Italy's 2020 funding outlook and how to trade it

by Chiara Cremonesi, FI Strategist (UniCredit Bank, London)

- In 2020, we expect Italy to issue EUR 240-245bn of domestic government bonds, with supply pressure basically unchanged compared to 2019.
- In terms of distribution of supply, there should be a moderate re-balancing from the 5Y to the 3Y tenor. Net supply of CTZs will go from positive in 2019 to neutral/moderately negative in 2020. Supply pressure will be high for BTPeis (as there will be no redemptions), but low for BTP-Italy. We continue to expect heavy issuance at the extra-long end.
- With this in mind, we recommend going long 5Y BTP vs. 3Y BTP, buying CTZs, either outright or vs. BTPs and selling BTPeis.

1. A recap of 2019 funding

In 2019, funding needs for Italy amounted to EUR 243bn, EUR 201bn from redemptions and EUR 41-42bn from cash deficit. The Treasury funded EUR 231bn through M/L domestic bond issuance (net of buybacks, which were sizeable in 2019, amounting to EUR 10bn), EUR 7bn through positive net supply of BOTs and more than EUR 7bn through USD-denominated bonds and private placements. According to our calculations, the Treasury issued a few billion more than needed to cover funding needs, so the Treasury cash position should improve moderately compared to EUR 35bn at the end of 2018. The use of other sources of funding than M/L-term domestic bonds allowed the Treasury to carry out a high amount of buybacks (EUR 10bn vs. EUR 5.6bn in 2018). Moreover, in 2019, Italy also carried out two exchange auctions, swapping more than EUR 4bn in debt. Gross of buybacks, Italy issued EUR 241bn of M/L domestic bonds in 2019, only moderately up from 2018.

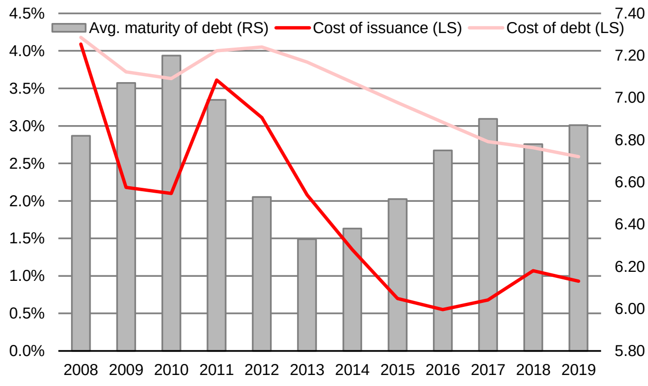
In 2019, a large portion of the funding was executed via syndicated deals. Indeed, six syndicated deals were executed in 2019: new 15Y, 30Y, 20Y, 10Y ILB, dollar-denominated bonds and the re-opening of the 50Y. This compares to one syndicated deal in 2018.

2019 also saw the return of issuance in USD, after nine years of absence from the market. Italy issued three different lines, with maturities of 5Y, 10Y and 30Y for a total amount of USD 7bn, de facto reconstructing the USD curve.

In 2019, cost of issuance (both M/L term and BOTs) was 0.93%, down from 1.07% in 2018. This led to a decline in the cost of debt to 2.58% at the end of 2019 from 2.71% at the end of 2018.

The high portion of funding executed at the long end allowed the Treasury to further lengthen the debt maturity in 2019, from 6.78 years to 6.87 years.

CHART 1: ITALY MARKETABLE DEBT: LONGER AVERAGE LIFE, LOWER AVERAGE COST



Source: Italian debt agency, UniCredit Research

2. What to expect in 2020

In 2020, domestic redemptions will amount to almost EUR 200bn, while international redemptions will be slightly more than EUR 3bn, resulting in total redemptions of EUR 203bn. We expect the cash deficit to be slightly lower than EUR 45bn. Total funding needs will therefore be around EUR 247bn. We expect the contribution of BOTs and other sources of funding to be lower in 2020 compared to 2019: we pencil in neutral net supply of BOTs, in line with the indications in the Treasury's funding plan, and a EUR 5bn contribution from international bonds. This would leave EUR 242bn to be financed via issuance of M/L-term domestic bonds, net of buybacks. Supply pressure will thus be very similar to 2019.

TABLE 1: FUNDING NEEDS AND SOURCES IN 2020

FUNDING NEEDS		FUNDING SOURCES		NET
Redemptions domestic	200	M/L domestic bonds	242	42
		BOTs	0	0
Redemptions international	3.2	Other *	5	1.8
Cash deficit	44	Cash	0	
Total	247	Total	247	43.8

*international bonds, private placements, etc.

Source: Italian debt agency, UniCredit Research

3. What to expect in terms of funding distribution: Italian Treasury guidelines

The Italian Treasury published its guidelines for 2020 funding at the end of last year. These are the key points:

1) **BOT:** The Treasury indicates that it is aiming for neutral net BOT supply. This is different to 2019, when net issuance of BOTs was positive by EUR 7bn. This means that the stock of BOTs in 2020 will likely remain unchanged at slightly less than EUR 115bn, while their share of total marketable debt will slightly decline.

2) **CTZs:** Redemptions in 2020 will amount to EUR 32bn, much higher than in the previous two years (when there was around EUR 23-24bn of redemptions each year). Indeed, net supply in this asset class has been positive in the last few years. This year, the Treasury plans to issue an amount in line or slightly lower than the redemptions, resulting in neutral/slightly negative net supply. Indeed, gross issuance of CTZs will likely be roughly in line with that in 2019, moderately above EUR 30bn. In contrast, net issuance will go from being highly positive in 2019 (just over EUR 8bn, not considering buybacks or exchange auctions) to neutral/slightly negative in 2020, a supportive factor for CTZs. The Treasury will likely issue two new benchmarks (both with maturity in 2022) in this asset class. According to our preliminary estimates, we expect the first new benchmark to be issued at the end-of-April auction, so the current benchmark, Nov21, should be re-opened three more times.

3) **CCTeu:** This asset class has not enjoyed very good demand in the last two years, even though net issuance has been negative (by almost EUR 3bn in 2019, taking into account the exchange auctions and the buybacks). In 2020, redemptions of CCTeus will be EUR 13bn (all due in December), and the Treasury indicated that net issuance could be positive (mainly due to the low amount of redemptions): we have penciled in a neutral/mildly positive net issuance given low investor appetite for this asset class. The Treasury expects to issue at least one new CCTeu in 2020, different from 2019, when it indicated it would issue two new benchmarks but in the end issued only one. Moreover, the Treasury will keep the option to issue off-the-run CCTeus, also according to demand. The bottom line is that the Treasury is clearly indicating in its 2020 funding plan that supply in this asset class will be moderate. The important news for this asset class is the maturity of new benchmarks, which the Treasury has indicated could be between 3Y and 7Y, different from last year when it was between 5Y and 7Y. We expect a new benchmark to be issued already at the end-of-January auction, settling in February.

4) **BTP 3Y and 5Y:** The Treasury will issue sizes very similar to those issued in 2019 (around EUR 33-35bn for each line), but expects a rebalancing of supply from the 5Y tenor to the 3Y tenor compared to 2019. We pencil in EUR 33.5bn of gross issuance at the 3Y and EUR 32.5bn of gross issuance at the 5Y, and at least two new benchmarks for each line. A possible timing for the new 3Y BTP would be mid-March, while for the new 5Y BTP the end-of-March auction settling in April.

5) **BTP 7Y and 10Y:** Gross issuance of 7Y BTPs is expected to be in line with that of 2019, around EUR 28bn, and we have penciled in at least one new 7Y benchmark; we expect the new benchmark to be issued in mid-June. According to the funding plan, gross issuance in 10Y BTPs is expected to be higher than last year (EUR 39bn excluding exchange auctions). However, when looking at the auction-by-auction breakdown, we would expect it to be only moderately higher. Net of exchange auctions, we expect around EUR 40bn of gross issuance at the 10Y and two new benchmarks. We expect the first one to be issued at the end-of-February auction, settling in March.

6) **Extra-long end BTPs:** In 2019, the Treasury issued EUR 40.5bn (excluding the issuance through exchange auctions) in extra-long bonds, representing 17% of the overall funding. This is the highest portion of funding executed at the extra-long end since 2016 (when it was 18%). The Treasury managed to issue one new line at each maturity (15Y, 20Y and 30Y) as well as re-open the 50Y via syndication. In 2020, the Treasury sees the possibility that issuance at these buckets will be slightly more moderate. However, in 2020, with QE ongoing, we think issuance volumes at the extra-long end will still be high. We expect a new 15Y and/or a new 30Y benchmark via syndication in 1Q and a new 50Y benchmark or the re-opening of the current one via syndication. This means that, in the absence of pronounced pressure on BTPs, the 10/30Y spread is unlikely to flatten sharply.

7) **BTPeis:** In 2020, there will be no redemptions of BTPeis; we expect gross supply to be in the EUR 14bn area, roughly in line with last year. The Treasury indicated that it will be looking to issue a new 5Y BTPei and, if conditions are favorable, a longer BTPei (we expect a new 15/20Y benchmark).

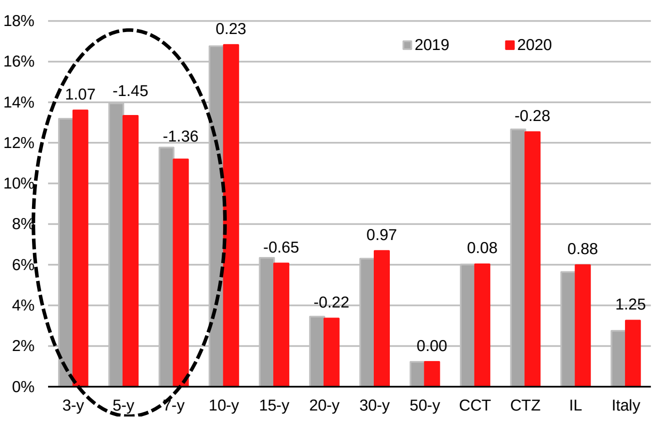
8) **BTP-I:** Redemptions of BTP-Italy in 2020 will be very heavy at EUR 23bn and we expect the issuance of a new benchmark (the Treasury indicated that it will issue at least one new benchmark in this asset class). The maturity of the new benchmark will be between four and eight years. Overall, considering total redemptions and supply for inflation-linked bonds (both linked to Italian and European inflation), the Treasury expects neutral net supply, leaving the stock of inflation-linked instruments unchanged in 2020.

9) **Green bonds:** The funding plan does not provide details or specify a timetable for the issuance of green bonds, but rather indicates that the Treasury will evaluate the opportunity to issue these instruments. In an interview, the head of the debt agency had suggested that this will be a theme for 2H. This way, Italy will join the club of eurozone countries already active in green bonds; Spain and Germany also said that they will issue green bonds in 2020.

10) **International bonds:** After nine years, in 2019, the Italian Treasury resumed the issuance of international bonds denominated in USD. The Treasury aims to continue being active in this asset class also in 2020, either through the re-opening of existing bonds or through the issuance of new benchmarks.

Chart 2 shows our expectations for the distribution of domestic bond issuance in 2020 and compares it with 2019. The only moderately relevant change would be at the 3Y tenor, where supply pressure would slightly increase compared to 2019 (and the Treasury is open to the possibility of issuing CCTeus with a 3Y maturity), while it would moderately decline at the belly of the curve.

CHART 2: DISTRIBUTION OF DOMESTIC M/L ISSUANCE, 2020 VS. 2019



The numbers above the bars shows the expected change in issuance in EUR bn in 2020 vs. 2019
Source: UniCredit Research

This has to be reconciled with our expectations for net supply in each asset class, as depicted in Table 2.

CTZs look much more supported compared to 2019, thanks to much higher redemptions, while BTPei might be more exposed to positive net issuance, as redemptions are coming from BTP-Italy.

TABLE 2: NET ISSUANCE BY ASSET CLASS

	2020			2019		
	Red.	Issuance	Net issuance	Red.	Issuance	Net issuance
CCT	13	15	1	12	15	3
CTZ	32	31	-1	23	31	8
BTP	132	174	42	143	176	33
BTPei	0	15	15	19	14	-5
BTP-I	23	8	-15	0	6.75	7

Note that the table does not include exchange auctions and buybacks

Source: UniCredit Research

We expect the average maturity of issuance for M/L term domestic bonds to be around 9 years in 2020, only moderately down compared to 2019 (9.11 years). If our expectations for the issuance breakdown in 2020 are correct, the average life of marketable debt will continue to increase.

Forecasting the cost of issuance for 2020 is difficult, as politics remains a wild card and Italian govies' performance is very sensitive to politics. What we know is that the average cost of M/L debt expiring in 2020 will be 2.14%. In 2019, the average cost of M/L term issuance was 1.61%, while in 2018 it was 1.78%, which means that unless there are one or more episodes triggering protracted and intense pressure on BTPs, 2020 might still be a year of declining cost of debt.

TABLE 3: TIMIING OF NEW BENCHMARKS

CTZ	End-April
CCTeu	End-January
3Y BTP	Mid-March
5Y BTP	End-March
7Y BTP	Mid-June
10Y BTP	End-February
15Y BTP	1Q
30Y BTP	1Q
BTPeis	New 5y: 1Q, New 15Y+: 2H
BTP-I	2H

If we are expecting two new benchmarks fro a line, we just indicated the timing of the first one
Source: UniCredit Research

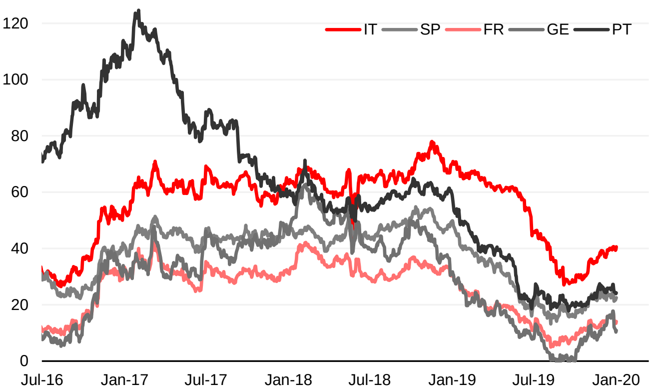
4. Our favorite trades on the Italian curve

The Italian funding plan for 2020 does not contain big news with respect to 2019 and is pretty much in line with our expectations. However, when combining its indications with market valuations and our general market view, we identify three main trades on Italian govies:

1) **Long 5Y vs. 3Y:** In 2020, supply will weigh more on the 3Y rather than the 5Y, the opposite of what happened in 2019. While this is true also for the 7Y, the 7Y-area looks very stretched on charts vs. the wings, even following some cheapening over the last one and a half months**.**

Moreover, the 3/5Y on the Italian curve is still much steeper than on the other eurozone curves. We would therefore suggest buying BTP 0.35% Feb25 vs. BTP 0.05% Jan23, current spread is 46bp, target 30bp, stop at 54bp, moderately negative carry of 0.5bp in three months.

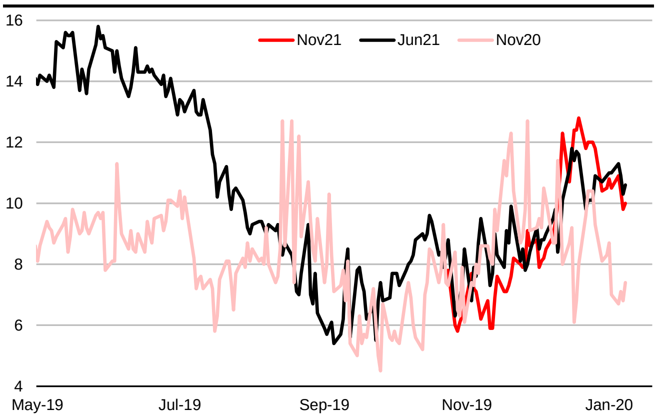
CHART 3: THE 3/5Y SPREAD ON THE BTP CURVE IS MUCH STEEPER THAN IN OTHER EUROZONE COUNTRIES



Source: Bloomberg, UniCredit Research

2) **Long CTZs vs. BTPs:** Since the end of October, CTZs have started cheapening again vs. BTPs and even the recent retracement leaves them at a cheap level vs. BTPs, in particular at the 2021 maturities (for instance CTZ Nov21 offers 10bp of yield pick-up vs. BTP Nov21, roughly in line with the pick-up offered by CTZ Jun21). After two years of positive net supply in this asset class, in 2020 net supply is expected to be neutral/slightly negative, which should support the asset class. Moreover, we expect more supply pressure on 3Y BTPs. In this respect, we would suggest buying CTZs outright or even in spread vs. BTPs. Taking CTZ Nov21 and BTP Nov21, and entering the trade at 10bp, we would set the target at 5bp and the stop loss at 12.5bp. The cost of carry is moderately positive (1bp in three months). A similar trade can be built with CTZ Jun21 and BTP 0.45% Jun21.

CHART 4: CTZS CHEAPENING VS. BTPS (YLD SPREAD, BP)

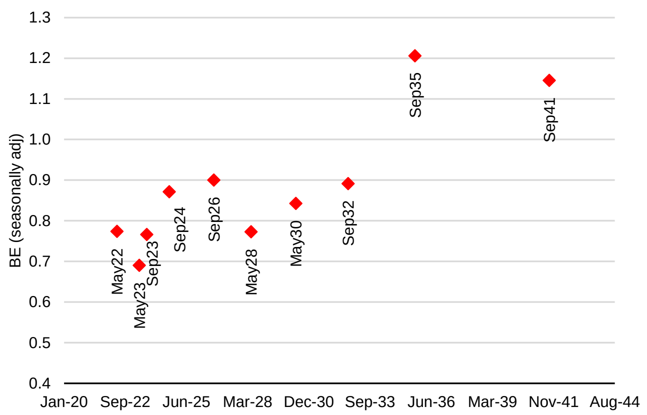


The spreads are calculated using BTPs matching the maturity of the corresponding CTZ

Source: Bloomberg, UniCredit Research

3) **Short BTPeis in BE:** In 2020, net supply of BTPeis will be heavily positive due to the absence of redemptions in this asset class; moreover, the Treasury has indicated that it will issue a new 5Y benchmark and possibly one at the longer maturity (15/20Y). There will be EUR 23bn of redemptions in BTP-I, but we estimate that more than EUR 14bn of those are in the hands of retail investors, for whom the switch into BTPei is not too appealing, thus we would expect limited support for BTPeis from BTP-I redemptions. Moreover, since the end of November, BTPeis have richened in BE (this was not linked to a rally in BTPs or an increase in oil prices). While they still trade at (seasonally adjusted) BE levels that are lower compared to the other EGBs, demand is not stellar for this asset class. Moreover, we doubt that inflation expectations will experience a meaningful increase during 2020; net supply will be heavy in 2020 and in case volatility in BTPs resurfaces, it might be a good idea to stay short in this asset class.

CHART 5: ITALIAN BE CURVE



Source: Bloomberg, UniCredit Research

Author
Chiara Cremonesi, FI Strategist
(UniCredit Bank, London)
+44 207 826-1771
chiara.cremonesi@unicredit.eu

Editor
Dr. Luca Cazzulani, Co-Head of Strategy Research, FI Strategist
(UniCredit Bank, Milan)
+39 02 8862-0640
luca.cazzulani@unicredit.eu

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This report was completed and first published on 9 January 2020 at 14:27.

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UniCredit Research* — Strategy Research

Erik F. Nielsen
Group Chief Economist
Global Head of CIB Research
+44 207 826-1765
erik.nielsen@unicredit.eu

Dr. Ingo Heimig
Head of Research Operations
& Regulatory Controls
+49 89 378-13952
ingo.heimig@unicredit.de

Heads of Strategy Research

Dr. Luca Cazzulani
Co-Head of Strategy Research
FI Strategist
+39 02 8862-0640
luca.cazzulani@unicredit.eu

Elia Lattuga
Co-Head of Strategy Research
Cross Asset Strategist
+44 207 826-1642
elia.lattuga@unicredit.eu

FI Strategy Research

Michael Rottmann
Head
+49 89 378-15121
michael.rottmann1@unicredit.de

Dr. Luca Cazzulani
Co-Head of Strategy Research
FI Strategist
+39 02 8862-0640
luca.cazzulani@unicredit.eu

Francesco Maria Di Bella
FI Strategist
+39 02 8862-0850
francescomaria.dibella@unicredit.eu

Chiara Cremonesi
FI Strategist
+44 207 826-1771
chiara.cremonesi@unicredit.eu

Kornelius Purps
FI Strategist
+49 89 378-12753
kornelius.purps@unicredit.de

FX Strategy Research

Roberto Mialich
FX Strategist
+39 02 8862-0658
roberto.mialich@unicredit.eu

Credit Strategy Research

Holger Kapitza
Credit & High Yield Strategy
+49 89 378-28745
holger.kapitza@unicredit.de

Dr. Stefan Kolek
EEMEA Corporate Credits & Strategy
+49 89 378-12495
stefan.kolek@unicredit.de

Equity Strategy Research

Christian Stocker, CEFA
Lead Equity Sector Strategist
+49 89 378-18603
christian.stocker@unicredit.de

Cross Asset Strategy Research

Elia Lattuga
Co-Head of Strategy Research
Cross Asset Strategist
+44 207 826-1642
elia.lattuga@unicredit.eu

UniCredit Research, Corporate & Investment Banking, UniCredit Bank AG, Am Eisbach 4, D-80538 Munich, globalresearch@unicredit.de
Bloomberg: UCCR, Internet: www.unicreditresearch.eu

SR 19/6

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