MyStratWeekly

Market views and strategy

Ostrum ASSET MANAGEMENT

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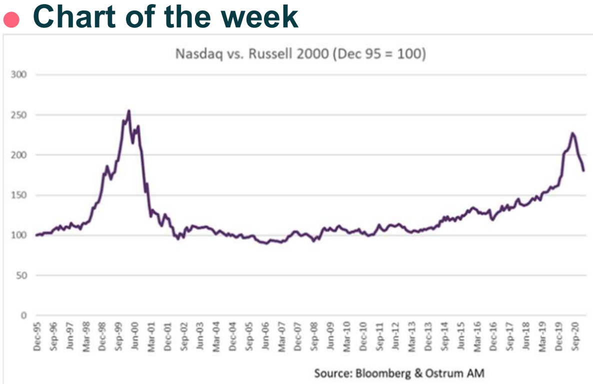
Topic of the week: The Maastricht criteria, remains of an ancient world

- **The Maastricht criteria and their modern incarnation, the Stability and Growth Pact (SGP), have been seldom respected since the introduction of the euro. Their credibility is therefore highly questionable.**
- **Nevertheless, they have led to a pro-cyclical policy that accentuates economic cycles.**
- **Reform therefore seems more than desirable, not only to avoid adverse effects of the CSP, but also to improve its credibility.**

Market review: Lagarde wins a battle, not yet the war

- **ECB ups the ante with increased pace of PEPP purchases in Q2;**
- **Yields resume rising in the US, as investors eye FOMC;**
- **Large sector rotation but market indices gain;**
- **Renewed credit spread compression.**

Chart of the week



While the Nasdaq had clearly outperformed the Russell 2000 over the past decade, it seems that we have hit an inflection point since the beginning of the year.

The chart illustrates the rotation of Nasdaq, which to a large extend is linked to the performance of large cap growth stocks, to the Russell 2000 with more value and small cap stocks.

The rise in rates, in particular real rates, but also the Biden recovery have penalized the high-duration sectors and favored the more cyclical sectors that had been neglected until then.

Figure of the week

3%

Source : Ostrum AM

The default rate on the European HY would be less than 3% according to our credit analysts. It had exceeded 10% in 2009.
The policy mix has done wonders to keep businesses afloat.

Stéphane Déo
Head of markets strategy

Axel Botte
Global strategist

Zouhoure Bousbih
Emerging countries strategist

Aline Goupil- Raguénès
Developed countries strategist

Topic of the week

The Maastricht criteria, remains of an ancient world

The Maastricht criteria and their modern incarnation, the Stability and Growth Pact (SGP), have certainly been rarely met since the introduction of the Euro. Nevertheless, they have led to a pro-cyclical policy that accentuates the scale of economic cycles. Reform therefore seems more than desirable, not only to avoid the undesirable effects of the SGP but also to improve its credibility.

A bit of history

It should be remembered that the Maastricht criteria are old. Very old. They belong to a world where sovereign rates had two figures. The early 1990s. Their relevance in today's world can therefore be questioned.

First, a historical reminder for our youngest readers. The convergence criteria (or "Maastricht criteria") were established by the Maastricht Treaty, which was signed on 7 February 1992 and entered into force on 1 November 1993.

The four criteria are defined in Article 121 of the Treaty establishing the European Community[1]. They require the control of inflation, of the public debt and the public deficit, the stability of the exchange rate and the convergence of interest rates.

- **Price stability:** the inflation rate of a given Member State must not exceed by more than 1.5 percentage points that of the three Member States with the lowest figures.
- **State of public finances**
  - Prohibition of an annual government deficit exceeding 3% of GDP
  - Prohibition of public debt exceeding 60% of GDP
- **Exchange rate:** No devaluation of currency; this was made obsolete with the introduction of the euro for the euro area countries. In addition, the Member States must have participated continuously in the European Monetary System (EMS) exchange rate mechanism during the two years preceding the examination of their situation, without experiencing serious tensions.
- **Long-term interest rates:** they should not exceed by more than 2% those of the three best performing Member States in terms of price stability.

These criteria had to be met for a country to join the Euro in 1999. The exchange rate criterion is, by definition, useless from the moment the country entered the Eurozone. Inflation and interest rate criteria were important in the context of the convergence required of a State before it entered the Euro. They have never been subject, for members of the Eurozone, to a binding enforcement policy.

There remain the two public finance criteria. The 3% criterion is essentially the result of a political reasoning: some countries (Germany not to name it) wanted to ensure that some countries (Italy not to name it) were not part of the first group that would adopt the Euro. The 3% target, while the Italian deficit was still at 7.3% in 1995, was "obviously" unreachable. In fact, Italy reduced its deficit to 3.0% in 1997 and 1998, and then in the following year it managed to join the Euro.

The 60% debt target is somewhat more economic: with a 3% deficit, 2% inflation, the central bank's target, and potential growth of 3%, the debt-to-GDP ratio stabilizes at 60%. QED.

Very limited compliance with the criteria

It should also be noted that compliance with these criteria is more than limited.

First, the mechanism to force a country to meet these criteria is abominably long, time-consuming, and complex. Moreover, there is a political element that is decisive since these sanctions are not automatic and a majority of countries must approve them. In fact, historically, the offending state is often so because the global economic cycle is in recession, and so a significant part of the other states are also in a delicate position and have very little desire to sanction a state when they are very likely to find themselves in its place.

After 35 excessive deficit procedures, none has led to sanctions.

[1] Source: INSEE.
https://www.insee.fr/fr/metadonnees/definition/c1348

The main steps (we have somewhat simplified) of an excessive deficit process, when a country has been identified as potentially guilty, are:

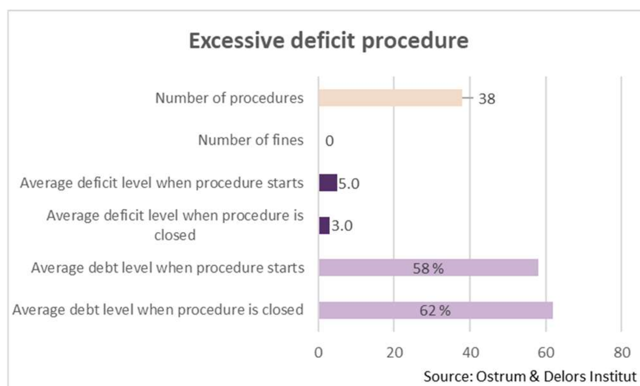
Procedure:	
The European Commission prepares a report assessing whether or not to initiate a procedure (Art. 126.3)	(Art. 126.3)
The Commission shall then notify the country and inform the Council whether it considers that an excessive deficit exists (Art 126.5 and 126.6)	(Art 126.5 et 126.6)
On a proposal from the Commission, the Council decides by a qualified majority whether or not there is an excessive deficit (Art 126.6)	(Art 126.6)
If the Council decides that there is an excessive deficit, it shall make recommendations to the country (Art 126.7)	(Art 126.7)
The Commission also imposes a time limit for taking corrective action (three or six months) (Art 126.7)	(Art 126.7)
If the country does not take sufficient corrective measures, the Council may decide to put it on notice by imposing a new deadline (three or six months) (Art 126.7)	(Art 126.7)
Sanctions:	
If the country persists, the Commission may recommend sanctions (Art 126.8)	(Art 126.8)
On a proposal from the Commission, the Council shall decide by a qualified majority to apply the sanctions (Art 126.8)	(Art 126.8)
Sanctions are applied in three stages:	
1. Interest-Bearing Deposit of 0.2% of GDP (preventive Phase)	
2. Non-interest bearing deposit of 0.2% of GDP (remedial phase)	
3. Deposit converted into fine up to 0.5% of GDP if the excessive deficit is not corrected	
NB: European Structural and Investment Fund payments may also be frozen	

(NB: our advice; do not waste time reading the whole table, just remember that it is long and boring)

In short, the likelihood of sanctions being imposed is close to zero. Moreover...

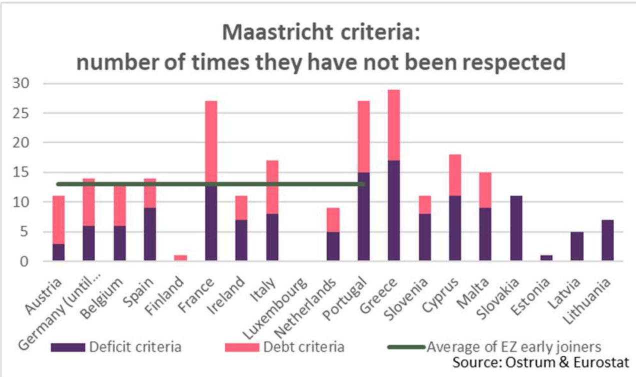
The excessive deficit procedure has never really worked. The chart below speaks for itself. Between 1999 and 2018, the date of the report on the subject by the Delors Institute, the Commission opened 38 proceedings, all of which were closed. Malta holds the record with 3 procedures. On average the procedures last a little more than 4 years, so the cumulative total time of all the procedures is about a century and a half.

But, and this is the essential point, no fines have ever been imposed! The deterrent aspect of the mechanism is therefore highly questionable. The same report concludes that this procedure is just “a means of monitoring budgetary progress by other Member States”.



Second, there is also probably a credibility problem. Let’s take a random example: France. France had a deficit of over 3% for nine consecutive years, from 2008 to 2016, only returning to 2.6% in 2017; Italy did not have a deficit of over 3% for 6 consecutive years after the 3.7% in 2011.

The credibility of France in reprimanding Italy is therefore not that obvious for us. More generally, each of the initial eleven members of the Euro has failed to meet the Maastricht criteria 13 times on average since 1999, 7 times for the deficit criterion and 6 times for the debt.



In conclusion, the so-called "Brussels diktats" have often been ignored. The excessive deficit procedure is particularly long and requires a unanimous vote of States when it comes to sanctions. The Commission's arsenal is therefore limited.

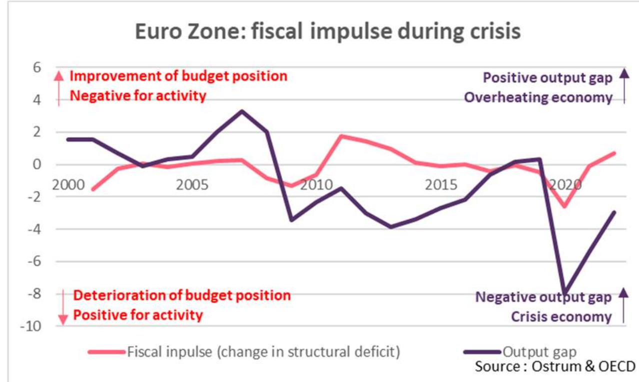
Corollaries: in the event of an excessive deficit, it is not the Commission that will twist the arm of the offending government, but the market. We will then have to expect a lot of volatility and significantly higher rates.

Significant adverse effects

While the binding aspect of the Maastricht criteria must be put into perspective, their impact must not be underestimated. And in particular the perverse effect they have created. When the economy is doing well, deficits shrink, and governments use the room for maneuver to support the economy. When the economy is in crisis, deficits grow, and governments need to put in place corrective measures in order not to exceed the 3% mark, slowing the activity during times of crisis by doing so.

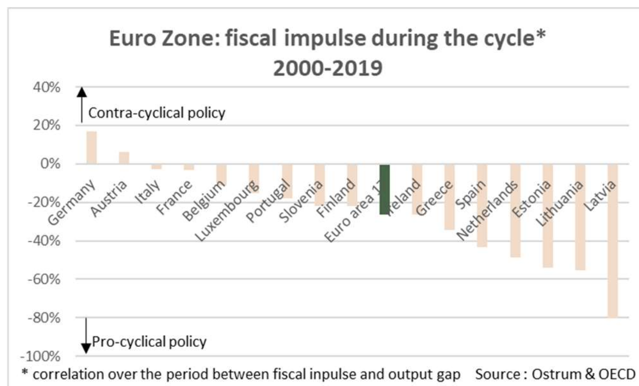
The application of the SGP has contributed to pro-cyclical fiscal policy and a decline in public investment.

The graph below shows what has actually happened since 2000. The two lines should evolve in parallel: for example, a positive output gap, therefore an overheated economy, should correspond to an improvement in the budgetary balance (fiscal consolidation), and vice versa. In fact, until 2019, the two curves mirror each other. We do have a pro-cyclical policy. Exactly the opposite of what needs to be done.



To simplify, over the period, we want a positive correlation between the two curves, whereas we obtain a negative one over the past two decades.

What about at the country level? Unfortunately, the situation is very similar. With the exception of Germany, the vast majority of Eurozone countries have indeed had a pro-cyclical policy over the past two decades, albeit to varying degrees.



These figures also show how unusual the response over the past year is: an unprecedented fiscal stimulus during the covid crisis. It is in sharp contrast with previous cycles.

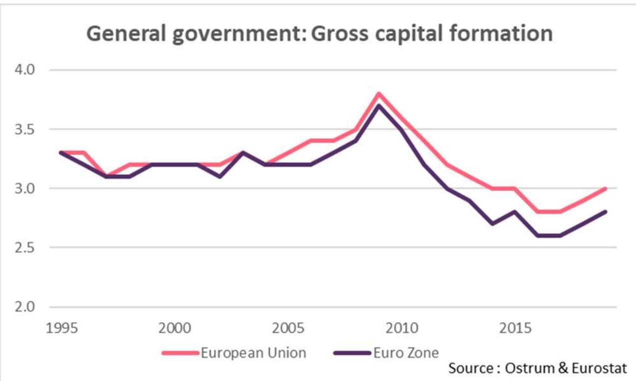
A reform that is more than welcome

The first consequence is that a reform of the Stability Pact is indeed more than welcome. Paolo Gentiloni, the European Commissioner for Economic and Monetary Affairs, has proposed fundamental changes to the Stability and Growth Pact (SGP). Basically, there are three points.

On the one hand, the European Commission used its so-called general escape clause to suspend the enforcement of the SGP and has proposed to maintain the escape clause in 2022, suspending the conditions of the SGP until the end of the year. The fiscal impulse, more timid than in the United States, will not be cut next year. This is a transitional measure but it ensures the sustainability of the economic recovery until the return of activity to the pre-crisis level.

Second point, Gentiloni proposes a more flexible activation of this safeguard clause to manage future cycles. The idea is to address the adverse effect we mentioned earlier: a fiscal tightening at the worst time of the crisis. At the end of the day it would lead to a more counter-cyclical policy.

Third idea, Gentiloni draws the consequences of another problem related to the application of the SGP: the significant decrease in public investment. Fiscal consolidation in the expenditure side has been very detrimental to public investment, as shown in the following graph. Between 2009 and 2019, public investment in the euro area fell by 0.9 GDP points. In the countries most affected by the crisis the trend is much worse: 3.1 percentage points of GDP lost for Spain, 2.6 for Greece, 2.2 for Portugal and 1.4 for Italy.



To avoid this, it is proposed to take into account “growth enhancing” spending and treat it differently in excessive deficit procedures.

These proposals pose a legal issue that we do not consider as insurmountable. Article 126 of the Treaty on the Functioning of the European Union states that “Member States shall avoid excessive government deficits”, but without specifying what is meant by “excessive deficits”[2]. The European Union framework for budgetary policies can therefore be amended without renegotiating the Treaty. In fact, a reform, which was part of the “six-pack” and amends the SGP entered into force at the end of 2011; another, the intergovernmental treaty on stability, coordination and governance, including the fiscal pact, at the beginning of 2013.

So, the acceptance of these proposals is primarily a political problem. It’s not at all obvious that they’re accepted.

Stéphane Déo

[2] Full article available on: https://www.doctrine.fr/l/traite-fonctionnement-union-europeenne/article-126/UE_TFUE_126

Market review

Lagarde wins a battle, not yet the war

Fed is now at bat

The rotation of financial strategies accelerated in the past few months. Dollar weakness is most often associated with lower bond yields, spread tightening and outperformance of growth stocks. Conversely a strong greenback tends to imply higher risk aversion fed by the fear of Treasury issuance crowding out demand for risky assets. The rise in yields favors banking stocks, cyclical value stocks and more generally assets linked to the reflation trade.

Rotations have been amplified as investors pay greater attention to Central Bank talk and stance. The ECB indeed met last week. Christine Lagarde made a surprise announcement committing to faster pace of PEPP purchases in the second quarter. It is hence not impossible that the quarterly update in economic projections may now be supplemented by guidance on the pace of market operations. The ECB has considerable means of action and will indeed raise buying at a time when net issuance will run more negative. The decision will thus add to excess demand for sovereign bonds which in turn may fan fears of collateral scarcity. Swap spreads have indeed traded wider of late which could be a sign of relative scarcity of German Bunds. This decision to quicken the pace of purchases was a consensus decision. Christine Lagarde likely carries a lot of responsibility. Faster bond buying appears at odds with upward revisions on inflation (1.5% this year) and economic growth (rounded up by 0.1pp in 2021 and 2022). The ECB's decision results from a 'holistic and multi-faceted' approach to identify impediments to policy transmission to the real economy. This argument is somewhat dubious as the observed tightening in bank lending standards to enterprises appears traceable to the economic outlook which may improve as lockdown measures ease and the EU recovery plan is implemented. The bank's capital and liquidity positions, competition from other banks and non-banks should support lending flows going forward. Furthermore, the rise in long-term interest rates reflect a desirable increase in inflation expectations whilst real Bund yields have remained unchanged this year. Credit spreads and sovereign bond spreads are stable or down so far in 2021, the euro depreciated by 2% and European stock indices are up 6%. In sum, the ECB is reacting to the correlation between Treasuries and Bunds, and, whilst arguing against it, does aim at micro-managing bond markets. The $1.9T Biden plan passed Congress and another infrastructure stimulus program may be adopted later this year. Immense federal borrowing needs may crowd out investments in other risk-free assets. With that in mind, the BoJ, which will hold its policy meeting on the day following the FOMC, may signal its intention to contain upward pressure on bond yields. The sharp appreciation of the dollar-yen exchange rate beyond 109, in the context of capital repatriation towards the end of the Japanese fiscal year, may indeed foreshadow a dovish BoJ statement.

The trend for higher US bond yields reversed briefly in the middle of last week. Short covering on bond futures was fostered by a modest reading in the February core CPI (0.1%m) and stronger-than-expected final investor demand at 3-year and 10-year Treasury bond auctions. Primary dealers had reportedly freed balance sheet space ahead of bond issuance. Market participants may have cashed in profits from earlier shorts ahead of the ECB governing council. Yields resume their uptrend on Friday to 1.60% area as investor focus turned to next week's FOMC meeting. Inflation will accelerate to 3/3.5% this spring. Central bankers know that private savings and foreign demand will fall short of federal borrowing needs. The Fed can incentivize banks to add to government bond holdings by maintaining the exemption of Treasury holdings from the SLR regulation. However, as banks tend to be less active at the back-end of the curve, expectations of a Fed Twist may persist. The Treasury market will continue to be a key driver of Bund markets even as ECB leans against upward pressure on yields and widen the T-note/Bund spread. Accelerated PEPP purchases weighed on sovereign spreads. Italy is trading about 94bp on 10-year maturities. Credit markets trade sideways in the euro area (90bp vs. Bunds) whilst USD credit suffered from increased issuance (including the Verizon deal) and Treasury yield volatility. Final demand for credit bonds in the US (as judged by ETF flows) is dwindling as risk-free bond yields move higher. Spread compression resumed on high yield and CDS indices (XO vs. IG). The iTraxx XO gauge is trading at tight levels around 240bp.

S&P 500 is up about 5% in 2021, yet its equal-weighted equivalent advanced double that amount. Weakness in technology stocks provide scope for active portfolio reshuffling. The magnitude of the equity rally also fosters a sharp increase in equity offerings in the US. In Europe, the CAC index broke above the 6,000 point threshold. Bank stocks briefly retraced part of the strong performance in 2021 (+20%) to the benefit of Technology before bouncing back following the ECB meeting. Defensive sectors (utilities, consumer staples) also benefitted from portfolio reallocation.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	15-Mar-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.69 %	-1	+0	+1
EUR Bunds 10y	-0.33%	-6	+5	+24
EUR Bunds 2s10s	36 bp	-4	+5	+23
USD Treasuries 2y	0.15 %	-1	+4	+3
USD Treasuries 10y	1.61 %	+2	+40	+70
USD Treasuries 2s10s	146 bp	+3	+36	+67
GBP Gilt 10y	0.8 %	+4	+23	+60
JPY JGB 10y	0.11 %	-1	+3	+9
€ Sovereign Spreads (10y)	15-Mar-21	-1wk (bp)	-1m (bp)	YTD (bp)
France	24 bp	0	+2	+1
Italy	93 bp	-10	+3	-18
Spain	63 bp	-4	-1	+2
Inflation Break-evens (10y)	15-Mar-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR OATi (9y)	113 bp	+3	+15	-
USD TIPS	226 bp	+5	+4	+28
GBP Gilt Index-Linked	348 bp	+10	+32	+48
EUR Credit Indices	15-Mar-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Corporate Credit OAS	89 bp	+0	+1	-3
EUR Agencies OAS	39 bp	+0	+0	-2
EUR Securitized - Covered OAS	31 bp	+1	+0	-1
EUR Pan-European High Yield OAS	313 bp	-7	-8	-45
EUR/USD CDS Indices 5y	15-Mar-21	-1wk (bp)	-1m (bp)	YTD (bp)
iTraxx IG	47 bp	-2	+1	0
iTraxx Crossover	244 bp	-12	+7	+3
CDX IG	52 bp	-2	+2	+2
CDX High Yield	297 bp	-9	+11	+3
Emerging Markets	15-Mar-21	-1wk (bp)	-1m (bp)	YTD (bp)
JPM EMBI Global Div. Spread	356 bp	-6	+15	+4
Currencies	15-Mar-21	-1wk (%)	-1m (%)	YTD (%)
EUR/USD	$1.193	+0.38	-1.47	-2.4
GBP/USD	$1.390	+0.04	-0.12	+1.79
USD/JPY	¥109.13	-0.55	-2.97	-5.34
Commodity Futures	15-Mar-21	-1wk ($)	-1m ($)	YTD ($)
Crude Brent	$68.8	$0.6	$6.1	$17.1
Gold	$1 731.2	$14.5	-$65.6	-$163.2
Equity Market Indices	15-Mar-21	-1wk (%)	-1m (%)	YTD (%)
S&P 500	3 948	3.31	0.33	5.11
EuroStoxx 50	3 830	1.77	2.56	7.80
CAC 40	6 036	2.25	4.32	8.73
Nikkei 225	29 767	3.56	-2.30	8.46
Shanghai Composite	3 420	-0.04	-6.43	-1.53
VIX - Implied Volatility Index	20.22	-20.61	1.25	-11.12

Source: Bloomberg, Ostrum Asset Management

Additional notes

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