# Week Ahead

Focus: Italy's rating, EC spring forecast, US deficits

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## IT: Fitch downgrades public debt

The corona crisis is particularly distressing for Italy, which had significant competitiveness deficits combined with a high public debt ratio even before the crisis erupted. For the rating agency Fitch, Italian government bonds are now only one notch away from junk since the unscheduled downgrade this week.

*From the point of view of the financial markets, which have remained stable in the current crisis thanks to the substantial expansion of the ECB purchase programs, the credit rating of the four major rating agencies (Moodys, S&P, Fitch and DBRS) is of particular importance. If Italy were to fall out of the investment grade rating range with all four rating agencies, the ECB would no longer be allowed to buy Italian government bonds in accordance with the current rules. However, the rating agency S&P confirmed Italy's rating only last week, leaving it at the second-lowest level of investment grade. Moody's announced in a press release on the same day that Italy's rating should remain unchanged due to the crisis. However, the official announcement of the rating update will not be made until May 8.*

*It is therefore highly unlikely that Italian government bonds will not be able to be bought by the ECB in the future. Even if Italy's credit rating were to deteriorate drastically as a result of the corona crisis, an exception would probably be granted temporarily - as is currently the case for Greece. After the end of the corona crisis, however, the question would then arise whether and how the ECB could return to its original set of rules. Based on these rules, the ECB would only be able to continue purchases of sovereign bonds after the loss of an investment grade rating if the country in question had previously accepted an ESM adjustment program under strict conditions. However, an ESM adjustment program with strict conditions attached would be unthinkable from Italy's domestic policy perspective.*

*After the crisis is over, it will be more important than ever for the Italian government to cooperate with the financial markets and the European partners to prevent the loss of the investment grade rating by all four rating agencies. However, for historical reasons, a change of government in Italy can occur quickly with potentially fatal consequences, as the government under Salvini and DiMaio has already proven in 2018/19. The confrontational course of this government with the EU caused Italy's yield premiums to rise sharply at the time.*

## EZ: how strongly will public debt ratios rise?

Next week (May 7), the European Commission will publish updated forecasts for the public debt ratios of all member states as part of its spring forecast. In view of the economic slump and the comprehensive aid packages, the public debt ratio of all Eurozone countries is expected to rise

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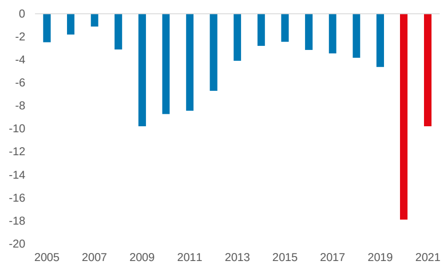
substantially by 10-15% of GDP in 2020. However, assuming an economic recovery, the government debt ratio should fall sharply in 2021. In the medium term, we expect the public debt ratio in many Eurozone countries to increase by 5-7% of GDP compared with pre-crisis levels.

## US deficit could reach 17.9% of GDP this year

**US Deficits, in % of GDP**




*Source: Congressional Budget Office, Erste Group Research*

The Congressional Budget Office (CBO) has released the first estimate for the development of public debt since the outbreak of the crisis. The public authority. expects a deficit of USD 3.7tn for the current fiscal year 2020 (end of September 2020) and USD 2.1tn for 2021. Relative to GDP, the deficits thus amount to 17.9% and 9.8%, respectively. This corresponds to an increase of 13pp and 5pp, respectively, compared to pre-crisis expectations.

To calculate these figures, the CBO makes the following assumptions: GDP in 2Q should contract by 11.8% from the first quarter. The following quarters will then show growth rates (in each case q/q) of 5.4% and 2.4%. The recovery should continue in 2021, but the US economy will not be able to close the gap left by the crisis by the end of the year. Real GDP at the end of 2021 will still be 6.7% lower than expected in January 2020. This is also reflected in the expectations for the unemployment rate. It should peak at 16% in the third quarter of this year and then fall to 9.5% at the end of 2021, which would still be well above the pre-crisis level of 3.5%. The CBO expects financing costs, i.e. government bond yields, to remain essentially unchanged over the period under review.

The CBO itself says that the uncertainty for the forecast is enormous. In our view, the assumptions are based on the expectation of a very tough battle against the spread of the virus. Thus, it is assumed that the average level of social distancing will remain unchanged until the end of June. The CBO also takes into account the risk of further waves of spread. In the second half of 2020, social distancing will not disappear, but only decrease by 75% on average. For the first half of 2021, the CBO still assumes restrictions.

*Based on these assumptions, the additional financing requirements of the central government will amount to just under USD 4tn, a total of USD 6tn by September 2021 (end of the fiscal year). Without a doubt, this is an enormous sum for an economy even such as the US, and needs to be financed. The deficit in the current fiscal year will be almost as high relative to GDP as it was in the first two years after the financial crisis began in 2008 taken together. We assume, however, that this amount can be financed without any rise in yields for this reason – the Fed will make its contribution. Since the beginning of March alone, the central bank's balance sheet total has expanded by about USD 2.5tn.*

# Economic calendar

| Ctry | Date | Time | Release | Period | Consens | Prior |
|---|---|---|---|---|---|---|
| **Eurozone** | | | | | | |
| FR | 4-May | 9:50 | PMI Index | Apr F | | 31.5 Index |
| IT | 4-May | 9:45 | PMI Index | Apr | | 40.3 Index |
| DE | 4-May | 9:55 | PMI Index | Apr F | | 34.4 Index |
| EA | 4-May | 10:00 | PMI Index | Apr F | | 33.6 Index |
| **USA** | | | | | | |
| | 1-May | 16:00 | PMI Index | Apr | 36.0 Index | 49.1 Index |
| | 6-May | 14:15 | ADP Employment | Apr | -14624.8 Tsd | -26.6 Tsd |
| | 8-May | 14:30 | Wages y/y | Apr | | 3.1% |
| | 8-May | 14:30 | Unempl. Rate | Apr | 15.1% | 4.4% |
| | 8-May | 14:30 | Chg. Non-Farm Payrolls | Apr | -18876.0 Tsd | -701.0 Tsd |
| **China** | | | | | | |

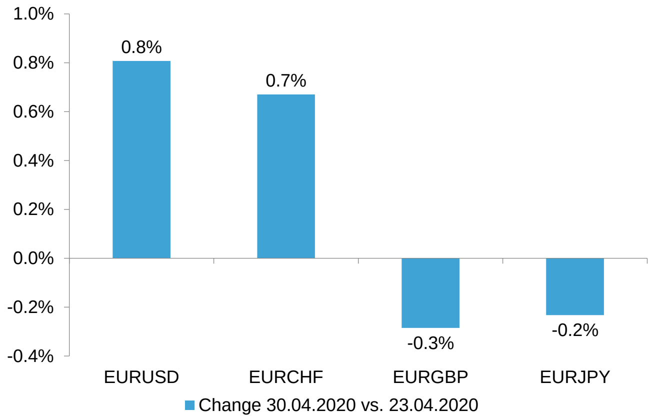
# Central bank events

| | Date | Time | Event |
|---|---|---|---|
| **ECB** | | | ECB calendar not updated yet |
| **Fed** | | | No monetary policy relevant events |

*Source: Market Data Provider, ECB, Federal Reserve, Erste Group Research*

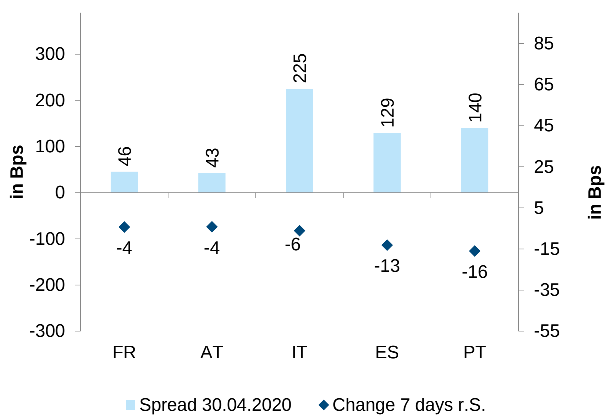
# Forex and government bond markets

**Exchange rates EUR: USD, CHF, GBP and JPY**
Changes compared to last week



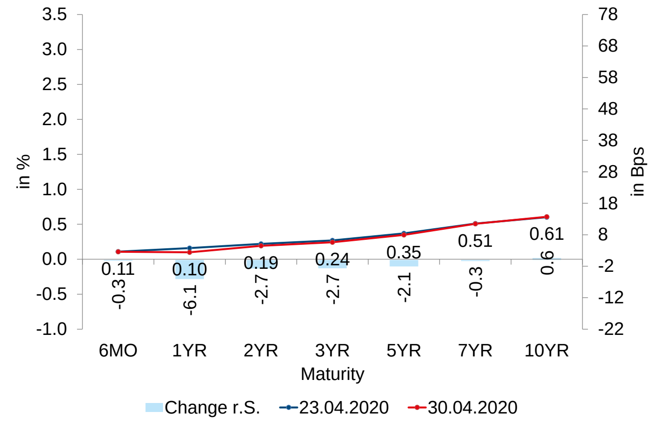

*Source: Market Data Provider, Erste Group Research*

**Eurozone spreads vs. Germany**
10Y government bonds



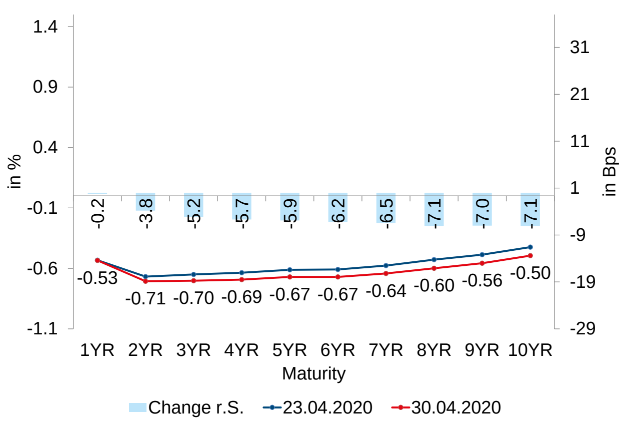

*Source: Market Data Provider, Erste Group Research*

**US Treasuries yield curve**
Changes compared to last week




*Source: Market Data Provider, Erste Group Research*

**DE Bund yield curve**
Changes compared to last week




*Source: Market Data Provider, Erste Group Research*

# Forecasts[1]

| GDP | 2018 | 2019 | 2020 | 2021 |
|---|---|---|---|---|
| **Eurozone** | 1.9 | 1.2 | -4.7 | 3.9 |
| **US** | 2.9 | 2.3 | -1.7 | 4.1 |

| Inflation | 2018 | 2019 | 2020 | 2021 |
|---|---|---|---|---|
| **Eurozone** | 1.7 | 1.2 | 0.7 | 1.7 |
| **US** | 2.4 | 1.8 | 1.9 | 2.2 |

| Interest rates | current | Jun.20 | Sep.20 | Dec.20 | Mar.21 |
|---|---|---|---|---|---|
| **ECB MRR** | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| **3M Euribor** | -0.26 | -0.50 | -0.50 | -0.50 | -0.50 |
| **Germany Govt. 10Y** | -0.50 | -0.50 | -0.40 | -0.20 | -0.10 |
| **Swap 10Y** | -0.09 | -0.20 | -0.10 | 0.10 | 0.20 |

| Interest rates | current | Jun.20 | Sep.20 | Dec.20 | Mar.21 |
|---|---|---|---|---|---|
| **Fed Funds Target Rate*** | 0.04 | 0.13 | 0.13 | 0.13 | 0.13 |
| **3M Libor** | 0.76 | 0.40 | 0.40 | 0.40 | 0.40 |
| **US Govt. 10Y** | 0.61 | 0.70 | 1.00 | 1.20 | 1.40 |
| **EURUSD** | 1.09 | 1.08 | 1.10 ↓ | 1.10 ↓ | 1.12 ↓ |

*Mid of target range

*In case of changes to our forecasts compared to the previous issue, arrows show the direction of the change.*
*Source: Market Data Provider, Erste Group Research*

[1] Note: In accordance with regulations, we are obliged to issue the following statement: Forecasts are not a reliable indicator of future performance.

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