A deep dive into Austria´s government bond market

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- A balanced budget is on the agenda of Austria's new government led by the Conservatives (ÖVP) and the Greens. With Austria's GDP growth set to exceed the eurozone average, Austrian macroeconomic fundamentals remain among the most solid in the euro area.
- About two thirds of Austrian bond market is held by foreign investors, and in particular by non-banks. 20% is held by domestic investors (half of which is held by domestic bank while investment managers and insurance companies account for an only modest share). The most price-sensitive investors (such as foreign asset managers) have reduced holdings of Austrian government debt following the beginning of QE, a factor that should provide stability.
- With investors extending maturities, we expect the Austrian curve to moderately flatten from current levels, especially in the 10/30Y segment.
- RAGBs are now trading at the same level as OATs. From a risk/reward perspective, we prefer RAGBs to OATs given their lower volatility and their higher correlation with Bunds.

1. New government combines economic and ecologic expertise

Austria has had a new government since 7 January 2020. Sebastian Kurz, the leader of the ÖVP, leads a coalition government of the ÖVP and the Greens as chancellor. Cooperation between these two parties has already proven to be functional at the provincial level (e.g. currently in Salzburg, Tyrol and Vorarlberg and, until 2015, in Upper Austria), although formally there are major differences in terms of the content of the parties' programs. In our opinion, a new government model could emerge for Austria, one that addresses the challenges of climate change more pro-actively while keeping the economic impact contained. While under this government, economic policy decisions will require stronger coordination between the parties than under the coalition of ÖVP and Freedom Party of Austria (FPÖ) (December 2017 to May 2019), we do not see this as posing any risks to the Austrian economy. Furthermore, there is an opportunity for more-progressive education and migration policy to be introduced, and Austria's European policy could once again assume greater weight.

According to the election results from autumn of last year, the ÖVP occupies the majority of ministerial posts (10 out of 13), and the coalition agreement bears predominantly signature aspects of ÖVP policy, especially with regard to economic and financial policy. The goal of achieving a balanced budget, depending on economic developments, remains in the foreground.

For the first time since 1974, Austria was able to achieve a general government budget surplus of 0.2% of GDP in 2018. We even expect Austria's fiscal surplus to have increased to 0.5% of GDP in 2019 thanks to a disciplined expenditure policy and the cyclically favorable development of revenues, as well as the benefits of low interest rates.

For 2020, we again expect Austria to achieve a slight budget surplus, but at 0.2% of GDP or about EUR 0.8 billion, this should be slightly lower than it was in the previous year. This is partly due to weaker economic growth and partly due to some expenditure-increasing measures adopted by parliament in the run-up to snap elections, such as a noticeable pension increase. These include, above all, a social-security bonus for low earners, which will lead to a loss in revenue of up to EUR 900 million (approximately 0.2% of GDP in 2020). This should be offset by only minor additional revenue from a digital tax on online advertising revenue, an increase in tobacco tax and the abolition of the import-sales-tax exemption limit.

Further tax reform is planned to be implemented from 2021 onwards, with the coalition agreement only becoming concrete with regard to income tax reform and reduction of the corporation tax rate. The planned reduction of the entry tax rate as applied to Austrian income tax (from 25% to 20%) and subsequent tax levels (from 35% to 30% and from 42% to 40% respectively) will lead to a total loss of revenue of almost EUR 4bn (0.9% of GDP) per year. Reduction of the corporate tax rate from its current 25% to 21% could result in a budget shortfall of around EUR 1.5bn, or 0.4% of GDP. In addition, the government has announced an increase in the family bonus from EUR 1,500 to EUR 1,750 per child per year. All in all, this will result in a loss of revenue of about EUR 6bn, which will be further increased by planned investments of about EUR 2bn in the expansion of public transport.

It is also possible to postpone or cancel measures in the event of a deterioration in economic development. Therefore, we do not expect a financing gap to arise that would prevent the government's goal of achieving a balanced budget over the economic cycle. In addition, despite that it is expected to cool off in the coming years, Austria's economy is expected to remain strong, and this should ensure positive development of tax revenues and charges – among other things, also due to an increase in income-tax revenue in Austria over and above the economic component through the effect of cold progression.

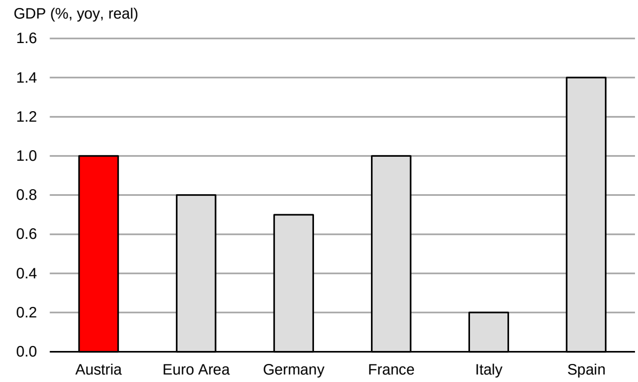
In a statement from November 2019, the European Commission pointed out that Austria will also fulfill EU fiscal rules in 2020. As Austria's debt ratio remains above the Maastricht limit of 60% of GDP, EU fiscal rules provide for sufficiently rapid debt reduction, which in our opinion, will even be surpassed, as Austria's debt is expected to decline from just over 70% of GDP to 68.3% in 2020.

2. As the economy loses momentum, growth is set to remain above the euro area average

After three years of growth of above 2%, the increase in Austria's GDP steadily slowed in 2019. As a result of the impact of weak global trade, Austrian foreign trade lost momentum, and Austria's strong export industry even slid into recession in mid-2019. However, strong domestic demand was able to maintain economic growth at an estimated 1.5% for 2019 as a whole. However, the slowdown in the pace of growth had an unfavorable effect on Austria's labor market. With employment growth slowing, the decline in the unemployment rate came to a halt in the course of the year. However, Austria's average annual unemployment rate of 4.6% was three-tenths lower than it was in 2018. Support came from continued-strong private consumption, which benefited from rising real wages and fiscal stimulus, such as the introduction of Family Bonus Plus. Although investment activity slowed amid lower foreign demand and a general deterioration in economic sentiment, gross fixed capital formation rose by more than 3% year-on-year. The flip side of Austria's strong domestic economy is that prices have increased at a comparatively higher rate in Austria. Despite declining from 2.0% in 2018 to an annual average of 1.5% in 2019, Austrian inflation remains above that of the eurozone.

The latest economic data indicate that the Austrian economy has started the year 2020 in a weaker condition than in 2019. Moreover, there are signs that Austria's economy could cool further. Weakness in global trade will continue to negatively affect the export industry. Due to a lack of foreign demand, we expect investment activity to be more restrained in 2020. Consumption is likely to therefore be the mainstay of growth. However, additional fiscal stimulus, including a reduction in health insurance premiums for low earners, is unlikely to be able to prevent a slight slowdown in consumption. In view of the expected slowdown in growth to 1%, the situation in the Austrian labor market is unlikely to improve further. For the first time since 2015, an increase in the unemployment rate in Austria is expected, although it should be only slight, by 0.1 percentage points (to 4.7%) in 2020. Due to the weaker growth, inflation should also remain manageable, at an average of 1.5%, in 2020, especially since an expected decline in oil prices should ease inflation in Austria.

CHART 1: GDP GROWTH IN AUSTRIA SHOULD AGAIN EXCEED THE EURO AREA AVERAGE IN 2020



Source: UniCredit Research

The Austrian economy should continue to show favorable key economic data in 2020 despite that it is expected to grow more moderately than it did in 2019. In addition, the new government has announced its intention to continue along the solid budget course of recent years despite reforms, particularly in the area of income tax, and a planned greening of the economy. In view of these factors, we do not expect there to be any changes in the ratings of the Republic of Austria in 2020.

TABLE 1: ECONOMIC OVERVIEW

	2017	2018	2019E	2020F	2021F
GDP (real, yoy, %)	2.5	2.4	1.5	1.0	1.3
Inflation (yearly average, %)	2.1	2.0	1.5	1.5	1.8
Unemployment rate (%)	5.5	4.9	4.6	4.7	4.7
Budget balance (% of GDP)	-0.7	0.2	0.5	0.2	0.2
Public debt (% of GDP)	78.3	74.0	70.4	68.3	66.0
Current account balance (% of GDP)	1.6	2.3	1.9	1.8	1.9

Source: Statistik Austria, OeNB, UniCredit Research

3. Details of 2020 funding plan and the contribution from QE

Based on our estimates, Austrian funding needs this year will amount to EUR 19.8bn, given EUR 14.8bn of domestic bond redemptions, EUR 4.6bn of international bond redemptions and a EUR 0.5bn cash deficit. Most of these needs (we expect EUR 18.3bn) will be covered by the issuance of RAGBs. This amount is between the targets announced by the Austrian treasury (EUR 18-21bn) at the end of last year. Notably, the range is the same as it was in 2019, when Austria sold EUR 20.1bn of RAGBs. In addition, we expect Austria to sell around EUR 1.5bn of international bonds.

TABLE 2: AUSTRIAN FUNDING OUTLOOK

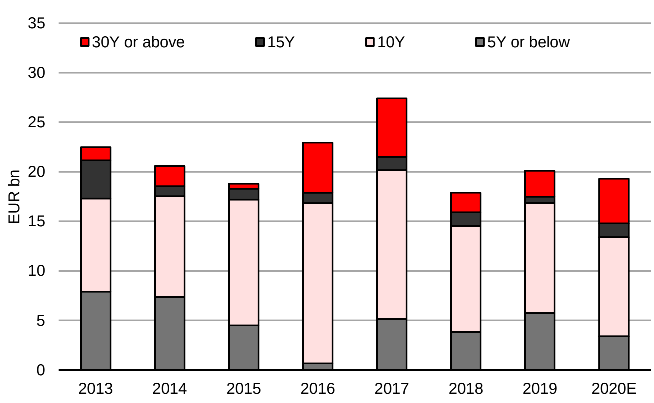
Funding needs (EUR bn)		Funding sources (EUR bn)	
Domestic bond redemptions	14.8	Domestic bond issuance	18.3
International bond redemptions	4.6	Treasury bills net supply	0.0
Cash deficit	0.5	Other sources (including international bonds)	1.5
Total	**19.8**	**Total**	**19.8**

Source: Austrian Treasury, Bloomberg, UniCredit Research

In light of our expectations, RAGB net supply is likely to be around EUR 3.5bn. QE purchases will play a very important role in supporting the market. Based on our estimates, if the ECB keeps conducting APP net purchases at its current pace (EUR 20bn per month), during 2020, it should purchase EUR 3.5bn of Austrian bonds, hence covering the entire net supply. Furthermore, we estimate that redemptions of RAGBs in the PSPP portfolio will amount to EUR 5.5bn. Hence, gross QE purchases should amount to around EUR 9bn. Therefore, about 50% of Austria's gross funding is likely to be absorbed by the ECB.

In the past, Austria has been particularly active in issuing extra-long government bonds. For reference, in 2019, the average maturity of new debt issued was more than 13 years, higher than the eurozone average of around 10 years. As demand for long European paper is likely to remain in the coming months, we expect that, in 2020, more than 30% of the RAGBs Austria issues will be at maturities of longer than ten years. In line with previous years, we expect the bulk of issuance to occur at the 10Y duration (EUR 10bn, 50% of overall gross supply). Chart 2 shows a comparison of the distribution of issuance in the past years, along with our expectations for 2020.

CHART 2: HEAVY SUPPLY AT THE LONG END



Source: Austrian Treasury, Bloomberg, UniCredit Research

In terms of new benchmarks, Austria will probably issue a new 10Y RAGB between the end of January and the beginning of February to replace RAGB 0.5% Feb29. Interpolating RAGB Feb29 and RAGB May34, a new 10Y benchmark maturing in February 2030 would be trading roughly 15bp richer than the swap curve. In addition, we expect Austria to issue a new 30Y benchmark, which would replace RAGB 1.50% Feb47. Furthermore, Austria is likely to reopen RAGB Jul24 as well as other extra-long RAGBs.

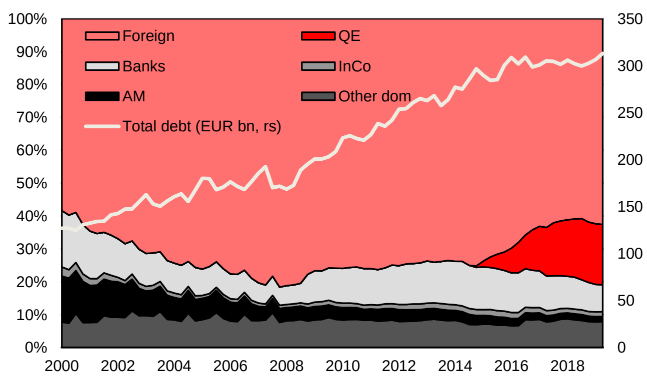
4. Who owns Austrian debt?

At the end of 3Q19, Austrian government debt amounted to EUR 313bn. Foreign investors held 63% of Austrian debt, domestic investors around 19% and the ECB 18%.

A look at domestic investors in more detail reveals that, at the end of 3Q19, banks held around 8% of Austrian government debt, while asset managers, insurance companies and pension funds accounted for a tiny 3%. Other domestic investors (non-financial corporates and the government sector) held roughly 8% of Austrian public debt. Therefore, the most price-sensitive domestic investors, namely investment managers and insurance companies, held only a small portion of Austrian government debt.

As shown in Chart 3, the share of Austrian debt held by domestic banks started to decline with the beginning of QE and now amounts to about 8%. Since early 2008 (at the beginning of the financial crisis), investment managers have progressively reduced their holdings (from 4% to 2%), while other domestic investors have more or less maintained their initial holdings of Austrian debt. The chart shows the important role played by the ECB. At the end of 3Q19, purchases under the PSPP accounted for 18% of the overall Austrian government debt. Most Austrian government bonds purchased by the ECB were sold by foreign investors: since the beginning of the QE, their holdings have decreased from 75% to 64%, while that of domestic investors has declined from 25% to 19%.

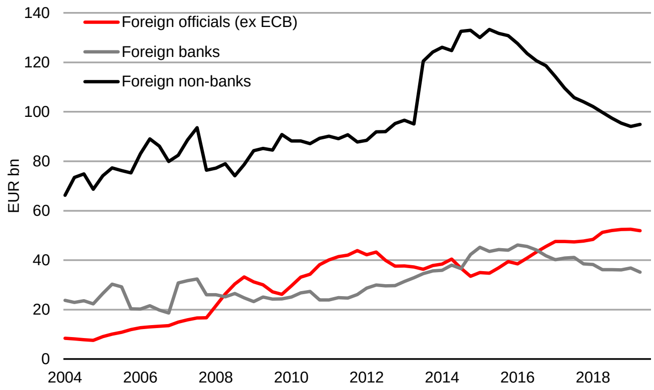
CHART 3: FOREIGN INVESTORS HOLD MORE THAN 60% OF AUSTRIAN DEBT



Source: OeNB, Bloomberg, UniCredit Research

Data from the IMF[1] (available from 1Q04 to 2Q19, see Chart 4) show that real-money investors (asset managers, insurers and pension funds) account for around 50% of such holdings by foreign investors. Since the start of QE, their share has decreased by almost EUR 40bn, while that attributed to foreign banks has remained almost unchanged. Foreign officials have also increased their presence in the RAGB market. Hence, in the last few years, the presence of investors with relatively low price sensitivity has increased, a factor that should provide stability.

CHART 4: FOREIGN INVESTORS OTHER THAN BANKS HAVE REDUCED HOLDINGS OF AUSTRIAN GOVERNMENT DEBT



Source: IMF, ECB, Bloomberg, UniCredit Research

As shown in Table 3, the distribution of Austrian government debt among foreign investors is quite similar to foreign holdings of the French debt. Conversely, foreign officials other than ECB, held a much more significant holding of German debt at the end of 2Q19.

TABLE 3: FOREIGN INVESTORS IN AUSTRIA, GERMANY AND FRANCE

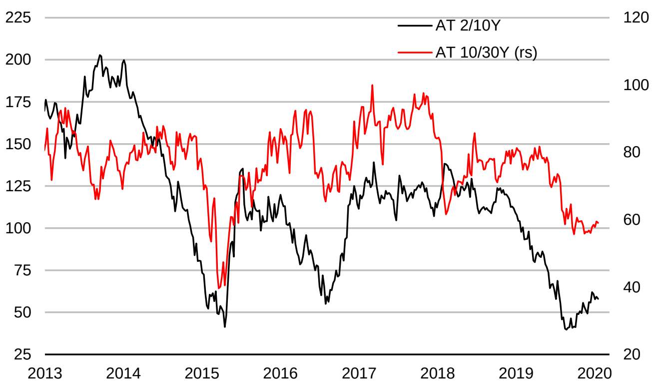
	AT	GE	FR
Foreign officials (ex ECB)	29%	79%	34%
Foreign banks	19%	16%	16%
Foreign non-banks	52%	5%	49%

Source: IMF, ECB, Bloomberg, UniCredit Research

5. AT curve at a glance

Mimicking other EGB curves, the RAGB curve is flatter than it has been in the past due to dovish monetary policies and decreasing inflation and interest rate risk. As shown in Chart 5, although the curve has recently bear steepened, the 2/10Y spread, currently trading slightly below 60bp, is still not trading far from its lowest level since 2013. On the other hand, the 10/30Y spread, despite the flattening observed in 2H19, is still steeper than the historical low (40bp) it reached at the beginning of the first round of QE. In light of both the uncertain economic outlook in the eurozone and ECB purchases of government bonds, we expect EGB curves to flatten in the coming months, with both the 2/10Y and the 10/30Y spreads close to historical lows.

CHART 5: THE RAGB CURVE REMAINS FLAT DESPITE RECENT STEEPENING



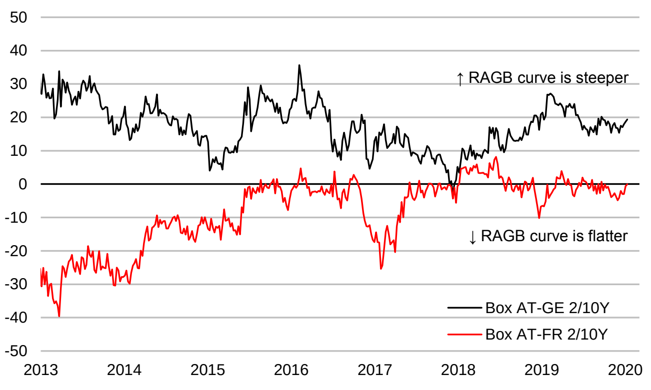
Source: Bloomberg, UniCredit Research

Compared to the German curve, the Austrian one is steeper, especially in the 2/10Y section, with the box spread currently trading around 20bp, roughly 5bp higher than its four-year average.

Excluding the first half of 2017, when political pressure in France led to a steepening of the 2/10Y section of the OAT curve, the Austrian curve is as steep as the French one. Indeed, the box spread is trading close to 0bp. From a historical perspective, therefore, we prefer a 2/10Y maturity extension on the RAGB curve rather than on the Bund curve.

[1] Data are based on the database compiled by Serkan Arslanalp and Takahiro Tsuda of the IMF. https://www.imf.org/en/Publications/WP/Issues/2016/12/31/Tracking-Global-Demand-for-Advanced-Economy-Sovereign-Debt-40135

CHART 6: THE RAGB CURVE IS STEEPER THAN THE BUND CURVE

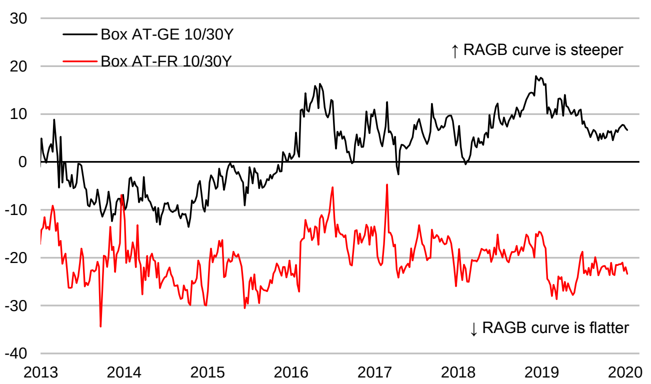


Source: Bloomberg, UniCredit Research

Conversely, Chart 7 shows that a 10/30Y maturity extension on the RAGB curve is less attractive than it is on the OAT curve. Furthermore, over the period considered, the box spread relative to OAT has been rather stable, meaning that demand differences between the two curves are resilient. As highlighted in Charts 3 and 4, strong demand for extra-long Austrian paper is likely to come from foreign rather than domestic insurance companies.

On the other hand, the 10/30Y AT-GE box spread is positive (7bp) but lower than its four-year average (around 8bp). Since 2016, the RAGB curve has generally been steeper than the Bund curve. Of the various reasons why the 10/30Y AT-GE box spread is positive, the following is worth mentioning. Since the beginning of QE, the Austrian treasury has been very active at the extra-long end of the curve, either issuing new benchmarks or reopening existing bonds. As shown in Chart 2, since 2016, supply at maturities equal to or higher than fifteen years has been between 15% and 25%. Conversely, the German treasury has kept issuance at extra-long buckets low and stable (between 5% and 10%).

CHART 7: THE RAGB CURVE IS STRUCTURALLY FLATTER THAN OAT CURVE



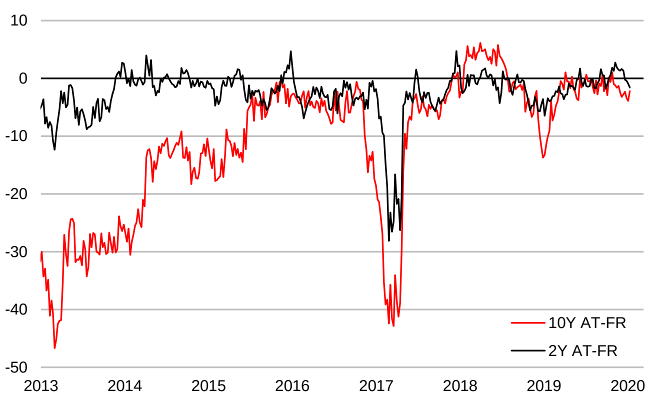
Source: Bloomberg, UniCredit Research

Finally, the RAGB curve is rather smooth, reflecting the relatively low number of these bonds as well as the low number of bonds with the same residual maturity but different issue dates. Existing bonds are also fairly well-spaced in terms of maturity. Because of its smooth shape, the RAGB curve only seldom presents relative value opportunities.

6. A deeper look at the credit spread between RAGBs and OATs

At the time of writing, the 10Y RAGB-OAT spread is trading almost flat, as is the 2Y spread. Although the main economic fundamentals are stronger for Austria than for France (lower deficit, lower debt-to-GDP ratio, higher expected GDP growth), the better liquidity of OATs has provided support to the market, keeping the yield spread of OATs vs. RAGBs tight.

CHART 8: YIELD SPREAD: AUSTRIA VS. FRANCE

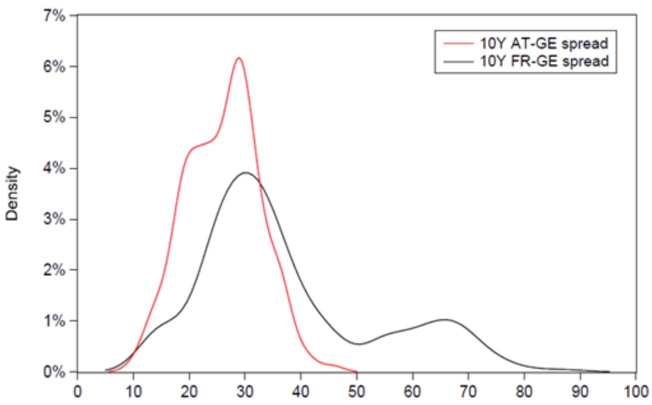


Source: Bloomberg, UniCredit Research

It is interesting to analyze the historical behavior of the RAGB-OAT spread. The chart below shows the historical distribution of the 10Y RAGB-Bund spread and the 10Y OAT-Bund yield differential from January 2013 to date. We chose to look at their spread against German Bunds both because this is a widespread market practice and because it helps to highlight country-specific events.

The interesting point highlighted in Chart 9 is that the AT-GE spread has been less volatile and less skewed towards high values than the FR-GE spread.

CHART 9: HISTORICAL SPREAD DISTRIBUTION OF AUSTRIA AND FRANCE VERSUS GERMANY

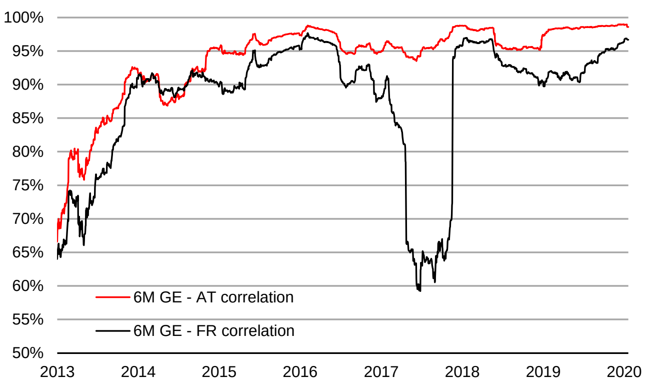


Source: Bloomberg, UniCredit Research

In this respect, buying OATs at their current spreads to Bunds does not offer a sufficient reward for the risks. Thus, RAGBs are attractive compared to their French peers.

The six-month rolling daily correlations of 10Y yields (Chart 10) confirm our findings. Even if one excludes the significant decline in correlation between OATs and Bunds occurred in the first half of 2017, which was caused by an increase in French political risk, the correlation between Austrian and German government bonds has been greater and more stable.

CHART 10: AT-GE CORRELATION HAS BEEN MORE STABLE AND HIGHER



Source: Bloomberg, UniCredit Research

7. A lesson of history from Austrian government bonds

The table below compares the performance of Austrian bonds with a number of European peers. The statistics are based on weekly data from 7-10Y Bloomberg and Barclays government bond indices during the period between January 2013 and January 2020.

TABLE 4: EGB PERFORMANCE IN THE LAST SEVEN YEARS

	GE	AT	NL	FR
Market value (EUR bn)	200	45	62	265
Modified duration	7.8	7.5	7.8	8.0
Average annualized return	3.34%	3.60%	3.57%	4.05%
Annualized volatility	4.05%	3.89%	3.93%	4.10%
Correlation with GE		94%	97%	89%
Beta with GE		0.90	0.94	0.90
Average YTM	0.38%	0.62%	0.57%	0.71%
Average spread to Bund (bp)		23	19	33
Min spread (bp)		5	4	8
Max spread (bp)		48	53	77
Spread volatility (bp)		61	69	97

Weekly data from 4 January 2013 to 17 January 2020
Source: Bloomberg, UniCredit Research

During the analyzed period, the Austrian index achieved the second highest performance with the lowest volatility. As we have already shown, Austrian government bonds are more correlated with Bunds than OATs but less correlated than DSLs. Given their high correlation with Bunds and their lower volatility, Austrian government bonds have a beta lower than one, making them a more defensive instrument than Bunds. This means that they tend to underperform Bunds when core yields decline and tend to outperform Bunds when core yields rise. These findings are also confirmed by the statistics found at the bottom of Table 4. Compared to DSLs despite their lower standard deviation, RAGBs have tended to offer more attractive yields.

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