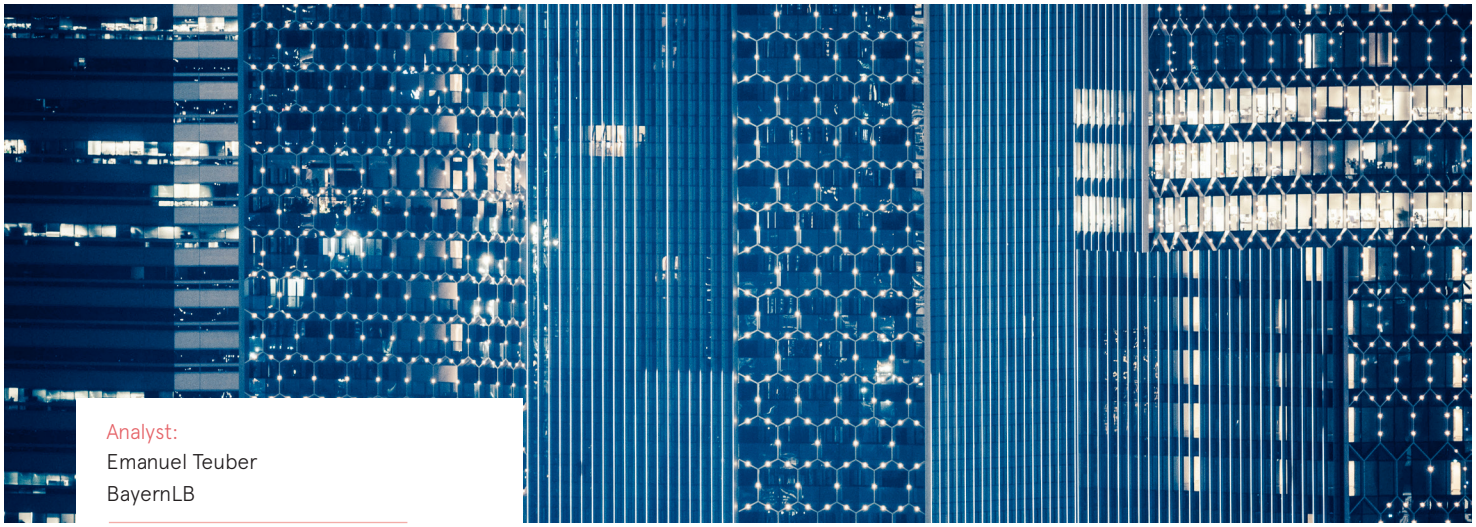


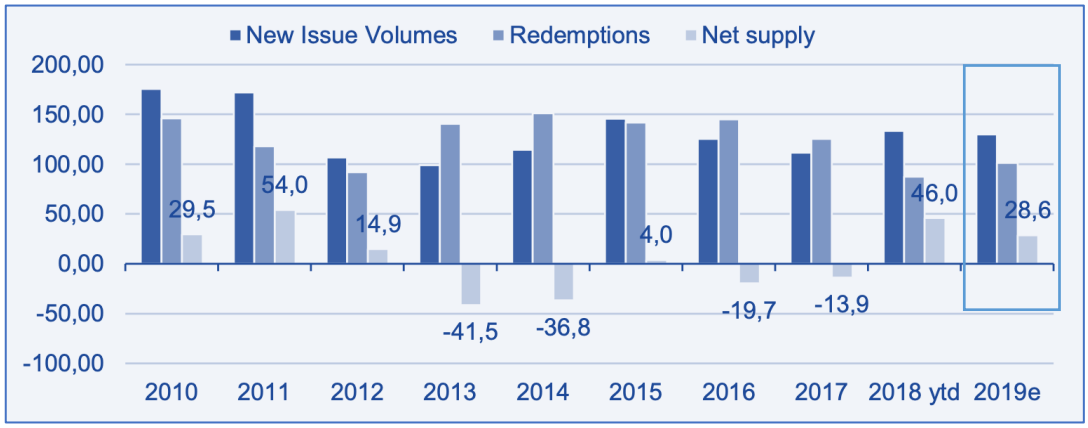
Analyst:
Emanuel Teuber
BayernLB

2019 outlook: It will all work without the ECB

- We expect solid new issue volume of EUR 125-135bn next year.
- This means that the covered bond market will grow for the second time in succession (net supply of around EUR 30bn).
- New issue activity is likely to be significantly raised in the first two months of the year. Not only because the largest volume of bonds will mature then (around EUR 23bn), but because rising spreads will also provide an incentive to launch issues as early as possible.
- A larger volume of maturing bonds of EUR 101bn, strong credit growth, new issuers, and the refinancing of the ECB's longer-term refinancing operations (TLTRO-II) are all factors which will support strong primary market activity.
- Conversely, reduced ECB activity, fewer investors, wider spreads and growth in deposits could act as an obstacle to new issue business.
- Political risks, particularly the debates about the Italian budget, Brexit, and trade disputes with the USA pose risks for the primary markets.

We expect solid new issue volume of between EUR 125bn and 135bn in 2019

Historic and future maturities and issue volumes in EUR bn



Source: BayernLB Research, ECB

Primary market: We expect strong new issue activity again in 2019

This year has proved surprisingly strong after all in terms of the supply of new issues. With EUR 133bn of EUR benchmark issues YTD, 2018 has already eclipsed the last two years, although the extremely high volume of 2015 will probably not be matched. Many analysts have been surprised by the high level of supply, given that only EUR 86.5bn of benchmark covered bonds have matured in 2018. Consequently, net supply has been positive again in the primary markets for some time (EUR +46bn YTD). The high level of issuing activity in the covered bond markets is attributable to strong credit growth as well as the phasing out of the ECB's third covered bond purchase programme (CBPP3), which is encouraging many issuers to pre-finance maturing bonds.

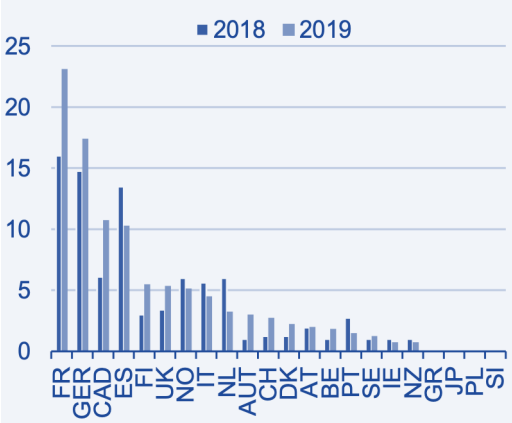
Next year we expect a similar new issue volume of between EUR 125bn and 135bn. If maturing bonds of EUR 101bn in the EUR benchmark segment are taken into account, there should be positive net supply of around EUR 30bn. This relatively strong market growth should be driven by the same factors which have already helped to achieve high new issue volume this year. New issue activity is likely to be very elevated in the first two months of 2019. Not only because the volume of maturing bonds will be highest then (around EUR 23bn), but because increasing spreads will also encourage issuers to launch issues as early as possible.

Positive factors

Four main factors are likely to impact on new issue activity:

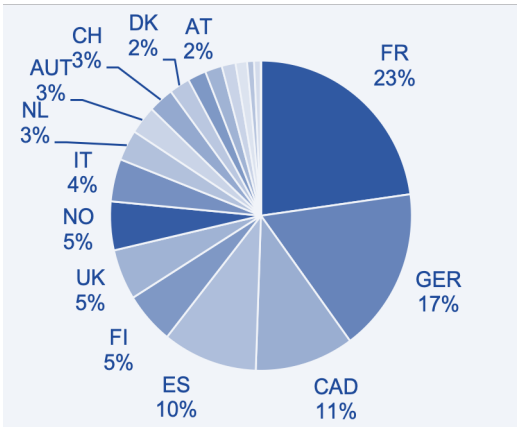
- A larger volume of maturing bonds (EUR 101bn) in the EUR benchmark segment
- Credit growth
- A growing number of covered bond issuers
- Refinancing of the ECB's targeted long-term refinancing operations (TLTRO II)

Maturities increase particularly in GER and FR
EUR benchmark maturities in EUR bn



Source: Markit, BayernLB Research

FR and GER have the largest volume of maturing bonds, followed by "new" market Canada
EUR benchmark maturities (EUR 101.4bn)



Source: Markit, BayernLB Research

Higher maturities

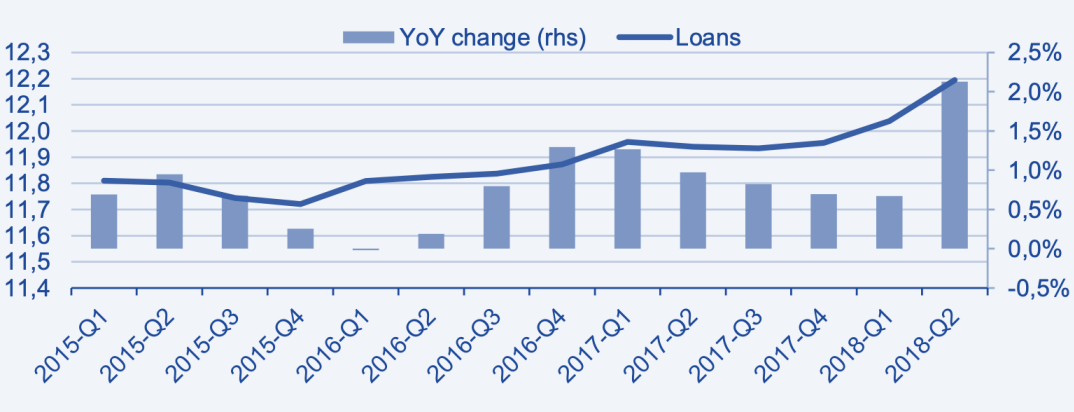
The volume of EUR benchmark bonds maturing this year was extremely low at EUR 87bn. The figure will increase by just over 17% to EUR 101bn in 2019. In Europe, maturities are surging in France (EUR 7bn) and Germany (EUR 2.7bn) in particular. However, the volume of maturing bonds in Canada will also increase by EUR 4.7bn. In contrast, maturities will decline in the Netherlands (EUR -2.75bn) and in the periphery (Italy, Spain and Portugal: EUR -5.5bn). Since periphery issuers, unlike their counterparts from the core markets, have not pre-financed to any significant degree this year due to difficult market conditions, new issue figures are unlikely to decline. Conversely, we expect new issues from the periphery to tend to increase to refinance TLTRO-II maturities. Since maturities last year were generally a poor indicator of new issue volume, they should not be overstated.

Credit growth

Credit growth, particularly in the EU, seems to be growing dynamically again, although the extremely strong first-half growth rates are now likely to have slowed to some extent. Some banks may also have adopted a slightly more defensive positioning in response to a slow cooling of the global economy, and have scaled back lending to some degree. However, there is no sign of this yet in most European countries, partly because many banks are still in search of profit given that interest rates remain low. We therefore expect credit growth to continue next year. This is also borne out by reports published recently by the ECB (link) and the EBA (link).

Based on ECB data, the volume of aggregated deposits at institutions in the European Union has increased to a greater extent than volumes in loan books, which means there is unlikely to be any major impetus for covered bonds. However, many important players in the European covered bond markets are specialist financial institutions with either very low or non-existent deposit ratios. This means they are still reliant on the capital markets as a funding source and covered bonds are still the best alternative here.

Dynamic credit growth likely to continue
Loans to companies and the public sector in EUR tn



Source: ECB, BayernLB Research

New issuers

Another point which speaks for continuing lively new issue business in 2019 is the steady growth in the number of issuers. While 608 bonds from 163 issuers were represented in the iBoxx EUR Covered towards the end of 2013, by 2017 the figure was 802 bonds from 169 issuers, and is currently 875 bonds from 168 issuers. However, it should be borne in mind that some issuers also have no outstanding benchmark bonds, but could launch issues again at any time. The universe of potential issuers has therefore expanded steadily and some new faces could also make an appearance in the markets in 2019. The fact alone that the first covered bonds have been issued from South Korea (Korea Housing Finance Corp) and Japan (Sumitomo Mitsui Banking Corp) could be a signal of more to come from these countries. However, emerging countries such as Brazil are also ready to become active.

The group of inactive issuers in particular (i.e. those with outstanding covered bonds who have not yet carried out any issues this year) is currently particularly large (51 institutions). These companies have often decided not to carry out new issues for systemic rather than idiosyncratic reasons. In 2018, foreign currency swaps were favourably priced for Australian and New Zealand issuers, while UK issuers suffered from negative news flow associated with Brexit, and second-tier Italian issuers were virtually shut out of the market.

TLTRO-II refinancing

The final point which could have a positive impact on new issue volumes is outstanding TLTRO-II funds which have been largely taken up by issuers from the European periphery. Since June this year banks have had the option of paying back the first tranche early. However, so far only a fraction of the outstanding funds have been repaid (EUR 14.bn), so small an amount that it is unlikely to have had any impact on issuing activity this year.

Overview of four TLTRO-II tranches
Amounts in EUR bn

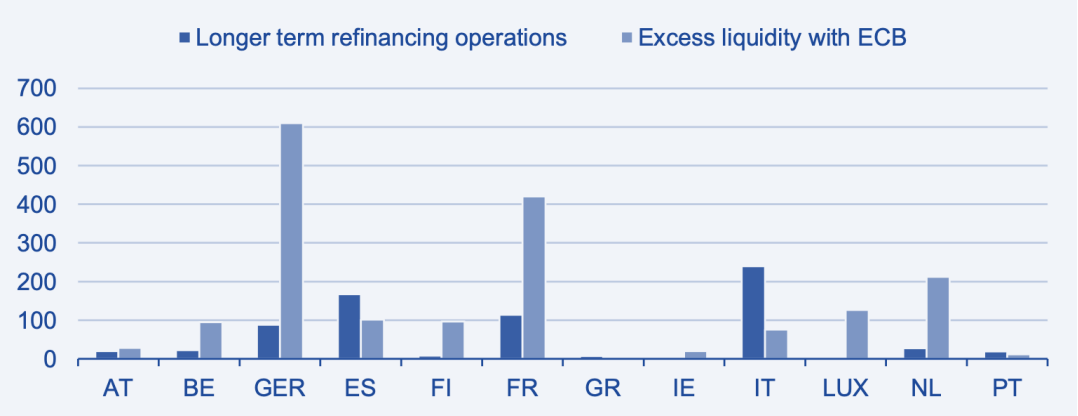
TLTRO-II Tranche	1	2	3	4
Initial settlement	6/29/2016	9/28/2016	12/21/2016	3/29/2017
Drawn amount	399,3	45,3	62,2	233,5
Number of bidders	514	249	200	474
Final maturity	6/24/2020	9/30/2020	12/16/2020	3/24/2021
Earliest possible repayment date	01.06.18	01.09.18	01.12.18	01.03.19

Source: ECB, BayernLB Research

However, the situation could change next year since, on the one hand, funds in the first TLTRO-II tranche which matures in June 2020 will no longer qualify for the net stable funding ratio (NSFR). On the other hand, banks should already be thinking about pre-financing the tranche which matures in 2020 to avoid the risk of having to venture into the market at the same time as all the other issuers. Banks from the periphery in particular (Italy, Spain, Portugal) who were the most active in the first tranches, are likely to be thinking about refinancing.

The volume of nearly EUR 400bn in the first tranche could certainly impact on the (covered) bond markets. However, the extent is difficult to predict. It depends how TLTRO maturities can be refinanced by individual banks. While banks from the European core countries have parked a large amount of excess liquidity with the ECB, and could use these funds to service maturing bonds, banks from the periphery have no such buffer (see graph below).

Italian and Spanish banks face challenging repayments
TLTRO-II drawings and estimated surplus liquidity with the ECB in Euro per 09/2018)



Source: ECB, BayernLB Research

There are two ways for banks to deal with this maturities: they can either reduce assets or obtain the necessary liquidity in the capital markets. We believe that the second option will be the relevant one or us, since covered bonds are particularly attractive here because of their low costs. In practice, a combination of the two options is likely to be used. Many periphery banks have made use of favourable TLTRO-II terms to invest in high yielding sovereign bonds of the home country, providing them with an attractive carry. Presumably, and hopefully, the sovereign bond investments have matching maturities. In this case, Italian banks would simply have to

use repayments from their sovereign bond portfolios in order to scale down TLTRO-II funds. Accordingly, this would leave only the credit portfolio which would have to be refinanced via the capital markets (deposits, bonds or ECB facilities).

However, it remains to be seen whether the markets would even be able to absorb higher new issue volume from the periphery at the moment, since the supply of new bonds on offer in the last two years has been fairly small. In our opinion, a larger volume could certainly be placed in the market, but not on the scale needed to balance out high volumes of TLTRO redemptions. This would be particularly true if the current political tensions in Italy do not ease. For this reason we believe the ECB is likely to launch a new round of TLTRO to prevent lending in the Eurozone from stalling again. However, if this happens, the terms are unlikely to be as generous as those of the current TLTRO-II. The interest rate, term, and credit growth targets are all likely to be more restrictive. The new lines could therefore generate interest mainly from banks with limited access to the capital markets. If there is a new round of refinancing, new issue volume could be slightly lower than we have forecast, although mainly for periphery banks. Banks with better refinancing conditions would be more likely to venture into the capital markets to avoid potential stigmatisation.

Negative factors

However, some negative factors could also impact on issuing activity:

- **Fewer purchases by the ECB within CBPP3** and to some extent associated **wider spreads.**
- Spreads could also widen additionally next year, partly because the CBPP3 has led to a **"crowding out" of private investors** in recent years.
- Finally, continuing strong growth in deposits could also have a negative effect on issuance activity.

Fewer ECB purchases

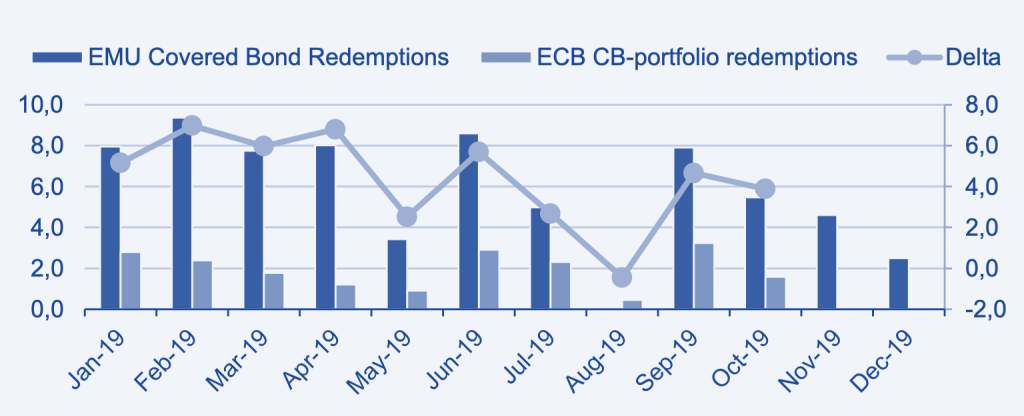
We have already discussed the CBPP3 and the ECB's withdrawal in detail recently. Our report explained that the placement risk for issuers will increase compared to 2018. A placing was easier at the beginning of 2018 since issuers knew that the ECB alone would buy up 50% or more of an issue. However, the ECB has reduced its holding ratio in the primary market over the year from 50% to initially 30%, and since October to only 10%. The failed debut of the French My Money Bank SCF at the end of September - which would have had a settlement date in October - should therefore strike a cautionary note for investors in 2019. Under extremely adverse conditions, this might also prompt weaker issuers (for example from the EU periphery) to almost completely avoid the primary market.

The absence of demand from the ECB could exert particular pressure on spreads in the first quarter. True, the ECB will most likely replace maturing bonds in its covered bond portfolio (see chart below). However, portfolio maturities will be much lower - particularly in the first quarter - than total maturities in the eligible covered bond segment (EMU issuers around EUR 17bn). This means that if the ECB does not completely decouple reinvestment from redemptions, the pressure on covered bond spreads could be

particularly high in January and February next year. Slackening issuance activity in the second half could however provide support for spreads again.

We expect solid new issue volume of between EUR 125bn and 135bn in 2019

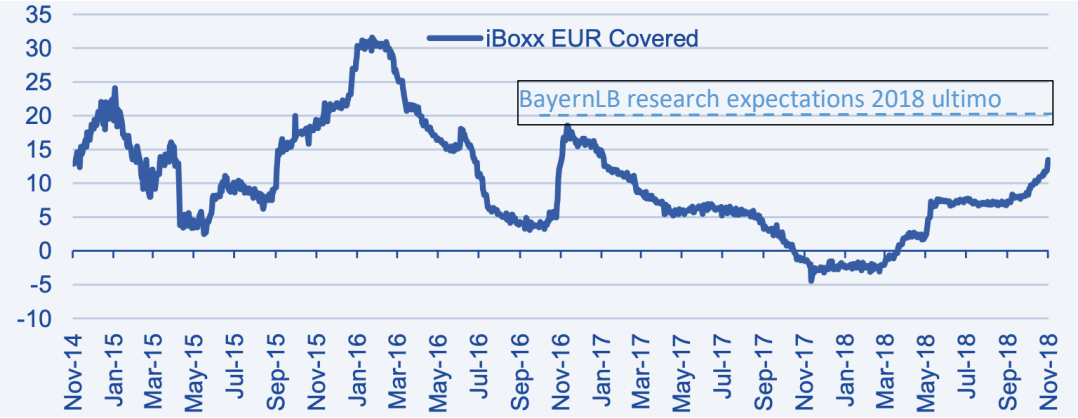
EMU covered bond maturities and ECB CBPP 3 maturities in EUR bn



Source: BayernLB Research, ECB

The spread widening of recent months could continue, at least in the first quarter

ASW in bp



Source: BayernLB Research, Markit

Wider spreads

Increasing spreads have a dampening effect on new issue activity. However, this factor will be less crucial because we do not expect the relative attractiveness of covered bonds as the cheapest source of funding for banks (after deposits) to suffer compared to other bonds. And so long as covered bonds remain the most economical instrument in a treasury banker's toolkit, we see no reason why spreads should fall. In terms of the three relevant factors **new issues, ECB support, and political risks,** levels of around 20 bp in the iBoxx EUR Covered Index are certainly possible by year-end. This level was last seen after Donald Trump's surprising election victory of November 2016. Above all, long phases of high spread volatility may have a negative impact on the new issue supply, since they make timing more difficult and can lead to completely closed markets.

Fewer investors

For new issues to become less risky in a climate without secure ECB backing (see My Money Bank above) issuers will have to win investors back. This point is particularly important for new issuers or those who have not been active in the market for a long time. As a result of the low yield level for covered bonds, yield-driven investors in particular, such as insurance companies, have withdrawn from the markets. However, asset managers and even some treasury investors who account for the greater proportion of covered bond investors, have to some extent turned their backs on this asset class. For this reason, issuers currently have a major incentive to pay high new issue premiums to ensure a successful transaction. This will also be reflected in wider spreads and presumably smaller issue sizes.

Political risks can work both ways

Finally, political risks remain an element of uncertainty which can have a massive impact on new issue volume, but which is extremely difficult to predict. In particular, political crises can reduce the available timeframe for issues. This is particularly relevant when average new issue volumes are low, as is expected to be the case in 2019. The budget debate in Italy, Brexit, and the trade disputes with the USA could hamper market access here. However, a surprisingly positive twist in one of these issues could also create positive impetus for the markets.

Abdruck aus
www.pfandbrief.market
Die digitale Platform der Pfandbrief-Community

Bildnachweis Titelbild
Fotograf: https://unsplash.com/@chuttersnap
Foto: https://unsplash.com/photos/IfmO3IJ1j_8