GENERALI INSURANCE ASSET MANAGEMENT

FOCAL POINT

EGBs: Private sector must (almost) absorb the issuance volume on its own

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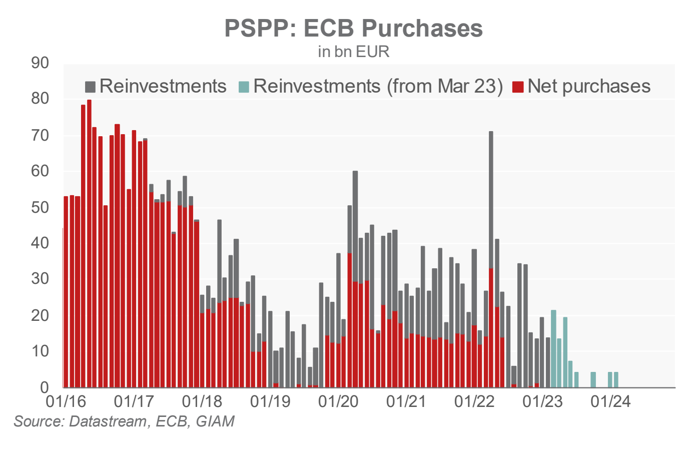
Our Focal Point series explores topical issues on macro, markets and investment

- **Given the ECB's Quantitative Tightening (QT), 2023 differs significantly from recent years in terms of the issuance volume to be taken down by the private sector. Since March, the ECB has only partially invested maturing bonds. We deem it likely that from July onwards, the ECB will hardly reinvest PSPP government bonds.**
- **Accordingly, EA net-net government bond issuance will rise to the highest level since the Great Financial Crisis in 2023. Aware of the tight technical situation, EA treasurers pushed ahead with issuing activity in Q1 and have already placed more than 30% of the scheduled annual volume.**
- **As in previous years, ESG bonds are also issued. Given the low volume, however, ESG bonds remain a niche product in the EA sovereign bond market.**
- **Given the partial withdrawal of the ECB, the technical situation will remain tense for the remainder of the year and into 2024, somewhat slowing the expected decline in yields over the next months.**

To a certain extent unnoticed given the turmoil in financial markets, there has been a structural turnaround in the European bond markets since the beginning of March. While the ECB already stopped its net purchases under the Public Sector Purchase Programme (PSPP) and the Pandemic Emergency Purchase Programme (PEPP) last year, this month the central bank started to stop reinvesting all maturing bonds purchased under the PSPP (the ECB committed to reinvesting maturing PEPP bonds at least until the end of 2024). Not only does this mark the end of years of active support for the bond markets, but it also implies the beginning of a cautious reduction in the central bank's holdings. Until the end of Q2, the ECB will not reinvest a volume of € 15bn per month. However, this refers to the entire Asset Purchase Programme (APP) and thus includes government bonds as well as Asset-Backed Securities, covered and corporate bonds. Government bonds also include supranationals. Hence, sovereign bonds only account for a volume of around EUR 10bn/month. This implies that between March and June, around € 40bn of maturing sovereign bonds will not be reinvested.

Additionally, the central bank has announced that it will review the extent of QT in the coming weeks. Notwithstanding the turmoil in financial markets, we assume that the volume will double to € 30bn from July. Considering again that this refers to the entire APP it implies that around €120 bn will be withdrawn from the sovereign bond market between July and December (bringing reinvestments to almost zero). For the financial market, this creates an entirely new situation that is characterized by a reversing of the long-term trend of increasing the absolute and relative importance of the ECB.

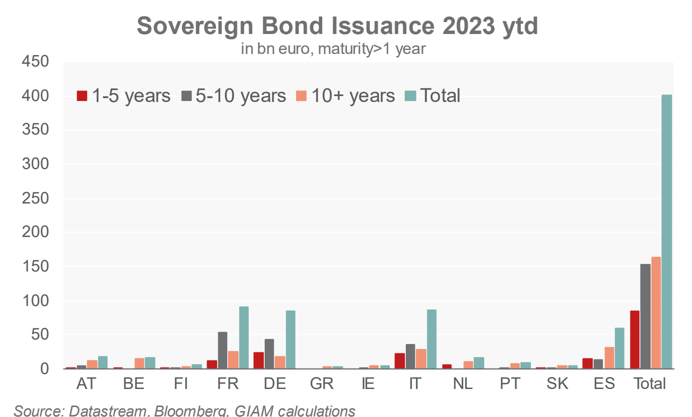
While the stock of sovereign bonds the ECB holds remains high considering the ongoing reinvestments of PEPP bonds and the current stock of PSPP sovereign bonds (we estimate that by the end of 2023, the ECB will still have almost €3650bn sovereign bonds on its books), private investors will have to step in.



Source: Datastream, ECB, GIAM

Gross issuance activity is ahead of schedule

Basically, the first quarter is always the one with the busiest issuing activity. However, knowing about the deteriorating technical situation, EA treasurers pushed issuance activity in Q1 to a particular extent – even during the turbulent time in March. By the end of March, a volume of more than € 400bn will have been issued (restricting the analysis to fixed income paper with maturity above 1 year). This is about one-third of the forecast annual issuance volume and slightly above the average share of issuances by the end of Q1 in previous years.

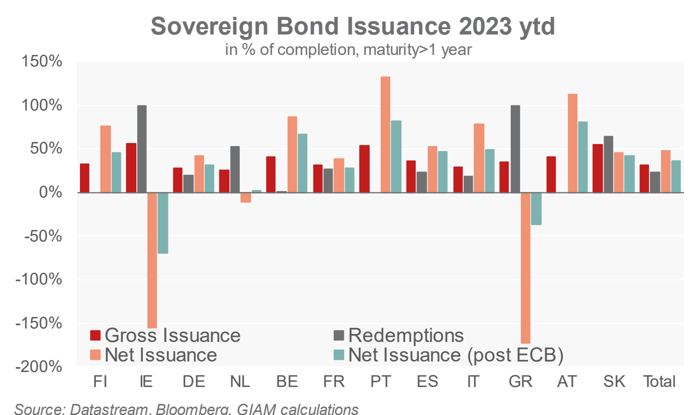


Source: Datastream, Bloomberg, GIAM calculations

The aggregate numbers conceal some interesting features at the national level. While France's issuing activity is in line with the EA average, Italy's and Germany's are slightly below average. On the contrary, some smaller countries have met already more than 50% of the gross funding needs (e.g., Ireland, Slovakia, Portugal). Despite the higher yield level EA treasurers continue to place a heavy emphasis on very long-dated bonds (additionally favoured by the inversion of the yield curve). Only about one-fifth of newly issued sovereign bonds had an original maturity below 5 years (compared to around one-fourth in previous years). This is compensated by an increasing share of almost 40% of bonds with an original maturity between 5 and 10 years. With a stake of over 40%, the share of very long-dated bonds (10+ years) remains very high. It is noteworthy that the large countries France, Germany, and (to a lesser extent) Italy have not focused on very long-dated bonds to the same extent as the EA average but have mainly issued bonds in the belly of the curve. As QT is not yet in full swing, we expect a continuation of the brisk issuance activity in Q2 and anticipate a completion of the annual issuance programme of at least 60% by the end of H1.

Although Q1 2023 is almost over, it should be emphasized that the planning of the EA treasurers is currently characterized by a high degree of uncertainty. While declining energy prices tend to reduce fiscal expenditures, the turmoil in the banking sector has the potential to increase funding needs. According to our current assessment, we expect a gross issuance volume of just over € 1250bn in 2023 which implies that about € 850bn still needs to be placed (a little above € 400bn have already been issued).

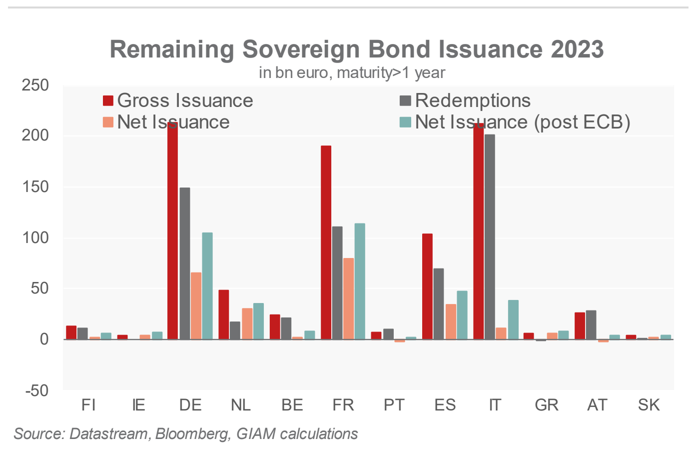
Because redemptions in Q1 tend to be below average, the situation concerning the net issuance year-to-date is even better than for gross issuances. As only a little more than € 180bn of sovereign bonds were redeemed in Q1 the net issuance year-to-date has already reached a level of around € 220bn. This means that roughly one-half of the net issuance volume is already completed (forecasting a slightly higher net issuance of € 450bn in 2023 compared to 2022), well above the share by the same date in previous years. This suggests that net issuance may decline somewhat in the coming months. However, this should not overshadow the fact that the absolute volume will remain high.



Source: Datastream, Bloomberg, GIAM calculations

Additionally, the situation is further clouded by the QT that has just begun. Net-net issuance (including ECB's QT) will reach the highest level since the Great Financial Crisis. As the ECB is forecast to withdraw funds worth € 160bn in 2023, it means

that the net-net issuance will be above € 600bn in 2023. Considering this additional factor, the net-net issuance has reached a level of a little more than 35%. Hence, while the percentage of issuance is slightly above the average of the last years at the end of Q1, the absolute volume that still needs to be placed is noticeably higher than in the past. Especially in H2 2023 when the ECB is set to largely stop reinvesting maturing PSPP bonds, the technical situation will deteriorate. Overall, however, we assume that the aggregate issuance volume is manageable given the volume already issued.



Source: Datastream, Bloomberg, GIAM calculations

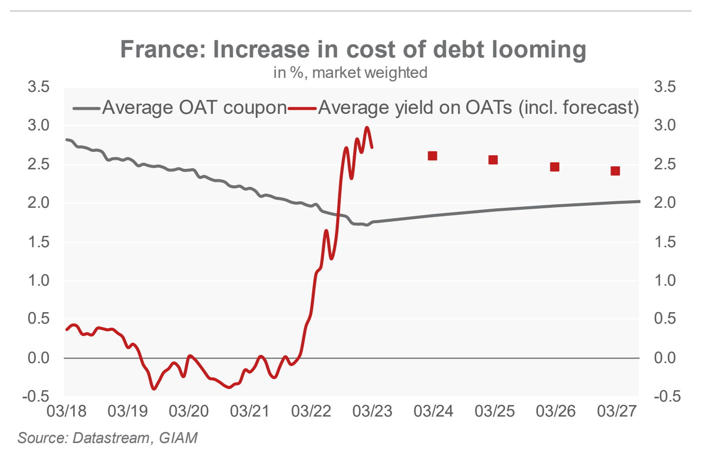
However, the overall picture again hides significant differences at the country level. Even considering the negative cash flow from ECB's QT some countries have achieved already a net issuance share of about two-thirds (Belgium) and even up to 80% (Portugal, Austria). On the contrary, some other countries still have most of the issuance activity ahead which can turn out to be a relevant negative factor going forward. Most strikingly, Ireland and Greece do not have further redemption flows in the remainder of the year. This means that the pending issuance volume of € 4bn (Ireland) and € 6bn (Greece) will have to be funded by the private sector without any support from the ECB. Of the larger EA countries, France appears to be in the weakest position. The outstanding gross issuance of more than € 190bn is offset by about € 110bn in redemptions. However, according to our calculations, the ECB will not reinvest a volume of up to € 35bn of maturing French bonds, implying a remaining net-net issuance worth up to € 120bn.

Two new ESG bonds in the market

In Q1, EA countries continued their strategy of financing part of their funding volume through ESG bonds. However, the share remains small. Year-to-date less than € 15bn of ESG bonds have been issued. This is not even 5% of the total issuance volume. Some EA countries have not yet issued any ESG bonds. ESG bonds thus remain a niche product in the EA sovereign bond market. Mostly already existing ESG bonds were tapped. Since the start of the year, only two already established issuers have issued new ESG bonds: Ireland (€ 3.5bn) and Slovenia (€ 1.25bn). Several countries have announced the issuance of ESG bonds in the coming months. Among others, Germany's Finance Agency will issue two (long-dated) new green bonds and thus continue to build up an EA green benchmark yield curve.

Technicals to slow yield decrease medium term

While it is too early to provide any reliable government bond supply estimates for 2024, the technical situation will not improve significantly next year. Assuming that there are no lasting distortions in financial markets, the ECB is set to continue with QT. This implies that the decline in PSPP sovereign bonds held by the ECB will accelerate and is likely to exceed € 200bn (compared to € 160bn in 2023). At the same time, it is to be expected that the funding requirements of the EA countries will not fall sufficiently to trigger a noticeable decrease in the net-net issuance compared to the current year.



Source: Datastream, GIAM

Moreover, given the higher yield level compared to previous years, interest expenses will increase not only because of high debt levels but also as maturing low-coupon bonds will be replaced with high-coupon bonds (e.g., the current average yield of Italian (French) bonds: 3.6% (2.7%) versus average coupon of 2.8% (1.8%)). Given the elevated debt levels, it cannot be excluded that debt sustainability concerns for countries with high funding needs might come to the fore – particularly in times of market stress.

Nevertheless, we do not forecast the utilization of primary markets to be the main driver of yields in the coming months. Rather, growth concerns and a declining inflation rate in conjunction with a more dovish ECB over the course of the year are likely to determine the yield trend. However, the tight technical situation is seen to limit the yield decline and tends to contribute to a steeper yield curve.

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