Exploring the impact of EU bonds on the EGB market

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- The ECB's strong presence in the sovereign-bond market, which we expect to continue through next year, together with robust demand from foreign central banks will further increase the scarcity of safe assets in the euro area.
- EU bonds could become an alternative to Bunds going forward, given their high rating, provided that their outstanding grows fast. Low ECB buying would also be desirable, to leave most outstanding bonds to private investors. From a portfolio perspective, EU bonds have shown a high and stable correlation with Bunds.
- Small and mid-size sovereign issuers are likely to face stronger competition from EU bonds, given they will feature similar liquidity. EU bonds also offer good diversification relative to semi-core bonds, as underpinned by their more-stable performance in times of market stress.
- The EU will become a key player in the EUR-denominated SSA primary market, but we do not expect that the higher liquidity and volume of EU bonds will negatively influence demand for other Supras and Agencies due to the relatively small yield pickup they offer.

EU big supply boost has begun

The EU has carried out the inaugural transaction to fund its Support to mitigate Unemployment Risks in an Emergency (SURE) program, by issuing EUR 17bn of 10Y and 20Y bonds. The operation was a huge success, with total orders in excess of EUR 230bn and over 500 investors submitting bids. This underpins how strong investor demand is for top-quality fixed-income assets denominated in euros.

We expect to see another EUR 15bn of EU supply related to SURE this year. This would bring the total to around EUR 30bn, with the remaining EUR 60-70bn to be issued next year (see *Covered Bond & Agency Monitor*, 8 October 2020, for more details). By the middle of next year, the EU will also start funding its Next Generation EU (NGEU) package, which could lead to an additional EUR 120-130bn of issuance.

In this note, we analyze the scarcity of Bunds and to what extent upcoming supply from the EU may present an alternative to German bonds, bringing some relief to excess demand. We also examine the possible impact on other euro-area sovereign issuers, focusing on core and semi-core.

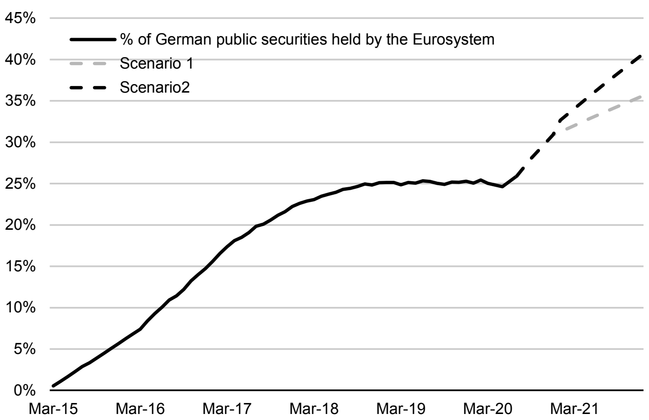
Scarcity of safe assets – reloaded

The ECB has provided tremendous support to European fixed-income markets in 2020. Until September, QE purchases of public-sector bonds have totaled EUR 720bn, and we estimate that they could reach EUR 940bn by year-end. In nominal terms, this could amount to EUR 850bn, thus covering a large share of the net supply of public securities in the euro area.

With regard to Germany, QE purchases have amounted to EUR 152bn up to September, and we estimate that the ECB could buy an additional EUR 50bn worth until year-end, reaching a total of EUR 200bn (around EUR 180bn in nominal terms). This would represent 85% of Germany's net supply for this year. We estimate that this ratio would be 55% for the Netherlands, 45% for Finland and 65% for Austria.

We expect QE purchases to continue also in 2021. Depending on the size of PEPP expansion and the amount of purchases that will be actually carried out, the ECB will potentially buy EUR 160-250bn of German securities, in nominal term. Net supply of German bonds should amount to around EUR 170bn. As a result, the ECB's share of the Bund market will continue to increase. Scarcity of Bunds is going to get worse, and the same goes for other core euro-area issuers.

EUROSYSTEM'S SHARE OF GERMAN SECURITES IS BOUND TO INCREASE



Scenario 1: 20bn/month in APP and EUR 600bn in PEPP. Scenario 2: EUR 20bn/month in APP and EUR 1300bn in PEPP

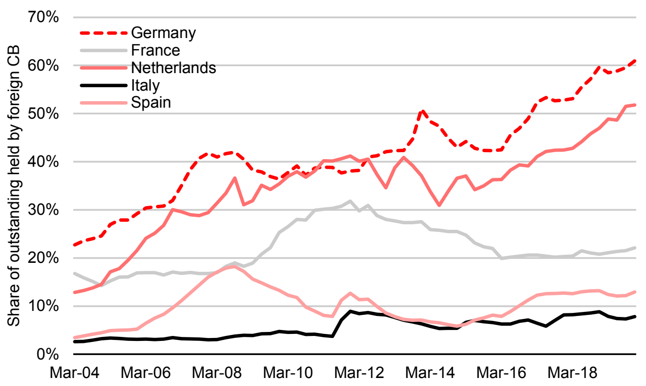
Source: ECB, Bloomberg, UniCredit Research

Who are the investors in core EGBs?

IMF data as of 4Q19 show that the investor base of core euro-area countries was heavily skewed towards the Eurosystem and foreign officials, which are typically not very price-sensitive. With the implementation of the PEPP in 2020, the situation has likely become even more extreme.

Foreign central banks have been steadily buying German and Dutch government bonds in the last ten years, while have been less keen on OATs. With the Eurosystem becoming an important buyer more recently, private investors have been progressively squeezed out of the market.

FOREIGN CENTRAL BANKS HAVE PILED UP CORE EGBS



Source: IMF, Bloomberg, UniCredit Research

That core EGBs are mainly held by buy-and-hold investors has an important consequence: their pricing is increasingly less linked to expectations and developments on the economy. This is, for example, reflected in the increasingly negative spread of 10Y Bund yields versus overnight-index-swap (OIS) rates.

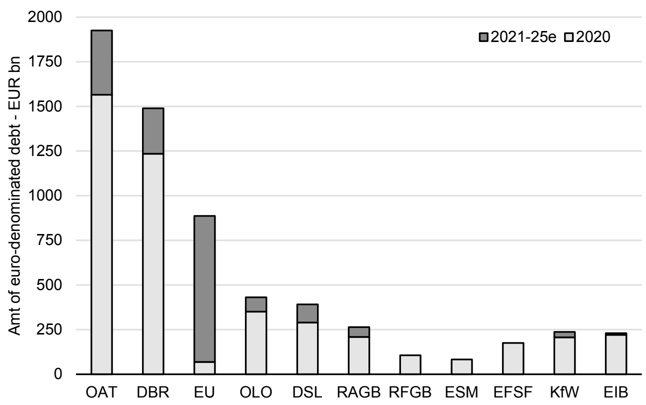
Such a strong presence of central banks is specific to the euro area. For comparison, the Fed also does QE, and USTs are an appealing investment for FX reserves managers and foreign central banks. However, the Fed and foreign officials account for roughly 40% of the market debt compared to over 80% in Bunds.

EU bonds as an alternative to core and semi-core EGBs

Can EU bonds represent an alternative to core EGBs? Right now, they belong to a different box as their issuance volume is much smaller. However, the NGEU and SURE programs imply that the amount outstanding will become very large, making EU bonds comparable to sovereigns.

The EU has just started to issue bonds to fund SURE and next year it will start issuance to fund NGEU. The total target size over a multi-year horizon is potentially very large. If such plans are fully implemented, the EU would become the third largest top-rated issuer of euro-denominated debt in the euro area within the next three to five years, with a total outstanding amount close to EUR 1tn, larger than other Supras and even of mid-size sovereigns, such as the Netherlands, Austria and Belgium. On the other hand, the outstanding of EU bonds will almost surely remain smaller than that of Germany and France.

THE EU IS SET TO BECOME THE THIRD TOP-RATED ISSUER OF EURO-DENOMINATED DEBT

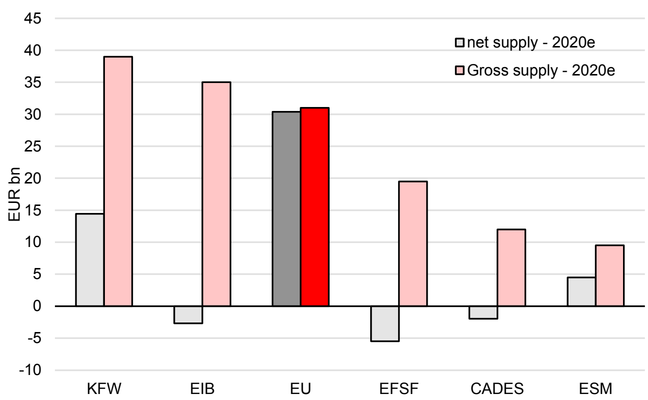


Source: Bloomberg, UniCredit Research

In any case, the EU will become a key player in the EUR-denominated SSA primary market already this year, under the (reasonable) assumption that issuance of SURE bonds will amount to around EUR 30bn. In 2020, the EU will be only slightly behind the EIB and KfW in terms of gross issuance and will be significantly larger in terms of net issuance. Next year, the EU will already be the largest issuer of euro-denominated bonds in the primary SSA market.

We do not expect that the higher liquidity and volume of EU bonds will negatively influence demand for bonds issued by ESM/EFSF or KfW due to the relatively small pickup in yield and given the generally strong demand for these issuers, as reflected in large order books.

EXPECTED EUR-DENOMINATED FUNDING IN 2020



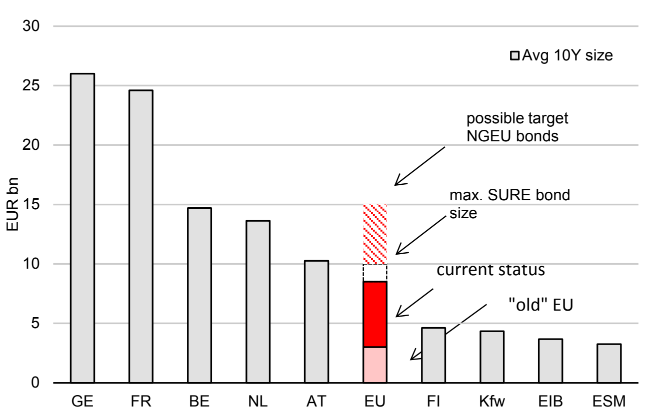
Source: Bloomberg, UniCredit Research

The EU plans to issue across the whole range of maturities. SURE issuance will have maturities of between 3Y and 30Y, with a maximum average maturity of 15Y. The presence of a full spectrum of maturities should attract a well-diversified range of investors.

The EU is rated AAA by Fitch and Moody's and is rated AA with positive outlook by S&P. It benefits from the unconditional support of all EU member states. The amounts due by the EU in any given year will not exceed 10% of the total outstanding in the context of the SURE program. A similar cap may be applied to the NGEU program, to limit the refinancing need. Hence, from a credit-risk perspective, EU bonds are a good potential substitute for core EGBs.

Until recently, with a total amount outstanding of just about EUR 50bn and an average bond size of EUR 4bn, EU bonds have been less liquid than all core EGBs. The new SURE bonds are on a different level, with an outstanding amount comparable to (if not larger than) that of bonds issued by small and mid-size sovereigns. SURE bonds are capped at EUR 10bn in size, due to the 10% maximum refinancing amount per year, and this implies benchmarks significantly smaller than Bunds and OATs, which reach an outstanding volume of EUR 20-25bn. However, issuance related to NGEU may present bonds with a larger outstanding amount, given that this program is much larger.

10Y BONDS: EU IS COMPARABLE TO MID-SIZE SOVEREIGNS



Source: Bloomberg, UniCredit Research

For some investors it will probably be relevant that EU bonds are included in major bond indices, but for others (banks and insurance companies for example) this should be less important. Similarly, this should not be a significant problem for central banks.

Competition with Bunds is likely to be a medium-term story. As of now, Bunds are far more liquid (also thanks to Eurex derivatives) and are well-established as risk-free assets. This role is unlikely to be challenged in the short term, and especially not before NGEU-related supply begins.

On the other hand, EU bonds are likely to be particularly attractive relative to mid-size issuers, such as Austria and Finland. Their liquidity is likely to be comparable, their ratings higher, and EU bonds are currently trading with higher yields, particularly up to the belly.

Who are the investors in EU bonds?

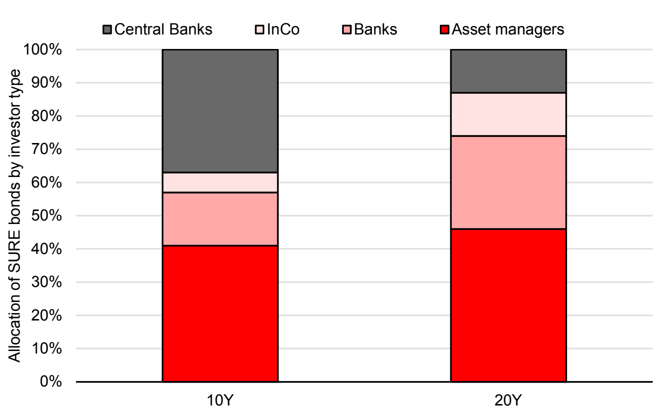
A starting point to understanding how EU bonds may affect demand for core EGBs is to look at their investor base.

The allocation of the first two SURE bonds offers interesting insight. Asset managers were predominant in both deals, a sign that EU bonds not being in the sovereign category is not hampering demand from these investors in a significant way.

The strong presence of banks in the allocation of the 20Y is an important signal of yield-hunting behavior. A similar message is conveyed by the relatively significant presence of insurance companies in the 20Y.

The two SURE bonds attracted high demand from ESG investors, given their status of social bonds. About 63% of the two bonds have been allocated to ESG investors. As the market for liquid ESG bonds is still limited, the SURE bonds were a welcome opportunity. This diversifies the investor base for EU bonds and the ESG feature might become a reason for some investors to switch from non-ESG sovereign bonds to EU SURE bonds going forward.

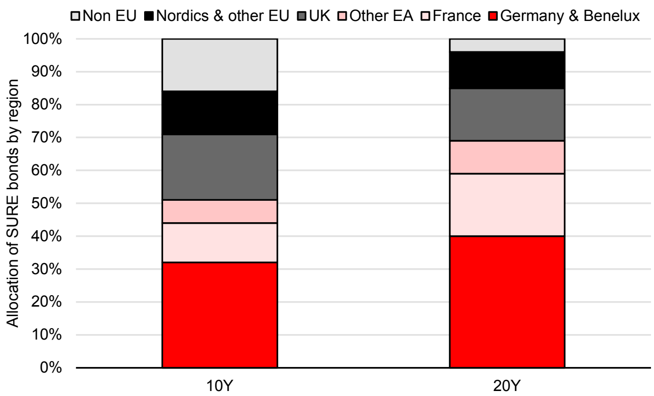
ASSET MANAGERS RECEIVED LARGE SHARE OF SURE BONDS



Source: EU, Bloomberg, UniCredit Research

In terms of geography, euro-area investors made up an average of 60% of the allocation. Unsurprisingly, German and Benelux investors account for a very large share of euro-area demand, which underpins both the demand for safe assets and the fact that scarcity induced by QE is particularly strong in these jurisdictions, where also domestic institutional investors tend to seek high rated bonds. UK and other European investors accounted for another 25-30% of allocation, so about 90% of the two deals were allotted within Europe. The strong participation of European investors sends a positive signal of confidence in the EU's policy response to the current crisis. Non-European investors are present in only marginal numbers. This could be due to, among other factors, lower rates compared to other jurisdictions.

WHO BOUGHT SURE BONDS: BREAKDOWN BY REGION



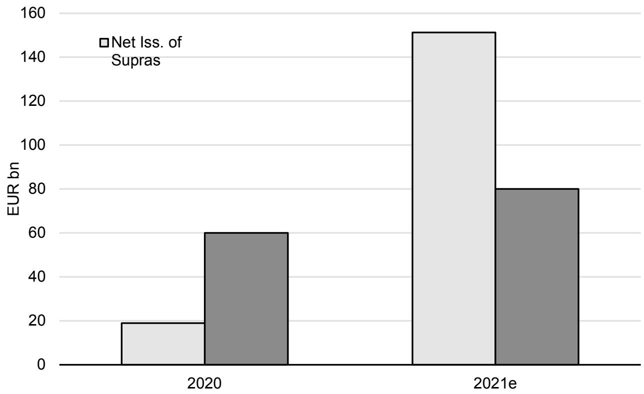
Source: EU, Bloomberg, UniCredit Research

How much will the ECB buy?

The ECB buys supranational bonds under its QE program: 10% of the public sector bond purchases in the APP and a bit less for the PEPP. It has purchased bonds worth EUR 55bn until September and we expect it to buy an additional EUR 15bn by YE – for a total of EUR 60-65bn in nominal terms. This amount will largely exceed net supply this year.

In 2021, we expect that the ECB may buy EUR 50-80bn of supranational bonds. If the EU is as active as currently expected, QE support will be significantly lower than in 2020.

ECB PURCHASES OF SUPRAS EXPECTED TO BE LOWER THAN NET SUPPLY IN 2021



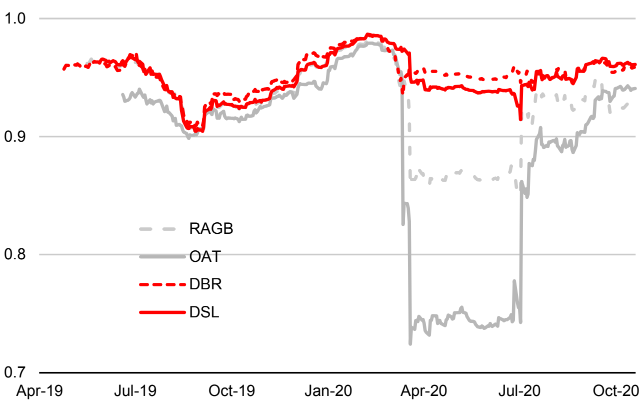
Source: ECB, Bloomberg, UniCredit Research

While it may be tempting for the ECB to step up purchases of Supras, also because they are subject to less stringent concentration limits, there is an important reason why it should not do this. The issuance of EU bonds represents a unique opportunity to develop a new reference for risk-free rates in the euro area. In this respect, it is important that the amount available in the market is large enough to reflect both demand for safe assets as well as monetary-policy expectations. We estimate that the ECB already owns around 40% of the supras market. Upcoming net supply should be used to increase the amount available for trading by the private sector.

What is the correlation with other sovereigns?

EU bonds offer a yield pick-up relative to core and semi-core EGBs, which is an attractive feature. How do they fare relative to other sovereigns? The following chart shows the rolling correlation of 10Y EU yields with those of other issuers.

CORRELATION BETWEEN EU BONDS AND BUNDS: STEADY AS IT GOES



Rolling 75-day correlation

Source: ECB, Bloomberg, UniCredit Research

The message is clear: correlation with Bunds is high and steady and the same goes for Dutch government bonds (DSL). In the case of these two sovereigns, especially DSL, EU bonds could be seen as an alternative, given the higher yield and similar behavior, even during stressful circumstances.

The chart also highlights that EU bonds' correlation with OATs and, to some extent, with RAGBs drops significantly in times of volatility. The chart focuses on the beginning of the pandemic, but a similar pattern was observed ahead of French presidential elections in early 2017. The fall in correlation suggest that EU bonds tend to behave like safe havens in periods of volatility. While one always has to take historical patterns' bearing on future trends with a pinch of salt, the chart below suggests that EU bonds are a very good alternative to the bonds of semi-core issuers. They pay a spread and are more stable during difficult periods.

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