

Focus on Italy: macroeconomic and fixed income scenario



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“For 2020, the Italian government projects an 8% GDP contraction, followed by a 4.7% rebound in 2021.”

- **The global background and Italy:** if we wanted to characterise the contraction and recovery pattern, we would probably describe it as a ‘long U-shaped’ recovery; in other words, as a gradual normalisation which will take some time before seeing a return to pre-crisis levels. **In Italy**, the government is estimating an 8% GDP contraction this year, followed by a 4.7% YoY rebound in 2021. In our analysis, we consider two possible reference scenarios for 2020 growth: -8.0% YoY (as per the government scenario) and -12.0% YoY.
- **Italy’s public finances:** in the short term, the government is expecting a deficit worth 10.4% of GDP and a debt/GDP ratio at 155.7% in 2020, in line with our expectations. A more adverse growth profile, with a 12% YoY contraction this year, would lead to a 13% deficit-to-GDP ratio and a debt-to-GDP ratio around 165%. Based on government estimates, if the economy grows by 6.1% in nominal terms with a deficit worth 5.7%, the debt could fall to 152.7% of GDP in 2021. We could then assume nominal growth at 2.4% in 2022, with a return to a primary surplus of around 1.0%, allowing the deficit-to-GDP ratio to fall below 3% and the debt-to-GDP ratio to shrink by an extra percentage point.
- **In the first four months of 2020, the primary market for Italian public debt has seen an intense level of activity:** the volume of gross and net supply placed so far has already reached around 47% and 75% respectively of the targets set in January for the entire year. The progress made to date in terms of net proceeds is likely to strengthen the role of the ECB with its asset purchase programmes in covering new and much higher issuance volumes, which will be added to those already planned for over the coming months.
- **We remain constructive on Italian public debt:** In relative terms Italian yields are more attractive than those offered by other peripheral countries. **The proposal by France and Germany to launch of a ‘health sovereignty strategy’** is an important step towards further integration in the Eurozone. The news **was well received by the market**, resulting in significant tightening of peripheral spreads, especially for Italy. **This is likely to continue in the short term.** The risk of Italian sovereign debt suffering a rating downgrade in the short term relates mainly to a possible move by S&P and Fitch, which both currently rate the country at an intermediate-level BBB rating, a notch above Moody’s (low BBB) with negative outlook, compared with a stable outlook for Moody’s. While S&P kept its previous assessment in its recent half-yearly review, in line with expectations, Fitch wasted no time in bringing forward its review -- originally scheduled in July -- and cut the rating by one notch to the same level as Moody’s, changing its outlook from negative to stable, also in line with Moody’s.

MACROECONOMIC SCENARIO

Which global background can we expect for 2020?

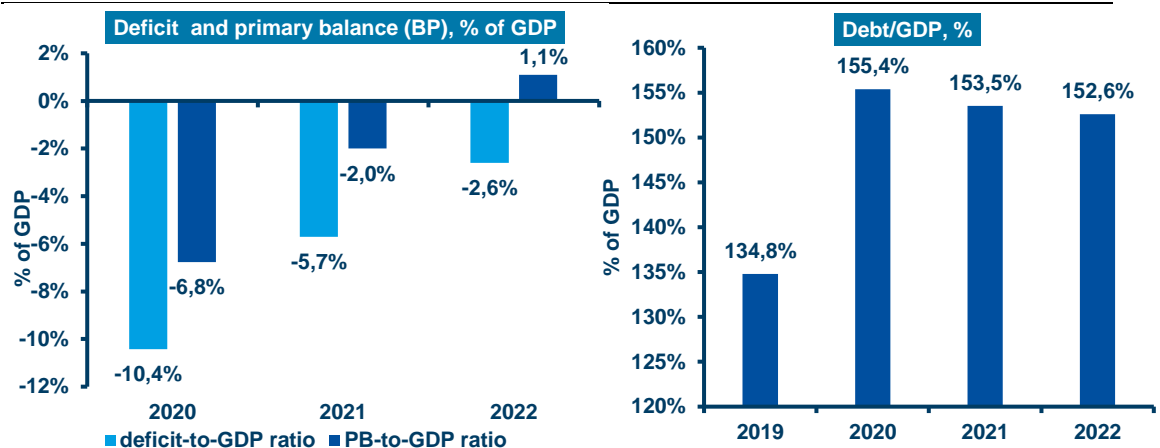
The first step is to assess the impact of the Covid-19 health crisis, which is not an easy task: not only are the affected countries at different stages of the infection, with different containment measures in place, but as the lockdown-induced shock to internal demand is added on top of the external-demand shock from main commercial partners having to tackle the same crisis, there will be a significant impact on both imports and exports.

Even countries that have made more progress in the virus containment may see their recovery hampered to some extent by a weaker global environment. This is why we are not expecting a ‘V-shaped’ recovery, that is, a swift return to GDP growth at pre-crisis levels. Rather, we expect a ‘long U-shaped’ recovery, with slow normalisation and the growth lost this year being made up over a long time, not before end-2021 at the earliest. We expect a deeper a more abrupt global recession than the one experienced during the 2008-09 financial crisis, especially for developed markets.

Which are your expectations for Italy? What about the government projections?

Italy is Europe's initial epicentre of the current pandemic, with lockdown measures already in place in the first quarter. In a bottom-up assessment, we look at the sectors most severely hit by the lockdown, which represent around 40% of national output. Otherwise, we could consider the discretionary consumer spending put at risk or prevented by the lockdown, which accounts for almost 20% of consumer spending. Under such considerations, we put the cost of each week of lockdown at 0.8-1.5% of GDP. Based on our estimates and on Q1 GDP data recently released, we downgraded our GDP forecasts and now expect a contraction of about -8.0/-11.0% YoY for 2020. In 2020, the contraction will be deeper in the first half of the year, while in the second half we expect a strong rebound, although this will not be enough to make up for the GDP lost early in the year. The Italian government expects a deep contraction in the first half of 2020, at -5.5% and -10.5% in the first and second quarters, respectively, and a bounce back of 9.6% and 3.8% in the third and fourth quarters, respectively, with average yearly growth at -8.0%. For 2021 they project annual growth at 4.7%, which corresponds to a quarterly growth dynamic in line with potential at best. For 2021 we take into account the base effect which will play a significant role in lifting the year growth rate. We are cautious and forecast a 4.0% YoY rebound as a central case, driven by a quarterly dynamic gradually returning to potential.

Debt and deficit projections, with 2022 nominal growth at 2.4%



Source: Amundi Research, Bloomberg. Data as of 27 April 2020.

Based on first-quarter GDP data, could you foresee a more extreme risk scenario for Italian GDP? What would be the impact?

Italy's first-quarter GDP shrank in line with government expectations. However, this is a preliminary release, and given the unusual conditions, there are major uncertainties surrounding such estimates. Data for the second and third quarters will be key, as they are likely to record the deepest contraction and the most marked recovery – respectively – of the quarterly growth pattern (the government scenario puts growth at -10.5% +9.6% QoQ in Q2 and Q3, respectively). A deeper Q2 GDP contraction or a significantly slower recovery in Q3 with 2020 average GDP growth at -15.0% YoY, would push the deficit-to-GDP ratio to 15.2% and the debt-to-GDP ratio above 172% in our analysis. As a consequence, Italy's new debt issuance will be above €230 billion. This would take the ECB's absorption capacity to around 75% of new issues, while under the government scenario, the ECB could absorb almost the entire 2020 new issues under its purchasing programmes.

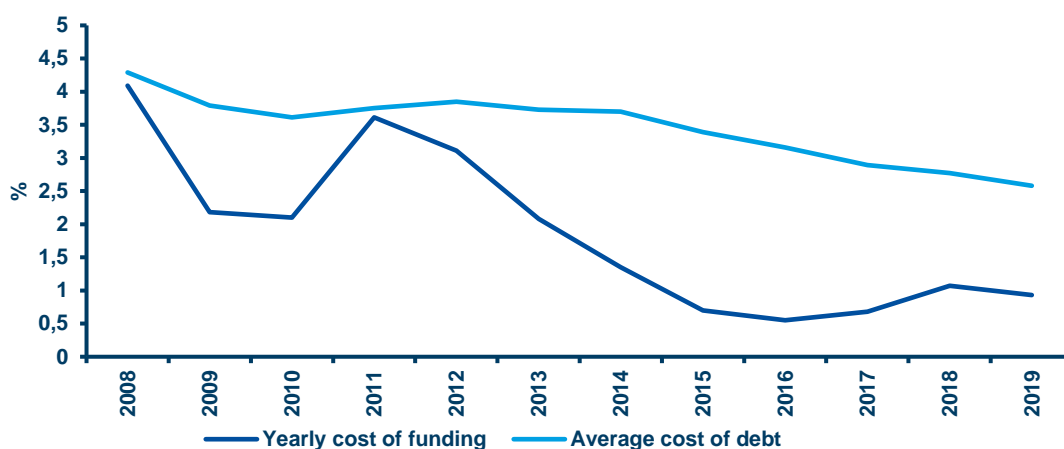
What is the fallout on Italy's public finances of the government's scenario and its risks with regard to sustainability?

The government expects the stimulus measures to push the deficit-to-GDP ratio to 10.4% in 2020, with a primary deficit of 6.8% and a debt-to-GDP ratio at 155.7%, assuming GDP deflator at 1.0%). Yet, in case of deeper 2020 GDP contraction at -12.0% YoY, the deficit-to-GDP ratio would spike up to 13.0%, with a primary deficit above 9.0% and a debt-to-GDP ratio above 164%, that is, about 20 percentage points above its 2019 level. According to the government

“The Italian government foresees the deficit-to-GDP ratio at 10.4% and the debt-to-GDP ratio at 155.7% in 2020.”

estimates, the economy will grow by 6.1% in nominal terms next year – or by 4.7% in real terms -- with a deficit-to-GDP ratio at 5.7%, allowing the debt-to-GDP ratio to decline to 152.7%. So far, the government has not made any projections beyond 2021 in its “Economic and Financial Document” (DEF). Looking into 2022, we assume GDP growth to return to potential, together with some normalisation in the inflation pattern, at around 1.7% YoY. We could also see a return to a primary surplus of around 1.0%, with the deficit-to-GDP ratio below 3% and the debt-to-GDP ratio cut by an extra percentage point. This is a starting point for a long-term sustainability analysis. Under a simple rule of thumb, we assume that the combination of 2.4% nominal GDP growth, borrowing costs at 2.4% or lower, and a primary surplus of 1.0% will cut the debt-to-GDP ratio by around one percentage point per year. This highlights two key elements: first, at this pace it will take decades for the debt to return to its pre-crisis levels without a significant growth stimulus and relying only on a substantial primary surplus for a prolonged period of time, thanks to either an increase in tax receipts or spending cuts. Secondly, Italy’s position is even more vulnerable to external growth and/or confidence shocks.

Italy: cost of debt, annual refinancing and debt stock



Source: Amundi Research, Bloomberg, Italian Ministry of Economy and Finance (MEF), Italian Treasury. Data as of 26 April 2020.

Public debt issuance is set to grow considerably due to the remarkable deficit increase: what about the refinancing of debt maturing in 2020?

In the first four months of the year, the primary market for Italian public debt has seen an intense level of activity: the volume of gross and net supply placed has already reached around 47% and 75%, respectively, of the targets set for the entire year in the government’s January projections. In particular, the acceleration of primary market activity in recent weeks – which included the use of syndicated instruments with maturities of up to ten years -- raised around €33 billion in terms of net supply out of €45 billion projected for the entire year before the Covid-19 crisis. The large share of long-term debt issues with maturities above ten years has helped keeping a long average life of the debt issued thus far, close to ten years compared with seven years for the entire stock of debt. To sum up, the Treasury’s aim is to keep overall borrowing costs as low as possible, while maintaining a long average maturity in order to reduce refinancing risks. In addition, a high percentage of the recent syndicated deals has been placed overseas, proving that yields have reached attractive levels. The progress made to date in terms of net proceeds will strengthen the role that the ECB has assumed with its asset purchase programmes in covering new and much larger issuance volumes, which will be added to those already planned over the coming months.

Has the ECB taken a central role in covering additional fiscal spending and keeping Italy’s borrowing costs under control?

With an annual deficit now estimated at around 10%, refinancing requirements have increased to some €170 billion according to our estimates, from an initial forecast of €45 billion: apart

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“The ECB has an important role in keeping down annual refinancing costs and overall debt, a key factor in debt sustainability at a time when public finance ratios are deteriorating.”

from the funds already raised, the amount needed will be substantial. The overall size of new purchases that the ECB began carrying out a few weeks ago is about €1,050 billion, most of which -- €750 billion -- under the pandemic emergency purchase programme (PEPP). Assuming that most of the flows relating to this programme go to the public sector, and that they are joined by a large share of the remaining purchases, we estimate that -- in accordance with the capital key rule -- Italy could receive enough funds to cover the additional funding needs arising from a double-digit fiscal deficit.

In addition, the option to expand the ECB interventions remains open, given that the macroeconomic and public finance estimates have deteriorated markedly since the PEPP was launched. Finally, looking at the available data on purchases for which we have a country breakdown, we see a significant divergence from the ECB's capital key rule: 70% of the ECB's total purchases carried out in March was allocated to three countries that add up to around 50% of the central bank's capital. In detail, the allocation to Italy was almost double what it should have been under the rule, confirming that the ECB is operating its programmes with maximum flexibility in order to keep yields and spreads under control. This takes us to the ECB's second important role, which is to keep refinancing costs and the overall debt under control, a key factor in debt sustainability at a time when public finance ratios are deteriorating.

Turning to the rating agencies, we have seen different decisions by S&P and Fitch, which until a few days ago had the same rating and outlook for Italy's public debt. What is your view on this, and on possible future developments?

The risk of Italian sovereign debt being downgraded in the short term was related mainly to a possible move by S&P and Fitch, both of which previously had an intermediate-level BBB rating, a notch above Moody's (low BBB), and on a negative outlook, compared with stable outlook for Moody's. While S&P kept its assessment unchanged in its recent review, in line with expectations, Fitch moved quickly and brought forward its review originally scheduled for July, cutting the rating by one notch -- to the same level as Moody's -- and changing its outlook from negative to stable, also in line with Moody's.

We have noticed diverging rationales behind these choices: on one side, the macroeconomic assumptions of S&P and Moody's converge towards a marked economic recovery in 2021, while Fitch expects a more limited rebound. Moreover, S&P and Moody's stress -- on one hand -- the central role of the ECB intervention in keeping borrowing costs under control, while, on the other hand, this role appears likely to be less crucial and more short-term oriented. Finally, the considerations over the potential European response and any use of existing instruments appear somewhat different. Following the latest Moody's confirmation of both rating and outlook, we will not have any further news on rating for some months. The focus will turn to possible fiscal developments at the European level, to the next ECB moves and to the macroeconomic surveys reported in this period of crisis.

Which are the latest political developments in the EU? What is your assessment of the recent joint proposal by France and Germany for a EUR 500Bn recovery fund?

The deepest recession since WWII and the significant increase in public debt make the current political picture particularly challenging for the EU. As mentioned above, much has been done in recent weeks at monetary policy level, including the launch of the PEPP and significant divergence of purchases from the capital keys.

There has also been major progress at political level. On 9 April, the Eurogroup approved a package worth €540 billion, which was subsequently confirmed at its 23 April meeting, including:

- a new facility for temporary Support to mitigate Unemployment Risks in an Emergency, (SURE) for EU countries, worth €100 billion;
- an €25-billion pan-European guarantee fund to deliver up to €200 billion of financing to small and medium-sized firms via the European Investment Bank; and
- an agreement has been reached for a precautionary credit line from the European Stability Mechanism of up to a maximum of 2% of GDP of the requiring country, which member states can access only for spending on direct or indirect costs related to the health crisis, including treatment and prevention.

“Based on the different assessments of the main rating agencies that have reviewed their view on Italy in recent weeks, we see diverging rationales behind their choices.”

“The proposal by France and Germany to launch of a ‘health sovereignty strategy’, in our view, is very important for future integration in the Eurozone.”

The proposal by France and Germany to launch of a ‘health sovereignty strategy’, together with the EU recovery fund and the authorisation for the EU Commission to borrow in the name of the EU, **appears to be the sort of news that markets were looking with regard to further European integration.** As in past occasions, Germany and France took the lead in taking further steps on the European front, pragmatically proposing a new solution to move forward from the current political impasse on developments regarding the recovery fund. The step looks to be a game-changer on the political front, as Germany had thus far remained close to the positions of northern countries -- recently staying mostly on the sidelines in the confrontation between the two prevailing groups of countries. This move also looks to be consistent with the statement released after the GCC ruling about the need for further integration and support for a stronger euro. The proposed amount (EUR 500Bn) for the Recovery Fund looks to be lower than numbers previously circulated in the press from different sources and players. This appears to be a better starting point to get dissenting countries on board with the initiative as well even if it is being portrayed as spending focused on hard-hit countries and sectors. **The news was well received by the market, resulting in significant tightening of peripheral spreads, especially for Italy. This is likely to continue in the short term.** Longer term, as often is the case with European politics, there are pros and cons. On the positive side:

- The Franco-German leadership is positive, and it is the first concrete sign of political willingness directed towards more fiscal integration.
- Initial issuance will come jointly from the two countries. Also, it is positive that those bonds will have long maturity.
- Following the powerful speech in the Bundestag by Angela Merkel and after the strong speech by the German president, Germany is clearly showing some commitment towards the Union.
- The collaboration sends a very strong signal to the most affected countries in the Union that solidarity is a founding pillar of the EU. This should also lead to fading momentum for nationalist parties.

On the negative side:

- The fund size appears small compared with what had been discussed previously (EUR 1Tn) and, as such, it will be insufficient to return Italy’s debt/GDP ratio to a sustainable level or to significantly support recovery in 2021.
- There has already been some pushback from the ‘Frugal four’ (Austria, Sweden, Denmark and the Netherlands). This shows that implementation is likely to take some time, with a risk of the need to compromise vs the initial proposal.

INVESTMENT IMPLICATIONS

Which has been the ECB role in containing BTP volatility?

The ECB is playing a decisive role in containing market volatility. One of its goals is to avoid fragmentation across the various government yield curves, i.e., to allow for an even transmission of monetary policy to every EU country. If member states are in different market phases, with yields falling in some countries and rising in others, the ECB’s tasks gets difficult. The main instrument being used by the ECB to reduce fragmentation is the PEPP. Since the PEPP was launched, we have noticed a reduction in BTP volatility, which is key to keeping financing costs low and to support investor confidence in Italian public debt. Such confidence has been testified by the high share of the issues allocated to international investors (76% for the former and 81% for the latter).

Do you believe that the recent ruling by the German constitutional court (GCC) on the legality of the PSPP is relevant?

This is a complex legal issue, but we believe that the ruling is relevant as long as it could make it more difficult for the ECB to expand its PEPP programme if necessary. In particular, this ruling has confirmed the legality of the purchase programme that the ECB launched some time ago, affirming that the use of unconventional monetary policy instruments does not breach the

ban on monetary financing of sovereign debt. At the same time, the court has given the ECB Governing Council three months to prove the appropriateness and proportionality of the operating procedures of the PSPP. The crux of the issue raised by the GCC seems to be not so much the choice of the instrument per se, but the methodology and size of the ECB intervention. The clarification that the ruling does not concern the more recent and substantial programme launched to contain the effects of the pandemic tempers the negative impact on the central bank's room for manoeuvre as perceived by the markets. However, this ruling comes at a crucial time, when the ECB is pondering a possible increase and/or extension of the PEPP, which was launched in March when the economic projections were more upbeat than they are now, and could therefore weigh on the way the new programme is developed going forward. This ruling could introduce some scepticism over the future scope of monetary policy in a phase in which important developments are expected on the European fiscal policy, with the need for an effective mix of the two to fight the current emergency. BTPs could be harmed by the German constitutional court's hints that the ECB purchases cannot be unlimited and must follow specific parameters:

- limited purchase volumes, stated in advance;
- 33% issue limit;
- compliance with the capital keys rule; and
- a floor for the credit quality of government bonds purchased.

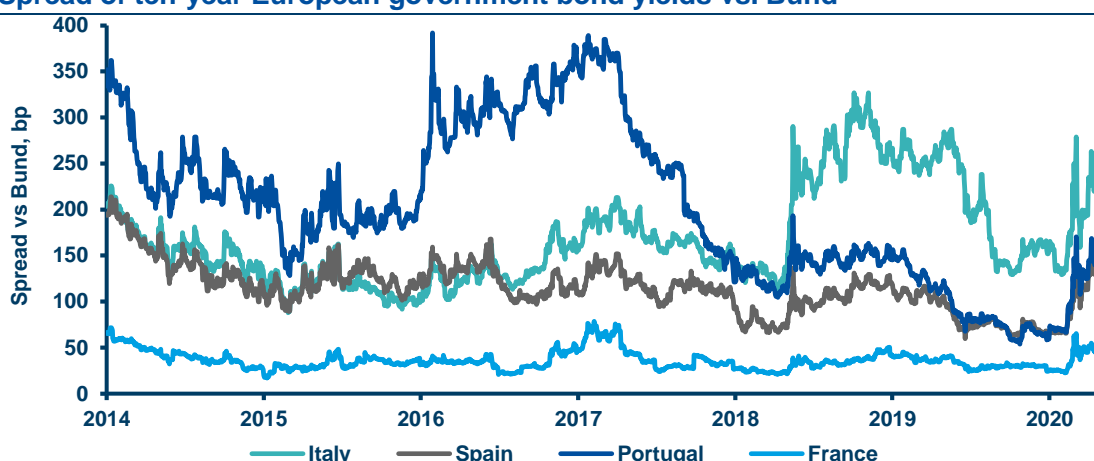
Although the ruling refers to the PSPP, some of these parameters are not defined in the PEPP. To sum up, this could make the market sceptical about the possibility for the ECB to use this tool more aggressively, particularly considering the position that the Bundesbank will take in the discussions.

In the end, what is your view on the BTP?

In relative terms, Italian yields are more attractive than those offered by other peripheral countries. Thanks to the ECB intervention, volatility has remained historically subdued. The risk is that the recent German Constitutional Court's ruling might lead to further market tensions and to an increase in the risk premium. There have been and will be tactical opportunities that investors can play, both on the overall level of yields and on the shape of the curve. During the recent crisis when Italy's spread had come under pressure, other peripheral countries have not been immune, the reason being that these countries share similar trends in terms of recession and debt increase. Monetary and fiscal assistance to EU member states and the likely commitment to move towards greater fiscal integration are strong supporting factors for the BTP.

“We are constructive on Italian public debt. The yields are more attractive than those offered by other peripheral countries' debt or by corporate bonds.”

Spread of ten-year European government bond yields vs. Bund



Source: Amundi, Bloomberg. Data as of 15 May 2020.

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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%).
- **Bond ratings:** If the ratings provided by Moody's and S&P for a security differ, the higher of the two ratings is used. Bond ratings are ordered highest to lowest in a portfolio. Based on S&P measures: AAA (highest possible rating) through BBB are considered investment grade; BB or lower ratings are considered non-investment grade. Cash equivalents and some bonds may not be rated.
- **PSPP:** Public sector corporate 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.

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