# ECB preview

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## QE expansion likely to press Euribor rates lower

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The main message by President Lagarde on Thursday is likely to be that the Governing Council is fully prepared to further increase the asset purchase programmes and that the ECB is using the full flexibility of the Pandemic Emergency Purchase Programme (PEPP) to address the recent increase in the Euribor rates and intra-euro spreads. We foresee larger purchases in short bonds in coming weeks to push the Euribor fixings slowly lower. On Thursday, we expect the ECB to announce the eligibility of fallen angels in the asset purchase programmes, similarly to what it did for the collateral requirements. Speeding up asset purchases towards the summer would pave the way to an increase in the PEPP purchases, possibly in June. We continue to hold on to our Jun20 vs. Dec20 euribor curve steepener.

### New QE measures unlikely on Thursday

At its meeting on 30 April, we expect the ECB to:

1. Reiterate that the Governing Council is fully prepared to increase the size of its asset purchase programmes and adjust their composition by as much as necessary and for as long as needed.
2. Emphasise that it can increase purchases of very short dated instruments (T-bills and CPs) under the PEPP programme in order to mitigate the rise in the short end yields and Euribor rates.
3. Make some below investment grade securities eligible for asset purchases, in line with the recent similar change concerning the eligibility of fallen angels as collateral from banks in liquidity providing operations.

Following the introduction of new asset purchases over past weeks, we believe it is unlikely that the ECB will announce an explicit increase to the existing QE programmes already this week.

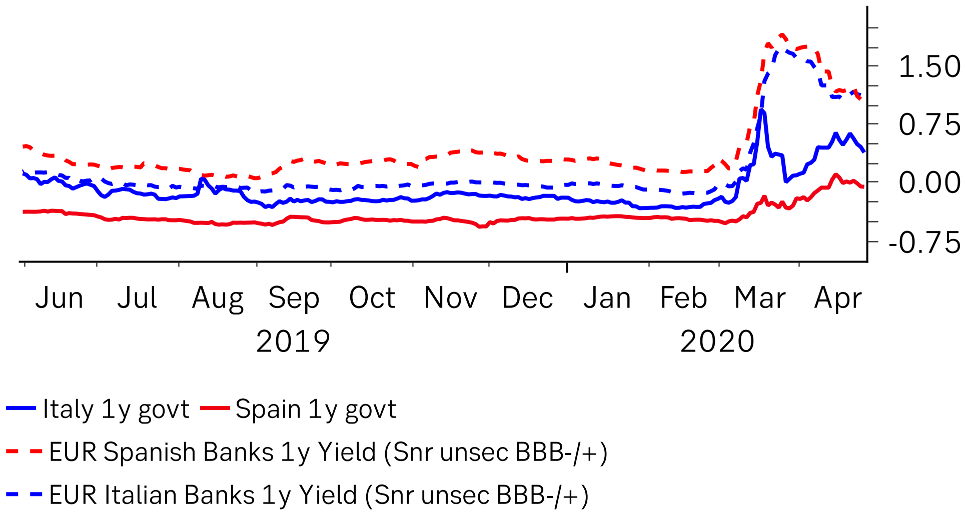
Over the coming weeks and months, we expect the ECB to use the flexibility of the Pandemic Emergency Purchase Programme (PEPP), directing purchases to where they are mostly needed, like the Italian securities, and T-bills and CPs. The ECB may also speed up the PEPP purchases from its average target of EUR 75bn / month if market conditions deteriorate and/or as an attempt to push down the short end of the yield curve and the Euribor rates, and to compress intra-euro spreads. Speeding up the pace of the PEPP purchases would pave the way for an increase of the PEPP programme possibly in June. At a later stage, the ECB may also say that it is prepared to buy credit ETFs if necessary in order to safeguard the credit market functioning.

### ECB needs to address the increasing Euribor problem

Euribor fixings have increased sharply during the past month, with the 3m fixing now almost 30bps higher than the March lows. 10bps of this move is explained by the higher policy rate expectations as the expected rate cut before the March meeting has been largely erased. The remaining 20bps is explained by the wider Euribor vs. OIS/ESTR spread. In our view, the main reasons behind this are the increasing government yields, general risk aversion resulting increasing risk premiums, and still large liquidity needs in the euro money market. The increasing Euribor rates will feed into higher financing cost of companies and households and the ECB needs to address this at the April meeting. If not, President Lagarde will get a question about it at the press conference. The easiest way to push Euribors lower would be to increase the purchases in the short-term government bonds and T-bills. A bolder move would be to include the bank credit into the corporate bond purchase program, but that is highly unlikely in our view. In addition to increasing the QE purchases in the short government debt, the ECB could increase the monthly QE purchases and push investors up on the credit curve, leading investors to increase the bank credit purchases. However, we regard it more likely that the ECB will wait before announcing another increase in the PEPP that has only recently started.

Euribor rates are still heavily relied on "expert judgement" of the panel banks rather than actual transactions. The "expert judgement" means that due to the lack of actual unsecured borrowing transactions between the banks, the panel banks must look at a variety of instruments, rates, and quotes in different maturities and try to come up with as good as possible estimate for the cost of uncollateralised borrowing from other banks at each Euribor maturity. Banks seldom get credit cheaper than their respective home country governments, and therefore government yields work as a floor for the borrowing cost for the banks. With the government yields in the short end of the curve increasing in several euro area countries, bank borrowing costs have followed suit. Furthermore, the increase in price of bank credit has been further exacerbated by rapidly increasing risk premiums across the asset classes, not least in the European bank equity and credit. When the Euribor panel banks estimate their unsecured borrowing cost in the interbank market, the above-mentioned developments are likely to drive the quoted Euribor rate levels higher. The chart below shows the generic aggregate Italian and Spanish bank sector 1y yield for BBB senior unsecured credit with the respective government yields.

**1y Spanish and Italian bank credit and government rates (%)**

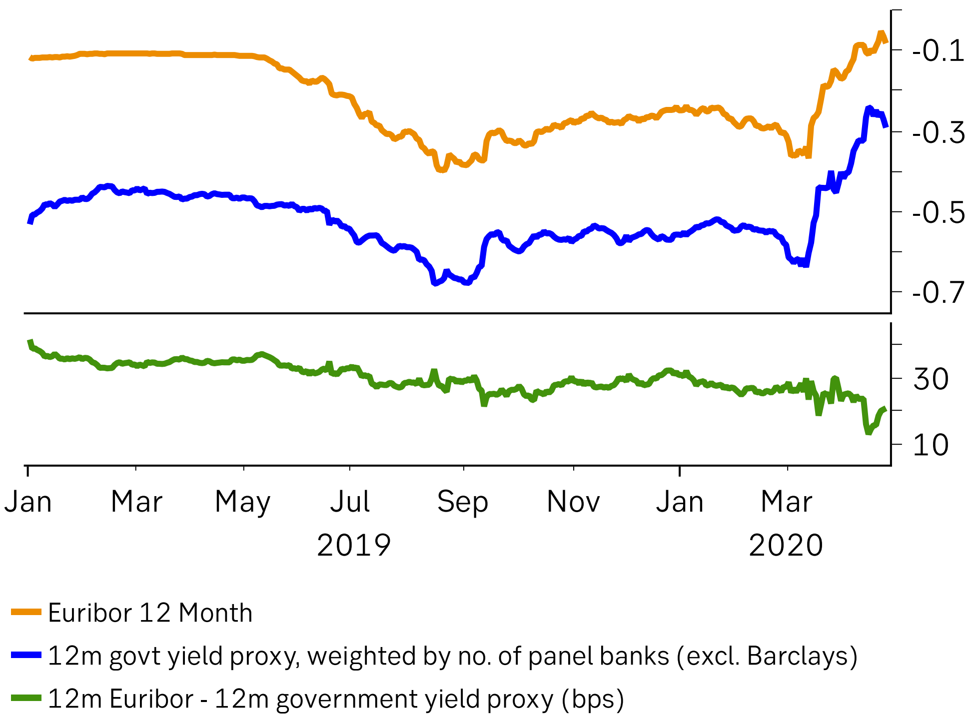



Source: Macrobond, Bloomberg, SEB

There are 17 banks in 8 euro area countries quoting Euribor rates (the 18th bank is Barclays in the UK). The final Euribor fixing is constructed by excluding the three highest and the three lowest quotes and taking a simple average from the rest. We have created a simple euro area wide 12 months government rate proxy using a methodology similar to Euribors (chart below). We leave the two German and two Italian banks out from the calculation (assuming they are the lowest and highest, respectively) and weigh the remaining government rates by the number of panels banks in each country. With the correlation not warranting causation, our 12-month government rate proxy has increased in line with the 12-month Euribor, with the spread between the government proxy and the 12-month Euribor fairly stable during the past years.

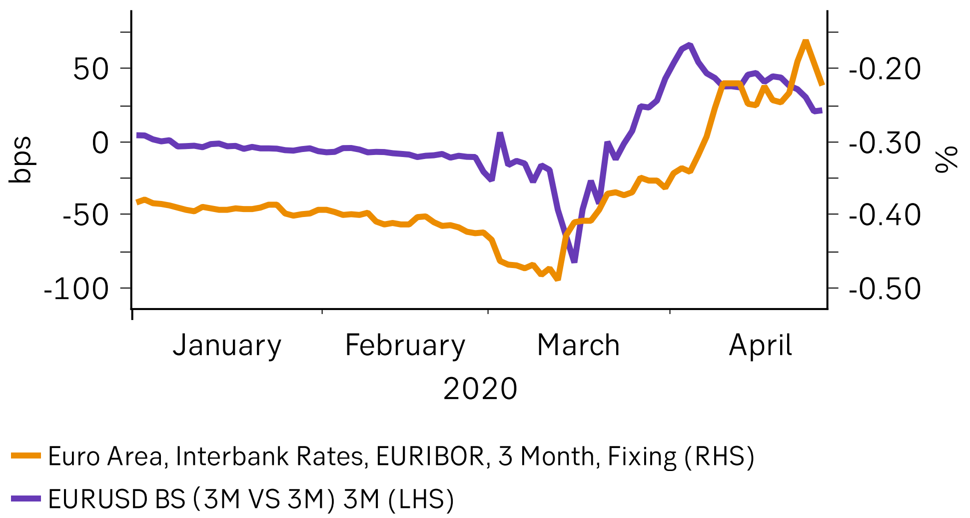
Another possible funding source that could affect the Euribor fixings is the FX and the cross-currency swap market. EUR/USD cross currency basis, measuring the supply/demand imbalance and the relative risk premiums between the currencies, has rapidly increased since mid-March, implying an increasing cost of borrowing in euros vs. dollars (chart below). 3m EURUSD xccy basis dipped temporarily lower in mid-March indicating an increasing demand in dollars in the FX swap market, but since then the Fed increasing the dollar liquidity has eased the dollar borrowing cost. The basis has increased since mid-March reflecting the increasing demand in euros and possibly a larger risk premium priced in for the euro borrowers. European banks and corporates may have borrowed euros in the FX swap market to satisfy their increasing liquidity needs, lifting the implied euro borrowing cost. The ECB and European public sector being relatively less proactive in the crisis management compared with the Fed may have increased the risk premium demanded by the euro lenders, further contributing to the increase in the basis. If banks are using the FX swap market as a funding source to price the euro liquidity, it could also affect the Euribor fixings.

**12m Euribor and EUR government proxy (%)**




Source: Macrobond, SEB

**3m Euribor and EURUSD xccy basis**




Source: Macrobond, SEB

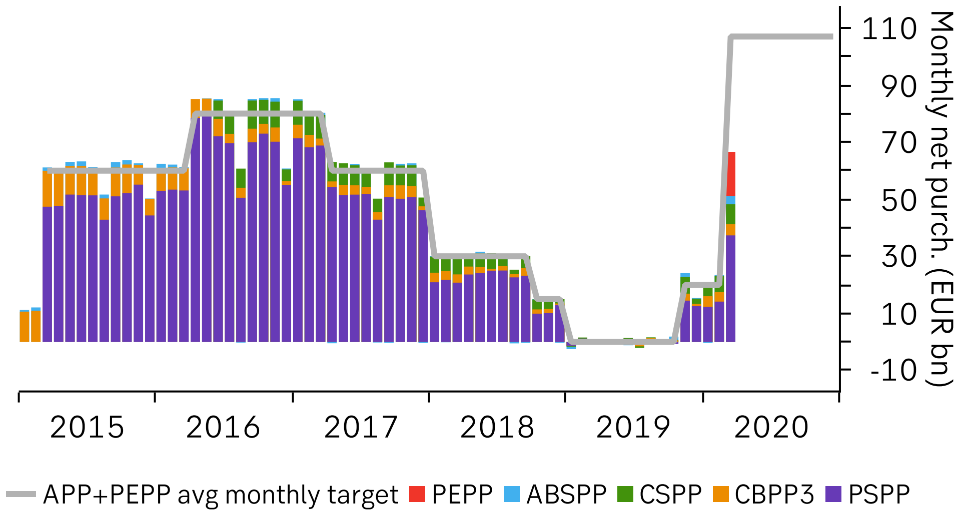
Under the PEPP, the minimum eligible maturity of the public sector debt is 70 days (max 31 years), which indicates that the ECB is willing to increase its purchases in the short-term debt, including T-bills. We have a good reason to believe that the ECB aims to cap the further increase in Euribor rates and as the financial markets continue to stabilize, we expect Euribors to start to slowly decline. On 15 April, we recommended to buy Jun20 vs. Dec20 Euribor futures and we hold on this position.

## Over 40% increase in the ECB's bond holdings in 2020

At the end of March, the ECB securities holdings under its asset purchase programmes amounted to EUR 2.8tn. The ECB has already announced net asset purchases totalling EUR 1110bn in 2020, resulting in the ECB's balance sheet increasing by 42% from end-2019 to end-2020 due to bond purchases alone. This includes the most recent two programmes, EUR 120bn of additional net asset purchases announced on 12 March and a EUR 750bn Pandemic Emergency Purchase Programme (PEPP) on 18 March (more details in Appendix below). Both programmes will run until end-2020 but the ECB has explicitly stated that it is prepared to scale up the programmes as needed.

On the back of the most recent programmes, the ECB's net asset purchase target in March-December 2020 increases to EUR 107bn / month from EUR 20bn / month in November 2019-February 2020. Out of the EUR 107bn intended average monthly purchases, EUR 32bn will be in the form of the Asset Purchase Programme (APP) and EUR 75bn in a substantially more flexible PEPP purchases.

**Asset purchase programmes (APP & PEPP): Montly net purchases**




Source: ECB, Bloomberg, SEB

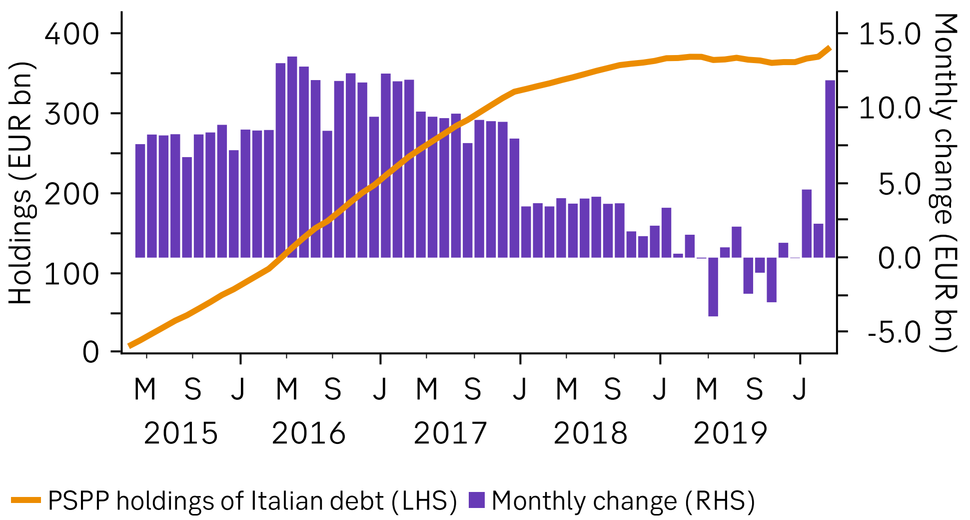
## PEPP allows purchases of as short as 70 days public debt instruments

The PEPP not only substantially boosts the envelope of net asset purchases, it also has a few important differences compared with the APP. Firstly, the PEPP is more flexible, allowing the ECB to channel purchases more freely between jurisdictions and asset classes, more effectively directing firepower where it is needed. Secondly, the PEPP allows purchases of as short as 70 days (and up to 31 years) public sector securities. This renders the PEPP a more efficient tool than the APP to mitigate the increase of T-bill rates in certain countries as the ECB could, if it so wishes, channel part of the PEPP purchases to very short dated instruments, including T-bills, specifically in the jurisdictions where a rise in T-bill rates has contributed to higher Euribor rates. For the same reason, it is also more effective than the APP to address country specific issues. Given its flexibility, an eventual QE extension would likely come as an increase in the PEPP rather than the APP.

## Headroom for substantially higher Italian bond purchases

The ECB holdings of the Italian bonds were EUR 382bn in end-March and the net purchases of the Italian bonds had been EUR 2.3/4.6bn in January/February. In March, net purchases of Italian bonds increased to nearly EUR 12bn, a part of which was most likely under the PEPP.

**PSPP holdings of debt securities: Italy**




Source: ECB, Bloomberg, SEB

First purchases under the PEPP were conducted in the week beginning 30 March with total PEPP purchases during the first week amounting to EUR 15.4bn (all countries included). The PEPP provides substantial headroom for increasing purchases of the Italian (or any other) bonds if necessary, even if only part of the PEPP's total net envelope of EUR 75 in average / month was directed to the Italian bonds. Based on the ECB's communication it appears likely that a substantial part of the PEPP firepower could indeed be directed where it is mostly needed. Therefore, it would not be surprising to see substantially higher net purchases of Italian bonds in the coming weeks to mitigate the pressure on yields.

Over the past week, the Italian 10y spread to Germany tightened from 263bps to 230bps, most likely partly due to the ECB's increased purchases and the S&P confirming Italy's sovereign credit rating on Friday at BBB. The ECB's latest available weekly data from 24 April reveals that during the first four weeks of the PEPP, the ECB purchased EUR 96.7bn under the programme with a substantial part of the purchases possibly directed to the Italian bonds.

To what extent the headroom provided by the APP (net purchases EUR 32bn / month, directed mostly according to the capital key) and the PEPP (EUR 75bn / month, directed much more freely) will succeed in alleviating the pressure of especially the Italian yields remains to be seen. It will depend on how much net supply there will eventually be in Italy and whether part of the financing will come from some EU mechanism like the ESM. Activation of the ESM would make it possible for the ECB to trigger potentially unlimited Outright Monetary Transactions (OMT), a programme that was introduced in 2012 but has never been tested.

## Recovery fund details expected soon

Last week, the EU Council endorsed the Eurogroup's 9 April agreement of a EUR 540bn package on workers, businesses, and sovereigns with the package aimed at being operational by 1 June. However, there was no agreement on details on how to establish a larger recovery fund (RF) targeted to the most COVID-19 affected sectors and countries and the upcoming long-term EU budget (MFF) for 2021-2027. The Council tasked the Commission to prepare a detailed plan for the RF and how it should be linked to the MFF. It is expected that the size of the RF could be EUR 1-1.5trn and according to talks involve a temporary increase of the EU budget from 1.2% to 2.0% with the increase in the form of government guarantees rather than cash. The support from the RF would likely be a mix of loans and grants. Indications are that the EU Commission could borrow EUR 320bn on the market against governments' increased guarantees to the EU budget. Around half of the EUR 320bn would be lent to the governments, providing a total envelope of around EUR 1.5tn of investments assuming a 10x leverage and the other half could be grants from the EU budget. The commission is expected to present a detailed plan for EU leaders early next week at the latest.

## Appendix: Asset purchase programmes

The ECB's asset purchase programmes consist of:

1. the Asset Purchase Programme (APP).
2. the Pandemic Emergency Purchase Programme (PEPP).

The ECB treats the PEPP as a separate programme from the APP. While the capital key guides both the APP and PEPP purchases, the securities purchases under the PEPP can be carried out in a more flexible manner in order to deal with the specific situation related to COVID-19, allowing more fluctuations in the distribution of purchases across countries, assets classes and time.

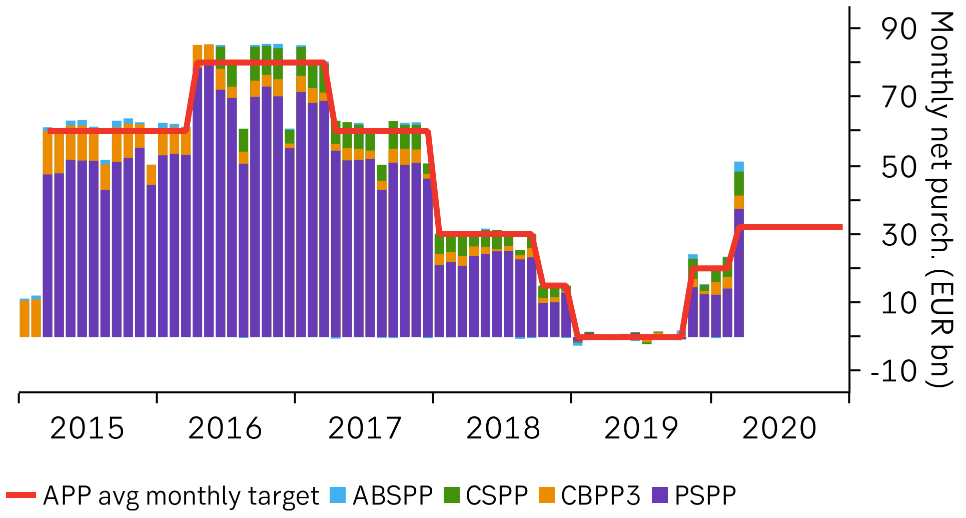
**Asset Purchase Programme (APP)**

The APP refers to the following four programmes:

1. Public sector purchase programme (PSPP).
2. Third covered bond purchase programme (CBPP3).
3. Corporate sector purchase programme (CSPP).
4. Asset-backed purchase programme (ABSPP).

Between January and October 2019, the ECB fully reinvested maturing securities in the APP portfolios, but did not conduct net purchases. The ECB re-started net asset purchases at a monthly pace of EUR 20bn in November 2019, expecting them to run as long as necessary and end shortly before the ECB begins raising the key policy rates. On 12 Mar this year, the ECB announced an additional EUR 120bn net asset purchases running until end-2020. Hence, APP net purchases will amount to an average of EUR 32bn / month in March-December this year. The chart below shows how the average net purchase target amount and actual APP purchases have developed over time.

**Asset Purchase Programme (APP): Monthly net purchases**




Source: ECB, Bloomberg, SEB

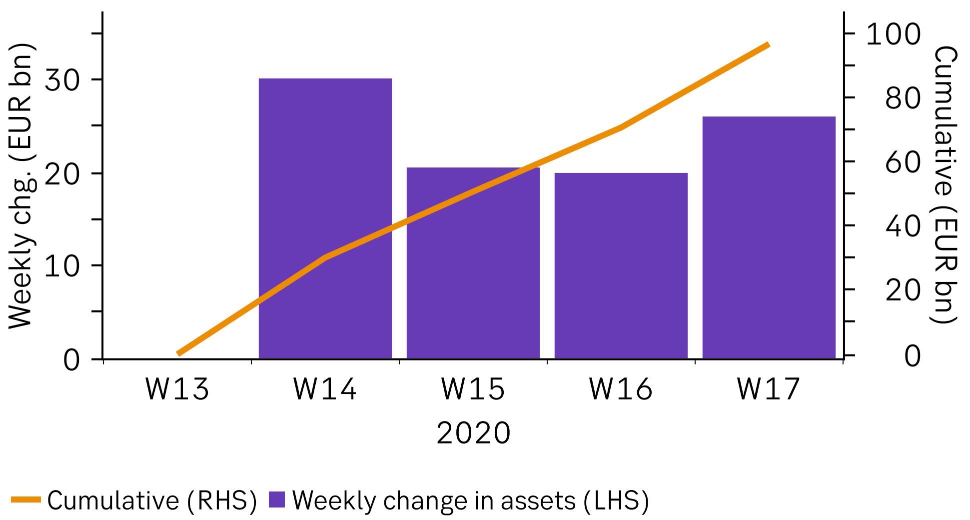
**Pandemic Emergency Purchase Programme (PEPP)**

On 18 Mar, the ECB announced a new EUR 750bn pandemic purchase programme with net purchases conducted until end-2020 (i.e. an average of EUR 75bn / month in March-December).

All assets that are eligible under the APP programme are also eligible under the PEPP programme. In addition, Greek government securities are eligible under the PEPP but not under the APP. Furthermore, non-financial commercial paper is now eligible both under the PEPP and CSPP (corporate sector purchase programme) and the residual maturity of public sector securities eligible for PEPP ranges from 70 days to 31 years. The PEPP purchases will be carried out in a flexible manner with no pre-defined distribution between asset classes.

The ECB will publish the aggregate book value of securities held under the PEPP on a weekly basis and PEPP monthly net purchases and cumulative net purchases on a monthly basis. The chart below shows the weekly PEPP purchases since the launch of the programme on 18 April.

**Pandemic Emergency Purchase Programme (PEPP): Weekly purchases**




Source: ECB, Bloomberg, SEB

**Other recent measures**

On 18 April the ECB extended eligible assets under the CSPP to include non-financial CPs and eased collateral standards.

On 22 April, the ECB eased minimum credit quality requirements for collateral, in certain cases accepting non-investment grade debt as a collateral in its financing operations (more here). The ECB has also established USD swap lines with the Fed and set up EUR swap lines with a number of small European non-euro central banks.