RBC Global Asset Management

European review: some deficits remain in the red

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Europe is no stranger to a debt crisis but Greece is making impressive strides in paying down its debts, says Kaspar Hense.

The temperature is much lower, with a number of countries doing well inreducing their debt-to-GDP ratios. However, some attention still needs to be paid to Italy.

Italian deficit spending higher than the EU would like

Alarm bells may not quite be ringing but the budget figures released by Italy in September were not as healthy as some would hope. Next year's growth forecast was cut to 1.2%, while deficit targets were raised to 5.3% this year and 4.5% in 2024.

It could be argued that some deficit spending is necessary in the circumstances, given that growth levels are fairly stagnant across the continent, where the shocks from Covid and energy supply concerns are still having their aftereffects. However, Italy's numbers are higher than the EU would like, particularly its more austere northern members.

There have occasionally been suggestions that Italy could lose its investment grade status, but at RBC BlueBay we consider that unlikely. Italy may still be shy of a flat primary deficit, with figures of 1.5% and 0.5% forecast this year and next, but this is still sufficient to keep its debt-to-GDP ratio stable for the time being.

The only caveat would be if Italy were to lose support from the EU. However, the prime minister, Giorgia Meloni, has been notably less confrontational than her deputy Matteo Salvini. She has aligned with the EU's stance on Ukraine and brokered EU funding to help Tunisia with its economy and to tackle irregular migration. Italy has also signalled its intention to withdraw from China's Belt and Road Initiative, as Europe develops its own worldwide infrastructure investment project. This productive relationship should help to smooth future budget negotiations.

Inflation will take time to come down

Across the wider continent, we see Europe being fairly aligned with global markets. Inflation is still sticky and needs time to come down, so we think that the ECB will maintain rates at 4% for the foreseeable future. Shelter inflation, in particular, will take time to come down, and so will wage inflation, with salary negotiations generally taking place on a two-yearly basis in Europe.

Yields should therefore remain at the higher end, with Italy's 10-year yields reaching 5% and German bunds sitting around 3%.

Meanwhile, the GDP outlook is not likely to significantly improve, with real growth remaining in the range of 0-1%. This means there should be long-term opportunities for investors to engage with fixed income markets.

On a technical level, there is a question mark around how well the European debt market will function. In March, the European Central Bank (ECB) ended its bond purchases known as PSPP (public sector purchase programme) investments, leaving some doubt as to whether the market will find a balance with supply.

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The ECB will be holding a monetary review in the first quarter of 2024, and we hope that it will allow itself more flexibility to engage in the market from time to time. It does have the TPI (Transmission Protection Instrument) programme, but there would have to be a significant move on Italian spreads for that to be re-engaged.

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