AEGON Asset Management

Monthly analysis – January

Regional government bond issues in 2010

With the steep rise in public debt throughout the world over the past year, management of the global financial crisis is carrying a high price. Due to the recession tax bases have shrunk, while unemployment benefit-related expenditures have soared. Restructuring of debt related to the reorganization of the financial sector and discretionary measures taken to invigorate the economy are further increasing debt burdens. Moreover, all this comes at a time when much of the developed world and the majority of emerging countries (excluding the American continent and the Middle East) are already struggling with long-term fiscal crises due to the financial imbalance brought on by the ageing of their societies. Government bond issuance in Germany is double that of last year, while Greece's serious financing difficulties have raised the spectre of sovereign bankruptcy on the horizon in the developed market, and in time other developed countries may follow.

In this environment, the countries of the Central and East European region must compete for the favours of investors and offer attractive conditions for the sale of their bonds. So how much pressure should we fear on the supply side? Below we will examine the bond issuance plans of three of the Visegrád countries, from which we will attempt to extrapolate the likely tensions between supply and demand in the year ahead.

In the **Czech Republic** in 2009, the gross borrowing requirement exceeded the planned figure by CZK 140 billion, or around double, as a consequence of the soaring (fivefold) increase in the central budget deficit. Bonds of a total value of some CZK 200 billion were issued on the domestic market to finance this shortfall, rather than the planned CZK 40-125 billion. In this way, the Czechs experienced a considerable shock as a result of bond issues in 2009, apparent in the yield premium on bonds over swaps, which remained high right up to the end of summer 2009.

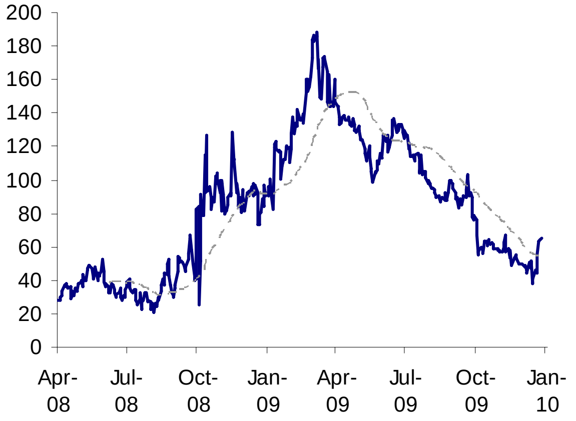
Issuance volumes in the Czech Republic, 2008-2010

(CZK billions)	2008	2009		2010
	Expected	Planned	Expected	Planned
State budget deficit	**20**	**38**	**179**	**163**
Gross borrowing requirement	**181**	**148**	**279**	**280**
Issues of bonds	**176**	**83-133**	**257**	**278**
on the domestic market	128	40-125	202	168
on the foreign market	48	0-74	55	110

Having been startled by the flood of bonds last year, equilibrium on the Czech market was finally more or less restored from September onwards as the banking system took an increased role in tandem with a regulatory change. Although the banking sector was slow to react due to an initial drastic increase in the costs of financing, the improvement in the banks' liquidity situation that came about with the shutdown in lending eventually resulted in significant potential on the demand side. The drastic decline in the base rate and the yield on short-term bond-type instruments made longer maturities increasingly attractive as the yield differential between maturities of 2 and 15 years continued to rise throughout the year, leading to what one might describe as a handsome reward for long-term investors at the end of the summer.

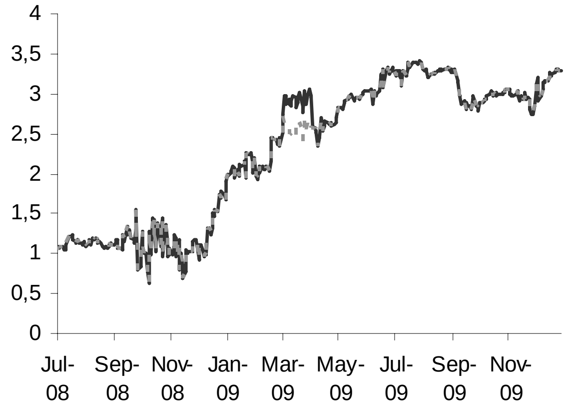
The aforementioned regulatory change affected the voluntary pension funds sector, which – contrary to popular belief – is a very significant factor on the Czech investment market (total assets of this sector amounted to almost CZK 200 billion in mid-2009, thus bringing the Czech voluntary sector close to the weight of the domestic private pension funds sector). These funds are characterized by a relatively conservative investment policy, partly because, as a consequence of the relevant regulations in force, pension accounts are not kept separately from the pension fund but are recorded on its balance sheet. Accordingly, the daily adjusted value of investments accumulates against the fund's own capital, and the sector therefore typically avoids longer-term bond investments and equities. The sector's risk-bearing capacity has been significantly enhanced by the regulation, valid from September 2009, whereby a maximum of up to 30% of the portfolio may be made up of government bonds rated no lower than those of the Czech Republic that are held until maturity, thus shielding their value from the movements of the market. In our estimation, one-off demand of some CZK 40 billion has appeared on this market as a result.

10-year asset-swap spread in Czech Republic



Source: Bloomberg

The 2-15-year spread on the Czech bond curve



Source: AEGON Fund Management

Compared to previous years, the supply of bonds will remain strong – and even increase slightly – in 2010. This year the planned gross borrowing requirement is CZK 280 billion (excluding instruments of less than a year's maturity), of which the central budget deficit accounts for CZK 160 billion, even despite austerity measures, while refinancing of matured bonds amounts to CZK 83 billion and redemptions another CZK 10 billion. According to the government's debt management strategy, a maximum of 50% of financing may still be secured on international markets. Based on the bond issuance schedule for the first quarter and statements to the press, we believe that the government will take advantage of this room for manoeuvre and the actual proportion of external financing will approach half the value of the entire bond issuance program. In theory, pressure on bonds can also be reduced (temporarily) by increasing the proportion of maturities of less than one year, although this move, while reducing the remaining duration of the debt, would also increase the financing risk. All things considered, the supply of CZK-denominated bonds in 2010 will be at least

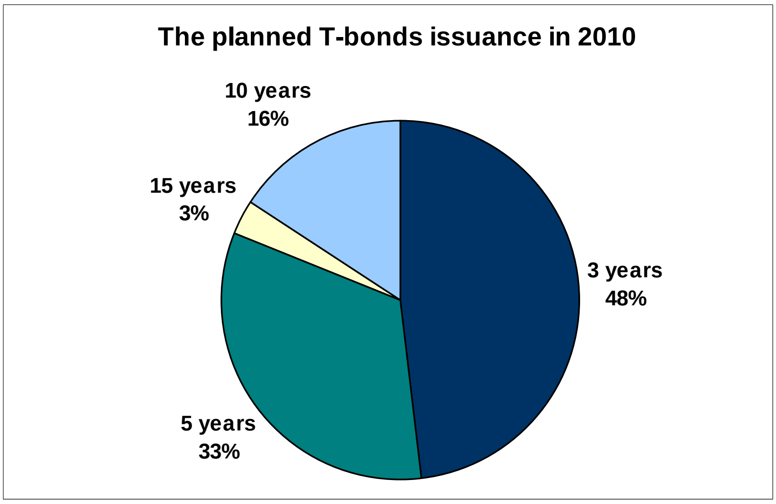
30% higher than in 2008, even in the event of an increased proportion of maturities of less than one year and the doubling of forex-denominated issues compared to last year. Moreover, if forex bonds squeeze out demand for bonds issued in the local currency, then it may take a while for the balance of supply and demand to be restored on the Czech bond market. Surplus demand for pension funds will be considerably lower in 2010 than last year, which similarly points in the direction of greater market tension. Until then, there is the prospect of rising bond yields and a steeper rise in the yield curve on the Czech bond market.

In **Hungary** in 2009, as a consequence of the complete drying up of the bond market, not only was there not a net issuance, there was actually a net redemption of bonds. Issue volumes reminiscent of calmer times on the market returned from summer, so that 2010 will certainly bring a sharp rise in bond issues compared to last year as a whole; however, compared to the second half of 2009, we can reckon on a largely steady schedule of bond issues.

2010 bond issuance structure, Hungary

(HUF billions)	HUF				Foreign currencies				Sum
	T-Bills	Bonds	Other	**Sum**	Bonds	Other market	Other non-market	**Sum**	
Gross issuance	4288	**1356**	215	**5859**	403	-	**402**	**805**	
Redemptions	4142	1186	-	5328	315	53	-	368	
Net issuance	146	**170**	215	531				**35**	**568**

The planned borrowing requirement for the budget in 2010 is HUF 982 billion, which, with redemptions of HUF 2,000 billion and planned gross issuance of HUF 2,400 billion, results in a net issuance figure of HUF 568 billion (disregarding discount Treasury bills rolled over within the year). The Government Debt Management Agency (ÁKK) has successfully issued bonds in a value of 2 billion USD dollars to refinance expiring foreign currency debt in the 10-year segment. At the same time, the Hungarian state will be able to rely on a similar amount from deposits set aside from IMF funds drawn down last year. As a result of all the above, it will be enough if the government attempts to shift around HUF 50 billion in bonds at its fortnightly auctions, a quite easily digestible amount when compared to last year's HUF 65 billion and HUF 60 billion in 2008. It is conceivable that the new forex adequacy requirement for private pension funds will also increase net demand from the sector in the course of 2010.



Although no serious pressure is yet apparent on the bond market in 2010, profound structural changes in Hungary's supranational credit-financed national debt will need to occur in the longer term. On the one hand, the scope for repayment of IMF and EU loans presupposes a continuous increase in the proportion of market financing. On the other hand, sooner or later a different tendency must occur: namely, a shift away from forex-denominated bonds towards forint financing. Thirdly, the average remaining term to maturity of the outstanding stock of forint-denominated bonds should increase in order to mitigate financing risks. Rather than increasing, the proportion of market financing in 2010 is largely stagnating because the ÁKK is able to use the IMF funds drawn down last year as an alternative to securing resources on the market, while the proportion of foreign currency debt shows no sign of substantially declining in 2010. As the present outlook indicates, these processes will dominate the issuance schedule after 2010, meaning that the supply of forint-denominated bonds needs to increase considerably. At the same time, within a flexible auction framework we may justifiably assume that the ÁKK will endeavour to ensure that the proportion of foreign currency debt remains as low as possible in 2010 and that, under favourable conditions on the demand side, it will decrease compared to the current proportion. For this reason, the balance of supply and demand in itself makes trading within bands on the Hungarian bond market a likely scenario.

In **Poland**, gross issuance amounts to approximately PLN 200 billion this year, of which PLN 110 billion is made up of expiring bonds and the remainder the borrowing requirement of the state budget in 2010. Despite increasing revenues from privatization, this is almost 20% greater than the 2009 value, indicating considerable market pressure ahead.

Issuance volumes in Poland, 2008-2010[1]

(PLN billions)	2008	2009 Expected	2010 Planned
State budget deficit	**43**	**57**	**82**
Gross borrowing requirement	**123**	**164**	**197**
T-Bills	**48**	**48**	**55**
Issues of bonds	**71**	**116**	**142**
on the domestic market	60	85	111
on the foreign market	11	31	31
Net borrowing requirement	**43**	**57**	**82**
Of which issues of bonds on the domestic market:	**10**	**40**	**52**

Due to the lower volume of maturing bonds, net issuance will increase much more dynamically than gross issuance in 2009, and an increase of 30% in net terms is already apparent in the case of zloty-denominated bonds. Despite this, gross bond issuance of around PLN 20 billion is planned in the first quarter of the year, which matches the figure in the corresponding period of last year, so that the greater part of the issuance program, like last year, will be concentrated in later quarters. On the international market, bond issues of a total value of PLN 31 billion are planned this year, similarly to 2009 (and including the successful issue of EUR 3 billion in bonds in January 2010). The sole consolation is the comparatively low bond exposure of pension funds, which can thus rein in the rising yields due to the busy issuance schedule.

Theoretically, the change that would see the amount of compulsory private pension contributions reduced (from the current 7.3% to 3%) would point towards a decreasing borrowing requirement. However, this is a step backwards which, in our opinion, would cause more harm than benefit in terms of the mood of the market, given that – though it might manage to hold back issuance – it would have an overall negative effect on the long-term fiscal position, while declining pension fund contributions would also lead to partially falling demand on the market.

[1] Our thanks go to Esther Law (Société Générale) for her help with the Polish data.

To summarize, we should expect serious pressure on the supply side on the Czech and Polish markets in 2010 – similar to last year and perhaps even stronger. In Hungary's case, meanwhile, we should expect a situation largely similar to that at the end of last year. In the Czech and Polish cases, all this, in addition to the crowding-out effect from heavy issuance in core markets, promises to lead to an increase in yields for as long as the balance of supply and demand is not restored. Although in Hungary the increasing proportion of forint-based financing, as a strategic goal, is not leading to pressure on supply for the time being, it may yet present an obstacle to declining yields.

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