EURO PERIPHERY BOND - UPDATE

THE ECB CANNOT IGNORE MARKET FRAGMENTATION

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SUMMARY

- The combination of market expectations for a faster and stronger ECB hiking cycle, the sharp slowdown in growth and the rise in sovereign bond yields has brought debt sustainability questions back onto the radar screens. The good news is that most countries have used years of extremely low rates to increase the duration of their outstanding debt, making them less sensitive to temporarily rising rates. However, a persistent rate shock has the potential to put the Italian debt to GDP ratio on an increasing path by 2030.
- Barring a further and persistent 200 bp increase in BTP yields, we estimate that Italy's public debt-to-GDP ratio should either stabilise (if yields move up by an additional 100 bp) or, in our baseline scenario, decline further towards 140% by 2030. We stick to our expectations of a tightening of the 10-year Italian spread vs the Bund from 195 bp (on 11 May) towards 160 bp by year-end.
- Key to this spread-tightening view is also our expectation that the ECB will underdeliver on the rate path currently priced in by market participants, being constrained by both weaker growth and higher financial market volatility, while we expect euro area inflation to moderate slightly in H2. However, in the meantime, the 10-year BTP spread could continue to hover around 200 bp until the end of the summer, with market participants potentially testing ECB's resolve to use the flexibility embedded in PEPP reinvestments.
- As such, the ECB could well announce its readiness to use this flexibility at its upcoming meetings if periphery government bond spreads vs the Bund widen further. However, barring a sharp and broad-based increase in periphery spreads, we do not expect the ECB to announce a new stability QE facility. The bar is too high as the ECB focuses again on its primary mandate: fighting inflation.

Debt sustainability is back in focus

Since the beginning of 2022, euro area sovereign bond yields have been rising sharply as higher and more persistent inflation than anticipated led to expectations that the European Central Bank (ECB) would accelerate the pace of monetary policy tightening**.** Market participants now expect the ECB to bring the deposit rate back to positive territory this year (from -0.5% on 11 May), starting with a likely 25 bp hike in July, bringing the deposit rate up to around 1.6% in 2023 according to the EURIBOR futures curve. This market repricing has led both the 10-year German and Italian government bond yields to hit new year-to-date highs of 1.0% and 3.0%, respectively in early May.

Inflation well above target has put the ECB under pressure to 'normalise' its monetary policy stance, despite rapidly slowing growth. According to recent comments made by Governing Council members, a July rate hike looks all but certain unless another major shock hits the euro area in the meantime.

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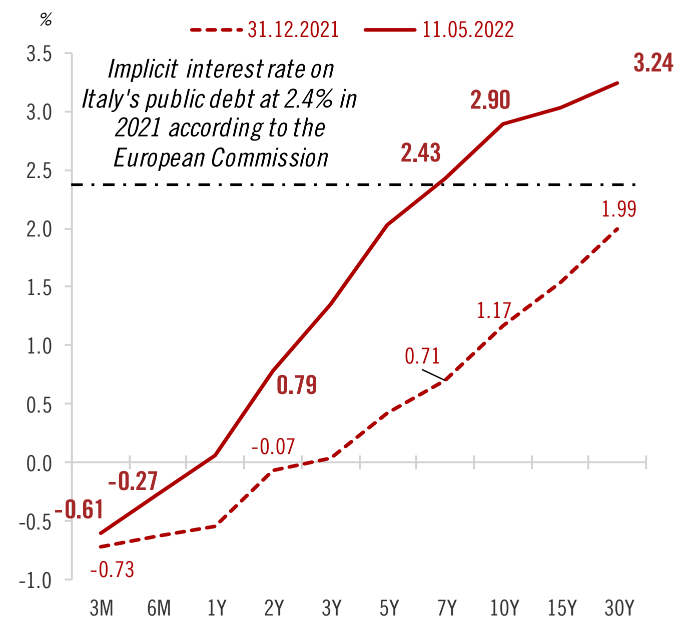
At the same time, ECB members are becoming more concerned that the window to hike rates beyond the summer will soon close if the economic slowdown deepens. For the ECB to keep hiking rates "gradually", which we understand as a quarterly pace once the deposit rate hits zero, a broad-based recession must be avoided.

The combination of market expectations for a faster and stronger ECB hiking cycle, the sharp slowdown in growth and the rise in sovereign bond yields has brought back into focus debt sustainability, particularly for Italy. The country is not only more exposed to the Russia-Ukraine crisis; rising political risk premia (general elections are scheduled for spring next year) and an elevated public debt to GDP ratio are additional worries.

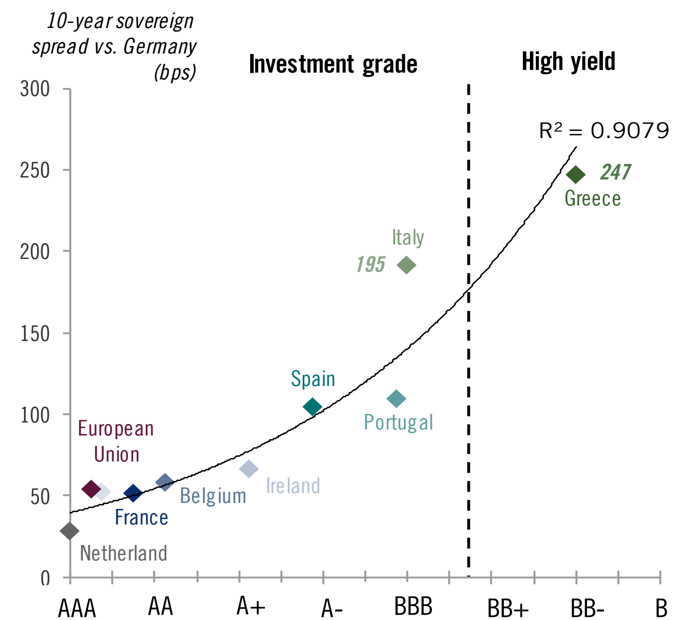
The good news is that most countries in the euro area have used the ultra-loose monetary policy environment over the past 10 years to increase the duration of their outstanding debt, making them less sensitive to temporarily rising rates and yields. The weighted average maturity of Italian debt is around seven years, so higher yields take time to change the cost of debt.

CHART 1: ITALIAN SOVEREIGN YIELD CURVE YEAR-TO-DATE EVOLUTION



Source: Pictet Wealth Management - AA&MR, Factset, 11.05.2022

CHART 2: EURO AREA SOVEREIGN RATINGS* AND 10-YEAR SPREADS



Source: Pictet Wealth Management - AA&MR; Bloomberg Finance L.P., 11.05.2022
* Average rating from S&P Global, Fitch Ratings, Moody's and DBRS Morningstar

The average cost of debt has also been declining since 2012 thanks to the ECB's buying programmes and extremely low rates. According to the European Commission (EC)'s calculations for Spain and Italy, it stood at 2.4% and 2.0%, respectively in 2021. Considering the sharp year-to-date upward movement in Italian sovereign bond (BTP) yields, we see that refinancing with bonds with maturities above seven years would lead to an increase in Italy's borrowing costs, whereas at the beginning of 2022, the 30-year Italian government bond (BTP) yield was trading below 2% (*see chart 1*).

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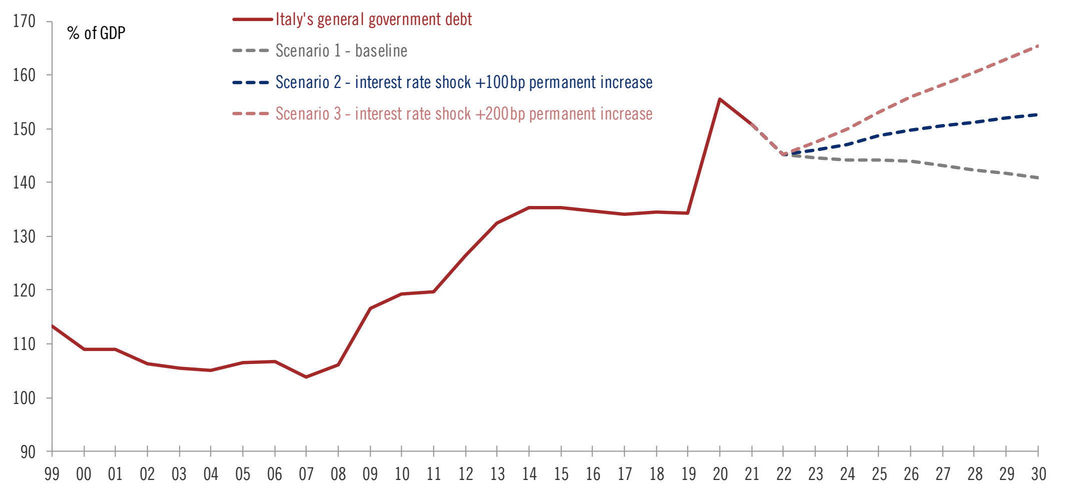
That said, a persistent shock has the potential to put the debt to GDP ratio on an increasing path by 2030 (see *chart 3*).

The bad news is that the current environment has led to more public spending to shield the impact of higher energy prices on consumers and firms. The growth outlook has deteriorated as well. Italy is particularly vulnerable owing to its higher exposure to Russian energy products and a higher share of industry in its economy. Higher headline inflation will lift nominal growth, but the key question is all about potential growth. Italy is currently receiving European Union (EU) money via the Next Generation EU. Hopes are that reforms and spending on key sectors will help boost potential growth. Ensuring that Italian economic growth rates substantially exceed pre-pandemic averages beyond the post-Covid bounce will be key to the sustainability of the Italy's public finances.

CHART 3: ITALY - DEBT TO GDP RATIO UNDER THREE DIFFERENT SCENARIOS



Source: PWM - AA&MR, European Commission, 11 May 2022

Market fragmentation is emerging again

Market participants' concerns regarding Italy's debt sustainability are probably one of the reasons for the higher risk premium on Italy's BTPs (the political risk being the other). Plotting the average euro area sovereign credit rating with their 10-year government bond spread vs the Bund, we see that there are two outliers: Italy and Portugal (*see chart 2*). In the case of the former, a tighter spread than suggested by the regression means that rating upgrades could be on the cards if Portugal's solid nominal GDP growth persists and enables it to rapidly decrease its debt-to-GDP ratio (which stood at 127% in 2021).

Regarding Italy, the approximately +50 bp spread difference with the level implied by the regression suggests that 10-year Italian bonds are trading at yield levels more consistent with a high-yield rating than an investment-grade (IG) one. This is consistent with the fact that, despite a very high public debt-to-GDP ratio for an IG rating, rating agencies

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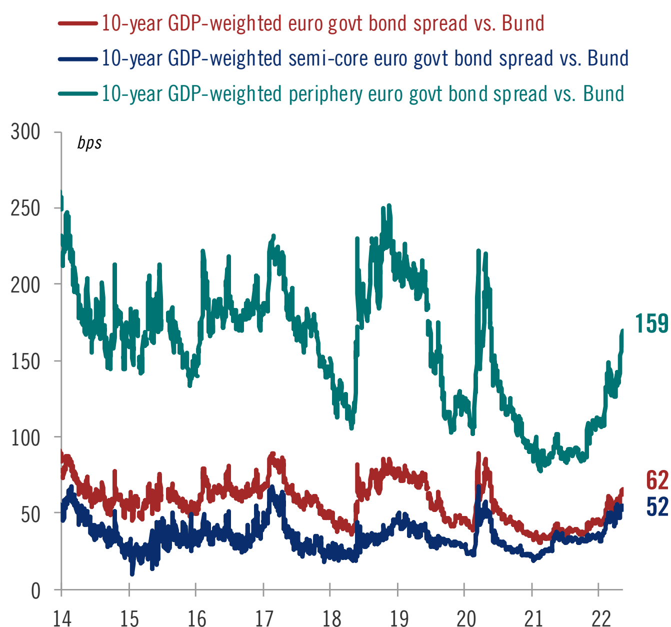
justify maintaining Italy in the IG camp partly because of its euro area membership (and the fiscal and monetary support that comes with it).

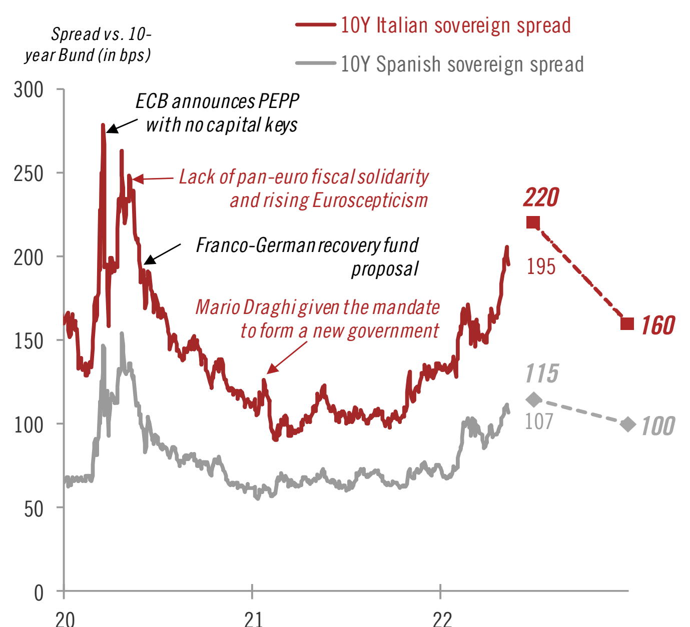
Along with the rise in euro area sovereign bond yields since the beginning of the year, 10-year spreads vs the Bund have also been widening, with the 10-year BTP spread standing at 195 bp and its Spanish counterpart at 107 bp (on 11 May, *see chart 5*). What is striking is how much wider the spread-widening has been for peripheral countries (Italy, Spain, Portugal and Greece) compared to the GDP-weighted average of all euro area government bonds and semi-core ones (France, Austria, Belgium, Ireland and Finland) (*see chart 4*).

CHART 4: 10-YEAR GDP-WEIGHTED EURO GOVERNMENT BOND SPREADS



Source: Pictet Wealth Management - AA&MR Factset, 11.05.2022

CHART 5: 10-YEAR ITALY AND SPAIN GOVERNMENT BOND SPREADS



Source: Pictet Wealth Management - AA&MR, Factset, 11.05.2022

This sharper reaction in periphery bond markets brings to the fore the risk of market fragmentation. However, at 159 bp the 10-year GDP-weighted periphery spread is still lower than the peak reached in 2020 and close to the average of 171 since 2014.

Although we believe that market fragmentation is not yet severe enough for the ECB to act upon it, the implicit assumption from markets has long been that the ECB would step in, one way or the other, if peripheral spreads widened to the point of impairing the transmission of monetary policy. ECB President Christine Lagarde has said repeatedly that the ECB stands ready to use the flexibility embedded in existing tools, including PEPP reinvestments, but also to design a new backstop facility to prevent spreads from becoming disconnected from macro and fiscal fundamentals. The question is whether the ECB will deliver on its promises and, if so, what their pain threshold is in terms of peripheral spreads.

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Constructive ambiguity for longer

Speculation over ECB interventions are not exactly new, but this time is different on all levels. Most crucially, inflation is well above target, which weakens the justification for asset purchases in general. At the same time, the euro area stands out as very vulnerable to global risks, including the war in Ukraine, the slowdown in China, or the rise in US bond yields. We have argued that this time, the case for a new QE facility should be made by the hawks – they know that the ECB will be in a position to go back to neutral if, and only if, peripheral bond spreads stop widening.

Yet there are many reasons to believe that the bar for ECB intervention is higher today than it was in the past, and that constructive ambiguity will likely prevail for now.

First, we don't believe that there is any agreement within the Governing Council in terms of the level of bond spreads that constitutes a threat to monetary policy transmission. The pain threshold depends on the drivers of the sell-off – as long as the move is predominantly driven by expectations of ECB rate hikes, higher BTP yields will be seen as a feature rather than a bug. Second, the average cost of debt has been declining for years, and it would take a sustained increase in bond yields to translate into a higher interest-rate burden weighing on long-term debt sustainability. Third, the moment the ECB becomes more explicit about a new tool, the market is likely to test it. The appetite for actual purchases, as opposed to verbal interventions, is likely to be very limited still.

In the meantime, the path of least resistance could see the ECB use the flexibility of QE reinvestments to mitigate widening of spreads. We estimate that PEPP reinvestments will amount to about EUR200bn over the next twelve months, with another EUR225bn in public bond redemptions coming from PSPP holdings. However, only a share of these amounts can be redirected towards the BTP market over time, even assuming that the flexibility embedded in the PEPP is transferred to the PSPP. In the event of a protracted sell-off, markets are likely to push for more.

Ideally, **a new stability QE facility would include the most efficient features from previous tools**, essentially building on the PEPP. It would have no ex ante limits in terms of volume. It would be flexible in terms of asset purchases relative to capital keys. And it would 'de-consolidate' bond holdings from other ECB bond portfolios (a crucial point to make any such programme credible given that some countries are close to 30% limits under the APP, and up to 15-20% under the PEPP). Last but not least, a new programme may include some degree of conditionality to mitigate the significant legal risks, possibly building on the existing coordination mechanisms designed with the EU Recovery and Resilience Facility. It would prove more complicated than that in practice, but another difference with previous episodes is that such mechanisms exist today.

Conclusion

Considering our view that, barring a further and persistent 200 bp increase in BTP yields, with the seven-year moving up from 2.4% (on 11 May) to 4.4%, Italy's public debt-to-GDP ratio should either stabilise (if yields move up by an additional 100 bp) or in our baseline scenario, decline further towards 140% by 2030, **we stick to our expectations of a**

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tightening of the 10-year Italian spread vs the Bund from 195 bp (on 11 May) towards 160 bp by year-end (*see chart 5 and* The end of negative euro bond yields (at least for now)).

Key to this spread tightening view is also our expectation that the ECB will underdeliver on the rate path currently priced in by market participants, being constrained by both weaker growth and higher financial market volatility, while we expect euro area inflation to moderate in H2 to fall back to ECB's 2% target in 2023. However, in the meantime, the **10-year BTP spread could continue to hover around 200 bp until the end of the summer, with market participants potentially testing ECB's resolve to use the flexibility embedded in PEPP reinvestments.**

As such, the ECB could well announce its readiness to use this flexibility at its upcoming meetings if periphery government bond spreads vs the Bund widen further. However, barring a sharp and broad-based increase in periphery spreads, we do not expect the ECB to announce a new stability QE facility. **The bar is too high as the ECB focuses again on its primary mandate: fighting inflation.**

Appendix

Debt ratio equations:

$$d_t = \frac{1+i}{1+g} * d_{t-1} - s_t$$

where d_t and d_{t-1} are the debt-to-GDP ratios in time periods t and t − 1, respectively; i and g are average cost of debt and growth rates (interest rate and nominal growth rate are often used as a proxy), respectively; and s is the primary budget balance as a percentage of GDP. The difference between the average cost of debt and the nominal growth rate (i - g) is key for the sustainability of public finances. If nominal growth exceeds the nominal cost of funding (i.e. if $g > i$), countries can run a primary deficit while keeping the debt ratio constant.

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