PICTET WEALTH MANAGEMENT

Euro area periphery - Update

Resilient economies and bond markets

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FLASH NOTE

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SUMMARY

- The Italian and Spanish economies slowed in Q2, but, unlike most core euro area countries, their overall performance over the first half of the year was positive. Both benefitted from pent-up demand from the pandemic (especially tourism) and from fiscal support.
- Looking ahead, we expect positive, albeit slowing, growth in H2 in Italy and Spain. Robust wage growth, slowing inflation and a resilient labour market will support household consumption, but tighter monetary policy will weigh on investment. The Next Generation EU fund (NGEU) will continue to support economic activity in peripheral euro area countries, even if implementation challenges have become apparent (especially in Italy).
- In line with economic resilience, Italian and Spanish sovereign bond markets have outperformed their core euro area peers year-to-date. We expect 10-year Italian and Spanish sovereign bond yields to stay broadly stable at their current levels until year's end, with only some slight spread widening against the Bund.
- The attractive carry they offer to investors and our expectation that economic growth will remain relatively resilient, along with limited risks of expansive fiscal policies, explain our more constructive view on periphery sovereign bonds than before. Moreover, while quantitative tightening is accelerating in H2, the likelihood that the ECB is near the end of its hiking cycle could limit the upward pressure on euro sovereign bond yields in our view.

TOURISM BOOM SUPPORTED GROWTH IN H1

Peripheral countries started the year on a strong footing, thanks to pent-up demand from the pandemic, a solid labour market and fiscal support. While the Italian and Spanish economies slowed in Q2, their overall performance over the first half of the year was positive (see *chart 1*).

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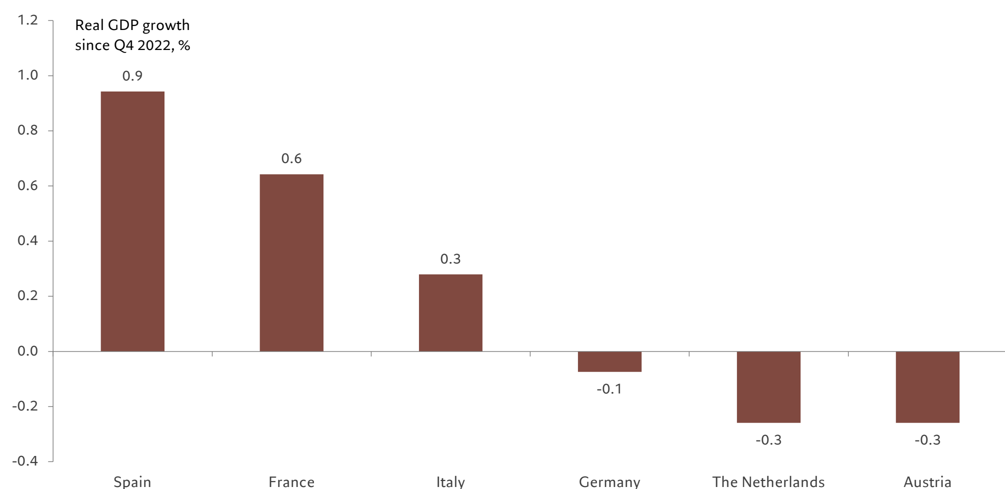
In Italy, GDP surprised to the downside by contracting 0.3% q-o-q in Q2 after jumping by 0.6% in Q1. The full GDP breakdown is not available yet but based on preliminary information from the national statistical office, the boom in tourism was not enough to compensate for weakness in manufacturing and agriculture. In Spain, thanks to resilient domestic demand, GDP grew by 0.4% q-o-q (slightly down from 0.5% in Q1). In particular, private consumption grew 1.6% on the quarter in Q2, partly reversing the negative figures for Q4 22 and Q1 23. This was likely driven by normalisation of energy prices and a rise in demand for travel services. Investment also expanded (4.6% q-o-q) especially in the construction sector, where q-o-q growth rose a sharp 7.3%, led by non-residential construction.

Looking ahead, we expect positive albeit slowing growth in H2 in Italy and Spain. Robust wage growth, slowing inflation and a resilient labour market will support household consumption, but tighter monetary policy will weigh on investment. Budgetary measures could become less supportive should EU fiscal rules be reinstated next year. The Italian government remains committed to keeping the public deficit and debt on a (slowly) declining trend.

Funds from the Next generation EU fund (NGEU) programme will continue to support economic activity in peripheral countries even if implementation challenges have become more apparent in Italy, its largest beneficiary. In Spain, so far implementation of its recovery plan has been relatively more successful than in other member states. In early June, the Spanish government provided an update of its progress to the European Commission, and asked for an expansion of NGEU funds (EUR91bn, of which EUR84bn are loans in addition of the EUR69.5bn in grants from the first recovery plan). The country is expected to receive the EU Commission's assessment in the coming weeks. We believe political uncertainty since the inconclusive general election in July will have only a limited impact on the recovery plan to which both the main parties are committed.

Chart 1: euro area real GDP growth in H1



Source: Pictet Wealth Management, Eurostat, as of 10 August 2023

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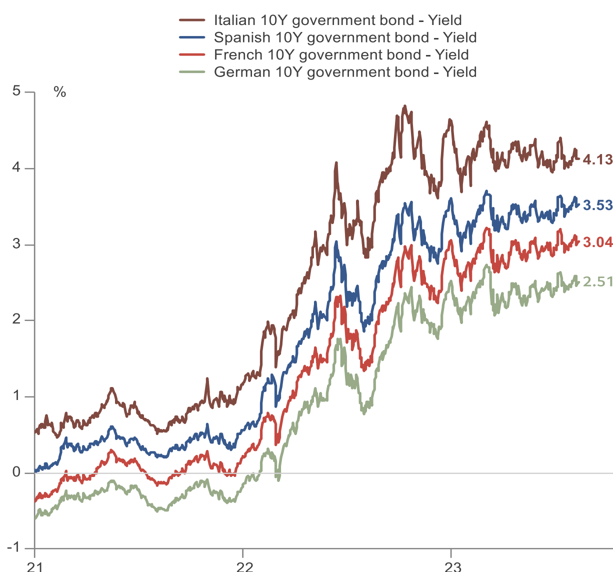
RESILIENCE REFLECTED IN THE BOND MARKET

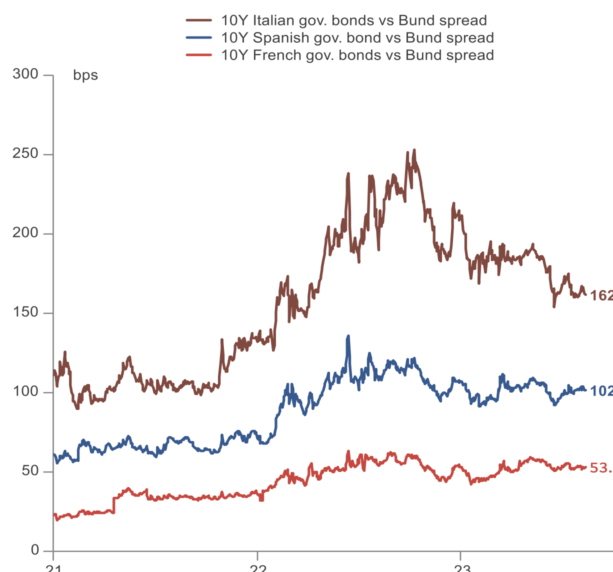
In line with economic resilience, Italian and Spanish sovereign bond markets have outperformed their peers in core countries. As of 10 August, the year-to-date performance of 10-year Italian and Spanish sovereign bonds was positive (at 6.7% and 2.3%, respectively, in euros) in stark contrast with the negative 2.3% posted by their German counterparts. Their outperformance is due both to tighter spreads versus the Bund (-48 bps in the case of Italy, to 162 bps) and more attractive carry thanks to higher yields (*see charts 2 & 3*).

Chart 2: Euro 10-year sovereign bond yields



Source: Pictet Wealth Management, FactSet, as of 10.08.2023

Chart 3: Euro 10-year sovereign bond spreads



Source: Pictet Wealth Management, FactSet, as of 10.08.2023

Despite wider Italian sovereign bond spreads around the time of the 2022 Italian general election, better-than-expected economic growth in Italy along with relative government fiscal conservatism has assuaged somewhat market participants' concerns about Italy's public debt dynamics. This could come as a surprise given the ECB's aggressive rate-hiking cycle since last year. Indeed, policy rate increases have contributed to pushing the 10-year Italian government bond (BTP) yield above 4% (from below 1% in late 2021), increasing the government's interest payment burden. In 2022, interest payments reached EUR83.2 bn (4.4% of GDP), an amount only slightly below levels that Italy was paying during the 2012 euro sovereign debt crisis.

Nevertheless, strong nominal GDP growth (in part thanks to elevated inflation) has pushed down Italy's public debt-to-GDP ratio from its 2020 peak, even if, at 134% (and 113% in Spain), it remains above the 2019 level.

On top of elevated nominal GDP growth, the ECB's 'transmission protection instrument' (TPI) has probably helped the periphery's debt situation. Unveiled in July 2022 as the ECB embarked on monetary policy tightening, the aim of the TPI is to "support the effective transmission of monetary policy" by countering

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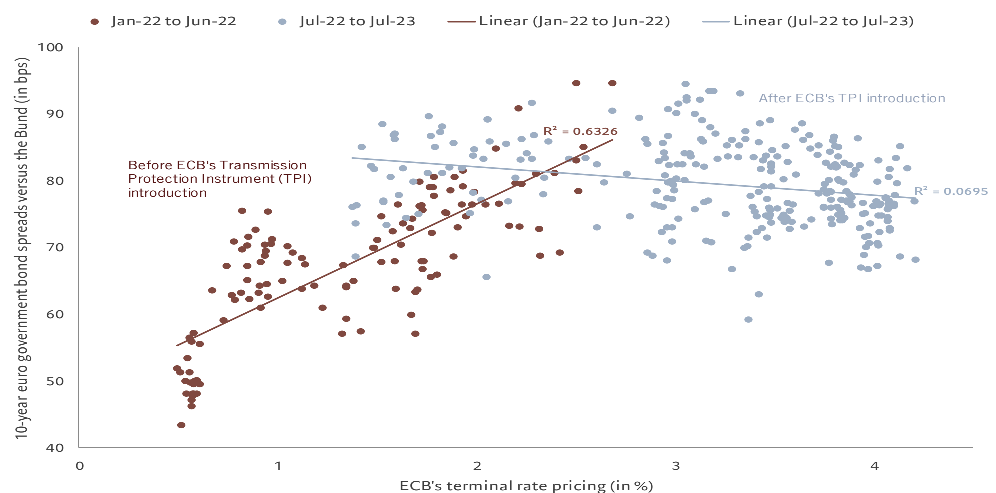
"unwarranted, disorderly market dynamics". In plain English, this means the ECB can buy government bonds experiencing "excessive" spread widening as long as the government issuer pursues "sound and sustainable fiscal and macroeconomic policies".

The TPI seems to have insulated euro area sovereign bond spreads movements somewhat from the rise in the market's terminal rate expectations (*see chart 4*). The lack of periphery bond spread widening this year is all the more remarkable when one remembers that the ECB has been reducing its balance sheet through passive quantitative tightening (QT) since the start of March. Since July it has not been reinvesting any of the proceeds from maturing bonds it has bought through its asset purchase programme (APP) since 2015. Even if the ECB continues to reinvest proceeds from its pandemic emergency purchase programme portfolio, the winding down of the APP is still going to reduce the ECB's holdings of euro sovereign bonds by about EUR25 bn a month in H2 this year.

Nevertheless, despite still elevated deficits and debt-to-GDP ratios, as well as higher yields and the ECB's reduced presence, euro periphery sovereign bond markets have been exceptionally resilient. Consequently, the ECB has seen no need to actually activate the TPI, its existence seeming to be powerful enough to ensure that peripheral sovereign spread movements versus German Bunds remain orderly.

Chart 4: 10-year euro government bond spreads relation to the ECB's terminal rate expected by market participants



Source: Pictet Wealth Management, Bloomberg Finance, L.P., FactSet, as of 07.08.2023

WHO ARE THE NEW MARGINAL BUYERS?

In a new regime where developed-market central banks are no longer the marginal buyer of sovereign bonds, who has taken their place? Whereas in the US the answer is straightforward (US households), it is more complex in the euro area. On aggregate, both foreigners and domestic buyers seem to have made up for the ECB's reduced footprint.

However, this observation needs to be qualified when it comes to the four biggest euro area economies individually (Germany, France, Italy and Spain). Foreigners

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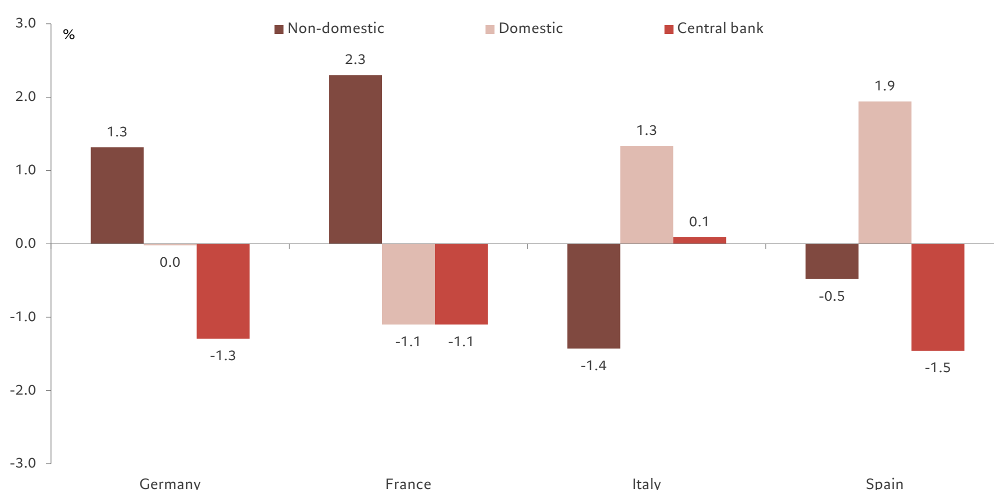
seem to have increased their holdings of German and French debt between the end of the ECB's bond buying on 1 July 2022 and 31 March 2023, whereas domestic bondholders followed the ECB by disinvesting (*see chart 5*). By contrast, in Italy and Spain, domestic buyers increased their holdings over the same period, while foreigners reduced them. This is especially visible in Italy, where the victory of a governing coalition featuring elements of the far right in last year's general election probably scared foreign investors away. At 31 March, foreigners held only 26% of outstanding Italian sovereign bonds, down from 32% at the end of 2019.

Part of the divergence in the behaviour of domestic bondholders between core and peripheral euro area countries can probably be explained by the absolute level of yields and the deposit betas of banks (i.e. the extent to which banks transmit a rise in the ECB's deposit rate to the rate they offer on their own deposit accounts).

In Italy and Spain 10-year sovereign bond yields stand at 4.1% and 3.5%, respectively, higher than in France and Germany (3.0% and 2.5%, respectively, on 10 August). This means that the yield pick-up households and corporate treasurers can get by investing excess cash in their domestic bond market is much higher in the periphery. This is even more true as the deposit beta of banks in the periphery has been lower than in core countries.

Chart 5: Change (estimated) in sovereign bond holdership share (Q2 22 to Q1 23)



Source: Pictet Wealth Management, National treasuries, National central banks and ECB

We would expect 10-year Italian and Spanish sovereign bond spreads against the Bund to widen only slightly at year's end (to 175 bps and 110 bps respectively), from their current level of 162 bps and 102 bps (on 10 August). Attractive carry, and relatively resilient economic growth, along with limited risks of budgetary expansion (particularly in Spain, given political stalemate) are all factors that explain why we are more constructive on peripheral euro area bonds than before. This environment could continue to make euro periphery sovereign bonds resilient to restrictive monetary policy. Moreover, even if QT is accelerating, the likelihood that the ECB is near the end of its hiking cycle (we expect the deposit rate to reach a terminal rate of 4% in September) could limit upward pressure on euro sovereign bond yields, in our view. For this reason, we expect 10-year Italian and Spanish sovereign bond yields to stay broadly stable until year's end, thereby continuing to offer an attractive carry.

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