Sunday Wrap

Greetings from the sunny Danish coast,

After spending the past several weeks discussing mostly European monetary policies – arguing that the ECB is likely to have tightened more than needed - I'll dedicate today's note to one of the big and positive surprises in European financial markets these past 12 months, namely the extremely well-behaved Italian sovereign spreads.

Not many people - if any - had expected Italian spreads to have tightened, not least given the pace and extent of interest rate hikes and the reversal of QE into QT.

But here you have it: By May of last year, 10-year Italian BTP-Bund spreads had doubled to around 200bp from some 100bp during most of the PEPP-supported 2021. The widening was caused primarily by the ECB's message that it was running out of patience with the inflationary impact of the commodity price shock, signaling one of the fastest and sharpest tightening moves of monetary conditions in decades. When the Italian elections last autumn then brought to power the mostly untested, historically euro-sceptic, coalition under PM Giorgia Meloni in late October 2022, spreads widened further to 250bp.

During the IMF annual meetings in October of last year in Washington, the future of Italian spreads was a frequent topic among both investors and the official sector. It's not much of an exaggeration to say that there were only two camps: Those expecting spreads to remain mostly in the 200-250bp range (myself included), and those arguing that they would blow out to unsustainable levels.

But we were all wrong – if to different degrees. Barely had the IMF meetings ended before spreads started their steep decline from 250bp to 180bp, and then – through a brief year-end spike – further down to the 160-170bp the Italian government enjoys today.

In today's note:

- **To set the stage, I'll remind you why the occasional claims that Italian sovereign debt is unsustainable is absurd.**
- **I'll then discuss the three different forces which delivered the positive development in Italian spreads during these past 9-12 months. I'll argue that most of these factors will continue to provide support for Italian debt.**

1. Italian debt is sustainable.

I have discussed on several previous occasions how misleading public debt/GDP is as a concept for evaluating a country's debt sustainability. Nobody would have graduated from college without knowing that one should be extremely careful not to mix stocks with flows. Furthermore, no single ratio is sufficient to capture a picture as complex as debt sustainability.

Interest payments as a share of fiscal revenue is a better place to start. It captures the share of available resources to the government, before borrowing, that needs to be allocated to the servicing of debt. It thereby touches on both the existing fiscal capacity and the potential political pain associated with the debt. Interest payments/GDP also works as a starting point, but I'd argue that it's less telling because of the political difficulties of raising taxes during a recession.

In Italy, interest payments/fiscal revenue was 9% last year, temporarily elevated by the higher inflation's impact on inflation-linked bonds. 9% is a tad higher than the ratio in other Southern European countries and France, but it's lower than, e.g., the UK, where interest payments now consume 11.7% (partly because the UK operates with a lower tax/GDP level). It's also lower than what Italy allocated to debt service payments during the years leading up to the great financial crisis (roughly 15%), let alone during the years prior to the introduction of the euro. On my colleague, Italian Chief Economist, Loredana Federico's, estimate, the Italian ratio might reach 10%-11% in 4-5 years when the higher interest rates have had their full impact on the debt stock.

The true burden of the debt service payments on the economy (and on the political fabric) also depends on who the interest payments are made to, i.e., who holds the debt. Roughly half of the Italian sovereign debt is held by domestic Italian investors, while the Eurosystem holds roughly 30% and foreign investors some 20%.

For the share of debt service payments made to domestic investors, the interest payment is no more than a domestic circulation of resources. This has consequences for income distribution, but it's still fueling to some extent the domestic economy. As we have witnessed repeatedly during recent decades, Italians are – rightly - pretty happy holding the sovereign's debt, and with household net wealth roughly six times GDP, there's a considerable source of potential financing available here. (A large share of the debt held by domestic creditors also serves as a pretty powerful incentive for any government not to consider any restructuring of the debt.)

For the share of the debt held by the Eurosystem, the interest payments simply support the central bank's p/l, from where potential profits (less likely in coming years) are returned, after a bit of provisioning, to the treasury. In contrast, interest payments to foreign creditors (the 20% of total debt) is a pure tax on the economy.

When you shake these numbers properly and compare them with other OECD countries, you can only conclude that Italian sovereign debt – while higher than desirable – ought to not be a concern for financial markets.

And yet, at times, it has been trading as if it was a concern to some market participants. Below, I'll argue that the spread tightening during these past 9-12 months is to a significant extent structural in nature, rather than trading (or flow) based.

2. The drivers of BTP-Bund spreads tightening during these past 9-12 months.

Since the peak in BTP-Bund spreads last autumn, Italian sovereign debt has been supported by three distinct, if interrelated, forces, namely (i) solid policies and policy communication by the Italian government; (ii) support from Italy's European partners, and (iii) generally constructive markets.

I'll take them in turn and argue that most of these forces will remain in place during the year ahead:

First, while much anxiety was expressed last year about the incoming government's likely fiscal policies, policies towards Europe as well as the Western alliance against Russia's attack on Ukraine, the reality of the Meloni-government became a sure-footed leadership which barely set a foot wrong on any of these critical issues from investors' point-of-view.

Following the blowout of the budget deficits in 2020-21 due to Covid, and the consequent fiscal support, including elevated support to the most vulnerable groups of society in 2022 due to the commodity price shock (like everywhere in Europe), the government stated in April that this year's budget deficit will be reduced to 4.5% of GDP and further to 3.7% of GDP next year, before hitting the magic 3% in 2025. So far so good, helped by one of Europe's strongest GDP growth rates. By late September, the government will need to re-state its budget objectives ahead of the presentation of the 2024 budget law by mid-October. The coalition partners appear to be gearing up to lobby for further spending ahead of the European election next spring, but so far it looks as if the Tesoro and the government will hold the line.

Furthermore, any investor concerns about Italy's attitude towards Europe (given Meloni's earlier position), and NATO's coordination of Western support for Ukraine (given her two coalition partners' past proximity to Putin) have been put aside after the Meloni government's policy towards Brussels and the war played out.

Second, Italy's European partners' have played an important supportive role for the Italian government's financing cost. The headline grabber is obviously the huge EUR 191.5bn NGEU's allocation to Italy. But with only EUR 67bn disbursed so far (and less than EUR 30bn used), the NGEU's role in the past 9-12 months' spread tightening has been predominantly via the NGEU's signal of European solidarity. But by the same token, looking ahead, huge European financing remains on the table for the Italian government, which ought to put a clear cap on spreads going forward.

The explicit and implicit support by the ECB has also played a role this past year. The ECB's Transmission Protection Instrument (TPI), introduced in July of last year, makes it possible for the ECB to buy virtually unlimited amounts of a member's sovereign debt to protect the transmission of monetary policy - so long as it judges, via a rather opaque process, that macro policies in the country remain sound. In most investors' view, this adds a powerful (and for speculators a dangerous) weapon to the ECB's tool box. (In contrast, the OMT – coming out of Draghi's "whatever it takes" statement 11 years ago – played a critical role in saving the euro, as it compressed spreads by several hundred basis points, and is a dedicated crisis tool, which requires an economic program with the ESM to be activated.)

Less explicitly, the ECB has also been supportive of Italian debt by exercising its well announced flexibility in its reinvestment program. So far, QT has been more relevant for German Bunds and French OAT, than for Italian BTPs. Indeed, as pointed out by my colleague, Luca Cazzulani, combining the PSPP and PEPP, ECB net purchases of BTPs have even been slightly net positive so far. That's unlikely to continue longer term, but I rather doubt that a gradual phasing out of the net positive purchases will alter the picture measurably.

Third, the general market sentiment as well as a number of technical factors have been supportive of Italian debt during the past 9-12 months. The robust market for most risky assets, including equities, is no doubt also reflected in peripheral sovereign spreads more broadly. In addition, as Luca has pointed out, the 2/10 year BTP spread was 140bp at the beginning of the year, vs -10bp in Bunds. In other words, 10-year BTPs offered a substantial roll-down and carry. Even now with the 2/10 year BTP spread at 25bp, long BTPs remain attractive compared with the -80bp on the Bund curve. Finally, as recently illustrated and mentioned above, demand from Italian retail investors remains strong and that carries over to overall BTP spreads. Following the highly successful sale of the BTP Valore, the curve tightened by an impressive 20bp.

All in all, while I wouldn't want to predict a complete end to past years' occasional stress in segments of European sovereign debt, including Italian BTPs, I do conclude that the balance of factors which have driven BTP-Bund spreads down to 160bp-170bp during these last 9-12 months are likely to remain in place – and I remain highly confident that the European institutional and policy combination, including the NGEU and the ECB toolbox, is now sufficiently powerful to address speculative attacks in the eurozone sovereign debt market.

With those general macro and institutional observations, if you are an investor or trader wondering about likely market moves in the months ahead, I hand you over to Luca Cazzulani and his excellent Strategy Research team at UniCredit, and/or our equally excellent Italian Chief Economist, Loredana Federico.

And with that, I'm off to one of my summer highlights: Picnic on the bank of the bay watching one of the funniest boat races around.

best,

Erik

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