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Market views and strategy

Ostrum ASSET MANAGEMENT

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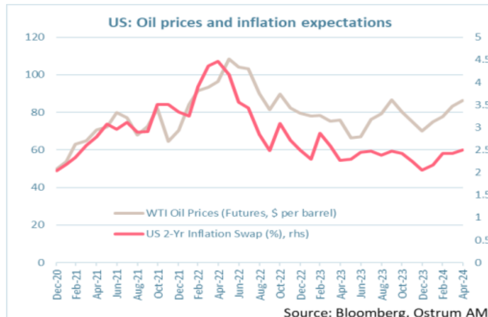
Topic of the week: Risk of downgrade of the French debt rating

- **The budget deficit turned out to be much higher than expected by the government in 2023: 5.5% of GDP compared to 4.9%;**
- **This is due to lower-than-anticipated revenues related to faster-than-expected disinflation in a context of sluggish growth;**
- **Despite additional savings of 10 billion euros and more to come, the target of a 4.4% deficit of GDP in 2024 appears ambitious;**
- **The objective to bring it below the 3% threshold by 2027 seems difficult to achieve;**
- **This budget overrun limits the government's ability to make the necessary investments in energy transition, digitalization, and defense, as well as to cope with a potential new shock;**
- **The risk of a downgrade of France's debt rating by S&P has increased. The impact is expected to be limited on the markets.**

Market review: Oil prices drifting higher

- **US job gains top 300k in March amid improving activity surveys;**
- **Higher oil prices sent equities lower;**
- **Euro credit spreads tighten ignoring equity weakness;**
- **Dollar stays firm, as Yellen criticizes China’s industrial policy.**

Chart of the week



The price of Brent crude oil has been gradually rising over the past few weeks. Oil prices continue to rise steadily due to tensions in the Middle East. OPEC's supply remains limited.

Furthermore, the cyclical improvement seen in global manufacturing surveys foreshadows an increase in demand. The beginning of the driving season in the United States also represents a significant source of demand.

In this context, the modest increase in 2-year inflation breakeven rates may present investment opportunities.

Figure of the week

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Source : Bloomberg

188 billion dollars: This is the unprecedented amount of green bond issuance globally, up by 16% year-on-year in the first quarter of 2024.

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● Topic of the week

Risk of downgrade of the French debt rating

The French budget deficit turned out to be much higher than the government's forecasts: 5.5% of GDP in 2023 compared to the expected 4.9%. In an attempt to reduce it, 10 billion euros in savings were announced in February, with more to come, and the government is seeking to achieve at least an additional 20 billion euros in savings in 2025. Despite these spending cuts, the objective of bringing the deficit below the 3% mark by 2027 appears difficult to achieve. This limits the government's capacity to make the extensive investments necessary for the green transition, digitalization, and defense, as well as to intervene in the event of a new shock. In this context, the risk of a downgrade of the sovereign debt rating in the coming weeks has increased.

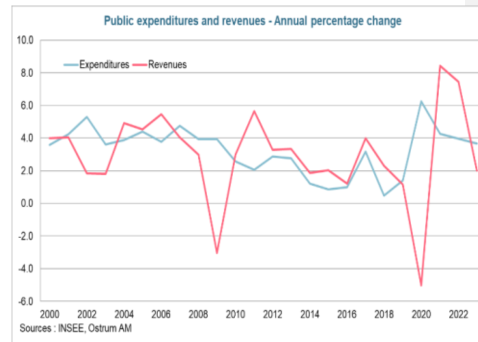
Budget deficit overshoot in 2023

The public deficit turned out to be much higher than the government's forecasts: at 154 billion euros, representing 5.5% of GDP in 2023, compared to the expected 4.9%. It is also an increase from the 2022 deficit, which was 4.8% of GDP.

Lower-than-expected revenues

This overrun is primarily due to lower-than-anticipated tax revenues. The Minister of Economy and Finance, Bruno Le Maire, estimated the shortfall in tax revenues at 21 billion euros for the year compared to what was expected. After two years of strong growth, linked to the strong rebound in post-Covid growth and the sharp acceleration of inflation, tax revenues have slowed significantly in 2023. They only increased by 2% year-on-year, after a 7.4% increase in 2022, primarily due to faster-than-expected disinflation and sluggish growth.

Revenue from corporate tax has decreased significantly (-10.7 billion euros) after an exceptional year, as have those related to property transfer taxes (-4.8 billion euros, a decrease of 22.2%), as a result of fewer transactions in the real estate market. Revenue from value-added tax (VAT) has also slowed significantly (2.8% after 7.6%).



Sources : INSEE, Ostrum AM

Overall, expenditures were generally in line with expectations. Their increase moderated slightly over the year: +3.7% in 2023 after +4% in 2022. They have grown less than inflation. It is worth noting that the latest measures taken to address the Covid-19 crisis have ended, and expenses to protect businesses and households from rising energy prices have stabilized. Furthermore, despite the sharp rise in interest rates, the interest burden decreased in 2023: -2.6 billion euros, a decrease of 4.9%, representing 1.8% of GDP. This is related to inflation-indexed securities.

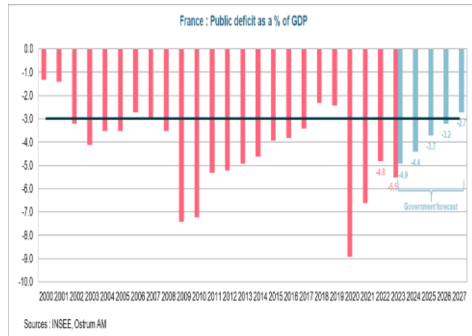
Finally, the growth was generally in line with the government's forecasts: 0.9% in 2023 compared to the expected 1%.

The significant increase in the deficit contributed to the rise in public debt over the year 2023: up by 147.6 billion euros, reaching 3,101.2 billion euros. The ratio of public debt to GDP, on the other hand, slightly decreased to 110.6%, compared to 111.9% in 2022. This is attributed to the faster growth of nominal GDP compared to that of the debt. It turned out to be higher than the government's target (109.7%).

The objective of returning to a deficit below 3% of GDP by 2027 appears difficult to achieve

Despite this significant budget overrun, the government maintains its objective of bringing the public deficit below 3% of GDP by 2027. Tax increases are currently excluded, and the adjustment will come from

lower expenses.



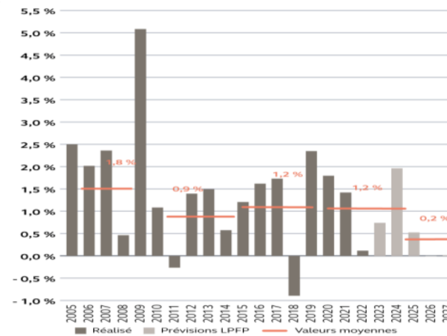
For 2024, the target of a 4.4% deficit appears very difficult to achieve even with additional savings, given the significant effort required in a context of low growth.

This figure is indeed based on overly optimistic growth prospects despite the recent downward revision by the government. The government anticipates a growth rate of 1% in 2024, down from the 1.4% announced in the fall. Given the low carry over at the end of 2023 (+0.2%) and data indicating continued weak consumption at the beginning of the year (household goods consumption decreased by 0.6% in January and stabilized in February), this 1% average growth rate for the year requires a strong acceleration of growth over the next 3 quarters. However, business surveys conducted in March do not indicate a rapid recovery. Business activity indices have at best returned to their long-term average for the INSEE survey, slightly above for the European Commission survey, or remain in contraction territory according to the S&P Global survey.

The downward revision of the growth outlook led the government to announce 10 billion euros in savings for the year 2024 in February. Others are currently being prepared given the larger-than-expected deficit in 2023. For 2025, the government has indicated that it is seeking at least an additional 20 billion euros in savings to be made. The government has requested a review of public spending at the state, local government, and social sphere levels to propose savings to be made. These new measures are expected to be announced as part of the stability program to be presented to the European Commission at the end of April.

In a more general sense, achieving the target of a 2.7% public deficit by 2027 is based on strong control of public spending. The 2024 Finance Bill assumes that expenses excluding interest charges and exceptional expenses will only increase by 0.2% per year in volume over the period 2025-2027, which has never occurred since 2005, as shown in the following graph from the Court of Auditors' report.

Growth rate of public spending (excluding interest charges and exceptional expenses) in volume (in %)



Source : Cour des Comptes

Government's more limited capacities

This significant budget overrun, combined with still optimistic growth forecasts and a very ambitious effort to control public spending from 2025 to 2027, make it difficult to achieve the objective of bringing the public deficit back below the 3% of GDP threshold. This comes in a context of increasing debt service costs following the rise in bond yields, in the wake of the strong monetary tightening by the ECB. The average maturity of French debt is 8.5 years, which allows for the spreading of this increase over time, as it applies gradually as the bonds come due and need to be refinanced at a higher rate.

The result of this budget overrun and downward revision of growth forecasts is a higher starting point for public debt this year. This translates into a more limited capacity for government intervention to finance the extensive investments needed in energy transition, digitalization, and defense. Just to meet France's decarbonization objectives by 2030, an additional 110

billion euros per year of low-carbon investments will be needed by 2030, compared to 2021, according to a recent study by the DG Treasury.

Furthermore, in the event of a new shock to economic activity, the government's room for maneuver will be more limited to take measures aimed at mitigating the consequences for households and businesses, as was done during the Covid-19 crisis or the energy shock.

Risk of credit rating downgrade by rating agencies

The risk: May 31 with the review by S&P

The credit rating agencies will make decisions on France's sovereign debt in the coming weeks: on April 26th for Fitch and Moody's, and on May 31st for S&P.

	Note	Perspective	Next review
Fitch	AA-	stable	26-avr
Moody's	Aa2	stable	26-avr
S&P	AA	negative	31-mai

Sources : S&P, Fitch, Moody's

Fitch issued a statement on April 2nd, in which it indicates that this budget overrun validates its decision made last April to downgrade France's rating from AA to AA-, with a stable outlook. It also specifies that a potential downgrade of the rating on April 26th will depend on a significant new increase in public debt, which it considers unlikely given the stable outlook attached to the rating.

The French sovereign debt is currently rated Aa2 by Moody's (equivalent to AA for S&P and Fitch), with a stable outlook. Given the significant budget overrun and high level of debt, the agency could decide to revise the outlook to negative to signal the risk of a potential downgrade of the rating.

The most significant risk comes from S&P on May 31st, whose AA rating has been attached with a negative outlook since December 2022 due to a significant public deficit and high public debt. During the review on December 1st, S&P indicated that the rating could be lowered in the next 12 months if the deficit did not decrease sufficiently to allow for a reduction of the public debt-to-GDP ratio, or if the interest burden exceeded 5% of revenues. On the second point, S&P can be reassured as the public debt-to-GDP ratio decreased in 2023 to 3.4%, compared to 3.7% in 2022, well below 5%. However, the situation is different regarding the first point, given the larger-than-expected public deficit.

Limited impact on the sovereign bond market

The consequences of a potential downgrade of France's sovereign debt rating by S&P, from AA to AA-, on sovereign bond markets are expected to be limited. When Fitch downgraded the rating by one notch on April 28th, 2023, the yield spread between French and German bonds did not widen significantly, as shown in the following graph.

The spread widening since March 21st partly incorporates concerns related to the French budget overrun, which had been expressed by some government members before the release of the INSEE data. However, it is also a consequence of global tensions in the bond markets as investors postpone the date of the Federal Reserve's first interest rate cut. Initially expected in May, then June and July, the markets now anticipate it in September. This follows data indicating stronger-than-expected US growth, a more robust job market, and slower-than-expected disinflation. In this context, after a significant narrowing of spreads since early November 2023, driven by expectations of monetary policy easing before the summer, spreads have been widening since late March.

Strong demand from investors

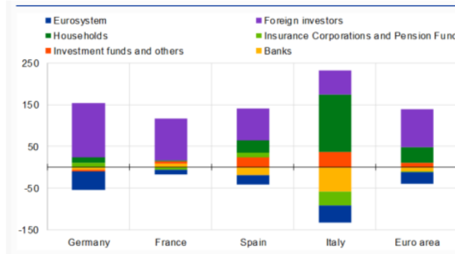
In the event of a downgrade, the debt will be rated AA, which remains of very good quality despite a

significant deficit and a high public debt-to-GDP ratio. This is largely due to the intrinsic characteristics of the French bond market. It is one of the most liquid and deep markets in the Eurozone and is therefore among the preferred markets for investors.

The context also remains positive for bond markets, with investors seeking to lock in higher interest rates ahead of the first central bank rate cuts. Thus, despite the reduced presence of the ECB in bond markets, with the cessation of reinvestments of maturing securities under the APP since July, and the record government issuances at the beginning of the year, Eurozone spreads have not widened. This is the result of increased purchases by foreign investors and households, as shown in the following chart from the ECB.

In France, there were significant net inflows from foreign investors in 2023, while in Italy, households greatly increased their presence in the bond market with the success of bond issuances targeted at them (BTP Valore).

Absorption of sovereign bonds by sector in 2023 (in %)



Sources: ECB, SHS.

Conclusion

The significant budget overrun recorded in 2023 poses the risk of a downgrade of France's sovereign debt rating by S&P on May 31st. The impact on the bond market of a potential downgrade is expected to be limited, as was the case a year ago when Fitch downgraded the rating to AA-. The French bond market is favored by investors due to its high liquidity and depth. Moreover, the environment remains favorable, with investors seeking to lock in higher interest rates before the central banks ease their monetary policies.

Aline Goupil-Raguénès

Market review

Oil prices drifting higher

The situation in the Middle East is fueling the rise in oil prices, stock markets are falling but credit is holding up.

Oil is once again derailing the stock markets. The barrel of crude reacts to the extension of the Israeli-Palestinian conflict to Iran by crossing the threshold of $90 for the first time since the fall of 2023. US support for Israel appears to be called into question following the latest developments. The instability in the region also affects inflation expectations and the prospects for monetary relief from the Fed. At the same time, trade tensions are increasing. The US Treasury's rhetoric has hardened with regards to Chinese over-capacity ahead of Janet Yellen's visit to Beijing. The weakness in the yuan and the collapse in export prices of Chinese goods linked to the energy transition (electric vehicles, photovoltaic panels, etc.) is unbearable for the US manufacturing sector. The protectionist risk is therefore increasing despite softer statements excluding a scenario of decoupling of the two largest economies in the world. In this troubled international context, US equities corrected by 2% as the double-digit performance in the 1st quarter of 2024 motivated profit taking. The yield on the US 10-Yr note briefly traded at 4.40%. The spread to German10-Yr Bunds has widened to 200 bp, close to the highs of the last two years. Conversely, the sharp tightening in credit spreads continues despite the tensions currently impacting the distressed part of the European high yield market. The greenback remains firm, as does gold.

The latest publications show US economic growth close to its potential in the 1st quarter. Employment increased by 303k in March, bringing the total job creation to 829k over the first three months of the year. The unemployment rate remains below 4%. Wage tensions appear contained (+4.1% for the average hourly wage). That said, the increase in the minimum wage in California (+18% for fast-food workers), on April 1, raises the risk of renewed pressure on labor costs. Domestic inflation is clearly out of line with the 2% objective. This is also the case in the euro area where the price of value added (+5.3% in 4Q 2024) is disconnected from inflation measured by the headline HICP (2.4% in March). Inflation in services (4%) has been unchanged in the past 5 months. The PMI surveys foreshadow an economic recovery, driven by the southern economies. The current steady rise in oil prices, in this context, risks putting an end to the disinflation trend. In China, business surveys are also improving.

The rise in crude oil and solid US data releases are contributing to the rise in long-term rates. The T-note is trading almost 20 bp above the quarterly close. The Fed's commitment to lower interest rates shifts financial risk to longer maturities. For this reason, the steepening of the yield curve via a further increase in the term premium is a plausible outcome. The Bund yield will also be under upward pressure given the spread level close to 200 bp. The euro area is not the 13th district of the Fed, but what is decided in Washington cannot be ignored, especially as the euro is now trading below $1.08. A premature accommodative shift in policy would risk weakening the single currency further, leading to a resurgence of imported inflation. That being said, the public finance situation is worrying in France and Italy. Fiscal consolidation is an unusual exercise to say the least, especially in France. However, the upcoming decisions of the credit rating agencies (in April and May) will fuel selling flows which have already sent the OAT spread above 50 bp. The revelation of fraud linked to European Union funds in Italy is also likely to put pressure on the Italian BTP spread. The widening in OAT and BTP yield premiums naturally impacted other sovereign debts.

Credit remains surprisingly upbeat in this context. Inflows into the asset class amplify the tightening of spreads. The average asset swap spread (75 bp), which, so far, appears insensitive to the risk of France's rating being downgraded, is at its tightest since 2022. The iTraxx spread is also stable about 55 bp. The high yield market is more turbulent. There are more candidates for default and the spreads of the weakest signatures are tightening. The iTraxx Cross-over is trading around 300bp. The stock markets corrected with the rise in oil prices and employment (S&P -2%). In Europe, banks and energy are holding up well in a generally falling equity market. Implied volatility rises above 15%. Shanghai took the opportunity to gain 2.5%.

Axel Botte

Main market indicators

G4 Government Bonds	08-Apr-24	1wk (bp)	1m (bp)	2024 (bp)
EUR Bunds 2y	2.91%	+6	+15	+50
EUR Bunds 10y	2.44%	+14	+17	+42
EUR Bunds 2s10s	-47bp	+8	+2	-8
USD Treasuries 2y	4.77%	+7	+30	+52
USD Treasuries 10y	4.43%	+12	+36	+55
USD Treasuries 2s10s	-34.2bp	+6	+6	+3
GBP Gilt 10y	4.11%	+18	+13	+57
JPY JGB 10y	0.8%	+6	-1	-28
€ Sovereign Spreads (10y)	**08-Apr-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
France	50bp	-1	-1	-3
Italy	141bp	+3	+3	-26
Spain	83bp	-4	-4	-14
Inflation Break-evens (10y)	**08-Apr-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
EUR 10y Inflation Swap	2.24%	+0	+6	+11
USD 10y Inflation Swap	2.59%	+2	+11	+18
GBP 10y Inflation Swap	3.72%	+4	+14	+18
EUR Credit Indices	**08-Apr-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
EUR Corporate Credit OAS	110bp	-4	-12	-28
EUR Agencies OAS	61bp	+0	-1	-9
EUR Securitized - Covered OAS	65bp	0	-4	-14
EUR Pan-European High Yield OAS	360bp	+2	+5	-39
EUR/USD CDS Indices 5y	**08-Apr-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
iTraxx IG	55bp	+1	+2	-4
iTraxx Crossover	301bp	+4	+8	-12
CDX IG	53bp	+0	+3	-4
CDX High Yield	339bp	+5	+10	-17
Emerging Markets	**08-Apr-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
JPM EMBI Global Div. Spread	331bp	-11	-38	-53
Currencies	**08-Apr-24**	**1wk (%)**	**1m (%)**	**2024 (%)**
EUR/USD	$1.083	0.894	-0.969	-1.9
GBP/USD	$1.263	0.638	-1.812	-0.8
USD/JPY	JPY 152	-0.079	-3.135	-7.1
Commodity Futures	**08-Apr-24**	**-1wk ($)**	**-1m ($)**	**2024 (%)**
Crude Brent	$89.8	$2.3	$8.2	17.1
Gold	$2 337.5	$99.4	$158.6	13.3
Equity Market Indices	**08-Apr-24**	**-1wk (%)**	**-1m (%)**	**2024 (%)**
S&P 500	5 204	-0.95	1.57	9.1
EuroStoxx 50	5 015	-1.35	1.08	10.9
CAC 40	8 061	-1.76	0.41	6.9
Nikkei 225	39 347	-1.15	-0.86	17.6
Shanghai Composite	3 047	1.22	0.27	2.4
VIX - Implied Volatility Index	16.03	23.21	8.75	28.8

Source: Bloomberg, Ostrum AM

Additional notes

Ostrum Asset Management

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