Investor trust towards Hungary remained unbroken in the first half of the year

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Debt management was successful in the first half of the year, as 60% of the planned full-year funding was completed and all three sub-markets performed well. The institutional HUF market deserves a closer look, where the trust of large investors was unbroken reflected by successful auctions. Yields on forint bonds have risen markedly, but taking into account international developments this should be considered as normal.

International sentiment driven by central banks

The evolution of international sentiment is an important factor for the Hungarian government securities market, as we cannot detach ourselves from the movements of the US or Western European markets. A brief summary of how international markets have evolved should come first, turning to the Hungarian market only afterwards.

Over the past six months, US and German ten-year benchmark yields have risen slightly. This came as a surprise, since according to general market consensus at the end of 2023, several rate cuts were expected for the first half of 2024. The Fed is holding off on its first rate cut for the time being, while the ECB made its first 25 basis points cut in June.

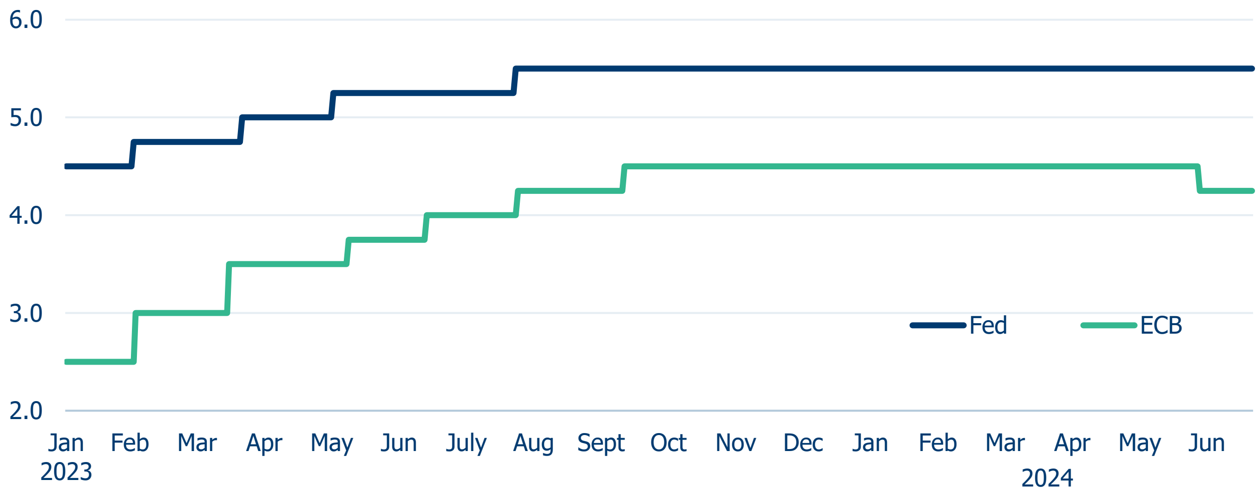

Figure 1. Interest rate of the Fed and the ECB (percent)

The rise in developed market yields on the secondary market was mainly driven by delayed interest rate cuts. The main reason is, US inflation appears to be stuck above 3%, exceeding the Fed's 2% target, consequently the Fed has yet to start its rate cut cycle amid strong growth and labour market data. However, weaker overseas economic data were released during the past few months, as a result, the strengthening of interest rate cut expectations cannot be ruled out. On the other hand, inflation rates in the euro area have slowed significantly amid fragile growth outlook, and the ECB started the interest rate cut cycle in June. Both central banks remain in data-driven mode.

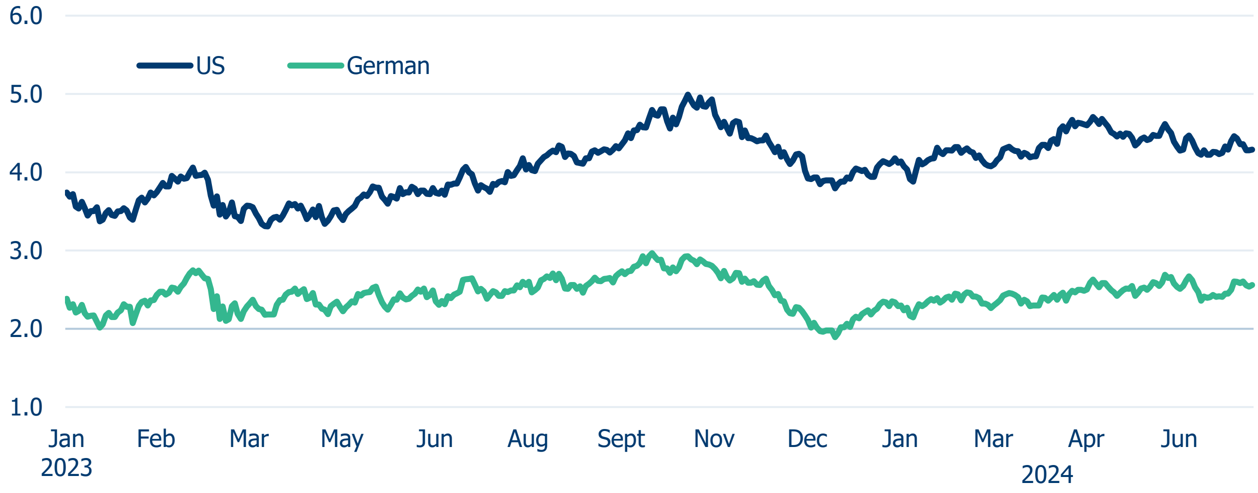

Figure 2: US and German 10 year benchmark yield (percent)

It was largely due to heightened expectations of interest rate cuts that yields in the US treasury market fell after reaching the 5% psychological ceiling in autumn 2023, followed by a period of sobering up at the beginning of 2024. In the past six months, the US 10-year yield has been hovering around 4.5% and ended the half-year at 4.3%. The German yield followed a similar trajectory, starting the year at around 2% and rising to 2.56% by the end of June.

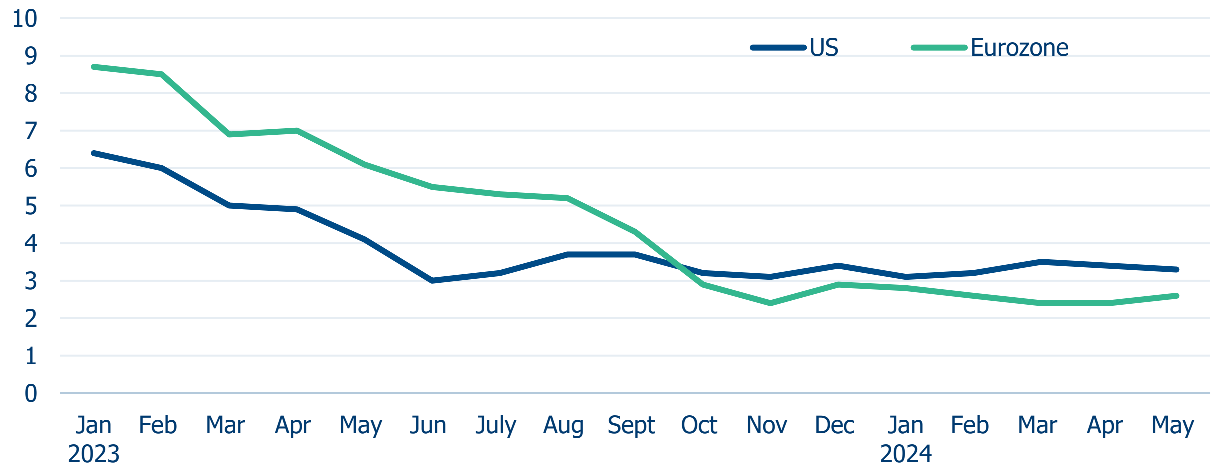

Figure 3. US and Eurozone inflation (percent)

Forint yield curve is normalizing

We have seen diverging trends in the discount Treasury Bill (T-Bills) and HUF bond markets in the first half of the year, with yields on T-Bill's falling and those on bonds rising. However, this is a natural process over the medium to long term, resulting in higher yields at the long end of the yield curve than at the short end, with the previously inverted and then flat yield curve normalising. Yield

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levels for each maturity range from 5.78% for 12 months to 6.54% for 10 years, compared to 2023 average of 7.3-11.4% for each maturity.

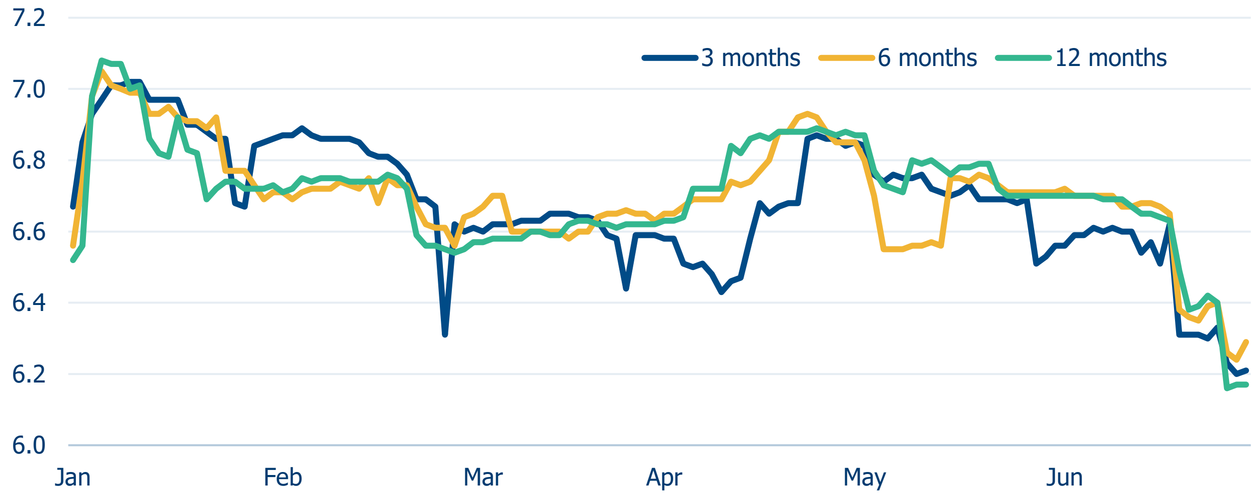

Figure 4. T-Bill benchmark yields in the first half of 2024 (percent)

The past year and a half has seen interesting movements on the Hungarian investment landscape, with significant retail capital flowing into bond funds. The normalisation of the yield curve and the decreasing central bank base rate may generate demand for HUF government bonds in the future, and investment funds that previously investing in central bank and other money market instruments may strengthen their presence on the government bond market.

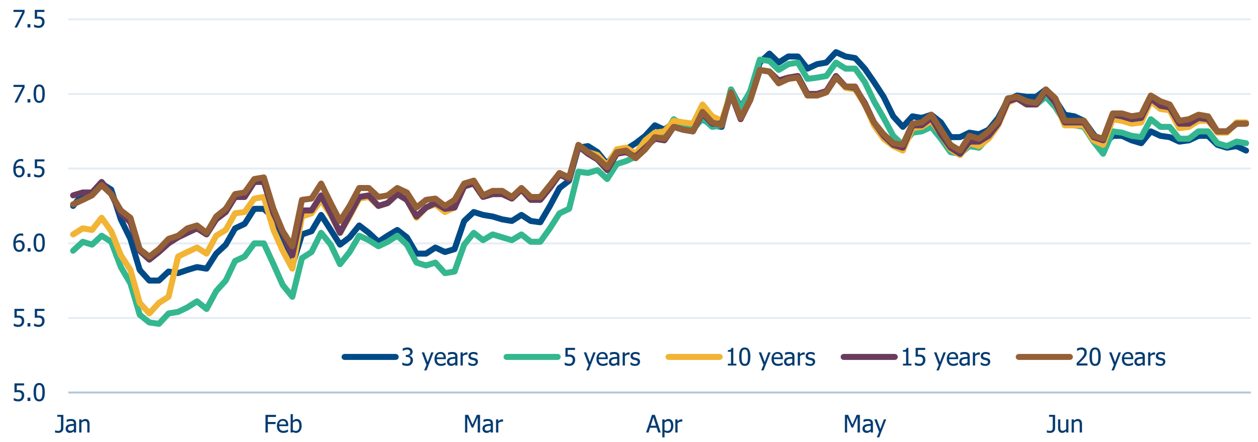

Figure 5. HGB benchmark yields in the first half of 2024 (percent)

Novelties on the T-Bills market

On the T-Bill market, ÁKK introduced significant innovations in 2024. As a consequence of the transformation of the auction system, the average number of series outstanding was reduced from 18 in 2023 to 8 by the end of June 2024, significantly increasing the liquidity of each series. In addition, ÁKK launched weekly T-Bill switch auctions in the second quarter of 2024. In Q2 2024, ÁKK exchanged HUF 72.15 billion of short-term T-Bills in eight switch auctions. As a result of the above innovations, demand on the T-Bill market has become more stable.

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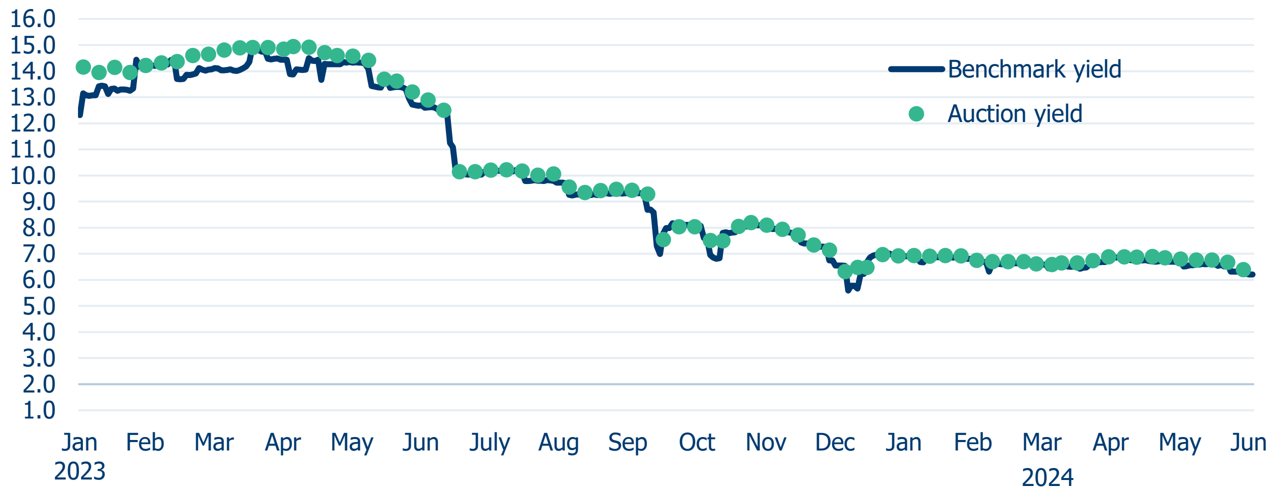

Figure 6. Auction yield and benchmark yield for the 3 months T-Bills (percent)

At the end of the first half of the year, the total stock of T-Bills amounted to HUF 2,093 billion, HUF 220 billion more than in December last year. In the revised annual plan, ÁKK expected a HUF 300 billion decline for 2024, which means that market developments so far have surpassed expectations. This is because institutional investors have significantly increased their purchases. This also means additional 2024 funding pool for ÁKK. The stock of T-Bills held by households declined in the first half of the year in line with plans.

In the first half of the year, ÁKK offered HUF 1,245 billion of T-Bills to investors in auctions, with a total bid of HUF 2,642 billion average coverage was 2.1. In response to the strong interest, ÁKK sold HUF 1,518.5 billion of T-bills, exceeding its half-year plan by more than HUF 270 billion.

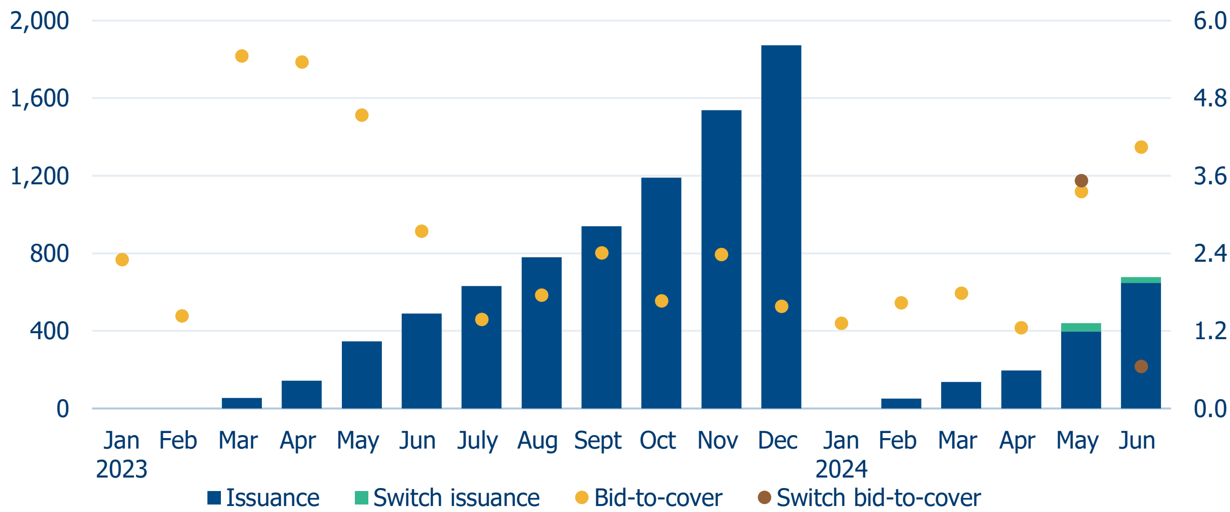

Figure 7. Cumulated issuance on 3 months T-Bill auctions and switch auctions (HUF billion, left axis) and the bid-to-cover ratio on auctions and switch auctions (right axis). ÁKK introduced the switch auctions from May 2024.

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Strong demand for HGBs

Financing conditions in the institutional HUF market were also favourable in the first half of the year, with ÁKK meeting 65% of its full-year issuance plan, and 80% of the full-year plan for three- and five-year paper, which means that institutional investor interest in these securities was particularly strong. In particular, there was strong market demand for five-year bonds, but overall the auctions were successful. The average auction coverage for different maturities ranged from 1.17 to 6.24, compared to the average range of 2.3 and 4.6 in 2023.

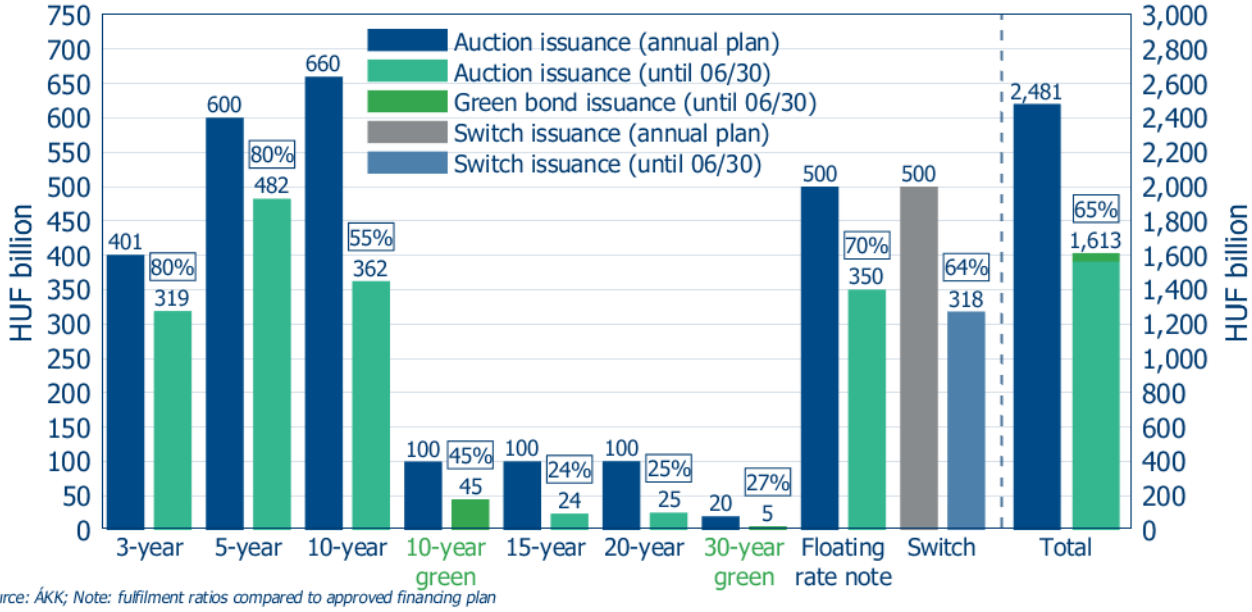

Figure 8. Fulfilment of institutional market bond issuance plan (excluding T-Bills and municipal bonds) categorized by tenor. The percentages indicate the ratio of the auction issuances fulfilled and settled until 30 June relative to the issuances planned for the entire year (excluding switch issues). Note: The data is based on value dates as opposed to deal dates. The figure does not contain T-Bill issuance plans.

ÁKK issued HUF 1,613 billion worth of HGBs in the first half of the year, thus the target issuance of HUF 2,481 billion for the full year can be overachieved.

Reducing the renewal risk is a key priority in ÁKK's institutional strategy. To achieve it, it is necessary to reduce the outstanding stock of government bonds maturing in 2025-2026, when the previous central bank covered operations ("MNB repo") will mature, totalling some HUF 2,580 billion, which includes a significant part of the series of government bonds maturing in 2025-26. The current activities of ÁKK, including the swap auctions, are aimed at reducing the market stock of government bonds covered by MNB repo maturities.

Bond yields have all risen in the first half of the year, with auctions seeing an increase of 54-114 basis points, while secondary market benchmark yields have risen by 37-75 basis points, depending on maturity. The rise in yields was driven by higher US bond yields and moderating expectations of central bank rate cuts in developed markets, as well as gloomy growth prospects in Europe and Hungary.

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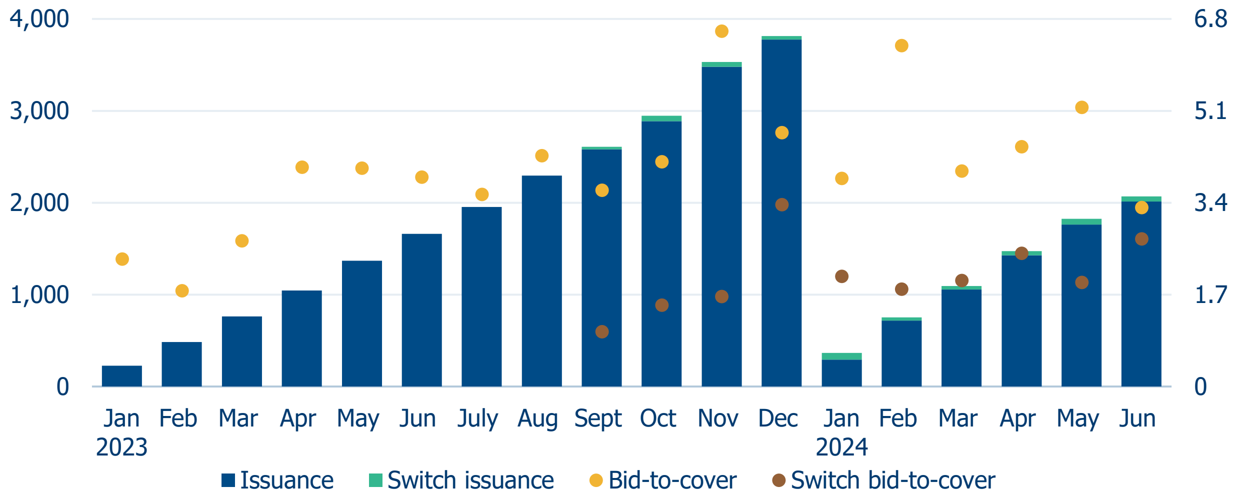

Figure 9. Cumulated HGB issuance on auctions and switch auctions (HUF billion, left axis) and the bid-to-cover ratio on auctions (right axis). ÁKK holds switch auctions from September 2023.

In addition to increasing bond yields, the asset swap spread (ASW) of HGBs has also risen, moving from negative territory in the previous period to positive values along almost the entire yield curve.

The price of fixed-rate government bonds can change significantly in case of yield curve shifts, i.e. if market yields rise. One way of mitigating this risk for investors is to enter into interest rate swaps (IRS), whereby the investor pays a fixed interest rate and receives a variable rate in return. The ASW expresses in numerical terms the iterated difference (spread) between the yield curve of the reference instrument (bonds in this case), and the yield curve of derivative instruments (IRS) at a given maturity. If ASW is positive, the bondholder receives a premium for assuming the interest rate risk of the bond, but if it is negative, the bondholder effectively pays a premium to eliminate the risk. Therefore, the recent return of the Hungarian spread to positive territory could in fact lead to increased investor interest.

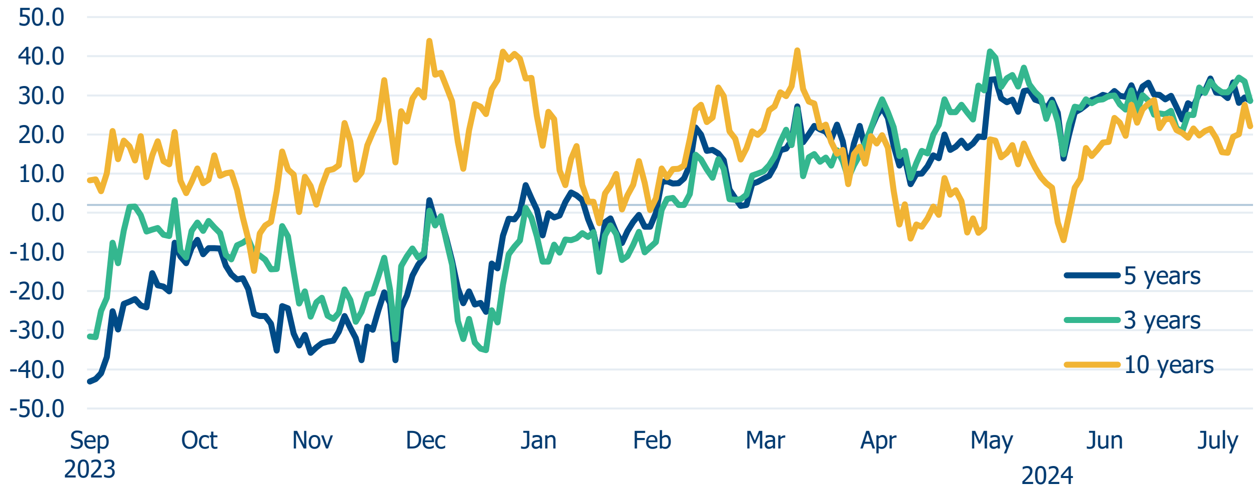

Figure 10. Asset swap spreads (ASW) of HGBs (bp)

How risky do international investors now consider Hungary?

Hungary's current risk premium relative to the region may have repercussions on the institutional HUF market, as it may affect the yield and demand for forint bonds. From this perspective, two

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indicators should be considered: CDS (Credit Default Swap) is a form of insurance to reduce the risk of default. The value of the transaction, expressed in basis points, indicates how much 'insurance fee' is payable based on the market's assessment.

In the event of default, the buyer receives the face value of the bond. The Hungarian five-year CDS spread was 122 basis points at the end of June, compared to 145 basis points for Romania, 68 for Poland and 29 for the Czech Republic. However, size and liquidity of the CDS market and, consequently, information content of CDS spreads has been greatly reduced nowadays, the adverse effects are reflected in the CDS spreads of sovereign bonds in the CEE region, distorting the country risk assessment based on CDS pricing.

For this reason, yield spread relative to each country is the other important and relevant risk indicator. However, this should not be calculated for a specific maturity, but based on the so-called Z-spread relating the yield of an individual bond to the zero-coupon yield curve. It is therefore a commonly used indicator for investor decisions, identifying over- and/or underpriced series in a given market situation. In case of Hungary, this FX bond spread is currently around 200 basis points on the 10-year maturity, with no significant movement in recent months. In the region, a noticeable narrowing was seen in case of the Romanian Z-spread, with Polish and Bulgarian spreads also declining to a lesser extent.

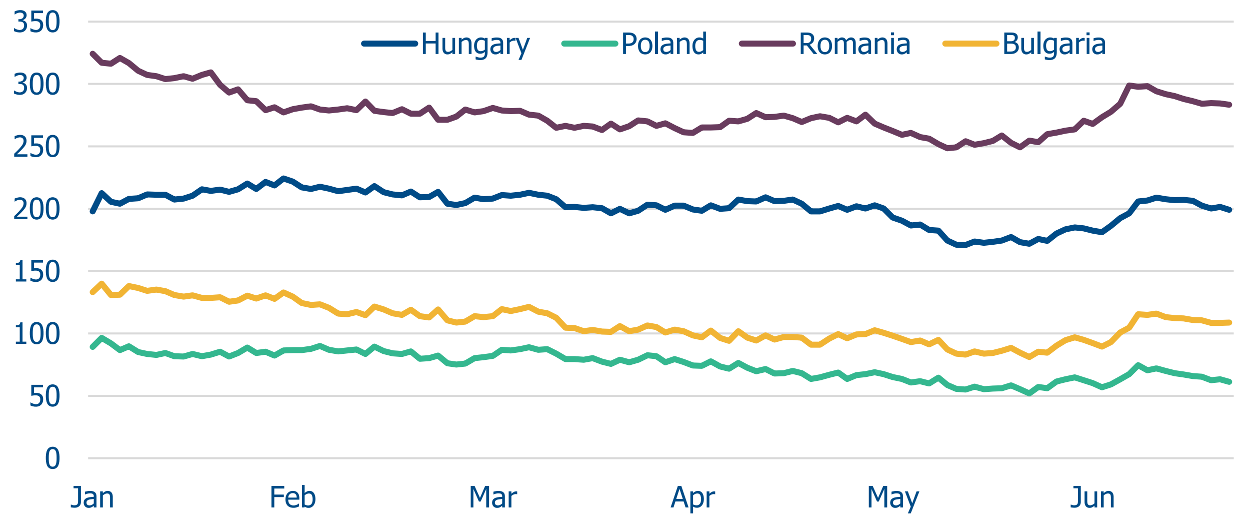

Figure 11. Z spreads of the CEE FX bonds from the beginning of 2024 (bp)

According to first-half data, demand for Hungarian government bonds and T-Bills was particularly strong, consequently, full-year financing is on track on a prorated basis. In addition, no risk factors can be identified that would materially divert the yield spread of Hungarian bonds from the regional trends.

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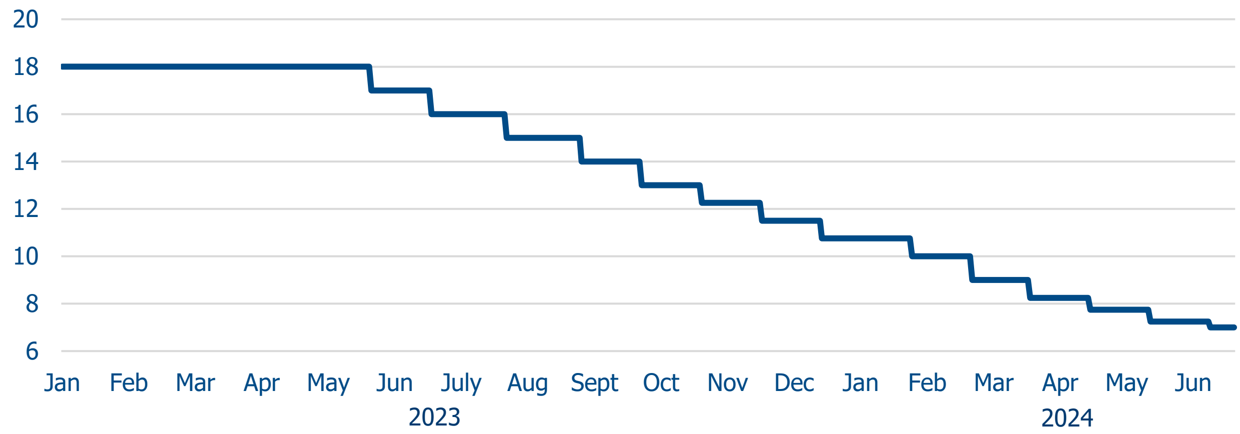

Figure 12. Interest rate of the National Bank of Hungary (percent)

The central bank continued its interest rate cut cycle in the first half of the year, bringing the base rate down to 7.00% by the end of June. Consequently, the Hungarian central bank base rate remained the highest in the region, but moved closer to the level of regional peers, while Hungarian real yields remained positive. The Hungarian central bank has already indicated that room for further easing is limited in the second half of the year.

The exchange rate of the forint against the euro has fluctuated significantly over the past year and a half, appreciating by 6 units overall. During the first half of this year as a whole, the Hungarian currency weakened by 3.2%. The exchange rate started the year around 380 and approached the 400 psychological level several times, but did not breach it.

Figure 13. EUR/HUF exchange rate

Foreign currency bond issuances reflect risk perception. Two major issuance took place at the beginning of the year. In January, ÁKK issued foreign currency bonds in the amount of USD 2.5 billion and EUR 1.5 billion taking advantage of favourable market conditions and strong demand. Both transactions raised more funds than originally planned, exceeding the original plan by a total of almost EUR 1 billion. Both auctions were oversubscribed. In case of the dollar transaction, yield premium was approximately 100 basis points more favourable than the USD transaction one year earlier.

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In the second half of the year, ÁKK plans no foreign currency bond issuance with a significant size, but may enter the Japanese and Chinese markets with smaller amounts, and a private placement may take place in case conditions are favourable.

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