

## Core Matters

# The ascent of quasi-government bonds

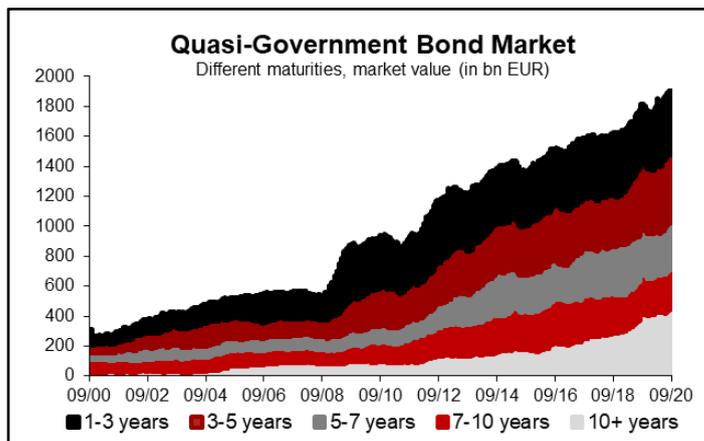
29 September 2020



**Author: Florian Späte**

- The market value of euro-denominated quasi-government bonds has multiplied in recent years. Amid the rescue measures of governments in response to Covid-19, the importance of this asset class is set to increase further.
- The trend towards a lengthening of new issue duration and the high quality of the issuers make quasi-government bonds attractive for long-term investors eager to earn yield and preserve risk capital.
- Despite a diverse composition – agency, non-euro area government, local government, supranational and government guaranteed securities – spreads are driven by similar factors like sovereign indebtedness and policy uncertainty.
- Quasi-government bond spreads have already receded from the highs marked in spring. Despite concerns about surging supply, ongoing ECB purchases are expected to ensure market stability in the foreseeable future.
- Additionally, the higher spread level is forecast to contribute to an overperformance of quasi-government bonds versus both covered and core government bonds in the long run.

Bond investors find it increasingly difficult to find attractive investment opportunities. On the one hand, the very low (and even negative) yield environment is likely to stay for long. The accommodative monetary policy stance, amplified by the negative growth impact of Covid-19, makes a meaningful rise in international yields very unlikely in the foreseeable future. On the other hand, the universe of highly rated issuers has shrunk over the recent years, as ratings have drifted down. Several developed countries have lost their AAA-rating and in light of the fiscal burden due to the economic consequences of the global pandemic a reversal of this trend is not in sight.



These developments put quasi-government bonds in the spotlight. Over recent years, this asset class has already grown strongly and the characteristics of quasi-government bonds make them attractive for long-term investors striving to save risk capital.

The outline of the paper is as follows. First, we describe the main features of quasi-government bonds and analyse the composition of the corresponding index. Second, we evaluate the attractiveness of this asset class in the current bond market environment. Third, we identify the common factors driving the performance of this asset class. Fourth, we assess the medium- and long-term outlook for quasi-government bonds. This is done with particular regard to the forthcoming issuance activity and the several ECB purchase programs.

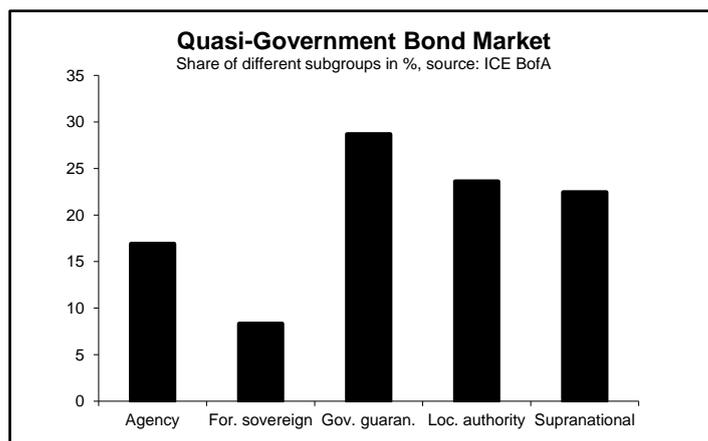
### Main characteristics of quasi-government bonds

The importance of quasi-government bonds has increased substantially over recent years. While the outstanding volume of euro-denominated investment grade quasi-government debt increased moderately until the Great Financial Crisis (GFC), its growth rate has risen significantly since then. The market value rose from slightly above €300 bn to around €550 bn between 2000 and 2008, and has now surged to over €1900 bn.<sup>1</sup> Overall, the face value of outstanding euro-denominated quasi-government bonds has multiplied more than six-fold over the last 20 years. This growth outpaced other fixed income asset classes, e.g., the outstanding amount of euro area sovereign bonds rose (only) from €3600 bn to around €9100 bn in the same period.

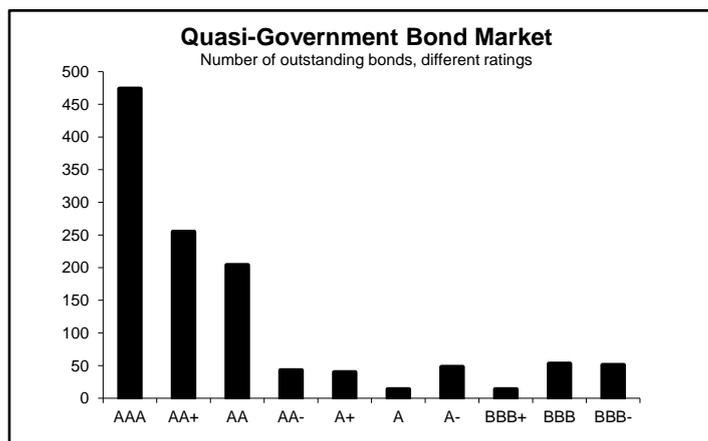
Although quasi-government bonds are summarized in one corresponding index, the composition is rather heteroge-

<sup>1</sup> In the following we always refer to the ICE BofAML Euro Quasi-Government Index in case specific numbers and characteristics of this asset class are discussed. The Bloomberg ticker is EQ00 Index and the Datastream mnemonic is MLQGVVCU.

neous. There are several sub-indices divided according to the **issuing entity** (in some cases the classification is not straightforward). In descending order the respective sub-groups are: government guaranteed (29% of the overall index), local authority (24%), supranationals (23%), agencies (17%), and foreign government bonds (8%).<sup>2</sup>



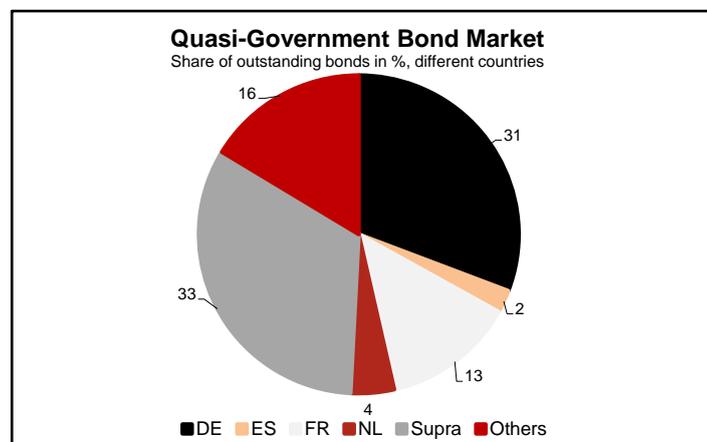
It should be noted that government ownership of an issuer does not qualify a bond to be a quasi-government one. Depending on the exact terms of the underlying contract a respective bond can also be classified as a corporate bond (case-by-case decision). In the following, we refer to the classification of the ICE BofAML Euro Quasi-Government Index, which takes this explicitly into account and does not focus merely on public ownership. According to ICE BofAML, an agency is – in distinction to a corporate – an entity that exclusively serves an explicit *public policy purpose*, hence is less focused on profitability than a typical corporation. Moreover, it was created by a specific statute and at the behest of a government (even if it was subsequently transformed into a stockholder company).



An outstanding feature of the euro quasi-government bond index is the **high rating level**. More than 45% of all bonds in the ICE BofAML Euro Quasi-Government Index have an AAA rating and almost 43% have an AA rating. Hence, almost 1000 bonds (out of currently around 1200) have a rating of at least AA.

The **geographical structure** of issuers is rather uneven. Almost one third of all outstanding debt is released by entities generally considered as supranationals, even if this is

not fully reflected in the respective sub-index (see above). This is due to the fact that some issuers generally perceived as supranationals are not classified as such. The most prominent example is the European Financial Stability Facility (EFSF) which is categorized as government guaranteed according to the index rules. Moreover, more than 30% of all outstanding bonds are issued by German entities and around 13% by French ones. With greater distance the Netherlands and Spain follow. It is noteworthy that e.g. Italian issuers hardly play a role.



The most important single issuers are currently the European Investment Bank (EIB), the German Kreditanstalt für Wiederaufbau (KfW) and the EFSF. The EIB has issued 60 bonds with a face value of more than €200 bn (more than 12% of the index). The KfW has 48 bonds outstanding (face value of €183 bn represents more than 10% of the index). The number of EFSF bonds is 39 (face value of almost €160 bn). This represents circa 9% of the overall index.

### Guarantee mechanisms and regulatory treatment

One of the essential characteristics of many quasi-government bonds are the various forms of **guarantee mechanisms**. Often quasi-government bonds are given the same rating level as the guarantor. This significantly impacts the risk weight.

Generally, there are several forms of guarantees (and many specific types at the national level). The most comprehensive form constitutes an explicit guarantee which can only be changed through a legislative process (many agencies have this type of guarantee). This offers investors a direct and unconditional claim against the guarantor. Additionally, this form of guarantee implies a risk weighting of 0% according to Basel III. Hence, these bonds can be subtracted from total assets for purposes of calculating the Capital Adequacy Ratio (CAR) – they are treated like government debt.

A slightly weaker form of responsibility is the maintenance obligation. In this case, the owner of an institution is requested to provide the necessary funds to always maintain the entity's solvency. Hence, it corresponds to an implicit guarantee. However, investors do not have an explicit claim against the owner (in contrast to the explicit guarantee). As the degree of maintenance obligation differs on a case-by-case basis the risk weighting is not in all cases 0% according to Basel III.

<sup>2</sup> For more details on the classification of the several sub-indices, see <https://www.theice.com/market-data/indices>.

Suprationals generally do not have an explicit guarantee, but in emergencies they have access (in addition to the already paid-in capital) – usually within a few days – to the callable capital. This is the portion of the capital not yet paid in by the owners. Hence, this de-facto kind of guarantee is limited in its amount. In this case, the quality of the callable capital can be assessed by the (weighted) rating of the shareholders.

Overall, the type of guarantee is decisive for the fair spread of a specific quasi-government bond. Both, the quality of the guarantee mechanism and the quality of the guarantor have to be taken into consideration. Concerning the guarantor, one has to distinguish in descending ranking between central, regional, local and no authority at all.

In addition to the guaranty mechanism, the **regulatory treatment** of quasi-government bonds impacts the attractiveness for financial institutions and, hence, the risk premiums of this asset class. Generally, the diversity of the regulatory framework is considerable. One has to distinguish between risk-weighting according to the Capital Requirement Ratio (CRR), the Liquidity Coverage Ratio (LCR), the Net Stable Funding Ratio (NSFR), the Solvency II classification and the ECB repo rules.

The risk-weighting of regional and local authorities pursuant to CRR is generally equal to the one of the central authority if tax collection rights exist and specific institutional arrangements ensure a comparable risk. Insofar an appropriate guarantee is available agencies can receive the same rating level as the guaranteeing government. It can be stated that most suprationals and many agencies have a risk-weighting of 0%.

Following the GFC supervisory authorities have issued regulations to increase the stability of banks. The LCR is designed to avoid short-term liquidity bottlenecks and the NSFR focuses on reducing medium-term funding risks. To operationalize the LCR the authorities define several liquidity levels (in descending order ranking from Level 1 to Level 2b). The classification is rather complex depending among others on the type of guarantee, the rating level of the guarantee and the country of domicile. Even bonds issued by banks can under certain conditions qualify as Level 1 assets. As a matter of principle, a higher liquidity level implies a lower spread level. Generally, many quasi-government bonds are assigned to Level 1. Hence, they are treated in the same way as government bonds.

The NSFR aims to reduce the dependency of short-term funding and is essentially determined by the Required Stable Funding (RSF). The RSF is based on the assets multiplied by a factor (so-called Required Stable Funding Factor, RSFF). In principle, it can be assumed that the higher the quality/liquidity and the shorter the remaining tenor of the asset, the lower the RSFF. Overall, many quasi-government bonds have a RSFF of 0%, but in some cases the RSFF is up to 85%.

Additionally, the classification of quasi-government bonds in the context of **Solvency II** is of interest. If certain conditions are met, issuers receive preferential regulatory status. In this case a stress factor of 0% is assigned which means no capital is required to cover the spread risk of these positions. In particular, suprationals benefit from this preferred status as most of them are equated with

government bonds. Many government guaranteed bonds, agencies and local authorities have this preferred status as well.

Finally, the **ECB eligibility for repo agreements** and applicable haircuts of quasi-government bonds is to be analysed. Regarding access to central bank liquidity it is important whether quasi-government bonds can be used for collateralized refinancing operations with the ECB.

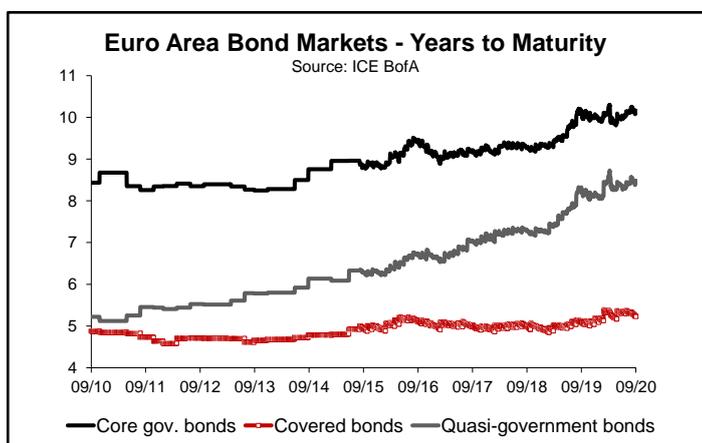
In a first step, it is initially determined whether the respective bonds are eligible for repo transactions at all. The central bank has defined various criteria that the fixed income papers must meet. Many, but by no means all bonds satisfy these criteria.<sup>3</sup> In a second step ECB eligible bonds are divided into five haircut categories which differ in terms of issuer classification and the type of asset. The category in principle determines the haircuts applied. However, the remaining maturity and the liquidity of a bond are also considered.

It can be said that ECB eligibility and respective haircuts represent a factor influencing the risk premium. While most quasi-government bonds are generally eligible they differ considerably with respect to the categories and the corresponding haircut.

Overall, the several guarantee mechanisms and the regulatory treatment of quasi-government bonds contribute to increasing their attractiveness. This applies all the more to investors who make investments also taking into account the availability of risk capital. As this is reflected in spread levels, a case-by-case analysis is essential for investment decisions.

### An enticing duration alternative

The negative yield level and shrinking universe of very high-rated bonds put investors in a difficult situation. The search for yield will remain one of the dominant topics in the years to come.



Quasi-government bonds can help to mitigate this situation. While their yield level is significantly below that of more risky fixed income assets the guarantees and preferred regulatory treatment put them in a better position for investors eager to save risk capital.

Hence, the most relevant benchmarks for quasi-government bonds are covered and core government

<sup>3</sup> For more details on the general and temporary framework, see <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014O0031>.

bonds.<sup>4</sup> While the rating is comparable, quasi-government bonds offer a slightly higher yield level (see below for more details). Apart from this, for the past ten years one particular development has made quasi-government bonds more attractive: while the average life to maturity of covered bonds has remained rather stable at around 5 years, that of quasi-government bonds has increased from about 5 years to well above 8 years. While it is still shorter than the one of core government bonds, the rise has been substantially stronger than for core government bonds.

### Drivers of quasi-government bonds

Though quasi-government bonds are very heterogeneous, is it still possible to identify common factors which drive the performance of this asset class? By and large, the answer is positive. We identify variables which show a high correlation with quasi-government bond spreads, before discussing fair value models. This will be used in the following to derive spread forecasts. While this is only of limited help to value a single bond, it shows whether the overall market is priced fairly.

We base our assessment on monthly data over 20 years and focus on the development of option-adjusted spreads versus German Bunds as dependent variable.<sup>5</sup>

The first approach refers to variables which show a high correlation with quasi-government bonds. These variables are mutually dependent as they are driven by common factors. Hence, one cannot directly use them to forecast the development of quasi-government bond spreads. However, it is possible to check whether the theoretically derived sign corresponds with the actual direction. Moreover, a sensitivity analysis can be produced. In particular euro area **swap spreads**, **covered bond spreads** and the **risk premium of euro area IG corporate bonds** show a fairly stable high degree of alignment with quasi-government bond spreads over time. The correlation coefficient of swap spreads is positive, but at 0.54 it is only moderate. However, the coefficient for IG corporate bond spreads is already at 0.88 and for covered bond spreads there is an almost perfect correlation at 0.98. This is not surprising as covered bonds are seen as closely related to quasi-government bonds concerning solvency risk and the return, but also for the group of investors. However, it can also be shown that the beta is only around 0.5. In other words, a given covered bond spread change tends to see a quasi-government bond spread move of half the amount.

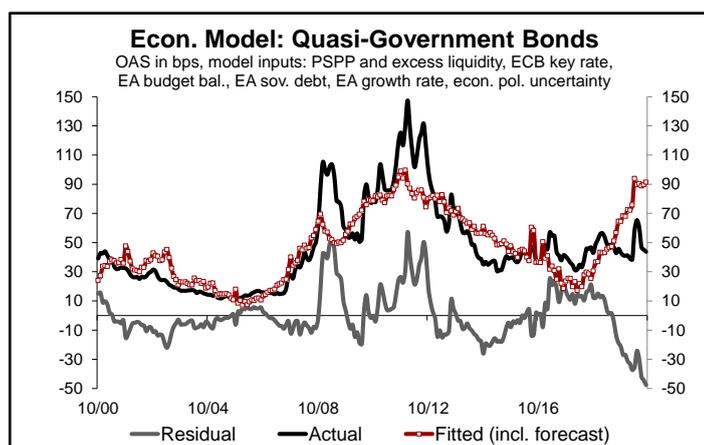
Moreover, **financial market volatility** usually shows a high correlation with the development of non-core sovereign spreads. A risk-off sentiment on financial markets (triggered for examples by an economic downturn) tends to widen spreads. Over the last 20 years there was in fact a positive correlation between the Euro Stoxx 50 Volatility Index and the spread development. Finally, the **issuance activity** influences the spread development: the higher the absolute issuance activity, the higher the spread level.

<sup>4</sup> For the sake of clarity, for covered bonds we refer to the ICE BofA Euro Covered Bond Index (Datastream mnemonic: MLECV0L) and for core government bonds we use the ICE BofA AAA/AA Euro Government Index (Datastream mnemonic: MLEG60L).

<sup>5</sup> As before, we refer again to the ICE BofAML Euro Quasi-Government Index.

Furthermore, we develop a regression model which focuses on economic variables and the impact of the ECB on the trend of quasi-government bond spreads. The aggregated **debt situation of euro area governments** adversely affects quasi-government bonds. It turns out that the government fiscal balance and debt (both in % of GDP) have a significant influence. The **actual GDP growth** rate is relevant as well. Higher growth reflects a sound economic situation and tends to lower the risk premium.<sup>6</sup> Additionally, the **economic policy uncertainty**<sup>7</sup> influences the risk sentiment and thereby the development of quasi-government bond spreads. Beyond these purely economic variables, the ECB's monetary policy is a major factor to consider as well. Three factors have proven to be particularly relevant. While the impact of the **ECB key rate** on the regression result has faded out in recent years, the contribution of the **excess liquidity** has risen in turn.<sup>8</sup> Finally, the ECB's extraordinary policy measures find their expression in the **monthly net purchases of assets**. As expected the additional demand by the central bank tends to reduce the spread.

All input variables have a significant (and directionally sensible) impact on quasi-government bond spreads. The overall model fit is satisfactory – with  $R^2$  is 67%. In the current extreme economic situation the model reflects the actual development of spreads only partially (despite smoothing it by using a Hodrick-Prescott filter). Especially, the worsening debt situation has taken its toll, drives up the risk premium of quasi-government bonds when applying the regression model (see chart below).



Based on the regression model, the fair value is 91 bps. This is well above the current level, suggesting a large overvaluation of this asset class.

But, as always, such models should be treated with caution. In light of the difficult economic situation characterised by skyrocketing fiscal deficits, increasing debt ratios

<sup>6</sup> As these time series are only available on a quarterly basis they are converted in a monthly time series. To remove the cyclical component of the time series, a Hodrick-Prescott filter is used.

<sup>7</sup> The applied index is constructed on three types of underlying components. First, it quantifies the coverage of policy-related economic uncertainty. Second, it reflects the tax legislation to expire in future years. Third, it uses disagreement among economic forecasters as a proxy for uncertainty.

See also: <https://www.policyuncertainty.com/methodology.html>.

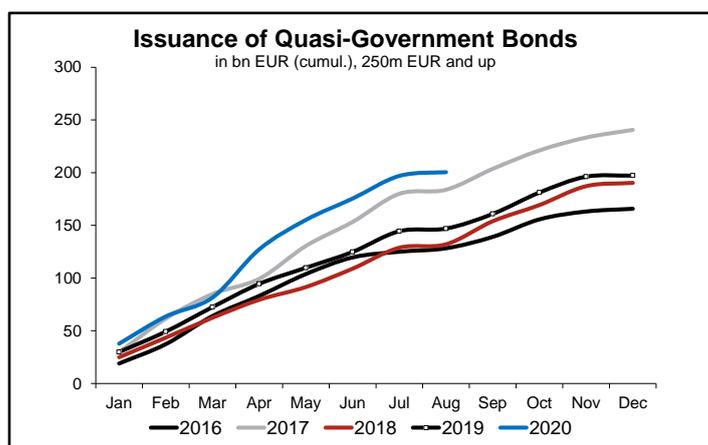
<sup>8</sup> The excess liquidity is calculated as the sum of the ECB's open market operations and the financial institutions' recourse to the Marginal Lending Facility minus autonomous liquidity factors and the reserve requirement.

and negative GDP growth rates, the model struggles to capture the spread development adequately. The relative value analysis on the base of the correlations with e.g. covered bonds indicates that there is no specific mispricing currently. Still, the valuation of quasi-government bonds appears to be somewhat ambitious taking into account the deep economic downturn.

It must be stressed that the model regression only points out misevaluations of the overall market. Specific bonds cannot be assessed by these models as the value of a single bond is very much driven by the terms of the security. E.g., the models do not consider the country of domicile. As the value of a guarantee depends on which country gives the guarantee (the sovereign risk is a major driver for the risk premium of a bond), an important component in the assessment of a bond is missing. The same argumentation applies to regulatory treatment. Finally, the way certain bonds are dealt with by the ECB is not reflected in the models – but the question of whether they are eligible for ECB repo operations is an important aspect.

### Issuance activity to increase strongly

The increasing importance of quasi-government bonds goes hand in hand with rising issuance volumes. In the following, we focus again on the development of the ICE BofAML Euro-Quasi Government Index. This implies we restrict the analysis to euro-denominated issuance although some issuers included in the index also issue bonds in foreign currency.<sup>9</sup> Short-term refunding via the money market is not considered either. It should be noted that some issuers have access to central bank liquidity. While this is a signal for strength in short-term funding, the lack of it does not imply weakness. Depending on the business model, central bank liquidity may be necessary or not. Finally, the fact that many entities issue benchmark-size bonds shows good market access and the strong demand from investors.



In recent years the issuance of conventional bonds has been supplemented with funds that are earmarked for socially responsible objectives ('green bonds'). In particular, supranationals have been active in this segment and have contributed to the establishment of these instruments. This trend will intensify in the future.

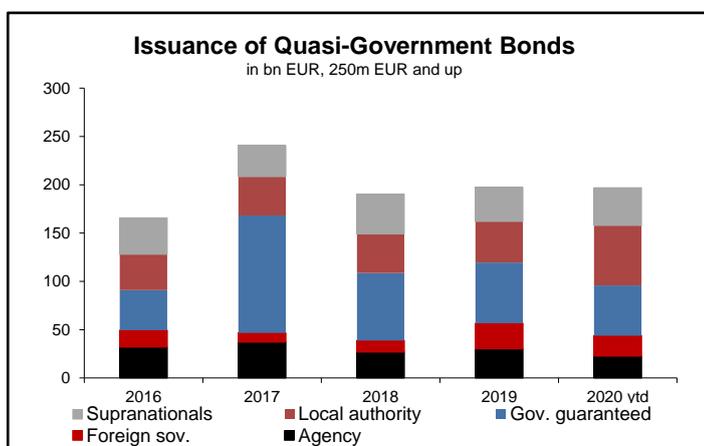
<sup>9</sup> Generally, a diversified funding strategy including the issuance of non-euro denominated bonds is an indication of a smooth access to capital market.

Restricting the analysis to quasi-government bonds with a volume of at least €250 m, year-to-date more than €240 bn have been issued. This is the highest volume ever reached at this point of the year. Moreover, it already exceeds the total annual volume of the last years. The previous annual record volume was around €240 bn in 2017.

In particular, local authorities and supranationals are responsible for the vivid activity on primary markets. Both segments already were off to a good start in the first quarter and the spreading of Covid-19 gave an extra boost to the issuance activity. The massive fiscal expansion triggered e.g. a strong increase in German federal states' funding targets. While the highest annual level to date was slightly above €40 bn, the current volume is already above €70 bn. By the end of the year, it will likely be above €80 bn.

However, the most important development for primary markets is still about to materialize. The EU heads of states forming the EU Council agreed in July 2020 on a €750 bn recovery fund. In addition to the unemployment insurance scheme (SURE, worth up to €100 bn) this means that the EU will tap bond market with record volumes. As both programs will be financed by capital market issuances, it implies an overall issuance volume of up to €850 bn over the next few years. Hence, the EU will become the largest issuer within supranationals (and one of the largest issuing entities in the euro area).<sup>10</sup>

The bulk of the recovery package will be disbursed by the Recovery and Resilience Facility (€672.5 bn), in the form of grants (€312.5 bn) and loans (€360 bn). The rest will be used to size up the EU budget. While currently all EU borrowings have a counterpart in the form of loans granted to EU member states, this will change as for grants there will be no loans as an equivalent. To guarantee the EU borrowings (and to secure the AAA rating of EU bonds), it is proposed to increase the national maximum contribution to the EU budget from currently 1.2% of the member state's Gross National Income to 2.0%.



As the results of the EU Summit were just a political declaration, the legal implementation will still have to follow. All member states will have to approve in accordance with their constitutional requirements. Hence, delays cannot be excluded and the respective issuance calendar is still rather vague at this point in time. We forecast an annual is-

<sup>10</sup> Hence, the EU will fund both programs by issuing bonds: the EU Recovery Fund and SURE.

suance between €150 bn and €175 bn in the years until 2024. The rest will be placed in the years through 2026.<sup>11</sup>

Increased payments to the EU budget will only begin in some years and to reduce the rollover pressure, the EU is likely to focus on medium- to very long-dated bonds (as the maximum maturity of forthcoming EU bonds will be 2058, ultra-long ones will not be issued). Particularly, very long-dated bonds are likely to be attractive for investors looking for duration.

Recently, the EU Commission released details regarding the size of SURE loans. While the request of Portugal and Hungary are still being reviewed, the total volume so far amounts to more than €90 bn. As EU member states can still make formal requests (and including the loan to be disbursed to Hungary) we expect the full €100 bn program will be utilized until mid-2021. Accordingly, to fund SURE we forecast the EU to issue bonds worth €100 bn. As SURE loans will have a maximum average maturity of 15 years, the respective bonds are likely to be concentrated in the 7-15-year bucket. Because the disbursement will start soon, the EU is expected to issue at least €30 bn in 2020 and the remainder in H1 2021.

Because the annual peak of EU bond issuance was €30 bn so far, these data show that financial markets will have to digest quite a chunk in the years to come (the peak likely to be already in 2021 with close to €200 bn).<sup>12</sup> One way to alleviate the burden will be to tap the green bond channel. This strategy is likely given investors' interest in these bonds and in view of the political will to support sustainable investments.<sup>13</sup>

Therefore there is no respite in sight for primary markets as issuance activity will remain through the turn of the year. Considering the SURE bonds by the EU and the ongoing high supply by other issuers we forecast issuance of quasi-government bonds to come close to €300 bn in 2020 (from €240 bn currently).

This volume will be exceeded by far next year. While some other issuers will appear less frequently on primary markets, the EU will be the most active issuer in 2021. The total issuance volume of quasi-government bonds is likely to reach the €400 bn threshold in 2021.

It is noteworthy that despite the strong increase in the outstanding of euro-denominated AAA-rated bonds in the years to come, its share (in % of GDP) will remain well below that of other AAA economies (on the basis of the second best rating: USA, Canada, Switzerland, Denmark, Norway, Sweden, Australia). Summing up AAA-rated euro area sovereign bonds, supranationals and the upcoming issuance of EU bonds the share will still be only slightly above 20% of euro area GDP. In the US, Treasuries alone make up for more than 60%. Hence, the upcoming high supply likely represents a welcome boost to the euro-denominated safe-asset pool.

<sup>11</sup> Amid a political agreement no new (net) bond issuance will take place beyond 2026.

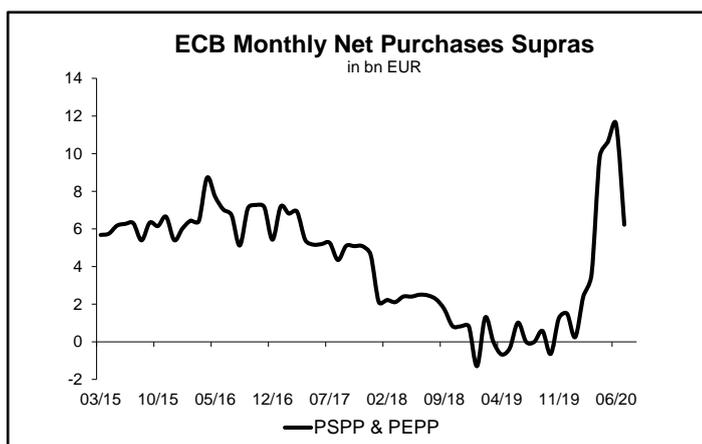
<sup>12</sup> As the EU has so far exclusively issued euro-denominated bonds a switch to foreign currency bonds appears rather unlikely.

<sup>13</sup> The extent to which the EU will rely on green bonds is as yet uncertain. According to recent news, up to one third of new EU bonds could be green ones. Hence, they are not included in the calculations. However, it is clear that the supply of conventional bonds will be reduced accordingly.

Despite the massive imminent increase in the outstanding volume of EU bonds, we doubt that the Bunds' status as the euro area benchmark will be affected. Bunds will remain more liquid and the build-up of EU debt will take time. Ultimately, as it stands now the upcoming bond issuance is planned as a one-off episode and not as a regularly recurring one.

### Ongoing ECB purchases a strong support

The sharp increase in supply raises the question of whether demand for quasi-government bonds will be sufficient going forward. Beside the regular investors, in particular, the ECB buys quasi-government bonds. While foreign sovereign bonds are excluded, the central bank purchases in principle all other fixed income papers included in the relevant index. This has been a considerable support for the market.



The ECB has restarted its Asset Purchase Programme (APP) at a monthly pace of €20 bn as of November 2019. In addition, the ECB added in March 2020 a temporary envelope of net asset purchases of €120 bn until the end of 2020. Finally, the central bank initiated a Pandemic Emergency Purchase Programme (PEPP) in March. Meanwhile this has been increased to a total of €1350 bn, with purchases set to run until at least June 2021. Although there is uncertainty about the exact monthly purchases, it can be assumed that the ECB will buy fixed income paper worth up to €500 bn until year-end.<sup>14</sup> Assuming that the APP will be extended at least until December 2021, but the envelope and the PEPP will not be rolled over, the ECB will purchase bonds worth around €730 bn in 2021.<sup>15</sup>

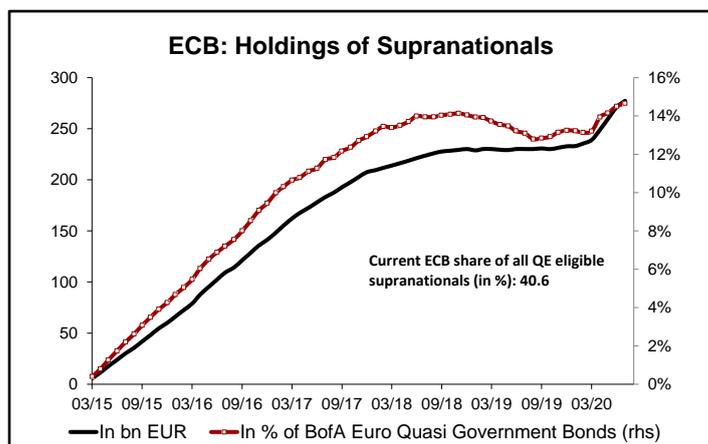
However, only a part of the total amount will be targeted at quasi-government bonds. The exact amount is not known as the complete breakdown of the several QE programs is not published in detail. The only subindex for which data are published is supranationals. While the share of supranationals fluctuates over time and depends on the program, we assume that the ECB will purchase €30 bn of supranationals in the remainder of the year and around €60 bn in 2021.

In addition to the flow analysis, the stock analysis is of interest as well. The accumulated net purchases of supranationals

<sup>14</sup> This amount is based on the assumption that the ECB will purchase €20 bn/month under the APP, it completely utilizes the envelope and buys on average €90 bn each month under the PEPP.

<sup>15</sup> In fact, an extension of the PEPP beyond June 2021 is very likely. But for the sake of clarity, we have not included any increased volume in our calculations.

tionals amounted to almost €290 bn as of August 2020. This represents more than 40% of all QE eligible supranationals.<sup>16</sup> Even considering the whole index under consideration, accumulated ECB purchases of supranationals represent around 15% of the index. These data show that – in addition to the purchases – the ECB holdings impact this asset class as well.



The allocation between other quasi-government bonds and sovereign bonds is managed flexibly.<sup>17</sup> As a result, we assume that the ECB will use the same amount it will spend on supranationals for other quasi-government bonds. Hence, the **ECB is seen to purchase quasi-government bonds worth €60 bn until the end of the year and €120 bn in 2021.**

Even though this is significantly more than in previous years it can be noted that the increase in ECB demand is lower than the growth in issuance volume. Next year in particular, the supply of probably up to €400 bn will far exceed the central bank's demand.

### Solid medium-term outlook

Finally, regarding the medium-term outlook (12-18 months) our projections suggest that the fair value of the regression model will decrease sharply. This is hardly surprising as the current dismal economic situation temporarily distorts the fair value estimate. As the growth rate recovers and budget deficits are expected to come down significantly from 2021 on, the expected spread returns to more normal levels. Moreover, the ECB is seen to pursue further an accommodative policy stance which continues to contribute to a lower fair value, too. Arguably, even in 18 months the model suggests a fair value of 45 bps, roughly in line with the current spread.

Looking at the correlation to other fixed income assets we see some scope for slightly tighter spreads. In addition, the equity volatility can also moderate further in the months to come. In contrast, the massive increase in supply may in and of itself trigger an upward move. We estimate that the higher supply is worth around 10 bps.

<sup>16</sup> Although the stock is likely to reach around €390 bn by the end of 2021 in view of the expected ECB purchases, the share will likely decrease somewhat considering the wall of supply in 2021. The ECB issue share for supranationals has been increased to 50%. Hence, there is ample leeway for the central bank to buy going forward.

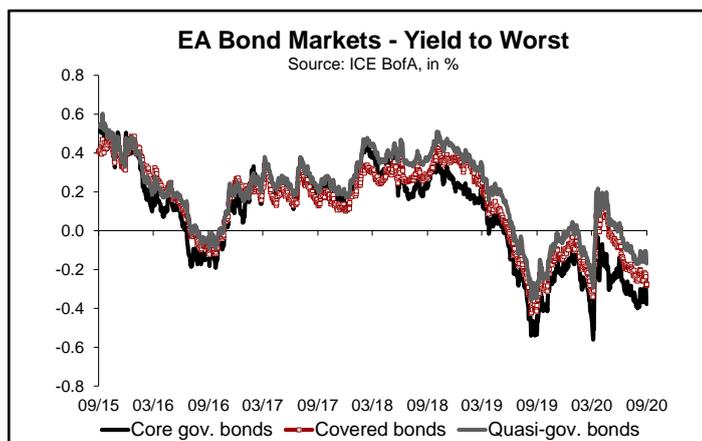
<sup>17</sup> It depends on several technical criteria. Among others, the issuer limit of 33% for sovereign bonds and the availability of quasi-government bonds of the respective country are considered.

To sum up, the regression model indicate a low fair value in line with current spread level on a medium-term horizon. The expected economic normalization will help, but the strong increase in supply is likely to stand in the way of a further narrowing. Accordingly, we would not derive a clear trend for future quasi-government bond spreads from the fundamental analysis.

Quasi-government bond spreads have tightened from the highs they reached in the wake of the market turmoil triggered by Covid-19. However, due to the shorter maturity they have still performed worse than core government bonds. While French OATs (which quasi-government bonds are often priced against) have yielded a total return of around 2.4% year-to-date, quasi-government bonds have generated a return of 1.7%.

Going forward, this is unlikely to last as the higher spread level gives quasi-government bonds a structural advantage over core government and covered bonds. Admittedly, the composite rating of quasi-government bonds is slightly below the one of covered and core government bonds (AA+ versus AAA). However, this is compensated by a higher yield. Although the modified duration of quasi-government bonds is lower than that of core government bonds (7.5 years versus 9.1 years) they offer a higher yield (-0.2% versus -0.4%). Irrespective of a lower duration (7.5 years versus 5.0 years) the yield level is also higher than that of covered bonds (-0.2% versus -0.3%). Hence, investments in quasi-government bonds are a means of getting a pickup to comparable assets and in the long run they are likely to deliver a higher total return than the peer group.

One aspect to be taken into account, however, is the massive increase in supply in the medium term triggered by the return of the EU as an issuing entity. As outlined above, the regular ECB purchases will only partially compensate for this. That said, the central bank demonstrated its flexibility in the past and could intervene in case spreads widen by increasing the proportion of quasi-government bonds. In particular, the PEPP – which we expect to remain in place in 2021 at least – is rather flexible and could be used for this. Once the PEPP is terminated, however, this support will vane.



An initial underperformance of the sub-index of supranationals cannot be excluded as financial market participants start preparing for incoming EU bonds and the EU finally starts issuing bonds (EU bonds have already slightly underperformed in recent weeks). This applies even more as

the EU does not have a well-established investor base so far.<sup>18</sup> As the EU supply will likely be geared toward very long-dated tenors (if e.g. EFSF bonds are taken as a blueprint) especially longer-dated supnationals look vulnerable in the near term.

However, this is unlikely to last as the **bonds related to the EU (EU, ESM, EIB, EFSF) trade currently rather cheap compared to other AAA-rated bonds.**<sup>19</sup> Moreover, the new very long-dated bonds meet investors' demand. In the first place, liability-driven investors will target these bonds. Additionally, the investor base of EU-related bonds is rather diversified. At around 60%, EFSF bonds have the lowest foreign ownership (EIB bonds have the highest share: 75%). As core and semi-core bonds have in the past benefitted from foreign inflows it is likely that investors will at least partially redirect to the increasing supply of supnationals. What is more, the primary market activity of other issuers is already well advanced. To date, euro area treasurers have placed around 80% of the annual target and quasi-government bond issuers even up to 85%. Hence, the upcoming issuance activity meets a rather cash-flow friendly environment. Finally, the increasing supply will contribute to a deepening of the yield curve. This will reduce the liquidity premium that issuers have had to pay until now due to the lack of market depth.

Hence, we doubt that a potential underperformance will last. Eventually, EU-related bonds are expected to trade at similar levels to French OATs (AA) – and once financial markets get used to them we cannot exclude that they trade through OATs.

## Conclusions

Quasi-government bonds are an asset class that has gained in importance over the recent years. The EU Recovery Fund will further accelerate this development as the EU will become one of the largest issuers in the euro area in the years to come.

This analysis has shown that quasi-government bonds are attractive for investors who aim to save risk capital by investing in high-rated fixed income assets on the one hand and look for a solid yield pick-up on the other. This combination distinguishes quasi-government bonds and sets them apart from other fixed income assets. The long maturities of quasi-government bonds represent another interesting feature, more so for Liability-driven investors looking to extend the duration of their assets.

However, the paper is an overview and evaluates quasi-government bonds relative to other fixed income assets. It does not substitute the necessary analysis of individual bonds. The complex structure of quasi-government bonds including the regulatory treatment, the strength of the guarantee and the underlying sovereign risk must be taken into account and have to be included in the assessment.

<sup>18</sup> A detailed analysis (and the current pricing) of EU-related issuers goes beyond this paper. However, it should be borne in mind that they differ in several aspects. Among others, the rating is not identical. While the EU and the EIB have an AAA rating from all three major rating agencies, the ESM has an AAA rating only from Fitch and S&P, but Moody's puts the ESM one notch lower. The EFSF has an AA rating by S&P and Fitch, but an Aa1 level from Moody's.

<sup>19</sup> In fact, an extension of the PEPP beyond June 2021 is very likely. But for the sake of clarity, we have not included any increased volume in our calculations.

# Imprint

**Issued by:** Generali Insurance Asset Management S.p.A. SGR, Research Department

**Head of Research:** Vincent Chaigneau (vincent.chaigneau@generali-invest.com)

**Head of Macro & Market Research:** Dr. Thomas Hempell, CFA (thomas.hempell@generali-invest.com)

**Team:**  
Elisabeth Assmuth (elisabeth.assmuth@generali-invest.com)  
Elisa Belgacem (elisa.belgacem@generali-invest.com)  
Radomír Jáč (radomir.jac@generali.com)  
Jakub Krátký (jakub.kratky@generali.com)  
Michele Morganti (michele.morganti@generali-invest.com)  
Vladimir Oleinikov, CFA (vladimir.oleinikov@generali-invest.com)  
Dr. Martin Pohl (martin.pohl@generali.com)  
Dr. Thorsten Runde (thorsten.runde@generali-invest.com)  
Dr. Christoph Siepmann (christoph.siepmann@generali-invest.com)  
Dr. Florian Späte, CIIA (florian.spaete@generali-invest.com)  
Guillaume Tresca (guillaume.tresca@generali-invest.com)  
Dr. Martin Wolburg, CIIA (martin.wolburg@generali-invest.com)  
Paolo Zanghieri, PhD (paolo.zanghieri@generali.com)

**Head of Insurance and AM Research:** Michele Morganti (michele.morganti@generali-invest.com)

**Team:**  
Raffaella Bagata (raffaella.bagata@generali.com)  
Alberto Cybo-Ottone, PhD (alberto.cybo@generali.com)  
Mattia Mammarella (mattia.mammarella@generali-invest.com)  
Roberto Menegato (roberto.menegato@generali.com)  
Giovanni Millo, PhD (giovanni.millo@generali.com)  
Antonio Salera, PhD (antonio.salera@generali.com)  
Cristiana Settimo (cristiana.settimo@generali.com)  
Federica Tartara, CFA (federica.tartara@generali.com)

**Sources for charts and tables:** Thomson Reuters Datastream, Bloomberg, own calculations  
Version completed: see front page

**In Italy:**  
Generali Insurance Asset Management  
S.p.A Società di gestione del risparmio

**In France:**  
Generali Insurance Asset Management  
S.p.A Società di gestione del risparmio

**In Germany:**  
Generali Insurance Asset Management  
S.p.A. Società di gestione del risparmio

Piazza Tre Torri  
20145 Milano MI, Italy

2, Rue Pillet-Will  
75009 Paris Cedex 09, France

Tunisstraße 19-23  
50667 Cologne, Germany

Via Niccolò Machiavelli, 4  
34132 Trieste TS, Italy

[www.generali-investments.com](http://www.generali-investments.com)

This document is based on information and opinions which Generali Insurance Asset Management S.p.A. Società di gestione del risparmio considers as reliable. However, no representation or warranty, expressed or implied, is made that such information or opinions are accurate or complete. Generali Insurance Asset Management S.p.A. Società di gestione del risparmio periodically updating the contents of this document, relieves itself from any responsibility concerning mistakes or omissions and shall not be considered responsible in case of possible changes or losses related to the improper use of the information herein provided. Opinions expressed in this document represent only the judgment of Generali Insurance Asset Management S.p.A. Società di gestione del risparmio and may be subject to any change without notification. They do not constitute an evaluation of any strategy or any investment in financial instruments. This document does not constitute an offer, solicitation or recommendation to buy or to sell financial instruments. Generali Insurance Asset Management S.p.A. Società di gestione del risparmio is not liable for any investment decision based on this document. Generali Investments may have taken, and may in the future take, investment decisions for the portfolios it manages which are contrary to the views expressed herein. Any reproduction, total or partial, of this document is prohibited without prior consent of Generali Insurance Asset Management S.p.A. Società di gestione del risparmio. Generali Investments is part of the Generali Group which was established in 1831 in Trieste as Assicurazioni Generali Austro-Italiache. Generali Investments is a commercial brand of Generali Investments Partners S.p.A. Società di gestione del risparmio, Generali Insurance Asset Management S.p.A. Società di gestione del risparmio, Generali Investments Luxembourg S.A. and Generali Investments Holding S.p.A..