EURO AREA PERIPHERY - UPDATE

FISCAL AND MONETARY POLICIES REMAIN A TAILWIND

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SUMMARY

- Mario Draghi appointment as prime minister last February has brought some welcome stability to Italy and increased confidence in the country. We expect Draghi to remain in place until the end of his term in 2023, continuing to deliver on an unprecedented reform agenda in the meantime.
- The aim of Next Generation EU is to repair the damage done by the pandemic but also to make Europe greener, more digital and more resilient to future crises. By boosting potential growth, the fund represents a unique opportunity for countries to improve debt sustainability.
- The ECB's medium-term inflation outlook means it is unlikely to end its asset purchases in the foreseeable future, although they could slow significantly in 2022. We still expect the ECB's purchases of government bonds to exceed net issuance for the third year running in 2022, meaning that its share of government bonds outstanding should continue to increase.
- Given that the ECB is keen to maintain favourable financial conditions and the remoteness of rate hikes we expect euro periphery bond spreads over Bunds to remain relatively tight.
- In contrast with Bunds, peripheral bonds continue to offer positive yields. A winding down of the ECB's emergency bond purchases could soon be announced, sending euro area government bond yields slightly higher by year's end, thus underpinning our underweight stance on euro government bonds overall. However, we are relatively more constructive on periphery government bonds given higher yields and the potential for further spread tightening.

Fiscal support as a tailwind

Political uncertainty has frequently been a source of volatility in the Italian bond market. Yet the nomination of **Mario Draghi as Prime Minister (PM) last February has brought an air of stability and improved confidence in the country.** We expect Draghi to remain PM until the end of his term in 2023 and to continue to deliver on an unprecedented reform agenda before then. Especially hard hit by the pandemic, Italy has submitted an ambitious recovery plan to the European authorities, amounting to EUR191.5 bn (10.7% of 2019 GDP). Of this, Draghi's administration intends to dedicate EUR86 bn to climate objectives and a further EUR42 bn to the digital transition. Spain has submitted a smaller recovery plan, worth EUR69.5 bn, equivalent to 5.6% of GDP. Unlike Italy, Spain has not requested loans from the EU's Recovery and Resilience facility, the heart of the Next Generation EU (NGEU) scheme. (*see chart 1*).

The aim of NGEU is to repair the damage done by the pandemic but also to make Europe greener, more digital and more resilient to future crises. By boosting potential growth, the fund represents a unique opportunity for countries to improve debt sustainability. Countries have spent aggressively to deal with the impact of the pandemic, leading to sharp rises in public debt. Indeed, based on recent data published by the International Monetary Fund, Spain's general government debt-to-GDP ratio is expected to reach 118% this year, and Italy's 157% (*see chart 2*).

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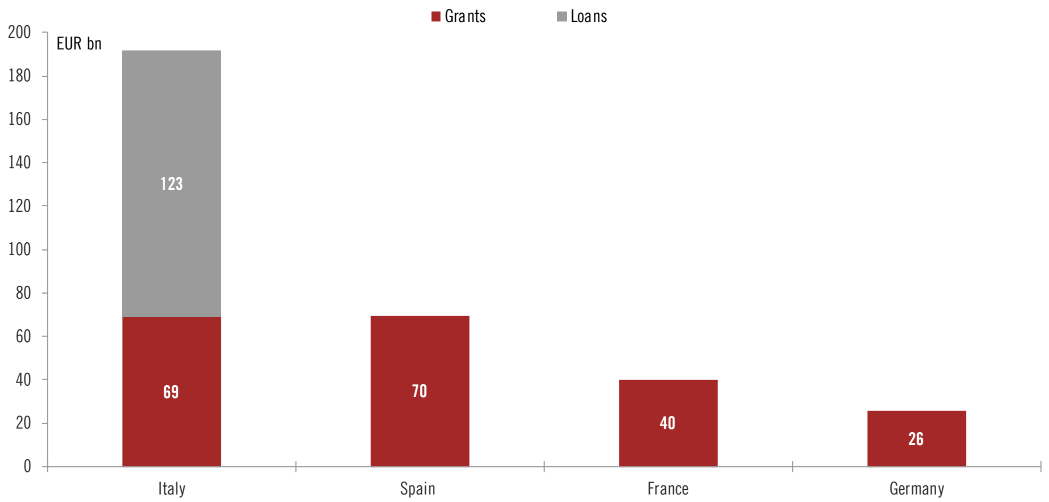
CHART 1: RECOVERY FUNDS REQUESTED OF THE EUROPEAN COMMISSION



Source: PWM - AA&MR, European Commission, August 2021

Unlike NGEU grants, NGEU loans are added to the recipient's debt burden (i.e. they increase the debt-to-GDP ratio). **Yet these loans make financial sense for peripheral countries since the EU is able to fund itself at a lower rate than these countries can individually.** On 20 September, the spread between 10-year EU bonds and the Bund was around 22 bps, which is lower than the equivalent spreads of most individual countries (*see chart 3*).

Arguably, **the creation of a permanent EU loan facility that enables euro area peripheral countries to access bond markets at the EU's lower cost of funding would help reduce their debt burdens** by decreasing their interest expenses. At this stage, discussions on this topic have not really started in earnest, but a successful implementation of the NGEU programme coupled with a potentially fiscally less conservative German government could plant the seeds for the creation of a permanent facility, making another step towards a form of EU debt mutualisation.

ECB as a major owner

As we have argued in a previous note written in June 2020 (see Policy activism in the euro area to make ballooning debt ratios manageable), although debt cancellation or any form of real debt monetisation is out of the question, **the likelihood that the ECB will prolong its quantitative easing (although not for ever) should effectively keep governments' debt burdens under control for years to come**. Indeed, the ECB's inflation outlook makes it unlikely it will pull the plug on asset purchases in the foreseeable future. In other words, based on the latest ECB 'staff projections, medium-term inflation will remain well below the target 2%, meaning the ECB's accommodative monetary stance is here to stay.

Nonetheless, the central bank will face important questions in the coming months, notably regarding how it switches buying from its pandemic emergency purchases programme (PEPP) to the conventional but less flexible asset purchase programme (APP).

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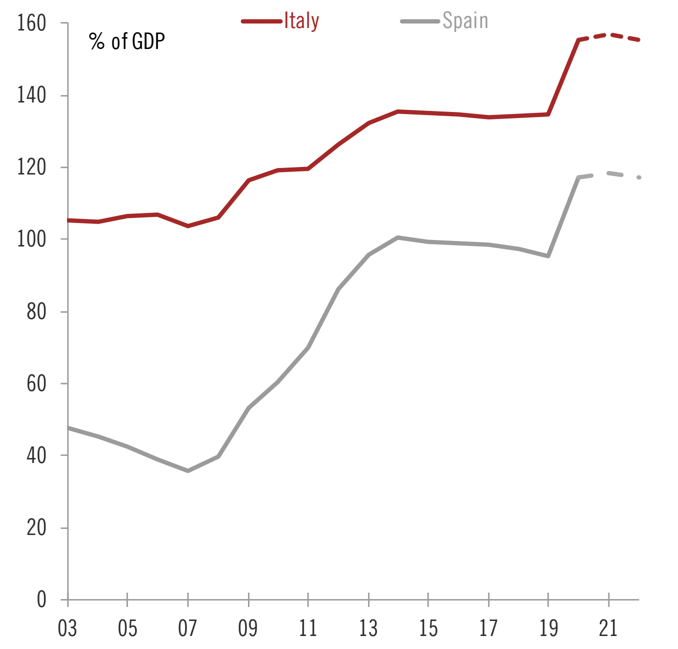
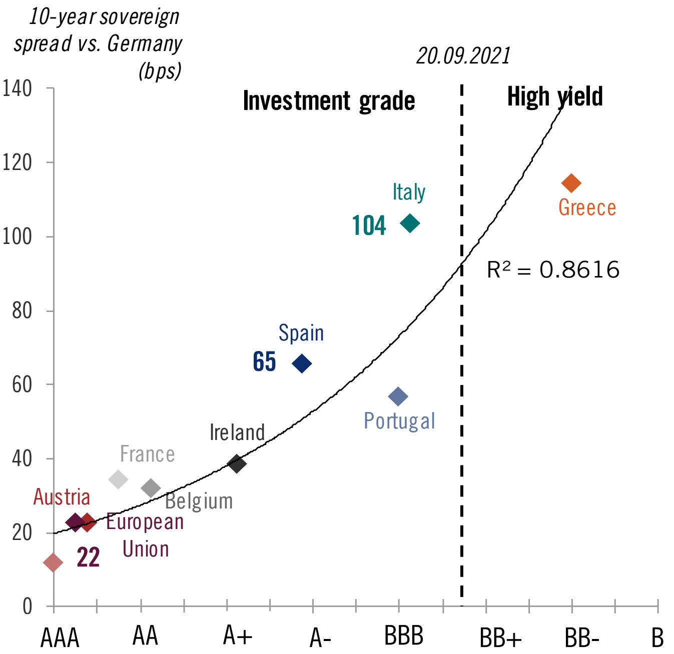
CHART 2: ITALY AND SPAIN'S PUBLIC DEBT



Source: PWM - AA&MR, IM, 2020F

CHART 3: 10-YEAR SOVEREIGN BOND SPREAD VS. CREDIT RATING



Source: PWM - AA&MR, Bloomberg, 20.09.2021

In December, we expect the ECB to announce an increase in the pace of its monthly APP purchases from EUR20 bn to EUR40 bn, starting in Q2 2022. We also expect the flexibility of the programme to be enhanced. The ECB's chief economist, Philip Lane, has been pushing a different approach. **This would see an annual envelope for asset purchases being set aside for the ECB Governing Council to employ in a flexible way, with the volume of purchases linked to increases in government bond supply**. The chance that this idea gains traction means that it will be important to monitor the 2022 budgets national governments have to submit to the European Commission. These submissions have to be made by mid-October

In all likelihood, the ECB's asset purchases will slow significantly in 2022, to around EUR500-600bn according to our projections, or about half the amount spent both in 2020 and 2021 (EUR1100 bn). But evidence suggests that the stock of QE matters more than the flow and **therefore the stock acquired by the ECB will continue to put persistent downward pressure on bond yields** (see Isabel Schnable, member of the ECB's executive board, speech here).

Unsurprisingly, a glance at total ECB holdings of euro government bonds from both programmes (APP and PEPP) shows **that the ECB's share of government bonds outstanding has been increasing sharply since the PEPP was launched in March last year**. The share of outstanding German government bonds the ECB holds (36%) is the largest among the four biggest euro area countries (*see chart 4*). The ECB's issue share (i.e. the ECB's share of the purchasable QE universe) stands even higher at 42%, but it holds only 28% of PSPP issuance (*see chart 5*). This means that the **ECB will likely need to communicate sooner rather than later about how flexible future its QE purchases** are likely to be relative to issuer limits or capital keys. The ECB is currently limited to

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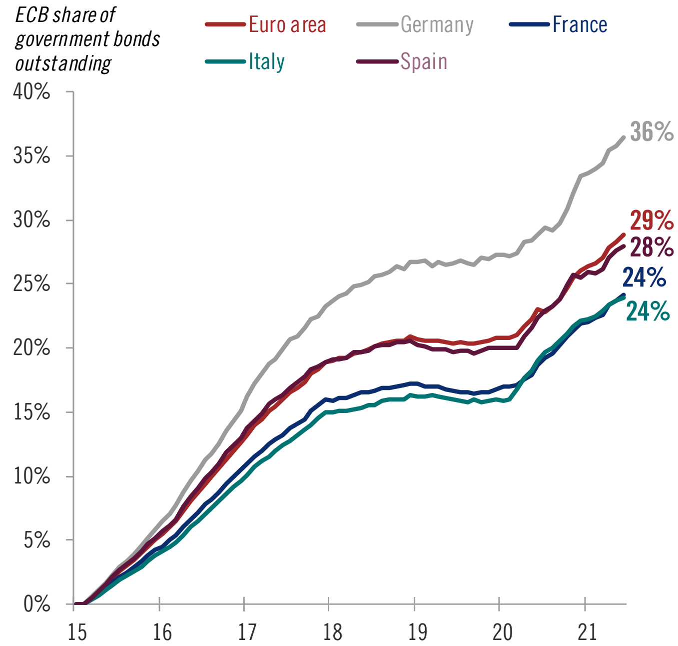
holding a maximum of 33% of a country's bond issuance and make purchases according to capital keys (which involves looking at each country's population and GDP).

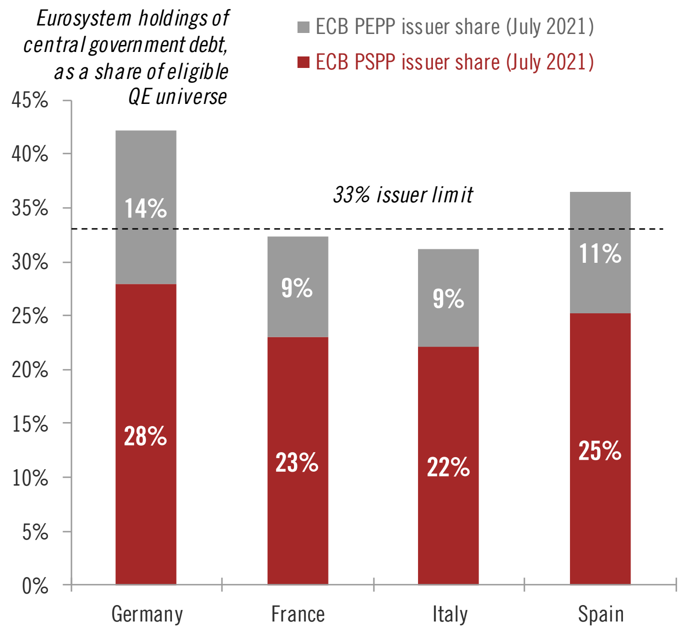
Italy's public debt-to-GDP ratio currently stands at 157% but falls to 133% if one excludes the ECB's holdings of Italian debt, while Spain's falls from 118% to a more bearable 90%. Although we expect the ECB to reduce the pace of QE significantly from March 2022 onwards, **its purchases are still likely to exceed the net issuance of government bonds for the third year in a row, meaning that its share of euro area government bonds outstanding should keep increasing**.

CHART 4: ECB'S SHARE OF GOVERNMENT BOND OUTSTANDING



Source: PWM - AA&MR, CIO Office, ECB, July 2021

CHART 5: ECB'S SHARE OF QE-ELIGIBLE GOVERNMENT BOND ISSUANCE



Source: PWM - AA&MR, CIO Office, ECB, Bloomberg, July 2021

On top of being a major owner and buyer of government bonds, the ECB's central role in the euro area bond market owes much to the attention it pays to financial conditions. While the ECB has avoided explicit yield curve control, **it remains alert to wide dispersions in government bond yields** and to sharp increases in yields caused by shifts in market expectations.

The ECB's focus on financial conditions and the remoteness of rate tightening lead us to expect yield dispersion within the euro area to remain low (i.e. sovereign bond spreads vs the Bund should remain relatively tight). Negative real yields and negative nominal yields (once adjusted for actual inflation) should maintain an environment of financial repression, which is detrimental to bond holders but beneficial to bond issuers. **Higher inflation should help euro area government debt sustainability as a whole**, as member states see their debt-to-GDP ratios reduced through higher nominal GDP.

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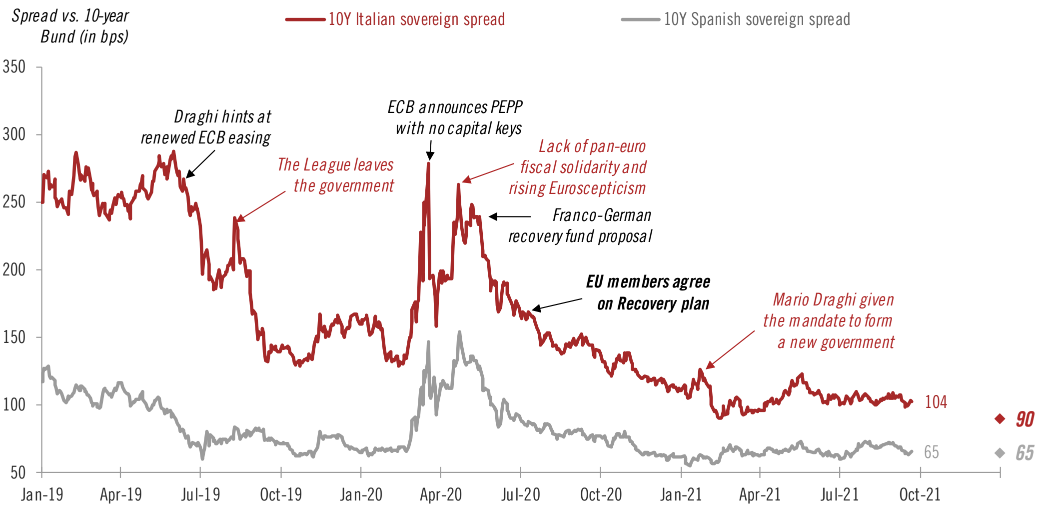
Conclusion

Unlike Bunds, 10-year Italian and Spanish bonds continue to offer positive yields. Having already fallen to multi-year lows, we expect spreads for Spanish and Italian paper over Bunds to remain low over the rest of the year (*see chart 6*). **We could see the 10-year Italian spread moving down from 104 bps on September 20 to 90 bps by year-end**, supported by reduced political uncertainty in Italy and the ECB's continued presence in the euro government bond market. As the ECB made clear earlier this month, even after it starts to taper its PEPP purchases, it stands to remain very dovish and is likely to be patient when it comes to raising rates as it tries to achieve its medium-term inflation target.

The winding down of PEPP purchases is likely to come in December and send bond yields slightly higher, underpinning our underweight stance on euro government bonds overall. However, **we are relatively more constructive on euro periphery government bonds than on core ones.** Indeed, higher yields together with tighter spreads could cushion the performance of peripheral bonds should our scenario of a rise in euro government bond yields materialise.

CHART 6: 10-YEAR EURO SOVEREIGN BOND SPREADS



Source: PWM - AA&MR, Bloomberg, 20.09.2021

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