

Covered Bond Strategy

Net Shrinkage, CBPP3 Purchases and Price Distortions

- **Net shrinkage, CBPP3 purchases, and price distortions:** The covered bond market is back in shrinkage mode and the ECB continues to buy strongly under CBPP3. We think it is time to switch into cheaper and partly lower-risk credits in the covered bond market.

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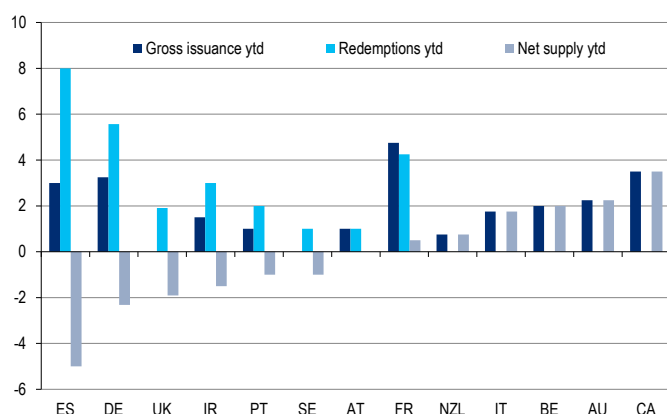
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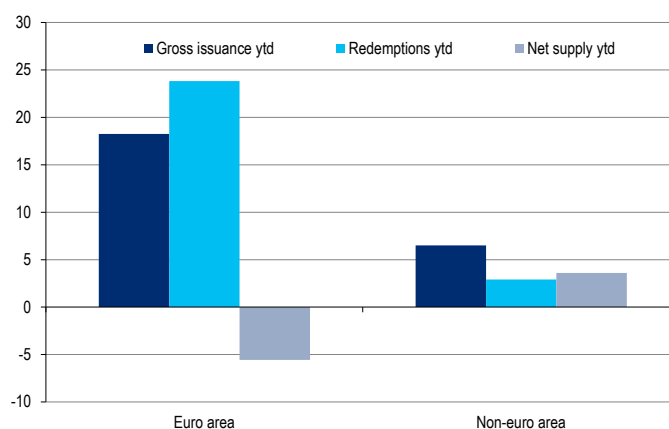
Groundhog Day: After one month of net positive supply, the euro benchmark covered bond market is back again in its now familiar shrinkage mode. The most notable shrinkage, unsurprisingly, was recorded in the Spanish cédula market, followed by Germany and the UK (Figure 1). This is in line with our [2015 Outlook](#). In the UK, issuers have already been active but have preferred to enter the GBP market. On the other side, non-euro area segments have seen positive net supply which should not surprise given the lack of redemptions in these markets. Yet, very early in the year, we have already reached a level in covered bond markets where the ECB needs to hunt for a declining amount of eligible assets. Only non-EEA issuers can compensate the lack of EA supply to a certain extent (Figure 2).

Figure 1. Net supply in euro benchmark covered bond market ytd, €bn



Source: Bloomberg, Citi Research

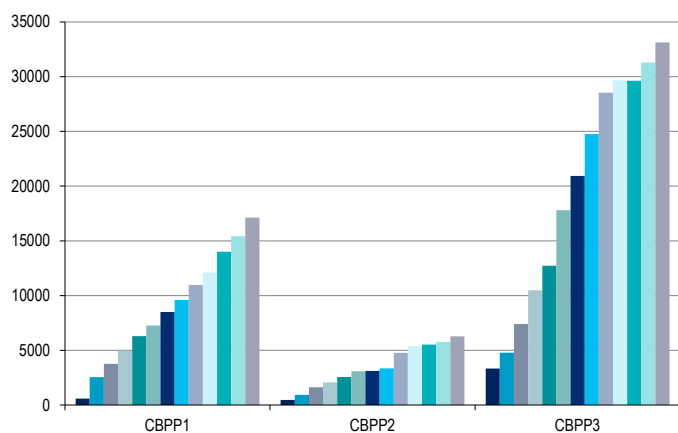
Figure 2. Net supply in euro benchmark covered bond market ytd, €bn



Source: Bloomberg, Citi Research

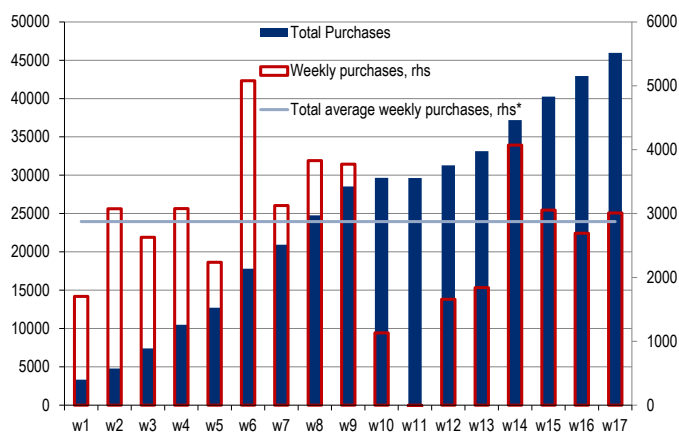
High CBPP3 volumes....: This obviously has repercussions for secondary markets which will continue to play out in the coming months. Our outlook for QE purchases in [sovereign markets](#) leads us to conclude that the ECB will shrink covered bond purchases only slightly and subject to the market environment (e.g. higher volume purchases during times of high primary market activity). At the current stage – i.e. after week 17 – CBPP3 volumes have substantially outpaced purchases under the former programs (Figure 3), while the latest weekly volumes don't suggest the ECB is about to step on the brakes with respect to covered bond purchases (Figure 4).

Figure 3. CBPP purchases in comparison after week 17, €mn



Source: ECB, Citi Research

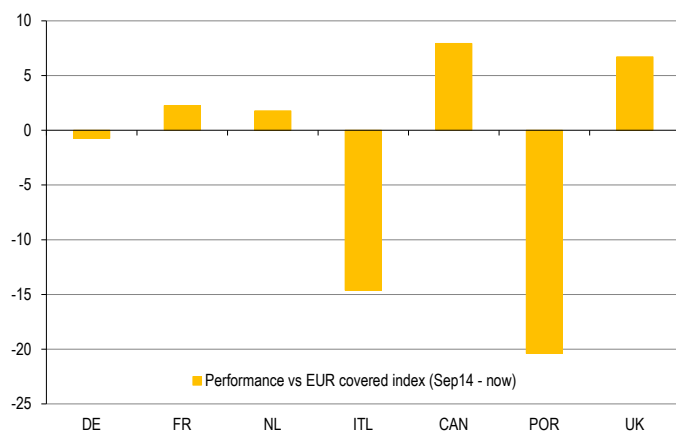
Figure 4. CBPP3 total and weekly purchases since inception, €mn



Source: ECB, Citi Research

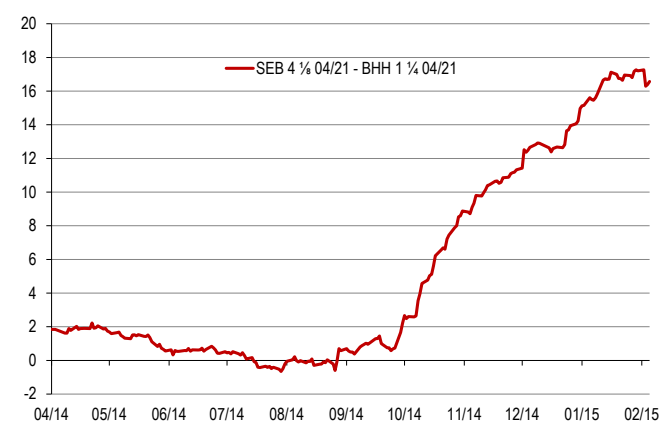
...leading to price distortions.... Investors are well aware of the implications of the enhanced purchase activity for relative valuation within the covered bond segment. The ECB splits market valuation on its eligibility criteria. This is most obvious when comparing strong non-EA credit with core euro-zone covered bond segments. While the general bullish tone supports spread compression, the ECB impact is largely seen in the outperformance of pfandbriefe and the strong underperformance of Canadian covered bonds versus swaps. Yet, we should add that Canadian covered bonds have already been highly active in primary markets, totaling €3.5bn (i.e. 16% of the total volume). But even when looking at segments that are treated equally in most important regulatory regimes, such as CRR, LCR, Solvency II and ECB treatment for repo operations (not for CBPP3), the spread difference has become marked. By way of example, SEB (Aaa/--/--) has underperformed German BHH (Aaa/--/AA+) by 16bp during the last four months.

Figure 5. YYS spread vs euro aggregate covered bond index, bp



Source: Markit, Citi Research

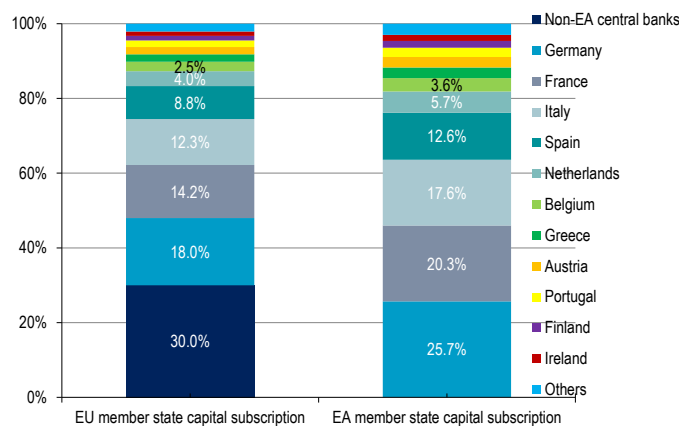
Figure 6. Yield spread between German and Swedish covered bond, bp



Source: Markit, Citi Research

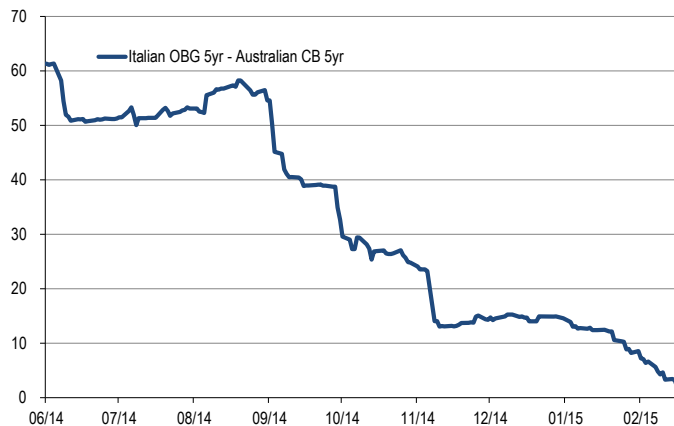
In line with this, Australian covered bonds have strongly underperformed peripheral markets, driven not only by the hunt for yield but also by CBPP3. As purchases under open market operations generally have to follow the ECB capital contribution key, the OBG market is particularly well placed to profit strongly from CBPP3 due to high capital share and the rather low volume of covered bonds outstanding. This has already led to very rich levels compared with non-EA segments.

Figure 7. ECB: National central banks' capital subscription, %



Source: ECB, Citi Research; including and excluding non-EA central banks

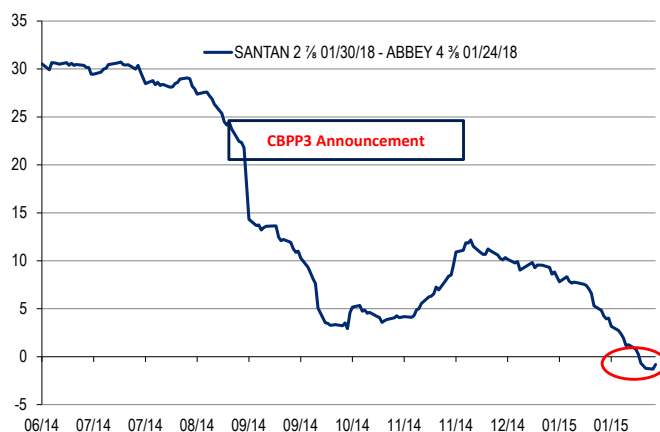
Figure 8. YYS spread between Italian and Australian covered bonds, bp



Source: Citi Research

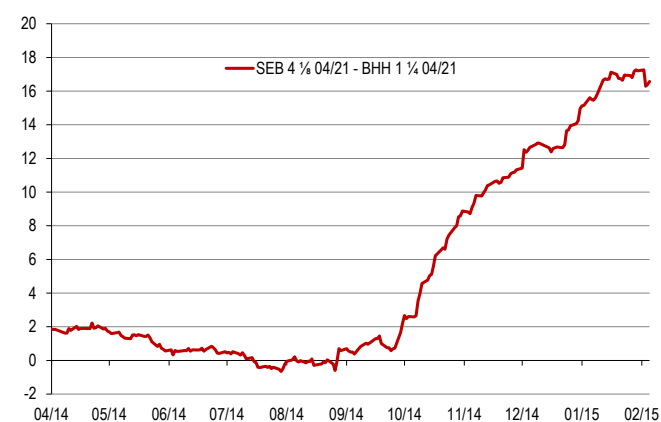
...and RV opportunities: This eventually suggests that investors that are not forced to beat a benchmark will look to avoid such segments where the ECB is heavily active. The implication, in line with our current view, is that the biggest scope for swap spread performance is still found in Tier-2 names of peripheral covered bond markets. With a central bank being determined to reach its balance sheet expansion target, all signs point to further swap spread compression in euro-area covered bond segments. Non-EA segments stand to profit from second-round effects as a significant number of investors will look for the higher-yielding alternative, which – in many cases – is also a step up in quality. Hence, as outlined in our latest [European SSA and Covered Bond Monthly](#), we would prefer covered bonds from the non-EA segment and peripheral covered bonds to (semi-)core EA covered bonds. It's particularly the Scandinavian and UK segments that are treated in line with EA segments under regulatory regimes. As an example, we would prefer the UK covered bonds of Santander Group, rated Aaa/AAA/AAA, to its Spanish peer, rated Aa2/--/AA, at a higher spread (Figure 9). As another example, Swedish covered bonds look historically attractive versus pfandbriefe, exemplified by SEB 04/21 versus BHH 04/21 (Figure 10).

Figure 9. Abbey trading cheaper than Santander Spain, yield spread, bp



Source: Citi Research

Figure 10. SEB strongly underperforming BHH, yield spread, bp



Source: Citi Research

Appendix A-1

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