The Major bond letter

Eurozone common issuance – a long time coming

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Financial analysts can justly be accused of looking for things to go wrong, especially in the bond market where bad news on the economy or politics often drives prices higher. The challenge to those with this innate tendency is to acknowledge when the news is 'good', when things are going right, which as far as Europe is concerned, is what has happened with the arrival of Eurozone common issuance.

Everything changed in the spring. The catalyst came with the COVID-19 pandemic, a massive economic shock that led to calls for a co-ordinated fiscal response at the European level. At long last proposals for common issuance, in the form of 'corona bonds', were taken seriously (see *Prisoner's Dilemma: Debt mutualisation is happening anyway*, 31 March 2020). As a result, the EU will become a big issuer in its own right, backed by its own source of taxation. This is a big step indeed. In the past the EU has issued but not in such big size, which will soon make it comparable with Spain, for example.

It has been 'a long time coming' from the perspective of someone who was an ECU (European Currency Unit) analyst in the early 1990s. Denmark's rejection of the Maastricht Treaty in 1992 ended the convergence trades and positive momentum back then.

Recognising paradigm shifts when they come is one of the keys to a successful investment strategy. There have been two positive steps taken by the Eurozone in the last two decades: the creation of the euro, the single currency, in 1999 and Mario Draghi's 'whatever it takes' in 2012. The arrival of the EU in 2020 as a major issuer in its own right could be the next positive step and lead to the following:

- All else equal, a positive development for Europe that reduces previous uncertainty is good for the euro currency.
- The new EU bonds might well 'crowd out' smaller supranationals and agencies.
- More importantly Europe may eventually have a bond market to rival the US if, as has been suggested, the EU issuance eventually becomes permanent.

Last week a number of records were broken (see *Making a big entrance: SURE bonds are a big success with investors*, 22 October 2020). The first EUR17bn SURE bonds (Support to mitigate Unemployment Risks in an Emergency) attracted orders more than double the entire EUR100bn programme. Significantly, as the largest ever social bond, most of the initial offering ended up in the hands of ESG investors. This bodes well for the much larger EUR750bn NGEU (Next Generation European Union fund), which is split between loans and grants.

There will be some robust challenges, both legal and practical, from nations that feel they are paying in, whilst others just take out. The 'looking-for-something-to-go-wrong' analysts will ask why should a country take EU loans if the cost is higher than they could achieve by issuing on their own? Or why not just take the grants and not the loans? Wouldn't there be stigma attached if Italy was taking loans but not Spain?

Perhaps mainstream economic thinkers are being a bit too rational in this approach and are missing the broader picture.

First, there is the paradox of the Japanification of the Eurozone, where the economic backdrop suggests interest rates will be no higher than zero for a very long time (see *Eurozone zombie paradox*, 20 October 2020). Indeed, reflecting this, the yield curve for swaps is in negative territory all the way up the curve. For the common issuance in the form of SURE and NGEU yields are likely to reflect this.

Second, based on today's yield curves, some of the stronger countries can issue bonds with yields below zero, whilst others issue with positive yields. Taking the five-year maturity point for the biggest issuers, the current range is set by Germany at -80bp and Italy at +13bp. Those countries with the lowest yields, such as the Netherlands and Germany, don't have to take the loans, it just means the EU Recovery Fund won't reach its full issue size of EUR750bn.

So there is cause for some optimism amid the gloom. If the aggregate interest rate for issuance is going to stay lower-for-longer this is a great starting point to fight unemployment and the impact of COVID-19 across the EU. Hopefully, those countries that have already 'profited' in times before common issuance from negative yields will find it easier to do the right thing for the sake of the longer-run prosperity of the EU.

Disclosure appendix

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Source: HSBC

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Source: HSBC

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