MyStratWeekly

Market views and strategy

Ostrum ASSET MANAGEMENT

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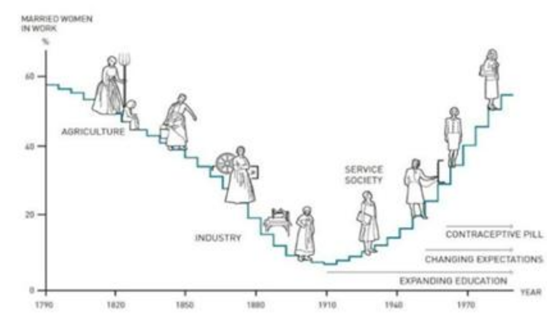
Topic of the week: Return of fears about the Italian debt

- **The Italian 10-year rate returned to the levels of 2012, during the sovereign debt crisis, and the spread returned to levels of 200 bp;**
- **The government ignited the powder with the upward revision of budget deficit forecasts;**
- **Fears about Italian sovereign debt are legitimate due to high public debt, slowing growth and rising interest rates which increase debt service;**
- **This comes as EU fiscal rules will be reinstated in January;**
- **Italy risks a downgrade of its sovereign debt rating over the coming weeks, likely to generate more mistrust on the part of investors and weigh on Italian rates.**

Market review: Uneasy stability

- **Curves flatten after the attack in Israel;**
- **US inflation remains at 3.7%;**
- **Resilient risk assets thanks to the Fed and Chinese stimulus;**
- **The dollar remains at near 2023 highs.**

Chart of the week



The U-shaped curve. © Johan Jarnestad/The Royal Swedish Academy of Sciences

La courbe en U de Claudia Goldin. JOHAN JARNESTAD / THE ROYAL SWEDISH ACADEMY OF SCIENCES

Claudia Goldin received the Nobel Prize in Economics this week, notably for her work on the economic condition of women.

The Harvard economist highlights the inequalities suffered by women in the labor market. Among his contributions, we find the U-shaped curve which describes the participation of women in the labor market according to the evolution of the structure of the agricultural then industrial economy, access to education, contraception and induced changes in expectations.

Figure of the week

9.8

Source : Bloomberg

This is the significant basis point difference between the median yield and the highest accepted yield at the last 30-year Treasury bond auction in the United States. Demand for long-term rates remains weak despite the geopolitical situation.

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●Topic of the week

Return of fears over Italian debt

The return of Italian rates to the levels reached during the sovereign debt crisis and the widening of the spread vis-à-vis Germany, towards 200 basis points, are bringing back fears about Italian sovereign debt. These are legitimate since the government has just revised upwards its budget deficit forecasts while growth slows, the interest charge increases, support from the ECB is reduced and the public debt remains one of the highest of the Eurozone, after Greece.

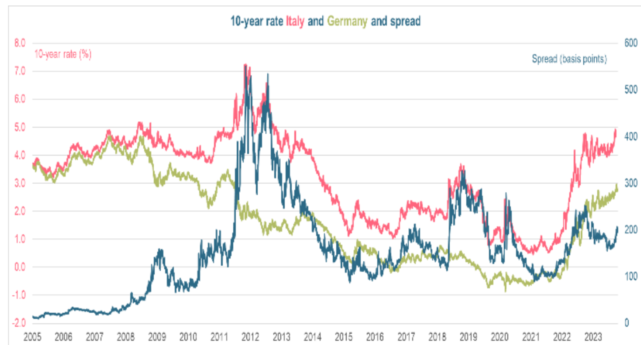
Causes of strong tensions on Italian rates and spreads

Italian rates have increased sharply since the end of 2022 in the wake of the strong monetary tightening carried out by the ECB. Tensions intensified from mid-September, with the 10-year rate peaking at 5% on October 4, a level reached in November 2012 during the sovereign debt crisis. This was accompanied by a widening of the spread compared to Germany reflecting a risk specific to Italy. The gap between the Italian and German 10-year rates crossed the threshold of 200 basis points on October 9, something that had not happened since the start of the year. Two factors contributed to these tensions.

Global repricing of the markets following the meetings of the ECB and especially the Fed

Tensions began to arise on September 14 following the ECB meeting. It raised its rates by 25 basis points, to bring the deposit rate to the historic high of 4%, due to inflation expected to "remain too high for too long". The important point was the change in communication. The ECB suggested that this hike was likely the last and that rates needed to stay at this restrictive level for long enough[1].

It was the Fed, on September 20, which ignited the situation while paradoxically it left its rates unchanged. It revised its growth outlook sharply upwards, revised downwards those concerning the unemployment rate and continued to anticipate continued high inflation. The most important thing was rate expectations. Median expectations of FOMC members continue to factor in one final rate hike by the end of the year. More importantly, the rate cuts expected in 2024 and 2025 are smaller compared to those planned in June. The announcement of larger US Treasury bond issuances in the 4th quarter also contributed to the rise in the term premium.



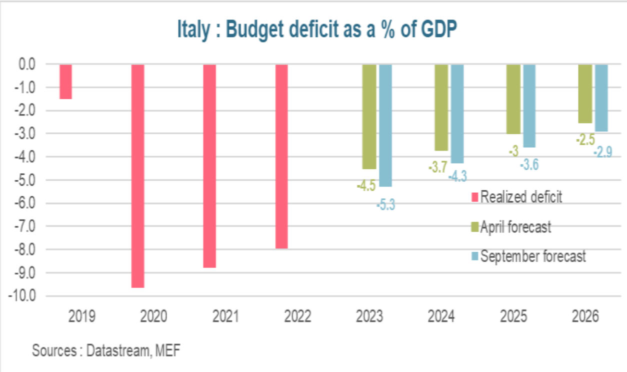
Sources : Bloomberg, Ostrum AM

Upward revision of the Italian budget deficit

While the bond markets were readjusting sharply following central bank meetings, the Italian government announced that it was revising its budget deficit forecasts upwards. This obviously amplified the tensions on Italian rates.

On September 27, the government presented the macroeconomic and financial framework intended to serve as a basis for discussions on the 2024 budget. The reduction in the public deficit is slower than that planned last April. Italy has postponed by one year, to 2026, the return of the public deficit in relation to GDP below the threshold of 3%. It was revised upwards to 5.3% in 2023, compared to 4.5% forecast last April, and to 4.3% in 2024, compared to 3.7% previously expected.

[1] https://www.ostrum.com/sites/default/files/1-ostrum-mediatheque/mystratweekly/2023/septembre/2023-09-18%20EN_OSTRUM_MyStratWeekly.pdf



The return to balance in the primary balance (budget balance excluding interest charges) was also postponed by one year, to 2025, compared to 2024 planned in April.

In this context, the public debt to GDP ratio is expected to stabilize at a high level, around 140% of GDP, by 2026 (139.6%). This ratio was nevertheless revised significantly downward in 2021 and 2022, following the upward revision of GDP growth in 2021, following a less strong impact of the Covid-19 crisis than initially reported. The public debt to GDP ratio was thus revised to 147.1% in 2021, against 149.9%, and 141.7% in 2022, against 144.4% previously reported.

Several factors contribute to the slower reduction of the public deficit.

Slowing growth

Like the rest of the Eurozone, Italian growth is slowing down under the increasingly strong impact of monetary tightening carried out by the ECB, continued high inflation and the lack of impetus from foreign trade. In addition, the government has made the conditions for obtaining tax advantages for the energy renovation of homes much less attractive.

The government had put in place a “super bonus” to revive growth during the Covid-19 crisis. Households could benefit from a 110% tax credit if they incurred expenses for the energy renovation of their home. This measure was all the more interesting as they could transfer this tax advantage and therefore not have to pay a single euro to finance these investments.

This resulted in a strong contribution to the growth of residential investment. Last February, the government made the conditions less attractive: the tax credit has been revised to 90% and is no more transferable. This resulted in a clear contraction in residential investment in T2. It should continue to weigh on growth. It had increased sharply in Q1, with households anticipating the imminent end of very attractive conditions.

For all of these reasons, the government has revised its growth prospects downward to 0.8% in 2023, compared to 1% expected last April, and 1.2% in 2024, compared to 1.5% previously expected. This figure of 1.2% takes into account budgetary measures. Without them, growth is estimated at 1% by the government. Growth in 2024 seems excessive. The Central Bank of Italy has just published its new forecasts: 0.7% in 2023, 0.8% in 2024 and 1% in 2025.

Strong impact of the “superbonus” in 2023

One factor alone explains most of the larger-than-expected deficit in 2023: the “superbonus”. The European Commission has changed the accounting standards concerning the integration of the super bonus into public accounts. The latter must be taken into account in the public expenditure item as soon as they are granted and no longer counted as less tax revenue when they are used. This resulted in a clear upward revision of public deficits between 2020 and 2022. This change in accounting methodology was renewed in 2023. In addition, government forecasts anticipated 67 billion euros of investments for renovation of housing in 2023. However, 79 billion euros had already been achieved at the end of September, which also contributes to the upward revision of the deficit.

Support measure in 2024

In 2024, the government has left itself room for maneuver of 0.7 percentage points of GDP in order to take fiscal measures to support growth. This represents 14 billion euros. Few details have been given at this stage. During the press conference, Giancarlo Giorgetti, the Minister of Finance, indicated that the tax cuts on the work of low-income workers would be extended. This represents almost 10 billion euros. Measures for the least advantaged households amounting to 1.3 billion euros would also be taken. The government intends to partly finance these measures with revenue from privatizations.

This budget constituted a test for the government of Giorgia Meloni. The 2023 budget was in fact drawn up mainly by the government of Mario Draghi. In a context of weaker growth, Giorgia Meloni tried to find a fair balance between fulfilling certain electoral promises while limiting the increase in the deficit. The government insisted on the government's prudence in budgetary matters. The European Commission could decide otherwise.

What do the markets fear?

Reinstatement of European Union budgetary rules in January 2024

These upward revisions to the deficit and public debt come as the European Union will reinstate budgetary rules in January 2024. These have been suspended since the shock linked to the Covid-19 crisis, which has allowed governments to take the necessary measures to revive their growth. Discussions are underway to reform this framework and give it a little more flexibility depending on the situation in each country. Whether countries agree to reform these rules by the end of 2023 or not, the criterion of 3% budget deficit should be reinstated as should the procedure concerning excessive deficits (in the event of exceeding 3%). The modalities for returning to a sustainable public finance trajectory could, however, be reviewed.

The markets fear that Italy will be the subject of an excessive deficit procedure by the European Commission. This could take place in March 2024, when the EC will give its opinion on the plan which will be presented to it in mid-October.

Markets anticipate a premature end to reinvestments under the PEPP

The PEPP is the emergency purchasing program to deal with the pandemic, launched by the ECB in March 2020. It has the particularity of offering a certain flexibility in the event of unjustified tensions on the spreads of certain countries threatening transmission of monetary policy. Between April and May 2020, when the Italian spread had widened significantly (up to 260 bp), the ECB favored purchases of Italian bonds, to the detriment of bonds from core countries such as France and Germany, which helped to calm tensions.

The ECB ended purchases under the PEPP in March 2022, it reiterates at each meeting that it will continue to reinvest the proceeds at least until the end of 2024. The markets anticipate a more rapid end to these reinvestments following the statement of some members of the ECB. However, the PEPP constitutes the ECB's first line of defense to ensure the transmission of monetary policy to all countries in the Eurozone, as Christine Lagarde recalled during the last meeting. If the demands for a premature end to reinvestments become more significant in the Board of Governors, the Italian spread should widen further.

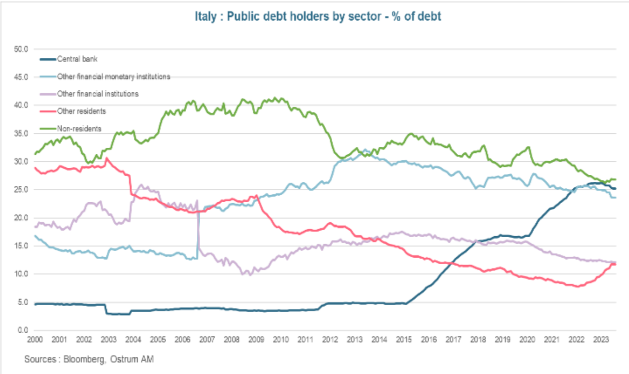
Fears of Italy's non-eligibility for the ECB's TPI

The Monetary Policy Transmission Protection Instrument (TPI) was presented in July 2022 by the ECB. It will take over from the PEPP when the latter is completed, in the event of unjustified tensions on spreads. Of unlimited size, all States are eligible on condition of meeting 4 criteria including that of respecting the budgetary rules of the EU, of not presenting a serious economic imbalance, of pursuing sound and sustainable macroeconomic policies, in accordance with the plan of recovery and resilience, and to have a sustainable public finance trajectory.

The markets fear that the upward revision of the budget deficit and the near stability of the debt-to-GDP ratio will lead the European Commission to trigger an excessive deficit procedure. Italy would then become ineligible for the TPI. Recent events show that a premature end to reinvestments under the PEPP is not desirable.

Success of the BTP Valore issuance ignored

The markets did not take into account the success of the 2nd BTP Valore issuance aimed at households. This was held from October 2 to 6 and covered a maturity of 5 years. Demand was 17.2 billion euros, close to the record of 18.2 billion reached during the first subscription in June. The success of issues reserved for individuals since 2022 has resulted in a sharp increase in the share of individuals in the holding of domestic bonds. It thus rose from 7.9% at the end of 2021 to 11.7% in August 2023, which made it possible to compensate for the lower holding by foreigners and more recently the lower purchases by the ECB (due to the end of reinvestments under the APP).



This good news was partly overshadowed by the fact that Italian banks have recently tended to reduce their holdings of domestic bonds and that the Italian Treasury revised its issuance program slightly upwards in the 4th quarter.

Fears over debt sustainability with the sharp rise in interest rates

The return of the 10-year rate to the levels of the 2011 crisis (at 5%) and the slowdown in growth have resurfaced fears about the sustainability of Italian debt. Higher interest rates result in an increase in debt service which weighs on the budget deficit and ultimately on the public debt.

However, the rise in rates will take some time before having a full impact on Italian public finances due to the average maturity of the debt: 7 years. As this is mainly at a fixed rate, the coupon of the bonds will only be affected when they mature and must be reissued. So this will take some time. The average cost of debt is 3.7% currently, it will gradually increase over time with the replacement of low coupon bonds.

Risk of downgrading the Italian debt rating by rating agencies

The upward revision of the public deficit and the absence of reduction in the debt-to-GDP ratio between 2023 and 2026 constitute a risk of downgrading the Italian sovereign debt rating. Over the coming weeks, the main agencies will have to decide.

Agency rating on italian debt

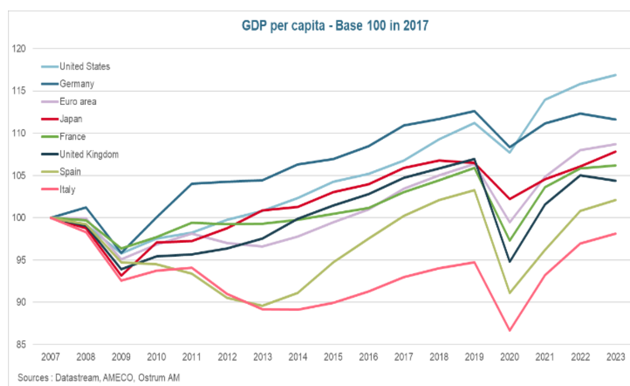
		Rating	Outlook
S&P	20-Oct-23	BBB	stable
Fitch	10-Nov-23	BBB	stable
Moody's	17-Nov-23	BBB-	negative

Sources : S&P, Fitch, Moody's, Ostrum AM

The main risk is November 17, with Moody's rating is only one notch from speculative category and the outlook is negative. The agency should probably keep the rating and its outlook unchanged, as they take into account the current risks in Italy. On the other hand, the S&P and Fitch agencies could be required to downgrade them, on October 20 for the first and November 10 for the second, which could reinforce mistrust on the part of investors. Fitch also reported that the government's revisions to budget deficit forecasts constituted "a significant easing of fiscal policy" compared to previous targets.

Italy's major problem: structurally weak growth

Italy's major problem lies in its weak long-term growth. As the following graph shows, Italy has not yet returned to the level of GDP per capita that prevailed in 2007, before the global financial crisis, unlike other countries.



This results from its low productivity growth and the rapid aging of its population. In this context, the NextGeneration EU funds constitute a fantastic opportunity for Italy[2]. As part of the recovery and resilience plan to deal with the Covid-19 crisis, Italy

2 https://www.ostrum.com/sites/default/files/Strat%C3%A9gie%20hebdo/2021/05.2021/2021-05-10%20EN_OSTRUM_MyStratWeekly.pdf

can receive 191.6 billion euros from the EU on the condition that it achieves the objectives set with the EC in terms of structural reforms and investments in the energy transition and digital technology. At this stage, Italy has received 85.4 billion euros out of the 191.6 billion euros available (including 69 billion in grants and 122.6 billion in loans on favorable terms). The government requested the 4th tranche of aid, on September 29, amounting to 16.5 billion. The EC will give its opinion in the next 2 months and then it will be the turn of the European Council to decide. Italy must continue the reforms and investments necessary to benefit from these funds and place growth on a sustainably higher trajectory, which will at the same time allow public debt to have a more sustainable trajectory.

Conclusion

An upward revision of the Italian public deficit was expected in 2023 due to the slowdown in growth and the impact of the change in accounting methodology concerning the "superbonus". On the other hand, the adoption of budgetary measures to support growth in 2024, while the EU reinstates fiscal rules in January, exposes Italy to the risk of a downgrade of its rating by rating agencies in the coming weeks and additional tensions on the Italian spread. Italy's major problem lies in its weak structural growth. The NextGeneration EU funds, as well as the reforms and investments attached to them, constitute a real opportunity for Italy. They will put the economy on a sustainably higher trajectory and public debt on a more sustainable trajectory. Italy must do everything to respect the programs to the letter and benefit from the funds.

Aline Goupil-Raguénès

Market review

Uneasy stability

Risk aversion generates a flattening of curves beneficial to risky assets supported by the rhetoric of the Fed and fiscal stimulus in China.

The Middle East is once again the scene of atrocities, which add to a deleterious geopolitical situation with the war in Ukraine and recurring Sino-American tensions over Taiwan. Despite the scale of geopolitical risks, which take precedence over the issue of interest rates, the reaction of financial markets has remained orderly. The risk aversion movement was limited to the safest government bonds and to a lesser extent to gold. The dollar keeps trading at rich levels but without further upside acceleration. Equity markets rose despite a relapse ahead of the weekend. Sovereign and credit spreads have tightened, and equity implied volatility remains remarkably low. The VIX index did not exceed 20% at the peak of stress last week. Thus, it is difficult to conclude that risk aversion is widespread in financial markets. The comments from Fed members helped to mitigate the downside risk on risky assets. The November rate hike, which remains fully justified by economic fundamentals, seems, in light of policymakers' comments, to be called into question after the sharp rise in long-term bond yields since the beginning of August.

In the troubled geopolitical backdrop, economic data releases took the backseat last week. However, the CPI was awaited by market participants as the November FOMC looms large. US inflation was stable at 3.7% in September while the underlying inflation rate stood at 4.1%. The slow disinflation process continues but service prices show a monthly increase of 0.6%. Rents seem to be accelerating again in the wake of the sharp rebound in housing prices. Housing thus complicates the convergence of inflation to the Fed's 2% target. The Fed nevertheless floated the idea that the rise in long-term yields reduces the need to act further on short-term interest rates. The latest increase in the Fed funds rate to 5.75% planned in September now seems less likely. The Fed will have 3Q 2023 GDP growth figures, labor costs and the PCE deflator at its disposal on November 1st. In addition to the Fed's dovish rhetoric, the announcement of a $160 billion fiscal stimulus plan in China as well as purchases of bank stocks on the market supported the financial markets.

In financial markets, risk aversion resulted in a sharp flattening of the yield curves. The US 10-year note yield fell by 19 bp to around 4.65%. Market participants are buying back the risk-free asset despite high inflation and a difficult 30-year T-bond auction in the United States. The rebuilding of the term premium continues in the background but the situation in the Middle East naturally channels flows towards US Treasuries. The Bund participates in the flight to quality bid to close last week around 2.75%. Meanwhile, sovereign spreads have partly erased the tensions of recent weeks. However, the ECB is believed to intend to discuss its PEPP reinvestment policy in December. Portugal's sovereign bonds continue to outperform. As for emerging government bonds, continued fund outflows do not prevent spreads from reducing. The shekel nevertheless lost 3% and Israel's CDS (A+) doubled to 130 bp. We see a financing solution from the IMF in favor of Egypt. Emerging high yield sovereigns offer value.

As regards corporate credit, the dovish Fed comments and the Chinese stimulus supported bond prices at the start of the week, so that spreads on the euro IG narrowed by 3 bp. The cash corporate bond market still underperforms CDS indices. That said, hybrid (-7 bp) or subordinated bank debt (-5 bp) performed well. The primary market activity was limited to a few deals mid-week. Issues with large amounts have weighed down the secondary market. In addition, some specific stories (Eutelsat, Fresenius) generated additional volatility. In high yield, most market segments (BB, B, Coco) performed well, unlike CCC. Tighter CDS index spreads sparked some cheap protection buying.

Equities weathered the turbulence almost without incident (+0.5% on the EuroStoxx 50). Rising oil benefits the energy sector, whilst utilities provided visibility and protection. Earnings releases in media and luxury cause divergent sectoral dynamics. The food retail stocks were also down due to persistent weakness in household consumption in Europe.

Axel Botte

Main market indicators

G4 Government Bonds	16-Oct-23	1wk (bp)	1m (bp)	2023 (bp)
EUR Bunds 2y	3.17%	+13	-5	+40
EUR Bunds 10y	2.79%	+2	+12	+22
EUR Bunds 2s10s	-37.7bp	-11	+17	-17
USD Treasuries 2y	5.08%	+0	+5	+66
USD Treasuries 10y	4.71%	-9	+37	+83
USD Treasuries 2s10s	-38.2bp	-10	+32	+18
GBP Gilt 10y	4.48%	+0	+12	+81
JPY JGB 10y	0.76%	-4	+1	-16
€ Sovereign Spreads (10y)	**16-Oct-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
France	62bp	-2	+6	+8
Italy	199bp	-7	+5	-14
Spain	112bp	-3	+3	+4
Inflation Break-evens (10y)	**16-Oct-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
EUR 10y Inflation Swap	2.49%	-1	-17	-6
USD 10y Inflation Swap	2.62%	+4	-3	+10
GBP 10y Inflation Swap	3.88%	-3	-11	-3
EUR Credit Indices	**16-Oct-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
EUR Corporate Credit OAS	161bp	-1	+8	-6
EUR Agencies OAS	82bp	+2	+7	+3
EUR Securitized - Covered OAS	90bp	+3	+7	+7
EUR Pan-European High Yield OAS	471bp	-4	+32	-41
EUR/USD CDS Indices 5y	**16-Oct-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
iTraxx IG	84bp	-3	+14	-7
iTraxx Crossover	446bp	-15	+56	-28
CDX IG	75bp	0	+12	-7
CDX High Yield	490bp	-2	+67	+6
Emerging Markets	**16-Oct-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
JPM EMBI Global Div. Spread	451bp	-1	+27	-2
Currencies	**16-Oct-23**	**1wk (%)**	**1m (%)**	**2023 (%)**
EUR/USD	$1.055	-0.189	-1.356	-1.5
GBP/USD	$1.218	-0.466	-1.631	0.8
USD/JPY	JPY 150	-0.795	-1.396	-12.4
Commodity Futures	**16-Oct-23**	**-1wk ($)**	**-1m ($)**	**2023 (%)**
Crude Brent	$89.7	$1.6	-$3.3	9.9
Gold	$1 916.9	$55.5	-$17.0	5.1
Equity Market Indices	**16-Oct-23**	**-1wk (%)**	**-1m (%)**	**2023 (%)**
S&P 500	4 367	0.72	-1.88	13.7
EuroStoxx 50	4 154	1.00	-3.29	9.5
CAC 40	7 047	0.36	-4.50	8.9
Nikkei 225	31 659	2.14	-5.59	21.3
Shanghai Composite	3 074	-0.75	-1.41	-0.5
VIX - Implied Volatility Index	17.65	-0.28	27.99	-18.6

Source: Bloomberg, Ostrum AM

Additional notes

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