More specifically, following a sharp compression in the differential between core and peripheral markets in the Eurozone (other than Greece), the rise in yields meant that relative value opportunities began to reappear. “The recent volatility pushed spreads between some of the peripheral Eurozone sovereigns and bunds beyond their normal range,” says Sam Diedrich, portfolio manager at PAAMCO in Irvine, California. “As long as you believe that the EU is not going to break up, this is making some spreads look attractive again.”

In practice, the recent performance of government bond yields left many investors asking whether bond prices had further to fall, or even signalled the start of a protracted bear market. In this environment, few have been brave enough to risk catching a falling knife until they see longer-term evidence of a return to stability in yields.

Prior to May’s mini-crash, however, issuance conditions for SSA borrowers had been complicated by the Public Sector Purchase program (PSPP) announced by the European Central Bank (ECB) in January. This commits Euro-area central banks to buying €60 billion of SSA issues, covered bonds and selected asset-backed securities in the secondary market each month between March 2015 and September 2016. That’s a lot of bonds – so many, in fact, that analysts have questioned if there are enough to go round. “One of the major concerns around ECB QE is whether there are enough bonds in the core countries and in Germany in particular for the ECB to buy,” wrote Deutsche Bank in a recent note entitled “ECB QE: Are there enough bunds?”
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Lee Cumbes, head of SSAR Origination for EMEA at Barclays in London, says that May’s dislocations may have been exacerbated by unusually high net supply. “If there was a month this year when pressure of supply was going to keep rates at an elevated level, it was May,” he says. “Net Eurozone supply adjusted for redemptions and coupons was about €70 billion, and QE buying of government bonds accounts for around €45 billion, so there was issuance that had to be absorbed by the market at what we saw to be very low yields. In contrast, the net supply forecast for June was minus €12 billion, and in July it falls to minus €100 billion, which means the ECB will have to find substantial volumes of bonds from end-holders. At a minimum, you would expect that to put a cap on yields.”

At BNP Paribas in London, head of global SSA DCM Jamie Stirling says that even in the absence of QE, regulatory pressure on banks is reducing liquidity and further distorting secondary market pricing levels. “Constraints on banks’ balance sheets and on their warehousing capacity exacerbate the problem of reduced liquidity,” he says.

Petra Wehlert, head of new issues at KfW in Frankfurt, says that one indication of how out of kilter secondary markets became in response to QE was the trading levels of borrowers like KfW relative to the sovereign curve. “At one stage KfW was trading through bunds, which was great for us and for investors holding our bonds, but it was at the same time a sign of how distorted markets had become,” she says.

The impact of secondary market illiquidity on relative trading levels has played havoc with conventional pricing mechanisms in the primary market, pushing new issue premiums wider. “For the time being, the days when you could instantly identify the appropriate pricing level for a €3 billion or €5 billion benchmark from the secondary market have gone,” says Wehlert.

In broad terms, there have been three safety valves for issuers navigating these treacherous waters in 2015. The first has been to anticipate the choppy market conditions by issuing early in the year, as SSA borrowers generally aim to do in any case. This has been the strategy adopted by a borrower such as CADES, the agency established in 1996 to amortize France’s social security deficit. “We started our program quickly this year precisely because we had a feeling that the ECB’s asset purchase program would distort the new issue market for Eurozone agencies,” says Patrice Ract Madoux, CADES’ Paris-based chairman. “We have been active in euros, dollars and sterling, and by early May we had completed €12 billion out of our total funding program for 2015 of €16 billion.”

A second option for borrowers has been to issue further down the yield curve, as KfW did in April when it printed its longest-dated euro transaction since 2007. An order book for its 2030 benchmark of €2.2 billion allowed KfW to raise €2 billion, which as Wehlert says is an extraordinarily large size for a 15-year bond.

Extending maturity profiles, however, is not always possible for borrowers committed to avoiding destabilizing asset-liability mismatches. Take the example of Spain’s state-owned Instituto de Credito Oficial (ICO). “Many of our peers have been moving to the medium and long end of the curve to cater to investor demand,” says Rodrigo Robledo, head of capital markets at ICO in Madrid. “We have a different strategy because our business model is based on lending to SMEs which is mostly concentrated in two- to three-year tenors at the moment. This has worked well for ICO because we have still been able to offer investors positive yields at the short end of the curve.”

As an example, Robledo points to the well-received Social Bond issued by ICO in January. This was a €1 billion three-year transaction, the proceeds of which were earmarked for SMEs in regions of Spain with a GDP per capita lower than the national average. Robledo says that the Social Bond, which offered a 9 bp pick-up over Spanish government bonds, generated over €2 billion of demand, with support coming both from traditional accounts and dedicated ESG (environmental, social and governance) investors.

Diversifying out of euros

A third option has been to look to markets outside issuers’ backyards, which for Eurozone-based SSA borrowers has meant US dollars and, to a lesser degree, currencies such as sterling, Australian dollars and even Chinese renminbi. At BNP Paribas, Stirling says that the dollar market has continued to function efficiently in recent months both at the short and the longer end of the curve. “The dollar market has been a very effective avenue for SSAs to raise duration, which is a relatively new development,” says Stirling. “Traditionally SSA borrowers were seldom able to issue beyond five years in dollars. This has changed over the last 18 months and there is now a very receptive market for 10-year issuance in dollars.”

Diversification out of euros has been an important component of CADES’ strategy, given that its options for longer term funding are constrained by its mandate. “We’re not supposed to exist beyond 2025, so we can’t issue bonds longer than 10 years,” says Ract Madoux. “Fortunately we have been able to show investors attractive yields at the shorter end of the curve in dollars and sterling.
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The French State Social Debt Agency

IN 2015, CADES HAS ALREADY ISSUED €12 BILLION OF BONDS*

* as at 31 March, 2015

The favorable cross-currency basis swap has allowed us to swap the proceeds back into euros to achieve very attractive all-in funding costs.”

Issuers historically regarded as parochial have also been turning to the dollar market for the first time. In May, for example, the German State of Saxony-Anhalt issued its debut syndicated dollar bond, generating demand of more than $1 billion for a two-year $750 million issue led by Barclays, Deutsche Bank and Morgan Stanley.

Growth numbers for the first quarter of 2015 support the view that QE may already be doing its job rather more effectively than expected. While German growth disappointed, the French economy expanded by 0.6 percent in the first three months of this year, which was well above even the most optimistic forecasts. Spain, meanwhile, posted growth in the first quarter of 0.9 percent, the fastest rise in GDP since 2007.

It is too early to assess whether these strong figures signal the resurgence in European inflation suggested by the recent rise in German government bond yields. According to data published by the European Commission’s statistics office, Eurostat, inflation was zero in April, compared with minus 0.1 percent in March.

In a note published in May, Morgan Stanley forecast that Eurozone inflation would be “above 1.7 percent by year-end and trending up”. This may explain why there has been a discernible focus among issuers and investors on the market for inflation-linked bonds. “Inflation-linked supply has been growing in the Eurozone market as well as in the TIPS market in the US, with new entrants such as Spain entering the sector,” says Cumbes at Barclays. “In this economic and rate environment, it is understandable that investors are looking to hedge some of their exposure against future inflation, and linkers as well as floating rate notes (FRNs) may be a good way of doing so.”

That may be, but to date there have been mixed signals about the strength of demand for exposure to longer-dated inflation-linked issuance. In March, the Spanish Treasury launched its third government bond linked to euro-area inflation (excluding tobacco), extending its inflation curve to 2030. Demand of some €6.7 billion from more than 160 accounts allowed the Tesoro to print a €3.5 billion 15-year linker, 79 percent of which was placed with investors outside Spain, but bankers say that the over-subscription level was below the issuer’s expectations.