Euro Area Watch

Italy: unstable equilibrium

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Macro
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BofAS

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See Team Page for List of Analysts

For a list of abbreviations and acronyms, see Exhibit 30 at the end of this report.

Back to debt-sustainability concerns

Italy remains a long-time worry for investors. Past-peak fiscal support (with the phasing out of emergency packages), coupled with the sustained tightening of monetary policy, poses headwinds to an economy on track for close to zero GDP growth in the next quarters. True, positive drivers of market perception stem from the national recovery and resilience plan (RRP) and a growth performance expected to remain above pre-Covid levels in 2024/25. That said, the current rates environment keeps debt-sustainability (DS) concerns alive and well.

One shock away from risk to debt sustainability

We refresh our DS models for Italy. Italy's debt-sustainability considerations envisage multiple equilibria. The updated debt trajectories show little room for comfort: the debt ratio would fail to correct below pre-pandemic levels for the next 5 years, and debt should settle at around 120% by 2032. For now, Italy is in a "patient equilibrium" in which markets are happy to give time. Yet, given significant DS risks, it would not take a huge shock for markets to worry and move to the bad equilibria. In a high-rates scenario (consistent with current market forwards), the 120% threshold no longer seems within reach. Punctual compliance with RRP (recovery and resilience plan) implementation and fiscal prudence would not be then an optionality.

2024 budget plan under the full markets' scrutiny

More optimistic official debt projections (than ours) yet reveal concerns about the debt burden. We regard the 2024 budget plan as a mark-to-market exercise confirming a narrower fiscal path ahead. Headroom for fiscal support in 2024 is tiny (a package worth EUR24bn was approved on Monday). Yet, even without idiosyncratic sources of fiscal policy noise, Italy is back under the full scrutiny of the markets (and rating of agencies). With EU fiscal rules back next year, Italian public finances fail to provide comfort for compliance from Brussels' perspective, too. On that, we suspect that RRP implementation – with plenty of risks for the upcoming deliverables – will be the first line of inquiry.

BTP: rope-walking

BTPs find themselves in an unstable equilibrium. Positioning is significantly short and underweight already, while the high supply after QT expected next year is mostly absorbed by impressive retail flows that may accelerate from here. If rates start a shallow path of normalisation, as per our forecasts, BTP-Bund should head back to 160bp. That is our central scenario.

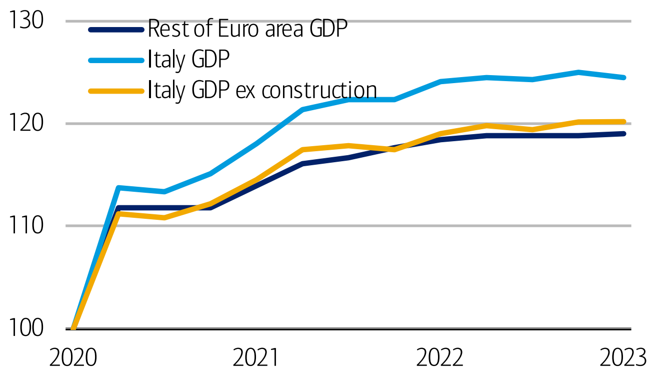
On the other hand, current levels of rates are already tough on debt sustainability, and Italy remains, by far, the highest-beta asset in the EGB space. Further rates increases from here risk getting spreads towards 300bp, but again, this is not our central scenario. We also expect rating agencies to avoid cutting ratings to junk – a junk rating from the average of the top three agencies could have a significant financial impact in Italy and beyond, in our view.

Economic support fading away…

We recently downgraded our already below-consensus GDP growth forecasts for Italy to 0.7% yoy in 2023 and 0.4% in 2024 (see the report, Europe Economic Weekly: Tell me why I paused, why I really, really paused 22 September 2023). We see the combination of monetary policy tightening, downbeat demand dynamics, slow NGEU absorption, and weak manufacturing as paving the way for stagnation until Spring next year. The change in policy mix – with both monetary and fiscal policy now aligning in restrictive territory – complicates Italy's macro picture considerably, we argue. Italy's credit impulse – the proxy for monetary policy transmission – has deteriorated materially since the start of the ECB hiking cycle (Exhibit 2). Adding to this, lately, fiscal policy has no longer endeavoured to offset monetary policy tightening. And, with past-peak fiscal help, the phasing out of some support measures (e.g., construction spending incentives) should contribute to softening growth momentum.

Exhibit 1: Euro area and Italian GDP growth (2Q20=100)

Italy has outperformed the Euro area average in the aftermath of the Covid shock; now the economy has entered in a stagnation phase



Source: Eurostat, BofA Global Research

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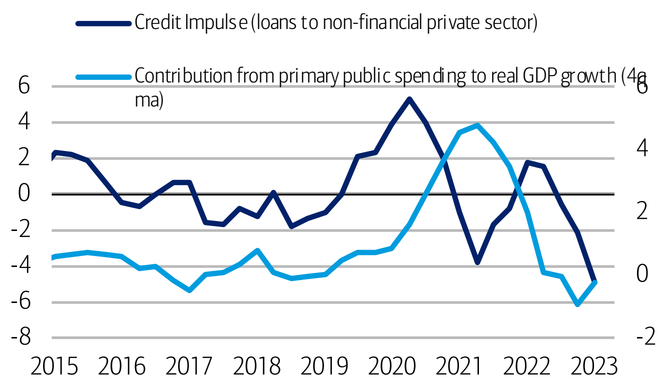
Exhibit 2: Fiscal impulse and credit impulse for Italy

Fiscal and credit impulse aligning in restrictive territory



Source: Eurostat, BofA Global Research. Note: credit impulse is defined as the yoy change in the flow of loans to the non-financial private sector, normalized by GDP

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… while yields are beyond the edge of the "comfort zone"

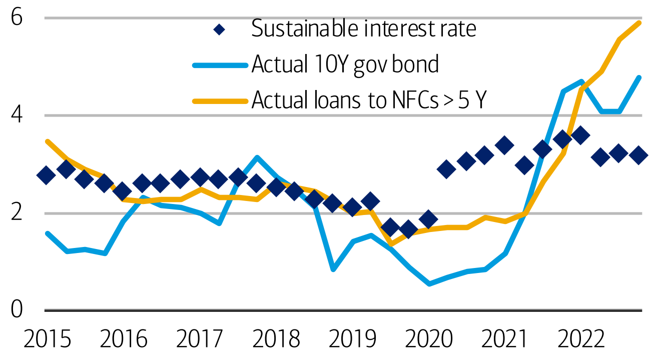
Downbeat growth adds to the current high level of yields. We have made the point before: it is not a matter of spreads but rather outright levels that are the issue. The very strong transmission of monetary policy appears clear in Italian data (see the report, Europe Economic Weekly: Something's Gotta Give 06 October 2023). One could argue how sustainable these rate levels actually are. At first glimpse, they seem to have surpassed the edge of the "comfort zone". Exhibit 3 compares current levels of sovereign and lending yields with the so-called "sustainable" long-term interest rate derived from long-term consensus forecasts (as the sum of the average of GDP and CPI forecasts for the next 10 years). In the past four quarters, both sovereign yields and lending conditions for Italian corporates have surpassed the level consistent with nominal long-term average GDP growth of circa (ca) 3%. Consequently, debt sustainability concerns have ramped up.

Debt sustainability: our base case sees debt at ca 140% for the next 5 years

We therefore refresh our debt-sustainability analysis. In our central scenario, GDP growth and inflation reflect our forecasts for 2023/25 while converging to long-term consensus expectations (real growth at 0.6% and inflation at 1.9%) from 2026 onwards. We assume potential growth of 0.6% (10-15bp higher than previous exercises amid potential gains from RRP implementation). We then assume the cyclically adjusted primary balance to be a consistent structural adjustment of 0.7-0.5% in 2024/25 (within the suggested range of the European Commission's 2023 country recommendations) while converging from 2026 to the 2007/19 average (ca 2.2%). Finally, we run two interest rate scenarios: one with BTP yields converging towards 2.5% in the next 10 years (the scenario more consistent with rates normalization from here) and the other with rates staying around 5% over the same period. We then calculate the passthrough into actual cost of debt after considering existing stocks, issuance of bonds and bills as well as redemptions. We use simplified assumptions for floating debt.

Exhibit 3: Sustainable interest rates versus 10-year (10Y) sovereign and corporate lending rates

Sovereign yields and corporate lending rates above the levels consistent with long-term nominal growth expectations



Source: ECB, Bloomberg, Consensus Economics, BofA Global Research

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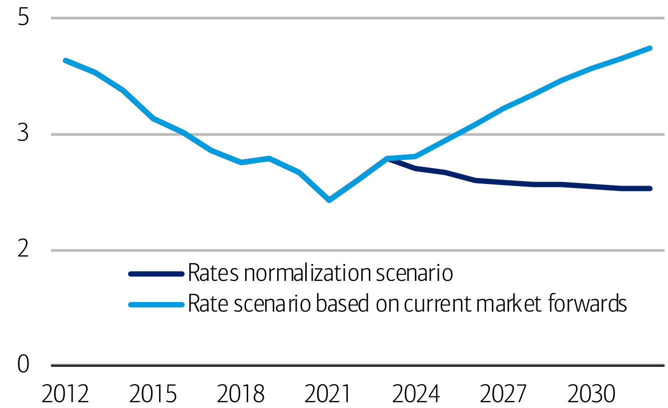
Exhibit 4: Italian cost of outstanding debt scenarios

Our central scenario assumes BTP yields converging towards 2.5% in the next 10 years; the alternative assumes rates staying around 5%



Source: Bloomberg, BofA Global Research

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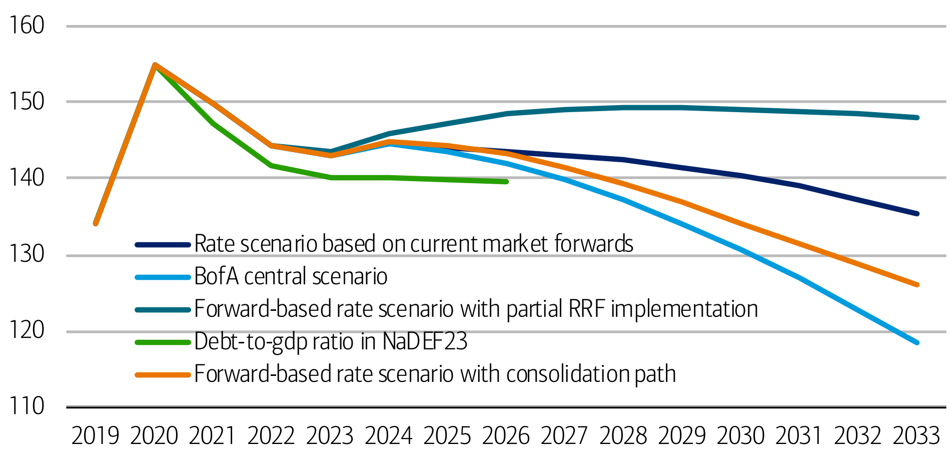
Exhibit 5 shows the updated debt trajectories. In our central scenario, the ratio gets stuck at around 140% until 2027. Also, the profile exhibits a downward path that is too gentle for the ratio to fall below 120% levels within the forecast horizon. The comparison with the alternative rate scenario is then stark, highlighting the vulnerability of Italian public finances to the evolution of rates. In the higher-rates scenario, the 120% threshold would no longer be within reach; rather, the debt ratio would be 16ppt higher than in our central scenario (Exhibit 5).

Exhibit 5: Alternative debt-sustainability scenarios

The alternative debt trajectories prove that DS would be at risk in a high-rates scenario; fiscal rectitude and timely compliance with RRP deadlines would not be an optionality



Source: Bloomberg, Consensus Forecasts, NaDEF 2023, BofA Global Research

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One shock away from risk to debt sustainability

The shape of the debt-to-GDP curve clearly reveals worries about debt sustainability conditions not being met in a shock scenario, leading to a potential real-rate sell-off in line with current market forwards. The source of the shock could vary, either an exogenous surprise (triggering a generalised repricing to the risk-free rate) or an idiosyncratic trigger (leading to BTP spread widening); for the sake of simplicity, we leave shock-driven growth/inflation implications aside. Such a situation would likely test market nerves on Italy's DS. Fiscal rectitude and punctual compliance with the recovery plan would not be an optionality.

We estimate the debt profile in the case of Italy being unable to meet RRP deadlines, hence failing to use in full the RRP fiscal firepower as planned. In this scenario, we assume an inability to meet the deadline for the 5th tranche scheduled for 2H23 and funds absorption in 2024/26 to be aligned to 2021/23. Without a RRP fiscal boost to growth, the debt burden would increase again in the short run and fail to show any downward trend on the forecast horizon (Exhibit 5).

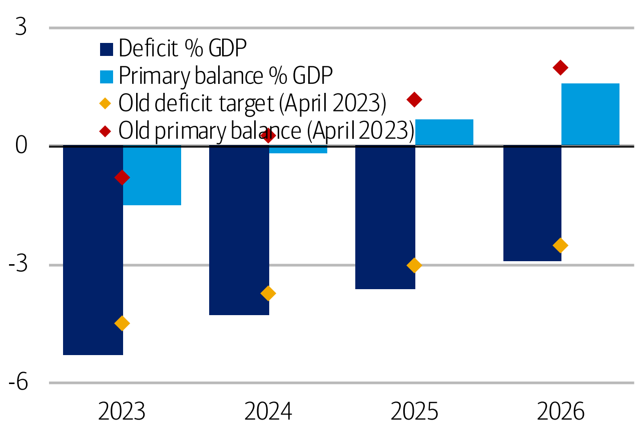
And, even with the RRP on track, a high-rates scenario would require some consolidation effort to realign the debt profile with our more buoyant central rates scenario. We assume a fiscal effort that could achieve a headline deficit below 3% as early as 2025 (consistent with a quick convergence of the cyclically adjusted primary balance to the 2007/19 average in 4 years). Even when taking into account the knock-on effect on GDP growth from fiscal tightening, active fiscal consolidation would put the public debt trajectory on a very similar path to our baseline.

Debt profile is the elephant in the room

How does our debt profile compare with official numbers? We take a look at the latest official macroeconomic projections, published in the so-called update of the Economic and Financial Document (NaDEF). In the official projections, the debt profile flirts with 140% levels for the next 5 years. Yet, the 2024 budget plan envisages a decline of less than 0.5ppt between 2023 and 2026, mostly due to the ambitious privatisation target (1% of GDP (EUR20bn) in 2024-26). This (and our more cautious view on growth) explains their more optimistic debt profile (Exhibit 5).

Exhibit 6: Government budget projections – revisions versus April's Stability Law

The latest budget revised higher deficit estimates; deficit targets are north of 3% for the whole forecast period



Source: NaDEF 2023, BofA Global Research

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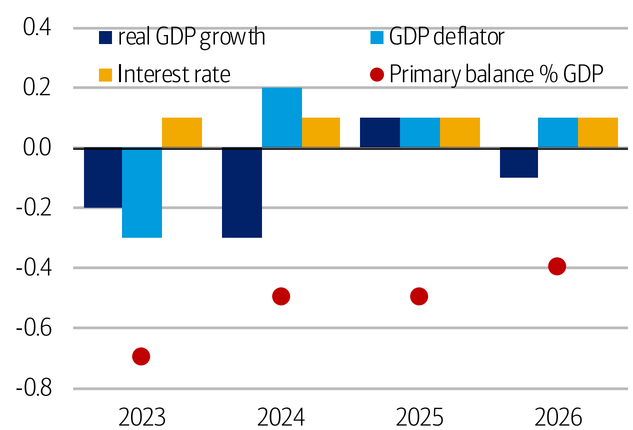
Exhibit 7: Delta in forecasts for the main macro variables, September versus April 2023

Weaker growth and higher rates feed through the new projections



Source: NaDEF 2023, BofA Global Research

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What about the budget? Some commentators have attributed the latest BTP widening to more-than-expected relaxed budget plans. We fail to share this view. True, fiscal deficits were set at 5.3% for 2023 and 4.3% in 2024 (versus April projections at 4.5% and 3.7%, respectively) and above-3% deficit targets persist throughout the whole horizon period (Exhibit 6). But we do not see these numbers as an attempt at imprudent fiscal planning by the current government. At most, we regard the latest fiscal plans as a mark-to-market exercise, with the deterioration of Italy's fiscal equation being the result of the complicated macro backdrop (Exhibit 7).

2024 budget plan: close to zero fiscal headroom in 2024E

On the 2024 budget plan, our main takeaways are as follows:

- The 2024 fiscal target points to a tiny fiscal space for fiscal support next year, at 0.7% of GDP. That will be devoted mainly to the reduction of the tax wedge (and remodulation of personal income tax brackets) and the renewal of public administration contracts. Including some spending cuts, the package would be worth EUR24bn, as approved on Monday by the government cabinet. Notably, the tax cuts are budgeted for one year only.

- The statistical treatment of the so-called "Superbonus" tax deductions led to a downward revision of the 2023 deficit. This, together with a higher-than-expected take of ca EUR20bn versus April estimates, led to a deficit deterioration worth 1.1% of GDP for the current year. On the flip side, 2024/25 deficit numbers improved by 0.3% and 0.2%, respectively (Exhibit 8).

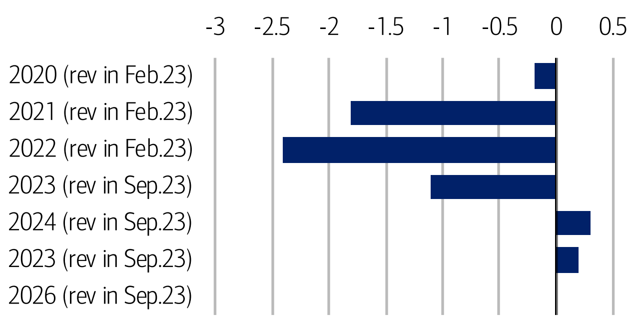
- Fiscal stance (proxied by the variation of the structural balance) is planned to turn less supportive, with a 1.1% improvement in 2024. The tightening reflects mostly the phasing out of energy crisis-related emergency measures (as well as the "Superbonus"). Yet, spending associated with RRP should continue to provide a boost to growth.

- Interest rate expenditure is set on a rising path from 2024E – around EUR12bn of extra expenditure per year versus April projections (ca 0.1% of GDP). Notably, despite quite upbeat GDP growth forecasts, the higher level of yields implies that the snowball effect would no longer have a debt-reducing impact from 2026E.

We highlight a good degree of uncertainty regarding these projections. The latest geopolitical developments, with potential implications for energy prices, imply further downside risks to growth. Also, the "Superbonus" computation remains a moving target, not only for its statistical treatment but also for any additional surprise on the effective take-up. Last but not least, the slower/partial implementation of the RRP may undermine the fiscal boost embedded in underlying growth numbers.

Exhibit 8: Impact of Super bonus statistical revisions on deficits

The classification from payable to non-payable of the tax credit related to the bonuses for the construction sector led to two rounds of statistical revisions over the year



Source: NaDEF 2023, BofA Global Research

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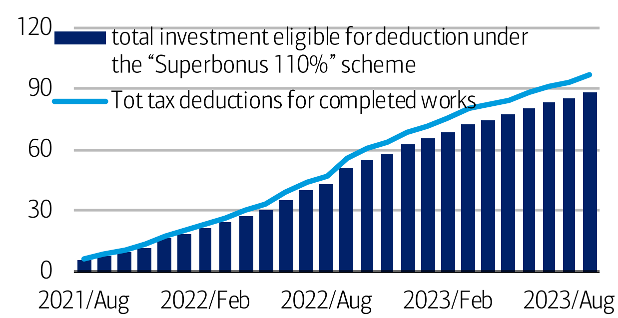
Exhibit 9: Investment eligible under Superbonus scheme

Up to September 2023, total investment eligible for deduction under the "Superbonus 110%" scheme exceeded EUR88bn



Source: Enea, BofA Global Research

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Fiscal prudence and punctual RRP implementation: a must-do call from Brussels

We are back in a situation in which the EU Commission's (EC) assessment of the 2024 budget will be followed closely by markets. We will need to wait for the second half of November for any official comment on the 2024 budget (in the aftermath of the Autumn forecast round – Exhibit 10). With the fiscal rules back next year, we expect Brussels' focus to be more on the state of play of the national recovery plan than on deviations from deficit/debt thresholds. As such, any market expectations for an imminent budget revision by Italy appear misplaced at this stage.

That said, we work under the assumption that by 1H24 the new fiscal rules will be effective. Based on the EC proposal, it is very likely that the old debt/deficit limits and the debt-declining requirement will be kept. In that respect, the Italian fiscal equation would likely fail to provide comfort. While the planned structural efforts embedded in official plans meet the EC's 2023 recommendations, risks for an excessive deficit procedure (EDP) are not negligible for Italy next year. A return to a Rome-Brussels clash is not unthinkable – albeit very inconvenient in a year of EU elections. Again, calls for fiscal rectitude could quickly follow, we think.

Exhibit 10: Calendar of main macro events for Italy

Rating review is likely to be an imminent market catalyst

Key macro/fiscal events and rating decisions	
29-Sep-23	Update of the Economic and Financial Document (NaDEF)
15-Oct-23	Submission of 2024 draft budget plan to the European Commission
20-Oct-23	rating decision - S&P
20-Oct-23	Deadline for the presentation of 2022 Budget to the Parliament
27-Oct-23	rating decision - DBRS
10-Nov-23	rating decision - Fitch
17-Nov-23	rating decision - Moody's
Mid-November	European Commission - Autumn Economic Forecasts
30-Nov-23	European Commission's assessment on the budget plan
31-Dec-23	Deadline for parliamentarian approval of 2024 Budget
By year-end	Expected payment of RRF 4th tranche
By year-end	Expected request for RRF 5th tranche
Jan 24	Update on national RRP implementation

Source: Bloomberg, BofA Global Research. RRF stands for Recovery and Resilience Facility

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Recovery plan implementation: losing momentum

What about the national recovery plan? The plan is approaching the end of the first half of its 6-yeard period. In 2021/22, Italy did relatively well in terms of RRP implementation, with punctuality for the deliverables agreed with the EC, albeit it was an easy reach, as in 2022, some RRP-funded interventions originally planned for 2021/22 were pushed forward over the second half of the RRP horizon (Exhibit 12). So far, Italy has received EUR84.5bn (in prefinancing and three tranches), and an additional EUR16.5bn is expected to flow in as a 4th tranche. For 2023, an extra EUR18bn is attached to the fulfilment of 69 objectives by year-end (Exhibit 11).

Exhibit 11: Timeline of RRP milestones and targets – Italy

In August, Italy proposed to revise 144 objectives; the Commission endorsed the revised plan in September

Year	Due to	No Objectives	No Milestones	No Targets	Amounts	of which: grants	of which: loans	Planned disbursements	Requests and payments
2020	31-Dec							24.9	Prefinancing Aug-21
2021	31-Dec	51	49	2	24.1	11.5	12.6	21	Disbursed in Apr-22
2022	30-Jun	45	44	1	24.1	11.5	12.6	21	Disbursed in Nov-22
	31-Dec	55	39	16	21.8	11.5	10.3	19	18.5*bn disbursed in Oct-23
2023	30-Jun	27	20	7	18.4	2.3	16.1	16	16.5bn requested in Sep-23
	31-Dec	69	23	46	20.7	8	12.6	18	
2024	30-Jun	31	13	18	12.6	2.3	10.3	11	
	31-Dec	58	8	50	21.3	6.3	14.9	18.5	
2025	30-Jun	20	5	15	12.6	2.3	10.3	11	
	31-Dec	51	5	46	14.9	4.6	10.3	13	
2026	30-Jun	120	7	113	20.8	8.5	12.3	18.1	
Tot		527	213	314	191.5	68.9	122.6	191.5	

Source: Corte dei Conti, BofA Global Research

Note: * the payment of the third instalment was reduced by ca 500mn as the associated target (on new student housing) was moved from 2H22 to 1H23. The fourth instalment will include those 500mn.

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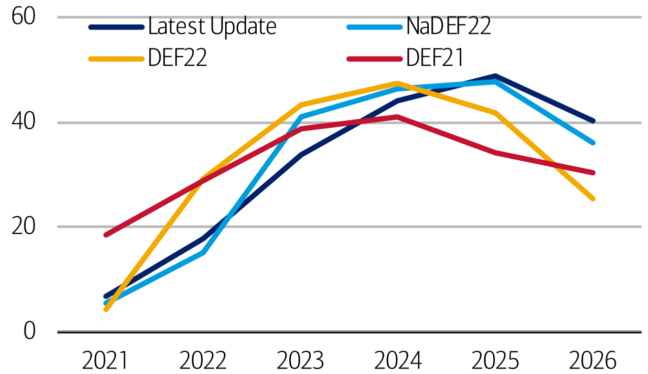
However, significant delays accrued this year. The payment of the 3rd tranche (in October) arrived with 10 months delay, as the underlying objectives were not met on time (and the EC requested a series of adjustments to ca 10 measures for full compliance with the agreed milestones). In July, Italy requested amending and recalibrating its RRP in areas no longer achievable (ca 144 objectives); the EC approved the amended plan in September. The redefinition of some quantitative targets (for both investments and reforms) could reduce the delays for delivering the next objectives. That said, implementation risks are significant, we think.

Exhibit 12: Updated timeline of national RRP allocation
Some of the interventions planned in the first 3 years of the plan have been delayed to the final period of the plan



Source: MEF, Corte dei Conti. BofA Global Research.

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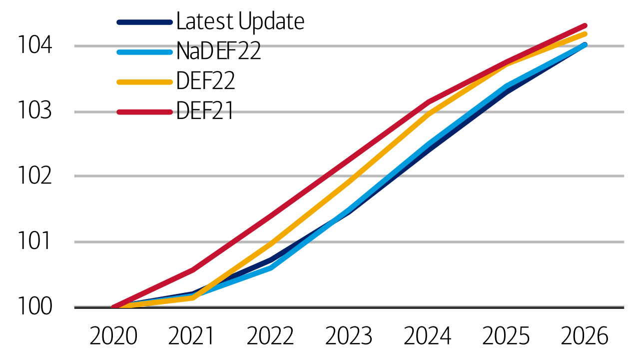
Exhibit 13: Impact on GDP levels of the different RRF planned allocation
The sooner funds will be deployed within the next 3 years, the better



Source: MEF, Corte dei Conti. BofA Global Research

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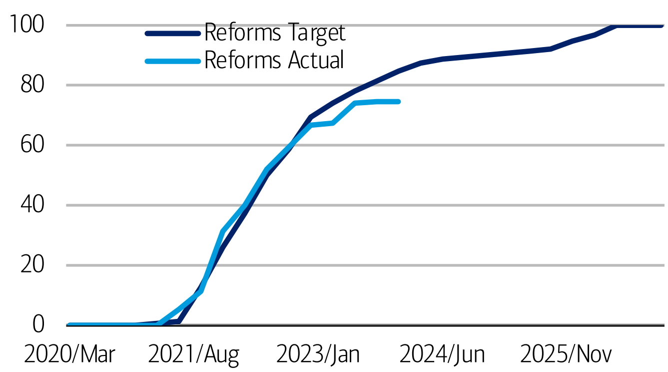
First, RRP "backlogs" keep accumulating. The most up-to-date timeline of RRP allocation (June 2023) further reduces the total funds planned for 2023/24 and concentrates even more resources in 2025/26 (Exhibit 11). This raises the bar for full deployment of funds in the remainder of the time horizon. An ambitious acceleration in fund absorption is needed to preserve the "do-ability" of the plan within the 6-year timespan. Also, timely deployment matters to maximise RRP's fiscal firepower. Exhibit 13 shows the GDP boost from RRP implementation consistent with the different timelines of fund deployments. GDP gains would have been higher with more front-loaded RRP usage in 2021/23 (assuming fiscal multiplier are higher in proximity of the shock). Conversely, the sooner funds are deployed in the next 3 years, the better.

Exhibit 14: Percentage of completion of reforms under RRP
The updated census of the Regis platform counts ca 74% of regulatory reforms to be completed



Source: Openpolis data

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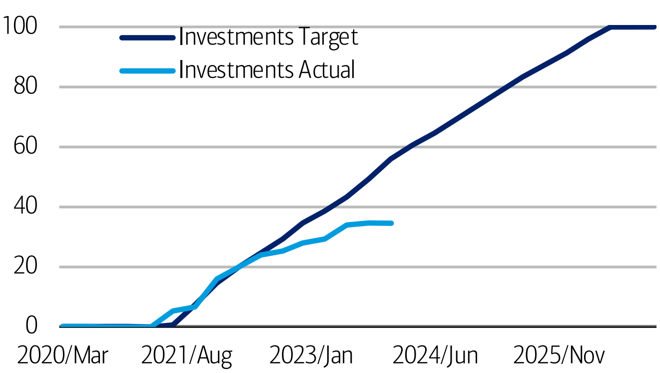
Exhibit 15: Percentage of completion of investments under RRP
The percentage falls to 33% when looking at completed investments



Source: Openpolis data

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Second, so far, delays have been more material for investments than for the reform pipeline (Exhibit 14 and Exhibit 15). And now the plan is reaching a stage at which the number of targets (mostly associated with implementation and proper investment spending) will be higher than the one of milestones (Exhibit 11). Third, for some projects, actual spending requires private sector involvement for RRF funds to be enhanced. In the current rates environment, that might not happen with capex being financed at 6%.

BTPs: rope-walking

BTPs find themselves in an unstable equilibrium – either we rally towards 160bp in 10y BTP-Bund together with a shallow trend of lower rates and lower vol, or we could be looking at the start of a wider financial impact. We are in the first camp.

Italy is benefitting from 1) short and underweight positioning (various indicators confirm the same), 2) relatively high growth for its standards, 3) a relatively stable government (and support from RRP), and 4) very strong demand from domestic retail investors that should continue from here, if not accelerate. These flows balance the high amount of net supply even after accounting for QT.

On the other hand, 1) fundamentally, BTPs are the only asset truly left in the periphery block (GGBs are seen converging towards Iberics – see the report, Euro Area Viewpoint: Investor trip to Greece: Key Takeaways 06 October 2023) and therefore retaining the highest beta to risk sentiment; 2) debt/GDP projections fail to show a steep downward trend and are highly vulnerable to the level of rates; 3) rating agencies may threaten a cut to junk – a low-probability event, in our view, but one that could have a significant financial impact as a tail event.

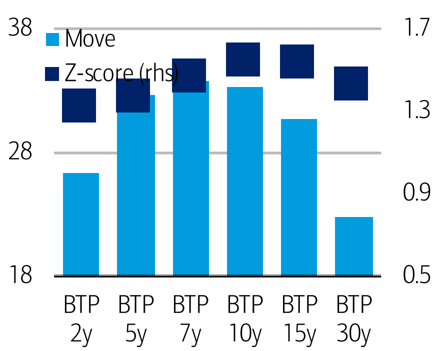
On balance, despite the large issuance numbers, the supply/demand picture looks supportive given the size of retail purchases and the short/underweight positioning amongst institutional investors. This should keep BTPs supported, unless the rates sell-off continues from here, posing a risk to debt sustainability.

With macro covered, in the sections below, we go deeper into technicals.

Budget worth 15bp widening, rest from real rates/vol

Italy-specific news cannot, on their own, justify the widening in BTP-Bund spreads seen since early September – see the report, European Rates Watch: 08 September 2023. Growth revisions are not surprising, the 2024 budget plan was a marking-to-market exercise that should not generate a conflict with the EU, while NGEU implementation, albeit slow, has accelerated from a long pause caused by the renegotiation of the programme (the government expects receiving the 4th tranche by year-end and finishing the 5th's "paperwork" by year-end; see Exhibit 11).

Exhibit 16: BTP spread moves since September
BTP-Bund widening large and prominent in 10-year



Source: Bloomberg

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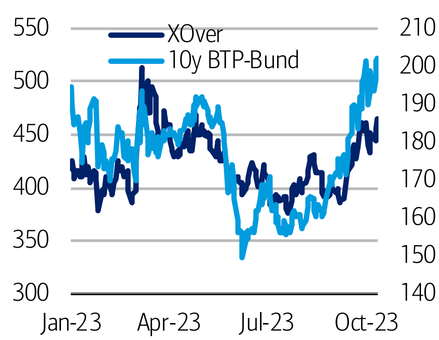
Exhibit 17: BPT-Bund versus XOver
Weakness in credit further supported BTP widening



Source: Bloomberg

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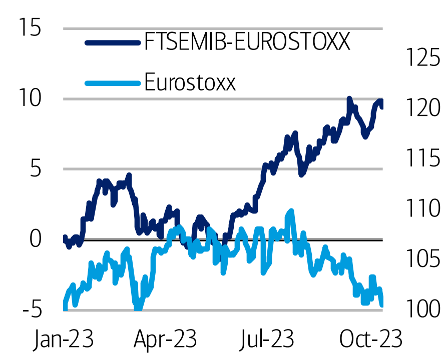
Exhibit 18: FTSEMIB outperforming SX5E
The weakness in Eurostoxx has been muted in FTSEMIB



Source: Bloomberg

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BTPs' underperformance started with a build-up in short positions in early September as contradicting headlines on 2023-2024 budget deficit targets started to arise – this component is worth about 15bp, in our view.

Since then, the weakness in both credit and equities propped the 10-year BTP-Bund spread further up. The upward revision in real neutral rates and, even more so, in term premia has increased risk assets' sensitivity to rates and added to the BTP bear case.

The relationship with rates is a highly non-linear, unstable one (Exhibit 19). BTP-Bund spreads used to widen in concomitance with rates from summer 2021 to mid-2022, but that relationship has broken down since.

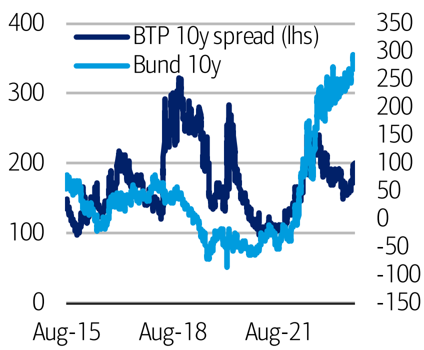
While nominal rates may rise, investors' expectations on long-term inflation may also rise, partially offsetting the expected real cost of debt in the future. The upward revision in inflation expectations relative to the disinflation era softens the burden on public finances. In fact, if we run the same comparison, that of BTP-Bund spreads, against real rates, the relationship improves on the margin.

Uncertainty around the equilibrium level of rates, proxied by three-month expiry implied volatility across the curve (Exhibit 21) remains, in the big picture, a strong, more reliable driver of BTP-Bund spreads.

The combination of 1) declining breakeven inflation / quickly rising real rates and 2) higher rates uncertainty is a bad mix for a country that, as we show in the macro section above, continues to display a tough sustainability picture.

Fundamentally, this, far more than the government's proposed budget (assuming no one could have reasonably expected sovereign-crisis style budget tightening, in excess of what was expected in the 2023 Stability Plan), is what is driving the current weakness in BTP-Bund. This driver is likely shared with the underperformance in equities/credit.

Exhibit 19: 10y BTP-Bund spread versus Bund
Weak BTP spread versus nominal rate relationship



Source: Bloomberg
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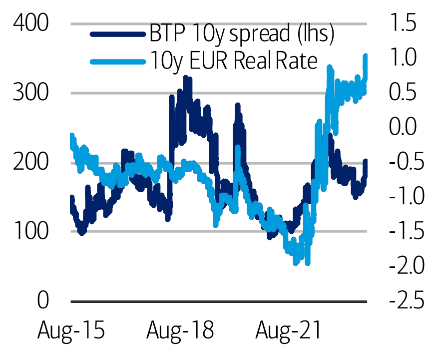
Exhibit 20: 10y BTP-Bund versus real rate
The increase in real rates is more notable



Source: Bloomberg
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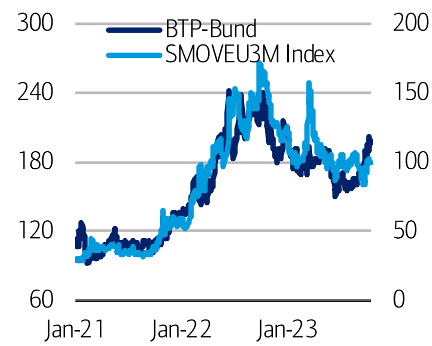
Exhibit 21: BTP-Bund versus rates volatility
Broadly, rates uncertainty remains the top driver



Source: Bloomberg
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Positioning remains short/underweight

If we dissect recent market movements further, we note that, in addition to the above fundamental reasons, there is likely also a build-up of short positioning for either speculative or hedging purposes.

Exhibit 22 shows that the widening in BTP-Bund spreads has happened also during rates rallies as BTPs suffered from the risk-off sentiment from recent events. The * MERGEFORMAT underperformance of the BTP future's Cheapest-to-Deliver bond on the curve during the credit sell-off (Exhibit 23) also suggests a build-up of hedges against further corporate bond sell-off.

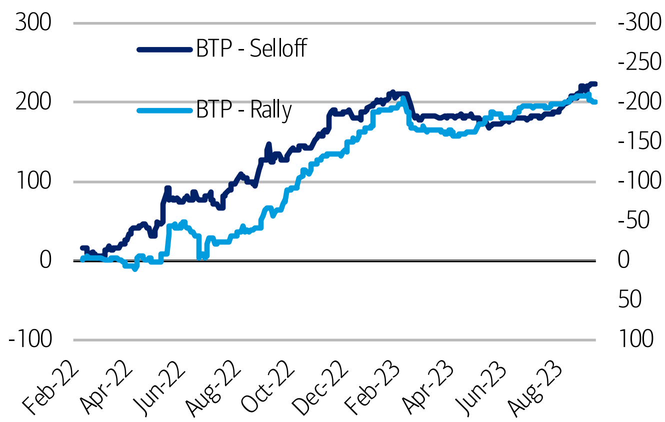
Positioning from fast money and international investors (the most volatile) cannot but be short and underweight BTPs, in our view.

The results of the latest FX and Rates Sentiment Survey (see the report, FX and Rates Sentiment Survey: I have a dollar 13 October 2023) show that the vast majority (80% when also netting for "Don't knows") of investors believe that spreads will trade within the current range or higher by the end of 2023.

The respondents to the Bull-Bear positioning proxy also showed a deepening underweight stance for the periphery complex – this likely is even more the case for BTPs than the rest of the members.

Fundamentally, it is very hard for a sizeable long positioning base to build up for Italy. Retail net flows from May-2022 until the latest available (June 2023) has risen by €127bn (Exhibit 24).

Exhibit 22: BTP-Bund spread daily moves on Bund rallies/selloffs
Cumulative BTP spread changes indicate weakness on both rates moves



Source: Bloomberg. Rally indicates a decrease in 10y Bund yield, Selloff the opposite. BTP-Rally is on RHS, inverted

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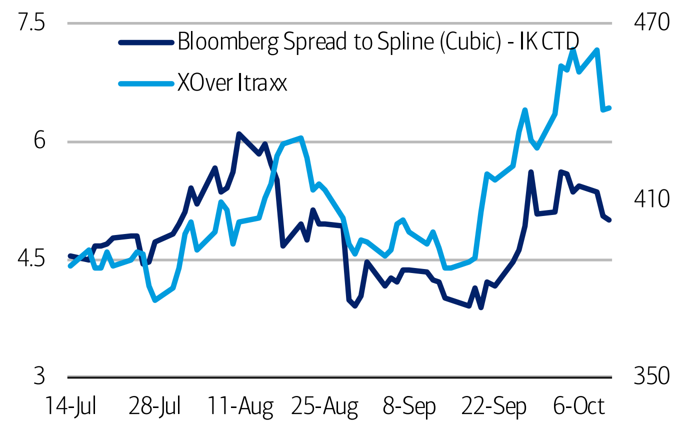
Exhibit 23: IK Futures contract CTD Bond spread to spline versus Credit
Cheapening of CTD contract and credit selloff suggest hedging short base



Source: Bloomberg. Xover shown on RHS

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The size of this flow is so big and well above that of net supply in 2023 and 2024 alike (in the range of €70-80bn) that it has forced all other private investors out of the BTP market.

Domestic banks have been net sellers in the order of €28bn – in the context of shrinking ECB balance sheet and TLTRO-end, this investor category is likely to remain on the sidelines, unless BTPs start suffering from a market access standpoint.

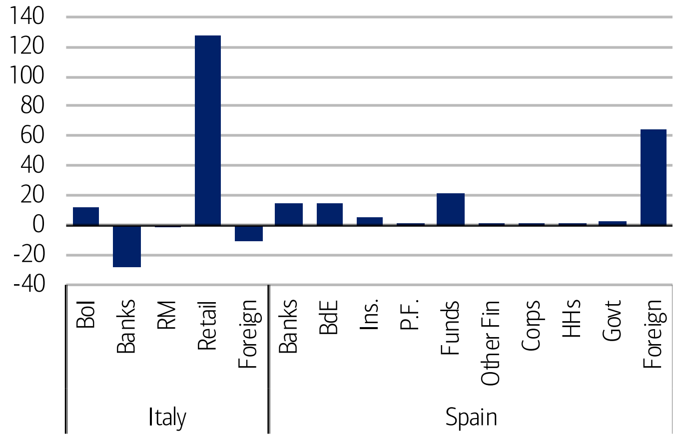
Domestic real money investors have also rebalanced away, resulting in flat net flows (they tend to be stable buyers).

Non-residents continued to get rid of BTPs in notional terms – the share of government debt held by this investor type is further down from 2022's 26% (itself the lowest amount since 1998 for Italy and significantly lower than the 41% Euro Area average).

Surprisingly, the sustained clips of retail investor demand for BTPs have not significantly slowed as domestic banks' interest offering for term deposits caught up with front-end yields (see the report, Liquid Insight: Retail flows into EGBs accelerating, but headwinds may appear 24 May 2023). As a reminder, for the retail community's composition of financial assets to return to the 2014 levels, there is space for another €260bn in net purchases from current levels.

Importantly, the current law proposal includes further fiscal incentives for domestic retail investors to hold BTPs directly – we cannot rule out a further acceleration in flows next year given the potential room in their financial portfolios.

Exhibit 24: Net flows in domestic debt by investor type since mid-2022
Data from May 2022 to June 2023 show dominating net flows from Italian retail



Source: Bankitalia, Banco Espana, national treasuries

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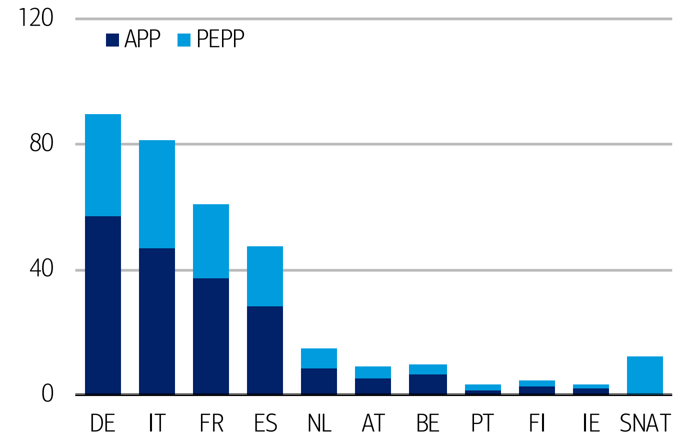
Exhibit 25: Assumed 2024 EGB redemptions in APP and PEPP portfolios
Large Italian redemptions drive QT flows up



Source: Bloomberg, ECB and own calculations. Numbers in EUR billions. APP = Asset Purchase Programme. PEPP = Pandemic Emergency Purchase Programme.

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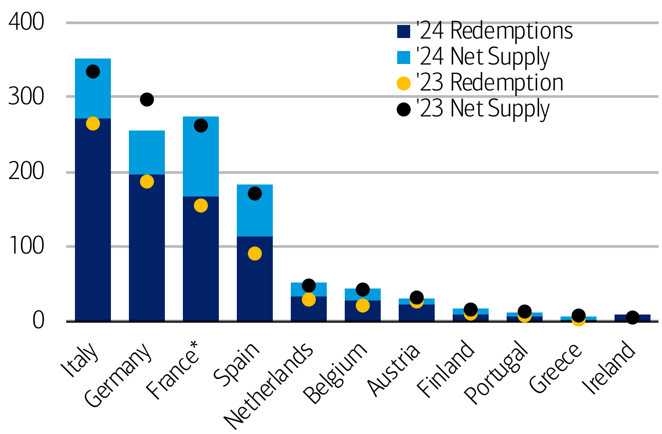
Supply, higher also before accounting for PEPP

One main takeaway from the call with the Italian Treasury this Tuesday should be that the 2024 draft budget proposal, at the current stage, is mostly a mark-to-market exercise worth around €24bn.

Exhibit 26: Bond supply values from the perspective of the issuer
Italian redemptions and deficits keeping it most exposed to markets



Source: Bloomberg, national treasuries/Ministries of Finance. Own calculations. Numbers in EURbn

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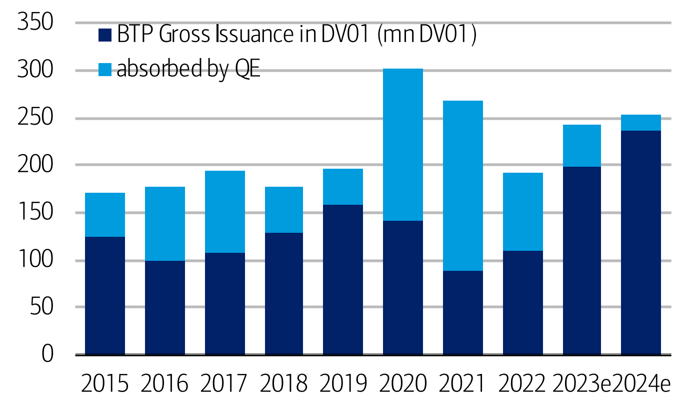
Exhibit 27: Supply in DV01 after accounting for ECB gross flows
DV01 delivery of BTPs increases further, albeit at a smaller pace than 2023



Source: Bloomberg, ECB and own calculations. 2024 assumes 50% of PEPP reinvestments over H2

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Turning into supply forecasts, even if the deficit as share of GDP declines in 2024 versus 2023, cash funding requirements are seen as increasing from 2023's €115bn to next year's €135bn in the current draft budget proposal.

The main reason behind this is that the cash effect of Superbonus incentives active shortly after Covid will be felt from next year to 2026 at clips on the order of €20-25bn.

After accounting for NGEU funding as well as use of liquidity from other branches of the public administration, 2024's supply of bonds net of redemptions should hover around €80bn, according to our assumptions, about €10bn higher than this year and the third-highest level since 2015.

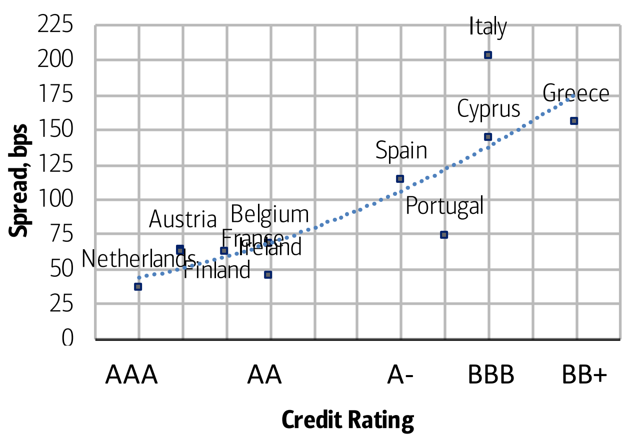
The government will likely also push aggressively for sales of state assets (especially those in big corporates) while ensuring that it retains control in strategic sectors – this, however, is likely more a story for 2025 and later.

In gross terms, that puts Italian bond supply next year on the order of €350bn, driven higher by not only cash requirements but also the higher redemptions (Exhibit 26).

Because of the high amount of gross issuance, when looking at supply numbers in DV01 terms, we are looking at a further increase next year relative to 2023 (Exhibit 27). The chart shows the duration absorption from PEPP reinvestments assuming a 50% tapering over the second half of the year. Given the early discussions by ECB officials on this matter, we cannot rule out much lower reinvestment activity into BTPs.

On this, the beginning of a declining rates trend in the Euro Area, coupled with the continuation of the strong demand from retail (interested as long as rates are above 3%), would make these issuance numbers absorbable, especially in the context of short/underweight positioning from institutional real money. The opposite scenario should move the 10-year BTP-Bund spread comfortably above 200bp and likely re-ignite worries about debt sustainability.

Exhibit 28: Average credit rating versus 10y Bond spreads to Germany
Italy stands out as particularly wide versus current rating



Source: Bloomberg

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Exhibit 29: Indicative schedule of rating review dates
All agencies have Italy on schedule from Friday to end of the year

Month	Date	Country	Agency
Oct	20-Oct-23	France	Moody's
	20-Oct-23	Ireland	Moody's
	20-Oct-23	United Kingdom	Moody's
	20-Oct-23	Greece	S&P
	20-Oct-23	**Italy**	**S&P**
	20-Oct-23	Netherlands	S&P
	20-Oct-23	United Kingdom	S&P
	27-Oct-23	**Italy**	**DBRS**
	27-Oct-23	Belgium	Moody's
	27-Oct-23	France	Fitch
	27-Oct-23	Finland	S&P
Nov	03-Nov-23	Ireland	DBRS
	10-Nov-23	**Italy**	**Fitch**
	17-Nov-23	United Kingdom	DBRS
	17-Nov-23	**Italy**	**Moody's**
	17-Nov-23	Portugal	Moody's
	17-Nov-23	Spain	Fitch
	17-Nov-23	Ireland	S&P
Dec	01-Dec-23	Germany	DBRS
	01-Dec-23	Spain	DBRS
	01-Dec-23	Finland	Moody's
	01-Dec-23	United Kingdom	Fitch
	01-Dec-23	Greece	Fitch
	01-Dec-23	Ireland	Fitch
	01-Dec-23	France	S&P
	08-Dec-23	Cyprus	Fitch

Source: DBRS, Moody's, Fitch, S&P

Ratings – more reasons to downgrade but not to junk

Net of the slow-moving variables on institutional strength and the likes, rating agencies are particularly sensitive to growth, public finances (deficits and debt/GDP) and, lately, implementation of RRPs' objectives.

While they typically look at medium-term forecasts, this year saw a deterioration in both growth and deficits. This happened in the context of much costlier debt in real terms, both because of ECB rates and because of widening spreads. As for the latter, Italy trades at levels consistent with below-IG rating if one takes peers as the baseline (Exhibit 28).

The EGB ratings calendar is busy with possible actions from today to the end of the year, but we think that Italy may escape actual cuts (we cannot rule out negative outlook changes). NGEU implementation has quickened after a pause that required re-negotiation while the government remains, for now, relatively well integrated in European (and beyond) decision making. The numerous emergencies that the European block needs to navigate should reduce leaders' appetite for fragmentation, and repeats/edits of the common issuance programmes cannot be ruled out – this is something particularly positive for the periphery.

It is a tough call. What is not tough, however, is estimating the impact of a potential downgrade to junk by the three agencies on average. In that scenario, we are probably looking at minimum €100bn in net sales from institutional investors in a year with almost full QT and with already high issuance. That likely means a loss of market access for Italy and a material widening of spreads north of 300bp, with predictable effects on financial balance sheets that are already weakened by the rates increase seen so far.

Exhibit 30: Common acronyms/abbreviations used in our reports

This list is subject to change

Acronym/Abbreviation	Definition	Acronym/Abbreviation	Definition
1H	First Half	IT	Italy
2H	Second Half	Jan	January
1Q	First Quarter	Jul	July
2Q	Second Quarter	Jun	June
3Q	Third Quarter	lhs	left-hand side
4Q	Fourth Quarter	m	month
ann	annualized	MA	Moving Average
APP	Asset Purchase Programme	Mar	March
Apr	April	MBM	Meeting-by-meeting
AS	Austria	mom	month-on-month
Aug	August	Mon	Monday
BdF	Banque de France (Bank of France)	MPC	Monetary Policy Committee
BE	Belgium	MWh	Megawatt-hour
BEA	Bureau of Economic Analysis	NGEU	NextGenerationEU
BLS	Bank Lending Survey	NE	Netherlands
BoE	Bank of England	Nov	November
BofA	Bank of America	NRRP	National Recovery and Resilience Plan
BoI	Banca d'Italia (Bank of Italy)	NSA	Non-seasonally Adjusted
BoJ	Bank of Japan	OAT	Obligations assimilables du Trésor
BoS	Banco de España (Bank of Spain)	OBR	Office for Budget Responsibility
bp	basis point	Oct	October
BTP	Buoni Poliennali del Tesoro	OECD	Organisation for Economic Co-operation and Development
Buba	Bundesbank	ONS	Office for National Statistics
ca	circa	p	preliminary/flash print
CA	Current Account	PBoC	People's Bank of China
CPI	Consumer Price Index	PEPP	Pandemic Emergency Purchase Programme
CSPP	Corporate Sector Purchase Programme	PMI	Purchasing Managers' Index
d	day	PSPP	Public Sector Purchase Programme
GE	Germany	PT	Portugal
Dec	December	QE	Quantitative Easing
DS	Debt sustainability	qoq	quarter-on-quarter
EA	Euro area	QT	Quantitative Tightening
EC	European Commission	RBA	Reserve Bank of Australia
ECB	European Central Bank	RBNZ	Reserve Bank of New Zealand
ECJ	European Court of Justice	rhs	right-hand side
EFSF	European Financial Stability Facility	RPI	Retail Price Index
EGB	European Government Bond	RRF	Recovery and Resilience Facility
EIB	European Investment Bank	SA	Seasonally Adjusted
EMOT	Economic Mood Tracker	SAFE	Survey on the access to finance of enterprises
EP	European Parliament	Sat	Saturday
SP	Spain	Sep	September

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This list is subject to change

Acronym/Abbreviation	Definition	Acronym/Abbreviation	Definition
ESI	Economic Sentiment Indicator	SMA	Survey of Monetary Analysts
ESM	European Stability Mechanism	SNB	Swiss National Bank
EU	European Union	SPF	Survey of Professional Forecasters
f	final print	Sun	Sunday
Feb	February	SURE	Support to mitigate Unemployment Risks in an Emergency
Fed	Federal Reserve	S&P	Standard & Poor's
FR	France	Thu	Thursday
Fri	Friday	TLTRO	Targeted Longer-term Refinancing Operations
GC	Governing Council	TPI	Transmission Protection Instrument
GDP	Gross Domestic Product	TTF	Title Transfer Facility
GNI	Gross National Income	Tue	Tuesday
GR	Greece	UK	United Kingdom
HICP	Harmonised Index of Consumer Prices	US	United States
HMT	His Majesty's Treasury	WDA	Work-day Adjusted
IMF	International Monetary Fund	Wed	Wednesday
INSEE	National Institute of Statistics and Economic Studies	y	year
IP	Industrial Production	yoy	year-on-year
IR	Ireland	ytd	year-to-date
PCA	Principal Component Analysis	EGB	Eurozone Government Bond
ORI	Optional Reverse Inquiry	C&R	Coupons and redemptions
DV01	Dollar Value of one basis points change		

Source: BofA Global Research

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