ITALY GOVERNMENT BOND UPDATE

POLITICS COULD PLACE ANTI-FRAGMENTATION TOOL IN JEOPARDY

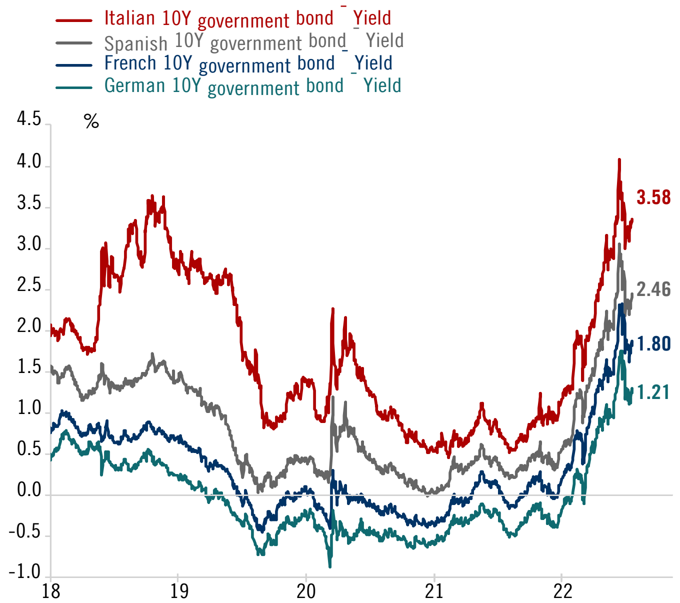
Author

LAURÉLINE RENAUD-CHATELAIN
lchatelain@pictet.com

SUMMARY

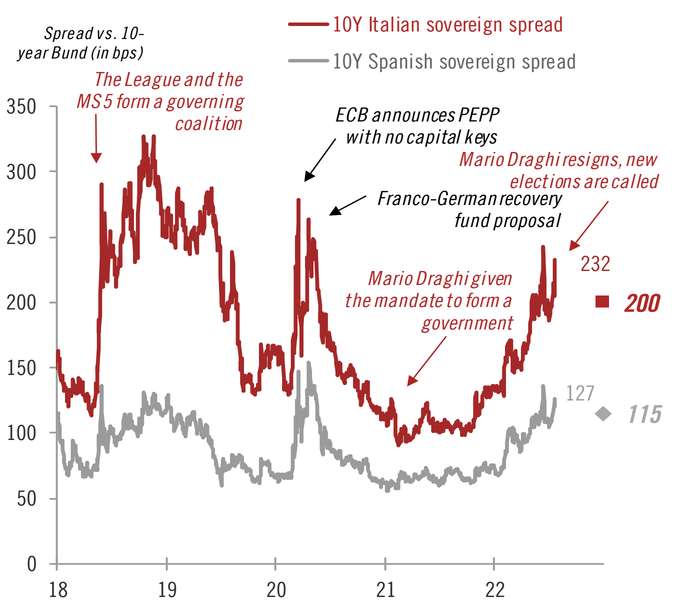
- Following the resignation of Italy's Prime Minister Mario Draghi and the European Central Bank (ECB)'s 50 bp rate hike on 21 July, the 10-year Italian government bond yield rose to 3.55%, with its spread vs. the German Bund reaching 232 bp.
- We expect Italian Buoni Poliennali del Tesoro (BTP) spreads to remain volatile and particularly vulnerable to Italian political risks, as snap elections are held on 25 September. Key for investors will be the thorough implementation of the National Recovery and Resilience Plan (NRRP), which is necessary to receive the next tranches of the Recovery and Resilience Facility (RRF).
- The ECB has delivered on its part by setting up a new Transmission Protection Instrument (TPI). Although the ECB is unlikely to cap BTP spreads should snap elections trigger a political crisis, the fact that the TPI is unlimited, unanimously agreed and at ECB's full discretion should still provide a backstop. It will prove useless however if the new government jeopardises Italy's eligibility for the TPI.
- In our central scenario we would expect the 10-year BTP spread to hover around 250 bp in the coming months due to political uncertainty with risks of larger rises. Our year-end forecast stands at 200 bp as we expect the next government to still receive fiscal support from the European Commission (EC) and monetary support from the ECB. Given upside risks on 10-year BTP yields we remain underweight euro periphery government bonds.

CHART 1 : 10-YEAR EURO GOVERNMENT BOND YIELDS



Source: PWM - CIO Office & Macro Research, Factset, 21.07.2022

CHART 2 : 10-EURO PERIPHERY SOVEREIGN BOND SPREADS VS. THE BUND



Source: PWM - CIO Office & Macro Research, Factset, 21.07.2022

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ECB delivers but how effective will it be?

After signalling a 25 bp hike of its policy rate at its previous meeting, **the ECB delivered a bolder 50 bp at its July meeting**, thereby bringing back the deposit rate to zero for the first time since 2014. Although the move was only partly priced in by market participants following reports in the press, 10-year Bund yield fell by 3 bps on the day to 1.22%, while **its Italian counterpart rose by 15 bp to 3.55%.** As such, 10-year euro government bond yields remain well below the peak of mid-June, when the BTP reached 4.08% (a level not seen since 2013) and the German Bund 1.76% (*see chart 1*). **Fears of recession have weighed on long-term bond yields globally and sent corporate and periphery government bond spreads wider** (*see chart 2*).

After peaking at 242 bp on 14 June, the 10-year BTP spread vs. the Bund had tightened again on market expectations that an anti-fragmentation tool (Transmission Protection Instrument, TPI) would be unveiled at the 21 July ECB meeting. **Although the ECB delivered again, the resignation of Italy's Prime Minister Mario Draghi prompted the 10-year BTP spread to widen to 232 bp on 21 July.** Mario Draghi took his decision after the centre-right parties (Forza Italia and Lega) in his governing coalition failed to vote for him in the confidence vote at the Senate on 20 July and the Five Star Movement (M5S) abstained. Although the ECB is unlikely to cap BTP spreads should snap elections trigger a political crisis, the fact that the **TPI is unlimited, unanimously agreed and at ECB's full discretion should still provide a backstop sufficient to prevent a sustained widening in peripheral bond spreads over the medium term**. Nevertheless, **its eligibility criteria still require the next Italian government to remain fiscally responsible**.

According to the press release, the **TPI should be activated in case of "unwarranted, disorderly market dynamics** that pose a serious threat to the transmission of monetary policy". This means that no specific level of euro periphery government bond yields or spreads has been communicated to trigger its activation. However, the timing of ECB's extraordinary meeting on 15 June, the day after the 10-year BTP yield closed at 4.08% and its spread at 242 bp, means that the pain threshold is probably close to these levels.

Italy's public debt headache

One of the four criteria for a country to be eligible to the TPI is "that the trajectory of public debt is sustainable". **Italy's debt sustainability question is likely to remain, with domestic politics the main driver of Italian government bond spreads**, given it is in rating agencies', investors' and now in ECB's sights. The launch of the TPI likely means that the **ECB reckons that in order to raise its deposit rate well above zero** (we forecast a deposit rate at 1.5% by mid-2023) it will have to make sure **the rise in the average cost of funding of the Italian government does not make Italy's debt unsustainable** through an 'unwarranted' widening of spread (i.e. linked to investors' speculation).

Looking at Italy's debt-to-GDP trajectory, **we estimate it could stabilise close to current levels (151% in 2021) if the 10-year BTP yield remains stable around 3.5%** (all else equal) in the upcoming decade. It would rise towards 170% if the yield settles permanently around 4.5%, effectively making Italy's debt unsustainable (*see chart 3*).

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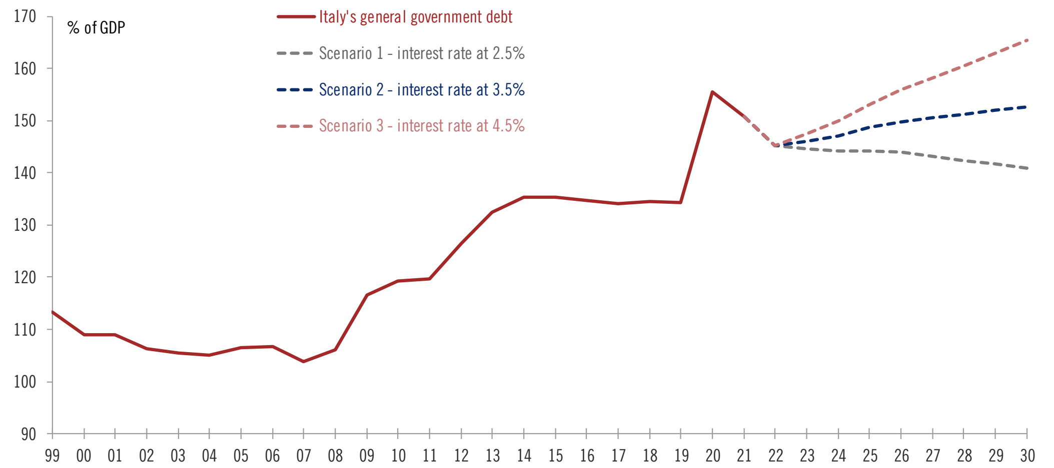
Beyond the cost of funding risk, **Italy's nominal GDP growth is also key**. Although elevated inflation usually boosts nominal growth and public revenues, leading to a fall in debt-to-GDP ratios, the energy shock Europe is encountering is already putting additional strains on public finances. For now, Italy's government has maintained its forecasted deficit at 5.6% of GDP for 2022, financing the fiscal support to counter high energy prices with savings within the budget and extraordinary taxes on the windfall profits of energy firms. Should gas rationing become necessary or high energy prices lead to a sharp drop in domestic consumption and production, the **recession could be more severe than we anticipate, thereby reducing government revenues**.

CHART 3: ITALY'S PUBLIC DEBT-TO-GDP RATIO AND OUR OWN PROJECTIONS



Source: PWM - CIO Office & Macro Research, European Commission

Political turmoil unlikely to be fought by the TPI

On top of looming risks from an energy crunch, a negative note emanated from Italian politics after a week-long saga regarding the survival of the government led by Mario Draghi. **His resignation as Prime Minister on 21 July** (his second resignation in a week) **was a clear negative for market participants.**

Italy is now less likely to remain on track with its reform agenda and be able to get the disbursement of the next tranches of Recovery and Resilience Facility (RRF) funds. **The snap elections on 25 September could delay both the process to vote on the 2023 budget and the implementation of the National Recovery and Resilience Plan** (NRRP), which is necessary to receive the next tranches of the RRF. The second tranche is still likely to be disbursed, meaning that Italy would have secured EUR42.1 bn (2.5% of 2021 nominal GDP) in grants and loans out of the EUR191.5 bn it was allocated. Uncertainties regarding the composition of the future governing coalition also mean that **Italy could in the future struggle to meet the necessary conditions to be eligible for the TPI**. This means that the current political uncertainty in Italy is making the TPI less credible to market participants as a tool to contain widening of euro periphery spreads.

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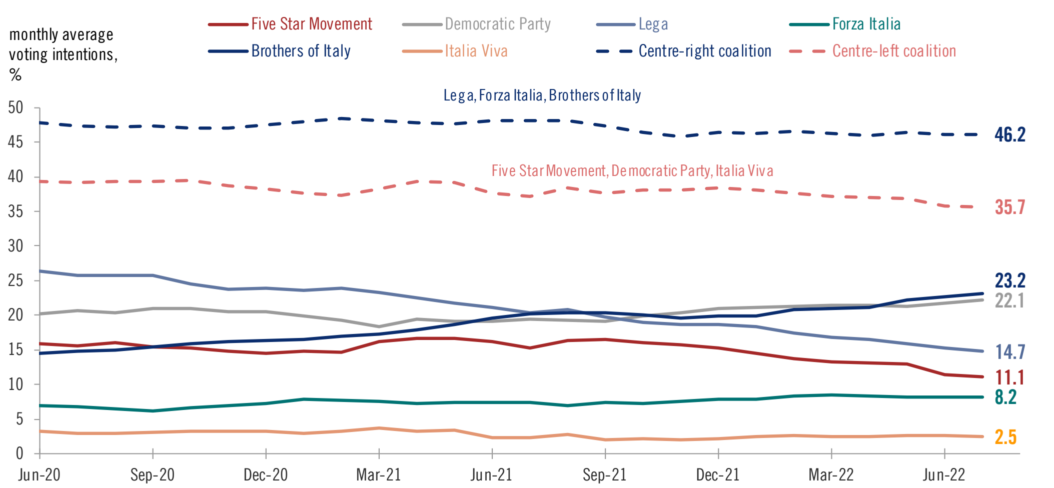
Back in 2018-2019 when the League and the M5S formed a populist and Eurosceptic governing coalition, the 10-year BTP spread averaged 255 bp. According to the latest polls, **the centre-right coalition with 46% of voting intentions could well be in position to govern after the snap elections**, while for a centre-left governing coalition it would very much depend on the small parties and M5S participation (*see chart 4*).

A positive compared to 2018-2019 is **the reduced Eurosceptic rhetoric from the far right**, as the European Union (EU) has finally provided more fiscal support through the RRF. Nevertheless, **both the League and the M5S have been calling for an increase in Italy's deficit**, so a backlash against the EC could take place in 2023 if the deficit is not reduced as planned. The **EC could still launch an Excessive Deficit Procedure** (EDP), if it deems the government budget at risk of destabilising public finances.

CHART 4: VOTING INTENTIONS FOR ITALIAN PARTIES



Source: PWM – CIO Office & Macro Research Various polls

We expect BTP spreads to remain volatile and vulnerable to Italian political risks. Key for investors is the thorough implementation of the NRRP, as it could boost potential growth through public investments. The ECB has delivered on its part by setting up the TPI. Although the **ECB is unlikely to cap BTP spreads should snap elections trigger a political crisis**, the fact that the TPI is unlimited, unanimously agreed and at ECB's full discretion should still **provide a backstop**. It will prove useless however if the new government jeopardises Italy's eligibility either by putting its debt-to-GDP ratio on an unsustainable path, by not complying with its NRRP or by being subjected to an EDP.

In our central scenario, we would expect the 10-year BTP spread to hover around 250 bps in the coming months due to political uncertainty with risks of larger rises. **Our year-end forecast stands at 200 bps as we expect the next government to still receive fiscal support from the EC and monetary support from the ECB.** But any drifting away from the EC requirements from the next government is likely to make Italy subject to severe spread widening pressures with the only resort potentially being to apply for the Outright Monetary Transactions (OMT) program. **Given upside risks on 10-year BTP yields we remain underweight euro periphery government bonds**.

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