The Investment Institute
by UniCredit

Coffee Break

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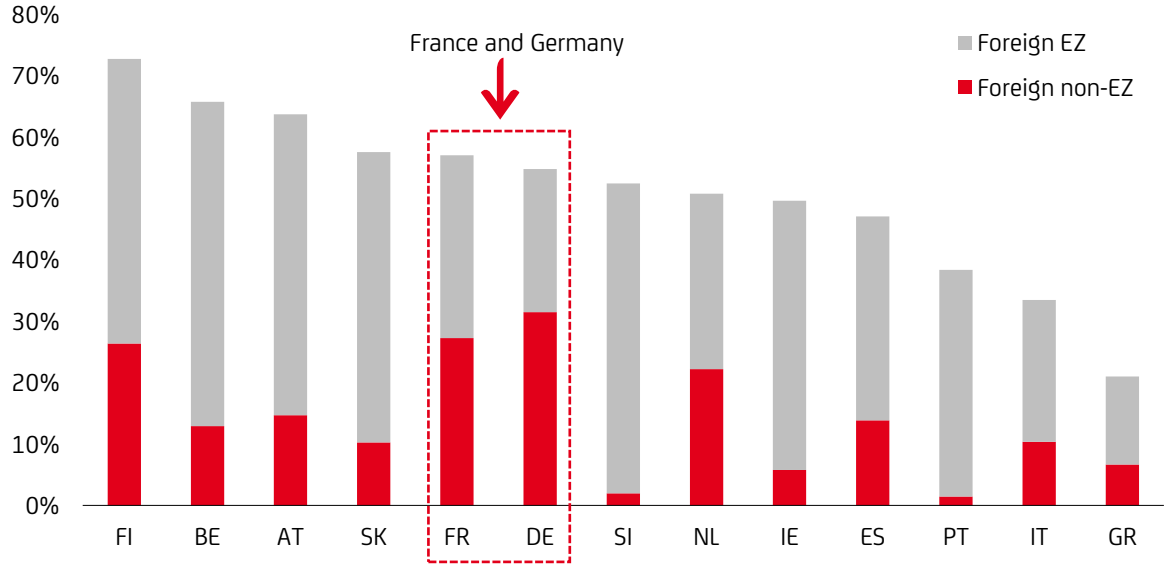
France's foreign investor challenge

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France and Germany stand out for their highly international investor bases, reflecting their economic importance and the deep liquidity of their sovereign markets. In today's environment, however, France's reliance on foreign demand could become a source of vulnerability.

WHICH COUNTRIES RELY MOST ON FOREIGN INVESTORS?

SHARE OF GOVERNMENT SECURITIES HELD BY FOREIGN INVESTORS



Source: ECB, The Investment Institute by UniCredit

THE CONTEXT

Balance of payments data released yesterday show that foreign investors were buyers of OATs in August, albeit very modestly. Until late summer, political uncertainty in France did not discourage foreign investors, which have added a total of EUR 200bn to their portfolio since the start of the year. With credit spread tensions now reemerging in the eurozone and investors becoming more selective in their investment decisions, the composition of the investor base is increasingly relevant. In today's *Coffee Break* we look at the presence of foreign investors in various EGB markets.



THE DATA

The chart shows the share of government securities held by foreign investors in selected euro area countries, separating investors based in the euro area from those based outside it. The aim is to distinguish sovereigns that are more exposed to international demand from those that benefit from a larger and potentially more stable domestic investor base.

The presence of foreign investors varies widely across countries, ranging from around 20% of outstanding securities in Greece to about 75% in Finland.

A key finding is that foreign ownership is overwhelmingly intra-euro area in nature. On average, around 75% of foreign holdings are attributable to investors located in other euro area countries. This highlights the growing importance of cross-border financial integration within the monetary union and suggests that sovereign bond markets are far less segmented than in the past. The pattern is also consistent with the increased geographical diversification of sovereign bond portfolios held by euro area banks in recent years (see *Coffee Break* - Eurozone banks: portfolio diversification continues).

In some countries, holdings by investors outside the euro area account for a particularly small share. Portugal is a good example: while foreign investors account for a sizeable share of the investor base, almost all of these holdings are concentrated within the euro area. Austria is another interesting case: it has a relatively high share of foreign ownership but mostly based in the euro area. Our take is that European investors seeking higher yields have viewed Portuguese and Austrian government bonds as alternatives to those of Spain and Germany, respectively. This may help explain their relative resilience in recent weeks.

By contrast, Germany and France stand out for the relatively strong presence of non-euro area investors, reflecting their role as highly liquid benchmark markets that attract global demand. Finland also appears to have comparatively strong appeal among investors from outside the monetary union.



OUR VIEW

The chart provides a useful framework for assessing the risks faced by euro area sovereign issuers in a market likely to remain characterised by greater investor selectivity. Foreign investors tend to react more strongly to domestic political developments than local investors, and this sensitivity is likely to be even greater among investors located outside the euro area.

It is not surprising that Germany and France have the most internationally diversified investor bases. Both sovereign markets are deep and liquid, their bonds are widely used as benchmark instruments, and both countries carry considerable political weight. As a result, they have traditionally been the preferred choice of investors wishing to gain exposure to euro area rates and duration while limiting credit risk.

However, some of these features are increasingly being challenged in France. Up until August, foreign investors were buyers of OATs, probably as the country's low dependence on energy imports outweighed its fiscal concerns. More recently, however, the need to adjust public spending amid social unrest and political uncertainty has weighed on investor sentiment. Although data are not yet available, the sharp widening of OAT spreads in September and October has probably weighed on demand from foreign investors. Sentiment is unlikely to improve until there is greater clarity on the policy outlook. Given foreign investors' already sizeable presence in the French government bond market, the scope for further reduce their holdings remains significant and should be regarded as a risk factor for OAT spreads.

The chart suggests that Germany would be the main beneficiary of any reallocation away from France. The Netherlands and Austria could also attract inflows as higher-yielding alternatives, albeit in less liquid markets. EU bonds have remained quite stable in recent weeks and, judging from this performance, could attract inflows as investors diversify away from French government debt.

By contrast, Italy's investor base appears relatively stable. A larger share of government debt is held domestically, supported in part by the Treasury's strategy of offering securities specifically targeted at retail investors. This should provide some insulation for BTPs during periods of market volatility and make the market less vulnerable to abrupt shifts in foreign investor sentiment.

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