MARKET COMMENTARY

ECB brings forward new anti-fragmentation tool in response to latest bond market woes

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- **At today's unscheduled meeting the Governing Council (GC) announced to flexibility reinvest PEPP redemptions and "*to accelerate the completion of the design of a new anti-fragmentation instrument*".**
- **The recent widening of Southern European bond amid hawkish rates repricing forced the ECB from verbal intervention into outright action.**
- **While today's announcement will probably appease markets for now. In a knee-jerk reaction the 10-year BTP-Bund spread receded by 25 bps.**
- **The pressure is now on the ECB to come up with an effective tool not violating the legal framework. A risk of disappointment remains.**
- **Looking further down the road, an effective anti-fragmentation tool would allow the ECB to move ahead more eagerly with policy normalisation.**

ECB takes anti-fragmentation action: At an unscheduled meeting the ECB today decided to "*apply flexibility in reinvesting redemptions coming due in the PEPP portfolio*…" and "t*o accelerate the completion of the design of a new anti-fragmentation instrument for consideration by the Governing Council*."

This week's spread widening let alarm bells ring: At the press conference following the June 9 regular GC meeting President Lagarde merely reiterated previous statements that PEPP reinvestments could be used flexibly and that the ECB was standing ready to *"design"* and *"deploy"* new instruments if needed. Fragmentation can be defined as a significant widening of sovereign bond spreads not backed by fundamentals. Already last week the ECB's proprietary measure of fragmentation (the difference between the GDP weighted 10Y yield and the 10Y OIS) went up strongly (see graphs below). However, since then GIIPS spreads had widened by about a further 20 bps with the 10-year BTP-Bund spread increasing towards 250 bps. Upwardly revised ECB as well as Fed rate hike expectations put non-core euro area government debt under even more pressure and let the alarm bells finally ring at the GC.

Markets appeased for now but design of new tool crucial: In a knew-jerk reaction markets cheered today's announcement. The 10-year BTP-Bund spread receded by about 25 bps and 10-year Bund yields came down by 14 bps. Thereby markets signaled that they deem the ECB's announcement credible. It is now up to the ECB to fulfil market expectations. The tweaking of PEPP reinvestments would enable the ECB to buy bonds at close to € 20 bn per month for the remainder of the year. However, this will not be enough in times of serious stress. When the ECB launched the PEPP in early 2020 it bought by more than € 100 bn per month. The fact that buying strongly deviated from the capital key suggests that most of it was used to fight fragmentation. Keeping this in mind markets now rightly expect something meaningful on top of the announced PEPP reinvestments.

Risk of disappointment remains: The new tool would need to be designed avoiding any suspicion of state financing. The new tool shall only address fragmentation. Hence, if there were fundamentally justified debt sustainability concerns, the OMT would rather be appropriate. So, the ECB has to come up with a view on fundamentally justified bond spreads and just fight the excess spread. Some conditionally would also make sense while at the same time the stigma related to OMT needs to be avoided. The new tool also needs to be applied with key rate decisions and be consistent with overall policy framework. Overall we think that the creation of this new tool is challenging and therefore there remains a risk of market disappointment. Moreover, disappointment could also come from the time at which the new tools is launched. By having announced it the ECB will probably be under pressure to become more concrete already at the July regular policy meeting.

Longer term the ECB cannot fight fragmentation alone: In the longer term the fight against fragmentation warrants more than new ECB tools. GC member Schnabel was quite explicit in stating that "*Governments need to take further steps, including by completing Banking and Capital Markets Union, by improving public risk-sharing through a permanent fiscal tool at European level, as well as by creating a euro area safe asset, properly designed to avoid adverse incentives*." The job of the ECB is – again – to buy time for governments to take the appropriate action.

Anti-fragmentation tool might speed up policy normalisation: A key obstacle against fast policy normalization was so far fragmentation, an argument frequently put forward especially by the more dovish GC members. However, if the ECB manages to successfully disentangle policy normalization from fragmentation it could proceed faster on its rate hiking trajectory. We are currently looking for a cumulative rate hike of 125 bps in 2022. The forthcoming launch of the anti-fragmentation tools implies increased upside risks to this forecast.

The ECB's Financing Conditions Dashboard

z-scores of respective variables with values > 0 indicating better than average financial conditions, < 0 the reverse; own calculations, latest data on lending rate estimated, BLS data monthly interpolated

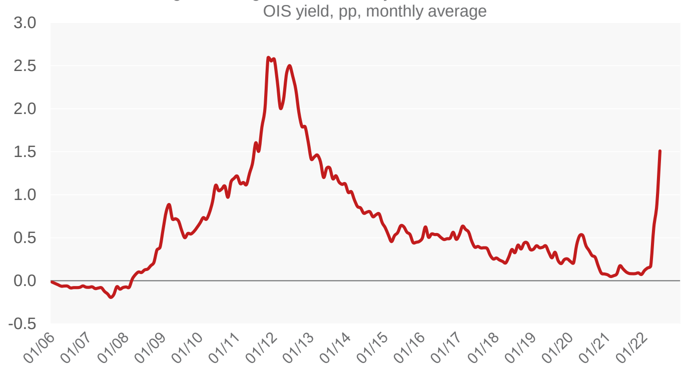
	2021	Q4 2021	Q1 2022	Apr-22	May-22	Jun-22
Gov. bond spread (GDP weighted)	1.45	1.48	1.28	-0.15	-0.98	-2.86
Term premium (10Y-1Y OIS)	1.01	0.75	-0.08	-0.46	-0.46	-0.46
BLS credit standards	-0.52	0.24	0.19	-0.49	-0.91	-0.59
BLS credit demand	-0.30	0.02	-0.14	-0.32	-0.42	-0.62
High Yield spread	1.02	0.78	0.09	-0.20	-1.06	-1.04
Lending rate	1.39	1.38	1.06	0.44	0.44	0.44
unweighted mean	**0.67**	**0.78**	**0.40**	**-0.20**	**-0.56**	**-0.85**
~ ex Lending rate	0.53	0.66	0.27	-0.32	-0.76	-1.11

last update: 14/06/2022

Source: Datastream, GIAM calculations

Bond spread rise indicates fragmentation

GDP weighted 10Y government bond yield of EMU economies minus 10Y OIS yield, pp, monthly average



Source: Datastream, GIAM calculations