

Main Events

Azimut Global Network

- * Milan
- * Abu Dhabi
- * Austin
- * Cairo
- * Chicago
- * Dubai
- * Dublin
- * Hong Kong
- * Estoril
- * Istanbul
- * Lugano
- * Luxembourg
- * Mexico City
- * Miami
- * Monaco
- * New York
- * Santiago
- * São Paulo
- * Shanghai
- * Singapore
- * St Louis
- * Sydney
- * Taipei



IT'S NOT DÉJÀ-VU

- **French government bonds were hit by heavy selling, resulting in a dramatic surge of the spread with Germany and bringing back memories of the 2011 European crisis**
- **Melenchon's proposal to cancel French debt held by the ECB is the likely catalyst that spooked investors, but the root causes of the sell-off lie in years of fiscal mismanagement, political gridlock, the rise of extremist parties, as well as the relentless rise in interest rates worldwide**
- **That said, Melenchon is polling quite low, and the ECB has powerful tools at its disposal to prevent any systemic risks. So, a repeat of what happened 15 years ago seems unlikely, but the risk of contagion and disorderly movements remains**

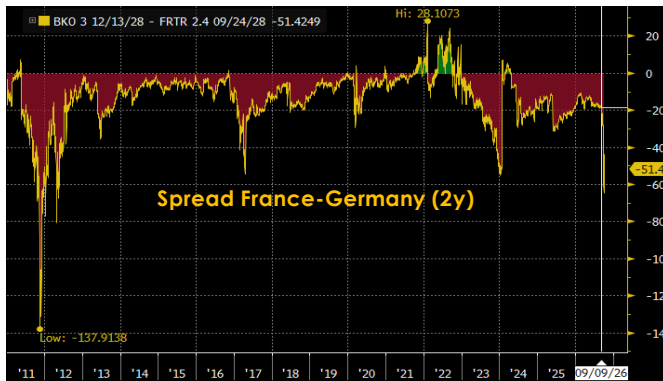
The relentless selling of sovereign bonds of the past several months has led to the first bout of market turmoil. The sell-off had ripple effects on the entire bond market, including the credit segments that had long remained immune to market turbulence.

France was officially the one to stir things up and find itself at the center of the storm. But the root causes of the disruptions we've witnessed are by no means new: the inability of governments to rein in excessive deficits, rising interest rates due to inflation fears and the exponential increase in the financing needs of governments and corporations, as well as reduced leniency on the part of investors.

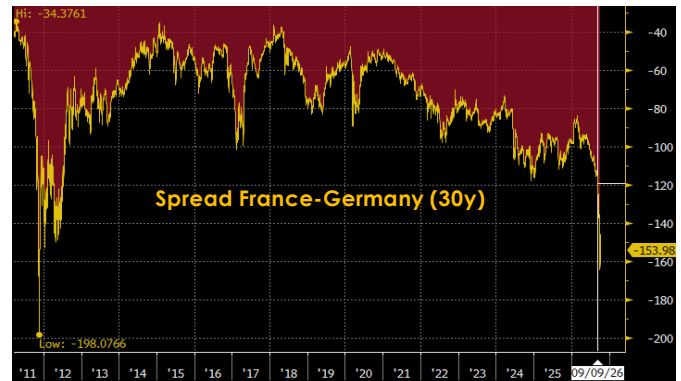
In addition to that, France has its own "merits": years and years of a gridlocked parliament, deficits well above the EU's 3% target, as well as concerns about the steadily growing support for far-left and far-right parties have translated into French bonds being among the worst performers in the past few years.

But the straw that broke the camel's back was likely the declaration by Melenchon, leader of the far-left party (La France Insoumise, usually translated as "Unbowed France"), that the ECB should cancel the French debt it owns, thereby creating more room for public spending. The proposal had been put forward during an election rally in late August, but it garnered much more attention after the ECB meeting on September 10, when Ms. Lagarde was asked to comment on the idea during the press conference.

(continued)



Source: Bloomberg



Source: Bloomberg

Talking about debt cancellation in a world where sovereign bonds were already not exactly the preferred asset class, didn't help. Unsurprisingly, the spread between France and Germany widened significantly thereafter.

That proposal might have also alarmed a group of investors particularly exposed to France: the Japanese. We had already argued in our report at the end of July that Japan would have strong incentives to repatriate assets invested abroad and reinvest them in domestic bonds. This move would have the dual advantage of supporting both the JGB market and the yen. In contrast, an outright intervention by the central bank to prop up government bonds would have caused the yen to depreciate—a scenario that is becoming increasingly politically difficult, especially following the joint intervention by Japan and the United States to support the yen.

Although all global bonds were potentially under threat—with the sole exception of US Treasuries, once again for political reasons—we recalled in that report that France was the most vulnerable country, as it was the third-largest destination for Japanese foreign investment after the United States and the Cayman. Could it be that Melenchon's floating the idea of canceling the debt prompted some Japanese investors to decide to expedite their exit? At the moment, there is no evidence, but the question is legitimate.

Whatever the cause, once it began, the widening of the spreads between France and Germany started to snowball, gaining more and more momentum. By the end of September, price movements had ceased to be relatively controlled and had become disorderly, as typically happens when the price is no longer determined by rational decisions but by forced liquidations and/or stop-loss orders.

Suddenly, after about 15 years of stability, price patterns of European government bonds have started to resemble those of 2011, with spreads between Germany and most other EU countries widening significantly as investors sought safe-haven assets. Ironically, however, the villains of 2025 were not in the dock this time. Quite the contrary. Many of the debtors considered the least reliable back then have turned into the most fiscally responsible. This time, it was France taking the beating. Italy has been caught in the middle, despite having shown a certain degree of stability in its debt-to-GDP ratio—albeit at high levels—and deficits close to the 3% threshold set by Brussels and therefore not alarming.

The drop in Italian government bonds, however, can also be explained by the fact that BTP futures are highly liquid instruments and that Italy continues to suffer from the stigma of being perceived as an unreliable debtor. Due to this combination of factors, investors might have used BTP futures to hedge their portfolios against the perceived risk of a possible repeat of the European debt crisis.

But how concrete is the risk that we might witness such a scenario? Probably not much, and for a variety of reasons.

	Debt to GDP ratio					Deficit/GDP 2025
	2018	2022	2026e	Delta 2018-2026e	Delta 2022-2026e	
Greece	190%	179%	137%	-52.7%	-42.3%	1.7%
Portugal	121%	111%	86%	-35.5%	-25.6%	0.7%
Japan	204%	228%	204%	0.7%	-23.4%	-1.7%
Spain	100%	109%	98%	-1.5%	-11.0%	-2.4%
Italy	134%	138%	138%	4.2%	0.0%	-3.1%
Germany	61%	64%	65%	3.8%	0.2%	-2.7%
Australia	42%	50%	51%	9.0%	0.6%	-0.1%
Switzerland	39%	36%	39%	-0.5%	2.6%	0.3%
United Kingdom	86%	98%	104%	18.0%	6.1%	-5.0%
United States	108%	119%	126%	18.1%	6.7%	-5.3%
France	99%	111%	118%	19.9%	7.0%	-5.1%
Canada	91%	104%	111%	19.9%	7.2%	-2.0%
China	56%	77%	107%	51.0%	29.6%	-4.8%

Source: Bloomberg, IMF, Azimut elaborations

(continued)

The first is that 15 years ago many of the major countries had much lower debt-to-GDP ratios (around 60%), while the few countries with ratios above 100% were outliers and viewed with suspicion. Today, the debt-to-GDP ratios of the major countries—with the exception of a few that have maintained fiscal discipline—are fairly similar and generally in the 100%–140% range. The Eurozone's aggregate debt-to-GDP ratio is just under 90%, and that of France is projected to reach 118% this year. So, if these levels of debt were truly the cause for concern, then the problem would not just be a European one.

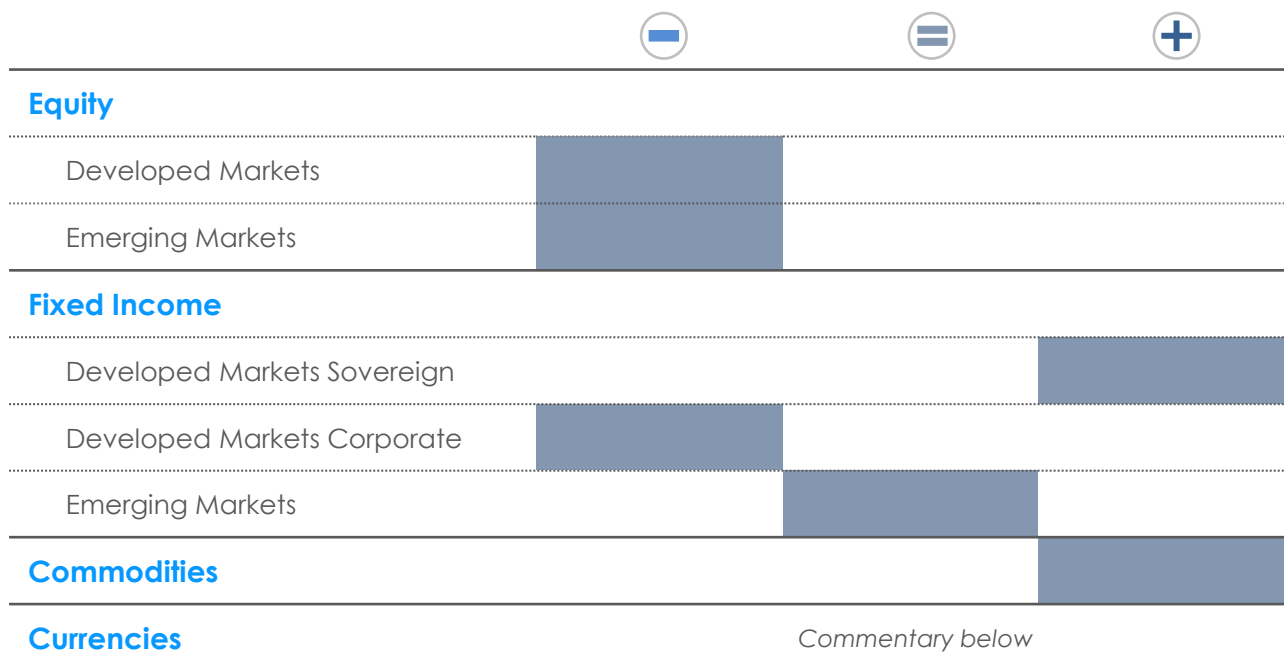
Second, if Melenchon's proposals were the cause of the panic, it should be noted that in the polls Marine Le Pen is well ahead in the presidential race, while Melenchon and Edouard Philippe are in a tight race for the second spot. Should Melenchon advance to the second round, Marine Le Pen is projected to win the runoff by a 70-30 margin. If instead Edouard Philippe were to make it to the runoff, it would mean that the risk posed by Melenchon has already been removed in the first round, regardless of the runoff's outcome. Since, according to projections, Marine Le Pen is expected to win in both runoff scenarios, it is worth noting that earlier this week she vowed to balance France's primary budget within 18 months of taking office, to implement spending cuts totaling 140 billion euros over her term, and to bring the French deficit below 3% by 2030 and below 2.5% by 2032. This is anything but fiscally irresponsible.

Third, since 2011 the ECB had the time to create new, powerful instruments to be used should a scenario like that one occur again. Instruments that were not available at that time. Among those, the Transmission Protection Instrument (TPI). This tool is designed to shield member states from sovereign debt contagion and market fragmentation, and allows the ECB to conduct purchases in the secondary market of government bonds from countries facing "unwarranted, disorderly market dynamics." The most powerful aspect is that the size of the purchases is unlimited. However, four conditions must be met for a country to be eligible for the program: compliance with EU fiscal rules, absence of severe macroeconomic imbalances, fiscal sustainability, and sound macroeconomic policies. Although it is difficult to argue that France currently meets these conditions, the other Eurozone countries are likely eligible. Therefore, the risk of contagion would be ruled out should the TPI be activated.

All things considered, although France's fiscal mismanagement in recent years has certainly contributed to worsening the situation, the sudden and sharp widening of spreads that we have recently observed in European government bonds seems most likely to be due to the relentless decline in bond prices in the preceding months, which then gained momentum, triggering panic selling and forced liquidations. Long positions in French OATs or Italian BTPs paired with short positions in German Bunds were fairly common carry trades, and the unwinding of these positions—along with a possible divestment by Japanese investors who were already planning to repatriate at least part of their foreign investments—could very well explain the disorderly price movements.

But while it could be argued that the recent sell-off in OATs and BTPs may have been exaggerated, one should not underestimate the fact that the sharp rise in interest rates worldwide is starting to produce some cracks in the market and increase the risk of a sudden contagion.

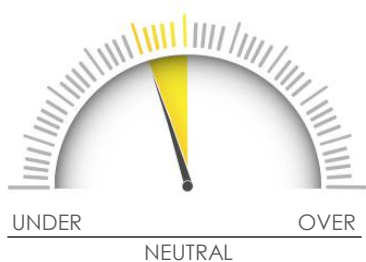
Asset Allocation View



⊖ UNDER = NEUTRAL ⊕ OVER

Equity

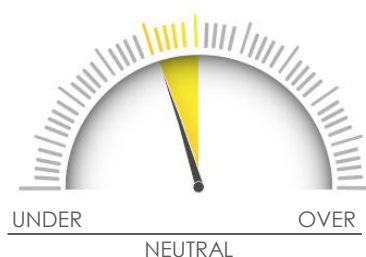
Developed Markets



We have maintained our **Slightly Underweight** recommendation on Developed Market equities. The cracks appearing in the fixed-income market, coupled with the recent steep rise in nominal and real interest rates as well as ongoing geopolitical tensions, are creating a tougher environment for equities. While we recognize that internal rotations among themes and sectors continue to support equity indices, we recommend keeping a more cautious approach, as the risk of disorderly movements or contagion from bonds is increasing. On the bright side, the most challenging period in terms of seasonality is slowly coming to an end, and the upcoming earnings season looks promising once again. Therefore, we continue to believe that any significant correction should be viewed as a buying opportunity, provided that economic and earnings growth remain solid.

US ⊕ Europe = Japan =

Emerging Markets



We have kept our **Slightly Underweight** recommendation on Emerging Market equities. The same factors—both positive and negative—mentioned above also apply here. Other reasons for caution stems from the hawkish stances of many central banks and the strengthening US dollar—all factors that typically weighs on emerging markets. On the positive side, emerging markets continue to trade at a significant discount relative to developed markets and remain the primary beneficiaries of hyperscalers' capex, owing to the heavy weighting of tech and semis in emerging market indices.

Asia ex-Japan = EEMEA = LATAM =

Fixed Income

Developed Markets Sovereign



We kept our **Slightly Overweight** recommendation on Developed Market sovereign bonds. Although geopolitics, inflationary pressures, and hawkish stances by central banks suggest that rates could continue to rise, we cannot ignore the fact that rates have returned to levels not seen in decades, particularly at the long ends, and only to a slightly lesser extent at the short ends. In a portfolio allocation, where one must consider the expected return of asset classes, the rise in rates cannot be ignored, and it is appropriate to gradually increase exposure. Not only to increase the portfolio's carry, but also because, from these levels, it is reasonable to expect that duration can act as a portfolio hedge in case of trouble. However, we emphasize "gradually over time" precisely because we cannot rule out the possibility that the rise will continue for a while longer or that other disorderly movements, as seen last week, may occur. We still prefer the short- and medium-term segments, which are subject to less volatility.

EU Core



EU Periphery



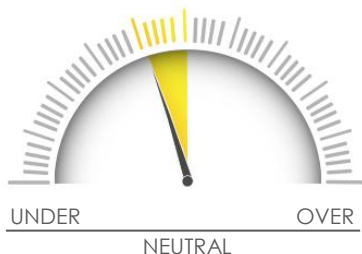
US Treasury



Japanese JGB



Developed Markets Corporate



After two back-to-back downgrades, we have maintained our **Slightly Underweight** recommendation on Developed Market corporate bonds. From extremely tight levels—which no longer adequately compensated for the implied credit risk—spreads have widened rather sharply since mid-September. As predicted, a surge in government bond volatility—which occurred on the French yield curve—spilled over into the credit markets. The current level of spreads is not yet considered adequate, so we continue to recommend caution. Within credit, we continue to prefer investment-grade bonds over high-yield.

IG Europe



IG US



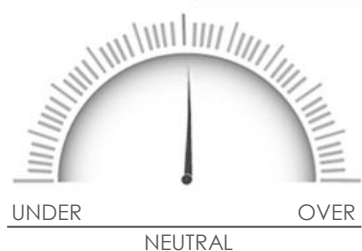
HY Europe



HY US



Emerging Markets



We have maintained our **Neutral** recommendation on Emerging Markets Debt. Spreads on emerging-market debt have also been affected by the recent turmoil in developed markets bonds. However, the overall yield to maturity remains higher for comparable ratings and volatility has been similar.

Local Currency



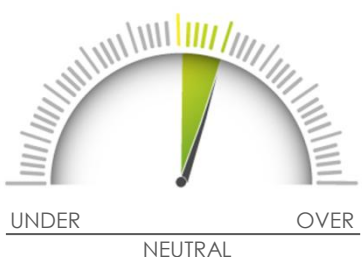
Hard Currency IG



Hard Currency HY



Commodities



We have maintained our **Slightly Overweight** recommendation for commodities. We remain tactically more cautious on precious metals given the risk that global rates may still move higher, but the long-term bull case remains intact. We have no such concerns about industrial metals, particularly rare earths, as supply shortages are set to worsen in the coming years due to their increasing adoption across various strategic sectors, including artificial intelligence, the space race, military applications, and energy production.

Precious



Energy



Industrial



Agricultural



Currencies

We have maintained our **Neutral** recommendation on the **US Dollar**. The recent strengthening of the greenback can be explained largely by fears that a repeat of the “EU periphery crisis” is unfolding. We do not share this view. The interest rate differential—which is the main driver of currency movements—has also supported the last move. However, further strengthening seems unlikely in the short term.

We have maintained our **Neutral** recommendation on the **Euro** as well. Recent concerns about Europe seem to be exaggerated and disruption on the European curves seems more the result of a few forced stops.

The recommendation on the **Chinese Renminbi** remains **Neutral**.

Likewise, the outlook for other **emerging market currencies** has been maintained at **Neutral**.

Euro	⊞	USD	⊞	CNY	⊞	Other EM	⊞
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