

Le Spread



A global bond sell-off is disproportionately impacting France given its poor debt and growth dynamics. 10-year yield spreads vs. Germany, a proxy of investor credit concerns, have reached the widest levels since 2012. There has been limited spillover to other markets, including Italian sovereign debt and the Euro currency. While the near-term outlook is challenging, higher yields themselves are dragging fiscal stability towards the top of the political agenda. Incentives are skewing towards a credible long-term fiscal response.

From now through to next May's Presidential election, risks look skewed to still wider spread levels. This is particularly the case if global yields stay at current levels or move higher. Marginal borrowing rates are too high for realistic expectations of nominal growth. The domestic situation is one of persistent deficits and fragmented politics, which the election could worsen. And, while the European Central Bank (ECB) does have tools to assist, a response is not yet warranted.

Ultimately, we do not think these are the initial tremors of a renewed Euro crisis. There are various paths to stabilisation, including through a serious domestic political response or eventual ECB support. Any easing of pressure on global bonds would also likely lead to respite in French and broader Eurozone debt concerns.

Chart 1: A significant widening

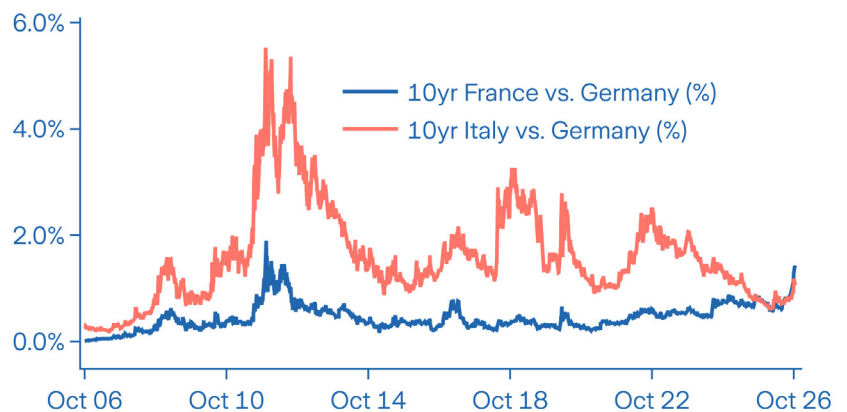


Source: Bloomberg

Background

While spread levels are low when compared to historical Eurozone stress periods, absolute yield levels are not. French weakness is a consequence of its high sensitivity to a rising global yield environment. Credit dynamics exist in the Eurozone in a more acute manner than other sovereign issuers. This is a result of a monetary union without a fiscal union, and institutional hurdles to central bank support. This doesn't mean defaults are likely, but it means that market pressure flare-ups are relatively common.

Chart 2: Perspective matters



Source: Bloomberg

Rising global yields are partially due to broad economic resilience. France is not benefiting. Its real growth is on track for an anaemic 0.5% vs. last year, with downside risks. With the government sector in retreat by necessity, private sector dynamics are weak. Consumers are pessimistic and unemployment is steadily rising. Corporate outlooks are weighed down by ongoing political and taxation uncertainty. With inflation rising less than in other Eurozone countries, France's real yields are rising to higher levels than peers. This places additional fiscal pressure on France, making it more vulnerable to the same level of ECB hikes or yield increases.

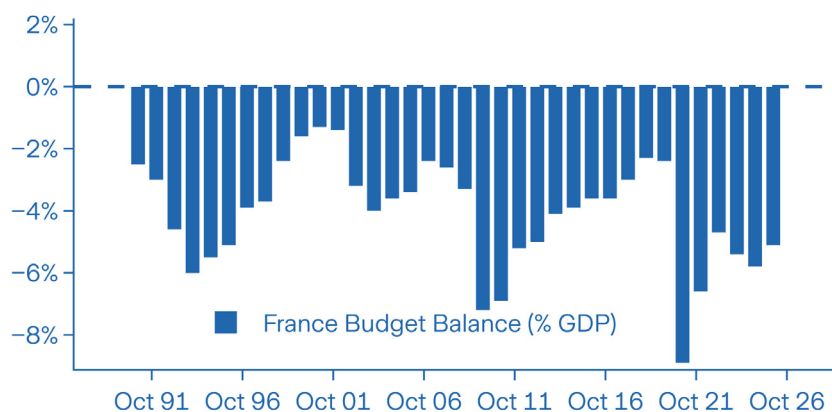
Debt & Deficits

France's debt dynamics have been a longstanding back-of-mind concern for investors. Through tumultuous Eurozone bond market history, France's spread levels were often low for its debt outlook, as investors valued its core EU institutional role. Conditions have deteriorated since Covid across debt, political, and international market metrics.

France's government debt-to-GDP has increased from under 100% in 2019 to likely above 120% by 2027. While Italy's debt ratio is higher, at around 140%, it has only increased by 5 percentage points since 2019, four times less than France. France also has high private debt, at around 215% of GDP, compared to Italy's 95%. France's private sector is significantly more levered and sensitive to changes in funding costs.

France's budget deficit currently stands above 5% of GDP, and it has not run a budget surplus for 30 years. One indicator of debt sustainability is the stabilising primary balance; the pre-interest budget balance needed to keep debt ratios steady at current conditions. Inputs are the cost of interest, nominal GDP growth, and the existing debt burden. Debt costs and burden are increasing, while improvements to long-run nominal growth remain elusive. If yields averaged 5% persistently, that would require around a 2% primary surplus. Today this stands at around -3% of GDP. It has not been positive since 2003. This would be a severe fiscal tightening, 5% of GDP. Today, French politicians are struggling to agree to a 0.4% deficit improvement.

Chart 3: In overdraft



Source: Bloomberg

The Political Economy

One fundamental problem is a lack of political consensus on how to reduce the deficit. A snap election in 2024 brought political stasis and a fragmented National Assembly. France's government expenditure and revenue figures rank among the highest in the Eurozone, and the developed world. This reduces the ability to squeeze more revenue through already-high taxes. The latest of three recent Prime Ministers, Sébastien Lecornu, has the unenviable job of passing a deficit-reducing budget. Pensions feature prominently in the debate and are the clearest example of the political difficulty of cuts.

The Presidential election further complicates the landscape. The outlook is highly uncertain and the candidate list is yet to be fully decided. Centrists suffer from the accusation that President Macron oversaw a significant deterioration in public finances. Less moderate candidates wait on either wing. While rhetoric has moderated on the issue of Frexit, a long-standing concern for euro-denominated bond holders, euroscepticism has not disappeared.

There is good news. The fragility of public finances and market volatility are increasingly on the minds of both politicians and the electorate. There are rising incentives for a short-term budget deal to ensure a form of stability in advance of the election. Presidential candidate Marine Le Pen announced plans to reduce the deficit, including a German-style golden rule requiring 0.5% annual tightening. She specifically cited recent moves in French debt markets. Separately, pollster Opinion Way finds that concerns around debt & deficits are the 4th highest issue in recent polls, a completely new entry in French electoral cycles.

Alternative proposals highlight a vigorous political debate. Jean-Luc Mélenchon of the LFI and second in the polls suggests the ECB simply cancel the French bonds it holds. He also wants the Bank of France governor prosecuted for treason for being concerned by the deficit. This rhetoric has not been taken positively by markets. Large student protests may yet grow broader. While protests & strikes are not out of the ordinary, meeting demands for increased spending in a variety of areas is difficult while the budget deficit remains above 5% of GDP.

The ECB backstop exists, but we're not there yet

The ECB can play a role in stabilising the market. But, despite advances in the Eurozone's structural financial integrity, that support is still elusive. The politics have become difficult on three levels: 1. QE programs came with clear financial costs, 2. France has specific problems, and 3. ECB support is now explicitly demanded by politicians. These increase the hurdle for support from an independent central bank. Additionally, in a low-inflation era, QE could reasonably claim to serve the primary purpose of monetary easing with the bonus of spread compression. Now, rising inflation means the bank is in policy tightening mode.

There is a level at which the backstop exists, even if it can't be known ex ante. The Transmission Protection Instrument (TPI) allows the ECB to backstop bonds in a crisis. Conditions are not yet met for this to be used for France. Italian spreads have previously been much wider than 1.5% without intervention. The clearest path to ECB support is if it can credibly claim that 'monetary transmission' is being hindered. The more volatility spills over into markets outside of France, the lower the hurdle becomes. Financial conditions are already tightening. Smaller steps could be taken. The ECB could simply release a statement saying they are closely monitoring market dynamics. Quantitative tightening could be paused, reducing pressure from high net bond supply.

While a further hike may be warranted due to the severity of energy hikes, the market's expectation of 3-4 more have rightfully been priced out in our view. The ECB has hiked interest rates twice this year, primarily due to the inflation related to higher international energy prices. While there has been resilience to Eurozone economic data, this is not resilience to unfavourable global market moves that result from the broader global capex cycle. We've been wary about the pace of tightening for the exact reasons we are seeing now. ECB members are dialling back expectations of further tightening. This is a welcome development given unwelcome financial tightening, and still limited evidence of second-round inflationary impact of energy price increases.

Looking ahead

France's weak debt and growth dynamics have made it vulnerable to significant weakness in global bond markets. A fragmented political situation compounds this. As we approach next year's Presidential election, risks are still skewed negatively. Funding levels are too high for comfort, and the political situation is likely to get worse before it gets better. As market concerns build, so are the concerns of the electorate and politicians. Ultimately, these high yields and spreads are likely to beget a favourable fiscal response. A French economic deterioration itself has dovish implications for the central bank through lower growth and inflation forecasts at the Eurozone level, warranting less aggressive tightening. Further negative spillovers to other Eurozone issuers would also likely see a supportive ECB response.

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