CENTRAL BANKS

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

Agustín García / María Martínez / Cristina Varela

Balance sheet expansion

- In the 17 months that the asset purchase programmes (APP) have been in force, the ECB has bought €944.9 billion worth of bonds under the public sector purchase programme (PSPP), €127.5[1] billion under the covered bond purchase programme (CBPP3) and €15.4[2] billion under the asset-backed securities purchase programme (ABSPP). Under the corporate bond purchase programme, it has acquired €13.2 billion in bonds since June 2016.
- In July, the asset purchase programme (APP), which includes public and private assets, slightly exceeded the monthly objective of €80 billion[3], with €80.6 billion being acquired. The ECB bought €69.7 billion worth of public sector bonds (PSPP), 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. The average maturity of purchases was 8.3 years, similar to previous months and less than the average of the bonds eligible under QE (9.1 years); in the coming months it is likely that the average maturity will increase, because the universe of bonds that the ECB can buy over -0.4% is continually declining. In June and July, as in previous months, the increase in monthly purchases approved in March (+€20 billion) was heavily skewed to the acquisition of government bonds.
- Under the private asset purchase programme, in July the ECB acquired assets for €10.9 billion, mainly concentrated in corporate bonds (€6.8 billion), since under the covered bonds programme (CBPP3) it acquired €3.3 billion and under the ABS programme it only purchased €0.9 billion.
- In its monetary policy meeting of 21 July, the ECB kept both interest rates and non-conventional measures unchanged, although it said it needs more time to re-evaluate the degree of flexibility of monetary policy. Therefore, we consider it very likely that the ECB will take some additional steps in September, but not radical measures. Although at the meeting Draghi gave no clear clues on the choice of any particular measure, expanding the asset purchase programme could be one of the preferred options in combination with the fine-tuning of its parameters. (see here).

Sovereign debt: banking exposure and sovereign issues

- Financial institutions in the Eurozone reduced their holdings of sovereign bonds by €18.3 billion in the second quarter (-€2.1 billion in June), unlike the first quarter of the year when they increased substantially. Specifically, in June, German and French banks mainly reduced their exposure to public debt (by €5 billion and €3 billion respectively), whereas Italian and Spanish banks further increased theirs (by €7.6 billion and €2.8 billion respectively). In this context, the recent increase in holdings of sovereign debt by financial institutions has been key to increasing sovereign debt exposure
- Overall, sovereign bond issue programmes are being fulfilled relatively well. On average, countries in the Eurozone have already issued more than 60% of their gross issuance target, including the countries of

[1] : €186.6 billion since the start of the programme in October 2014.
2 : €20.4 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.

the European periphery (Spain 70%, Italy 64%, Portugal 70%). In this environment of low interest rates, strategies continue in search of profitability, which has helped to increase the average life of new sovereign bond issues. Issues in tranches of over 10 years has increased by about 13% compared to 2015

Corporate Debt: a new programme, the CSPP.

- The corporate sector purchase programme (CSPP) began on 8 June. In July, the ECB acquired assets for €6.8 billion, slightly higher than the figure acquired the previous month (when it was €6.3 billion). The ECB's purchases have focused on the most representative sectors in bond indices: energy, gas and electricity. In the case of Spain, the largest number of securities was bought in the electricity, energy and telecommunications sectors, but also in insurance and highways. In the case of Germany, bond purchases in the automotive sector are also notable.
- While the ECB continues to focus purchases on the secondary market (94.14%), in July it increased purchases in the primary market (12.4% versus 6% in June).
- Since the announcement of this new programme in March, leading companies in the Eurozone likely to issue eligible bonds within the CSPP have begun to issue a significant amount of debt compared to the same period in previous years (see Figure 12). Although issues were moderated in June-July due to uncertainties (Brexit, Fed), the volume of issues is still above 2015 and very close to the level of 2014.

Market environment

- Financial markets have reacted in an orderly fashion to the risks involved in the Brexit scenario. In any case, at first, the result of the British referendum in favour of leaving the European Union led to a strong risk aversion which resulted in an increased of safe-haven flows towards bond markets, which sank the interest rate on the 10-year German bond into negative territory, and temporarily increased risk premia in the European periphery, but not in a significant fashion thanks to the purchases made by the ECB. However, once it seemed that the exit of the UK would be carried out in an orderly manner, the downward pressure on interest rates and risk premia in the periphery relaxed, although the environment of weak growth is keeping interest rates on 10 year German bonds in negative territory, benefiting purchases of Spanish and Italian government bonds that offer higher returns. Downward pressure on interest rates in the Eurozone has led to more than 50% of the outstanding debt eligible by the ECB having negative returns, reducing the stock of bonds eligible for purchase (mainly German bonds). Since the ECB has not announced a change in the parameters of the PSPP, the scarcity of German bonds has led the ECB to increase the average life of German bonds being bought, dragging down the spread sloped between the German 10-30 year yields.

- The European banking sector has continued to suffer, both as a result of the uncertainty for the sector due to Brexit and the environment of negative interest rates. In addition, the Italian banks' non-performing loan portfolios banks and political uncertainty (constitutional referendum in Italy) have led to underperformance of the Italian debt compared to Spanish debt (Figure 7).
- The euro also depreciated significantly to levels below $1.09 after the outcome of the UK referendum. Although the orderly exit of the UK and the delay in increases in interest rates by the US Federal Reserve Bank have contributed to the subsequent recovery of the euro, it is still trading below pre-referendum levels.
- The search for yield strategies and the ECB purchase programme have led to a fall in the euro denominated corporate debt yields, both in investment grade (-31 bps in a month) and high yield bonds

(-90 bps in a month). There was a general improvement in performance in all sectors, although to a lesser extent in the energy sector.

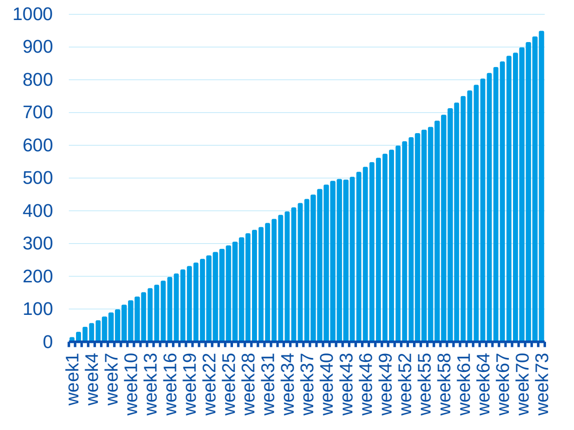
Macroeconomic environment

- GDP growth in the whole Eurozone slowed to 0.3% QoQ in the second quarter after the reversal of some temporary factors driving the strong advance earlier in the year (0.6% QoQ), especially in France and Germany. Without yet knowing the breakdown of GDP by component, available data suggest that a moderation in domestic demand was behind this slowdown in growth, only partially offset by the improvement in net exports. For this quarter only confidence surveys for the month of July are known, which remained practically stable and suggest some resistance by activity in the face of the sharp rise in uncertainty following the Brexit vote. With this still very limited information, our short-term MICA-BBVA model estimates GDP growth of around 0.3% for the third quarter, consistent with our forecast average annual growth of 1.6% for 2016. However, the biases continue to decline as we are still seeing that the uncertainty associated with the UK's exit process from the EU could weigh down consumption and investment decisions in the coming quarters.
- Regarding prices, inflation increased again by 0.1 pp to 0.2% YoY in July mainly due to the rebound in unprocessed food prices, while core inflation remained stable at 0.8% YoY. Going forward, we still expect a weak and relatively stable core inflation of slightly below 1% for the remainder of the year. The evolution of the price of oil will remain the main determinant of the evolution of the overall rate in the coming months, so we expect that it will gradually rebound to rates slightly below 1% around the end of the year.

What we expect from the ECB

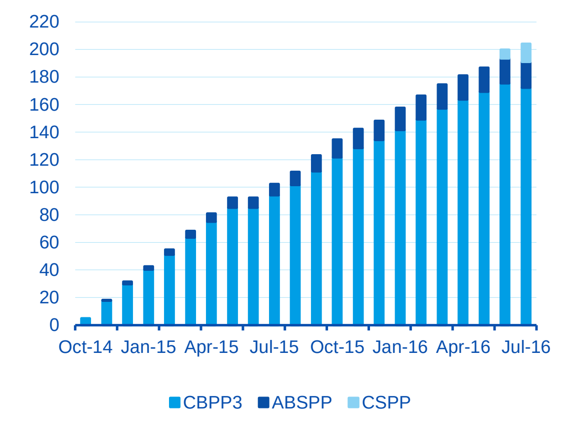
- In its monetary policy meeting of 21 July, the ECB kept both interest rates and non-conventional measures unchanged, although it said it needs more time to re-evaluate the degree of flexibility of monetary policy. Therefore, we consider it very likely that the ECB will take some additional steps in September, but not radical measures. Although at the meeting Draghi gave no clear clues on the choice of any particular measure, expanding the asset purchase programme could be one of the preferred options in combination with the fine-tuning of its parameters, mainly due to lack of volume of debt eligible under the APP in some countries.

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



Source: ECB and BBVA Research

Figure 2
CBPP3, ABSPP and CSPP Cumulative weekly purchases (€ billions)



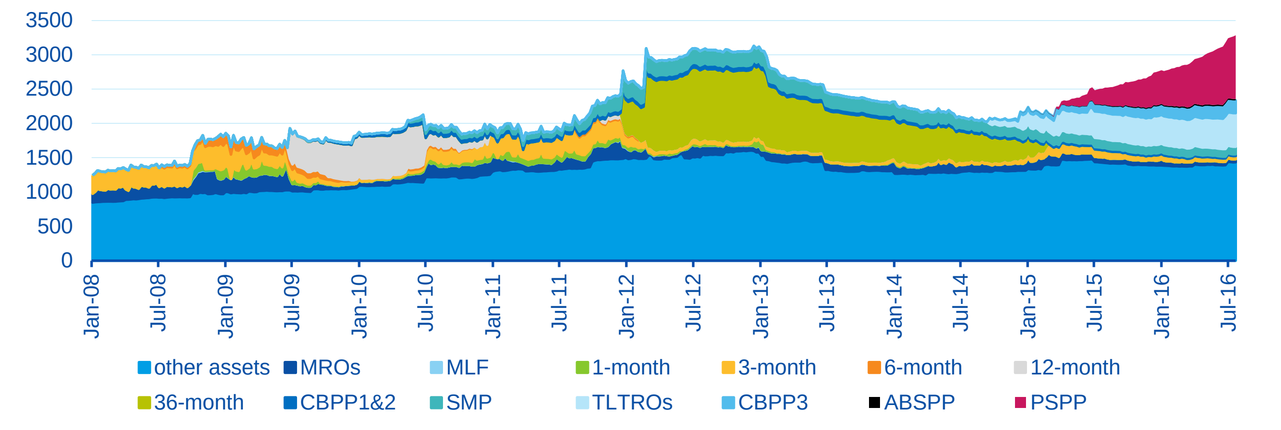
Source: ECB and BBVA Research

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	May-16	jun-16	jul-16
TLTRO	82,6			130,0			97,8			73,8			15,5			18,3			7,3			405,7	
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	5,6	6,1	3,3
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	0,0	0,5	0,9
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	79,6	72,1	69,7
CSPP																						6,4	6,8

Source: ECB and BBVA Research

Figure 3
ECB balance sheet (€ billions)



Source: ECB, Bloomberg and BBVA Research

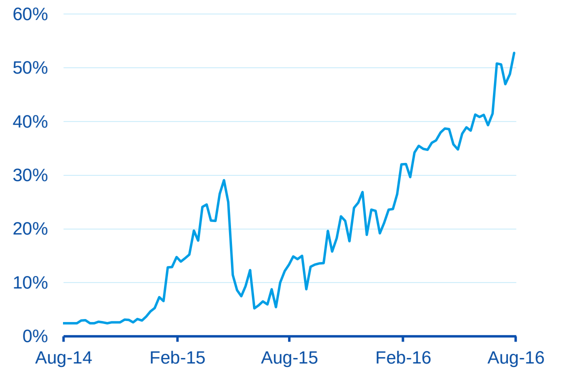
Table 2
ECB eligible outstanding corporate bonds* (€ billions)

Sector	Total	FR	DE	IT	ES	NL	BE	CH	AT	PT	IE	US	FI	GB	LU
Total	434.2	206.2	156.0	84.6	61.5	40.9	31.8	20.2	10.1	8.0	4.2	3.6	5.4	4.2	2.3
Utilities	123.6	48.2	16.2	39.1	27.0	10.1	6.0	0.0	2.5	6.8	1.1	0.0	2.1	0.0	0.0
Technology	9.6	0.0	5.3	0.0	0.9	3.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Materials	19.1	9.3	15.6	0.0	0.0	3.6	0.5	8.7	0.0	0.0	0.0	0.0	0.0	2.1	0.0
Industrials	54.8	40.7	12.4	8.5	6.3	1.0	0.8	2.0	0.7	1.2	0.7	2.5	0.0	0.0	0.0
Health Care	15.5	12.4	6.0	0.0	0.0	0.0	0.0	3.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financials	22.9	24.6	15.8	3.8	1.9	5.5	0.1	0.0	0.3	0.0	0.0	0.0	2.7	0.0	0.9
Energy	43.0	12.1	2.3	15.4	5.7	13.5	0.7	0.0	4.3	0.0	0.0	1.1	0.0	0.0	0.0
Consumer Staples	41.5	10.0	3.2	0.0	0.8	3.6	23.0	4.8	0.0	0.0	0.8	0.0	0.0	0.0	0.0
Consumer Discretionary	54.5	26.8	64.5	8.4	0.7	0.0	0.0	1.0	0.6	0.0	1.7	0.0	0.0	0.0	0.0
Communications	58.5	22.2	14.7	9.5	18.2	0.4	0.6	0.0	1.8	0.0	0.0	0.0	0.6	2.1	1.4

*By country of risk

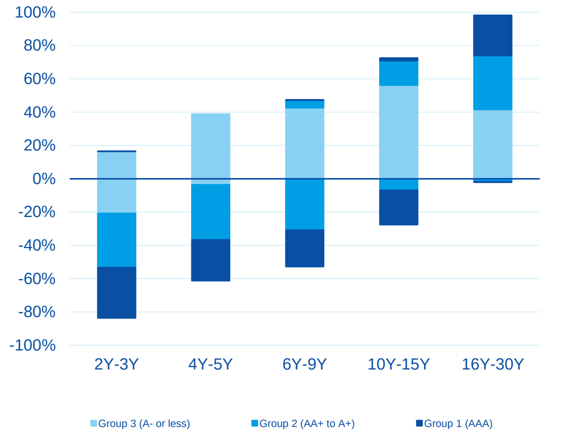
Source: ECB, Bloomberg and BBVA Research

Figure 4
% of sovereign debt* (Eurozone) with negative rates as % of total debt



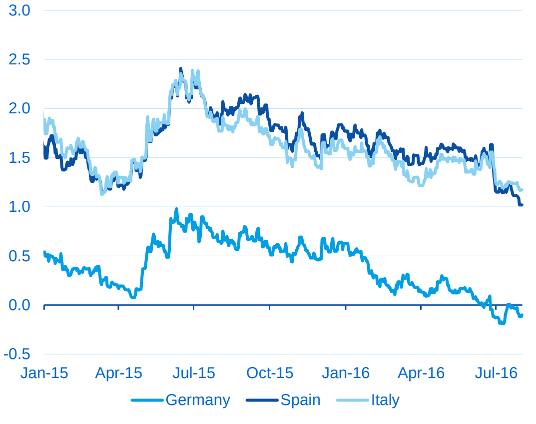
*Eligible under the PSPP
Source: Bloomberg and BBVA Research

Figure 5
% of sovereign debt* (Eurozone) with positive/negative rates, by country rating.



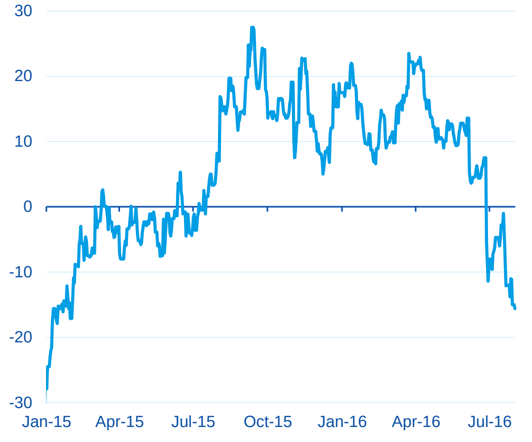
Source: Bloomberg and BBVA Research

Figure 6
Ten-year interest rates (%)



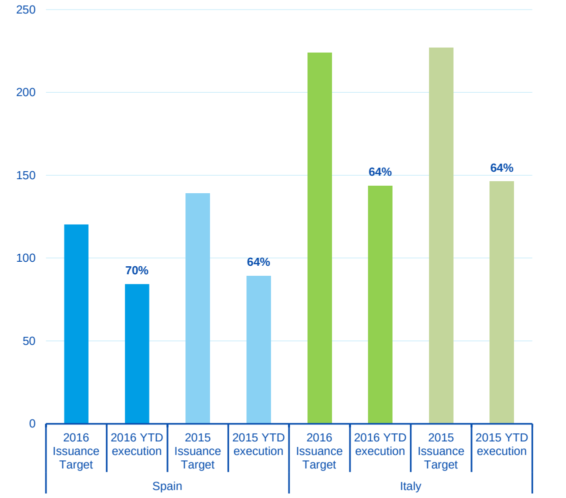
Source: Bloomberg and BBVA Research

Figure 7
Differential ten-year bond yield Spain-Italy (bps)



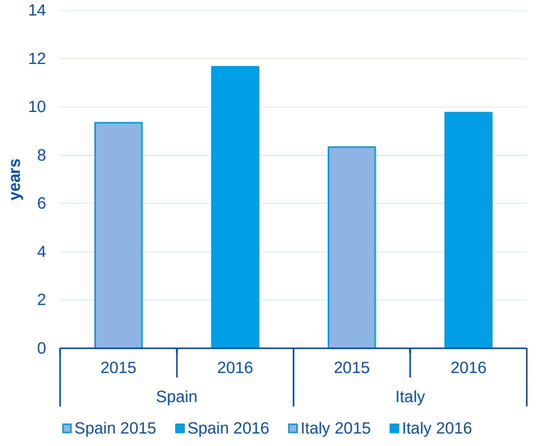
Source: Bloomberg and BBVA Research

Figure 8
Execution of medium- and long-term sovering bond issue programmes (data to July, € billions)



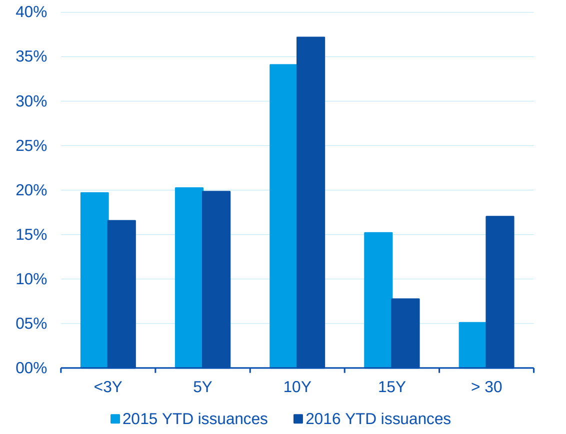
Source: National Treasuries, Bloomberg and BBVA Research

Figure 9
Average life of sovereign bond new issues (data to July)



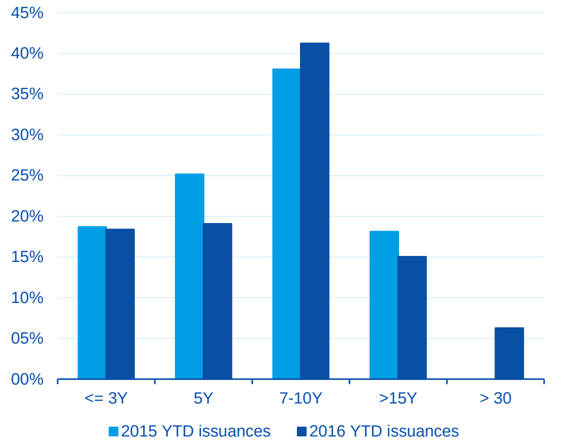
Source: National Treasuries, Bloomberg and BBVA Research

Figure 10
Spain: Gross issuance of sovereign bonds by maturity (% of total gross issuance accumulated in the year, data to May)



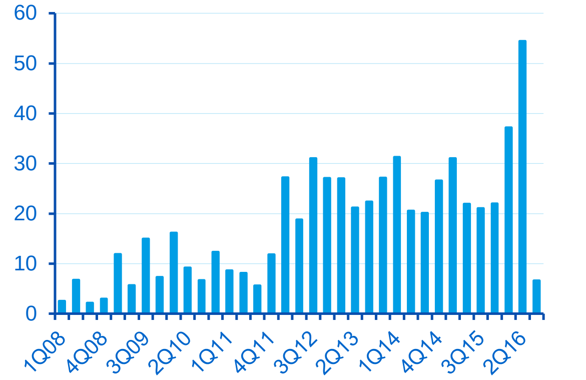
Source: Central banks, National Treasuries and BBVA Research

Figure 11
Italy: Gross issuance of sovereign bonds by maturity (% of total gross issuance accumulated in the year, data to May)



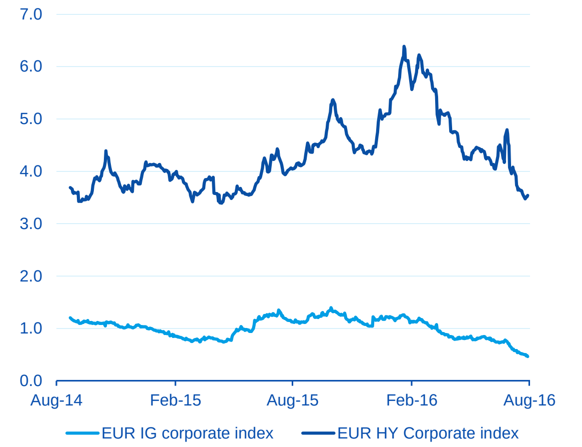
Source: Bloomberg, National Treasuries and BBVA Research

Figure 12
Issuances of corporate debt eligible under the CSPP, (€ billions). * 3Q16 includes until 31 July



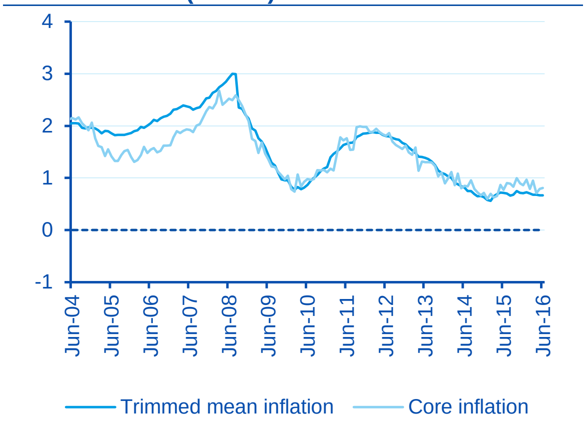
Source: Bloomberg and BBVA Research

Figure 13
Index non-bank corporate bonds issued in euros (% yield)



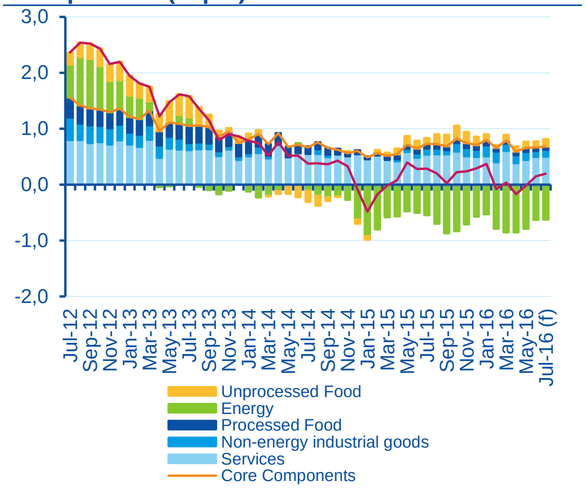
Source: Bloomberg and BBVA Research

Figure 14
EMU: inflation (% YoY)



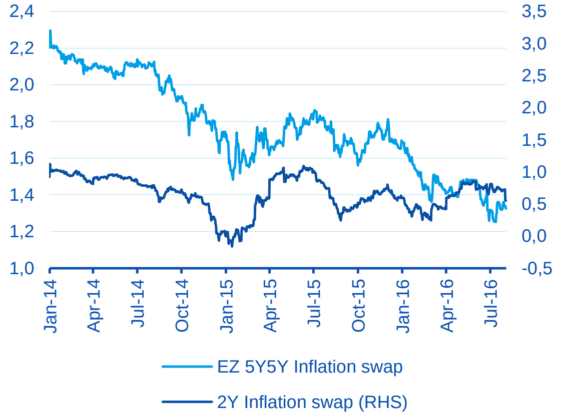
Source: Bloomberg and BBVA Research

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



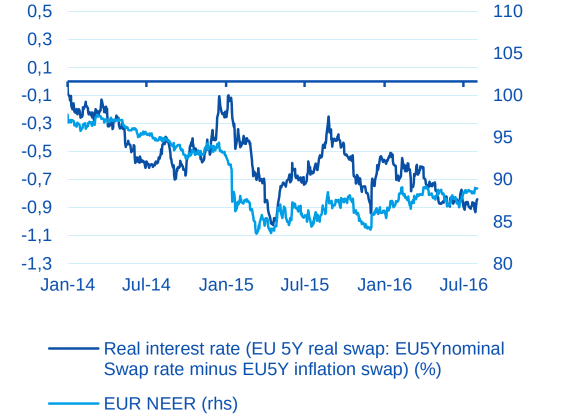
Source: Bloomberg and BBVA Research

Figure 16
Euro zone: Market inflation expectations



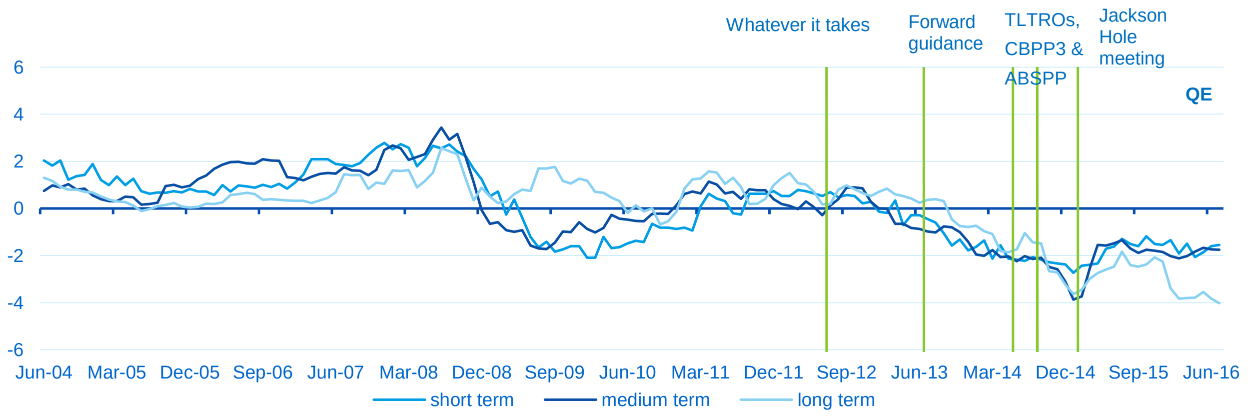
Source: Bloomberg and BBVA Research

Figure 17
Financial conditions



Source: Bloomberg and BBVA Research

Figure 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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