

What can upset spreads: lingering levels with uncertain fiscal policies and political risk

Persistent expansion of government expenditure and public debt establishes the foundations for economic stagnation and the gradual erosion of living standards. Fiscal deficits are not a sustainable engine of growth; rather, they often signal the misallocation of resources and the postponement of necessary structural reforms. Rising sovereign indebtedness dampens productivity growth and fuels inflation, especially when fiscal authorities become reliant on continuous debt issuance irrespective of the business cycle and monetary conditions. There are plenty of examples in the recent past.

Periods of mild economic expansion are constrained by widening budget deficits, rising tax pressures, and proliferating regulatory burdens. Unsound public accounts crowd out private investment by absorbing available capital and channeling it into often unproductive government processes. This process enlarges the bureaucratic apparatus, weakens incentives for innovation, and fosters persistent inflationary dynamics. Ultimately, the outcome is slower growth, diminished competitiveness, and declining real income.

The rise in gold prices and the strong upward momentum reflect growing investors distrust in the ability to achieve debt sustainability through expenditure-side fiscal consolidation over the medium to long term. Central Banks appear to share similar concerns (gold has surpassed the euro to become the second largest global reserve asset). Recent developments and fiscal uncertainties suggest that ongoing political instability continues to cloud the outlook for credible consolidation strategies. Gold's rise has occurred largely independently of broader market movements, standing out amid subdued fluctuations in other asset classes.

Long term yields rose across most advanced economies despite Central Banks rate cuts.

So far in 2025, political and fiscal risks in certain European countries and in the UK have been offset by overall market strength. This resilience is evident in tight credit spreads across both investment-grade (IG) and high-yield (HY) segments, record-high equity markets, elevated valuations, and generally soft but positive economic data. Contagion risk among European economies has remained virtually absent. Broadly speaking, risk sentiment has stayed firm, with credit yields below historical averages. Issuance has remained robust for high-quality borrowers, while even weak credits have found access to funding—particularly in the leveraged loan market.

The quantity of money available in the financial system has played a key role in shaping conditions in the European credit market. Average credit spreads are likely to remain for some time in the ranges defined by movements in April 2025.

Can we conclude that risky assets have reached a “resilience point,” capable of shrugging off fiscal policy uncertainty and polarized political views? I do not believe so, even if some credit managers argue otherwise. While sentiment may remain relatively stable for investment-grade (IG) assets, the leveraged market is already showing signs of divergence, reflecting shifting perceptions of the future trajectory of fiscal policy.

The current European high-yield market is particularly vulnerable, with its outlook clouded by high interest rates, ongoing trade disputes, and persistent fiscal uncertainty. Leveraged loans are increasingly fragile as investors and CLOs rotate capital toward higher-quality assets amid perceived turmoil in the fiscal arena, weak corporate earnings that strain heavily indebted balance sheets, and stringent tests in structured vehicles that compel the disposal of underperforming and CCC-rated names. Investor withdrawals from fiscally vulnerable countries, where sovereign yields are volatile and elevated, can severely disrupt corporate primary markets and hinder debt-restructuring efforts or refinancings among high-yield issuers with approaching debt maturities.

This is a dynamic I have long observed: in Europe, instability in government debt and negative dynamics in fiscal policies, complicate the price discovery for corporate debt. Sectors traditionally considered risky, such as Retail, Consumer Goods-influenced by consumption and saving rates-, and cyclical industries like Travel, Leisure, and Hospitality, are now in the company of sectors closely linked to public spending, including Healthcare and Infrastructure (the distressed nature of Healthcare sector makes it a novel case over the last 30 years that I observe and trade European credits. As far as the Infrastructure is concerned, we would need to go back to the Great Financial Crisis to find stress levels comparable to those seen today).The current market reflects a cautious approach toward industries whose cash flows suffer from uncertainty regarding the timing and magnitude of payments linked to public administration. It is short-sighted to attempt to remove political and government-specific risk factors from the analysis.

Tail risks in Europe have expanded rather than diminished. This trend can possibly explain the underperformance of many HY French borrowers-very levered, we all agree- embattled in a complex and unprecedented high yield market conditions (the list of the names is long and spans a diverse array of sectors).

The environment French corporates operate is clouded by rising costs (not only energy or commodities but also salaries), weak consumer demand (higher savings as labour market stagnates and real wages growth remains flat), and productivity drag.

Some investors seek approaches demanding elevated yields and high credit spreads, whereas others elect to remain fully uninvested.

Corporate conditions are less benign, and companies cut back on investments; one-to-one meetings with borrowers squeezed by poor sentiment, reduced profitability and low cash in the balance sheets, may help investors who overlook these risks gain a clearer perspective. I recommend engaging directly with corporates rather than relying on sell-side analysts, bookrunners, or financial advisors.

Credit portfolio managers do not approach debt with hostility or anger, yet they remain wary of being blindsided by another mini-budget fiasco in the style of Liz Truss occurred at the end of 2022. Driving a country growth through excessive borrowing makes the economy more prone to crises, shortens expansion phases, and raises the cost of capital for businesses. Questions about policymakers' ability to build consensus on fiscal policy amid deepening political divides result in volatility in government bond yields, eroded confidence, and heightened distress in the corporate sector.

When dealing with highly indebted nations and their corporates, "timing the market can sometimes outperform time in the market". The detrimental economic effects and the deterioration of financial conditions resulting from fiscal policy uncertainty in France were, to some extent, discernible.

IASON Company is successfully advising financial institutions on many market risks and cooperate with the main actors for implementing the most convenient and advantageous policies that fit and exploit market circumstances and volatility.

FOLLOW US!



ESSENTIAL SERVICES FOR
FINANCIAL INSTITUTIONS

