Issuer strategies in European sovereign and SSA markets

Negative rates force investors, European sovereign and SSA issuers to alter strategies

The European sovereign debt crisis, regulatory and technological change, and central banks' large-scale and unconventional monetary policies have significantly reshaped financial market conditions over the last few years. Amid such sizeable change, disentangling the marginal impact of any single factor constitutes an extraordinary challenge. Yet, it is fair to say that, while some of these changes triggered the foreseeable or intended market reaction, in other cases the interaction of a number of factors led markets to uncharted territory. They also required European sovereign and supranational, sub-sovereign and agency (SSA) bond market participants to reconsider their strategies.

The crisis, regulatory change, and unconventional monetary policy have altered euro area debt market conditions.

When the ECB announced, for example, its PSPP in January 2015, it soon became evident that such a large buyer was going to put significant downward pressure on European sovereign yields and spreads, and considerably flatten yield curves. Indeed, as a reference, the German 10-year sovereign bond, which yielded 0.52% the day before the PSPP announcement, reached an historical low of - 0.19% in July 2016. Similarly, the 10-year spread relative to Germany dropped on average by about 50 basis points in Italy and Ireland, 30 basis points in Spain, and 60 basis points in Portugal between 2014 and 2015. As a consequence, in their hunt for yield, investors rethought their investment strategies, shifting across asset classes or moving further out along the yield curve.

The ECB's PSPP, for example, depressed yields and spreads, and helped flatten yield curves in 2015 and 2016.

At the same time, PSPP may have weighed on market liquidity.[26] Indeed, the large and credible PSPP market intervention persuaded investors not to challenge the ECB, leading to one-sided trades with a corresponding drop in flows and liquidity. While the PSPP may have aggravated these dynamics, they had started before the PSPP, driven by factors such as regulatory changes limiting primary dealers' room to manoeuvre, and the shifts on the buy-side towards bigger and more concentrated asset managers.

The PSPP may also have contributed to tighter liquidity.

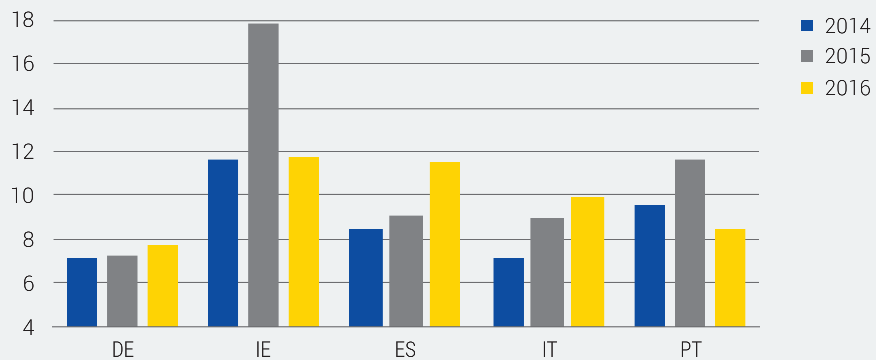
European issuers modified their strategies to benefit from the new environment. On the positive side, they were able, until very recently, to extend the average maturity of their issuances and to reduce their costs significantly (Figures 27 and 28).[27]

The changes meant issuers could extend the average maturity of their issuances and cut costs.

[26] In the press conference that followed the ECB meeting in December 2016, ECB President Mario Draghi said: "We are aware that our purchase programme has contributed, among other relevant factors, to increase the repo rates used to obtain collateral of the best credit quality". As a result, the ECB decided to accept cash as collateral in its PSPP securities lending to support "the euro area repo market liquidity and functioning".

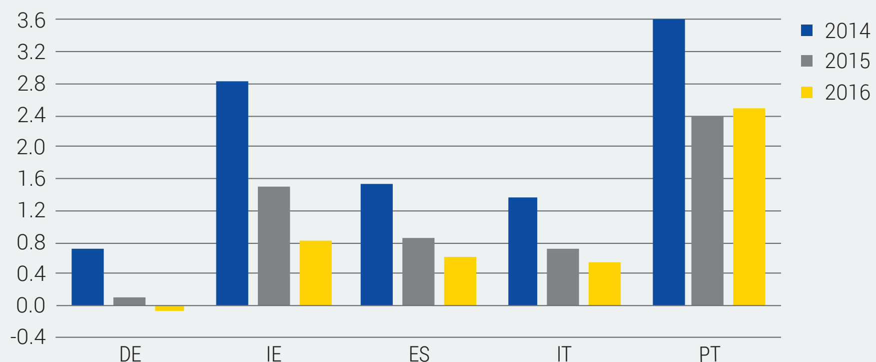
[27] Due to various country-specific factors, Portugal constitutes an exception to this pattern between 2015 and 2016. The high-weighted average maturity at issuance in Ireland in 2015 should be considered an exceptional point, distorted by a significant issuance of 30-year bonds.

Figure 27
Weighted average maturity at issuance
(in years)



Source: ESM calculations based on national treasuries' data

Figure 28
Cost of issuance
(in %)



Source: ESM calculations based on national treasuries' data

Demand for high-quality assets remains high.

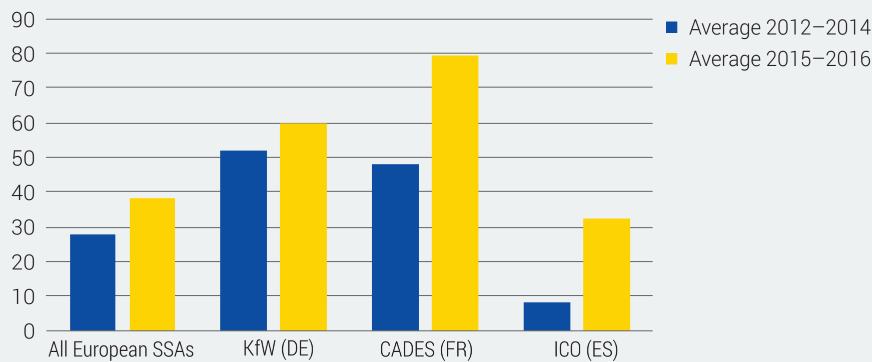
In doing so, they took advantage of the persistently low-yield environment with flattening curves which resulted from, principally, the sizeable ECB purchases in relation to net issuance, the long-term bond buying of investors 'riding-the-yield curve', and the regulatory changes favouring demand for relatively safe and liquid assets. In particular, under Basel III's liquidity coverage ratio, banks needed to dramatically increase their holdings in high-quality assets such as sovereign and supranational bonds. Whilst most banks had already complied with ratio requirements, the rollover of maturing bonds and fresh capital meant that banks' treasuries maintained their healthy appetite in 2016. Meanwhile, the Solvency II Directive also fueled the insurance sector's demand for high-quality assets.

Nonetheless, issuers have needed to diversify their client base and add liquidity to their bonds to cope with high financing needs and limited market liquidity.

But issuers also face challenges. On the negative side, European issuers, with very high GFN,[28] have needed to cope with a scenario where overall market liquidity has declined and the gap between liquid and illiquid assets has widened. To do so, issuers have devoted considerable effort over the last few years to diversifying their client base and to strengthening the liquidity of their assets.

[28] As a reference, gross bond issuance will amount to about €720 billion in the four biggest euro area sovereign bond markets in 2017, which is €6 billion more than in 2016.

Figure 29
Issuance in USD
(% of total issuance)

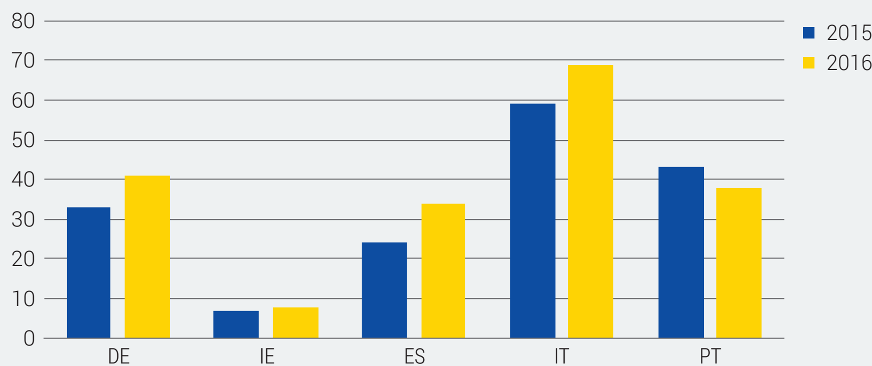


Source: ESM calculations based on Bloomberg data

To diversify, European sovereign and SSA issuers have increasingly looked into less standard instruments. These include inflation-linked bonds, green bonds, and non-euro-denominated bonds. The preference for dollar versus euro issuance has been particularly marked in the European supranational sector lately (Figure 29). In terms of liquidity, given that most trading on any given bond typically happens around auction days, European issuers have tilted towards a more frequent market presence at the expense of tapping smaller amounts on average (Figures 30 and 31).

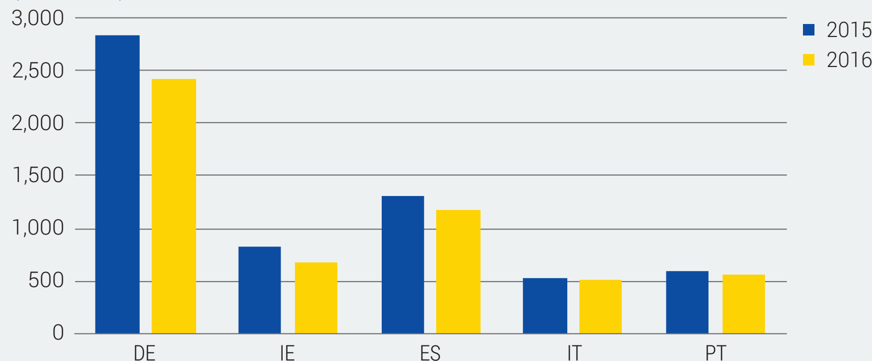
To do so, they have made use of less standard instruments and tapped smaller amounts more frequently.

Figure 30
Number of taps



Source: ESM calculations based on Bloomberg and national treasuries' data

Figure 31
Average amount issued per tap
(in € million)



Source: ESM calculations based on Bloomberg and national treasuries' data

At the end of 2016, market sentiment shifted, favouring accelerating growth and reflation.

A large market repricing is the main challenge looking forward. In the last quarter of 2016, in response to a number of factors,[29] investors seemed to start pricing in a new macroeconomic and market scenario. In particular, market sentiment began to move away from a secular-stagnation view towards an alternative one where global growth could potentially accelerate, a reflationary process may emerge, and the persistently supportive monetary policy could gradually come to an end.

As a result, the sovereign bond curve steepened, and investor attention swapped to equity markets.

Naturally, this shift in investors' central scenario altered markets, which saw increases in bond yields, steepening yield curves, and an overall rotation to equity from fixed income. Amid this bond price sell-off, peripheral bond spreads against Germany have also widened considerably since late September 2016.

It is yet unclear whether this new investor view will hold sway for long and how issuers will respond.

Looking ahead, it remains to be seen how the forthcoming economic figures and political developments may lead markets to accelerate or to undo the recent repricing trends, and how European issuers will react to a tougher scenario for bonds. In this regard, despite the increases just mentioned, global bond yields could still rise sharply from current levels if expectations of a reflationary scenario strengthen. This could lead to significant market turmoil especially taking into account how much key market players are exposed to interest rate risk.

When the ECB scales back its purchase programmes, however, there is a risk of substantial widening of peripheral spreads.

The ECB's asset purchase programmes led to a significant reduction in peripheral spreads, even taking into account other standard determinants of credit risk. When these programmes are scaled back, the risk could be that peripheral spreads see a non-negligible widening again. This would raise countries' financing costs again and might therefore require additional adjustments in fiscal policy.

[29] These include: the increased momentum in global economic activity; the acceleration in headline inflation figures; the outcome of the US presidential election and the announcement of more fiscal stimulus for the US economy and expectations of a more aggressive tightening in US monetary policy than previously anticipated.