

June 24, 2024

Markets Rediscover Fiscal Scrutiny

Electoral platforms reintroduce fiscal premia globally

- Eurozone not alone in facing fiscal risks as debt servicing costs rise
- Idiosyncratic advantages for US and UK can only go so far
- Fiscal signals also reflected in EM flow divergence

Bond spreads, FX volatility and flow all adding fiscal premia

Political risk will be high on the agenda this week as markets gear up for the first round of France's legislative elections. This is an event which was not on a crowded 2024 electoral calendar. Judging by market gyrations since President Macron called the vote, it is perhaps one event too many for the European Union to manage in such a short space of time.

We stand by the view that the realised impact of changes in the French government will not be as strong as initial price action in OATs and the euro suggested. Furthermore, short-term policies should also not detract from the structural challenges facing Europe and much of the developed world. For example, the impending publication of former European Central Bank President and Italian Prime Minister Draghi's potentially seminal report on EU competitiveness has been completely lost amongst the political noise.

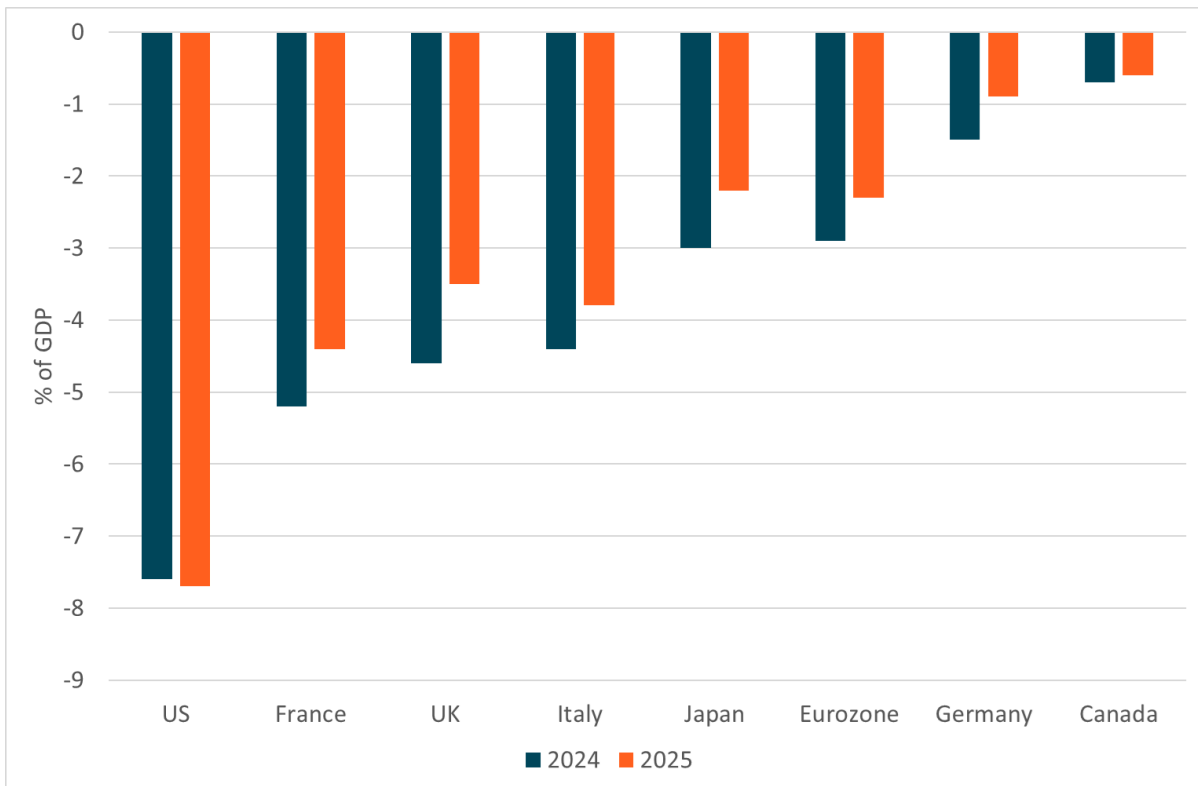
On the other hand, the events over the last two weeks have also shed critical light on debt sustainability, which had been under surprisingly little scrutiny over the last few years as both nominal and real yields surged. For the Eurozone, the tailwinds from the realisation of joint issuance after the launch of Next-Generation EU (NGEU) has contributed materially to the decline in risk premia. Furthermore, during the initial surge in inflation, real yields collapsed to the extent that fiscal trajectories looked far healthier. Even now, contingent liabilities such as

public-sector pensions are benefitting from the rise in discount rates.

What changed the calculus for France, at least initially, were fears of additional fiscal stimulus. Multiple political blocs proposed spending increases and a reduction in retirement ages, leading to fears of a renewed rise in unfunded liabilities (often characteristic of populist policies). According to the OECD's latest update on France, while "most of the fiscal support implemented in the context of the inflationary shock has been removed...Further fiscal consolidation will be needed to reduce public debt, which is projected at 115.6% of GDP in 2025". This is the starting point so any additional burden and accompanying debt supply would require re-assessment. Spillover effect in the EU is also a risk as the European Commission last week already detailed excessive deficits for eight member states.

While concerns over Europe's debt sustainability appear valid, we believe the electoral pledges in upcoming UK and US elections warrant additional scrutiny, too. According to the OECD (exhibit #1), France is sandwiched between the US and UK as having the worst deficit outcomes this year and next – even before considering spending pledges which may or may not be introduced after elections in the latter countries. The US enjoys exorbitant privilege due to reserve status and the UK's debt maturity profile is unusually long by G7 standards. Also being able to issue their own currency, the market has given both countries considerable latitude in the process. Even so, fiscal space will likely be extremely limited in the current environment. If anything, recent price action in the OAT market can serve as a reminder to major issuing governments that bond markets can still extract risk premia.

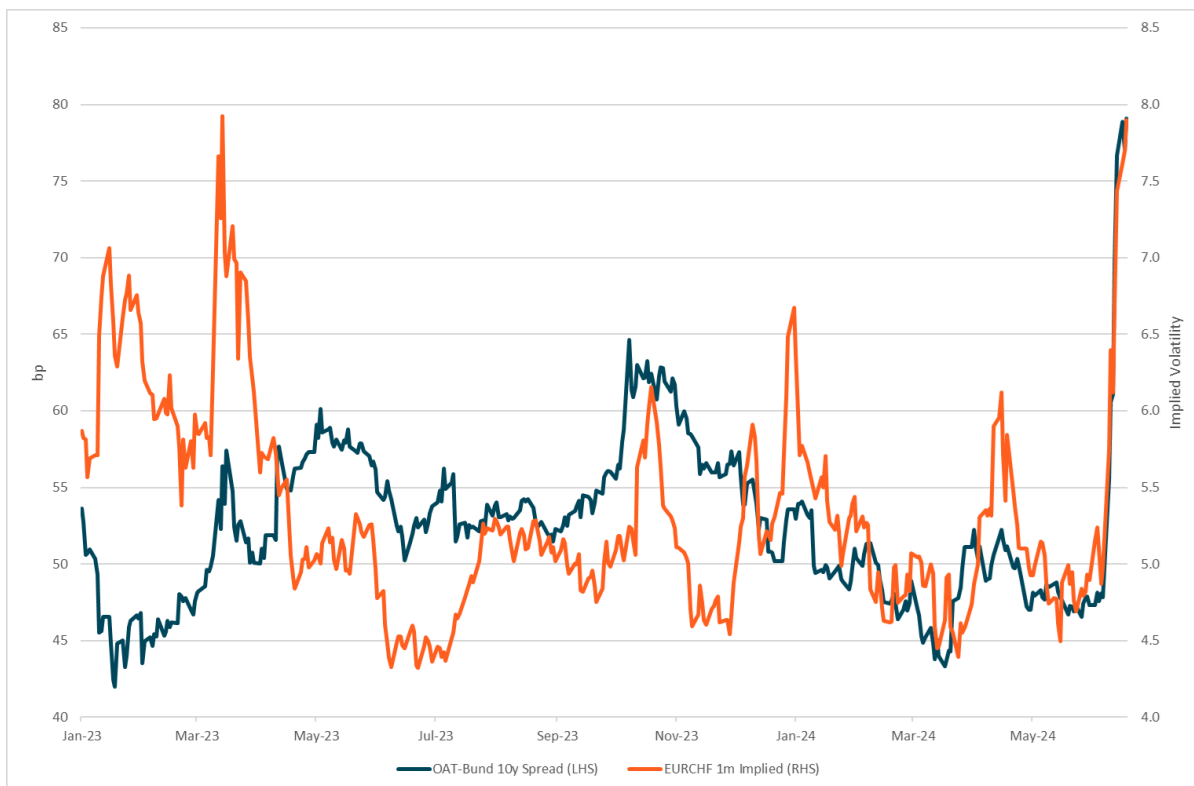
Exhibit #1: OECD Deficit Projections



Source: OECD, BNY Mellon

FX markets may have been comparatively calm; participants appear to have very little interest in revisiting arguments around the Eurozone’s longevity. Major populist parties have largely abandoned or sidelined original platforms questioning membership of the EU or the Eurozone. On a marginal basis, however, protection is being sought. Outside of EURUSD, we can see that EURCHF implied volatility has also increased materially – and in a synchronised manner with the OAT-Bund spread (exhibit #2). While rotating into the Swiss franc is a conventional reaction, FX options markets are equally measured as any Swiss National Bank response would likely entail countering surge flow into the franc.

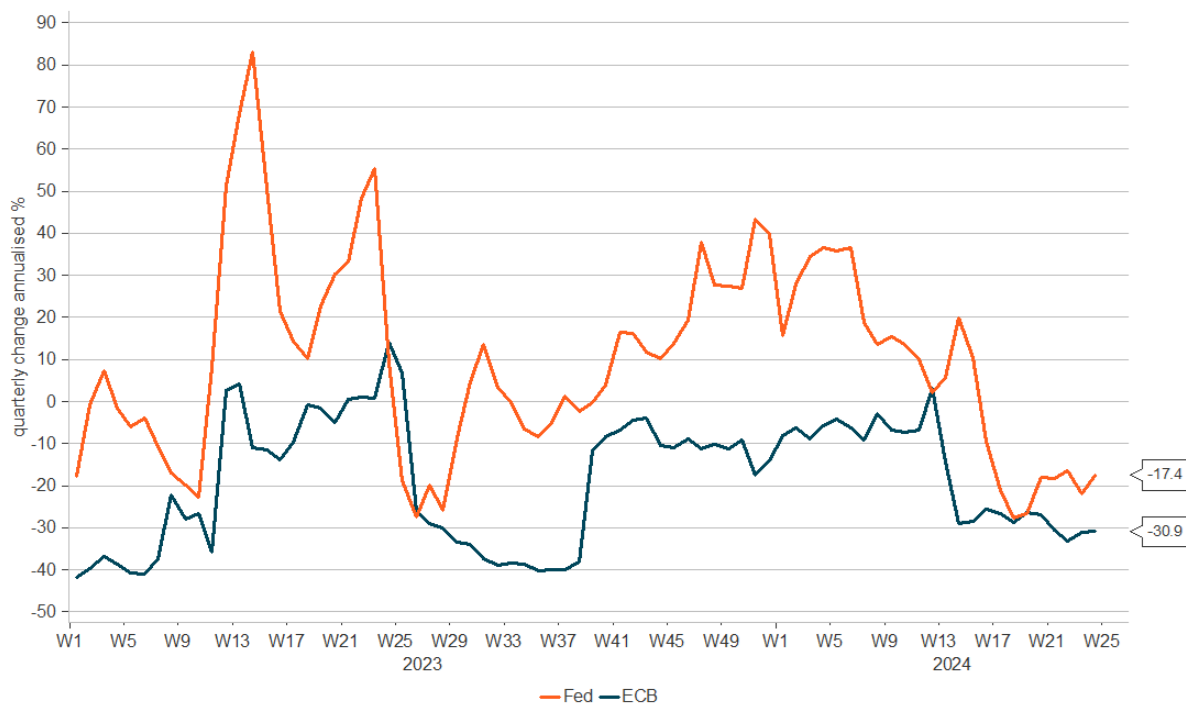
Exhibit #2: OAT-Bund 10y Spread vs. EURCHF Implied Volatility



Source: Bloomberg, BNY Mellon

There is also the risk of central banks immediately stepping in to provide liquidity and increase bank reserves sharply upon the first sign of financial instability, i.e., engaging in volatility compression. The ECB has extensive experience in this regard and the Fed's and Bank of England's respective interventions in 2023 and 2022 were also well executed. Given that parallels are being drawn with the latter episode for France, the ECB will also know how to contain the process. One of the immediate policy measures, even as a precautionary move, would likely be to revisit the pace of reinvestment reductions in the PEPP programme. Already, the ECB's excess liquidity drainage is now faster than the Fed's and, moreover, set to accelerate. We question whether this is congruent with the commencement of an easing cycle, even if the ECB is not actively exactly selling Eurozone government securities into the market, which was a process the BoE needed to delay in 2022. Reports over the past week have suggested that the ECB's Governing Council is comfortable with the situation in sovereign bond markets. If precautionary easing is off the table, tightening financial conditions on the margins amid some degree of stress must be avoided, in our view.

Exhibit #3: Excess Liquidity Change, Fed vs. ECB



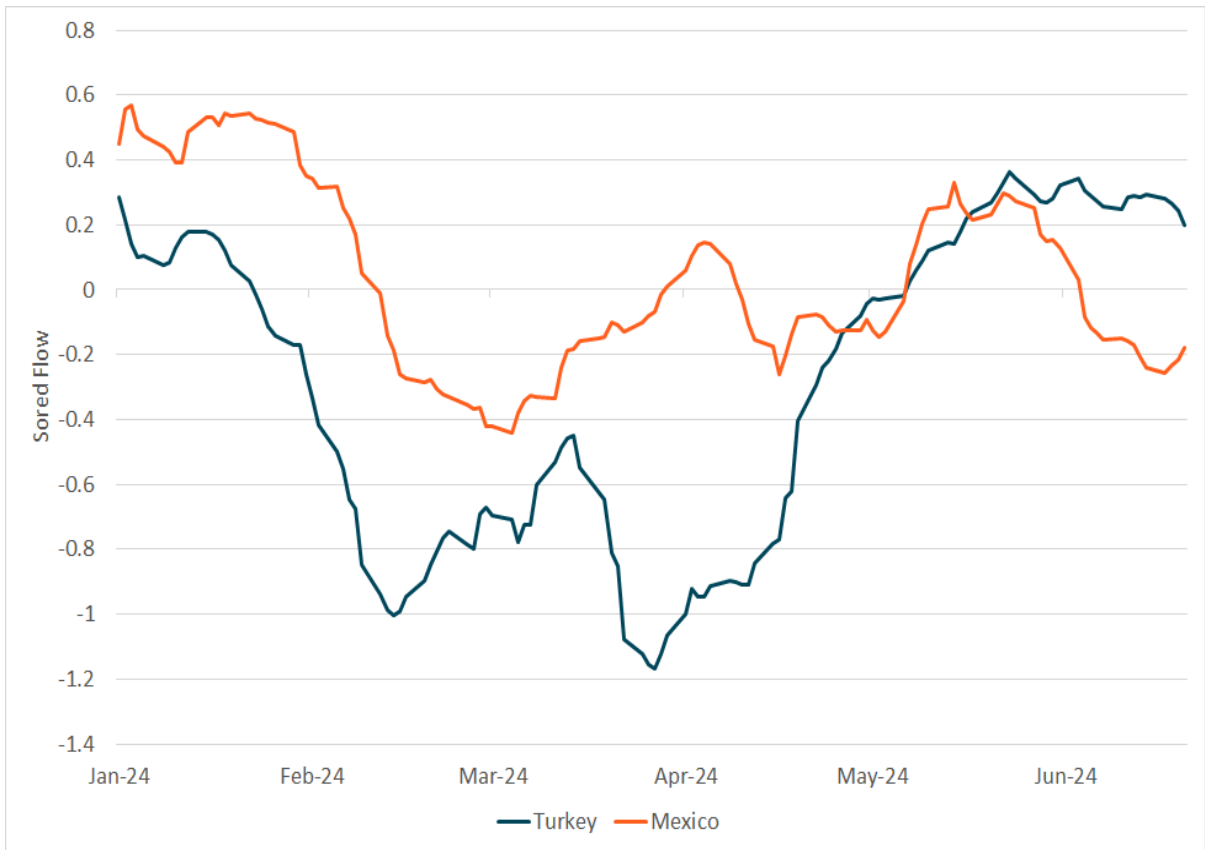
Source: Macrobond, BNY Mellon

Although focus is currently on Europe and may yet be directed towards the US, fiscal premia remains a theme in a global asset allocation. At the beginning of June, markets were still absorbing the results of general elections in key emerging market countries. Behind the scenes, asset allocation rotation away from fiscal risk is ongoing, even superseding real rates as the primary benchmark for investment intentions.

For example, we can see that in sovereign debt, there has been significant deterioration in flows into Mexico, while Turkey flows continue to perform well (exhibit #4). That represents a role reversing from much of the first half of the year. While Turkey’s fundamentals remain challenging, there is broader confidence in the direction of travel for monetary and fiscal credibility. The jury is now out on the latter regarding Mexico, and there is significant legacy positioning to unwind, both in sovereign bonds in and the peso.

There is clear asset allocation demand for economies with clear fiscal constraint and on the path towards debt sustainability. Unfortunately, the political cost and social cost remain too high for the vast majority of governments – both incumbent and potential – to countenance.

Exhibit #4: Mexico vs. Turkey Sovereign Flow



Source: BNY Mellon

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Please direct questions or comments to: iFlow@BNYMellon.com



Geoff Yu
 EMEA MACRO STRATEGIST

CONTACT GEOFF  

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