Week Ahead

Focus: Eurozone sovereign bonds

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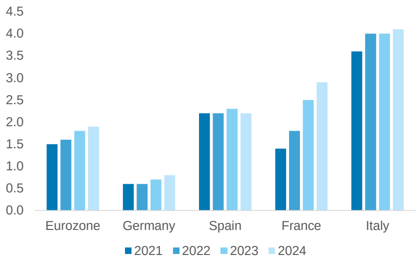
Yield spreads should remain lower

Given the events of 2011 and 2012 in the Eurozone, the rapid rise in interest rates over the course of this year fueled concerns that some countries could come under pressure again. The European sovereign debt crisis was triggered by misreporting of public budgets (Greece), high foreign debt and bank distress, mainly due to burst real estate bubbles, which all resulted in an acute need for financing.

This is a crucial difference from the current situation. The increase in financing costs will be a continuous process for public budgets. Only those parts of the public debt that will expire and thus have to be refinanced, as well as new debt, will be affected. The European Commission expects interest payments to rise by an average of just two-tenths of economic output in the Eurozone next year. A considerable part of this is attributable to France alone. In Italy, by contrast, interest payments should remain stable relative to economic output in 2023 compared with 2022. The European Commission also expects interest payments to increase only very slowly in 2024.

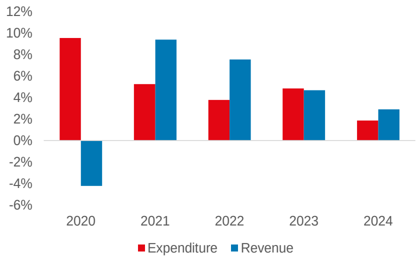
Public sector interest payments, in % of GDP



Source: AMECO, Erste Group Research

While higher inflation due to higher interest rates has a slow negative impact on government budgets, immediate positive effects come from revenues. Inflation led to an immediate strong increase in government revenues in 2021 and 2022, which was also significantly higher than the increase in spending (excluding interest) in 2022, despite the aid packages against energy inflation. This made up a lot of ground from 2020, when COVID led to a massive increase in spending and a decline in revenues. Even though inflation will fall next year, it will remain high on average for the year and will thus continue to boost public sector revenues. Expenditures will rise by roughly the same percentage. Overall, this means that government budget deficits in 2023 should remain virtually unchanged from 2022. The European Commission also expects little change for 2024. Thus, no significant deterioration in public budgets can be seen for the next two years.

Eurozone: public expenditures and revenues, y/y in %



Souce: AMECO, Eurostat, Erste Group Research

The sudden change in monetary policy, and with it the prospect of rapid interest rate hikes, led to a massive sell-off on the bond markets from the spring. In the process, the yield premiums of virtually all European government bonds against Germany rose. The elections in Italy in September then caused further uncertainty. Since October, however, yield spreads have narrowed significantly, which was probably also due to the course taken by the new Italian government. More crucially, however, there was a slight easing on the bond markets and yields generally fell. We expect this latest narrowing of yield spreads to at least hold. The stabilization of the European bond market that we expect after a very turbulent 2022, together with the outlook for public budgets, speaks in favor of this.

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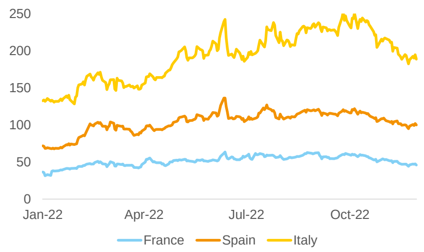
10y sovereign yield spreads vs. Germany, in basis points



Souce: Market data provider, Erste Group Research

The foreseeable withdrawal of liquidity by the ECB poses risks. We expect the ECB to reduce its portfolio from the APP program from April. Based on the expected redemption payments, we assume a maximum amount of EUR 25bn per month that could be withdrawn from the market in this way in terms of liquidity. However, with a total APP portfolio size of more than EUR 3,400bn, this means only a slow reduction. In addition, the PEPP portfolio, which is about half the size, but allows flexibility in reinvestment, will remain in place and support individual markets as needed. In the event of more severe market turmoil, the ECB may intervene through its TPI program. Repayments of banks' TLTRO loans to the ECB will almost certainly be much faster. We estimate that close to EUR 1,200bn will be repaid by the summer. To what extent this will affect the bond market is uncertain. Based on the development of the bank’s holdings of government bonds, we assume that most of the TLTRO loans have been re-deposited with the ECB and not invested in the bond market. The unwinding of these positions should therefore not have a noticeable impact on the bond market.

Economic calendar

Ctry	Date	Time	Release	Period	Consens	Prior
Eurozone						
EA	7-Dec	11:00	GDP q/q	3Q F	0.2%	0.2%
EA	7-Dec	11:00	GDP y/y	3Q F	2.1%	2.1%
USA						
China						
	9-Dec	3:30	Inflation y/y	Nov	1.6%	2.1%

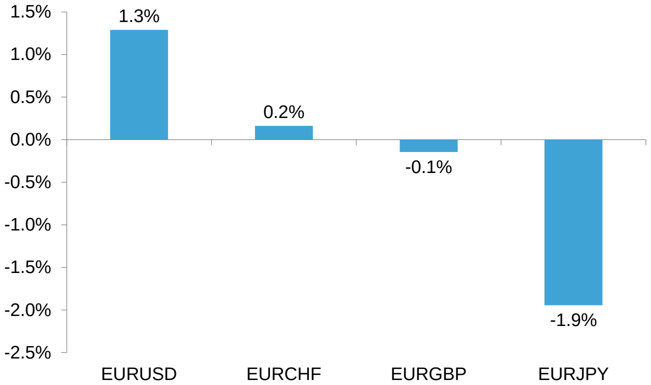
Central bank events

	Date	Time	Representative	Forum	Location
ECB	3-Dec	03:30	Christine Lagarde	Panel discussion	Bank of Thailand / BIS
	7-Dec	08:10	Philip Lane	Speech	Chinese State Administration of Foreign Exchange
	7-Dec	15:30	Fabio Panetta	Speech	London Business School
Fed			No monetary policy relevant events		

Source: Market Data Provider, ECB, Federal Reserve, Erste Group Research

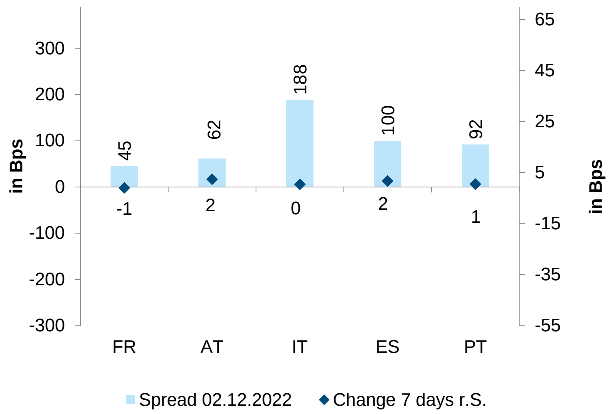
Forex and government bond markets

Exchange rates EUR: USD, CHF, GBP and JPY
Changes compared to last week



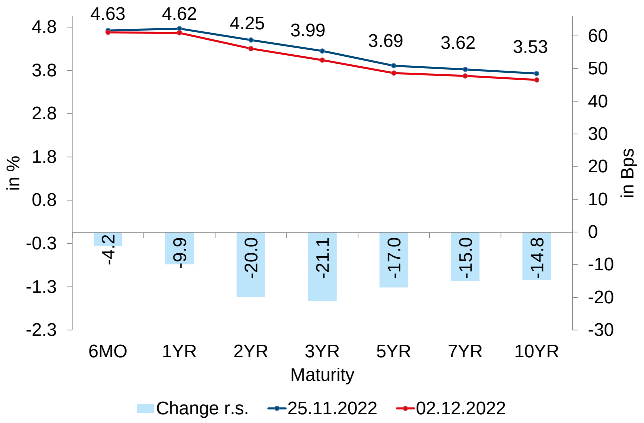
Source: Market Data Provider, Erste Group Research

Eurozone spreads vs. Germany
10Y government bonds



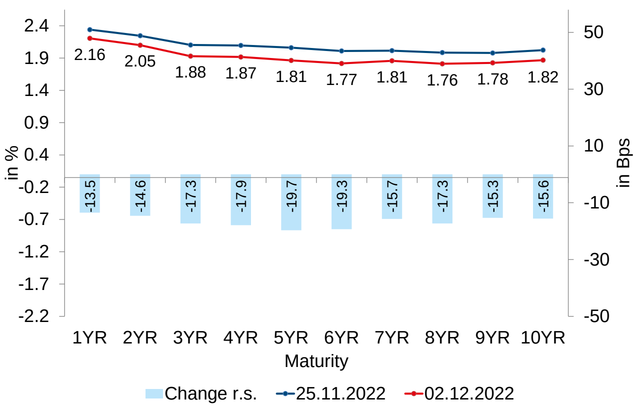
Source: Market Data Provider, Erste Group Research

US Treasuries yield curve
Changes compared to last week



Source: Market Data Provider, Erste Group Research

DE Bund yield curve
Changes compared to last week



Source: Market Data Provider, Erste Group Research

Forecasts[1]

GDP	2021	2022	2023	2024
Eurozone	5.3	3.2	0.3	0.7
US	5.7	1.8	0.8	1.2

Inflation	2021	2022	2023	2024
Eurozone	2.6	8.4	5.6	2.0
US	4.7	8.1	3.3	1.9

Interest rates	current	Mar.23	Jun.23	Sep.23	Dec.23
ECB MRR	2.00	2.75 ↑	2.75 ↑	2.75 ↑	2.75
ECB Deposit Rate	1.50	2.25	2.25	2.25 ↓	2.25
3M Euribor	1.97	2.22	2.23 ↑	2.26 ↑	2.29
Germany Govt. 10Y	1.81	1.90 ↓	1.80	1.70	1.80
Swap 10Y	2.54	2.50 ↓	2.30 ↓	2.20 ↓	2.30

Interest rates	current	Mar.23	Jun.23	Sep.23	Dec.23
Fed Funds Target Rate*	3.83	4.88	4.88	4.88	4.63
3M Libor	4.78	4.96	4.96	4.96	4.71
US Govt. 10Y	3.53	3.60	3.30	3.10	2.80
EURUSD	1.05	1.05 ↑	1.08 ↑	1.08 ↑	1.08

*Mid of target range

In case of changes to our forecasts compared to the previous issue, arrows show the direction of the change.

Source: Market Data Provider, Erste Group Research

[1] Note: In accordance with regulations, we are obliged to issue the following statement: Forecasts are not a reliable indicator of future performance.

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