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MARKETS INSIGHTS /

Marie Thibout, Economist & Strategist

EUROPEAN SOVEREIGN BONDS
WILL PERIPHERAL SPREADS WIDEN AGAIN?

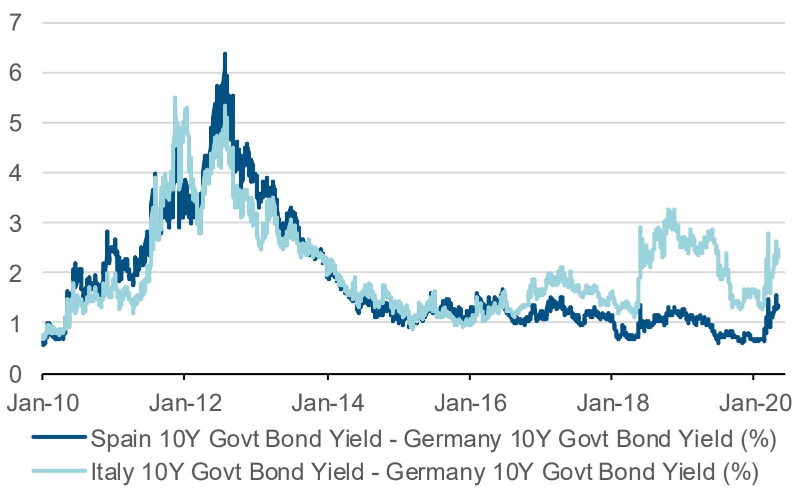
The ruling of the German constitutional court against the European Central Bank (ECB) recalls the dark hours of the European sovereign debt crisis and the previous judicial debate on the ECB's Outright Monetary Transactions (OMT) program. Fears of a widening of peripheral spreads are rising. Why is the situation different today?

In “normal times”, all the ingredients for a rise in peripheral spreads would be there. Tensions are rising over the conduct of monetary and fiscal policy. Eurozone finance ministers were unable to agree in April on a coordinated and supportive fiscal response to the epidemic. While an initial agreement was difficult to reach on an emergency support plan of 540 billion euros, the pooling of debt in the form of Coronabonds or Eurobonds is not on the agenda. Negotiations on a support fund to boost growth in the countries most affected by the epidemic are at a standstill, as the Nordic countries do not wish to provide grants, preferring instead loan schemes.

In addition, according to the European Commission, the euro zone deficit is forecast to soar to 8.5% of GDP in 2020. The public debt is expected to rise above the 100% mark, after a 17 percentage point increase. The deterioration in public finances will be most noticeable in the peripheral countries, which have been more affected by the virus than their northern neighbours. This could revive concerns regarding public debt sustainability. We expect that a deep recession would also rekindle political and social tensions.

In other circumstances, all these elements should have triggered a sharp widening of peripheral spreads. However, we believe the ECB's interventions should prevent this in the medium term. Regarding the German constitutional ruling, it should not be a concern for the moment, in our view. It relates to the former public purchase programme (PSPP), and not to the most recent pandemic emergency purchase programme of €750 bn (PEPP). Besides, the German court asked for justifications of the former PSPP but declared that it was legal. Finally, the ECB is not answerable to national courts but to the European court of justice.

More importantly, the PEPP allows the ECB to be very flexible in its purchases and to target its interventions when needed, as there is no pre-defined amount of purchases per month and the former issuer limit (a third of country's eligible bonds) has been removed. On top of that, the ECB has been proactive in easing it collateral policy so that assets of issuers whose rating have been downgraded below BBB⁻ since the beginning of April are still eligible, as long as their rating remains at BB minimum. In the case of Italy for example, this would have allowed Italian sovereign bonds to remain on the ECB's list of eligible collateral, even if rating agencies had downgraded the country's sovereign rating below investment grade.



Sources: Refinitiv , Mirabaud Asset Management

These elements, combined with a increase in the PEPP that we anticipate, should allow peripheral spread to remain relatively stable in our view, as long as the ECB purchases continue.

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