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The forgotten stimulus – uncovering the revival of Europe's peripheral markets

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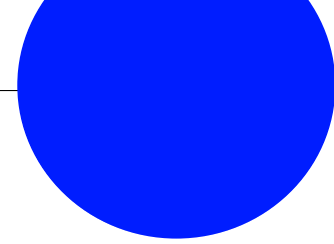


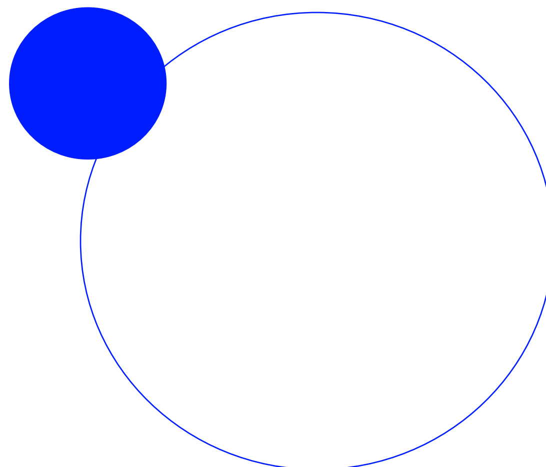
Overview

The tables have turned. Known as the “locomotive of Europe” and the “growth engine of Europe”, the German economy has recently been described again as the “sick man of Europe” – a term first attributed to Czar Nicholas I of Russia in reference to the economic decline of the Ottoman Empire and later to the German economy, post Reunification in the late 1990s-2000s. By contrast, Spain, once an economy beset by high debt, inflation and unemployment, is now set to power ahead in 2024-2025, with a far higher growth expectation of 1.9% in 2024, and 2.1% in 2025, than Germany’s GDP growth estimates of 0.2% in 2024 and 1.3% in 2025, and the Euro area’s 0.8% and 1.2%[1].

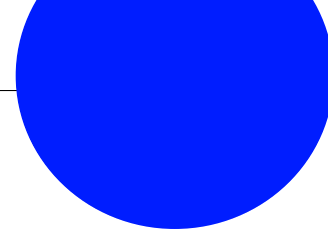
Helped by robust consumption, tourism and a sizeable share of the EU’s Recovery and Resilience Facility (RRF) funding, under the aegis of the Next Generation EU (NGEU)[2], Spain’s economic reversal in fortunes is becoming increasingly apparent in financial markets, but it is not alone.

This paper provides valuable and unique insights into the structural differences and investment opportunities within European markets. It underscores the differentiated opportunities and risks within the Eurozone, shaped by the interplay of fiscal stimulus, market composition, and economic growth dynamics. Here is what it means:

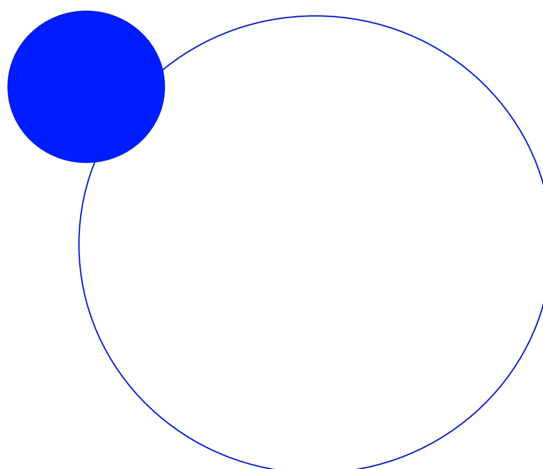
- **Focus on peripheral markets with tailwinds from RRF Funding**: Spain and Italy, as major beneficiaries of the NGEU Recovery and Resilience Facility, are experiencing significant fiscal boosts that support their financial markets. Investors could explore opportunities in these markets, particularly in sectors and assets benefiting from targeted stimulus.



[1] Economic forecast for Spain - European Commission (europa.eu) and Economic forecast for Germany - European Commission (europa.eu)
[2] Recovery and Resilience Plans - European Commission (europa.eu).



- **Germany presents challenges amid economic weakness**: Germany’s markets, closely tied to its lacklustre economy, offer fewer opportunities relative to Spain and Italy. The modest fiscal injection has provided a buffer against outright contraction, but growth prospects remain subdued, making Germany less compelling for growth-focused investors.
- **Risks from public finance strains**: Italy’s public finances remain under pressure, even with RRF injections helping to bridge fiscal gaps. While this does not yet pose an immediate risk to financial markets, it could impact long-term stability and should be monitored closely.
- **Divergent Growth Dynamics in 2024–25**: Spain is expected to lead Eurozone growth in the coming years, outpacing both Italy and Germany. Investors might consider positioning for this growth through Spanish equities and growth-sensitive sectors.
- **Sector-specific strategies may outperform**: Rate-sensitive sectors in Italy and the financial-heavy fixed income market in Spain have outperformed. Investors could tailor strategies to capitalise on these sector-specific dynamics while being mindful of concentration risks.
- **Ex-Financials in Spain have better valuations compared to Italy**: Italy's strong performance in equities and bonds over the past decade highlights its relative resilience. Meanwhile, Spain's equity valuations—especially excluding financials— reflect stronger growth prospects.



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RRF financial support helps lift EU economy – some background

Since February 2021, EU economies have benefited from a vast financial funding facility under the Next Generation EU. This programme was launched to address the impact of Covid in the Eurozone, and, later, the dependence on fossil fuels during the energy crisis in 2022. It combines reforms and public investment, with the Recovery and Resilience Facility (RRF) at its core funding, and addresses the green and digital transition. RRF is providing an unprecedented amount of funding in the EU's history of about €700 billion (out of a maximum of about €800 billion, made up of EU grants (~350bn) and loans (~290bn)) by 2026 via capital markets, with the EU as the issuer, and Spain and Italy among the largest recipients[3].

Spanish and Italian economic growth boosted by cheaper EU RRF funding

EU research simulation suggests the RRF funding could add a minimum of 0.8% to 1.1% of extra real growth to the Euro area by 2026, and possibly higher[4]. By 2027, Spain is set to receive €163 billion in EU[5] grants and loans, including funds from Spain's Brexit funding share (Brexit Adjustment Reserve (BAR[6])). In total, this equates to around 11% of Spain's GDP, mostly earmarked to increasing the country's energy efficiency and improve its electrification. Spain has been one of the EU nations at the forefront of the energy transition, with the objective of achieving national climate neutrality via 100% renewable energy in the electricity mix, and 97% renewable energy via large development in solar, wind and renewable hydrogen by 2050[7].

Italy is another large EU recipient of note. It is to receive a total allocation of some €190+ billion in loans and grants, compared to France and Germany's more modest €30-40 billion grants, mostly allocated to their digital and green transition (REPowerEU), after Russia's invasion of Ukraine in 2022 caused significant disruptions in the global energy market. But unlike Spain, its economic growth has been stunted by generous tax credits for home improvements introduced during Covid. This 'Superbonus' has already left billions in shortfall in the public accounts and could eventually cost the Italian treasury some €219 billion, or around 10% of GDP overall. Therefore, Italy's debt per GDP ratio is set to rise to 139%[8] by 2026 but its budget deficit to return to 3% of GDP (from about 3.8% projected in 2024) as GDP growth recovers to 1.0-1.2% in 2025/26, from 0.7% in 2024[9].

[3] Recovery and Resilience Scoreboard (europa.eu).
[4] Quantifying Spillovers of Next Generation EU Investment (europa.eu), Philipp Pfeiffer, Janos Varga and Jan in 't Veld, 2021 ISSN 2443-8022.
[5] Commission endorses Spain's RRP (europa.eu).
[6] Brexit Adjustment Reserve (europa.eu)
[7] Spain - Countries & Regions - IEA.
[8] Economic forecast for Italy - European Commission (europa.eu).
[9] Italy's 'Superbonus' Spending Puts Its Debt Ratio on an Upward Trajectory (fitchratings.com).

RRF funding − bond matters

How will the RRF funding work in practice? The EU issues a mixture of EU-Bonds, EU-Bills and NextGeneration EU Green Bonds (~30% of the RRF funding). Repayment of EU borrowing allocated to NGEU is expected to start in 2028 and will take place over a 30-year period, until 2058. The loans will be repaid by the borrowing EU member states, while the grants will be repaid by the EU budget[10], therefore constituting genuine fiscal stimulus, since it will fund spending without increasing the debt or deficit ratios for the purposes of the stability and growth pact. Meanwhile, the EU loans are to replace, but not increase, an equal amount of deficit-financed spending by member states[11], allowing Spain and Italy as primary borrowers to access the higher AA/AAA EU credit quality rating, and a lower cost of funding.

The catch

The EU reactivated the general escape clause from the fiscal compact at the end of 2023, after temporarily lifting it during Covid, which means member states are once again under pressure to substantially reduce their accumulated debt. Under the rules, EU members have a fiscal obligation of maintaining their budget deficit within three percent of GDP, and public debt, within 60% of GDP. Breaking the rules can have painful financial consequences as observed in France in 2024. Its breach of the EU's 3%-60% fiscal rule led to the downgrade of its long-term S&P credit quality from AA to AA- in May.

Borrowers will have a short window, up to the end of 2027, to reduce their public debt before the EU starts repaying the NGEU loans. Then, they will be accountable for some €25 billion annually for the next 30 years to be repaid into the EU budget. However, these are expected to cover less than 50% of the revenue projected to be generated from NGEU loan repayments, raising the question of how much extra funding may be needed to cover any shortfalls. In anticipation, the EU has already increased its gross national income requirement from EU nations by 0.6% to 2.0%, though it is far from certain whether this additional headroom will be enough.

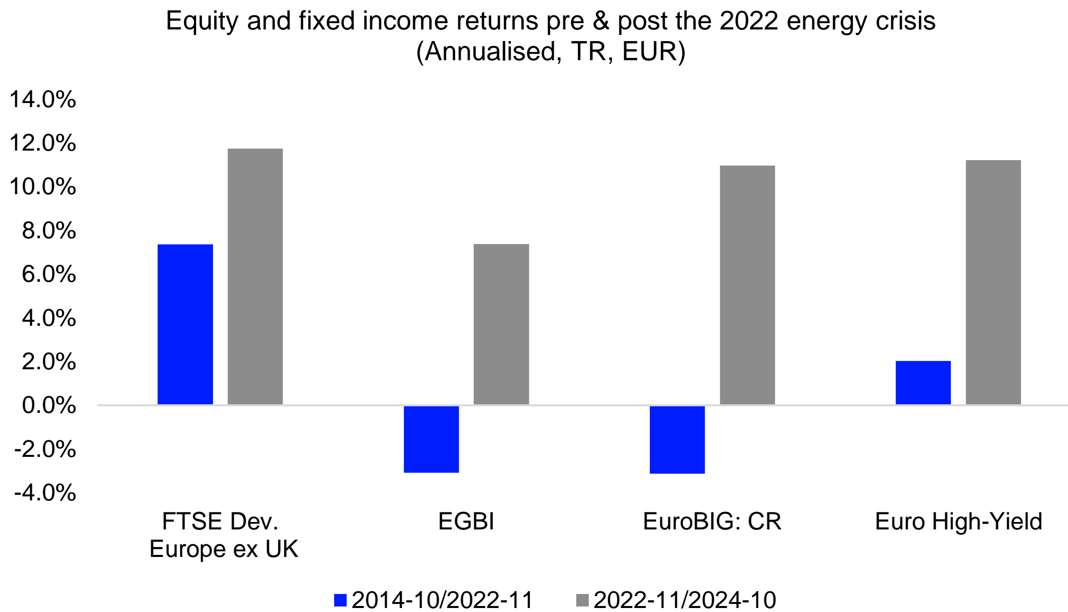
Impact on financial markets

Looking at the 10-year market equity and fixed income performance before and after the Eurozone energy crisis in 2022 reveals the impact in the subsequent bond rally, which followed the substantial RRF injection to finance REPowerEU[12]. At the same time, news that the EU gas storage facilities had avoided shortages by nearly reaching full capacity before the winter season combined with central banks finally signalling a greater willingness to slow the pace of aggressive tightening measures also helped sentiment.

As Chart 1 shows, Eurozone government bond (FTSE EGBI), credit (FTSE EuroBIG Corp and Euro High Yield) and equity (FTSE Developed ex UK) markets have all seen a notable uplifts in performance since Q4 2022, compared to the previous eight-year period. European equities have gained 12%, marginally outperforming credits' 11% returns, and European government bonds have recovered their losses of 3% during the pre-energy crisis period, after returning 7% in the last two years.

[10] NextGenerationEU - European Commission (europa.eu).
[11] The EU recovery plan: funding arrangements and their impacts - Funcas.
[12] REPowerEU (europa.eu).

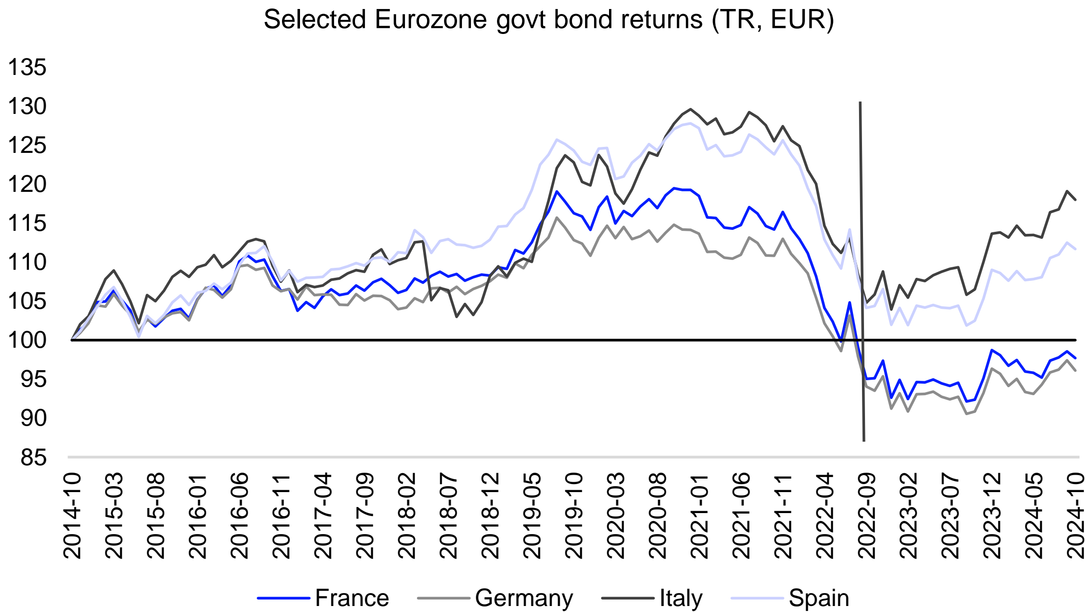
Chart 1. Comparison of Eurozone financial market performance pre and post energy crisis



Source: Source: FTSE Russell, LSEG, FTSE EMU Government Bond Index (EGBI), FTSE EuroBIG Index, FTSE Euro High Yield Index and FTSE Developed Europe ex UK Index as of October 31, 2024, total returns in euro terms. Past performance is no guarantee to future results.

The performance of government bonds on a regional basis shows the strength of the recovery over the 10-year period, especially for Spain and Italy, which have gained 12% and 18% respectively, compared to a loss of 4% for German Bunds.

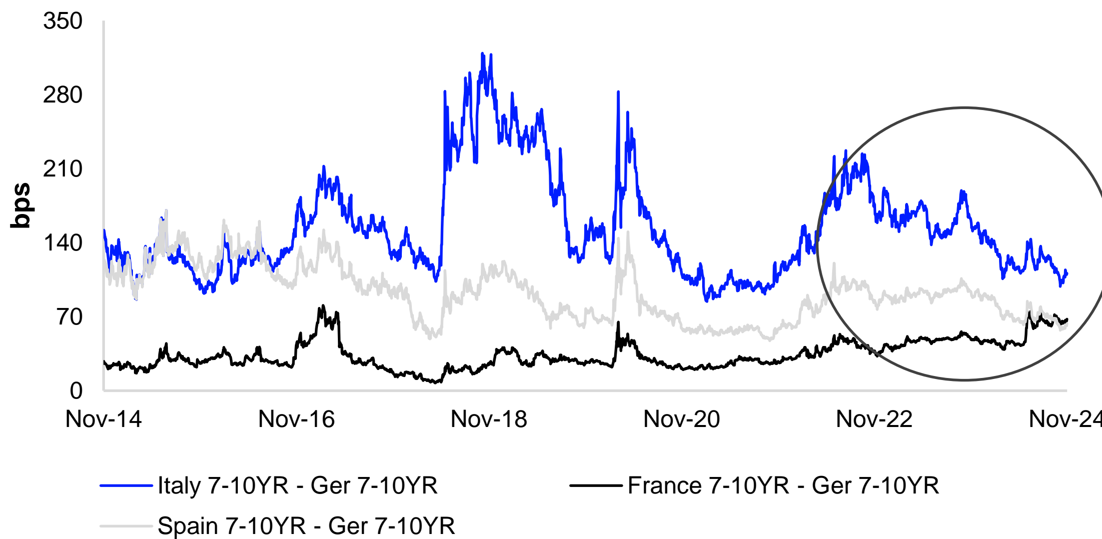
Chart 2. Spain and Italy lead the government bond market recovery in 2022



Source: Source: FTSE Russell, LSEG, FTSE EMU Government Bond Index (EGBI) as of October 31, 2024, total returns in euro terms. Past performance is no guarantee to future results.

The collapse in Italian BTPs and Spanish Bonos spreads in Chart 3 illustrates the dramatic recovery of the last two years. 7-10 year Spanish spreads have fallen by nearly 60bp in the last 10 years, about half of which since October 2022. By contrast, French spreads have gained about 45bp over the decade, with much of the widening seen in the last two years (about +30bp). The move has resulted in Spanish spreads falling through OATs for the first time in 10 years, despite the lower S&P's credit rating of A for Spain versus France's AA- rating. France's budget deterioration and credit quality downgrade were largely to blame, in addition to the political uncertainty since President Macron's snapshot election in the summer 2024.

Chart 3. 7-10 year Spanish spreads are lower than French spreads

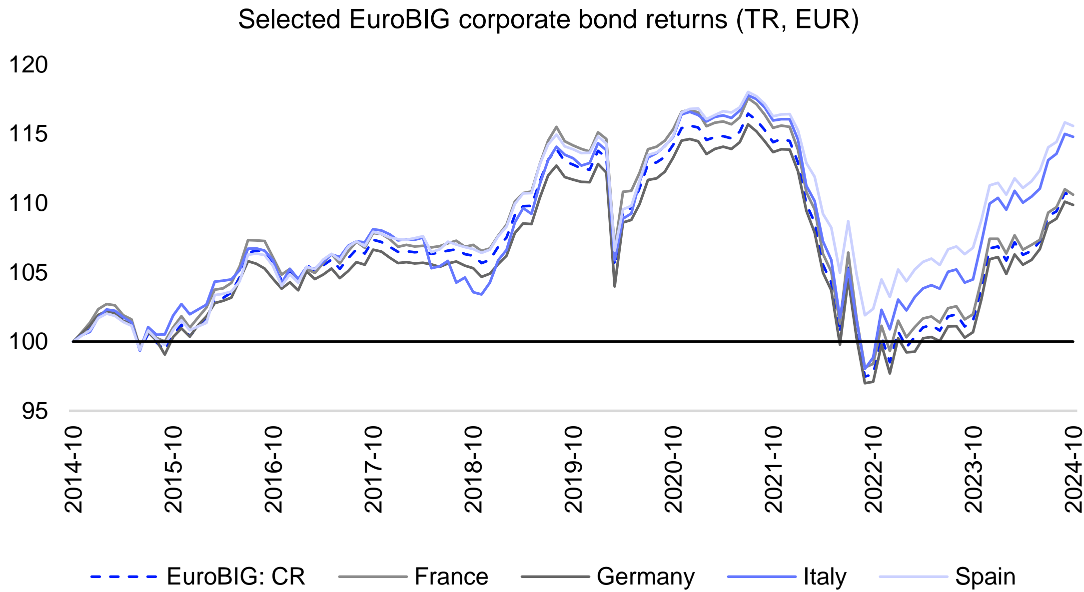


Source: FTSE Russell, LSEG, FTSE EMU Government Bond Index (EGBI) as of November 12, 2024. Past performance is no guarantee to future results.

Peripheral European investment grade corporates outperform

Like Eurozone government bonds, Spanish and Italian investment grade (IG) corporate bonds have also led the 10-year market performance of the EuroBIG Corporate universe, especially since 2022. The latter has returned 10%, led by the 15-16% returns from Spanish and Italian IG corporates, while Germany's returns were in line with the market (Chart 4).

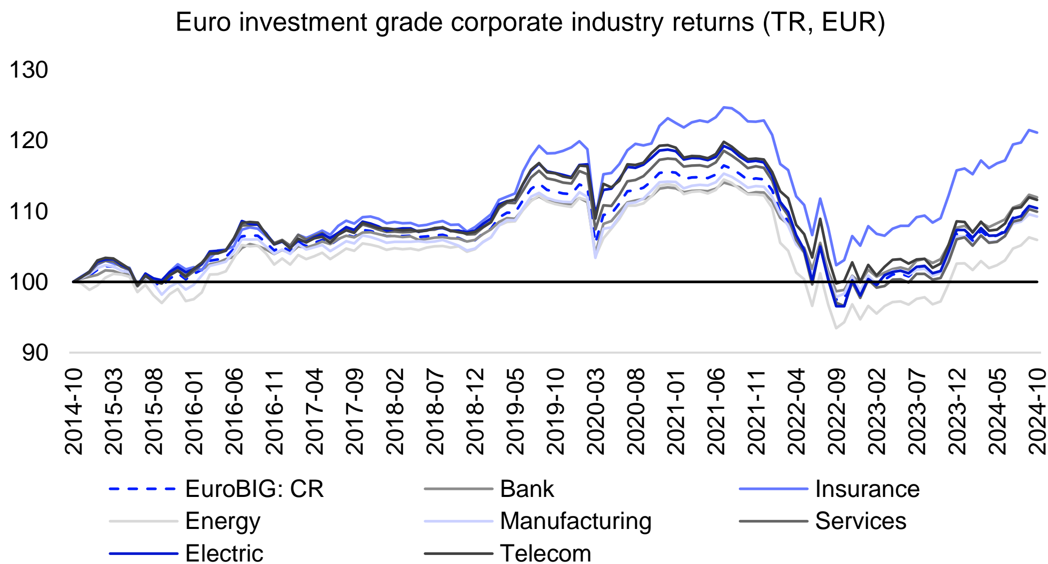
Chart 4. Spain and Italy lead 10-year IG corporate bond returns



Source: FTSE Russell, LSEG, FTSE EuroBIG Corp as of October 31, 2024, total return, in euro terms. Past performance is no guarantee to future results.

From an industry perspective, rate sensitive sectors have outperformed. Insurance has returned 21% over the 10-year period, with its performance decoupling from other industries in 2019, followed by 12% in banks, both of which outperforming the average 10% return of the FTSE EuroBIG Corp universe. By contrast, energy has underperformed, with a smaller 6% gain (Chart 5).

Chart 5. Rate-sensitive industries lead Eurozone IG corporate performance over 10 years



Source: FTSE Russell, LSEG, FTSE EuroBIG Corp as of October 31, 2024, total return, in euro terms. Past performance is no guarantee to future results.

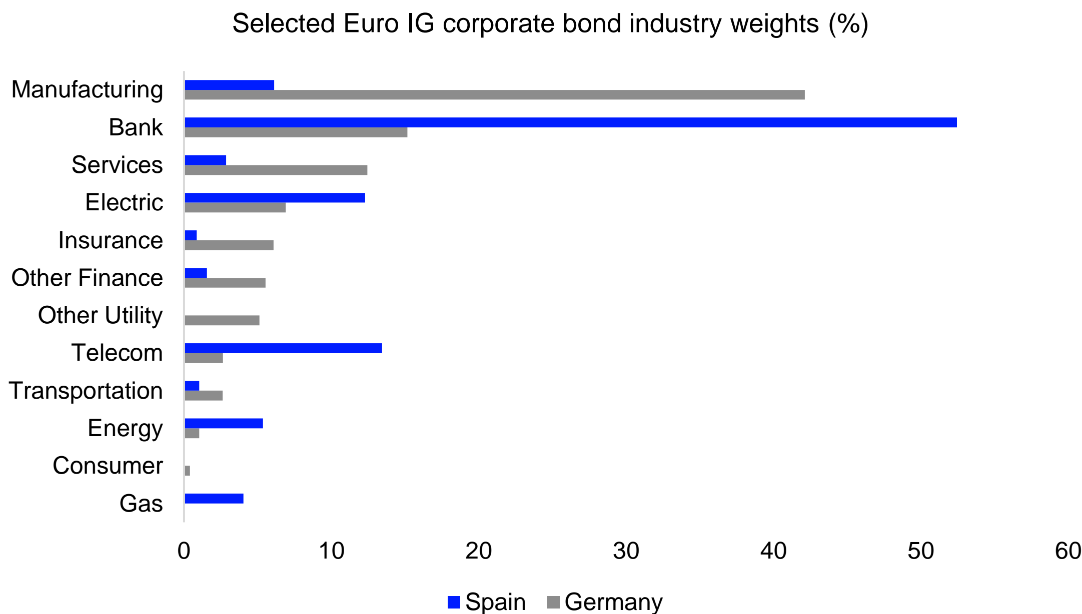
The difference in industry composition helps to explain the variation in returns between Italian, Spanish and German IG corporates. For example, Chart 6 shows that Spanish banks dominate the Spanish IG corporate bond universe with a 52% exposure, as do Italian banks with a 36% weight, compared to Germany's more modest 15% weight in the sector. Electric and Energy are also well represented in the Spanish and Italian IG markets, as they expand their infrastructure and transitions towards renewables.

In Germany, Manufacturing has the highest weight of 42% (compared to 6% in Spain and 2% Italy), reflecting the size of its automotive industry, followed by 15% in Bank and 12% in Services (vs 3% in Spain). Insurance, the best performing industry, represents 6% in Germany compared to a sub-1% weight in Spain.

As a result of these differences in industry composition, Germany has registered a negative/flat return due to Manufacturing and Services, whose 9-10% returns respectively were below the universe's average 10%+ returns. Its higher exposure to Insurance also helped performance. Spain and Italy's IG corporate bond performance was held back by their higher Energy weights. However, Telecom is another sector to have held up relatively well (up 12% over 10 years), helping Spanish performance, given its 13% exposure (Chart 6).

But overall, Spanish and Italian IG corporate bonds have outperformed their German equivalents because of their exposure to banks, which dominate their markets and have gained 12%.

Chart 6. Industry differences between Germany vs Spain and Italy IG corporate bond markets

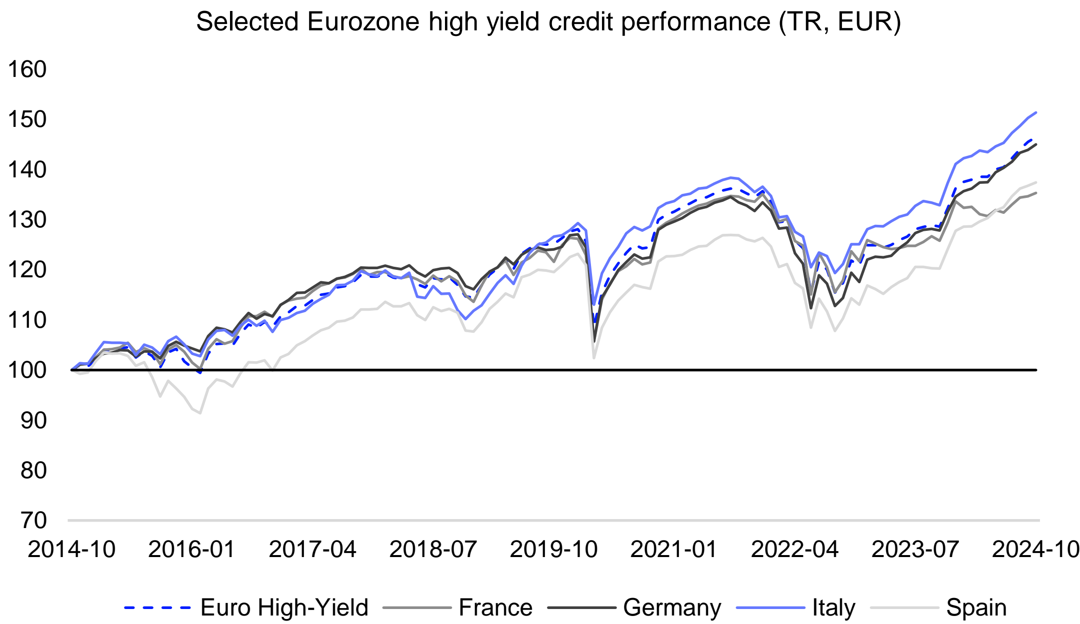


Source: FTSE Russell, LSEG, FTSE EuroBIG Corporate as of October 18, 2024.

A twist for Euro high yield returns

While both Spain and Italy have led the performance in IG bonds over the last 10 years, Euro high yield (HY) credit performance has favoured Italy, but not Spain. As Chart 7 shows, Italian HY credits have gained 51%, while the performance for Germany (+45%) and Spain (+37%) has been lower than the market (46%). Why?

Chart 7. The Netherlands and Italy lead Euro HY credit performance over 10 years

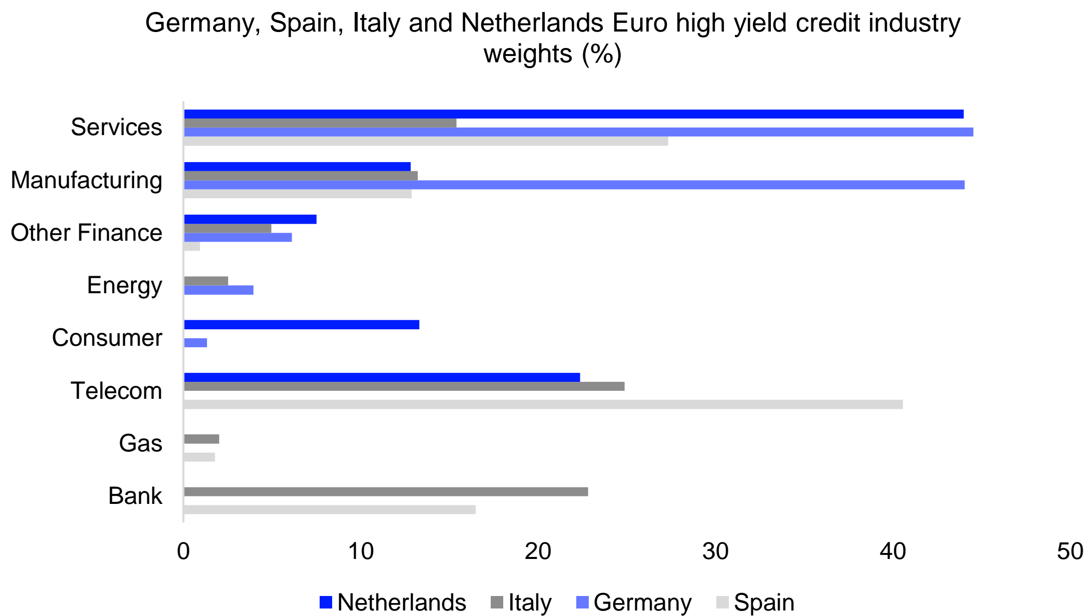


Source: FTSE Russell, LSEG, as of October 31, 2024. Total returns in euros. Past performance is no guarantee to future results.

Lower industry concentration

The main reason for this difference in performance can be found again in the disparity in industry weights. The Euro high yield universe shows Italy has the least industry concentration versus other countries, with the largest sectors, Bank (weight of 23%) and Telecom (25%) representing 48% of the Italian HY market. By contrast, 99% of the German HY market is dominated by Services (45%) and Manufacturing (44%). Telecom (41%) and Service (27%) represent 68% of the Spanish market, and 85% when including banks (17%) (Chart 8).

Chart 8. Italy has the broadest industry representation in the high yield universe

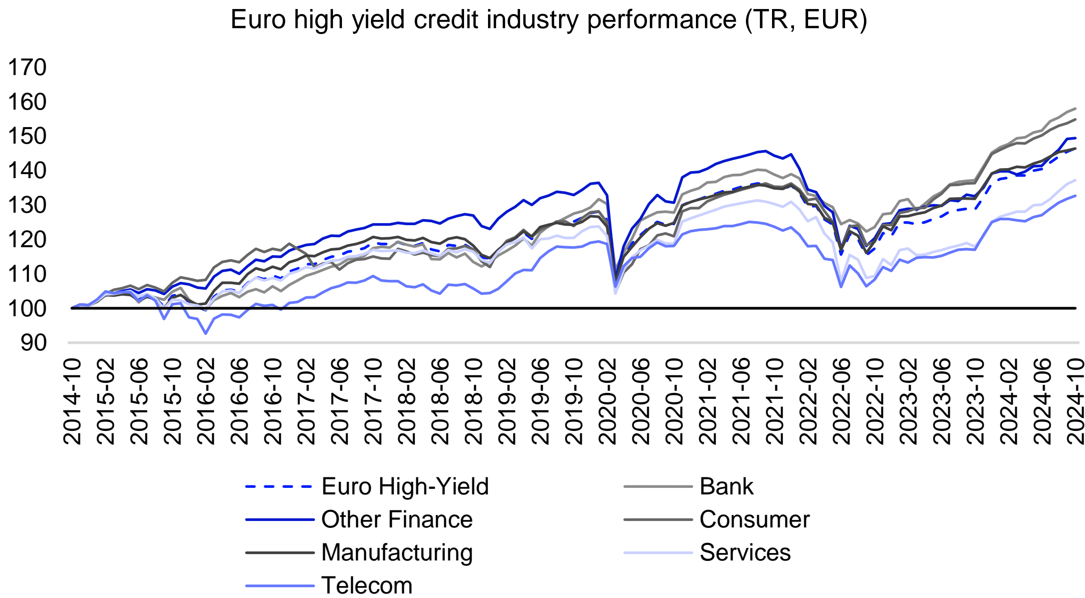


Source: FTSE Russell, LSEG, FTSE Euro High Yield Index as of October 25, 2024.

The overall performance of the Euro HY universe over the last decade shows an average cumulative gain of 46%. The rate sensitive Bank (58% gain) and Other Finance sectors (49%) have outperformed, while the Consumer sector, up by 55%, was also strong. However, returns for Services (37%) and Telecom (33%) were lower than the market.

Consequently, Spain's exposure to the Telecom (41%) and Services (27%) sectors have had a negative contribution on its high yield performance, compared to Italy, which has a lower weight of 25% and 15% respectively in these sectors. In addition, the Italian HY market has benefited from its broader industry composition, with a higher weight in Bank (23%) vs Spain (15%) and in Other Finance (5%) vs Spain (1%). Meanwhile, the German high yield credit market has benefited from its positions in Other Finance and Manufacturing, resulting in a performance in line with the market.

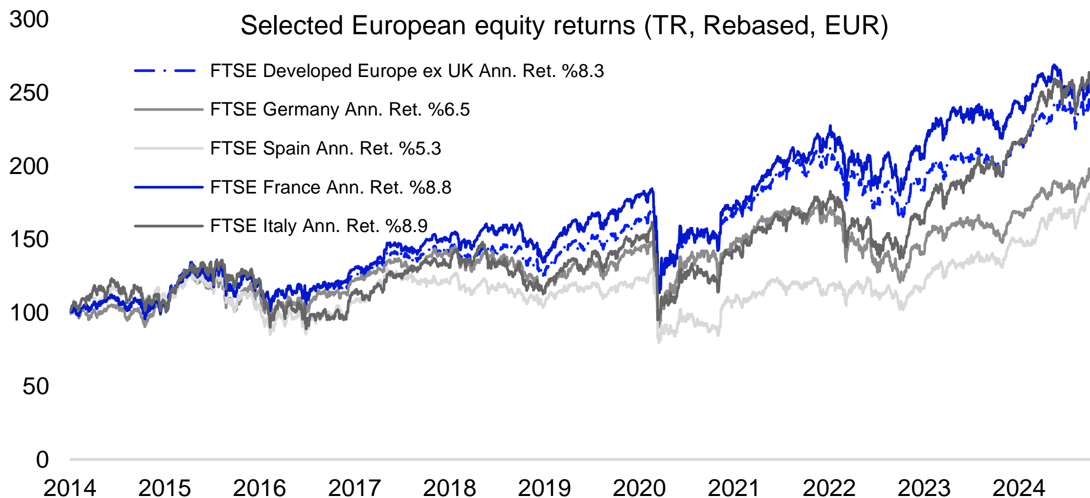
Chart 9. Banks and other finance give the Italian high yield market an edge



Source: FTSE Russell, LSEG, FTSE Euro High Yield Index as of October 31, 2024, total returns in euro terms. Past performance is no guarantee to future results.

Turning to equities, European equity markets have also performed positively since 2014, and with a notable difference between regions. FTSE Italy (8.9% annualised returns) had a notable outperformance compared to other European equity returns (Chart 10). On the other hand, both the FTSE Germany (6.5%) and FTSE Spain (5.2%) have underperformed the overall European equity markets.

Chart 10. Equity leadership is similar to Euro high yield



*Annualised Return calculated between 2014 January to 2024 October.

Source: FTSE Russell, LSEG, FTSE All-World Index Series as of October 31, 2024, total returns in euro terms. Past performance is no guarantee to future results.

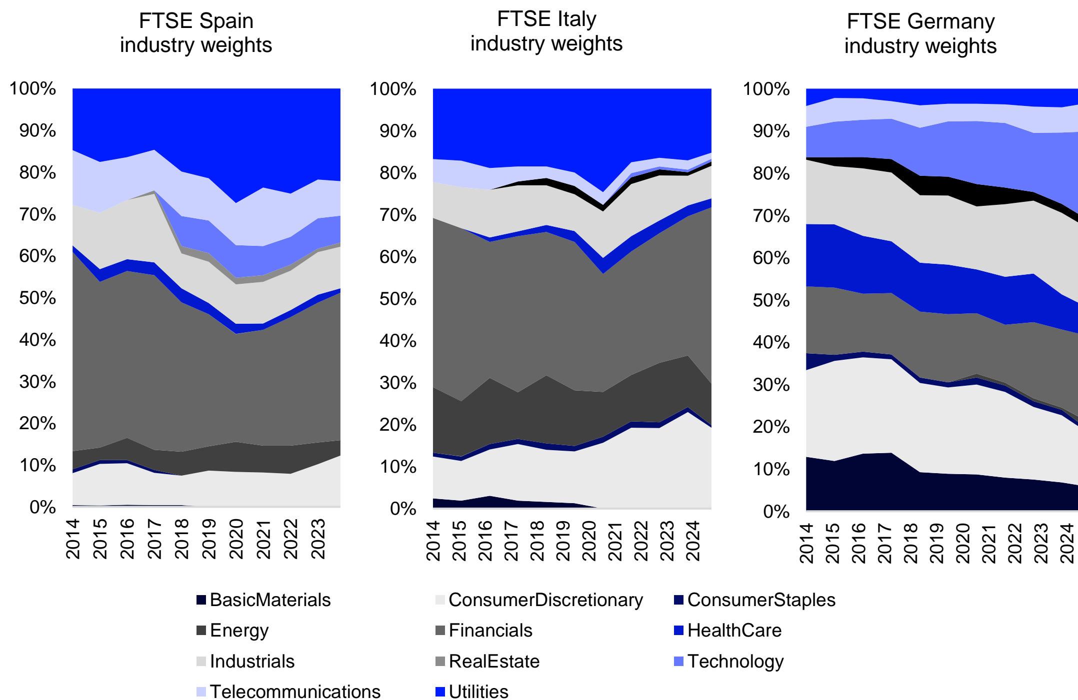
Italy, Spain vs German equity industry weights

A key driver of performance differences between country indices lies in their varying industry compositions. Chart 11 illustrates the evolution of industry weights for FTSE Italy, FTSE Spain and FTSE Germany over the past decade, offering insights into their structural distinctions.

The first striking distinction lies in the degree of industry concentration. Take FTSE Spain, for instance: as of October 2024, the index is heavily skewed toward Financials (35%) and Utilities (22%), which together comprise over 57% of its total weight. A similar pattern emerges in FTSE Italy, where Financials (42%) and Utilities (15%) likewise dominate, collectively accounting for more than 57% of the index. In contrast, FTSE Germany displays greater diversification, with Technology (20%) and Financials (20%) comprising 40% of the total index.

The second notable trend is the rising prominence of technology in FTSE Spain and, more strikingly, in FTSE Germany, though not in FTSE Italy. Over the past decade, the technology sector's weight in FTSE Germany has increased from 7% to 20%, underscoring the nation's increased focus on innovation. FTSE Spain has also embraced the sector, with technology accounting for over 6% of the index. In contrast, FTSE Italy lags significantly, with tech representing less than 1% of its weight. This divergence highlights this uneven distribution of technology's influence across countries, reflecting its growing role in shaping regional and global investment narratives.

Chart 11. FTSE Germany has a more diversified industry exposure vs FTSE Spain and FTSE Italy



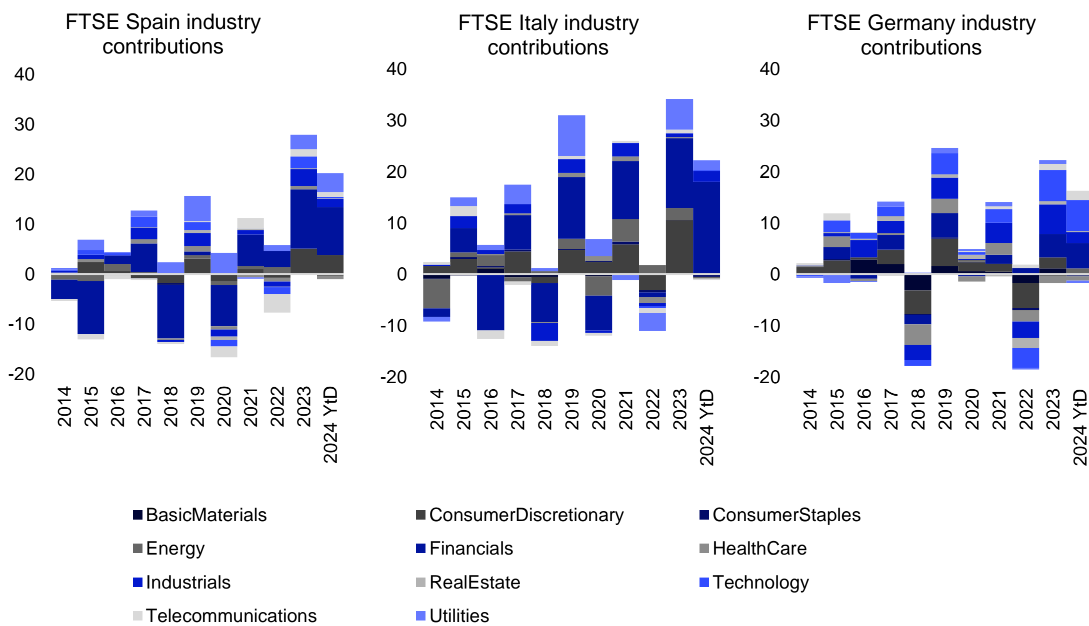
Source: FTSE Russell, LSEG, FTSE All-World Index Series, Industry weights January 2014 to October 2024.

FTSE German equity sector has a broad spectrum of growth drivers

With its higher weight and growing influence, the technology industry has undeniably been a significant driver of performance within the FTSE Germany but it is by no means the sole contributor. Over the past decade, other sectors such as Financials, Industrials, and Consumer Discretionary have also played pivotal roles in bolstering the overall market. As Chart 12 shows, these industries have collectively contributed to the performance of FTSE Germany, reflecting a diversified economic base and a broad spectrum of growth drivers.

In contrast, FTSE Italy and FTSE Spain present a markedly different narrative in terms of industrial contributions. These two indices' higher industry concentration means that Financials have been the dominant force, driving most of the returns and underpinning the index's performance. This influence has been so pronounced that it has overshadowed other industries. Nonetheless, Utilities, and Industrials, while smaller in comparison, have also made notable contributions to index performance. Another important point to note is the higher contribution from Financials to FTSE Italy, compared to FTSE Spain, which mostly explains the overall outperformance of FTSE Italy (Chart 12).

Chart 12. Financials dominate Spanish and Italian equity contributions



Source: FTSE Russell, LSEG, FTSE All-World Index Series as of October 31, 2024, total returns in euro terms. Past performance is no guarantee to future results.

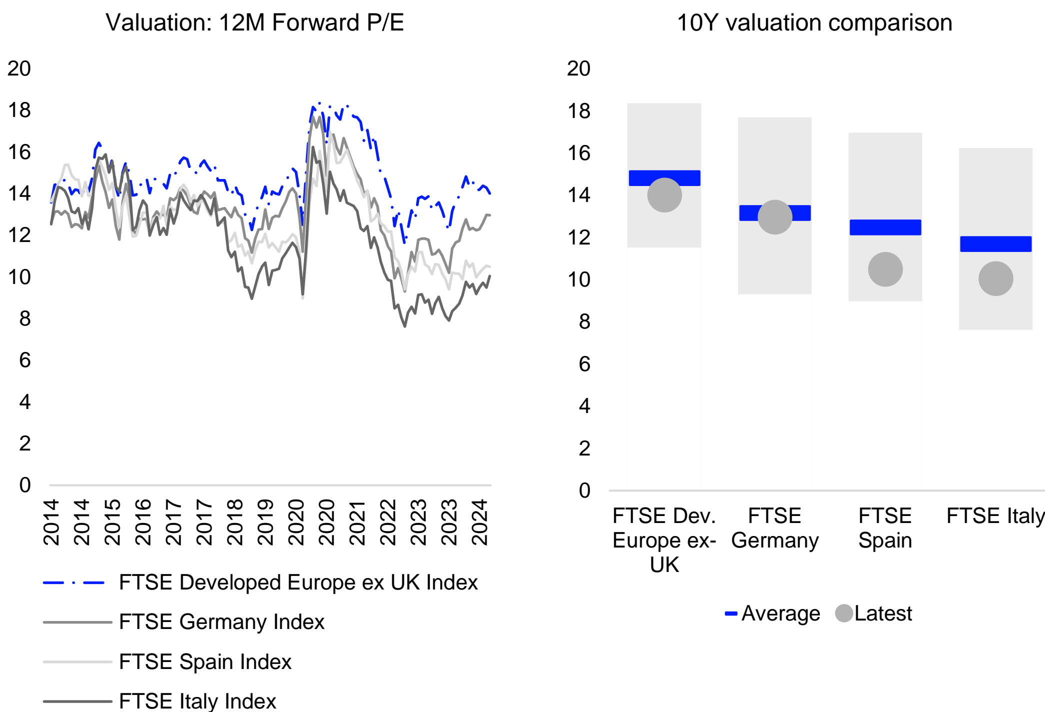
The divergence in industrial contributions between FTSE Spain, FTSE Italy and FTSE Germany underscores the varied economic landscapes and sectoral strengths of these markets. FTSE Germany's performance is characterised by a more balanced contribution across multiple industries, highlighting the importance of sectoral diversity. On the other hand, FTSE Italy and FTSE Spain's reliance on the financial sector illustrates a more concentrated source of return, with other sectors playing supportive yet significant roles in the equity market.

Valuation and market concentration

Over the past decade, the valuations of FTSE Spain, FTSE Italy and FTSE Germany have consistently lagged the broader FTSE Developed Europe ex UK market. This trend has been a persistent feature of the European equity landscape, reflecting underlying economic and sectoral dynamics within these markets. However, recent developments have introduced a notable shift in this pattern, particularly concerning Germany.

As illustrated in Chart 13, the valuation of FTSE Germany has experienced an upward adjustment recently. This change is mostly attributed to the robust performance of the technology sector, bringing the FTSE Germany's 12M forward P/E ratio closer to its historical averages. On the other hand, compared to its historical averages, FTSE Italy and FTSE Spain are currently valued at a lower 12M Forward P/E ratio relative to Germany.

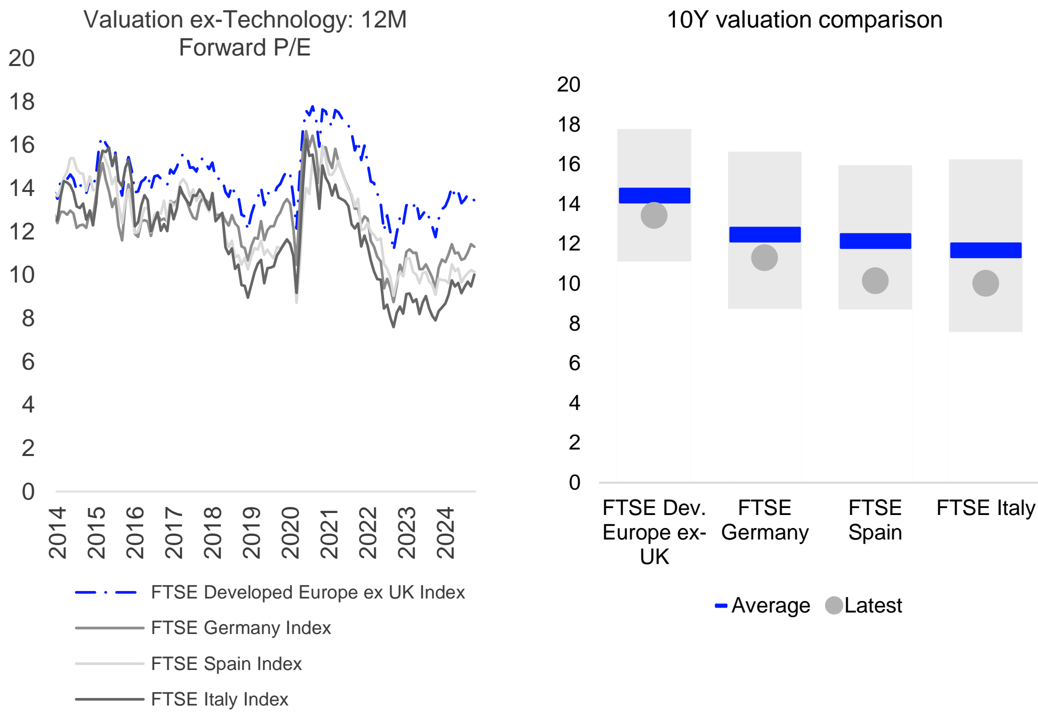
Chart 13: Industry weights matter for valuations



Source: FTSE Russell, LSEG, FTSE All-World Index Series as of October 31, 2024. Past performance is no guarantee to future results.

A more nuanced picture emerges when the Technology industry is excluded from the analysis. Stripping out the contributions of technology reveals that the valuation of FTSE Germany converges closely with that of FTSE Spain and Italy (Chart 14). This convergence underscores the pivotal role that sectoral composition plays in shaping market valuations and highlights the importance of considering industry-specific factors when evaluating index performance.

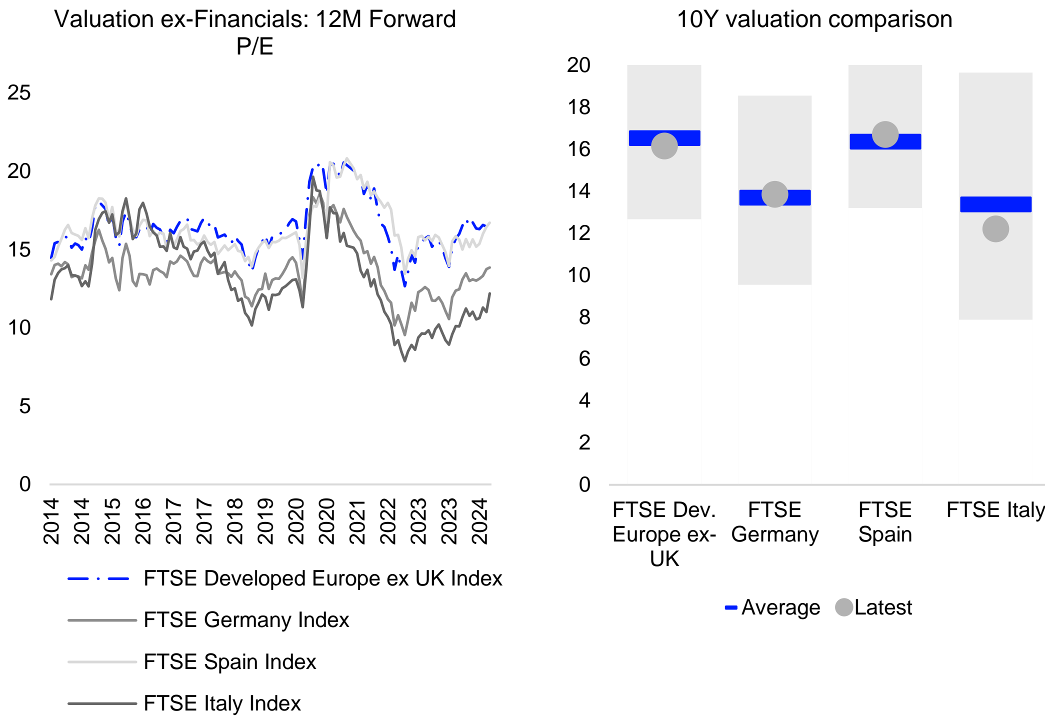
Chart 14. Ex Technology, German equity valuation is lower than its 10 year average



Source: FTSE Russell, LSEG, FTSE All-World Index Series as of October 31, 2024. Past performance is no guarantee to future results.

A comparable analysis can be conducted for FTSE Spain and FTSE Italy by stripping out Financials, given their substantial weight. As Chart 15 illustrates, excluding Financials aligns FTSE Spain's valuation with its 10-year average, while FTSE Italy's valuation moves closer to the historical norm, though it remains below the decade-long trend. Across countries, FTSE Spain emerges with a higher valuation than FTSE Germany or FTSE Italy once Financials are removed from the equation.

Chart 15. Ex Financials, Valuations are in line with 10 year averages for Germany, Spain and slightly lower for Italy



Source: FTSE Russell, LSEG, FTSE All-World Index Series as of October 31, 2024. Past performance is no guarantee to future results.

Conclusion

Overall, this paper provides valuable insights into the structural differences and investment opportunities within European markets. It also highlights the significant fiscal boost to the Euro area economy from the RRF funding, underpinning the recovery in the region's financial markets. However, the impact on financial markets and the economy shows divergences between EU nations, with the size of the RRF allocation and financial market composition being significant factors.

Both Spain and Italy, as some of the largest NGEU recipients and among Europe's largest economies, have seen a significant recovery in their financial market performance since 2022. Italy has led the outperformance in both equity and fixed income markets over the 10-year period, while strong gains were only evidenced in Spain's investment grade fixed income market, due to its large exposure to Financial issuers. The performance of Spain's high yield credit and equities has been held back by its industry composition and concentration to underperforming Telecom and Services, and a low relative exposure to Technology.

Germany's financial market performance has been more closely aligned to its weak economy and underperforming markets, than say Italy, whose economy has also been weak, but the broader composition of its financial market and emphasis on rate sensitive sectors have been a greater benefit compared to Spain and Germany.

Equity valuations are better in Spain, especially if taking out financials from the calculation, in line with its stronger growth prospects.

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