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Sizing Up the ECB CSPP Comeback

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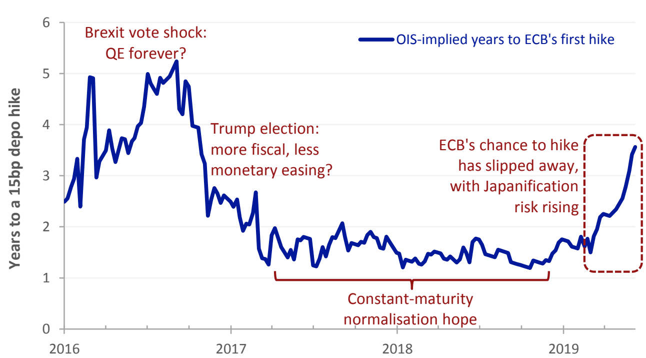
What do credit markets think about the odds of a CSPP restart?

Markets are demanding more central bank sugar. With relatively limited room to cut rates, we might see a restart of QE/CSPP over the next 12 months. In fact, key ECB officials have deliberately signalled that this is now a possibility.

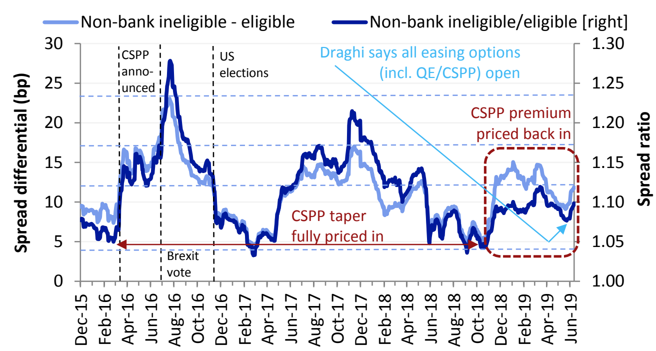
In this report, we try to assess what credit markets imply about the odds of net CSPP purchases being restarted. We then discuss how much capacity there is in the EUR IG market for the ECB to run such a programme for an extended period of time, if needed.

Figure 1: The **ECB "missed" the chance to hike**...



Source : Deutsche Bank

Figure 2: ...and **markets** are **pricing in** a return of **CSPP**



Source : Deutsche Bank, Markit

What do markets think about the odds of a CSPP restart?

Markets are demanding more central bank sugar. Some of it is justified by macro prints, given increased policy uncertainty over trade, Brexit and Italy that risks exacerbating the secular slowdown. However, the Fed cut frenzy implies that market participants expect the supertanker to turn on a dime and give President Trump the chance to do another 180 on trade shortly afterwards, hoping to sail to the election sunset on the forced central bank stimulus (with increased probability of a recession after the elections).

We are not sure Jay Powell intends to make things that easy, even if we acknowledge that the power of markets to dictate central bank policy is quite impressive at this point. Be that as it may, it is obvious that the ECB may be forced by the external environment to ease further. With relatively limited room to cut rates, we might soon see a restart of QE/CSPP. In fact, key ECB officials have deliberately signalled that this is now a possibility.

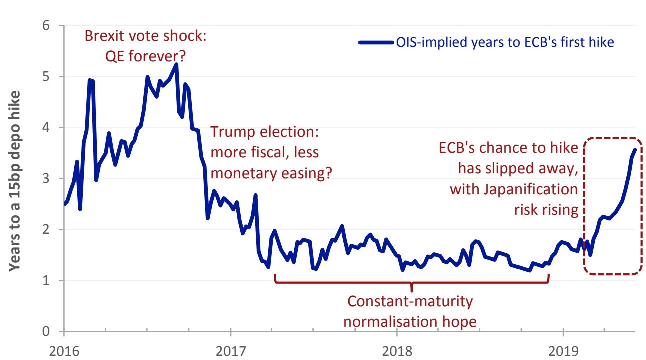
*"**We will do everything within our mandate. If the economy slams on the brakes, we could do more**."*
Francois Villeroy de Galhau (front-runner to replace Mario Draghi), 12 June 2019

*"**The policy space is there and… if adverse contingencies were to materialise, the Governing Council stands ready to act and use… all the instruments that are in the toolbox.**"*
Mario Draghi, ECB President, 6 June 2019

With the Bund yield at -0.25% as we type, the environment for credit is closer still to what we described in our report Value of High-Grade Corporate Bonds in Japanified Europe (12 April 2019). Ultimately, the point of financial repression is to make lenders so desperate to lend (save) that they are willing to pay borrowers. Particularly if real rates are deeply below zero, default risks stay low and credit can perform even if the economy loses dynamism. (This is perhaps best illustrated in Fig. 11 in the Appendix. It shows that there are **$11.6tn of bonds globally that currently trade with a negative yield**, which is **21.6% of the global IG universe**.)

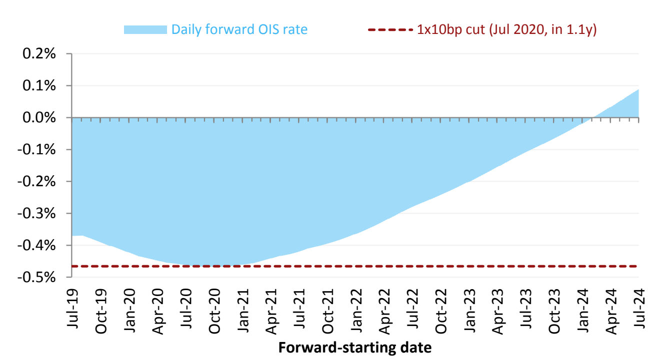
Of course, the tail risk is that it will not be enough and the economy plunges anyway. This is particularly a long-term risk. At present, however, we think that central banks still possess ammunition to buy more time. Clearly, the ECB seems to have "missed" the chance to hike this cycle (Fig. 3) and the market is now pricing a depo rate cut instead (Fig. 4).

Figure 3: The **ECB "missed" the chance to hike**...



Source : Deutsche Bank

Figure 4: ...with markets pricing in a **depo rate cut** instead



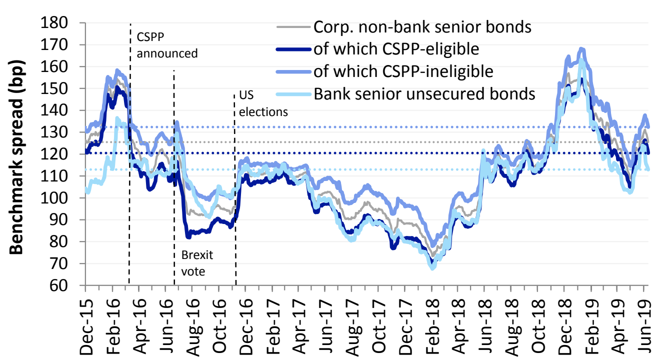
Source : Deutsche Bank

However, there is a lower bound on policy rates, even if there is considerable uncertainty about where exactly it lies. At some point, when the so-called reversal rate is reached, further cuts become contractionary, particularly in bank-based economies like Europe. Thus, QE/CSPP would be the next logical step in the easing toolbox, if only because it has been tested already. Direct central bank purchases of corporate bonds, on top of private demand, provide additional support for spreads.

We think market pricing is consistent with roughly 50% probability that the CSPP comes back within the next 12 months. Obviously, the number is very approximate and there is no exact way to elicit this probability from financial instruments. However, if we take the simplistic approach of looking at the (absolute) spread differential between CSPP-eligible and ineligible bonds over time (Fig. 6), we are not too far from the middle of that range. (The differential is below the mid-point of the full range and above the midpoint of the range if we exclude the short-lived spike after the Brexit vote in 2016.) As the chart also shows, the probability has ticked up following the most recent ECB meeting at which QE/CSPP was discussed as an option if needed. The recent credit rally has been partly fuelled by this ECB put.

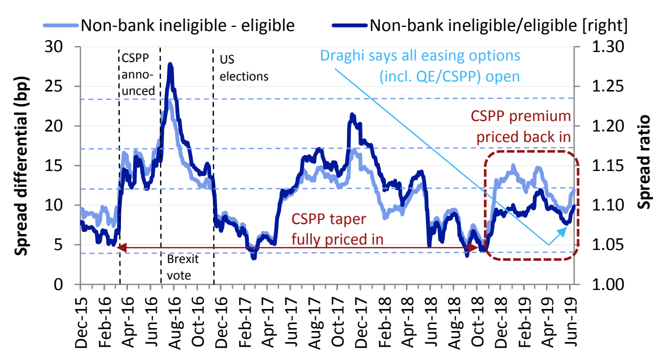
Figure 5 shows that spreads of CSPP-eligible bonds are now at the same level as at the end of 2015, ahead of the macro driven sell-off in early 2016. Bank senior bonds are still a bit wider than back then but note that due to regulatory changes, the index now includes more explicit bail-in instruments (SNP/HoldCo) and so it is difficult to make a like-for-like historical comparison.

Figure 5: **EUR IG** bonds - **CSPP eligible vs. ineligible**...



Source : Deutsche Bank, Markit

Figure 6: ...and their **spread differentials and ratios**



Source : Deutsche Bank, Markit

We think that compared to the other QE components, returning to the CSPP in its previous format would face the least challenges in terms of scarcity and self-imposed limits on holdings. Of course, the downside of the programme is the fact that unsecured lending to corporates comes with idiosyncratic risks that can attract unwanted publicity even if they may be negligible at the portfolio level (compare the Steinhoff or Atlantia cases in the past).

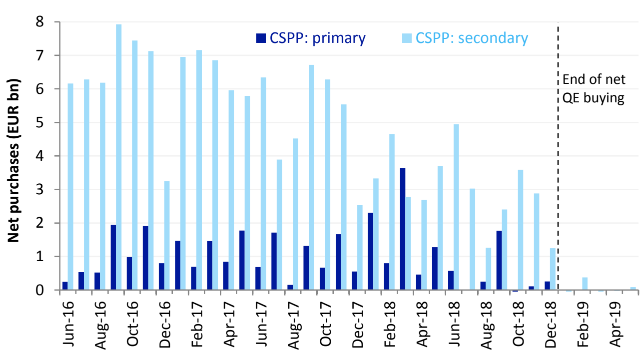
Overall, **given the continued growth of the eligible universe and almost no legal constraints on primary purchases, we think the ECB might not have a problem buying up to €10bn a month for years if need be, achieving meaningful credit easing for corporates**. (With TLTROs having been put in place to ease bank funding over the next few years.) In the remaining space, we therefore briefly review the past CSPP dynamics and assess how much capacity there is in the market for the ECB to restart and run such a programme for an extended period of time.

In particular, we think the following features illustrate the capacity well:

- *Peak* CSPP flow was just below €10bn in net terms, of which about €2bn was purchased in the primary market (Sep 2016, as per Fig. 7). We think there should be enough capacity in the market to accommodate such a level of net purchases on a regular monthly basis, on average.

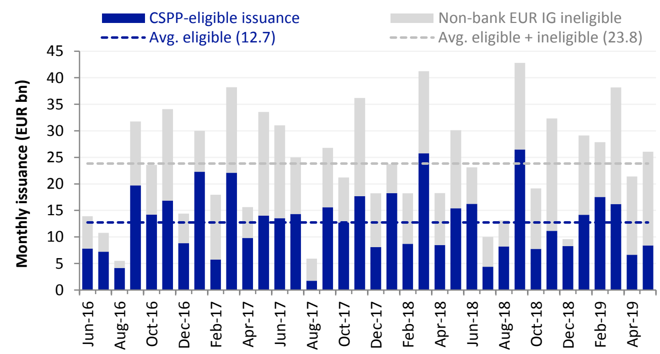
- During most of the programme, redemptions were negligible. The CSPP portfolio has seasoned since then, so the average monthly CSPP redemptions over the next 12 months are now going to be €1.1bn, which corresponds to gross monthly buying in the current reinvestment stage. (This compares to €14.7bn in the PSPP. In both programmes, about 8% of current holdings are going to mature over the next 12 months.)
- Since the programme started, CSPP-eligible issuance has averaged nearly €13bn a month (€150bn a year), i.e. over 50% of total EUR IG non-bank issuance in that period (Fig. 8). E.g. without exceeding 10% allocations, this should enable the ECB to buy over €1bn a month in the primary on average.
- The rest would be sourced in the secondary. Currently, the ECB holds €178bn of corporate bonds, which is about 20% of the CSPP-eligible universe (Fig. 9). There is still about €700bn of eligible assets left and in recent years, some €50bn more has been created via *net* issuance annually. Additional issuance of CSPP-ineligible EUR IG bonds then provides a close substitute for private investors crowded out by the ECB.
- There seems no need to relax the CSPP eligibility criteria. In Europe, bank disintermediation and increased reliance of corporates on markets has ensured that EUR IG has been a healthily growing asset class (Fig. 10). Therefore, unless something changes, the ECB might be able to buy €10bn per month for years without running into major scarcity constraints.

Figure 7: Net monthly **CSPP purchases**



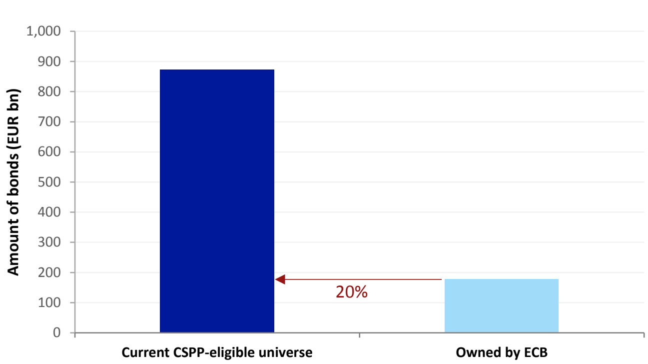
Source : Deutsche Bank, ECB

Figure 8: Monthly CSPP-eligible and ineligible **issuance**



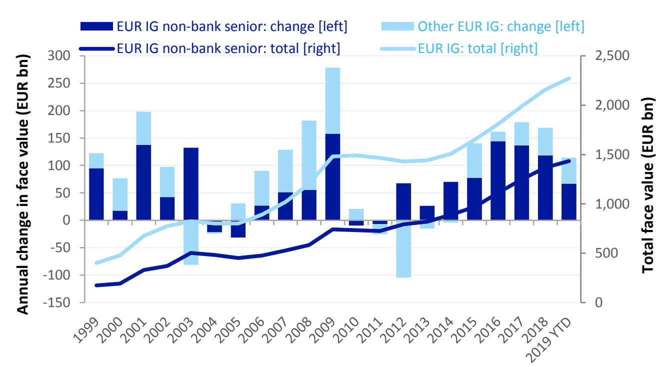
Source : Deutsche Bank, Bloomberg Finance LP

Figure 9: **CSPP-eligible** bond **universe**



Source : Deutsche Bank

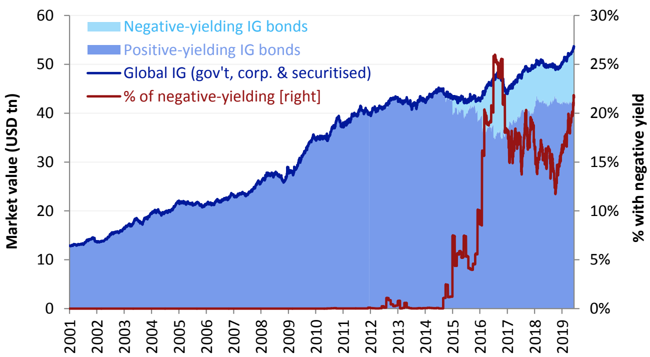
Figure 10: **Growth** of the **EUR IG** corporate bond universe



Source : Deutsche Bank, ICE BofAML indices

Appendix

Figure 11: Global IG bonds (gov't, corp. & securitised) with **negative yield: $11.6tn (21.6% of total** $53.6tn)



Source : Deutsche Bank, Bloomberg Barclays LP
Data series used: Bloomberg Barclays Global Aggregate Bond index

Appendix 1

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