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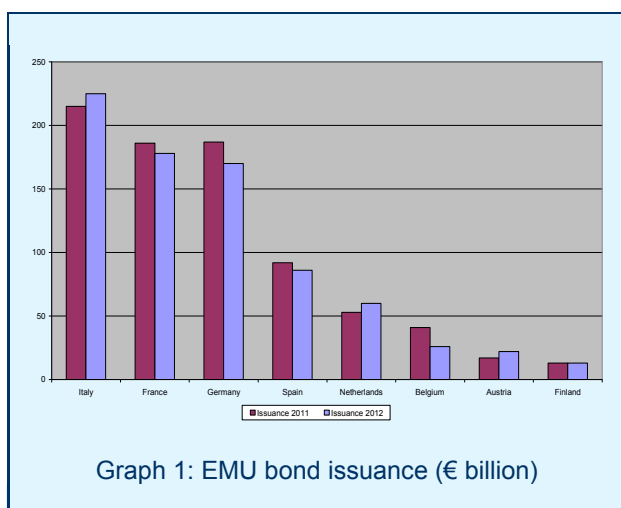
EMU 2012 supply outlook

- EMU bond supply estimated at €780B in 2012; lion share to be issued in the sub 5-yr sector
- Italian 2012 bond issuance expected around €225B, Spanish bond issuance at €86B
- Will investors find their way back to the auctions? We think they will!

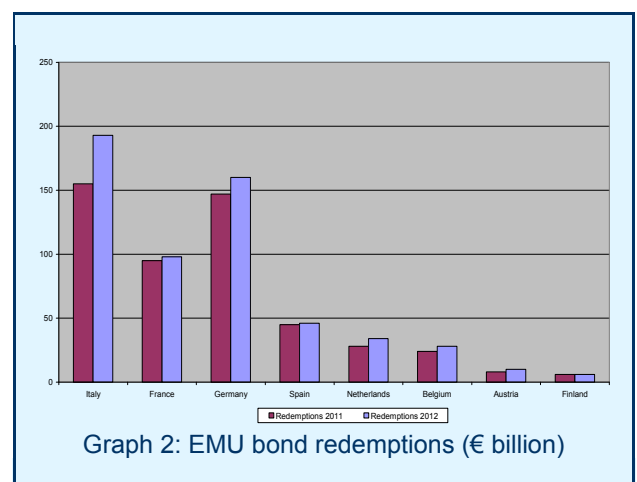
One of the main topics for markets this year is the EMU bond supply. As the sovereign debt crisis proliferated last summer, sovereign bonds were sold across the board. National treasuries had to dig deep in their pockets to find investors for their final funding for 2011. At the beginning of the new year, all national debt agencies start again from scratch and the battle to attract investors will be harsh. Traditionally, national treasuries frontload their bond issuance to take away pressure towards the end of the year. This means that there will be a lot of supply in the coming months. **The crucial question is whether, especially Spain and Italy, will be able to fulfil their refinancing needs.**

More specific: 16% in the sub-2-yr sector, 39% in the 2-5 yr, 34% in the 5-10yr and 11% at the longer tenors. Risks to the issued amount are on the upside of expectations given the recession fears looming over the EMU which may result in higher than expected budget deficits. We exclude the PIG countries, because we don't see them returning to the bond market this year, and the 6 smaller EMU members (Slovakia, Slovenia, Estonia, Cyprus, Malta and Luxembourg).

Bond redemptions for the same set of countries amount to €575B compared with €508B last year. The higher redemptions don't lead to a higher overall issuance in 2012 because of the shrinking deficits across the EMU. Exceptions are Italy, the Netherlands and Austria.



Graph 1: EMU bond issuance (€ billion)



Graph 2: EMU bond redemptions (€ billion)

We estimate this year's total bond issuance around €780B (down from €804B in 2011). If we assume the same distribution of maturity as last year, the bulk of the amount will be issued in the sub-5-yr sector (+/-55%).

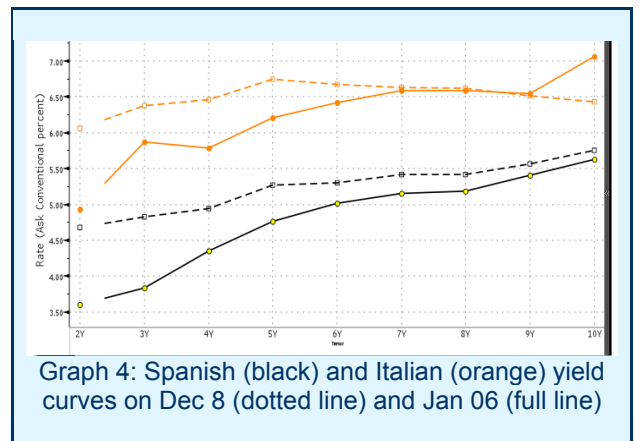
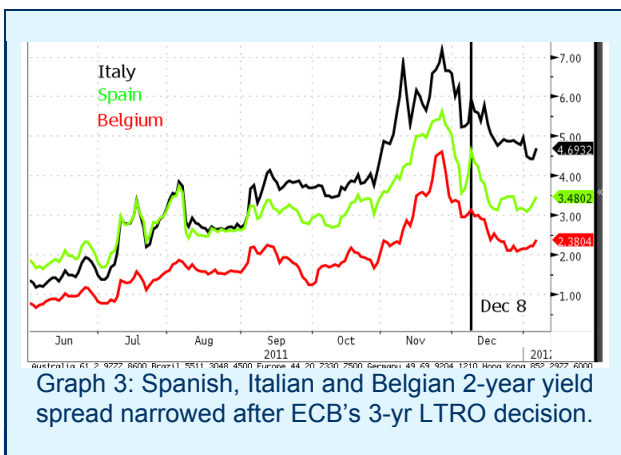
Who buys sovereign debt anno 2012?

Banks, who are traditional buyers of government bonds, faced a deleveraging process and lost interest in sovereign paper during the second half of 2011. At the Jul 21 EU Summit, leaders decided that private bondholders should take losses on Greek debt. Three months later, at the Oct 26 EU-Summit, EU leaders agreed on a 9% core tier one capital requirement by the end of June 2012 in an effort to recapitalize the banking sector. On top, the bank sovereign bond portfolio would be valued mark-to-market. Both decisions pushed banks to dump sovereign debt.

However, this selling wave seems over now and markets have reached a new equilibrium, **which means that there is room for buying albeit probably not to the same extent as was the case in the past.** One can also argue that banks could use some of the nearly free liquidity from the **ECB 3-year LTRO's** as an incentive for a carry trade into short term (up to 3-year) government paper. French president Sarkozy and governor of the Bank of France Noyer for example threw up the idea for their domestic banks. **We think that this form of financial repression will also play in other EMU countries, to ensure sufficient demand at auctions.**

Pension and insurance funds are mostly investors in paper with a good creditworthiness (AAA). Since the outbreak of the crisis last summer, many of them held on to cash positions or didn't reinvest maturing bonds because of the very low yields these bonds offered. However, these funds will probably start picking up government bonds again (mostly top notch quality). Less creditworthy bonds might also find support, to a lesser extent, from domestic funds.

The ECB's SMP programme is another, indirect, buyer of less creditworthy (Italian/Spanish) paper. In this case, issued government paper comes in the hands of (mostly) domestic accounts who have the option to sell it back to the ECB. Question is of course how far the ECB will take this programme, as they already bought over €200B sovereign bonds this way and they keep repeating that the programme is only temporary (since May 2010) in nature. Since the restart of the bond buying programme in August, the ECB first bought more Spanish and Italian bonds than the respective treasuries issued. However, that changed towards the end of the year (Nov/Dec) when the treasury issued more than the ECB bought. This means that there still was/is private interest in these government bonds. Should this interest disappear however, the ECB will stand ready to up their bond buying and support government bond markets.



Since the day of the ECB decision until the start of the year, short term government bonds rallied which resulted in a narrowing yield spread versus German bonds (see graph 1). Another proof of the carry trade idea is seen in the steepening of the yield curves. Graph 2 shows the Italian and Spanish curves from 2-to-10 year sector at the day of the ECB meeting (Dec 08 2011) and last Friday (Jan 06 2012).

Other buyers are **fund managers and central banks**, who usually account for a good share at auctions. We don't have a strong view whether fund managers will keep the share of sovereign debt in their portfolio's level but concerning central banks there are no reasons to assume they would stop buying EMU government paper.

The EFSF becomes a potential buyer as well. Under its new mandate, the fund can intervene in the primary and secondary debt markets. However, we doubt the fund can take on more issuance than the planned €24B (EFSF & EFSM) for the financial aid programmes of Portugal and Ireland. Once the second Greek bailout deal is agreed upon, this amount can increase further. This would be problematic as the markets don't really believe in the construction of the EFSF and given that the current target can already be challenging. Apart from the inaugural EFSF-bond, demand hasn't really been overwhelming for the other four EFSF-issues. Another threat to the EFSF issuance is that a AAA-country could be stripped from its top-notch rating. This would normally increase the EFSF's funding cost, as it would

also lower the fund's rating, and might make it even harder to attract investors.

An advantage is that the launch of the successor of the EFSF, the ESM, is brought forward by one year (June 2012) and that EU leaders are looking to accelerate the payments to the fund. This increases the amount of available funds to support countries in trouble (ESM has paid-in capital whereas the EFSF needs to drain funds from the market). At the March 2012 EU Summit, EU leaders will also look at increasing the current €500B capacity. **All in all however, we don't expect these European rescue funds, especially the EFSF, to get involved at auctions or in secondary market transactions.**

Finally, the IMF has also the potential to play a role. Not as an (in)direct buyer of sovereign debt but perhaps via a Flexible Credit Line which lowers a country's funding need.

Despite the market fears, we believe that for the above mentioned reasons Spain and Italy will after all find private investors (and/or support from ECB/IMF) to take up their sovereign debt, enabling them to refinance themselves throughout, and especially at the start, of the year.

	Iss. '12	Iss. '11	Red. '12	Red. '11
Italy	€ 225	€ 215	€ 193	€ 155
France	€ 178	€ 186	€ 98	€ 95
Germany	€ 170	€ 187	€ 160	€ 147
Spain	€ 86	€ 92	€ 46	€ 45
Nether.	€ 60	€ 53	€ 34	€ 28
Belgium	€ 26	€ 41	€ 28	€ 24
Austria	€ 22	€ 17	€ 10	€ 8
Finland	€ 13	€ 13	€ 6	€ 6
Total	€ 780	€ 804	€ 575	€ 508

Table 1: Overview bond issuance and bond redemptions (2011-2012; € billion)

Italy & Spain

Market participants will closely monitor EMU bond issuance, especially in Italy and Spain.

Italy needs to raise the most in 2012, with €193B bonds redeeming and a total funding need of about €225B, assuming no change in net bill issuance. Compared with last year, there is a significant increase in bond redemptions but this is largely offset by the lower estimated budget deficit. **In table 2, you see the projected 2012 issuance over different maturities, based on the relative distribution last year. Italy's 2011 issuance was already largely targeted on the shorter maturities (60% <= 5-year).** Given the circumstances, chances are of course that this amount will be even higher this year.

In Spain, the 2012 bond issuance will be around €86B, slightly lower than last year's €92B. Last year, Spain issued relatively more longer term maturities (compared to Italy), but also here the chances or high for a shift towards more shorter term issuance.

Given the **relatively long average maturity of the Italian and Spanish debt** (respectively 7.1 and 6.6 years), shorter term issuance shouldn't be an immediate problem. A lot of question marks have also been raised recently on the sustainability of the Italian (and Spanish) yield levels. **However, the BIS calculated recently that it would take a long time for elevated yields to translate into significant additional debt service costs.** If the Italian yield curve of Nov 09 2011 (2-10 yr sector between 7-7.5%) persisted throughout 2012, the additional yearly cost would amount to 0.95% of 2010 GDP (€0.95B).

Lower Belgian issuance

The largest relative change is the Belgian OLO issuance. This is due to last year's unexpected Dexia bill (which elevated 2011 issuance) and a lower expected deficit for 2012 (lower 2012 issuance). The total financing requirement (excl. bills; €38.5B) for Belgium is of course larger than the €26B bonds the treasury plans to issue but other medium and long term funding will be used to bridge the gap. For example, as a result of the huge retail participation in a State note issue, the Belgian debt agency envisages an increase in the issuance for private investors leading to an expected amount of €6B. Net change in outstanding bills is also expected to increase by €2B. Last year Belgium issued the highest relative amount of bonds with a longer term tenor (>10-yr) in a successful effort to lengthen the average maturity of the Belgian outstanding government debt. The average term to maturity increased from 6.44 years at the start of the year to 6.72 years at the end of 2011.

Shift in the Netherlands

Another remarkable change is the shift from bills into bonds in the Netherlands. The Dutch agency (DSTA) lowers the outstanding bills by the end of 2012 with €10B compared with the outstanding amount by the end of last year. By increasing the call on the capital market (bonds), the DSTA is aiming for a more rapid decline of the money market (bills) to its desired level of approximately €30B. At this level, the money market will, following its buffer function, be better able to absorb unforeseen changes in the funding need. Given the sound Dutch fundamentals, the current spread over German bunds still seems relatively wide and we don't think the shift to increased bond issuance will be a problem.

Mathias Van der Jeugt, KBC Brussels

Tenor	2011: relative issuance				Tenor	2012: projected issuance (€ billion)				
	0-2	2-5	5-10	10+		0-2	2-5	5-10	10+	Total
Finland	0%	50%	46%	4%	Finland	€ 0,00	€ 6,50	€ 6,00	€ 0,50	€ 13,00
Nether.	14%	40%	38%	9%	Nether.	€ 8,39	€ 23,93	€ 22,55	€ 5,14	€ 60,00
Belgium	2%	35%	33%	30%	Belgium	€ 0,48	€ 9,14	€ 8,67	€ 7,70	€ 26,00
France	11%	42%	31%	17%	France	€ 18,90	€ 74,78	€ 54,64	€ 29,69	€ 178,00
Austria	5%	29%	46%	20%	Austria	€ 1,14	€ 6,48	€ 10,03	€ 4,35	€ 22,00
Germany	36%	27%	33%	4%	Germany	€ 61,83	€ 45,46	€ 55,43	€ 7,27	€ 170,00
Italy	15%	44%	34%	7%	Italy	€ 32,84	€ 97,96	€ 77,48	€ 16,72	€ 225,00
Spain	2%	51%	37%	11%	Spain	€ 1,47	€ 43,54	€ 31,80	€ 9,19	€ 86,00
Total						€ 125,05	€ 307,81	€ 266,59	€ 80,56	€ 780,00
Total %						16%	39%	34%	10%	100%

Table 2: Relative projected issuance for 2012 per country

Brussels Research (KBC)	Global Sales Force
Piet Lammens +32 2 417 59 41	Brussels
Peter Wuyts +32 2 417 32 35	Corporate Desk +32 2 417 45 82
Didier Hanesse +32 2 417 59 43	Commercial Desk +32 2 417 53 23
Joke Mertens +32 2 417 30 59	Institutional Desk +32 2 417 46 25
Mathias Van der Jeugt +32 2 417 51 94	
Dublin Research (KBC Bank Ireland)	
Austin Hughes +353 1 6646892	London +44 207 256 4848
Prague Research (CSOB)	Frankfurt +49 69 756 19372
Jan Cermak +420 2 6135 3578	Paris +33 153 89 83 15
Jan Bures +420 2 6135 3574	New York +1 212 541 06 97
	Singapore +65 533 34 10
Bratislava Research (CSOB)	
Marek Gabris +421 2 5966 8809	Prague +420 2 6135 3535
	Bratislava +421 2 5966 8436
Warsaw Research (Kredybank)	Budapest +36 1 328 99 63
Piotr Radzewicz +48 22 6345 946	Warsaw +48 22 634 5210
Budapest Research (K&H)	Moscow +7 495 228 69 61
Gyorgy Barcza +36 1 328 99 89	

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