GENERALI INVESTMENTS

Focal Point

Spain: Headwinds ahead but Bonos to stay solid

February 20, 2020

Florian Späte / Martin Wolburg

- In Spain, the new, fragile left-wing minority coalition plans to unwind key elements of the 2012 labor market reforms and intends to increase income and corporate taxes.
- Activity will diminish on the back of reduced employment growth, receding economic slack, an upwards adjustment in the household savings rate and elevated political uncertainty.
- We see GDP growth moderating towards 1.4% by 2021, broadly in line with potential. Thereby we expect the outperformance of Spain against the euro area lasting since 2015 to narrow significantly.
- The excellent performance of Spanish sovereign bonds in recent years will fade out. While moderating, Spanish growth will remain above the euro area average and fiscal metrics are seen to improve slightly. Amid the search for yield this will trigger somewhat tighter sovereign spreads and Spanish Bonos are expected to perform better than euro area core government bonds going forward.

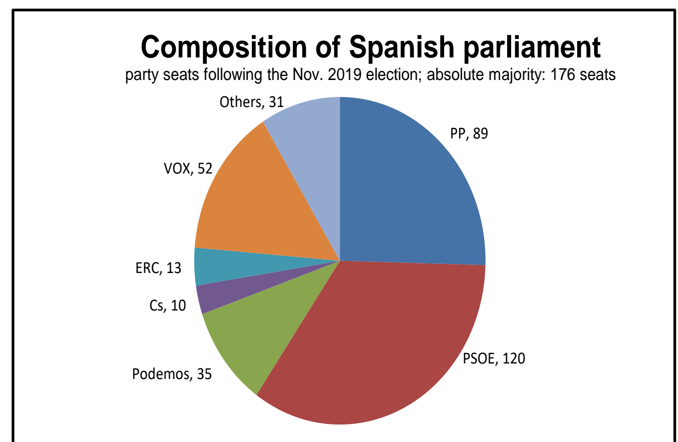
Over the past years, Spain was a kind of star performer among the euro area economies. It rose like a phoenix from the euro crisis. This recovery was not only triggered by the highly accommodative ECB monetary policy stance and a more benign global environment. It was additionally boosted by bold reforms that helped Spain to recover with a strong momentum. From 2015 to 2019 Spain's output cumulatively grew by 4.4 pp above the euro area average. Spanish government bonds (Bonos) have benefited and outperformed the European peers.

Looking ahead, there are reasons to expect a less sunny development of the Spanish economy. A key obstacle emanates from politics. Following almost two years of stalemate, Spain narrowly managed to form a minority government in January. The new, left-wing minority government plans to unwind some key post-crisis reforms at a time when the catch-up recovery is losing momentum anyway and the international economy has become much more uncertain. Spanish economic outperformance will thus narrow over the coming years. While the investment in Spanish government bonds will yield lower returns than in the past, we do not expect losses.

Fragile minority government

Following the euro crisis, Spain's political system has come under pressure. The country's two party system traditionally saw power alternating between the conservatives (PP) and the socialists (PSoE). It imploded in 2015, when both parties suffered strong losses while parties like the newly founded left-wing Podemos gained.

The parliament became fragmented, resulting in the formation of much more unstable minority governments. A



fresh election in 2016 led to a conservative-led minority government that was replaced by a socialist led one in 2018. It broke down in early 2019 when Catalan pro-independence lawmakers joined forces with the right-of-center opposition to defeat the budget proposal due to differences on how to deal with the Catalan question. Two general elections, in April and November 2019, did not reduce fragmentation.

On January 7, PM Sanchez managed to finally become elected as PM thereby ending the almost two year lasting period of caretaker governments. He was only narrowly elected in the third ballot when a relative majority became sufficient. An alignment with various smaller parties (Basque National Party, Cantabria's PRC, Nueva Canarias and Compromis) took place while the pro-Catalan ERC abstained: 166 yes votes to 165 No, with 18 abstentions. Looking ahead, the new government will need to align with

various smaller parties, which could prove challenging when it comes to key issues like the budget. Moreover, the highly sensitive Catalan question has the potential to burst the fragile alliance. Therefore, political uncertainty will persist.

Agenda: unwinding of reforms a blow to growth

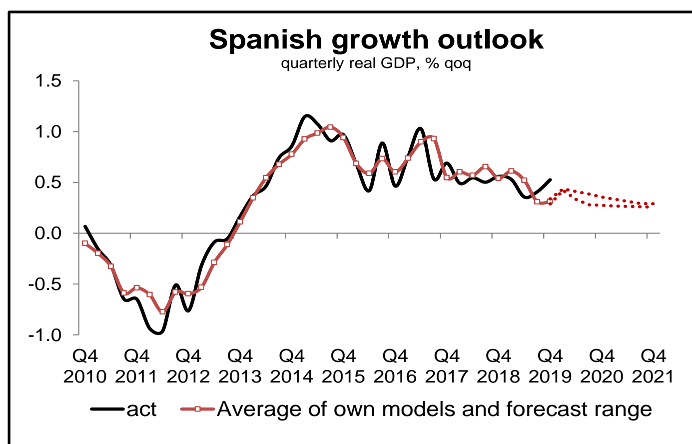
Under the pressure of the euro crisis Spain adopted bold reforms. The 2012 labor market legislation focused on the easing of dismissals and the reform of the collective bargaining process. Moreover, the public sector was downsized and its costs reduced while deregulation in the services sector took place. The European Commission estimated that the main measures included in its National Reform Programmes of 2013 and 2014 (as well as those actually being adopted) added around 0.2 percentage points to annual GDP growth and boosted employment by about 4 pp over the past five years.

Major measures from the PSoE / Podemos coalition agreement
Tax Policy
* New minimum corporate tax rate of 15%, 18% for banks, oil and gas companies * Introduction of a tax targeting stock market transactions * Increase of tax rate for capital gains > 140k by 4 pp * Hike of personal income tax rate by 2 pp for incomes > € 130k and by 4 pp for incomes > 300k
Labour Market
* Lift minimum wage to 60% of average national wage, from about 45%, until the next election * Shielding services like health, education, security and social support from privatization * Proposals to roll back some elements of the 2012 labor market reforms and strengthening
Pensions
* Plans to eliminate the linking of pensions to life expectancy and the revaluation index that links pension rises to the performance of the Spanish economy * Pensions will be re-evaluated according to Spains inflation index and minimum pensions will be raised
Public Finances
* PSoE and Podemos agreed to keep reducing the budget deficit and public debt

Looking ahead, the agenda of the new Spanish government foresees a partial unwinding of these reforms. Especially the envisaged increase in the minimum wage and higher job protection will dampen employment expansion in the medium term. The proposed measures resulting in higher pensions will increase labour costs as well. Higher corporate and high income taxes will reduce incentives for investment. While the details of the new government's measures are not yet known, it is likely that they will harm growth once implemented.

Growth to weaken

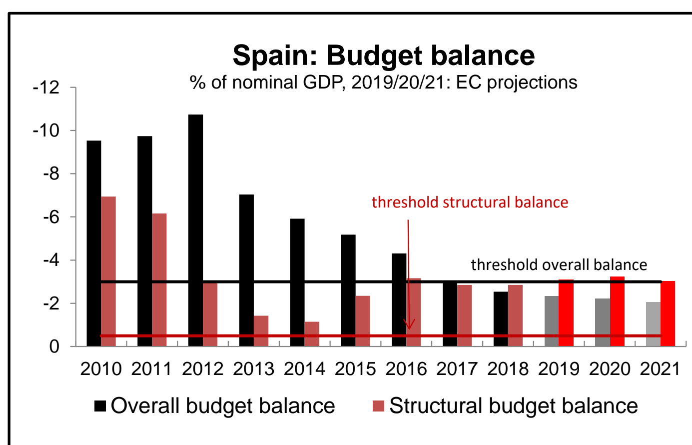
Over the years to come we thus expect the Spanish economy to embark on a lower growth trajectory. Apart from political uncertainties and unwound reforms, the cyclical underpinning of activity will also weaken: First, the output gap has narrowed according to various sources. Its 2020 measure varies from a small underutilization (-0.4%, OECD) to overutilization (1.7%, EC) making clear that the post-crisis catch-up potential has been largely exploited. A related topic is the labor market improvement: In Q2/2014 employment growth moved from contraction into expansion and has risen since then by 2.5% per year on average. With a December reading of 13.7% the unemployment rate is now below the equilibrium (NAIRU) level (EC: 15.0% for 2020) hinting at slowing employment gains. Second, wage growth has the potential to strengthen in such an environment, especially given the scheduled increase of the minimum wage. But given that the savings rate of 6.4% (Q3/2019) is well below the pre-GFC average of 9.1%, we expect an extra income to contribute little to consumption growth. Third, we see the risk of a more restrictive fiscal stance (see next section). Last, the international environment will be less conducive to growth with German activity and EMU growth expected to remain muted, global expansion to suffer from lower US and Chinese growth, the Brexit disintegration harming European growth and de-globalization imposing new challenges.



As a result, we expect GDP growth to come down from 2.0% in 2019 towards 1.4% by 2021. This would be broadly in line with potential but the outperformance versus the euro area will likely narrow to 0.2 pp.

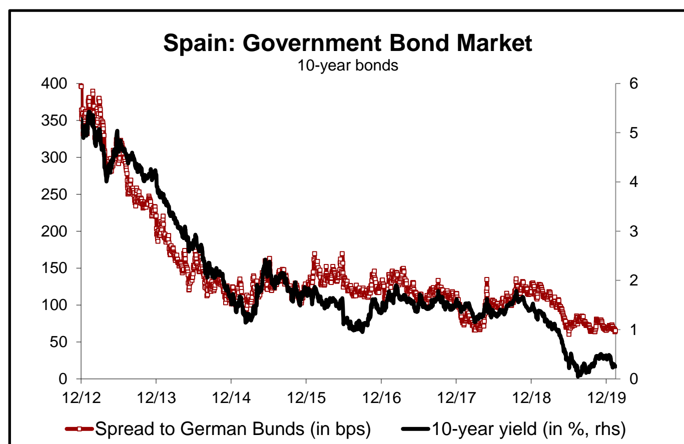
Underlying budgetary stance to stay stretched

The Achilles heel of the Spanish recovery was public finances: Spain favored growth over consolidation. Since 2015 the structural budget balance has increased again. With a reading of about -3% it is way above the -0.5% objective from the EU's Fiscal Compact. The debt-to-GDP ratio improved only gradually from its 2014 peak of 100.7% to likely 96.7% by 2019. The coalition agreed, having the European rules in mind, to keep reducing the budget deficit and public debt. With growth coming down, Spain will need to embark on consolidation measures. However, we expect the left-wing coalition to do only what is inevitable to appease the EC, leaving the underlying budgetary situation stretched.



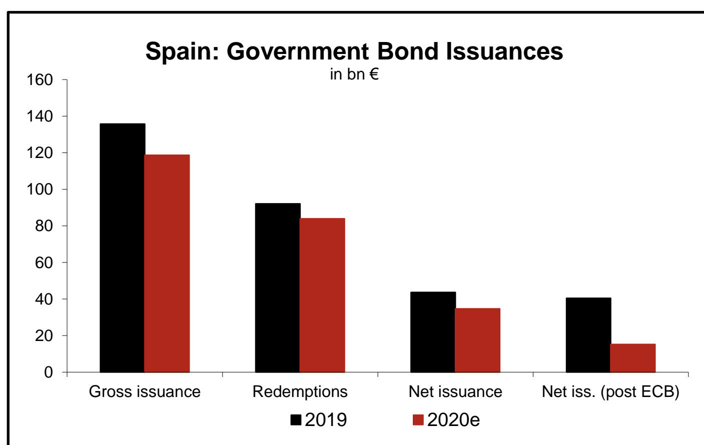
The best days for Spanish Bonos have passed

Over the last years, Spanish government bonds have performed very well. They have achieved an average total annual return of 6.7% since 2013 (euro area average: 4.2%). What is more, they surpassed the euro area average in every single year in this period. Again, last year Spanish Bonos rendered 8.6% (versus euro area average of 6.9%) and the spread versus German Bunds tightened from 98 bps to 58 bps (to 65 bps for 10-year bonds).



The flip side of the coin is the limited potential to perform well going forward. The current average yield is only 0.14% (10-year: 0.29%). Hence, the future current income will be much lower. What is more, a lukewarm recovery of the euro area economy and slightly higher inflation over the course of 2020 are likely to trigger a moderate upward trend in euro area yields. Hence, capital losses are on the cards. Further headwinds arise from the discussed political uncertainties, reform unwinding and growth slowdown which limit the potential to perform well at first sight.

The average rating of Spain is A- (in line with our internal rating). It makes Spain one of the poorer rated countries in the euro area. Given the existence of a minority government and the unresolved issue about Catalonia, we do not expect any positive change in the foreseeable future.



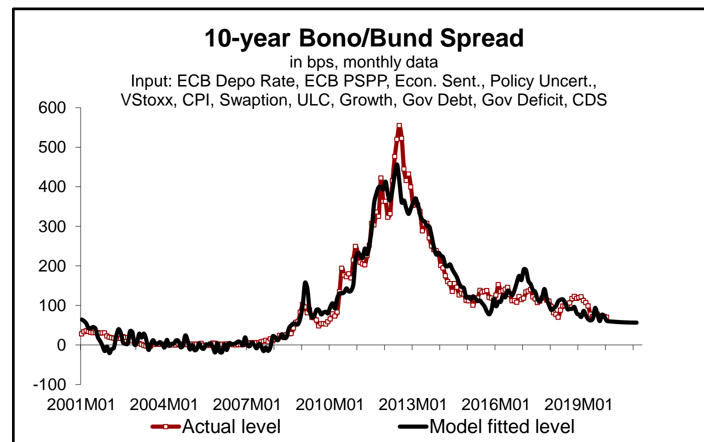
But, there are a number of factors which will support Bonos over the medium term. To start with, the environment for higher yielding sovereign bonds is forecast to remain benign in 2020. The low yield environment will continue to push investors into higher yielding bonds. After Greek and Italian government bonds, Spanish Bonos still offer the third-highest yield level in the euro area. With many medium- and even long-dated euro area core bonds having a negative yield, demand for Bonos is forecast to remain decent. This is reflected in the ownership structure of Spanish government bonds, too. The share of Bonos held by non-domestic investors has continuously increased in recent years from less than 30% in 2012 to 46.7% as of late. A positive side effect is that the share of Spanish banks is on a lasting downtrend. Meanwhile, they hold less than 15% of all outstanding Spanish government bonds (close to 20% e.g. in Italy). This limits the risk of tensions in the financial sector in times of a more volatile government bond market environment.

Moreover, the technical situation for Spanish Bonos appears rather attractive as well. The gross issuance is likely to decrease in 2020 compared to last year from € 136 bn to € 119 bn amid lower redemptions (from € 92 bn to € 84 bn) and a reduction in net issuance (by € 9 bn to € 35 bn). Furthermore, assuming the ECB will assign 65% of its new QE programme to government bonds, the central bank will take down nearly € 20 bn of new Spanish bonds. The remaining net issuance of only € 15 bn is seen to be taken down smoothly by financial markets. Year-to-date, Spain's issuance programme is already well advanced. Currently, almost 25% of its annual gross target is already placed (well ahead of last years' average).

In addition, despite slowing activity, Spain's growth rate is seen to remain slightly above the euro area average. Finally, it is likely that the new minority government will at least aim for a stronger social balance reducing the division of society.

Some (limited) scope for tighter Bono spreads

Our analysis signals a slight undervaluation of 10-year Bonos. While the current spread to 10-year Bunds is 68 bps, our model points to a fair value in the low-60s. On a 1-year horizon, this fair value is expected to decrease to the mid-50s. The main driving factors for the tightening are the reduction in the fiscal deficit, the still solid growth performance of Spain and the ECB's purchase programme.



Overall, we expect the return of Spanish Bonos to be much lower in 2020 compared with the past. But, the trend towards a convergence of sovereign bond spreads is forecast to continue. While Italian and Greek bonds are seen to benefit even more, Bonos will likely perform better than euro area core bonds amid tightening spreads.

However, the extent of the outperformance will be more limited than in the past. The start into the year has been shaky (spread widening by 3 bps since the end of 2019, total return year-to-date: 1.5% - Spain is the weakest market among European government bonds). But we see some catch up potential in the months to come. Although some losses appear unavoidable over the rest of 2020, we forecast Spanish Bonos to maintain a positive total return over the year as a whole. In contrast, euro area core government bonds are likely to yield a negative total return in 2020.

Imprint

Issued by: **Generali Insurance Asset Management S.p.A. SGR, Research Department**

Head of Research: Vincent Chaigneau (vincent.chaigneau@generali-invest.com)

Head of Macro & Market Research: Dr. Thomas Hempell, CFA (thomas.hempell@generali-invest.com)

Team:
Elisabeth Assmuth (elisabeth.assmuth@generali-invest.com)
Elisa Belgacem (elisa.belgacem@generali-invest.com)
Radomír Jáč (radomir.jac@generali.com)
Jakub Krátký (jakub.kratky@generali.com)
Michele Morganti (michele.morganti@generali-invest.com)
Vladimir Oleinikov, CFA (vladimir.oleinikov@generali-invest.com)
Dr. Martin Pohl (martin.pohl@generali.com)
Dr. Thorsten Runde (thorsten.runde@generali-invest.com)
Dr. Christoph Siepmann (christoph.siepmann@generali-invest.com)
Dr. Florian Späte, CIIA (florian.spaete@generali-invest.com)
Dr. Martin Wolburg, CIIA (martin.wolburg@generali-invest.com)
Paolo Zanghieri, PhD (paolo.zanghieri@generali.com)

Head of Insurance and AM Research: Michele Morganti (michele.morganti@generali-invest.com)

Team:
Raffaella Bagata (raffaella.bagata@generali.com)
Alberto Cybo-Ottone, PhD (alberto.cybo@generali.com)
Mattia Mammarella (mattia.mammarella@generali-invest.com)
Roberto Menegato (roberto.menegato@generali.com)
Giovanni Millo, PhD (giovanni.millo@generali.com)
Antonio Salera, PhD (antonio.salera@generali.com)
Cristiana Settimo (cristiana.settimo@generali.com)
Federica Tartara, CFA (federica.tartara@generali.com)

Sources for charts and tables: Thomson Reuters Datastream, Bloomberg, own calculations
Version completed on February 20, 2019

In Italy:
Generali Insurance Asset Management
S.p.A Società di gestione del risparmio

Piazza Tre Torri
20145 Milano MI, Italy

Via Niccolò Machiavelli, 4
34132 Trieste TS, Italy

In France:
Generali Insurance Asset Management
S.p.A Società di gestione del risparmio

2, Rue Pillet-Will
75009 Paris Cedex 09, France

In Germany:
Generali Insurance Asset Management
S.p.A. Società di gestione del risparmio

Tunisstraße 19-23
50667 Cologne, Germany

www.generali-investments.com

This document is based on information and opinions which Generali Insurance Asset Management S.p.A. Società di gestione del risparmio considers as reliable. However, no representation or warranty, expressed or implied, is made that such information or opinions are accurate or complete. Generali Insurance Asset Management S.p.A. Società di gestione del risparmio periodically updating the contents of this document, relieves itself from any responsibility concerning mistakes or omissions and shall not be considered responsible in case of possible changes or losses related to the improper use of the information herein provided. Opinions expressed in this document represent only the judgment of Generali Insurance Asset Management S.p.A. Società di gestione del risparmio and may be subject to any change without notification. They do not constitute an evaluation of any strategy or any investment in financial instruments. This document does not constitute an offer, solicitation or recommendation to buy or to sell financial instruments. Generali Insurance Asset Management S.p.A. Società di gestione del risparmio is not liable for any investment decision based on this document. Generali Investments may have taken, and may in the future take, investment decisions for the portfolios it manages which are contrary to the views expressed herein. Any reproduction, total or partial, of this document is prohibited without prior consent of Generali Insurance Asset Management S.p.A. Società di gestione del risparmio. Generali Investments is part of the Generali Group which was established in 1831 in Trieste as Assicurazioni Generali Austro-Italiche. Generali Investments is a commercial brand of Generali Investments Partners S.p.A. Società di gestione del risparmio, Generali Insurance Asset Management S.p.A. Società di gestione del risparmio, Generali Investments Luxembourg S.A. and Generali Investments Holding S.p.A..