MyStratWeekly

Market views and strategy

Ostrum ASSET MANAGEMENT

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N° 102 // **February 27, 2023**

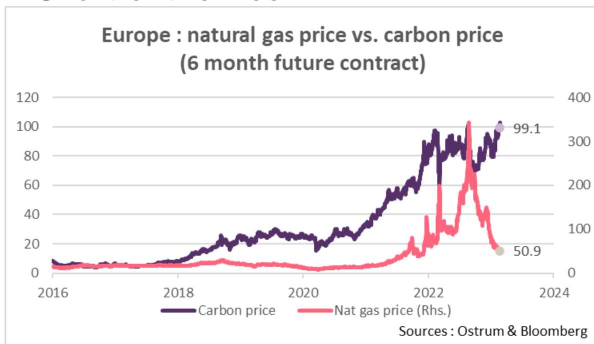
Topic of the week: Greece: the comeback!

- **Greece's rating continues to improve. This is anything but a surprise;**
- **The trajectory owes much to cyclical aspects and in particular to the rebound from the crisis of the last decade;**
- **The legacy is heavy, but the debt trajectory is one of the most ambitious and therefore justifies the improvement of the rating;**
- **There are also developments, particularly on the ESG front, that suggest that Greece has changed dramatically.**

Market review: Higher inflation weighs on markets

- **Markets reeling from accelerating US inflation;**
- **They anticipate higher key rates for longer;**
- **Strong tensions on sovereign yields, especially on the short end;**
- **Equity markets record their worst week of the year.**

Chart of the week



The price of carbon emissions (improperly called "pollution rights") exceeded €100 per tonne for the first time last week.

The good news is that this price increase is a strong incentive to decarbonize the economy. It is becoming more and more expensive to use fossil fuels. Good news in the long term.

The bad news is that this increase is partly due to the fact that the gas shortage has led to a significant use of coal and therefore to significant purchases on carbon emissions. Bad news in the short term.

Figure of the week

94

The word "inflation" is used 94 times in the Fed's minutes.
The word "recession" 4 times.

Source : Ostrum AM

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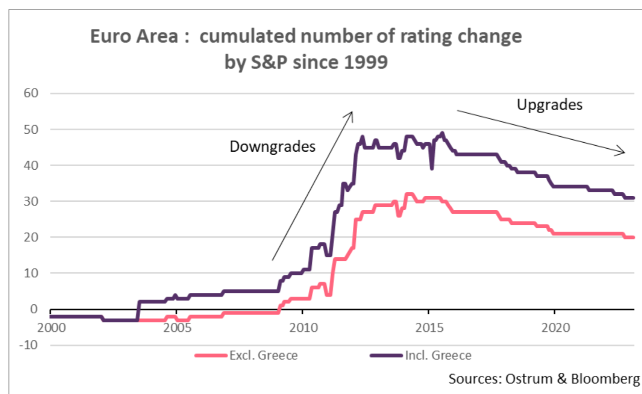
Topic of the week

Greece: the comeback!

The rating of Greece continues to improve. This is anything but a surprise. This is linked to cyclical aspects and in particular to the rebound after the crisis of the last decade. But there are also some developments, particularly on the ESG front, that suggest that Greece has profoundly changed.

La remontada

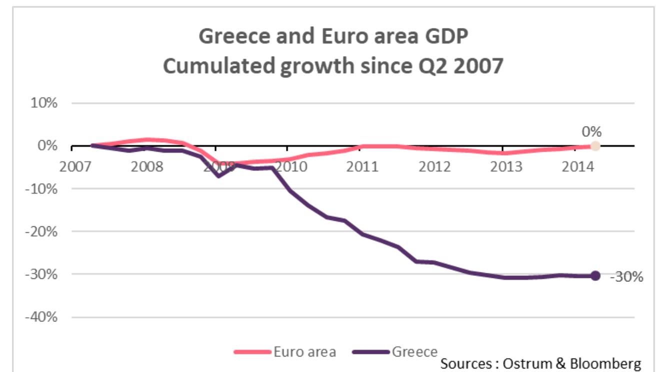
On 27 January, Fitch changed Greece's rating to BB+. This is the sixth consecutive grade increase since June 30, 2015, when the agency raised the grade to CC. Same direction for S&P where Greece was lowered to CCC – on 29 June 2015 and has been increased seven times since reaching BB+ on 22 April 2022. Finally, Greece was Caa3 at Moody's on 1 July 2015, it has been increased five times since reaching Ba3 on 6 November 2020.



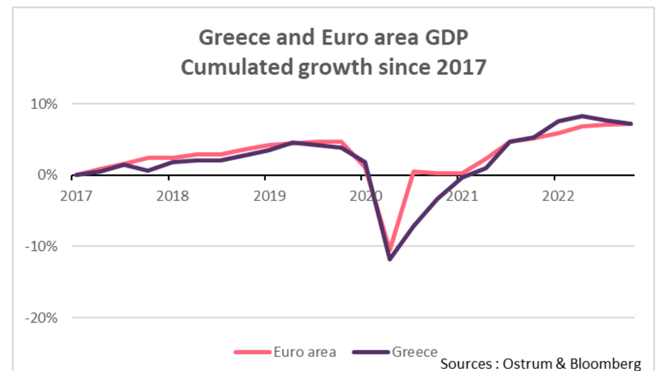
An impressive comeback, certainly after an equally impressive descent into hell. Justified? We think so. And this is what we will explain below. Is this the end? Probably not. The remontada is due to the usual effect of post-crisis rebound. But there are also factors that suggest that Greece has changed more profoundly.

The cleaning of the economy

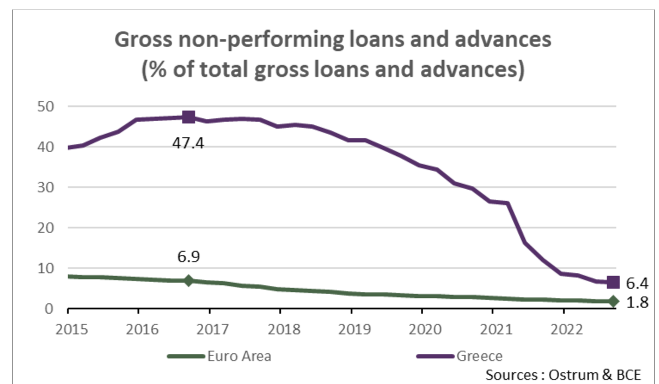
Part of the story is linked, quite simply, to the stabilization of the economy after a very important weight loss cure. Between the second quarter of 2007, when the Greek GDP reached an all-time high, and the seven years that followed, activity contracted by 30%. While the Eurozone's performance over the same period was anything but glorious, zero growth, Greek performance is extreme.



However, the situation is now stabilized and Greek GDP over the last five years has performed in line with that of the Eurozone. In its latest Article IV, the IMF comments, "Greece has weathered the pandemic well, with a much stronger recovery than expected." A welcome outcome is the very rapid decline in the unemployment rate from 27.7% in 2013 to 11.6% at the end of last year.

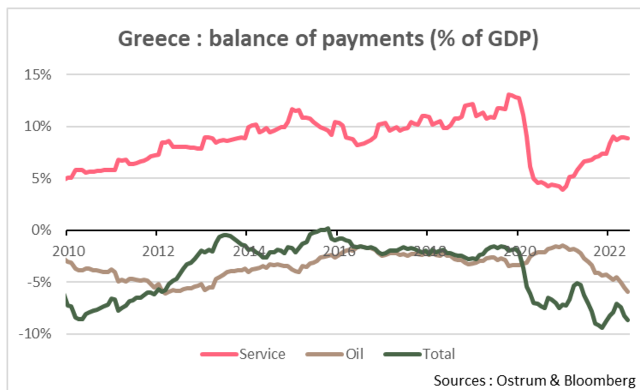


It is also important to emphasize the financial aspect with an equally colossal effort to improve the financial system. The best illustration is the level of bad loans which, according to the ECB's figures, reached the incredible level of 47.4% in the third quarter of 2013. The latest figure, Q3 2022, is down to 6.4%!



However, there is one point that needs to be watched. External imbalances are widening again. This was one of the major causes of the previous crisis. The balance of payments recovered: between 2014 and 2019, the deficit averaged only 1.7% of GDP. But Greece has had to absorb two recent shocks which have greatly affected the external balance.

- First, the Covid crisis, which obviously had a significant impact on tourism flows, and therefore on the balance of services, which fell by almost 10 percentage points (ppt) of GDP. It's up very quickly, and that's good news.
- Then the energy crisis, which widened the oil deficit by more than 4 ppt of GDP. This part is unfortunately more sustainable.



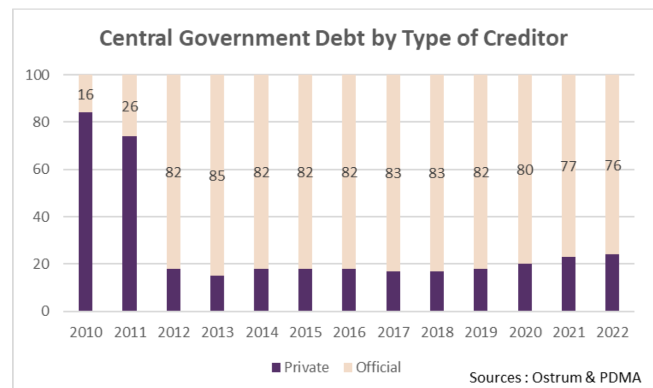
Public finances

The legacy is very heavy with, after the crisis of the previous decade, a ratio debt on GDP that reached 209.5% in the first quarter 2021, according to Eurostat. However, the momentum is very encouraging. The latest figure available for the third quarter of 2022 was 178.2%, a drop of more than 30 points in two years, far, far from other countries.

In a previous MyStratWeekly, we simulated the debt trajectory of the main eurozone countries based on forecast budget data published by the European Commission. We have the results of the next chart. Greece is certainly the country with the largest debt by far. But according to our calculations, it is also the country that has the "spontaneous" trajectory of decline. Here again by far: our models suggest a 33 ppt reduction over 10 years. The IMF in its latest report has an even faster 25 ppt decline in just 5 years.

It is very important to emphasize also the uniqueness of the Greek public debt. Here too, the legacy of the previous crisis, the ESM (European Stability Mechanism) holds about 55% of Greece's public debt and the remaining weighted maturity of the ESM/EFSF loans is 31 years. Due to the low interest rate on these loans – thanks to the ESM's low financing cost, which was assessed AAA over this period – the annual service costs of these loans remain very moderate. Greek public finances are therefore largely immune to rate movements, while rising inflation improves nominal budgetary revenues.

During the financial crisis, the ESM was the main means of support. The EU added further aid to combat the current crisis. Greece will receive a significant share of these programs, about 17.8% of its GDP.



As a result, according to the Greek Debt Agency, the average residual maturity was 17.5 years in 2022 while the average rate was 1.54%.

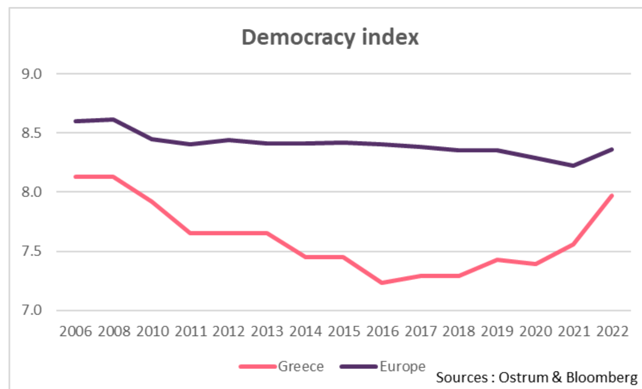
Structural aspects: ESG

The elements we have just highlighted are very common: GDP, the trajectory of public finances, the health of the financial sector, external balances. A classic for a country emerging from an IMF plan.

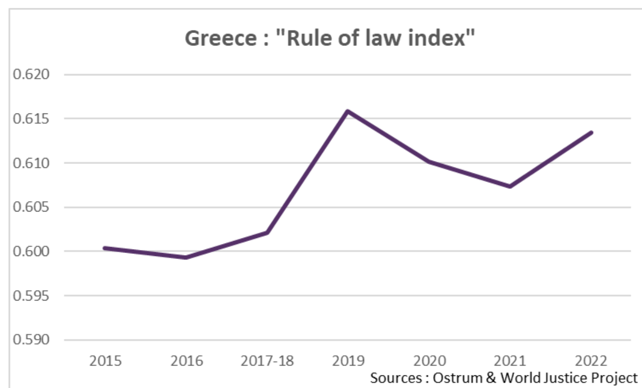
It is also interesting to look at ESG data from Greece. There has indeed been a much less spectacular development in this area, but it is equally important in our opinion.

Greece has shown, beyond reason, that the GSS, and in particular the "G" is a fundamental element for understanding an economy. The weakness of the state and its lack of organization were one of the causes of the collapse of the previous decade. Things have changed, for example with the help of the European Commission which dedicated a «task force» to help Greece to set up a modern tax system. Those substantive efforts paid off as a number of indicators show.

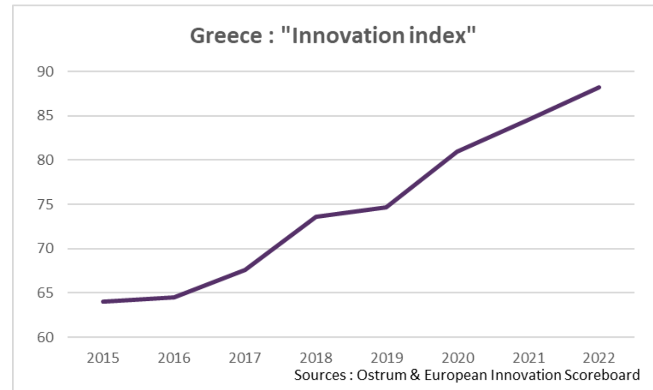
The Democracy Index, for example, had suffered greatly during the crisis. It has recovered and returned to levels close to those prevailing in Europe.



Similarly, the «Rule of law» index has been well oriented for a little less than a decade.



We can also note that the World Bank provides a "starting business" index, it gives a score of 96.0 to Greece, 11th country in the world, while the OECD average is 91.3. Last indicator to highlight in this vein, the European Commission calculates an innovation index. Here too, the improvement is very clear for Greece, which lagged far behind and is converging towards the European average.



It therefore appears that Greece has made significant progress on a number of structural governance indicators. While these basic efforts are less spectacular than the improvement of certain economic variables, they are equally important in the medium term. And encouraging for the future. We think they don't get enough attention from commentators.

Conclusion

Greece has seen its rating raised several times. It seems to us that the adjustment is not over and that further improvements are to come. Certainly the legacy is heavy, especially in terms of liabilities. The sovereign debt and the net external position remain the most negative in Europe, and by far. But the debt trajectory is also by far the most ambitious and therefore justifies the improvement of the rating.

Less commented, and perhaps more important in the long run, Greece's ESG scores also rose sharply. This is perhaps the most encouraging aspect in the medium term.

Stéphane Déo

Market review

Higher inflation weighs on markets

Stronger-than-expected inflation raises fears of higher policy rates for longer from central banks.

The bond and equity markets were affected by fears of greater monetary tightening by central banks in order to curb excessive inflation.

Although the week started calmly with the closing of the American markets for President Day, the markets reacted on Tuesday morning to the publication of the S&P survey, which was much better than expected. The composite PMI index for the Eurozone stood at 52.3 in February, against 50.3 in January, moving away from the stability threshold of 50 and signaling an acceleration in activity. The composite index in the United Kingdom also came out much better than expected, as did that of the United States. The improvement came from services and therefore potentially from additional domestic tensions, as activity continues to contract in the manufacturing sector, affected in particular by the drop in new foreign orders.

Subsequently, it was the upward revision of inflation in the Eurozone that caught the eye. It finally came out at 8.6% in January, against 8.5% in the 1st publication, due to higher core inflation (excluding food and energy): 5.3% against 5.2%. This is at a new historic high due to stronger contributions from goods and services. This reflects a diffusion of higher energy prices to a larger number of sectors as well as domestic pressures related to rising wages. These figures argue for a 50-bp ECB rate hike in March and continued hikes. Market deposit rate expectations thus increased to 3.75% in October 2023, from 3.59% in September 2023 at the end of last week. This led Governor Francois Villeroy de Galhau to indicate that markets were overreacting to ECB rate expectations. The minutes of the ECB meeting and the February inflation figures, which will be released this week, will provide a better understanding of the extent of the tightening to be carried out.

It was then the turn of the United States to hold the attention. If the markets did not take into account the downward revision of the GDP of the 4th quarter (2.7% at an annualized rate against 2.9%), they were worried about the GDP deflator higher than initially reported (3.9% against 3.5% at an annual rate). Finally, it was the personal consumption expenditure (PCE) price index, the Fed's favorite measure of inflation, which gave the final blow on Friday afternoon. The index came in at 5.4%, against 5% expected by the consensus, and the December figure was revised up to 5.3%.

Jerome Powell had indicated at the end of the Fed meeting that the central bank was closely following the price of core services ex-housing, this being the most likely to reflect domestic inflationary pressures. The latter rose by 0.6% over the month and accelerated to 4.6% over one year, against 4.3% in December, to return to the level of October.

While the Fed Minutes signaled the need for further rate hikes due to a very tight labor market and far too high inflation, the numbers released since then (jobs, retail sales, consumption, inflation and PCE) presage a higher terminal rate and its maintenance at a high level for longer. Market expectations for the Fed rate rose to 5.4% in July 2023 from 5.28% at the end of last week.

In this context, sovereign bond markets experienced strong tensions. They were greater on the short end of the yield curve, which contains monetary policy expectations. The German 2-year rate thus tightened by 15 bp over the week to end at 3%, its highest since 2008, and the 10-year rate rose by 10 bp to close at 2.5%. In the United States, the 2-year rate rose by 20 bp to settle at 4.8%, its highest level since 2007, and the 10-year rose 13 bps to close at 3.9%. In this context of stronger than expected inflation, the breakeven points in the euro zone increased by 9 bp to 2.52%.

The spreads of the peripheral countries held up relatively well : the Spanish spread remained unchanged, with a 15-year syndication which went well, and the Italian spread settled at 190 bps (+4 bps). Spreads on the credit market in the Euro zone widened by 3 bp for IG and by 5 bp on HY.

On foreign exchange, the dollar appreciated over the week in a context of risk aversion and expectations of further rate hikes from the Fed. The dollar-yen exchange rate has risen towards 136. During his hearing before Parliament, with a view to his confirmation as head of BoJ, Kazuo Ueda subscribed to the continuity of the current monetary policy. The rise in inflation above the 2% target is linked to the prices of imported goods and is therefore not sustainable, which justifies maintaining a very accommodating monetary policy. It is a way of not tying its hands before his arrival at the head of the BoJ in April and of taking the time to assess inflationary pressures coming from the labor market before modifying monetary policy.

The equity markets, which had so far withstood fears of greater monetary tightening relatively well, fell by 2.9% for the S&P and by 2.2% for the Eurostoxx 50 and the CAC 40. Growth stocks, more sensitive to rising rates for future profits, were the most affected.

Aline Goupil-Raguénès
Developed countries strategist

Main market indicators

G4 Government Bonds	27-Feb-23	1wk (bp)	1m (bp)	2022 (bp)
EUR Bunds 2y	3.01%	+11	+43	+24
EUR Bunds 10y	2.52%	+6	+28	-5
EUR Bunds 2s10s	-49.3bp	-5	-15	-29
USD Treasuries 2y	4.81%	+20	+61	+39
USD Treasuries 10y	3.93%	+12	+43	+6
USD Treasuries 2s10s	-88.8bp	-8	-19	-33
GBP Gilt 10y	3.73%	+25	+40	+5
JPY JGB 10y	0.51%	+0	-1	+8
€ Sovereign Spreads (10y)	**27-Feb-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
France	47.2bp	+1	+1	-7
Italy	186.7bp	0	0	-28
Spain	95.8bp	-1	-4	-13
Inflation Break-evens (10y)	**27-Feb-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR 10y Inflation Swap	2.52%	+8	+23	-3
USD 10y Inflation Swap	2.55%	-4	+5	+1
GBP 10y Inflation Swap	3.78%	+3	+13	-12
EUR Credit Indices	**27-Feb-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR Corporate Credit OAS	147bp	+3	-8	-20
EUR Agencies OAS	71bp	+1	-5	-8
EUR Securitized - Covered OAS	79bp	+1	-5	-5
EUR Pan-European High Yield OAS	437bp	+5	-34	-75
EUR/USD CDS Indices 5y	**27-Feb-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
iTraxx IG	80bp	+2	+2	-11
iTraxx Crossover	415bp	+7	+9	-58
CDX IG	77bp	+4	+6	-5
CDX High Yield	465bp	+20	+35	-19
Emerging Markets	**27-Feb-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
JPM EMBI Global Div. Spread	445bp	-9	+2	-7
Currencies	**27-Feb-23**	**1wk (%)**	**1m (%)**	**2022 (%)**
EUR/USD	$1.055	-1.235	-2.889	-1.4
GBP/USD	$1.196	-0.607	-3.384	-1.0
USD/JPY	JPY 136	-1.338	-4.542	-3.6
Commodity Futures	**27-Feb-23**	**-1wk ($)**	**-1m ($)**	**2022 (%)**
Crude Brent	$83.1	-$1.0	-$3.3	-2.95
Gold	$1 811.5	-$29.4	-$116.5	-0.68
Equity Market Indices	**27-Feb-23**	**-1wk (%)**	**-1m (%)**	**2022 (%)**
S&P 500	3 970	-2.94	-2.47	3.4
EuroStoxx 50	4 179	-2.16	0.02	10.2
CAC 40	7 187	-2.02	1.27	11.0
Nikkei 225	27 424	-0.32	0.15	5.1
Shanghai Composite	3 258	-0.98	-0.21	5.5
VIX - Implied Volatility Index	21.67	7.44	17.07	0.0

Source: Bloomberg, Ostrum AM

Additional notes

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