



# GLOBAL MARKETS UPDATE

## Fiscal health and the outlook for the euro-zone’s bond markets

- We continue to forecast a small fall in euro-zone yield spreads over Bunds in the next year or so. However, rising risks to the upside in recent months and differences in fiscal positions between countries may mean that the relative picture for some spreads has changed.
- Euro-zone bond yields continued to fall yesterday, and yield spreads were stable, despite the release of the [European Commission’s assessment](#) of EU members’ national budgets, which reported that some of them – including France, Germany, Italy and Portugal – are not fully in line with its recommendations. This suggests that the assessments didn’t come as much of a surprise, or that investors are not particularly interested in the minutiae of the European Commission’s fiscal analysis. But it also reflects the relative importance of other drivers when it comes to the general outlook for euro-zone yield spreads over Bunds.
- We recently published a [note](#) setting out our view that **the risk of a material increase in euro-zone yield spreads has risen, but that we still forecast them to fall a bit by end-2024**. There, we argued that emerging concerns about debt sustainability and renewed worries about the outlook for the euro-zone economy would continue to exert upward pressure on peripheral spreads. But we expect that to be outweighed by downward pressure coming from easing monetary policy and falling global bond yields.
- **The sharp fall in euro-zone government bond yields over recent weeks is consistent with that view.** Indeed, the rally that started after the [US September Employment report](#), was sustained by continued weak euro-zone economic data (see [here](#) and [here](#)) and accelerated after the [US CPI data](#) release last week brought bond yields in the euro-zone close to, or even *below*, their levels at the start of this year. (See Chart 1.) That is also the case for most yield spreads over Bunds, which in some cases have fallen considerably over the year as a whole. (See Chart 2.) Greece’s spread, for example, fell after the emphatic electoral win of a central-right party perceived as market friendly by investors.

Chart 1: Changes In 10-Year Government Bond Yields (bp)

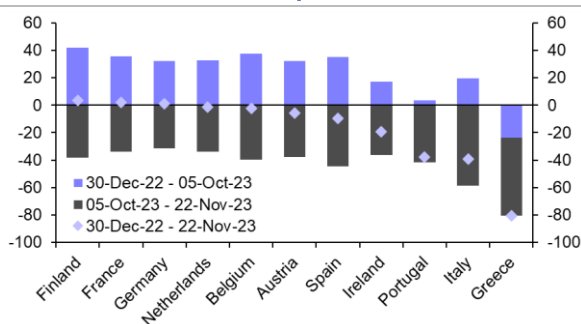
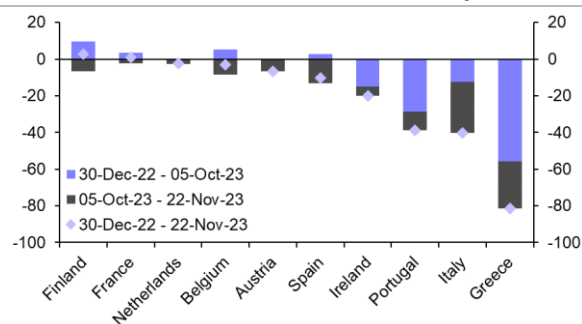


Chart 2: Changes In Yield Spreads Of 10-Year Government Bond Over Bunds (bp)



Sources: Refinitiv, Capital Economics.

- Turning from the picture for the euro-zone as whole, there are some interesting country-specific developments that are worth highlighting.
- The 10-year BTP spread, which has been by far the highest among those in euro-zone markets in recent years, will probably remain so for a long while yet. We expect rising bond yields in the longer run to send Italy’s already massive sovereign debt on an upward path, adding significant upward pressure on that spread. At the same time, we doubt there will be a major sell off in BTPs in the near term. Indeed, Moody’s decision to lift Italy’s credit outlook from ‘negative’ to ‘stable’ prompted a rally in BTPs last Friday.
- Meanwhile, the relative picture among the euro-zone bond markets does seem to have changed somewhat in recent months – in particular, in the case of France’s and Portugal’s 10-year spreads over Bunds.



- While peripheral spreads have, in general, been stable since the start of the year, the French spread has widened a bit since then. Meanwhile, its Portuguese counterpart has narrowed substantially. (See Chart 3.) The rise in France’s spread is probably due to the country’s **vulnerable fiscal position**: it is one of the G7 countries with a primary deficit that appears incompatible with a stable, or falling, debt-to-GDP ratio. Meanwhile, in **Portugal**, the government expected to report a primary surplus of around 2.8% of GDP this year which would be consistent with a falling debt-to-GDP ratio.
- **We think the two spreads, which are now at similar levels for the first time since the Global Financial Crisis, to remain so, at least in the next couple of years. For one, we expect the French spread over Bunds to remain wider than it’s been historically.** In our view, the fiscal tightening proposed in the draft 2024 budget which is likely to be forced through parliament is too limited and too slow to meaningfully improve the large primary deficit. And without a majority in parliament, we doubt the government will be able to tighten policy any more than already agreed in the draft budget.
- **What’s more, we expect the Portuguese spread to stay narrower than in the past.** After all, Portugal’s draft 2024 budget – already approved by parliament – adds more assurance to investors that the country’s fiscal position will continue on a responsible path, despite Prime Minister António Costa recent resignation. Moody’s two-levels upgrade of **Portugal’s credit rating** last Friday supports this view too.
- Admittedly, the risks around the outlook for fiscal policy in Portugal beyond 2024 did rise with the possibility of a new government installed after the snap elections now due in March next year. But, while it is uncertain who will be in power, none of the major parties are advocating much looser fiscal policy.
- **The convergence of Portugal’s spread over Bunds towards that of France also created a significant gap between it and Spain’s spread (see Chart 3 again), which we think will also persist in the next couple of years, albeit a bit narrower than it is now.** That is because, as it stands, Spain’s primary deficit seems too large for a stable debt-to-GDP ratio going forward. And we doubt its fiscal position under a new coalition government will be too different from how it’s been in recent years.
- **The upshot is that we project the yield spreads of euro-zone government bonds over Bunds to end 2024 a bit below their current levels. While that implies that the spread of 10-year BTPs over Bunds will remain significantly wider than others in the periphery, it also means that the relative perceived risk between Portugal’s and France’s sovereign debt has shifted in favour of the former.** (See Chart 4.)

Chart 3: Yield Spreads Of 10-Year Government Bond Over Bunds (bp)

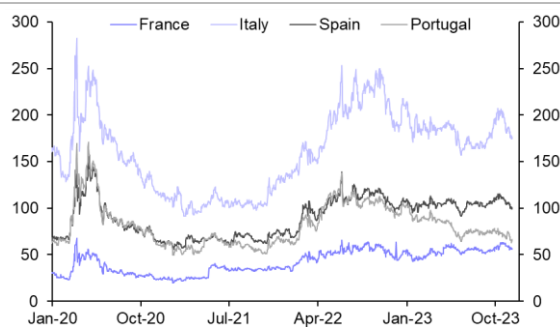
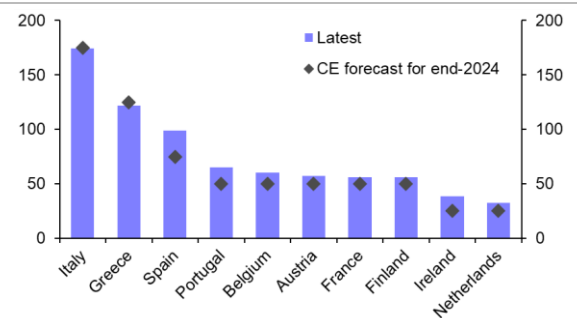


Chart 4: Yield Spreads Of 10-Year Government Bond Over Bunds (bp)



Sources: Refinitiv, Capital Economics.



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