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Supply vs demand of EMU EGB in 2021

Euro area sovereign debt issuance vs. ECB purchase dynamics look favourable in 2021. On the supply side, net issuance should decrease vs 2020, thanks to lower aggregated numbers of budget deficits, incoming support from EU funds, and for some countries, the use of increased cash accounts and higher bond redemptions. On the demand side, following December PEPP increase ECB potential purchases look more than adequate to cover for new debt and to provide as well a cushion for eventual additional funding needs.

QE potential to absorb the supply of sovereign debt looks strong in 2021

Euro area sovereign debt issuance vs. ECB purchase dynamics favourable to bond technicals in 2021

In this paper, we focus on the technical factors that are likely to dominate supply-demand dynamics for European Government Bonds (EGB) this year and which are set to continue driving Eurozone fixed income markets. As in our cross asset thematic paper published last September tilted on the remaining months of 2020, we compare the currently estimated supply of sovereign debt in 2021 with potential ECB purchases to assess the extent to which monetary policy can continue supporting the current environment of low yields, and ultimately keep the search for yields alive. Our conclusions show that the ECB's method of calibrating its QE potential in December indicates it is more than adequate to absorb the rise in sovereign debt currently projected within the Eurozone and to provide a significant cushion and backstop in the event of an increase in funding needs. To quote the ECB President's own words during the Q&A session following the December meeting: *"with the volumes that we have, with what is left under the previous PEPP, over €600 billion, plus what we have decided today, it allows us for **significant constant market presence**."*

2021 supply dynamics of EMU-10 sovereign debt

Our projections, based on draft budgets and published funding plans for 2021, point to an overall lower funding need of the EMU-10 versus the first year of the pandemic crisis, which saw fiscal deficits spiking to record levels. In 2021, the net increase in overall marketable debt (bonds and bills) should be roughly EUR 160bn lower than in 2020, with a decrease of EUR 100bn for core countries and EUR 60bn for peripheral countries.

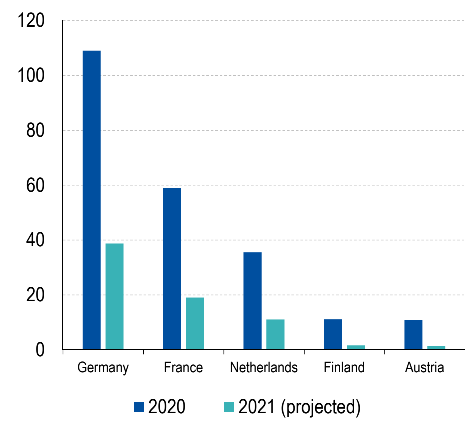
The following three main drivers of lower net supply of marketable public debt are expected this year:

1. a decrease in aggregated numbers of budget deficits, despite countries showing different fiscal trends vs. 2020,
2. support from EU funds, through EC SURE and the EU recovery fund,
3. for some countries, the use of increased cash accounts, alternative sources of financing and higher bond redemptions.

Funding mix to change mainly in core countries

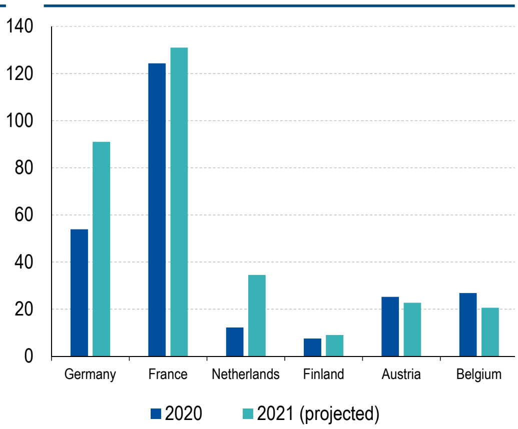
In terms of the split between medium- and long-term instruments and monetary market instruments, the projected net issuance of EMU-10 **bonds** is likely to remain close to 2020 volumes at EUR 530bn vs. EUR 515bn in 2020, while a sharp fall is expected net issuance of **bills** to less than EUR 80bn from a record of nearly EUR 250bn in 2020. As we pointed out also in our September analysis, the extraordinary funding needs caused by the Covid crisis were matched in 2020 by different

1/ Core countries: net issuance of Bills, in EUR bn



Source: Bloomberg, Amundi Research. Data as of January 15, 2021. Belgium not included, as numbers close to flat in both years

2/ Core countries: net issuance of Bonds, in EUR bn



Source: Bloomberg, Amundi Research. Data as of January 15, 2021

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Periphery countries are among those supported by the full combination of major factors that will drive lower net supply in 2021

funding mixes in core countries and periphery countries. As in the aftermath of the GFC and the sovereign crisis, core countries turned to sizeable issuance of bills and short-dated government bonds, while periphery countries continued to favour mid and longer dated bonds, in order to keep average debt maturity high and reduce refunding risk in subsequent years. 2020 ended with net debt issuance split almost 50-50 between bonds and bills for core countries, and 90% bonds for periphery countries. The funding mix in core countries is likely to show a bigger change this year as 2021 is expected to see a return to a more usual mix of 80-20 for bonds & bills, while in periphery countries bonds could reach 95%/97% after 90% last year. Net bond issuance is likely to be higher in Q121 due to front-loading and low redemptions, but then it should subside in the following quarters. Core countries are likely to see an increase in net EGB issuance mainly on the back of the change in the expected funding mix between bonds and bills, with a significant fall in the net issuance of bills (from EUR 225bn to EUR 72bn).

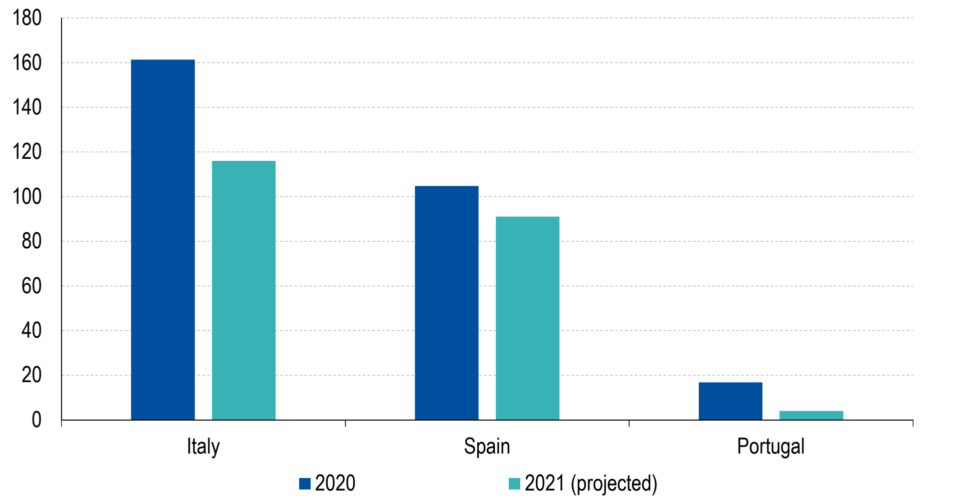
Debt market dynamics of periphery countries supported by lower deficits, higher redemptions, EU funds

Periphery countries are among those supported by the full combination of the three major factors outlined above that will drive lower net supply in 2021. Along with the fact that deficits are expected to be lower, the EU funds likely to be available in 2021 should reduce the level of recourse to the markets by periphery countries. Italy, Spain and Portugal should together receive a volume of resources close to a combined 60% of the SURE & Recovery Funds estimated to be available before year-end. At the same time and contrary to core countries, which will have less support from bond redemptions this year (lower than in 2020), maturing debt appears higher for each of the three periphery countries, by a combined volume of EUR 35bn, which will therefore help to reduce net supply. Concerning bills, expected changes are residual, with Spain likely to make some use of them after successfully increasing the average maturity of its debt relative to other countries in 2020. Bills should remain a potential cushion allowing flexible management of potentially higher fiscal needs. Finally, Portugal plans to use a high proportion of its cash account, which will be stronger thanks to last year's funding, to cover this year's needs.

What about potential ECB purchases?

Together with supply dynamics, we also estimated the potential firepower of ECB QE in relation to the net issuance of sovereign debt projected for 2021. Many different scenarios may be built on the distribution of QE flows over the next 15 months, bearing in mind also that the total amount available may not be entirely used. It could also be argued that 2021 will see more flows on a relative basis than Q1 2022, as economic recovery should gain ground and fiscal support from NGEU should gradually kick in, opening to a sort of QE front running. In our projections we refrained from this kind of scenario and favoured a more neutral view of QE deployment over time, assuming a steady monthly use of firepower, with a proportion of QE allocated to public debt similar to 2020 and assuming capital key rules will be followed on a country basis. The results show a strong QE capacity to absorb the supply of sovereign debt, thanks to the combination of decreased funding needs and the recent increase in QE potential on the back of the December package. The results also show that net EGB issuance is likely to be negative after the ECB potential QE for all countries:

3/ **Periphery countries: net issuance of Bonds & Bills, in EUR bn**



Source: Bloomberg, Amundi Research - Data as of January 15, 2021

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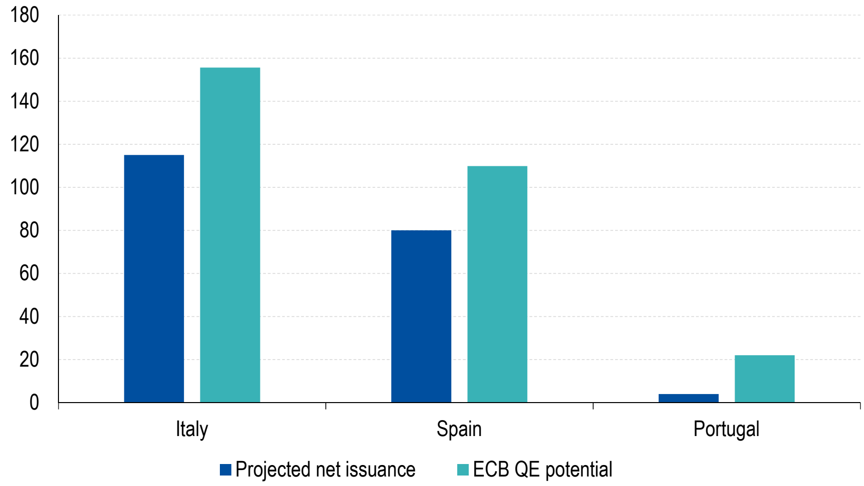
The ECB's firepower provides a substantial cushion for an increase in funding requirements

4/ Periphery countries: projected bond net issuance vs estimated ECB QE potential, in EUR bn



Source: Bloomberg, Amundi Research - Data as of January 15, 2021

the picture for periphery countries is shown in the last chart reported.

In conclusion, the numbers confirm that EGB technicals will continue to be strongly supported by monetary policy in 2021. Risks to sovereign debt supply are mostly to the upside, as governments remain committed to providing fiscal support and plans are subject to revision as restrictions to economic activity persist. At the same time, we expect some eventual variations to be absorbed in bill stocks as was the case last year, while the ECB's firepower provides a substantial cushion for an increase in funding requirements.

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