MyStratWeekly
Market views and strategy

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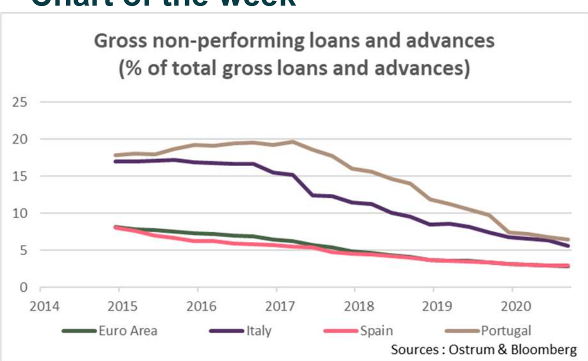
Topic of the week: in defense of Italy

- **Italian problems are notorious: very high public debt, anemic growth, ageing population, etc.**
- **This paper focuses solely on certain positive aspects that are often underestimated: a strong external position, conservative fiscal management, rates that have become favorable, etc...**
- **A more positive view of, with lower rates, could do much to place Italy on a more positive path. That is why, too, the arrival of Mario Draghi is crucial.**

Market review: Stress testing equities' duration risk

- **T-note breaks through 1.30% ceiling amid steepening pressure**
- **Growth stocks pull back…**
- **… despite supportive earnings releases**
- **Energy crisis in the US, crude prices rise further**

Chart of the week



The ECB has just published the bad debt data of banks in Europe for the third quarter of 2020.

For the Eurozone, the rate rose from 8.1% at the end of 2014 (first digit in the series) to 2.8% in Q3 2020, a two-thirds decrease. The decline in Italy (from 17.0% to 5.6%), Spain (from 8.0% to 3.0%) or Portugal (from 17.8% to 6.5%) is of the same magnitude.

However, we must put this good news into perspective. The bad debt rate is a lagging indicator, it is clear that the Covid crisis should push these numbers up. On the other hand, these national aggregates hide a very large disparity at the level of banks).

Figure of the week

150

Source : Ostrum AM

150 bps is the slope between the 5 and the 30-year yields in the United States. A mark passed last week. And even 156 bp last Friday. We need to go back to August 2014 to find a similar level.

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● **Topic of the week**

In defense of Italy

The Italian problems are well known and widely discussed. This paper focuses only on certain positive aspects that are often underestimated: a solid external position, conservative fiscal management, rates that have become favorable, etc... The Italian situation is indisputably difficult, it is however less catastrophic than often mentioned.

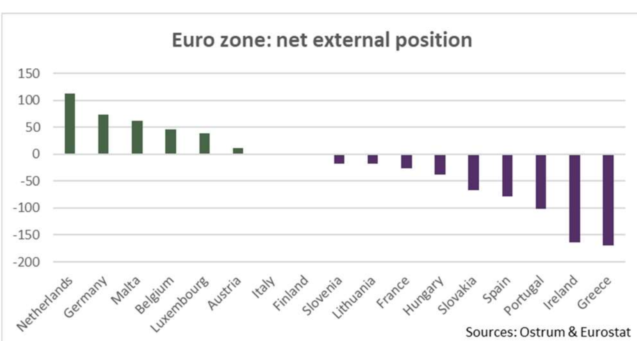
The economic problems of Italy are well known and widely commented: a very high public debt, anemic growth, an aging population, a plethoric and inefficient administration. The litany is known. This article tries to take the opposite of this view, which too often looks like a portrait load. There are a number of encouraging aspects to the Italian economy, and we take the side here of focusing only on those aspects.

Strong external position

If the Italian public debt has been very high for a long time, there is a fundamental difference with, for example, Greece. Italy's external position is almost in balance.

The external position reflects the situation of an economy vis-à-vis the rest of the world. It is calculated as the difference in the foreign assets of a country minus its liabilities, it is therefore the net debt of a country vis-à-vis the rest of the world: it therefore represents the assets or the net debt of the residents vis-à-vis the rest of the world.

The graph below gives the situation for the euro area countries (Q3 2020 data published by Eurostat).



The net position of Italy is actually positive, albeit by a tiny 0.2%. But it's better than the position of France, a deficit of 26% of GDP, nothing dramatic, or the position of the other peripherals, a 79% deficit for Spain, 101% for Portugal and, on a league on its own, Greece with a 170% deficit.

How did we get here? The change in the net external position depends mainly on the balance of payments: a positive current account and the country increases its assets abroad; a negative current account and the country becomes indebted to the outside world. Outside Italy there has never been a significant external deficit, so its external debt stock has never increased alarmingly. Following the crisis in 2009, the external current accounts turned sharply. This is mainly due to significant domestic austerity rather than to dynamic exports. Since then, therefore, the Italian net position has improved, and has slowly converged towards balance.

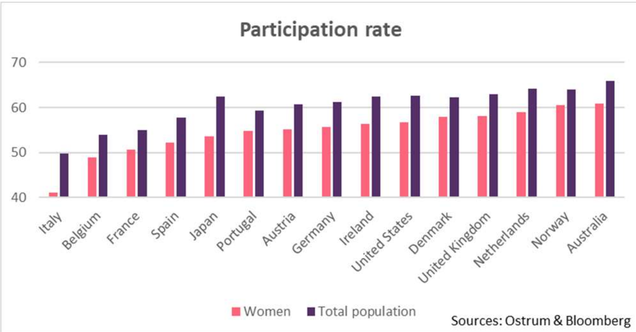
Why is this important? On the one hand, because the net external position of countries greatly contributes to their fragility in the event of a crisis. The Bank of France, in analyzing the sovereign crisis of the last decade, noted this aspect in a study.

Another point is that a restructuring of the Italian debt becomes almost useless. A default from Greece is very useful (for Greece that is), since Greece improves its situation (less debt to repay) to the detriment of its foreign creditors. Of course, there is a reputational effect that lasts for many years and therefore constitutes a cost for future financing. To simplify, a default in the case of Greece amounts to a transfer of wealth from foreign investors to Greece. In the case of Italy this transfer will be much weaker, if not non-existent, since the net external position is zero. A default would be, above all, a transfer of wealth from Italy … to Italy.

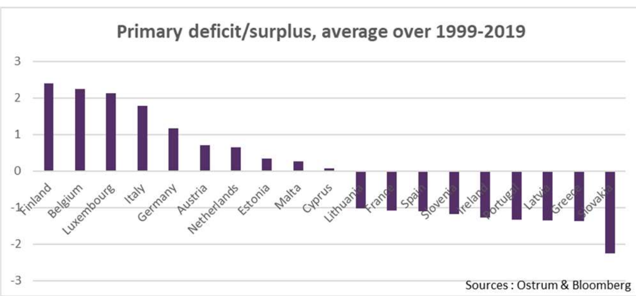
Conservative fiscal management

The level of public debt is of course very high. But one important point to emphasize is that this stock is essentially a legacy of an unduly laxist policy before the introduction of the euro. Since then, the management of public finances has been very prudent.

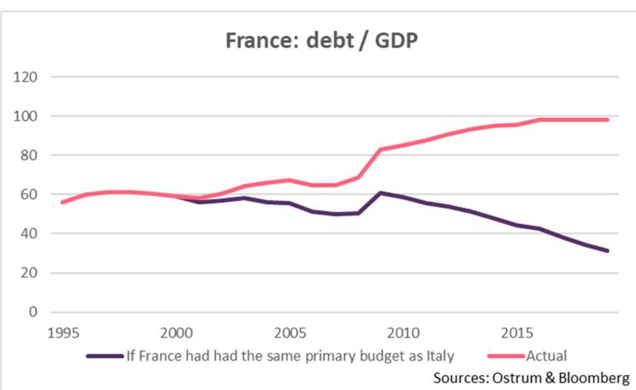
Figures show that in 1999 Italy, with a debt to GDP of 113%, was clearly among the worst offenders. In contrast, over the next 20 years, the ratio grew by only 21%, which places Italy in the average.



To get there, with very low growth, it took serious budgetary management. Indeed, Italy's primary surplus (the primary deficit or surplus is the deficit excluding interest charges) has been one of the highest over the past 20 years. Successive Italian governments have pursued a very rigorous budgetary policy since the entry into the Euro, in fact since 1995. Cumulative primary surpluses since 1999 represent 37.3% of GDP!



To illustrate our point, we took the example of another country, at random we chose France: what would have been the trajectory of the debt if France had had the fiscal policy of Italy. The answer is unambiguous, instead of a debt to GDP of 98.1% in 2019, France would have been at 31.4%.

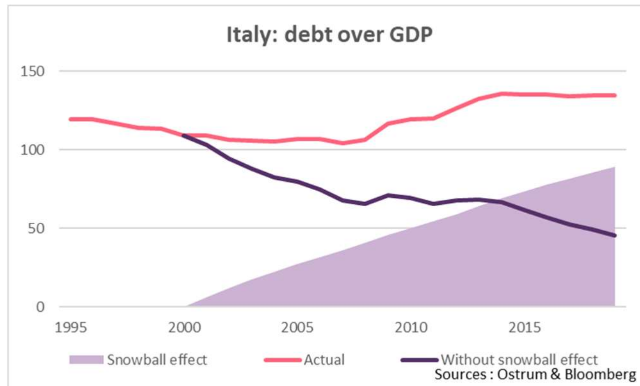


The conclusion is that Italy does not lack budgetary orthodoxy, on the contrary on the past quarter century. Rather, it lacks growth.

Interest rate

More interesting, interest rates are considerably lower than they have been in the past.

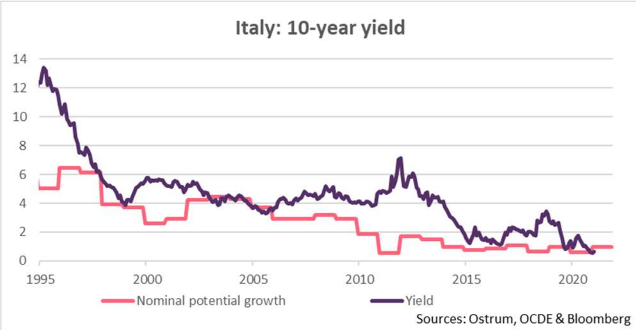
This budget surplus was de facto just enough to counteract the snowball effect of the debt: a large debt generates financial costs, which increase the debt. Without these snowball effects, the dynamics of the Italian debt would be quite different as shown in the graph below. The snowball effect obviously depends on the level of interest rates, the "snowball" effect is also reduced.



This leads to another remark: the cost of debt has decreased considerably. This is obviously true in level with an Italian 10-year old close to 0.65% whereas it was at 2.9% on average over the previous decade and 4.5% over the decade 2000-2009.

This is also true in relative terms. Rates are now below the OECD's estimate of potential growth. And that changes everything, because the growth effect becomes greater than the snowball effect. In other words, to use economists' jargon, the "spontaneous trajectory" of debt is down.

The debt « snowball effect » is considerable! Lower rates will dampen it.



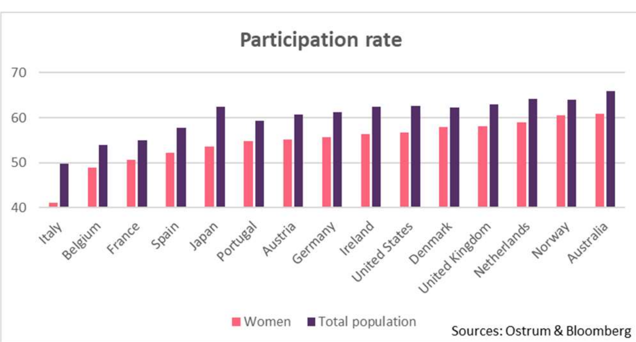
We had calculated in a previous MyStratWeekly (cf. "ECB and its material impact on public debt", December 14, 2020) that Italy, despite the increase of the debt will have a decrease of debt service of almost 5 billion this year because of the low rates.

This is great news. But the weakness of this argument is that it is, at least for the moment, extremely dependent on the intervention of the ECB. The risk, especially next year when the PEPP expires (after two extensions the program is scheduled until March 2022). An increase in rates when they are less administered by the ECB would revive the snowball effect.

Growth

Of course, one of Italy's major weaknesses is its level of growth, which remains deficient. Productivity is low and labor force growth is negative. There is little hope.

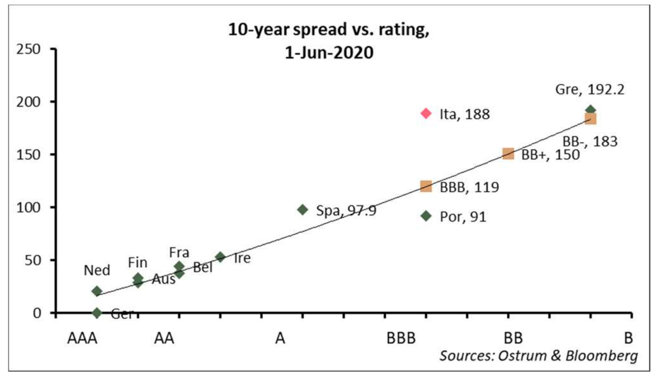
However, there is one lever that the new government could play a role in: the participation rate, which is one of the lowest in the OECD. In the chart below, Italy is the only one of the 16 countries with a participation rate below 50%. Worse! The female participation rate is only 41%, or 8.7 points less, only Japan is worse with a female participation rate 8.8 points below the national average.



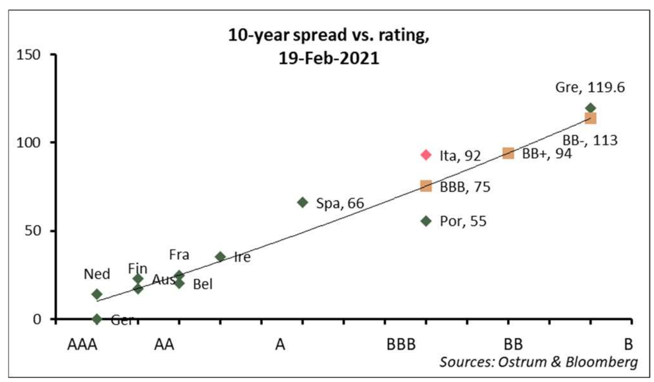
Reforms can be taken to facilitate the return of the population to the labour force, especially for women. This is probably one of the major challenges of the new government.

Market attitude

The market was very skeptical of Italy. The chart below shows, in the middle of last year, the relationship between the rating of the euro area states and their spreads to Germany. Not surprisingly, there is a very strong relationship. Except in one case: Italy, which at the time had a spread that corresponded to a BB- rating, like Greece, and thus very far from the actual BBB rating. So, there was a very significant premium on Italy.



The same chart, with quotes from last Friday gives a very different view. Italy is (almost) back in line with a spread consistent with its rating, the difference has become negligible.



It is also interesting to look at the probability of leaving the Euro. Let's start with a clarification: the author of this lines thinks that it is virtually impossible to get out of the Euro and that the debate on Italexit is nonsensical. But what matters is the view of the markets and the stress attached to this scenario. We can have an indirect measure by looking at the CDS on the Italian government. There are two types. The "D03" that is triggered when a country defaults, the "D14" that corresponds to a broader definition of the default and in particular the risk of redenomination (including the exit of the Euro). The price difference between these two CDSs is therefore a proxy of Italexit stress as perceived by the market.

As you can see from the chart below, we are at our lowest level in more than three years. If we have to be very careful with these figures, especially the liquidity on these markets is very weak, the signal is probably the good one: the exit of the Euro is no longer a subject for the market.

Pricing of Italexit by markets

Source: Ostrum & Bloomberg

Conclusion

Once again, it is undeniable that the Italian situation is difficult, especially in terms of growth and budgetary situation. There are, however, elements, often forgotten, that partly balance this worrying observation: external position, fiscal conservatism are part of it.

The novelty is perhaps elsewhere, the markets seem more complacent on the situation with a risk premium that has diminished considerably over the past two years, the appointment of Mario Draghi having helped to further reduce the risk premium this year. An optimistic view would be to say that this places Italy on a different equilibrium: low rates lead to an improvement in debt over the long term, thus to a lower risk premium. A virtuous circle that may seem utopian. However, this is what happened in the 1990s when the decline in rates improved the fiscal position, which reassured markets and lowered rates. The result was a deficit of 3% in 1999, which enabled Italy to join the Euro.

The other analysis is that these low rates and this market optimism owes much to the action of the ECB. When QE ends, rates will return to higher levels and the virtuous circle will end immediately.

This is also why the arrival of Mario Draghi is important, he can tip the balance on the right side if he manages to put in place an adequate policy. Or simply if he reassures the markets sufficiently.

Stéphane Déo

Market review

Stress testing equities' duration risk

Stocks' sensitivity to interest rate may be key to short-term developments across financial market

The main question for financial markets going forward is whether there exists a level of US long-term bond yields that may jeopardize the hectic advance in stock markets and the trend for spread compression engineered by fiscal and monetary policy support since last spring. Yet, it is fair to say that January FOMC minutes do not hint at changes in the pace of asset purchases, but financial markets may test the Fed's tolerance for higher inflation. Sooner or later, Jerome Powell may be forced to be more specific about what a temporary overshoot of the sacrosanct 2% inflation goal means for policymakers. Producer price inflation accelerated markedly in January (+1.2%m) as many manufacturing companies report bottlenecks and supply-chain tensions. Housing prices are also up some 10% from a year ago, which will likely be an issue for millions of Americans once moratoria on foreclosures will be lifted. Yet the Fed does not seem to envisage dialing down support to mortgage-backed securities' markets ($40b purchases per month). Furthermore, January retail sales (+5.3%m), which beat consensus expectations significantly, leave us perplex as regards the need to stimulate consumer demand via direct transfers. The crisis is first and foremost a sanitary crisis (which vaccination of up to 1.5mn persons per day will help to deal with) and households' propensity to spend is intact in spite of current impediments to growth due to climate events, that is currently paralyzing Texas. US oil output is down by a third in the past few days whilst renewable energy production also faces disruptions. Energy prices have indeed shot higher.

In this context, the yield on 10-year US treasuries, rose to an intraday high at 1.33% on Wednesday. This entails the latest acceleration to the upside in a prolonged period of yield curve steepening. The 5s30s spread, trading at a 2015 high, broke above the 150bp mark. The 20-year bond auction (last Wednesday) drew the smallest demand for this maturity since the Treasury decided to reopen the maturity last year. That said, it is worth noting that the rise in inflation is no longer the only driver of bond yields. Indeed, 10-year breakeven rates have stabilized even as the uptrend in oil prices continued to push short-term breakevens higher. The latest yield increase is hence traceable to real yields which reflect both stronger economic growth and the expected deterioration in public finances. The Biden Administration may be able to get the bulk of its stimulus proposal through Congress in March after a few amendments regarding, for instance, the minimum wage increase.

The US Treasury's decision to limit bond and supply and draw down cash holdings held with the Federal Reserve ($1.5T) may also have contributed to a steeper yield curve by weighing on short-term bond yields. One cannot rule out that T-bill issuance revert to negative-yield territory which could prompt action from the Federal reserve such as a technical increase in the IoER. The increase in 30-year US yields (from 1.19% in late July to 2.05% currently) has no yet impacted mortgage rates which hold just under 3%. That said, the widening in US swap spreads appears traceable to hedging from federal agencies anticipating lower refinancing activity. The 30-year USD swap spread (-20bp) has widened by as much as 30bp since the end of July.

European bond markets (Gilts, Bunds) cannot escape the pressure from rising US yields. Bunds depreciated to -0.35% yields as the 30-year Bund auction drew demand of only €1.6b at 0.10% yield. Competition from syndicated peripheral bond deals offering however meager positive yields (0.5% on the latest 10-year BTP sale) has been weighing on long-term risk-free rates. The order book on the Italian deal reached a whopping €110b (with €10b issued) whilst 30-year BTPei offering received €24b buying interests from investors (€4b issued). The weight of ECB purchases, somewhat mitigated by January syndication activity, remains a significant hurdle to higher yields all the more so that APP redemptions in the second quarter will translate into accelerated ECB gross purchases going forward. That said, profit-taking have resulted in BTP spreads moving back towards 100bp.

Trading volumes on US equity marketplaces are quite revealing of a bubbly market environment. Speculative short positioning is now larger than before the January 2018 VIX tantrum. The outperformance of US growth stocks, which goes hand in hand with lower long-term yields, may take a turn for the worse should yields move materially higher from here. The break above 1.30% coincided with an initial 3% drawdown in Nasdaq trading. The rise in energy costs may accelerate sectoral rotation flows as it weighs on industrials' margins. That said, earnings publications are quite upbeat in the US. S&P 500 earnings are up 6.2% from a year ago with a large majority of upside surprises. In Europe, oil companies and banks outperformed last week amid higher market volatility. The Euro Stoxx 50 peaked at 3740 last Tuesday before drifting lower in the wake of the Nasdaq's fall. As in the US, 4Q20 earnings publications have been encouraging and point to significant recovery in profitability to the tune of 30% growth in 2021.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	22-Feb-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.69 %	+1	+2	+1
EUR Bunds 10y	-0.34%	+4	+17	+23
EUR Bunds 2s10s	35 bp	+3	+15	+22
USD Treasuries 2y	0.11 %	0	-1	-1
USD Treasuries 10y	1.35 %	+14	+26	+44
USD Treasuries 2s10s	124 bp	+14	+28	+45
GBP Gilt 10y	0.68 %	+11	+37	+48
JPY JGB 10y	0.13 %	+4	+8	+10
€ Sovereign Spreads (10y)	**22-Feb-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
France	25 bp	+2	+1	+2
Italy	94 bp	+3	-33	-18
Spain	66 bp	+2	+3	+5
Inflation Break-evens (10y)	**22-Feb-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR OATi (9y)	94 bp	-4	+0	-
USD TIPS	216 bp	-6	+8	+18
GBP Gilt Index-Linked	329 bp	+13	+26	+29
EUR Credit Indices	**22-Feb-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR Corporate Credit OAS	86 bp	-2	-5	-6
EUR Agencies OAS	39 bp	+0	+0	-2
EUR Securitized - Covered OAS	30 bp	-1	-1	-3
EUR Pan-European High Yield OAS	312 bp	-9	-37	-46
EUR/USD CDS Indices 5y	**22-Feb-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
iTraxx IG	48 bp	+2	0	+1
iTraxx Crossover	250 bp	+13	-3	+9
CDX IG	53 bp	+2	+2	+2
CDX High Yield	299 bp	+13	-3	+5
Emerging Markets	**22-Feb-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
JPM EMBI Global Div. Spread	345 bp	+4	-14	-7
Currencies	**22-Feb-21**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
EUR/USD	$1.216	+0.29	-0.06	-0.43
GBP/USD	$1.408	+1.27	+2.88	+3
USD/JPY	¥105.05	+0.31	-1.21	-1.71
Commodity Futures	**22-Feb-21**	**-1wk ($)**	**-1m ($)**	**YTD ($)**
Crude Brent	$64.7	$1.4	$9.5	$12.9
Gold	$1 810.0	-$8.9	-$45.6	-$88.4
Equity Market Indices	**22-Feb-21**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
S&P 500	3 893	-1.07	1.33	3.64
EuroStoxx 50	3 700	-0.92	2.70	4.14
CAC 40	5 767	-0.33	3.74	3.89
Nikkei 225	30 156	0.24	5.32	9.88
Shanghai Composite	3 642	3.11	0.99	4.88
VIX - Implied Volatility Index	22.41	12.22	2.28	-1.49

Source: Bloomberg, Ostrum Asset Management

Additional notes

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