

Not only the ECB. Italian debt has also been buttressed by the Recovery Fund launch and the appeal of its performance

The BTP race is not over yet. There are still risks

Maximilian Cellino

The year 2020, just a few weeks into its last quarter, will be remembered for a long time to come – also for Italian Treasuries (BTPs). In the space of a few months, Italian government bonds have sunk into bond hell, then ascended back up to heaven in the form of the historical lows recently reached by ten-year yields. A journey of recovery after the COVID-19 shock in March, with the ECB playing a crucial supporting role along the way.

After the initial misunderstanding caused by that, “We’re not here to reduce the spread”, announcement by President Christine Lagarde, the Eurotower has played its part admirably by purchasing over €136 billion worth of Italian government bonds, starting from the time of peak COVID-19 infections in mid-March. Through the “traditional” PSPP programme, and especially the PEPP pandemic plan, the central bank has, in effect, covered the net issues made in 2020, during which time the government has had to dip deeper into its purse than ever before.

Gluttonously good yields, but for how long?

The Italian banks were not shy about underwriting the national debt, and although the share held by households is minimal, it was only in the summer that foreign investors gingerly began to reappear (after the start of negotiations for a far-reaching Recovery Fund) after having literally running away during the worst phase of the lockdown. Their interest in BTPs was reignited, at least in part, by yields unmatched in the developed world (at a time when rates were predominantly negative or down to decimal fractions) but which are now also starting to shrink significantly.

Much of the Italian curve – at least until the three-year bonds mature, as yesterday’s Treasury auction reminds us – will indeed be below zero this autumn, and there are those who wonder if even the ten-year BTPs will sooner or later fall into negative yields. Analysts, however, are even more pessimistic: “We think the ‘yield famine’ might continue until

the 2027 or 2028 maturities,” says **Francesco Castelli**, Head of Fixed Income at **Banor Capital**. An opinion shared by Marie-Anne Allier, bond manager at Carmignac, who notes that, if the German rate were to remain at its current -0.50% level, “It would take an Italy-Germany spread of 50 basis points to get ten-year Italian treasuries to 0%, which brings us back to before the global financial crisis and euro debt, when sovereign risk was not fairly appraised by investors”.

Alternatively, the negative ten-year BTP scenario could happen if the ECB further lowers interest rates (a possibility that Lagarde herself hinted at a few weeks ago) to -1% or even -2%. Although not impossible in theory, this eventuality is, however, dismissed by managers. As Castelli argues, “The Eurotower is aware that such a move would have adverse consequences, particularly on the balance sheets of commercial banks, and I think it would prefer to extend its purchase of securities indefinitely or expand its list of purchasable assets rather than get nasty with unnecessarily negative rates”.

The ECB push (and more)

This last factor—the fact that the central institution will guarantee near unconditional support to individual countries (and not just Italy) in the coming months and possibly beyond—is key, though not the everything, in keeping managers well-disposed towards euro area government bonds. “The net supply of bonds will be negative for the rest of 2020 and 2021, and we have finally obtained an historic support measure from the EU institutions through the Recovery Fund,” notes Allier, who warns, however, that, “the enormous amount of liquidity injected into the system by central banks shores up demand, regardless of market conditions, particularly for countries with higher spreads like Italy”.

Completing the picture is a political landscape that currently appears less likely to generate pressure than in the past. Darrell Delamaide, analyst at Investing.com, says, “Italy is perceived as particularly vulnerable because the coalition government in Rome is fragile. But the positive

market reaction to last month’s vote, when La Lega failed to make gains in key regions such as Tuscany, has done much to reassure investors”.

Low rates but not forever

A generally favourable outlook doesn’t mean that Italian rates will settle at a lower level than at present, even over a slightly extended time horizon, one reason being that this country is inevitably more exposed to investors opting to flee from risk. “The fact that the ECB and the EU are acting as a safety net now does not mean that the situation will last forever”, warns Allier.

In fact, the market could quickly forget the fact that the unprecedented amount of money injected into the system can lead not just to increased growth, but also to more inflation and, therefore, higher yields. “The yield curve,” says the Carmignac manager, “could then tighten, leading to a rise in long-term yields and lower bond prices”. In such a scenario, there is a significant probability of higher rates on Italian government bonds in the medium term, especially at higher maturities, even if the spread between Italy and Germany were to shrink further.

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BILLION EURO

The amount of Italian government bonds purchased by the ECB through the PSPP and PEPP plans at the height of COVID crisis from mid-March until September 2020

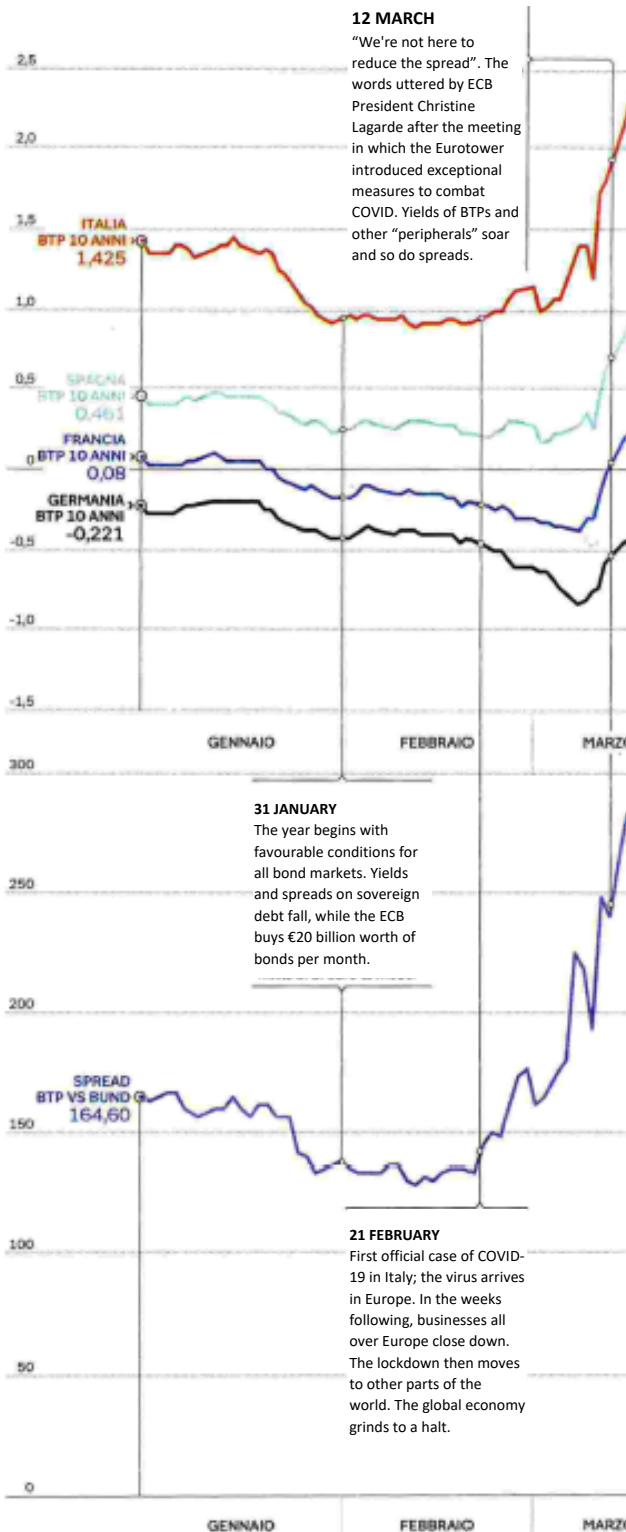
Italian ten-year yields are unlikely to fall below zero, but the short-term outlook remains positive

2020 close up

THE COVID CRISIS AS SEEN BY SOVEREIGN BONDS

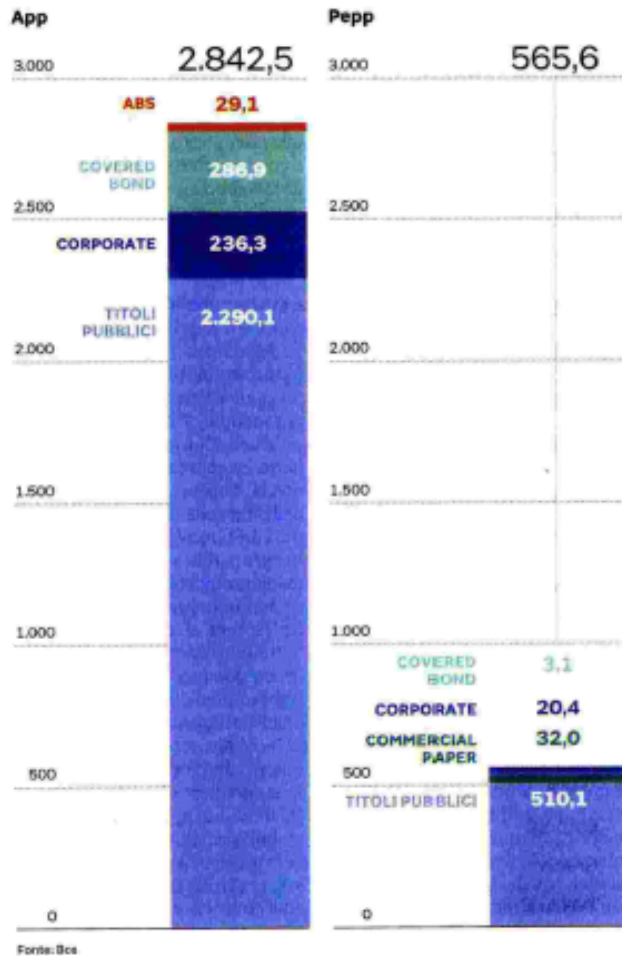
Percentage yield of ten-year bonds in France, Germany and Spain and the BTP-Bund spread in basis points

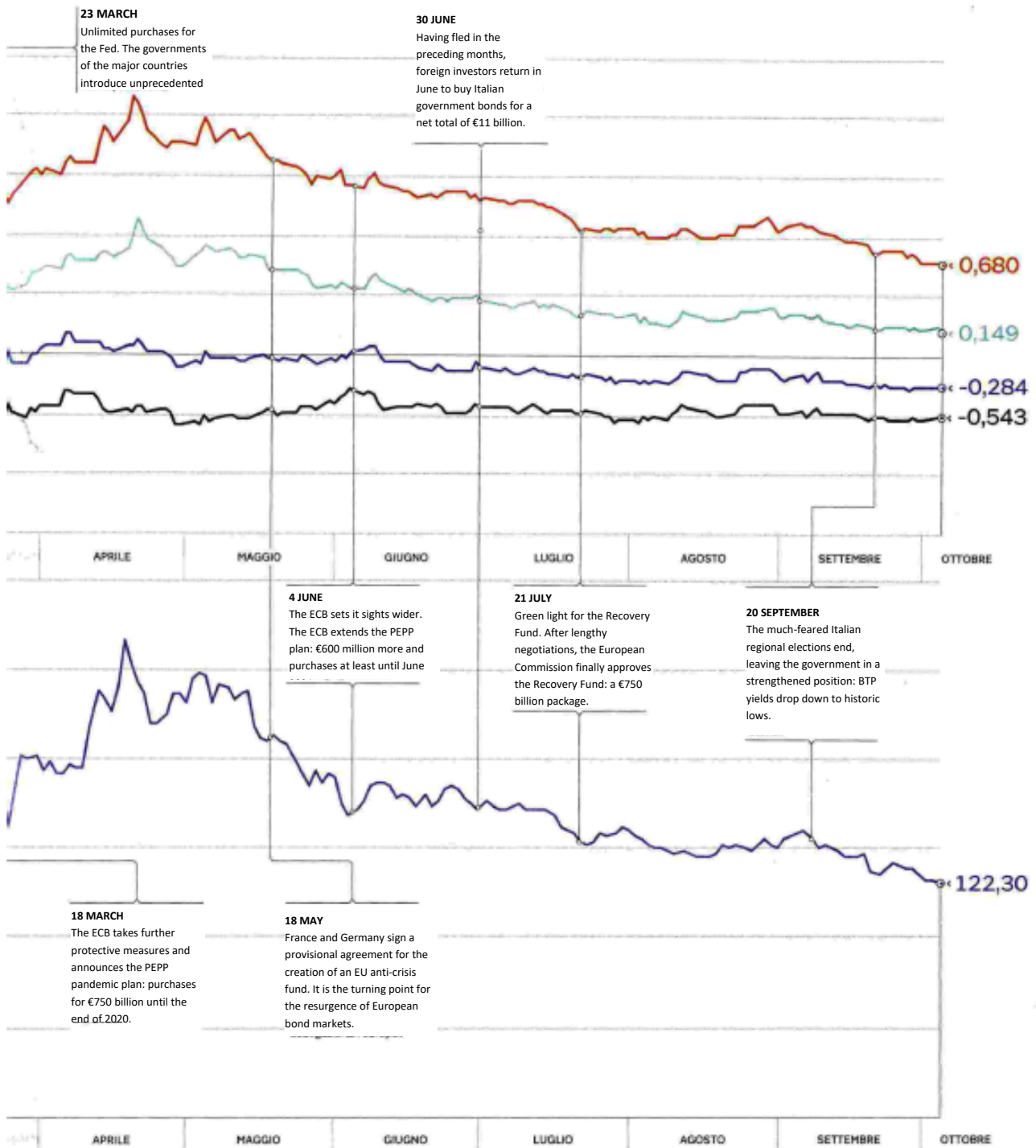
Data updated 13 October



SECURITIES HELD BY THE ECB

End of September. Amounts in billions of



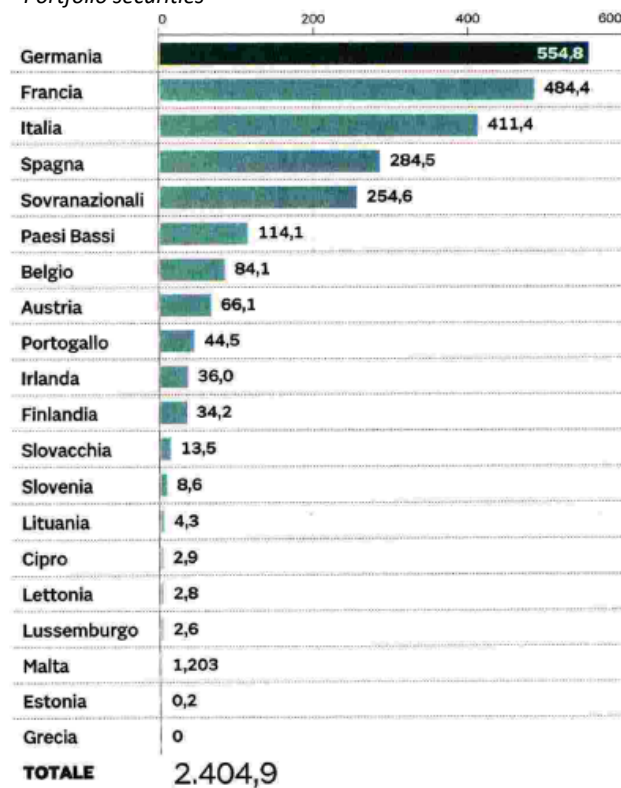


PUBLIC SECURITIES PURCHASED BY THE ECB

Amounts in billions of euro

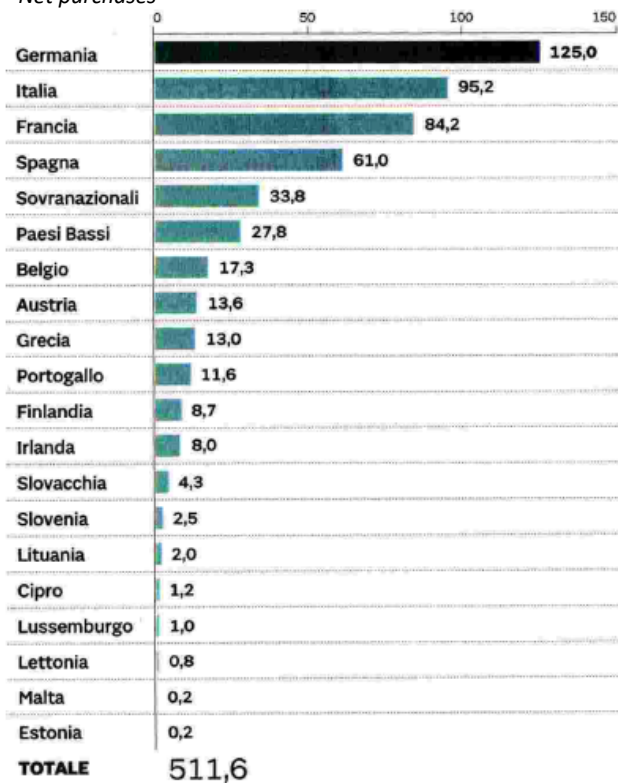
PSPP

Portfolio securities



PEPP

Net purchases



Source: ECB

FOCUS ON THE COUNTRIES

1

THE COMPARISON

US Treasury bonds yield more

Dynamics

The total return index, i.e. with coupon payments reinvested, on US ten-year maturities from beginning of the year, in euro, are performing at 8.5%. This is the top performing bond among the world's leading maturities. The Japanese equivalents, for example, are in the red by 4.7%

2

THE SAFE HAVEN

The increasingly negative Bund rate

The paradox

Would any of you pay to lend money? The answer is obviously no. Yet that is happening with the German Bund and with many other securities showing a negative yield. One of the reasons for this situation is excess liquidity in circulation seeking a safe haven in times of crisis.

3

THE DIFFERENTIAL

BTP-Bund spread on a downward trajectory

Two speeds

Earlier this year, the yield difference between the ten-year Italian and German treasuries was 164.6 basis points. Then, after the outbreak of the pandemic, the spread rose to well over 260 basis points. But with ECB intervention and new EU fiscal policy, the indicator dropped to 122.

4

WORLDWIDE DATA

The dangerous debt race

The debt-to-GDP ratio

Many countries have resorted to government spending to counter the economic and health crises, and this has led to a surge in public debt. The latest estimates say that US debt-to-GDP ratio, for example, is expected to reach 140% in 2021. But in the euro zone the forecast is a little under 100%

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