MyStratWeekly

Market views and strategy

Ostrum ASSET MANAGEMENT

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Topic of the week: budgetary short-sightedness?

- **Projected budget deficits this year remain large. Budgets should contribute to growth and absorb the energy shock;**
- **In the medium term, this puts public finances on a worrying trajectory and, above all, limits the room for maneuver should another crisis affect the European economy;**
- **So far so good, but once again, focus on immediate interest. Yet another example of "budgetary short-sightedness"?**

Market review: Immaculate rally

- **Disinflation keeps everything rally going;**
- **US inflations down to 6.5;**
- **Renewed downward pressure on bond yields;**
- **Risky assets still upbeat amid lower dollar.**

Chart of the week

China is reopening and one high-frequency gauge for increasing activity and return to normalcy is the metro passenger volume. The chart shows the two main cities, Beijing and Shanghai. Overall, transport volume were about 1/4 of normal in China at the end of last year. They are now rapidly up and back to about 3/4 depending on the cities.

This illustrates the rapid reopening of the Chinese economy. A major element for the global growth trajectory. Hence also for inflation.

Figure of the week

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2022 was the 5th warmest year on record. Temperatures were almost 1.2 degrees above pre-industrial levels.

Source : Ostrum AM

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Topic of the week

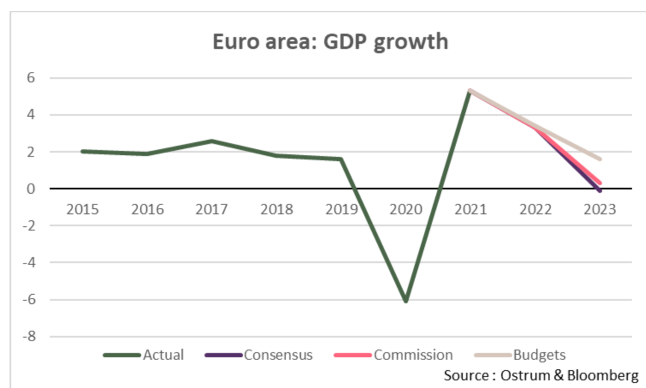
Budgetary short-sightedness?

Projected budget deficits this year remain large. Budgets should contribute to growth and help absorb the energy shock. These deficits also place the eurozone on a very worrying debt "spontaneous trajectory" over time. We will not be able to avoid a much more ambitious budgetary tightening in the future.

So far so good

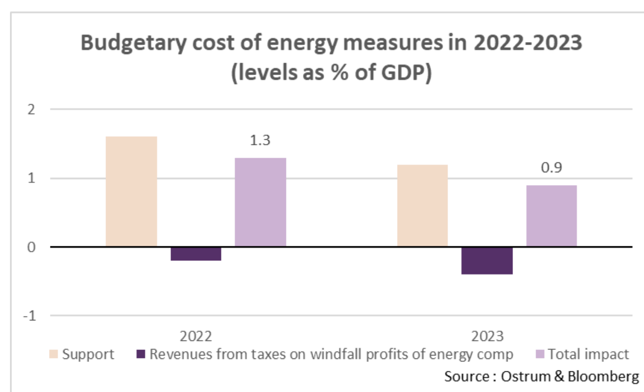
The ECB has just published an article on budgetary policies[1]. It uses the figures of the European Commission on planned budgetary trajectories on the basis of government draft budgetary plans published last autumn[2]. The Member States of the Union must, in the context of the "Stability and Growth Pact", provide their budgetary projections, which allows the Commission to produce an appraisal and recommendations.

It should be noted in the introduction that these deficit forecasts are based on rather optimistic growth assumptions. The Commission's forecast for 2023 (+0.3%) is higher than the consensus (-0.1%) but seems credible to us (Ostrum expects 0.2%), the forecasts of the states are a much more comfortable 1.6%.



In this favorable environment, deficits are expected to ease from 3.9% of GDP in 2022 to 3.2% in 2023. As a result, the debt-to-GDP ratio would also improve from 93.9% to 92.5%. However, temporary measures related to the COVID crisis are disappearing, adding 3.3% to the deficit in 2021, 0.9% in 2022 and 0.0% in 2023. This 0.9% saving is therefore not reflected in the fall in the deficit since it only improves by 0.7 percentage points.

It should be noted that the budgetary effort related to the energy crisis is also fading. It is conceivable that these measures will be substantially reduced in 2024, resulting in a potential deficit improvement of 0.9 percentage points.



According to ECB figures and analyses, the total fiscal stimulus related to the energy crisis and the war in Ukraine included in the projections amounts to about 2% of GDP in 2022-23. Based on government measures currently approved, about one-third of these fiscal stimulus measures – particularly spending to offset rising energy prices and inflation, to some extent, increased defense capabilities – are expected to continue to have a fiscal impact in 2024.

In terms of supporting the economy, budgets are doing a lot. The ECB article cited above notes that "the ECB's latest projections include a significantly higher number of energy-related support measures than in the Commission's baseline, indicating an expansionary fiscal stance in 2023. Global support for the energy crisis is estimated at around 2% of GDP."

In summary, so far everything is going well, the budgetary effort made, after the budgetary effort of the COVID crisis, is very substantial and largely explains the resilience of the Eurozone economy.

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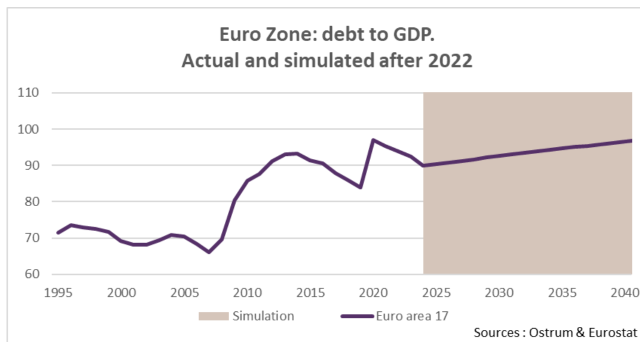
[1] Available on: https://www.ecb.europa.eu/pub/economic-bulletin/focus/2023/html/ecb.ebbox202208_08~8caa7063ac.en.html

[2] Available on: https://economy-finance.ec.europa.eu/system/files/2022-11/com_2022_900_1_en_chapeau.pdf

Backfire

Building on all these budget data we simulate the trajectory of the debt to GDP of the Eurozone. The result is shown on the graph below. Data up to 2021 are actual data, those for 2022 and 2023 are those corresponding to the budget programmes carried over by the Commission. What follows is our "all other things being equal" simulation: a hypothesis that growth stabilizes at potential and budgetary policy remains unchanged, etc.

In this case, the "spontaneous debt trajectory" (as we say in economists' jargon) remains upward slopping, albeit moderately. The budget consolidations for this year are therefore insufficient to put European public finances on a satisfactory path, a downward sloping one. The "stabilizing deficit" (another jargon term for the level of deficit that stabilizes the debt-to-GDP ratio) would then be, according to our calculations, 1.4%. With a deficit still slightly higher than 3%, the debt-to-GDP ratio should therefore continue to rise by 1.1/2 points each year. Measured in this way the margin is therefore not so important towards balance.



We must underline that this is a simulation, not a forecast. The result is quite optimistic for several reasons:

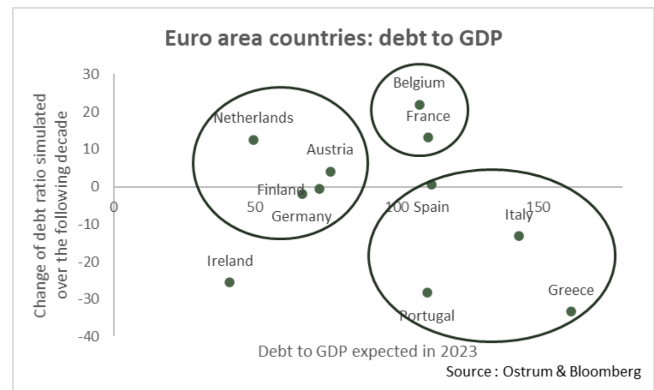
- We take, as is, the figures from the various budget forecasts, which still seem quite optimistic to us;
- The idea of stabilizing growth at potential makes sense to generate a "spontaneous" trajectory but obviously by 2040 we will go through recessions, with the usual step-up effect on debt;
- The "all other things being equal" simulation leads to the assumption that the cost of debt is constant. Of course, the cost will go up, so the debt service, hence the deficit. The snowball effect should be stronger than our numbers;
- We do not take EU debt into account in these figures: the idea of socializing debt via SURE or other programmes is undoubtedly a good idea. But it is an additional layer of public debt that will have to be paid back.

So, we have to look at our simulations more as a floor on the trajectory. The conclusion is therefore simple: it seems inevitable that the countries of the euro area will have to implement a significant budgetary tightening in the years to come.

And, as a corollary, if we were unlucky to face yet another crisis in the near future, the budgetary leeway we have seems rather limited.

Discrepancies

These figures need to be detailed. Not surprisingly, there is a significant divergence at the country level. The divergence is evident in terms of debt levels, which range within the 11 main countries in 2023 from 161% in Greece to 41% in Ireland.



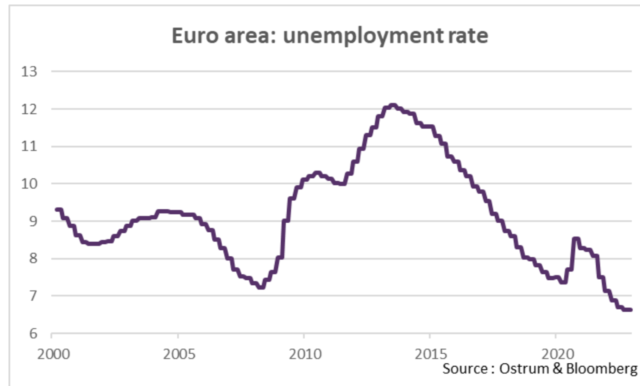
But, and this is probably an even more important point, the difference is equally striking in terms of spontaneous dynamics. Once again, we must keep in mind the limitations of the approach mentioned above. Nevertheless, we find four distinct groups of countries:

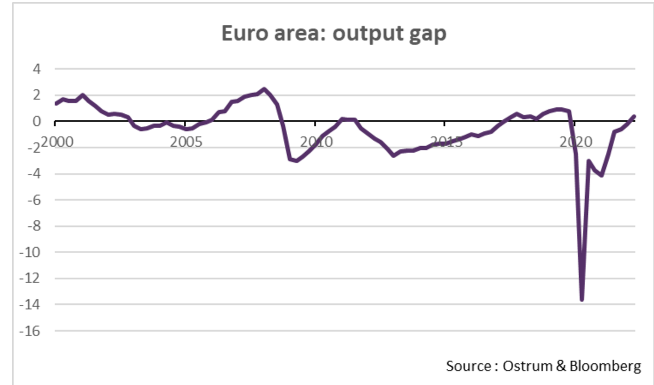
- **Good boys:** makes Ireland the only "good one" with GDP debt close to 40% and comfortable budget margins;
- **Former good boys:** Netherlands, Austria, Germany and Finland. These countries have a debt to GDP ratio of around 60% but have not made enough effort to secure a debt reduction;
- **Bad but repentant:** Italy, Spain, Portugal and Greece. With debt well above 100%, but a downward trend in the debt ratio;
- **Bad boys:** France and Belgium. With high debt, above 100% and a trajectory that remains upward sloping. These are, of course, the countries of greatest concern.

Conclusion

The two shocks that the European economy has just faced, COVID and the energy crisis, have been largely absorbed by an extremely ambitious fiscal policy. Otherwise, the cyclical decline could have been much worse, with serious consequences, for example, in terms of the failures of companies that would have damaged the recovery. The reaction, however pharaonic, was therefore very largely justified in our opinion.

The current policy is much more debatable. The unemployment rate is at an all-time low in the Eurozone, the output gap is positive according to Bloomberg's estimates. A reasonable counter-cyclical fiscal policy would therefore suggest that governments reduce their support for the economy much more ambitiously and start to build back room for maneuver for a future crisis.





This is far from the case.
In the short term, this is good news for economic growth which should therefore be sustained.

In the medium term the conclusion is much more ambiguous. This puts public finances on a worrying trajectory and, above all, limits the room for maneuver should another crisis affect the European economy.

So far so good. But once again, the focus is on immediate interest: another example of "Budgetary short-sightedness"?

Stéphane Déo

Market review

Immaculate rally

The sharp rise in asset prices fueled by disinflation and hopes of monetary easing now must face the consequences of the recovery in China

US inflation was shaping up to be the leading economic publication and a market mover last week. The lack of a surprise in the US CPI report added some fuel to the broad-based rebound in markets since the start of the year. Equities are up 5 to 6% in the United States across the main stock indices taking advantage of a declining dollar which reflects an idyllic scenario of disinflation and monetary easing. European stocks gain 2%. On the fixed income markets, bond issuance totaled an unprecedented amount of €100 billion last week. New borrowing did not prevent a widespread tightening in sovereign and credit spreads. The yield on US 10-year notes is hovering around 3.50% after having rebounded, twice, on the technical support of 3.42%. Euro area sovereign spreads are back to last autumn lows, so Italian BTP spreads trade once again close to 180 bps on 10-year maturities. High yield spreads tightened by more than 20 bp in both Europe and the United States.

US inflation for December came out in line with expectations at 6.5% over the past twelve months. The deceleration in inflation is mainly due to the decline in energy prices, with the exception of domestic gas and electricity, which are on the rise, despite the downward trend on the futures markets. Core inflation also fell to 5.7% from 6% the previous month. However, service prices are still on the rise. Excluding energy, service inflation indeed exceeds 7% over one year. Housing also rose by 0.8% month over month in December whilst a slow deceleration in housing costs is still expected from next spring onwards. In short, the normalization of consumer goods' prices runs parallel to the inertia of service inflation. At the same time, the reopening of China risks calling into question the observed reversal in the prices of goods. The awakening of the Chinese economy is already causing a significant lengthening of delivery times and a rapid recovery in the prices of industrial metals (copper, ferrous metals). In addition, Chinese oil demand rose in December to 48 million tons. "Immaculate disinflation", the new fashionable term accompanying the bullish run in the financial markets, will perhaps turn out to be, dare I say, "transitory". The improving outlook in China is echoed in Europe. Industrial production in the euro area has stabilized in the three months to November. In France, nuclear electricity production is gradually picking up. German GDP probably stagnated in the 4th quarter as preliminary estimates point to 1.9% annual growth in 2022, far from the disaster scenarios mentioned last year.

Current market environment bears witness to the difficulty of central banks to anchor their tight policy stance. The US CPI report, though in line with expectations at 6.5%, fueled a further decline in Treasury yields. Central bankers reiterate their commitment to monetary tightening, but a consensus is forming within the FOMC for more measured rate increases of 25 bp going forward. The 2-year yield fell to its lowest since October at 4.15%. The yield curve remains very inverted with a 2-10 year spread at -68 bp. The memory of 10-year yields averaging 2% between 2012 and 2021 is still fueling demand for Treasuries. However, carry on a long Treasury position, or the opportunity cost of holding bonds, is unfavorable. A sharp rise in long-term yields is a risk if growth continues. In the euro area, the fall in energy inflation considerably reduces the downside risks to activity. However, the increase in underlying inflation still argues for monetary tightening by the ECB. Market expectations point to a deposit rate of 3.25% in the spring. The Bank's balance sheet is shrinking through TLTRO repayments (€63bn in January) before quantitative tightening kicks in March. Despite this, the Bund (2.15%) is trading near the deposit rate. The many syndications in January are attracting very strong demand from institutional investors. Total weekly issues amount to €100 billion. The French OAT is trading below 50 bp against Bunds. The pension reform is a positive for French public finances, but the budget trajectory remains problematic in the long term. Italian bonds are also in high demand. Buybacks of speculative shorts on BTP continues, bringing the spread to 180bp, i.e. the lowest spreads since early December. The homothetic downshift in rates and spreads persists so that sovereigns react proportionally to changes in Bund yields. Thus, Spanish PGBs and Bonos are tightening below the 100 bp threshold.

The credit market is improving, echoing both the decline in sovereign yields and the rise in equities. The busy primary market is somewhat curbing the narrowing in IG spreads (-3 bps since December 31). In contrast, low issuance in high yield helps spreads tighter by 30 bps in Europe and 50 bps in the United States since the start of the year. The levels of yields unseen in credit for 10 years sparked a strong start in 2022. Euro credit indeed offers 4%yields, higher than the dividend yields on equities and well above the paltry 0.5% of January 2022.

On equity markets, the rebound in high-beta stocks continues. The outperformance of the equal-weighted S&P versus the cap-weighted index highlights the breadth of the market's revaluation. The decline in the euro allows the US market to narrow its performance gap vis-à-vis Europe. The first US bank earnings releases are nevertheless mixed. However, sentiment towards European equities has improved. Real estate and consumer stocks are outperforming in the wake of technology.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	16-Jan-23	1wk (bp)	1m (bp)	2022 (bp)
EUR Bunds 2y	2.58%	-3	+15	-19
EUR Bunds 10y	2.17%	-5	+2	-40
EUR Bunds 2s10s	-41.1bp	-2	-13	-20
USD Treasuries 2y	4.23%	+2	+5	-19
USD Treasuries 10y	3.5%	-3	+2	-37
USD Treasuries 2s10s	-73.5bp	-5	-3	-18
GBP Gilt 10y	3.4%	-12	+8	-27
JPY JGB 10y	0.53%	+2	+1	+8
€ Sovereign Spreads (10y)	**16-Jan-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
France	46.48bp	-4	-8	-8
Italy	183.76bp	-12	-30	-30
Spain	98.87bp	-5	-10	-10
Inflation Break-evens (10y)	**16-Jan-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR 10y Inflation Swap	2.28%	-3	-17	-27
USD 10y Inflation Swap	2.4%	-3	-14	-12
GBP 10y Inflation Swap	3.6%	-2	-22	-31
EUR Credit Indices	**16-Jan-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR Corporate Credit OAS	161bp	-8	-10	-6
EUR Agencies OAS	74bp	-3	-7	-5
EUR Securitized - Covered OAS	78bp	-3	-12	-6
EUR Pan-European High Yield OAS	473bp	-32	-49	-39
EUR/USD CDS Indices 5y	**16-Jan-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
iTraxx IG	80bp	0	-16	-11
iTraxx Crossover	416bp	-2	-82	-58
CDX IG	70bp	-3	-14	-12
CDX High Yield	424bp	-19	-72	-60
Emerging Markets	**16-Jan-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
JPM EMBI Global Div. Spread	451bp	-18	-1	-1
Currencies	**16-Jan-23**	**1wk (%)**	**1m (%)**	**2022 (%)**
EUR/USD	$1.082	0.820	2.192	1.1
GBP/USD	$1.221	0.181	0.477	1.0
USD/JPY	JPY 128	2.662	6.337	2.1
Commodity Futures	**16-Jan-23**	**-1wk ($)**	**-1m ($)**	**2022 (%)**
Crude Brent	$84.4	$4.8	$4.9	-1.73
Gold	$1 914.7	$42.9	$121.6	4.97
Equity Market Indices	**16-Jan-23**	**-1wk (%)**	**-1m (%)**	**2022 (%)**
S&P 500	3 999	2.67	3.81	4.2
EuroStoxx 50	4 158	2.20	9.30	9.6
CAC 40	7 048	2.04	9.23	8.9
Nikkei 225	25 822	-0.58	-6.19	-1.0
Shanghai Composite	3 228	1.62	1.89	4.5
VIX - Implied Volatility Index	19.44	-11.52	-14.06	-10.3

Source: Bloomberg, Ostrum AM

Additional notes

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