MyStratWeekly
Market views and strategy

Ostrum ASSET MANAGEMENT

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N° 022 // **10 May 2021**

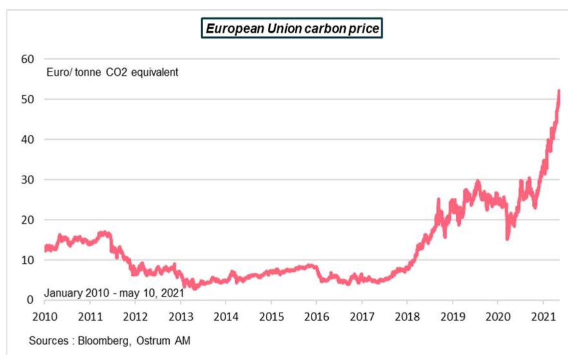
Topic of the week: The European recovery plan: a great opportunity for Italy

- **Italy presented an ambitious recovery and resilience to the European Commission in order to benefit from his payments;**
- **This is a great opportunity for Italy to increase public investment in the energy and digital transition, reduce the divergence between North and South, implement reforms and allow an increase in long term growth;**
- **The reduction in the public debt to GDP ratio which will result from the implementation of the plan calls for a narrowing of the Italian spread.**

Market review: Bad news is good news?

- **Yellen pays lip service amid volatility bout;**
- **Mediocre job data reignites the liquidity push;**
- **TIPS outperformance continues;**
- **Pressure on peripheral sovereigns, credit proves resilient.**

Chart of the week



In Europe, the price of carbon has recorded a spectacular increase since the end of 2020 (+ 71% since December 11) to cross for the first time the bar of 50 euros per ton of CO2. This is the result of setting a more ambitious interim target for reducing greenhouse gas emissions for 2030 (by at least 55% compared to 1990) in order to achieve climate neutrality by 2050. This foreshadows a smaller allocation of emission allowances from the EU to companies, which generates pressure on the price of carbon. This is a good way to encourage companies to become less polluting.

Figure of the week

59%

Source: IMF

The share of dollar foreign exchange reserves held by central banks. This is the lowest level in 25 years.

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● **Topic of the week**

The European recovery plan: a great opportunity for Italy

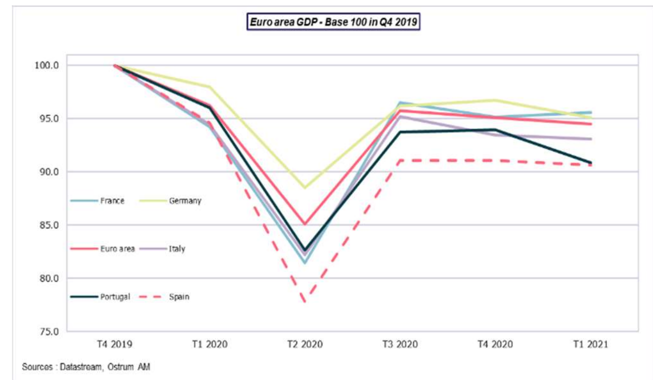
Governments are presenting the European Commission with a recovery and resilience plan in order to benefit from the first payments of Next Generation EU during the summer. These must meet a number of investment and reform criteria. The plan presented by Italy is ambitious and constitutes a real opportunity to put the economy on a higher and sustainable growth path and thus reduce the ratio of public debt to GDP. Combined with the assurance that favorable financing conditions will be maintained from the ECB, this plan, if effectively implemented, pleads for a narrowing of the Italian spread.

A year ago, faced with the shock linked to Covid-19, France and Germany presented a proposal to create a European recovery fund. This was largely taken up by the European Commission and gave rise, on July 21, 2020, to a historic agreement for Europe with the creation of Next Generation EU.

The European recovery plan

A historic agreement

The countries most affected by the Covid-19 crisis, such as Spain and Italy depending more heavily on tourism, are those with the least room for maneuver to face it given a high public debt ratio. In order to prevent the recovery from operating too unevenly within the European Union, at the risk of weighing on the dynamics of other countries, given the importance of intra-zone trade, and creating new potential tensions, both financial and political, the 27 agreed on the creation of a European recovery fund backed by the multiannual European budget 2021-2027.



This agreement is historic in two respects: for the first time, the European Commission will be able to borrow massively on the bond markets on behalf of all European countries: 750 billion euros between 2021 and 2026 at the price of 2018, or 800 billion at current prices, which represents 6% of the EU's 2020 GDP. An instrument is created for this purpose: Next Generation EU. The other point is that a significant part of the funds will be paid in the form of grants, therefore not reimbursed by the beneficiary countries, and another in the form of loans on favorable terms, since the loans will benefit from the high rating of the European Union debt.

This significant, temporary and targeted agreement constitutes a considerable step forward for the European Union towards greater solidarity and cooperation between the Member States and a step forward towards the creation of a secure European benchmark asset through record amounts of common debt that are going to be issued by the Commission.

The recovery and resilience facility

The Recovery and Resilience Facility (RRF) is the main component of Next Generation EU. In the amount of 672.5 billion (2018 prices), it includes 312.5 billion in grants and 360 billion in loans. The remaining funds are distributed among the six items of the European budget, the first of which is ReactEU (47.5 billion euros). This is a new initiative whose funds will be disbursed in 2021-2022 to strengthen the recovery in favor of cohesion and the territories of Europe.

The grants issued under the RRF amount to 338 billion euros in current prices. The breakdown by country depends for 70% of the population of each of them, on the inverse of the GDP / capita and the average unemployment rate over the period 2015-2019 compared to the EU average. For the remaining 30%, the last criterion has been replaced by the loss of real GDP observed in 2020 and the cumulative loss of GDP over the period 2020-2021. Spain and Italy will be able to receive the largest amounts of subsidies with 68.9 billion euros and 69.5 billion euros respectively. Expressed as a % of GDP (of 2020), these subsidies represent 4.2% of Italian GDP and 6.3% of Spanish GDP. Croatia, Greece and Bulgaria are the main beneficiaries of RRF grants as % of

GDP (13%, 10.8% and 10.5% respectively). Governments can also apply for loans with a maximum value of 6.8% of their gross national income in 2019. These are attractive for countries with higher rates than EU loans such as Italy, Spain, Portugal and Greece in particular.

National recovery and resilience plans

In order to benefit from European Union aid, each government must present a recovery and resilience plan to the European Commission that meets a number of criteria, particularly in terms of public investment and reforms.

What are the criteria set by the Commission?

The plans include public investments and reforms that will be assessed on the basis of 11 criteria, including in particular:

- at least 37% of expenditure will relate to investments or reforms for the energy transition;
- at least 20% of spending will be allocated to digital transformation;
- the reforms will have to respond in part to the specific recommendations by country formulated by the European Commission;
- the plans must in particular strengthen the growth potential, create jobs and reduce inequalities.

What timetable?

The date of April 30 was given as an indication so that the governments present their final plan. They can do this at any time until mid-2022. The European Commission has two months to assess these plans, translate them into legally binding acts, including the proposal for a Council implementing decision. The latter will in turn have one month to validate the plans presented by the Member States by qualified majority.

The first payments should therefore not be made before July, or even August, for countries that presented their final plan at the end of April, such as Portugal, Greece, Spain, Italy, France. and Germany. The Commission will then be able to pre-finance an amount of 13% of the plan. Thereafter, the payments will be made twice a year at most, provided that the countries respect the various intermediate values and targets of their recovery plan.

Last condition: raising the own resources ceiling

Payments can begin on condition that all member countries agree to the increase in the own resources ceiling of the European budget by June 30. This decision is essential to allow the European Commission to borrow the amount of 800 billion euros on the financial markets over 6 years, these resources constituting a guarantee for investors. The decision of the German court of justice to reject an application to suspend this ratification has reduced fears of a delay in the launch of Next Generation EU. However, this text remains to be validated by certain countries.

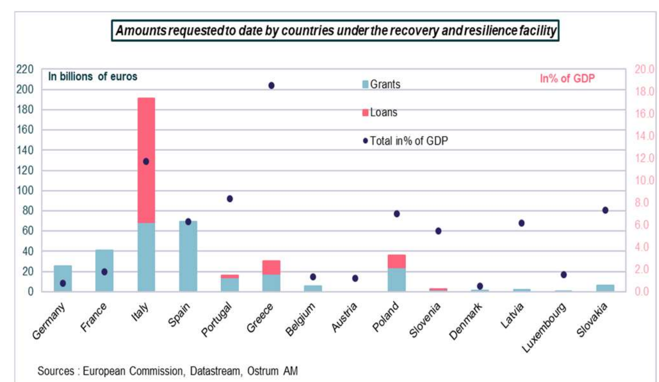
Italy's recovery and resilience plan

Largest and one of the highest amounts as a % of GDP

Funds requested under the RRF: 191.5 billion euros

To date, 14 countries have presented their final recovery and resilience plan to the European Commission. Italy and Greece are the only economies to have requested all the funds available under the RRF from the European Union, using both grants and all loans. Italy will be able to receive 68.9 billion euros in grants and 122.6 billion euros in loans, for a total of 191.5 billion euros. Almost 50% of the loans will be used to finance new investments. Spain only asked for grants while leaving the door open to possible recourse to loans.

The amounts requested so far under the RRF are shown below. Grants and loans are expressed in billions of euros and the total as a % of GDP. In total, the amounts requested by Italy under the RRF represent 11.7% of GDP (in 2020), placing it in 2nd place behind Greece (18.5% of GDP), the latter having also requested loans in addition to subsidies just like Portugal, Poland and Slovenia. In Spain, the plan represents 6.3% of GDP.



Resc-EU: 13.5 billion euros

Italy has also requested Resc-EU to the tune of 13.5 billion euros, thus bringing funding linked to Next Generation EU to 204.5 billion euros, or 12.5% of 2020 GDP. These Resc-EU funds will be paid out of the period 2021-2022 in the form of grants. Added to those RRF, Italy will receive a total of 82 billion euros in grants, or 5% of GDP, to finance new investment projects without inflating its budget deficit.

National fund: 31 billion euros

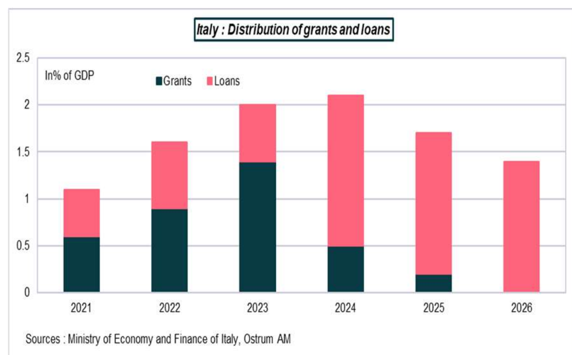
Italy strengthens Next Generation EU with the establishment of a national fund of 31 billion euros to finance additional investment projects in line with the objectives of the plan. This will contribute on average to an additional deficit of 6 billion euros per year over the period 2022-2033.

Italy's recovery and resilience plan

	In billions of euros	In% of GDP
Next generation Eu wich :	205	12.5
Recovery and resilience facility	191.5	11.7
Subventions	68.9	4.2
Loans	122.6	7.5
Resc-EU	13.5	0.8
National funds	31	1.9
Total	236	14.4

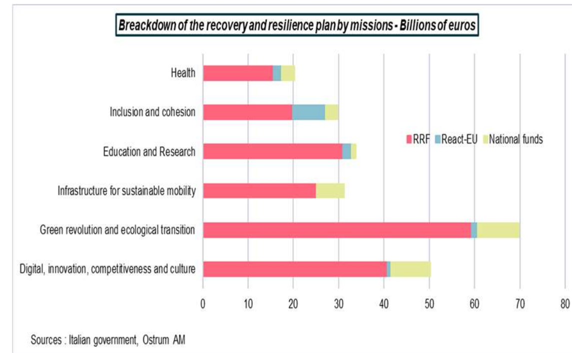
Sources: Italian government, Ostrum AM

As a first step, grants under the RRF will represent a significant part of disbursements to reach a peak in 2023. They will be intended to finance new investments likely to boost growth without increasing Italy's deficit. The loans will take over thereafter to become predominant in 2025 and 2026. They will finance existing projects but also new ones. This distribution is intended to give Italy time to strengthen its growth in the long term and to be able to repay loans more easily afterwards. Repayments of loans requested by member countries under Next Generation EU will only take place from 2028 and until 2058 at the latest.



The plan includes 6 missions

Italy's recovery and resilience plan covers 6 missions in which funds from the RRF, React-EU and the complementary fund are allocated. These missions are in turn divided into 2 to 4 components, or 16 actions in total.



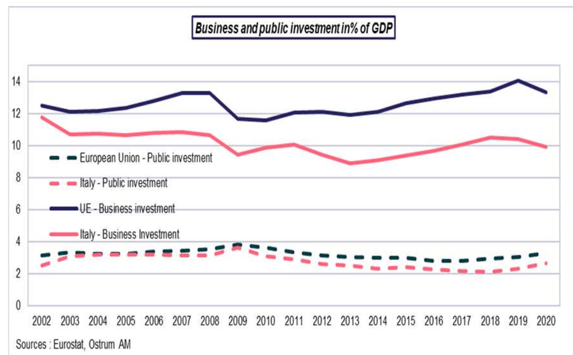
The item concerning the green revolution and ecological transition is the most important (70 billion euros) followed by that of digital, innovation, competitiveness and culture (50 billion euros). This complies with the requirements of the European Union in this area since, according to the Italian government, 40% of the amounts are intended for the ecological transition (higher than the target of 37% of the EU) and 27% concern investments in digital (above the 20% target).

The 1st mission includes in particular tax incentives for companies to invest in research and development and promote innovation. Resources are allocated to develop 5G and broadband as well as the digitization of public administration and the promotion of tourism and culture.
The second mission concerning ecological transition is fully in line with the European Green Pact with investments intended to improve energy efficiency by developing in particular renewable energies, the hydrogen sector and the renovation of buildings.
More than 50% of infrastructure investments will go to the South in order to reduce the large gap with the North. They will concern in particular the development of high-speed trains, the renovation of the rail network and the port infrastructures. The "education and research" mission includes the creation of new nurseries and nursery schools as well as the improvement of research and training. The "inclusion and cohesion" mission aims to facilitate participation in the labor market, in particular with the creation of a fund to encourage women to set up their business. The health system will also be strengthened.

Sharp increase in public investment

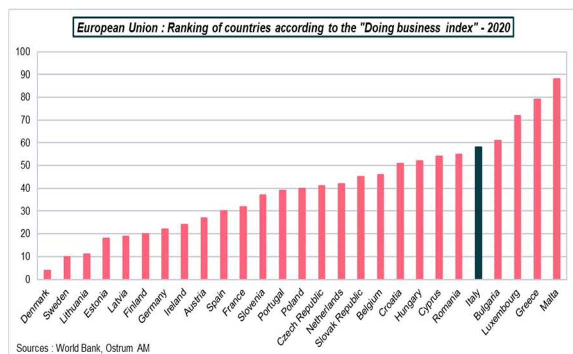
The Italian plan is therefore based on a sharp increase in public investment to make the economy greener and more digital by investing in infrastructure and education in particular. The aim is to increase productivity, which has stagnated in Italy for more than 20 years due in particular to insufficient private and public investment and the importance in the productive fabric of very small businesses and SMEs families who have a limited capacity for innovation. While Italy's investment as a % of GDP was lower than that of the

European Union before the 2008/2009 crisis, the latter fell more sharply with the recession. The austerity policy put in place after the sovereign debt crisis subsequently weighed on public investment. The recovery and resilience plan thus aims, via a sharp increase in public investment, to create a spillover effect on private investment and have a stronger impact on internal demand and employment and to catch up with vis-à-vis the European Union.



Essentials reforms

Mario Draghi, Prime Minister of the Government of National Unity, has made it clear that for the plan to be successful for Italy, additional investments must go hand in hand with reforms. These concern four areas: justice, public administration, the simplification of procedures and the strengthening of competition. They turn out to be essential, as illustrated by the ranking by country carried out by the World Bank according to the "Doing business" indicator shown below for EU countries. This indicator ranks 190 countries according to the ease of doing business, taking into account 10 criteria (such as starting a business, obtaining a building permit, etc.). Italy occupies 58th place in the world and is far behind France (32nd) and Germany (22nd).



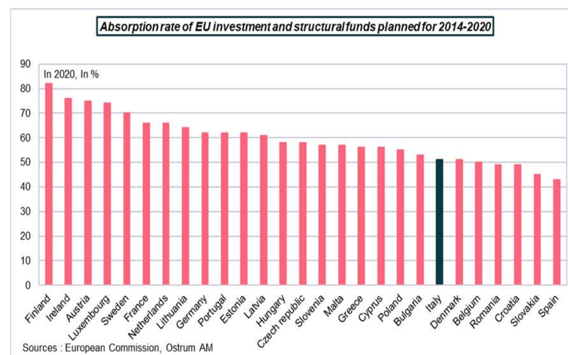
The heaviness of the bureaucracy is partly to blame. The plan aims to increase the efficiency of public administration by making investments in digital technology, simplifying administrative procedures and investing in vocational training. The judicial system also contributes to the slow growth of Italy, in particular because of the length of the trials. The third reform lies in the simplification of procedures to allow faster implementation of projects and public investments in particular. Finally, the last area lies in an increase in competition in services in particular. These measures are essential to remove the obstacles to public investment so that European funds can be effectively invested on time in the projects identified in the recovery and resilience plan.

Impact of the plan:

The sharp increase in public investment combined with the implementation of reforms is likely to significantly increase growth. According to government forecasts, the RRP is expected to increase real GDP growth by 3.6 percentage points (pp) in 2026 compared to the baseline scenario without RRP. This corresponds to an increase of 0.6 pp in GDP on average per year. The increase in the capital stock will also have effects beyond 2026, the impact of which will be all the greater as reforms succeed in improving Italy's productivity in the long term. The government forecasts an increase in potential growth by 0.8 percentage point to reach 1.4% in 2026. This higher growth will translate into a mechanical fall in the ratio of public debt to GDP. The "snowball" effect, which is the difference between the average interest rate and the nominal GDP growth rate, will turn negative and result in a decrease in the debt-to-GDP ratio.

Risks on the implementation of the plan

The impact of the recovery and resilience plan on growth obviously depends on the effective implementation of the latter. However, Italy, like many countries, has in the past made limited use of the European Union funds available to it. As shown in the following graph, in 2020 Italy only used 51% of the European Union's investment and structural funds planned for the period 2014-2020. This shows the importance of carrying out structural reforms so that the government can use EU funds on time and efficiently.



The second risk comes from the fact that Mario Draghi will only be at the head of the government for the first years of

the plan, until 2023. The new government will then have to continue the implementation of public investments and reforms to benefit from the EU payments and boost growth.

Consequences for the bond market

While the first payments of the European recovery plan will not take place before the summer, it has had a significant impact on the bond markets since the announcement of the Franco-German proposal on May 18, 2020. Taken up by the European Commission on May 27 and validated by the 27 Heads of State on July 21, this allowed a clear easing of the spread of Italy against Germany, as shown in the following chart, as well in other peripheral countries.

Spreads in peripheral countries had previously widened sharply due to investor concerns about an upcoming increase in public debt, following the announcement of large-scale fiscal measures by governments to limit the impact of the health crisis on growth. Next Generation EU has reassured the markets since for the first time the European Union will borrow significantly on the markets on behalf of all European countries to pay a significant share of subsidies to the countries most affected by the crisis and with a level of high public debt.

This thus amplified the fall in European bond rates, and in Italy in particular, initiated by the launch of the emergency purchasing program in the face of the ECB pandemic (PEPP) on March 18, 2020, and its strong message on its unlimited determination to preserve the integrity of the Euro zone. This program allows the central bank to buy bonds massively and flexibly in the event of unjustified pressure on rates, which it did for Italy. The ECB's monetary policy thus makes it possible to keep rates low to facilitate the financing by governments of their stimulus plan and thus allow growth to return to its pre-crisis level more quickly. Since then, the strengthening of the PEPP, the prospect of the implementation of the European recovery plan then the arrival of Mario Draghi at the head of a national unity government, after the break-up of the coalition on February 12, 2021 allowed the Italian spread to continue to decline and settle below 100 basis points (bps) in February and March, compared to 239bps on May 15, 2020.

Since the end of April, the spread in Italy has tended to widen to return to around 118bp. The markets focused in particular on the government's announcement of new budgetary measures for 2021 to deal with the consequences of the resurgence of Covid-19, with in particular measures intended to extend aid to businesses and self-employed workers as well as the moratorium on loans. The weaker than expected growth following the new containment measures and these additional measures of 40 billion euros (2.4% of GDP in 2020) should result in an increase in the budget deficit to 11.8% of GDP in 2021, according to the government. However, these prove to be essential given the unprecedented shock linked to the Covid-19 crisis, the strongest recession since the Second World War, to allow the Italian economy to return to its pre-crisis level during the 2nd semester 2022 and avoid a lasting impact.

Mario Draghi makes growth his priority in order not to repeat the mistakes of the 2008/2009 crisis, the too rapid withdrawal of growth support measures which led to a new recession. His acquired credibility as President of the ECB and his determination and commitment to implement the RRP to increase public investment and complete the reforms, which have weighed on Italian growth for almost 20 years, are factors very favorable for the Italian spread. Raising productivity is one of the key elements for increasing potential growth and enabling public debt reduction.

In addition, with the European recovery plan, the European Union will become one of the biggest emitters in the Euro zone. It will issue 800 billion euros between mid-2021 and 2026, or 150 billion euros per year on average, of which 30% in green bonds. It will be a safe asset issuing across the full part of the curve and thus rivaling German bonds. This will thus be likely to weigh on German rates and also contribute to the narrowing of the Italian spread.

Conclusion

Next Generation EU is a tremendous opportunity for Italy to increase public investment in the energy and digital transition, reduce the divergence between North and South and allow an increase in productivity, the stagnation of which is largely responsible for the weak growth for slightly over 20 years. In order for this plan to be successful, Mario Draghi pledged to implement an ambitious plan with key reforms to put the economy on a higher growth path. The success of Next Generation EU is essential for Europe to overcome this crisis and allow this instrument to be used again in the event of another shock.

Aline Goupil-Raguénès

Market review

Bad news is good news?

TIPS and equities seemingly price in a prolonged period of accommodative monetary policy.

Janet Yellen moved markets signaling the risk of higher rates before making a timely corrective statement the next day that ironed out a swift 2% drop in the S&P 500 midweek. Meanwhile, the Fed, in a new bout of schizophrenia, also injected its half-yearly dose of warning against risks to financial stability linked to asset valuation levels. The Fed is not the only central bank blowing hot and cold on the financial markets. The global monetary backdrop is turning gradually less supportive, but language precautions remain. The BoE left the APF envelope unchanged at £ 875 billion while reducing its weekly bond purchases from £ 1bn to £ 3.4 billion, ensuring a smooth QE exit in the fourth quarter. The ECB is trying to prepare the financial markets for a reduction in the PEPP in June while signaling a potential offset via an increase in APP currently set at € 20 billion per month.

Surveys continue to paint a solid growth environment. The ISM indices are holding above 60 in April. The backlog of orders will ensure a high level of production for the next few months as inventory levels are low. However, pressures on logistics chains and rising commodity prices are increasing. It is fair to say that US growth is mainly constrained by supply factors. This is crucial in determining the appropriate stimulus. Given the prevailing balance of power in Congress, a consensus is emerging for a corporate tax rate raised to 25% instead of the 28% proposed by the Biden administration. As regards the household stimulus bill, earned income tax credits and access to education appear crucial. Hiring difficulties are indeed piling up. Skills are in short supply across a range of industries. High federal income transfers may have indeed increased the reserve wages of the least-skilled workers. The $ 300 federal unemployment benefit expires in September. These frictional effects and strong demographic trends still weigh on participation. The latest employment figure denotes all economic indicators. The seasonal adjustment wipes out 823k new jobs in April and the seasonally adjusted figure of 266k hence appears dubious. The unemployment rate rose to 6.1%. In the euro zone, PMIs are reassuring about the prospects for economic recovery. The Chinese Services Caixin PMI (56.3) is also encouraging as the export performance. China's trade surplus stood at $ 42 billion in April.

The negative surprise on US employment has triggered a bout of extreme volatility. The US 10-year note immediately broke the 1.50% threshold in reaction to the NFP release publication before rising again towards 1.57% at the weekly close. Any slowdown in the ongoing employment recovery will help maintain the current monetary policy. Because of this, the 5yr has eased to 0.74% and the 5s30s curve spread re-steepened considerably. In addition, the US Treasury has released its refunding schedule for the current quarter. The monthly issue sizes will remain unchanged for nominal bonds (2 to 30 years). However, strong demand for TIPS is prompting the US Treasury to gradually increase its indexed borrowing by $ 1 billion each month. Total TIPS issuance this year will increase by $ 10 billion to $ 20 billion compared to 2020. Cash flow forecast at the end of July shows assets of $ 450 billion. This is important as the suspension of the debt ceiling will come to an end on July 31. The US Treasury anticipates a new suspension or an increase in the ceiling, but this constraint will weigh on Congress debates as well as on the dynamics of T-bills. Demand for TIPS is fueled by the rise in commodities which contrasts with the Fed's denial of the reality of inflation. The real yield on 10-year TIPS thus plunged 14bp over the past week. In the euro zone, the ECB's communication missteps are causing greater volatility on the Bund. The German loan hovers around -0.20%. Peripheral debts are absorbing a bit more difficultly from a primary market supplied in Spain, especially as a 30-year BTP syndication seems to be looming in the coming weeks. The Italian 10-year spread is 119bp. The deterioration in deficits and the upcoming competition from European issues are also weighing on the OAT (+ 3bp).

The European credit market has proven resilient to bond yield volatility. Flows are improving on both the US and European investment grade. Upward pressure on peripheral sovereign bonds argue for reallocations into corporate credit, where spreads have been quite stable since the start of the year. Primary market issuance picked up after the earnings publication period. Recent issuance is being well bid by high yield investors. Hybrid securities underperformed due to high valuation levels. Synthetic indices, usually quick to react to equity volatility, continue to move within a narrow range. The iTraxx Crossover index is trading around 250bp. Investor demand for high yield remains strong despite total issuance exceeding 60% in the 2020 record year (€ 102 billion). The compression theme is weakening.

The negative headlines on US jobs in April prolongs this favorable liquidity environment, so that buybacks of T-note contracts are accompanied by long positions on Nasdaq futures. Profit growth is obviously supporting the rating, but this sensitivity to interest rates seems abnormally high at present. Profits of US banks and commodities companies doubled year on year. The risk of patent lifting on the Covid vaccine weighed on the health sector.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	10-May-21	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.69 %	+0	+2	+1
EUR Bunds 10y	-0.21%	-1	+9	+36
EUR Bunds 2s10s	47 bp	-1	+8	+34
USD Treasuries 2y	0.15 %	-1	0	+3
USD Treasuries 10y	1.6 %	+0	-6	+69
USD Treasuries 2s10s	145 bp	+1	-6	+66
GBP Gilt 10y	0.79 %	-5	+1	+59
JPY JGB 10y	0.09 %	-1	-2	+7
€ Sovereign Spreads (10y)	**10-May-21**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
France	38 bp	+2	+12	+15
Italy	114 bp	+6	+11	+3
Spain	68 bp	+2	0	+6
Inflation Break-evens (10y)	**10-May-21**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR OATi	144 bp	+8	+14	-
USD TIPS	254 bp	+11	+21	+55
GBP Gilt Index-Linked	355 bp	+5	+5	+55
EUR Credit Indices	**10-May-21**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR Corporate Credit OAS	84 bp	+0	-3	-8
EUR Agencies OAS	39 bp	+0	+0	-2
EUR Securitized - Covered OAS	31 bp	-1	0	-2
EUR Pan-European High Yield OAS	298 bp	+2	-5	-60
EUR/USD CDS Indices 5y	**10-May-21**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
iTraxx IG	50 bp	+0	-1	+2
iTraxx Crossover	251 bp	+2	+2	+9
CDX IG	51 bp	+1	0	+1
CDX High Yield	290 bp	+4	-5	-4
Emerging Markets	**10-May-21**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
JPM EMBI Global Div. Spread	336 bp	-3	-14	-16
Currencies	**10-May-21**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.214	+0.65	+1.95	-0.6
GBP/USD	$1.413	+1.6	+2.85	+3.39
USD/JPY	¥108.77	+0.28	+0.56	-5.07
Commodity Futures	**10-May-21**	**-1wk ($)**	**-1m ($)**	**Ytd ($)**
Crude Brent	$68.3	$0.7	$5.7	$16.8
Gold	$1 838.5	$45.6	$105.7	-$59.9
Equity Market Indices	**10-May-21**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
S&P 500	4 205	0.30	1.85	11.96
EuroStoxx 50	4 023	0.58	1.12	13.25
CAC 40	6 386	1.24	3.51	15.03
Nikkei 225	29 518	1.82	-0.84	7.56
Shanghai Composite	3 428	-0.84	-0.66	-1.30
VIX - Implied Volatility Index	18.43	0.66	10.43	-18.99

Source: Bloomberg, Ostrum Asset Management

Additional notes

Ostrum Asset Management

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Natixis Investment Managers

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