

## In case you missed it: How green is your recovery?

As daily Covid-19 cases surpass 60,000 in the US, markets are understandably concerned. Nonetheless, the UK went back to its beloved pubs this week and in our latest podcast, we focus on Chancellor Rishi Sunak's latest measures and ask if they'll be enough? Also, the ECB is going green, so we take a look at which countries are pushing for a green recovery

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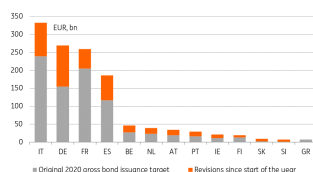
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Article | 9 July 2020

## ECB preview: The breather meeting

Next week's meeting should tell more about Christine Lagarde's communication skills than about the future path of monetary policy



Source: Shutterstock

They have deserved it. After all the excitement since March, next week's meeting should give the ECB some time to reflect and take stock. It will not be the moment to decide on any new action.

The June meeting had not only delivered an increase in the size of the Pandemic Emergency Purchase Programme (PEPP) but also addressed the German Constitutional Court's ruling on the Public Sector Purchase Programme (PSPP) and paved the way for a workaround. By now, the minutes of the meeting and the German parliament's assessment should have eased the tension and reduced the tail risk of the Bundesbank eventually having to step out of the PSPP. The ECB can again concentrate on fighting the economic impact from Covid-19.

Overall, there is too little new data evidence to change the base case. If anything, the ECB is also witnessing a rebound in economic activity in the eurozone, driven by the lifting of the lockdown measures. Also, the ECB will have closely followed latest German data, showing that external demand and industrial production is lagging behind domestic consumption. The exact size of the economic impact in the second quarter will only become clear towards the end of the month with the first estimates for GDP growth. Currently, there is an interesting discrepancy between more real-time and experimental GDP growth trackers and more conventional forecasts.

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*The real test case will come in the second half of the year.*

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The latter being more optimistic than the former. In any case, in our view, the real test case will come in the second half of the year. June data should still be positive, continuing the – at least initial – V-shaped recovery. Therefore, July data will in our view be key for the future path of monetary policy.

The inflation outlook has also hardly changed since the June meeting. Despite some inflationary pressure in some pockets of the economy due to some price mark-ups, the overall picture with high unemployment, increased uncertainty and the risk of companies going out of business is clearly disinflationary.

Looking beyond next week's meeting, there is the ongoing question on whether to once again increase the size of the PEPP or maybe even to end the programme earlier than expected. The ECB has always emphasized the flexibility of the programme and the fact the eurozone bond yields are back at pre-crisis levels as well as some slowing of the pace of the ECB purchases has given rise to speculation in markets about a possible earlier end. In our view, this speculation is premature. The economic outlook for the eurozone is simply too uncertain. Also, the negotiations (and eventual decision) on the European Recovery Fund will also have an impact on bond yields. An agreement next week should stabilize bond yields. Disagreement and postponement could add new pressure on peripheral yields.

All in all, the next important stop for the ECB will be the September and October meetings. This is when there will be clear information and evidence on the shape of the recovery going into the second half of the year. Next week's meeting will rather be a test for ECB President Christine Lagarde's communication skills. What will she tell if there is actually nothing to say?

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# Bulgaria and Croatia set to join the lengthy ERM II process

Despite the current tide in European politics to slow EU expansion, Bulgaria and Croatia are proving more integration is possible. Ultimately, the...



[News reports](#) have been emerging overnight that a decision to accept Bulgaria and Croatia's bids for ERM-II will be taken today at the EU finance ministers video conference.

While this is not necessarily a huge surprise given that the ECB successfully closed its assessment on the two country's banking sectors in early June, it does stand as a bright spot and welcome development amid the gloomy Covid-19 induced socio-economic background.

Coming somewhat against the current tide in European politics to slow EU expansion, Bulgaria and Croatia are proving that more integration is possible within the EU, in the context of other politicians in Europe still contemplating Brexit example or the EU's relatively fragmented response to the Covid-19 crisis.

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*We believe Bulgaria and Croatia joining the ERM-II does not mean a guarantee that the euro adoption process is now on autopilot*

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Nevertheless, we believe Bulgaria and Croatia joining the ERM-II does not mean a guarantee that the euro adoption process is now on autopilot as both countries still face important challenges. These might tend to be tilted towards the qualitative side for Bulgaria (institutional framework, rule of law) and quantitative side for Croatia (public finances sustainability), but the reality is that none of the two will meet all the convergence criteria anytime soon.

News reports about [Bulgaria](#) and [Croatia](#) joining the ERM

## The Maastricht criteria

To adopt the common currency, a candidate country needs to meet four main convergence criteria known as Maastricht criteria:

1. **Price stability** - Average inflation should not exceed more than 1.5 percentage points above the rate of the three best performing member states.
2. **Sustainable public finances** - Budget deficit below 3.0% of GDP and the debt-to-GDP ratio remains below 60%.
3. **Convergence sustainability** - Long-term interest rates don't exceed more than 2 percentage points of the three best performing member states in terms of price stability
4. **Exchange rate stability** - Participation in ERM-II for at least two years

Equally important and implied by the adoption process, a fifth criteria is the legislative compatibility, as national legislation needs to be adapted to the treaties and statute of the European central bank, i.e. ensuring central bank independence and prohibition of monetary financing.

## What is ERM?

ERM stands for Exchange rate mechanism and is meant to ensure that prior to adopting the euro, the candidate country can control its economy without recourse to excessive currency fluctuations.

ERM-II was introduced in 1999, together with the single currency and it is a compulsory step for the countries wanting to join the eurozone. Thus, for a period of at least two years, a country needs to demonstrate that it can maintain its currency stable within a maximum tolerance band of  $\pm 15\%$  around a central parity rate for a period of at least two years.

## Central parity rate: What is this all about?

The candidate country needs to demonstrate that it can maintain the relative stability of the currency.

The decision on the central parity rate is taken by mutual agreement of the ECB and finance ministers and central bank governors of the euro and non-euro area countries participating in the ERM. The maximum variation band around this central rate is 15%, but a narrower band can also be set.

The Danish krone, for example, has a fluctuation band of  $\pm 2.25\%$  but for the Baltic countries, Slovenia and Slovakia the band was set at 15% band at the time of ERM-II entrance. It's worth mentioning that the central rate can be changed by mutual agreement of the parties, as was the

case of the Slovak koruna which was revaluated by 17.6% in 2008.

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*The Bulgarian lev has been successfully pegged to the euro at a fixed rate since 1997. Croatia's case is slightly more nuanced, but essentially its rate is a quasi-peg*

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In Bulgaria's case, the currency board arrangement (CBA) in place since 1997 managed to successfully peg the Bulgarian lev to the euro at a fixed FX rate of 1.95583 BGN/EUR. This has remained unchanged since then and we have strong confidence that it can be preserved in the upcoming years too until the country joins the eurozone.

Croatia's case is slightly more nuanced than Bulgaria, but essentially its FX rate is a quasi-peg. The Croatian central bank uses the exchange rate as its main instrument to achieve price stability. Hence, tightly controlling the FX volatility is already embedded in the central bank's institutional memory and of course its policy framework.

The Covid-19 crisis came with some depreciation pressures in March 2020, firmly tempered by the central bank which allowed only for a mere 2-2.5% temporary kuna depreciation. All things considered, we believe that maintaining the stability of the kuna around a central parity rate, which we estimate to be set at 7.55 (usually the rate is set around the current market levels) will not pose major challenges for Croatia.

## Challenges for the euro adoption lay elsewhere

In its latest Convergence report, the European Commission underlines that Bulgaria does not fulfil two criteria (leaving aside the FX rate stability which is currently tackled via ERM-II), namely the legislative compatibility and the price stability.

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*The inflation criteria for Bulgaria could prove trickier than one might imagine while the relatively high-debt-to-GDP ration in Croatia will be the main problem*

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While on the former we don't expect major challenges, the inflation criteria could prove trickier than one might think. We anticipate that the future unit labour costs growth will pose constant upward pressure on inflation for many years to come, in particular in the services area. Also, in the European Commission's words, "the relatively low-price level in Bulgaria (about 49% of the euro-area average in 2018) suggests significant potential for price level convergence in the long term". While in the short-term (2020/2021) inflation developments might look encouraging given the expected fall in the inflation rate, we believe that these should be viewed as temporary - on the back of the volatile oil prices and temporary demand contraction. Over the medium to long run, Bulgaria's lengthy catching-up process will -undoubtedly in our view- trigger price pressures which will be difficult to contain within the Maastricht criteria.

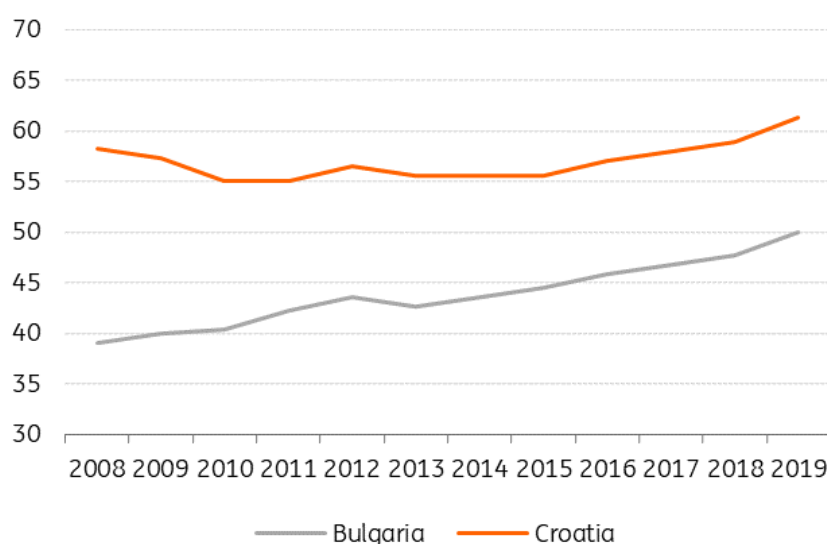


For Croatia, the main weakness in our view is in its relatively high debt-to-GDP ratio which we estimate to reach 86% in 2020 after years of efforts which brought it close to 70% in 2019. To some extent, the government will also need to reinforce the hard-gained credibility regarding the budget deficit, after the probable overshoot in 2020 for which we estimate a 8.0% of GDP deficit. The recent ruling coalition victory in parliamentary elections implies policy continuity, but swiftly bringing the deficit back below 3.0% of GDP could prove quite difficult, especially given the tentative fiscal relaxation plans for 2021.

In our view, Croatia looks unlikely to reduce the debt-to-GDP level below 60% before five years, however, this should not be a showstopper, or in the ECB's own words "Member States with government debt ratios to GDP in excess of 60% are expected to bring them down towards the reference level at a satisfactory pace".

In essence, this means that if every other criteria is fulfilled and the debt-to-GDP is credibly decreasing, the euro adoption will not be blocked.

## GDP per capita in PPS (% versus EU-19)



Source: Eurostat, ING

## Covid-19 placed rating upgrades on ice but ERM II brings them back

ERM II entry will definitely bring rating upgrades back on the agenda.

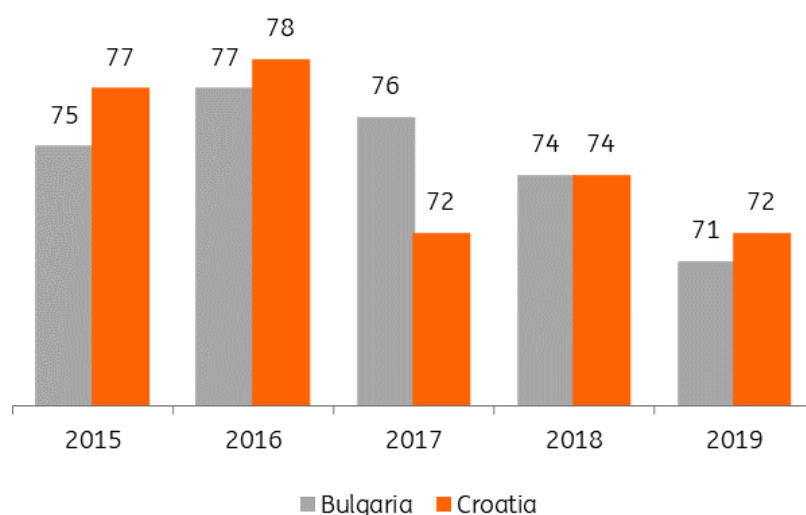
All rating agencies consider euro adoption process as a positive (as an anchor for reforms and fiscal prudence) and euro adoption itself (notably due to the euro's reserve currency status and with all euro-denominated debt becoming local currency debt).

Indeed, both countries have been upgrade stories in recent years thanks to healthy external balance sheets, supportive fiscal policies and structural reforms, with Croatia (Ba2 positive/BBB-stable/BBB-stable) having reached investment-grade status last year. Meanwhile, Bulgaria (Baa2 positive/BBB stable/BBB stable) had all hopes up given three positive outlooks earlier this year, but the Covid-19 outbreak dashed all hopes.

We believe that ERM II brings rating upgrades back on the cards, most likely at Moody's given the positive outlooks and Fitch which has outlined a more formal approach:

- **Moody's** is the only rating agency that has kept Bulgaria (Baa2) and Croatia (Ba2) on a positive outlook. The rating agency still expected ERM II entry to be pushed back to 2021 due to the ongoing crisis. The green light would therefore likely result in an upgrade. More positives could eventually come from the planned EU recovery fund (the initial proposal indicated c.EUR12bn and EUR10bn for Bulgaria and Croatia, respectively).
- **S&P** looks less likely to upgrade which has moved the outlook on Bulgaria's BBB rating back to stable at the end of May. For both Bulgaria and Croatia, S&P needs to see an improving growth outlook or, in the case of Bulgaria, a strong external performance. We note that S&P applies a heavy penalty for Bulgaria's monetary assessment given the currency board regime while ERM II is seen as strengthening monetary credibility over time. As a result, we could see positive outlooks coming back, with review dates on 18 September and 27 November for Croatia and Bulgaria, respectively.
- **Fitch** has outlined a process for the rating implications of the euro adoption process in August 2019, expecting an upgrade if a country is formally admitted into ERM II (and if it is short and euro adoption is credible), followed by another upgrade once a country gets the green light to formally adopt the euro. In the case of Croatia, Fitch has voiced some concerns on fulfilling the euro-convergence criteria, notably on high public debt. This makes an upgrade of Bulgaria more likely while there is a chance that Croatia's BBB- rating only moves to a positive outlook.

## Percentage of respondents saying that the country is not ready for the euro



Source: EC, ING

Seen by many as one last checkpoint before joining the eurozone, the reality is that successfully completing the ERM-II ticks only one out of the several boxes which need to be checked before adopting the euro.

We believe that both Bulgaria and Croatia will find it easier to meet ERM-II requirements than other criteria like price stability in the case of Bulgaria or budget deficit/debt sustainability for Croatia.

In the end, as with most decisions taken at EU level (e.g. Schengen area entrance, EU funds distribution/accession etc.), the final decision will inevitably be a political one and will likely take into account other aspects not specifically written down in the euro adoption blueprint, such as the rule of law, institutional strength or legislative predictability.

We, therefore, believe that the road to euro adoption for both countries will go well beyond the earliest possible adoption date - which is 1 January 2023.

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# Listen: The UK's profound economic challenge

UK Chancellor Rishi Sunak has laid out the next phase in the government's response to the Covid-19 pandemic, as the economy reopens after a...



Chancellor Sunak announced new measures to support the job market, as the furlough scheme ends in October, cuts to VAT and property taxes, as well as restaurant vouchers, to help sectors that have been hit particularly hard by the crisis. But will these plans really help to minimise job losses and stimulate demand, as consumers remain wary about the virus and social distancing measures remain in place. [In this podcast](#), ING's Developed Markets Economist James Smith tells Senior Editor Rebecca Byrne what he's expecting, and how Brexit will complicate matters even further.

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# Are European governments pushing for a green recovery?

Sustainability was already a hot-topic pre-Covid-19, but will this trend still continue or be abandoned? We focus on the European Commission's...



Source: Shutterstock

Lockdowns obviously limit CO<sub>2</sub> emissions. Aeroplanes don't fly, cars, trucks standstill and factories are closed. [Research shows](#), 7 April was peak lockdown - the day that places accounting for 89% of the world's greenhouse-gas emissions were in lockdown. On that day CO<sub>2</sub> emissions were 17% lower compared to the daily average of 2019.

Even though this is the largest drop in emissions ever, it remains disappointingly low. Indeed, stopping the world economy is not enough to reach climate neutrality, which the Paris agreement aims to reach by mid-century. On top of that, it comes at an enormous economic cost and it severely hinders wellbeing.

*On 7 April 2020 - peak lockdown day, CO<sub>2</sub> emissions were 17% lower compared to the daily average of 2019*



Before Covid-19, climate change and the trend towards a more sustainable world was already gaining importance. For example, the Eurobarometer from last March showed that 91% of European citizens find that climate change is a serious problem in the EU and 83% said European legislation is necessary to protect the environment.

And it seems that some existing trends that supported the green transition are reinforced due to the lockdown. If homework becomes a more important feature of how we work, then it could have a positive impact on CO2 emissions. Globalisation was also under pressure before the pandemic, and this could further increase due to value chain disruptions. This trend could also lead to fewer carbon emissions. On the other hand, during difficult economic times, consumers generally go for the cheaper option and finding other characteristics, such as the environmental impact, less important.

It is still too early to make a final judgement whether the economic recovery will be green. An important factor that could influence this is, of course, government action. In order to dampen the economic fallout of the Covid-19 crisis, governments have embarked in massive emergency plans, to help companies and citizens with the immediate negative impact of the crisis, and some have already communicated a recovery plan, to reignite and support economic activity after the economic shock. Given the trending importance of sustainability before Covid-19, an important question arises: "Will the recovery plan be designed to support both economic activity and the sustainability trend?" Or will the green agenda be postponed or even abandoned?"

In this article, we focus on the proposal of the European Commission and what is happening in the six largest eurozone countries. We also look at what the recovery plans mean for the automotive, construction and energy sector. It is still early days, but we have the impression that the green agenda is not being abandoned.

## The European Commission's proposal pushes for green

At the end of 2019, the European Commission published its ambitious European Green Deal. The plan aims to transform the European economy to be climate neutral by 2050, which implies having net-zero greenhouse gas emissions. The Covid-19 crisis obviously interrupted this process, but did it also weaken the determination to make the green transition? The short answer is no.

About a month ago, the European Commission published its proposal, dubbed Next Generation EU, to reignite the European economy and the green transition is a crucial element. The proposal aims to *"kick-start the European economy, boost the green and digital transitions, and make it fairer, more resilient and more sustainable for future generations"*.

The proposal would add €750bn to the European budget (about 5.4% of European GDP in 2019), making a total budget of €1850bn, and would be used over a period of four years starting in 2021 (there is also extra money for 2020, but this is based on the previous European budget). If the extra money is spread evenly over the four years, then the program equals 1.3% of the European GDP.

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The extra money would be raised on financial markets by the European Commission and then distributed to the member states. €560bn will be given to the members' states in either grants (€310bn) or loans (€250bn) and €190bn is allocated to already existing specific European programs using grants (about €130bn) and guarantees (about €60bn). This extra money should be used in measures taken over the period 2021-2024.

On top of this extra money, the Commission also calculated that support via a number of investment programs could attract private money. The proposal, for example, cites that the 15bn from the Strategic Investment Facility, a program to support strategic investments in the EU which is part of the InvestEU program, could generate investment of over €150bn.

**But it is difficult to quantify how much money goes to making the economy green**

A crucial question is how much of this money will be used to support the green transition. This is a hard question to quantify.

First, the €560bn is allocated to the member states without an accompanying program. The proposal cites that money can be used to fund investment and reforms to make the member states more resilient. It adds that these investments and reforms should focus on the green and digital transition. But it also says it should address economic and social challenges that will be even more critical after the Covid-19 crisis in areas such as employment, education, innovation and health. So this part of the proposal will not always directly fund green projects. But importantly, the money cannot be used for projects that go against the green transition.

Concerning the €190bn already allocated to specific European programs, it is easier to judge whether it supports the green transition or not. About €25bn is allocated to programs that will have no direct impact on making the European economy green, such as defence or humanitarian aid.

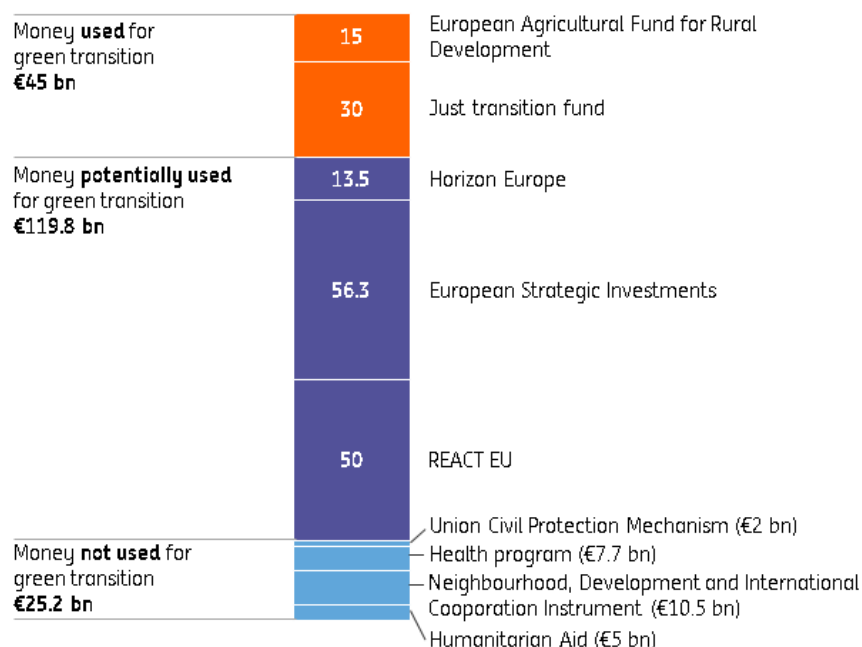
The European Agricultural Fund for Rural Development program, in contrast, has the sole goal to support the green transition in the agricultural sector and rural areas. €15bn is added to the existing program bringing the total to about €90bn. This money should support farmers and rural areas to make the structural change necessary to implement the European green deal. The Just Transition Fund - a fund to alleviate the socio-economic impact of the green transition, can also be counted as 100% green. Re-skilling of workers, for example, and therefore keeping people employed should help to keep public support for the green transition elevated. €30bn is added to the existing program bringing the total to €40bn.

The remaining money allocated to specific programs could be used for the green transition, but it is not yet possible to measure how much exactly will be used for that purpose. The proposal mentions that these funds can be used for green projects, but other causes too. The Invest EU program, for example, can also be used for investments in artificial intelligence and the digitization of industry. The proposal, however, specifically cites a number of activities to invest in with the potential to get Europe's economy growing and making the green transition: large scale

renovation, renewable energies and clean hydrogen solutions, clean transport, sustainable food and a smart circular economy.

### €45bn goes directly to green projects

Part of Next Generation EU that is already allocated to specific programs in billions of euro that can be used over the period 2021-2024



Source: European Commission and ING calculations

## How the money is paid back will also influence the green transition

At first, the extra money will be raised on financial markets by the European Commission and would be repaid after 2027 and by 2058 at the latest.

This makes it possible that national governments do not have to increase their annual contribution to the EU budget at a time when public finances are under severe pressure. On top of that, the Commission proposes new taxes on the European level that can be used to pay back the loans and so country contributions wouldn't have to increase by as much. The proposal also states that if these taxes are implemented before 2028, then the receipts will be used to lower the country contributions. We do not think, however, that these taxes will be implemented immediately. We feel that 2024 would be the earliest to see some new taxes. Companies, therefore, would have time to adjust.

Interestingly, some of the tax reform would influence incentives towards greener decisions. Specifically, they propose a tax on non-recycled plastics, packaging waste and extending the emissions trading system-scheme by adding the maritime and aviation sectors. There is also talk of a carbon border adjustment mechanism.

## Do the national governments also have a green reflex?

### Germany

During the Covid-19 crisis, Germany transformed from the austerity champion to a big spender. After a massive emergency stimulus, Germany embarked on a massive recovery plan, worth €130bn or 4% of GDP. The key goal of the plan is to stimulate activity. VAT, for example, is lowered from July onwards until the end of 2020 to stimulate consumption.

But the plan also includes a number of measures that support the green transition. According to our calculations, about € 42bn could be used for the green transition. A big chunk focuses on the energy sector: Subsidies for renewable energy in 2021 and 2022 (€11bn) and to the development of a hydrogen strategy (€7bn). The car industry will be affected by measures worth €9.2bn. In particular, €2bn will be used to double the premiums to buy electric cars, from €3,000 to €6,000 for cars that cost up to €40,000 until the end of 2021. €2.5bn will be used to expand Germany's charging infrastructure for electric cars. Making buildings more energy efficient is also on the list (€2bn).

### France

There is not yet a comprehensive recovery plan, although France already announced plans for three strategic sectors: aeronautics, automobile and tourism. Only part of these measures contained in these plans are new as they rely heavily on the instruments put in place earlier in the crisis.

Some of the support for these sectors supports the green transition but it is difficult to quantify how much will be allocated for the green agenda. The support for AirFrance (€3bn direct loans and €4bn credit guarantees) comes with green strings attached. The company should work to become the world's most environmentally friendly airline. The company should reduce its CO2 emissions by 50% by 2024 for domestic flights, it should renew its fleet with more efficient aircraft and use more biofuel.

The French car industry receives an aid package of more than €8bn, with some support for the green agenda. The bulk of it, about €5bn, goes to Renault. The government wants that the company invests more in electromobility, even though there are no hard conditions. As in Germany, subsidies for low-emission cars are also increased and France will also invest in charging points. The conversion of combustion vehicles to electric ones will also be supported.

### Italy

The discussions about a recovery plan are ongoing. An expert group proposed more than 100 projects, including green ones, but nothing is official yet. The difficult fiscal position, with a debt to GDP ratio of 135% in 2019 and forecasted to rise to 160% in 2020, makes the country reluctant to go on a spending spree. The funding of a comprehensive recovery plan would mainly have to come from Next Generation EU. The discussion about the allocation of these funds is ongoing, so it is unclear how much would go to Italy. But it is safe to say that these funds would not be used to go against the green transition as it is one of the conditions to receive the EU money. And part of it is likely to be spent on the green transition as this is also cited in the Next Generation EU proposal.

### Spain

The situation in Spain is similar to the one in Italy. A reconstruction commission is currently discussing various proposals, but nothing is official yet. Financing would mainly have to come from Europe due to the difficult fiscal position. The structural deficit was estimated at 4% in 2019, which

is the highest in the eurozone, while the debt to GDP ratio is also high (about 95% in 2019 and is projected to rise to more than 115% in 2020).

### The Netherlands

The Netherlands has already announced a number of emergency measures, but there is no formal recovery plan yet. Normally, the government should present the budget for 2021 late September, which could include some measure to support the recovery. The fiscal position of the Netherlands is certainly not a problem to embark on an ambitious plan.

Before the Covid-19 crisis, however, the Dutch government already announced an ambitious climate plan that aimed at reducing CO2 emissions by 49% by 2030 compared to 1990. Among other measures, the plan would introduce a carbon tax for large companies, shut down coal-fired power plants. The crisis, however, has some impact on the implementation of the program and some measures, such as the carbon tax, are loosened.

The Dutch national bank, however, said that extra green investments should now be made. They also want financial institutions to bring their investment and credit policy more in line with the Paris climate agreement.

### Belgium

Politically, Belgium is in a difficult situation. On the federal level, a care-taker government is currently in power and negotiations to form a new government are still ongoing. The care-taker government took a number of emergency measures, but there is no public information on a potential recovery plan. It is possible that it is part of the new coalition agreement currently discussed. On the other hand, the National Bank of Belgium communicated that a recovery plan in Belgium is not possible due to the difficult fiscal position.

The importance of green measures in the next coalition agreement will obviously depend on the parties forming the coalition. Time will tell if Belgium has the green reflex.

### Germany takes the lead in supporting the green transition

	Recovery plan		Fiscal position	
	Already in place	Amount allocated to green projects	Debt to GDP ratio in 2019	Structural balance in 2019
Germany	Yes	€42bn out of €130bn	59.8	0.9
France	Partial	Not possible to quantify	98.1	-2.8
Italy	Ongoing	Unknown	138.8	-1.5
Spain	Ongoing	Unknown	95.5	-4
Netherlands	Ongoing	Unknown	48.6	0.6
Belgium	Unknown	Unknown	98.6	-2.6

Source: European Commission and ING calculations

## What sectors will be affected?

Even though the recovery plans are not complete, there is already some indication on the sectors that could be more affected than others. Below we discuss the automotive, energy and construction sector. It is likely that three will play an important role in the green recovery.

### Automotive

One could think that the sharp drop in oil prices due to the Covid-19 crisis hampers the incentive to buy a low-emission car. But a lower oil price does not necessarily imply low prices at the pump. In France, for example, the price of a litre of Super 95 was about €1.50 early March and declined to €1.30 by early April, a drop of 13%. The oil price, in contrast, fell from about €47 a litre to €14 over the same period, a drop of 70%. Indeed, high taxes on motor fuels limit the impact of an oil price shock. On top of that, once the economy gains strength the oil price should increase again. As people generally do not sell cars quickly, a short period of low oil prices does not impact the overall cost too much.

Moreover, Germany and France decided to raise the subsidies for low-emission cars and to expand the system of charging points. Spain, as the second-largest passenger car producers in the EU, will probably use the EU funds to support its car industry. If they use it to back the green transition, by also supporting electrification, then the EU will easily accept it.

On top of this demand-side stimulus, the sector is also pushed to produce low-emission cars due to new regulation. Indeed, from 2021 onwards, the average CO<sub>2</sub> emission per produced car in Europe should be no more than 95 grams.

Electrification of the fleet was already one of the trends in automotive before Covid-19, and it seems that this trend is currently reinforced.

## Energy

On the energy front, it is likely that some investment in renewable energy will be postponed due to the economic effects of Covid-19. But overall, we feel that the willingness to support renewables remains intact, on both the company and governmental level, even though it is too early to know if the support will be enough to reach the goal to become carbon neutral by 2050.

The European Commission, for example, does not backtrack on its commitment to making the European Union carbon neutral by 2050 and cites investments in renewables and hydrogen in its proposal. Germany also will invest €7bn in a hydrogen strategy.

Oil and gas companies obviously take notice of these governmental plans and push them to adjust. The economic impact of the crisis, on the other hand, also seems to accelerate their transformation. Mid-April, in the middle of the Covid-19 crisis in Europe, Royal Dutch Shell, for example, joined other energy majors, such as BP and Repsol, in announcing their indentation to become a net-zero emitter. The company also reinforced its commitment to lower the carbon intensity of its products. So oil and gas companies are not backtracking on their climate commitments due to the crisis. Moreover, a number of energy majors downgraded their oil and gas price forecast in the medium run, citing that the crisis will lead to lower demand for a prolonged period and that it will accelerate the shift towards cleaner energy. This led to asset write-downs.

## Construction

Modernising buildings and making them more energy efficient is one of the activities that would high impact on our CO<sub>2</sub> emissions. And indeed, renovation is something that is supported in the recovery plans of the European Commission and Germany, and it is also part of the Dutch climate plan of mid-2019. Interestingly, it is a labour-intensive sector and so it would push up employment at a time when it is really needed.

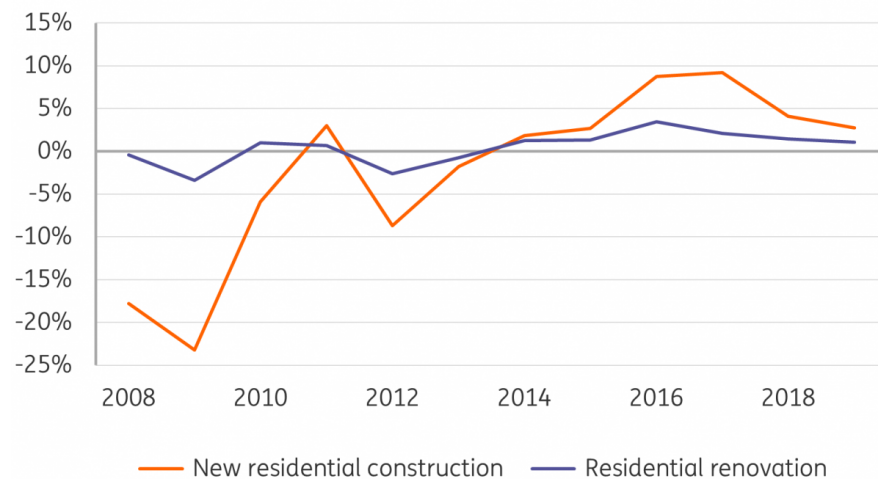
It is indeed a promising idea, although there is one thing we cannot overlook. The renovation sector



is generally less business cycle dependent than the new construction sector. During the financial crisis of 2008, for example, we saw new construction output drop significantly in western Europe, while the renovation sector did much better. Indeed, it is easier to postpone a new building project than a renovation of a leaking roof. This implies that stimulating renovation could lead to upward pressure on capacity in this specific segment and in turn on prices. Higher prices should, in theory, attract new companies into the sector, but this takes time. So one cannot expect this to be a quick fix.

### New construction more cyclical than renovation

Development production volumes Western Europe (EC-15), % yoy



Source: Euroconstruct

## The green agenda isn't being abandoned

After the emergency measures taken due to the Covid-19 crisis, more and more governments are investigating possible recovery plans.

An important question is whether these plans will give an extra stimulus to the green transition. It is still early days, but we have the impression that the willingness to push for a continued green transition is not hampered because of the crisis. The German plan has a large green component and the proposal by the European Commission does not show any signs of backtracking on their green agenda.

For some European countries, such as Spain and Italy, the difficult fiscal position makes it hard to have an ambitious recovery plan in general and therefore make it less easy to introduce new measures that support the green transition. But these countries could receive funds from Europe which could, in turn, be used to both support the economy and the green transition.

Even though there is still a lot of uncertainty, we can conclude that the green agenda is not abandoned due to the Covid-19 crisis and there is a chance that it will be reinforced.

## ESG to outperform in the long term

Despite little differential between green and grey at current spread levels, over the long-term, we expect ESG to outperform. ESG mutual fund inflows have...



The European central bank president, Christine Lagarde has been clear; the fight against climate change is of utmost importance.

Yesterday, Lagarde stated that ECB's green policy is now at the top of the agenda. Of course, as part of the ECB's 'strategic review', the ECB will be looking into every avenue but their purchasing programmes are certainly a tool that can be utilised.

As it stands, there is very little structural outperformance for sustainable versus grey. There have been some cases of funding advantages in issuing green, and in times of volatility, sustainable spreads tend to be more sticky. However, in the long-term, we expect environmental, social, governance tilted bonds to outperform non-ESG with a structural difference and will trade tighter than grey bonds. This will offer a considerable cost advantage to green bond issuers.

Catalysts for outperformance in the long term:

- **ECB continually indicating the importance of green**

The ECB has indicated the importance of sustainability and green bonds. Lagarde has now stated the ECB's green policy is at the top of the agenda and bond purchasing could very well be the tool used. If ECB is to go further with targeting green bonds under their bond

purchasing programmes (CSPP & PEPP), spreads will certainly price this in with tighter green bond spreads.

- **Substantial inflows into ESG mutual funds**

In both EUR and USD, ESG mutual funds have seen considerably more inflows versus non-ESG mutual funds. The 1-year accumulated inflows amount to a much higher percentage of assets under management in ESG.

- **High demand for a limited yet growing pool of assets**

As the green bond universe still remains limited, but with growing demand, there is high competition to invest. Currently, the Euro green bond supply has slowed slightly, maintaining the limited nature of green bonds. Furthermore, growing regulations for asset managers lead to additional disbalance between demand & supply.

## ECB is going green

There is little outperformance in ESG tilted spreads thus far, but we expect the spread differential to increase long term, as ESG tilted spreads begin to outperform grey and trade tighter. The ECB will play a role in this.

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*In the long-term, we expect ESG tilted bonds to outperform non-ESG with a structural difference*

---

The ECB has indicated numerous times the importance of green and sustainable bonds. Now Lagarde has stated that the ECB will put sustainability at the forefront of their agenda and by the method of execution, they utilise their corporate bond purchasing programmes (CSPP & PEPP).

As it stands, the ECB holds 82 corporate green bonds under CSPP & PEPP, which accounts for 5% of the holdings (based on the number of corporate bonds). Although this is quite a considerable number in relation to the corporate green bond universe. Lagarde mentioned the ECB holds roughly 20% of the green bond universe (whole APP & PEPP). But looking directly at corporate purchases, the 82 green bonds held are roughly 45% of the eligible corporate green bond universe (180 bonds).

Of course, if the ECB add additional focus into green holdings, whereby they increasingly target green and sustainable bonds, ESG performance will soon follow.

## Substantial inflows into ESG funds vs Non-ESG

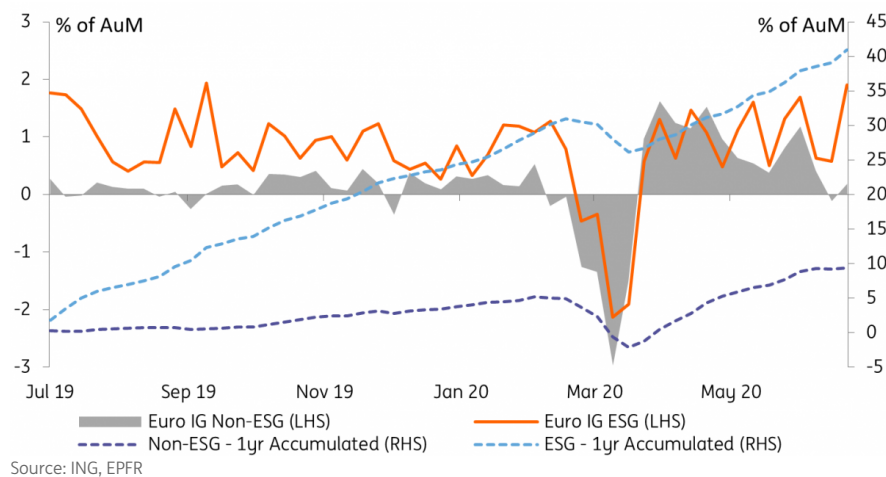
Investment-grade ESG only mutual funds see considerably more inflows compared to non-ESG funds. In both EUR and USD investment grade mutual funds, ESG funds pencil in substantially more inflows in a percentage of assets under management basis (AuM).

As seen in Figures 1 and 2, over the span of the past 12 months, inflows have been very dominant for ESG funds. This is particularly the case in EUR, whereby apart from at the beginning of the crisis every week saw inflows. This has resulted in a considerable 1yr accumulation of inflows of just over 40% of assets under management, relative to the 10% inflows of assets under management seen in non-ESG funds.

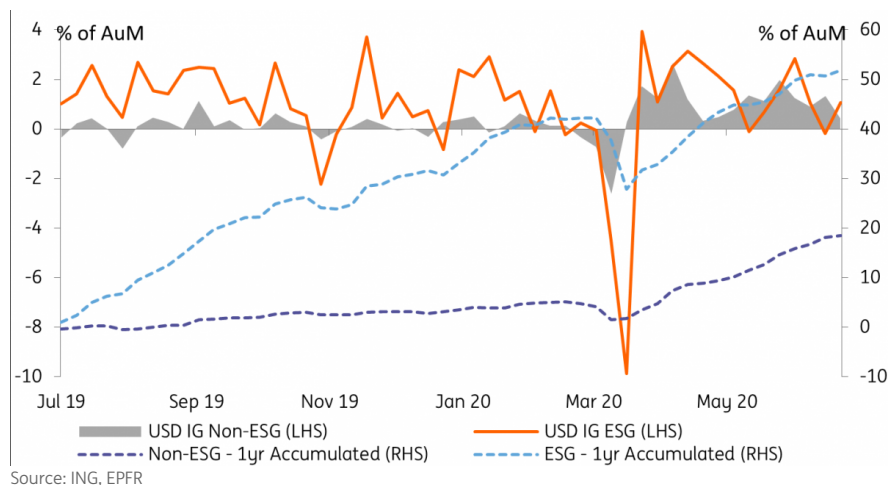
USD ESG mutual fund flows have certainly been more volatile, and have dipped into outflows on occasion. Nonetheless, the 1-year accumulated inflows for ESG funds total just over 50% of AuM, compared to 18% of AuM in non-ESG funds.

As these inflows increase and the continuous growth in popularity for ESG, green bonds will certainly perform well compared to their grey bonds.

**Fig 1 Euro Corporate mutual fund flows ESG vs Non-ESG**



**Fig 2 USD Corporate mutual fund flows ESG vs Non-ESG**



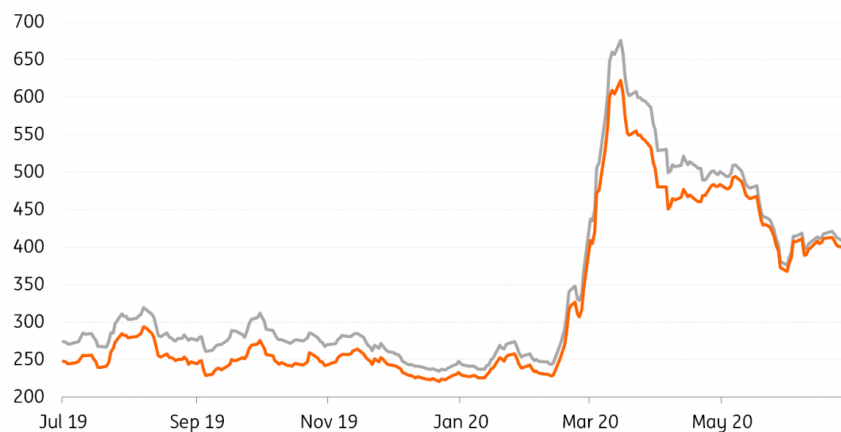
## No outperformance in ESG thus far

Despite the considerable inflows into ESG mutual funds, ASW spreads are not pricing in any outperformance for sustainable over grey. Thus far in most cases, sustainable tends to trade relatively in line with their grey curve, although this is name dependant. Indeed a number of utilities and industrials clearly benefit from tighter spreads on their sustainable issues, majority of others show a mixed bag, mostly falling in line with grey. Although, in the past there has been some moments of sustainable outperformance, particularly in volatile times, as spreads tend to be more sticky due to less flexible investors

As seen in Figure 3, which illustrates the ASW spread developments of a Euro investment grade index and a Euro investment grade index with an ESG tilt, they trade very much in line with each other, as the ESG tilt index remains within 1-7bp tighter than the overall index.

Although, the limited universe of ESG/green bonds will assist in the rally, as the growing demand for sustainability will have investors competing. Particularly as green bond supply is slowing slightly, yet demand is growing substantially, particularly with the ECB driving focus on green bonds. Supply of ESG remains limited due to many issuers not being seen as ESG worthy investments. Furthermore, the growing regulatory pressure on asset managers also leads to disbalance between demand and supply.

**Fig 3 Euro IG spreads vs Euro IG ESG tilt spreads**



Source: ING, ICE

We expect sustainability to become more relevant in bond pricing and spreads, although only in the long term.

Indeed the ECB will truly drive the preference for ESG, alongside the increasing inflows into ESG tilted mutual funds. Despite the lack of outperformance structurally thus far, the growing demand will act as a catalyst in tightening, particularly as the disbalance between demand and supply continues.

We are bullish on sustainable over grey and believe a structural difference will develop as sustainable outperforms grey.

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# UK: What the Chancellor's announcement means for the economy and sterling

The Chancellor's announcements are innovative but unlikely to completely change the game for either the UK economic outlook or the pound. We think the...



Source: Shutterstock

## Chancellor unveils new job support amid rising unemployment

Ahead of Chancellor Rishi Sunak's summer economic update today, [we set out four key challenges he faces](#) as we enter the Covid-19 recovery phase. And by far, the biggest out of the four is linked to jobs. Unemployment is on the rise as firms grapple with the challenging new, socially-distanced operating environment.

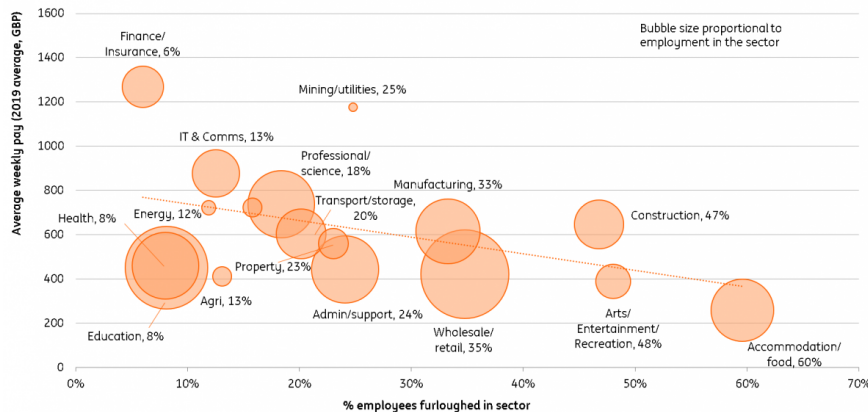
The Chancellor has opted against extending the flagship Job Retention scheme beyond October, and don't forget that the state's contribution to wage bills will be gradually reduced until then. Clearly, removing such unprecedented government intervention in the labour market is going to bring about job losses. But the big announcement today is that the government will pay a £1000 bonus per employee that is brought back from furlough, and kept employed until January.

On the face of it this is a fairly generous policy. In the accommodation/food sector, one of the heaviest users of the furlough scheme, that would be enough to pay around a month of earnings, based on the average of 2019 weekly pay. Anecdotally, it also seems that those staff members

being furloughed were often towards the lower end of pay brackets.

Will this change the course of the jobs market? Not entirely - clearly if you are a business that has either had capacity significantly reduced by the new safety measures, or have seen demand collapse due to changing consumer habits, it's unlikely to save jobs when the furlough scheme is unwound. But nevertheless this scheme should at face value help cushion some of the blow for firms more widely, and it's also worth noting that companies will get the bonus even if they've already brought staff back from furlough.

## The job retention scheme by sector



Source: UK Government, ONS

## Property/VAT tax cuts unlikely to significantly move the needle

The other key takeaway from the statement is that by-and-large, tax cuts were avoided. As we noted in our previous piece, involuntary savings will have dramatically increased for many who have been more fortunate to continue earning through the crisis. If demand remains low now that the economy has largely reopened, then it is therefore more likely motivated by safety concerns rather than financial constraints.

Admittedly, the government has opted to cut VAT for selected industries, and more interestingly the government will cover 50% of restaurant bills through August (Mon-Wed) up to a maximum of £10 per person. This seems to be an evolution of the voucher scheme proposed over the weekend, and probably stands a better chance of luring people back out to hospitality businesses, as it eliminates the risk of the equivalent cash injection being saved rather than spent. That said, the size of this measure is, in reality, fairly small.

There was also a fairly sizable change to stamp duty (a property tax), although our feeling is that the housing market will continue to be dominated by concerns surrounding job security, despite this new government support.

## Controlling the virus much more critical for UK growth

In short then, there are some innovative policies in the Chancellor's latest statement, although for markets this is not a huge intervention, at least compared to the big numbers everybody has become accustomed to. It's unlikely the schemes announced will cost nearly as much as the £30bn (or roughly 1.5% of GDP) estimated by the Treasury.

It should though, at least at the margin, help cushion some of the turbulence in the jobs market over coming months. But more importantly, no amount of fiscal support can mask the fact that the UK recovery hinges almost solely on avoiding a return to repeated, widespread lockdowns.

Not only is it important to businesses, which will be looking for an operating environment that is as stable as possible until a vaccine or similar treatment is available. But consumer confidence in the safety measures is going to be absolutely key, and in many cases will probably be a bigger driver of spending over coming months than financial health.

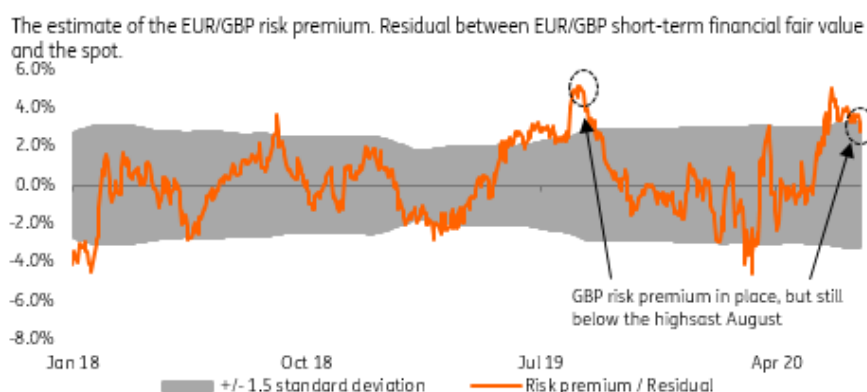
## GBP: New announcements are no game changer, and will only provide short-term respite

The pound's reaction to Chancellor Sunak's fiscal announcement was fairly muted, given that sterling had already front-run the event yesterday (in terms of gains) after policy details started to emerge ahead of the announcement today.

While the size of the stimulus announced is modestly larger than expected, in our view it is not significant enough to prompt further GBP gains. The announced measures today do not significantly alter our UK growth outlook, and with the overriding GBP driver (UK-EU trade negotiations) still looking fairly uncertain, more gains in GBP are unlikely.

We see EUR/GBP moving towards 0.92 within three months as the lack of anticipated progress in UK-EU trade negotiations should translate into further risk premium being built into the currency. Based on our estimates, and following the recent GBP rebound, less than a 3% risk premium is currently built into GBP vs EUR (Figure 1). We think it's likely that the risk premium will increase above 5% ([read GBP: The ongoing disappointment](#)) if no meaningful progress in negotiations occurs this summer – which is our base case.

**Figure 1: GBP risk premium**



Source: Bloomberg, ING

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# Green bonds fade while social bonds blaze

We estimate sustainability bond issuance to have reached the equivalent of €135bn in the first six months of 2020. While the issuance of green bonds...

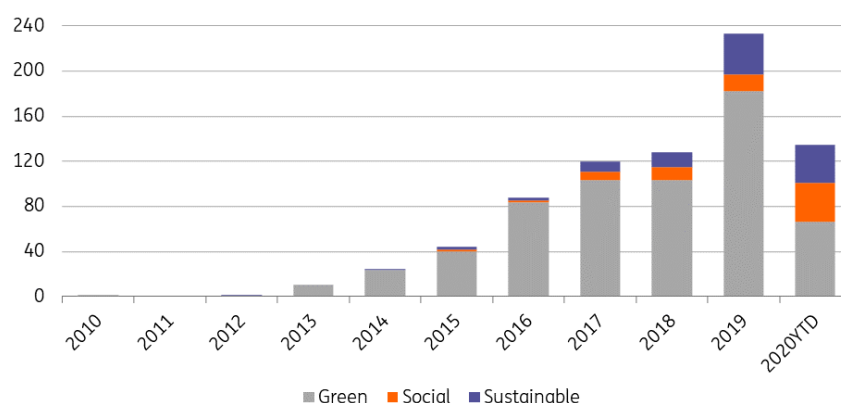


With an equivalent of €135bn in the first six months of 2020, the sustainability bond market recorded another strong expansion. However, the picture has been less rosy for green bonds. This asset class was expected to continue growing at a robust pace but the first six months of the year proved disappointing. Is the Covid-19 pandemic playing a role?

We think so.

With lockdowns across the globe, some green projects have been put on hold, but Covid-19 has shifted a number of issuers' attention towards the pandemic and its social, health and economic consequences. Social bond supply reached €34bn in the first six months 2020 compared with €15bn for the full year 2019. The surge comes from new issuers as well as issuers generally active on the green bond market. Mostly, these issuers are agencies and local authorities.

## Total sustainability bonds issuance (in €bn equivalent)



Source: ING

## Pandemic bonds break through

Since February 2020, "pandemic bonds" emerged on the bond markets in several regions. However, the pandemic label follows a very simple definition as it merely pertains to a term-sheet, making reference to the proceeds being used to fund Covid-19 relief efforts and no particular underlying framework.

**€237bn** Pandemic bonds issued in 1H20

## Pandemic bonds

The China Merchants Bank was the first to print a pandemic bond in February 2020, followed by the Bank of China and other Chinese institutions and agencies in March.

Among the biggest issuers is the Spanish government with a €15bn 10-year bond that was later topped up to over €21bn. Also, the Indonesian government issued a pandemic bond in three tranches worth around a total of US\$4.3bn in April 2020. These government issues highlight the very broad definition, which does not even capture the entire effort to stem the pandemic. One could argue that most countries' funding plan revisions since March represent some effort to finance the crisis response.

With that caveat in mind, we can say, pandemic bond issuances reached an equivalent €237bn.

## Social and sustainable bonds favoured over green bonds

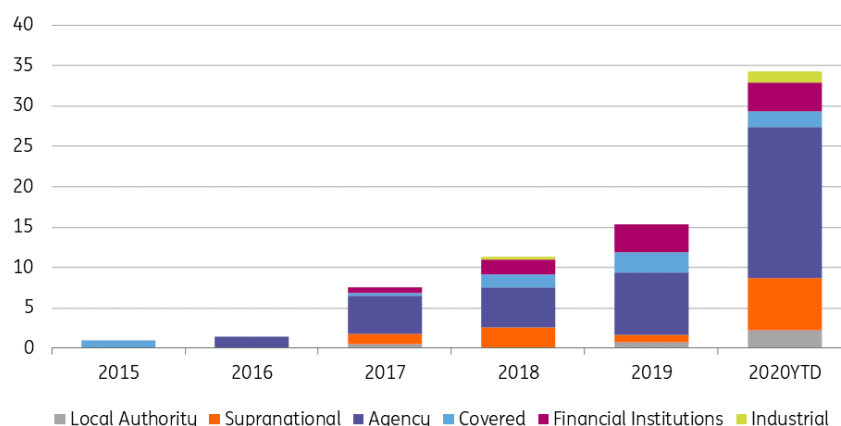
With €237bn of pandemic bonds issued in the first six months of 2020, not all pandemic bonds fall under the category of social or sustainable bonds. Actually, only about 15% of these bonds have a social or sustainable framework. According to the ICMA, all types of issuers in debt capital markets can issue a social or sustainable bond related to Covid-19, as long as all the four core components



of the Bond principles are addressed.

The issuance of sustainable bonds reached €34bn in 1H20 compared with €35bn for the full year 2020. Social bonds put in an even stronger performance, with supply more than doubling. In the first six month of 2020, issuers printed €34.3bn in social bonds compared with €15.4bn in 2019.

## Social bonds issuance (in €bn equivalent)



Source: ING

Agencies and supranationals were behind the social bonds' strong progress.

Actually, in the first half of 2020, a number of these issuers did not approach the green bond market at all despite the fact they were regular issuers in the past few years. For entities such as the Korean Development Bank, Instituto de Credito, the African Development Bank or the Caisse Française de Financement Local, their attention focused mainly on the Covid-19 pandemic and the financing needs to mitigate its impact.

We estimate that about €8bn of social bonds were issued by entities usually active in the green bond market.

We believe that the social and sustainable bond supply will continue its expansion in the second half of 2020 and maybe beyond as the pandemic is not yet under control.

The European Stability Mechanism announced it could provide up to €240bn in pandemic crisis credit lines, although we think that about €80bn is more realistic if not still on the high side. Green bonds issuance may lose some steam in 2020 but we think this is a temporary slowdown. Investments in renewables, electricity grids, electric cars and charging stations, as well as the construction and renovation of buildings and infrastructure, will continue to be strongly supported by governments and corporates' engagement towards energy transition.

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## National debt levels – A cautionary tale

The IMF's latest forecasts suggest a deeper contraction for 2020 with growth falling by 4.9% in 2020, followed by a muted recovery in 2021



### National debt levels – A cautionary tale

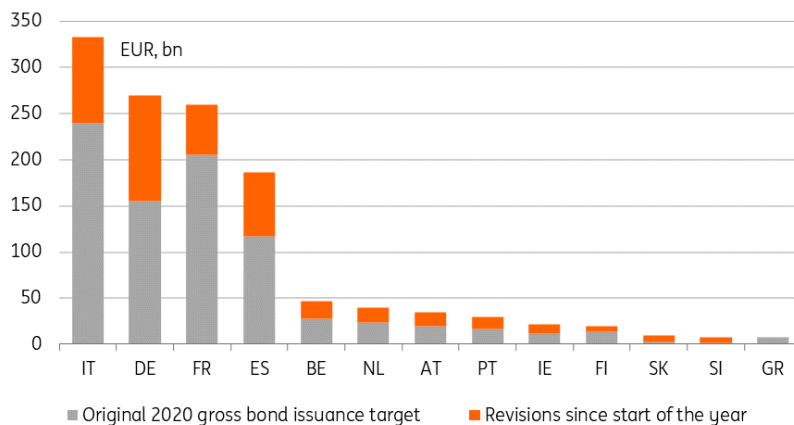
Emerging markets in 2020 are expected to see a contraction of 3%. That's the first substantial contraction in this century for this group of economies. But, if we look within the emerging markets world, there are actually stark contrasts. For example, we still see that Asia is doing much better. It is only seen contracting by the IMF by -0.8%. And a lot of that is thanks to stimulus by China, which is still seen growing by 1% this year. Latin America, on the other hand, is seeing a big contraction, especially in Argentina, Brazil and Mexico, with the latter two seeing contractions of around 10%.

[Watch video](#)

Article | 7 July 2020

## Supply, rates and curve: What to expect in 2H20 and beyond

We probably haven't seen the last upward revision to European states deficits, but the ECB should absorb most of it. The duration and average maturity...



Source: Debt agencies, ING

### Large scale ECB buying ...

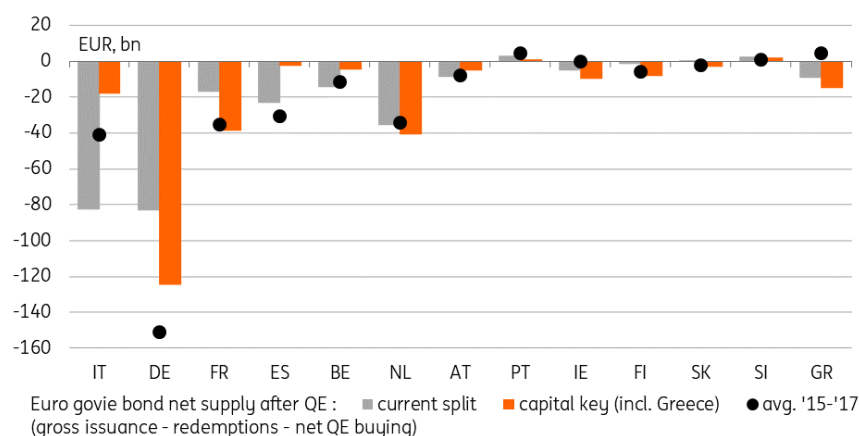
European central bank government bond purchases have become a crucial factor for fixed income markets.

The sheer volume the ECB is willing to spend is unprecedented: €360bn via APP this year and €1350bn via the Pandemic Emergency Purchase Programme (PEPP) until mid-2021. But equally unprecedented is the sudden increase in governments' funding needs as they battle against the fallout from Covid-19.

The large part of this financing is raised via the issuance of government bonds. We estimate that this issuance could reach at least €1280bn this year, up from initial projections of around €875bn at the beginning of the year. In terms of net new supply, i.e. after subtracting bond redemptions, the figure still stands at €590bn.

If we make the assumptions that the split across asset classes stays roughly unchanged and also that the ECB will keep buying at the current speed for the rest of the year, we estimate that the central bank will buy around €870bn in public sector assets, excluding supranationals such as ESM and EFSF bonds.

## 2020 EGB net supply after QE



Source: ECB, debt agencies, ING

## For vastly increased funding needs

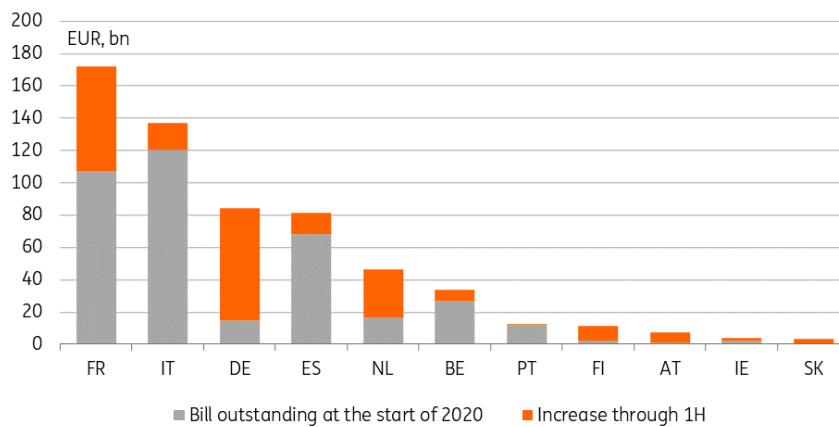
That, in turn, implies that the market, instead of having to absorb a net new supply of €590bn, is effectively facing a withdrawal of €280bn in bonds.

The chart above shows which jurisdictions are likely to be the main beneficiaries of the ECB purchases. We depict a split according to that of purchases from March through May (the ECB releases data for the PEPP only every other month) and if the ECB were to strictly adhere to its capital subscription key.

While this back of the envelope calculation highlights the magnitude of the ECB intervention in bond markets, it does oversimplify matters, especially where the duration of purchases is a concern. Recall that with the launch of PEPP, the ECB has also included money market instruments in its list of QE eligible assets.

And governments have raised a lot of their initial funding via treasury bills. The aggregate outstanding bills have risen from €371bn to €593bn over the course of the first half of 2020. That is an increase of €222bn and we believe this figure could eventually double by the end of the year, raising the stock to more than €800bn. This then either needs to be rolled or – more likely in our view – termed out. As the PEPP reinvests until end 2022, it would make sense to use those two years to replace bills funding with bonds issuance.

## Bills issuance was ramped up - and will potentially be termed out within the PEPP reinvestment period



Source: Bloomberg, ING

## Stock vs flow: not all is priced in advance

Assessing the market impact of structurally higher debt stock is no trivial task.

Financial markets are forward-looking by nature and tend to reflect future flow in advance. In the case of debt sales and central bank purchases, they can typically be known a long-time in advance. This suggests a significant part of the increase in Eurozone sovereign debt issuance, and ECB purchases should be priced in already.

We've addressed that aspect of the stock effect of higher debt and higher central bank balance sheet [in previous publications](#). We concluded that in the first phase of the crisis QE is priced with a higher degree of certainty than debt increases. This is particularly true in the case of PEPP due to the ECB's professed preference for front-loading purchases. On the other hand, there is still much uncertainty about how wide deficits will be in the coming years as governments scramble more measures to support their economies. This, in short, justifies the sharp drop in interest rates this year, and our call for a gentle rise in the coming years.

It remains that if the future path for debt stock and ECB balance sheet can be largely predicted months in advance, the day to day flow of debt sales and purchases have a residual market impact that is far from negligible. This is the aspect we aim to study here. More specifically, we aim to assess the impact of changes in the total duration of debt available in the market on rates direction (parallel shifts upward or downward of the yield curve), and of the weighted average maturity of supply on the slope of the curve (when corrected for the impact of direction).

## Rates direction: A gentle rise confirmed

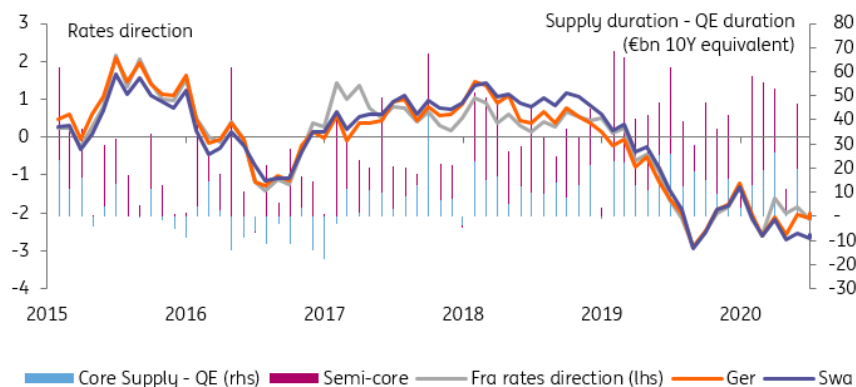
That first aspect is probably the most difficult to track, but also the most important.

We estimate that since 2015, rates direction accounted for around 95% of the German curve's volatility. In short, our conclusion is that it is more difficult to draw a strong inference about rates direction from the expected flow of debt sales and ECB purchases than before.

At the onset of QE, and particularly when the program was increased in 2016, the resulting squeeze on interest markets was evident: Central bank purchases resulted in a net reduction in the amount of duration available for other investors to buy. This was particularly true for core sovereign debt markets such as Germany and the Netherlands. The result was in line with expectations: interest rates dropped and reached an all-time low around the middle of 2016.

The flow picture has lost relevance since 2019 with a drop in rates not commensurate with the amount of duration being added to the market in 2019 by government issuance. That this discrepancy has subsided until now can easily be explained by the outsized risk posed by the Covid epidemic on the world economy.

## More duration should lift rates - slowly



Source: Bloomberg, ING

Looking ahead, a combination of tapered QE and governments 'terming out' the large T-bills stock issued at the onset of this crisis brings the risk of a reversion higher in interest rates. We do not expect this to be a sharp move, however: the higher supply duration in the coming month will be dominated by an increase in the average maturity of debt, whilst deficits should shrink in 2021 compared to 2020.

Nor do we expect this to be a linear process. Supply seasonality is strong and so the market impact can be anticipated, to an extent. The next likely spike in supply duration should occur in September/October of this year. Its market impact would, of course, be dampened if the ECB decides to add to its QE target in the autumn.

The start of 2021 also promises to see a sharp increase in debt sales. The impact there will be harder to offset in our view and we expect rates direction to be skewed higher into January. Our end-2020 forecast for 10-year EUR swap rates now stands at only 0% but we acknowledge that markets might be tempted to price the Q1 2021 supply glut in December, bringing temporary upside risk to this forecast.

## Maturity matters: re-steepening likely in 2021

The next aspect to study is the impact of the average maturity of supply on the curve slope. We focus here on the non-directional slope to account for the fact that EUR yield curve has been in a clear bull-flattening/bear-steepening trend. Put simply, most of the slope moves since 2015 are

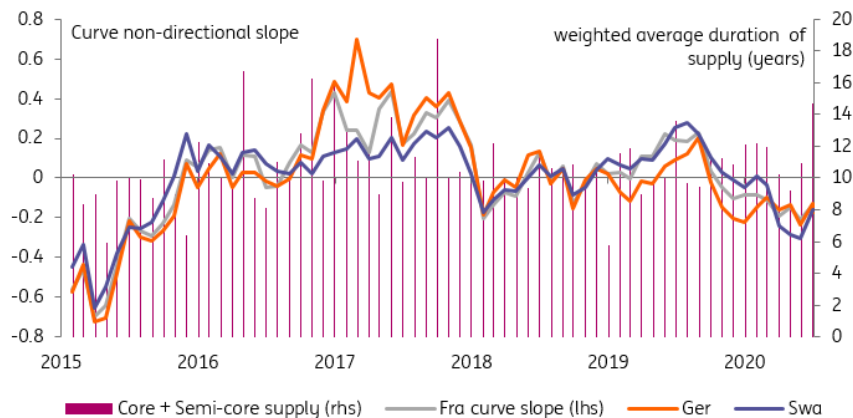


explained by rates direction. The residuals, accounting for roughly 5% of the yield curve's volatility, is what we study here.

We think the ECB's QE has played an important role in fostering a market environment favourable to long-dated sovereign issuance. This was most notable in 2016-17 with the average duration of core and semi-core supply regularly jumping above 10 years, and on occasions above 15 years.

This period coincided with the steepest yield curve of the past 5 years.

## EUR curves are slightly flat currently



Source: Bloomberg, ING

Adjusted for the exceptionally low level of interest rates, EUR curves are flat but far from their most extreme levels.

One explanation in our view is that accounting for the surge in the stock of T-bills, the average maturity of debt sales has actually dropped sharply since March 2020.

As we explained above we view this as a transitory stage in the process of sovereigns terming out their issuance. Our base case is thus for EUR curve to steepen more than the gentle rise in interest rates would suggest, with the long-end likely to react first. Here too the Q1 2021 financing round seems a prime candidate for when this will occur, as a result, we expect EUR swap 10s30s to steepen to 35bp by the end of 2020.

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Article | 8 July 2020

## Zinc: A delicate supply status

Zinc prices spiked on the latest shipping issue from Red Dog Mine in Alaska, meanwhile, the mine supply from major disrupted mines in South America were...



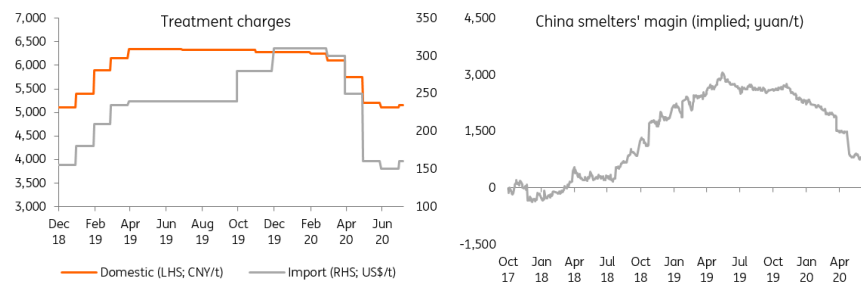
Source: Shutterstock

### 1 Covid-19 disruptions have erased more than half of mine supply growth

So far Covid-19 related disruptions have helped to erase more than half of expected Zinc mine supply growth in 2020. Mine supply losses (including price related) have so far hit 0.65 million tonnes mainly from Peru, Mexico and Bolivia. Yet Australia, the largest zinc producer and the top supplier to China has remained unaffected.

Nevertheless, we are still expecting around 200kt mine growth, but this is primarily based on the assumption that mines could return to schedule over 2H20.

**Fig 1. Falling TCs are taking a toll on smelters' margin**



Source: Bloomberg, ING

## 2 Losses also seen from smelters and China supply has remained muted

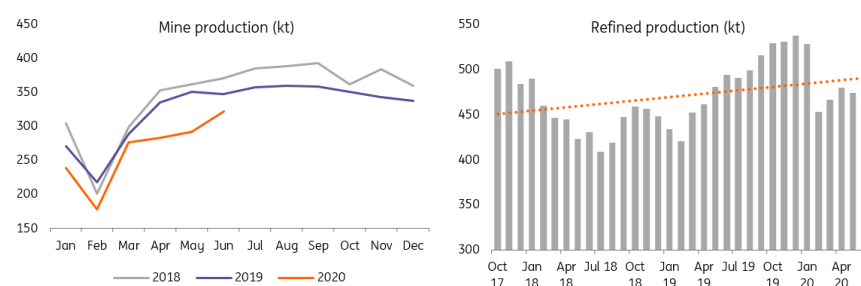
Production losses have also been seen in refined zinc. So far the losses totalled to just above 100kt from multiple regions around the world, including China, Namibia (Skopian), Mexico (Torreón), India (Hindustan) and Peru's Cajamaquilla has been running at reduced capacities.

As [we noted in early May](#), expectations have since risen over concentrate supply tightness which dovetailed with low concentrate inventories in hand from smelters which together halved the spot treatment charges. And as expected, falling treatment charges (TCs) saw smelting margins deteriorate over 2Q20 and weaker refined production over May and June.

Meanwhile, domestic mines accelerated over the past two months, but is still below the levels seen from previous years.

[Zinc still has new stories to tell](#)

**Fig 2. Production from China has remained muted so far**



Source: Bloomberg, ING

## 3 Mine supply risks exist in 2H despite recent TCs upbeat

Since late May, mines have been gradually returning including Antamina, which is set to return to full operations by 3Q20. Tail risks still exist along with the recovery path rather than being derailed. More recently into July, treatment charges for both imported and domestic concentrate have risen moderately, but it's still too early to call concentrate tightness is over unless smelters are pushed to stay in maintenance for longer or even production cuts.

The latest shipping issue with Teck's Red Dog has also added more concerns with mine supply in the market, with LME 3-month prices now sitting comfortably above its 60-day moving average. The impact is still waiting to be seen, but this may have come at a 'bad' time as things were just about to improve, and also because most of their concentrate sales are focused in 2H because of a seasonal pattern due to local climate impacts to shipments.

In this case, we reckon it may delay a treatment charges recovery in the market.

#### 4 Overall lack of a prevalent theme, but mind short-term dislocations in supply and demand geographically

Despite a lack of prevalent themes in fundamentals, prices have been range-bound at around US\$2,000/t over the past two months. Other than the above-discussed supply issue that we are keeping an eye on, we also identify a few potential themes that could unfold in 2H.

a) **Inventory - reportable vs available;** Reportable inventories have risen this year from around 50kt to the latest 120kt, and historically this is still the lowest since 1Q08. This is backed by anecdotal reports that warehouse companies have offered incentives to attract metals back online and stock financing deals have also helped to the stock visualisation. We raised a similar question regarding [aluminium](#), to what extent existing inventories are available for end-users. In the LME market, last Friday's aluminium tom-next spread spike is backing this concern, and we won't be surprised if the same was happening to zinc. In addition, to further consider below scenarios b) and c), this could keep the ex-China market tight and upside risks with LME spreads or physical premiums are likely.

b) **Pent-up (end-use) demand in the ex-China market** – Downstream activities from Europe and the US are picking up post lockdown, as we have seen in the car market and construction sector. It remains to be seen as to whether this would follow a similar path as seen in China i.e., a restocking along the supply chain and support demand recovery for zinc in Europe and the US.

c) **China arbitrage** is still likely given the asymmetric recovery path after Covid-19 and different market dynamics. This will lead to inventories leaning towards the Chinese market as this has already been seen in 2Q20.

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