PICTET 1805

Flash Note

Spain: sovereign bond

Robust outlook supports low Spanish sovereign bond spreads

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Strong and broad-based economic activity combined with the Catalan crisis's limited impact pushed Fitch to upgrade its Spanish sovereign debt rating in January, enhancing Spanish spread compression versus Bunds.

The compression in Spanish spreads is impressive given not only the political uncertainty in Catalonia, but also the forthcoming Italian general elections and the removal of some stimulus by the ECB. Given the improved macroeconomic environment, peripheral euro area countries seem less vulnerable than they were before the launch of quantitative easing in 2015.

We have revised our Spanish bond forecasts in light of recent developments. We now expect a slight widening of the 10-year Spanish sovereign bond spread to 90bp over Bunds at end-2018, lower than expected previously (130bp) and we expect the Spanish 10-year yield to stand at 1.8% at end-2018 (previously 2.2%).

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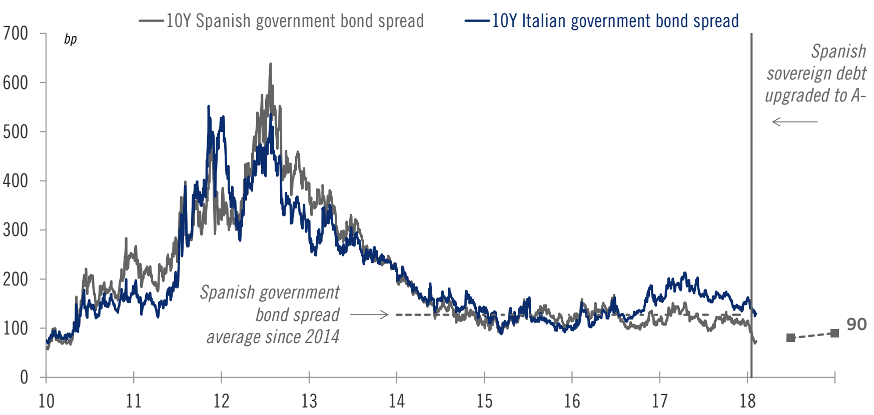
Strong, relatively broad-based economic recovery and the "limited" economic impact of the Catalan crisis pushed Fitch to upgrade Spanish sovereign debt by one notch to A-/Stable in January. The upgrade triggered a significant rally, with the spread on Spanish 10-year bonds versus Bunds dropping below 70 basis points (bp) (on February 1, 2018) for the first time since 2009, when Spain still had the best rating (AAA/Aaa) from the three main rating agencies. Since 2014, when the European sovereign debt crisis ended, the 10-year Spanish government bond spread versus its German counterpart has averaged 127bp (see *Chart 1*). The compression in Spanish spreads is even more impressive in light of the enduring political uncertainty in Catalonia, the forthcoming Italian general elections, and the gradual unwinding of European Central Bank (ECB) stimulus. But with the improved macroeconomic environment, peripheral euro area countries in general seem more robust than they were before the ECB launched quantitative easing (QE) at the beginning of 2015.

We have revised our Spanish bond spread and yield forecast to take account of recent developments. We now expect **the 10-year Spanish sovereign bond spread over its German counterpart to widen slightly from 73bp (on February 6, 2018) to 90bp at the end of 2018,** lower than the 130bp expected previously. **Building on our forecast of a rise of the 10-year German Bund yield to 0.9% at end-2018, we expect the 10-year Spanish sovereign bond yield to rise from 1.4% to 1.8%** (our previous forecast was 2.2% for the end of this year).

Chart 1: 10-year Spanish and Italian government bond spread versus Germany



Source: Pictet WM - AA&MR, Bloomberg

Spanish growth to moderate, but to stay strong in 2018

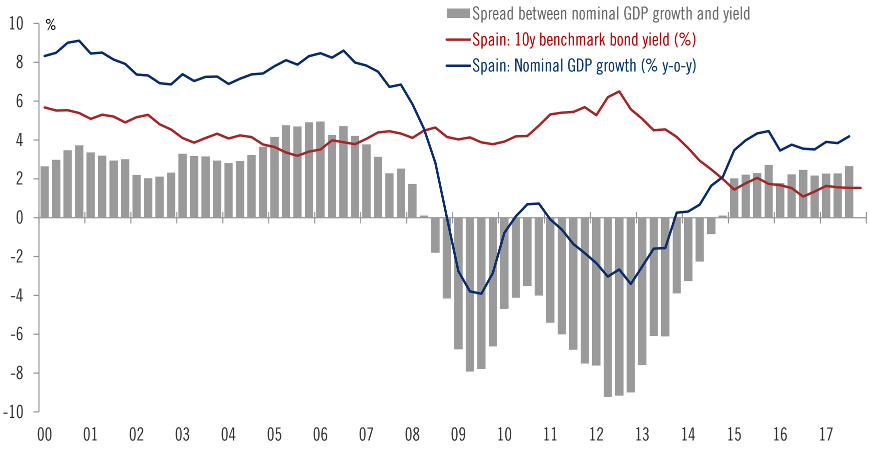
Spanish economic activity surprised on the upside in 2017, with GDP growth averaging more than 3% for the third year in a row. The growth was not only strong but was also relatively broad based. Domestic demand was (again) the main engine, with strong job creation underpinning private consumption. Improvement in profit margins and better access to credit stimulated corporate investment. Even investment in construction showed some signs of revival, while net trade's contribution turned positive.

Looking ahead, we expect Spanish economic activity to moderate in 2018, but to remain robust. **We forecast GDP growth of 2.5% in 2018**, lower than 3.1% in 2017, but enough to ensure that Spain remains among the fastest-growing euro area economies. **Domestic demand should remain the main contributor to GDP, but should moderate somewhat** for several reasons. The base effect of lower taxes introduced in 2015 and of low oil prices should fade; after gains of close to 2 million workers since 2014, employment growth is expected to soften somewhat; the saving rate is close to a historic low and wage growth remains subdued; and fiscal policy is expected to move to being neutral after having been expansionary in recent years.

Spain's budget deficit is expected to fall below 3% in 2018 according to European Commission forecasts, allowing Spain to exit the Commission's excessive deficit procedure (EDP). The improvement in the fiscal deficit is due to the cyclical improvement in the economy and lower interest costs, courtesy of the ECB's expansionary monetary policy. The implied interest rate on debt is at its lowest level since the launch of European monetary union in 1999. This factor, combined with an average debt maturity of seven years and robust nominal growth (see *Chart 2*), **should provide sufficient buffers against negative events in the short term.**

Turning to price dynamics, as in other euro area countries, **there are still no signs that increases in capacity utilisation are giving rise to inflationary pressures in Spain**. We expect Spanish HICP headline inflation to average 1.6% in 2018, after 2.0% in 2017.

Chart 2: Spain 10-year government bond yield and nominal GDP growth



Source: Pictet WM - AA&MR, Instituto Nacional de Estadistica

A political crisis without economic consequences?

The real impact of the current political turmoil in Catalonia is difficult to measure, as growth in Spain was already expected to slow somewhat in late 2017 and in 2018. The latest Spanish GDP data suggest that the impact has been rather limited at an aggregate level. According to a Bank of Spain analysis, the strength of exports has partly countered the adverse effects of uncertainty over the political situation, at least outside Catalonia. That said, **if prolonged, the political uncertainty could potentially impinge on confidence and spending decisions** not only in Catalonia but also in other regions.

So far, muted market reaction suggests that investors believe the risks associated with Catalan political uncertainty are still contained. We do not think that, as things stand, these risks will lead to a systemic crisis in Spain.

2018: a smooth transition to less ECB support?

The main event of 2018 for euro area sovereign bonds should be the ECB's exit from quantitative easing. Indeed, we expect the central bank to reduce its bond purchases gradually to zero by early 2019. We anticipate that the exit will go smoothly, with the ECB preparing market participants by changing its forward guidance in the coming months.

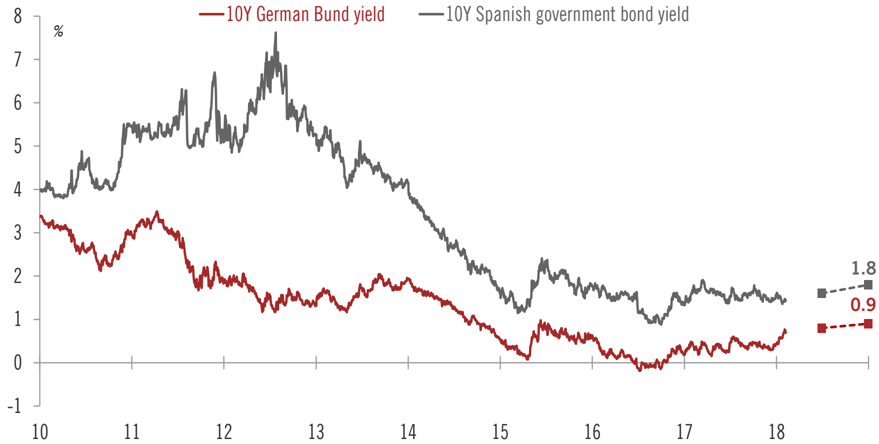
The Public Sector Purchase Programme (PSPP), as ECB's sovereign bonds purchases programme is officially called, has helped support sovereign bonds since its launch in March 2015 by reducing their volatility and keeping yields low even in the face of political turmoil—as the lack of reaction of Spanish government bond spreads to the Catalan crisis illustrates. In 2017, the ECB purchased an average of EUR6.7 bn of Spanish sovereign bonds each month, but reduced its purchases by more than half, to EUR2.7 bn, in January of this year. We expect this level to be roughly maintained until September and from then on to fall gradually to a monthly average of EUR1.3 bn in 2019, as the ECB reinvests redemptions from maturing sovereign bonds.

These continued purchases mean that the ECB will remain an active market participant. But its influence will steadily diminish, which should lead to a slight widening of the 10-year Spanish government bond spread versus Germany to 90bp at the end of 2018, lower than the 130bp we expected previously (see Flash Note on Italy & Spain: Sovereign bonds outlook). Also contributing to widening is our forecast that Spain's real GDP growth will fall below 3%, for the first time in three years, to 2.5% in 2018. This slight slowdown comes partly from the lack of significant reforms since the 2016 elections brought a right-wing minority government back into office. The political gridlock surrounding the Catalan crisis means we expect no major structural reforms in the near term.

10-year Spanish bond yield to rise slightly in 2018

Building on our end-of-year forecast of a slight widening of the 10-year Spanish government bond spread from 73 bp (on February 6, 2018) to 90 bp and of a rise in the 10-year German Bund yield from 0.69% to 0.90% (see Flash Note on Core sovereign yields), our central scenario is that the 10-year Spanish government yield will be around 1.8% by the end of the year, lower than the 2.2% we expected previously (see *Chart 3*). In two alternative scenarios, the 10-year Spanish government bond yield could increase more. In a more positive scenario (25% probability), the 10-year German Bund yield could rise higher than we expect due to accelerating inflation and to an ECB rate hike in Q3 2019 (our base case). In a more negative scenario (10% probability), Spanish spreads could widen more if the Catalan crisis were to hit Spain's economic growth. **However, we remain comfortable with our central scenario (65% probability) of a slight widening of the 10-year Spanish sovereign bond spread to 90bp and to a rise in its yield to 1.8% at end 2018 for the reasons outlined above.**

Chart 3: 10-year Spanish and German government bonds yield



Source: Pictet WM - AA&MR, Bloomberg

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