MyStratWeekly
Market views and strategy

Ostrum
ASSET MANAGEMENT

N° 066 // **April 20, 2022**

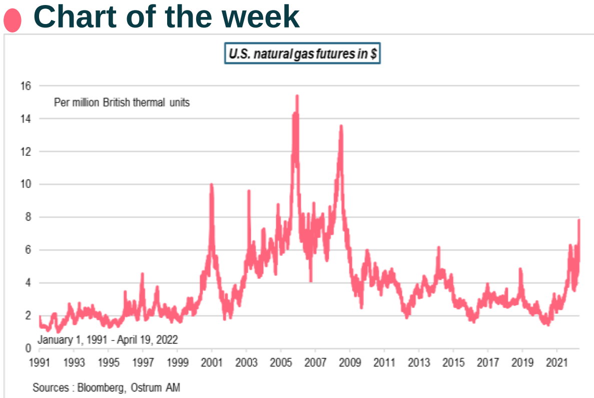
Topic of the week: France, under the volcano

- **Despite the continued deterioration of the debt, the situation is not really alarming at the moment. Lower interest rates have significantly reduced debt service, so sustainability is not an issue;**
- **This conclusion holds, however, if and only if the significant deficit inherited from the Covid period is reduced to a more reasonable level and rates remain low;**
- **A victory by the extreme right could challenge this precarious balance and put France's debt on a very worrying trajectory:**
- **The market seems very complacent regarding that risk.**

Market review: ECB: flexibility, optionality, gradualism… until June?

- **Lagarde defends a cautious approach, the euro stalls;**
- **Extreme volatility on bonds and steepening of curves;**
- **Swap spreads still under pressure;**
- **The Nasdaq (-6% in April) did not resist the rise of the T-note.**

Chart of the week



The price of natural gas in the United States exceeded the $8 mark during the session to reach a 13-year high. The supply is struggling to adapt to the sharp increase in demand after the Covid-19 crisis.

This is also amplified by the sharp increase in liquefied natural gas exports to Europe in order to reduce its dependence on Russian gas.

Inventories are thus 18% lower than normal while a drop in temperatures is expected at the end of the month.

Figure of the week

101

Source : Ostrum AM

For the 1st time since March 2020, the DXY dollar index rose above 101 on expectations of an aggressive Federal Reserve rate hike against other central banks.

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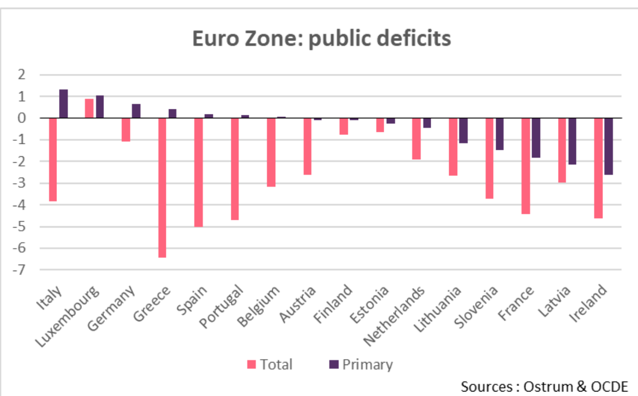
● **Topic of the week**

France, under the volcano

Despite the very strong rise in public debt over the past two decades, the sustainability of French debt is not really a cause for concern. Under the assumption that the massive 2021 deficit, largely due to the Covid crisis, the debt level will stabilize. But this owes a lot to the level of rates that allows to support a high level of debt without the cost exploding. If the market got scared after the presidential elections and the rates went up, all of this would become much more complicated.

A chronic deficit

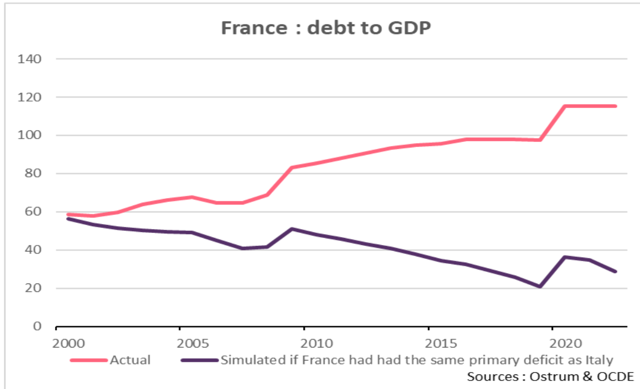
France is not a model of budgetary orthodoxy. According to the OECD's latest Outlook, France's average deficit since 2004 has been 4.4% of GDP. This figure places France in 12th position among the 16 countries of the Eurozone on the chart below.



It should be added that during this period France's debt to GDP was lower than the Eurozone average, albeit by a small amount, until 2014 and that it benefited from relatively low interest rates compared to the Eurozone average. As a result, debt service remained limited and well below average. In other words, the primary deficit (i.e. the deficit before debt service) places France on an even more worrying level. The primary deficit averaged 1.9% over the period, ranking France 14th. We are only beaten by Latvia and Ireland.

To illustrate the point, we did a simulation of the French debt trajectory if France had had Italy's primary balance over the entire period.

Using the latest OECD outlook, France's GDP debt was 115.1% in 2021. According to our calculations, if France had led the Italian policy, and all other things being equal, its debt on GDP would have fallen to 34.7%. The bad boy in terms of fiscal policy is not always the one we think.



As long as rates stay low

Despite the continued deterioration of the debt, the situation is not really alarming at the moment. And this is above all because the increase in the debt has been accompanied by a fall in rates. The debt-to-GDP ratio is therefore less worrying than it would have been a decade or two ago.

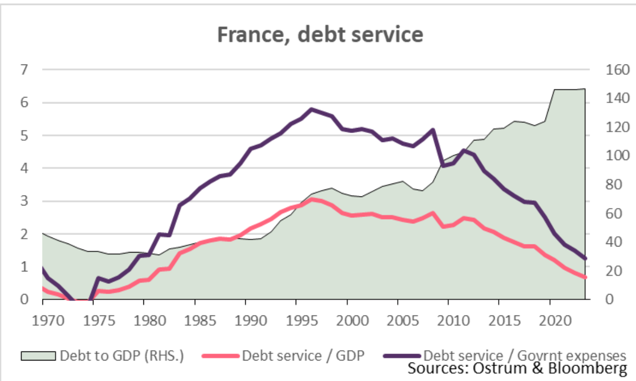
It should be noted that the debt-to-GDP ratio is a heresy. We divide a stock (the debt) by a flow (the GDP) which is totally inappropriate from a methodological point of view. But come on, nobody cares.

The important point is that debt servicing, and therefore long-term sustainability, is also affected by the level of rates. Again, using the OECD figures, we have seen a steady decline in debt service since 2010, when it was $50.4 billion, whereas it was only $26.1 billion in 2021. The decline in interest rates thus dominated the effect of the increase in debt.
According to our calculations, this burden is expected to fall again this year by one or two billion, despite the recent increase in rates. Indeed, the new debt will be issued at rates that remain historically low while the debt reaching maturity will be reissued at rates much lower than the coupons it paid.

A few calculations, reproduced in the graph below, show that the share of debt servicing collapsed, accounting for 5.7% of State expenditure (and 3.1% of GDP) in 1995 and currently only 1.6% of State expenditure (and 0.7% of GDP).
There are several consequences to this:

- on the one hand this shows that the approach in terms of debt to GDP is very inadequate and even misleading;

- on the other hand, the situation in terms of debt sustainability is not worrying at this level, since the burden of debt has paradoxically improved;
- finally, and perhaps most importantly, this reasoning only holds up as long as rates fall. A change in trend would be very difficult to absorb.



Admittedly, budgetary ambition remains very deficient. But, thanks to lower rates, the sustainability of public debt is not open to doubt.

Two conditions

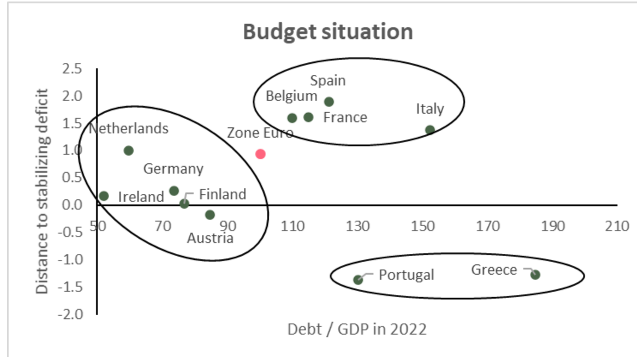
The debt trajectory, and therefore French fiscal sustainability, is not really worrying, under two assumptions.

First hypothesis: the deficit is reduced to a reasonable level. The OECD forecasts show a deficit of 8.0% in 2021 but falling to 3.8% in 2023, which is a much more reasonable number but implies a rigorous budgetary consolidation by then.

So far we're nowhere near that. Again on the basis of the OECD figures, we calculate the "stabilizing deficit" (in economist's jargon this is the deficit needed to keep the debt-to-GDP ratio constant) for 11 countries in the Eurozone. France is part of a group that includes Belgium, Spain and Italy, with a debt of more than 100% but above all a deficit 1.5 ppt higher than the stabilizing deficit. This means that the debt to GDP is still on a very clearly upward trajectory.

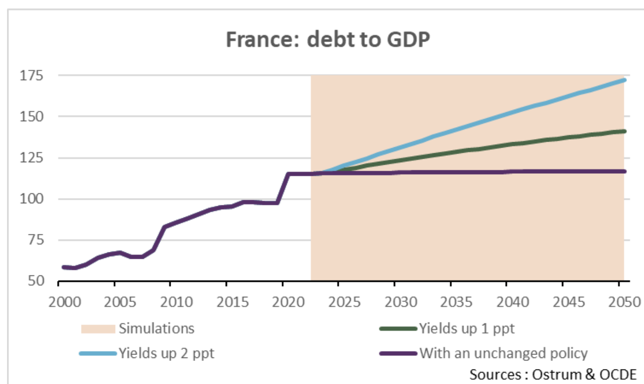
Fiscal consolidation is inevitable to return to a long-term sustainable deficit.

It is also appropriate to examine the rating of the agencies when reading this graph. France has an AA rating for S&P while Spain is A and Italy BBB. This difference is not an obvious one to justify if we simply look at the budget figures. This note, however, helps to maintain favourable borrowing conditions for France.



Second hypothesis: rates that remain moderate. The other side of the coin is that when the debt level is high, the future trajectory of that same debt is very much dependent on the level of rates. If rates rise, debt service reacts in proportion to the debt stock, thus adding to the deficit. More deficit is a debt that grows faster … and thus a deficit that grows even deeper. An exponential path from which it is difficult to get out.

The next graph shows a simulation we did. For 2022 and 2023, we take the OECD projections, and then we assume an unchanged fiscal policy. With a primary deficit of 3.8% (the OECD figure for 2023), the debt is broadly stabilized.

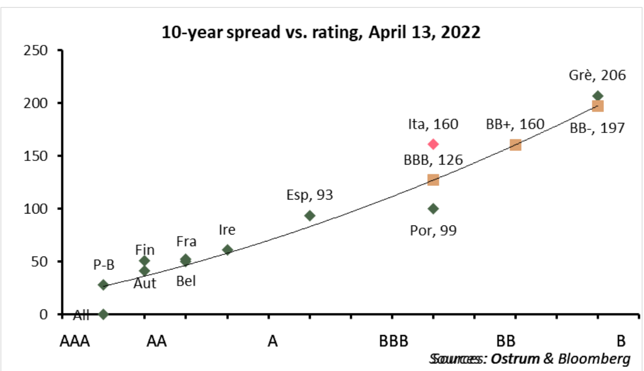


An increase in the level of rates of 1 ppt, which is not excessive, would put the debt on a trajectory that would rise again quite clearly. It should be noted, however, that in the simulation below, we assume that the cost of debt is increasing by 1 ppt, and a large part of this debt will only be renewed gradually, and therefore the impact would be more diffuse. The fact remains that the trajectory is becoming worrisome.

In short, France's fiscal situation can quickly turn into a very complicated situation if the government does not implement fiscal consolidation after the elections. The RN's election platform, with a package of measures that, if implemented, would lead to a much larger deficit, is therefore a source of risk that must not be overlooked. In this case, the risk of a loss of market confidence, and thus of significantly higher rates, is also very likely. Finally, in the case of a victory of the extreme right it will also be necessary to make the hypothesis that the will of European solidarity will be reduced to the maximum and that the mechanisms of stabilization would not be used. Again, it's a safety net that would disappear.

A very complacent market

Right now the markets don't seem to take the risk very seriously. Admittedly, the French spreads have diverged, but in a general movement to increase the risk premium. The graph below shows that the French spreads are at a level that is completely in line with the current score. So there is no idiosyncratic risk included. There is no risk premium for French elections.



It is also interesting to note that, if the French spread has deviated, the probability of a Frexit has not moved at all while the probability of an RN government is increasing. We look at the difference between two CDS (Credit Default Swap, contracts that insure the investor against the risk of default of an issuer). There are two types of sovereign CDS, the "D03" and "D14", the second provides a broader assurance with in particular a trigger for risk of redenomination, and therefore exit from the Euro. The difference between the two CDSs can therefore be seen as a measure of the risk of exit from the Euro seen by the markets.

However, the difference between the two has hardly changed (cf. the Bloomberg chart below) despite the increase in the RN in the polls. The nonsense of the Frexit is forgotten, the market no longer believes in it at all.

Conclusion

Economists talk about "multiple balances", as is the case for the French debt. While market confidence remains, rates remain low and the sustainability of French debt is not really at risk. Market confidence is therefore justified. If markets, on the other hand, lose confidence, rates rise, and the long-term sustainability of debt is more than precarious. Then the markets are right to be afraid.

So it's very volatile, and it's not impossible to move from one "balance" to the other. It's all about trust. In this context, the position of the market, which seems to care about elections as if it were a bad thing, seems to us to be far too complacent. The risk is not only that of a risk premium which is rising sharply but also of a very complicated budgetary situation.

Stéphane Déo

Market review

ECB: flexibility, optionality, gradualism… until June?

Despite high inflation, the ECB insists on the necessary flexibility of its policy.

T-notes and Bunds are experiencing considerable volatility with a weekly amplitude of rate variations close to 20 bp. High volatility is symptomatic of the uncertainty surrounding the extent of monetary tightening now required to anchor inflation at central bank targets. In the United States, Fed members have, for several weeks now, hinted at the start of quantitative tightening and a 50 bp rate hike in May. US inflation stood at 8.5% in March. The strength of the dollar helped reduce upward pressure on the prices of imported consumer goods, so that the underlying index slowed to 0.3%m. Retail sales remained solid in March (+17.7% at an annualized rate in 1Q 22) but the rise in gasoline is forcing decisions to cut back some spending, especially as the level of goods consumption is still abnormally high. Upbeat activity surveys (Empire at +24 in April) and the rebound in household confidence nevertheless bode well for US growth going forward.

In the euro area, inflation is a concern at 7.5% in March and would undoubtedly require a truly restrictive monetary policy. However, the ECB is facing increased risks of an economic downturn due to the war in Ukraine. Household and business confidence has fallen. Bank lending surveys point to a tightening of credit conditions in the first quarter, which should lead to a slowdown in credit growth. The April 14 press conference was an opportunity for Christine Lagarde to recall that flexibility, gradualism and optionality will continue to shape the ECB's asset purchase programs. The APP will be reduced from €40 billion in April to €20 billion in June, but an extension into the third quarter is possible. Tapping the remaining envelope of the PEPP (approximately €150 billion) is also a possibility under certain conditions. The first rate hike will come after the end of QE, without further indication. In addition, the ECB's communication seemingly ignores the weakness in the euro exchange rate. The single currency plunged below $1.08 during Christine Lagarde's speech. However, there were rumors of a consensus within the Governing council for a rate hike as early as July. The jury is still out on this matter. In June, the ECB will likely lower its growth projection and raise expected inflation. The markets will scrutinize the decimal point of the inflation projection for 2024 which could open the door to a rate hike. The risk of a recession is already palpable in Germany. Christine Lagarde also refuted speculation about a new market stabilization program… while emphasizing that the ECB could intervene quickly (see SMP, PEPP). As for the political risk in France, a market intervention seems inconceivable.

Fixed income markets remain extremely volatile. The short investor positioning ahead of the March CPI release was unwound later last week. The T-note yield hence initially rose to 2.84% before dipping back below 2.70% before closing the week at 2.82%. This latest movement reflects the reduction in risky positions before the long Easter break. The steepening of the yield curve is brutal. The 2-10 year spread (+34 bp) was up +19 bp over one week. A 50bp rise now looks set in May but the upcoming quantitative tightening is starting to reverse the flattening pressure that has prevailed so far. The T-note may quickly test the 3% threshold. Mortgage rates have crossed the 5% threshold at 30 years, which will cause a slowdown in residential investment. As regards the euro bond markets, the Bund followed on from the rise in the T-note yields. UST-Bund spread resistance around 200bp fostered Bund selling flows. The German 10-year bond did not benefit from the slight decline in short rate expectations after the ECB's communication (-3 bp on Schatz). Curve steepening (79 bp on the 2-10 year spread) has therefore resumed in the euro area as inflation expectations increased further. The 10-year break-even inflation rate is still around 2.90%. The German 30-year yield is now trading above 1%. French 10-year spreads stabilized around 50bp ahead of the second round of presidential elections. The Italian BTP hovers around 165 bp. However, this lull in sovereign spreads has no effect on the level of swap spreads, which remain fragile. The 10-year swap spread indeed rose to around 75 bps.

The credit market is under pressure. The IG spread in the euro area (134bp against Bund) is up 5bp so far in April. Competition from higher sovereign yields and the expected cyclical downturn in the euro area imply a risk of further widening of spreads. Support from the CSPP (€1.8bn in the first week of April) and contained net issuance limit the expected rise in spreads to 4bp over the one-month horizon. The high yield market is experiencing a resurgence of risk aversion. Spreads were up 17bp over one week at 410bp against Bund. The absence of new speculative-grade bond issues for six weeks is a sign of difficult market conditions for corporate issuers. Redemptions on high-yield funds are accumulating as protection buying on CDS indices (XO at 375 bp) emerge.

Equity markets are having a rough start in the second quarter. The Nasdaq is down 6% in April, the European indices fell by around 1%. Fund inflows in the United States are insufficient to compensate for the discount in valuations due to the rise in rates, in particular on growth stocks. Earnings releases from US banks are far from stellar. The earnings season is also marked by early profit warnings in Europe.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	19-Apr-22	1wk (bp)	1m (bp)	2022 (bp)
EUR Bunds 2y	0.07%	-1	+41	+69
EUR Bunds 10y	0.93%	+14	+55	+110
EUR Bunds 2s10s	85.1bp	+14	+15	+42
USD Treasuries 2y	2.47%	+6	+53	+174
USD Treasuries 10y	2.88%	+16	+73	+137
USD Treasuries 2s10s	40.7bp	+10	+20	-37
GBP Gilt 10y	1.97%	+17	+48	+100
JPY JGB 10y	0.25%	+0	+1	+4
€ Sovereign Spreads (10y)	**19-Apr-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
France	46.63bp	-4	+3	+9
Italy	160.92bp	-1	+12	+26
Spain	91.41bp	-1	+2	+17
Inflation Break-evens (10y)	**19-Apr-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR 10y Inflation Swap	3.05%	+5	+47	+96
USD 10y Inflation Swap	3.13%	+5	+5	+36
GBP 10y Inflation Swap	4.55%	-3	-5	+37
EUR Credit Indices	**19-Apr-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR Corporate Credit OAS	134bp	+2	-18	+39
EUR Agencies OAS	63bp	-2	-2	+14
EUR Securitized - Covered OAS	74bp	+2	+1	+28
EUR Pan-European High Yield OAS	410bp	+17	-43	+92
EUR/USD CDS Indices 5y	**19-Apr-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
iTraxx IG	80bp	+2	+2	+33
iTraxx Crossover	383bp	+10	+11	+141
CDX IG	74bp	+3	+2	+25
CDX High Yield	412bp	+8	+45	+119
Emerging Markets	**19-Apr-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
JPM EMBI Global Div. Spread	404bp	-1	-55	+36
Currencies	**19-Apr-22**	**1wk (%)**	**1m (%)**	**2022 (%)**
EUR/USD	$1.079	-0.314	-2.015	-5.1
GBP/USD	$1.302	0.108	-1.169	-3.8
USD/JPY	JPY 128	-2.245	-6.853	-10.3
Commodity Futures	**19-Apr-22**	**-1wk ($)**	**-1m ($)**	**2022 (%)**
Crude Brent	$111.8	$13.3	$6.7	46.34
Gold	$1 979.2	$12.4	$43.3	8.20
Equity Market Indices	**19-Apr-22**	**-1wk (%)**	**-1m (%)**	**2022 (%)**
S&P 500	4 392	-2.15	-1.60	-7.9
EuroStoxx 50	3 808	-1.30	1.88	-11.4
CAC 40	6 514	-0.53	2.49	-8.9
Nikkei 225	26 985	2.47	0.59	-6.3
Shanghai Composite	3 194	-0.60	-1.75	-12.2
VIX - Implied Volatility Index	22.56	-7.43	-5.49	31.0

Source: Bloomberg, Ostrum AM

Additional notes

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