Ostrum ASSET MANAGEMENT

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Market views and strategy

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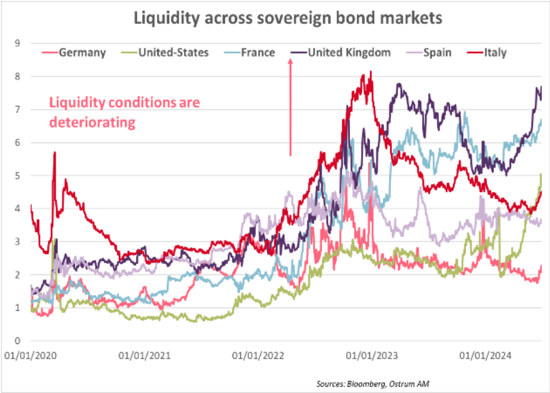
Topic of the week: European bonds: Heading towards the risk-free reference asset
by Aline Goupil-Raguénès,

- To address climate change, ensure the digitalization of the economy and strengthen its defense, the European Union must make massive investments, totaling more than 5 trillion euros between 2025 and 2031;
- The majority will be funded through private investments, with a significant portion coming from public investments;
- Meeting these common objectives requires the participation of all countries. However, some countries have very limited budgetary leeway;
- The EU bonds must therefore rapidly become the risk-free reference asset within the EU.

Market review: A turbulent end to the first half of the year
by Axel Botte

- Yields rise as markets await French elections results;
- Some tensions on euro sovereign spreads;
- Breakeven inflation rates ignore the rebound in oil prices to $86;
- US equities continue to outperform European stocks.

Chart of the week



The main sovereign bond markets are usually highly liquid and most of the time more liquid than other markets during times of stress. This is essential to allow market participants to buy and sell securities easily without causing significant price movements.

However, the liquidity of some major bond markets has significantly decreased, as indicated by Bloomberg liquidity indices (an increase in the index signals a decrease in liquidity). This is particularly the case for the United States, the United Kingdom and France. This partly reflects the uncertainty related to central banks, especially the Fed, as well as uncertainty related to upcoming elections in France, the United Kingdom, and the United States, and their implications for fiscal policy.

Figure of the week

2.2

The 10-year Chinese bond yield has reached a 22-year low at 2.2%. Investors are anticipating the adoption of a more accommodative monetary policy by the central bank to support growth.

Source: Bloomberg

Topic of the week

European bonds: Heading towards the risk-free reference asset

The European Union needs to make massive investments in the coming years to address climate change, ensure the digitalization of the economy and strengthen its defense. While the majority of these investments will be made by the private sector, public financing will have a crucial role to play. In this context, European Union bonds must become the risk-free asset of reference to achieve these objectives.

Massive investments to be made within the EU

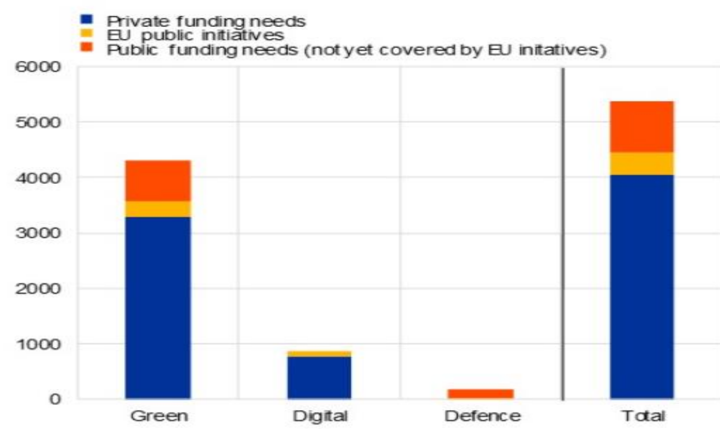
The European Union needs to invest over 5 additional trillion euros between 2025 and 2031

To achieve carbon neutrality by 2050, develop digitalization and increase spending in the defense sector to ensure EU security, in a less collaborative world with increased geopolitical risks, EU investments will need to be much larger than in the past. In a recent article published on its blog, the ECB reviews the estimates of the European Commission and NATO to assess their amount. The additional investments to be made, compared to the historical average, are estimated at 5.4 trillion euros over the period 2025-2031. The majority will be financed by the private sector (in blue on the graph): companies, households, and investors, and a significant portion by the public sector: 1.3 trillion, according to the ECB's estimates.

The financing will be mainly done by the private sector, with a significant portion coming from the public sector (1.3 trillion euros)

On these 1.3 trillion euros, 400 billion euros are available through existing EU financing (in yellow on the graph): the EU budget, the Recovery and Resilience Facility of Next Generation EU, the European Investment Bank, and other funding sources such as InvestEU. This means that there is a shortfall of 900 billion euros in public funding (in red) to meet all of these challenges.

Additional EU investments required in climate, digital, and defense sectors for 2025-2031 – Billion of euros



Source: ECB

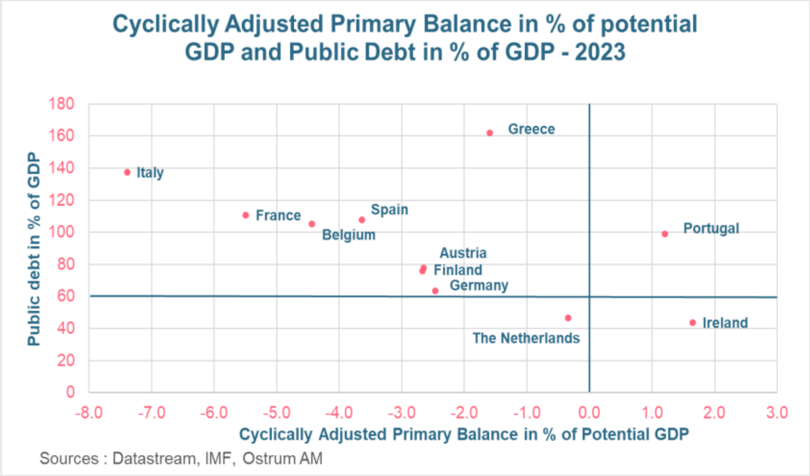
Given the high uncertainty, the authors apply a margin of +/- 20% to their findings and arrive at an estimate of a public financing requirement ranging from 0.6% to 1% of the EU's GDP per year. These estimates are quite conservative as they do not take into account the investments to be made in the areas of health and education.

Need for common financing

Meeting these common objectives requires increased investments across all countries

These public investments can be financed at the national or EU level. Climate and defense challenges are common objectives. If a country fails to achieve them, the situation of the entire EU will be affected. However, the budgetary leeway of some countries is limited due to a high public debt-to-GDP ratio. Some countries may significantly increase their investments while others are not able to do so, thus reducing the impact of overall spending within the EU and therefore not fulfilling the common goal of achieving carbon neutrality and ensuring the defense of the EU. The graph below shows the significant divergence between countries in terms of public finances. Some countries like Greece and Italy are heavily indebted, unlike the Netherlands and Germany. This is exacerbated in some countries by a significant cyclically adjusted primary deficit (budget balance, excluding interest payments and adjusted for the economic cycle) as in Italy, in France and Belgium.

Some countries, however, do not have sufficient budgetary leeway



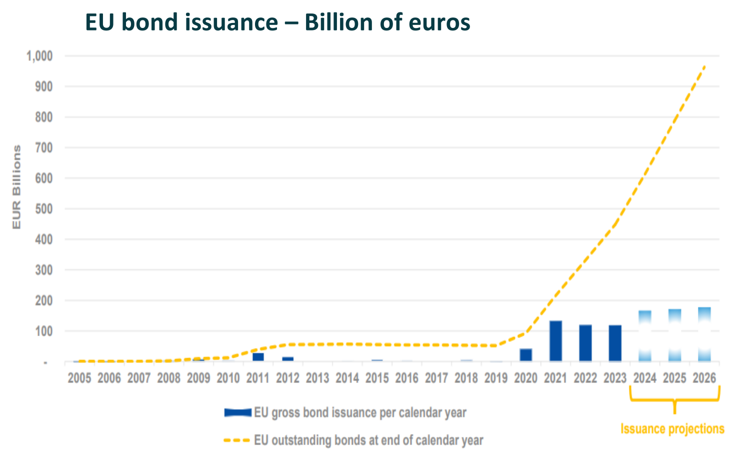
It is necessary to resort to common financing through European Union bonds

The stability and growth pact reform adopted last April provides a little leeway for governments, as the period for adjusting public spending can be extended to 7 years, compared to 4 years otherwise, if countries make the necessary investments for the energy and digital transition. However, this proves to be insufficient. To meet all the challenges of the EU, it is thus necessary to resort to common borrowing through European Union bonds.

EU Bonds: A Future Risk-Free Asset

The EU has become a major issuer

The European Commission has been issuing bonds for over 40 years to finance EU programs. The issuance has been massive since 2020 following the extensive measures taken by governments to address the unprecedented shock of the Covid-19 crisis. The temporary programs SURE and NextGeneration EU have been a real game-changer for the EU bond market.



Sources : EU, Ostrum AM

The SURE and Next Generation EU programs have enabled the EU to issue extensively in the bond markets

The SURE program, amounting to 100 billion euros, was launched in April 2020 to finance short-time work schemes to preserve jobs and household incomes affected by the Covid-19 crisis. It was followed, in 2021, by the Next Generation EU program, aimed at financing the European recovery plan to address the Covid-19 crisis. The amount can reach up to 806.9 billion euros (at current prices), or 750 billion euros at 2018 prices. If countries implement the necessary reforms and investments to make their economy more resilient, greener and digital, they can benefit from grants and loans at favorable rates. The countries most affected by the Covid-19 crisis receive more funds. Recently, the EC has launched a facility to support Ukraine, with an amount of 50 billion euros, of which 33 billion euros will be financed through bond issuance.

As of the end of May 2024, the EU had issued 514 billion euros, mostly to finance the Next Generation EU program. By 2026, when it is expected to be completed, the EU is projected to have issued nearly 1 trillion euros. The market will thus be roughly equivalent in size to the Spanish market, making it the EU's fifth largest issuer.

A risk-free asset

The EU debt is highly rated by credit rating agencies

The EU is one of the safest issuers in the Eurozone. The EU's debt is rated AAA by Fitch and Moody's (Aaa) and AA+ by S&P. This very good quality results from the fact that the EU's debt is backed by the European budget. This allows the EU to finance itself at rates lower than the weighted average rate of the EU countries.

To finance Next Generation EU, the ceiling for each country's own resources that must be contributed to the EU budget has been temporarily raised by 0.6 percentage points of GNI, to be increased to 2% of the EU's GNI. The EU's resources will also be increased.

Leading Green Bond Issuer

The EU will issue 240 billion euros of green bonds to finance Next Generation EU

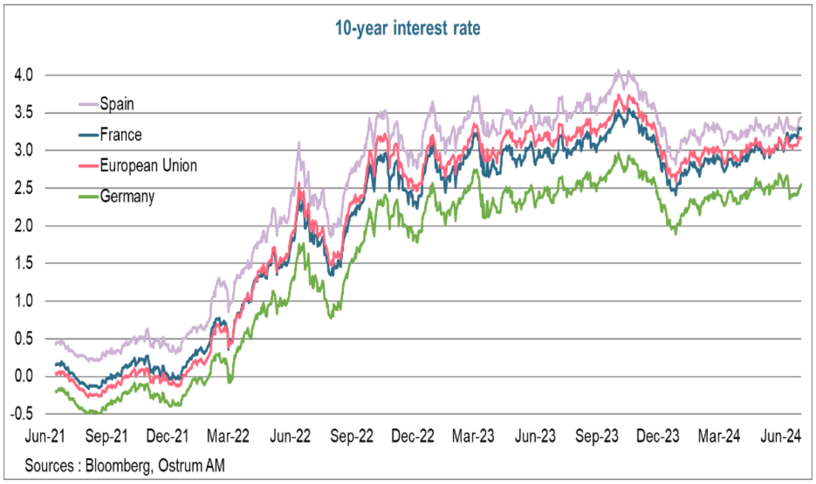
The EU stands out from other sovereigns by the significant size of green bonds issued. In order to access funds from NextGeneration EU, countries must allocate at least 37% of investments and reforms to the energy transition. To finance these expenses, the EC will issue 30% of the

NextGeneration EU program in the form of green bonds (240 billion euros). The first issuance of EU green bonds took place in October 2021, with a maturity of 15 years and a total amount of 12 billion euros, the largest ever issued. It was heavily oversubscribed, with demand reaching 135 billion euros. The EU is responding to the demand from investors who are eager and incentivized to decarbonize their portfolios. To this end, the EU has established a green bond framework to ensure transparency and traceability of funds. The first impact report was published in December 2023. In 2026, the EU is expected to become the world's largest green bond issuer.

Passage from supranational bonds to sovereign bonds

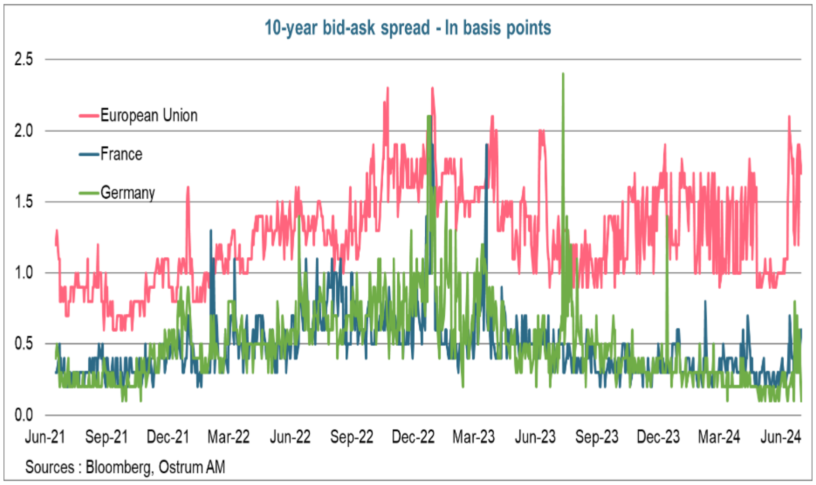
EU debt trades at levels close to French debt despite a higher credit rating.

Despite having a higher credit rating than French debt (rated Aa2 by Moody's and AA- by S&P and Fitch), EU bonds trade at interest rate levels close to French bonds. On June 28, 2024, the 10-year EU rate closed at 3.2%, compared to 3.3% for the French 10-year and 2.5% for the German 10-year.



This is due to a liquidity premium

This premium is a liquidity premium. It is not equivalent to that of the German and French bond markets. Despite massive issuances across the entire yield curve, including the short end, and significant trading volume in the secondary market, the spread between bid and ask prices in the secondary market is larger for EU bonds than for Germany and France.



The end of the Next Generation EU program in 2026 creates uncertainty for investors

This is due to the fact that the EU yield curve is recent and, most importantly, to the limited duration of the Next Generation EU program. Net issuances end in 2026, creating uncertainty for investors beyond this date. Repayments will end in 2058. This is likely the main reason why MSCI did not include EU bonds in its sovereign bond indices on June 12. EU bonds are therefore considered supranational bonds (similar to those of the European Investment Bank) and not sovereign bonds. MSCI will review this issue in the first half of 2025. The index provider ICE, on the other hand, is expected to make a decision in early August.

Including EU debt in sovereign indices would allow EU bonds to be treated as sovereign bonds.

The inclusion of EU bonds in European sovereign indices would lead to a significant increase in buying flows and therefore demand and liquidity, as fund managers seek to replicate the composition of the benchmark index in their portfolios. A study by the EC reveals that for 75% of investors, the integration of EU bonds into benchmark bond indices is the most important step for them to trade like sovereign bonds.

Conclusion

To finance the massive investments needed to address the EU's challenges, joint debt issuances are necessary due to the limited borrowing capacity of some countries. Discussions are ongoing between governments, under the impetus of France, but have not led to real progress so far. Continuing massive EU bond issuances beyond Next Generation EU will increase investor confidence, promoting integration of EU bonds into benchmark indices and increase market liquidity. EU bonds will thus be the necessary risk-free asset to address the climate, digital, and defense challenges within the European Union.

Aline Goupil-Raguénès

Market review

A turbulent end to the first half of the year

The first half concludes on a very positive note for global stocks, despite the volatility caused by political risk. Long-term interest rates have risen by 40 to 60 bps, with the exception of the 10-year Chinese bond yield, down by 35 bps. The bulk of the spread tightening since the beginning of the year has held.

The political risk continues to paralyze market participants in the run-up to the first round of legislative elections in France. In the United States, the debate between Trump and Biden brings a lot of uncertainties for the Democrats. The flattening of the yield curve reflects a reduction in risk for longer maturities. The return of the Bund to 2.45% is therefore not indicative of relaxation and reduced risk aversion. The 10-year OAT hits a new high at 83 basis points on the eve of the election. Credit spreads are narrowing slightly, given that the quarterly close and the political context are not conducive to risk-taking. Meanwhile, the yen's downward spiral seems endless. The dollar-yen rate climbs back above 160, in turn fueling downward pressure on the yuan.

The US economic growth finally comes in at 1.4% in the first quarter. Private consumption has been revised down to a meager 1.5%, in line with weak retail sales. However, productive investment remains strong. The 16% increase in housing investment raises hopes for a rebound in household spending. The trade balance weighed in at 0.7 percentage points. Activity is expected to improve to around 2-2.5% in the second quarter with the replenishment of inventories. In Europe, surveys show a decline towards the end of the quarter. Political uncertainty is not helping. However, gradual disinflation is leading to an increase in purchasing power. Harmonized inflation stands at 2.6% in France and 3.5% in Spain. Expectations, however, moderate over a 3-year horizon (2.3%).

In the markets, the rise in long-term yields is not a sign of lower risk aversion. Political risk is on everyone's mind. The Bund yield is trading around 2.45%. The 10-year French OAT is under pressure at 83-bp spreads, while the AFT announces a decrease in the auction size scheduled on July 4th. The debt agency is striving to meet the collateral needs of primary dealers. Swap spreads are trading above 40 basis points at 2 and 5 years' maturities. The Italian BTP ends the week on a negative note at 158-bp spreads. Inflation break-evens (2% on the 10-year Bund) continue to ignore the rebound in crude oil ($86). In the United States, the PCE deflator is in line with projections after the May CPI release. Slow disinflation is gradually lowering the ceiling on US bond yields. The fiscal outlook beyond the November election points to a risk of steepening in the US the yield curve.

Corporate borrowers took advantage of the last window of opportunity to tap markets before the French elections and the quieter summer months. The slight widening of spreads ensured decent demand in the investment-grade universe. The average asset swap spread is back below 80 bps. Subordinated financials outperformed, with the iTraxx IG stabilizing above 60 bps. Protection buying on the iTraxx Crossover is moderating around 325 bps. The stock markets continue to be dominated by US technology stocks. The French CAC's underperformance (-2%) persists against major European indices. The Nikkei continues to benefit from the weakness in the Japanese yen.

Axel Botte

Main market indicators

G4 Government Bonds	01-Jul-24	1wk (bp)	1m (bp)	2024 (bp)
EUR Bunds 2y	2.91%	+11	-18	+51
EUR Bunds 10y	2.58%	+16	-8	+56
EUR Bunds 2s10s	-33.6bp	+5	+10	+5
USD Treasuries 2y	4.76%	+4	-11	+51
USD Treasuries 10y	4.44%	+21	-6	+56
USD Treasuries 2s10s	-32.2bp	+17	+5	+5
GBP Gilt 10y	4.25%	+17	-7	+71
JPY JGB 10y	1.06%	+7	-7	-31
€ Sovereign Spreads (10y)	01-Jul-24	1wk (bp)	1m (bp)	2024 (bp)
France	74bp	-2	-6	+21
Italy	150bp	-2	-8	-17
Spain	87bp	+1	-5	-9
Inflation Break-evens (10y)	01-Jul-24	1wk (bp)	1m (bp)	2024 (bp)
EUR 10y Inflation Swap	2.23%	0	-3	+9
USD 10y Inflation Swap	2.56%	+8	-3	+15
GBP 10y Inflation Swap	3.66%	+3	-11	+13
EUR Credit Indices	01-Jul-24	1wk (bp)	1m (bp)	2024 (bp)
EUR Corporate Credit OAS	120bp	-1	+11	-18
EUR Agencies OAS	72bp	+0	+16	+2
EUR Securitized - Covered OAS	69bp	+0	+10	-10
EUR Pan-European High Yield OAS	370bp	-1	+33	-29
EUR/USD CDS Indices 5y	01-Jul-24	1wk (bp)	1m (bp)	2024 (bp)
iTraxx IG	58bp	-3	+6	-1
iTraxx Crossover	309bp	-9	+18	-5
CDX IG	52bp	-1	+2	-5
CDX High Yield	339bp	-1	+4	-17
Emerging Markets	01-Jul-24	1wk (bp)	1m (bp)	2024 (bp)
JPM EMBI Global Div. Spread	391bp	-4	+16	+7
Currencies	01-Jul-24	1wk (%)	1m (%)	2024 (%)
EUR/USD	$1.076	0.224	-1.348	-2.6
GBP/USD	$1.269	0.000	-0.953	-0.4
USD/JPY	JPY 161	-1.054	-3.248	-12.6
Commodity Futures	01-Jul-24	-1wk ($)	-1m ($)	2024 (%)
Crude Brent	$85.9	$0.7	$5.0	13.2
Gold	$2 331.7	-$2.9	-$19.0	13.0
Equity Market Indices	01-Jul-24	-1wk (%)	-1m (%)	2024 (%)
S&P 500	5 464	0.30	3.54	14.6
EuroStoxx 50	4 951	0.01	-0.65	9.5
CAC 40	7 617	-1.17	-4.70	1.0
Nikkei 225	39 631	2.13	2.97	18.4
Shanghai Composite	2 995	1.07	-2.98	0.7
VIX - Implied Volatility Index	13.04	-2.18	0.93	4.7

Source: Bloomberg, Ostrum AM

Additional notes

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