

Will Eurozone bonds go ‘back to the future’?

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Headlines surrounding the Italian budget saga and sovereign debt ratings have certainly garnered their fair share of interest within the global bond markets. Interestingly, the heightened anxiety level has produced fears of another potential contagion event, as investors witnessed during the ‘Grexit’¹ episode. Naturally, that has raised the question of whether Eurozone bond markets could experience a “back to the future” moment; in other words, reliving the past.

When contemplating the possibility of such a scenario developing, it is rather useful to examine how various Eurozone sovereign debt markets have behaved in this latest bout of uncertainty, more specifically looking at the countries that were full participants in the Grexit contagion event (Italy, Spain, Portugal and Ireland). These four nations were deemed the periphery countries of the Eurozone, and as the reader will recall, were at the centre of concern, not only if Greece elected to leave the Euro, but also due to their own respective fiscal/financial challenges at the time.

Figure 1: 10-year government bond yield spreads vs. German bunds

Source: Bloomberg, WisdomTree, 29 October 2018.

Historical performance is not an indication of future performance and any investments may go down in value. Note: Ireland bond data was discontinued between 11 October 2011 15 March 2013.

The initial results are in, and thus far, the concerns raised regarding Italy have been confined to Italy and have not yet spread to the other three aforementioned countries. A valuable tool in discerning potential ‘contagion’ fears lies in the yield difference, or spread, between an asset that is viewed as being more of a safe-haven, such as the 10-year German Bund and the like maturity sovereign issues of the other countries in question. As figure 1 clearly reveals, this most recent bout of concern has stood in stark contrast to the Grexit experience. Indeed, the ‘Grexit experience’ really captures the issues that were confronting not just Greece, but the other four periphery countries as well and lasted from roughly mid-2010 to mid-2013 or so.

Let’s look at some the numbers or spread levels for perspective. The peak period of duress was captured between 2011 and 2012. At that time, Portugal experienced the most notable spread widening versus the bund, with the peak differential ballooning out +1560 basis points (bp) in January 2012. For Spain and Italy, the peak readings were +639bp and +553bp, respectively. So, where are we now? The Portugal 10-year spread stands at +150bp as of this writing, with Spain coming in a bit narrower at +117bp. On a year-to-date basis, both readings are essentially unchanged. Examining developments from a more recent context when the Italian budget and credit rating news started making front-page headlines in late

September, the Spanish 10-year spread widened out only 19bp, while for Portugal the increase was also on the more modest side of 16bp. What about Italy? The Italian 10-year BTP/bunds spread has risen by almost +140bp year-to-date, and +65bp from late September.

Where do we go from here? The recent actions from both Moody's and S&P ratings agencies seem to have lifted a veil of uncertainty on the Italian government bond market, at least for now. For the record, Moody's did lower the actual rating for Italy a notch to Baa3, but shifted their outlook to 'stable'. For S&P, the rating itself was left unchanged at BBB, however the outlook was downgraded to 'negative'. In the immediate aftermath of the S&P announcement, the Italian 10-year yield fell 35bp from its most recent peak, with the BTP/bund spread narrowing 25bp.

Conclusion

Despite the fact the worst credit rating fears were not realized, the potential for continued negative headlines has not been removed. To be sure, S&P noted the Italian budget outlook will remain a key area of contention in their lowering of the sovereign outlook. The EU's 'negative opinion' regarding Italy's budget will more than likely be a saga that continues to play out. In fact, the recent disappointing print of zero growth in Q3 GDP quarter/quarter does not bode well on the budget front either. While contagion is always a risk if developments were to spiral downward from here, the lack of a clear-cut trend for the other periphery countries up to this point has been somewhat encouraging but stay tuned the outlook remains a volatile one.

All data from Bloomberg as of 29 October 2018.

1 Refers to Greece's possible withdrawal from the Eurozone, which made frequent news headlines from 2012 to 2015.

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