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Euro fixed income: EGB supply/demand dynamics to improve in H2-21

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According to our estimates, EMU-10 countries altogether have already placed almost two/thirds of the overall net issuance projected for 2021

EMU-10 EGB net issuance, net of ECB QE purchases, is likely to be negative in H2 this year for three main reasons: 1) front loading of sovereign debt supply in H1, 2) roughly 60% of yearly bond redemptions still to come, and 3) ECB QE purchases to remain steadily high. The supranational debt market will keep growing remarkably, driven by NGEU EU funding, following SURE bond issues in H1, with the ECB likely to keep playing a supportive role in this segment, too.

After record Q1 issuance, EMU-10 countries kept the primary market quite busy in Q2, too

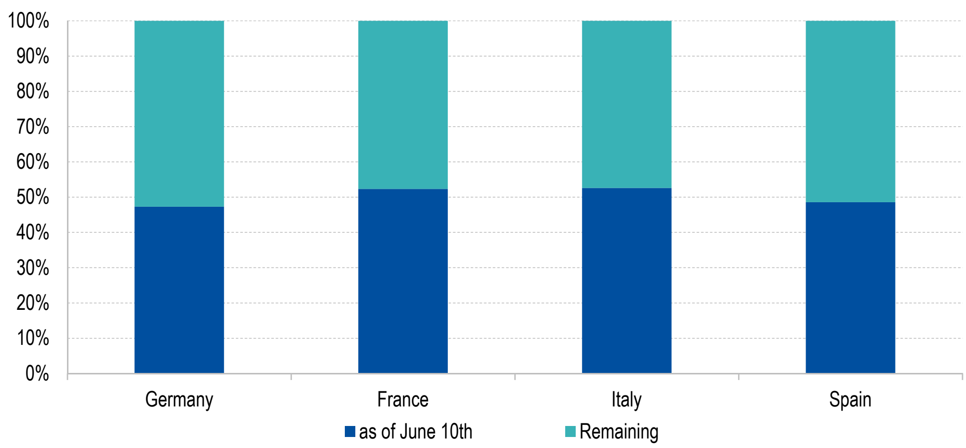
After Q1, which saw EMU-10 EGB gross supply record its second-largest quarter since 2015, and on a 10-yr WAM[1]-equivalent basis, a new record high, Q2 is about to deliver significantly greater progress in matching yearly funding targets, despite increasing in the meantime, on the back of additional recently-approved fiscal packages. At the time of writing, by 10 June EMU-10 EGB cumulative gross supply rose from EUR 370bn in March to EUR 660bn and in 10-yr WAM-equivalent climbed from roughly EUR 460bn to EUR 770bn: more importantly, net issuance (gross issuance less bond redemptions) increased from EUR 265bn in Q1 to EUR 380bn.

The picture looks quite different moving from gross to net issuance: progress on gross issuance points to a broad, average 50% placed so far, while momentum in net issuance looks much better for most countries, as roughly 60% of the overall scheduled yearly redemptions for EMU-10 countries are still ahead. According to our current yearly estimates, accounting for higher deficits now expected vs. the start of the year, EMU-10 countries have altogether already placed quite a remarkable share (almost two/thirds) of the overall amount projected for 2021, estimated to be in the region of €590bn. Despite differences in funding progress at country level, front-running activity also looks strong by historical standards. A look at the positioning of single countries from that standpoint sees Italy leading the "big four", while the other six countries are almost all quite close to reach their net funding targets for the entire year.

The progress in the funding mix, to some extent "re-balance" differences among the "big four" on gaps in net supply delivered so far. Countries lagging on volumes of year-to-date net issuance generally achieved more progress by maintaining a high duration of gross issuance. Average weighted maturity of new French and Spanish bond supply, for example, was quite high year to date: in 10-yr equivalent terms, in fact, gross issuance volumes for both countries was respectively 1.34 and 1.20 times the overall volume placed, while for both Italy and Germany this ratio came out just under 1.0. At the same time, a look at progress in Bills net funding still sees Germany (EUR 12.5bn) and France (EUR 6.6bn) relying more on short-term debt, while Italy, with negative net issuance year to date (-EUR 4bn), still has some leeway to reduce bond supply in the remaining months of the year. Spain is instead making use of short-term supply (EUR 6.3bn), also thanks to the high duration of its bond debt.

[1] *Weighted Average Maturity*

1/ **Progress in yearly bond gross issuance, in %: "big four" countries**



Source: Bloomberg, Amundi Research - Data as of 10 June 2021

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As the ECB is going dy demand for sovereign debt, the progress in year-to-date funding clearly means better dynamics to come in H2-21

The combination of the front-loading of sovereign supply and upcoming ECB QE should mean lower upside pressure from technicals on yields and spread levels in H2

As the ECB is going to keep a relatively steady monthly volume in its demand for sovereign debt, in light of the recently-announced "steady hand" on PEPP at its June meeting, the progress in year-to-date funding clearly means better dynamics to come in H2-21. Overall, so far the ECB has not matched net supply issued by countries more active in front-running, but looking forward the balance is set to turn with the ratio between central bank estimated purchases and remaining net supply likely to rise to more than 2x. The ratio of the expected balance between ECB demand and new debt is going to be high for Italy and Germany in the big four and quite high for all other smaller countries, assuming no deviations from capital keys. In the case of Italian sovereign debt, for example, according to our estimates the ECB had bought roughly two-thirds of year-to-date net issuance, but is estimated to cover 2.3x for the remaining net funding in 2021. These estimates already take into account 10% of public programmes to be allocated to Supranational bonds (see the sections below and inset). Last but not least, the ECB steadily increased the average weighted maturity of its PEPP portfolio, especially among core countries, finally strengthening the "qualitative" support beyond the pure numbers. This should help ECB targeting stable spreads and yields levels, in order to maintain easy financing conditions.

Following supply of SURE bonds in H1, supranational debt market to keep growing in H2, driven by NGEU EU new issuance

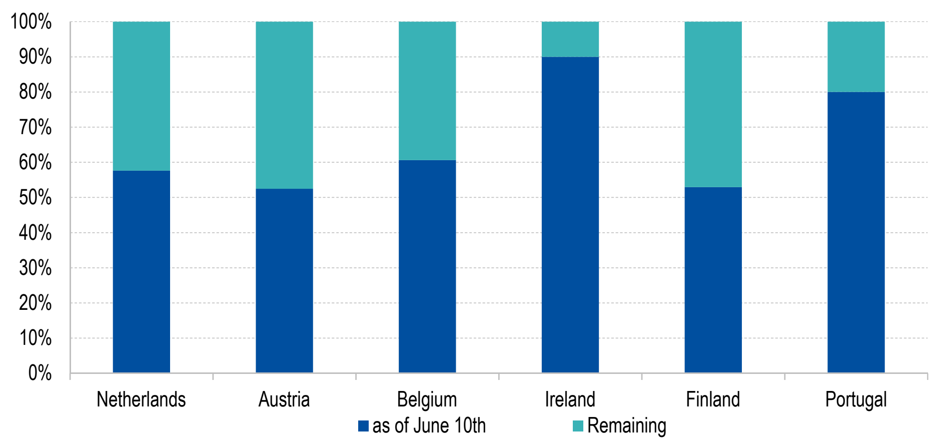
Shortly following the announcement of the funding plan for H2 this year, the EU issued its first NGEU bond (EUR 20bn, 10Y). The deal was a success, both in terms of demand (more than 7x the final size) and in terms of pricing vs. initial guidance, confirming the strong demand for such high-rated debt in the European fixed income segment. As the funding plan estimates *"around EUR 80bn"* of bonds until year-end **(see inset for more details)**, this first bond already represents one-quarter of the overall targeted size, while two additional deals are expected to be placed next month, before August break.

The NGEU issuance follows on the heels of SURE bond supply, which started in autumn last year and remained active in H1 this year, in January (EUR 14bn) but especially in February/March (EUR 22bn) and to a lesser extent in April/May (EUR 14bn). The EUR 80bn issuance volume currently planned by the EU for the rest of the year almost matches roughly EUR 90bn in remaining net issuance estimated to be placed in the semi-core sovereign debt segment.

ECB still playing a major role in supporting EU issuance

Since EU SURE bonds started in Q4 last year, the ECB increased its allocation to supranationals and has more leeway to do so. For the third time in a row, the latest bi-monthly detailed figures published by the ECB confirmed a more sustained path of purchases for supranational debt in the PEPP public debt segment. The share of SSA purchases in April-May '21 was only marginally lower (close to 9%) than in Dec 2020-Mar 2021 (at 10%). The latest slightly lower proportion could be also related to the fact that SURE issuance in April/May dropped to EUR 14bn from EUR 22bn in February/March, but at the same time, in absolute terms, the last two months saw the highest volume allocated to SSA since the PEPP began. Following the start of EU SURE issuance (in autumn 2020), the share of PEPP allocated to SSA moved higher, from a previous 6% average to almost 10%

2/ **Progress in yearly bond gross issuance, in %: other EMU-10 countries**



Source: Bloomberg, Amundi Research - Data as of 10 June 2021

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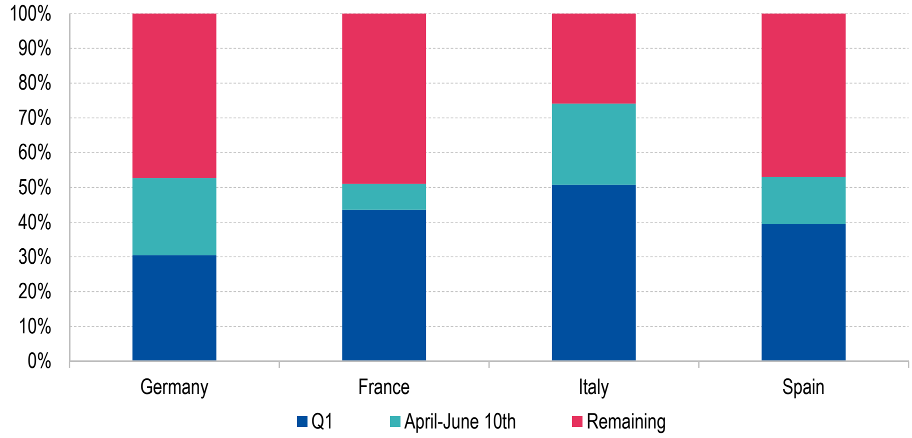
3/ **Progress in yearly bond net funding, in%: "big four" countries**



Source: Bloomberg, Amundi Research - Data as of 10 June 2021

NGEU issuance: background and current announced plan

The EU announced its first 6-month funding plan under NGEU, estimating "around EUR 80bn" of bonds until year-end, "to be topped up by tens of billions of euros of short-term EU-Bills to cover the remaining financing requirements." The EC "will update the funding plan in Sept, when it has a more precise overview of the funding needs of the EU Member States (MS) for the last months of the year."

"The first bond issuance will take place via a syndication. Further syndicated transactions are foreseen to take place before the end of July." Market expectations point to an issuance volume of between EUR 30bn and EUR 40bn before August break, i.e. close to half of the currently announced volume, probably with two issues following the first placed in June, all to be syndicated. "The Commission also intends to start issuing EU-Bonds and EU-Bills through auction procedures as of September 2021. Once the auction system is in place, the Commission will regularly organise syndications and auctions for the bonds. It will also organise regular auctions for EU-Bills." Since September, syndicated and regularly auctioned deals will be combined. NGEU H2-21 funding will increase the debt universe targeted by ECB PEPP, but is unlikely to change the supportive balance of technicals on the EGB market.

EU-Bonds

"Issuing bonds through benchmark maturities (3, 5, 7, 10, 15, 20, 25, 30 years) is the principal way for an issuer to implement its funding plan. The Next Generation EU issuance programme will give the Commission the opportunity to consolidate a regular presence on all parts of the yield curve with as liquid as possible EU-Bonds. Rather than issuing new bonds with new maturities, the Commission will, where possible, augment the amount of already issued bonds. By doing so, the outstanding amount of the bond will make these bonds more liquid in the secondary market trading and hence more attractive to investors."

EU-Bills

The Commission will also start to issue securities with a shorter maturity – below one year – to be known as EU-Bills. These will give the EU access to the deep and liquid money market, offering it the flexibility to determine the size of each transaction based on actual liquidity needs. To issue EU-Bills, the Commission will rely on auctions, in line with standard market practice.

Funding technique

As "Syndications are the traditional technique for debt issuance by supranational issuers" and "the Commission has used syndication exclusively in the past", the adoption of auctions, "the favoured issuance technique used by large EU sovereigns", goes in the direction of moving on from a pure "supra status" in terms of funding. Bill issuance is also headed in this direction. The goal is to "enable the Commission to attract the necessary funding, even under difficult market conditions, enlarge the investor base and reduce funding costs."

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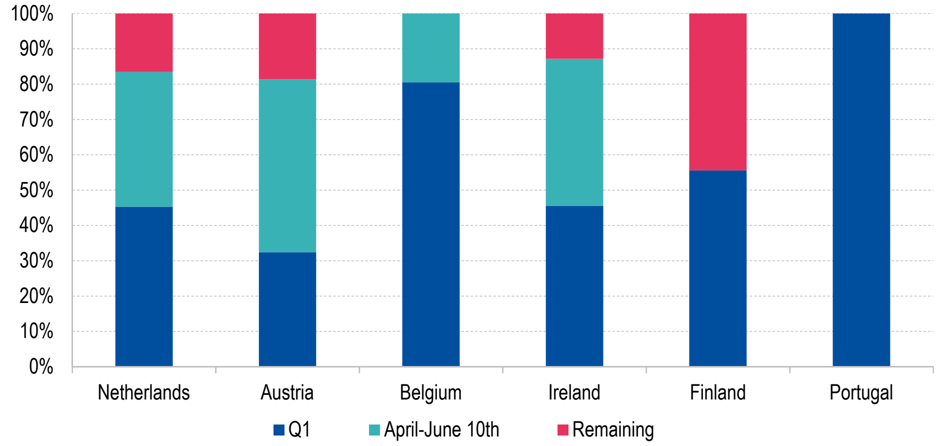
We can expect the ECB to use its flexibility to keep supporting upcoming EU issuance also in the NGEU funding plan over the coming quarters

4/ **Progress in yearly net funding, in%: other EMU-10 countries**



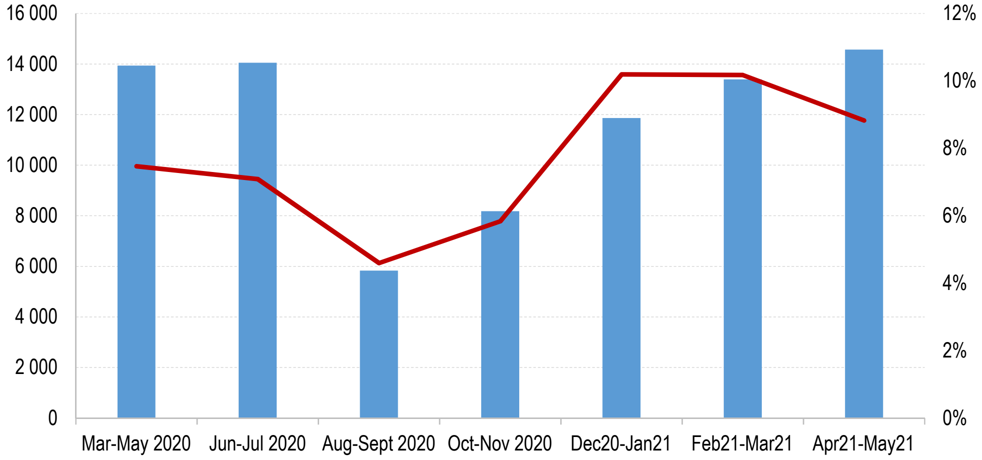
Source: Bloomberg, Amundi Research - Data as of 10 June 2021

of public debt purchases in the last six months. PEPP purchases have moved hand-in-hand with the rise in EU issuance, not only in terms of volumes but also average maturity. The WAM of SSA holdings has kept climbing, currently at 10.4 years, and its overall increase coincides with the launch of the EU SURE programme, including bonds with long tenors.

We can therefore expect the ECB to use its flexibility to also keep supporting upcoming EU issuance in the NGEU funding plan over the coming quarters. It is reasonable to assume that the share of PEPP allocation to the segment will remain close to the recent 10% or may even slightly increase, as SSA cumulative allocation is still lower since the programme started (in the 7% region). A 10% allocation would roughly mean potentially between EUR 55bn and EUR 60bn, to counterbalance the steady increase in EU supply. Even assuming a share higher than 10%, it would have only marginal effects on total volumes allocated to absorb sovereign debt: even in this case, in fact, EGB supply net of QE should remain in deeply negative territory in H2.

Finalised on 21 June 2021

5/ **PEPP bi-monthly purchases of supranational debt: in EUR mn (l.h.s.) and in % of public debt (r.h.s.)**



Source: ECB, Amundi Research - Data as of May 2021

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