Bundles | 18 June 2021

# Surprise, surprise

In a not exactly shock move, the US Fed signalled that maybe inflation isn't as transitory as it thought it might be. So, expect an interest rate rise in 2023 We examine the implications and talk about it all in our podcast. Our credit team revisit their new year predictions; future direction there is all about rates. And our rates team are worried...

## In this bundle

Rates Spark

## Rates Spark: Carry on worrying

As the dust settles, the implications of the ECB and Fed June meetings are subtle. EUR rates should be shielded to an extent from a hawkish Fed but, if...

By Padhraic Garvey, CFA and Benjamin Schroeder

Article | 16 June 2021

FX | United States

# Federal Reserve fires the starting gun

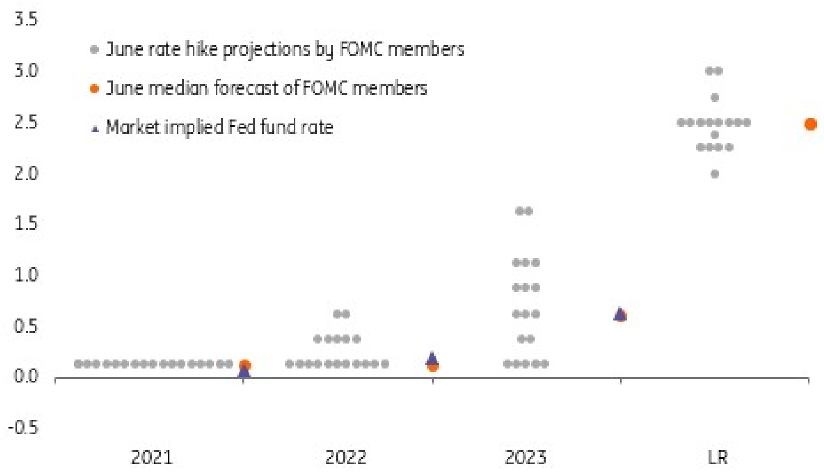
While monetary policy was unchanged the new Federal Reserve forecasts signal officials are not so confident in their transitory inflation narrative. With growth also revised up the Fed are now indicating we should be braced for 50bp of rate hikes in 2023 with the prospect of an earlier QE taper that potentially has an earlier conclusion

Fed Chair, Jerome Powell

## All about the dots - 2023 rate hike start

No shock surprises on the monetary policy front (rates held at 0-0.25% and QE purchases maintained at $120bn per month split $80bn Treasuries and $40bn agency mortgage backed securities), but the forecast changes are highly significant. There are now 50bp of Fed hikes by 2023 as the median forecast of officials with 13 out of 18 going for some form of move in 2023 versus just seven when they were last polled in March. Previously they were signalling that it was more likely to be 2024 before the first hike. There are now 7 out of 18 going for a 2022 rate hike versus four previously. The Longer run forecast remains 2.5%.

## Federal Reserve "dot plot" of individual forecasts for the Fed funds target rate




Source: Macrobond, ING

The Fed's 4Q YoY GDP forecast for 2021 was revised up to 7% from 6.5%, 2022 stays at 3.3% while 2023 has been revised up to 2.4% from 2.2%, which presumably reflects some optimism on President Biden's spending plans. There are even more substantial inflation changes with Core PCE now to end the year at 3% year-on-year versus 2.2% previously predicted with the 2022 and 2023 forecasts revised up a tenth of a percentage point. It appears therefore that the narrative remains that inflation will be transitory, but it is clear from the press conference they are less confident in that assessment than they were a couple of months ago – Jerome Powell certainly talking about the risks it stays elevated for longer. The revisions to unemployment are tiny (see table below).

## Federal Reserve June forecasts versus previous March predictions

| | 2021 | 2022 | 2023 | Longer run |
|---|---|---|---|---|
| **Change in real GDP (June Fed forecast)** | **7.0** | **3.3** | **2.4** | **1.8** |
| Previous Fed projection (March) | 6.5 | 3.3 | 2.2 | 1.8 |
| **Unemployment rate (June Fed forecast)** | **4.5** | **3.8** | **3.5** | **4.0** |
| Previous Fed projection (March) | 4.5 | 3.9 | 3.5 | 4.0 |
| **Core PCE inflation (June Fed forecast)** | **3.0** | **2.1** | **2.1** | **-** |
| Previous Fed projection (March) | 2.2 | 2.0 | 2.1 | - |
| **Federal funds rate (June Fed forecast)** | **0.1** | **0.1** | **0.6** | **2.5** |
| Previous Fed projection (March) | 0.1 | 0.1 | 0.1 | 2.5 |

Source: Federal Reserve, ING

Despite these major moves the accompanying statement is little changed – merely some descriptives around vaccinations with an acknowledgement that inflation is no longer running "persistently" below the long run goal of 2%, which is pretty obvious to everyone.

## A clear hawkish shift

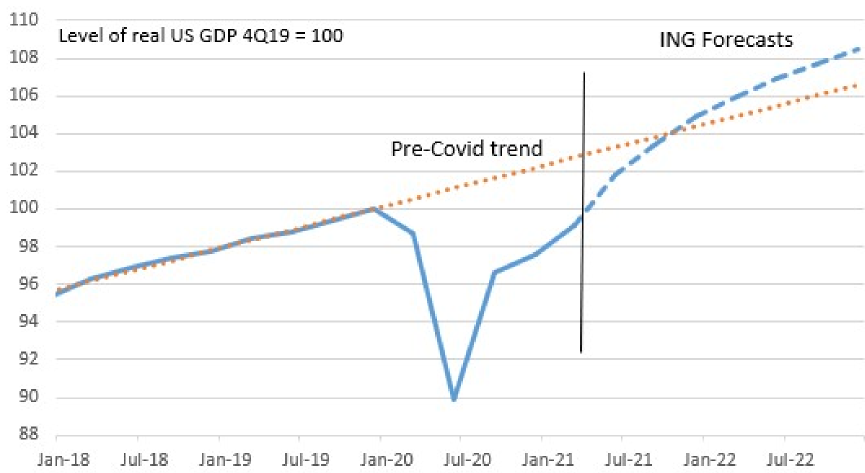
The forecasts are the big story today and signal a more hawkish shift than generally thought was likely with the yield curve steepening and moving a higher. The 50bp of hikes the Fed are now pencilling in is merely in line with what the Fed funds futures market was pricing, but it clearly fires the starting gun on the prospect for a QE tapering discussion that could start a little earlier than thought and conclude more quickly – hence the wake-up call for the Treasury market.

This will be more formally acknowledged at the Federal Reserve's Jackson Hole conference in late August with the September FOMC (the next forecast update from the Fed) laying out the path. We had been expecting the tapering announcement to come at the December FOMC and be concluded before the end of next year, but the timeframe could certainly be brought forward.

## ING view: Three 25bp hikes in 2023

Like the Fed, we are very upbeat on US growth prospects given the scale of stimulus injected into the economy, the improvement seen in consumer finances coupled with anticipated pent-up demand for leisure, travel and entertainment services and the red hot property market. The result is that we strongly suspect that the US economy will end the year larger than what would have been the case had the pandemic not happened and the activity continued along its pre-pandemic trend (see chart below).

## US GDP levels - ING forecast versus pre-pandemic path




Source: Macrobond, ING

We are nervous that scarring from the pandemic means that the supply capacity of the economy may not be able to fully meet that demand. There are clear re-opening frictions already compounded by a shortage of suitable workers. Manufacturers also have a record backlog of orders while they know their customers are running the lowest inventory levels on record, according to the ISM. This provides a decent pricing power environment that allows companies to pass higher costs on more easily.

Then there is the housing market, which is seeing booming prices, which will inevitably feed through into higher housing components of CPI. In consequence we see inflation remaining well above the 2% target for much of the next three years. If wages start responding more meaningfully the risks of inflation remaining higher for longer will be even greater.

*We look for three 25bp rate rises in 2023.*

While the Fed has shifted its stance to focus more on the labour market to ensure more people in society feel the benefits of a growing economy – through jobs and wage increases – we doubt they will tolerate an overheating economy. We look for three 25bp rate rises in 2023, starting in the first quarter.

## IOER: A technical move, but still the effect and marginal direction of policy is clear

The 5bp hike in the rate on excess reserves (from 10bp to 15bp) is a technical move, and is being downplayed by the Fed as being just that. At the same time, it is certainly not a loosening in policy, and in fact fits with a series of moves of late that have been of a tightening ilk. Remember in recent months, the Fed decided not to extend the leeway granted to banks in the treatment of reserves and bonds on their leverage ratios. That was a tightening. The decision to sell its (small) corporate bonds portfolio is also a tightening. The 5bp hike today is in a similar vein of a gradual chipping away at stimulus. A technical move, but all of this is pointing in the same direction.

*The 5bp hike in the rate on excess reserves is a gradual chipping away at stimulus.*

The Fed also hiked the rate at its reverse repo window by 5bp (from zero to 5bp). This, together with the 5bp hike in the IOER, is designed to coax up rates on the front end of the curve. This has been a policy choice that could have been executed for a number of months now, but became more front and centre given the large flight of cash back to the Fed at this window in recent weeks. The hike in the rate itself is not going to be a trigger a lower use of this facility. But the combination of this elevation plus the one of excess reserves changes the dynamic on the ultra-front end. It should directly push up the SOFR rate (likely also by 5bp; market driven), and will impact higher alternatives in this space ranging all the way into the bills market.

Market rates are higher generally in consequence. The 10yr is back up towards 1.55% and the 2yr is approaching 20bp. That's the highest for the 2yr in about a year, which makes sense as it is now sniffing out a rate hike before it matures. And there's been an even bigger move on the 5yr, as the 5yr underperforms on the curve (still a tad rich to the curve, but more neutral now than it was). This is a classic bearish reaction and one that can act as a momentum change as the market being to pivot towards rate-hike preparedness, from a point of neglect of that as an imminent risk.

A big move has been seen in real yields too, practically a 10bp gap higher, and forcing inflation expectations down (a tad). Still deeply negative (at c.-80bp in the 10yr), but moving higher again. This is important too. If the recovery higher in rates is to have legs, it should ideally come from less negative real yields. The fall in inflation expectations also tells us the market place is pricing in a better protection from the Fed. Not much, but certainly more than was in evidence before the FOMC meeting outcome.

## Hawkish surprise gives the dollar a lift

The Fed has quietly set the cat amongst the pigeons with the median expectation of the Dot Plot shifting to two hikes in 2023 from none previously. That lends itself to a narrative – even though this is still more than eighteen months away – of a slightly faster Fed tightening cycle. This has seen Dec 2023 Eurodollar contract fall a relatively sharp 10 ticks and even yields at the short end of the US Treasury curve start to edge up. The dollar tends to take more notice of the short end of the curve, being more sensitive as it is to Fed policy.

The FX market reaction has seen the high beta NOK, ZAR and MXN take the lion's share of the losses ($/NOK is nearly 2% higher on the day), while the rest of the $/Majors are up around 0.6%. Given the news that we are perhaps marginally closer to Fed tightening than we thought, dollar sensitivity to US data releases and Fed-speak look likely to increase. Perhaps EUR/USD 1 year implied volatility does not break below 6% after all?

But the August Jackson Hole Fed symposium is still over two months away and it may be hard for investors to ignore the appeal of yield this summer – especially in light of some very aggressive and front-loaded tightening cycles in the likes of Brazil and Russia.

> *EUR/USD testing and perhaps breaking 1.25 later this year could be harder to achieve.*

What it may mean, however, is that investors think twice about funding carry trade strategies out of USD and instead the JPY and the EUR may be increasingly favoured. Certainly, today's Fed news makes our forecast of EUR/USD testing and perhaps breaking 1.25 later this year a little harder to achieve. And for the short term a correction to 1.1920 area looks the risk.

This Fed move also comes on a day when a report suggests Chinese authorities are preparing to intervene in commodity markets by releasing some of their strategic stockpiles in industrial metals. This can add to the correction in the strongly-backed commodity FX complex.

Unless a bond market sell-off really gets out of hand, it is not clear that equities need to suffer a deep correction on this. And given that the Fed's balance sheet is likely to still be expending well into 2022 – albeit it a slower rate – it looks too early to call a significant turn in the risk asset cycle.

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Podcast | 18 June 2021

# Listen: What the Fed's hawkish shift means for bonds

A hawkish announcement from the Federal Reserve has prompted investors to reassess the outlook for asset purchases and the timing of interest rate hikes. In this podcast, ING's Padhraic Garvey looks at the implications for the US Treasury market


At its monetary policy meeting on Wednesday, the Federal Reserve raised its forecasts for growth and inflation and brought forward its projection for an increase in interest rates. A majority of officials now predict two hikes in 2023, while more than a third are calling for a hike as soon as next year.

In this podcast, ING's Regional Head of Research in the Americas, Padhraic Garvey, tells Senior Editor Rebecca Byrne what the news means for market interest rates in the months ahead.

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United States

# US spending momentum continues as price risks mount

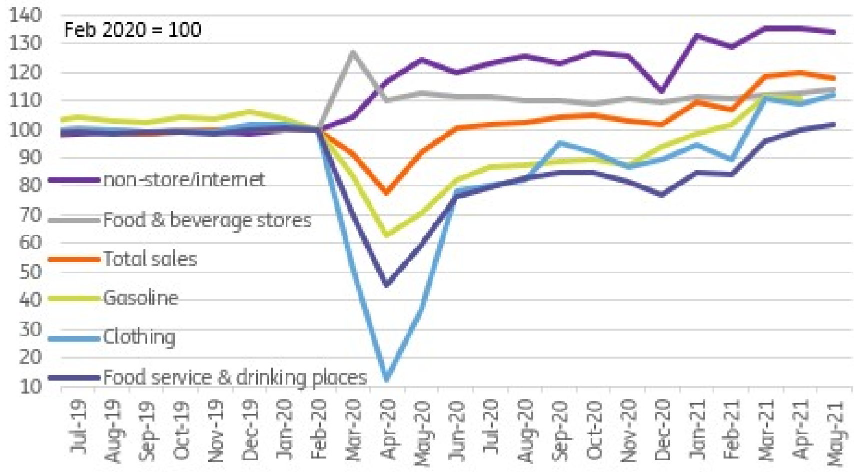
US retail sales dipped, but remain at incredibly strong levels even as the re-opening means there are an increasing number of options on which to spend money. Meanwhile, inflation pressures continue to rise as economic frictions show little sign of easing

## Spending softens, but from record levels

US retail sales were down 1.3% month-on-month in May, but it is important to point out we saw some significant upward revisions. April's initially reported 0% MoM figure has been revised up to 0.9% growth, so in dollar level terms the May spending number is actually a bit better.

The details show auto sales were down 3.7% MoM, which comes as no surprise. We already knew that vehicle sales slowed in May to unit sales of 17mn from 18.5mn in April. As with the housing market, it may well be the lack of supply of available vehicles that is causing the slowdown given production/supply chain issues rather than any drop off in demand.

## US retail sales levels




Source: Macrobond, ING

There were broad-based falls with furniture (-2.1%), building materials (-5.9%), general merchandise (-3.3%), miscellaneous (-5.0%) and electronics (-3.4%) all reporting declines. This was partially offset by gains in clothing (+3%), health and personal care (+1.8%), food (+1%) and gasoline station sales (+0.7%). Eating and drinking also continued to make a recovery (+1.8%), the third consecutive monthly gain.

## Robust foundations for continued spending strength

Coming after the significant April upward revisions and March's stimulus fueled 11.3% MoM surge this isn't a bad outcome. Moreover, retail sales is typically "only" 40-45% of total consumer spending, which in turn is usually around 65-70% of GDP. Clearly it is a very important component of overall economic activity, but with the economy re-opening there are a greater number of options on which to spend money. We will increasingly see a movement away from "things" that are picked up in retail sales, towards "experiences", such as travel, entertainment and leisure, which are not.

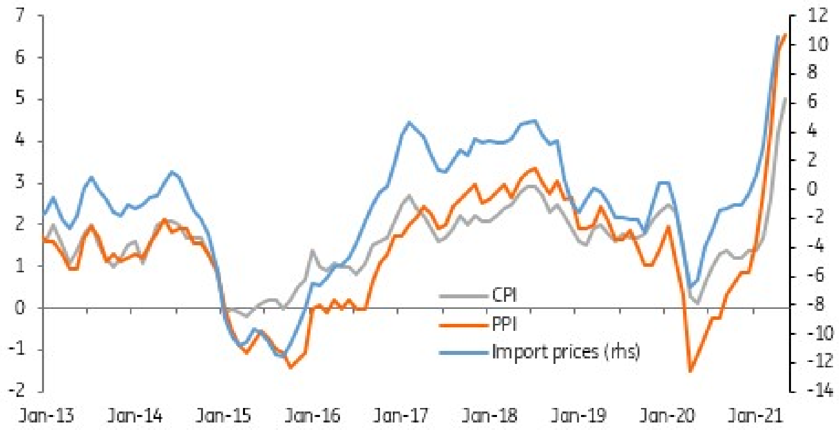
Consumer finances remain in great shape with incomes showing increasing signs of picking up and credit card borrowing having been paid down. Meanwhile, last week's Federal Reserve flow of funds data showed households have seen their wealth surge $20tn since the end of 2019 with $3tn of that increase in liquid cash, checking and time savings deposits. That is a huge amount of financial ammunition that could support strong consumer spending over the next few years let alone the next few months.

## PPI indicates broadening pipeline price pressures

We have also had the producer price inflation report. It showed a pick-up in inflation with MoM price rises hitting 0.8% versus the 0.5% consensus while ex food and energy came in at 0.7% versus 0.5% predictions.

Food showed the second consecutive 2%+MoM reading while transportation and warehousing rose 1.9% MoM after 2.1%, 1.5% and 1.4% MoM increases. Other components also posted sizeable gains, which is indicating a broadening out of inflation pressures.

## US YoY inflation measures (%)




Source: Macrobond, ING

Moreover, the manufacturing sector is experiencing growing corporate pricing power. The ISM reported order books continue to grow strongly, but production is struggling to keep pace. This means the backlog of orders has risen to new all-time highs while at the same time customer inventories are at record lows. This suggests pipeline price pressures will continue to build, which is another reason for us to believe consumer price inflation could stay higher for longer.

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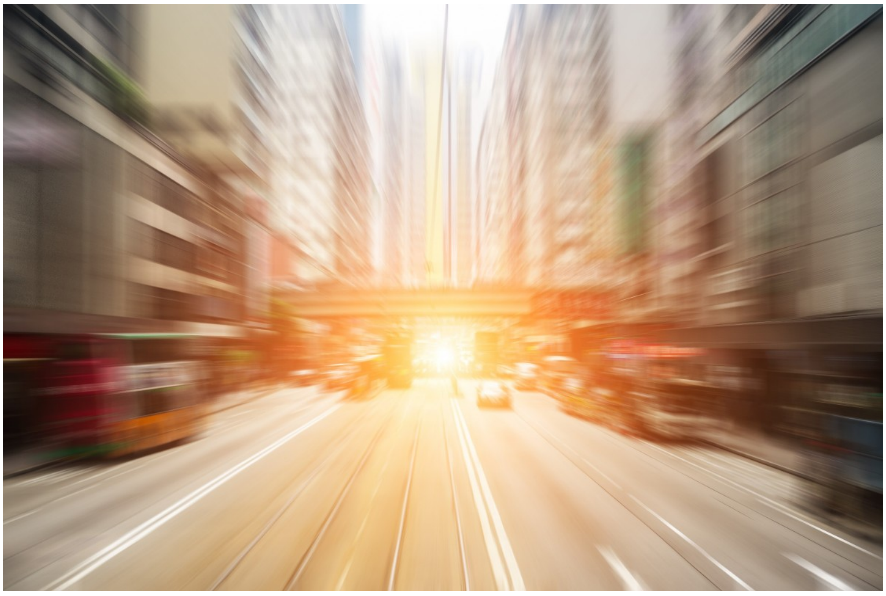
Article | 14 June 2021 Credit

# Credit Outlook - 21 calls for 2021: I want to break free (again)

We update our Credit Outlook for 2021, taking selected strategic calls. Where we look at what has happened thus far in 2021, and where our expectations are for the second half of the year. But quite simply, we think the greatest single determinant for credit market direction over the next few months will be rates.



Source: Shutterstock

## After rolling in the deep, we want to break free

We often compare the state of the credit markets to song titles. Late last year, when we published our 2021 outlook, we dubbed it rolling in the deep, referring to how we expected credit spreads to tighten due to strong technicals despite underlying deterioration of leverage.

The call has been successful so far with pretty decent excess returns over swap rates, but total returns are almost exclusively negative due to underlying rates. For the second part of the year that returns picture is set to remain in tact, inflationary threat, pressure on credit metrics, low if any inflows and curve steepening combine for a less bullish environment thus this time credit spread tightening will not alleviate the pain.

Indeed we have frequently used Queen as our source of analogies, and as credit continues to trade at the low end of the 2021 range, we see potential for it to test the upper band of that range and basically for spreads to say, once again, we want to break free.

## 2021 thus far – don't you remember

2021 has been as expected whereby the compression trade was indeed at the forefront, as spreads were in a slow slugging grind tighter.

Taking Euro financial and corporate indices as proxies, financials have tightened 9 basis points in total since the beginning of the year and corporates have tightened by 12bp. Meanwhile, Euro corporate BBB spreads have tightened 16bp year-to-date.

## Spread developments and forecasted widening chart


Source: ING, ICE

The sector breakdown does illustrate the recent compression, with the likes of autos, leisure, services and real estate all outperforming substantially. Additionally, autos, leisure and real estate are the only sectors with positive total return on a YTD basis.

## Spreads and return per sector YTD

| | YTD Spread Differential (bp) | YTD Total Return (%) | YTD Excess Return (%) |
|---|---|---|---|
| Euro IG Non-Financial | -12 | -0.57 | 0.88 |
| Euro IG Financial | -9 | -0.15 | 0.69 |
| Autos | -24 | 0.50 | 1.47 |
| Transport | -13 | -0.99 | 0.92 |
| Energy | -1 | -0.74 | 0.68 |
| Utilities | -8 | -0.80 | 0.65 |
| Consumers | -8 | -1.07 | 0.61 |
| Retail | -19 | -0.34 | 0.92 |
| Leisure | -26 | 0.59 | 1.11 |
| Health | -6 | -1.38 | 0.54 |
| Telecom | -9 | -1.00 | 0.63 |
| Media | -18 | -0.03 | 1.26 |
| Technology | -12 | -0.68 | 0.59 |
| Services | -21 | -0.01 | 1.00 |
| Industrials | -16 | -0.28 | 0.87 |
| Capital Goods | -14 | -0.28 | 1.05 |
| Real Estate | -22 | 0.30 | 1.61 |
| Bank Senior | -6 | -0.25 | 0.53 |
| Insurance | -3 | -0.98 | 0.30 |

Source: ING

Source: ING

Additionally, there has already been some slight steepening of curves. Outflows from longer-dated funds have accelerated over the past few weeks, particularly in USD. The USD market has had less of a demand for higher beta. In Euro, there has been a change for shorter duration debt. Flows have been largely skewed to the 3-5yr maturity. This may well indicate future softness in credit.

## 1 The credit markets

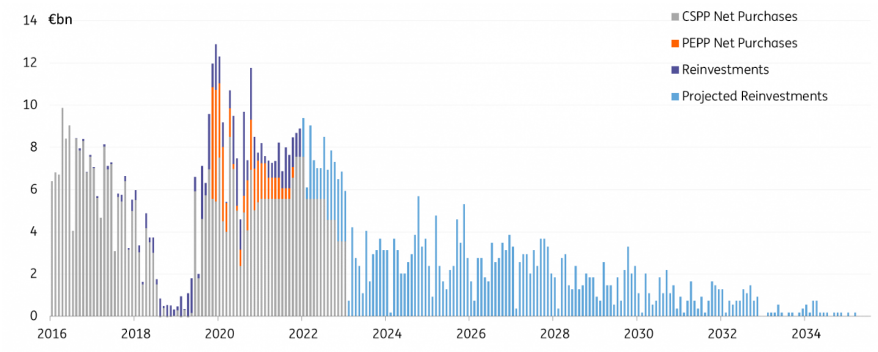
The greatest single determinant for credit market direction over the next few months will quite simply be rates.

The backdrop of a potential inflationary threat and dare we say it, the T-word - tapering will, despite strong credit market technicals, have a pronounced effect on positioning necessary for some excess returns in 2H21. In contrast to our 21 calls for 2021, we are now, therefore, a little more bearish.

Any widening in credit will be limited; the ECB failed to give further guidance last week and made no mention of tapering nor slowing PEPP. As expected the ECB meeting was rather uneventful. The only noteworthy thing was that front-loading of PEPP would continue. This means there will likely be around €2bn in corporate purchases per month under PEPP. This comes on top of the €5.5bn average net purchases from CSPP per month.

Additionally, coming into the second half of the year we are more likely to see less ECB eligible supply coming into the market, in the form of corporate hybrid supply and Reverse Yankee supply. In which case, we may see the ECB being pushed more and more into the secondary market. This is of course very supportive for spreads and we favour eligible debt for the second half of the year. This may also delay our bearish stance somewhat for eligible debt, as the ECB keep spreads supported.

## ECB's corporate purchases and future projection




Source: ING, ECB

Of course, the messaging from the ECB, in terms of the end of PEPP, is centred around keeping the support in play as long as needed.

However, it must indeed end at some point, and a potential option for the ECB to add a smoothing effect is to increase APP purchases to absorb the pain. This could be as significant as €40-50bn per month, up from the current €20bn per month. Whilst most will be needed to target PSPP; we feel that the ever popular CSPP will also benefit. Indeed we wouldn't be surprised that the net result is zero; in other words, CSPP increase in purchases of corporate credit could outweigh the lack of further PEPP involvement in credit. That bump in purchases could be to the tune of the current net €5.5bn to target €7bn per month. Currently, CSPP runs at 25% of APP, so a slight decline would still mean a net rise.

These strong technicals are further supported by a few other elements:

- Exodus from credit unlikely given that rates will remain historically low; the need for even the slightest bit of possible yield ensures a lasting bid for credit.
- Looking farther afield, CSPP may well remain active until mid-2023. The messaging here from the ECB is that it shall remain until shortly before they start raising the key ECB interest rates. Our economists are looking for the first rake hike to be in late 2023.
- Besides looking even further afield, the reinvestments of redemptions by CSPP shows an increasing trend whereby later in 2023 and into 2024 onwards, we expect that when we look at only the re-investment flows, the credit will still be supported by a bid of some €2.5bn a month on average.
- The slowing of supply compared to 2020 and the expected drop for H2 2021 also entails that CSPP struggles to purchase the volume needed through the preferred route of primary purchases but is increasingly pushed into the secondary market hence supporting spreads.

Nonetheless, the current tight valuations, supply (targeting the long-end), and importantly upwardly mobile underlying rates will combine to create a less positive environment for credit.

The shorter maturities are favoured for the second half of the year,

- Defensive positioning.
- Credit in the short-end is cosmetically cheap as it has in the recent past struggled, in spread terms, to dive further into negative-yielding territory. A slow rise in short-end rates improves the potential for this negative-yielding credit to tighten.

- L&M exercises target the short-end as excess liquidity raised in 2020 is put to work. Consequent supply targets the long-end.
- Parking liquidity, the same excess liquidity, is at times used to buy short-dated credit.

On the other side of the pond, the FED firesale of ETF and corporate bond holdings might not be too much of a big news item or direct driver for spreads, but it is just another ingredient to a more bearish credit outlook. In combination with more pressure on rates in the US, the limited ETF and mutual fund inflows will struggle to keep pace with these sales. Despite low supply, we feel that spreads will be softer in USD, both softer in terms of relative performance to EUR and expecting these too to target and end of year target of the higher end of the 2021 trading range.

What does this mean in terms of credit markets

- Excess returns at best minimal
- Favour short-end
- Play hybrids for yield selectively
- Compression trade starts to falter, assess risk to higher beta sectors.

## 2 Corporate supply – right on track to hit forecast of €350bn

On a year-to-date basis, corporate supply is sitting at €162bn. This is, of course, below the substantial crisis-fuelled supply of last year, sitting at €242bn YTD. But supply is now running ahead of 2019's YTD supply of €156bn. Supply thus far is nicely in line with our forecast of €350bn by the year-end, in which we had forecast €200bn in the first half and €150bn in the second half of the year.

We expect supply in June to pencil in c.€30-35bn, leaving the first half of 2021 supply just marginally shy of the €200bn expectation.

### Forecasted supply per quarter

| | €bn |
|---|---|
| Q1 | 106.2 |
| Q2 F | 94 |
| Q3 F | 80 |
| Q4 F | 70 |
| Total | 350 |

Source: ING

We have, however, slightly adjusted our sector breakdown of supply. The real estate sector in particular has been very substantial this year.

On a YTD basis, the real estate supply sits at €28bn, up significantly from €16bn last year YTD and €10bn in 2019 YTD. We expect real estate supply will remain relatively heavy and reach up to €50bn by the year-end.

On the other hand, the consumer sector has been rather underwhelming, with just €6bn YTD. When compared to the substantial €47bn pencilled in by this time last year, and €23bn in 2019.

## Supply forecasts per sector

| | 2021 YTD Supply | 2021 Forecast Supply | 2021 Forecast Redemptions | 2021 Forecast Net Supply |
|---|---|---|---|---|
| Auto | 18 | 35 | 34 | 1 |
| Consumer | 16 | 40 | 27 | 13 |
| Healthcare | 8 | 20 | 18 | 2 |
| Industrial & Chemicals | 27 | 60 | 35 | 25 |
| Real Estate | 28 | 50 | 12 | 38 |
| TMT | 22 | 55 | 40 | 15 |
| Utility | 34 | 70 | 37 | 33 |
| Others | 10 | 20 | 12 | 8 |
| **Totals** | **162** | **350** | **214** | **136** |

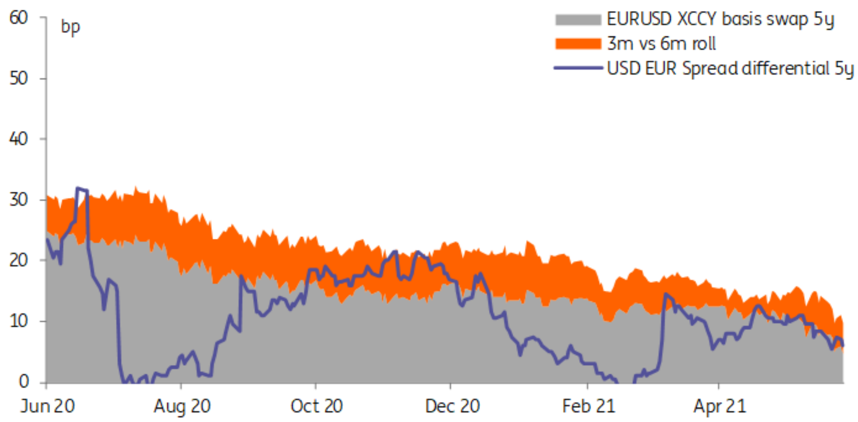
Source: ING

## 3 Reverse Yankee supply expected to rise - USD to underperform EUR

We still expect USD spreads to underperform against EUR later in 2021. Alongside this, we see the cross-currency basis swap and 3m vs 6m roll to remain tight and expect it to remain so. In combination, this will offer a cost-saving advantage for US corporates to issue in EUR and swap back to USD. As a result, we stand by our forecast for corporate Reverse Yankee supply to reach €80bn by the end of the year.

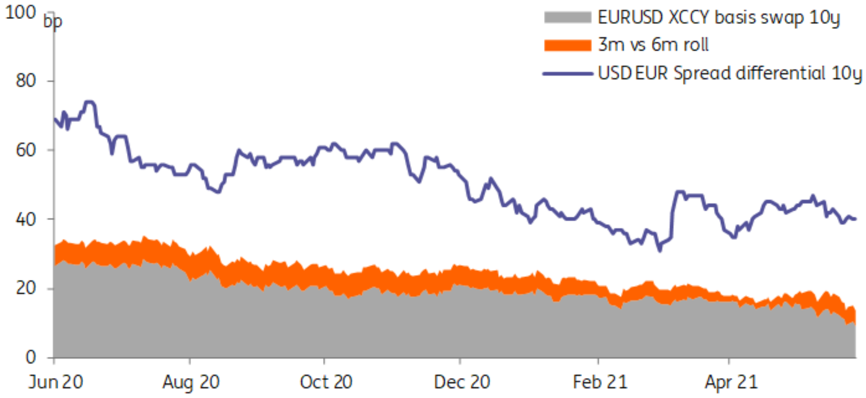
USD spreads will particularly underperform against EUR spreads when we see the inevitable weakness in the credit markets in the second half of the year, particularly when we begin seeing widening on the back of inflationary fears, tapering and a rise in rates. This is largely due to the technical picture being notably stronger in Euro than in USD, particularly with the ECB remaining active in purchasing corporate debt.

## Cross currency basis and excess USD over Euro 5yr




Source: ING, ICE

## Cross currency basis and excess USD over Euro 10yr




Source: ING, ICE

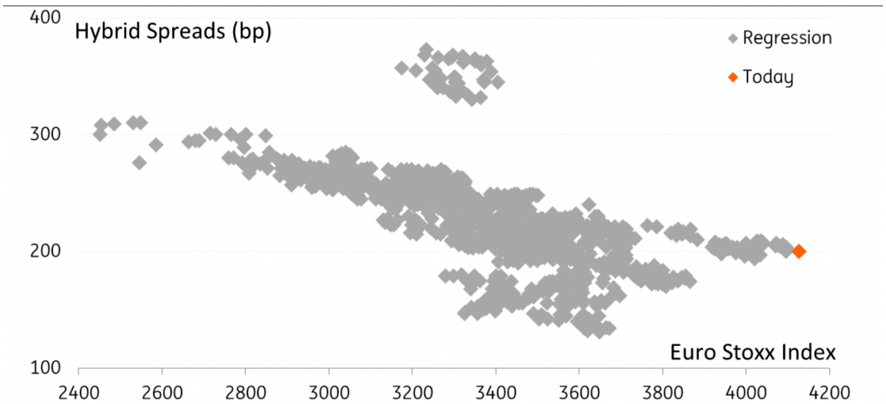
## 4 Corporate hybrids - we expect hybrid supply to continue to be substantial

Corporate hybrids have also seen significant supply. The YTD total is up to €22bn. This is already ahead of the previous year's full-year totals. Nonetheless, this is still marginally below our expectations, and still, a sizeable amount of supply is required to reach our forecast of €50bn. In any case, we expect hybrid supply to continue to be significant.

There is still significant value in hybrids relative to Equities in terms of valuation, but hybrids are trading very much in line with BB rates spreads. However, when compared to B rated spreads, there is certainly some value to be found.

## Hybrids vs Equities

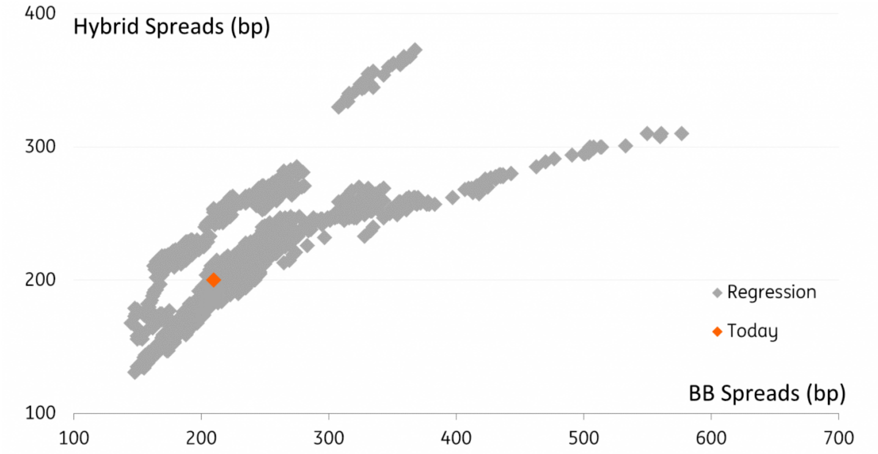
Illustration of a regression between corporate hybrid spreads and equity prices over the past 5 years




Source: ING, ICE

## Hybrids vs BB Spreads

Illustration of a regression between corporate hybrid spreads and equity prices over the past 5 years




Source: ING, ICE

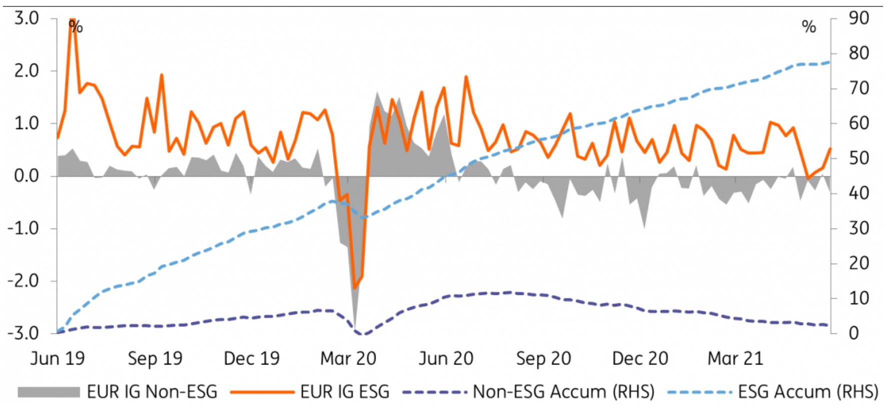
## 5 ESG - Covid the catalyst for ESG in credit

When credit markets widened and concerns over Covid-19 grew at the start of the pandemic, there was a huge outflow from mutual funds that invested into credit. Some 30% of assets under management were withdrawn in a month or so. But the retracement of these funds has been strong, and 2020 ended with net inflows. A closer look at this shows a very green picture as the initial Covid exodus has caused demand for green to increase relative to grey debt. Fund flows inflowing into ESG have basically dominated flows and caused a shift from grey to green. Indeed in some cases, non-ESG funds have seen outflows over the last few years.

Over the past two years, ESG funds have accumulated a substantial inflow of 85% of assets under management (AuM). Non-ESG funds have seen only marginal inflows, which has accumulated to just 3% of AuM over the past two years. And indeed, non-ESG funds have seen mostly outflows since August of 2020.

## Euro fund flows – ESG vs Non-ESG

Funds inflowing into ESG mutual funds is very substantial




Source: ING, EPFR

The growing ESG market is still unbalanced in terms of demand and supply. Indeed there is a clear increasing and strong demand for ESG debt. However, the supply is still lacking in relative terms. Sustainable-linked bonds do offer an easier way for issuers to come to the ESG market. As the market grows, we will see normality and balance prevail.

ESG supply has consistently been increasing. Already there has been €30bn in corporate ESG supply this year, running ahead of last year's €18bn. This year, financials have supplied €24bn, up significantly from the €6bn supplied last year YTD. Last year pencilled in &euro 64bn in total ESG supply, of which €39bn was from corporates and €25bn from financials. We forecast ESG supply to reach at least €50bn in Corporates and &euro 50bn in Financials this year.

We see the sustainability linked bonds market as the fast-food of ESG bond finance compared with the white linen tablecloth variety of green bonds, which are best associated with a Michelin-starred restaurant where everything is perfectly laid out. By which we mean, sustainability linked bonds are significantly easier, simpler and quicker to issue, and as such, these bonds are certainly gaining traction. Last year saw €3.5bn in supply. Already in 2021, €3.3bn has been supplied.

We see this as supportive in several ways:

- It allows more issuers to tap ESG demand as the process of issuance is far less complicated. This will be particularly advantageous for less frequent issuers.
- It adds more volume to the ESG market as a whole as an alternative to a green bond. The ESG market is certainly growing year on year. However, there is still a balance issue relative to the strong demand for it.
- It is still ECB-eligible. The ECB has included a provision to work around their guidelines in which debt with a step coupon is in principle ineligible as collateral by making step coupon bonds eligible if they are tied to ESG targets.

## Update on our 21 calls for 2021

**1. Technicals dominate, carry pays, spread softness potentially for 2H21**

Technicals still dominate as the ECB remains active, net supply remains relatively low, and fund flows are positive, albeit marginal. We still expect spread widening in the second half of the year.

**2. Steepening curves to persist, Hybrids to hit €50bn**

Curves have begun steepening over the past few weeks from the very flat levels. We expect this to continue, notably as spreads widen and rates rise. This will be particularly seen in BBB rated curves. Hybrids supply sitting at €22bn YTD.

**3. Value in USD, reverse yankee supply will resurge**

Reverse yankee supply has been limited this far, but we expected a late runner. Sitting at just €25bn YTD, we expect supply to pick up in the second half of the year as USD spreads are expected to underperform against EUR spreads.

**4. Expected default rates too low**

We expect default rates to rise slightly from here, but we also expect default rates to stay elevated for a prolonged period. Under the basis of our economic outlook, spreads are looking too rich as we expect widening, a continuation of downgrades and fallen angels and the growing pool of leverage with worsening leverage metrics.

**5. Prefer corporates over financials**

We maintain our preference for corporates over financials on the back of CSPP and PEPP purchases and a more challenging environment for European banks in 2021. We maintain our Overweight stance on utilities, telecoms, healthcare, household goods and banks bail-in.

**8. Corporate supply to fall, but will still be a sizeable amount**

Supply thus far is nicely in line with our forecast of €350bn by the year-end, in which we had forecast €200bn in the first half and €150bn in the second half of the year. We expect supply in June to pencil in c.€30-35bn, leaving the first half of 2021 supply just marginally shy of the €200bn expectation.

**16. Financials Supply: More of the same**

After further favourable TLTRO conditions, our financials supply forecast was taken down. In any case, it will still be very similar to slightly less supply compared to last year.

**19. 2021: another groundbreaking year for sustainable supply**

The growing ESG market is still unbalanced in terms of demand and supply. Indeed there is a clear increasing and strong demand for ESG debt. However, the supply is still lacking in relative terms. Sustainable-linked bonds do offer an easier way for issuers to come to the ESG market. As the market grows, we will see normality and balance prevail.

**20. ESG to outperform in 2021**

The growing demand will indeed produce a 'greenium' (green premium). However, this is not currently being seen in the considerably tight environment in which we're trading. We will likely see more ESG outperformance when spreads begin to widen, as ESG spreads will hold firmer.

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# Rates Spark: Carry on worrying

As the dust settles, the implications of the ECB and Fed June meetings are subtle. EUR rates should be shielded to an extent from a hawkish Fed but, if the outlook deteriorates, long-end rates will continue falling. This is a bond market that refuses to bow to contemporaneous macro circumstances, and in fact sees something nasty down the line.

Source: Shutterstock

## Despite the Fed, monetary conditions in fact have loosened when you look at the fall in the 30yr rate

Some USD 756bn went back to the Fed on the reverse repo facility yesterday, a new record high - so much for the technical hikes of 5bp. These do affect the price of liquidity (on the reverse repo and excess reserve buckets), but do nothing to address the excess of liquidity, which continues to grow.

*The 10yr is now below where it was before the Fed*

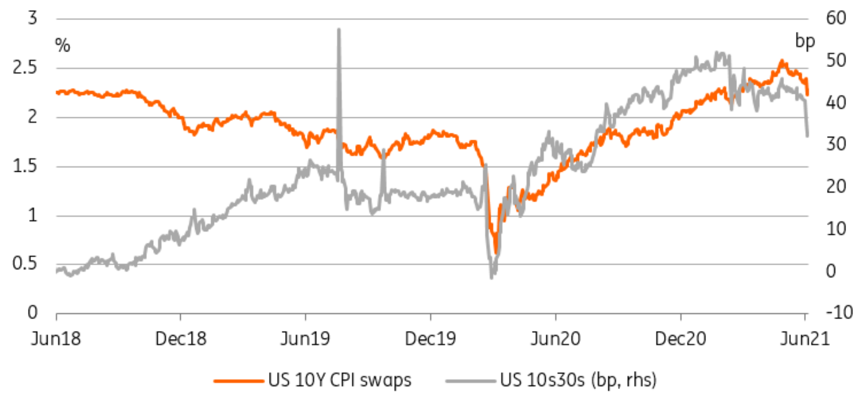
The 10yr is now below where it was before the Fed, in sub-1.5% territory again. It's not all about excess liquidity, but clearly there is a rump of liquidity outside of that, which filters into the fixed income market. In addition the fall in nominal rates is coming entirely from a fall in inflation expectations. Real yields are practically static - the 10yr is still deep negative at -75bp, but doing nothing.

In contrast inflation expectations dropped from over 2.3% to almost 2.2%, pulling nominal rates down with them, or at least coinciding with the fall in nominal rates. The 5yr area is still cheapening to the curve, but the dominant move is coming from the back end; the 10/30yr is almost 20bp flatter in a few days.

*Post Fed reation is morphing into a monetary loosening coming from the 30yr*

Having had an implied monetary tightening on higher 30yr mortgage rates, that is morphing into a definite monetary loosening as 30yr rates head ever lower. This is a bond market that continues to refuse to bow to contemporaneous macro circumstances, and seems to insist that it sees something nasty down the line.

## A hawkish Fed and dimmer outlook are reflected in a flatter curve, and lower inflation swaps




## FOMC and bottlenecks all point to flatter curves

Going forward, the implications are more subtle than they first seem. Firstly, it will take time for markets to wholeheartedly shift the narrative to seeing signs of inflation as putting upward pressure on rates, by way of higher Fed tightening probability. Secondly, this apparent shift in Fed tone comes at a time markets are increasingly cautious about the outlook.

*This apparent shift in Fed tone comes at a time markets are increasingly cautious about the outlook*

The Fed played no small part in this but the resulting reaction might well be that long-end rates decline further to price an early end to the recovery, precipitated by the Fed. This would go a long way to explain the fact that long-dated US rates more than retraced their post-FOMC sell-off yesterday. The other factor might be worries about the Delta Covid-19 variant spreading quickly among one of the most vaccinated populations in the world, or further threat to global supply chains from bottlenecks in China.

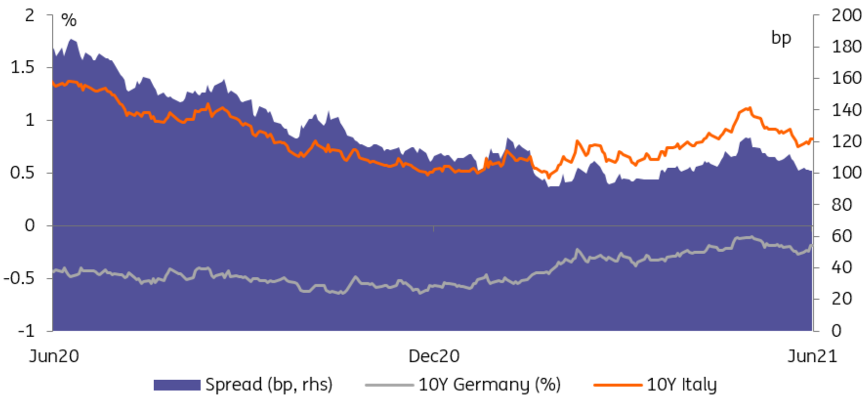
## The subtle implications for EUR rates

Starting with the market implications of recent central bank events, the Fed has very much thrown a spanner in the works to investors gearing up to a quiet summer dominated by carry-chasing behaviour. On the face of it, it looks like a major risk to the status quo has materialised. In practice, the implications are more subtle. The ECB's tone one week prior served as a major endorsement to low volatility/carry-chasing strategies. This hasn't changed.

*The ECB's tone one week prior served as a major endorsement to low volatility/carry-chasing strategies*

We expect the ECB's dovish tone, even in the face of greater optimism, to shield European markets to some of the effects of a more hawkish Fed. This is particularly true in higher yielding bond markets where spreads offer a buffer against rises in risk-free rates. Our view seems confirmed by the mechanical tightening observed post-FOMC between Italian and German yields. It helps that the former might benefit from improved growth expectations.

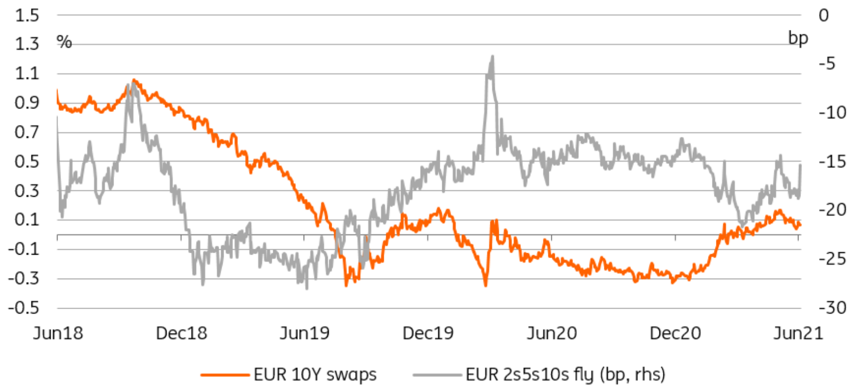
## Higher yielding EUR debt has weathered the Fed's change of tone, we expect tighter spreads still




Source: Refinitiv, ING

At the safer end of the credit spectrum, regular readers will know our view that EUR rates are still on a rising path, albeit gentle. A more hawkish Fed adds to our conviction although the way it manifests itself on the curve might seem disconnected with the outlook for monetary policy in the Eurozone. For instance, the steepening of EUR 2s5s and cheapening of EUR 2s5s10s both indicate the markets do see a read-cross to the path for EUR rates, even if the ECB has indicated it will be comparatively patient.

## The main impact on the EUR curve has been a greater ECB hike discount




Source: Refinitiv, ING

## Today's events and market view

There is very little by way of economic releases today so the field is clear for the post FOMC-adjustment to continue. This means flatter curves, especially if sentiment deteriorates further.

Fridays can be an opportunity for bond markets to breathe after a week of busy supply, but also an opportunity to prepare for the following week. We're expecting a 10Y Spain syndication to materialise. Another EU deal is also possible although it would imply a request for proposal to be sent to banks today.

Finally, today is the last day before the first round of the French regional elections (the next round is the following Sunday). The far right Rassemblement National (RN, formerly Front National) could win the presidency of one region and put the importance of next year's presidential vote into sharper relief. The lag between the two is significant, around 10 months, but RN successes could add to supply pressure on the semi-core sector.

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