Liquid Insight

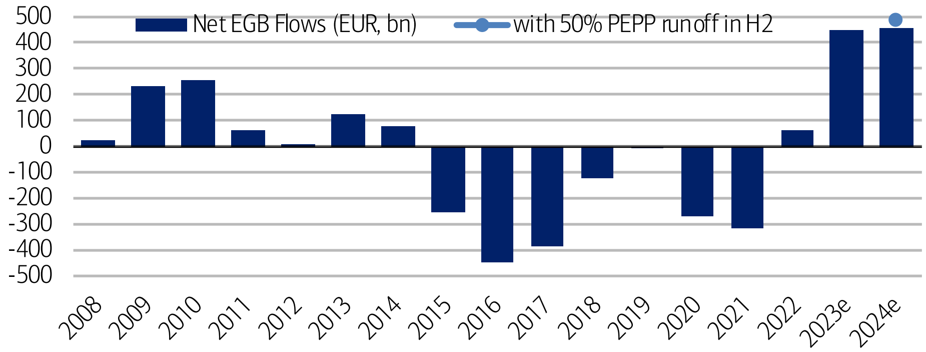
Do not expect large cuts to EGB net issuance

Key takeaways

- Despite large issuance flows, demand can again shield EGBs from major repricing
- France, German agencies/regions as well Supras may be most affected by the acceleration in QT flows

By Erjon Satko and Alessandro Infelise Zhou

Chart of the day: EGB supply net of coupons, redemptions, QE/QT
Despite fiscal tightening, net supply flows remain large in the Euro Area



Source: National treasuries, ECB, Bloomberg, Own calculations. Numbers in EUR billions

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Fiscal tightening, but still high bond supply

We expect Eurozone government funding needs to decline in 2024 relative to 2023. This fiscal tightening however can be easily covered by phasing out energy support measures.

However, also because of the acceleration of passive ECB QT flows, net-net EGB supply (Chart of the Day) is unlikely to drop. Timing-wise, because of large redemption flows in Q1 2024 vs the prior year, the impact of high issuance in 2024 may be felt more in Q2.

Even if our numbers still present upside risks, we would caution against taking this as a major rationale for a bond short. In fact, on a number of metrics (Exhibit 3), Q1 this year was a much harder challenge from a supply perspective and yet EGBs fared much better than expected. A decline in volatility and the expected arrival to terminal rates can keep demand supported also in 2024, even if positioning is currently long.

On a cross-country level, France stands out as the issuer where supply pressures may be the strongest. Periphery sees high forecast uncertainty from NGEU tranche timing, Germany from "off-balance sheet" fund usage. The acceleration of QT may be more impactful for German regions/agencies and supras.

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Source: BofA Global Research

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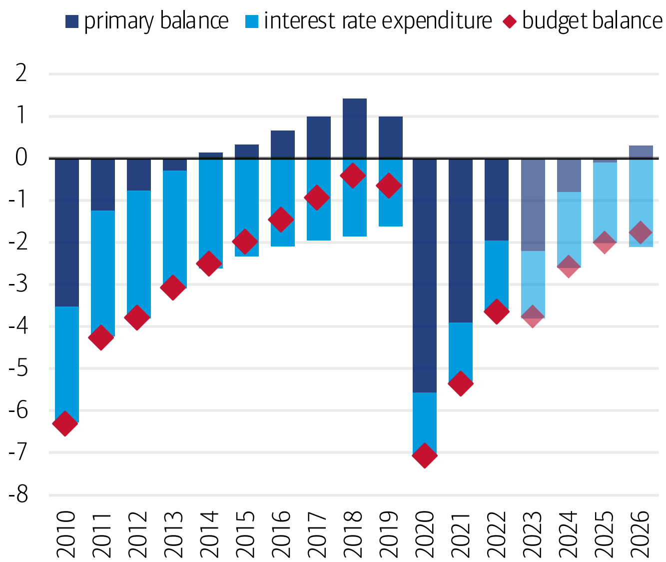
2024 Eurozone fiscal policy: smooth turn

How will Euro area fiscal policy look in 2024? In our macroeconomic outlook we assume it will turn mildly restrictive. A sense-check with the European Commission guidance and governments' National Stability and Covergence plans comforts us on that. The fiscal impulse won't be supportive next year, but the adjustment should be relatively smooth – a stop to energy-related subsidies should do the heavy lifting.

Exhibit 1: Euro area planned aggregated fiscal deficit, % of GDP
National plans project Euro area deficit dropping from 3.8% to 2.6% in 2024



Source: National Stability and Convergence Plans

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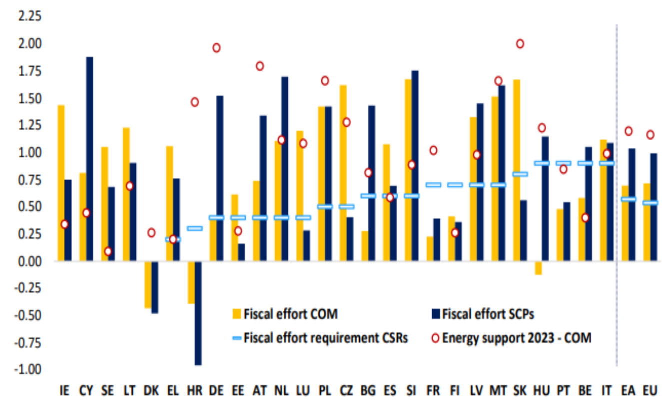
Exhibit 2: 2024 fiscal effort in national plans (SCPs) vs EU recommendations (CSRs), % of GDP
Germany's fiscal consolidation plans expected to exceed EU recommendations. Italy/Spain more or less in line with recommendations. France's consolidation efforts much more limited



Source: European Commission, National Stability and Convergence Plans. Notes: COM= European Commission, SCPs: stability and convergence programmes, CSRs: country-specific recommendations. Country codes: IE = Ireland, CY = Cyprus, SE = Sweden, LT = Lithuania, DK = Denmark, EL = Greece, HR = Croatia, DE = Germany, EE = Estonia, AT = Austria, NL = Netherlands, LU = Luxembourg, PL = Poland, CZ = Czechia, BG = Bulgaria, ES = Spain, SI = Slovenia, FR = France, FI = Finland, LV = Latvia, MT = Malta, SK = Slovakia, HU = Hungary, PT = Portugal, BE = Belgium, IT = Italy, EA = Euro Area, EU = European Union.

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The plans presented by the member states in 1H23 would imply clear deficit reductions in 2024 (Exhibit 1). In Exhibit 2, we show the fiscal efforts (expressed as adjustment in net primary expenditure, as % of GDP) planned by each national government (defined as SCPs), compared with European Commission recommendations for each country (defined as CSRs) and its no-policy-change forecasts (defined as COM). In most countries, the discontinuation of energy-related subsidies by end-2023 would be sufficient to bring fiscal aggregates in line with the European Commission's guidance. As things stand, painful cuts to social expenditure should generally not be necessary.

All Euro area members plan to restrict fiscal policy to a certain extent, but there are very important cross-country differences: Germany seems on track to adjust much more than required by EU targets, Italy/Spain plan to broadly match the EU recommendations but France will clearly fall short, with a much more limited primary expenditure correction.

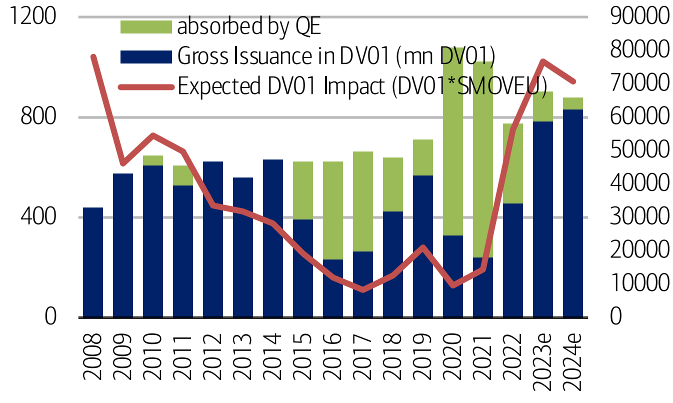
Fiscal tightening will not mean lower bond issuance

The repercussions of budget deficits into gross bond issuance are rarely 1:1. Not only Treasuries can use alternative funding sources (different from bonds issued by the central government) but what counts as deficit from an accounting perspective may not necessarily fit with we see on a cashflow basis.

With that in mind and with the added uncertainty deriving from the fact that we do not yet have detailed budgets for 2024 (even less so how countries plan to finance them) we run a first, broad-brush, analysis of Eurozone Government Bond supply numbers in 2024.

Exhibit 3: EGB gross issuance in DV01, DV01*Vol and ECB share

If volatility continue on the current normalization path, the 2024 bond supply outlook remains challenging but less so than in 2023



Source: ECB, National Treasuries, Bloomberg and own calculation

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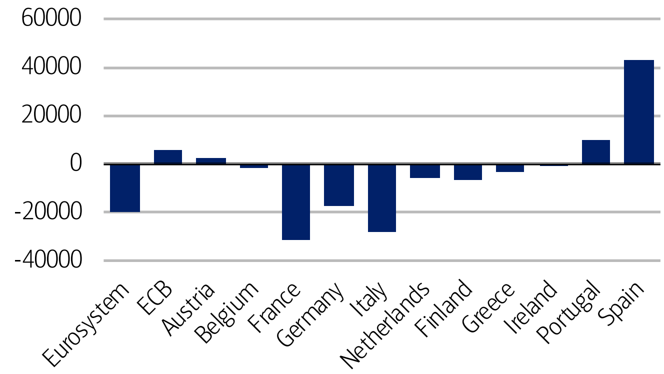
Exhibit 4: Government cash as difference to same month in 2019

Cash surpluses available for pre-funding have largely disappeared this year



Source: ECB. Values in EUR millions

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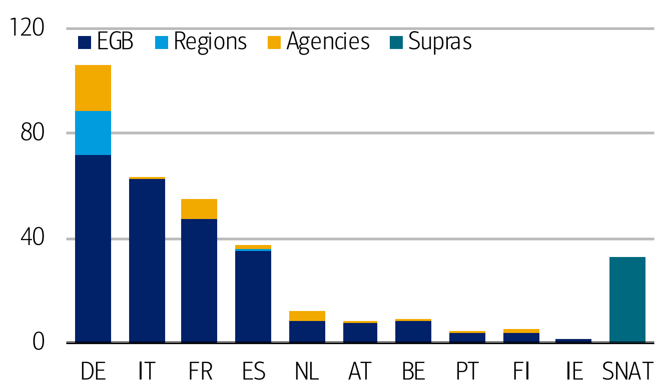
The Chart of the Day shows that, after accounting from potential reinvestment flows, net-net EGB issuance is largely unchanged in 2024 vs 2023. That is essentially due to the fact that the acceleration of passive QT by the ECB cancels out the expected effect from the fiscal adjustment – an addition of PEPP QT (assumed at 50% run-down rate in this case) from H2 would set the net-net supply number comfortably above 2023.

Focusing on ECB flows, from now to the end of 2024, we note that there is likely a skew of redemptions in ECB's QE portfolio towards Supranational issuers and German regions/agencies. Given the accelerated exit of the ECB from QE reinvestments, we therefore see demand pressures for these categories of issuers from the QT story in isolation (on top of the usual general EGB spread widening pressure).

Exhibit 5: Assumed split of APP redemptions up to end of 2024

German bond holdings under the APP to drop the fastest



Source: ECB, Bloomberg and own calculations. Numbers in EUR billion.

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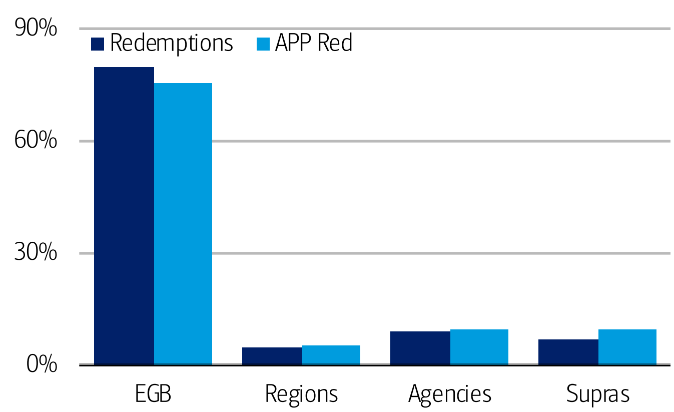
Exhibit 6: Distribution of bond maturities and APP redemptions by type

APP redemptions are skewed towards Supras and Agencies



Source: ECB, Bloomberg and own calculations

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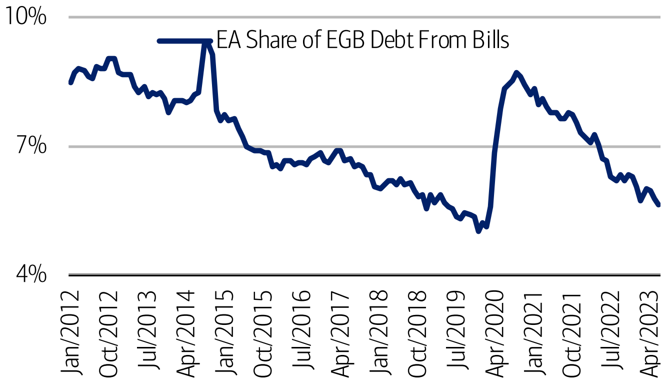
Risks remain skewed towards higher rather than lower net supply numbers in 2024. We note that the availability of "excess cash" reserves in the Euro Area is limited (Exhibit 4), constraining the capacity to use pre-funding (a feature we have been used to during the times of lower rates, and positive net incomes from the central banks being redistributed back to the Ministries of Finance – we now have the opposite).

Also, the share of bills relative to total debt outstanding is still above pre-Covid levels, especially for Finland, Austria and Germany leading to risks of higher bond issuance targets from these countries in particular (if they want to rebalance the debt split).

Exhibit 7: Share of government debt securities from bills

Bills funding may have to decline further before reaching 2019 levels (low cash holdings, inverted curve and risk of no-remuneration of deposits may increase the incentive to reduce bills outstanding)



Source: ECB

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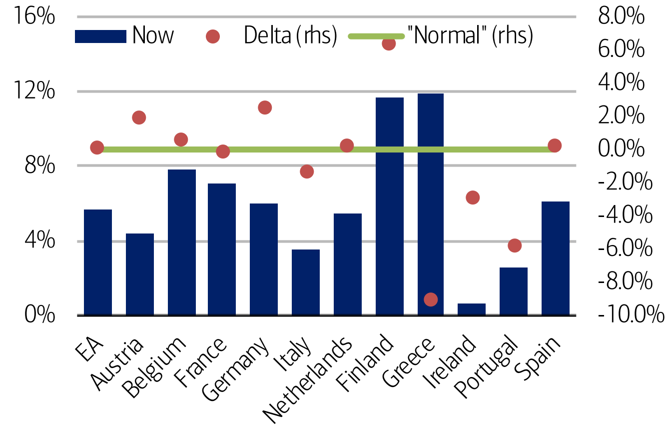
Exhibit 8: Bills share of funding and deviation from 2019 levels

Germany, Austria and Finland may have space to reduce bills, increase bonds



Source: ECB

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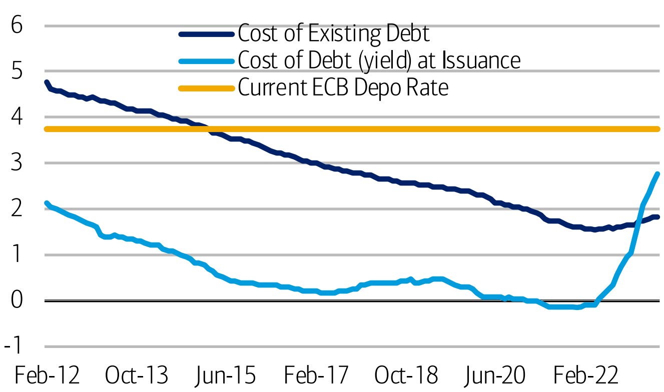
As we said, the rise in yields and cost of debt is another element pressuring supply higher but we think that the surprise element resides more in the lack of profit redistribution from central banks. The interest cost effect is not as big as one may think looking at the rates times series (Exhibit 9). The average cost of legacy debt is in fact relatively high, especially for countries such as Italy, making the effect of higher yields at issuance more manageable (often a maturing bond has a coupon relatively comparable to the newly issued one's).

Exhibit 9: Cost of new issuance vs that of legacy debt

The quick rise in global rates is not that much above the cost of legacy debt (particularly in the periphery)



Source: ECB. Values in %es

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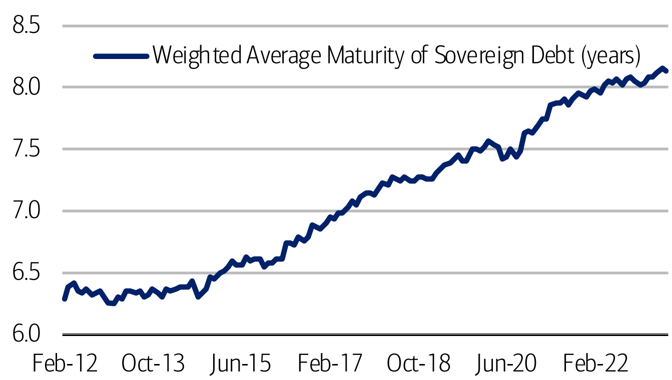
Exhibit 10: Average maturity of outstanding debt

The rise in debt maturities during the low-rate era is helping soften the transmission from costlier new issuance



Source: ECB

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Significant country by country differences but guidance is limited

Closer to Q4 we will refine our forecasts on a country by country basis a we receive clearer guidance from 2024 budgets. For the moment we are assuming Germany net issuance in the order of €60bn (of which c. €10bn from the defense fund and c. €29bn from the climate fund). Our understanding is the original plan assumed c. €45bn for the Economic Stabilisation Fund but given the success of European policymakers' quest for alternative natural gas sources we expect a re-design – this would lead to German gross issuance in the order of €260bn. The same argument skews risks towards a lower funding target for Q4 this year, similarly to the Q3 experience.

Our numbers assume a very limited effort from France leading to a gross supply of €290-300bn (from which €15-25bn in buybacks would need to be deducted).

The Italian assumption is particularly uncertain for us given that the country is running at a faster issuance pace than we expected this year in the first place and it is uncertain whether a potential addition of BTP Valore or BTP Italia before year-end would generate pre-funding cash (cash levels have been relatively low so far despite issuance because of the the delayed tax payments on few items). For the sake of this exercise, we are assuming gross bond issuance at c. €315bn there. Spain sees a significant uptick in redemption flows in 2024, pushing our assumed gross bond issuance target to c.€183bn.

Another (major) layer of uncertainty for periphery countries is the timing and progress of NGEU funding tranches. This is a pure risk in the sense that funding tranches may be delayed/cancelled in 2024 leading partially to higher issuance, or this year's slowdown may be recouped next year (leading to lower issuance numbers). This last scenario is something that may partially fit what is happening with Italy this year.

Exhibit 12: Common acronyms/abbreviations used in our reports
This list is subject to change

Acronym/Abbreviation	Definition	Acronym/Abbreviation	Definition
1H	First Half	IT	Italy
2H	Second Half	Jan	January
1Q	First Quarter	Jul	July
2Q	Second Quarter	Jun	June
3Q	Third Quarter	lhs	left-hand side
4Q	Fourth Quarter	m	month
ann	annualized	MA	Moving Average
APP	Asset Purchase Programme	Mar	March
Apr	April	MBM	Meeting-by-meeting
AS	Austria	mom	month-on-month
Aug	August	Mon	Monday
BdF	Banque de France (Bank of France)	MPC	Monetary Policy Committee
BE	Belgium	MWh	Megawatt-hour
BEA	Bureau of Economic Analysis	NGEU	NextGenerationEU
BLS	Bank Lending Survey	NE	Netherlands
BoE	Bank of England	Nov	November
BofA	Bank of America	NRRP	National Recovery and Resilience Plan
BoI	Banca d'Italia (Bank of Italy)	NSA	Non-seasonally Adjusted
BoJ	Bank of Japan	OAT	Obligations assimilables du Trésor
BoS	Banco de España (Bank of Spain)	OBR	Office for Budget Responsibility
bp	basis point	Oct	October
BTP	Buoni Poliennali del Tesoro	OECD	Organisation for Economic Co-operation and Development
Buba	Bundesbank	ONS	Office for National Statistics
c	circa	p	preliminary/flash print
CA	Current Account	PBoC	People's Bank of China
CPI	Consumer Price Index	PEPP	Pandemic Emergency Purchase Programme
CSPP	Corporate Sector Purchase Programme	PMI	Purchasing Managers' Index
d	day	PSPP	Public Sector Purchase Programme
GE	Germany	PT	Portugal
Dec	December	QE	Quantitative Easing
DS	Debt sustainability	qoq	quarter-on-quarter
EA	Euro area	QT	Quantitative Tightening
EC	European Commission	RBA	Reserve Bank of Australia
ECB	European Central Bank	RBNZ	Reserve Bank of New Zealand
ECJ	European Court of Justice	rhs	right-hand side
EFSF	European Financial Stability Facility	RPI	Retail Price Index
EGB	European Government Bond	RRF	Recovery and Resilience Facility
EIB	European Investment Bank	SA	Seasonally Adjusted
EMOT	Economic Mood Tracker	SAFE	Survey on the access to finance of enterprises
EP	European Parliament	Sat	Saturday
SP	Spain	Sep	September
ESI	Economic Sentiment Indicator	SMA	Survey of Monetary Analysts
ESM	European Stability Mechanism	SNB	Swiss National Bank
EU	European Union	SPF	Survey of Professional Forecasters
f	final print	Sun	Sunday
Feb	February	SURE	Support to mitigate Unemployment Risks in an Emergency
Fed	Federal Reserve	S&P	Standard & Poor's
FR	France	Thu	Thursday

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This list is subject to change

Acronym/Abbreviation	Definition	Acronym/Abbreviation	Definition
Fri	Friday	TLTRO	Targeted Longer-term Refinancing Operations
GC	Governing Council	TPI	Transmission Protection Instrument
GDP	Gross Domestic Product	TTF	Title Transfer Facility
GNI	Gross National Income	Tue	Tuesday
GR	Greece	UK	United Kingdom
HICP	Harmonised Index of Consumer Prices	US	United States
HMT	His Majesty's Treasury	WDA	Work-day Adjusted
IMF	International Monetary Fund	Wed	Wednesday
INSEE	National Institute of Statistics and Economic Studies	y	year
IP	Industrial Production	yoy	year-on-year
IR	Ireland	ytd	year-to-date
PCA	Principal Component Analysis	EGB	Eurozone Governmeny Bond
ORI	Optional Reverse Inquiry	C&R	Coupons and redemptions
DV01	Dollar Value of one basis points change		

Source: BofA Global Research

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Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- Miracle on Main Street **Global FX Weekly**, 11 Aug 2023
- R*s be our guide **Global Rates Weekly**, 11 Aug 2023
- The market bias against the USD, **Liquid Cross Border Flows**, 7 August 2023

Rates, FX & EM trades for 2023

For a complete list of our open trade recommendations, as well as our trade recommendations closed over the past 12 months, see the reports below:

Global FX Weekly: Miracle on Main Street 11 August 2023

Global Rates Weekly: R*s be our guide 11 August 2023

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