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A deep dive into ECB stimulus and its support for Euro fixed-income markets

March saw ECB increasing its PEPP purchases and injecting higher than expected liquidity through a successful TLTRO tender. In this piece, our analysis dives into QE recently published figures, demand/supply balance of Euro fixed-income markets and PEPP expected trends. ECB's role is going to remain prominent in supporting both sovereign and corporate debt.

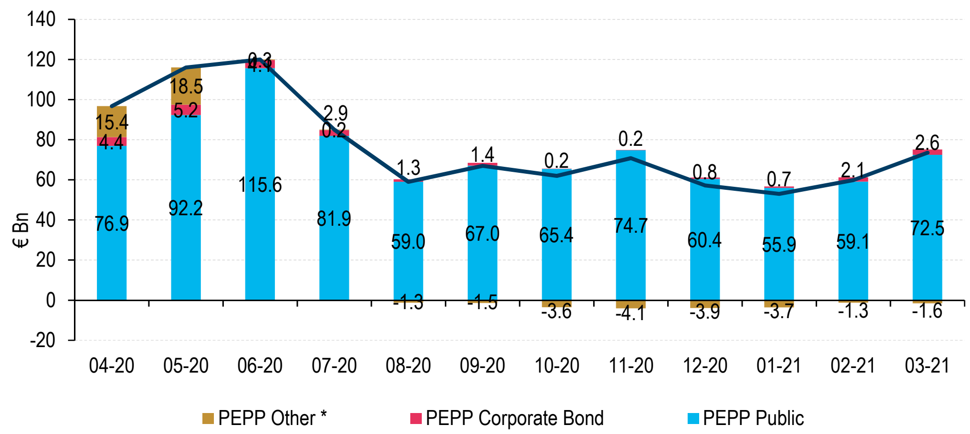
QE step-up and successful TLTRO tender to keep supporting fixed-income markets

1. Latest bi-monthly PEPP update: analysis of the numbers and main takeaways:

On 11 March 2021, the ECB announced that it expects "*purchases under the PEPP over the next quarter to be conducted at a significantly higher pace than during the first months of this year*". The chart below shows that, following the announcement, the pace has already increased in March with respect to January and February

Surprisingly, in the past two months, the ECB has increased its purchases of corporate bonds (€4bn over the two months), but this amount still accounts for less than 4% of PEPP purchases and barely exceeded commercial paper redemptions (€3.85bn). **We expect the ECB to keep buying mainly government bonds within the PEPP until the end of the program and**, if necessary, **to increase or decrease the allocation to private bonds in the APP**.

1/ **ECB monthly net asset purchases of PEPP breakdown (in €bn)**



Source: ECB, Amundi Research, As of 03/31/2021
* PEPP Other = commercial paper+cover bd

The important facts of this latest bi-monthly publication are the following:

- **Longer maturities bought in the past two months:** The weighted average maturity (WAM) of all public-sector bond purchases under the PEPP has increased by almost a year, probably above nine years in February-March 2021. The bulk of the increase in the duration of the PEPP portfolio was recorded in key countries, particularly in Germany and the Netherlands. However, the same trend has also been noted in peripheral countries, such as Italy and Portugal, previously registering a relatively steady decrease in average duration since the start of the program. The generalised increase in duration of ECB purchases probably has two main reasons: **(1)** The ECB "adapted" its demand to record supply of longer duration debt at the EGB level YTD. **(2)** Higher bond reinvestments supported the lengthening of German Bunds' average duration in the PEPP, on the back of increased redemptions of short-term paper bought last year and reinvested in longer instruments in recent months.
- **Country breakdown is almost in line with capital keys across all major countries:** as peripheral spreads are now hovering around their tightest levels of the past decade, the ECB has continued to follow capital keys in country allocations, with marginal deviations due to limited availability of bonds in smaller issuing countries like Estonia, Malta, Luxembourg, Latvia, Lithuania and Slovakia. As a result, the ECB underbought these countries relative to their capital keys, automatically implying slight overbuying in larger countries like Germany, France, Italy and Spain.
- **PEPP purchases of supranationals achieved its target:** For the second time in a row, supranational PEPP purchases have reached 10% of public sector bond volumes, the target set under the PSPP.

We expect the ECB to keep buying mainly government bonds within the PEPP and, if necessary, to increase or decrease the allocation to private bonds in the APP

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We anticipate that the ECB could increase its purchases of supranational bonds when NGEU funding activity begins (expected in late Q2 2021), supporting EU primary market activity through its demand

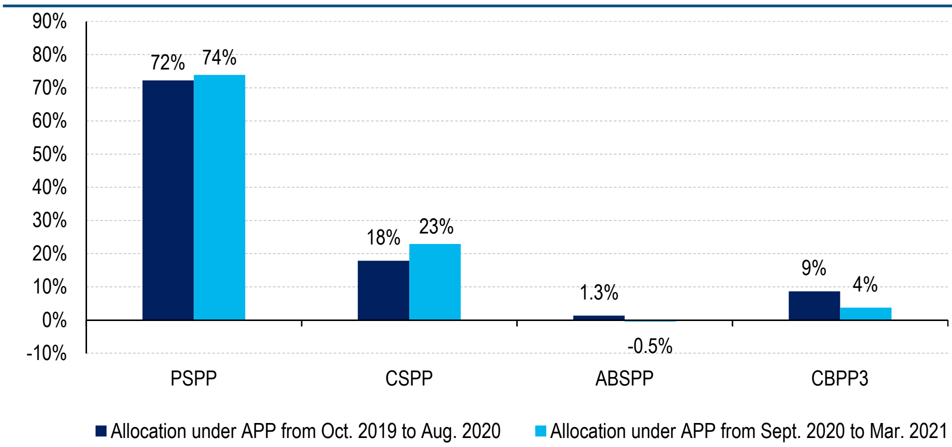
Purchases of supranational bonds were limited at the start of the PEPP, probably also because of their scarcity (the ECB was probably reluctant to hold more than 50% of these bonds). Nevertheless, since the start of EU issuance for the SURE fund (in autumn 2020), the ECB has gained more room for expanding its support to the asset class. **We anticipate that the ECB could increase its purchases of supranational bonds when NGEU funding activity begins (expected in late Q2 2021), supporting EU primary market activity through its demand.**

2. APP analysis: the focus on CSPP and the support for private programmes (mainly corporates)

In March 2021, the ECB's net asset purchases under APP increased to €23.3 billion from €21 billion in February. The breakdown by program in APP is as follows: PSPP (€15bn, 64.3% of the total), CSPP (€6.9bn, 29.8%), CBPP3 (€0.7bn, 2.9%) and ABSPP (€0.7bn, 2.9%).

Although the PEPP remains oriented towards the public sector, **the CSPP was weighted more heavily in the March APP** (up to 30% from 20% in February), confirming that the intensification of the PEPP may lead to a more "private-sector friendly" APP over the next few months. One of Lagarde's main commitments has been to maintain favourable financing conditions in all markets, including credit, and the ECB has so far achieved effective results. Euro credit spreads were quite resilient and also performed quite well during the March bond selloff. Subsequently, real EUR 10-year rates fell, thanks to the ECB's verbal intervention (while remaining higher elsewhere). The ECB put has therefore played a big role in reducing rate volatility in recent weeks. Due to strong corporate bond purchases, the ECB's exposure to European credit has increased over the past six months (see chart below). The average monthly Asset Purchase Program (APP) to Enterprise Sector Purchase Program (CSPP) allocation has increased from 18% between October 2019 and August 2020 to 23% from September 2020 to present. Euro credit spreads were quite resilient and performed well also during March bond selloff, with active primary market for speculative grade bonds supported by investors' flows. Technical factors are going to remain supported within the IG segment, also thanks to the recent slowdown in supply of corporate debt eligible for the CSPP: huge liquidity accumulated, higher volumes of bank loans and remarkable bond funding achieved last year are likely to prevent net issuance from growing as in 2020, ultimately improving the ECB demand/supply balance.

2/ **ECB has increased its exposure to credit since Q4 2020 via the APP**



Source: Datastream, Amundi Research, Data as of 03/31/2021

3. March TLTRO above expectations: main takes for markets and financials

Last but not least, the March tender was the second largest (€330bn) of recent TLTRO III operations, while market expectations pointed to a much lower take-up, with the highest estimates pointing to €250bn and a consensus closer to €100bn. The positive surprise is probably due also to the assumption of large participation by banks but with low take-up by bigger institutions. Our guess is that a higher-than-expected take-up signals that banks are probably confident about reaching needed thresholds in order to benefit from the lowest provided cost of funding, and are also therefore more confident in their credit lending trends over the coming months. The remarkable liquidity injection has had a positive effect in terms of additional monetary stimulus at work, indirectly supporting QE efforts on rates and yields, especially in curve front-ends. Our take is that IG financials' technicals should be more supported, as well, as debt supply is likely to be lower than previously estimated, on the back of higher reliance on ECB funding.

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EGB and corporate bond supply vs ECB purchases

- **Quite some progress in EGB funding achieved in Q1**

Q1 saw EMU-10 EGB gross supply record its second largest quarter since 2015, and, on a 10yr WAM-equivalent basis, a new record high, close to €460bn. Long maturities dominated EGB issuance, especially in syndicated issues. Moving from gross to net issuance, the picture looks even stronger vs previous years, despite Q1 tends showing a positive seasonality of net EGB supply, namely a combination of high issuance and low redemption volumes. According to our estimates, in fact, EMU-10 countries altogether placed more than €260bn net supply, quite a remarkable share (almost 50%) of the overall amount projected for the 2021, estimated to be in the region of €530bn, according to initial announcements. Despite remarkable differences in funding progress at country level, front-running activity was strong by historical standards, with peripheral countries (55%) in the lead, and core countries (45%) lagging but not far from the overall average.

Massive supply was favoured by many factors, still mostly at work, among them, very low funding costs, high volumes of liquidity available, yield search live and kicking, and ongoing support from ECB QE. Despite higher volatility in fixed-income markets, mainly imported by US Treasuries, the steepening of yield curves had only limited impacts on primary market activity, which also remained strong in March.

ECB QE and higher redemptions to support the technical picture, despite additional funding needs

According to numbers published by the ECB, combined PEPP and PSPP volumes covered a bit more than three quarters of overall sovereign net funding in the first three months of the year, therefore failing to absorb the entire net funding, as happened most of last year. Following this unusual quarter, we expect net supply, net of ECB QE, to return to negative territory. The anticipated increase in ECB QE over the next quarter coincides with a drop in net EGB supply, the latter not so much the result of a big drop in issuance amounts but mostly due to a significant increase in bond redemptions in Q2 vs Q1. EGB redemptions scheduled for Q2 and Q3, in fact, are almost double (roughly €200bn) the volume recorded in Q1. Assuming an increase of ECB demand of roughly €50bn in the next three months, this would mean a powerful combined effect of these two forces. Even assuming a return to a €60bn monthly path in Q3, higher redemptions alone should keep the balance in favour of negative net issuance in summer. At the same time, however, initial 2021 issuance plans are going to be revised upward on the back of additional fiscal measures recently announced in many countries in order to counter the negative impact of lockdown extensions. Although the picture is not yet complete and evolving, revisions in budget deficits for 2021 already announced, for example in Italy and Germany, are going to lead to higher net funding needs over the coming quarters. Comparing ECB firepower with numbers announced so far, however, the technical picture still looks quite favourable: as we outlined in previous publications, the "buffer" offered by the increased PEPP envelope vs eventual additional funding needs looks high for 2021. Even an increase in the range of €100-150bn of LT debt net supply would keep ECB QE firepower for 2021 in the ratio of 1.3 times overall net issuance.

- **Different scenarios for the PEPP path vs Q1 2022**

The ECB's QE program is expected to run until March 2022, but pandemic trends and post-Covid economic fragmentation in the euro area will likely prolong the needed support, also in order to make the NGEU more efficient. ECB firepower for the next 12 months looks enormous: €905bn (PEPP) + €20bn / month (APP) or around €95bn / month. If the ECB continues to accelerate

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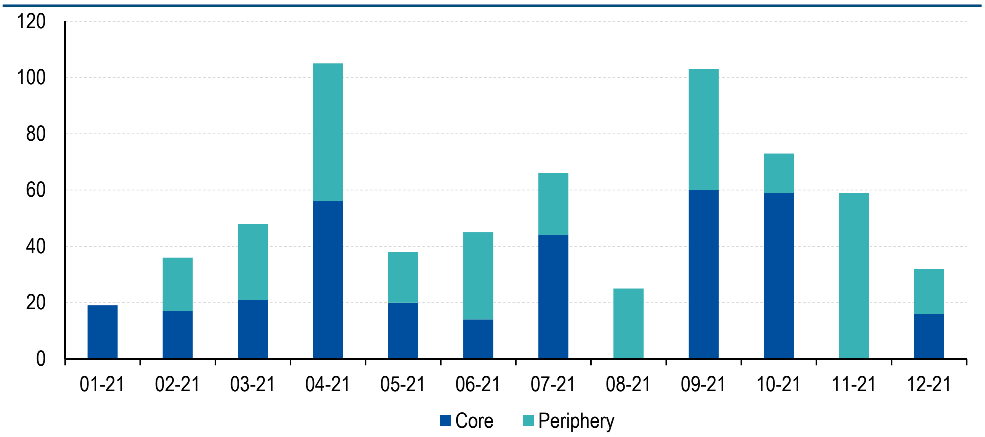
3/ **EMU-10 scheduled redemptions, in €bn**



Source: Bloomberg, Amundi Research, Data as of 03/31/2021

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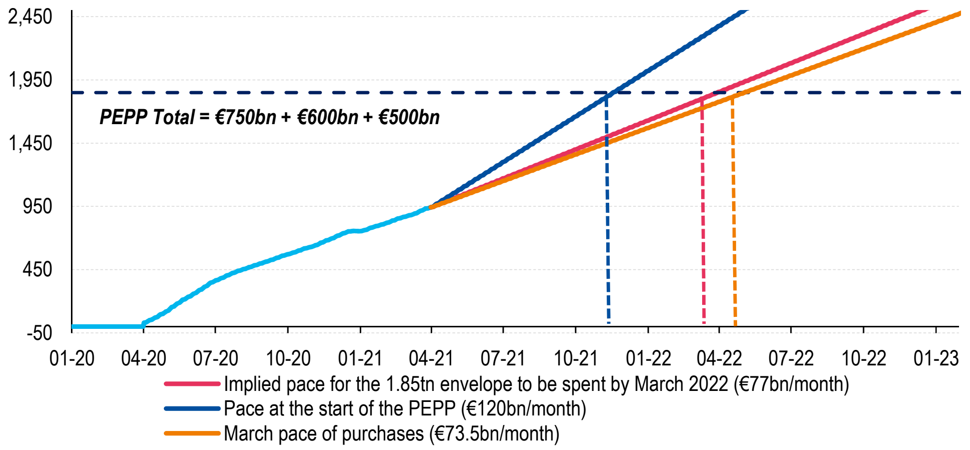
the pace of purchases, the PEPP envelope of €1,850bn could be entirely used up by March 2020. The chart below shows that a still relatively high average path (€73.5bn in March) could lengthen the horizon of entire PEPP use beyond 12 months.

4/ **ECB's PEPP cumulative purchases (€bn)**



Source: ECB, Amundi Research, Data as of 04/02/2021

Latest messages from the ECB's March minutes and what to expect over the coming months

What is clear from the minutes of latest ECB meeting is that the Council agreed to a quarterly review of PEPP path in the future, mainly based on developments of financial conditions and inflation outlook. Following the Q2 PEPP step-up, the market consensus points to a likely return to lower levels of purchases in Q3, probably back in the region of Q1 volumes of roughly €60bn per month. Although the debate about the assessment of "favourable financing conditions" still looks open within the ECB, the dovish stance keeps driving major policy decisions, like the extension/increase in PEPP at the end of last year and the more recent step-up in the PEPP path in Q2. This sort of step-by-step approach, confirmed by the quarterly review of purchases, is likely to proceed over the coming months, until a more structural decision will have to be taken about the size and horizon of monetary stimulus looking into 2022. Additional fiscal needs at country level this year and a recovery plan requiring a multi-year horizon to be deployed are good reasons to expect ECB dovish majority to prevail also in the future, although divergences are likely to increase inside the board as the economic recovery starts. In the meantime, over the coming quarters the technical picture for European fixed income markets will continue to be quite supported by ECB's increasingly prominent role in terms of both sovereign and corporate debt holdings. As long as economic fragmentation prevails in Eurozone, monetary policy has to keep targeting low funding costs of public debt, as fiscal stimulus, in presence of high deficits, may be effective only in such a stable financing environment. In the absence of a significant rise in growth expectations, the ECB will therefore keep preventing financial fragmentation.

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