



Focal Point

Debt issuance cannot keep up with ECB purchases

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- The euro area issuance activity in most countries is more advanced at this stage of the year than in prior years. Therewith, treasurers have exploited the benign funding situation, resulting in a muted supply over the rest of 2016.
- Lower fiscal deficits compared to 2015 are contributing to the friendly market environment in 2016. But, above all, the enlarged ECB's QE program will ensure a negative net issuance in all euro area countries.
- Since an extension of the QE program until September 2017 is likely, the ECB will become an ever more important player on euro area bond markets. As net issuance is expected to shrink marginally to € 190bn in 2017, the ECB will hold more than 20% of all outstanding euro area government bonds by the end of next year.
- Notwithstanding negative side effects like higher volatility, the purchase program will remain a strong supporting factor for euro area bond markets next year. In this environment the upward potential for yields remains limited.

Although euro area government yields have rebounded from the historical trough reached after the Brexit vote, 2016 is likely to be another year of decreasing yields. Treasurers in the euro area have exploited the benign market environment and the issuance activity at this stage of the year is at an advanced stage. This is not least possible due to the strong technical support by the ECB which contributes to a strong displacement effect.

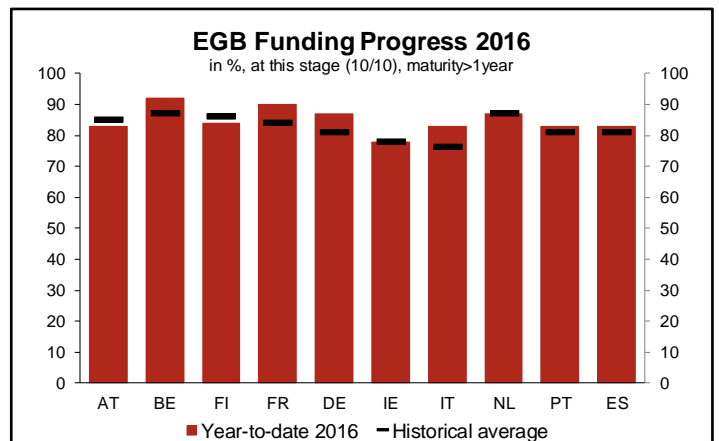
The environment is unlikely to change substantially in 2017 as the expected extension of the asset purchase program (APP) will secure a strong demand for euro area government bonds. In this environment bond markets will remain backed and a potential increase in euro area government yields is seen to remain contained next year.

Negative Italian net issuance in Q4 2016

At the beginning of the fourth quarter, the gross issuance of euro area sovereigns year-to-date amounts to € 675bn (restricting the analysis to bonds with a maturity of more than one year). While the issuance progress differs from country to country, the overall funding progress is well advanced. Almost 85% of the scheduled issuance in 2016 has already been placed, leaving a manageable supply for the remainder of 2016. In most countries the completion is more progressed than in the past. The four large countries (France, Germany, Italy, Spain) are all ahead of schedule.

In the remainder of the year, we forecast an issuance volume of around € 140bn. As usual, the current quarter will be the one with the lowest issuance volume. This implies that net issuance in Q4 will be roughly € 20bn. Although this will be more than in Q3 (- € 25bn), it will be below the

quarterly average for 2016 and upcoming supply is unlikely to be a problem for financial markets.

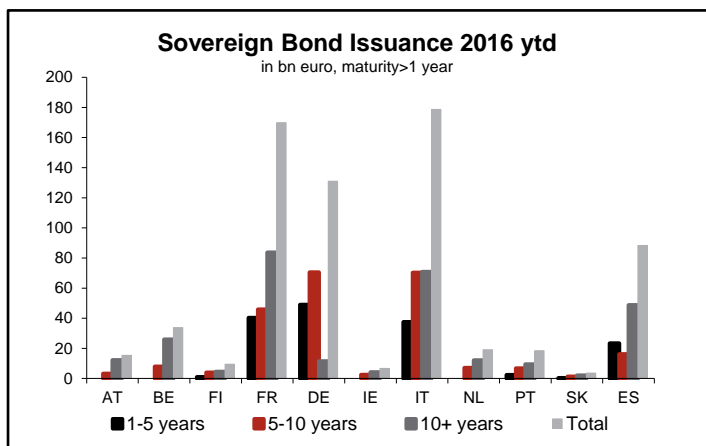


Taking into account redemptions, the most notable development will take place in Italy. Even without ECB purchases, Italian net supply will be negative in the remainder of the year. While this is a strong technical support for Italian government bonds in the weeks to come, the forthcoming political events (e.g. Italian referendum) may trigger some volatility. This applies all the more as given the good sentiment on bond markets and the smooth absorption of new bonds in 2016 so far, it is unlikely that the utilization of primary markets will become a key factor going forward.

Treasuries focusing on very long-dated bonds

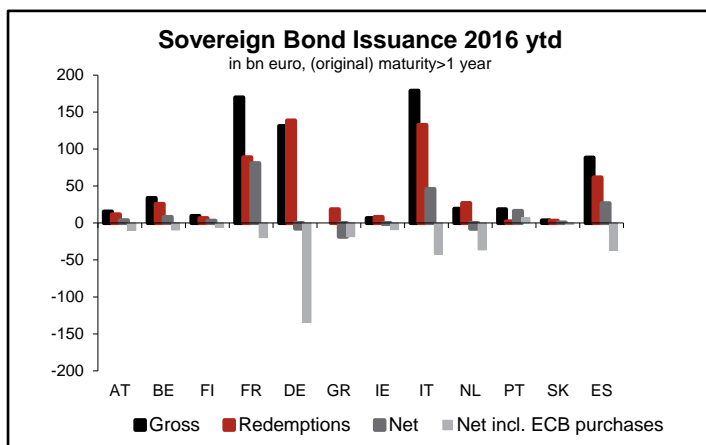
Another striking feature of the issuance activity in 2016 is the extension of maturities. While this trend has started al-

ready a few years ago, it has gained further momentum this year. More than 40% of all new issuance have a maturity of more than 10 years and the share of short-dated bonds has fallen to less than one quarter. Not only euro area core issuers have focused on very long-dated bonds, but also Southern European treasurers have exploited the bull flattening of the very long end of the yield curve. For example, more than 55% of all new Spanish bonds issued in 2016 have an issuance maturity of more than 10 years.



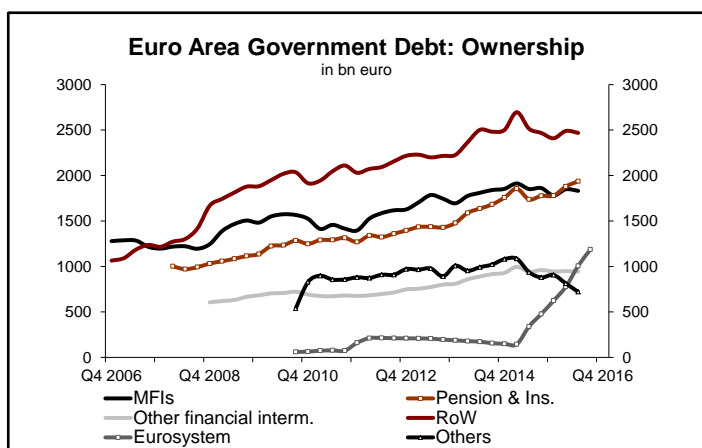
Increasing significance of the ECB

While on balance lower fiscal deficits have contributed to the benign market environment and the smooth absorption of new issuances, the dominant driver of euro area government bond markets has been the ECB. Since the start of the year the ECB has bought more than € 500bn of government bonds. Purchases will reach around € 660bn by the end of the year. Taking into account ECB purchases, the net issuance of all euro area countries will be in negative territory in 2016. In addition, there is a strong dislocation effect for the euro area as a whole. Taking into account the net issuance, the central bank will have taken around € 450bn of government bonds out of the market this year. In our writings we have stressed the resulting trickledown effect several times. The strong performance of all euro denominated fixed income assets in 2016 is a strong indication that this effect has materialized.



As the APP comes on top of the Securities Market Program (active between 2010 and 2012), the share of euro area government bonds held by the ECB has increased strongly in 2016. By the end of the year, the central bank will own more than € 1300bn of euro area government bonds. This implies that at the end of the year the central

bank will hold nearly 15% of all government bonds on its balance sheet (up from less than 8% at the end of the last year). This increase will be at the expense of monetary and financial institutions and foreign investors. Their share has been on a downtrend already since 2009 and 2011, respectively. While foreign investors could reduce euro area financial markets for the time being and the banking sector is still on a broad-based deleveraging trend, the cascading effect mentioned above can be limited. However, other investors – this includes private investors – have reduced their holding of government debt in recent quarters as well (in absolute numbers by around € 350bn since the start of QE). This group tends to be more flexible and is likely to be responsible for a large part of the trickledown effect.



Main drivers on bond markets to persist in 2017

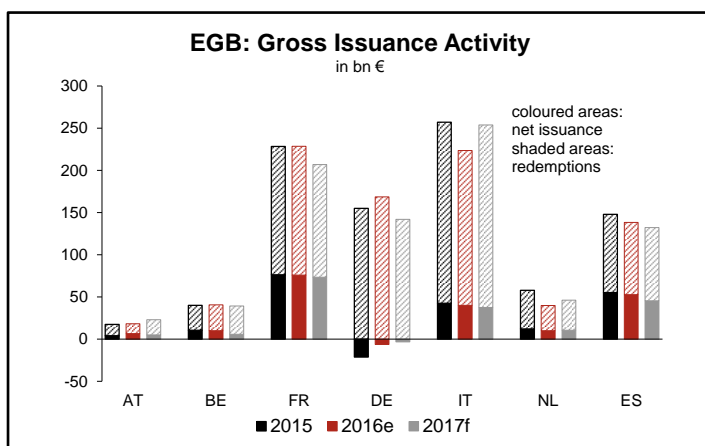
The favorable environment is forecast to remain next year. In the following, we analyze government bond markets from both sides – supply and demand. The moderate economic rebound is expected to continue which will contribute to lower euro area governments' funding needs. However, the fiscal discipline in many European countries is seen to become more lax. The flexibility by the European authorities shown this year regarding the Excessive Deficit Procedure for Spain and Portugal can be interpreted as a shift towards an easier fiscal policy stance. On balance, we expect the net issuance to come down only slightly by € 15bn in 2017 compared to the current year. Spain is likely to make the greatest contribution as we see the fiscal deficit (in % of GDP) to shrink by 0.8pp to a still high 3.9%.

The amount of government bonds coming due next year will not change much compared to 2016. Overall, according to our calculations redemptions will increase by a small single-digit billion euro amount. However, this conceals some interesting features of single countries. Germany stands out as its redemptions will decrease by around € 25bn next year. This is more than offset as redemptions of Italian government bonds will increase by more than € 30bn to more than € 216bn. Overall, euro area government gross bond issuance is unlikely to change much next year. Italy is expected to remain the largest issuer as it is seen to increase gross issuance by € 30bn – exclusively due to higher redemptions.

This steady supply will meet a still strong demand. Restricting the analysis to the ECB, we have to make an assumption regarding the APP. Taking into account the very low current inflation rate and our forecast for 2017 (1.3%),

the ECB is unlikely to end the APP already in March. Below, it is assumed that the APP will be extended until September 2017 followed by a gradual tapering. This implies that the ECB will buy around € 680bn of government bonds in 2017 – even slightly more than in 2016 and around three quarters of the complete gross supply. By the end of next year, the central bank will hold more than € 2000bn of euro area government bonds. In other words, the ECB will own more than 20% of all outstanding euro area government bonds at the end of 2017. These numbers clearly demonstrate that a small adjustment of eligibility criteria expected for the next ECB meeting (or at latest for the December meeting) will not be sufficient to tackle the scarcity issue. Most likely, the ECB will have to soften several criteria. A combination of different measures will then be sufficient to continue the purchase program.

What is more, in contrast to recent years, significant accounting profits are unlikely, taking into account the tapering of the ECB purchases expected towards the end of 2017 and the ambitious valuation particularly of euro area core government bond markets.



As bond purchases will by far outpace the net issuance of euro area government bonds, the ECB will take another € 490bn out of the market. Hence, the dislocation of current government bond investors will even intensify a little compared to this year. The negative side effects of the APP will become even clearer. Since the start of the APP bond market liquidity has deteriorated strongly. As dealer deleveraging continues and the several regulatory reforms tend to reduce liquidity as well, a turn for the better is not in sight. This means that bond market volatility is expected to increase and, in times of market stress, large deviations from the fair value levels can occur.

Notwithstanding the unwelcome fallout of the APP, the program will remain a strong supporting factor for euro area bond markets in 2017. The cascading effect will remain important and will continue to depress both private and public bond spreads.

Conclusion

Euro area treasurers are well on track to meet their funding targets in 2016. This is unlikely to change next year as funding needs remain contained and the ECB's APP lends strong technical support to bond markets. Assuming the central bank will extend its purchase program, the leeway for higher government bond yields remains limited. However, higher headline inflation rates are expected to leave their mark on inflation expectations as well. In combination with the forecast continuation of the moderate, but positive euro area growth this should prevent a further significant leg lower for euro area government yields. Therefore, investors should position for a continuation of the very low yield environment next year – characterized by a low carry.

Imprint

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