CENTRAL BANKS

Monitoring the expansion of the ECB balance sheet (April 2016)

Agustín García / María Martínez / Cristina Varela

Balance sheet expansion

- In the 14 months that the asset purchase programmes (APP) have been in force, the ECB has bought €726.5 billion worth of bonds under the public sector purchase programme (PSPP), €122.4[1] billion under the covered bond purchase programme (CBPP3) and €15.5[2] billion under the asset-backed securities purchase programme (ABSPP).
- In April, the asset purchase programme (APP), which includes public and private assets, exceeded the monthly objective of €80 billion[3], with €85.2 billion being acquired. The ECB bought €78.5 billion worth of public sector bonds, with a country distribution practically in line with the ECB's capital key, taking into account a small adjustment for the non-purchase of Greek bonds[4]. The average maturity of the purchases was eight years, similar to previous months and less than the average of the eligible euro-zone bonds under QE (9.1 years). In April, the extra €20 billion of monthly purchases approved in March were heavily biased towards government and covered bonds, and we expect to see this pattern continue in May. (The corporate sector purchase programme (CSPP) will not start until June.)
- Under the private sector asset purchasing programme, the ECB has acquired €6.7 billion, significantly less than the average purchases since the start of both programmes (ABSPP and CBPP3), which is €10.7 billion, concentrated in covered bonds (€6.6 billion).
- In its monetary policy meeting of 21 April, the ECB kept both interest rates and non-conventional measures unchanged, along with the downward bias, given the risks of further declines in activity. We are not expecting any additional measures in the next few months. (See).

Sovereign debt: banking exposure and sovereign issues

- Financial institutions in the euro zone reduced their holdings of sovereign bonds by €4.1 billion in March, breaking the trend of the past few months. Specifically, French and Belgian banks reduced their exposure to public debt, by €5.9 billion and €2.5 billion respectively, whereas Spanish and Italian banks further increase theirs (by €1.4 billion and €0.3 billion respectively.
- Issues of sovereign bonds in the euro zone as a whole are running at a slightly slower pace than that seen last year (38% of the gross issuance target in 2016, as against 40% in 2015). In the case of Italy and Spain the pattern is similar. Spain has issued 38.8% of its gross issuance target for 2016 (which has been reduced by €5 billion to €120 billion). Italy for its part has reached 35% of its issuance target for the year. We are seeing longer average lives in new issues, not only because some countries such as Ireland and Belgium have issued 100-year bonds (albeit in limited amounts) but also because, in general, issues at terms over ten years are increasing compared with last year (€75.5 billion so far, compared with €69.5

1 : €172.3 billion since the start of the programme in October 2014.
2 : €19 billion since the programme started in November 2014.
3 : In its March monetary policy meeting, the ECB announced a €20 billion increase in its monthly purchases under the APP, to €80 billion.
4 : For the time being, as Draghi explained in last July's monetary policy meeting, Greece does not meet the criteria for the ECB to start buying its bonds.

billion in 2015). In the case of Spain and Italy, we have seen more issues at 10- and 30-year terms and fewer at 15 years.

Corporate Debt: a new programme, the CSPP

- In its monetary policy meeting of 21 April, the ECB revealed the details of the corporate sector purchase programme (CSPP). (See). In general, the higher issue share limit of 70%, combined with the wide range of maturities to be bought (from 6 months to 30 years) indicates that the ECB faces a limited market. The volume of assets available (estimated at €600 billion) (table 2) is concentrated in just a few countries and a small number of companies. Since the announcement of this new programme, the main companies in the euro zone have started to issue significant amounts of debt in comparison with the same period of previous years (see Graph 12) and yields on corporate bonds have declined. Details are still awaited, particularly as to how the benchmarks will be defined. Furthermore, the volume of monthly purchases, which are to start in June, has yet to be disclosed.

Market environment

- During much of April, the financial markets continued to be supported by the rising trend in oil prices, which held in spite of the failure to reach agreement in the April meeting on freezing production. Also, the dovish tone of the central banks and the improvement in China's economic indicators favoured risk assets. Nonetheless, confirmation of low first-quarter growth in the US and the weakness shown by corporate earnings, mainly in Europe, once again led to increased market risk premiums and a correction on stock markets in the latter part of the month and at the beginning of May.
- Curiously, given this context, both carry trade currencies, the yen and the euro, appreciated, with the euro returning to levels above US$1.14 and the yen gaining nearly 5% to its highest level since June 2014. The movement was largely due to the weakness of the dollar, associated in turn with the lack of clear signals from the US Federal Reserve as to when it will resume its interest rate hikes. Moreover, in the case of the yen, appreciation was all the faster because of the lack of greater monetary easing to counter the weakness of economic data. As for the euro, its appreciation may also have been intensified by the change in the ECB's intervention strategy, which is now more inclined towards the use of quantitative measures than to cutting interest rates.
- German bonds, with some volatility, remained in the low range, burdened by low inflationary expectations, low growth, the ECB's intensification of its bond purchase programme and the flight to safety.
- Peripheral euro zone countries' risk premiums continued to widen during April despite ECB support. Italy is the country that has suffered the most widening since the end of March (+25 bps), reflecting the renewed surfacing of NPL problems in the banks' portfolios. Although the first steps have been taken towards solving this problem, contributions to the bank bailout fund are still perceived as inadequate. Furthermore, the political uncertainties in Spain and the difficulties in reaching an agreement between Greece and its European creditors have also taken their toll.

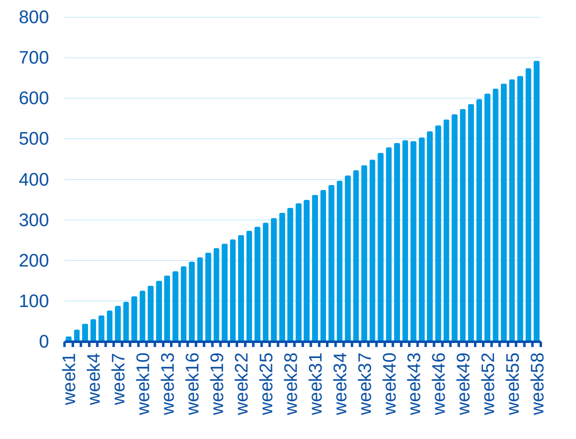
Macroeconomic environment

- The National Account advance indicator showed that GDP growth in the euro zone as a whole accelerated from 0.3% to 0.5% QoQ in the first quarter of 2016, about 0.1 pp more than expected and thus proving resistant to the sharp increase in uncertainty at the beginning of the year. However, this acceleration was partly due to transitory factors (Easter falling early this year, upturn in French consumer spending following November's terrorist attacks) which boosted domestic demand and made up for the slump in exports. The latest data also suggest that this rate of economic progress will be difficult to maintain: On the one hand, following February's positive activity data, those we have seen so far for March (falling retail sales and weak exports) are less encouraging. And on the other, confidence surveys conducted in April point to more moderate growth (some stabilisation in PMIs and slight improvement in European Commission indicators, but without reversing the falls of February and March).
- All in all, with all this information (which is still very limited as regards the second quarter), our MICA-BBVA model estimates growth of around 0.3%-0.4% QoQ for Q2 2016. Accordingly, despite the positive surprise in the first quarter, we continue to be cautious and expect a modest recovery of 1.6% in 2016.
- As regards prices, inflation fell by 0.2 pp to a negative 0.2% YoY in April, in line with expectations, as a result of the fall in energy prices, but also of the moderation in inflation of services, which caused underlying inflation to moderate by two tenths of a percentage point to 0.8% YoY. This was expected (indeed the moderation was somewhat less than envisaged in our forecasts) due to the effect of the difference in timing of Easter compared with last year, which was behind the sharp increase seen in March. Going forward, we continue to expect weak and relatively stable underlying inflation, somewhat below 1%, throughout the year, with trends in the price of oil continuing to be the main determinant of the overall inflation rate in the coming months, such that negative rates could persist during the second quarter and only pick up slowly after the summer to reach somewhat positive rates at year-end (around 0.5% YoY).

What we expect from the ECB

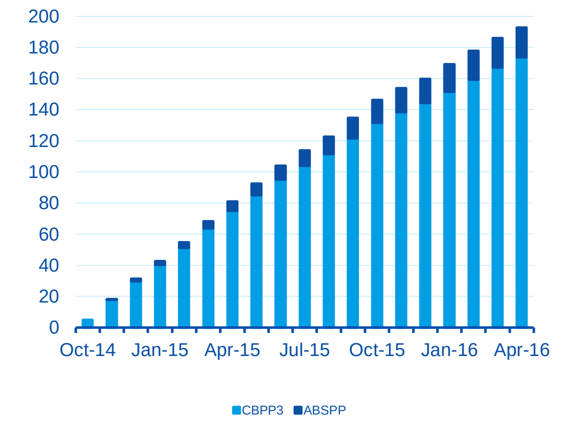
- The monetary policy meeting of 21 April produced no changes in the ECB's stance, with the MRO and deposit rates left unchanged at 0.0% and -0.4% respectively. The ECB confirmed its moderate tone and reaffirmed the trend towards greater flexibility, asserting that, if necessary to attain its objective, it would "act by using all the instruments available within [its] mandate". The ECB hopes and believes however that the recent package of measures will have the desired effects. In June the purchase of corporate bonds (CSPP) will start to be put into effect, along with the new round of TLTROs. For our part, we are not expecting any additional measures in the short term.

Graph 1
PSPP: weekly purchases of bonds, cumulative since 9 March 2015, (€ billions).



Sources: ECB and BBVA Research

Graph 2
CBPP3 and ABSPP
Cumulative weekly purchases (€ billions)



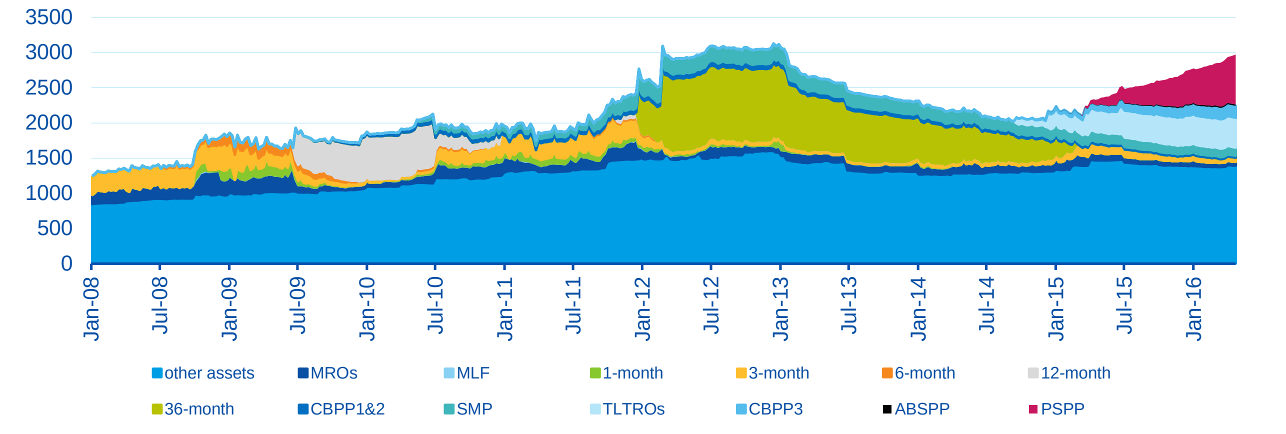
Sources: ECB and BBVA Research

Table 1
Monetary expansion measures (€ billions)

	Sep-14	Oct-14	Nov-14	Dec-14	Jan-15	Feb-15	Mar-15	Apr-15	May-15	Jun-15	Jul-15	Aug-15	Sep-15	Oct-15	Nov-15	Dec-15	Jan-16	Feb-16	Mar-16	Apr-16
TLTRO	82,6			130,0			97,8			73,8			15,5			18,3			7,3	
CBPP3		4,8	13,0	11,8	10,6	11,0	12,4	11,5	10,0	9,9	9,0	7,5	10,1	10,0	6,9	5,8	7,2	7,8	7,8	6,6
ABSPP		0,0	0,4	1,0	0,6	1,1	1,2	1,2	1,4	1,6	0,9	1,3	1,9	1,6	0,6	0,1	2,3	0,9	0,4	0,1
PSPP							47,4	47,7	51,6	51,4	51,4	42,8	51,0	52,2	55,1	44,3	52,9	53,4	53,1	78,5

Sources: ECB and BBVA Research

Graph 3
ECB balance sheet (€ billions)



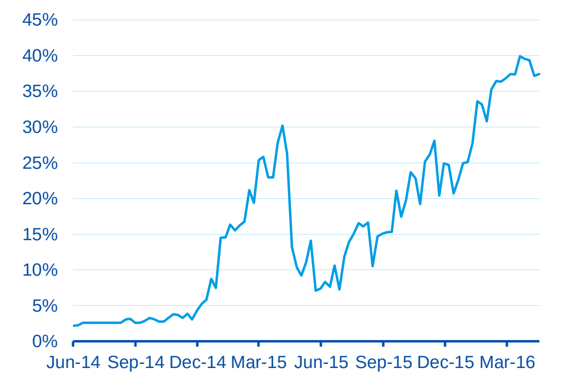
Sources: ECB, Bloomberg and BBVA Research

Table 2
Amount outstanding of ECB-elegible Corporate debt ECB-elegible (EUR bn)

Sector	Total	FR	NL	DE	IT	ES	BE	LU	AT	IE	FI	PT	GB
Total	619	189	170	73	66	40	33	17	10	9	5	2	3
Utilities	159	48	49	4	30	15	6	0	2	1	2	0	0
Technology	9	1	2	5	0	1	0	0	0	0	0	0	0
Materials	34	6	9	12	0	0	1	6	0	0	0	0	0
Industrials	73	35	13	5	8	5	2	1	1	2	0	2	0
Health Care	22	12	3	5	0	0	0	1	0	0	1	0	0
Financials	51	22	19	3	4	0	0	1	0	0	2	0	0
Energy	49	10	17	2	14	0	1	0	4	0	0	0	0
Consumer Staples	50	10	8	2	0	1	23	3	0	0	0	0	3
Consumer Discretionar	102	25	34	32	2	1	0	1	1	7	0	0	0
Communications	71	20	16	3	8	18	1	2	2	0	1	0	0

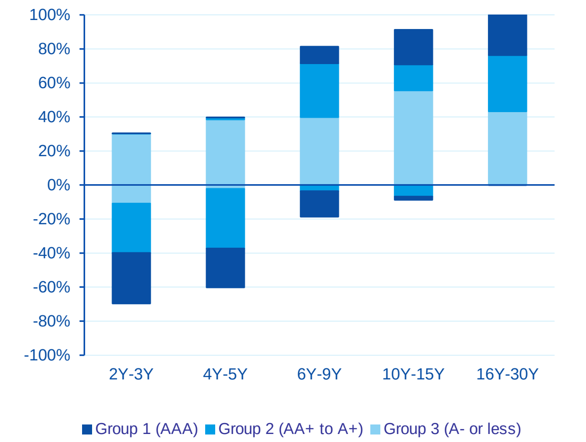
Source: Bloomberg and BBVA Research

Graph 4
% of sovereign debt* (euro-zone) with negative rates as % of total debt



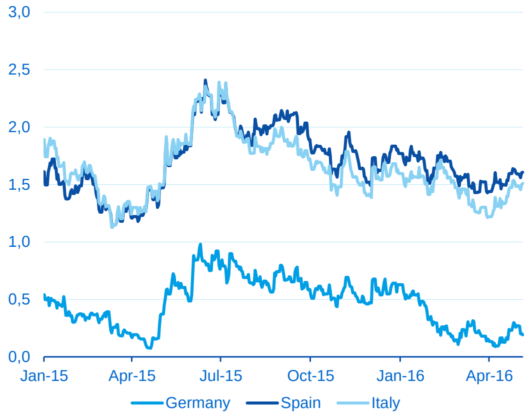
*Eligible under the PSPP
Sources: Bloomberg and BBVA Research

Graph 5
% of sovereign debt* (euro-zone) with positive/negative rates, by country rating.



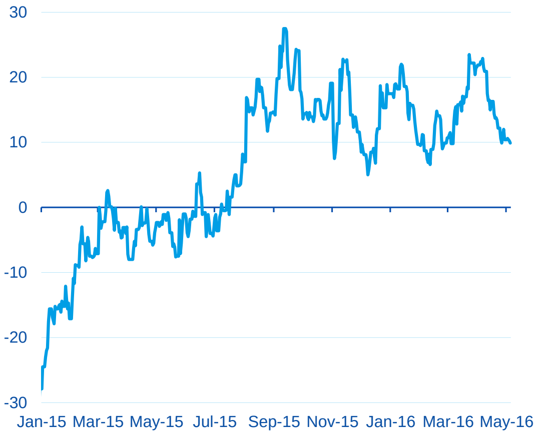
*Eligible under the PSPP
Sources: Bloomberg and BBVA Research

Graph 6
Ten-year interest rates (%)



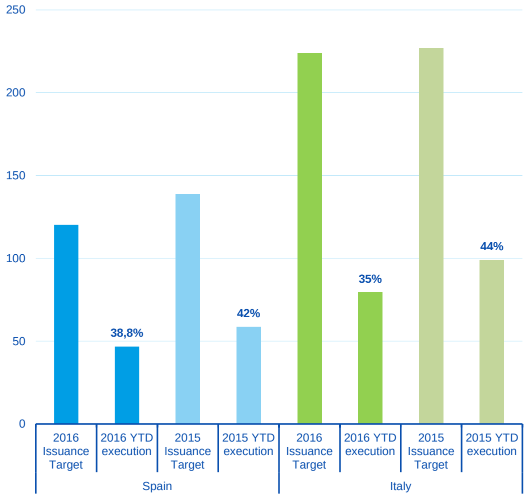
Sources: Bloomberg and BBVA Research

Graph 7
ten-year sovereign yield spread Spain-Italy (bps)



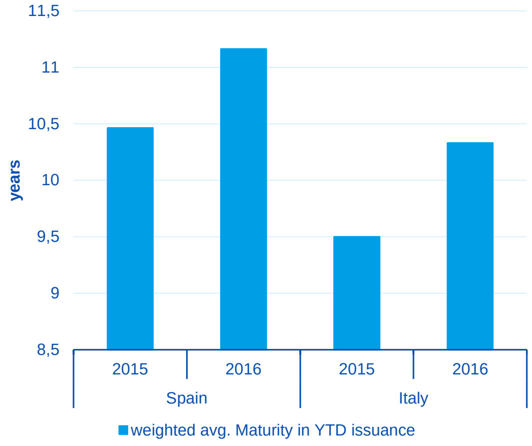
Source: Bloomberg and BBVA Research

Graph 8
Development of medium- and long-term bond issue programmes (April, € bn)



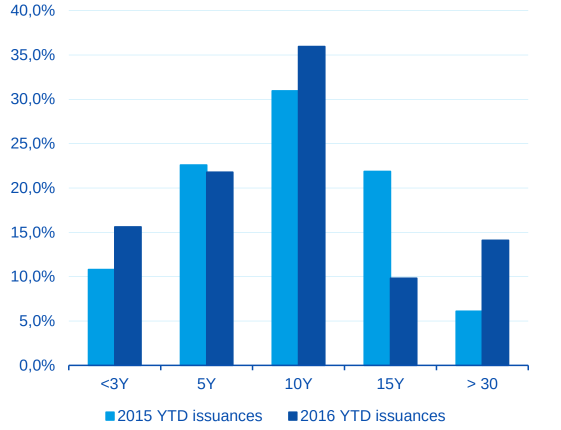
Source: National Treasuries, Bloomberg and BBVA Research

Graph 9
Average life of new issuances of Long and medium-term debt (YTD)



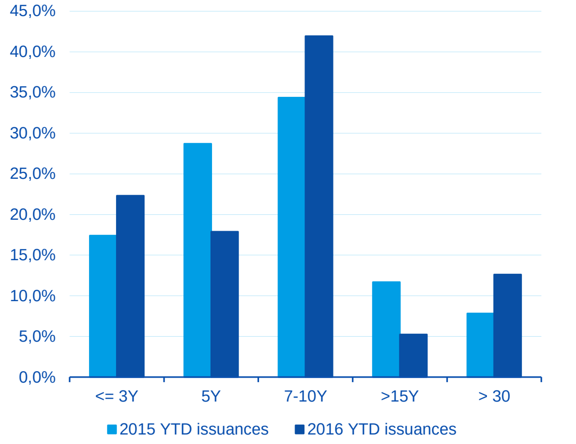
Source: National Treasuries, Bloomberg and BBVA Research

Graph 10
Spain: Issuances by tenor (as percentage of YTD medium and long-term MT and LT bond issuances)



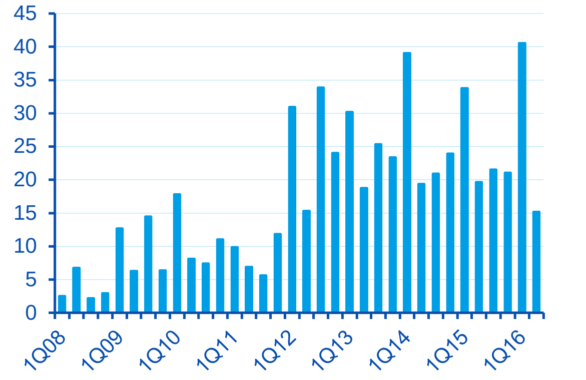
Source: National Treasuries, Bloomberg and BBVA Research

Graph 11
Italy: Issuances by tenor (as precentage of YTD medium and long-term MT and LT bond issuances)



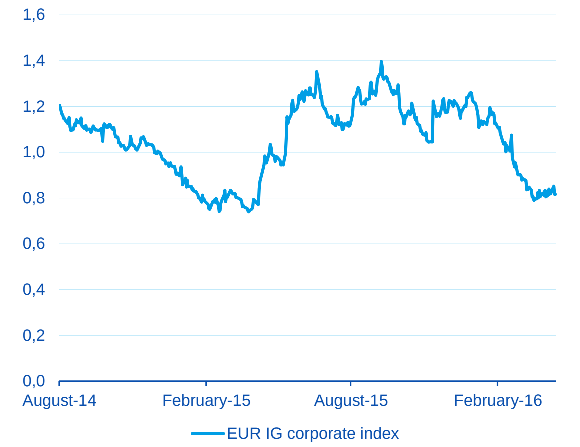
Source: National Treasuries, Bloomberg and BBVA Research

Graph 12
Debt issuances (corporates eligible under CSPP). *
2Q16 only includes April



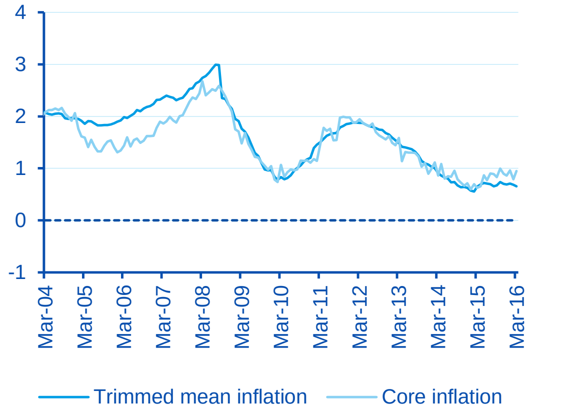
Source: ECB and BBVA Research

Graph 13
IG EUR corporate bond index (%Yield)



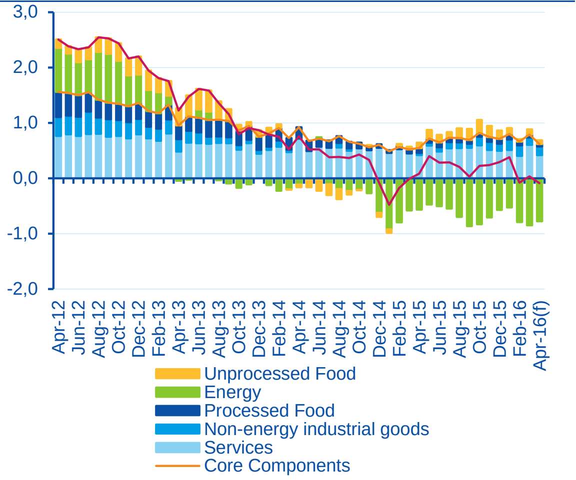
Source: Bloomberg and BBVA Research

Graph 14
EMU: inflation (% YoY)



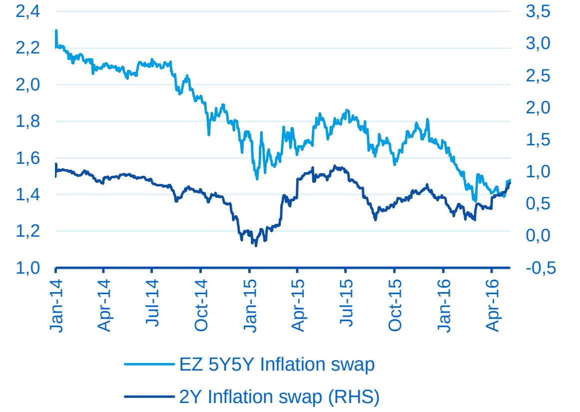
Source: Bloomberg and BBVA Research

Graph 15
EMU: Inflation (% YoY) and contribution of components (% pts)



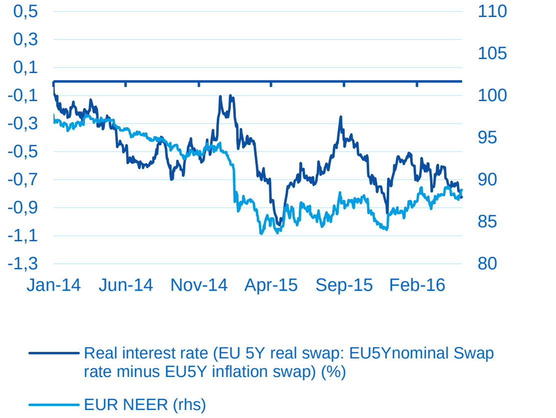
Source: Bloomberg and BBVA Research

Graph 16
Euro-zone: Inflationary expectations implicit in the markets



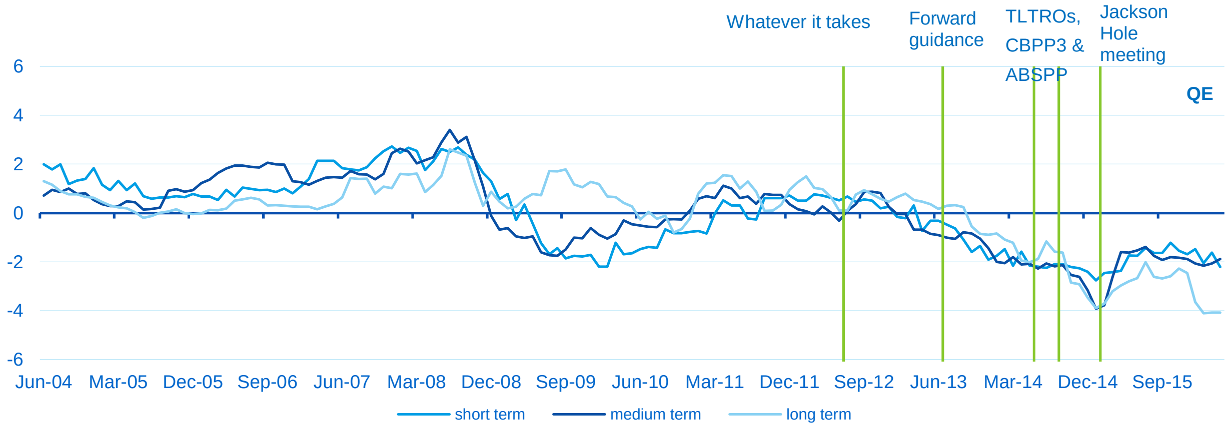
Source: Bloomberg and BBVA Research

Graph 17
Tightening financial conditions



Source: Bloomberg and BBVA Research

Graph 18
Compound indicators for monitoring inflation*
Standard deviations from the mean



*These indicators are constructed using PCA (principal component analysis). To combine these different variables in each sub-index, a z-score is calculated for each, and then the first principal component of these z-scores. The variables included in the short term are: headline and core inflation and GDP deflator. In the medium term: ECB inflation forecasts at a two-year horizon, the 2 yr inflation swap and inflation at a two-year horizon published by the Survey of Professional Forecasters. In the long term: the 5 yr inflation swap, the long-term inflation published by the Survey of Professional Forecasters and the 5 yr/5 yr forward inflation swap. An economic observatory explaining the indicators will be published on the website.
Source: Bloomberg and BBVA Research

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