GENERALI INVESTMENTS

Focal Point

ECB to still absorb 2018 sovereign bond issuance

June 30, 2017

Author: Florian Späte

- Euro area government bond issuance has reached around 60% of the expected gross annual volume by the end of Q2 (in net terms almost two thirds). Therewith, the average monthly issuance volume will decline going forward.
- What is more, the support from QE is expected to remain substantial in the months to come. It will be sufficient to squeeze net issuance of all euro area countries available to markets until year-end into the red.
- At year-end, the ECB will hold more than 20% of all outstanding euro area government bonds. Particularly the scarcity of German Bunds will become an even more pressing issue as the self-imposed issuer limit of 33% is getting closer.
- Although a phasing out of QE from the beginning of 2018 is likely, the ECB purchases will be sufficient to keep the average net supply of euro area government bonds next year close to zero. While it is unlikely to prevent an increase in euro area government bond yields going forward, it will limit their upside potential.

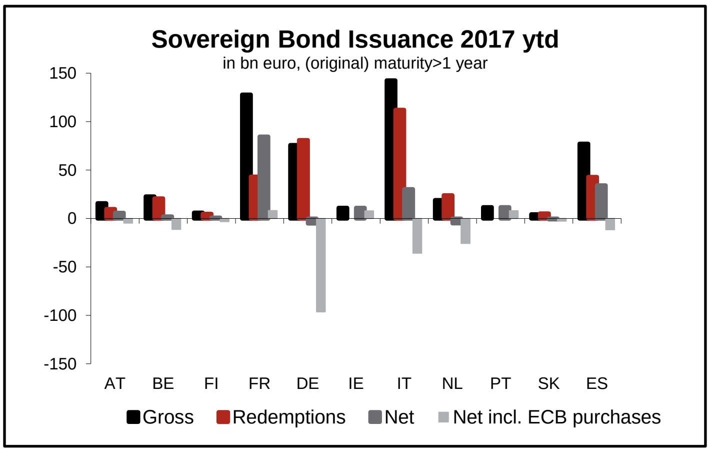
The issuance activity of euro area government bonds is already well advanced. Hence, the use of the primary market will decrease in the second half of the year. Moreover, the ECB will continue to absorb a large part of the gross supply. Hence, the issuer limit of 33% will come into reach in some countries towards the end of the year. Although the ECB is expected to exit the QE programme over the course of next year, the central bank will remain an important driver for euro area sovereign bonds in 2018. Hence, the ongoing substantial displacement effect will limit the upside potential for euro area sovereign yields.

Bond issuance above last year at this stage

Euro area treasurers have exploited the friendly bond market environment in recent months. At the end of H1 the gross issuance volume has reached already around € 520bn. This means that 60% of the expected gross volume for 2017 has already been issued. It is in line with the seasonal pattern that treasurers are more active in the first half of the year than in the second one, but 60% is above the historical average (around 57%). Although redemptions are concentrated in the first half of the year as well, they are less skewed. This implies that particularly the net issuance is well advanced. According to our calculations, almost two thirds of the net issuance of around € 200bn in 2017 has already been absorbed by financial markets.

The aggregate numbers conceal some interesting features at the national level. Among the larger countries, the gross issuance progress of France is slightly above the euro area average. In contrast, Germany has issued less than 50% of the estimated annual volume so far – therewith it ranks last among all euro area countries. Some smaller countries (e.g. Ireland) have met already more than 70% of their gross funding needs.

With respect to maturities, the situation is largely unchanged compared to the last year. Treasurers continue to exploit the low yield environment and focus on long-dated maturities. While only one quarter of new sovereign bonds had an original maturity below 5 years, around 40% of all new bonds had a maturity of more than 10 years.

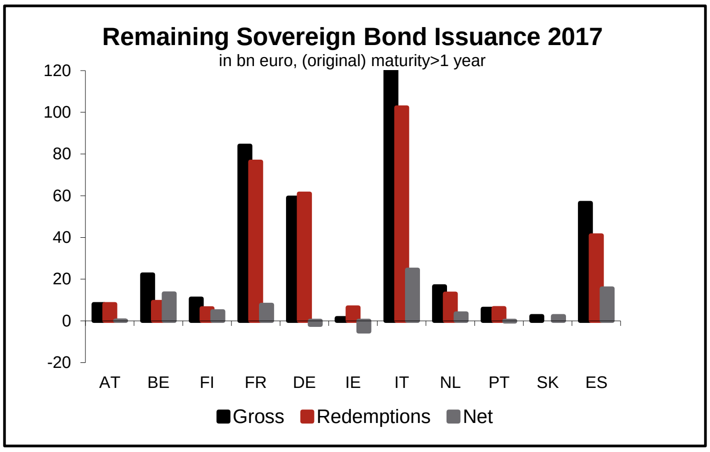


With respect to the net issuance year-to-date, two countries stand out. On the one hand, France has settled around € 70bn (more than 70% of the estimated net issuance in 2017). Despite the high supply, French sovereign bonds have performed well, also thanks to the election of Emmanuel Macron as new president and the subsequent landslide victory of his party in the parliamentary elections. On the other hand, Germany has a negative net issuance year-to-date. This is mainly due to its generally low borrowing requirements.

However, taking into account ECB purchases the aggregate net issuance drops well into negative territory. Almost all countries exhibit a negative net issuance when QE is considered. This shows the central bank's substantial support for euro area sovereign bond markets.

Manageable bond supply until year-end

In light of the well advanced issuance activity, it is no surprise that the average monthly issuance volume will decline going forward. As usual, August and December will be the weakest months. On average, the monthly gross supply will fall by more than € 25bn to around € 60bn. The average net issuance will decrease to slightly above € 10bn per month. Although the ECB lowered its monthly purchases of government bonds to a level of a bit above € 40bn, the difference to the low net issuance indicates the ongoing support by the central bank. The displacement effect will be around € 30bn each month. Hence, the ECB absorbs not only the complete net supply in H2, but it takes down about two thirds of the gross supply (in terms of figures as the ECB is not active on the primary government bond market).

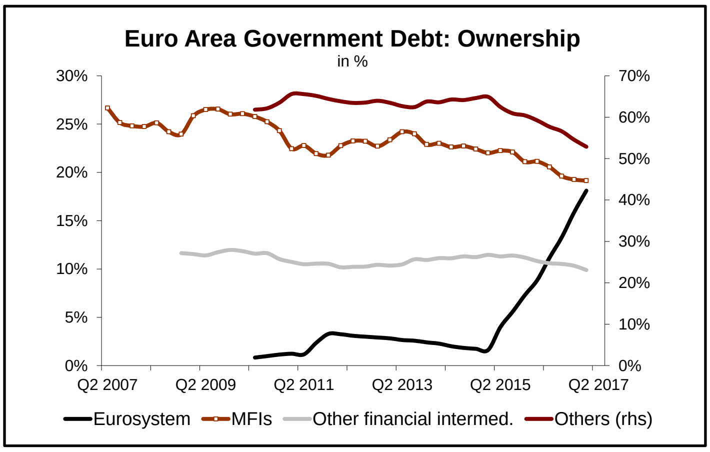


In terms of countries, Italy has the highest net issuance in absolute terms. However, taking into account the QE purchases, the Italian net issuance falls well into negative territory (circa - € 20bn). There is no euro area country which is characterized (including ECB purchases) by a positive net issuance in H2. Hence, upcoming supply is unlikely to be a problem for financial markets. Quite the contrary, it can be said that the well advanced issuance activity in combination with the ongoing QE programme will be an important technical factor supporting euro area bond markets in the months to come.

ECB to hold one fifth of all outstanding govies

The ECB has further increased its influence on euro area sovereign bond markets in recent months. In the first half of 2017 the central bank bought nearly € 290bn of euro area sovereign bonds and this number will increase to more than € 530bn by the end of the year (with ECB overall asset purchases reduced to € 60bn in April). The complete displacement effect for 2017 will be around € 330bn (of which € 180bn will occur in H2). Although the crowding out of other investors will be slightly lower than in 2016, it is still massive and the effects should not be underestimated.

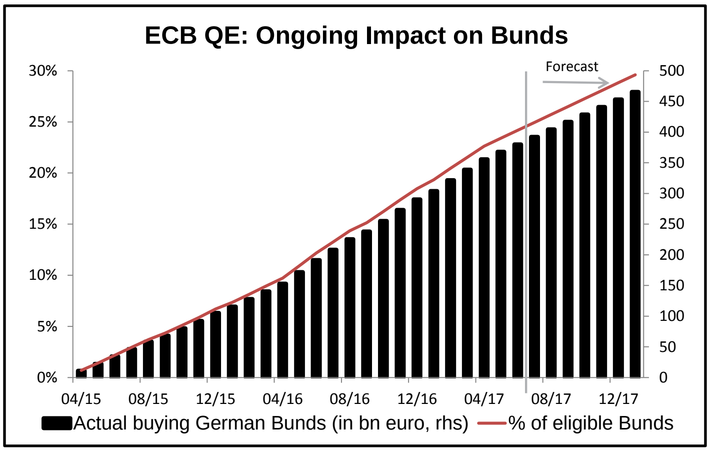
Independent of other fundamental factors, this dislocation effect is one reason for the solid performance of euro area government bond markets until late June. Moreover, the trickledown effect to other fixed income markets is evident. Public and private spreads have been depressed by the ECB's ongoing strong market intervention.



The chart above illustrates the growing importance of the central bank. At the end of Q1, the ECB held around € 1580bn (or 18%) of government bonds. By the end of the year, the total amount will be above € 1950bn (well above 20%). This is at the expense of other investor groups. Particularly, monetary and financial institutions and foreign investors have reduced their holdings in recent years. As an end of the deleveraging trend in the financial sector is not in sight and the share of foreigners is still substantial, this trend is expected to continue for the time being.

Scarcity of some bonds to come to the fore again

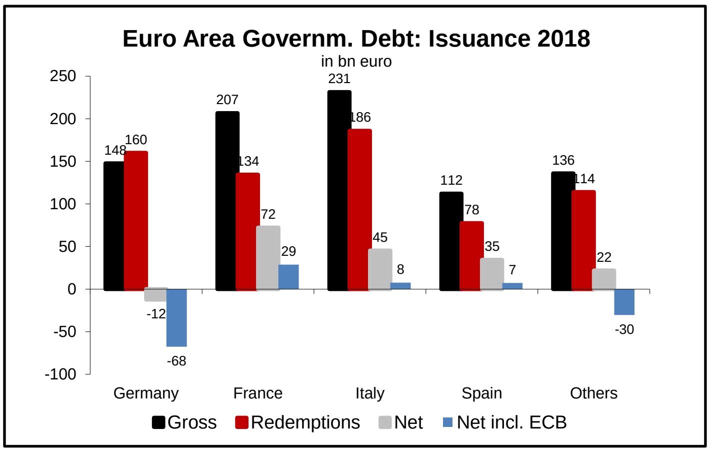
While the aggregate number is already impressive, it conceals some problems related to the purchases according to the ECB capital key. In the past, the central bank deviated in some cases from the implied buying amount (e.g. due to a lack of eligible bonds). As an offset, other euro area bonds were purchased.



However, in light of the self-imposed criteria this system is reaching its limits. Currently, the ECB holds more than € 390bn of German Bunds (nearly 25% of the eligible total). While the central bank has scope to continue its QE programme until the end of 2017, it implies that the ECB will hold nearly 30% of all eligible German papers until then. But, already in recent months the ECB purchased less Bunds than implied by the capital key. Considering that the ECB will phase out its QE programme and taking into account the issuer limit of 33%, the scarcity issue will become pressing again in 2018. Although we expect the ECB to handle the purchases according to capital keys flexibly, the price of German Bunds is expected to incorporate a considerable degree of scarcity.

ECB to absorb the bond net supply even in 2018

Given the improved macroeconomic environment, the ECB is expected to announce (or at least discuss) the QE exit strategy in September. In our opinion, the central bank will phase out its bond purchases starting in January. For the following calculations we assume that the programme will be finished by September 2018. Therefore, the absolute volume of government bonds purchased next year will be much lower. Still, even in this case the ECB will buy government bonds worth more than € 180bn in 2018.



Although it is too early to estimate the exact bond issuance volume in 2018, it can be said that the volume of the QE programme will be close to the net issuance level next year. Hence, while there will be no further displacement effect, the phasing out of the programme will be sufficient to absorb the aggregate euro area net issuance volume.

However, this does not imply that, after considering ECB purchases, the net issuance of all euro area countries will be close to zero. The different budget situation leads to a differing net supply. While e.g. Germany will continue to have a negative net supply in 2018, France will effectively have to use the primary market even taking into account the ECB purchases.

ECB to absorb bond net supply even in 2018

While in recent days comments by the ECB which were perceived as hawkish and the continuation of strong macroeconomic data releases put upward pressure on euro area yields, the continuation of the QE programme in the months to come will have a dampening effect on euro area sovereign yields. The negative net supply until year-end is a strong technical factor which has an opposing effect to the improved macroeconomic environment. This effect will not disappear next year and it is forecast to still impact euro area government bond markets (to a varying degree). However, we do not expect the QE programme to be the dominant factor in the months to come, but only to dampen the expected increase in euro area sovereign yields (12-month forecast 10-year Bund yield: 0.75%). Given that the utilization of primary markets has not been a key factor for the determination of the yield development in the past, this is unlikely to happen in future. Eventually, the solid growth environment in combination with increasing underlying price pressure will drive up yields. What is more, starting in 2018 the slowly declining market distortion due to the ECB withdrawal from the bond market is seen to have a yield increasing impact, too.

Imprint

Head of Research (*ad interim*):	Santo Borsellino (santo.borsellino@generali-invest.com)
Deputy Head of Research:	Dr. Thomas Hempell, CFA (thomas.hempell@generali-invest.com)
Team:	Luca Colussa, CFA (luca.colussa@generali-invest.com) Radomír Jáč (radomir.jac@generali.com) Jakub Krátký (jakub.kratky@generali.com) Michele Morganti (michele.morganti@generali-invest.com) Vladimir Oleinikov, CFA (vladimir.oleinikov@generali-invest.com) Dr. Martin Pohl (martin.pohl@generali.com) Dr. Thorsten Runde (thorsten.runde@generali-invest.com) Frank Ruppel (frank.ruppel@generali-invest.com) Dr. Christoph Siepmann (christoph.siepmann@generali-invest.com) Dr. Florian Späte, CIIA (florian.spaete@generali-invest.com) Dr. Martin Wolburg, CIIA (martin.wolburg@generali-invest.com) Paolo Zanghieri (paolo.zanghieri@generali.com)

Issued by:	Generali Investments Europe Research Department Cologne, Germany · Trieste, Italy Tunisstraße 19-23, D-50667 Cologne
Sources for charts and tables:	Thomson Reuters Datastream, Bloomberg, own calculations

In Italy:	**In France:**	**In Germany:**
Generali Investments Europe S.p.A Società di gestione del risparmio Corso Italia, 6 20122 Milano MI, Italy	Generali Investments Europe S.p.A Società di gestione del risparmio 2, Rue Pillet-Will 75009 Paris Cedex 09, France	Generali Investments Europe S.p.A. Società di gestione del risparmio Tunisstraße 19-23 50667 Cologne, Germany

www.generali-invest.com