MyStratWeekly
Market views and strategy

Ostrum ASSET MANAGEMENT

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N° 062 // **March 21, 2022**

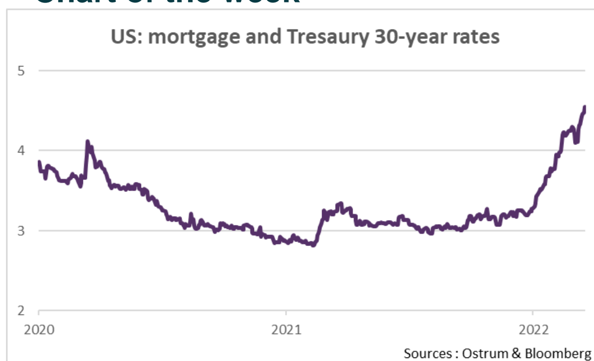
Topic of the week: Is the public debt sustainability at risk?

- **If rates have risen the debt service will be affected for the Eurozone states, though our calculations show this will remain in very reasonable proportions;**
- **Our simulations show that the impact of rising rates is very slow to impact public finances. The cost of debt should even continue to fall this year;**
- **However, the debt-to-GDP trajectory is exponential in the vast majority of countries due to a deficit inherited from the Covid period. These deficit levels are unsustainable and must be eliminated as quickly as possible during periods of strong growth.**

Market review: The Fed reacts, at last

- **Fed expects 2% Fed funds rates by year-end;**
- **Investor sentiment improves as China commits to financial stability;**
- **T-note yields around 2.20%, mortgage rates up strongly;**
- **BoJ fosters yen weakness.**

Chart of the week



Since the beginning of the year, 30-year Treasury rates have increased from 2.02% to 2.44%, a very rapid increase. 30-year mortgage rates have tended to over-adjust from this increase, gaining 125 bps YTD to reach 4.55% a year-over-year high.

The US real estate market was very clearly overheated, aided in part by extremely favourable financial conditions. This rise in mortgage rates is therefore partly beneficial because it will moderate the dynamics of a market that looked more and more like a bubble.

Figure of the week

30

Source : Ostrum AM

30 bp, the expected decline in Fed funds in 2024 according to the futures market.
The market is already betting on rate cuts the year after next.

Stéphane Déo
Head of markets strategy
stephane.deo@ostrum.com

Axel Botte
Global strategist
axel.botte@ostrum.com

Zouhoure Bousbih
Emerging countries strategist
zouhoure.bousbih@ostrum.com

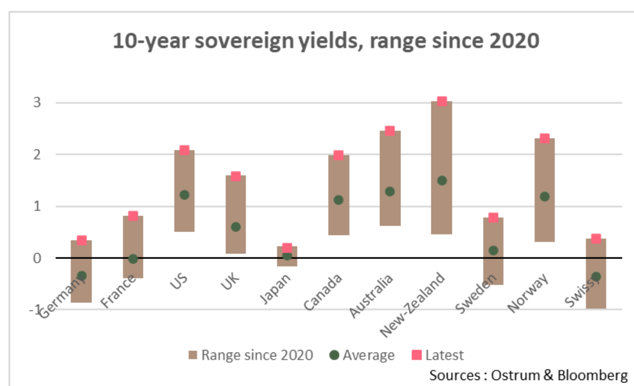
Aline Goupil- Raguénès
Developed countries strategist
aline.goupil-raguenes@ostrum.com

Topic of the week

Is the public debt sustainability at risk?

While rates have rebounded in the markets, they remain historically at very low levels. The debt service will therefore be affected for the Eurozone states, but our calculations show this will remain in reasonable proportions. The cost of debt should even continue to fall this year. On the other hand, the sensitivity to interest rates has increased enormously and the level of sustainable deficit is lower. In the long run therefore, the trajectory of public finances is much more vulnerable, especially if deficits are not eliminated.

The changing tone of the ECB during its two latest meetings has led to higher yields on sovereign debt in Europe. In view of the mountain of accumulated debt, this leads to an increase in debt service, and therefore a larger deficit… that should create more debt. To take an example, if rates rise by 100 bps in Italy, which has a GDP debt of around 150%, this would mathematically lead to an increase in debt service of 1.5% of GDP.

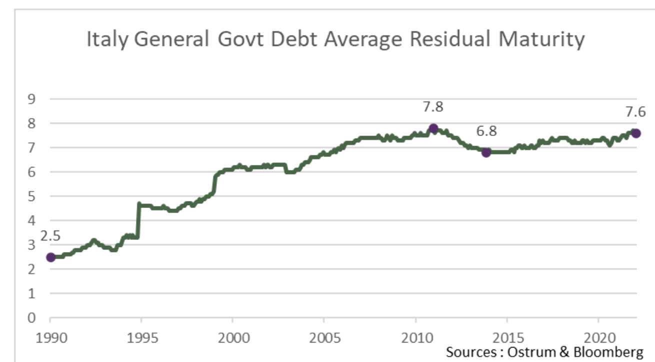


The reality is more complex, much more complex in truth. It is the purpose of this paper to explain the few subtleties to keep in mind.

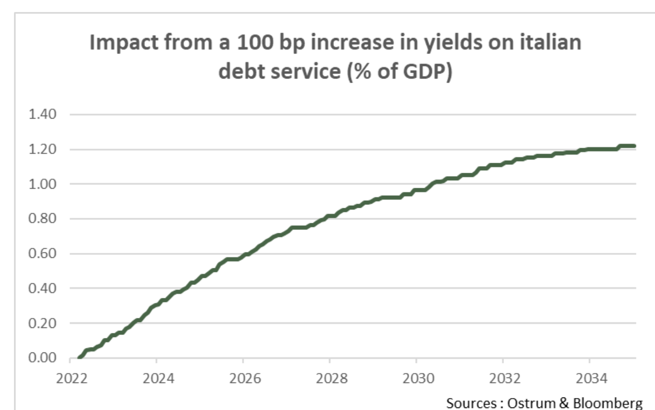
Patience and length of time

The first point is that a country's borrowing is essentially fixed rate. For example, on March 3, the French Treasury issued an OAT at maturity 25-May-2032 with a coupon of 0% until maturity. And market rates can do whatever they want, it won't change anything. The coupon will be affected when the debt matures and will be reissued, when it is "rolled", in May 2032.

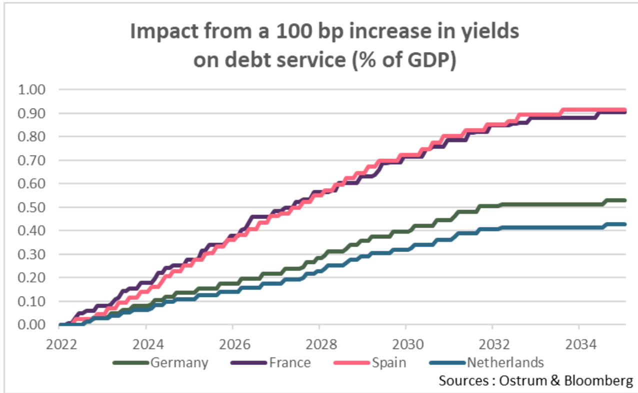
To come back to the example of Italy, the chart below shows that the average duration of the debt has increased considerably, approaching 8 years. The debt "roll" is therefore very slow and a rise in rates will affect Italian public finances very gradually.



If we analyze the characteristics of the 121 Italian bonds and under the hypothesis of a 100 bps rise (far from it), here is how debt service would then progress as the debt is "rolled".



As we can see, the rate hikes impact the budget very gradually, with only 0.3% of the additional deficit by the end of next year. Even if we end up with a mathematical impact of 1.5% on public finances. We repeated the exercise for the four other major European countries. Same observation: the impact is very slow to spread.



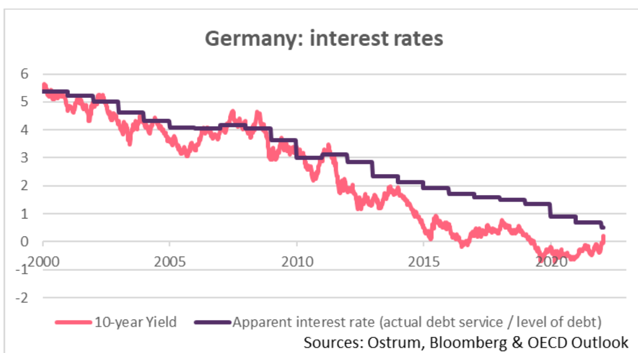
Apparent interest rate

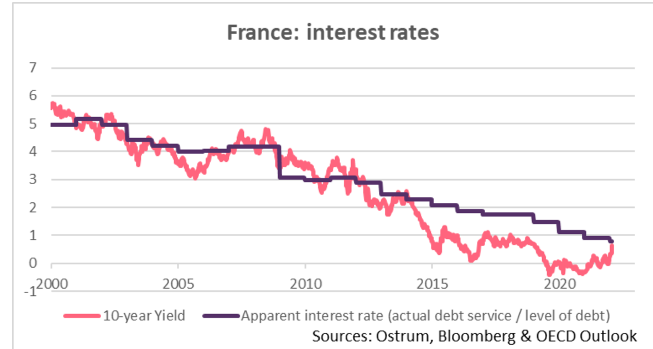
Another point to keep in mind, the argument "the rates have increased so the cost of state financing will increase" is paradoxically false.

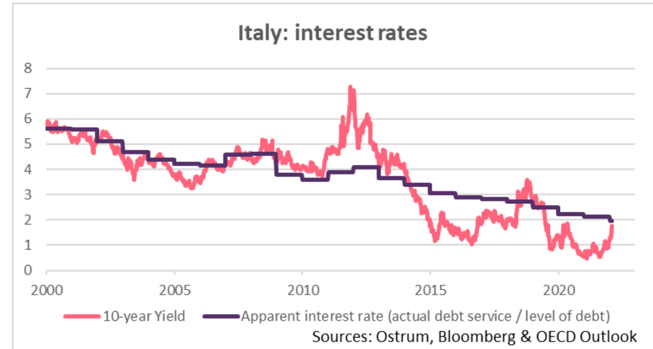
You have to introduce what economists call the "apparent rate". It's the observed debt service divided by the level of debt. So that's the actual cost of the public debt. Let's take an example: according to OECD figures, France's debt was 2.850 billion in 2021 and debt service was 26 billion over the year. The ratio between the two is 0.92%, which is the average rate paid by the French Treasury on the French debt last year, the "apparent rate".

The latter is much higher than the market rate because the French State still pays coupons on loans issued several years ago. For example, the OAT that matures on 25-April-2022 always pays a coupon of 3% per year. When it matures, it will obviously be reissued with a much lower coupon (probably at 0% by the way).

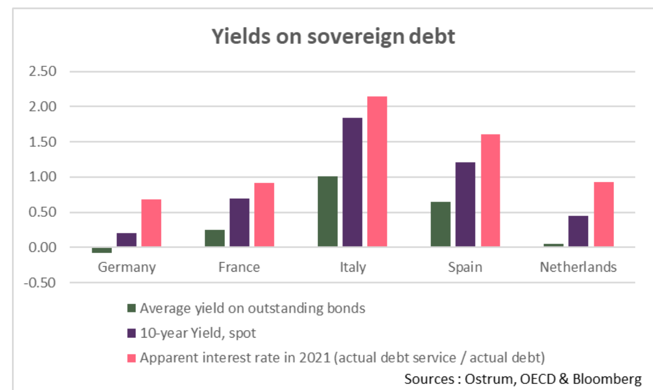
The graphs below show, for Germany, France and then Italy, the evolution of the apparent rate and the 10-year rate.







Again, we need to be more specific. Countries don't just borrow at 10-years, they borrow on the whole curve. The cost of issue is therefore an average of the rates at different maturities. On the chart below we have calculated the average rate for the five major countries by weighting the maturities according to the size of the existing borrowings. This approach therefore gives a good approximation of the average rate at which new borrowings will be issued.

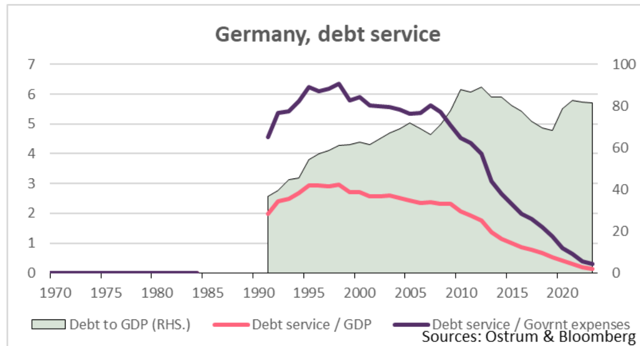


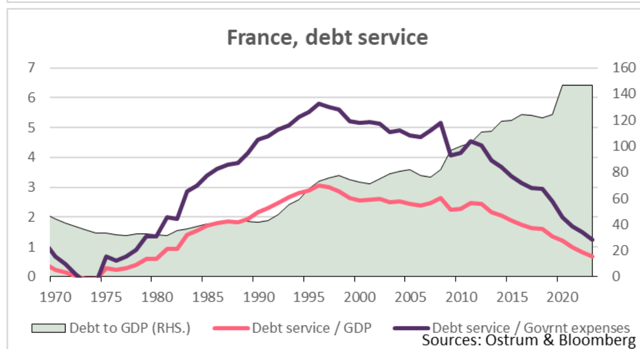
In all cases, the average rate on the curve is much lower than the apparent rate, so emissions will be below the apparent rate … and bring it down.

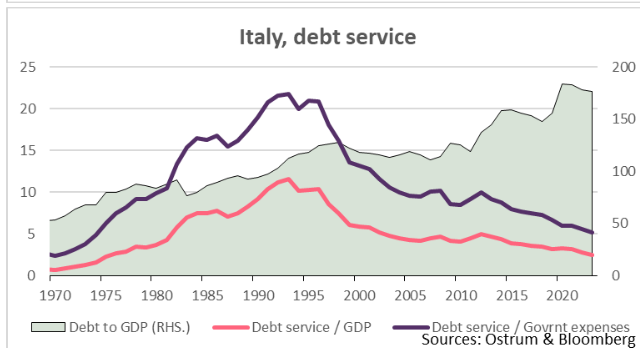
Some debt service simulations

Over the past two decades the level of debt has continued

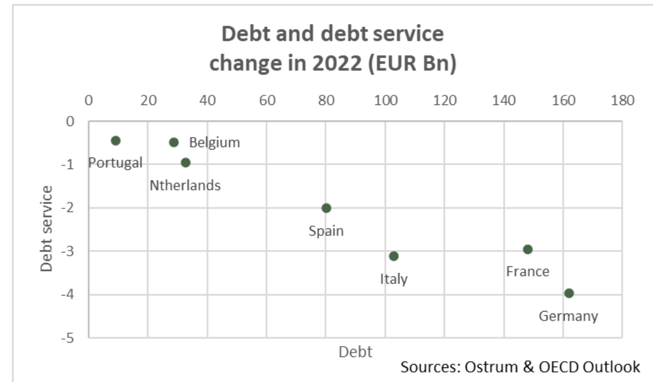
to rise, but rates have continued to fall. So what about debt servicing? For Germany, France and Italy, debt service has fallen sharply, particularly since the introduction of the Euro and the convergence of peripheral rates (see graphs below).







For 2022, figures from the OECD's latest "Outlook" show that for the eight Eurozone countries represented below, their debt will rise unsurprisingly this year. But everyone will also see their debt service reduced. Without going into too much detail in the calculations, we analyzed line-by-line the securities issued by the French Treasury and we arrive at a less favorable figure with a drop of "only" 1.5 billion. A figure that remains substantial but more modest; certainly an effect of the recent rise in rates that reduces savings on new emissions.



Some debt service simulations

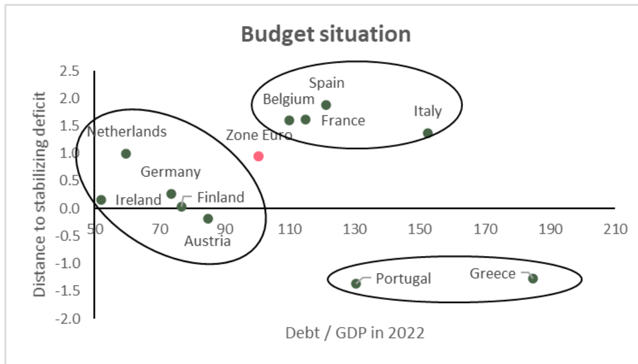
All this tends to show that the debt trajectory is not fundamentally affected by the level of rates, which remains very low and therefore very favorable. The problem, however, is the level of deficit. The forecast deficit for the Euro Area, according to OECD figures, remains 3.8% a clearly excessive figure to stabilize the debt-to-GDP ratio.

Then we have to introduce another concept, that of a "stabilizing deficit". This is the level of deficit for a given level of debt, interest rates and growth, that will stabilize the debt-to-GDP ratio. A higher deficit would create an increase in the debt, thus an increase in debt servicing, thus a larger deficit, and thus an acceleration of the debt. An exponential path that is therefore not tenable.

We have calculated these stabilizing deficits for the Eurozone countries. First of all, it should be noted that according to the OECD, the deficit is improving this year by 2.8 ppt. That's a very significant number. However, we will still have to eliminate almost one point of deficit in order to achieve balance. Of course the goal should be to do even better so that the debt falls in a period of recovery.

	Primary balance 2021	Primary balance 2022	Stabilizing primary deficit (with 3% nominal GDP growth)	Change needed
Austria	-5.4	-1.3	-1.5	-0.2
Belgium	-6.7	-3.4	-1.8	1.6
Finland	-4.0	-2.2	-2.2	0.0
France	-7.0	-4.0	-2.3	1.6
Germany	-4.6	-2.0	-1.8	0.3
Greece	-7.0	-1.6	-2.8	-1.3
Ireland	-2.4	-0.9	-0.8	0.2
Italy	-6.2	-2.8	-1.4	1.4
Netherland	-5.5	-2.3	-1.3	1.0
Portugal	-1.8	-0.1	-1.4	-1.4
Spain	-6.4	-3.6	-1.7	1.9
Zone Euro	**-5.6**	**-2.7**	**-1.7**	**0.9**

The disparities by country are also significant as shown in the graph below.



Essentially, there are three groups:

- **The Bad Repentant Students:** Greece and Portugal. With a high level of debt, but a favourable fiscal position, and therefore a downward trajectory of the debt-to-GDP ratio.
- **The unrepentant bad pupils:** Belgium, France, Spain and Italy. With a high debt, more than 100% of GDP, but also an excessive deficit that does not stabilize the ratio and therefore the need for a fiscal tightening of at least 1 percentage point of GDP.
- **Good students:** Netherlands, Ireland, Germany and Austria. With debt ratios below the EU average and a relatively low need for fiscal tightening.

Conclusion: the problem is not the level of the rates but the deficit

The conclusion from the figures is that the current rate level is far from worrisome. It remains comfortably below the historical level of rates and therefore the emissions of European states are always at very favorable conditions. The average debt rate of these states will continue to fall.

However, the debt-to-GDP trajectory is exponential in the vast majority of countries due to a deficit inherited from the Covid period. These deficit levels are unsustainable and must be eliminated as quickly as possible during periods of strong growth. In theory, these exceptional deficits were related to the Covid crisis and are therefore purely cyclical or temporary in nature and should deflate rapidly. In practice it seems that some States (once again!) have succeeded in transforming a good part of this cyclical deficit into a structural one, for example by sustaining certain emergency measures.

Laudable goal to support growth but seen in the short term as it puts public finances on trajectories that are simply not sustainable. The risk is then that, once again, the budget will have to tighten when the market panics, that is to say during the next crisis. In short, we are moving blithely towards a pro-cyclical policy: always stimulating while the economy has recovered, and restrictive during the next crisis.

Stéphane Déo

Market review

The Fed reacts, at last

The Fed forecasts rates at 2% at the end of the year, market volatility dissipates

The war in Ukraine is entering its fourth week. The bombardments intensified, even in the western part of Ukraine, near the Polish border, on the military bases used by NATO. These attacks and the Kremlin's erratic communication do not seem to leave room for a ceasefire and real negotiations with Ukraine. The US has increased its military aid to Ukraine whilst warning China about the consequences of any support for Russia's actions. President Joe Biden may travel to Brussels and a visit to Ukraine has been mentioned. Meanwhile, financial market volatility has come down somewhat. Equity indices rebounded sharply. The Chinese authorities have reassured market participants on several pressing issues: financial stability is a priority, a dialogue with the US authorities regarding the listing of Chinese firms has begun, the regulatory crackdown aimed at large technology companies is coming to an end 'soon' and the support for ailing Chinese property developers is reaffirmed. These statements led to significant short covering, ending a downward spiral in the stock prices of Chinese technology giants. Monetary support from the PBoC should also increase despite the status quo on rates observed last week.

As regards the economic backdrop, it is worth noting that most data currently available reflect the situation that prevailed before the invasion of Ukraine. US data releases still appear rock solid. Retail sales jumped 4.9%m in January and rose a further 0.3%m in February. The rise in consumer prices (7.9% in February) is nevertheless the main factor weighing on household confidence. The price index should still accelerate to around 9% in the spring. The labor market is tight, so that wage growth will continue. The Fed clearly favors inflation, which obviously remains well above target. The Fed therefore proceeded with an initial rate hike of 25 bp. A total of 150 bp, probably meaning 25 bp hikes at every FOMC in 2022, is the policymakers' preferred scenario. Fed funds should thus reach 2% at the end of the year. The March 16 decision was not unanimous. James Bullard would have preferred a 50 bp move and 6 other committee members are projecting some 50 bp hikes this year. Upside risks on Fed rates will persist. On the other hand, the terminal rate was slightly lowered to 2.25%. This revision sparked another bout of yield curve flattening. The Fed may be concerned about a too rapid upturn in the term premium once the reduction in the balance sheet will have begun. This balance sheet run-off should begin in May or June. The March 16 FOMC minutes will feature run-off simulations. One possible scenario is a decrease in asset holdings of $100bn per month, for a total of $1.500Tn. The inversion of the yield curve reflects the perceived risks to activity and the expected effect on future inflation of the more restrictive monetary policy. In the UK, the BoE also hiked rates by 25 bp, its third move since December. No MPC participant voted in favor of a 50 bp move, which turned out to provide a short-term bond-bullish surprise. Conversely, the BoJ surprised by encouraging yen weakness.

Financial market volatility appears to be easing somewhat. The yield on T-notes is hovering around 2.15%. The US yield curve has flattened back to its tightest levels of 2022 at 20 bp on the 2s10s spread. Appetite for the US long-dated bonds also shrank 10s30s spreads by almost 10 bp last week. The downward revision to the terminal rate, the expected decline in forward inflation and potential downside risks to activity are all fueling demand for long Treasuries. At the same time, mortgage rates are up to nearly 4.30%, their highest level since 2019. MBS portfolio hedging flows should contribute to a widening in long-term swap spreads. In the euro area, the Bund fluctuates around 0.35%. The steepening trend appears to have legs, especially on the 2-10 year segment. Swap spreads eased but are still around 15 bp wider than pre-crisis levels. Covered bonds and other proxy swaps are benefiting from the tightening in swap spreads. Peripheral bonds also seem to have priced in the announcement of the end of QE even as both Italy and France extended their plans to support the economy.

The credit market remains under pressure, in part due to outflows from credit funds. Primary market activity has slowed markedly since February. We have seen a reduction in maturities of new issues in IG space and increasing new issue premiums. The level of spreads (147 bp) now seems sufficiently attractive to ease upward pressures on spreads, especially since the level of cash in credit funds is now high. High yield spreads (440bp against Bund) are showing signs of stabilizing. The negative convexity effect (reduced financial flexibility of borrowers) had magnified the widening of spreads. Hedging flows (via purchases of protection on the iTraxx indices) have now reversed as sentiment improves. The resale of CDS hedges tightened the spread of the iTraxx Crossover index from an intraday high of 427 bp on March 7 to around 345 bp.

The volatility in European equities has decreased. Foreign capitulation flows are also diminished, energy prices are receding, and central bank meetings are being digested by market participants. Yield curve flattening spurred growth stocks, and, to a lesser degree, the quality/visibility investment theme has turned more profitable to the detriment of stocks offering high dividend payouts and the consumer-related sectors.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	21-Mar-22	1wk (bp)	1m (bp)	2022 (bp)
EUR Bunds 2y	-0.32%	+2	+13	+30
EUR Bunds 10y	0.4%	+3	+20	+58
EUR Bunds 2s10s	72bp	+1	+6	+29
USD Treasuries 2y	1.98%	+12	+52	+125
USD Treasuries 10y	2.19%	+5	+26	+68
USD Treasuries 2s10s	19.7bp	-7	-26	-58
GBP Gilt 10y	1.53%	-6	+12	+56
JPY JGB 10y	0.21%	+1	-4	+3
€ Sovereign Spreads (10y)	**21-Mar-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
France	46.16bp	0	-1	+9
Italy	154.01bp	-6	-3	+19
Spain	95.27bp	-3	-3	+21
Inflation Break-evens (10y)	**21-Mar-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR 10y Inflation Swap	2.54%	-12	+46	+44
USD 10y Inflation Swap	3.09%	-3	+45	+32
GBP 10y Inflation Swap	4.63%	-8	+19	+45
EUR Credit Indices	**21-Mar-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR Corporate Credit OAS	146bp	-7	+20	+51
EUR Agencies OAS	62bp	-4	+0	+13
EUR Securitized - Covered OAS	70bp	-5	+5	+24
EUR Pan-European High Yield OAS	438bp	-17	+41	+120
EUR/USD CDS Indices 5y	**21-Mar-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
iTraxx IG	76bp	-4	+5	+28
iTraxx Crossover	359bp	-22	+10	+117
CDX IG	64bp	-12	-5	+15
CDX High Yield	358bp	-52	-13	+65
Emerging Markets	**21-Mar-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
JPM EMBI Global Div. Spread	459bp	-38	+62	+90
Currencies	**21-Mar-22**	**1wk (%)**	**1m (%)**	**2022 (%)**
EUR/USD	$1.106	1.134	-2.184	-2.7
GBP/USD	$1.315	1.138	-3.323	-2.8
USD/JPY	JPY 119	-0.889	-3.782	-3.5
Commodity Futures	**21-Mar-22**	**-1wk ($)**	**-1m ($)**	**2022 (%)**
Crude Brent	$112.7	$5.8	$19.7	46.55
Gold	$1 925.5	-$25.4	$19.2	5.26
Equity Market Indices	**21-Mar-22**	**-1wk (%)**	**-1m (%)**	**2022 (%)**
S&P 500	4 463	6.16	2.63	-6.4
EuroStoxx 50	3 903	4.32	-2.08	-9.2
CAC 40	6 624	3.99	-2.42	-7.4
Nikkei 225	26 827	6.62	-0.31	-6.8
Shanghai Composite	3 254	0.94	-6.79	-10.6
VIX - Implied Volatility Index	24.89	-21.66	-10.31	44.5

Source: Bloomberg, Ostrum AM

Additional notes

Ostrum Asset Management

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