

Rates Outlook: The bond supply dynamic and sovereign spreads

Eurozone net issuance will decline in 2022, but is outweighed by the ECB reducing its footprint. There will be a clear fall in US net issuance in 2022 versus 2021. Crucially, even though the Federal Reserve will stop buying, buying adjusted net supply should actually still feel lighter in 2022. Gilt investors need to absorb more debt as the BoE steps away.



Source: Shutterstock

EUR sovereign supply: Moderately lower issuance

We expect gross **European government bond** issuance (EGB) in 2022 to decline only slightly versus 2021. We calculate gross issuance of €1.2t next year versus €1.25t this year as less pandemic related spending is required and economies are recovering. We see net issuance next year falling to €460b from €560b as total redemptions amount to €735b in 2022 versus €667b this year. Taking into account only slightly lower coupon payments, the overall net flow will fall from just above €400b in 2021 to around €310b in 2022.

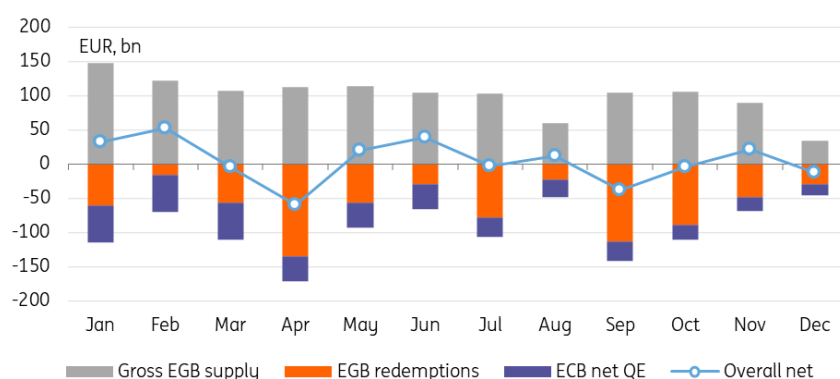
Issuance should see downward pressure given large cash buffers and Next Generation EU payouts, only partially offset by the desire to term out.

Uncertainty surrounding our forecast remains greater than usual. While most countries, with the notable exception Spain, are facing higher bond redemptions next year, bond issuance should still see downward pressure given, for instance, larger cash buffers and also the incorporation of Next Generation EU payouts into countries' funding mix. That may well be offset in part by an inclination to first reduce or at least term out reliance on shorter-dated funding which had been ramped up at the height of the pandemic.

Also, as of now, the impact of the fourth wave of the pandemic is still unclear. We would suspect that measures are more targeted now and are overall less costly as governments gain more experience in dealing with the crisis. The publication of funding outlooks starting in December may provide more clarity on funding strategies but given the nature of the pandemic, funding needs can remain in flux.

The so-called **E-names** should see higher issuance next year, mainly as the EU's Next Generation EU funding activities gather steam. The official guidance is for issuance of €150b per year. Add to that minor volumes for the EU's other programmes and perhaps even some residual funding for the EU's SURE programme. On the downside, it is still unclear whether all the available loans will be handed out. The application period for the loan component runs until 2023. Also still unclear is when recovery plans for Poland and Hungary are approved and under what conditions. The European Financial Stability Facility/European Stability Mechanism will together issue €27.5b, €3b more than last year.

The ECB's QE ensures that net supply to private investors is close to flat



Source: Refinitiv, ING forecast

The ECB remains an important factor to reckon with even as its footprint shrinks. The Pandemic Emergency Purchase Programme (PEPP) is likely to end after March next year - its end possibly smoothed over with a new programme - but the ECB would continue buying via the regular Asset

Purchase Programme (APP) at a steady €20b/month pace. In this baseline scenario, we estimate that the ECB could still buy a net €410b of government bonds alone. That is still more than the European government bond net issuance flow of €310b, i.e. issuance minus redemptions and coupons. While rising, the net EGB cash flow to private investors will thus remain negative in 2022. We look for minus €100b, up from an estimated minus €260b this year.

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There are levers which the ECB may adjust aside from the pure headline volume, such as raising the share of sovereign, supranational and agencies (SSA) purchases. We think there is no need for the ECB to prop up EU issuance at this stage. EGB issuer limits are also of lesser concern now with QE set to slow, leaving little pressure for the ECB to look into SSA purchases instead. More clarity should be provided soon at the 16 December ECB meeting.

EUR sovereign spreads: Peaking in 1Q amid slowing QE and politics

	Current value	Year ahead	4Q21	1Q22	2Q22	3Q22	4Q22
10Y Italy-Germany	126bp	Wider	130bp	150bp	130bp	110bp	100bp

The ECB's substantial market interventions via PEPP and the EU's support via the Recovery and Resilience Facility (RRF) have been a boon for sovereign spreads. Still, the past weeks have already shown that the prospect of one of these support pillars being scaled back can have noticeable repercussions, especially at a time when uncertainty over the (global) monetary policy outlook is already increasing market volatility. Our base case view, as illustrated by the spread of 10Y Italian government bonds over Germany, sees spreads peaking in the first quarter of 2022 before gradually retreating towards the lows seen this year. While the ECB's support will remain sizeable (see previous section) the extent of any spread recovery will also depend on how much of the PEPP's flexibility, in terms of volumes and country allocation, the ECB will keep on board for the existing or any future buying programmes.

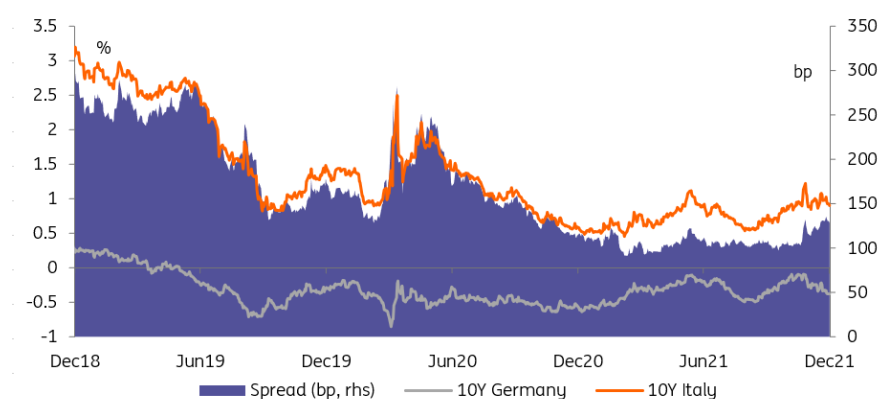
With the ECB's most flexible programme ending and higher market volatility, investors will demand greater compensation for holding higher beta assets

The ECB looks intent on bringing PEPP to an end after March next year, but it postponed

the decision on what follows until February given uncertainty surrounding the resurgence in the pandemic. Being seen as dovish could help spreads in the very near term, but leaving markets unclear over the next couple of months quickly offsets that benefit. Keep in mind that the start of the year is marked by primary bond markets springing back into action. Technically, this issuance surge is still buffered by the final months of net PEPP purchases as well as the ECB's regular APP. The latter will also continue buying for the foreseeable future ensuring a still respectable overall ECB footprint. However, with the ECB's most flexible programme seen ending and higher "imported" market volatility from global policy tightening, we think investors will demand greater compensation for holding higher beta assets, especially for longer maturity issues.

This may be all the more true as eurozone politics will return to the headlines early in the year with presidential elections in France and Italy. With regards to the periphery in particular, the EU's Recovery and Resilience Facility kept political concerns at bay for much of the past year. More fundamentally, the prospect of reform and substantial investment has bolstered the economic outlook, also manifesting in sovereign rating upgrades. However, these prospects hinge on the timely execution of recovery plans and reforms over the coming years.

Politics will add temporary jolts to waning ECB support



Source: Refinitiv, ING

Italy's presidential election: Setting the stage 2023

Italy's new president will be elected by parliament and regional representatives in January. There is much talk of current Prime Minister Mario Draghi taking over the post from the outgoing President Sergio Mattarella. This would offer markets some reassurance ahead of the general elections in spring 2023, where current polling shows traditionally eurosceptic right-wing parties in a strong position, with the Brothers of Italy at the forefront.

The national unity government formed around PM Draghi has calmed market concerns over Italian politics. As Draghi has been the glue of this technocratic government, leaving this position bears the risk of destabilising it at a critical time when the implementation of the Recovery Plan is still in its infancy. Early elections cannot be excluded.

An optimal market outcome would be the temporary confirmation of current President Mattarella, leaving him in place until Draghi's current legislature ends in the spring of 2023. Draghi could then oversee the further implementation of the Recovery Plan from the higher

level of president. However, Mattarella has so far signalled no desire for this.

French elections: Bye bye Frexit

A repeat of 2017 looks unlikely, but then again, history never repeats itself exactly. Investors will take heart from the fact that no major party, or candidate, has brandished the threat of leaving the EU, or the eurozone. Markets will also cheer President Emmanuel Macron's commanding lead in the first and second voting rounds. Things could get interesting if the traditional (Les Republicains, led by Pécresse) right dilutes support from the incumbent, but the odds of no traditional candidate making it to the run-off are slim.

Inevitable election uncertainty will likely add to sovereign spreads volatility in the first quarter, but the election should quickly fade from investors' minds in favour of the much more important topic of central bank tightening.

USD sovereign supply: Net supply pressure eases significantly in 2022

US Treasury issuance for 2021 will end up at around \$5t, the highest ever, bolstered by a fiscal deficit running at about 13.5% of GDP. The fiscal deficit should shrink to below 7% of GDP for 2022 helped by stronger tax revenues. That equates to a net issuance cash need of some \$1.75t. On top of that, there is some \$2.25t of redemptions to re-finance, bringing overall issuance for 2022 to about \$4t, back to around the issuance levels seen in 2020.

Total issuance in the region of \$4t for 2022 is still well above issuance levels seen in the immediate pre-pandemic years, which ran at around \$2.7t in 2018 for example. Looking forward to 2023, even though the fiscal deficit will shrink further, to a little under 5% of GDP, slightly higher redemptions and a larger cash economy should see the issuance volume fall only slightly, to just below \$4t.

Even though the Fed will stop buying, net supply should still feel lighter in 2022 relative to 2021.

Bottom line, this points to refunding amounts in the area of \$1t per refunding quarter for the foreseeable future.

When we focus on net issuance, we find that there is a clear fall from 2021, with net issuance declining by some \$1.5t in 2022. Against that, we should factor in the tapering of the Federal Reserve. The Fed is currently buying US Treasuries at an annualised rate of some \$1t. In that sense, overall net supply pressure will shrink by some \$0.5t, in underlying terms. So even though the Fed stops buying, net supply should still feel lighter in 2022 relative to 2021.

GBP sovereign supply: Higher net impact as BoE steps away

Gross Gilt issuance should fall to £203b in 2022 from £231b this year. The drop in net issuance will be even larger as bond redemptions will double to £98b from £49b. Thus after the net Gilt issuance of £184b this year we should see a drop to £105b in 2022.

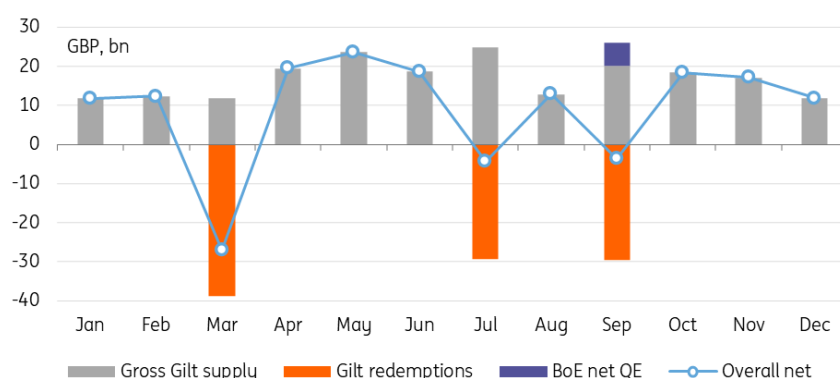
Despite the drop in net issuance, private investors will still have to absorb a significantly higher amount of debt next year

However, the BoE has just ended net asset purchases, which means that despite the drop in net issuance, private investors will still have to absorb a significantly higher amount of debt next year. Looking ahead, the BoE has indicated that should Bank Rate reach 0.5%, it will look to start passively running down its holdings by ceasing reinvestments. We think Bank Rate will reach that threshold only late in the summer, meaning that the larger gilt redemptions from the BoE's portfolio earlier in the year should still be reinvested.

BoE gilt holdings should thus shrink by only £6b next year, meaning the net gilt flow to private investors should reach £110b. That, however, is already a significant increase versus this year, where net gilt flows barely reached £14b on the back of the BoE purchasing almost £170b over the course of the year.

At 1%, the BoE has indicated it will begin actively selling bonds from its portfolio. We reckon this will only happen in 2023, if at all.

Net gilt supply will be positive for most of 2022



Source: UK DMO, BOE, ING

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