Wide Angle Shot: ECB - Lost in Market Steering?

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The ECB now wants to limit "unjustified" yield/spread breakouts. Euro government bond markets had previously come under pressure in light of global market tensions and upcoming first ECB rate hikes. We see ECB in a delicate situation in the short and medium term: there is no unity within the institution, decision-making is slow and comprehensive market control is treading on thin ice. Especially since we currently do not see any drastic "fundamental distortions" of euro country spreads in the broader capital market context.

Rapid change of strategy in one week

At the beginning of June, at the ECB's regular interest rate meeting, the need for an **anti-fragmentation instrument (AFI)** was downplayed by the ECB. **Only one week later**, the **markets** have **forced the ECB** to a sharp **U-turn** or "emergency meeting" and a **signal** in the direction of **market resp. spread control**. We are skeptical about the ECB's quick turnaround as well as the then rather cautious concrete announcement last Wednesday. To sum up: At present, there seems to be **no consensus** within the **ECB** to commit to a comprehensive market control with possibly necessary surprise elements. And this despite the fact that the monetary policy turnaround and possible side effects or financial market stability risks have been a relevant topic at least since the turn of the year. In this respect, the mere announcement of a forthcoming AFI plus unspecified flexible reinvestments from the ECB's extensive bond portfolio was probably not enough to stabilize fixed-income securities markets.

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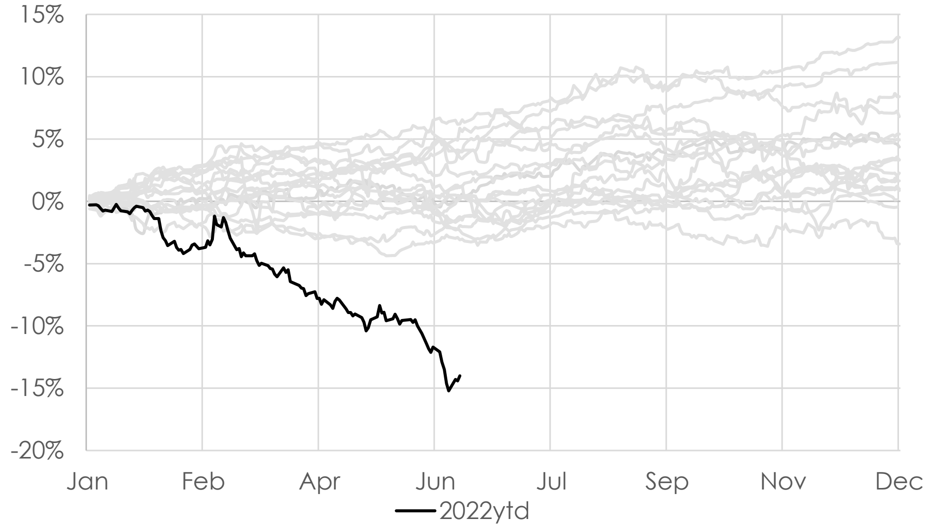
Chart 1 - EUR IG government bonds yearly total return 2005 - 2022ytd



**data as of 17 June 2022; Bloomberg Finance L.P., ICE BofAML, Raiffeisen Research*

Market steering - if, then properly!?

In recent years, the **ECB** has engaged in **much more extensive market steering** than, for instance, the U.S. Fed. The ECB has expanded its balance sheet much more significantly than the U.S. Fed, inducing more extensive market distortions. This is especially true in the highly fragmented **euro sovereign bond market**, where it has to some extent acted as an "**anchor investor**." On the one hand, the ECB has squeezed interest rates and capital market yields much more than the Fed, while at the same time actively tightening interest rates on risky securities (government and non-government). The exit from the ECB's ultra-expansive and unconventional monetary policy is now proving much more difficult. There have been warning voices for some time and therefore also discussions about a new bond purchase program (AFI) to limit sharp short-term spikes and widenings in financing conditions for sovereigns, banks and corporates.

From a **fundamental** point of view, the **planned reinvestments** from the former bond purchase programs (and especially if they are really flexible) **could certainly stabilize the European sovereign bond markets**. In fact, the reinvestment volumes on an annual basis in 2022 and 2023 correspond to earlier net new purchase volumes in times of quantitative easing. However, with its **wide-ranging market intervention**, the ECB has **stepped onto "thin ice"** where fundamental medium- and long-term trends are not always the only issue. The financial markets have obviously forced the ECB to react in recent days. It seems quite easy to position oneself against the ECB at the moment. Benchmark yields have already risen very sharply, and much of the distortion induced by monetary policy has already been priced out here. This makes it **easier to position** oneself **against the ECB** in spread transactions without taking on too much duration risk. This is facilitated by the fact that the ECB has already clearly communicated several times that too large yield differentials in the euro area are not tolerable from a central bank perspective or in terms of the effectiveness of monetary policy transmission. Now market participants are testing the ECB.

When a central bank engages in wide-ranging market intervention, we think it makes sense — if necessary — to act quickly and decisively. It is all the more **surprising** that the **ECB** was only able to **present a half-baked solution** at its special or "emergency" meeting last Wednesday (see press release). The latter shows that there are **apparently still** very extensive or fundamental **differences of opinion within the ECB**. In other words, it is apparently not fully accepted in all euro central banks that the ECB has developed more in the direction of an "Anglo-Saxon" central bank in recent years respectively that it is no longer clearly a successor institution of the Deutsche Bundesbank. Although regulatory policy considerations are made, they are apparently no longer always in the foreground. In this respect, the latest action is not only disappointing for the markets, but also shows that **there is no comprehensive monetary and economic policy consensus** within the ECB or among the euro central banks. On the one hand, this shows that the revision of the ECB's monetary policy strategy (frantically completed a year ago) may have been less consensual. There seems to be no consensus on how far and how exactly unconventional monetary policy is really permanent. On the other hand, **this does not bode well for a** probably coming and **inevitable AFI**. We think that such an instrument could turn out to be rather too cautious from a market perspective. In the coming days, we also expect some diverging wordings from ECB representatives, while the AFI should already be in place by the time of the ECB Forum in Sintra (June 27-29), for instance, or by July at the latest for the first rate hike; which would certainly be a sporty schedule.

The cocktail of (monetary) policy tensions in Europe, in the ECB, the possibility of hesitant and suboptimal solutions in combination with nervous global fixed income markets and speculative opportunities against the ECB should, in our view, not particularly calm the European (sovereign) bond markets for the time being. In this respect, we continue to expect some market uncertainty. In addition, the "Karlsruhe factor" must be taken into account.

How strongly does the Karlsruhe factor shape the ECB's actions - and what is the way out?

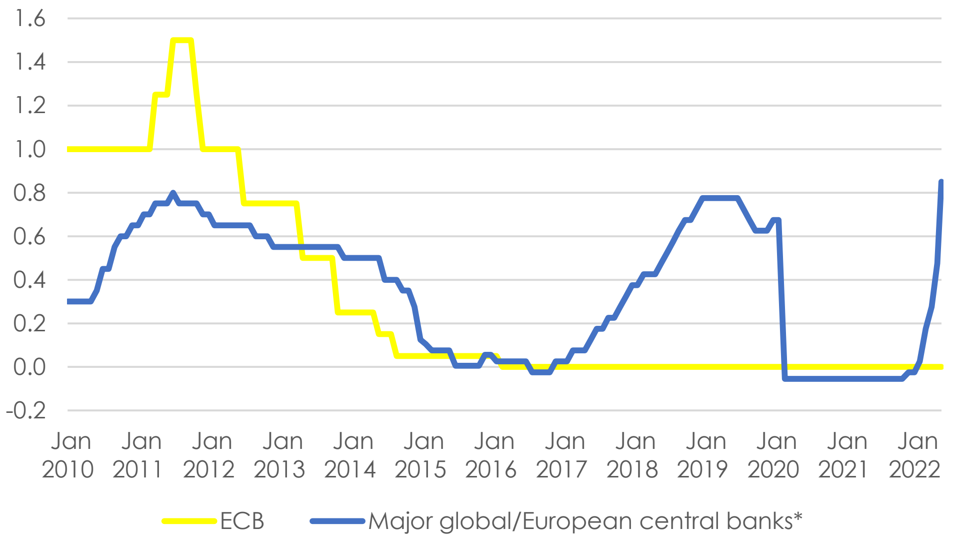
In recent years, certain **hurdles** have been imposed on the ECB by **lawsuits** at the **German Constitutional Court** (BVG) in Karlsruhe. The important message from Karlsruhe (since 2020) is: ECB action must comply with the so-called proportionality (**see on this**). This is especially true with regard to bond purchases or unconventional measures (such as the PEPP, see a post by ECB Executive Board member Isabel Schnabel on the ECB blog: Necessary, suitable and proportionate). Therefore, the ECB's room for maneuver today is much smaller under Ms. Lagarde than it was in the last decade and under ECB President Draghi.

In this respect, it was clear that **limits are hereby imposed on the ECB** with regard to an AFI and that comprehensive monetary stabilization measures have to be justified very thoroughly. It is therefore all the more interesting that the ECB, despite recognizable but rather moderate market tensions, convened an emergency meeting quite quickly and put concrete action on the table. After all, the **Italy spread**, for example, has behaved more like comparable securities in recent weeks (see also Fixed Income Market view later), there were **not necessarily country-specific trends**. Moreover, from a fundamental perspective, a new euro crisis or sovereign debt sustainability crisis is rather far away. In this respect, the **ECB** has simultaneously **put itself under pressure to move and justify**, but then also failed to deliver pragmatically. Markets are disappointed and any necessary policy consensus on the **AFI** could lead to “too little or too less”, taking into account the “**BVG factor**”. Also, the imposals could even lead to the market stabilizing factor being rather small. For instance, the ECB could actively sell “safe” government bonds and buy spread-bearing government bonds in exchange in order to play on the “BVG mitigation factor” to avoid expanding the total holdings of government bonds. In our view, such a policy mix would not necessarily lead to relief in terms of financing conditions and would include extensive redistributive elements. After all, in the course of the PEPP, it was suggested that temporary deviations from the capital key should be straightened out in the long term, which argues against selling off "safe" government securities. Moreover, selling pressure on benchmark yields could run counter to the AFI intention.

We think the **ECB could justify the appropriateness of** upcoming interventions under an **AFI** on the basis of the **need to safeguard monetary policy normalization** or tightening for the euro area as a whole (which the ECB has failed to do in the last decade) and a **possible time limit** (about half the duration of unconventional monetary policy under

APP and PEPP at most, i.e., about 3-4 years at most) in the context of **special market circumstances** (such as a monetary policy turnaround and a special global inflation situation). Better than actively selling bonds of the core euro countries (and moving further away from the capital key!) would be, in our view, to absorb **newly created liquidity** (pro forma). At present, however, an AFI cannot be permanent either! Otherwise, the economic governance of the Eurozone (including the OMT and the ESM) would be finally brought to a halt. The BVG could probably not simply agree to this.

Chart 2 - Key rates: ECB vs. other central banks (%)



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Hectic at the start of the cosmetic monetary tightening cycle - what is the ECB doing during QT?

Ultimately, the **markets** have already **put pressure on the ECB before the start** of a rather cautious monetary tightening cycle compared to some other global or European non-EUR central banks. And after all, the ECB is **clearly not yet about** an outright unwinding of unconventional monetary policy (**quantitative tightening**). At present, the ECB is "only" concerned with moderate key rate hikes from the zero interest rate range, while real interest rates (also for so-called southern euro countries) remain deeply negative. The ECB has not yet made any announcements regarding the reduction of unconventional monetary policy beyond the long-term refinancing operations for banks in the euro area.

However, this also means that the **ECB is currently even actively playing with a certain degree of market uncertainty**, for example with regard to possible follow-up transactions for the long-term refinancing operations (LTROs). Since the ECB is currently playing with the markets and apparently deliberately leaves them in uncertainty or wanted to leave them in uncertainty (until last Wednesday also with regard to an AFI), the financial markets have already de facto confronted the ECB with a "yield taper tantrum". From this perspective, it is rather critical that the **ECB has allowed itself to be put under pressure so quickly without** having any **counter-reactions ready.** But this also makes it clear that the ECB will probably not succeed in substantially and actively reducing its balance sheet in the coming years. The path to quantitative tightening seems to be permanently blocked for the ECB. In our view, this must be taken into account in a possible AFI and its duration.

Spread management: OK in the short and medium term, not in the longer term - AFI, OMT and ESM?

In our view, the **AFI** should be designed in such a way that it **does not simply become permanent** and **does not apply unquestioningly to every euro area country**. In this way, the ECB could consider itself in safe territory in the event of a proportionality test. Moreover, precise control of asset prices (and spread caps for government bonds are price limits for government bonds) is an undertaking that needs to be questioned. After all, fine-tuning the fundamentally justified level of a country spread is different from managing benchmark interest rates in the money and capital markets, where there are more valid concepts for fundamentally sensible targets. However, **country spreads** are usually the **result of complex and interacting factors**, including country-specific economic risks, global risk premiums or political trends in a country. At the same time, a **certain limitation of the AFI** would **leave the path to OMT and ESM** open at a later stage of monetary policy normalization and in the event of clearly country-specific risks.

At present, it is still understandable and justifiable not to rely on these policy instruments. After all, **in the first stage of monetary policy normalization** after a **decade of very active monetary policy** management of the financial markets with the ECB as the "anchor investor" in some market segments, one **can place some responsibility on the ECB to make this exit meaningful**. However, recent market tensions also unfortunately show that the phase of ultra-expansionary monetary policy was not used and the generous NGEU package was apparently not effective enough from the perspective of financial market participants **to sustainably mitigate macro-financial (debt) risks in some euro countries.** If the ECB were to commit to long-term or permanent spread control, we believe this would require a comprehensive consensus, and we do not see this at present. In this respect, we think that OMT and ESM will have to remain in play, despite an AFI.

The fixed income investors- & market perspective

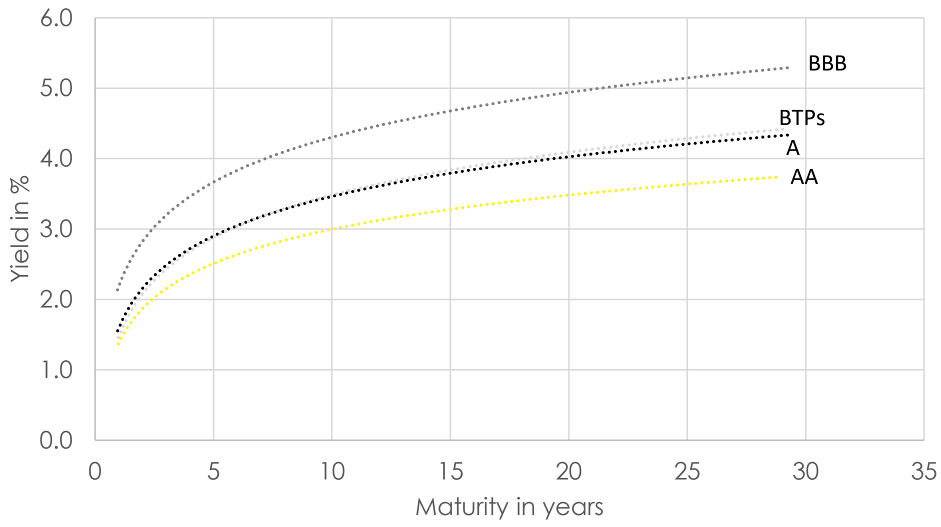
While the **ECB** speaks of **(fundamentally unfounded) speculation** when it comes to the **widening of EUR country spreads,** we believe that this can also be viewed differently. The market is doing exactly what the market is supposed to do. It uncovers weaknesses and tries to exploit them as profitably as possible. If the **largest European fixed income investor (ECB)**, whose **market share has grown steadily over the past decade, decides to keep its market volumes constant** for the next few years and not to grow any further, this will almost automatically have an **impact on the market and the risk sentiment.** Consequently, risk premiums inevitably rise as well. Of course, this factor weighs even more heavily when the investor is the central bank, which is not price-sensitive.

Thus, the question inevitably arises as to which market shift is or was unnatural here. The ECB, as a **non-price-sensitive investor with a market share of up to 40%**, has undoubtedly induced significant distortions in the EUR fixed income and EUR credit markets. At the same time, the massive bond purchase programs in combination with the negative/low interest rate policy and the attractive TLTRO conditions (refinancing opportunities for banks) have led to a situation, where Europe and the **European financial markets** now seem to be **dependent on cheap money and permanent central bank financing.** It seems to be the same as with any "addiction": Withdrawal is only possible with severe complications. A first interest rate step of 0.25% with a one-month lead time, including reinvestment of all purchasing programs, does not seem to us to be "cold turkey" style, but rather a slow deprivation. But it seems that even this slow deprivation has already failed, as the ECB has just issued a work order for a new "anti-fragmentation instrument" (AFI) after its special meeting last week, which is supposed to limit sovereign bond spreads in the euro zone.

Here we are at the topic: What is understood (in ECB circles) by fragmentation? And above all, at what point does one speak of an **overreaction of the market** or an unjustified fragmentation, which is driven by speculation? All of this is likely to be **difficult to measure**. However, it should be clear that the yield/spread levels of recent years have certainly not always reflected the different credit ratings, budget policies and fundamentals of the euro countries. For example, we cannot simply agree with some **Italian statements** that see a fundamentally fair yield **spread between the Bund** (German government bonds) and **BTP** (Italian government bonds) at 100 to 150 basis points (bp). In the current market phase, this reflects rather less the fundamentals nor the credit rating levels nor the **relative market pricing**. In the case of BTP to Bund, for example, the relevant comparison here would be between a weak investment grade rating (BBB), with a downside risk (!), and Germany (which holds the highest credit rating, AAA).

If we look at the **current yield levels in a peer group comparison**, we see that **Italy** is **rather fairly or possibly even rather expensively valued** and thus a market overreaction (in terms of yield levels) is not (clearly) given. If we compare Italian government bonds with corporate bonds, their yields are even well below (positively for Italy) their actual rating peer group. In terms of ratings, they are more on a par with companies in the A-rating range, i.e. at the same level as companies with an average credit rating that is 3 notches better. In this respect, one can even say that the **euro government bond market continues to be generously priced** or is characterized by market distortions in favor of the issuers/euro countries.

Chart 3 - Yield comparison BTP vs corporate bonds per rating bucket



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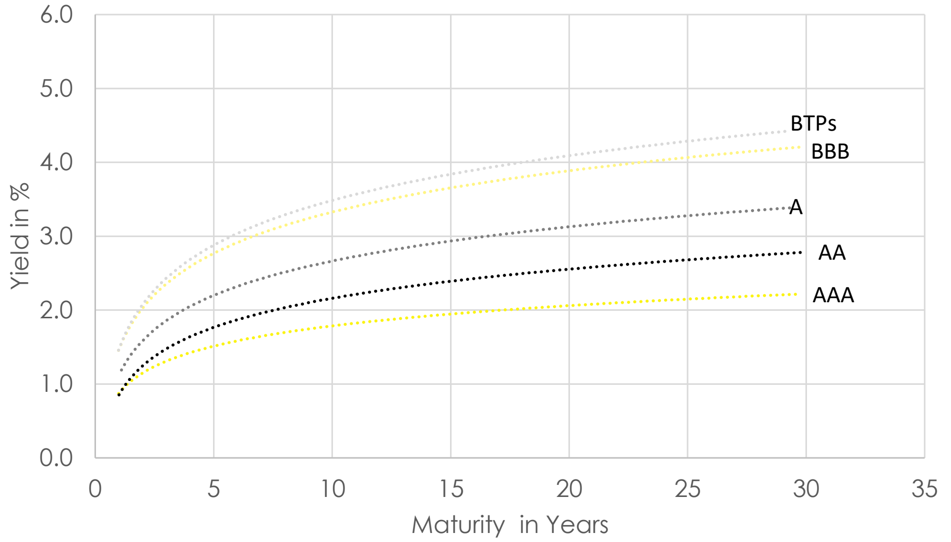
If we compare **Italian government bonds to government bonds of a peer group**, we see that they seem to be **fairly priced** and are very close to the rating peer group. However, it should be noted that Italy forms the bulk of the rating peer group. This is only supplemented by Portugal and Cyprus. Fundamentally, Cyprus seems more suitable as a comparison, and they are quoted at the same level as Italy. Considering Italy's above-average debt ratio, the prospect of higher refinancing costs and their effects, this rating also seems rather "Italy-friendly". We even leave political risks out of the equation for the time being, and in this context, a slight risk premium seems to make sense in the case of Italy.

Chart 4 - Yield comparison government bonds per rating bucket



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All in all, **we do not see a clear market "overreaction" at present**, but a rational price development. However, in our opinion, this could have been slightly more moderate if the ECB had acted differently in recent months. Some unfortunate appearances, forecasts that are difficult to comprehend and some "clumsy" communication mean that the **ECB is currently perceived by the market as a rather "weak"** central bank. This accelerates market adjustments and contributes to investors trying to exploit this weakness as profitably as possible. The market was also visibly disappointed that the ECB seemed to be surprised by the effects of its actions on the one hand and that it apparently did not have a coordinated plan B in the drawer, as outlined above, on the other. From our point of view, the reinvestments (in case of doubt even announced early reinvestments) including clear communication would have potentially been enough to get the markets to agree in a "friendlier" way. But this shows that the ECB is currently rather weak when it comes to market control.

However, the problem started earlier. In our view, the ECB would have had the opportunity to underline its strength in advance with a **proactive policy** regarding **TLTRO III** or possible **alternatives/successor transactions** and thus not become a **plaything of the markets**. For example, the announcement of a green TLTRO, as mentioned in the last press conference, would have been appropriate already at the end of 2021. On the one hand, this would have shown that the ECB holds the reins in its own hands and, on the other hand, it would have spared itself the fact that many European (major) banks are currently sitting out the TLTRO maturities (partly in government bond positions) and future refinancing cliffs are almost inevitable. Thus, the ECB is now almost inevitably pushed into a new TLTRO.

In our view, the **ECB's "new" AFI program** should help to lower or stabilize the yields of the euro sovereigns with weaker credit ratings in the medium term. The decisive factor is likely to be the design. The **question** will be whether the new instrument can really **help** the **euro countries to slowly deprive** themselves off (permanent) **net new purchases** of government bonds **or** whether this will not lead to the game starting all over again and the ECB **finally finding no way out of permanent asset and bond purchases.** Should the new AFI program, as often discussed, provide for **spread caps**, we would regard this as a **final departure from the (free) capital market**. This would ultimately open the door to so-called **"financial repression"** (in the sense of politically controlled money and capital market interest rates in nominal and/or real terms). In addition to country spread caps, we would then perhaps also be a little closer to yield level control.

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