

Interest Rate Strategy

EGB spreads: market left alone

The market is on its own: on the one hand, monetary policy can only play catch-up with inflation, without achieving its full effect since the rise in prices is mainly due to the energy price shock; on the other hand, fiscal policy is constrained at national level by the severe debt situation and the rising cost of borrowing, and at European level by the loss of support for a shared financing plan to cover the enormous expenditure required. In this sense, the political risk to eurozone spreads will not be merely a national issue but increasingly a European one as well.

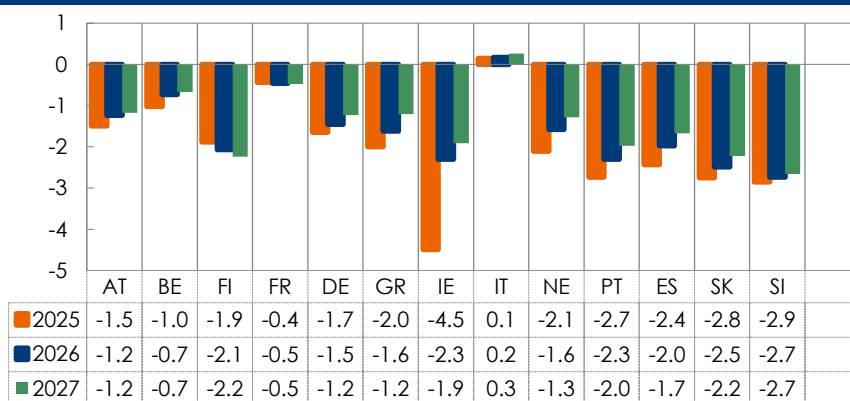
In the absence of further steps towards greater risk-sharing at European level, debt sustainability therefore once again depends primarily on national budgets, increasing the sensitivity of spreads to the fiscal and political dynamics of individual countries.

Recent market developments suggest that sovereign risk premiums are becoming increasingly sensitive not only to the environment of higher interest rates, but also to political and fiscal considerations. Whilst initially the OAT-Bund and BTP-Bund spreads reacted only moderately to the rise in rates, the markets are now once again pricing in the political risks and sustainability concerns surrounding fiscal trajectories.

Rising yields and fiscal risk

The chart below shows the trend in the 'r-g' variable based on IMF forecasts and calculated as a 5-year forward moving average (i.e. the 2027 figure is the average for the years 2027–2031), so as to represent a medium-term scenario that is most likely to influence market dynamics. In general, the main message of the chart is that the Eurozone will continue to benefit from an environment in which the r-g spread remains negative in almost all countries, despite several years of high official interest rates. This suggests that the average cost of debt will continue to rise more slowly than nominal economic growth, thereby continuing to have a favourable impact on public debt dynamics. However, the aggregate figure masks significant differences amongst the major sovereign issuers – differences which are likely to be more important to the market than the absolute level of debt.

'r-g' variable (5-year forward moving average based on IMF forecasts, %)



Source: International Monetary Fund, Intesa Sanpaolo

Germany maintains a moderately negative r-g (-1.2 per cent in 2027), confirming a structurally sustainable debt trajectory despite rising public expenditure requirements and funding needs linked to defence and investment. Spain ranks among the countries that benefit most from the macroeconomic environment, with an r-g that remains significantly negative (-1.7 per cent in

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2027). The combination of relatively high nominal growth, a more favourable demographic trend compared with other core countries and an average cost of debt that remains contained continues to generate an automatic reduction in the debt-to-GDP ratio. This provides an important anchor for Bonos-Bund spreads, particularly during a phase of gradual monetary policy tightening.

The situation in France is more complex. Although the spread remains negative (-0.4/-0.5%), the safety margin appears much narrower than that of other major peripheral issuers. In practice, the support derived from nominal growth exceeding the cost of debt is almost exhausted. With deficits still high and a fiscal consolidation path that lacks credibility, the dynamics of French debt are becoming increasingly sensitive to the primary surplus required for stabilisation. For the market, this means a growing correlation between spreads and the perceived risk to sustainability. Italy, on the other hand, represents the most delicate case from a structural perspective. The shift in the r-g ratio into slightly positive territory (+0.2 per cent in 2027) implies that the contribution of nominal growth to debt reduction is essentially nil, and stabilising the debt-to-GDP ratio therefore requires high primary surpluses, given the current level of debt as a percentage of GDP. Although the positive figure is very modest and does not signal any imminent strain, it indicates that Italy will be the first major issuer to emerge from the exceptionally favourable conditions that have characterised the post-pandemic years.

For the government bond market, the comparison between Italy and France is particularly interesting. France has lower debt but a more deteriorated fiscal trajectory; Italy, by contrast, has a relatively more disciplined fiscal position but a less favourable r-g. Consequently, the traditional distinction between French 'fiscal' risk and Italian 'debt stock' risk could become less clear-cut in the coming years, increasing the sensitivity of both spreads to sustainability issues as well as to the 2027 elections.

From a strategic perspective, the message from the analysis of the r-g variable is that the main driver of the narrowing of peripheral spreads will no longer be the r-g differential – which is tending to converge towards zero – but rather the ability of governments to maintain credible deficit reduction paths. In an environment where real interest rates are structurally higher than in the pre-Covid decade, fiscal discipline will gradually return to being the dominant driver of relative performance between BTPs, OATs, Bonos and Bunds.

Political risk is shifting to the European level

Investors' attention will increasingly turn to the 2027 election cycle, which will see three of the eurozone's major countries – France, Italy and Spain – holding elections simultaneously. Beyond the domestic implications for public finances, the markets are beginning to assess the risk that the rise of extremist and Eurosceptic parties could alter the political balance in Europe and erode support for greater fiscal integration. The fear is that a more fragmented political landscape will make it more difficult to implement common budgetary initiatives and risk-sharing mechanisms, which in recent years have been a key element in managing economic shocks and financing the Union's strategic investments.

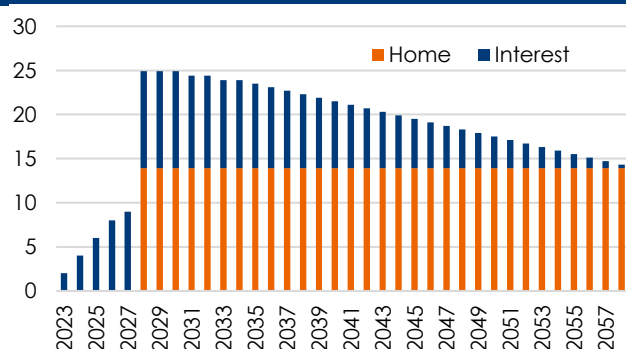
Recent electoral developments in Germany have already highlighted these tensions. The Merz government has adopted a more cautious stance towards the proposed Multiannual Financial Framework, reinforcing market fears that future EU-level spending initiatives may face greater political resistance. This is particularly relevant at a time when Europe is facing significant funding needs linked to defence, the energy transition, industrial policy and infrastructure investment.

The European Commission has framed the negotiations on the 2028–2034 multiannual financial framework (MFF) on the basis that an increasing share of European resources should be allocated

to European public goods: defence, security, industrial competitiveness, energy infrastructure, innovation, technology and support for Ukraine. The rationale is that these are areas where national spending is less efficient than a coordinated European response. At the same time, the Commission proposes to increase the EU's own resources and to maintain the capacity to issue debt to finance European lending programmes, utilising the infrastructure built under NextGenerationEU. The MFF proposal provides for new European funding activities linked to loans to Member States and external programmes such as support for Ukraine.

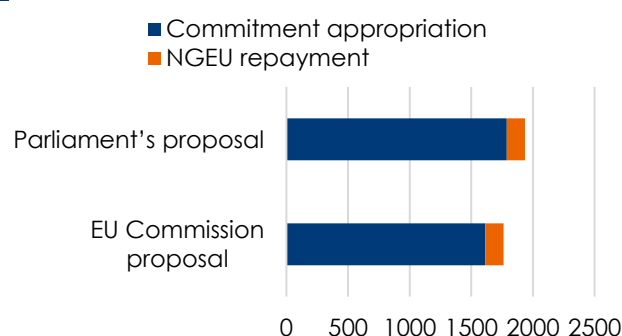
In the debate on the 2028–2034 EU budget, the cost of repaying the debt incurred under Next Generation EU (NGEU) is emerging as one of the main factors putting pressure on European accounts. The European Commission has estimated that the cost of servicing NGEU debt in the next multiannual financial framework will amount to €149.3 billion, equivalent to 0.11 per cent of the EU's gross national income. Precisely to prevent these costs from squeezing the resources available for other European policies, the European Parliament proposes keeping expenditure on debt repayments and interest outside the budget ceilings, thereby safeguarding funding for priority areas such as cohesion, agriculture, competitiveness and defence. The Parliament also reiterates the need to introduce new EU own resources, which are considered essential for sustainably financing the NGEU debt service without increasing the burden on national budgets or reducing the Union's investment capacity.

NGEU grants: annual capital repayments and interest payments borne by the EU under a fixed-share scenario (EUR billion)



Source: European Parliament BUDG Committee, Intesa Sanpaolo

Comparison of the Commission's and Parliament's positions on the MFF 2028–2034 (EUR billion)



Source: European Parliament BUDG Committee, Intesa Sanpaolo

In recent months, German Chancellor Merz has led the so-called 'frugal' countries (Germany, the Netherlands, Austria, Finland, Denmark and Sweden), opposing both an increase in the EU budget and any move towards permanent debt mutualisation. The prospect of reduced budgetary capacity at EU level inevitably shifts a greater share of future spending requirements onto national budgets. For highly indebted countries such as France and Italy, this heightens concerns regarding medium-term debt dynamics. In a context where nominal interest rates – and, above all, real interest rates – remain significantly above the levels prevailing during the QE era, governments are gradually refinancing maturing debt at substantially higher costs. This increases debt servicing costs, reduces fiscal flexibility and makes debt trajectories more sensitive to slower growth or weaker fiscal outcomes.

From a market perspective, this represents a structural shift in the sovereign spread regime. During the period characterised by the ECB's abundant liquidity and negative rates, fiscal fundamentals played a secondary role in the formation of risk premiums. Today, however, the context is profoundly different: the reduction of the ECB's balance sheet through *quantitative tightening* continues to increase the amount of debt that the private sector must absorb, exerting upward pressure on yields and the *term premium*. At the same time, the process of European fiscal

integration appears to have stalled, with limited progress towards permanent common financing instruments and reduced political willingness to share risks. In the absence of a further strengthening of European fiscal capacity, the burden of adjustment falls mainly on national budgets. In this context, any perception of weaker fiscal discipline, political instability or a reduction in European solidarity could more quickly lead to a widening of spreads, particularly at the longer end of the curve, where investors are most exposed to the risk of a persistent build-up of public debt and a regime of structurally higher yields.

Wider spreads, but no signs of systemic stress for the ECB

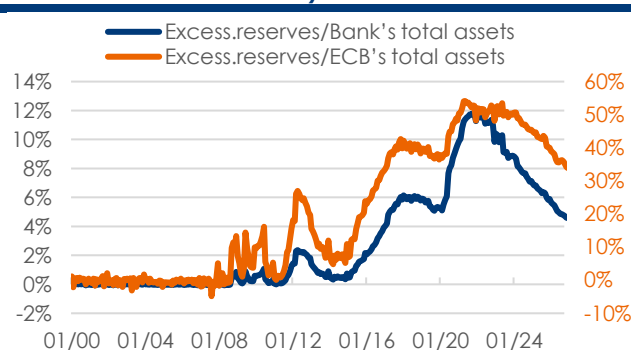
In addition to the rise in ECB rates, which continues to exert pressure on government bond yields through the gradual pass-through of tighter financial conditions to the cost of public debt, *quantitative tightening* represents a further source of vulnerability for the European sovereign market. The reduction in the ECB's balance sheet continues to increase the volume of government bonds that must be absorbed by private investors, at a time characterised by high borrowing requirements and a growing net supply of debt. According to data already released by the ECB, maturing government bonds in its portfolios amount to around €50 billion between now and the end of the year and €310 billion in 2027 (see table with our estimates by issuer).

Maturities of government bonds in the ECB's portfolios (EUR billion)

	APP	2024 PEPP	Total rollover	APP	2027 PEPP	Total rollover
AT	5	5	10	5	4	9
BE	7	6	13	6	5	11
CY	0	0	1	0	0	1
DE	49	42	91	46	36	83
EE	1	0	1	0	0	1
ES	22	19	41	21	16	37
FI	3	3	6	3	3	6
FR	38	32	70	36	28	64
IE	3	3	6	3	2	5
IT	32	27	59	30	23	53
LT	1	1	2	1	1	2
LU	1	1	1	1	0	1
LV	1	1	1	1	1	1
MT	0	0	0	0	0	0
NL	11	9	20	10	8	18
PT	4	4	8	4	3	7
SI	1	1	2	1	1	2
SK	2	2	4	2	2	4
GR	0	4	4	0	3	3
Eurozone	182	159	341	171	138	309

Source: ECB, Bloomberg, Intesa Sanpaolo

Excess liquidity below pre-Covid levels by year-end (ISP forecasts from October 2026)



Source: Bloomberg, Intesa Sanpaolo

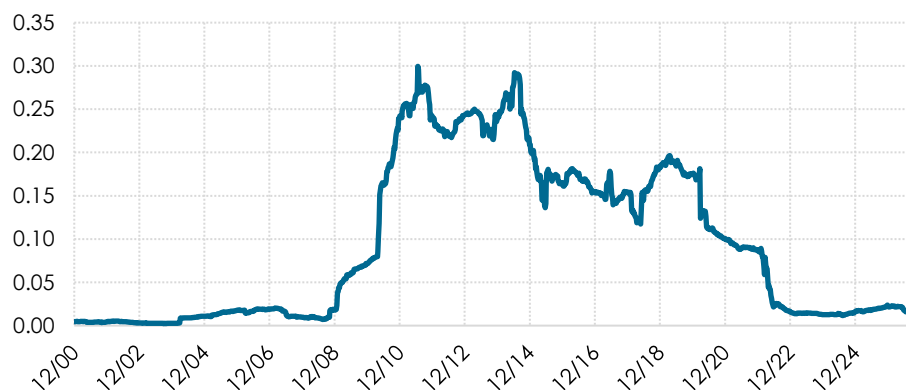
The reduction in the ECB's balance sheet will therefore be significant, with the banking system's excess reserves – *all other things being equal* – falling to 30 per cent of the ECB's balance sheet, below the pre-Covid level of 38 per cent and close to the average levels seen in 2016 (chart). However, despite this unfavourable picture, our financial fragmentation indicator¹ still shows only a moderate increase compared with the exceptionally low levels observed in recent years. Yield trends continue to reflect predominantly common macroeconomic factors and the repricing of interest rate risk, rather than a significant divergence in financing conditions across euro area countries. The indicator remains, in fact, far from the levels historically associated with episodes of systemic stress and does not currently signal any impairment of monetary policy transmission. In the absence of a marked deterioration in the European fiscal or political landscape, there are therefore no conditions that would make it likely for the ECB to intervene using its anti-fragmentation tools.

Quantitative tightening (QT) and the absence of central bank support are not in themselves new developments for the markets, but the difference compared with previous years is that QT now

¹ Interest Rate Strategy, C. Manenti, "Euro government bonds and the risk of fragmentation", 7 April 2026

takes place against a backdrop of higher yields, greater sensitivity to fiscal sustainability and less scope for spread compression. Consequently, a factor that has so far been largely absorbed by the market now risks becoming a more visible source of pressure on sovereign spreads.

Eurozone government bond market fragmentation indicator (%)



Note: proportion of variance explained by the second principal component of benchmark 10-year yields, calculated using PCA on a 24-month moving window – Source: Bloomberg, Intesa Sanpaolo

Conclusion: the risk to spreads is increasingly European

Although the euro government bond market has experienced a significant sell-off, it has shown no signs of systemic fragmentation; however, the environment in which we find ourselves has changed structurally compared with previous years.

Quantitative tightening continues to increase the supply of debt to be absorbed, whilst the convergence of the *r-g* variable towards zero reduces one of the main factors that have favoured the compression of spreads in recent years. We believe, however, that the main risk factor is linked not so much to domestic political dynamics – although these are significant in the run-up to the French elections and possible developments in the Italian political landscape – but rather to uncertainty over the evolution of the European fiscal architecture. Negotiations on the 2028–2034 EU budget, the debate on the financing of European public goods and differences among Member States regarding the use of new common debt could, in fact, have a direct impact on the risk premium demanded by investors. Any deadlock on these issues would risk increasing the risk premium demanded by investors, particularly for highly indebted issuers.

The market is in a dilemma: on the one hand, monetary policy can only play catch-up with inflation, without achieving its full effect since the rise in prices is mainly due to the energy price shock; on the other hand, fiscal policy is constrained at national level by the severe debt situation and the rising cost of debt itself, and at European level by the loss of support for a plan to share the financing of the enormous expenditure to be incurred. In this sense, the political risk to eurozone spreads will not be merely a national issue but increasingly a European one as well.

Appendix

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