Summer Project: Short 10Y Italian GBs
Aug 31st: Final Pitch

Thesis
The high inflation and negative growth of the current energy shock endangers European countries with already-large debt burdens, vulnerable economies, and unfavourable politics, which should push up their yields. Italian government bonds fit this description best. I believe that worse-than-expected energy and political risks paired with a less-effective TPI provides room for further downside in Italian GBs from both a fundamental (on the basis of which the ECB wouldn't intervene) and a sentimental perspective.

Energy, Inflation
Russian gas flow cuts paired with higher stockpiling demand from the EU have pushed natgas prices higher. Though the EU is successfully approaching their target of 80% of capacity by November, I do not see this as adequate in the context of further flow cuts and issues with switching away from gas. [A, B, C] The drawn-out conflict in Ukraine and a still-strong rouble indicate that Russia will continue to cut gas flows into the Winter to put pressure on European governments. There has been limited success in switching to coal, oil, and lumber, but inadequate EZ-wide infrastructure, tight global coal markets, and rising petroleum prices will hamper overly-optimistic REPowerEU plans. A severe European drought has lulled, but water levels remain extremely low and I expect the drought to have continuing effects, impacting hydroelectric and nuclear power generation, river shipping of coal, and food supplies.

Heading into the winter, a weak polar vortex and La Nina anomalies indicate a cold, dry Winter in Europe and NA,[D, E] which may increase pressure on energy more than expected. The prices of energy commodities should rise in general and spill over further. I think that the EU now has the political capital to act on electricity prices, which may be done by decoupling electricity and gas markets (currently, the costliest electricity sets the prices for all other forms of electricity, with gas being the primary culprit for recent spikes) and enacting additional regulations, including capping gas prices and reimbursing energy companies and/or providing consumers support. These policies will redistribute energy-driven strain at a large cost to fiscal space, but the cost of non-gas energy will also increase and fixed contracts will still be rolling over higher.

The August inflation rate of 9.1% (vs. 8.9% in July) beat expectations of 9.0% and confirmed my view of increasing, broader-base inflation driven by the pass-through of rising electricity costs into food, services, and industrial and non-industrial goods. On top of energy contract roll-overs, the impact of extreme weather on regional and global food availability will also support increases in inflation this Winter. I retain my view of at-least 10% inflation this Winter and persistently high inflation throughout 2023 (economists continue to revise 2023 inflation estimates upwards). While fiscal support will decrease adverse primary effects, high inflation coupled with slowing economic activity and tightening fiscal space due to energy stimulus will encourage faster rate front-loading, growing economic vulnerability, political instability, and debt concerns in at-risk countries.

Debt, Economy, Politics
Out of Euro area peripheries, Italy has a worrisome combination of debt burden and macroeconomic vulnerabilities supporting this selection. Italy's debt distribution is front-loaded with over EUR300 bn or ~13% of its total debt burden maturing and having to be rolled over in 2023 and a weighted-average maturity of 7 years. [F] Additionally, Italy has weaker firms (with less buffers to offset input price increases and slowing growth), higher NPL ratios, larger banks exposure to domestic sovereigns, and higher loan guarantees from domestic sovereigns. Italian banks have the greatest exposure to domestic sovereign debt securities relative to total assets in the Euro area; exposures continued to increase, especially at shorter maturities. [G] Given that buffers may have already been eroded due to COVID and post-COVID supply shortages, it is more likely that the economy and government revenues will be impacted harder by rate hikes,

energy shock, and recession. Further, the political situation, with eurosceptic and populist parties performing very well in the polls for the September 25 election is concerning. [H] I expect that Fratelli d'Italia will win and form a coalition government alongside Lega Nord and Forza Italia headed by Meloni that has a majority in the Italian parliament, encouraging further redenomination ("Italexit") and other political risk, such as excessive deficit spending or coming into conflict with the EU or other Eurosystem institutions which can jeopardise eligibility for TPI and other programs. Redenomination risk has been undervalued (using old vs new CDS spread, one of which insures against redenomination) and support for eurosceptic and populist parties will only rise into the elections.

ECB Policy

As expected, intensified PEPP reinvestments into Italian GBs only temporarily halted their yields' march higher, because fundamentals do not support only ~3% 10Y Italian yields. Key members of the ECB have now indicated that inflation has deteriorated further, with six Governing Council members publicly stating that a >50bps move should be discussed. Markets project a 60% chance of 75bps with rates at 166bps by year-end. This is higher than my previous expectations of 50bps and 1.5%, though I think that this is fairly in line with fundamentals; rates should be normalised to the ~1.5% level as soon as possible before a near-certain recession this winter or early next year. I do believe that the ECB should front-load more aggressively and that the terminal rate may exceed normalisation in the context of persistent inflation through 2023 and higher long-term inflation, which should support Italian yields (though the market has been quickly pricing in more aggressive hikes).

The key discussion now for Italian bonds is the TPI. Legal challenges have cast doubt on TPI as a risk-sharing mechanism, and I now see German courts as rejecting mutual risk-sharing. These legal challenges may erode the usefulness of the instrument and the market's reaction to its deployment, contributing to higher Italian yields and a weaker-than-expected impact from a potential TPI trigger. For context, the legal framework for TPI has yet to be published over six weeks after its announcement, while PEPP's was published within a week of announcement. The ECB has stated that the TPI will only be activated if yields diverge markedly from fundamentals and purchases will focus on 1-10Y bonds. The 4% level on the 10Y Italian yield is a key level for market participants, and so if it is broken, there may be an overreaction that precipitates TPI, but given the current fundamentals a yield of around or just above 4% isn't completely unwarranted. However, I think that legal issues with the programme and concerns over a Meloni government in Italy hostile to economic policy conditions will overshadow the TPI and prevent it from appearing (and being) as effective as intended, leading to higher yields especially in 1-10Y bonds, which are the focus of the instrument.

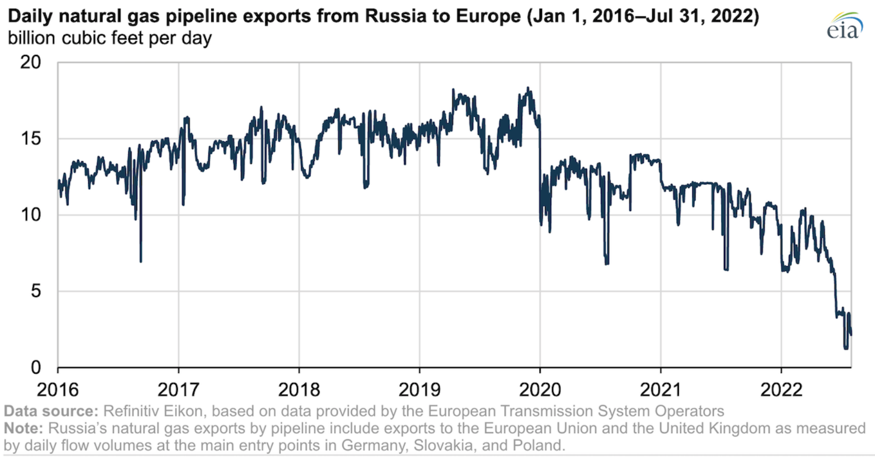
Trade Expression

I believe that Italian bonds of 10Y tenor are optimal because the 10Y is a key reference for the TPI and market participants. Most 'short-term' risks discussed have strong impacts on fundamentals in the macroeconomy, political institutions, and debt sustainability which should impact the 10Y. A spread trade to Bunds is more complex than in the past because Germany's energy vulnerabilities overshadow their continued safe-haven status. This means that other Eurozone countries, particularly France, which is much less vulnerable to energy disruptions, may also attract some safe-haven flows. A spread trade with a split of German and French bonds may be an option, though I don't think that it adds enough value to the trade to justify the allocation.

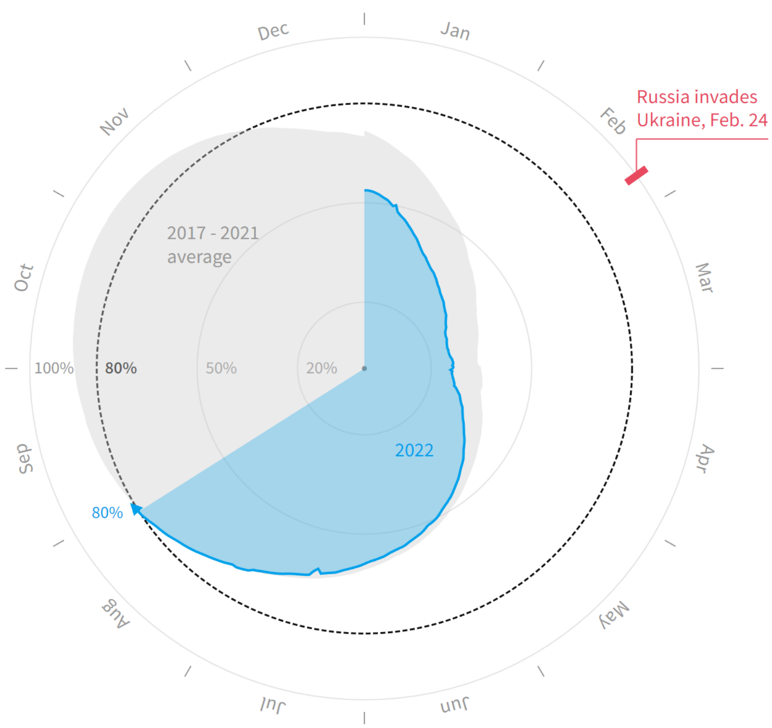
Since my mid-August update, data on inflation, political polling, and energy have strongly affirmed my overall views, but this has led the trade to become oversaturated as institutions have placed large bets against Italian debt - hedge funds have allocated almost $40 billion on short Italian GB positions. Partially, as a result, the key 10Y yield has risen from 3.072% to 3.874%. Still, I think that there is more room to go in the trade, since my views on politics and TPI (and, somewhat, on energy) are not yet fully priced in. I would set a temporary target of a 4% yield, though that may rise as additional information on TPI and the ECB's next hike comes out, which can be used to judge whether the yields can be expected to break much over 4%.

Appendix

A. Data on NatGas Flows Russia to EU



B. European Average NatGas Stockpile



C. Dutch TTF NatGas, Front Month; Proxy for EU-wide NatGas Prices

ICE Endex

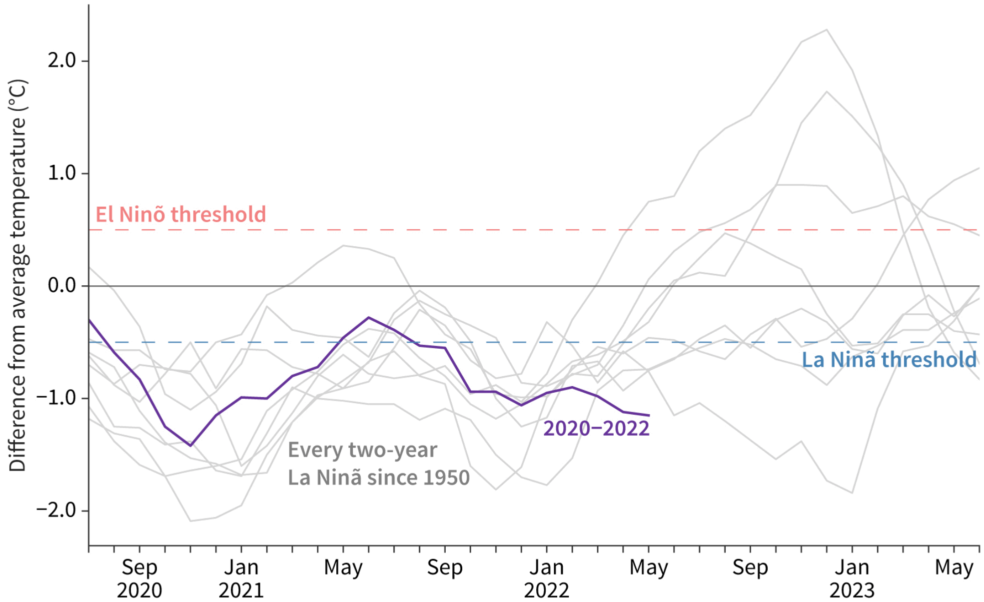
Dutch TTF Gas Futures

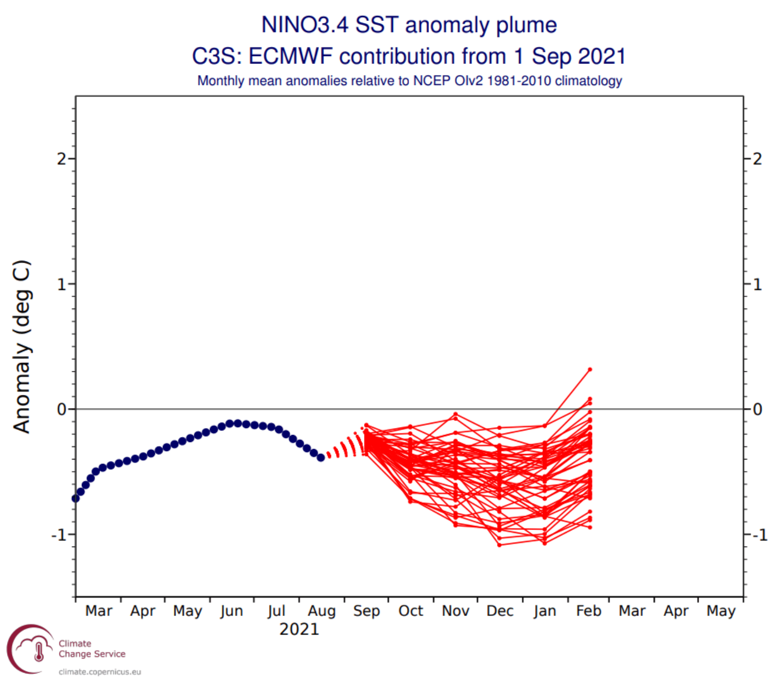
CONTRACT	LAST	TIME(GMT)	% CHANGE	VOLUME
OCT22	243.465	8/31/2022 11:06 AM	-8.240	15670

INTRADAY | 3 MONTHS | 1 YEAR | 2 YEARS — LAST UPDATE TIME: 08-31-2022 11:16 AM GMT

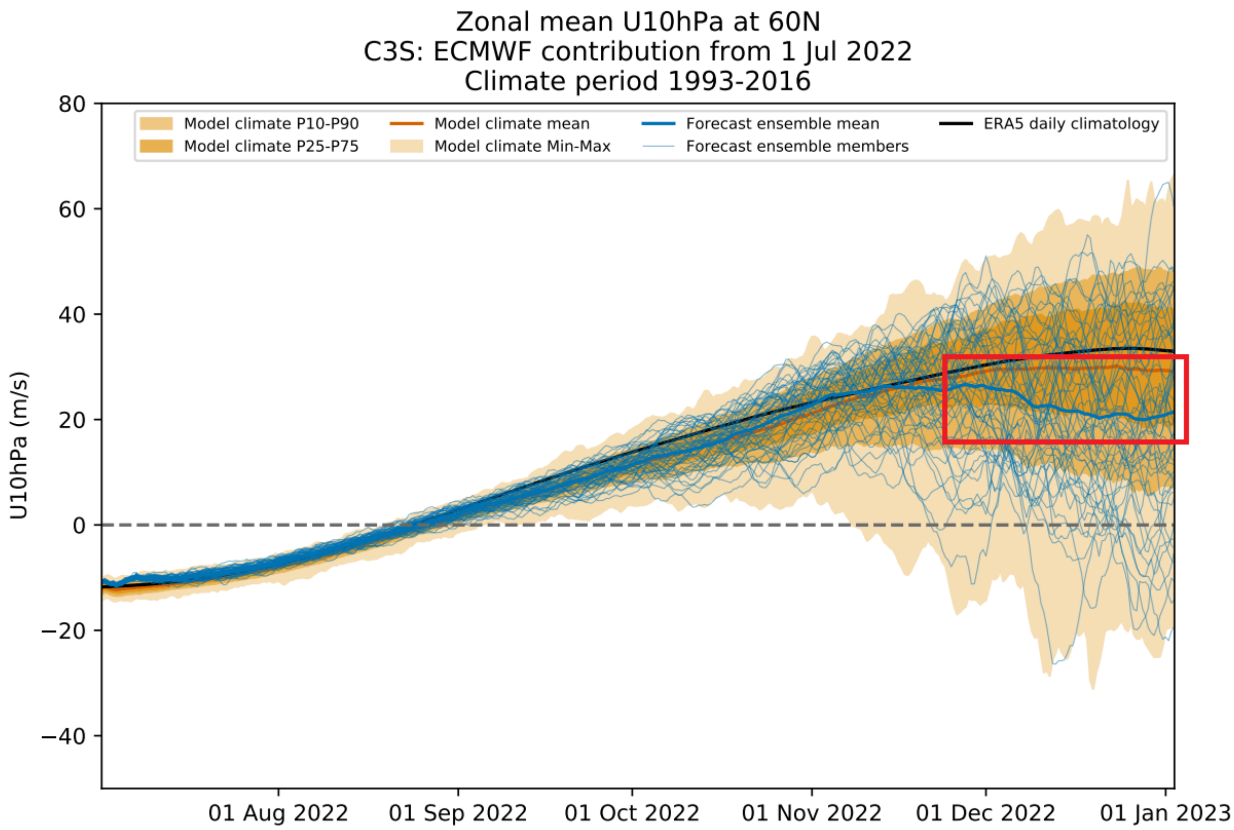
D. La Nina Temperature Anomaly

Monthly sea surface temperature Ninõ 3.4 Index values



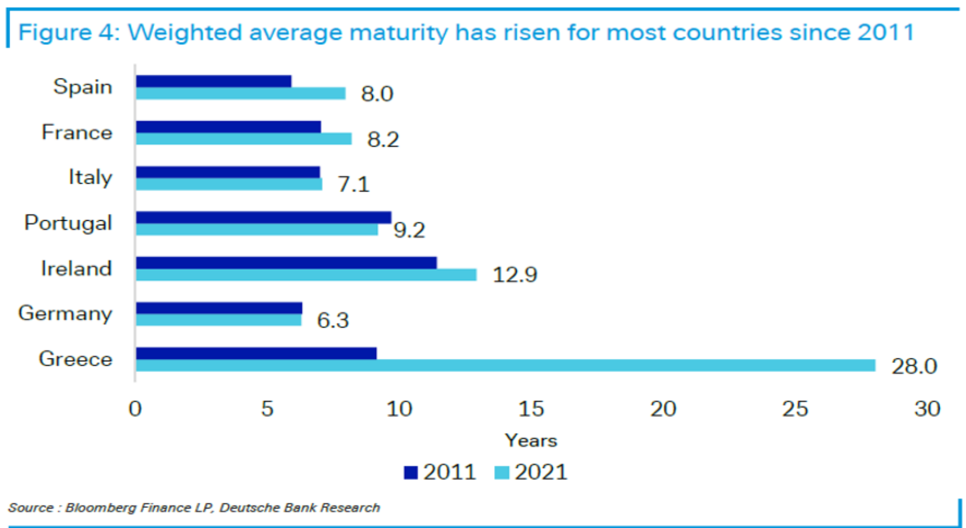


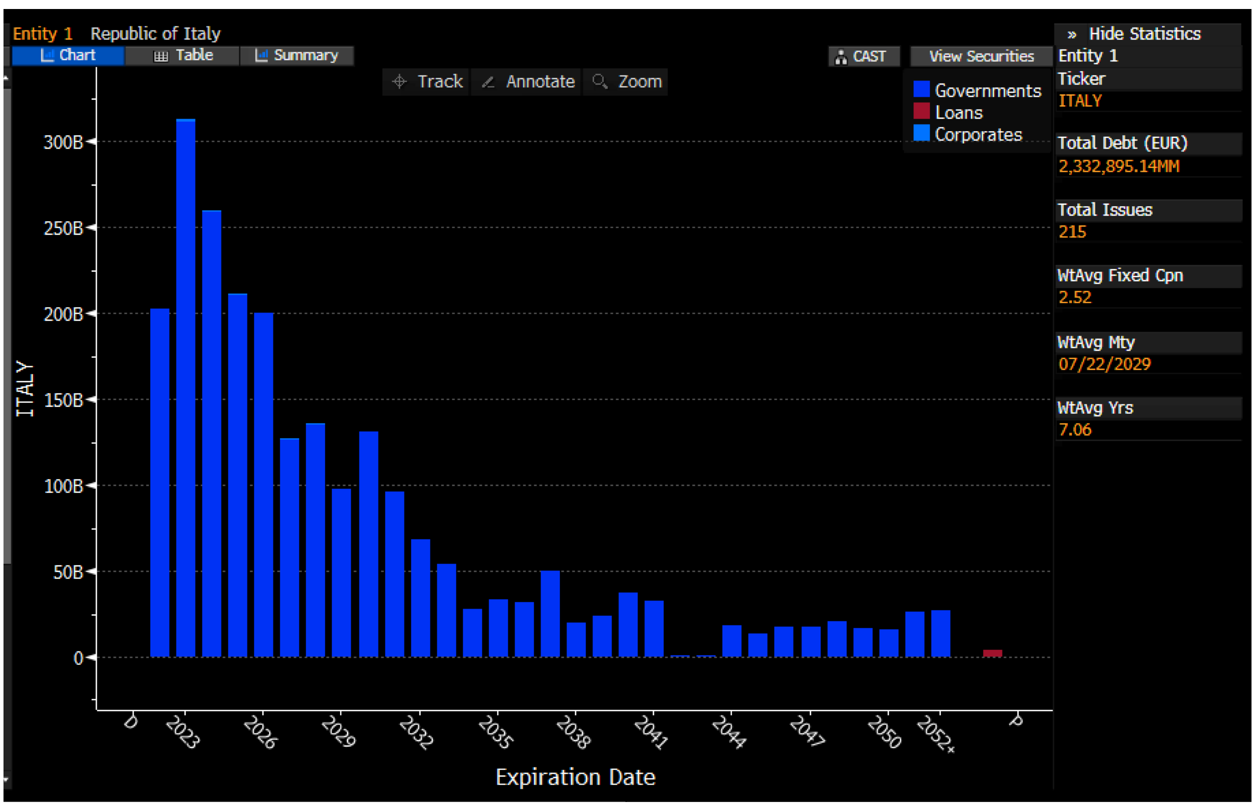
E. Expected Stratospheric Winds



F. Italy's Debt Burden

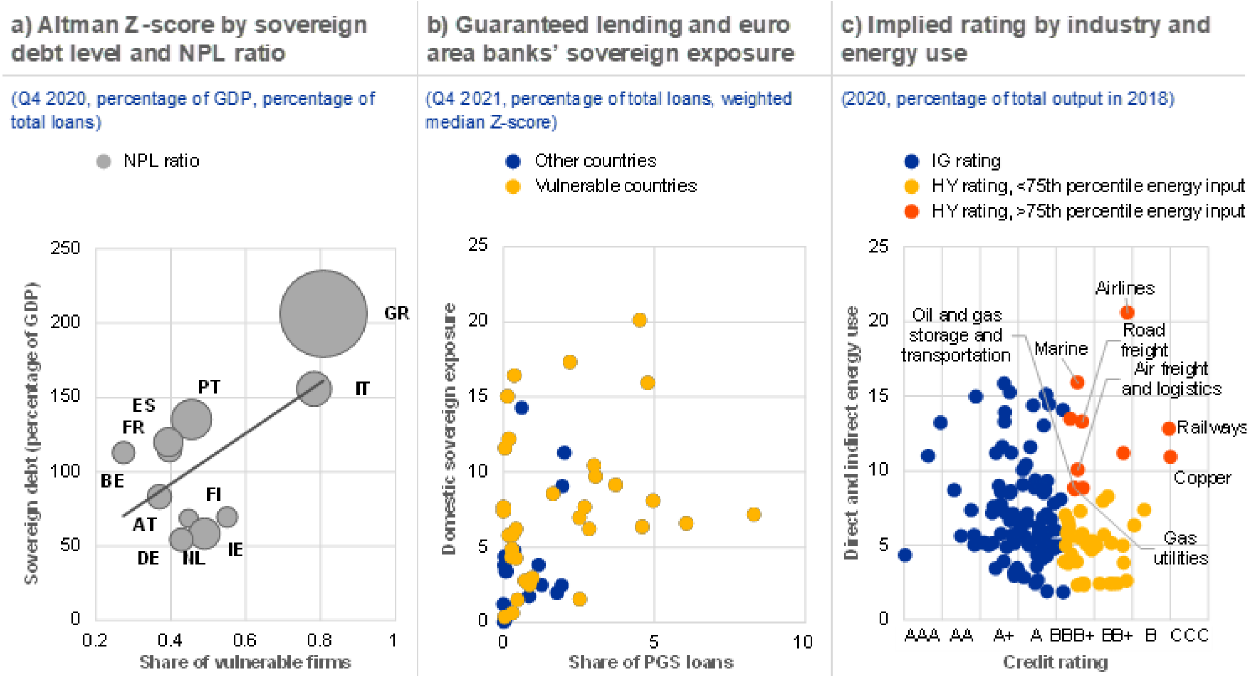
Source: Deutsche Bank Research



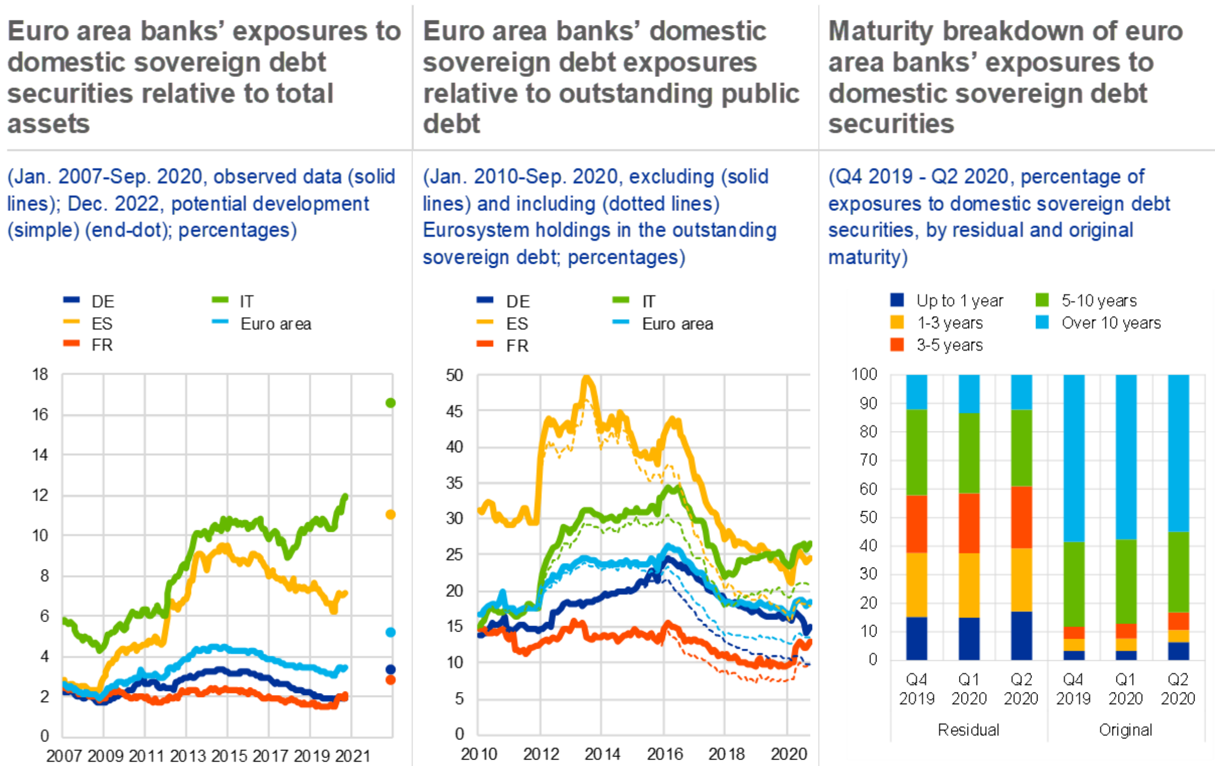


G. Economic Vulnerabilities: Italy

1. Corporate and Financial Vulnerabilities in the Euro Area



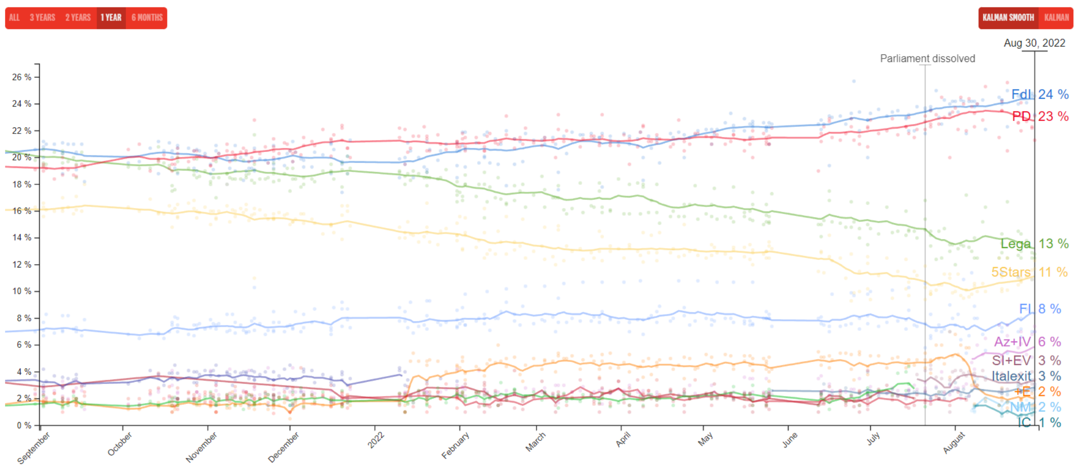
2. Bank Exposures to Domestic Sovereign Debt Securities (2020 Data)



H. Italian Politics; September 25 Elections

Italy – 2022 general election

Italy goes to the polls on September 25 to elect a new parliament. Here's the latest polling data from POLITICO Poll of Polls. What is Poll of Polls and how does it work? Read more here.



Brothers of Italy
Fratelli d'Italia
Leadership: Giorgia Meloni
EP affiliation: ECR

Democratic Party
Partito Democratico
Leadership: Enrico Letta
EP affiliation: S&D

League
Lega
Leadership: Matteo Salvini
EP affiliation: ID

5Star Movement
Movimento 5 Stelle
Leadership: Giuseppe Conte
EP affiliation: NI

Forward Italy
Forza Italia
Leadership: Silvio Berlusconi
EP affiliation: EPP

Action & Italy Alive
Azione & Italia Viva
Leadership: Carlo Calenda & Matteo Renzi
EP affiliation: RE

Greens and Left Alliance
Alleanza Verdi e Sinistra
Leadership: Nicola Fratoianni & Angelo Bonelli
EP affiliation: Greens/EFA/GUE/NGL

Italexit – For Italy with Paragone
Italexit – Per l'Italia con Paragone
Leadership: Gianluigi Paragone
EP affiliation: New/Unaffiliated

More Europe (prev. with Azione)
Più Europa
Leadership: Emma Bonino
EP affiliation: RE

Us Moderates
Noi moderati
Leadership: Maurizio Lupi
EP affiliation: New/Unaffiliated

Civic Commitment
Impegno Civico
Leadership: Luigi Di Maio
EP affiliation: New/Unaffiliated

Italy old vs new CDS (proxy for redenomination or Italexit risk)