Rates focus

OATs: Still *trop tôt*

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We remain underweight French government bonds.

Although French domestic investors are underinvested in domestic bonds and have sufficient balance-sheet capacity to absorb a meaningful reduction in foreign holdings and/or further selloffs, they might not be willing to buy large volumes of OATs at current prices and at the current political juncture, given the prospect of further volatility ahead stemming from political and fiscal risks.

Moreover, barring meaningful policymaker action, transitioning towards greater domestic ownership of French debt will have to happen in a context of much higher monetary policy rates, the lack of a massive, price-insensitive buyer (the ECB) and a much higher deficit (and therefore net supply) than in the aftermath of the eurozone debt crisis episode (for peripheral countries).

Against this backdrop, we expect French govies to remain vulnerable to episodes of volatility in the next few months.

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Foreign investors increased their holdings of French debt until fall

Foreign investors entered the recent period of stress with elevated exposure to French debt.

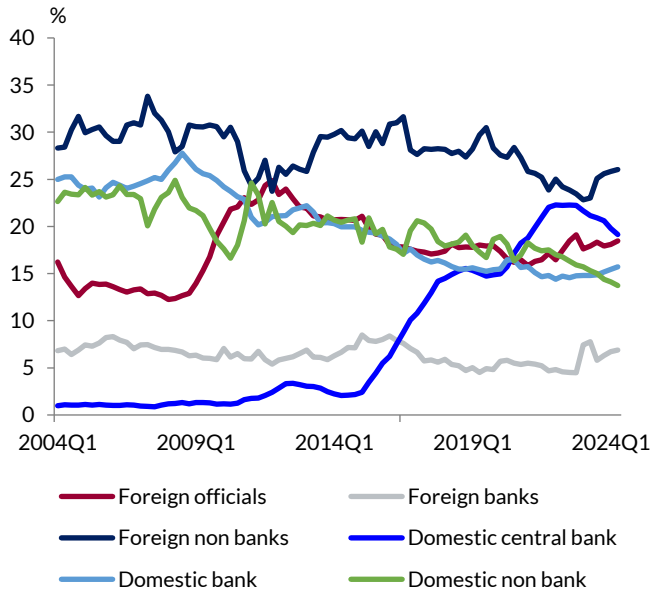
Non-residents have been steadily increasing their holdings of French debt since 2022, with a further acceleration in the last six months (**Figure 1 & 2**); according to the IMF, the increase in foreigners' ownership of French debt was concentrated among foreign non-banks and foreign banks, while foreign officials' holdings of French debt have declined as a portion of total debt. Taking into account that almost 70% of foreigners holding of French debt are currently NOT foreign officials, the recent increase in foreigners' holdings adds a source of volatility to an already volatile debt holding structure.

Data from the IMF and ECB are available only up to Q2, but Japanese MOF data indicate that Japanese investors accelerated their purchases of French govies in July and August (latest data available), after weak inflows in the first part of the year (**Figure 4**).

Last but not least, data from the balance of payments (the most timely data, Net incurrence of liabilities, portfolio investment) show that it was only in September that foreign flows into French debt, (both government and corporate securities) declined to the historically low level of almost zero.

Figure 1

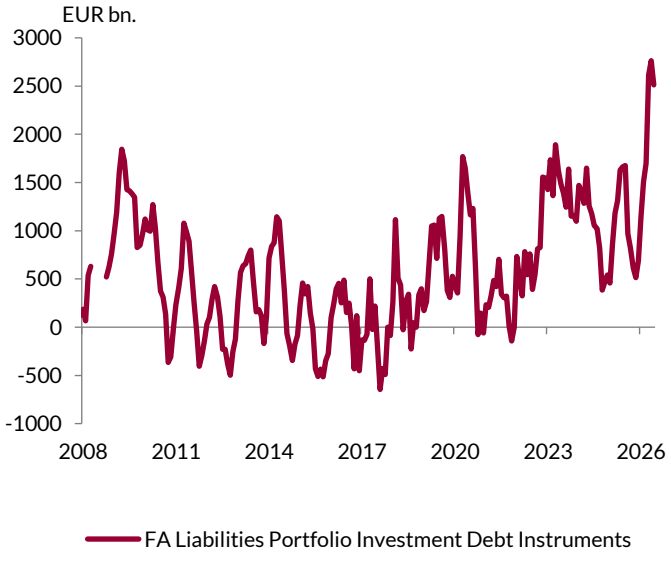
Foreigners are overweight French debt



Source: IMF, ANIMA Research

Figure 2

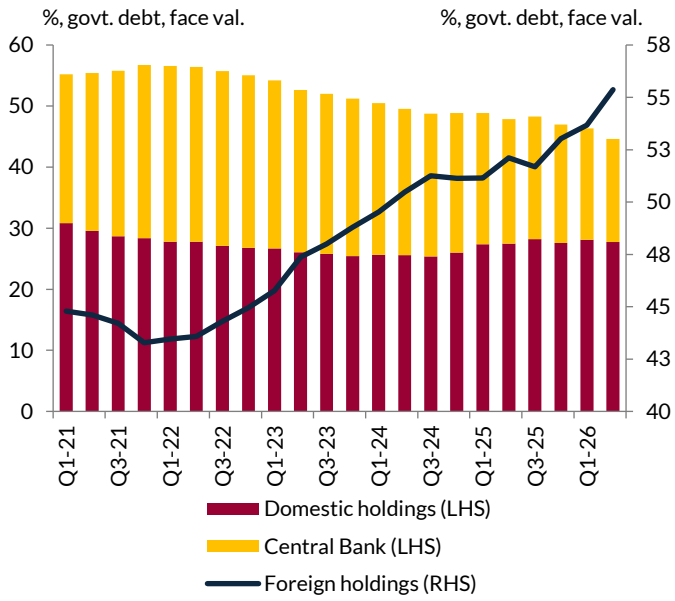
Non-residents have recently absorbed the ECB's QT



Rolling six-months sum of flows into French debt (both corporate and government). Source: Haver Analytics, ANIMA Research

Figure 3

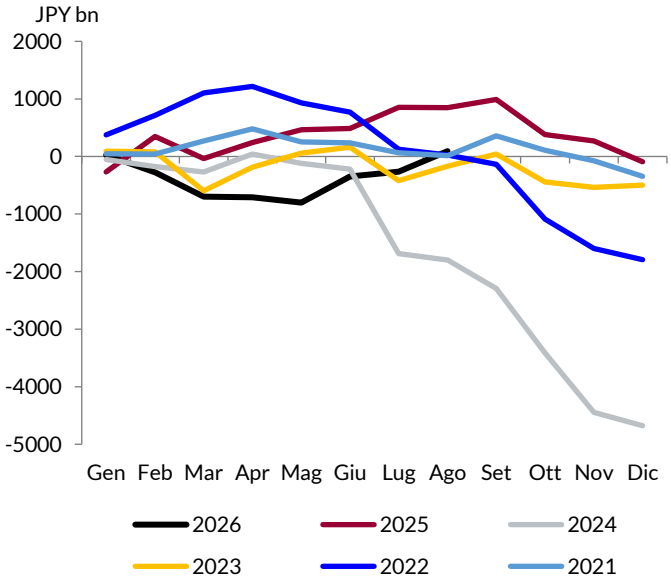
Non-residents have recently absorbed ECB's QT



Source: Haver Analytics, ANIMA Research

Figure 4

Japanese investors' holdings of French bonds increased during the summer



Source: Bloomberg, Japanese MOF, ANIMA Research

Domestic investors are underweight

French domestic investors remain relatively underweight in their own sovereign debt, indicating that in principle they have room to increase their holdings in the next few months.

Among domestic holders of French government debt, the most relevant are the central bank (with QE holdings), banks and insurance funds, while investment funds (Other FIs) hold a relatively small amount of French sovereign debt (less than 2%).

While banks have moderately increased their holdings of French govies since 2022 (**Figure 5**), both banks and insurance funds remain heavily underweight French govies compared to the period before the eurozone debt crisis (**Figure 1**).

Against this backdrop, we stress-test the absorption capacity of the French domestic investor base, both from the point of view of its historical levels of domestic public debt holdings and from the point of view of its balance sheet (flows of funds analysis).

First, we identify three potential sources of supply:

1) Projected French net government bond issuance in 2027.
2) French securities returning to the market within the ECB's QT programme in 2027.
3) Potential sales by foreign investors. To estimate potential foreign selling, we assume foreign banks and non-banks reduce their French government bond holdings at half the pace observed in the Italian government bond market between 2010 and 2012. On the other hand, we assume that foreign official investors' ownership will remain relatively stable.

We also assume that foreign investors purchase neither the new net issuance expected in 2027 nor the securities released by the central bank. Under this scenario,

the total volume of French government bonds that would need to be absorbed is around EUR 490bn (**Figure 7 & 8**).

Second, we estimate the absorption capacity of domestic banks, insurance funds and investment funds.

1) We assume that banks' and non-banks' holdings of French government debt can rise to around 25% for each of the two categories (from around 17% and 15%, respectively), back to the 2010-2011 levels.

2) From the asset point of view, we assume that:

   a) Domestic banks can stretch their holdings to almost 4% of their assets (from the current 2.4%), considering that not only did banks reduce their holdings of govies, but they also diversified away from OATs from 2024 onwards (**Figure 6**).

   b) Insurance funds will go back to holding around 29% of their assets in French govies, from the current 22%, back to the 2021 levels. These actors have been diversifying heavily away from debt securities and into equities in the last few years.

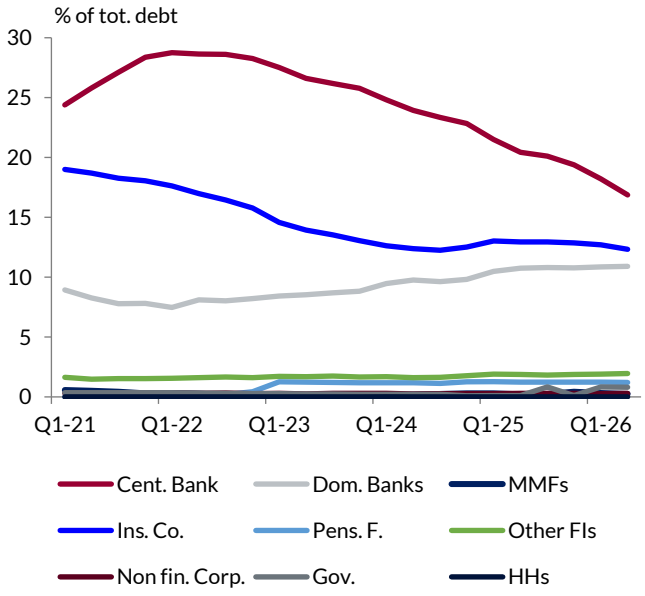
   c) Investment funds will increase holdings of OATs in line with the trend over the last few years.

Depending on whether we use methodology 1 or 2, the amount that domestic investors could potentially absorb is between EUR 420 and 485bn (**Figure 7 & 8**).

The results therefore suggest that domestic capacity is broadly sufficient to accommodate the potential supply.

Figure 5

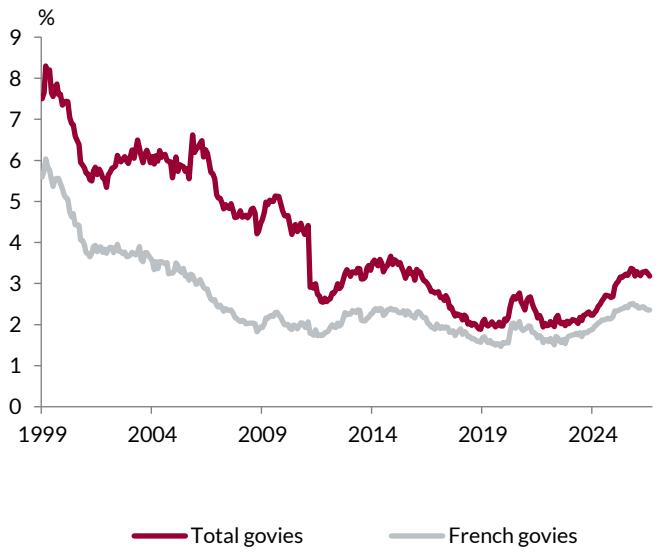
Banks and insurance companies are the most relevant domestic investors in OATs



Source: Haver Analytics, ECB, ANIMA Research

Figure 6

French banks have reduced their home bias



French banks' holdings of government debt as % of their total assets.
Source: Haver Analytics, ECB, ANIMA Research

Figure 7

Stress testing the firepower of French domestic investors – Methodology 1

Room to expand exposure		Potential selling	
Domestic banks	220	Net supply 2027	144
Domestic non-banks	200	QT	85
		Potential foreign selling	261
Total	**420**	**Total**	**490**

Source: Haver Analytics, ECB, IMF, ANIMA Research

Figure 8

Stress testing the firepower of French domestic investors – Methodology 2

Room to expand exposure		Potential selling	
Domestic banks	220	Net supply 2027	144
P&I	230	QT	85
Other FI	36	Potential foreign selling	261
Total	**486**	**Total**	**490**

Source: Haver Analytics, ECB, IMF, ANIMA Research

The case of Italy

While our analysis shows that domestic investors have sufficient room on their balance sheets to absorb a heavy selling wave from foreign investors, **they might not be willing to buy large volumes of OATs at current prices and at the current political juncture, given the prospect of further volatility ahead stemming from political and fiscal risks.**

Moreover, barring meaningful policymaker action, **transitioning towards greater domestic ownership of French debt will have to happen in a context of much higher monetary policy rates, the lack of a massive price-insensitive buyer (the ECB) and a much higher deficit (and therefore net supply) than in the aftermath of the eurozone debt crisis episode (for peripheral countries).**

Take the case of Italy, for instance.

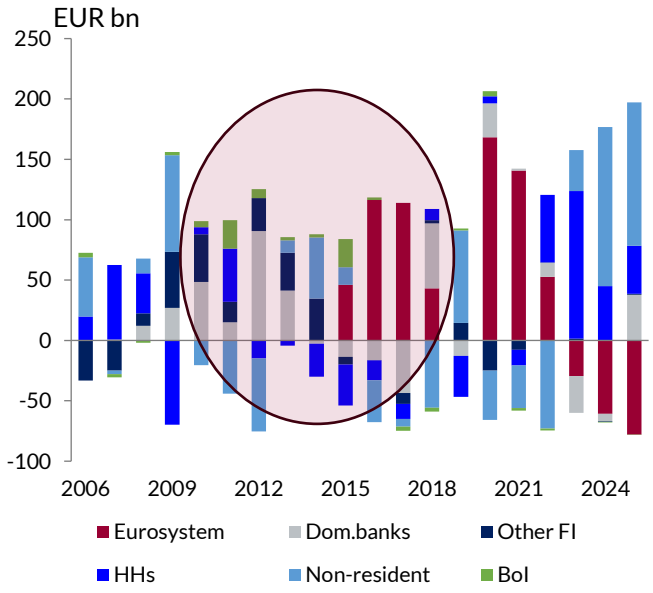
When foreign investors materially reduced their exposure to BTPs in 2010-2012, Italian banks and other domestic financial institutions initially absorbed a substantial share of the selling. As their capacity became more constrained, the ECB started QE, de facto absorbing more of the total Italian net supply as a price-insensitive investor and a forced buyer (**Figure 9**). Moreover, at that time, Italy's net deficit was lower than France's (**Figure 10**).

France faces a less favourable outlook, as the shift towards greater domestic ownership would need to occur against a backdrop of elevated net issuance and the ECB's quantitative tightening.

Against this backdrop, **we expect French govies to remain vulnerable to episodes of volatility in the next few months.**

Figure 9

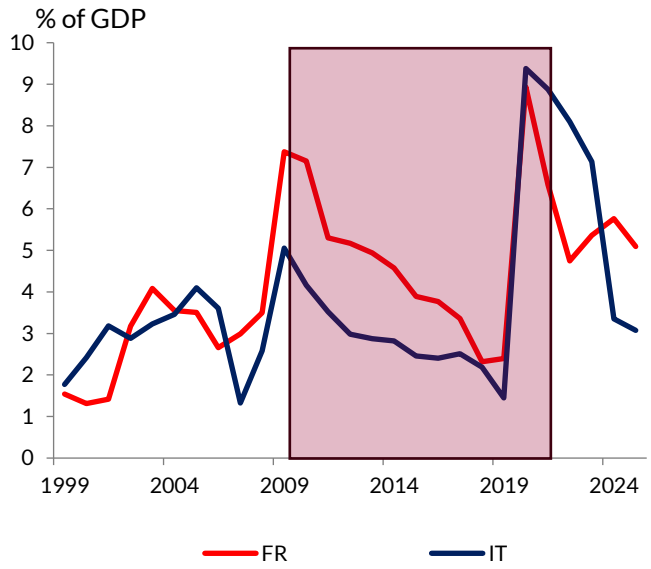
Domestic banks and FIs first, and then the ECB to the rescue of BTPs



The chart shows the breakdown of investors who absorbed net sovereign bond issuance from Italy in each year. Source: Bloomberg, Haver Analytics, Bank of Italy, ANIMA Research

Figure 10

Much lower net issuance for Italy during the crisis



Source: Haver Analytics, ANIMA Research

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