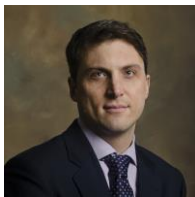




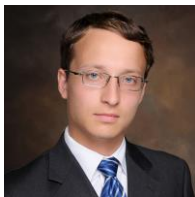
## PRICE POINT

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Timely intelligence and  
analysis for our clients.



Kenneth Orchard  
*Portfolio Manager,  
European Fixed Income*



Ivan Morozov  
*Portfolio Analyst,  
European Fixed Income*

## Fixed Income.

# EURO SOVEREIGN OUTLOOK— SIX PRINCIPAL INFLUENCES TO CONSIDER IN 2016.

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### EXECUTIVE SUMMARY

The eurozone's gradual economic improvement is expected to continue in 2016, albeit modestly, with an extremely supportive policy mix helping to underpin stability in the region. Euro sovereign ratings are improving, signaling a more positive environment. With that said, inflation is expected to stay well below the European Central Bank's (ECB) target level, an ongoing thorn in its side, while political risk poses a main threat to the near-term outlook.

In this Price Point, T. Rowe Price Fixed Income Specialists Ken Orchard and Ivan Morozov provide an overview of the euro sovereign debt landscape in 2016, identifying six key factors expected to be the primary influences on market performance.

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After years of economic stagnation, the gradual recovery in the eurozone is beginning to show signs of sustainability. Extremely supportive policy and favorable developments—such as low oil prices, a weaker euro, falling unemployment, and improving credit conditions—all bode well for the region in 2016. However, the outlook is not without risks, political uncertainty chief among them. We believe the following six factors will have a strong influence on markets over the coming year.

### 1. ECONOMIC GROWTH. CONTINUING, ALBEIT MODEST.

Future activity indicators suggest that the pace of economic growth during the first half of 2016 is likely to remain unchanged from that of 2015. Over the past year, domestic demand has gained ascendancy as the main growth driver in almost all eurozone countries. Employment is rising, albeit at a slow pace, which is positive for domestic consumption and encouraging for the cyclical recovery. Fiscal policy also remains supportive for domestic demand, with the cash saved on lower interest payments being spent on social and investment projects. Lower oil prices are similarly flowing through to domestic spending. Given that most European countries are energy importers, the continuing decline in oil prices means reduced household energy bills, not to mention lower production costs for companies—both of which will encourage

economic activity in Europe. Investment activity has picked up as companies face pressure to renew capital stocks after years of underinvestment, while a weaker euro is also a boost for exporters.

That said, economic divergence between countries will again be a feature in 2016, although potentially less pronounced than in 2015. As before, countries with more competitive economies, stronger budget positions, and lower debt burdens are expected to grow at above the eurozone average rate. The largest of this group is Germany, along with the Netherlands, Latvia, Lithuania, and Slovakia. In addition, Ireland, Slovenia, and Spain are also likely to outperform the eurozone average, thanks to strong cyclical recoveries, strengthening banking sectors, improved housing markets, and growth-supportive policies. In 2015, Ireland's GDP growth rate exceeded 6% (one of the fastest globally), and we anticipate another strong year for the country. Conversely, France and Italy are likely to grow at below-average levels. Despite implementing some important economic reforms, both countries have much to do in order to restore competitiveness, compared with their eurozone peers.

## **2. FISCAL POLICY. SOME ROOM FOR FLEXIBILITY.**

We expect another year of marginally looser fiscal policy, as austerity is again put on hold. In most eurozone countries, 2016 budgets factor in at least some measures aimed at stimulating the economy. Of course, any fiscal stimulus has negative implications for structural budget positions, given that it generally means taking on additional debt. We expect the headline aggregate budget deficit of eurozone countries to remain at around 2.2% of GDP in 2016, broadly unchanged from 2015. However, the stable headline number masks some deterioration in structural budget positions, as the deficit would have risen were it not for the reduction in interest payments (due to lower bond yields) and rising tax revenues.

As in 2015, significant differences in the fiscal positions of individual governments will be a feature. Specifically, we expect Spain, Italy, France, and Portugal to continue running above-average budget deficits in 2016, possibly breaching the targets specified by the European Commission under European Union (EU) rules. However, for political reasons, we do not see this leading to any penalties or legal action against those countries, nor do we see the market being overly concerned about debt sustainability. Despite still moderately high budget deficits, the current pace of economic growth, along with low interest rates, should be enough to at least stabilize public debt ratios in most countries.

## **3. MONETARY POLICY. EXTREMELY LOOSE AND SET TO GET LOOSER.**

The sole policy objective of the ECB is to keep inflation at just below 2%. Currently, the ECB forecasts inflation to be only at 1.6% by the end of 2017. This puts the ECB under considerable pressure to maintain an extremely loose policy framework in the hope of driving inflation closer to target. Given the deterioration we have seen in the global environment since the beginning of 2016, the ECB is likely to be particularly sensitive to any persistent downside risks. With this in mind, we anticipate further easing measures from the ECB, starting with a cut to the deposit rate at its March meeting. Currently at -0.3%, we expect a further cut of at least 10, but more likely 20, basis points. Meanwhile, despite previous signs of resistance from more conservative members of the ECB Board, we also see the current QE program being extended at some point this year, perhaps as early as the first quarter. The ECB is already buying a significant amount of the existing euro sovereign debt (€60bn of securities purchased every month under the current program). An extension of QE will push the net supply of government bonds further into negative territory and maintain even firmer downward pressure on yields. Additional QE in Europe is also expected to cause the euro to further weaken against the U.S. dollar.

## **4. INFLATION. STAYING LOW, BUT ABOVE ZERO.**

The low inflation trend in Europe shows little sign of materially changing in 2016. Headline inflation is likely to dip below zero early in the year, due to the recent slide in oil prices. However, we believe it could rebound sharply by the end the year to around 1%, as the downward pressure from low energy prices diminishes. Overall, headline inflation will be volatile and very much influenced by oil price movements. Meanwhile, we expect core inflation, which excludes energy and food prices, to rise at a very slow pace, increasing marginally to just above 1% year on year by the end of 2016. Unemployment in the eurozone, though declining, remains high at 10.5%. Such a

high level of extra labor supply continues to be a key impediment to wage growth in most eurozone countries. Given all these considerations, we believe the ECB is some years away from achieving its target 2% inflation rate on a sustained basis.

#### **5. SOVEREIGN RATINGS. SHOWING AN IMPROVING TREND.**

Having overcome the acute stage of the crisis, euro sovereign ratings are beginning to improve, in contrast to the generally downward trend in other parts of the world, most notably emerging markets. In 2015, average euro sovereign ratings remained stable and, excluding Greece, there was even a slight improvement in average rating levels for the second year in a row. We expect the positive trend to continue in 2016, with continuing economic growth supportive of credit metrics in the European countries. Despite more accommodative fiscal policies, headline fiscal numbers in most of the eurozone sovereigns continue to improve.

We expect ratings for Ireland and Slovenia to be upgraded by Moody's, possibly in the early half of the year. We also see a high probability of Spain and Cyprus being upgraded at some point later in the year. Elsewhere, while France and Finland are experiencing deteriorating rating trends, we do not expect downgrades in 2016, unless there is a large external shock.

#### **6. POLITICAL RISK. PROMINENT, BUT MANAGEABLE.**

Political risk appears to be the main threat to the eurozone outlook in 2016, although we do not anticipate financial markets coming under the kind of extreme stress witnessed in 2011–2012, at the peak of the euro sovereign debt crisis. With that said, there are a few risk factors, such as the challenges of implementing the Greek financial support program, which may put pressure on eurozone assets at some point. Political uncertainty in Spain and Portugal also stand out as potential sources of volatility.

The situation in Greece has calmed down over recent months but is likely to be back in the headlines later in 2016. Following tough, drawn-out negotiations, the Greek government signed a new financial assistance program with the EU. However, Greece is already behind on implementing some of the reforms required under the program. In particular, Greece must implement highly unpopular pension reform, something that is proving difficult for the Syriza-led government, given its small majority. We expect the necessary reforms will be made in the end, but it may require a change in the government's composition or even necessitate new elections being called. Once implemented, the reforms will pave the way for talks on the official debt restructuring with the European Union, and after negotiations, we expect Greece will be granted extensions of debt maturities and lower rates on existing debt.

Once the government has secured this key debt-restructuring goal, the incentives to stick to the conditions of the reform program will be low, in our view, which may cause another round of political uncertainty. Accordingly, we expect Greek sovereign yields to remain high and volatile in 2016. The main risk event, in our view, is the debt repayment to the ECB in July. Concerns about Greece's ability to repay the debt and remain in the eurozone may prompt volatility in other peripheral markets, as happened during the summer of 2015. That said, Greece is much less systemically important now than five years ago. If it leaves the eurozone—which is not our base-case scenario—euro assets are likely to sell off, but we do not anticipate the kind of financial market stress that occurred in 2011–2012.

In terms of the 2016 European election schedule, the landscape is relatively light, with Ireland, Slovakia, Lithuania, and Cyprus due to have general elections this year. We believe the incumbent governments will win the elections in Ireland, Slovakia, and Lithuania, and so we do not anticipate any major policy changes in these countries. In Cyprus, parliamentary elections are not as important since the country is a presidential republic and the president is responsible for all main policy decisions. There is, however, heightened risk potential in relation to Spain and Portugal after general elections in 2015 produced inconclusive results in both countries.

In Spain, while the governing center-right Partido Popular (PP) Party received more votes than any other party, it failed to secure enough parliamentary seats to form a government on its own. Still without a government in early

2016, our base-case scenario is a grand coalition being formed between PP and its historical rival, the center-left Partido Socialista Obrero Español (PSOE), as the only viable majority coalition option. Negotiations between the two parties are likely to last until early spring, and it is not clear if they will produce any viable result. The alternative would be another round of general elections. Both scenarios mean months without a government, which would be negative for Spanish assets. Another risk factor in Spain is a renewal of the independence process in Catalonia. After months of negotiations, Catalan pro-independence parties have formed a majority regional government. They now plan to unilaterally implement pro-independence measures, which will be challenged by the national government. We do not believe that Catalonia will become independent, as the majority of the Catalan population is still against such pro-independence moves. Instead, we think that a new constitutional agreement will be signed between the national and Catalan governments; a move that would, at least temporarily, weaken the push for independence. However, there will likely be several months of political uncertainty and escalation in Spain.

The story is similar in Portugal, with the incumbent Social Democratic Party (PSD) government winning the most votes in last year's election but failing to secure enough seats to form a government. Seizing its opportunity, the second-placed center-left Socialist Party Partido Socialista (PS) set about uniting all the left forces, including the most radical ones, to form a coalition government of its own. However, we expect this government to be unstable—conflict between the coalition partners has already started to emerge—raising the prospect of new elections being called in 2016.

We anticipate the eurozone remaining in general standby mode during 2016. We do not expect growth to accelerate substantially in 2016 but rather see a continuation of the recent modest improvement. Uncertainty has risen since the beginning of the year, and we now anticipate further policy stimulus in response to the weaker environment. Weak inflation and political risks remain visible headwinds, and while these are potentially unsettling influences, we do not envisage European financial markets coming under the kind of extreme stress that occurred in 2011–2012, at the peak of the sovereign debt crisis.

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