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Market views and strategy

Ostrum ASSET MANAGEMENT

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N° 136 // **November 27, 2023**

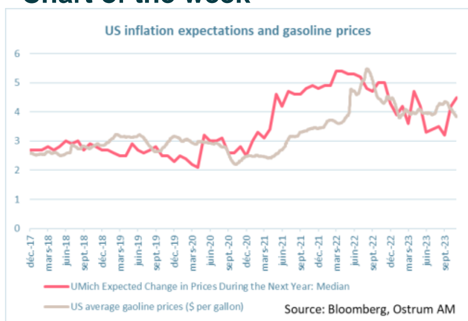
Topic of the week: Portugal: The elections do not call into question the continuation of strong improvement in public finances

- **The Prime Minister created a surprise by announcing his resignation;**
- **The legislative elections of March 10 will not call into question the rapid reduction of the public debt;**
- **Portugal is one of the rare countries in the Eurozone to return to a budget surplus this year and to see its public debt fall below 100% of GDP from 2024 or 2025;**
- **This is the fruit of years of fiscal prudence, following the sovereign debt crisis, and strong growth;**
- **Portugal's performance contrasts with the slow reduction of budgetary imbalances in the Eurozone and more particularly with France, Belgium and Italy, while the EC will reinstate budgetary rules at the start of 2024.**

Market review: The German imbroglio

- **Germany: budget vote postponed by a week;**
- **ECB: PEPP reinvestments to be discussed in December;**
- **Sharp pickup in flows into risky asset funds;**
- **High yield outperforms.**

Chart of the week



Despite the drop in gasoline prices since September 20, from \$4.4 per gallon to the current \$3.8, inflation expectations among American households are increasing. According to the University of Michigan confidence index, median one-year inflation expectations have increased considerably over the past 2 months, going from 3.2% in September to 4.5% in November and returning to the levels reached in April. 5-year inflation expectations also increased, from 3% in October to 3.2% in November, reaching their highest level since March 2011. American households fear that the process of rapid disinflation will not be sustainable.

Figure of the week

-9

Source : Bloomberg

The change in basis points in the German 10-Yr yield as the debt agency announces it will cease issuance of inflation-linked bonds from 2024.

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• Topic of the week

Portugal: The elections do not call into question the continuation of strong improvement in public finances

The surprise announcement of the resignation of the Prime Minister on November 7 and the holding of early legislative elections on March 10 do not call into question the dynamic of rapid reduction of Portugal's public debt. This did not dissuade the rating agency Moody's from raising the sovereign debt rating by 2 notches, bringing it to A3 with a stable outlook.

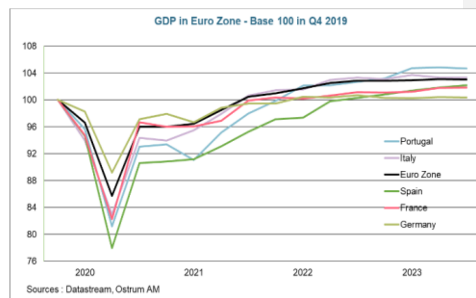
Political uncertainty

On November 7, Prime Minister Antonio Costa created a surprise by announcing his resignation. This follows suspicions of corruption and influence peddling within his government. The chief of staff was placed in provisional detention and Antonio Costa is the subject of an investigation by the Public Prosecutor's Office. Suspicions relate to the award of contracts in the context of projects linked to two lithium mines, a green hydrogen production site and a data storage center.

The President, Marcelo Rebelo de Sousa, has decided to dissolve Parliament and call early legislative elections on March 10. Antonio Costa nevertheless remains in his post until the arrival of his successor. This will allow the government to vote on the 2024 finance law on November 29 and will give the different parties time to prepare for the elections. Antonio Costa, leader of the Socialist Party, has been at the head of Portugal for 8 years and obtained an absolute majority in the legislative elections of January 2022.

Robust growth

If Portugal was one of the economies most affected by the Covid-19 crisis, its rebound was one of the strongest, as shown in the following graph. In the 2nd quarter of 2020, Portuguese GDP contracted by 18.8% compared to the level of the 4th quarter of 2019, compared to 14.3% in the Eurozone. Like Spain and Italy, the Portuguese economy has been affected more than other economies due to the importance of the tourism sector in its activity. Portugal's rebound was more significant. In the 3rd quarter of 2023, the level of GDP is 4.6% higher than the pre-Covid level, compared to 3% for the Eurozone. Growth was thus 6.8% in Portugal in 2022 compared to 3.4% in the Eurozone.



The recovery was linked to household consumption and exports. Consumption benefited from extensive government support measures, a very robust job market and the drop in the household savings rate compared to the peak reached during the Covid crisis. Exports, for their part, benefited from the strong rebound in tourism, whose activity now exceeds pre-Covid levels. Tourism represents 8.7% of GDP and 17.5% of exports in 2022.

Slowdown in 2023

Like the rest of the Eurozone, growth is slowing due to the end of the post-Covid catch-up effect, continued high inflation (3.2% in October), weak global demand and the increasingly significant impact of the monetary tightening carried out by the ECB. This results in a drop in residential investment, with the majority of loans (84.2%) being at variable rates and indexed to Euribor. This is partly offset by rising wages. The government raised the minimum wage by 7.8% at the start of 2023 and plans to increase it by 7.9% in 2024 to counter the effects of high inflation.

GDP thus contracted by 0.1% in the 3rd quarter of 2023, after 0% in Q2 and growth of 1.5% in Q1. However, growth should be one of the most dynamic in the Eurozone. The growth overhang in the 3rd

quarter (average annual growth in 2023 assuming stability of GDP in Q4) is one of the highest: 2.1% compared to 0.5% in the Eurozone.

The investment benefits from funds from NextGeneration EU

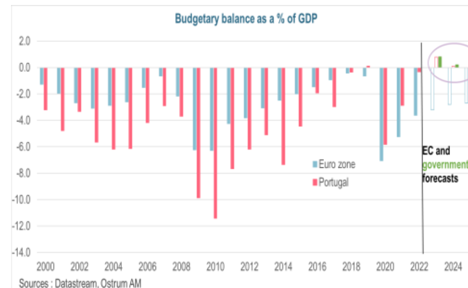
The investment will continue to benefit from the payment of funds from NextGeneration EU. Portugal is one of the countries benefiting the most from payments from the European Union as part of the Next Generation EU program. The European Union has just accepted the revision of Portugal's program. Like many countries, it incorporates a new chapter to reduce its dependence on fossil energy (RepowerEU) and a slightly higher demand for loans. Under the Recovery and Resilience Facility, Portugal can receive up to 22.2 billion euros, including 16.3 billion in grants and 5.9 billion in loans. To achieve this, the country must continue its structural reforms and necessary investments in digital and energy transition. This constitutes support for potential growth. The government estimates an increase of 3.5 pp by 2025 and the EC an increase of between 1.5% and 2.4% of GDP by 2026.

Rapid improvement in public finances

Return to budget surplus in 2023

Like all economies, Portugal recorded a large public deficit in 2020 (5.8% of GDP compared to 7% for the Eurozone), with governments taking major measures to support growth in the face of the unprecedented shock of Covid-19. Subsequently, Portugal's deficit reduced much more quickly than in the rest of the zone to return almost to balance from 2022 and show a surplus from 2023. The government and the European Commission expect a budget surplus of 0.8% of GDP in 2023. In the Eurozone, the budget balance is only improving slowly to still remain in deficit of 3.2% in 2023, 2.8% in 2024 and 2.7% in 2025, according to the latest forecasts from the European Commission.

This rapid return to budget balance is linked to Portugal's stronger nominal growth. Revenues benefit from a robust job market, rising wages and still high inflation. At the same time, spending is lower due to the end of measures to deal with the Covid-19 crisis and a less significant net budgetary impact of spending adopted to deal with the energy crisis (1.3% of GDP in 2023 compared to 2% in 2022 according to the EC). Portugal also returned to a primary surplus in 2022: 1.6% of GDP, which increased in 2023: 2.8% forecast by the EC.



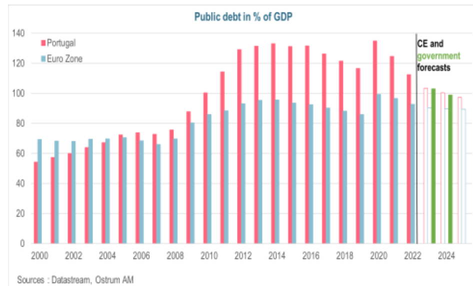
For 2024, the EC plans a reduction in the budget surplus to 0.1% of GDP and the government to 0.2%. Revenues will be lower due to slower growth, tax measures adopted and lower inflation. Expenditure will be higher, in particular civil servant salaries and social transfers. Portugal will nevertheless remain one of the rare countries in the Eurozone not to experience a budget deficit, a reflection of its fiscal prudence. Portugal will remain one of the rare economies to record a primary surplus: 2.4% and 2.3% of GDP in 2024 and 2025 according to the EC.

Public debt expected below 100% of GDP

The Covid-19 crisis has only temporarily stopped the reduction in the ratio of public debt to GDP which had been at work since 2010. After having increased sharply in 2020 to settle at 135% of GDP (compared to 117% in 2019), the ratio has fallen sharply and at a rate among the fastest in the Eurozone countries. The debt should return to around 103% of GDP in 2023 and fall below 100% from 2024 according to the government (98.9% against 100.3% expected by the EC). The EC expects it to be 97.2% in 2025.

This rapid improvement comes from strong nominal growth and the return to budget balance. Public debt should continue to be reduced rapidly given that Portugal is one of the rare countries in the zone to post a primary surplus (budgetary balance excluding interest charges) and to benefit from a growth rate higher than the rate of interest on the debt. In addition, the average residual maturity of the debt is 7.5 years,

allowing a slow diffusion of the increase in interest rates.



The markets are confident

The markets showed little movement following the announcement of Antonio Costa's resignation on November 7, as shown in the following graph. The 10-year rate spread (difference between the Portuguese 10-year rate and the German 10-year rate) widened by only 3 basis points between November 6 and 8, to 74 bps, before quickly tightening. This demonstrates investor confidence that public finances will continue to improve rapidly despite upcoming elections and the formation of a new government next year.

The markets were particularly reassured by the President's decision to delay the official acceptance of Antonio Costa's resignation in order to allow the 2024 budget to be voted on at the end of November. Furthermore, in the event of an opposition victory, the center-right party is also keen to continue prudent management of public finances and thus continue to receive funds from the European Union.

The markets were also reassured by Moody's decision to raise Portugal's sovereign debt rating by 2 notches, from Baa2 to A3, with a stable outlook, on November 17. This is now comparable to that of Fitch: A-, stable outlook, which was raised by one notch in September. Standard & Poor's, for its part, revised the outlook from stable to positive on September 8, leaving the door open to an increase in the rating, currently BBB+.

Strong household demand in 2023

Despite the ECB's lesser presence on the bond markets (with the cessation of reinvestments of payments under the APP since July), Portugal's spread has narrowed significantly. This coincided with strong household demand for savings certificates. It reached 10.8 billion euros over the year, allowing the government to finance half of its financing needs for the year 2023 and thus reduce its bond issues. These long maturity products offer more attractive returns given the rise in interest rates. Until the beginning of June, savings certificates had a maturity of 10 years and offered a yield equal to 3-month Euribor + 1%. It was capped at 3.5%. Since then, conditions have become less attractive. The maturity is 15 years and the rate is 3-month Euribor with a ceiling set at 2.5%. This resulted in a drop in households net subscriptions.

Conclusion

The upcoming elections do not call into question the continuation of the rapid improvement in Portugal's public finances, the result of years of fiscal prudence since the sovereign debt crisis, and the return of robust growth. These two factors are expected to persist. The country has returned to a balanced budget, returned to primary surpluses and should see its public debt quickly fall below 100% of GDP. These performances contrast with the slow improvement in public finances in the Eurozone and in particular with France, Belgium and Italy, while the European Commission will reinstate budgetary rules at the start of 2024.

Aline Goupil-Raguénès

Market review

The German imbroglio

Thanksgiving week is often not very lively, but the German budget woes kept volatility high on rates.

The Thanksgiving-shortened week resulted in low trading volumes in financial markets. The T-note yield stood at 4.40% at the close on Wednesday before rising again on Friday due to profit-taking and the fiscal outlook in Germany and the United Kingdom. A significant increase in public borrowing is expected in 2024. Credit spreads benefit from low volatility. Flows are returning to equity mutual funds in the hope of monetary relief, however hypothetical. Tightening could instead accelerate, with PEPP reinvestments on the agenda for the upcoming December ECB Council. Euro corporate credit spreads are narrowing, particularly on high yield. The iTraxx Crossover shrank by over 80 bp in a month. The decline of the US dollar continues: the euro is now trading above $1.09. The Chinese Renminbi also rose 0.8% to 7.15 against the greenback.

The economic situation remains worrying in the euro area. The German economy contracted by 0.1% between July and September according to the second GDP estimate. Public and private consumption remains fragile while investment spending was relatively stronger despite the ongoing contraction in housing. Fiscal policy is at the heart of debates in Germany. The constitutional court rejected Berlin's decision to reallocate €60 billion in Covid loans (in special funds) to energy transition investments included in the federal budget. The Court's ruling postponed the budget vote by a week. Negotiations between the different members of the German government coalition are difficult. The Minister of Finance has also suspended the debt limit set out in the constitution. The latest economic surveys, however, suggest a stabilization of activity. The first part of the year will remain mediocre before an improvement in the wake of a recovery in consumption.

In the United States, the publication of the household confidence survey (University of Michigan) revealed a sharp rise in 12-month inflation expectations, despite the significant decline in gasoline prices. The fall in oil prices accelerated after the OPEC meeting was postponed by one week. Saudi Arabia cannot convince its cartel partners to reduce their oil production quotas.

The financial markets remain generally upbeat. Equity markets rose by almost 1% in Europe. The S&P is on track to post one of the best Novembers in its history. Globally, we have observed a clear recovery in equity flows over the past two weeks according to EPFR data with $40 billion in inflows. The level of short rates keeps money flowing into money market funds after about $1,200 billion inflows in 2023. On the US Treasuries market, the 10-year T-note is approaching 4.50% in limited volumes. Anticipation of a more expansionary budget in Germany sent the Bund yield above 2.60%. The ECB also suggests that a debate on the PEPP reinvestment policy will start soon in 2024. Expectations in terms of monetary relief should also be tempered. The Schatz yield rose back above 3%. Swap spreads decreased by an additional 2 bp last week. The German debt agency also announced that sales of index-linked bonds will stop from 2024. The outstanding amount of €66 billion is currently valued at €82 billion given the rise in prices, which could be problematic given with regard to the constitutional brake on debt. This decision resulted in an instantaneous 9-bp drop in the German 10-year real yield and a concomitant increase in breakeven inflation rates. Demand will undoubtedly shift onto French and Italian linkers. Sovereign spreads benefited from the rebound in German bond yields, particularly Greece which is trading below 120 bp (on 10-year maturities). In emerging bond markets, Milei's election was ultimately well received by the markets. The appointment of the former Minister of Finance in the Macri government is a positive signal.

The credit market has consolidated its recent good momentum. Three-quarters of November issues tightened after launch. The primary market still totals €13 billion this week, concentrated before Thanksgiving. New issue premiums are between 5 and 10 bp and order books are fairly full thanks to the resumption of flows into ETFs and credit funds (+€1.3 billion over one week). The average IG spread stands at 97 bp against swap. High yield spreads are narrowing in the wake of the crossover below 380 bp.

Axel Botte

Main market indicators

G4 Government Bonds	27-Nov-23	1wk (bp)	1m (bp)	2023 (bp)
EUR Bunds 2y	3%	-2	-3	+24
EUR Bunds 10y	2.56%	-5	-27	-1
EUR Bunds 2s10s	-44.8bp	-3	-24	-24
USD Treasuries 2y	4.92%	+1	-8	+49
USD Treasuries 10y	4.43%	+1	-41	+55
USD Treasuries 2s10s	-49.5bp	+0	-33	+6
GBP Gilt 10y	4.22%	+10	-32	+55
JPY JGB 10y	0.78%	+3	-1	-13
€ Sovereign Spreads (10y)	27-Nov-23	1wk (bp)	1m (bp)	2023 (bp)
France	56bp	0	-6	+2
Italy	175bp	+2	-17	-38
Spain	99bp	+0	-8	-9
Inflation Break-evens (10y)	27-Nov-23	1wk (bp)	1m (bp)	2023 (bp)
EUR 10y Inflation Swap	2.32%	-1	-17	-23
USD 10y Inflation Swap	2.48%	-8	-20	-5
GBP 10y Inflation Swap	3.75%	+0	-13	-17
EUR Credit Indices	27-Nov-23	1wk (bp)	1m (bp)	2023 (bp)
EUR Corporate Credit OAS	148bp	-1	-15	-19
EUR Agencies OAS	72bp	-1	-8	-7
EUR Securitized - Covered OAS	80bp	-1	-8	-4
EUR Pan-European High Yield OAS	440bp	-20	-45	-72
EUR/USD CDS Indices 5y	27-Nov-23	1wk (bp)	1m (bp)	2023 (bp)
iTraxx IG	69bp	+1	-19	-21
iTraxx Crossover	381bp	-1	-84	-92
CDX IG	64bp	+0	-18	-18
CDX High Yield	410bp	0	-118	-74
Emerging Markets	27-Nov-23	1wk (bp)	1m (bp)	2023 (bp)
JPM EMBI Global Div. Spread	411bp	-15	-37	-41
Currencies	27-Nov-23	1wk (%)	1m (%)	2023 (%)
EUR/USD	$1.094	-0.037	3.512	2.2
GBP/USD	$1.262	0.896	4.084	4.4
USD/JPY	JPY 149	-0.269	0.585	-11.9
Commodity Futures	27-Nov-23	-1wk ($)	-1m ($)	2023 (%)
Crude Brent	$80.6	-$1.7	-$8.6	-0.7
Gold	$2 013.3	$35.2	$6.9	10.4
Equity Market Indices	27-Nov-23	-1wk (%)	-1m (%)	2023 (%)
S&P 500	4 554	0.89	10.61	18.6
EuroStoxx 50	4 369	0.62	8.84	15.2
CAC 40	7 288	0.57	7.26	12.6
Nikkei 225	33 448	-0.41	7.92	28.2
Shanghai Composite	3 032	-1.19	0.46	-1.9
VIX - Implied Volatility Index	12.84	-6.96	-39.63	-40.7

Source: Bloomberg, Ostrum AM

Additional notes

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