European defence spending and the implications on EGB and SSA markets

‘LITTLE BY LITTLE’, (OASIS, 2002)

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#1

ReArm Europe

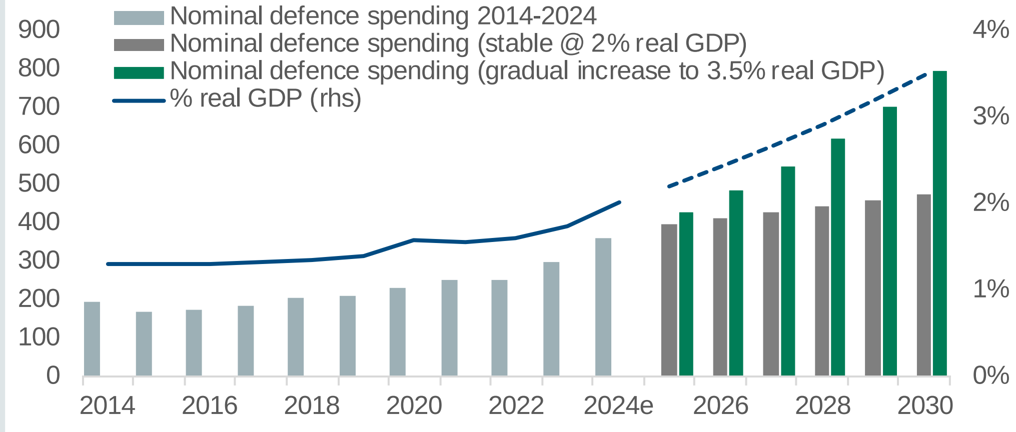
BASICS AND HEADLINE NUMBERS

European politics: defence spending – who, how much and when?

Commission's ReArm Europe plan to increase defence spending

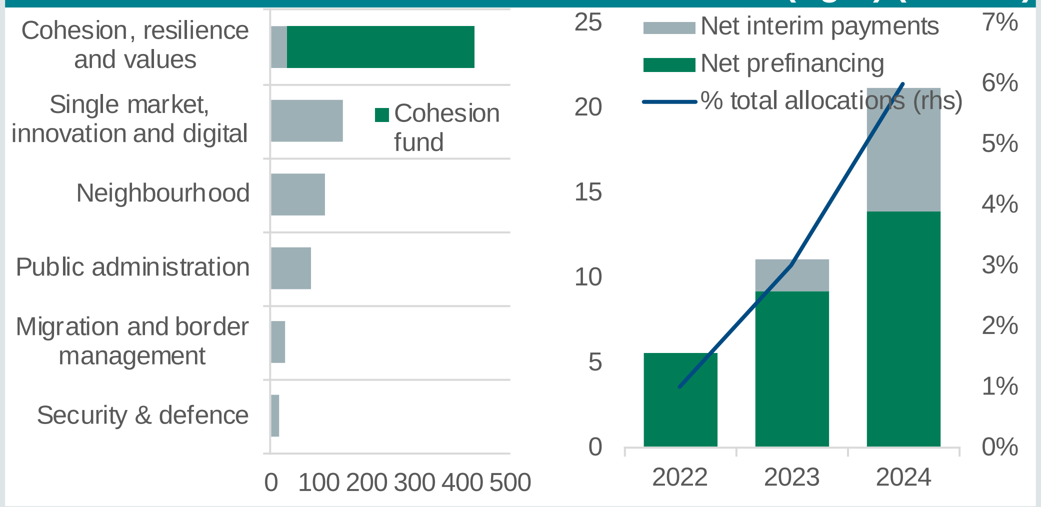
- Donald Trump has put the topic of defence high on the Euro agenda
  - President Trump mentioned before that he would like defence spending to reach 5% of GDP. But around 3.5% – similar to the US – would appear as a more realistic target. Based on 2024 figures, an increase to 3.5% would mean additional needs of EUR200-250bn per year. A scenario that would see defence spending gradually rise to 3.5% of GDP by 2030 would mean c.EUR1trn additional spending over the next five years (2025-30).
- Commission proposes an EUR800bn package based on five proposals
  - The Council endorsed the Commission's proposals with formal agreements on those measures likely to take place at the Council meetings on 20-21 March and 26-27 June.
  - The bulk of the funding (c.EUR650bn) will come from **national budgets** notably thanks to the activation of the **escape clause** to exclude defence spending from their annual deficits.
  - A **new instrument** will be established to provide member states with up to EUR150bn loans backed by the EU budget.
  - Member states will be offered the possibility to **repurpose their current grant allocations under the relevant EU budget** for defence spending.
  - The **EIB** will step up its support to defence while safeguarding its operations and financing capacity. The EIB's Board of Governors will notably re-evaluate the list of excluded activities and "increase the available funding in the field of security and defence".
  - The Commission will also consider measures to further mobilise private financing for the defence industry notably by "signalling to private investors the importance of the defence industry".

Scenario of an increase to 3.5% of real GDP by 2030* vs defence spending remaining at 2% of real GDP (USDbn)



** Figures beyond 2024 based on estimated increase in defence spending relative to real GDP. We used the OECD real GDP long-term forecast and an assumption of 2% inflation to estimate nominal figures.*

Breakdown EU 2021-27 budget in current prices (left) and disbursement of the EU Cohesion funds so far (right) (EURbn)



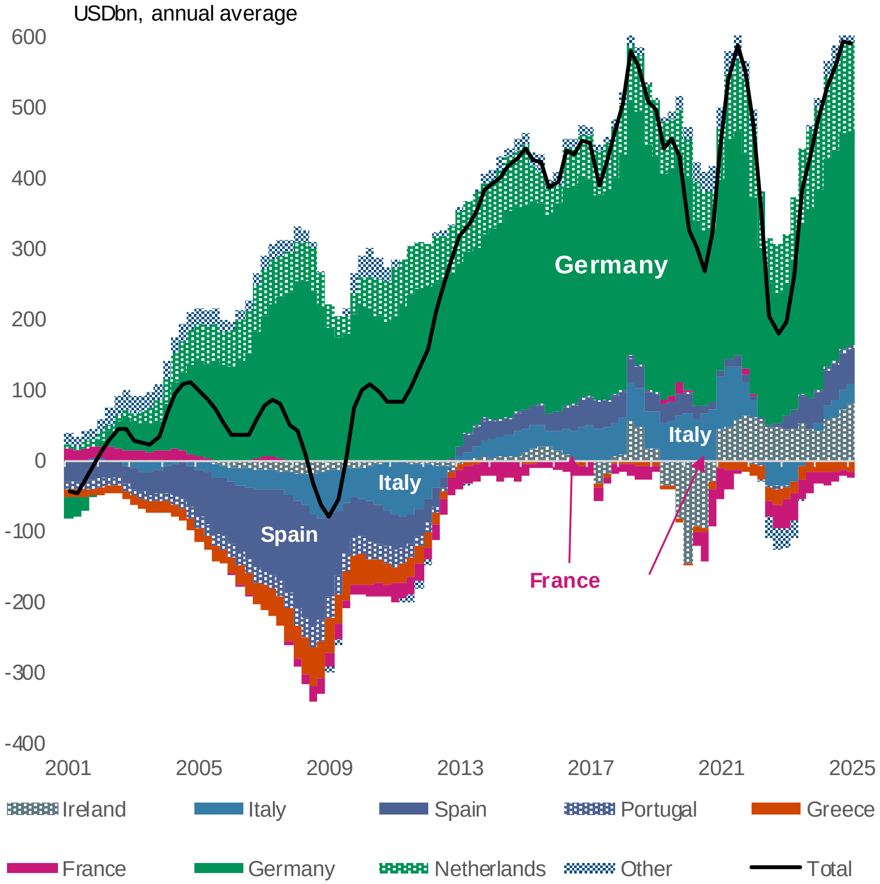
Source all charts: ESM, EIB, Crédit Agricole CIB

#2

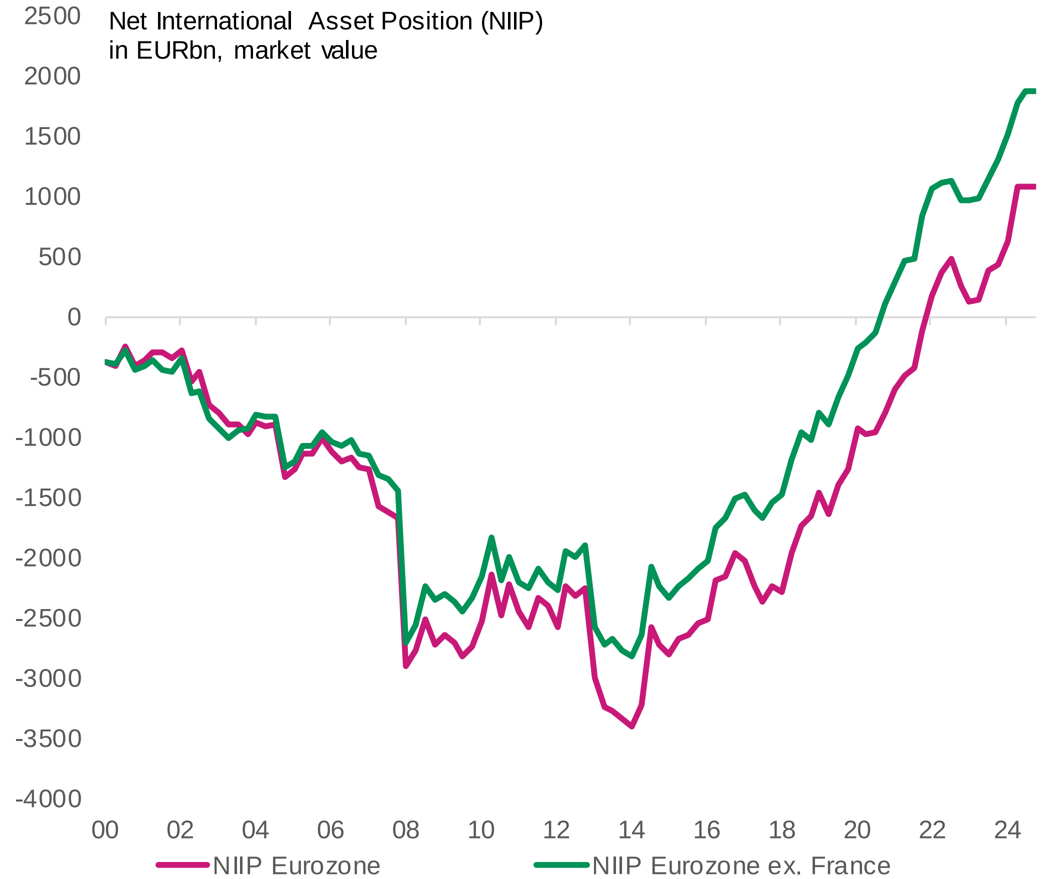
The economics of defence spending for Europe

Investment capacity: a massive amount of wealth following ten years of excess savings

Almost USD600bn of current account surplus per year now

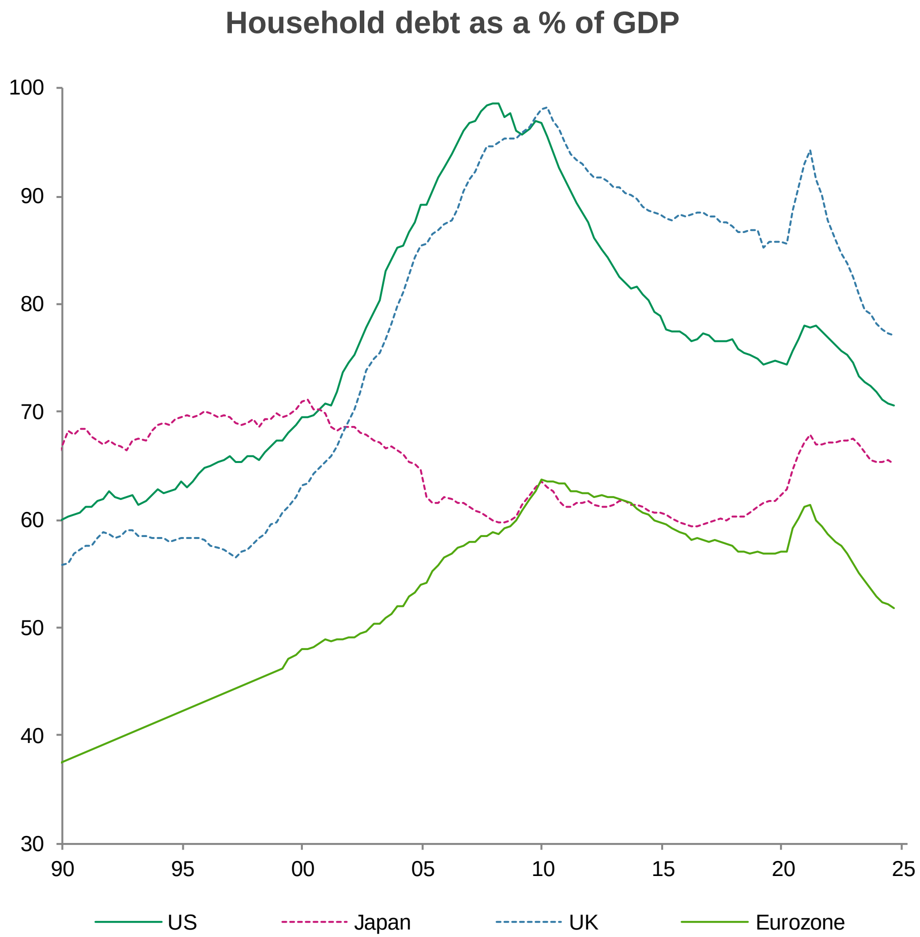


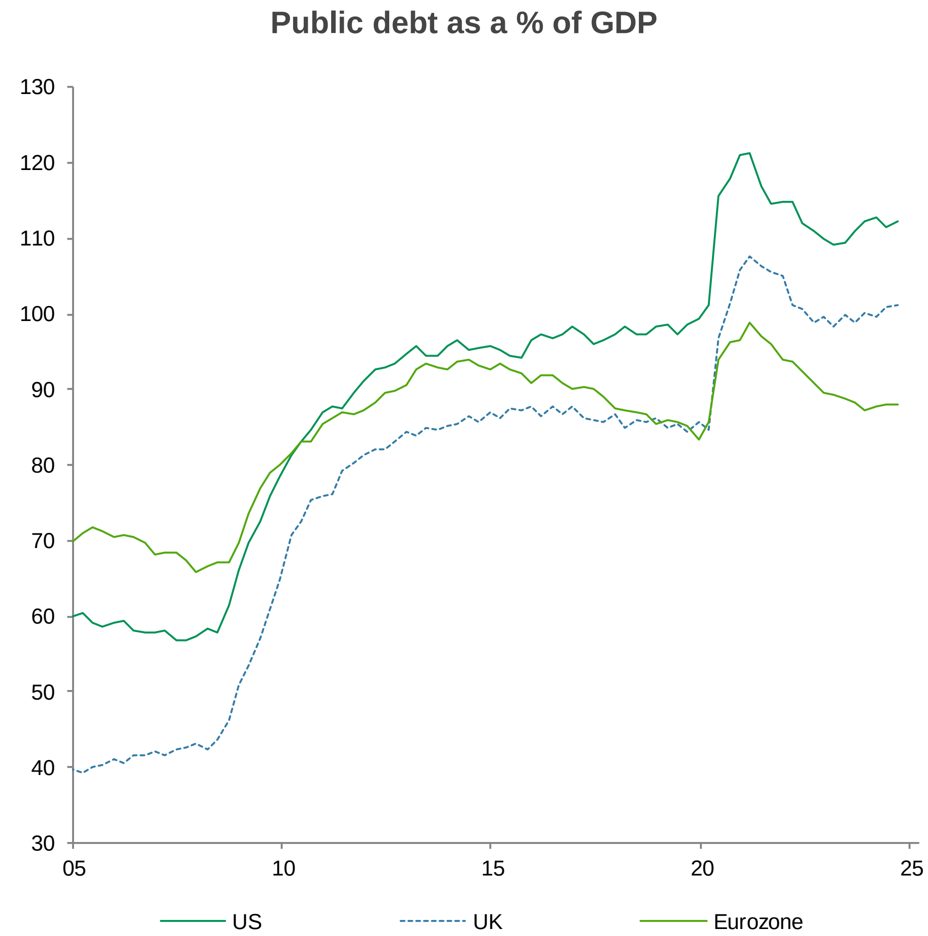
Net wealth over the rest of the world almost EUR6trn higher than 10 years ago



Source all charts: BIS, IMF, Bloomberg, Crédit Agricole CIB

Leverage capacity: following ten years of deleveraging

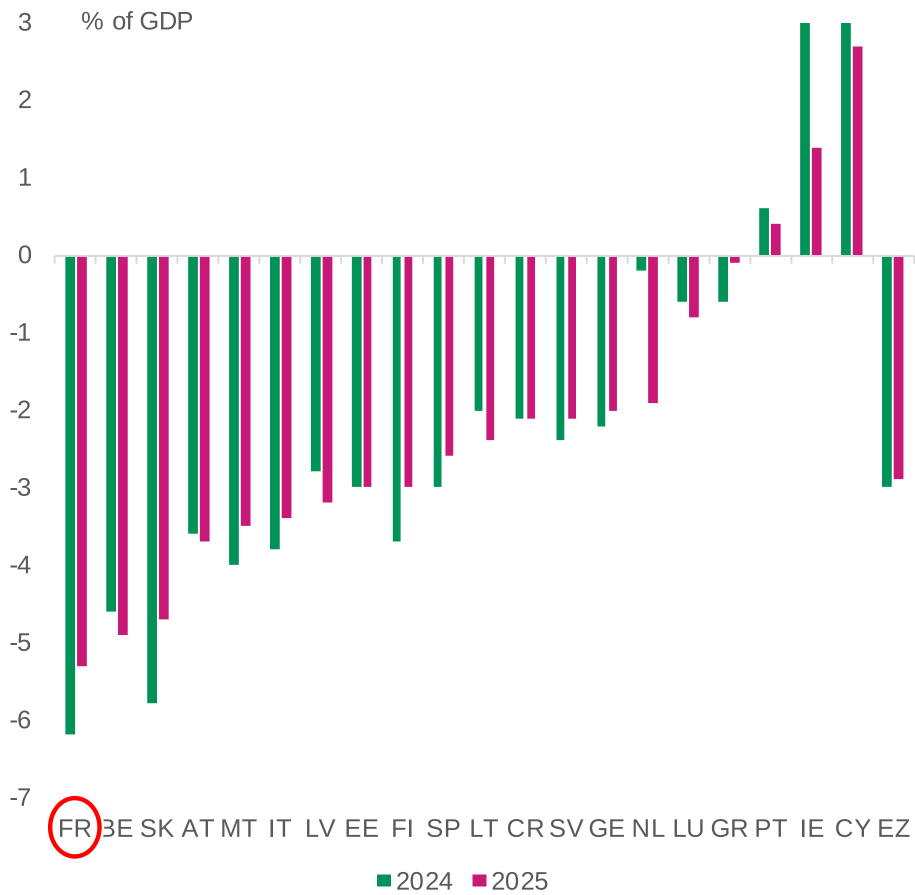




Source all charts: BIS, Bloomberg, Crédit Agricole CIB

Public finances: diverging positions under the surface

General government balance

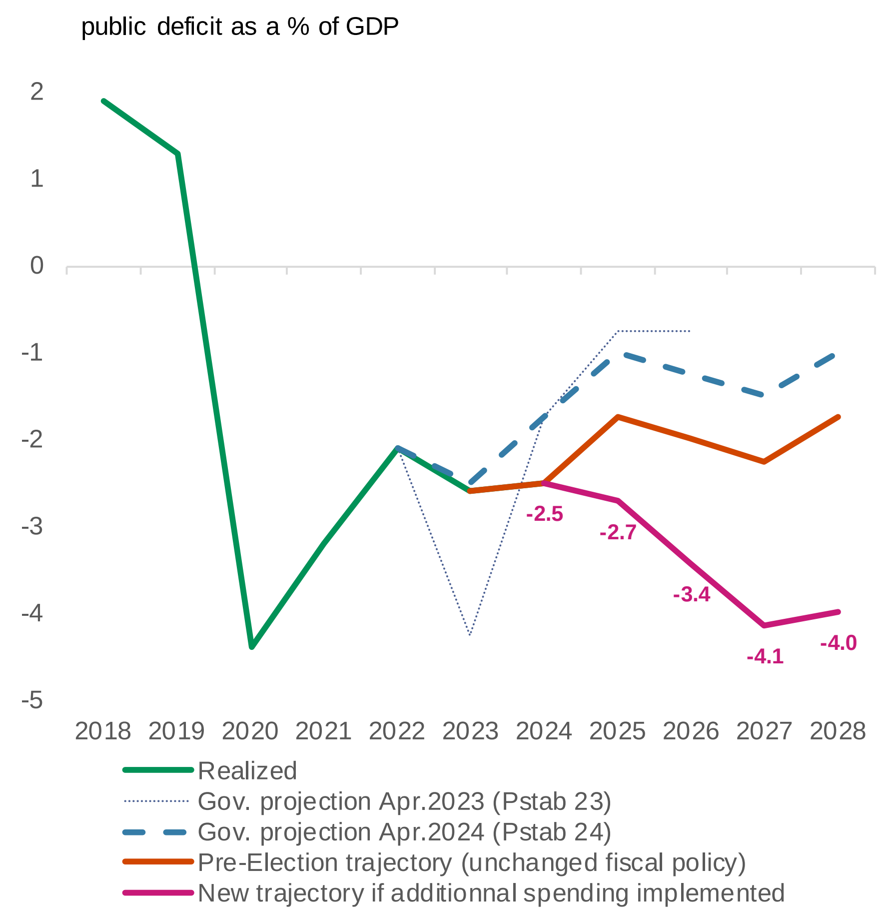


Public debt

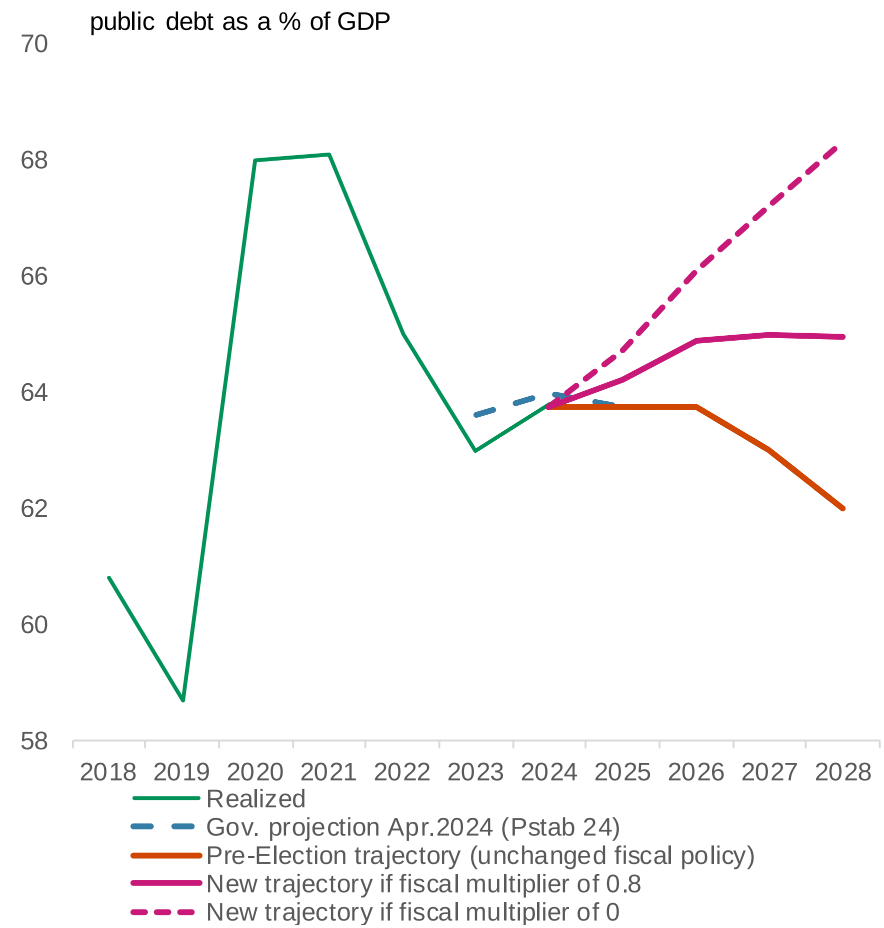
Source all charts: European Commission, Eurostat, Crédit Agricole SA, Crédit Agricole CIB

German public finances: already a U-turn

Public deficit projection under possible fiscal assumptions: 2ppt more per year, for the next ten years



German Public debt won't be less sustainable, even in a worst case scenario



Source all charts: German Ministry of Finance, Eurostat, Crédit Agricole SA, Crédit Agricole CIB

#3

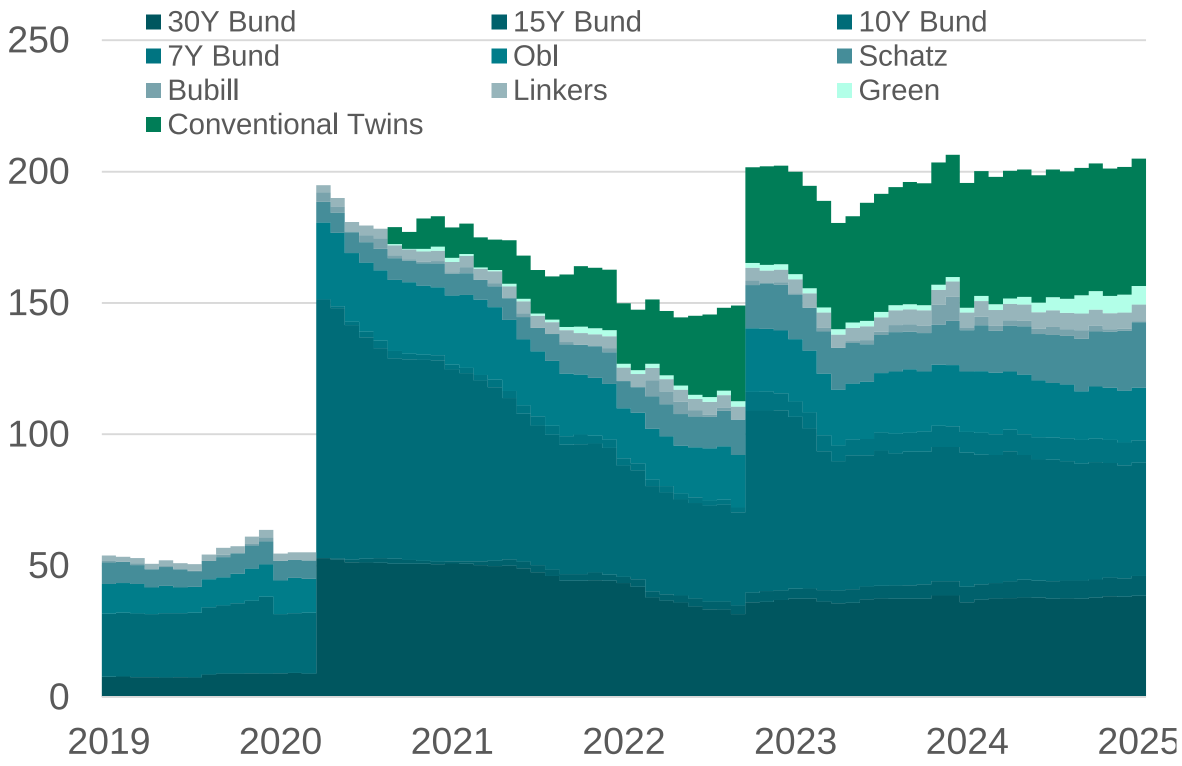
Impact on EUR rates markets

EGB SUPPLY, EGB SPREADS AND BUND-ASW

Available mix for direct funding of defence

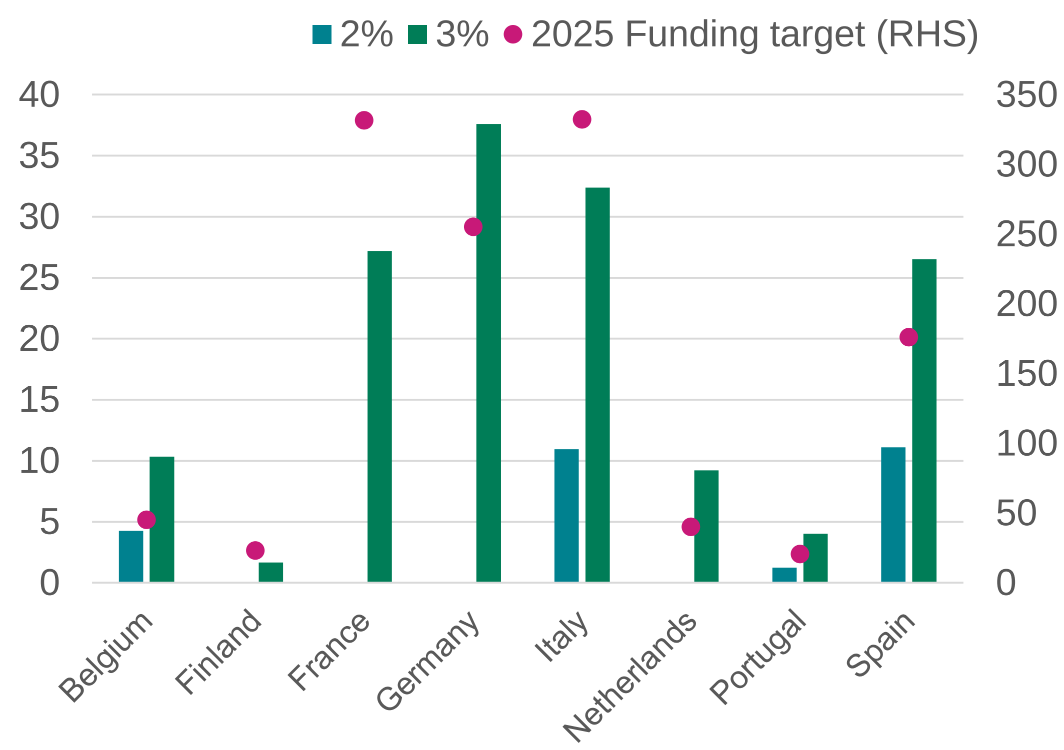
- Beyond reallocating funds in existing budgets, DMOs can mitigate the increase in headline issuance using alternative funding sources.
- 2025 funding programmes already made extensive use of alternative funding instruments.
- In the case of Germany, monetisation of own holdings has a potential far below the current stock of EUR205bn
- State-level initiatives to face headwinds of deteriorating debt sustainability metrics

DFA own holdings (EURbn)



Source: Deutsche FinanzAgentur

Annualised additional budget to reach 2 or 3% GDP spending

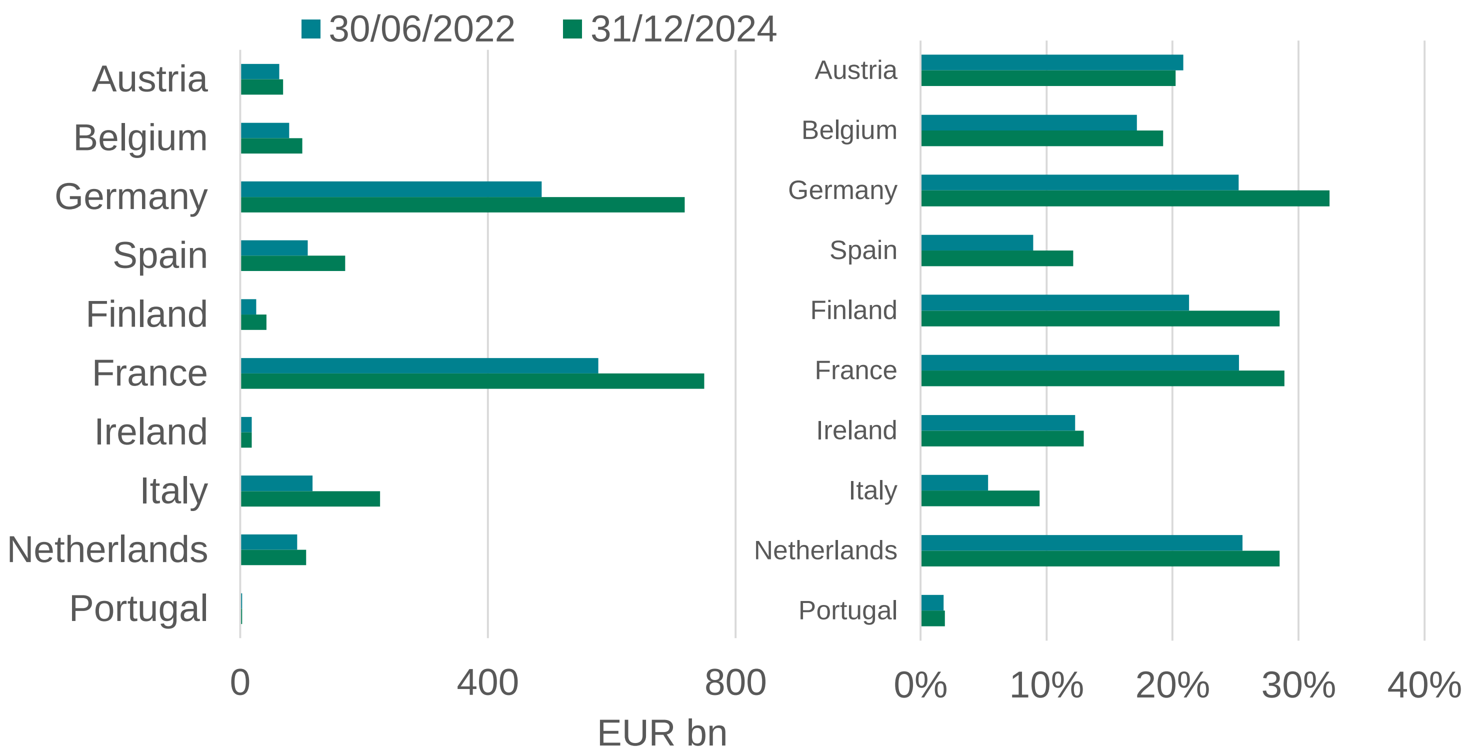


Source: Crédit Agricole CIB, NATO

Can EMU withstand the additional issuance on its own?

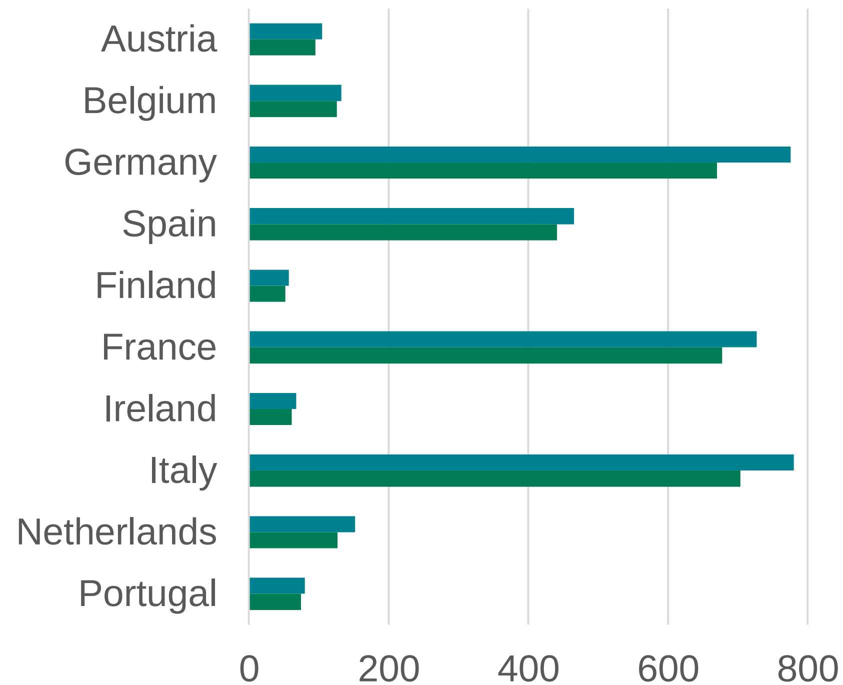
- Extra-EMU investors were key absorbers of net EGB supply in 2024, more than offsetting the decrease in Eurosystem holdings
- This was especially true for Germany and Italy, with gyration in OAT holdings in Q4.
- Aggregate values hide more complex trends, but local savings and NBFI account should be able to absorb higher issuance, albeit with concessions

MLT debt securities held by extra-EMU investors, outstanding & share



Source : ECB, DMOs, Crédit Agricole CIB

MLT debt securities held by Eurosystem (outstanding)



Source: Crédit Agricole CIB

German ASW curve implications

Maturity impacted by considered driver

Funding / positioning: while reserve drain and higher collateral pressure repo yields higher, positioning is bound to stay neutral or shift

Relative velocity: receiving flows to evaporate as cycle reaches its end, decent odds of hikes down the line would be a game changer

Collateral appeal: balance sheet costs are not constant, NSFR quantity decrease should be offset by higher bond risk premia. Better carry and rolldown will be needed to reinforce Obl ASW appeal vs reserves.

Collateral value: free float increase should theoretically lower collateral value, as turnover of debt outstanding hit more yield-sensitive investors.

Flight to Quality premium: with higher GDP growth expectations and the ECB (almost) done with its easing cycle, rates volatility is bound to pick up as range of potential outcomes shifts higher. More upside in tail scenarios should bring a marginal support eventually.

Credit: countries with deteriorating debt-to-GDP trajectory tend to have relatively steeper credit curves.

Demand for long-end duration: convexity appeal of long-end bonds, but demand a function of liability profile. PF reform to potentially play a role?

Impact on German ASW curve

2Y	More hawkish ECB bias to support Schatz ASW despite repo pressure
5Y	Should act as pivot point with limited tightening potential
10Y	We keep our ESTR + 35 target and expect support thereafter
30Y	Further underperformance as issuance will outpace demand ESTR + 70

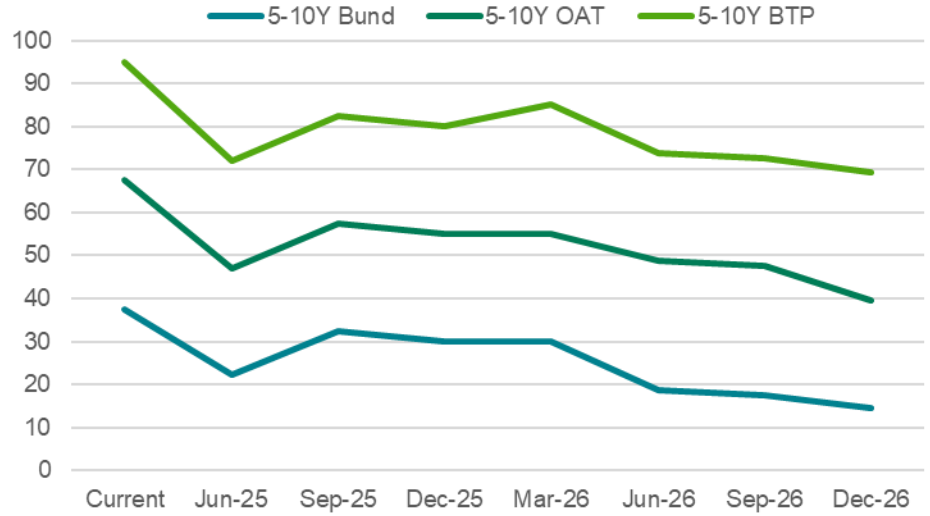
Source: Crédit Agricole CIB

EGB spread outlook: not as bright as it initially sounds

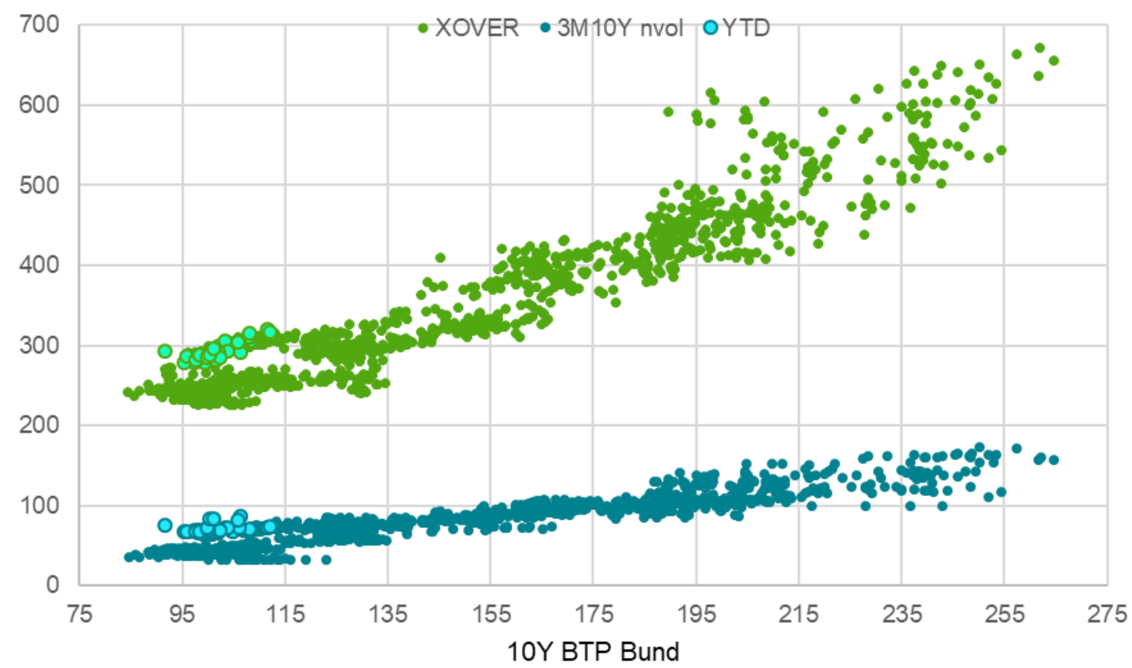
- Positive environment for growth and slightly higher inflation expectations to bring further tightening pressure over the short term.
- Implementation hurdles and breach of the ECB volatility containment to ultimately weigh, especially in the case of further risky asset underperformance.
- On a debt sustainability POV, tug of war between positive pass-through in German fiscal initiative and idiosyncratic multiplier for defence investment. Defence laggards unlikely to significantly deteriorate their hard earned fiscal consolidation, unless joint bond issuance.

EGB spreads forecast

	spot	3M	EoY
10Y OAT-Bund	69	65	60
10Y BTP-Bund	110	115	105
10Y Bono-Bund	63	60	55
10Y PGB-Bund	50	55	50
10Y OLO-Bund	56	60	58



Rekindling the spreads/vol relationship



Source: Crédit Agricole CIB

#4

Impact on SSA markets

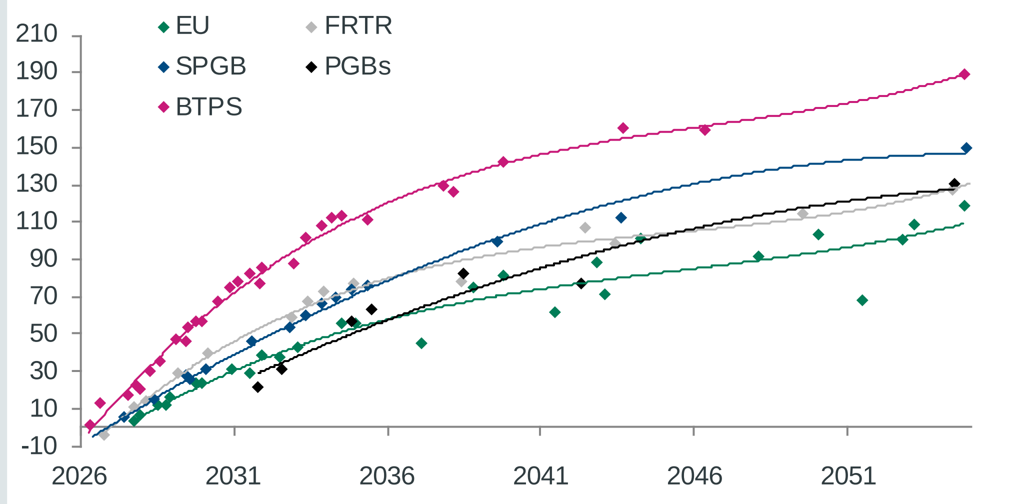
WHO, HOW MUCH AND WHEN

European politics: defence spending – who, how much and when?

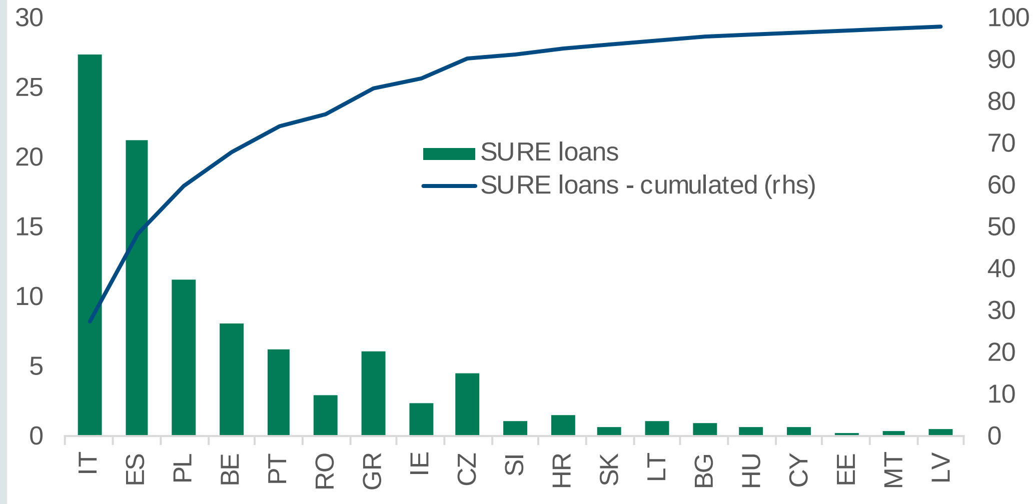
Joint European funding for defence

- Options under discussion range from no impact on SSA funding volumes to a very sizeable impact
  - With the announcement of a new EU instrument, the question as to which entity will be used for this (EU, ESM, EIB or a new entity) has been answered, at least for the time being.
- Detail of the new EU instrument
  - Size will be EUR150bn with disbursements by the “end of the decade” or 2029 (hence c.EUR37bn if disbursed over 2027-29). It will be a SURE-like instrument allowing the EU to grant loans backed by its budget.
  - However, EU treaties require any new loan programme to ensure the integrity of the EU budget. For the SURE programme, member states provided additional (and voluntary) guarantees to the EU budget for 25% of the total size of the instrument (EUR100bn). But for the new instrument, guarantees as a share of the total loans may be much smaller and even possibly not necessary at all. The own resources ceiling was initially sized to guarantee both the EU budget and the NGEU programme. However, the NGEU programme will be smaller than expected as EUR93bn of loans were not requested. Whether additional guarantees would be needed for the remaining c.EUR60bn of loans remains to be seen. However, if guarantees are indeed needed, they should only represent a fraction of this.
  - The take-up by member states will above all depend on their economic interest to request those loans. In the past, SURE or NGEU loans have been requested by peripheral member states (IT, ES, PT or GR) or countries from Eastern Europe (eg, PL, RO, CZ). However, even semi-core countries such as Belgium were among the SURE loan recipients. This time around, we could see France join the ranks of those asking for loans.

ASW curve selected issuers (bp)



SURE loan take-up by member states (EURbn)



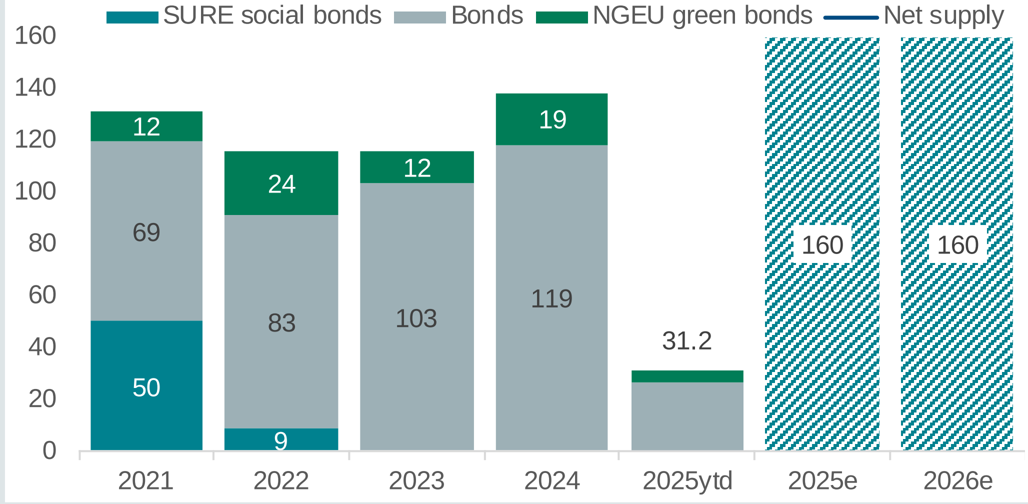
Source all charts: EU, Bloomberg, Crédit Agricole CIB

European politics: defence spending – who, how much and when?

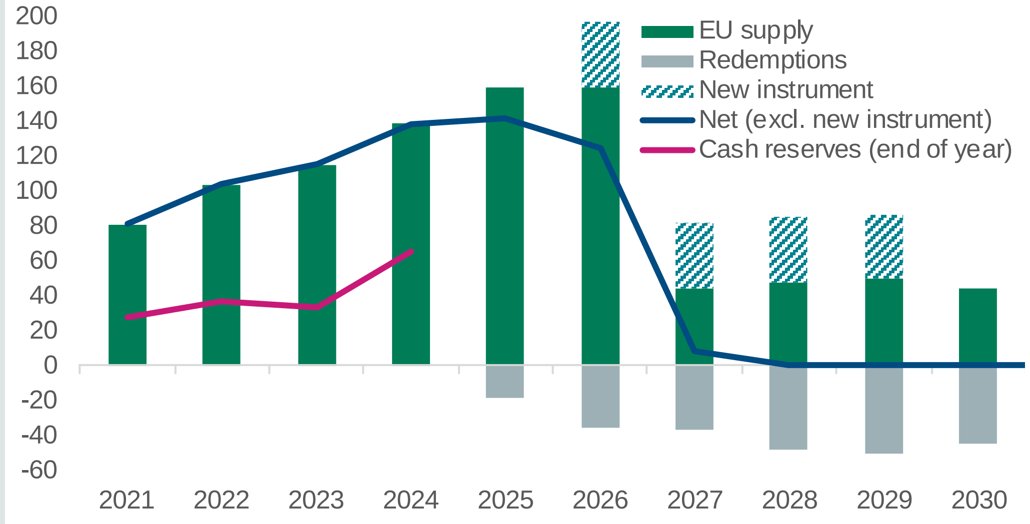
Modelling the EU funding needs and impact of a new instrument

- We have modelled the profile of EU funding needs in the coming years based on a number of simplistic assumptions
  - Supply of EUR160bn over 2025-26. We assume a full rolling of NGEU debt over 2027-30 which leads to refinancing needs of EUR45-50bn. This could be reduced by c.EUR20bn if NGEU loan amortisations start from 2027.
  - To model the breakdown of the new supply by tenors every year, we have used the average breakdown of supply over 2021-25.
  - We added the EUR150bn for defence evenly over four years (2026-29).
- For EU funding needs, there are two things that are critical in our view
  - The **disbursement profile of the new defence loans**: Backloading of the disbursements beyond 2026 could in fact be seen as positive. It would ensure that EU supply remains in a EUR80-100bn ballpark range from 2027 (roughly similar to KFW) supporting the liquidity of its curve. But a frontloading of the payments into 2026 (or even 2025) would add to the already existing supply pressure. The EU has already indicated NO impact on its H125 funding target. But if it adds to the H2 tally for which the EU has already guided us towards EUR70bn, it could become a problem.
  - **NGEU disbursements going according to plan**: Funding needs will remain a function of member states requesting the NGEU funds already allocated to them. This should not be a concern for the remaining grants (c.EUR150bn). However, there is more uncertainty around the loans, in particular for countries such as Spain. The Spanish curve is currently trading relatively close to the EU, and the country is thus not particularly incentivised to make requests for the time being. This could lead to delays in disbursements or even Spain asking to write off all or part of those loans in the end, which would lead to lower EU funding needs.

Past and expected EU funding excluding defence (EURbn)



Model of the EU funding profile until 2030* (EURbn)



** See assumptions for 2025-30 in the text.*

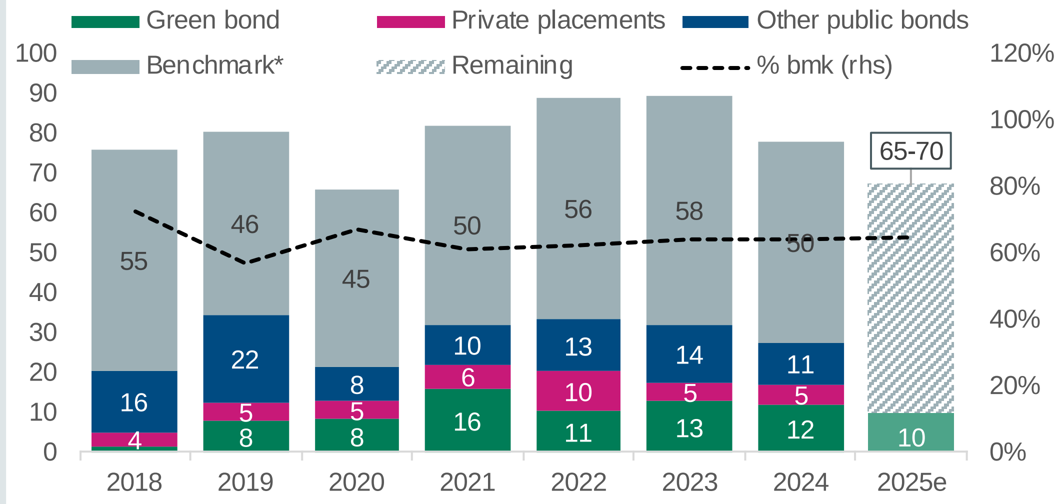
Source all charts: EU, Crédit Agricole CIB

SSA primary markets: German defence and infrastructure plan

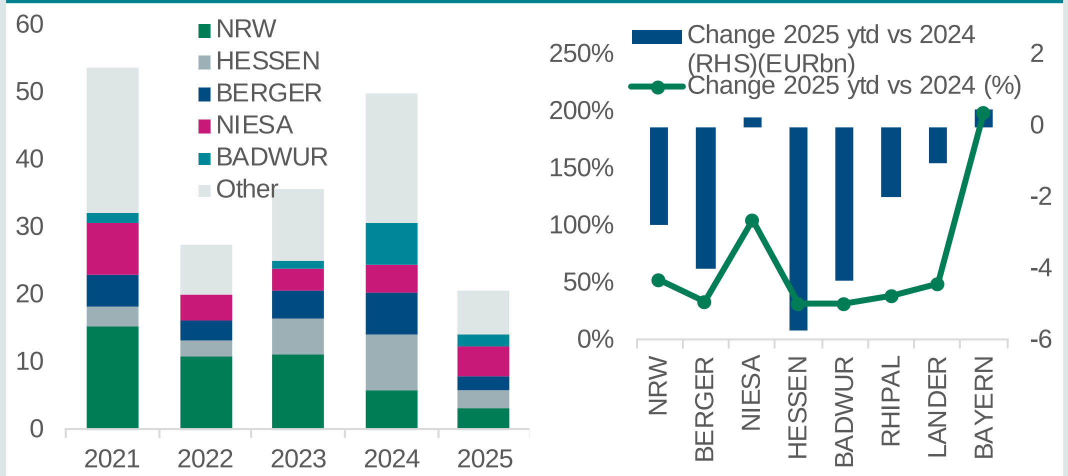
The “Whatever it takes” and impact on German SSAs

- What has been announced?
  - Creation of a EUR500bn **infrastructure fund** across ten years with EUR100bn of this to be earmarked for German States and municipalities.
  - The **amendment to the debt brake for defence** entails that EUR44bn of defence spending (1% of GDP) will count towards the debt brake. Anything above that will not. Hence, assuming a 3% target, 2% would be exempt from the debt brake and we would be talking about EUR440bn across the next five years (EUR88bn per year exempt with total annual defence spending reaching EUR132bn).
  - **Bundesländer** will be given more fiscal flexibility. They will be granted the same 0.35% structural deficit per year as the Bund.
  - The timeline is 10 years on the infrastructure fund while there is none on defence spending. Of course, we are talking about long-term projects, and while quick results may be wanted, the realities may be different
- What does all of this mean for SSA supply out of Germany?
  - **German Länder** will have a combination of lower funding needs from the infrastructure fund (which is funded by the Bund) than would otherwise be the case against slightly more fiscal flexibility and hence higher funding needs coming from the 0.35% structural deficit Länder can run per year going forward. Assuming all of the EUR100bn were to go to Länder, we would be talking about the Bund replacing EUR10bn of funding via an additional EUR14bn from the structural deficit.
  - **German development banks** are not directly impacted. In fact, the risk of KFW getting tapped on the shoulder to take on additional spending and hence funding (the issuer is not part of Germany’s debt and deficit figures after all) seems off the table for now, and we would not expect to see next year’s funding target exceed “normal” levels for the issuer (EUR75-85bn).

KFW past funding volumes vs 2025 funding target (EURbn)



German Bundesländer – EUR benchmark issuance volumes (lhs, EURbn) and supply 2025 YTD vs 2024 (rhs, % and EURbn)



Source all charts: KFW, Bloomberg, Crédit Agricole CIB

#5

Bottom line

GERMANY (HAS TO BE) LEADING THE WAY

Bottom line (1/2)

Macro

- Will Europe be able to finance a significant rise in public spending, mainly in defence?
  - Europe has a massive financial capacity right now, following years of outstanding current account surplus (EUR500bn per year now, mainly driven by Germany), excess savings and deleveraging of both the private & the public sector (debt-to-GDP ratios have returned to mid-2000s level on aggregate).
  - This financial capacity is located in the private sector as well as in the public sector of core Eurozone countries (eg, Germany & the Netherlands). Higher public deficit & debt loads in France and to a lesser extent in peripheral countries that successfully deleveraged over the past years provide them with lower incentives to follow Germany.
- What to expect then?
  - A big German push: over the next ten years, an additional EUR500bn spent on defence relative to the previous baseline coupled with a massive infrastructure plan of an equivalent amount. The latter should be a key support for German and Eurozone growth going forward.
  - A more prudent increase in defence spending of other member states as well as some help coming from the EU.

EGB

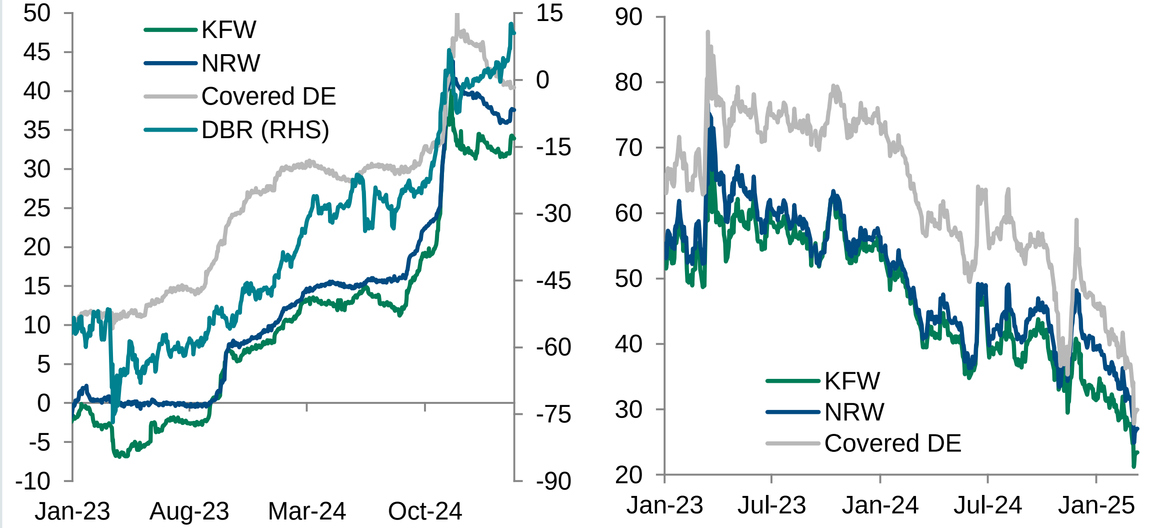
- How is it going to be financed?
  - For now, only Germany should significantly revise up its debt issuance, with little room for alternative funding. We expect own holdings run off to provide a EUR15bn yearly buffer. Other countries might see a negative trade off between higher defence spending and hard earned fiscal consolidation, hinting at alternative funding or private savings.
- How about debt sustainability and supply absorption?
  - We do not expect increased EGB free float and GDP outlook to stress markets, opening the door a more hawkish ECB bias. Our main scenario is a steepening of 2-5Y & 2-10Y swap slopes; we expect 10Y EUR IRS at c.2.80%. German 10Y real yield should settle at c.100bp.
- Which market impacts?
  - We see some support on the front end of the German ASW curve, but the long end should steepen further on increased free float.
  - EGB spreads to face the headwind of higher interest rates volatility and a more adverse environment for carry trades. Countries with a weak GDP growth outlook and high pass-through to German activity should benefit the most from the situation, while laggards in defence spending with little fiscal leeway should underperform unless the local support for defence allows for a low ramp-up.

Bottom line (2/2)

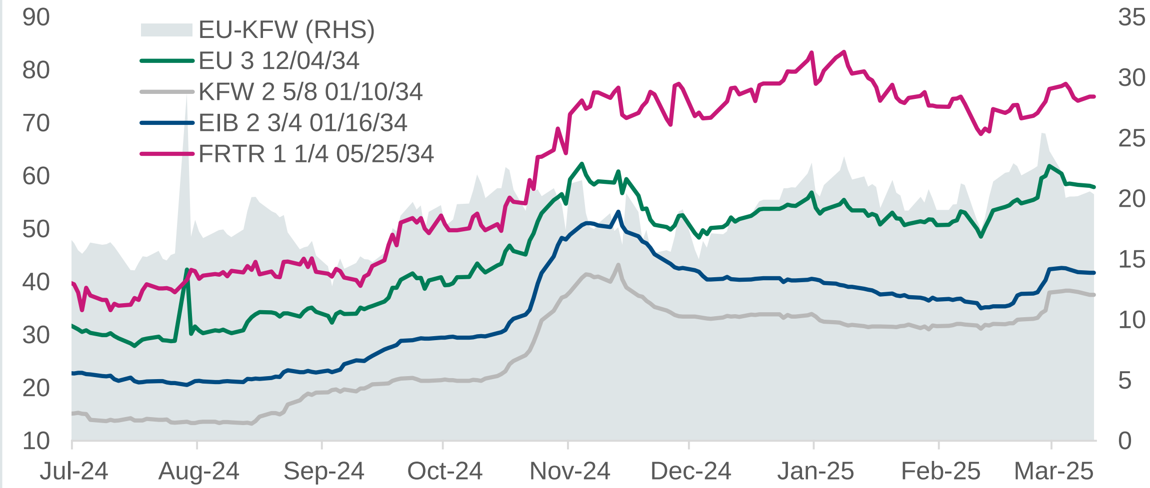
Impact on SSA sectors

- Who is going to get involved in the end?
  - The main focus at this point is on the EU via a new loan programme targeted at defence. The EIB will be involved too, but with its focus on private sector counterparties, its involvement will be limited for the time being.
  - At the national level, the only SSAs to be involved are the German Länder; none of the development banks will play an active role.
- What volumes will we be talking about and when?
  - For the EU, we are talking about EUR150bn. The actual amounts will depend on member states asking for these loans, though. Some of those with the highest potential savings are most likely going to be dragging their feet on defence because they do not have the fiscal capacity or lack the political will to add. Hence, there is a good chance that such EU funding would be rather back-loaded on the 2025-29 horizon.
- What about the spread impact?
  - The main spread driver for the time being will continue to be Bund-ASW. In case of further Bund weakness, SSAs will outperform Bunds but widen vs swaps. The only risk from defence spending would be a front-loaded EU funding pattern. Adding more to an already busy H225 and 2026 would lead to a wider and steeper EU curve. However, this should not impact wider SSA markets much – it would be an EU-only story.

Evolution of 10Y ASW spreads (left) and spreads vs Bunds (right)(bp)



ASW spread evolution selected EGB and SSA

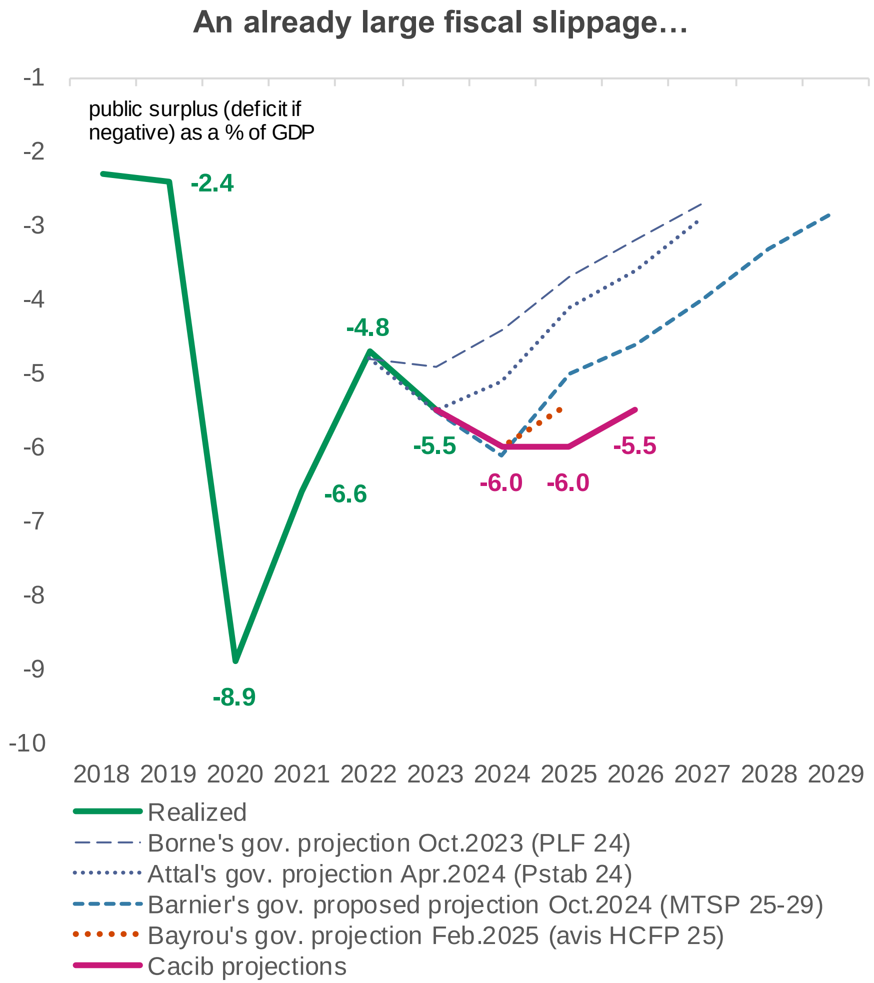


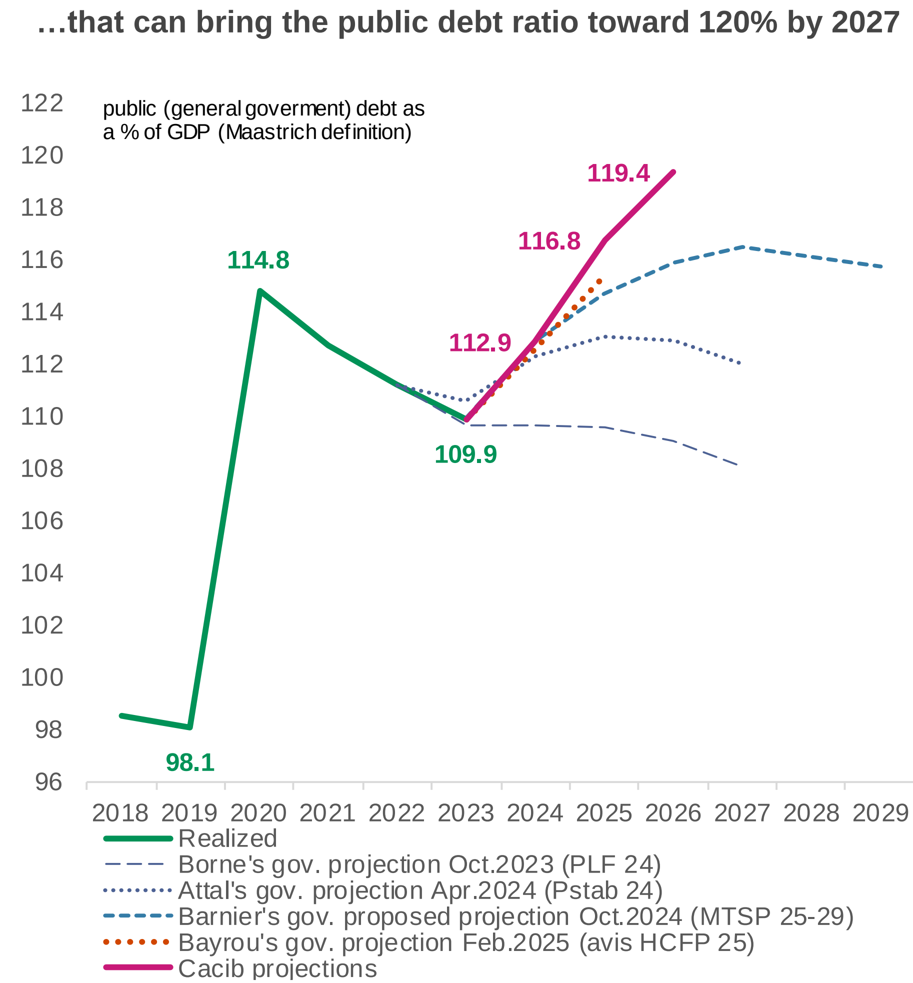
Source all charts: Bloomberg, Crédit Agricole CIB

#6

Appendix

French public finances: fiscal adjustment deeply needed

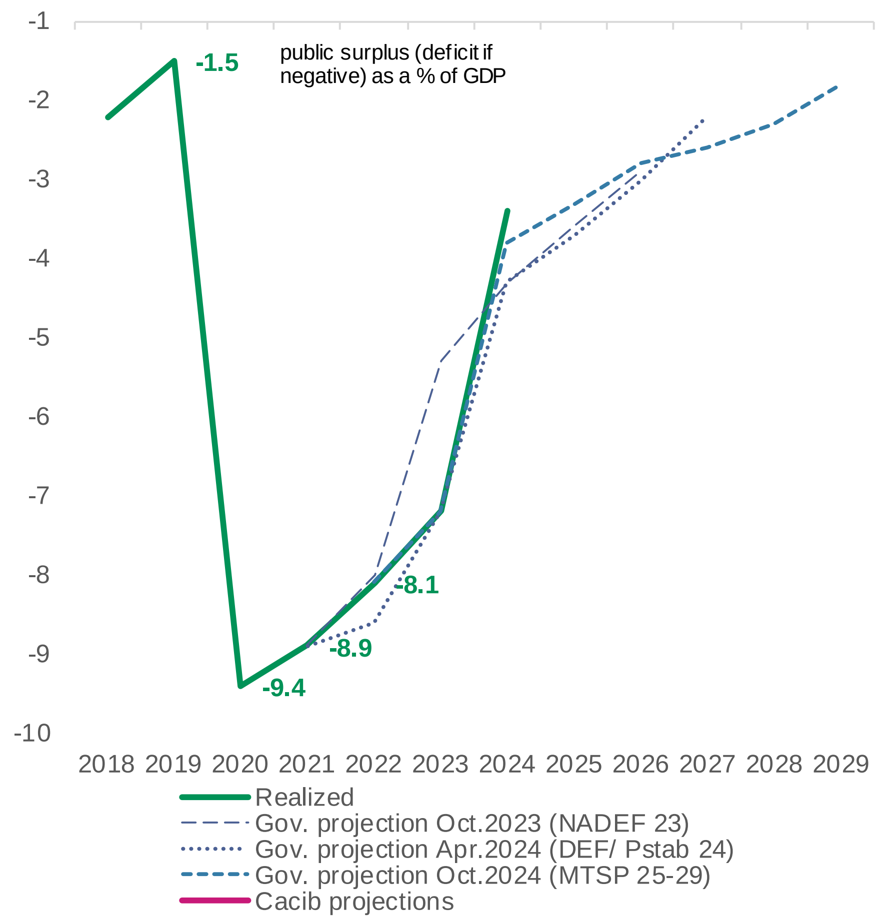




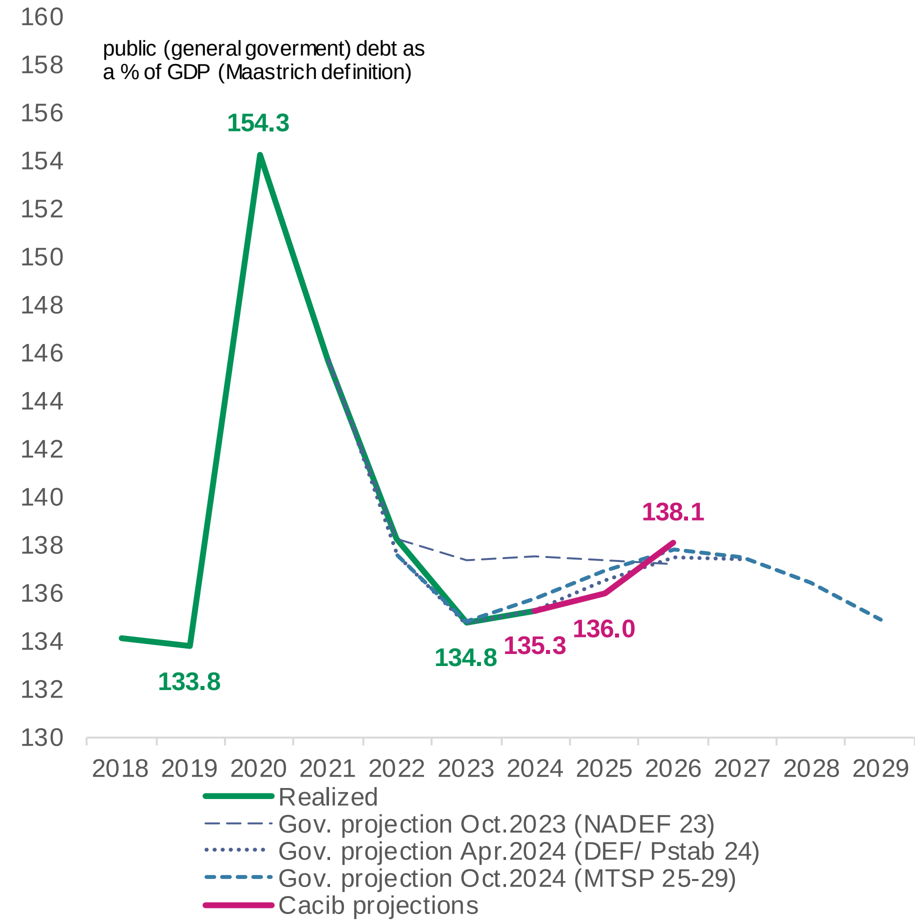
Source all charts: French Ministry of Finance, Eurostat, Crédit Agricole SA, Crédit Agricole CIB

Italian public finances: two-thirds of the fiscal adjustment delivered

Consolidation still needed, but ahead of schedule…



…which implies a moderate bump on debt-to-GDP ratio by 2026-27 around 138%



Source all charts: Italian Ministry of Finance (MEF), Eurostat, Crédit Agricole SA, Crédit Agricole CIB

Disclosures

Certification

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Recommendation System

5Y CDS recommendation

Performance of credit instruments: We express our expectation of how the 5Y CDS is going to perform vis-à-vis its sector over a one month timeframe. When the analyst changes a recommendation he/she should indicate in the analysis when the last recommendation was made.

SELL: CDS spreads should outperform the sector performance.
NEUTRAL: CDS spreads should perform in line with the sector performance.
BUY: CDS spreads should underperform the sector performance.|

Credit metrics trend

Credit metrics trend reflect s the expected evolution of the credit metrics of an issuer over the coming 12 months. Credit metrics are usually based on two main drivers: (1) the profitability of the activities and (2) the evolution of the capital structure.

POSITIVE: credit metrics are expected to improve over the coming 12 months.
STABLE: credit metrics are expected to remain stable over the coming 12 months.
NEGATIVE: credit metrics are expected to deteriorate over the coming 12 months.

as at 17/02/2025	All covered companies		Companies where Crédit Agricole CIB provided Investment Banking Services in past 12 months	
	Count	Percent	Count	Percent *(of 'all covered companies')*
Sell	7	15	7	100
Neutral	31	65	25	81
Buy	10	21	6	60

Senior/subordinated bond recommendation (per issuer on a six-month horizon)

BUY: Overweight exposure to all the issuer's senior/subordinated bonds. Corresponds to a strong positive conviction about the issuer in terms of both credit metrics and relative valuation aspects.
ADD: Overweight exposure to some specific or all senior/subordinated bonds of the issuer. Fundamental opinion is positive on the credit's underlying. Relative value analysis can lead us to overweight or maintain the position on some specific bonds.
NEUTRAL: Maintain position based on stable credit fundamentals. Relative value analysis can lead us to overweight/underweight or maintain the position on some or all senior/subordinated bonds of the issuer.
REDUCE: Underweight exposure to some specific or all senior/subordinated bonds of the issuer. Fundamental opinion is negative on the credit's underlying. Relative value analysis can lead us to underweight or maintain the position on some specific bonds.
SELL: Underweight exposure to all the issuer's senior/subordinated bonds. Corresponds to a strong negative conviction about the issuer in terms of both credit metrics and relative valuation aspects.

as at 17/02/2025	All covered companies		Companies where Crédit Agricole CIB provided Investment Banking Services in past 12 months	
	Count *SN / SB* *SBI / T2 / AT1*	Percent (%) *SN / SB* *SBI / T2 / AT1*	Count *SN / SB* *SBI / T2 / AT1*	Percent (%) *SN / SB* *SBI / T2 / AT1* *(of 'all companies covered')*
Buy	0 *(for all)*	0	0	0
Add	12 / 2 8 / 9 / 12	22 / 15 35 / 38 / 63	10 / 2 6 / 9 / 10	83 / 100 75 / 100 / 83
Neutral	34 / 8 6 / 11 / 3	63 / 62 26 / 46 / 16	29 / 5 5 / 6 / 2	85 / 63 83 / 55 / 67
Reduce	8 / 3 9 / 4 / 4	15 / 23 39 / 17 / 21	3 / 1 6 / 3 / 3	38 / 33 67 / 75 / 75
Sell	0 *(for all)*	0	0	0

SN= senior bonds; SB = subordinated bonds;
[Banks] SBI = senior bail-in bonds; T2 = Tier 2; AT1 = AT1

Frequency of updates to recommendation

The recommendation, opinions, estimates and projections are current as of the date of the recommendation and are subject to change without notice. Crédit Agricole CIB has no obligation to update, modify or amend the recommendation or to otherwise notify a recipient thereof if any opinion, forecast or estimate contained in the recommendation changes or subsequently becomes inaccurate.

Additional recommendation obligations – *available from Crédit Agricole CIB upon request:*

- A list of all the recommendation changes on any financial instrument or issuer disseminated within the last 12 months.
- Where Crédit Agricole CIB is a market-maker or liquidity provider in the financial instruments of the issuer.

Energy transition score

The assessment of the impacts of the energy transition on issuers is, among other elements, part of our ESG analysis, which is in turn, among other elements, included in our recommendation system. The energy transition score reflects (1) the issuer-related sector's expected sensitivity to the impact of the energy transition (Sector Exposure with a ranking of High, Medium and Low) and (2) the disruption to the issuer's business model (Issuer Score) derived from the greening of the economy. With the need to develop resilience to environmental risks and offering the opportunity to "build back better", issuers' scores aim to provide a picture based on the most available reported data of an issuer's risk exposure to the energy transition impacts. An issuer's score varies from -3 to +3 depending on said issuer's exposure to (1) regulatory risk; (2) technological risks; (3) geographies; and (4) businesses. These scores have been translated into a colour scaling system (from dark green, corresponding to the lowest level of exposure, to dark red, corresponding to the highest level of exposure). The main macro scenario used to calculate those sectors' score is the Sustainable Development Scenario (SDS) provided by the International Energy Agency (IEA). The Issuer Score is usually calculated based on two main drivers: (1) expected growth potential; and (2) identification of potential stranded assets. For more details on the methodology, please see the following link.

HIGH: the sector is, directly or indirectly, highly exposed to energy transition issues and is expected to be highly impacted by the need to make adjustments to mitigate the impacts from the energy transition
MEDIUM: the sector is, directly or indirectly, moderately exposed to energy transition issues and is expected to be moderately impacted by the need to make adjustments to mitigate the impacts from the energy transition
LOW: the sector has, directly or indirectly, a limited exposure to energy transition issues and is expected to be slightly impacted by the need to make adjustments to mitigate the impacts from the energy transition|

Valuation and methodology

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- Reward analysis is usually based on valuation models. Valuation may be based on proprietary models or external models provided by sources considered as reliable (eg, Bloomberg). Among other factors, valuation models may be based on relative value models, quantitative models, cross-asset models. While recommendations are focused on spreads, they may also include a yield valuation approach as well as a total return approach.
- Investment recommendations may also be based on other technical aspects, including observing the market and underlying movements in particular instruments or issuers. This analysis will take into account key criteria such as market liquidity of the financial instrument or issuer at the time of production of the recommendation.

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