FLASHBACK OR NEW TRACK? MARKETS REACT AS NATIONAL LOCKDOWNS RETURN

Wisdomtree EU
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Stricter lockdown restrictions are being reimposed across Europe including Germany, France, Greece, Belgium, Italy, Spain and most recently the UK to name a few. One key difference this time around is that each country has added its variation to activities that need to be restricted to contain the virus. This moves us away from the loosening of restrictions we noted for some time as governments tried to revive their local economies from the strong economic contraction caused by national lockdown measures imposed at the start of the pandemic.

As the flu season takes hold and the Covid-19 cases begin to climb, the healthcare system is once again showing signs of strain but now countries having seen the broad based impact of the restrictions on the economy and are considering different measures to contain the spread of the virus. For example, France, which is expected to remain in lockdown until 1 December 2020, has taken somewhat similar measures to the first lockdown with individuals only allowed to leave their homes to buy essential goods, for medical reasons and to exercise for an hour a day meanwhile unlike the first lockdown schools and creches will remain open. In contrast, from 2 November Germany will enforce a partial lockdown which will also last four weeks and will allow shops to remain open with restrictions on space, but gyms, theatres and hotels will be closed.

Most recently, the UK announced a stricter national lockdown similar to France which forces non-essential shops to close but allows schools and nurseries to remain open4. In this blog, we will explore how the bond market has reacted to the recent rise in stricter lockdown measures across Europe and delve into what could be providing support to European Sovereign bond markets amid the weaker growth prospects.

While the current scenario is leaning towards a less favourable one for the European economy one can consider the impact to be less severe than the first global lockdown. We already see that there are different restrictions between countries and more importantly that businesses and households have already spent several months under tight restrictions which have allowed them to become better equipped for the second wave. In some cases, many businesses have expanded their online presence as customers shifted their behaviour towards more online shopping amid the crisis. The travel and hospitality sector will likely once again feel the pain meanwhile other sectors will benefit or obtain more support.

It appears that the market is currently not concerned about the European Central Bank (ECB) and the European Union’s firepower to support EU member states during this crisis.

Government Bond Markets React

- **Germany:** The long end of the German government bond yield curve which can provide an insight into investors' expectations for growth fell with 30 year yield levels falling from -0.16% on 25 November to -0.22% by the end of the week reflecting investor concerns about future economic growth resulting from new lockdown measures being imposed across Europe.

- **Italy:** While Italian Sovereign yields rose under the first lockdown, for now Italian Sovereign yields remain contained with 30-year yields falling from 1.67% to 1.59% for the same period.

- **Spain:** Spanish Sovereign bond yields have also remained contained with yields across the curve generally falling.

Peripheral European government bonds maintain support from investors despite the risk off sentiment in the market noted during the week of 25 November as the stimulus measures such as the Pandemic Emergency Purchase Programme (PEPP) with an envelope of €1.35 trillion and the new issuance of European Union (EU) bonds in October under the SURE[1] programme signal strong signs of support for EU member states.

How did the market react to the new issuance of the EU bonds to tackle the health crisis?

In late October 2020, investors purchased the initial EU social bonds under the SURE instrument in the primary markets. "The deal consisted of two bonds, with notional of €10 billion due for repayment in October 2030 and €7 billion due for repayment in 2040. There was very strong investor interest in this highly rated instrument, and the bonds were more than 13 times oversubscribed, resulting in favourable pricing terms".[2] This transaction marks a record for the highest issued amount in EUR from a Supranational institution and classifies as the largest Social transaction ever printed. It was noted that 578 investors participated to the 10-year tranche and 514 investors in the 20-year tranche.[3]

For investors, the EU bonds issued under the SURE program are a bold statement from the European Union highlighting a more unified Europe amid the current crisis. Under SURE, EU member states agree to help one another through the Union by making financial assistance available through loans[1]. €87.9 billion in financial support to 17 Member States has already been approved with the recent EU bonds issued in October 2020 helping to fund SURE which has now allowed funds to be disbursed to Italy, Spain and Poland.

The market is also anticipating the final approval of €750 billion of EU bonds aimed at funding the EU recovery fund which will provide further support to EU member states amid the Covid-19 crisis. Aside from the yield pick-up that EU bonds offer over German Sovereign bonds, they also signify a path forward towards a more unified Europe in times of crisis which we have not always seen in past crisis. As issuance of EU bonds picks up in 2021, we are likely to see more investor demand as European Sovereign and supranational bond issuance increasingly find a place within investor portfolios potentially looking to create resilience amid future uncertainty.

Source

[1] SURE is the support to mitigate unemployment risks in an emergency. https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/financial-assistance-eu/funding-mechanisms-and-facilities/sure_en

[2] https://ec.europa.eu/commission/presscorner/detail/en/ip_20_1990

[3] Highlights from the European Commission press release dated 20 October 2020. https://ec.europa.eu/info/sites/info/files/about_the_european_commission/eu_budget/sure_1st_dual_tranche_press_release_final_cln.pdf

[4] https://www.bbc.co.uk/news/explainers-53640249

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