contract, and it reflects inland storage problems in the US. More global oil indicators such as Brent or for some Asian oil importers, Dubai benchmarks, aren't trading so low - Brent is about \$26 and Dubai front-month contracts closer to \$21 (both positive). Our Head

of Global Commodities Strategy, Warren Patterson, [warns that](#) with this May contract expiring today, we may see the June contract coming under pressure. But we'll leave the intricacies of oil price dynamics for him to cover in his team's note later.

It's also the case that whenever something like this happens, you have to ask, "Why?" Yes, there's too much oil, but more importantly, there's way too much oil for the state of collapsed US and indeed global demand we currently have. These weak prices largely reflect the shutdown of the US economy, and so we should probably be revising our forecasts lower, to reflect this, not to mention the faster decline in US drilling activity and investment that we are likely to see as a result.

Then there is the main point that I made in one of my dailies not so long ago - that much lower oil is:

1. Not like a global tax cut as some often suggest;
2. It isn't even really a zero-sum game as others attest;
3. What it is, is a deviation from the optimal price of oil, the price at which producers and consumers are equally miserable/happy and the gains in one direction will always be less than the losses in the other direction like any other product in any other market and just as in any basic microeconomic textbook. We could be talking about jam or toothpaste...

What is a wonder is that institutions like the IMF peddled such nonsense as their ready-reckoners for oil for as long as they did.

To cut a long story short, there are some exceptions at the extremes where we can make glib generalisations - India is a big oil importer (normally) so in time, may see some benefit from much lower oil prices, and Malaysia is the region's only sizeable net oil exporter, so it doesn't help them. But for the rest of Asia, such a big negative deviation from the optimal price of oil (in the \$55-65 range in recent years) describes such a big terms-of-trade shock to the oil-producing nations, that it will likely weigh heavily on their demand for Asia's exports - that is assuming the Covid -19 pandemic moves on allowing exports and production to resume. And the hit from that will be bigger than any consumption benefit derived from these lower prices.

Moreover, right now, Covid-19 remains by far the bigger story, and you could file this oil development as a sub-story under the pandemic.

The news on the pandemic itself is generally looking a bit more positive, though Russia, and many Central and South American countries sound to be making heavy weather of it. And the US new case numbers remain stubbornly high, as states like Ohio see their daily case numbers triple in about a week. It only takes one of these states to blow up and you have a new New York.

This is another reason I worry about the race to re-open. But to follow these numbers, you *have* to look at the state-level figures (or deeper if you can get them). Looking at aggregates for the US now was as silly as it was to look at global new case counts in mid-February, as China got on top of its outbreak, only to see figures elsewhere begin to accelerate.

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Podcast | 23 April 2020

## Listen: Why the Great Oil Crash may not be over

US oil prices have recovered some ground after tanking this week to historic lows. But the outlook for crude still looks bleak. In this podcast, ING's Head of Commodities Strategy Warren Patterson explains why prices could turn negative again next month



### Too much oil and nowhere to put it

Shuttered factories and grounded aeroplanes have sapped demand for oil around the world, and producers have been slow to react. With too much oil and nowhere to store it, prices have collapsed. [In this podcast, ING's Head of Commodities Strategy Warren Patterson](#) tells Senior Editor Rebecca Byrne what to expect now.

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## Asia FX Talking: Looking for a way out

The evolving narrative for much of the developed world is peaking Covid-19 cases leading to hopes for an end to lockdowns and the possible re-start of economies. For Asia, things are, inevitably, more complicated, and that is likely to reflect in currency strength in the coming weeks



Source: Shutterstock

The evolving narrative for much of the developed world is of a peak in Covid-19 cases is leading to hopes for an end to lockdowns and the possible re-start of economies. For Asia, things are, inevitably, more complicated, and that is likely to reflect in currency strength in the coming weeks.

China and Korea are well on the road to recovery and both have seen currencies strengthen, though the KRW has recently come under renewed pressure as speculation about the health of North Korea's leader grows. And China has given the rest of the world a taste of what is in store for GDP with its -6.8%YoY print for 1Q20. Australia and New Zealand too have seen their new-case count drop sharply following lockdowns and both the AUD and NZD have bounced higher.

Thailand and the Philippines have seen lockdowns cap the spread of the virus and may realistically start to consider de-confinement in the coming weeks if cases fall further.

Singapore and Japan after good starts, have belatedly joined those in lockdown as the situations worsen. And the less-than-convincing partial lockdowns in Indonesia and the chaotic lockdown in

India has not yet led to any believable improvement, though India is already inexplicitly talking about reopening.

This is a messy backdrop for economies and currencies. That isn't going to change soon.

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## GCC currency pegs: Unprecedented times, unprecedented measures?

These are unprecedented times in global energy markets. Does the crash in oil prices spell the end for Gulf Cooperation Council's 30-year-old currency pegs? While certain GCC members face significant challenges, GCC authorities have a lot invested in the pegs and have considerable resources to resist devaluation



Source: Shutterstock

Saudi Energy Ministry, Prince Abdulaziz bin Salman Al-Saud, Minister of Energy of Saudi Arabia, chairs a virtual summit of the Group of 20 energy ministers to coordinate a response to plummeting oil prices

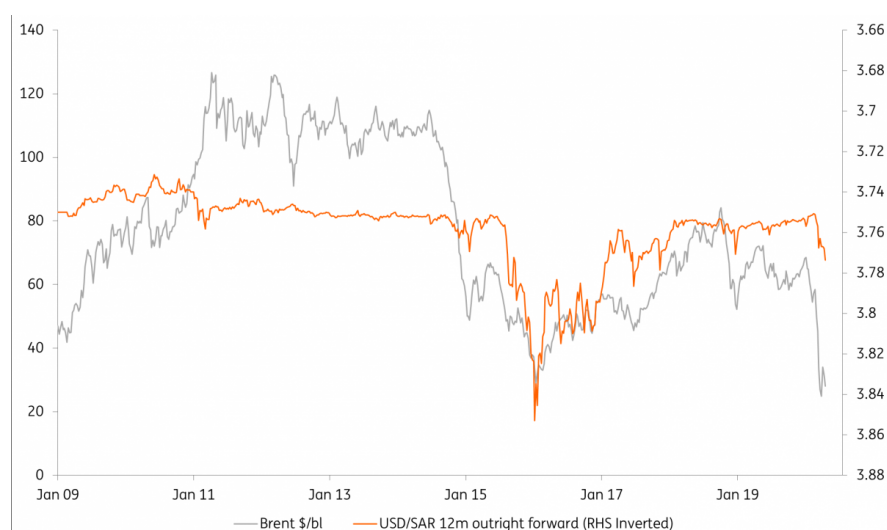
### Pegs have held in good times and bad

The GCC countries - Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the UAE - have been running currency pegs or managed FX regimes against the USD since the early 1970s. Given the dollar-based nature of their economies, the pegs have been seen as an essential anchor for policy credibility (out-sourcing monetary policy to the Federal Reserve) and that has served the region well.

Depending on the price of oil, over the years, these pegged regimes have seen pressure to revalue (strong oil, under-valued currencies seen as inflationary). Or, as now, the pressure to devalue (weak oil, over-valued currencies seen as deflationary). Local authorities have a strong track record of

seeing these cycles out.

## The 3.75 peg in USD/SAR has held through the ups and downs of the oil market



Source: Bloomberg, ING

### Is this time different?

For a start, the GCC members' progress of diversifying their revenue dependence away from oil has been mixed. Saudi Arabia in 2020 is still expected to earn 63% of government revenues from oil receipts. That figure is as high as 76% for Oman but as low as 39% for Qatar. Second, many countries have achieved limited progress in reining in fiscal spending over the last few years, with government debt/GDP having risen notably in Bahrain (from 66% in 2015 to 102% in 2019 according to the IMF), Oman (15% to 60%) and Saudi Arabia (6% to 23%).

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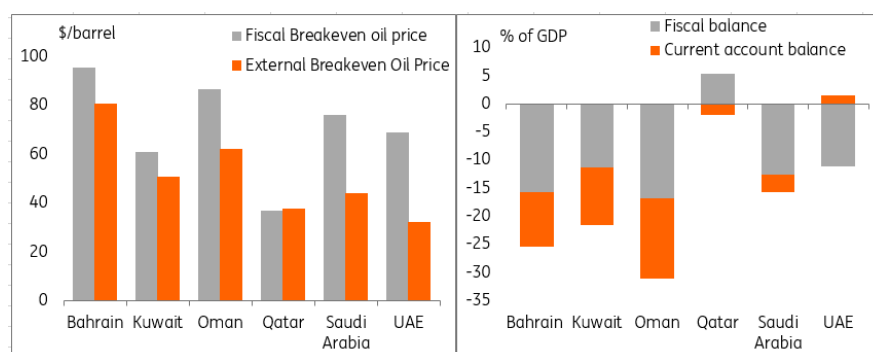
*The dependency of GCC markets on oil revenue naturally has a big say in both national budgets and the current account balance*

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The dependency of GCC markets on oil revenue naturally has a big say in both national budgets and the current account balance. The first chart below outlines IMF figures on the required break-even oil prices in fiscal terms (at which the fiscal balance is zero) and in external terms (at which the current account is zero). Clearly Bahrain and Oman have their work cut out given budgetary break-even oil prices at \$80/bl+.

The second chart looks at 2020 IMF forecasts for fiscal and current deficits in terms of GDP. Again Bahrain and Oman stand-out here. That is why Bahrain's and Oman's sovereign credit default swaps (the cost of insuring against a sovereign default) trade at 474bp and 699bp respectively, versus levels of 42bp and 64bp for Qatar and Saudi Arabia.

## 2020 forecasts for i) Break-even oil prices (\$/bl) and ii) fiscal and current account balances (% of GDP)



Source: IMF

### Would a devaluation help?

The case for a GCC voluntary currency devaluation appears weak.

Firstly, the loss of the credible anchor will be costly – e.g. what kind of devaluation is sufficient, who decides policy and what are their motives? Secondly, [studies suggest](#) that trade inelasticities mean that devaluations would actually lead to a deterioration in the non-oil trade balance.

What about an involuntary devaluation then? Here the view is that sustained pressure on an exchange rate peg and the ensuing loss of reserves make the existing FX arrangement untenable. An example here was Korea's attempt to resist devaluation in 1997 during the Asian currency crisis. The Bank of Korea lost 40% of its FX reserves on intervention and then de-valued anyway.

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*Based on conventional metrics of import cover and short term debt to FX reserves, Bahrain looks the least able to withstand sustained pressure*

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But, as above, the GCC has a long history of defending currency pegs and still has considerable resources. Notably, Kuwait, Qatar, Saudi Arabia, and the UAE boast substantial sovereign wealth assets. In the case of Saudi Arabia, currency reserves stand at around \$500bn, with one of its Sovereign Wealth Funds (PIF) holding \$320bn. The strong buffers have also been key in maintaining market confidence, with Abu Dhabi, Qatar, and Saudi Arabia altogether having raised \$24bn from international capital markets in April.

Based on conventional metrics of import cover and short term debt to FX reserves, Bahrain looks the least able to withstand sustained pressure. However, we would expect support from fellow GCC members to remain forthcoming for socio-economic and geopolitical reasons but also for fear that allowing one GCC member to devalue would invariably lead to contagion in the region. For reference, the IMF and Bank of International Settlement data forecast Bahrain with a \$7.5bn current account deficit this year and \$15bn of short-term liabilities to BIS reporting banks.

Oman's starting point into the current crisis is more favourable but deteriorating at a fast pace as the large fiscal and current account deficits above indicate.

Given Oman's neutral foreign policy which has been preserved amid the ongoing spat between Saudi Arabia, Bahrain, the UAE and Egypt on the one side and Qatar on the other, it is unclear whether stronger GCC countries would be willing to step in case of need. If push comes to shove and oil prices remain in low gear for a more extended period, we could see a similar situation to that of Bahrain ahead of the bailout in 2018, with investors scrutinizing FX reserves against external debt maturities which remain large over the next few years.

### [Trade Elasticities in the Middle East and Central Asia: What is the Role of Oil?](#)

## Pressure on pegs likely to remain, however, through 2Q20

While we do not think the pegs will be broken in this cycle, it is hard to see the pressure coming off the pegs in the next few weeks. That pressure typically is expressed through the FX forwards market.

Below we show the current stress in the 12-month FX forwards market, seen as a gauge of where these GCC spot rates could be trading in twelve months' time. At the moment, as in the CDS space, the Omani Rial is under the most pressure with a 5% depreciation priced in over the next twelve months.

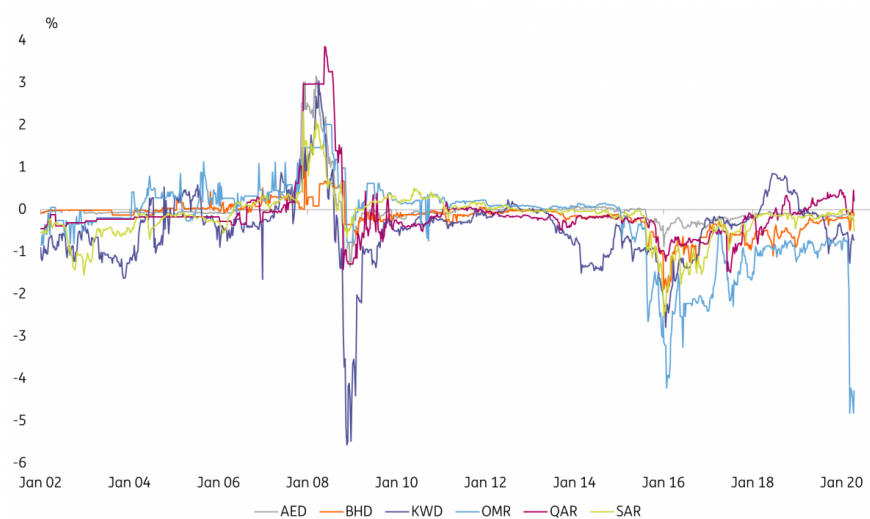
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*There is a real risk of a repeat performance in the June 2020 WTI contract when it comes to expire on 18 May*

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[As our commodities team noted today](#), there is a real risk of a repeat performance in the June 2020 WTI contract when it comes to expire on 18 May – just as we saw heavy WTI losses on the back of the May 2020 contract expiration yesterday. And until we don't have better transparency on lockdown exit strategies and a better picture of the demand destruction in oil markets, that we'll see a sustainable rebound in crude oil prices.

## Implied (via FX forwards) twelve month change against USD



Source: Bloomberg, ING

It, therefore, looks like the more vulnerable of the GCC currencies, Oman and Bahrain, can stay under pressure in the FX forwards market through the Spring. But based on strong support within the GCC bloc and what should be a second-half recovery in Brent crude to the \$35/45 (according to our team), we see GCC pegs intact and implied yields on the FX forwards dropping back to levels seen through 2018/2019 as the summer progresses.

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# CIS Sovereigns: Better positioned than 2014/15 but risks loom

Despite the substantial negative impact on growth and fiscal and external dynamics amid the dual shocks from Covid-19 and low oil prices, the CIS region's oil & gas sovereigns including Azerbaijan, Kazakhstan and Russia appear to have sufficient capacity to deal with temporarily lower prices thanks to fiscal reserves and sovereign net external assets



Source: Shutterstock

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Article | 20 April 2020

# IBOR transition: €STR discounting delays due to coronavirus

The coronavirus pandemic is throwing a spanner in the works in the transition away from IBOR rates. Even though the end-2021 deadline has been confirmed, there are increasing signs of disruptions. The fact that clearing houses will now switch to €STR discounting on 27 July instead of 22 June is just another example. We take a look at the implications



The ECB's inflation forecasts, in particular, suggest the current neutral stance on policy is the right one

## Lack of consensus for €STR discounting delay

It will not come as a surprise to anyone that the coronavirus epidemic is proving to be a headache for the regulator and market participants working to transition away from IBOR benchmarks to new risk-free rates (RFR). Clearing houses (CCP) announced last week they were going to delay the switch from Eonia interest rate benchmark to the euro short-term rate or €STR benchmark and price alignment interest (PAI) by five weeks to 27 July.

According to the [minutes of a teleconference](#) of the Working Group of euro RFR, an informal survey among members yielded no consensus for a three-month delay.

However, a postponing was deemed necessary by a majority of members to allow market participants to be ready, and to reduce operational risks. In the same meeting, the working group

was presented with a result of a members survey suggesting a delay in the consultation on Euribor fallbacks.

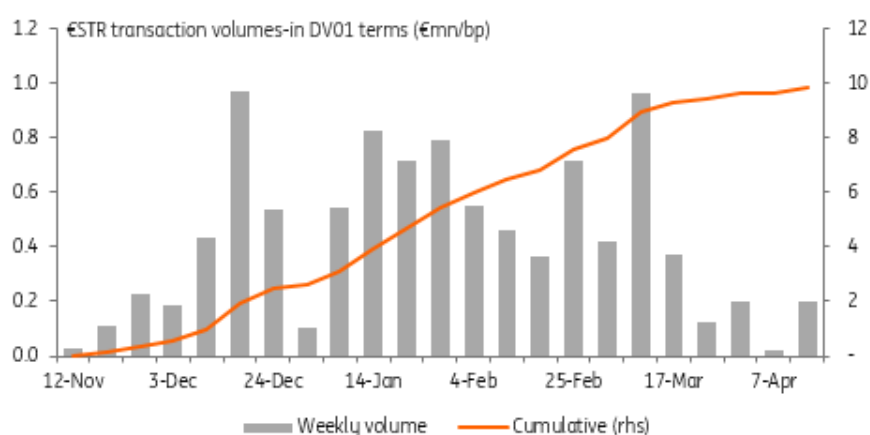
According to the minutes, this would postpone the publication of the results from mid-December 2020 to January 2021.

## Potential clash with other deadlines

Opponents to the delay noted that the proximity of the EUR (initially planned for 19 - 22nd June) and USD RFR discount and PAI switches (still due to go ahead on 16-17 October) would make the change a struggle. It is therefore likely that the new date decided by the CCP represents a middle ground between the initial extension and no delay at all.

The industry had pinned its hopes on the discounting and PAI change 'big bang' to be a catalyst for €STR swap volumes to pick-up and eventually overtake Eonia swaps. The build-up in €STRS swaps has been slow and we expect that the fall in cleared volumes since mid-march is a reflection of temporary migration towards more liquid products in times of market stress.

## Slow build-up in €STR swap volumes



Source: Bloomberg, ING

## Possible delays in other jurisdictions

As a reminder, the eurozone is not the only jurisdiction where there have been signs of delay in the IBOR transition.

In the UK, [the FCA acknowledged](#) that the timeframe of the transition in some market segments, such as loans, was at risk. In the US, the [ARRC also said](#) it will keep the impact of the epidemic in mind when setting up its 2020 objective and best practices.

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## Turkey: The CBT cuts for the eighth consecutive time

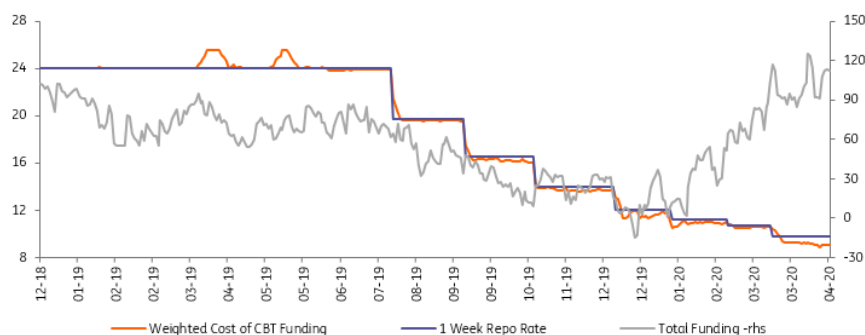
The CBT has extended its cutting cycle - against a backdrop of demand weakness, falling price pressures and the accommodative policy stance of global central banks.



The Turkish Central Bank in Ankara

In April MPC, the CBT cut the policy rate (1-week repo rate) by another 100bp to 8.75%, comparing market consensus at 9.25% (and our call at 9%) likely on the back of 1) objective to provide additional support to ongoing policy mix that targets to mitigate downside risks to the growth, 2) negative output gap weighing on inflation despite likely impact of TRY weakness and 3) shift in global policies amid Covid-19 concerns with aggressive and immediate stimulus.

## CBT Funding (in % and TRY bn)



Source: CBT, ING

On the inflation outlook, the CBT sees the impact of inflation expectations, demand conditions and producer prices on “mild trend” of core indicators. Regarding the rate decision, the CBT, once again, cited the growing downside risks to inflation thanks to 1) continued plunge in commodity prices, especially oil as we have already seen significant downward adjustment in local fuel prices in recent weeks despite currency depreciation 2) weakening demand conditions given the hit from the coronavirus outbreak, though adverse impact of declining production and sales on variable costs needs to be closely monitored.

In the statement, the CBT kept key guidance sentences unchanged. The Bank reiterated that “a cautious monetary stance” is required so as to keep “the disinflation process in track with the targeted path” and that it would continue to determine monetary policy by considering “the indicators of the underlying inflation trend to ensure the continuation of the disinflation process”.

In the remainder of the statement, the CBT also shared views about 1) current global outlook 2) importance of financial stability with healthy functioning of financial markets, the credit channel and firms’ cash flows so as to contain effect of the pandemic on the economy 3) external rebalancing and likely moderate course in the period ahead with lower imports driven plunge in oil prices and sluggish domestic demand.

Overall, the CBT extended policy easing by another more than expected cut while it does not signal that this is the final move of the cutting cycle. In the period ahead, currency developments that can risk price and financial stability will be closely watched.

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## Brexit: Why an extension to the transition period still seems likely

As UK-EU trade talks resume, the British government has insisted it won't ask to extend the 11-month transition period. But given the risks involved with a sharp change in trading conditions at the start of 2021, particularly if that were to coincide with another Covid-19 outbreak, we think an extension looks increasingly likely



Source: Shutterstock

British Prime Minister Boris Johnson welcomes European Commission President Ursula von der Leyen to 10 Downing Street

### Brexit talks are soldiering on, despite coronavirus

Brexit - remember that?

It's a little over two months since the UK formally left the EU, although it feels like much longer. But despite the global outbreak of the coronavirus pandemic, trade talks between the two sides are still continuing in the background, albeit via conference calls. Both sides will meet for further virtual talks this week.

As things stand, the UK's post-Brexit transition period - during which the UK's trade relationship with Europe remains virtually unchanged - is still due to end on 31 December 2020. The UK government [said last week](#) that it won't ask for an extension, nor will it accept one even if the EU offers it.

## Is a deal still possible?

We think this position could change. After all, both sides have until late-June to agree to an extension. But first a quick recap.

Back in February, before coronavirus had really taken hold in Europe, the general consensus among trade experts was that a bare-bones trade deal covering goods was just about possible this year, assuming the UK agreed on some key issues.

[Fishing](#) is clearly one, while perhaps the biggest sticking point was the so-called 'level-field commitments'. [We concluded back in February](#) that the whole process may well boil down to whether the UK is prepared to stick to EU rules on state aid.

That's probably still the case, but the onset of coronavirus means more time will inevitably be needed, regardless of whether the UK government is open to compromise on a deal. Here are three key reasons why:

### 1 Time isn't on anyone's side

Firstly, the time and resources available to agree on a deal are clearly diminished.

Trade deals are typically multi-year exercises, but in this case, the UK and EU realistically have until October to agree on terms, allowing time for ratification. And while formal talks are continuing, many of the civil service resources previously assigned to support negotiations have been reallocated to deal with the coronavirus emergency response.

Admittedly many of the thornier issues were always likely to be left untouched until after the summer. But these are tough, political choices, and with the health crisis likely to persist for many more months to come, Brexit simply isn't going to be high up politicians' list of priorities - on either side of the channel.

### 2 Businesses won't be ready for a change in trading conditions

But the transition period wasn't just designed to facilitate negotiations, it was also there to give businesses time to prepare for the future relationship. This is where failing to extend the transition period looks risky.

Regardless of whether a free-trade agreement (FTA) is concluded this year, there will still be major changes to the UK's trading relationship at the start of 2021. New customs documentation will be required, and in the case of services, access to the European market will become significantly more restrictive.

Even before coronavirus, there were concerns that the 11-month transition wouldn't leave enough time for businesses to adapt. Before the original Brexit deal was agreed in 2019, there were concerns that many firms, particularly small-medium size enterprises were not fully prepared for a 'no deal' exit.

The same is still likely to be true now, and with coronavirus set to continue causing wide-scale disruptions for a range of UK businesses, it is unlikely that many firms will have the capacity to increase readiness for a sharp change in trading conditions in 2021.

### 3 Supply chain disruption pose risks to coronavirus response

However, the biggest risk with not extending the transition period is linked to Covid-19 itself.

While lockdowns are likely to be gradually unwound later this quarter, many scientists expect there to be future outbreaks. If that were to coincide with the end of the transition period over the winter, then it could be deeply disruptive.

Supply chains have proven fairly resilient over recent weeks, despite surging demand for certain consumer products. But that could change with the introduction of new customs processes at the borders. With or without a free-trade agreement, there would likely be some initial disruption at the ports.

In that case, it's not inconceivable that medical supply chains could be disrupted. It was for this very reason that the UK government asked all pharmaceutical companies to stockpile at least six-weeks worth of drugs ahead of the original Brexit deadlines.

[The Centre for European Reform](#) has roughly estimated that anywhere from a quarter to half of imported NHS protective equipment is sourced from the EU.

#### Possible extension agreement in June?

We (and a growing chorus of Brexit commentators) believe an extension to the transition period remains likely, and it's really a question of 'when'. Two-thirds of the public said they would approve of an extension, according to a recent [Focaldata poll](#).

Officials have until late-June to agree on an extension, and it looks likely that both sides will use a planned June conference to take stock. If an extension is agreed, the default position would be for it to last for two years, in exchange for the UK making ongoing budget contributions during that time.

However, UK negotiators may well push for a clause that allows that time period to be shortened, if a deal can be agreed and ratified sooner than expected.

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# What have we learnt from the UK's updated borrowing plan?

There is much to learn from the UK's updated borrowing plan. We think it signals more borrowing is on the cards for developed countries, and that debt is here to stay. We expect limited impact on GBP interest rates thanks to the Bank of England intervention. The lack of additional T-bill supply is also welcome news for money markets such as commercial paper



## More borrowing, one step at a time

The first take away from UK's [updated borrowing remit](#) covering the May to July period is that the Debt Management Office (DMO) is taking things one step at a time.

A new update will be published at the end of June with presumably new borrowing targets. We think this makes sense. Despite the sharp increase in borrowing, the coronavirus crisis is only in its infancy and we really don't know how much the measures put in place will end up costing.

[UK Debt Management Office revises its 2020-21 financing remit](#)

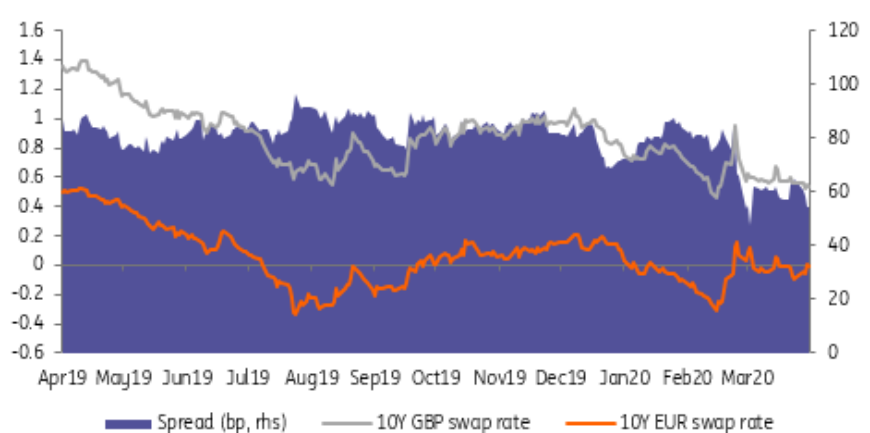
## We think there will be more

Updates to annual borrowing plans are not unusual but the scale of the change is: from £156bn of gilt issuance for the whole of the 2020-21 fiscal year to £180bn in a three-month period. The DMO says it would be wrong to assume that the pace of debt sales in the first four months should be extrapolated to the whole fiscal year (running from April 2020 to March 2021).

Given the exceptional circumstance and our view that we are still in a phase of downgrading growth expectations, we do not rule out abundant supply for the rest of the year.

Referring to [a scenario analysis](#) published by the Office for Budget Responsibility highlighting an additional £218bn borrowing need compared to the pre-virus budget. At the time the scenario described was premised on more pessimistic assumptions than consensus. But we think these assumptions are quickly becoming the base case now.

## GBP rates remained low after the announcement



Source: Bloomberg, ING

## Impact for GBP interest rates ?

The next question is whether investors can absorb it without 'choking on gilts', and what impact will the new plan have on GBP interest rates.

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*Given the exceptional circumstance and our view that we are still in a phase of downgrading growth expectations, we do not rule out abundant supply for the rest of the year*

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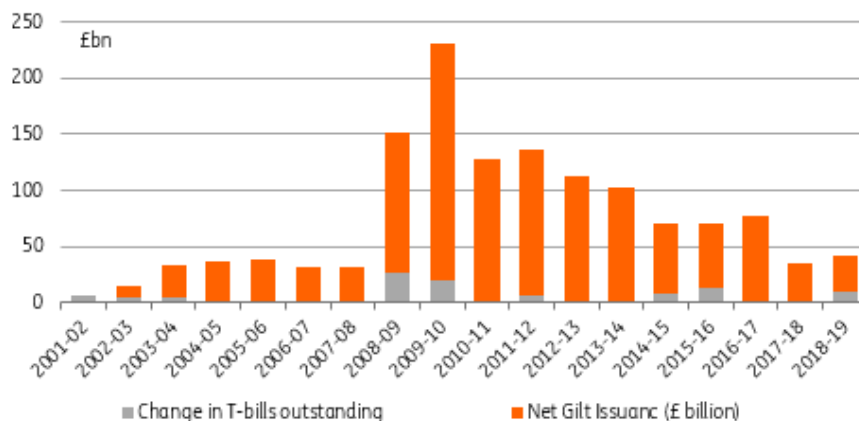
We have argued [previously](#) that the gilt market can absorb a significant amount of extra issuance without flinching. For instance, in the fiscal year 2008-09, the DMO managed to raise £150bn, followed by an additional £230bn the following year, the majority through gilt sales. Market reaction to the new borrowing plan has been muted and the spread of 10-year sterling swap and bond rates to their euro equivalent remains historically low.

We thus have no doubt that the amounts discussed can be absorbed. For comparison, the Bank of

England aims to increase its QE portfolio by £200bn, with the vast majority invested in gilts. The question is whether or not this is the last update. We think probably not, but in case of worsening financial stress, the central bank has the possibility to increase its purchases.

[The agreement between BOE and UK Treasury rekindles debate on direct monetary financing](#)

## We've been there before: UK borrowing capacity is large



Source: DMO, ING

## Good news for money markets

The good news for sterling money market is that the DMO expects it will rely solely on gilts to finance the extra deficit. One of our concerns since the beginning of the pandemic is that additional T-bill issuance could [crowd out lower-rated assets, such as commercial paper \(CP\)](#). This adds to our view that the Treasury might rely on [overdraft at the BOE, the Ways and Means facility](#), rather than flood the market with debt.

The message overall is positive: the Treasury, the central bank, and DMO know they are walking on eggshells when it comes to financial stability, and are acting accordingly.

There is another takeaway from the choice of long-term instruments to finance new deficits: the debt is here to stay.

This might be seen as a slightly dimmer development for those who still believe that the coronavirus recession will be a transitory event. To us, this might be an indication that there is no plan to engage in self-defeating fiscal tightening that would threaten the recovery. We hope to be proven right in future official communication but in our opinion, growing out of the additional debt pile is the most effective strategy.

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