PICTET WEALTH MANAGEMENT

Italian sovereign bonds 2023 outlook

A ray of sunshine through the clouds

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FLASH NOTE

SUMMARY

- The rise in interest rates has brought back into focus discussions about debt sustainability in highly-indebted countries, like Italy.
- Italy's debt-to-GDP ratio has fallen in 2021 and 2022 despite massive public spending to counter the impact of the pandemic and the war in Ukraine. This might seem counterintuitive, but higher nominal GDP growth (thanks to high inflation) has played a big role in improving the debt picture.
- After some widening around the snap elections, the 10-year Italian sovereign spread against the Bund fell again below 200 bps, to 186 bps (on 16 February), sustained both by the relative fiscal rectitude of the new right-wing government and by the dissipation of the energy price crunch.
- Considering the improving outlook for Italy, we expect the 10-year spread to hover below 200bps in H1, before increasing slightly towards 220bps by year-end. Our expected spread widening later this year is primarily related to our concerns over an elevated policy rate and new price-sensitive buyers as the European Central Bank reduces its footprint. This could translate into higher Italian sovereign bond yields and could again spark concerns with regards to debt sustainability, so we remain underweight on euro periphery government bonds overall.

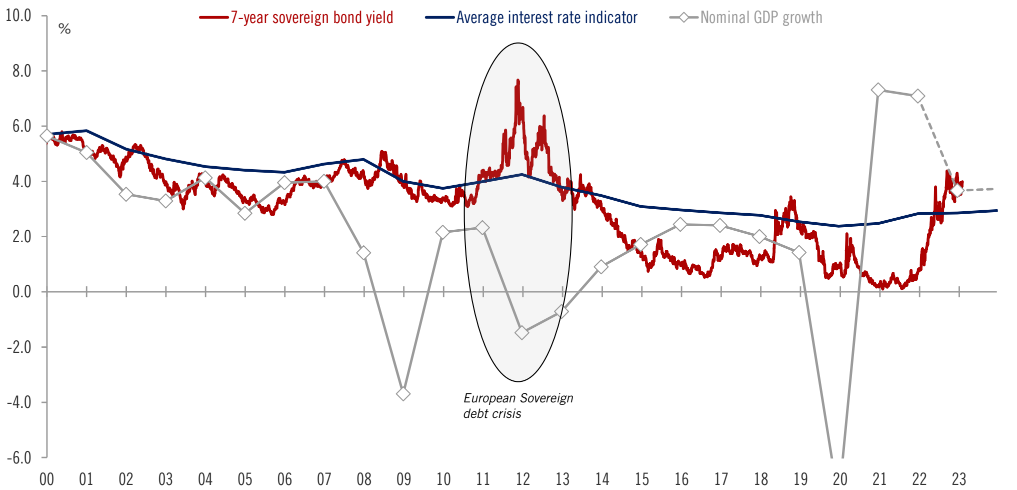
THANK YOU ELEVATED NOMINAL GROWTH

The forceful policy response of governments to Covid-19 and the war in Ukraine in the context of raising interest rates has put public debt sustainability back into focus, particularly for highly-indebted countries like Italy. A key determinant of debt dynamics and sovereign sustainability analysis is the difference between the average interest rate that governments pay on their debt and the nominal growth rate of the economy. When the nominal growth rate is higher than the average interest rate, the government can run a primary deficit while keeping the debt ratio constant. From 2000 to 2020, the average interest rate was higher than the nominal growth rate in Italy, while the picture changed from 2021 (see *chart 1*).

Italy's debt-to-GDP ratio fell from around 155% in 2020, to 150% in 2021 and 145% in 2022, thanks to strong nominal GDP growth. This downward trend is likely to continue in 2023, as still-elevated inflation will keep nominal growth higher.

Furthermore, given the high average residual maturity (7.8 years), the recent increase in Italian sovereign bond yields will be relatively slow to feed into higher interest payments. Nevertheless, in 2022 the Italian government saw its interest expenses surge to EUR76 bn from a historic low of EUR57 bn in 2020. **These financing costs are likely to rise further in the years ahead due both to primary deficits and elevated yields.**

Chart 1: Italy's government cost of funding and nominal GDP growth



Source: Pictet Wealth Management, AMECO, European Commission, Bloomberg LP, as of 15.02.2023

THE NEW GOVERNMENT IS NOT ROCKING THE BOAT

On 5 August 2022, **Moody's downgraded Italy's sovereign rating outlook to negative, opening the door for a downgrade of its rating to high yield** (HY) (Moody's assigns a Baa3 rating to Italy, which is one notch above HY). At the time, Moody's primary concern was the derailment of the structural reforms planned in the National Recovery and Resilience Plan (NRRP) by a new government following the resignation of Mario Draghi. **After some widening around the snap elections, the 10-year Italian sovereign bond** (Buoni del Tesoro Poliennali, BTP) **spread against the Bund fell again below 200bp, to 186bp** (on 16 February, *see chart 2*), sustained both by the relative fiscal rectitude of the new right-wing government and by the dissipation of the energy price crunch.

In mid-December, the EC stated that Italy's 2023 Draft Budgetary Plan was in line with the fiscal stance outlined in the Council recommendations. In addition, last November, Italy received EUR21bn (€10 bn in grants and EUR11 bn in loans) under the second tranche of National Recovery and Resilience Plan (NRRP) funds,

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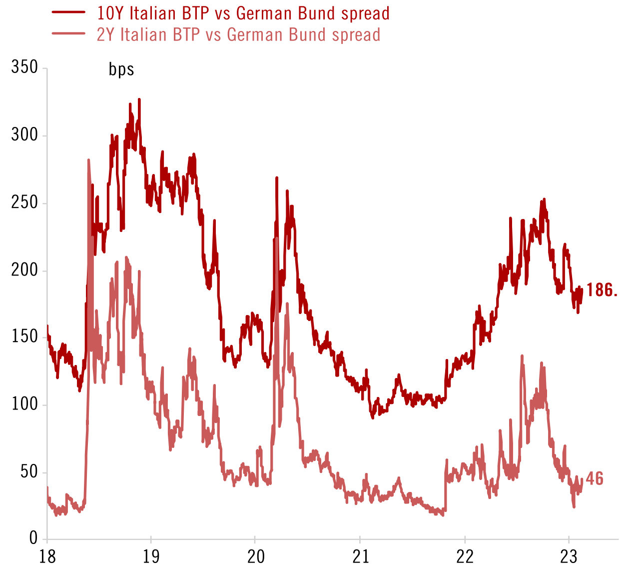
bringing the total funding received so far to almost EUR67 bn. The payment of the third instalment of NRRP funds (EUR 19bn) will be made in the coming months.

The grants and loans available from the EU have enabled Italy to partly spend without tapping the bond market. Despite a general government borrowing requirement amounting to EUR54 bn in 2022, Italy's net issuance of medium- and long-term bonds stood at only EUR15.9 bn last year (down from EUR87.2 bn in 2021), thanks in part to EUR22 bn financed by loans from the European Union. The Department of the Treasury foresees about EUR50 bn of net issuance this year.

Additionally, the improving growth outlook and the recent fall in energy prices could further improve the state of the government finances. Finally, recent regional elections in Lombardy and Lazio have confirmed centre-right's dominance. **Ahead of the May 2024 European elections, there are no other major electoral events, so that could mean calm waters on the political front**.

Chart 2: Ten- and two-year Italian sovereign bond spreads



Source: Pictet Wealth Management, FactSet, 16.02.2023

Chart 3: Amount of Italian sovereign debt held and the two-year bond yield

Source: Pictet Wealth Management, DataStream, December 2022

REDUCED SHORT-TERM CONCERNS, BUT A STILL CHALLENGING OUTLOOK

As illustrated by the two-year BTP spread tightening back to historical lows (to 46bp on 16 February, *see chart 2*), **market participants seem to have much less short-term concerns with regard to Italy's public debt sustainability**. This is likely also to be the case for ratings agencies. Moody's next review of Italy on 19 May is unlikely to result in a downgrade to HY. If the Italian government stays the course on structural reforms and deficit reduction, and if a recession is averted, Moody's could well put Italy's rating outlook back to stable in H2, reducing the threat of an HY rating.

Nevertheless, despite rays of sunshine, clouds remain on the horizon. For one, the European Central Bank (ECB) is on track to hike its policy rate to our 3.5% expected level, and it could well maintain it in the coming years. **This is likely to push the**

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seven-year BTP yield up from 3.93% (on 16 February), **to above the 4.5% threshold we have identified as sensitive for medium-term debt sustainability** (see Italy government bond update).

Second, as the ECB embarks on quantitative tightening (QT) in March, it will slowly reduce its large footprint in the Italian sovereign bond market (it owns 26% of bonds outstanding). **It means that a price-insensitive actor will be replaced by more sensitive ones**. Aside from foreigners (27% share), **non-financial residents could make a comeback, in particular Italian households**. The Italian government is exploring ways to incentivise Italian savings into domestic sovereign bonds. **In the past, the best incentive has been attractive yields** (*see chart 3*). And with a share of only 7%, non-financial residents have scope to increase their holdings if history is any guide (they owned 53% in 1990). Nevertheless, **this will likely require yields to remain elevated and could also mean much more volatility**.

Considering the improving outlook for Italy, **we expect the 10-year BTP spread to hover below 200 bps in H1, before increasing slightly towards 220 bps in H2**. Our expected spread widening later this year is primarily related to our concerns that the clouds mentioned above (elevated policy rate and new price-sensitive buyers) could translate into **higher Italian sovereign bond yields and that it could again spark concerns with regard to debt sustainability. Hence, we remain underweight on euro periphery government bonds overall.**

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