THIS MONTH'S TOPIC

Demand supports Italian debt issuance as primary markets move into the spotlight

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Finalised on 29/01/2019

The essential

In a year that will see the end of net PSPP purchases by the ECB and an increase in projected net issuance, we focus on Italy's funding strategy and primary market outlook for 2019, a topic likely to become more closely monitored on the markets' radar screens over the next quarters. Despite a challenging H2 2018, trends in the average cost of funding and average debt maturity have not yet shown a material impact on Italy's debt structure, as we will show in this piece.

The very start of 2019 saw quite a strong and successful new issuance activity run by the Italian Treasury, and thanks to brisk demand, in just a few weeks Italy has already collected roughly 10% and 50%, respectively, of overall gross and net issuance for the whole year, according to our latest projections and guidelines from the Italian Treasury. It also must be noted that deal reception and post-issuance performance were generally encouraging not only for Italian BTPs but also for new debt issued by other peripheral countries, confirming that yield search is still alive in the Eurozone in the context of a more dovish monetary policy environment. However, despite these promising signs and the recent tightening in spreads following the budget agreement between the government and the European Commission, the macro picture still looks weaker than last year and downside risks have increased, also due to external factors.

Italy's funding strategy, primary market outlook for 2019 and the structure of Italian debt

Italy has recently published the yearly document in which the Treasury outlines its funding strategy for the upcoming 12 months *("Linee guida della gestione del debito pubblico - Anno 2019" MEF)*

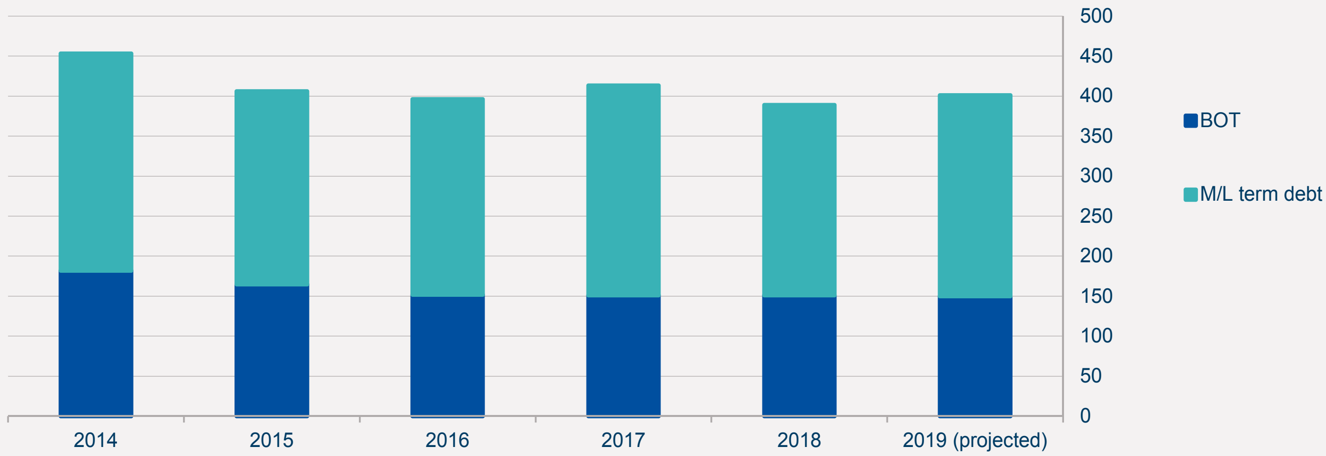
The guidelines outlined by the Italian Treasury on its funding strategy for 2019 show several detailed goals, but in a nutshell they point to transparency, managing primary market activity in a regular and forecastable way, and concentrating issuance where potential demand looks more robust and market depth greater. The diversification of the investor base is another goal for 2019, which could be targeted by possibly issuing in foreign currency.

The Italian Treasury also aims to optimize the mix between the average funding maturity and average funding cost over the year, which certainly looks more challenging than in previous years.

A challenging year in terms of issuance volumes

- 2019 Italy's **M/L term debt issuance** is estimated to be in the **EUR 250bn** area and will offset:
    - redemptions (higher than in 2018) amounting to EUR 201bn, with a EUR 17bn increase vs the previous year,
    - the cash deficit, expected to be EUR 50bn area (close to 2018 level).
- The **BOTs** (Bills) component should remain stable in the **EUR 150bn** area.
- Therefore, projections for 2019 point to an **overall funding volume** close to **EUR 400bn**, higher than the EUR 390bn issued in 2018.

1/ **Italian Government Debt: yearly issuance, by type of instruments (in EUR bn)**



Source: Bloomberg, Amundi Research. Data as of 25 January 2019

Among the curve segments, in relation to 2018, supply is expected to be lower at the belly of the curve (5 and 7-yr) and higher at the short end (2 and 3-yr) and long end (10-yr and 15-30 yr)

The expected distribution of the issuance mix among different curve segments seems to point to the goal of consolidating the structure achieved in recent years, in particular with a higher average maturity, while containing funding costs in light of the strong steepening in the yield curve in the latest quarters. Since early May 2018, in fact, 3-yr and 5-yr maturities have recorded quite a steepening vs the corresponding 2-yr, while the opposite took place in the 7-yr to 10-yr and extra-long segments. Moving onto a more detailed analysis by curve buckets we summarize the main points below:

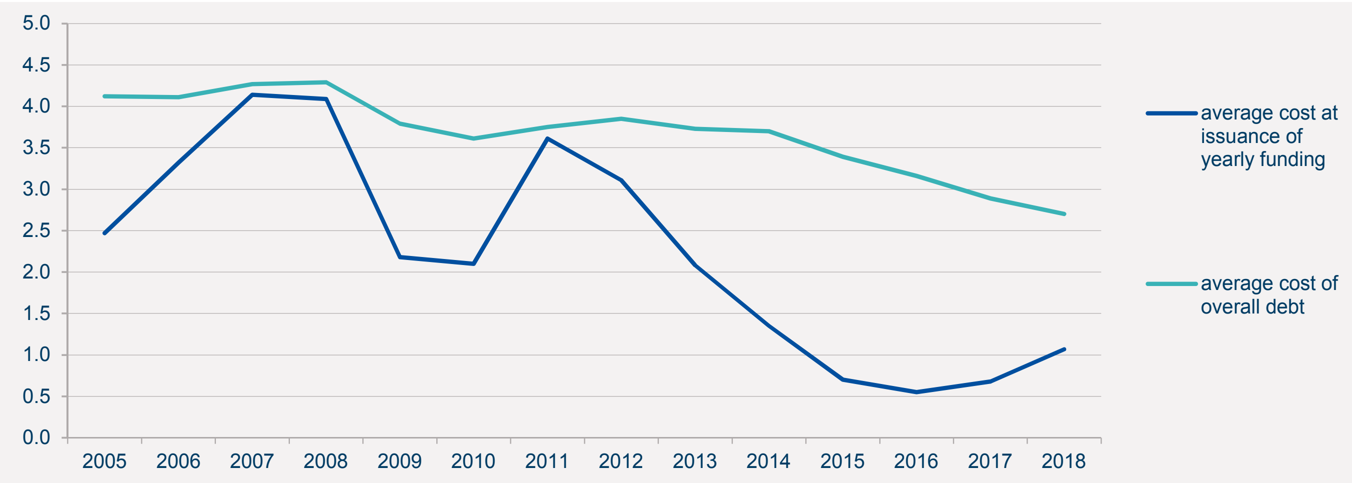
- **3-yr and 5-yr BTP**: 3-yr and 5-yr BTPs respectively totaled EUR 36bn and EUR 31bn of new issuance in 2018, with a calibration of volumes vs the 3-yr (in percentage of the overall issued debt). Total issuance in 2019 on these two maturities should remain in line with the 2018 calibration, and probably more skewed towards the 3-yr rather than the 5-yr. The Treasury expects a positive net issuance on the 3-yr (more than EUR 24bn in redemptions) and a negative net issuance on the 5-yr (EUR 47bn redemptions).
- **7-yr BTP**: Gross supply is expected to be lower this year than the EUR 33bn volume recorded in 2018, mainly because of lower redemptions in this tenor: however, net supply will be positive, increasing the weight of this segment in overall debt.
- **10-yr BTP**: Issuance amounted to EUR 36bn in 2018. With gross supply expected to be above EUR 48bn this year, this tenor will continue to play a significant role in 2019. At the same time, however, net supply in this segment should be slightly negative.
- **15, 20, 30 and 50-yr BTP**: in its guidelines, the Italian Treasury mentioned the goal of remaining active in this segment, despite more challenging market conditions. Consistent with this goal, the Treasury has already issued a new EUR 10bn 15-yr bond and depending on market conditions may sell a new 30-yr. Last year, a total volume of EUR 30bn was issued in the extra-long maturities segment and Italy targets similar issuance volume in the next 12 months. Taking into account a significant maturity in the 15-yr segment of close to 23bn, net issuance should be positive in this segment.

What about trends in the cost of funding and the average maturity of Italian debt?

- The **average life of debt** has decreased only slightly, from 6.9 years in December 2017 to **6.78 years at the end of 2018.**
- At the same time, in 2018 the **yearly funding cost** rose for the first time in recent years to **1.07%,** up from **0.7% in** 2015, **0.55% in** 2016 and **0.68%** in 2017: funding costs began to rise from the second half of May.
- A 1.07% the average yearly funding cost is still quite low by both historical standards and relative to **the average cost of the whole stock of outstanding debt,** which fell further in 2018 to **2.7%** (the last available data are for October), down from 2.89% in 2017 and 3.16% in 2016.
- The chart shows trends in both the yearly funding cost and the average cost of overall outstanding debt: thanks to the sharp fall in the yearly funding cost in 2013-2015, a lagged substantial drop in the average cost of overall debt was seen in the following years (down from 3.7% in 2015 to 2.7% in 2018).

- Assuming current yield levels as the average funding costs for 2019, a further but limited rise in the yearly funding cost to 1.3%/1.4% is likely.
- Based on the Bank of Italy's recent indications, the rise in the yearly funding cost that materialized last year should have a limited impact on the overall cost of debt (**see last FSR November 2018**). "*The long average residual maturity of outstanding securities (6.7 years) slows down the transmission of yield increases to the cost of the debt: with no changes in the composition of the stock of securities, **a permanent increase of 1 percentage point in yields at issue** would lead to an increase in the average cost of debt of about **0.1 percentage points after one year, 0.2 points after two years, and 0.4 points after three year**s. Medium-and long-term securities (more than 12 months) maturing in 2019 amount to about €200 billion; taking account of securities with shorter residual maturities and of the need to cover the general government deficit as well, next year's gross issues will amount to about €400 billion.*"

2/ **Italian Government Debt: average cost of yearly funding and average cost of overall debt, in % points**



Source: Bloomberg, Amundi Research. Data as of 25 January 2019

The year started with successful new issuance activity by the Italian Treasury

The Italian Treasury was quite active in the primary market at the start of the year. After just three weeks, in fact, new issuance of M/L term debt issuance already totaled more than EUR 25bn.

- In pure number terms, this means that relative to refunding needs for the whole year, Italy has already covered 10% of overall scheduled gross issuance and a remarkable 50% of its entire 2019 net funding needs.
- In terms of tenor of issued debt, the Italian Treasury managed to place quite long bonds, as the average maturity of new issuance is close to 11 years, almost double the average maturity of its total outstanding debt. This was made possible thanks to EUR 10bn of a new 15-yr BTP and EUR 2.6bn and 1.5bn, respectively, of new 10-yr and new 30-yr BTPs.
- With respect to the much less challenging market conditions of 2018, this year activity is encouraging, as the amount issued year to date totals EUR 1bn more than the amount issued by the same date last year. To make things less simple, January is one of the very few months of 2019 with no redemptions at all.
- Italian Treasury auction results were generally good, both in terms of the amount issued relative to targeted amounts (always at the upper end of the announced auction range) and in terms of bid-to-cover ratios.
- The syndicated 15-yr bond not only collected record orders, amounting to EUR 35.5bn (cover ratio 3.6x), but it also drew quite a high initial offer from abroad, as foreign investors accounted for around two-thirds of the order book, with quite a broad distribution by investor type, not tilted towards long-term investors. A record high volume was in fact allocated to fund managers (55%), while geographical distribution saw a large share allocated to investors based in Germany, Austria and Switzerland (21%) – around double the average historical allocation to these three countries for similar long-dated syndicated BTPs issued in the last four years.
- The spread tightening that followed the closure of the syndicated 15-yr BTP seems to confirm real interest in the country's new debt.
- Among other peripheral countries, following the success of the Italian Treasury, Spain also collected a record order book for a 10-year euro sovereign note, while Portugal and Ireland had already both sold EUR 4bn 10-yr bonds with order books of over EUR 24bn and EUR 18bn respectively.

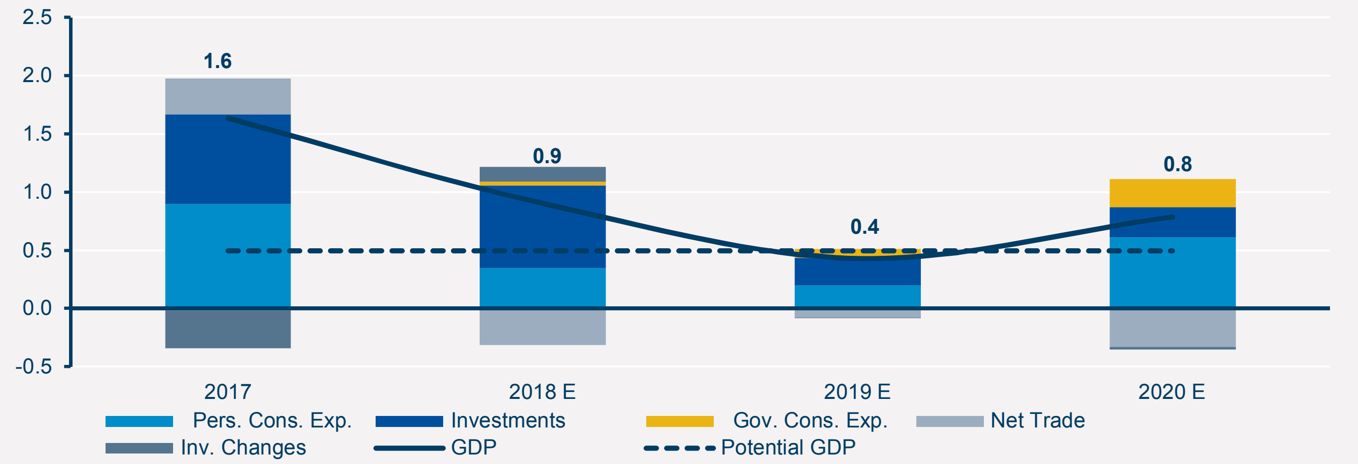
The Italian macro picture looks weaker

Thanks to the final agreement reached by the Italian government and the European Commission on the 2019 budget, pressure on the BTP has somewhat eased, a relief mostly due to the Italian Government's implicit commitment to work within the EU framework of laws and institutions.

Yet we must acknowledge the increased risks of a technical recession in Italy, where the Q3 18 GDP reading was negative and Q4 also looks likely to be very weak. This in turn could put at risk the achievement of the deficit target for the year (2.04%) and the decline in the Debt/GDP ratio as well, because realized growth may be much lower than the assumption used to set the targets. The inflation path also looks likely to remain subdued.

While we expect the Italian economy will grow in the 0.5% range (actual forecast 0.4% YoY average for 2019), slightly below the baseline projections of the Ministry of Economy and Finance and the Bank of Italy (0.6% YoY in 2019), we also think that risks to the downside are high. Significant risks come from the external side: deceleration in global trade and slower growth in key euro area trade partners could weigh on the export-led part of the economy. On the domestic side, the decline in business confidence coupled with a slowdown in capex and private investments may be a drag on internal demand. Consumers still remain overall optimistic even though there has been a slight deceleration in real disposable income, and they have marginally increased their propensity to save, while the labour market keeps slowly declining. On the other hand, lower oil prices could represent an upside risk.

3/ **Italy GDP & contributions**



Source: Thomson-Reuters Datastream, ISTAT, Amundi Research, Data as of 28/01/2019

Conclusion

January saw the first wave of Italian BTPs being well received in the primary market, despite the lack of redemptions. In this respect, there will be redemptions again in the next two months, as EUR 23.1bn in BTPs will mature at the beginning of February and a similar amount will mature in March, therefore offering some support to the secondary market, and indirectly to upcoming auctions. Short-term technicals supported a partial return of foreign demand, as according to available data, "non-residents" had strongly reduced their holdings in the last three quarters of 2018. This would tend to explain the relatively high participation of foreign investors in Italian and other peripheral countries' primary market and the distribution by investor type at a time when ECB rates are no longer expected to move up this year. Italy has already covered a significant portion of yearly net supply by issuing long bonds: its funding strategy aims to optimize the mix of average maturity and average funding costs, keeping the first stable while calibrating issuance across the steeper curve to address the second objective. Despite the slight rise in funding costs, the average cost of overall debt remains low vs previous years and should not be strongly impacted in the next one to two years. However, the year has just started and it remains quite challenging in terms of overall funding needs and supply, as we outlined in the numbers shown in the first section. Furthermore, the main medium- to long-term challenges still relate to the weaker macro trends we analysed in the last section and persisting political uncertainties in the Eurozone (Brexit and European elections, first) and outside the Eurozone.

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February 2019 #02

Document issued by Amundi, “société par actions simplifiée”- SAS with a capital of €1,086,262,605 - Portfolio manager regulated by the AMF under number GP04000036 – Head office: 90 boulevard Pasteur – 75015 Paris – France – 437 574 452 RCS Paris – www.amundi.com

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