

## EURO PERIPHERY 2019 OUTLOOK

## ECONOMIC FUNDAMENTALS BACK IN FOCUS

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## SUMMARY

- After a year when peripheral countries' old demons made a reappearance with Italy's public debt back into spotlight, the focus should shift to economic fundamentals in 2019. Both the Spanish and Italian economies are set to slow down, although the situation is more serious in Italy, as Spain should remain one of the most vigorous economies in the euro area. In both countries, the political equilibrium remains fragile, with a risk of snap elections in 2019.
- With the end of the quantitative easing (QE), European Central Bank (ECB) bond purchases are set to have a negligible impact on markets. However, the extent to which the ECB manages to hike rates this year will be key for euro area periphery bonds. Given disappointing euro area data, the possibility that we see no rate hikes at all this year is increasing.
- Economic slowdown, political uncertainty and the potential for fresh confrontation between Italy and Europe will keep the environment volatile for peripheral bonds. We are underweight peripheral sovereign debt, and will likely remain so at least until we have reassurance on the economic and political front. In our central scenario (55% probability), we expect the 10-year Italian spread versus the Bund to remain in a range of 250-300 bps this year — but a more drastic economic deceleration and an early general election could push spreads above these ranges again. While there could also be elections in Spain, we expect Spanish spreads to rise only slightly, averaging 130-150 bps over the Bund.

CHART 1: 10-YEAR ITALIAN SOVEREIGN SPREAD



Source: PWM - AA&amp;MR, Bloomberg, 14.01.2019

CHART 2: 10-YEAR SPANISH SOVEREIGN SPREAD



Source: PWM - AA&amp;MR, Bloomberg, 14.01.2019

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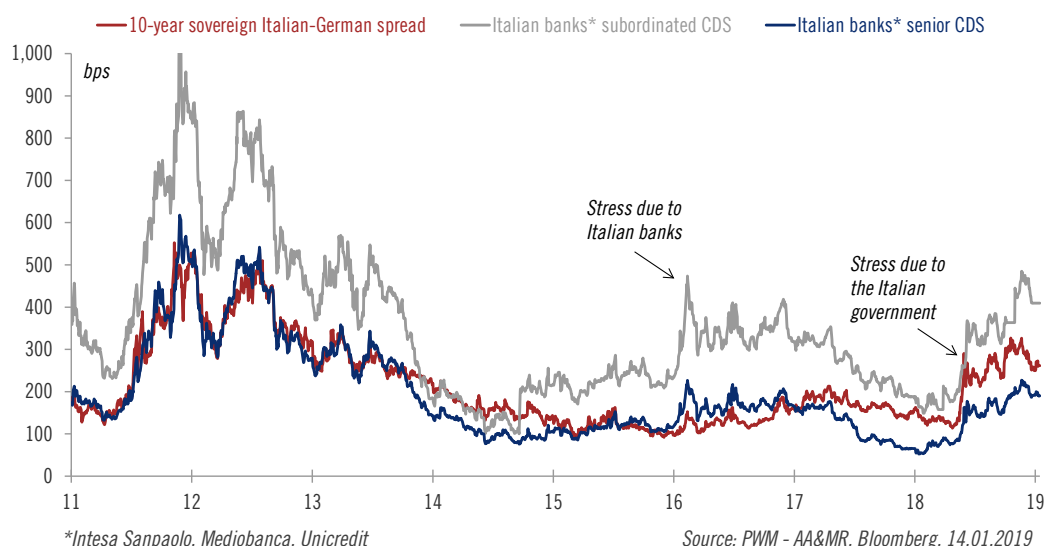
#### Italy: 2019 budget saga has quietened down for now, but risks remain

After battling for more than two months over a 2019 budget plan defiantly non-compliant with the EU's fiscal rules, Rome and Brussels struck a last-minute agreement in December that avoided the opening of an Excessive Deficit Procedure (EDP) against Italy. But while the Italian budget saga has quietened down for now, risks remain. In particular, **the concessions made by the Italians on their budgetary plans as well as the contentious rescue of lender Banca Carige have the potential to feed tensions within the government coalition.** Both governing partners, the Five Star Movement and the League, will do all they can to stay in office, at least until the European Parliament elections in May. **But talk of a snap general election may gain momentum thereafter.**

Fundamental concerns remain over Italy's economic outlook. After negative Q3 GDP growth, **the ghost of a technical recession has resurfaced.** Business and consumer confidence has been significantly eroded by political uncertainty. The budget climbdown could help restore confidence somewhat, but the economic outlook remains challenging. Italian banks will probably continue to suffer from the rising costs of funding (due to widening Italian sovereign spreads) and the fallout from economic stagnation.

Hence, the difficulty experienced by Banca Carige is no surprise. Even though the bank's small size should facilitate an orderly wind down, **the Italian government could find itself in a tricky position should other small lenders also face capital adequacy issues.** As in 2016, stress in the banking sector (through widening credit default swaps (CDS)) would probably push Italian sovereign spreads above 300 bps toward 450 bps (see Chart 3). We include this risk in our negative scenario for Italian sovereign debt, to which we assign a 30% probability (see Chart 1 above).

CHART 3: ITALIAN SOVEREIGN SPREAD AND ITALIAN BANKS' CDS



On the fiscal front, the risk of overshooting the 2.04% deficit target agreed with Brussels for 2019 is significant, as the government's growth and fiscal baselines remain highly optimistic, in our view. To achieve 1% GDP growth this year, Italy will need to record average quarter-on-quarter (q-o-q) growth of 0.4%, which seems ambitious. Our own forecast is for 0.8% growth in 2019, with risks tilted to the downside. **A sharper and**

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**longer deceleration of the economy could bring Italy's high debt-to-GDP ratio back into focus** (see Chart 4).

The European Commission (EC) will continue to closely monitor budgetary developments there and the government's execution of its 2019 budget (see our Flash Note [here](#)). Alongside the EC and investors, rating agencies will also closely monitor Italy's debt trajectory. Fitch Ratings and S&P Global are due to review Italy's sovereign debt rating (to which they have both assigned a negative outlook) this quarter. **Thanks to the reduction of Italy's projected deficit to 2.04% of GDP for 2019, they are likely to stay put rather than follow Moody's by downgrading Italy's rating to just one notch above high yield.** However, if, as we expect, Italy fails to meet its 2.04%, both agencies could downgrade Italy's rating by one notch in the second half of 2019, possibly pushing sovereign spreads higher again.

CHART 4: ITALY'S DEBT-TO-GDP TRAJECTORY



Source: PWM - AA&MR, European Commission, 31.12.2018

In short, economic slowdown, tensions within the governing coalition, potential fresh confrontation with Europe, a cascade of small lender failures and ratings downgrades all have to the potential to push Italian sovereign yields rapidly higher again. **In our central scenario, we expect the 10-year Italian spread versus the Bund to remain in a range of 250-300 bps during the year, but a more drastic economic deceleration in Italy and the spectre of a rating downgrade could again push spreads above 300 bps.**

#### Spain: growth is holding up, but clouds are forming

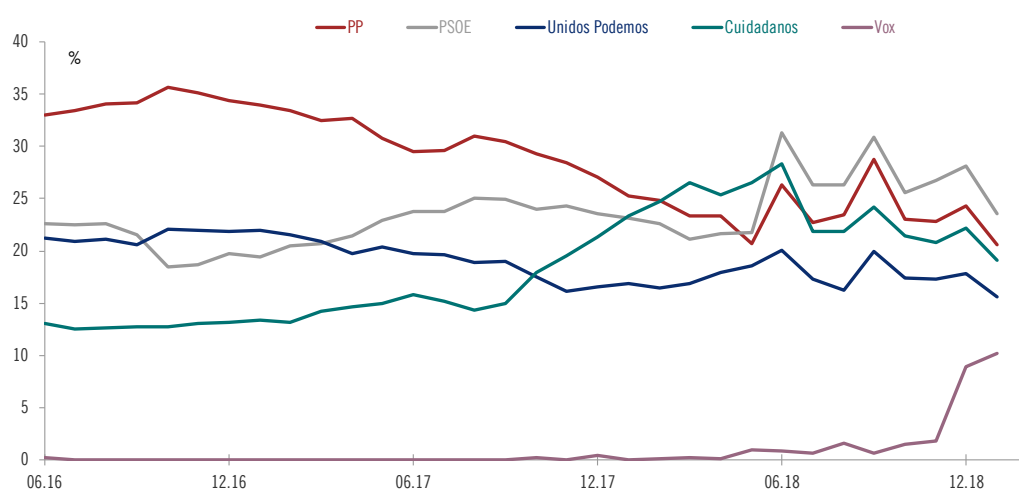
In contrast to Italy, economic growth is not really the issue in Spain. The pace of growth is expected to moderate in 2019, but Spain is likely to continue to outpace the other big euro area economies, with real GDP growth of 2.6% in 2018 and 2.1% in 2019. Nevertheless, there are risks. Politically, the situation is rather complex. The current socialist government does not have a parliamentary majority and is struggling to pass its 2019 budget. The government has a deficit target of 1.3% for 2019. The target is lower than the previous proposal of 1.8% of GDP, and significantly lower than the 2.7% estimated for 2018. But political developments will make the fiscal adjustment much more difficult.

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Passing a budget would boost the chances of Prime Minister Pedro Sanchez's minority government seeing out this legislative term, due to expire in 2020. By contrast, **failure to pass a budget would increase the chances of early elections**. As in other European countries, political fragmentation is increasing in Spain (witness the emergence of Far-Right party Vox (see *Chart 5*)) and needs to be monitored closely should snap elections take place.

CHART 5: POPULARITY OF SPANISH POLITICAL PARTIES (OPINION POLLS AVERAGE)



Source: PWM - AA&MR, Various polls, 14.01.2019

Given the economy should remain healthy, and given the limited risk of fiscal slippage, neither Spanish economic fundamentals nor fiscal policy should worry investors in H1. We believe the 10-year Spanish sovereign spread versus the Bund will average 130 bps in H1, slightly up from 119 bps on January 14. However, the complex political picture could mean volatility returns in H2, be it because of the risk of snap elections or because of fraught 2020 budget negotiations. **These considerations explain our forecast that the spread on 10-year Spanish debt will average around 130-150 bps in the second half of 2019.**

#### ECB: QE to become negligible, all eyes on rate hikes

After the end of QE in December, the ECB's sovereign bond purchases will be negligible in 2019, consisting only of reinvestments of maturing securities. **The ECB's diminishing presence on the bond market could lead to the return to the kind of volatility seen in 2018.** In any case, the ability of the ECB to keep bond spreads suppressed has already probably faded, as illustrated by the spike of the 10-year Italian sovereign spread above 300 bps at the height of the budget crisis late last year.

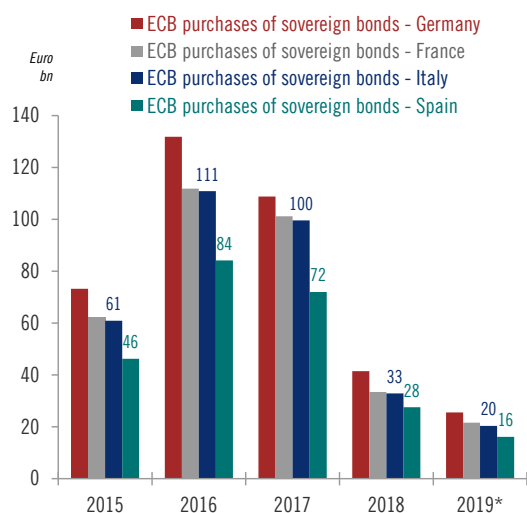
At the peak of QE in 2016-2017, the ECB purchased an estimated average of EUR106 bn of Italian and EUR78 bn of Spanish sovereign bonds per year (see *Chart 6*). These purchases led to a sharp increase of the share of outstanding government bonds held by the ECB — from 0 at the start of 2015 to 19% in the case of Italian bonds at end-2018, and from 0 to 24% in the case of Spanish bonds (see *Chart 7*).

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The volume of maturing sovereign bonds that the ECB will reinvest this year will be negligible, amounting to about EUR20bn for Italy and EUR16 bn for Spain. Taking into account net issuance, the share of the ECB's holdings of total sovereign debt outstanding will gradually fall (except for Germany, due to negative net issuance). **Both measures show that both the flow effect (i.e. ECB purchases) and the stock effect (i.e. ECB holdings) will gradually fade and cease to be a useful factor for bond investors.**

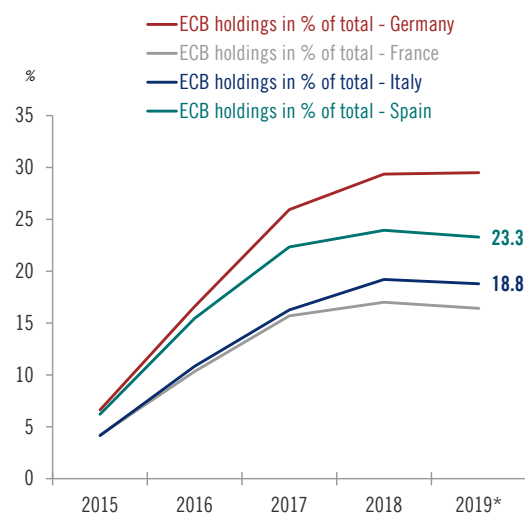
CHART 6: ECB'S SOVEREIGN BONDS PURCHASES



Source: PWM - AA&MR estimates, ECB, 31.12.2018

\*Based on expected net issuance and estimated redemptions per country

CHART 7: ECB'S SOVEREIGN HOLDINGS IN % OF TOTAL



Source: PWM - AA&MR estimates, ECB, Factset, 31.12.2018

This does not mean that the ECB's impact on bond markets will become negligible; all eyes are now on its planned rate-hiking cycle. The recent deterioration in economic data in the euro area, with Italy and Germany both posting negative GDP growth in Q3 2018, along with sluggish headline inflation (due to the fall in the oil price), could push the ECB to change its forward guidance and delay its first rate hike. In our central scenario, we still expect hikes in the second half of this year, but the possibility of seeing no rate rise at all in 2019 has increased significantly in recent months. **In any case, the ECB's policy normalisation will likely be very gradual, thereby limiting the upward pressure on sovereign yields.**

### Conclusion

In light of recent developments in the euro area and the broader world economy, our expectation for a rebound of the 10-year German Bund yield from 0.23% on January 14 to 0.8% by year-end is looking a bit optimistic and a lower forecast of 0.6% looks more realistic. Our forecast of 250-300 bps for Italian 10-year spreads and of 130-150 bps for 10-year Spanish spreads versus the Bund (see Chart 1 and 2 above) allows us to compute year-end ranges for the 10-year Italian and Spanish sovereign yields. **The former should rise from 2.8% on January 14 to about 3.1-3.6% by year's end and the latter from 1.4% to 1.9-2.1%, driven by a higher Bund yield and wider spreads. These forecasts underpin our current underweighting of euro periphery sovereign bonds.**

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