THIS MONTH'S TOPIC

Italy: a long and winding road

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The essential

Arm-wrestling within the Italian government and between Italy and Brussels to find a solution to the Italian budget and avoid the Excessive Deficit Procedure.

After Italy's exit from a technical recession in H2 2018, economic data are still pointing to weakness, and many risks loom in the second half of this year. Weak growth prospects are making it more difficult to comply with deficit and debt targets, although some savings may come from lower spending. In any case, the 2020 budget is the most challenging test for the government.

Besides the persistent challenges we just referred to, short-term technicals and relative value look favourable to Italian debt. H1 2019, in fact, closed with promising achievements in debt refunding activity conducted by the Italian Treasury, thanks as well to the return of foreign investors, while the H2 demand-supply balance looks to be supported by higher volumes of redemptions. Relative value has favoured recent spread tightening and yield hunting in the European "desert of yield" is likely to remain, as the ECB has become more dovish.

Italy retakes centre stage in Europe

The Italian government and the European Commission are once again at loggerheads after Brussels affirmed that, based on their assessment, an excessive deficit procedure against Italy is warranted for violation of the debt rule in 2018.

EDP and the critical 2020 Budget Law

As we write, the procedure is in its early stages and, in theory, could still be averted, as it would require approval at next ECOFIN meeting (scheduled for 9 July). Recent press articles[1] have even suggested that the European Commission may not trigger an EDP, raising hopes that the Italian government could revise its spending plans and avoid a clash with the EU.

Negotiations are reportedly progressing between the Italian Government and the EU Commission on the basis of updated projections by the Italian ministry, which may show a better-than-expected outcome in terms of deficits for 2019 and 2020. This would be due both to higher revenues (owing to the tax amnesty scheme and to higher dividends from controlled companies) and to lower expenditures (due to a lower take-up rate for early retirement scheme and the citizenship income package).

As we write, the Italian Government approved two different measures able to bring the deficit projection for 2019 back to the 2.0% level agreed with the European Commission back in December 2018: the combined effects from the budget adjustment law and the law decree would save €7.6 bn, compared to April deficit projections and represent an important move from the Italian Government to get to a compromise with the EU Commission.

As a result, the EU Commission on the 3rd of July decided not to recommend to the Ecofin to start the EDP against Italy, as the three conditions to avoid it were met: to compensate the 2018 realised deviation, to correct the 2019 expected deviation and to have some commitments about 2020 budget.

[1] *Brussels to pause budget sanctions on Italy, Financial Times, 24/06/2019*

Economic background

From an economic point of view, the Italian economy likely faced a weak spot in 2019H1. After exiting from a technical recession in 2018 H2 by posting a meagre 0.1% QoQ growth in the first quarter of 2019, the second quarter is posed to be weak. Coincident indicators monitored by the Bank of Italy and the National Statistical Bureau (ISTAT) all point to stagnating activity between April and June. For the second half of the year, official projections expect a normalisation to somewhat higher quarterly growth on the basis of a modest recovery in export-led demand.

Our forecasts for the Italian economy are for average annual growth of 0.1% YoY in 2019, followed by 0.5% in 2020. Key drivers to our call are decent growth in domestic demand, albeit characterised by a weak performance from investments and capex, and a pickup in external demand from H2.

On the domestic side, personal consumption is getting some support from still-resilient consumer confidence, especially in the personal assessment component, although optimism about the overall economy has been deteriorating somewhat. Household spending for final consumption has been holding up recently, notwithstanding a deceleration in disposable income and purchasing power, thanks to a decline in the savings rate. Recent measures for increasing disposable income among lower-income persons may have some limited impact on supporting consumption, but the Italian government itself does not consider these measures to be a game changer this year. On the investments side, business confidence has been declining over the past 12 months, likely due to a combination of domestic and external factors in both the manufacturing and service sectors. However, some signs of recovery have shown up recently in surveys. Yet, on a net basis, firms reportedly are reluctant to invest and access to credit appear to be somewhat more difficult.

Inflation is broadly expected to remain muted, in the 1% range, as unemployment remains relatively high and wage and salary dynamics subdued, albeit supported in 2018 by a raise in public employees' wages.

Projected fiscal patterns

In this macroeconomic context, the governments' growth targets (as per April projections) are not far from the consensus in 2019-2020, yet major concerns remain on its ability to maintain the debt/GDP ratio on a downward path due to risks of fiscal slippage and lower inflation. The key to the projections is indeed the VAT rate hike (approx. €23bn) expected to take place under current law in 2020. On the one hand, it would limit the deficit expansion, but, on the other, it would have a temporary effect in lifting the GDP deflator, thus lowering the debt /GDP ratio from the expected 132.6% of 2019 to 131.3% in 2020. Yet, the government appears to be quite vocal in signalling that this VAT increase would not take place.

As a reference, the EU Commission's projections, which do not reflect this VAT hike, project the debt/GDP ratio to move from 133.7% in 2019 to 135.2% in 2020. Together with the high debt level, of particular concern to the debt sustainability projections is the expected path of the primary balance, which, over the government's forecast horizon, remains well below the levels that would be required to put debt/GDP on a stable downward path, in the context of the current macroeconomic projections and high interest expenses (3.6% of GDP in 2019-2020).

Italian debt: supportive technicals and attractive relative value driving Italian spreads

Technicals

H1-09 saw promising trends in Italy's refunding…

By the end of June roughly 60% of yearly scheduled new issuance of medium- and long-term Italian debt is likely to be completed by the Italian Treasury, with a high average maturity close to 10 years. Just to summarize the main numbers and facts of H1 trends in this respect:

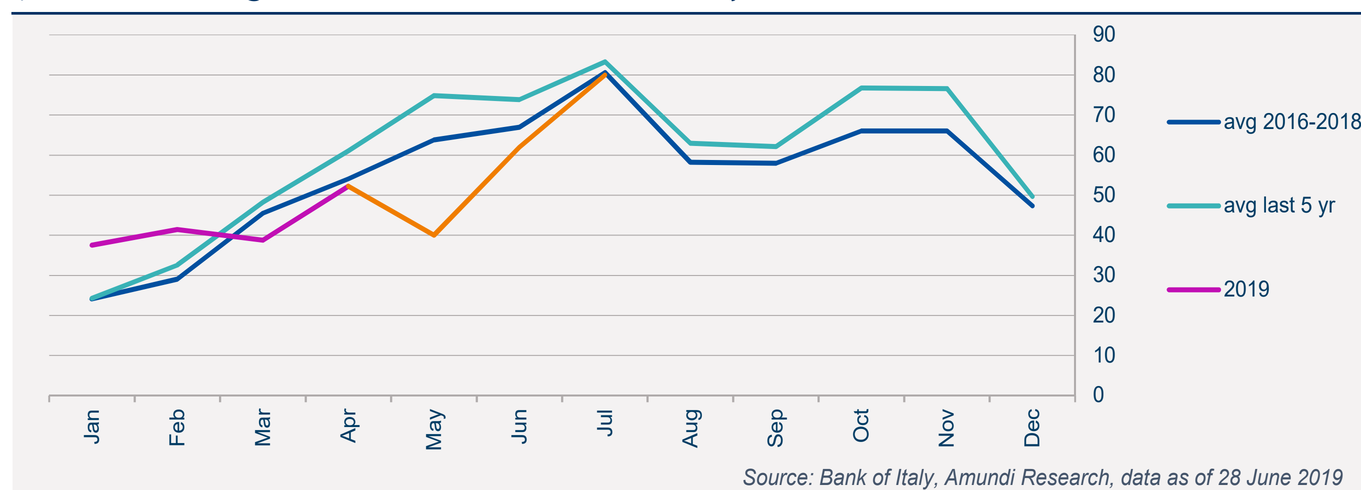
- Italy issued almost €150 bn in new medium long term debt, or 60% of the estimated €250bn overall issuance expected in 2019;
- Net issuance totalled €62 bn, more than the €50 bn projected yearly net issuance;
- Following very long deals in January and February on 15yr and 30yr maturities, the Treasury placed a 20yr BTP in June, keeping the average maturity of new debt close to 10 years, higher than the 6.8-yr average maturity in overall debt stock;
- Year-to-date extra-long debt represents 25% of total issuance, well above the 14% of the same period of 2018. The Italian Treasury is probably close to its targeted volumes in the 15yr area and close to 70% of targeted issuance in the 30yr;
- The demand side had recorded the return in size of foreign investors in Q1 (by roughly €20 bn), which in turn supported strong supply-side activity by the Italian Treasury. Investor demand generally still looks supportive, being sustained by recent market trends and new dovish messages from the ECB. The new 20-yr bond issued in June collected a book of €24 bn, four times the final amount issued. Both geographical and investor type

breakdown showed that the search for yield is mainly from Europe (core and UK) and from asset managers and banks, with foreign investors making up almost two thirds of the demand. Overall, these details seem to confirm that non-domestic institutional investors keep reversing 2018 negative flows.

... and H2 demand-supply balance looks supported by higher volumes of redemptions

- Heavy issuance of extra-long bonds represents the main difference with respect to previous years: long duration of issued debt means that Italy now has a buffer of flexibility in managing next months' auctions, which are likely to focus more on 2-3 yr and 10 yr, in order to reduce pressure on the 5-7 yr section.
- This will provide the Treasury with more flexibility in managing the duration of coming auctions, which may turn out to be more short-term-oriented, in case of volatility and higher risk aversion in H2.
- H1 2019 recorded roughly €85 bn of redemptions, around 40% of overall yearly overall flows.
- H2 2019 therefore looks supported by high volumes of redemptions, as July will be the last month of the year with almost flat volumes of maturing bonds. September and October, on the contrary, will respectively record €43bn and €26 bn of redemptions.
- Cumulated net issuance is therefore likely to grow further and to peak by the end of July, then to fall in the following months. According to our estimates, net issuance is likely to peak in July, close to previous years peaks, in the €75/80 bn region and then to fall vs 50 bn by year end.
- The seasonality of net issuance is quite evident from the reported chart and we outline a few points here:
  1. H1 always shows quite a rise in net issuance to levels close to each year's peak, and then in H2 net issuance tended to fall (this is true considering last three and give years, together with the 2019 trend);
  2. In H2, net issuance always tends to be quite negative in August and December,
  3. September is likely to take August's place this year, with a sharp fall of cumulated yearly issuance.

1/ Italian sovereign bonds: cumulated net issuance, in EUR bn



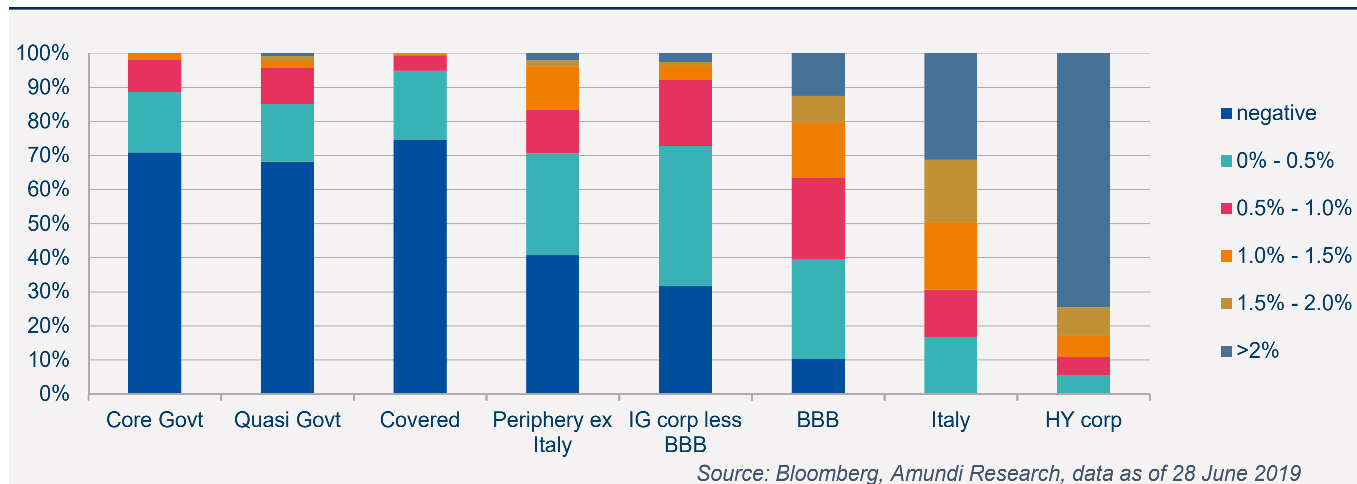
Source: Bank of Italy, Amundi Research, data as of 28 June 2019

Relative value has favoured recent spread tightening: yield hunting is here to stay

On the back of the substantial change in the ECB's monetary policy stance and recent dovish messages from Draghi, together with the sudden revisions in market implied US rates, EUR-denominated bond yields felt much more the "gravity force" from central banks or rate expectations. Among other results, this has meant that most core countries' curves have slipped into negative territory in maturities up to 10 yr, along with a comparable dramatic shift down of other segments, like quasi-government, agency and covered bonds. The desert of yield recently entered uncharted territory in the Eurozone. This is summarized by the reported chart 2), which, for each asset class belonging to EUR fixed income, shows the distribution of debt by yield bucket, from negative to above 2%, as of early June. In order to better develop the analysis, we break down periphery government bonds into two segments: Italy and the rest of periphery, while among corporate bonds we differentiated between BBB-rated and higher rated IG bonds (namely AAA-AA and A-rated). Interestingly, Italy shows a mix of offered yields between BBB corporates and HY debt. Valuations are more attractive also on a volatility-adjusted basis, as spreads remain more in range in the past few months.

As anticipated, chart 2) represents, for each asset class belonging to EUR fixed income, the distribution of debt by yield bucket, from negative to above 2%: Italy shows a mix between BBB corporate and HY debt. Most core govie, quasi-govie and covered bond debt is in negative or flat territory.

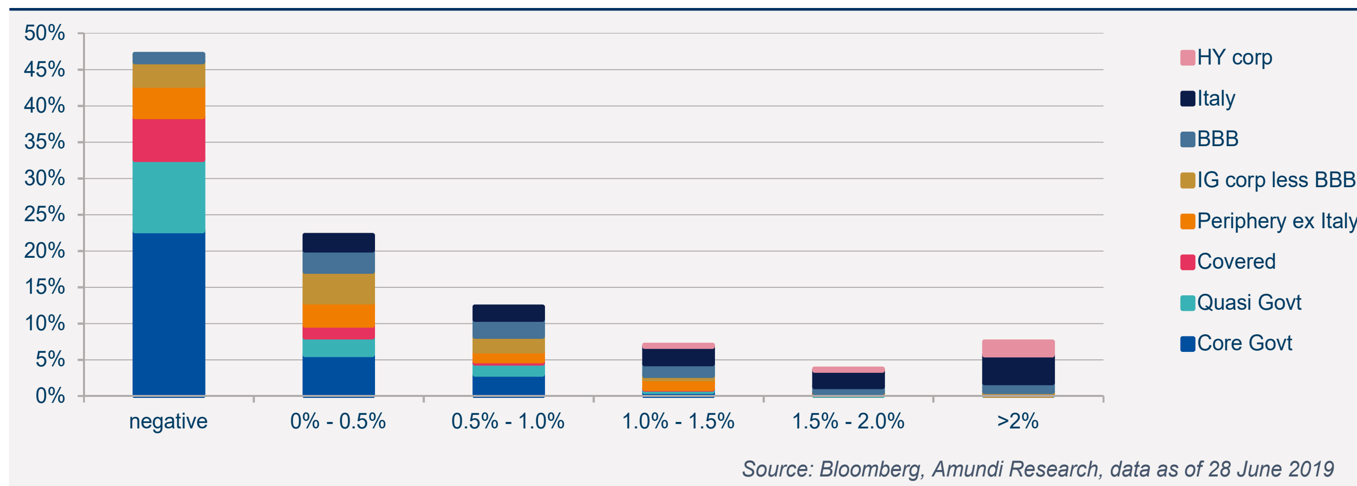
2/ **EUR fixed income debt: distribution by yield bucket for each asset class, as of June 28th**



Source: Bloomberg, Amundi Research, data as of 28 June 2019

Where are positive yields available? The following chart 3) shows it, considering the entire market: just 11% of overall EUR denominated debt offer an yield above 1.5%, mostly by Italy and HY segment. Debt with negative yield reached 47% of the total, debt with an yield close to zero reached 22%.

3/**EUR fixed income debt: distribution by yield buckets of the entire market, as of June 28th**



Source: Bloomberg, Amundi Research, data as of 28 June 2019

A few considerations are important, in our view, in analysing the picture offered by fixed income market

- Most core government bonds, quasi-government bonds and covered bond debt is in negative or flat yield territory: the debt belonging to these "safe" haven segments together accounts for 55% of overall available debt in the EUR fixed income market.
- Moving on to periphery debt, if Italy is excluded, the situation doesn't significantly improve, as this segment represents 11% of EUR fixed-income debt, but offers only 8% of the still available positive yield, a very similar mix of IG excluded BBBs (respectively at 10% and 8%).
- This leaves us with the last three segments: BBB corporates, Italian debt and HY debt, which together make up just a quarter of the market "benchmark" but cumulate around 70% of yield left.
- If we focus on debt yielding more than 1.5%, most of the available debt is represented by Italy and HY.
- If HY bonds are excluded from the computation, for example for rating constraints limited to IG, the dominant role of Italy rises to 40% of the remaining overall yield available.

The return by the end of June of 10-yr spreads in the lower levels of last month's range trading, despite renewed uncertainties about a possible EDP and a persistent weak macro picture shows to what extent technicals are prevailing over other factors in this new phase of lower rates for longer and risks of more QE. The subsequent, sharp fall of BTP spread to the 200 bp area, as we are writing, was also supported by the favourable decision of the EU Commission not to trigger the EDP. In a nutshell, technicals and valuations are likely to continue partially balancing political uncertainties and weak growth.

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