4 ECB's QE proceeds at full steam but the bond market recently corrected: is the squeeze over?

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The essential

As we have already outlined in previous publications, the impressive size of the ECB's extended purchase programme combined with negative deposit facility rates has already had a dramatic impact on sovereign bond yields and more pressure is expected to come over the coming months.

Ironically, such a rapid and remarkable fall in core government bond yields had even raised questions about the QE programme's full viability. However, these concerns recently eased on the back of the remarkable correction of bond markets. This piece addresses the topic of bond scarcity and market squeeze in light of current yield levels, especially among core government bonds, a topic which is likely to remain in market players' thoughts.

Draghi confirmed that QE will be fully implemented

As we have already outlined in previous publications, the size of the ECB's extended purchase programme is impressive as the ECB intends to buy €60 bn of assets every month (most of which will be government bonds) until at least the end of 2016, at a time when eurozone public debt is rising only slowly. This programme has already had a dramatic impact on sovereign bond yields and will have an even stronger impact over the next few months and quarters, when the market participants most likely to sell bonds to the ECB will have liquidated their exposure. The struggle to find sovereign bonds from some countries will be more intense than ever.

The ECB imposed some constraints on itself and the national central banks regarding the Public Sector Purchase Programme (PSPP): they can only buy central government bond securities (no subnational entities), the residual maturity must be between 2 and 30 years and the yield must be above the ECB's deposit rate, i.e. minus 0.20%. This limits the stock of securities eligible for the PSPP. These constraints will be highly problematic for German sovereign bonds as only 64% of German public debt is attributable to the central administration (a very atypical situation in the eurozone) and as German yields are already below minus 0.20% on the shortest maturities of the 2-30 year segment. The share of the German central administration debt held by the Eurosystem will be around 20% at the end of the PSPP. As a consequence, there will probably be a market squeeze on some segments on the eurozone fixed-income market: difficulty buying some securities, extremely low yields and possibly a significant loss of liquidity.

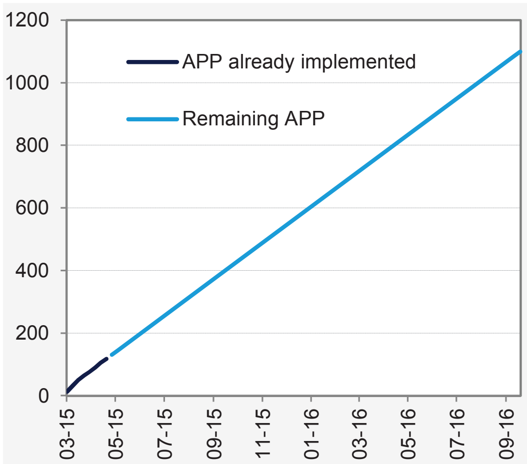
> "At the end of the PSPP, the Eurosystem will hold around 20% of the stock of German central government bonds"

The squeeze of the core government bond market and the very last correction: state of the art and the "what if" question

This being said, last week saw quite a rapid and dramatic rise in bond yields, not only in the Eurozone but in other advanced areas, too (US, UK, Canada, Australia, etc.). Profit taking, stretched valuations, rise of oil prices and partially easing deflationary fears are among most cited factors behind this remarkable move. To some extent, rising uncertainties on the back of stalling Greek negotiations exacerbated the natural "gravity" to which German yields appeared subject until few days ago. Bearing that in mind, however, end of April's numbers showed that more than 30% of bunds' market value was trading below the -20 b.p. threshold, the minimum yield target for the ECB's QE. Though 45% of German bund yields were already negative on January 21, the day before the ECB's QE announcement, no German bunds were yielding below this threshold on that date, yet!

The graph n°2 shows that, together with German government bonds, Finnish and Dutch government bonds also recently fell into the "non-eligible zone" before the recent correction, respectively with 13% and 8% of their overall debt outstanding. "What if" questions posed by journalists to Draghi in the latest press conference about the "scarcity" issue, therefore, arise from the assumed continuation of this trend over the coming months. The graph may be of some help to answer this question: a remarkable portion of core government bonds and agencies' and supra-nationals' QE-targeted securities was trading very close to the -20 b.p. threshold. To be more precise, 19% of German bunds, 27% of Dutch debt, 26% of French OATs and 18% of agencies and supra-nationals QE-eligible securities were yielding within 10 b.p. of the threshold. The overall value of this portion of debt represented around 21% of overall core government and quasi government bonds. When

1 Implementation of the expanded Asset Purchase Programme (APP), in €bn



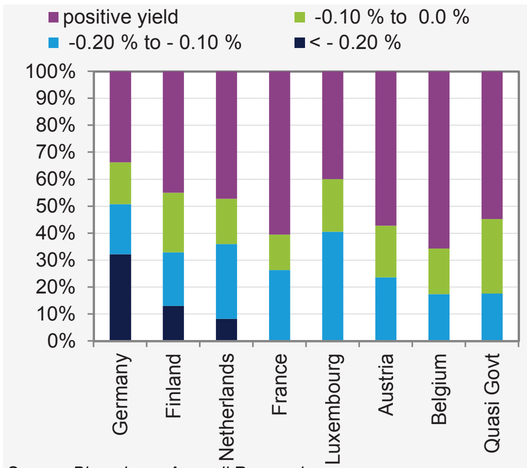
Source: Datastream, Amundi Research

we are writing, as of May the 6th, however, market conditions look quite different: the graph n°3 shows how the portion of bonds trading below the “non-eligibility” zone has halved in Germany (passing from 30% to 15%) and disappeared in Finland and the Netherlands. At the same time, the portion of bonds close to the threshold of -20 b.p. has fallen, too, from 21% to 11%. Therefore, in light of current repricing the issue of bond scarcity clearly eased. At the same time, if the yield squeeze goes on, Germany looks to be in the frontline in the process of moving to a “scarcity position” under the capital key rule, more so than other countries. The expected balance of supply and redemptions of German bunds, furthermore, means that Germany is one of the few countries least at risk of experiencing a growing outstanding debt. Keep in mind that at the beginning of May, only 10% of the extended Asset Purchase Programme (APP) has been implemented. Put another way, 90% of ECB’s QE has still to be implemented.

Therefore, what to expect?

Comparing the QE to a just-started marathon, Draghi underlined the ECB’s strong commitment to fully implement the entire programme, dismissing “tapering” scenarios. He rightly pointed out that concerns on liquidity and scarcity are “premature” at this stage, implicitly also dismissing that, depending on the programme’s effectiveness, these issues won’t have to be addressed in the future. To some extent, our reading is that the more the effective the program is in compressing yields, also thanks to expected net issuance trends, the more its implementation technicalities may need to be revisited at some point in the future. In this respect, Draghi outlined that, if needed, the design of the programme is flexible enough to be adjusted. Among eventual options, a further cut in the deposit facility was firmly excluded, but other adjustment options probably remain on the table: among them, revisiting some of the constraints, such as the maximum 25% limit for a single issue or a larger universe of high quality issuers. In terms of the latter, the ECB already somewhat answered the question in the last meeting, adding a new list of agencies to the QE universe for a total outstanding debt of around EUR 100 bn. In the meantime, let the QE proceed and do its job.

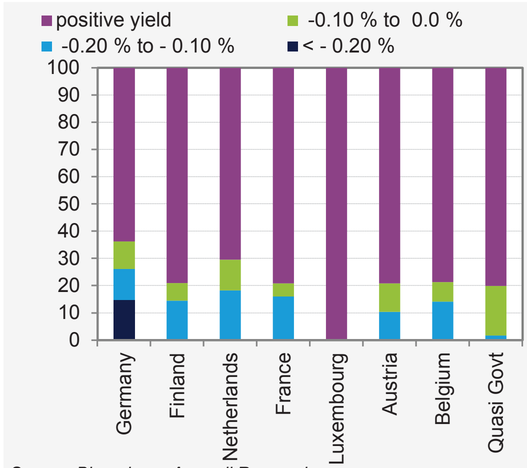
2 EUR core govt bonds: breakdown of outstanding debt by YTM, in % as of April 21st



Source: Bloomberg, Amundi Research

> 90% of ECB’s QE has still to be implemented

3 EUR core govt bonds: breakdown of outstanding debt by YTM, in % as of May 5th



Source: Bloomberg, Amundi Research

> Draghi underlined the ECB’s strong commitment to fully implement the entire programme

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