Confidence must be earned

Amundi ASSET MANAGEMENT

Thematic paper | CROSS ASSET Investment Strategy

February 2018

The improvement of peripheral bonds' fundamentals has accelerated

RESEARCH STRATEGY & ANALYSIS

The improvement of peripheral bonds' fundamentals has accelerated

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and FX Strategy

Finalised on 15/02/2018

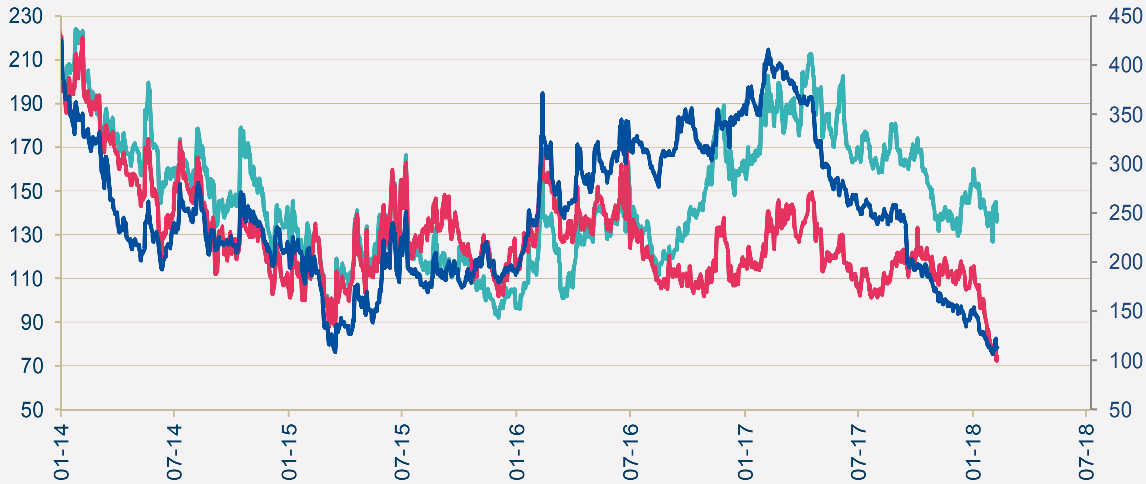
The essential

Two events pushed down Eurozone sovereign spreads in 2017: the French presidential election in April & May, which dissipated investors' fears about Eurosceptic movements, and the announcement on 26 October of a smaller-than-expected reduction in ECB's QE for 2018 (monthly purchases lowered from € 60 bn to €30bn). However, it is important to point out that the fundamentals of European sovereign bonds have improved recently and provide strong support for this segment of the market.

The conventional thinking is that the ECB's QE had a positive impact on the sovereign spreads because of :

- **a direct impact: the heavy purchases of sovereign bonds** (at the end of 2017, the Eurosystem had purchased €1889 bn of sovereign bonds under the PSPP)
- **an indirect impact: the improvement of fundamentals** as, even if it is difficult to measure precisely, it is reasonable to assert that the ECB's QE has boosted and is still boosting real GDP growth and inflation (improving consequently the debt-to-GDP dynamics).

1/ **10y. yield spread with Germany**



Source: Datastream, Amundi Research

While the direct impact of the QE (technical factors) on peripheral sovereign spreads had been quick to materialize, it is important to note that the indirect impact (associated to the improvement of fundamentals) is only exerting its full impact for some months.

Indeed, economic growth and inflation accelerated in the euro area rather recently. In Q4 2017, euro area GDP growth was 2.7% y-o-y, after capping slightly below 2% over the 2014-2015-2016 period. In addition, total inflation finally approached 1.5%, after being zero on average over the three years from 2014 to 2016. **As a result, nominal GDP growth accelerated sharply in 2017 compared to the previous years. previous years, which is very positive for the dynamics of the debt-to-GDP ratio.**

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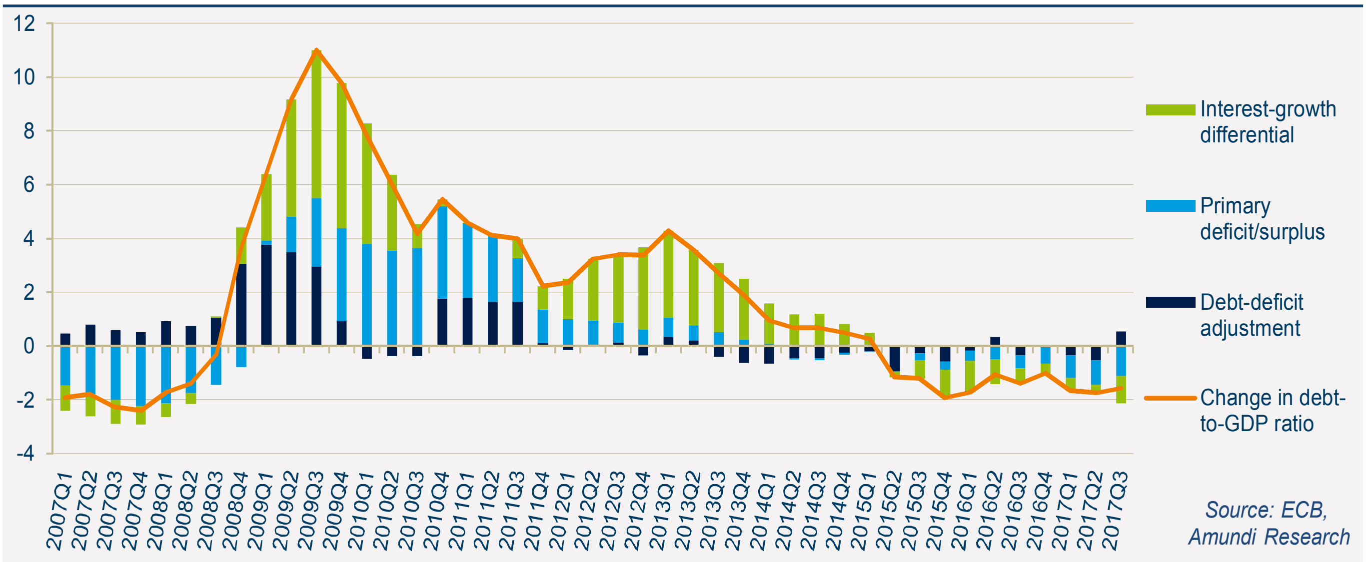
Recall that the evolution of the debt-to-GDP ratio dt is governed by the equation :

$$d_t - d_{t-1} = d_{t-1}\frac{(r-g)}{1+g} - p_t + dda_t$$

where:

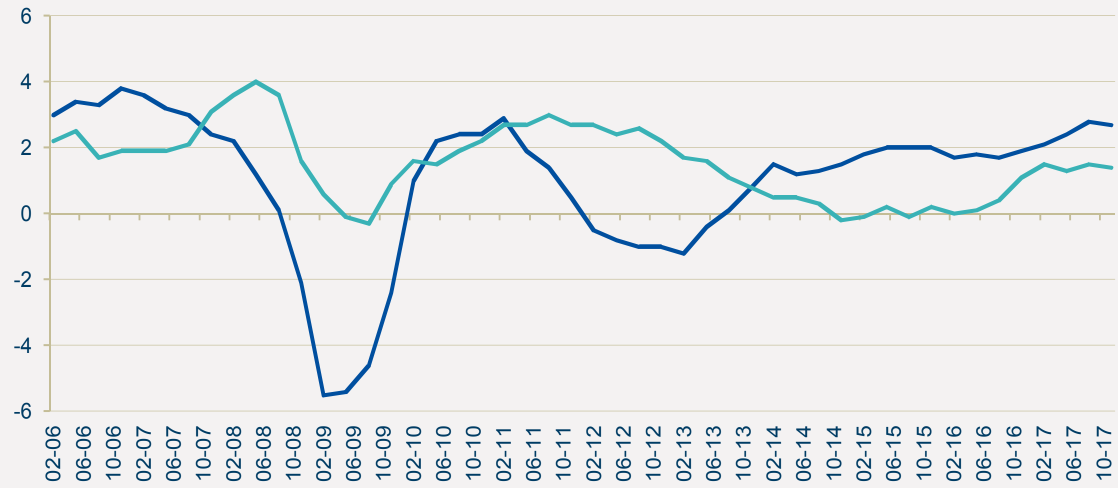
- d_t represents the debt-to-GDP ratio
- p_t represents the primary balance (difference between income and state expenditure)
- r the average interest rate paid on the public debt
- g Nominal GDP growth
- dda_t the debt-deficit adjustment, which corresponds to transactions in financial assets and valuation effects.

2/ Eurozone: change in debt-to-GDP ratio (4q. rolling)



In the dynamics of the debt-to-GDP ratio, the difference between the average interest rate paid on the public debt and nominal GDP growth plays a decisive role. When interest rates are higher than nominal GDP growth, we are talking about a "snowball effect" because the numerator of the debt-to-GDP ratio is growing faster than the denominator. In contrast, lower interest rates than nominal GDP growth contribute to the decline in the debt-to-GDP ratio.

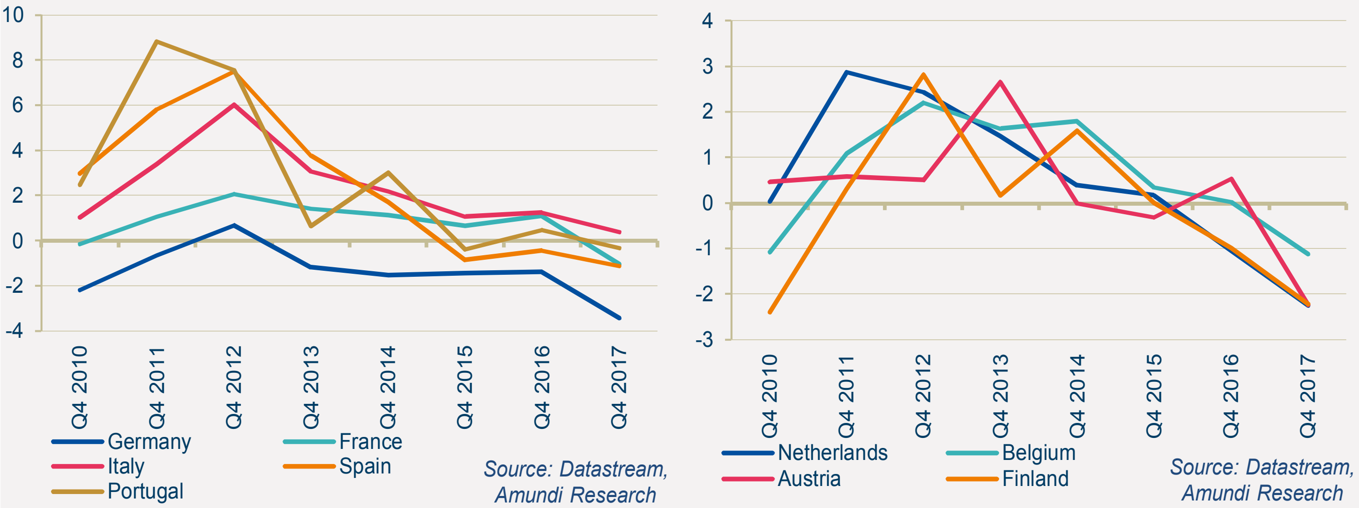
3/ Eurozone: GDP growth & inflation



Source: Datastream, Amundi Research

For the majority of euro area countries, the difference between the average interest rate paid on the public debt and the nominal GDP growth fell sharply in 2017 (thanks to the acceleration of economic growth and to the recovery of inflation and as market rates remained very low). It is now negative or very close to zero for all countries. For Germany, the difference between the average interest rate paid on the public debt and nominal GDP growth is very negative, at around 340 bps at the end of 2017. For Austria, the Finland and the Netherlands, this difference was around - 220 pbs. For France, this difference has just gone into negative territory to reach about - 100 pbs, levels similar to those of Spain. Italy is the only major country for which this difference was still positive, at about 40bps, but this quantity has fallen sharply compared to previous years.

4/ Spread between the average interest rate paid on the public debt and the nominal GDP growth



Source: Datastream, Amundi Research

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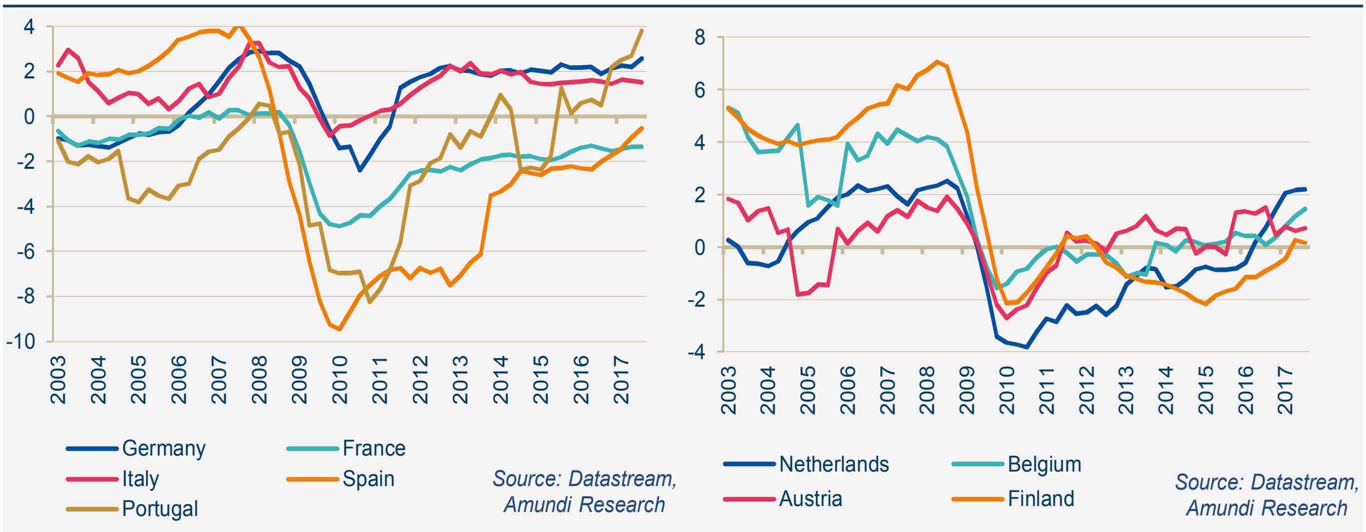
Overall, the evolution of the primary balance has been positive in recent quarters. A large number of countries are in a primary surplus situation. The evolution in Portugal was the most impressive, as the primary surplus of this country rose sharply, to 3.8% of GDP in Q3 2017. The primary deficit of Spain has fallen considerably last quarters, from 3.5% at the end of 2013 to 0.5% in Q3 2017. In this respect, France is a bad student because its primary deficit has only slightly decreased in recent years and is the only country where the primary deficit still exceeds 1% of GDP. Germany's primary surplus now stands at 2.6% of GDP and that of Italy at 1.5%. The primary balance of Finland and Belgium has also improved significantly in recent quarters.

The decline in the spread between the average interest rate paid on the debt and nominal GDP growth almost everywhere in Europe contribute to a very marked improvement in the dynamics of the debt-to-GDP ratio. Will it last? This is very likely. Forecasts from the European Commission (for example) show that nominal GDP growth should remain as strong in 2018 and 2019 as it is in 2017. The same is true for the evolution of the primary balance.

5/ **Primary balance (as % of GDP)**



Rating agencies have begun to upgrade the rating of peripheral countries in recent quarters (see box on credit ratings). Ireland is the country for which the rating has been the most upgraded, followed by Spain, Portugal and even Italy. It is important to recall that the credit rating remains the variable the most strongly linked to sovereign spreads, even more than the debt-to-GDP ratio, than the expected change in the debt-to-GDP ratio or than the primary balance.

Conclusion

The fundamentals of peripheral sovereign bonds have improved significantly recently with the acceleration of economic growth and inflation, but also with the improvement of the primary balance. This has contributed to the contraction of sovereign spreads in recent months, particularly as credit rating agencies have begun to upgrade credit ratings in a number of countries. The improvement in fundamentals should continue over the coming quarters, which is a positive signal for the evolution of spreads.


The evolution of Eurozone credit ratings in 2017 and 2018
[No change in 2017-2018
Germany, France, Netherlands, Slovakia, Latvia, Finland,
Luxembourg, Lithuania, Austria, Estonia, Belgium]
IRELAND
Moody's
A3 → A2
Fitch
A → A+
SLOVENIA
Moody's
Baa3 → Baa1
Fitch
A → A+
GREECE
Moody's
Caa3 → Caa2
S&P
[Upgrade on 19 January 2018]
B- → B
Fitch
CCC → B-
PORTUGAL
S&P
BB+ → BB-
Fitch
BB+ → BBB-
ITALY
S&P
BBB- → BBB
Fitch
BBB+ → BBB
SPAIN
Fitch
[Upgrade on 19/01/2017]
BBB+ → A-
MALTA
Fitch
A → A+
CYPRUS
Moody's
B1 → Ba3
S&P
BB → BB+
Fitch
BB- → BB

NOTES

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