GENERALI ASSET MANAGEMENT

FOCAL POINT

Euro Area: Stalling deficit reduction and QT to drive net government bond issuance to record high

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Our Focal Point series explores topical issues on macro, markets and investment

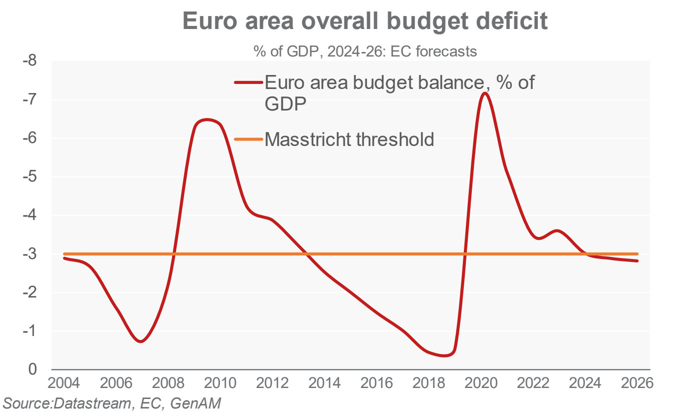
- **In 2025, the euro area budget deficit will according to the latest European Commission (EC) projection fall only marginally to -2.9%, from -3.0% in 2024.**
- **There are huge differences among countries with France is expected to have the highest deficit in 2025 at -5.3%, the ousting of the Barnier government making an even higher deficit under the next government likely. General downside risks due to activity and political woes also in Germany tilt the budget risks to the upside.**
- **The ECB will start to fully stop PEPP reinvestments in January 2025 lifting monthly Quantitative Tightening (QT) by an additional € 7.5bn. This implies that more than € 400bn of government bonds will not be reinvested in 2025.**
- **Euro area government bond net-net issuance will continue to rise to a record level of around € 850bn as the ECB intensifies its QT. Gross issuance will decline moderately to a still high level of € 1.27tr in 2025, reflecting slightly falling net issuance and lower redemptions.**
- **At the country level, France is the largest issuer in terms of both net and gross issuance. Some smaller countries will benefit from their sound fiscal policy.**

2025 will mark a turning point at government bonds markets. It will be the first year since 2014 without ECB asset purchases as it announced that it will also stop partial reinvestments under the PEPP. This will push net-net issuance to a high of € 850bn. Moreover, there will be striking differences among countries. Due to its political crisis and the fact that it will be the largest issuer, France will stay in the spotlight of markets. In what follows we will take a closer look at the 2025 issuance activity that sets the stage for sovereign bond markets.

Upside risks to 2025 deficit projections

With the suspension of the Stability and Growth Pact (SGP) being over and the revised SGP now in place, deficit reduction will need to continue. According to the latest European Commission (EC) forecast the aggregate euro area deficit is set to recede somewhat in 2025, to -2.9% from -3.0% before.

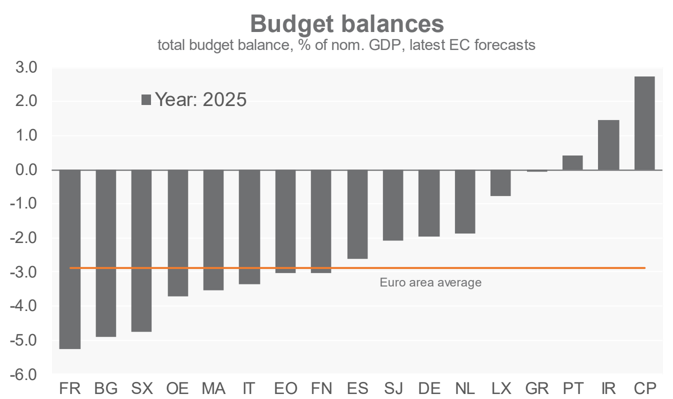
However, this rather benign headline figure rests on the assumption of a 1.3% annual GDP growth next year. We deem this much too optimistic and look for only 0.8%. Following the EC and assuming a semi-elasticity of the budget-to-GDP ratio of about 0.5 this implies a ¼ pp higher deficit. Clearly, countries can and might to a certain extent offset slipping deficits through consolidation measures. We are sceptical and see the risks tilted to the upside.



Source:Datastream, EC, GenAM

France exhibiting the highest deficit

Looking at countries, the pattern is quite heterogenous. Cyprus, Ireland, and Portugal are set to show surpluses while France, Belgium and Slovakia are expected to experience deficits around 5%. The projected French deficit looks particularly uncertain. In case of France the EC growth forecast of 0.8% is in line with our expectation. However, the EC forecast of a -5.3% deficit factors in revenue-increasing measures amounting to almost € 21.6bn (0.7% of GDP) and expenditure-decreasing measures, mainly on public consumption and social transfers, worth almost € 12bn (0.4% of GDP). Interest payments on government debt are set to rise further by 0.3 ppt, to 2.5% of GDP. But the latest political woes resulted in a breakdown of Prime Minister Barnier's government which submitted these plans to the EC. The key reason was stiff opposition from the extreme right as well as left on key consolidation measures. The next government will now need to pass the 2025 budget. However, this is unlikely to take place in due time and the stiff political headwinds from the extremes make a passing unlikely. In such a case, a provisional budget, which simply reproduces the 2024 budget, will probably be put in place, the various parliamentary groups reportedly signalled some willingness.

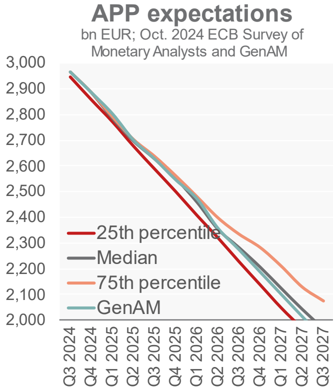


Source: Datastream, GenAM

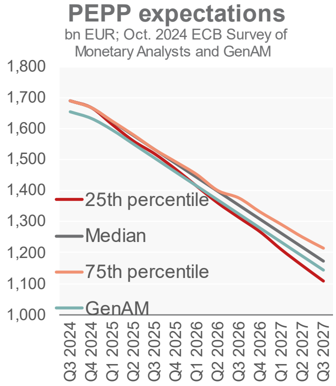
This implies a clearly higher 2025 deficit than incorporated in the EC projections. The degree of shortfall, however, is subject to uncertainty. Revenues will be lower as among others increases in social security contributions, a surcharge on corporation tax, tax on the highest incomes, will not be approved by parliament amounting to about € 30bn. On the other hand, no indexation of the income tax scale should lift revenue by about € 4bn which should be enough to broadly compensate for the indexation in pensions. On the expenditure side, sticking to the 2024 budget implies a reduction in real public spending, which should normally have risen by around 3% to compensate for inflation and growth. This leads to savings of about €15 bn. All in all, we conjecture that the French 2025 deficit could be about € 15bn higher than initially foreseen translating into a higher deficit of up to 0.5pp.

ECB no longer buying sovereigns

Since the launch of Quantitative Easing (QE) in 2015 the ECB had always been a buyer on the sovereign bond market, either by buying new bonds or by reinvesting redemptions from purchased ones. After having had stopped PSPP reinvestments already in 2023, the ECB capped PEPP reinvestments to €7.5 bn from July 2024 onwards and will fully stop them from January 2025 onwards. Purchases made under the PEPP almost fully consist of sovereign bonds. We expect that maturing PEPP bonds sum up to € 15bn per month on average or € 180bn in 2025. The ECB stated that under the PSPP more than € 250bn will mature in 2025 so that more than € 430bn will need to be absorbed by the market. Our assumption on passive QT is in line with projection from the ECB's Survey of Monetary Analysts (see charts below).



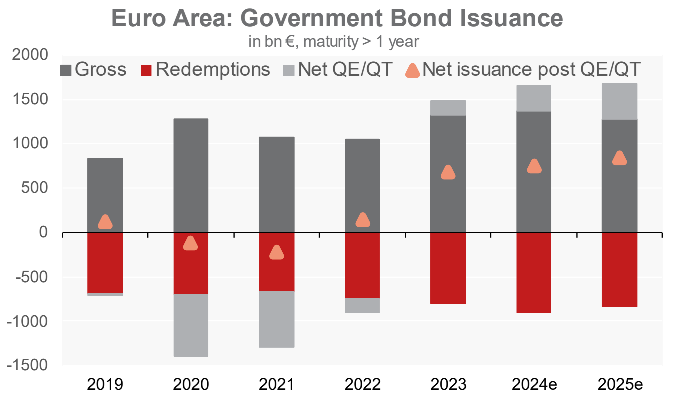
Source: ECB, GenAM



Source: ECB, GenAM

Still heavy government bond supply to absorb

On this basis, we forecast the supply of government bond in 2025. As always, this is subject to several uncertainties at this stage. It is not yet clear for all countries to what extent they will rely on NextGenerationEU loan disbursements and/or cash and/or whether they will partially replace bond issuance with T-bills to finance their funding needs. In addition, uncertainties are currently exacerbated by the complex political landscape in some EA countries. Austria, Belgium and Spain have not yet approved budgets for the coming year. In addition, economic heavyweights France (see above) and Germany have yet to pass a budget. This means that around two-thirds of upcoming bond issuance is still uncertain and therefore vulnerable to future revisions.

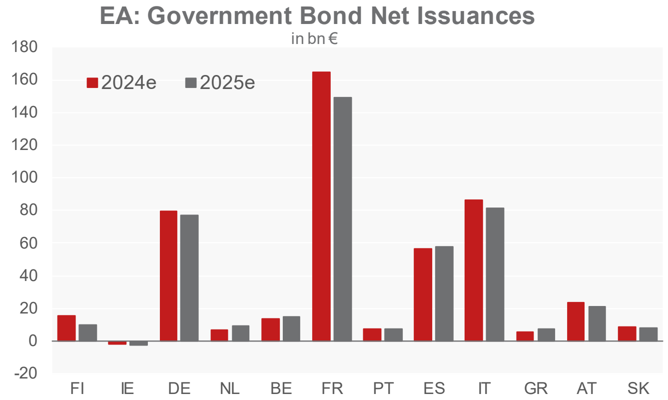


Source: Bloomberg, Datastream, GenAM

On the information currently available, we expect net issuance to fall from just under € 470bn to around € 440bn in 2025 because of moderately declining budget deficits. Given falling redemptions (€ 830bn versus € 900bn in 2024), this leads to a slight decline in gross issuance for the EA (from € 1.37tr to € 1.27tr). Although slightly below the levels of the last two years, gross issuance will remain on a high level compared to the pre-Covid period.

As explained above, the situation in the primary market will be decisively shaped by the ECB in 2025 as the central bank will not reinvest any maturing government bonds in its holdings. Considering that the above figure of more than € 250bn includes supranationals, we estimate that the volume not reinvested PSPP bonds in the sovereign segment will be € 230bn in 2025. Contrary to the PSPP, the ECB does not publish any forward-looking redemption data for the PEPP. Therefore, the uncertainty here is higher than with the PSPP. We estimate that a total close to € 180bn of maturing PEPP bonds will not be reinvested in 2025 (see above), meaning the ECB will not reinvest almost € 410bn of maturing sovereign bonds in 2025. With net issuance of around € 440bn, net-net issuance (including ECB QT) will be close to € 850bn next year, another record.

At the country level, France will be the main issuer both in terms of gross (€ 328bn) and net (€ 149bn) issuance. Although net issuance will decrease moderately from very high levels in 2024 (as explained above, risks are to the upside), France's net-net issuance will even rise by around € 10bn to a record level of € 234bn. Italy's gross issuance will decrease to € 318bn (from € 373bn) but mainly due to lower redemptions. Noteworthy, with a primary surplus targeted for 2025, Italy's net funding needs are exclusively for debt servicing. In addition to France, Italy as well as Germany will set a record for net-net issuance in 2025. Noteworthy, Portugal and even more Ireland and to some extent also Greece benefit from sound fiscal policies. The net issuance is very low or even negative in the case of Ireland. Hence, absorption of the supply is likely to be particularly smooth for these countries.



Source: Bloomberg, Datastream, GenAM

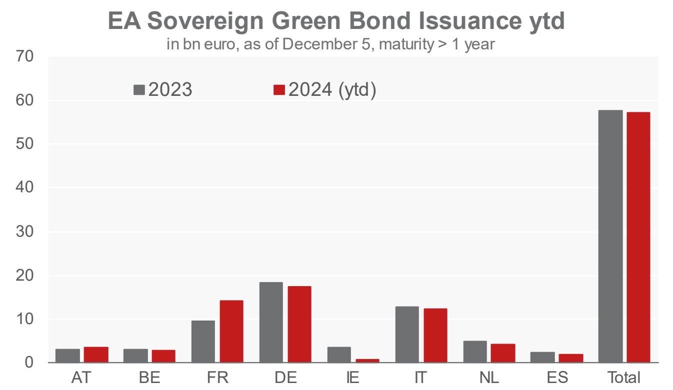
With the ECB's QT hitting the market with a vengeance next year, we expect the share of very long-term bonds (10+ years) to fall slightly next year from over 40% in 2024. In addition, as usual, treasurers are expected to be particularly active at the start of the year and issuance activity to be front-loaded. Around one third of the issuance volume is likely to be placed already in Q1.

Overall, we expect the wall of supply to eventually be smoothly absorbed by the market. As in previous years, non-residents are likely to take up the net supply and the bonds not reinvested by the ECB. Given the uncertain political situation in France for the time being, only the demand for French OATs could be under pressure (and against the background of high net supply). Ultimately, however, domestic investors should fill the gap, if necessary, at higher spreads. On the back of declining attractiveness due to lower yields we forecast a declining focus on retail issuance (as has happened already in Belgium and Portugal). Nevertheless, Italian households will continue to be an important investor group for Italian BTPs.

Green bond segment set to expand

As in previous years, EA sovereigns also issued some of the 2024 bonds as green bonds. Since the beginning of the year, a total of € 57bn has been placed on the market, roughly on a par with the previous year. In addition to three new green bonds (France, Germany, Italy), existing bonds were tapped. Very long-term bonds with a residual maturity of more than 10 years remain the preferred segment (>70%). Overall, the outstanding volume of ESG sovereign bonds (except for the social bonds from Luxembourg (09/2032) and Latvia (01/2030), all EA government ESG bonds are green bonds) now exceeds € 283bn, with France (€ 76bn) slightly ahead of

Germany (€ 73bn). In relative terms, however, Ireland is ahead with around 8% of green bonds.



Source: Datastream, Bloomberg, GenAM calculations

As demand for green bonds remains strong, we expect EA sovereign green bond issuance in 2025 to be close to the current year's level. As only one bond (Germany 0% 10/2025) with a volume of € 8.5bn matures, the outstanding volume is seen to increase by almost € 50bn to around € 330bn in 2025.

Imprint

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