MyStratWeekly
Market views and strategy

Ostrum ASSET MANAGEMENT

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N° 120 // **July 3, 2023**

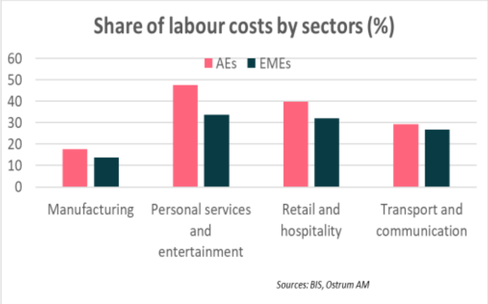
Topic of the week: Access to finance of enterprises in the Eurozone and investment

- **The bi-annual ECB survey on access to finance of Euro area enterprises reveals a significant gap between corporate financing needs and their availability – the highest since the sovereign debt crisis;**
- **Corporate financing conditions have deteriorated sharply;**
- **Faced with sharp increases in interest rates, companies are reducing their demand for loans, which will weigh on investment;**
- **Continued unprecedented monetary tightening by the ECB creates uncertainty about the scale of the adjustment.**

Market review: A resilient US economy

- **Markets are almost in line with the Fed's rate guidance;**
- **US GDP growth revised up to 2% in 1Q 2023;**
- **T-note burst past 3.80%, Bunds held under 2.50%;**
- **Equities end the first half of 2023 on a positive note.**

Chart of the week



Central banks in developed countries are particularly sensitive to the risk of a price-wage spiral.

Developed economies are in fact dominated by the service sector where wage costs represent between 30% and 45% of costs depending on the sector. The manufacturing sector is more capital-intensive and the share of wages is lower by 3% to 14% depending on the sector considered.

In emerging countries, the share of wages is much lower.

Figure of the week

0.3%

Source : ECB

The annual growth of the M2 monetary aggregate in the euro area. It is the lowest growth on record.

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Topic of the week

Access to finance of enterprises in the Eurozone and investment

The ECB's biannual survey on companies' access to finance is not very well known, although it is rich in information. It provides qualitative information on the health and financing difficulties encountered by non-financial companies depending in particular on their size and their country of origin. The current context of strong monetary tightening by the ECB makes this survey particularly interesting for understanding the impact on companies and in particular on investment.

Sharp deterioration in financing conditions

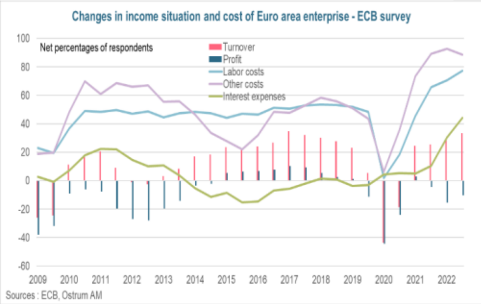
The latest ECB survey on access to finance of enterprises (SAFE), published in June, covers the period from October 2022 to March 2023.

Increase in turnover and decrease in profits

Non-financial companies in the Eurozone once again recorded an increase in their turnover over the period. The net percentage of responses (difference between the % of companies having recorded an increase in their turnover and the % of those having recorded a decrease) is 33%. The increase is stronger for large companies (net percentage of 54%) than for SMEs (21%).

On the other hand, profits continued to fall (-10% net). This is due to SMEs since the profits of large companies have stabilized over the period. The decline in profits mainly affected companies belonging to industry, construction and trade.

The decline in profits is again linked to the sharp rise in costs faced by companies. Labour costs recorded an all-time high (since 2009): 77% of net responses. Other costs, related to materials and energy, continue to increase sharply even if at a slightly slower rate over the period (89% against 93% net). This notably reflects lower energy prices and reduced tensions in supply chains.



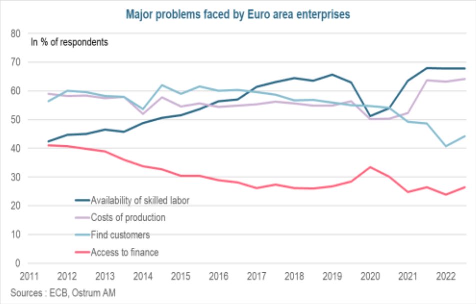
Finally, companies are much more likely to report an increase in interest expenses (44% of responses net), a record. The net proportion is higher for large companies than for SMEs. This is the result of the sharp rise in interest rates following monetary tightening by the ECB.

For the large countries, there is no major difference in terms of the evolution of turnover and profits. On the other hand, Italian companies are less likely to report an increase in labor costs and Italian and Spanish companies are more likely to report an increase in interest expenses.

During this survey, the ECB asked 2 ad-hoc questions to companies. On average, they expect a 6.1% increase in their selling price over the next 12 months and a 5.4% increase in wages. The cost of labor is the most important factor in determining the selling price, followed by other costs, inflation prospects and demand conditions.

Main problem for companies: the lack of skilled labor

The lack of skilled labor remains the main problem facing companies, followed closely by the rising cost of production. Access to finance lags far behind, after the lack of customers.



This is consistent with the current labor market situation, which is proving to be very tight, with an unemployment rate at a historic low (6.5% in May 2023) and a lack of labor in certain sectors.

Slowdown in demand for external financing

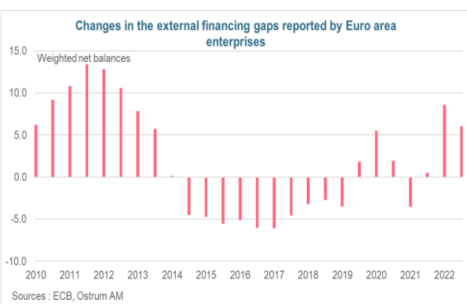
To finance themselves, companies have four means at their disposal: internal financing, via retained earnings, or external financing through bank loans, bond issues or equity raising.

The survey shows that over the past 6 months, fewer companies have reported an increase in demand for external financing (4% net for bank loans compared to 9%, 6 months ago). This moderation can be observed on all external financing with the exception of other loans. This mainly concerns large companies rather than SMEs.

Deterioration in the availability of external financing

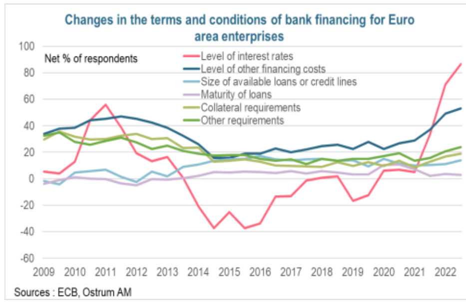
Firms are reporting a slight deterioration in the supply of financing in both bank lending and bond markets. They attribute it to the deterioration in the outlook for activity, even if this is less marked than in the previous survey. On the other hand, it considers banks' willingness to lend to be unchanged from the last survey.

These two factors (lower demand and lower availability of external financing) resulted in **a second consecutive increase in the "financial gap"**. Apart from the previous survey, this gap is at its highest since 2013, during the sovereign debt crisis. It is higher for French companies and lower for Italian companies.



Sharp deterioration in financial conditions

A large number of companies have postponed an increase in interest rates and an increase in other financing costs. The net % are at an all-time high.



This is in line with the sharp rise in interest rates observed within the economies following the sharp increase in ECB rates.

Companies expect further deterioration in financing conditions

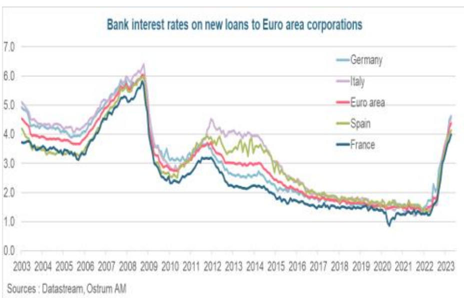
Over the next 6 months, companies anticipate further deterioration. This mainly concerns bank loans and lines of credit. The deterioration is the most significant since the start of the survey in 2009, and is more marked for Germany, Spain and France. On the other hand, companies expect unchanged financing conditions with regard to the issuance of bonds and the raising of funds. Finally, they are more optimistic about internal financing, which is expected to increase slightly. This results from the fact that they are more likely to anticipate an increase in their turnover (32% net compared to 13% during the previous survey) and particularly in Italy and Spain.

What do we observe?

Bank loans remain the main source of financing for companies even if the share of financing via the bond market has increased since the financial crisis to represent approximately 30% of financing, against 15% in mid-2008. The share of bank loans is higher for small businesses given more limited access to the bond market.

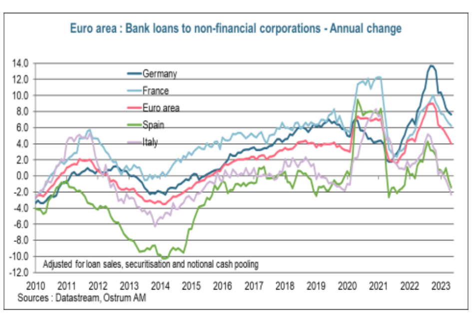
Sharp rise in interest rates

In the wake of the strong and rapid monetary tightening carried out by the ECB, interest rates on new loans granted to non-financial companies have risen sharply since the start of 2022. This movement was initiated by the announcement of the ECB, in December 2021, of the end of its pandemic emergency purchase program (PEPP) at the end of March 2022. It accelerated from July 2022 with the sharp increases in key rates. The composite interest rate on new loans granted to companies in the euro zone thus increased by 300 basis points between December 2021 and April 2023 (latest data available). This came as the ECB raised rates by 350 basis points over the period to bring the deposit rate to 3%. The rise in rates is comparable in the different countries of the Eurozone.



Sharp slowdown in business loans

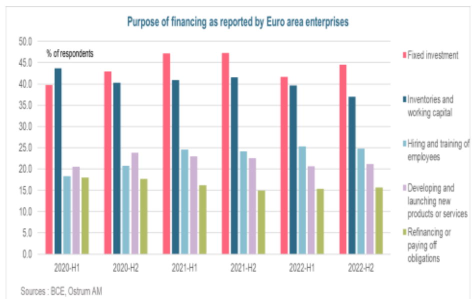
Faced with the sharp rise in interest rates, loans granted to companies have slowed sharply. After peaking at 9% in October 2022, their annual growth rate fell to 4% in May for the Eurozone. This adjustment concerns all countries. Lending is slowing in Germany and France and contracting slightly in Spain and Italy.



This attests to the strong transmission of monetary tightening on credit conditions, interest rates and demand for loans.

Implications for business investment

Companies use internal and external financing to finance their investments first (45% of responses net), followed secondly by the financing of inventories and their working capital. Demand for the latter pattern has moderated due to less strain in supply chains.



The sharp tightening of credit conditions by banks and the sharp rise in interest rates will therefore weigh first on corporate investment. This is the purpose of the strong monetary tightening made by the ECB. This seeks to weigh on the loans granted to households and businesses to curb domestic demand through investment and ultimately on inflation, which is still proving too high (5.5% in June).

Towards a sharper slowdown in demand for corporate loans

Since May, the ECB has raised rates an additional 50 basis points and signaled that it intends to raise them again at the July meeting, while hinting at further tightening. Business financing conditions via bank loans will thus deteriorate further and weigh on business loans.

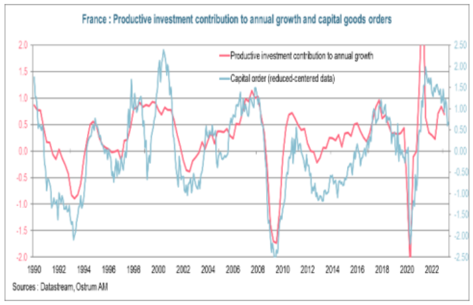
The ECB rate hike is unprecedented in terms of magnitude and speed and follows a long period of historically low rates. This could lead to greater sensitivity of demand for loans, particularly from businesses, to interest rate variations. However, the impact could be moderated by the investments made by companies in the framework of Next Generation EU.

The most indebted companies as well as the most capital-intensive and producing durable consumer goods will be the most affected. Those belonging to the service sector will be less exposed since demand is less sensitive to changes in interest rates. This may partly explain the contrasting dynamics between activity in the manufacturing sector, which is contracting, and that of services, which is growing, albeit at a more moderate pace.

Regarding internal financing, the higher rates make it more attractive for companies to invest in deposits or short-term financial products rather than financing investments or their stocks.

Continued monetary tightening should therefore weigh more heavily on the dynamics of corporate investment. In the latest ECB survey of commercial banks, the enterprises indicate that the main factor behind the decline in business loan demand is rising interest rates followed closely by business investment.

In addition, the latest INSEE survey predicts a weakening in investment. New orders from companies belonging to the capital goods sector have clearly deteriorated since the start of the year, after peaking in August 2021 (post-Covid recovery). However, orders remain above their long-term average. This suggests a slowdown in productive investment as shown in the following chart.



Conclusion

The ECB survey revealed a wide gap between the need for corporate financing and its availability, at its highest since 2013, during the sovereign debt crisis. The sharp and rapid rise in interest rates is affecting the demand for business loans. This portends a slowdown in business investment over the next few months. The uncertainty about its magnitude is significant given the unprecedented monetary tightening carried out by the ECB in terms of rate hikes and speed, after a long period of historically low interest rates.

Aline Goupil-Raguénès

Market review

A resilient US economy

The likelihood of a recession in the United States is receding and the markets now seem to be pricing in the announced Fed tightening.

Revisions to US economic growth seem to validate the Federal Reserve's hawkish stance. During the ECB seminar in Sintra, the major central banks, with the notable exception of the BoJ, once again reiterated the need to curb price pressures. The inertia of consumer prices worries central banks and the IMF and fully justifies the new round of monetary tightening that financial markets are now pricing in. Importantly, this occurred without significant damage to risky asset markets. Sector rotations did take place within the US stock market to the benefit of small-cap stocks predominantly. Besides the stellar performance of the Magnificent 7 (large-cap technology stocks), the equal-weighted S&P is still up nicely with a 5% advance at the half-year close. This half-year close spurs demand for Bund collateral which keeps swap spreads at high levels. At the same time, the reimbursement of the June 2020 TLTRO (€477 billion) led to selling of peripheral sovereign bonds, including short-term Italian BTPs. Corporate credit fared better, including high yield which had been hit by profit taking since mid-June. On the foreign exchange market, the Japanese yen continues to slide to the 145 area, dragging the Chinese Renminbi beyond 7.25 against the U.S. dollar. In Europe, Sweden's Riksbank raised its policy rates, highlighting concerns about the protracted weakness of the Krona in currency markets.

US economic growth was finally revised upward to 2% at annualized rate between January and March. This significant revision reflects both the strength of household spending on services and a stronger contribution from exports. LNG exports to Europe create a significant growth opportunity for gas producers who face very low prices in the United States ($2 per MBtu). Business investment was mixed. Expenditure on structures increased by 15.8% in 1Q 2023, the same hefty pace than in the previous quarter. The implementation of the CHIPS Act and the IRA is leading to a sharp increase in manufacturing output capacity. Corporate spending on equipment and R&D, however, fell. That said, durable goods orders point to a stronger quarter for business investment between April and June. Restocking will support goods production. In addition, the recovery in the housing sector is confirmed. New home sales came out at 763k (annualized) in May. Housing prices have been on the rise for several months now. This rebound in the residential sector echoes the pickup in homebuilder confidence and the strong improvement in housing starts reported recently. The much-anticipated US recession indeed looks remote.

In the euro area, inflation data remains inconsistent with the ECB's price stability objective. Wage pressures, resulting from persistent hiring difficulties, continue to fuel core inflation, especially as corporate margins are slow to adjust. The weakening in bank credit data is partly traceable to elevated self-financing and a decline in opportunistic refinancing demand. The ECB hence retains some leeway to lean against consumer price pressures. Inflation stood at 5.5% in June with an underlying index up slightly by 0.1pp to 5.4%. In Spain, harmonized headline inflation fell to just 1.6% in June but the decline in the core index excluding energy and food remains very slow (5.9% in June). However, PM Pedro Sanchez maintains the measures against the high cost of living at the risk of spurring excess demand and triggering an even stronger response from the ECB.

The Treasury bond market now seems to price in the latest announcements from the Federal Reserve. The FOMC minutes will shed some light on Jerome Powell's decision to signal two more hikes in 2023. The anchoring of long-term expectations keeps the yield curve deeply inverted to the tune of 100 bps on the 2-10 year segment. It is essential for the Fed to preserve its credibility on inflation to avoid a violent rise in long-term interest rates. The T-note nevertheless responded to upward revision on 1Q 2023 GDP and broke the 3.80% threshold. The 2-year bond yield still has room to climb towards 5 %.

In the euro area, the market reaction was more muted on Bunds as the 2.50% ceiling holds. The half-year closing generates a need for collateral which contributed to widen swap spreads from already very high levels (close to 73 bp on the Schatz). The inversion of the term structure of rates remains significant (-76 bps on 2-10 years) with Schatz yields close to 3.20%. Sovereign spreads have cheapened somewhat in the wake of swap spreads. The reimbursement of the TLTROs (€477 billion on June 28) may have led to the unwinding of carry strategies from the banks. Short-dated BTP spreads therefore widened.

On credit markets, we observe a slight widening in spreads of around 2 bps on European investment grade (163 bps against Bunds). Financials are holding up better than cyclicals in this context of rising interest rates. Hybrid bonds performed well. In June, three-quarters of new credit issues tightened compared with about 90% for financial institutions' bonds. After more than €25 billion in new issuance last week, the primary market should slow down with the start of summer and the upcoming of quarterly earnings season. Profit taking is easing in high yield bond markets. Speculative-grade spreads still tightened by around 30 bps in June. On equities, the performance of European banks (+6%) is driving the indices up. Chemical stocks rebounded despite ongoing pressure on margins along with other cyclicals, while healthcare sectors lagged.

Axel Botte

Main market indicators

G4 Government Bonds	03-Jul-23	1wk (bp)	1m (bp)	2023 (bp)
EUR Bunds 2y	3.21%	+13	+41	+45
EUR Bunds 10y	2.38%	+7	+7	-19
EUR Bunds 2s10s	-84.1bp	-6	-35	-64
USD Treasuries 2y	4.86%	+12	+37	+44
USD Treasuries 10y	3.79%	+6	+10	-9
USD Treasuries 2s10s	-108.1bp	-5	-27	-52
GBP Gilt 10y	4.4%	+10	+25	+73
JPY JGB 10y	0.41%	+4	-7	-19
€ Sovereign Spreads (10y)	03-Jul-23	1wk (bp)	1m (bp)	2023 (bp)
France	54bp	+1	+0	-1
Italy	169bp	+5	+1	-44
Spain	99bp	+3	+0	-9
Inflation Break-evens (10y)	03-Jul-23	1wk (bp)	1m (bp)	2023 (bp)
EUR 10y Inflation Swap	2.52%	-2	+2	-3
USD 10y Inflation Swap	2.56%	+5	+4	+4
GBP 10y Inflation Swap	3.89%	-1	+11	-2
EUR Credit Indices	03-Jul-23	1wk (bp)	1m (bp)	2023 (bp)
EUR Corporate Credit OAS	163bp	+2	-6	-4
EUR Agencies OAS	78bp	+2	-4	-1
EUR Securitized - Covered OAS	88bp	+2	-4	+4
EUR Pan-European High Yield OAS	456bp	-8	-33	-56
EUR/USD CDS Indices 5y	03-Jul-23	1wk (bp)	1m (bp)	2023 (bp)
iTraxx IG	73bp	-6	-4	-17
iTraxx Crossover	401bp	-22	-14	-73
CDX IG	67bp	-6	-5	-15
CDX High Yield	435bp	-32	-18	-49
Emerging Markets	03-Jul-23	1wk (bp)	1m (bp)	2023 (bp)
JPM EMBI Global Div. Spread	432bp	-12	-44	-20
Currencies	03-Jul-23	1wk (%)	1m (%)	2023 (%)
EUR/USD	$1.092	0.156	1.960	2.0
GBP/USD	$1.271	-0.024	2.187	5.2
USD/JPY	JPY 144	-0.389	-3.117	-9.0
Commodity Futures	03-Jul-23	-1wk ($)	-1m ($)	2023 (%)
Crude Brent	$75.2	$0.8	-$0.8	-9.5
Gold	$1 929.1	$5.9	-$32.8	5.8
Equity Market Indices	03-Jul-23	-1wk (%)	-1m (%)	2023 (%)
S&P 500	4 448	2.74	3.86	15.8
EuroStoxx 50	4 403	2.86	1.84	16.1
CAC 40	7 392	2.89	1.66	14.2
Nikkei 225	33 753	3.22	7.07	29.4
Shanghai Composite	3 244	2.96	0.43	5.0
VIX - Implied Volatility Index	13.82	-3.02	-5.34	-36.2

Source: Bloomberg, Ostrum AM

Ostrum ASSET MANAGEMENT

Enhancing your power to act

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