Market Commentary – Supportive technical situation for EA government bonds in H2 2021, but choppier times to follow

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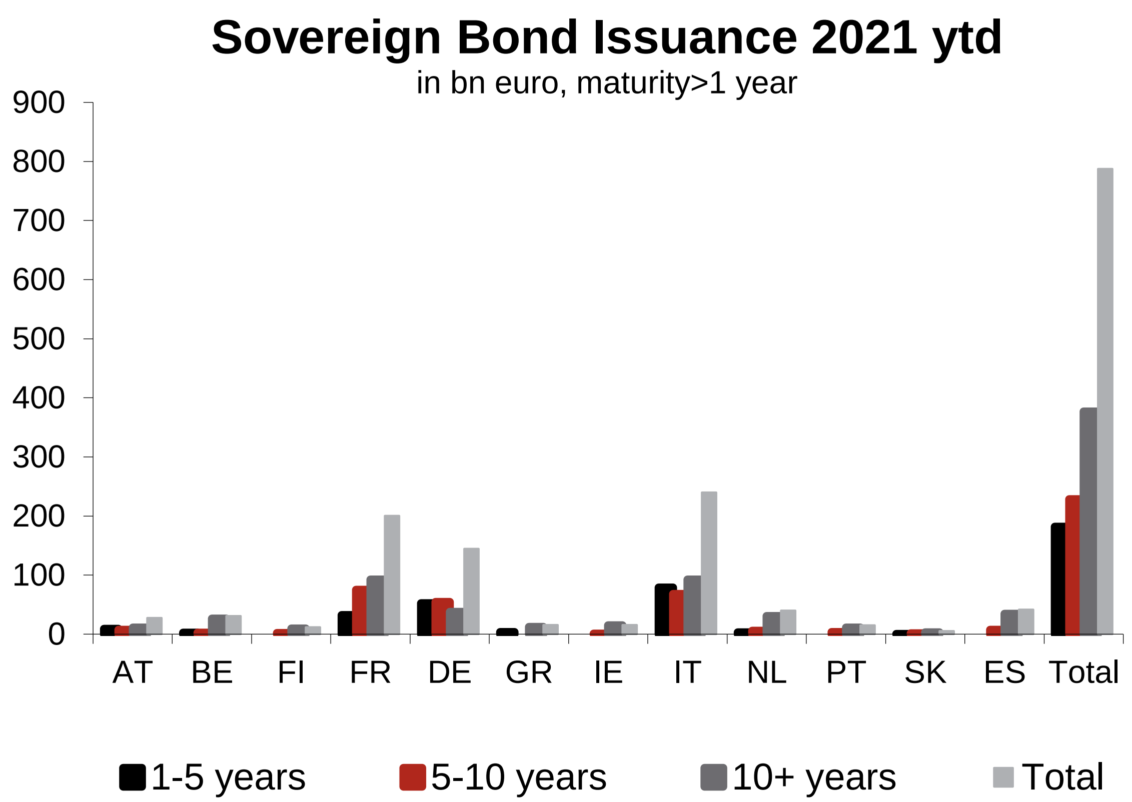
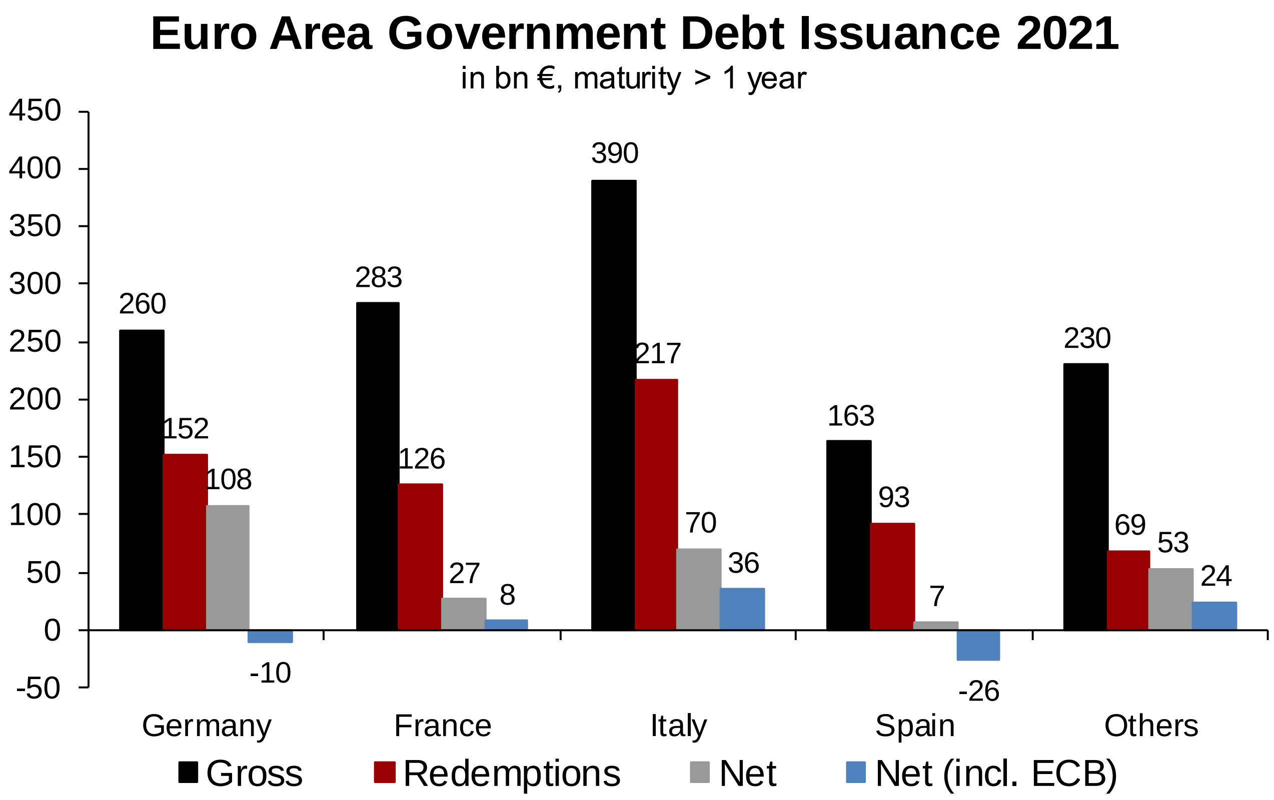
- **Euro area treasurers have placed already almost 60% of the estimated annual sovereign bond volume in H1 2021.**
- **Amid the well-advanced euro area sovereign bond issuance and the elevated pace of ECB purchases net supply will be negative during H2.**
- **This will support euro area sovereign bonds going forward. However, the much less benign cash flow situation in 2022 casts its shadows ahead and confirms our expectation of rising yields.**

Euro area treasurers have continued the brisk issuance activity in Q2 2021. After completing more than 30% of the estimated annual sovereign bond issuance in Q1 (see here), they have issued **almost 60% of the annual volume at the end of Q2**. Not least thanks to purchases by euro area MFIs (notwithstanding significant ECB purchases banks have also increased their government bond holdings since the start of Covid-19) the supply was taken up without lasting problems in H1. This reduces the pressure in H2 and results in a **benign cash flow situation going forward**.



It turns out that some countries are even further advanced. While the large countries (IT, FR, DE, SP) are a bit lagging some smaller countries (e.g. PT, GR) are more advanced with a placed share above 75%. We doubt that there is a significant risk of upside revisions to the annual targets. On the one hand, the economic momentum is strong in the euro area which in and of itself reduces the funding needs. On the other hand, euro area treasurers have ample cash reserves. In case of unforeseen funding needs treasurers could merely run down their ample cash reserves. If funding needs were lower than currently expected treasurers would likely reduce the still elevated t-bill issuance. Consequently, we see the issuance volume in H2 to be broadly in line with expectations.



We estimate an **issuance volume of around € 540bn in H2**. As redemptions will be € 315bn in H2, this implies a forthcoming net issuance of € 225bn until year-end. It is important to stress that we forecast the ECB to remain very active in H2. This implies that the central bank will not only conduct its PEPP purchases at a significantly higher pace than during the firsts months of the year in Q3, but there is a rather high probability that the central bank will also buy € 80 bn/month in Q4 (with the exception of seasonally reduced purchases in August and December, see here). Accordingly, we expect the ECB to take down € 320bn in H2 which means that the **net supply (post QE) will be close to €-100 bn**. Hence, from a cash flow perspective H2 is unlikely to be challenging.

Regarding the term structure, it is expected that considering the still rather low yield level euro area treasurers will continue **to focus on long-dated maturities**. Almost 50% of the newly issued bonds had a maturity of 10 years or more. The average maturity was above 12 years. This is significantly above last years' average. What is more, the EU will be much more active than in recent years. Until the end of 2021 around € 80bn will be issued (but, € 35bn are already placed) and going forward the EU signaled an annual volume of € 150bn on average. Amid investors' requests the EU will also focus on long-dated maturities. This is only partially matched by the estimated weighted average maturity (WAM) of ECB purchases. Despite an upward trend the WAM is still only at 9 years. This strengthens our expectation of **steeper yield curves**.

Notwithstanding the benign technical situation in H2, it is unlikely that financial markets can suck much honey from it. After a negative performance in H1 (total return -2.9% ytd), we see further losses for EGBs in H2. While short-dated yields are likely to remain well anchored by the ECB, there is **upside potential for long-dated yields**. Overcoming of the pandemic and leeway for higher inflation expectations are likely to trigger higher yields. This applies even more as real long-dated yields are still close to the historical troughs and have ample of scope to rise going forward.

This fundamentally more difficult environment will be accompanied by a less benign technical situation in 2022. Notwithstanding great uncertainty at this point in time, government bond supply is forecast to decrease only moderately in 2022. However, the ECB will start to reduce its purchases at government bond markets next year. Even if the ECB's APP will continue over the course of 2022, the purchase volume will fall significantly. Accordingly, this will lift government bond net supply noticeably into positive territory and contributes to our rather cautious outlook for euro area government bond markets.

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