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ECB: ANOTHER EUR1.6TN IN QE TO REACH THE LIGHT AT THE END OF THE TUNNEL

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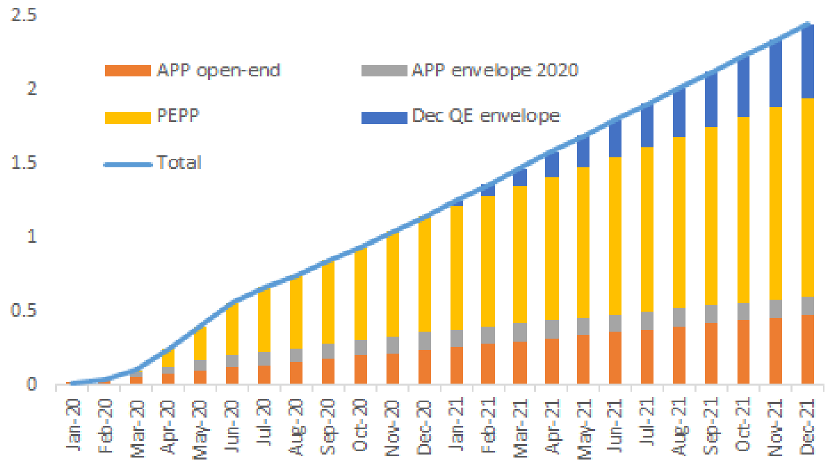
The ECB's December dilemma: Recalibrating the policy response so that it is bold enough in the context of subdued short-term prospects but flexible enough to respond to potential upside risks to the outlook for 2021 and beyond. At the October policy meeting – the week that France and Germany renewed national Covid-19 restrictions following a spike in infections – ECB president Christine Lagarde pre-committed to boosting the monetary policy response come December, arguing that more visibility on the macroeconomic front would allow for an optimal recalibration of the policy stance. The positive news that has since emerged on the vaccine front will not fundamentally alter that plan, but it will influence the parameters of the December policy decisions. After all, while vaccine breakthroughs will have no sizeable impact on the immediate short-term outlook, downside risks to the outlook for economic growth and inflation in 2021 and beyond have notably reduced as a result. Hence, the ECB's December decision will be all about striking a balance between a bold policy response that continues to put a firm lid on sovereign and private refinancing costs, while at the same time allowing for sufficient flexibility in case upside risks to the macroeconomic outlook materialize as soon as the second half of 2021.

On the asset purchase front, the ECB – applying key lessons from the pandemic management playbook – should opt for a big and bold announcement next week. After all, it needs to reassure markets that it has set aside enough ammunition to provide a backstop for an adequate fiscal response to the pandemic. With borrowing costs in many Eurozone countries at record lows, the key focus of the ECB should be on cementing and extending these favorable conditions in the context of a more protracted economic crisis. So, how much are we talking about? Given the high uncertainty around what QE dose is needed – since it depends on several moving puzzle pieces, including the speed of the economic recovery and the fiscal policy response, as well as market conditions – the ECB should rather err on the cautious side. We think a December QE top-up to the tune of EUR500bn should do the trick. After all, this would allow it to also maintain in 2021 the average monthly asset purchase pace of EUR110bn it has set since March , when added to the EUR20bn in monthly Asset Purchase Program (APP) purchases and the expected unspent Pandemic Emergency Purchase Program (PEPP) powder of around EUR600bn as of end-2020 (Figure 1). In practice, this will mean increasing the ECB balance sheet by another EUR1.6tn in QE purchases in 2021, bringing the total spent on asset purchases between March 2020 and December 2021 to a cool EUR2.4tn.

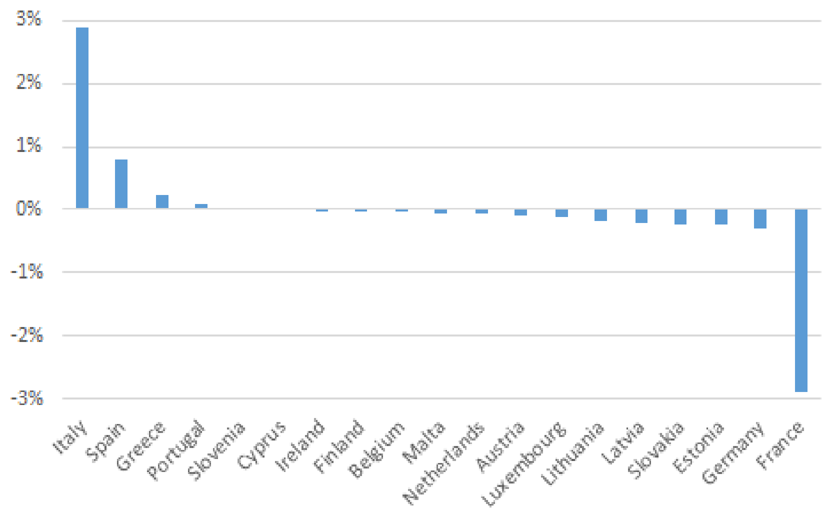
Figure 1 – ECB asset purchases under PEPP & APP (EUR tn)



Sources: Refinitiv, Euler Hermes, Allianz Research

How to spend it: The EUR500bn QE top-up should come in the form of an envelope to be deployed in a flexible manner across time and policy tools. Flexibility is key when it comes to implementation. First of all, the QE reload should not be understood as a target for but rather a cap on asset purchases. After all, the "threat" of a sizeable QE envelope to be deployed at any time to put out fires in bond markets has, in our view, a greater spread compressing impact than a set monthly pace of asset purchases. In fact, we think the ECB may end up spending only 80% of the flexible components of its asset purchase program by end-2021 as a result. Second, the QE top-up should be spent across the APP as well as the PEPP, as deemed most appropriate in the coming months. In September we argued that the traditional QE program's role in the ECB's monetary policy response should be upgraded going forward as the sense of an emergency had abated. After all, in the context of a return to normalcy, the APP could be put back in charge, with the flexibility inherent in the PEPP only used to a limited degree – as the very contained divergences of PEPP holdings from the capital key suggest. (Figure 2)

Figure 2 - Public sector securities holdings under PEPP (% of total vs. capital key in %)



Sources: Refinitiv, Euler Hermes, Allianz Research

However, the renewed wave of Covid-19 restrictions that has since swept across Europe instead also helps justify reloading the PEPP's powder keg. Given the high uncertainty surrounding the outlook, in our view, the ECB would get the biggest bang for its buck if it opted for some constructive ambiguity and put forward a flexible QE envelope filled with EUR500bn to be spent on the asset purchase program deemed most appropriate at the time. For instance, it could initially continue with average monthly PEPP purchases to the tune of EUR 80bn as Covid-19 restrictions are likely to remain elevated in early 2021 to avoid a third wave and in turn a triple-dip, only to then revert to higher APP purchases in the second half of 2021 as the recovery gains traction. To better navigate the looming APP limits (i.e. the issue(r) limit), we expect the ECB to aim for a higher share of supranational bonds, which would also be desirable by providing more support to issuance plans at the European level.

In light of concerns about how the market may digest such an innovative flexible QE envelope, the possibility that the ECB may in the end solely opt for a boost to the PEPP or allocate fixed separate amounts to the PEPP and the APP instead cannot be excluded (our best guess would then be for EUR380 bn vs. EUR120bn respectively).

Meanwhile we would not advise the ECB to drop the key principle of market neutrality and increase the maturity of bonds purchased under QE or extend the reinvestment horizon to further compress long-end yields. Instead the ECB should consider an extension of the time horizon for flexible QE purchases (APP & PEPP) beyond end-2021 as we currently anticipate, to demonstrate a firm commitment to an accommodative policy stance while at the same time retaining policy flexibility.

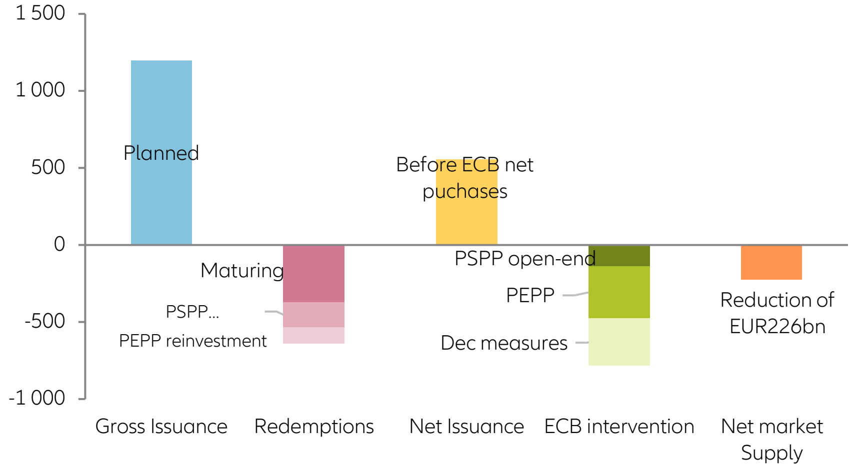
Reinforcing support for the banking sector, where the worst is still to come. Next to providing a credible backstop to Eurozone governments' fiscal responses, the ECB will also have to reinforce its support for the banking sector. After all, just as 2020 was all about tackling liquidity risk, 2021 will be all about mitigating credit risk. Once again monetary policy is not in the policy driving seat here; rather it's up to more fiscal support, for instance via governments extending state-guaranteed loans, and further regulatory forbearance that helps address the rise in NPLs and capital concerns, to make a real difference. But even if recalibrating TLTROS is unlikely to boost lending by much, at least on the margin it would help soften the expected tightening in credit conditions (as indicated by the ECB's Q3 Bank Lending Survey), which is likely to be triggered by rising NPLs, and in turn could help reduce the risk of a credit crunch. Hence, next week we expect the ECB to announce additional tender operations and to make the conditions more generous. There are many options when it comes to tweaking the TLTRO modalities; however, we think in particular (i) a lengthening of the period in which banks can borrow at the most favorable rate to end-2021, (ii) an increase in the borrowing allowance and (iii) an extension of the TLTRO maturity from three years to four to five years would go a long way in cementing the favorable access to funding.

THE MARKET IMPACT OF THE ECB'S COVID-19 POLICY RESPONSE

The ECB's continued bond-buying spree will see the sovereign debt market supply continue to shrink in 2021 despite another record-year of debt

issuance. Gross issuance of long-term[1] Eurozone government bonds (central government) in 2021 should remain close to this year's record level of EUR1.2tn while net issuance should reach EUR550bn. This would correspond to a 7.5% increase of the outstanding volume.

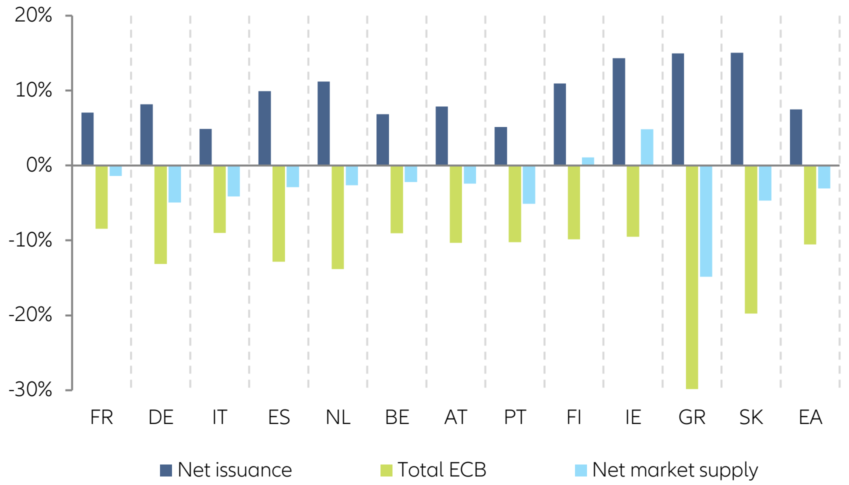
Figure 3 – ECB will again strongly reduce net market supply of Eurozone government bonds in 2021 (supply components in EUR bn)



Sources: National debt agencies, Refinitiv, Allianz Research

However, taking into account the expected ECB bond purchases and assuming that the expected December envelope of EUR500bn will be fully exhausted, the 2021 net market supply will not increase but instead shrink by EUR225bn (see Figure 3). So while the outstanding volume of long-term government bonds will increase by 7.5%, net market supply will be down 3% on the back of a 2% decline in 2020. According to our estimates, the country with the biggest ECB-induced supply reduction will be Greece (15%), thanks to its inclusion in the PEPP. Meanwhile, for the four Eurozone heavyweights, net market supply looks set to decline by 5.0% for Germany, 1.4% for France, 4.1% for Italy and 2.9% for Spain (see Figure 4).

Figure 4 – Evolution of net supply of long-term central government bonds in 2021 (in % outstanding volume)

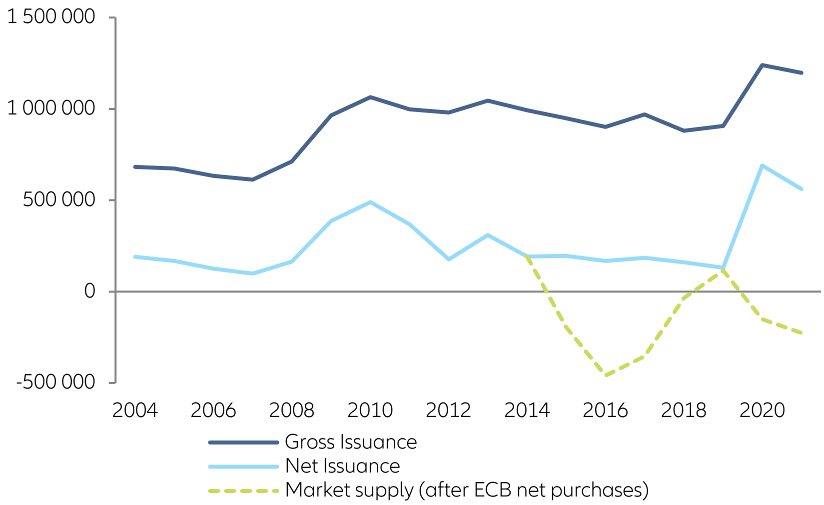


Sources: National debt agencies, ECB, Refinitiv, Allianz Research

[1] Maturity at issuance larger than 12 months

The ECB impact on 2021 supply flows is relatively smaller than in 2016 as QE and debt issuance have grown in lockstep. The overall decline in net market supply will remain well below the peak of 2016 when it slumped by EUR460bn or 7% of outstanding volume. This means that although being at record levels in absolute terms, ECB net purchases exert and will exert a relatively smaller impact on the supply flows of Eurozone long-term government bonds compared to earlier QE episodes. This can be explained by the fact that this time - unlike in 2015/2016 - government bond issuance and central bank net purchases have increased hand in hand. Indeed, gross bond issuance will be 2.5 times higher in 2021 compared to 2016 (see Figure 5).

Figure 5 – Reduction of net market supply will be less powerful compared to 2016 (in EUR mn)



Sources: National debt agencies, ECB, Refinitiv, Allianz Research

The Eurosystem is on course to hold up to 50% of long-term Eurozone sovereign bonds by end-2021. However, when it comes to the structural impact of QE on sovereign bond yields it is not the impact on flows that prevails but the impact on stocks. In other words, the share of outstanding government bond volumes held by the ECB (i.e. the Eurosystem). With the increase of PSPP and the launch of PEPP the ECB has massively altered the holding structure of Eurozone government bonds, operating a major shift from private investors to the central bank. Given the current dynamic between net issuance and net QE purchases, we think that the Eurosystem is on course to hold almost 50% of Eurozone long-term sovereign bonds by the end of 2021. In general, the higher the central bank's share of the government bond stock, the stronger the reduction of net market supply, the stronger the downside pressure on yields with a flattening slope effect (duration extraction).[2]

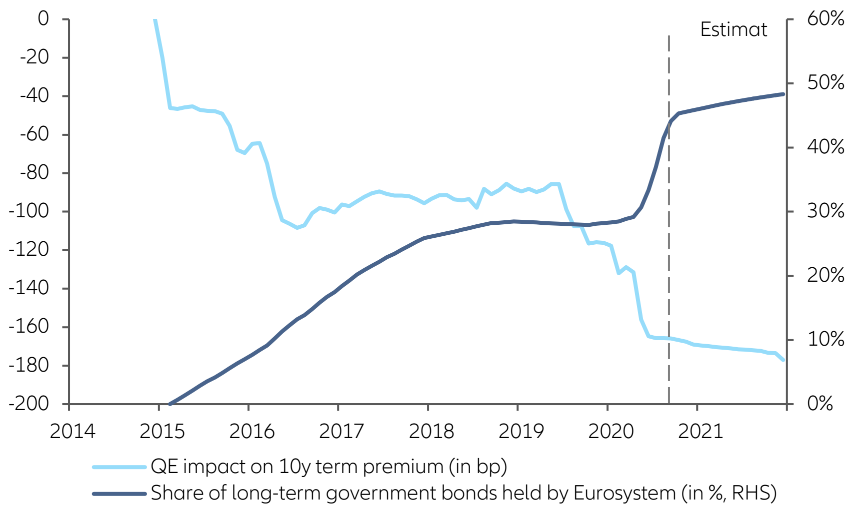
The dampening effect of QE on Eurozone long-term sovereign yields could reach up to 180bp in 2021, limiting the yield upside. Currently we estimate the yield compression for the 10y Eurozone benchmark at 165bp. For this analysis we use the same model as the ECB[3], knowing full well that other

[2] See our detailed report on duration extraction: The big compression: The erosion of duration risk

[3] Eser, F., Lemke, W., Nyholm, K., Radde, S. and Vladu, A., 2019. "Tracing the impact of the ECB's asset purchase programme on the yield curve," Working Paper Series 2293, European Central Bank.

term structure models come up with results that are about half this value. According to this model, if the Eurosystem's sovereign bond portfolio's duration is maintained at the current level (7.1 years for PSPP and 6.9 years for PEPP), the QE-induced yield compression could rise to 180bp by the end of next year (see Figure 6). In that context, even if some inflation repricing in terms of levels (inflation expectation) or volatility (inflation risk premium) might occur next year with the economic recovery unfolding, the yield of 10y German Bund may hardly rise above the -0.50% threshold.

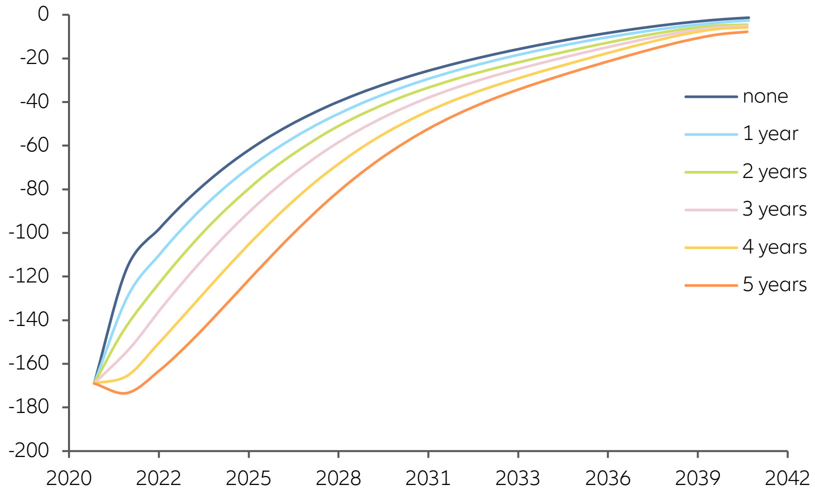
Figure 6 – Supply reduction less strong than in 2016 (in EUR mn)



Note: using a 3 years full reinvestment period based on the model by Eser et al. (2019)
Sources: ECB, Refinitiv, Allianz Research

The impact of the Covid-19 crisis on Eurozone yields will be felt for more than a decade. This compression effect is here to stay, being structural by nature. Indeed, even if the ECB would at some point taper or even end sovereign bond net purchases, a multi-year phase of full portfolio reinvestment would likely still follow to avoid monetary conditions tightening too fast. Our calculations suggest that if the ECB stopped buying bonds today and did not commit to reinvestment, 10y yields could rise up to 70bps within 12 months. Meanwhile a full reinvestment period of three years would contain the upward pressure at 20bps only. We also see that it will take around 10 to 15 years for the dampening effects to become insignificant. This means that even when the Covid-19 crisis is eventually over, the monetary policy response to this crisis will leave a long-lasting mark on Eurozone sovereign bond markets (see Figure 7).

Figure 7 - Impact of current sovereign bond holdings of the Eurosystem on the 10y term premium in different reinvestment scenarios (in bp)



Note: based on Eser et al. (2019) using current weighted average maturity
Sources: ECB, Allianz Research

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