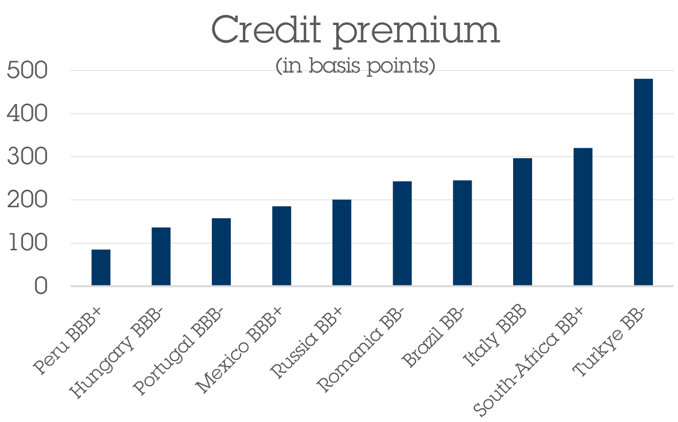
3 december 2018

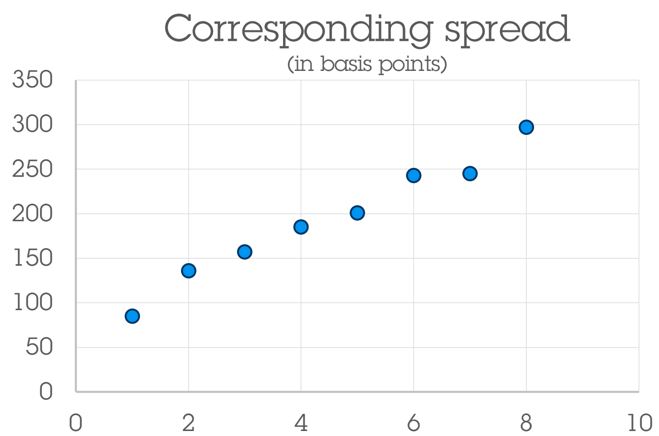
"European junk bond market to grow six-fold in 2019"

"European politics will remain firmly on the investment radar in 2019. An excessive debt procedure against Italy could force rating agencies to severely impact the junk bond market."

Italy is set to remain in the spotlight in 2019. The European Commission recently recommended the launch of an excessive debt procedure against the largest Southern European economy. This could result in the course of 2019 in fines and/or the curtailing of European subsidies. The prompt for this is, of course, the expansive budgetary policy of Italy's new populist coalition – a policy that breaks earlier promises and European agreements and rules in this area.

The outcome of all this obviously isn't set in stone: European heads of government have yet to sign off on the disciplinary procedure and it is difficult (if not impossible) to enforce payment of a fine. What's more, the European elections are due shortly in Italy too. Observers believe (backed by opinion polls) that these could shift the balance of power in the coalition, potentially triggering fresh national elections. If these were to produce a more homogeneous (right-wing) coalition, a more focused and potentially less expansive budgetary policy would become a possibility. Right-wing voters traditionally attach greater importance, after all, to healthy government finances. And since it is also these voters who hold the largest share of Italy's substantial private savings reserves, they have little to gain from gambling with Italy's membership of the euro area.

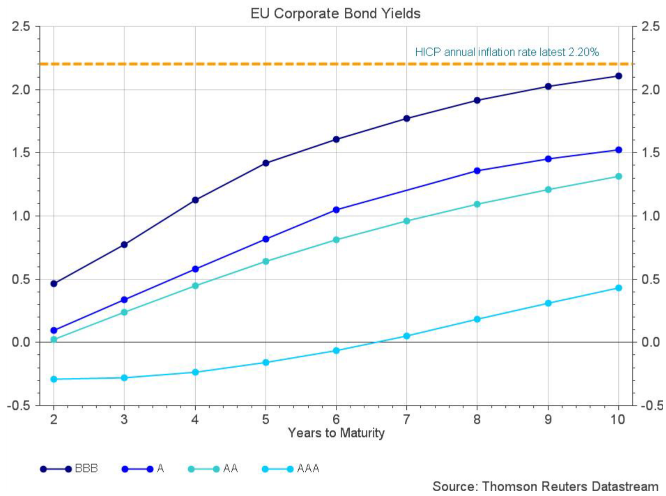




What we can say with certainty is that the major rating agencies have all downgraded either Italy's cred it rating (Moody's) or the outlook for that rating (S&P and Fitch) in recent weeks. Moody's now has Italy on the lowest rung before dropping into the junk category. There is one additional rung to go for each of the other two agencies (but the outlook is negative in both cases). The ratings are scheduled to be updated in the spring of 2019. In the meantime, Italy is already paying a risk premium for new loans comparable to government issuers with confirmed junk status.

The Italian economy is not immune to the heightened uncertainty either. Due in part to tighter financial conditions – higher risk premiums for government loans also make private borrowing more expensive and harder to come by – Italian growth ground to a halt in the third quarter. Leading indicators suggest that this slowdown is set to continue. A technical recession cannot be ruled out. Sluggish growth is clearly unhelpful for Italian debt and the country's creditworthiness, although it ought to be weighed against other factors such as a hitherto strong external position and, as in Belgium, a thriving private sector.

What is also beyond doubt is that any Italian downgrade to junk status would prove seismic for the European bond market. According to Bank of America, European junk rated corporations currently have 282 billion euros' worth of outstanding bonds. If we throw in a further 32 billion euros in freely negotiable Greek sovereign paper and around 50 billion in low-rated euro loans from emerging market issuers, we end up with a euro junk bond market amounting to around 400 billion euros. All that pales into insignificance compared to the 1 906 billion euros of negotiable Italian sovereign debt, even though the ECB holds about a fifth of this. On top of that, there is over 100 billion euros in Italian corporate bonds, most issuers of which would also receive a lower rating in the event that the government is downgraded.



Since a lot of funds and wealth management mandates, even when actively managed, have strict ratings limits in their prospectuses and contracts, there would appear to be no prospect of an Italian downgrade being absorbed smoothly. Non-Italian banks and insurers will not be eager to have these risky assets on their balance sheets, either. Not to mention the fact that the ECB will no longer be able to reinvest its maturing Italian bonds in Italian paper, while the refinancing of the Italian banks at the central bank would also be jeopardised. Financial instability in Italy and possibly also the economic contamination of other member states would then be unavoidable and a fresh euro crisis would come nearer, especially since the European rescue fund ESM only holds a fraction of the funds (383 billion euros) it would take to rescue Italy.

For the time being, we expect reason to prevail and a compromise to be found. Italian citizens recently gave two signals regarding the direction in which things ought to go. According to the Eurobarometer, the popularity of the single currency was up 12 percentage points in Italy at the end of last month. In other words, a substantial majority of Italians consider the euro to be a good thing, for both their own and the European economy. Meanwhile, the largely unsuccessful issue in a difficult budgetary period of a bond aimed specifically at local savers is hardly evidence that the budgetary policy is viewed as sustainable.

European politics will remain firmly on the investment radar in 2019. All this does not mean, however, that 2019 will be a bad year for investors in European corporate bonds. If the wrangling in Italy could be pushed into the background at least temporarily, more attention could be paid to the fundamentals. Persistently robust economic growth, European businesses that, unlike their US counterparts, have mostly kept their balance sheets in excellent condition (as illustrated by the fact that a lot more rating upgrades continue to be published than downgrades) and above all cheaper valuations following the recent sharp corrections, are all optimistic signs compared to the still very expensive bonds of better rated governments.

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