

Fixed Income

CZGB Focus

What to expect from CZGBs in 2021?



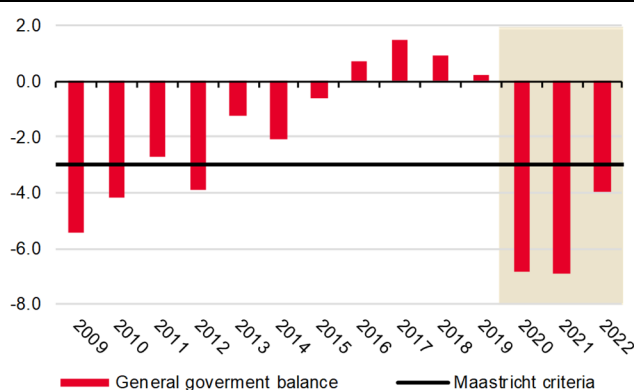
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The state budget law for this year does not include the significant cut in personal income tax approved just before year-end. Therefore, in the coming months, the government will present a new proposal that will imply higher CZGB issuance. In our view, this year's public finance deficit will prove similar to last year's, as will net CZGB issuance. Due to the high expected CZGB supply and heavy redemption calendar, ASW seasonality will be amplified in 1H. The deterioration in public finances keeps alive the risk of a rating outlook downgrade. In the middle of the year, we will find out whether the Czech Republic will again be included among the developed economies in the GBI index family, and if it is, this would likely mean a significant outflow from the bond market. Domestic banks will likely remain the main buyer of CZGBs, to the detriment of foreign investors. We recommend selling the CZGB 2031 in ASW.

Public finances to see similar deficit as last year

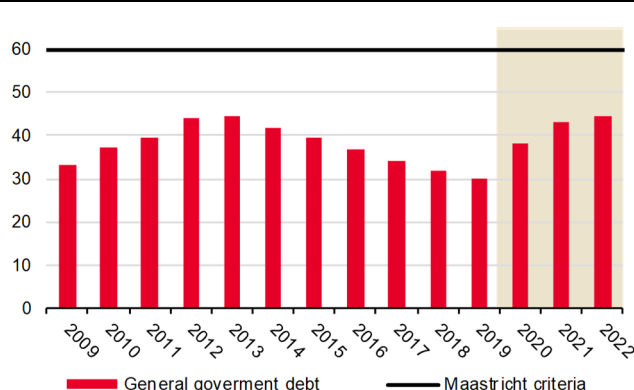
At the end of December, the Chamber of Deputies hastily passed the state budget for this year, envisaging a deficit of CZK320bn (5.5% of GDP). In addition, a significant personal income tax cut was approved, including an increase in the tax deduction that will have a negative impact on the deficit of CZK100bn. This was not included in the approved version of the 2021 budget law, so we expect that after the publication of the new macroeconomic forecasts next week, the MinFin will present a new version of the state budget, to be discussed in the Chamber of Deputies in February/March. The proposed budget will probably envisage a deficit of over CZK400bn. Our view is a CZK400bn shortfall, as the MinFin repeatedly tends to underestimate tax revenues. Having a better budget result than expected has become a political strategy in the last nine years. **The 2021 general government deficit should thus be similar to last year's (6.9% of GDP in 2021 vs 6.8% in 2020). The public debt should continue to grow from last year's estimated 38.0% to 43.1% of GDP.**

Public finance balance (% of GDP)



Source: SG Cross Asset Research/EM, Komerční banka, CZSO

Public debt (% of GDP)



Source: SG Cross Asset Research/EM, Komerční banka, CZSO

Record CZGB issuance in first half of year

According to our calculations, the lower-than-planned state budget deficit in 2020 and increased MinFin activity in the secondary market last year made it possible to keep this year's borrowing needs under control. On the other hand, the current official MinFin debt management strategy for 2021 will have to be revised in mid-2021 due to the higher state budget deficit after tax cuts are taken into account. **We estimate that this year's borrowing needs will be only slightly lower than last year's (CZK628.3bn vs CZK646.3bn; 10.9% of GDP vs 11.1%) and that net CZGB issuance will be the roughly same (CZK395.7bn vs CZK403.7bn).** Compared to 2020, we expect higher EUR borrowing needs. In our view, these will be covered by issuance of euro-denominated CZGBs under domestic law, which the MinFin introduced two years ago. These should become eligible as collateral with the ECB this year, which should increase their attractiveness to foreign investors.

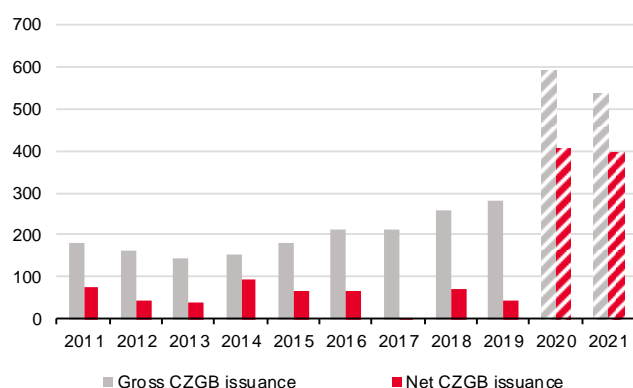
Funding programme and issuance activity for 2021 (CZKbn)

	MinFin	KB
State budget deficit	320.0	400.0
Transfers and other operations of state financial assets	0.0	0.0
T-Bonds denominated in local currency redemptions	141.4	141.2
T-Bonds denominated in foreign currency redemptions	56.0	51.6
Redemptions and early redemptions on savings bonds	0.0	0.0
Money market instruments redemptions	25.4	25.4
Redemption of T-bills		25.4
Redemption of other money market instruments		0.0
Repayments on credits and loans	3.5	3.5
Total financing needs	546.3	647.1
Money market instruments		20.0
T-bills		20.0
Other money market instruments		0.0
Gross issuance of CZK-denominated T-bonds on domestic market	Min. 400	536.9
Gross issuance of EUR-denominated T-bonds on domestic market		51.4
Gross issuance of T-bonds on foreign market		0.0
Gross issuance of savings government bonds		15.0
Received credits and loans		5.0
Financial asset and liquidity management		18.8
Total financing sources		647.1
Gross borrowing requirement		628.3
Net CZGB issuance		395.7

Source: SG Cross Asset Research/EM. Komerční banka. MinFin

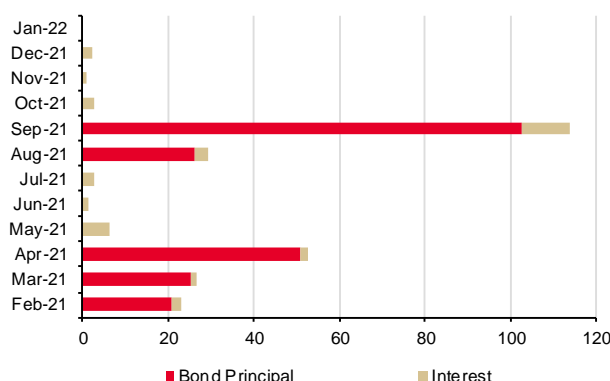
Due to the heavy redemption calendar in the coming months, we expect that the MinFin will issue the vast majority of CZGBs in 1H21. The MinFin has a medium-term target of an average CZGB maturity of 6y (currently 5.6y). However, last year it issued more shorter maturities than planned in an effort to meet stronger demand for that part of the curve. In our view, it will try to compensate this year if demand for the longer sections of the curve allows it. In the 6y+ bucket, the MinFin currently has room for issuance of c.CZK250bn, which implies **the need for several new issues this year.**

CZGB issuance (CZKbn)



Source: SG Cross Asset Research/EM, Komerční banka, MinFin

CZGB and T-bill redemptions calendar (CZKbn)



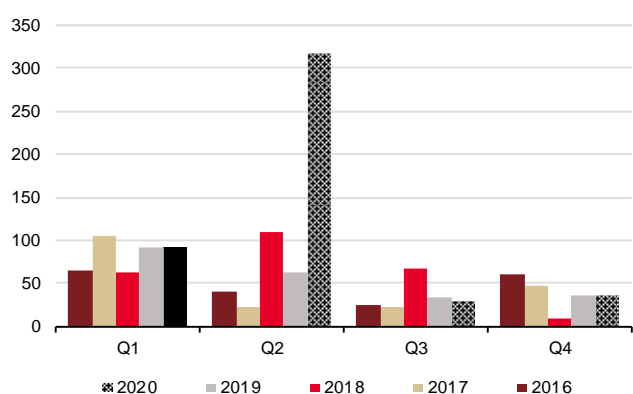
Source: SG Cross Asset Research/EM, Komerční banka, MinFin

Further growth in yields, CZGB cheapening in ASW terms

We expect further growth in CZGB yields this year, supported by growing expectations of CNB rate hikes, strong bond supply, and pressure from rising yields in developed markets. The CNB's current forecast envisages a swift rise in interest rates this year. Our November forecast assumes the first rate hike at the beginning of next year due to a stronger koruna and lower inflation compared to the CNB view. But the latest economic data have generated the possibility that interest rates may be hiked earlier, but probably not before 4Q21. However, market expectations will likely support CZGB yields already in 1H21.

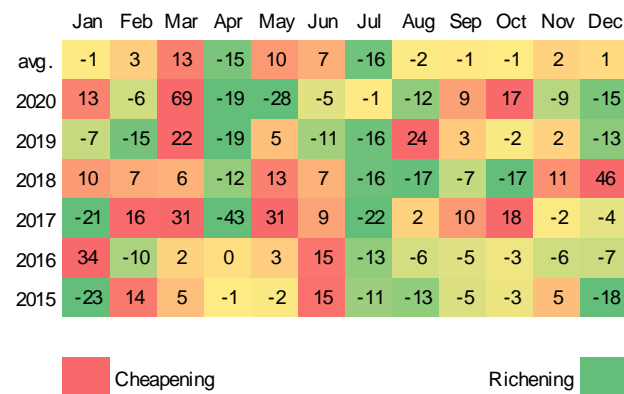
The MinFin usually delivers most CZGB supply in the first half of the year, creating ASW seasonality. In our view, this year will see record bond supply, which will likely be even more concentrated in the first half of the year than usual due to the redemptions calendar. Compared to last year, however, the market will likely have a free hand due to the absence of CNB verbal intervention, like we saw last May. At that time, the central bank gained new tools approved by Parliament and mentioned the possibility of CZGB purchases to support demand and mitigate a possible sell-off. However, this year, the CNB's unconventional instruments are most likely off the table. **We still recommend selling the CZGB 2031 in ASW.**

CZGBs sold in the primary market (CZKbn)



Source: SG Cross Asset Research/EM, Komerční banka, MinFin

10y ASW changes (bps)



Source: SG Cross Asset Research/EM, Komerční banka, Bloomberg

CZGB technicals: mixed picture and risks

Sovereign rating: risk of downgrade persists

Last year, all major rating agencies confirmed the Czech Republic's current rating. However, on average, they expect 1-1.5pp lower public finance deficits for 2020 and 2021 compared to our forecasts. In addition, Fitch and Moody's have criticized the government-approved tax package since the last rating review, so we see plenty of room for them to revise their forecasts. Overall, we

continue to see the risk of a rating outlook downgrade this year. First in line is Fitch, which we think adopted most pessimistic view during the coronavirus crisis last year.

Sovereign rating overview

	Local currency	Outlook	Foreign currency	Outlook	Next rating review		
S&P	AA	STABLE	AA-	STABLE	30-Apr	29-Oct	
Moody's	Aa3	STABLE	Aa3	STABLE	22-Feb	6-Aug	
Fitch	AA-	STABLE	AA-	STABLE	22-Jan	25-Jun	10-Dec

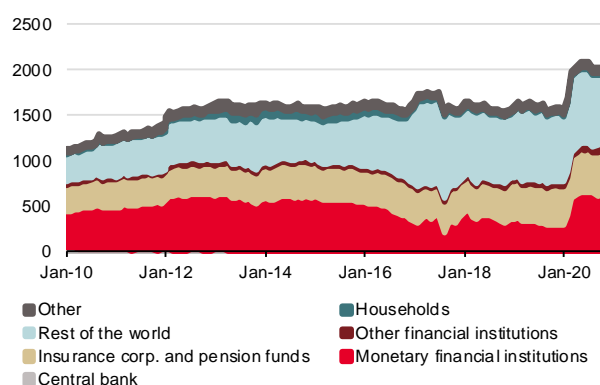
Source: SG Cross Asset Research/EM, Komerční banka, Bloomberg

The Czech Republic return among the developed economies is coming

In 2017, the Czech Republic was moved from the developed to the emerging economies of the JPM bond index family after its GNI per capita in USD fell below the threshold due to the CNB's FX floor. However, the Czech Republic has returned above this level, and it is thus only a matter of time before it will be excluded from the GBI-EM index and moved to the developed index. In our view, this will cause a significant outflow from the CZGB market due to the much lower weight of the country among developed economies than among emerging economies. **We expect the Czech Republic to be excluded from the GBI-EM index and included in the GBI index at the beginning of 2022.** However, the data available to confirm this step will be published in the middle of this year.

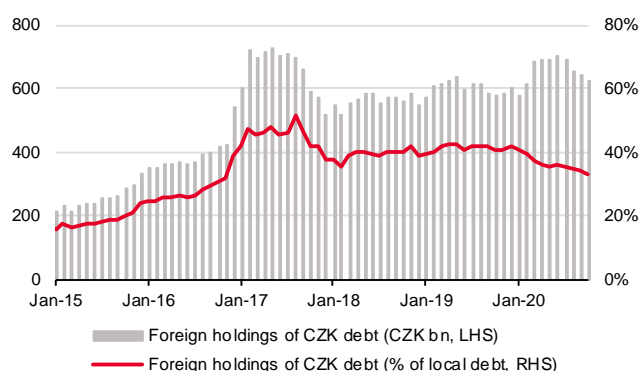
Until then, **we expect new CZGB issues to be included in the GBI-EM index** due to the recent maturity of previously included bonds. In addition, the Czech Republic has much fewer bonds in the index than regional peers. Index rebalancing is usually announced in the middle of the month, and the inclusion of a bond is usually associated with a strong inflow. Our best guess for inclusion is the CZGB 1.25% Feb-25 or CZGB 0.5% Nov-29.

CZGB bondholder structure (CZKbn)



Source: SG Cross Asset Research/EM, Komerční banka, Bloomberg, MinFin

Share of non-resident bondholders down to 32.7%



Source: SG Cross Asset Research/EM, Komerční banka, Bloomberg, MinFin

CZGB bondholder structure: domestic banks re-establish their positions

After a sharp increase in CZGB supply last spring, the share of foreign investors has been steadily declining. In November, the figure was 32.7%, the lowest level since the end of 2016. At the beginning of 2020, foreign entities still held up to 41.6% of all Czech government bonds. In absolute terms, however, their volume has increased since the beginning of last year. **Most new government bonds saw demand mainly from domestic entities, led by banks. In this way, the banks are gradually rebuilding their positions from the years before the CNB's FX floor**, both in nominal and relative terms. In the coming months, we expect this trend to continue given the high CZGB supply planned for this year, the still-high volume of free liquidity in the domestic banking sector, and the low CNB repo rate.

Government bond overview

Government bond overview									Rich-cheap analysis											
Bond	Dur.	Issued last 90D	Issuance limit	Yield	Δ1W	Δ1M	FX hedged	ASW	Δ1W	Δ1M	Min	90D	Max	Z-Score	Rank	Spline spread	Rank	Carry Roll 90D	Rank	
3.85 Sep-21	0.7	0.0	100%	-0.18	23	4	-0.77	-55	9	8	-106		-30	0.2	5	6.8	17	-22.2	18	
0.00 Feb-22	1.1	0.0	6%	0.06	0	10	-0.54	-37	5	11	-59		-27	0.5	3	-6.2	3	-1.8	17	
0.10 Apr-22	1.2	0.0	100%	0.13	3	9	-0.50	-33	2	11	-50		-24	0.8	2	-9.0	1	0.8	16	
4.70 Sep-22	1.6	0.0	100%	0.14	1	15	-0.52	-39	1	20	-69		-34	1.0	1	0.3	12	2.2	15	
0.45 Oct-23	2.8	0.0	80%	0.37	2	-1	-0.44	-33	-1	-2	-48		-7	-0.3	14	2.5	13	5.4	5	
5.70 May-24	3.1	0.0	100%	0.33	0	5	-0.57	-50	-3	4	-72		-23	-0.1	11	18.8	18	4.6	7	
1.25 Feb-25	3.9	0.0	100%	0.72	0	2	-0.24	-17	-4	-1	-34		4	0.1	8	-7.3	2	6.7	1	
2.40 Sep-25	4.4	0.0	69%	0.75	0	-4	-0.23	-20	-4	-7	-35		-1	-0.3	16	-0.5	11	6.2	2	
1.00 Jun-26	5.3	0.0	104%	0.89	1	-1	-0.14	-12	-3	-6	-28		7	-0.2	12	-3.3	6	6.0	3	
0.25 Feb-27	6.0	0.0	83%	0.98	1	-2	-0.08	-8	-4	-8	-25		14	-0.3	13	-4.6	4	5.7	4	
2.50 Aug-28	6.9	0.0	84%	1.05	0	-2	0.01	-5	-5	-10	-20		13	-0.3	15	4.5	16	4.9	6	
2.75 Jul-29	7.6	0.0	67%	1.14	0	-1	0.11	0	-7	-10	-14		14	-0.1	9	3.4	14	4.5	8	
0.05 Nov-29	8.7	15.1	89%	1.22	2	-1	0.11	3	-6	-11	-9		16	0.1	7	-1.9	7	4.2	9	
0.95 May-30	8.8	4.5	87%	1.26	1	0	0.18	6	-4	-8	-5		17	0.2	6	-3.5	5	4.2	10	
1.20 Mar-31	9.4	0.0	67%	1.29	1	-1	0.22	5	-9	-14	-6		16	-0.1	10	-1.4	9	3.8	11	
2.00 Oct-33	11.2	0.0	80%	1.39	3	1	0.36	8	-6	-12	-6		20	0.3	4	-0.8	10	3.1	13	
4.20 Dec-36	12.4	0.0	63%	1.43	2	2	0.46	5	-8	-11	-7		26	-0.3	17	3.9	15	3.0	14	
1.50 Apr-40	16.4	6.1	75%	1.63	4	6	0.59	12	-5	-3	7		43	-1.0	18	-1.5	8	3.4	12	

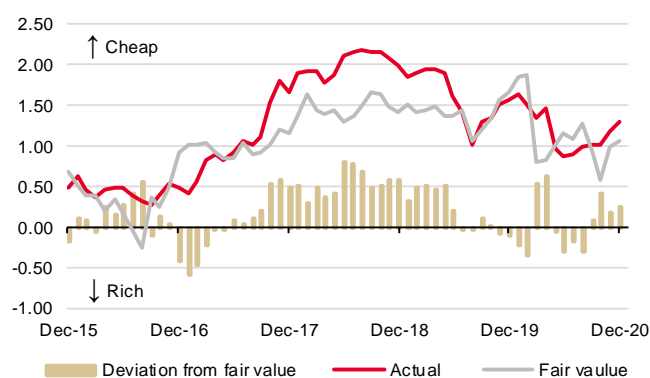
Source: SG Cross Asset Research/EM, Komerční banka, Bloomberg, CNB, MinFin

Market implied policy rates

	Spot rate	+/- bp since last week	
2W Repo Rate	0.25%	0.0	
3M PRIBOR	0.36%	0.0	
Next CNB meeting	Thursday, 04 February, 2021		
Forward dates	Implied policy rate	Rate change priced in (bp)	+/- bp since last week
1M	0.24%	-0.7	-0.5
2M	0.24%	-1.0	-1.0
3M	0.24%	-1.1	-1.9
6M	0.27%	1.5	-3.5
9M	0.35%	10.3	-5.7
12M	0.44%	19.0	-8.5
2Y	0.89%	64.4	6.6
5Y	1.25%	100.2	0.2

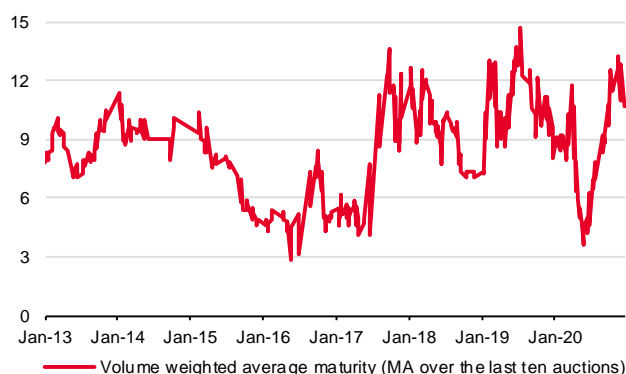
Source: SG Cross Asset Research/EM, Komerční banka, Bloomberg

10y CZGB yield fair value model



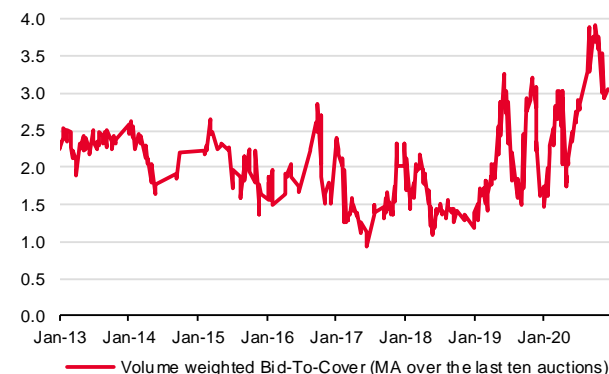
Source: SG Cross Asset Research/EM, Komerční banka, Macrobond

Average maturity of newly issued bonds (years)



Source: SG Cross Asset Research/EM, Komerční banka, CNB

Primary market demand (b/c)



Source: SG Cross Asset Research/EM, Komerční banka, CNB

Note: Bonds included in the sample are non-callable bullet bonds issued by Czech Government with a maturity greater than 3 months and less than 20 years, bonds excluded are zero-coupon bonds, inflation linked bonds and floating bonds; * insufficient time series; issuance in CZKbn, the issuance limit includes a possible extension according to the issuance terms; FX-hedged vs EUR using xccy; ● actual ASW; ◆ average ASW over the last 90D; Z-score means the number of std. deviations from the average; spline spread = actual yield - estimated yield indicates richness/cheapness vs fair value; estimated yield is derived from the estimated curve using on-the-run bonds for each maturity bucket and cubic spline interpolation; CarryRoll - the carry is calculated as the bond's forward yield at horizon data minus today's yield, the roll is calculated as the bond's spline fitted yield at maturity minus the spline-fitted yield at maturity, less the horizon period; ranks sort bonds from the cheapest to the most richest according to a given method; 10y CZGB yield fair value model = five-year rolling regression incorporating growth (IP), inflation (CPI), FX and 10Y EUR yield

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