MyStratWeekly

Market views and strategy

N° 108 // **April 24, 2023**

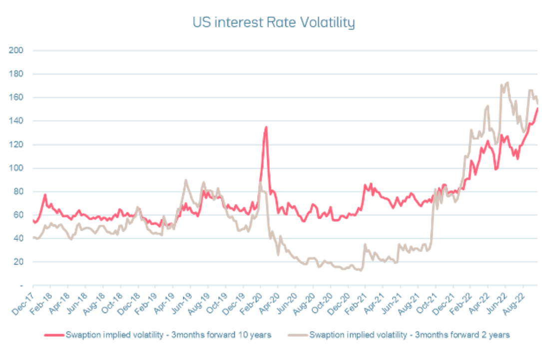
Topic of the week: Italy: mind the gap.

- **The Italian government's monthly cash deficit shows a sharp deterioration in the financing requirement in March;**
- **This unexpected deterioration in the cash deficit comes after the sharp upward revisions to public deficits between 2020 and 2022;**
- **The cost of the energy package since last summer and the recent downturn in tax revenues indeed point to fiscal slippage in 2023;**
- **A new projection of the 2023 deficit should be communicated at the end of April by the government;**
- **The Italian BTP market seems to ignore this risk, as spreads show remarkable resilience around 185 bps against 10-year Bunds.**

Market review: Credit benefits from market lull

- **Sideways trading in rate markets;**
- **Mixed data in the US, stronger growth in China;**
- **Lower volatility, a boon for credit;**
- **European stocks outperforming the S&P.**

Chart of the week



Source: Bloomberg, Ostrum AM

In the United States, the volatility of short-term rates (2 years) has been above that of 10-year rates for some time. The end of unconventional monetary policy and the abrupt monetary tightening from 2022 has reversed the term structure of interest rate volatility.

With the prospect of a status quo on Fed funds rates now, the volatility of long-term rates has approached the level of 2-year volatility. If this persists, a normalization of the term premium is likely.

Figure of the week

1.428

Source : Ostrum AM

It is India's population in billion people. India just overtook China as the World's most populous nation according to the UN.

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Topic of the week

Italy : mind the gap

The Italian bond market has been immune to rate increases and sailed through the rate volatility and banking turmoil in March. In the meantime, a seemingly sharp deterioration in public finances has gone unnoticed. In this note, we dig into monthly government balance figures and borrowing requirement projections to gauge the risk of a negative surprise on Italian debt markets as the ECB pushes monetary tightening to markets.

Digging into government deficit numbers

Italy's public debt (€2.7 trillion or 144% of GDP in December 2022) has long been a hot topic in financial markets. Revisions to government deficit figures following new European accounting rules (see below) are staggering: 9.7% of GDP in 2020 (up from 9.5% initially reported), 9.0% (from 7.2%) in 2021 and 8% in 2022 compared with a target of 5.6% set in November. As the ECB raises interest rates and cuts bond holdings, the situation of Italian finances is worth monitoring.

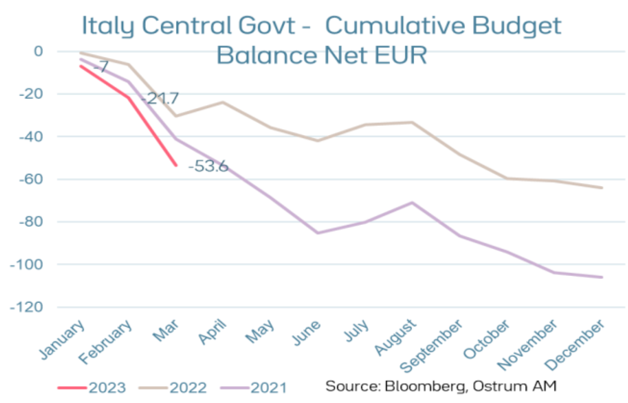
Keeping track of government finances can be tricky. Central government balances may not be aligned with net borrowing under the Maastricht definition given differences in the timing or seasonality of tax revenue and payments. Measures introduced since the pandemic and following the cost-of-living crisis further altered the seasonal profile of the deficit. Yet, at the end of the day, the cash deficit determines actual funding needs, market borrowing and ultimately debt levels.

The official deficit target for 2023 is to be updated later this month. The government's deficit forecast is currently 4.5% of GDP, which, at first glance, appears much less than the 8% shortfall for 2022. However, it looks like something is brewing under the surface.

First glance at the monthly cash balance data

Monthly cash figures for the central government showed a large €31.9 billion deficit in March, following a noticeable deterioration in the prior two months. At €53.6 billion, the cumulative balance shows a €23.8 billion gap compared with the first quarter of 2022.

In addition, the Italian government cash balance has shown no improvement since the fiscal measures to offset the burden of high energy prices took effect last summer.



Meanwhile, Italian government currency and consolidated deposits with the Eurosystem fell by some €24 billion since August last year.

There are a few potential explanations for the fiscal slippage. The details for the central government balance are only available until February 2023. Hence, we would need additional data to better assess the reasons behind the deterioration in the cash deficit observed in March.

	2023		2022		% Chg
Central Government Indicators	Jan	Feb	Jan	Feb	Jan-Feb
A. Overall balance (1-2)	-7.224	-14.985	-602	-5.196	
1 Total revenue / Inflows	47.454	40.408	44.203	43.055	0.7%
Taxes, of which	35.788	31.465	35.803	33.996	-3.6%
Direct Taxes	25.804	16.276	25.261	18.441	-3.7%
Indirect Taxes	9.984	15.189	10.542	15.555	-3.5%
Inflows from operations in financial instruments	4.282	3.729	1.549	2.951	78.0%
2 Total expenditures / Outflows	54.679	55.392	44.805	48.251	18.3%
Compensation of empoyees	9.699	7.302	9.472	7.219	1.9%
Interest	2.556	5.633	2.293	5.248	8.6%
Outflows from operations in financial instruments	2.835	4.832	2.436	3.885	21.3%

Source: Italy Ministry of Finance

Costly transfers

On the expenditure side, the shortfall appears partly traceable to social security payments including the revaluation of pensions at the start of 2023 in line with recorded inflation. In addition, the government's generous support measures for households and firms to mitigate the impact of the rise in energy prices have raised government spending since the summer of 2022. These government outlays show up as transfers to the energy and environmental services fund (CSEA), which manages both tariff collections and disbursements of the government's packages.

The worsening in the government's cash balance is also attributable to subsidies dating back to the recovery from covid. Italy spent massive amounts on subsidies for building renovations (sometimes referred to as 'superbonus'). The effect of subsidies on the cash deficit is hard to grasp.

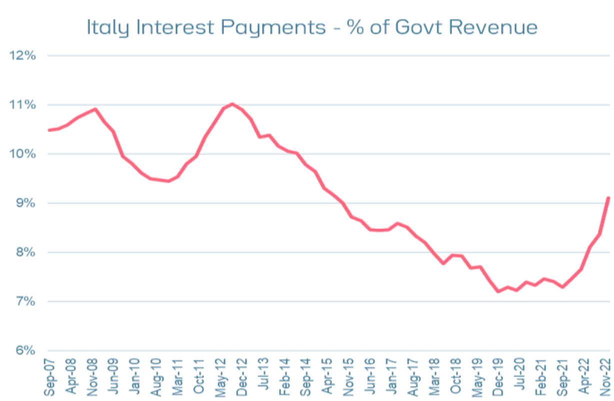
Transferrable tax credits must now be recorded in their year of issuance in the accrual-basis Maastricht definition of the borrowing requirement. As stated above, this change in accounting rules led to large upward revisions to Italian public deficit figures over the 2020-2022 period. However, the cash impact of the tax credits will be felt over time.

Lastly, interest payments (especially for inflation-linked bonds and floating-rate notes) raised government expenditure to a degree. The Italian debt portfolio includes a significant share of inflation-linked bonds (€156 billion BTPei and €106 billion BTP Italia) and variable-rate notes (€145 billion CCTeu). Whilst France and other countries have comparable amounts of inflation-linked borrowing, the large share of FRNs (CCTeu) in Italy's debt portfolio is unparalleled by other euro area governments.

ISTAT provides estimates for the cost of public debt. Most often, interest charges are compared to GDP or the amount of debt outstanding, but it is arguably more telling to look at interest payments as a share of government revenue.

Italy's interest payments averaged 9.1% of government revenue in the four quarters to December 2022, up from the low 7s just two years ago. Credit rating agencies usually consider 8% as a threshold, beyond which monitoring is indeed warranted.

When Italy nearly lost market access in August 2011, the interest share was just shy of 10%. The ECB intervened with unprecedented bond buying (with weekly SMP purchases) then came Mario Draghi's 'whatever it takes' in 2012 and financial repression in the form of quantitative easing (QE) from March 2015. The current 9% interest share last prevailed before QE.



Source: Bloomberg, Ostrum AM

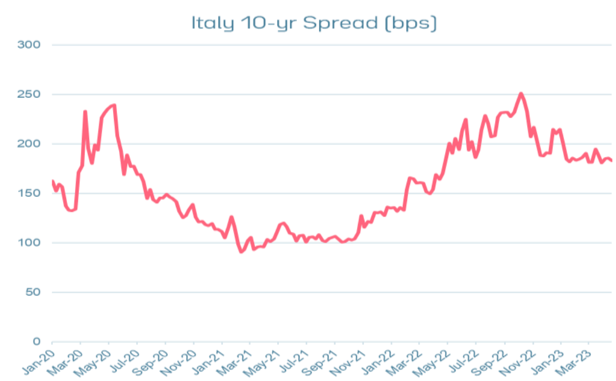
State revenue: No more inflation dividend

On the revenue side, the February 2023 report data show falling tax receipts to the tune of 3.6% on a year-over-year basis. In the first two months of 2023, direct and indirect taxes are down 3.7% and 3.5% respectively compared with January-February 2022. This is significant since, by not moving tax brackets, the Italian government has enjoyed inflated revenue so far. The inflation boost to tax receipts is therefore waning at a time when government spending has started to adjust to the reality of high and sustained inflation. The effect of inflation on the Italian government's cash balance may thus worsen in the months to come.

In addition, the payment of the tranche of the Recovery and Resilience Facility has been delayed to May by the Commission. The delay may have worsened the cash profile in March, although the 2022 RRF tranche was actually paid out in April. Once the April data is out, we will know whether the postponement of EU funds did contribute to the larger shortfall.

A complacent BTP market?

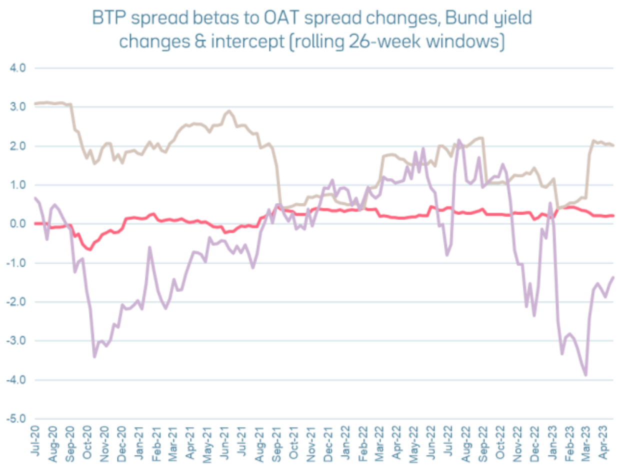
The deterioration in the public balance has gone unnoticed by markets. Italian bonds have indeed outperformed German Bunds so far this year. Spreads on 10-year Italian BTPs have been trading sideways within 200 bps since the start of the year, well below the 2022 highs of 240 bps.



Source: Bloomberg, Ostrum AM

All euro area sovereign spreads have weathered the historical rate volatility in March as market participants focus on the banks and the outlook for ECB policy rates. Sovereign bond syndications, including BTP sales, had been well received by markets in January and February providing some leeway for borrowers.

Consequently, BTP spreads have moved in keeping with historical betas to other spreads (for example OATs) over the past 6 months. Using a standard regression analysis, the beta of BTP spreads to OAT spreads was stable around 2 in the past six months. In other words, changes in BTP spreads reflected the overall sovereign risk rather than Italy's fundamentals. Tightening pressure shows in the sharply negative value of the intercept term (-1.5 bp per week) whilst there is a negligible beta to Bund yields (+0.2) even as risk-free bonds went wild. In sum, there is a risk of complacency regarding idiosyncratic Italian risk.



Source: Bloomberg, Ostrum AM

ECB QT: what's at stake for Italy?

Italy is the largest euro area sovereign issuer in gross terms with €315 billion to market this year (on JP Morgan estimates). Net bond issuance is expected to be relatively low (at €57 billion in 2023), but as argued above, the borrowing requirement may turn out to be larger than planned. There is one caveat: faster NGEU disbursements or more loans from REPowerEU could alleviate concern about additional bond supply.

Quantitative tightening may change the flow dynamics of the euro area bond market amid higher issuance from supranational entities. However, QT was set at a modest pace of €15 billion a month from March to June. As concerns the Italian market, the ECB could let €2-3 billion BTPs mature each month until June. This looks manageable for now, but Italy bond maturities tend to be larger-than-average in the second half. This could be a disadvantage if the ECB decides to quicken the pace of balance sheet contraction from July.

To keep things into perspective, the ECB holds Italian public-sector debt securities via two asset purchase programs (PSPP & PEPP) to the tune of €731 billion, not to mention Italian government bonds received as collateral for TLTRO loans for instance. The ECB publishes a list of bonds it makes available for lending. Holdings at the security level are not disclosed but one can assume that the ECB has purchased the maximum 25% share of each eligible security. Of the €250 billion worth of lendable bonds coming due this year, the ECB may have as much as €62 billion BTPs to roll in 2023. Hence QT for Italy could represent a third to half that amount.

Conclusion

Italian bond markets have outperformed so far in 2023 despite higher ECB rates and looming quantitative tightening. However, the government cash balance appears to be worsening due to costly transfers to households and firms, higher interest costs and the end of the inflation boost to revenue. The outsized government cash deficit in March must be monitored as the ECB tightens policy further.

Axel Botte

Market review

Credit benefits from market lull

Sideways trading in rates last week, some mixed statistics in the United States and the return of credit flows

Calm returned to the interest rate markets at the end of last week after a sharp rise the previous week. The yield on T-note hovers around 3.50% moved alternatively by the hawkish message from central bankers and mixed data in the Western economies. Chinese macroeconomic news, however, confirmed that a recovery is on track thanks to the improving trade surplus. The earnings season also brings its share of surprises and market volatility. Credit spreads are tightening despite renewed widening of swap spreads and credit indices (iTraxx Crossover in particular). The US dollar is stable, which did not prevent profit taking on a few currencies (NZD) which had been supported recently by their central banks. At the same time, equity volatility remains reduced.

On economic grounds, Chinese data points to a recovery in activity. Quarterly GDP growth stands at 2.2% in the first quarter (+4.5% over one year). The large-scale monetary stimulus observed between January and March echoes the government's growth target of close to 5% this year. The rebound in consumption and the increasing trade surplus are fueling the economic recovery, but investment, including foreign direct investment, continues to slow down. The improvement in the Chinese trade balance is traceable to the a pickup in Asian demand. China's demographic challenges are considerable. In the euro area, activity surveys turned out to be somewhat disappointing in the manufacturing sector, but service activity confirms the developing economic upturn. Across the Channel, inflation continues to surprise on the rise at 10.1% in March. The BoE is also facing significant wage pressures with year-over-year increases of more than 6%. The need to raise rates further. In the United States, activity in the housing sector seems to have bottomed out. Residential investment should continue to subtract from growth, which will still be around 2% in the first quarter (in annualized terms). The Beige Book indicates a localized tightening of credit conditions, particularly in New York. John Williams, President of the New York Fed, seemed to be leaning towards a monetary status quo after one final rate increase indeed due to tougher credit conditions.

The US T-note yield briefly broke the 10-year 3.60% threshold. Investor surveys show that consensus has returned to neutral (or moderately short). The low ratio of trading volumes of put options compared to call options reflects the recent implementation of hedging strategies against the risk of an economic hard landing. This asymmetry to the downside in interest rates can also be observed in the valuation of 2-year bonds, which are not reflective of a prolonged status quo by the Federal Reserve. The market is not yet validating the 'pause' scenario, which contribute to keep the yield curve inverted. The gradual increase in volatility on long-term rates nevertheless suggests a return of a term premium.

Bund yields remain subject to US market gyrations market whilst UK Gilts underperform in the wake of still high inflation. The sovereign primary market was quite busy last week with €32 billion issuance, including a success with Italian 5-year inflation bond. Flows into sovereign funds highlight strong interest from investors. Sovereign spreads are indeed holding up. The OAT spread is trading around 56 bps and Italian debt remains almost invariably around 185 bps. Sovereign bonds remain a source of stability for investors. Emerging sovereign debt funds denominated in US dollars (492 bps, +6 bps) nevertheless underwent a few outflows, which were however redeployed on the bond markets in local currencies.

The credit market is seeing a pickup in investor demand with inflows of around €1bn on credit ETFs. The primary market presents 8 transactions including 5 non-financial corporate debt issues, all well received by the market. The funds had also retained cash to be reused. However, the CDS indices are wider again and secondary market liquidity remains patchy (rather wide bid-offer spreads) despite a risk-on environment favorable to spread tightening. High yield is also lively with a slightly more active primary. The yields offered are attractive (over 10% for B- issue for instance). The AT1 market, under fire following the bankruptcy of Credit Suisse, is showing signs of life with a first AT1 deal by Sumitomo in Japan.

The equity market is trading sideways this week amid mixed earnings publications. The S&P 500 has had three consecutive down sessions as Europe holds up in line with favorable reallocations to the Old Continent since the start of the year. The capital account of the United States indeed reveals net selling of US equities by non-resident investors. European automobile stocks suffered from erratic announcements regarding Tesla's pricing strategies. Banks took advantage of upward pressures on interest rate early on last week before retreating. The energy sector lost ground as the price of a barrel fell $5 over the week.

Finally, the US dollar is flat or rising modestly, which leaves room for some profit taking on the New Zealand dollar, for example.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	24-Apr-23	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	2.94 %	+6	+55	+18
EUR Bunds 10y	2.49%	+2	+36	-8
EUR Bunds 2s10s	-45 bp	-4	-18	-26
USD Treasuries 2y	4.17 %	-2	+41	-25
USD Treasuries 10y	3.54 %	-6	+16	-34
USD Treasuries 2s10s	-63 bp	-4	-24	-8
GBP Gilt 10y	3.77 %	+8	+49	+10
JPY JGB 10y	0.47 %	-1	+16	+5
€ Sovereign Spreads (10y)	**24-Apr-23**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
France	56 bp	+1	+4	+2
Italy	186 bp	+3	-2	-28
Spain	103 bp	+1	-3	-6
Inflation Break-evens (10y)	**24-Apr-23**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR OATi	280 bp	-2	+16	-
USD TIPS	229 bp	-2	+8	-1
GBP Gilt Index-Linked	380 bp	+0	+30	+18
EUR Credit Indices	**24-Apr-23**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR Corporate Credit OAS	157 bp	-4	-23	-10
EUR Agencies OAS	77 bp	+1	-1	-2
EUR Securitized - Covered OAS	87 bp	+4	-2	+3
EUR Pan-European High Yield OAS	486 bp	+1	-33	-26
EUR/USD CDS Indices 5y	**24-Apr-23**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
iTraxx IG	83 bp	+1	-14	-7
iTraxx Crossover	440 bp	+8	-56	-34
CDX IG	76 bp	+2	-11	-6
CDX High Yield	471 bp	+7	-58	-13
Emerging Markets	**24-Apr-23**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
JPM EMBI Global Div. Spread	490 bp	+12	-3	+38
Currencies	**24-Apr-23**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
EUR/USD	$1.100	+0.83	+2.26	+2.78
GBP/USD	$1.244	+0.65	+1.66	+2.92
USD/JPY	¥134.68	-0.16	-2.93	-2.64
Commodity Futures	**24-Apr-23**	**-1wk ($)**	**-1m ($)**	**YTD ($)**
Crude Brent	$81.4	-$3.3	$6.8	-$3.3
Gold	$1 981.8	-$9.8	$3.6	$157.7
Equity Market Indices	**24-Apr-23**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
S&P 500	4 134	-0.10	4.09	7.66
EuroStoxx 50	4 408	0.92	6.71	16.19
CAC 40	7 580	1.09	8.05	17.09
Nikkei 225	28 594	0.28	4.41	9.58
Shanghai Composite	3 275	-3.25	0.30	6.03
VIX - Implied Volatility Index	17.53	3.42	-19.37	-19.10

Source: Bloomberg, Ostrum Asset Management

Additional notes

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