14 January 2021

Italy: ECB's umbrella to protect bond market, despite uncertain political situation

Matteo GERMANO
Head of Multi Asset
CIO Italy

Sergio BERTONCINI
Senior Fixed Income Strategist

Isabelle VIC-PHILIPPE
Head of Euro Aggregate

- ***Political situation****: On 13 January, Italia Viva – a minor coalition partner led by former Prime Minister Matteo Renzi – pulled out of the ruling coalition, leaving the government short of a majority in the Senate****. However, we believe that snap elections are unlikely for now****. In our view, the most likely scenarios are: Prime Minister Giuseppe Conte* ***could seek to win a confidence vote,*** *with support from parties both inside and outside the ruling majority and also unaffiliated lawmakers (Gruppo Misto);* ***Conte could step down, triggering a new round of talks*** *that could eventually lead to a new administration, headed by Conte himself or another Prime Minister, with support from the same alliance; or a caretaker administration could be appointed to manage the government until the next election.*
- ***Financial markets appear to be holding up, with the ECB's action helping keep volatility at historically subdued levels.*** *At its December 2020 meeting, the* ***ECB*** *expanded its pandemic emergency purchase programme (PEPP) by a further €500bn to an overall size of €1.85tn, and also extended its reinvestment policy. We believe that the ECB's action should keep the average cost of funding low.* ***Technicals*** *will remain strong in 2021, thanks to the ECB purchases, lower expected net issuance and the persisting 'hunt-for-yield' among investors. The role played by the ECB will remain crucial over the next few years.* ***Current valuations are tight and offer limited room for further spread narrowing.*** *In relative terms, Italian yields are more attractive than those of other peripheral countries. We remain constructive on Italian sovereign debt. As the risk premium narrows further, the curve should flatten and investors should position on the very long end of the curve.* ***The ten-year BTP-Bund spread is expected to trade in the 100-125bp range throughout the political crisis****. Investors in the Italian government bonds market should consider any slip in the Italian bond market as an opportunity to increase their exposure.*
- ***Macroeconomic scenario****: Low potential growth, which results from a chronic lack of investment, is the Achilles' heel of the Italian economy.* ***Real GDP*** *should contract by 8.6-9.0% in 2020, rebound by some 3.2-3.7% this year, and slow to 3.0-3.4% in 2022.* ***Italy's public debt-to-GDP ratio*** *should rise from 135% in 2019 to around 160% in 2020****. Italy's debt is mainly -- about 70% -- owned by domestic investors, while foreign investors make up the remaining 30%.*** *The share owned by the Eurosystem of central banks has increased since the launch of QE in 2015 and stood at 24% of marketable debt at September 2020. It is expected to rise to some 28% by the end of 2021 on the back of the ECB's asset purchases. We expect Italy's budget deficit to hit 11.4% of GDP in 2020, and then decline to 8.2% in 2021.*
- ***We believe that the Next Generation EU package is a game changer for EU fiscal policy,*** *and could boost Italy's growth significantly in the medium/long term. The* ***pandemic will deepen the social divide*** *within the country between people who have a 'regular' job and those in the informal economy who cannot rely on any welfare programme. In addition, uncertainty remains high among people who can count on a job, and the savings rate has topped 20% in the second quarter of 2020, boosting cash availability in bank accounts.* ***Part of this large amount of savings will be available to be invested into the real economy****.*

POLITICAL SITUATION

On 13 January, Italia Viva – a minor coalition partner led by former Prime Minister Matteo Renzi – pulled out of the ruling coalition, leaving the government short of a majority in the Senate. Renzi said that ministers from his party would quit the cabinet over disagreements on how to invest funds from the Next Generation EU fund and the appropriateness of asking for an ESM credit line. However, snap elections appear unlikely for now, as Italian president Sergio Mattarella is said to be reluctant to see the country vote during the pandemic. In our view, the most likely scenarios are:

- **Prime Minister Giuseppe Conte could seek to win a confidence vote,** with support from parties both inside and outside the ruling majority and also unaffiliated lawmakers (for example, Gruppo Misto). This could mean relying on forces such as Silvio Berlusconi's Forza Italia party to keep the government in power.
- **Conte could step down,** triggering a new round of talks among parties that could eventually lead to a new administration, headed by Conte himself or another Prime Minister, supported by the same alliance.
- **A caretaker administration** could be appointed to manage the government until the next election.

"Investors on the Italian government bonds market should consider any slip in the Italian bond market as an opportunity to increase their exposure."

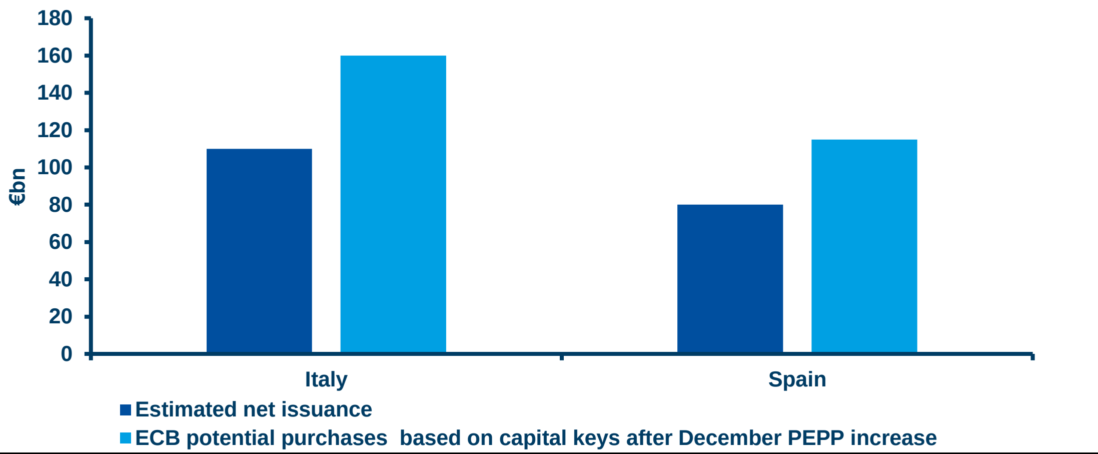
FIXED INCOME MARKET

In early trading on 14 January 2021, financial markets appeared to be holding up, with the ten-year BTP-Bund spread up only 3bp. It would appear that markets have become somewhat accustomed to Italy's political crises. At the same time, the ECB's action is helping to keep volatility at historically subdued levels. **The ten-year BTP-Bund spread should trade in the 100-125bp range throughout the political crisis.** Investors in the Italian government bonds market should consider any slip in the Italian bond market as an opportunity to increase their exposure.

The ECB plays a key role in absorbing additional debt and keeping funding costs low

- In response to Covid-19, the ECB has launched a €1.85tn pandemic emergency purchase programme (PEPP), with the size having been **expanded by €500bn at the December ECB meeting**, together with an extension from June 2022 to at least the end of 2023.
- **We expect ECB policy to keep the average cost of funding low** – it is currently about 0.7% for 2020 – and that this will contribute to the reduction in the cost of funding for the overall stock of debt, which currently sits at about 2.5%. Given the weak inflation environment, we expect the ECB to continue to provide strong support to the debt market over the coming years. This, coupled with the recent increase and extension of net QE flows and of ECB reinvestments up to the end of 2023, should support a persisting low cost-of-funding environment.

2021 ECB potential bond purchases vs. expected net issuance for Italy and Spain



Source: Amundi Research based on Bloomberg data as of 11 January 2021.

"The ECB purchases will cover the combined bonds and bills net issuance in 2020 and are likely to exceed Italy's net funding needs currently projected for 2021."

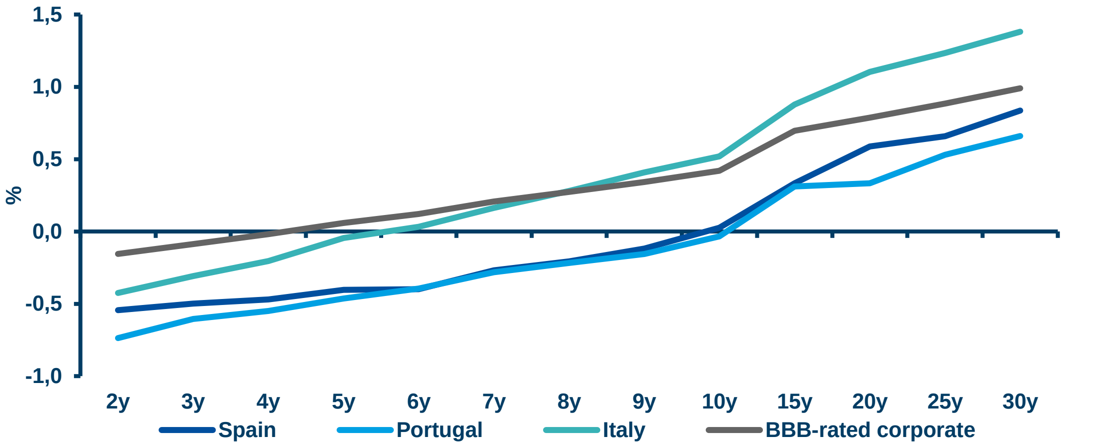
Technicals, supply and demand

- Technicals will remain strong in 2021, thanks to the ECB purchases, lower expected net issuance and the persisting 'hunt-for-yield' drive among investors.
- **The ECB purchases covered the combined bonds and bills net issuance in 2020 and are likely to exceed Italy's net funding needs currently projected for 2021**.
- The role played by the ECB will remain crucial over the coming years; its relevance has been acknowledged by the latest S&P and Fitch Italian sovereign rating reviews.
- On 23 October 2020, S&P confirmed Italy's sovereign rating at BBB, while upgrading the outlook to stable from negative, mainly thanks to the combined strong support from monetary and fiscal policy. The rating agency acknowledged the high uncertainty surrounding Italy's macroeconomic outlook due to the pandemic and that risks to its short-term outlook are skewed to the downside. However, **the extraordinary policy response at both the national and European levels, including from the ECB, offsets the adverse fallout** on growth, supporting the outlook upgrade.
- On 4 December 2020, Fitch confirmed Italy's rating at BBB-, with a stable outlook. According to the rating agency, the pandemic has had a significant impact on Italy's economy and the sovereign's fiscal position. The high debt-to-GDP ratio will weigh on the rating, while the latter will be supported by a diversified and high value-added economy.

Our view: constructive view on Italian debt, preference for the long end of the curve

Italian yields are more attractive than those offered by other peripheral countries.This has given rise to strong demand from Japanese investors in search of more attractive returns than those offered by core and semi-core Eurozone bond yields. **We believe that the Next Generation EU package is a game changer for EU fiscal policy and for Italy.** Current valuations are tight and offer limited space for further spread narrowing; following the strong tightening delivered over the past few months, Italian spreads are back close to the 'low-risk-premium' area of 2015-16, with ten-year BTP vs. Bund spreads at 100-130bp. We remain constructive on Italian sovereign debt. As the risk premium narrows further, the curve should flatten and investors should position on the very long end of the Italian curve.

Peripheral and BBB-rated corporate curves, as of 13 January 2021



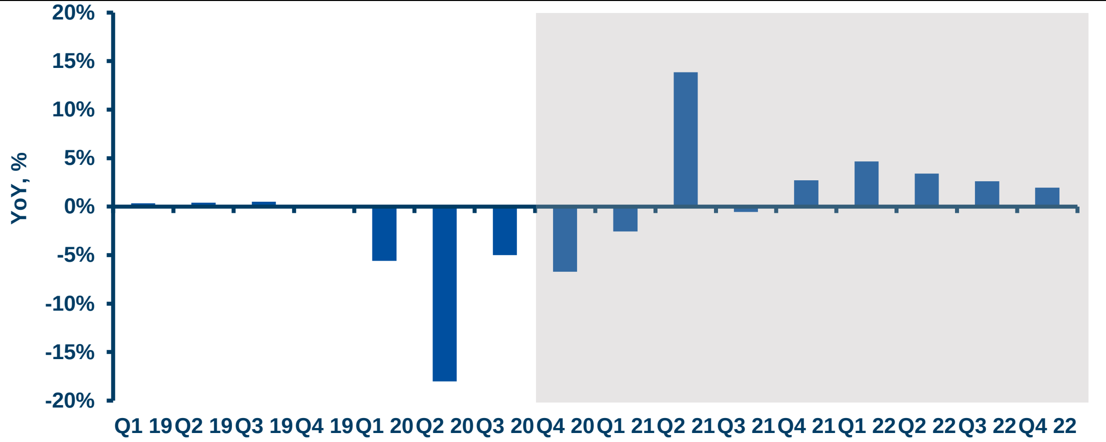
Source: Amundi Research on Bloomberg data as of 13 January 2021.

MACROECONOMIC SCENARIO

Low potential growth is the Achilles' heel of the Italian economy

- **Economic weakness is a long-standing feature of the Italian economy**: it has its roots well before the 2008 Great Financial Crisis (GFC) and hinges on the country's limited productivity gains over time. This low productivity is mainly the result of a chronic lack of investment, setting aside structural effects such as the expansion of the tertiary sector.
- **By the end of 2019, the Italian economy had still not recovered to its pre-GFC level** and unemployment was high, at 9.5%, with higher unemployment rates in southern Italy and among young people.
- Under our central scenario**,** we expect real GDP to contract by 8.6-9.0% in 2020, then rebound by some 3.2-3.7% this year, and slow to 3.0-3.4% in 2022. Our growth forecasts for 2021 and 2022 are well above Italy's growth potential and are based on the assumption that the Next Generation EU fund will lead to high-productivity projects being implemented throughout the country effectively and quickly, kickstarting both domestic and external demand, particularly from 2022.

Italy's real GDP growth and forecasts



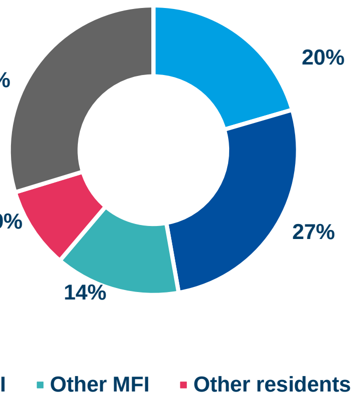
Source: Amundi Research. Data and forecasts are as of 12 January 2021.

High public debt will limit the room for fiscal manoeuvre

"Italy's public debt-to-GDP ratio should skyrocket as a consequence of the pandemic, from 135% in 2019 to 159% in 2020."

- **Italy's public debt-to-GDP ratio should skyrocket as a consequence of the pandemic, from 135% in 2019 to almost 160% in 2020.** This is due to both a very deep recession and a high budget deficit in response to the pandemic, as Italy has been among the countries hardest hit by Covid-19.
- The breakdown of the holders of Italian public debt shows a high share of domestic investors -- about 70% of the overall outstanding debt -- while foreign investors make up the remaining 30%. **The share owned by foreign investors has shrunk following the GFC and the sovereign debt crisis,** from about 50% to the current level, but has remained stable since 2012. Over the past few months, foreign private investors became net buyers of Italian public debt after strong outflows in March and April 2020. Among domestic investors, banks and other financial institutions currently account for 27% of the overall public debt, while households account for only about 4%.
- The share of Italy's public debt owned by the Eurosystem of central banks has increased since the launch of QE in 2015 and stood at 21% in September 2020. Considering marketable debt only, this share should rise to about 25% by year-end, and to roughly 28% by the end of 2021.

General government debt, breakdown by holders at end-September 2020

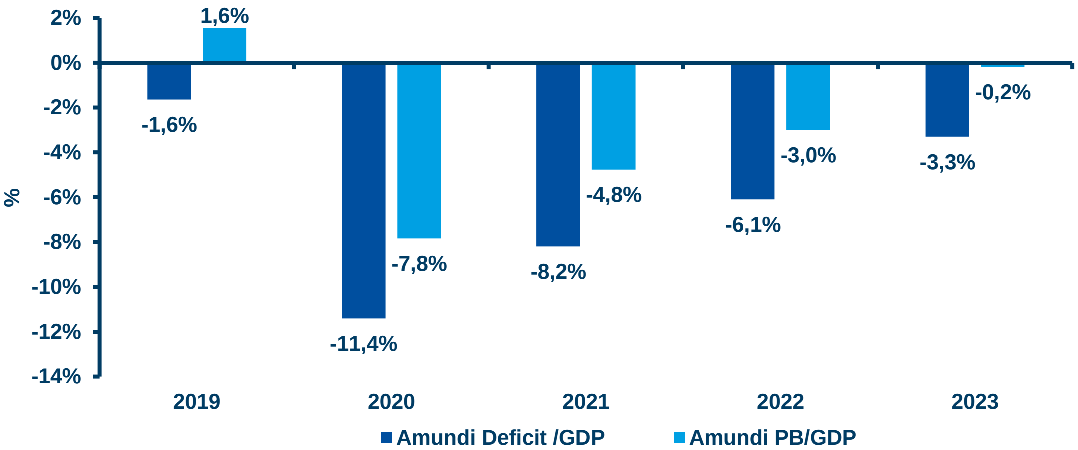


Source: Amundi, Bank of Italy. Data as of 15 December 2020.

- In recent years, the Italian government has managed to stabilise public debt dynamics, despite anemic growth, thanks to recurrent primary surpluses**.** We expect **Italy's budget deficit** to hit 11.4% of GDP in 2020. The budget deficit-to-GDP ratio should decline to 8.2% in 2021.

"Given the weak inflation environment, we expect the ECB to continue to provide strong support to the debt market over the coming years."

Italy's deficit and primary balance, as a share of GDP



Source: Amundi Research. Data and forecasts are as of 13 January 2021.

Covid-19 crisis fallout on Italy's society

According to Censis -- the Italian socio-economic research centre -- the pandemic has deepened the social divide within the country between people who have a 'regular' job and those in the informal economy who cannot rely on any welfare programme. In the third quarter of 2020, the number of unemployed had increased by almost 500,000 people, mostly women and young people. In addition, uncertainty remains high among those who can count on a job, and therefore **the savings rate has skyrocketed, topping 20% in the second quarter of 2020**, according to ISTAT, the Italian statistical office. This has boosted the availability of cash in bank accounts. The aid paid out by government to the hardest hit sectors – worth €26 billion overall – has not been enough to maintain previous standards of living, especially among the self-employed. Under such a scenario, most respondents to the Censis survey said they did not feel comfortable starting a new activity. The social divide has emerged particularly strongly in two sectors of the Italian economy: education and healthcare. In addition, there are huge differences among regions. Overall, the Covid-19 crisis will deepen inequalities within Italian society. **On the positive side, the large amount of precautionary savings will be available to be invested into the real economy. Asset managers will play a key role in designing investment solutions that can channel such resources into the real economy.**

Focus: Next Generation EU fund will be essential to support the Italian recovery

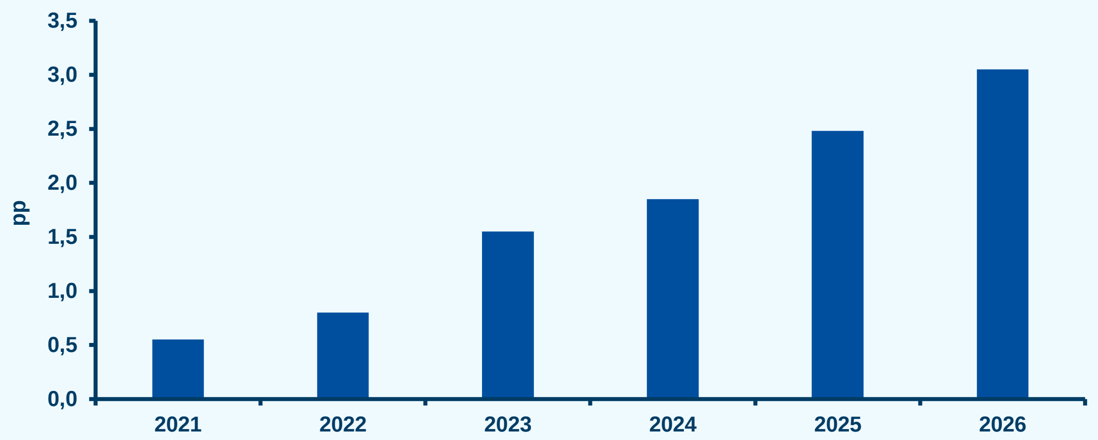
In July 2020 **EU leaders agreed on a €750bn fund to support the bloc's economic recovery from the pandemic**. The emergency fund will give out €390bn of grants and €360bn of low interest rate loans to EU member states. Italy will be among the largest beneficiaries of the plan and will receive €209bn in combined grants and loans.

On 12 January 2021 the Italian government approved a draft plan to be submitted to the Commission, which outlines its priorities on how to deploy funds from the Next Generation EU fund. The draft includes projects worth an overall €222bn, costing far more than the funds available to Italy, indicating that the government is safeguarding its position in case any of its projects are not approved. The government aims to allocate more than 70% of the funds to public investments, as these can generate a positive pass-through effect to private investments. The government will focus on six areas:

- **Digitalisation of the economy, innovation, competitiveness and culture**: This includes tourism, broadband internet connection and 5G, with a focus on health and social infrastructure in southern Italy. The amount budgeted is €46bn, including projects already in place.
- **Green transition:** This covers the energy transition, sustainable local public transportation and upgrading public buildings. The amount budgeted is €69bn, including projects already in place.
- **Sustainable mobility-enhancing infrastructure**: This includes high-speed railway projects and route maintenance. The amount budgeted is €32bn, including projects already in place.
- **Education and research:** This covers policies aimed at improving the availability of education and enhancing the school-work link. The amount budgeted is €28bn, including projects already in place.
- **Inclusive growth**: This includes labour market policies and any specific action targeted at disadvantaged areas and groups. The amount budgeted is €28bn, including projects already in place.
- **Healthcare**: This will be vital in the post-pandemic economy and these projects are aimed at improving research and innovation, as well as local health assistance. This package will be worth €20bn.

According to the government's draft, the impact of these projects on Italy's growth will rise over time, thanks to the impact of public investments on other economic sectors (the multiplier effect). They are expected to add about 0.5pp to 2021 growth, rising to 3.0pp in 2026.

Projected impact of NGEU investment plans on Italy's growth



Source: Amundi, #NEXTGENERATIONITALIA. Data as of 13 January 2021.

AMUNDI INVESTMENT INSIGHTS UNIT

The Amundi Investment Insights Unit (AIIU) aims to transform our CIO expertise, and Amundi's overall investment knowledge, into actionable insights and tools tailored around investor needs. In a world where investors are exposed to information from multiple sources we aim to become the partner of choice for the provision of regular, clear, timely, engaging and relevant insights that can help our clients make informed investment decisions.

Discover Amundi Investment Insights at www.amundi.com

Definitions

- **Asset purchase programme:** A type of monetary policy wherein central banks purchase securities from the market to increase money supply and encourage lending and investment.
- **Basis points:** One basis point is a unit of measure equal to one one-hundredth of one percentage point (0.01%).
- **Curve flattening:** A flattening yield curve may be a result of long-term interest rates falling more than short-term interest rates or short-term rates increasing more than long-term rates.
- **PEPP:** Pandemic emergency purchase programme.
- **Quantitative easing (QE):** QE is a monetary policy instrument used by central banks to stimulate the economy by buying financial assets from commercial banks and other financial institutions.
- **Spread:** The difference between two prices or interest rates.
- **U-shaped recovery:** A U-shaped recovery is a type of economic recession and recovery that resembles a U shape when charted.
- **Volatility:** A statistical measure of the dispersion of returns for a given security or market index. Usually, the higher the volatility, the riskier the security/market.

Chief editors

Pascal BLANQUÉ
Chief Investment Officer

Vincent MORTIER
Deputy Chief Investment Office

Amundi
ASSET MANAGEMENT