

Rates Strategy

BTP: Premium Shield

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***We remain tactically LONG on BTPs**, as we believe that the idiosyncratic premium embedded in the curve will continue to shelter BTPs from excessive widening in risk-off contexts against the backdrop of stable political equilibrium and ongoing fiscal discipline.*

Meanwhile, until there is clarity on when traffic in the Strait of Hormuz will resume, we expect volatility in BTPs to remain high.

*Against this backdrop, **we recommend gradually extending exposure on sell-offs to the 3.95-4% area** (vs. 3.85-3.90% previously), **and we keep our threshold to turn NEUTRAL at 3.20%**.*

***Strategically, we remain NEUTRAL at this stage.** While we expect volatility to remain contained and BTPs to continue benefiting from their idiosyncratic premium, we do not see the case for 1) structurally lower core yields 2) lower BTP-Bund spread in the medium-term.*

BTP: So far so good

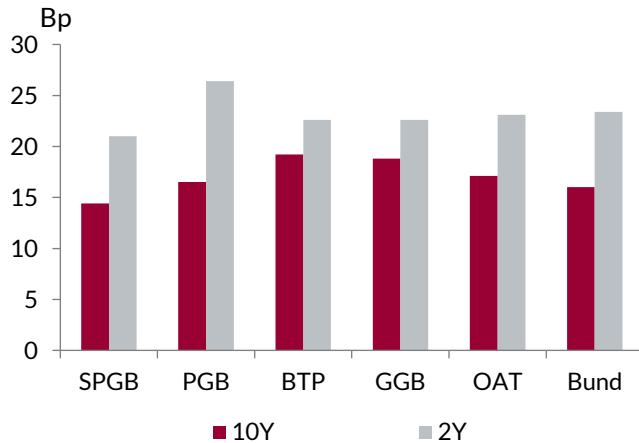
The war in the Middle East has weighed on BTPs leading to their underperformance vs. EGBs. However, BTPs have remained relatively well behaved compared to past episodes of geopolitical or political instability. We believe that this is due to domestic strength relative to the past, with the idiosyncratic risk embedded in BTPs having evolved into an idiosyncratic premium. Going forward, we continue to see the idiosyncratic premium shielding BTP valuations from external negative factors and keeping volatility relatively contained.

Against this backdrop, **we recommend keeping a tactical LONG position and gradually extending exposure on sell-offs to the 3.95-4% area** (vs. 3.85-3.90% previously), **while keeping our threshold to turn NEUTRAL at 3.20%.**

Strategically, we remain NEUTRAL at this stage. While we expect volatility to remain contained and BTPs to continue benefiting from their idiosyncratic premium, we do not see the case for 1) structurally lower core yields 2) a lower BTP-Bund spread in the medium-term.

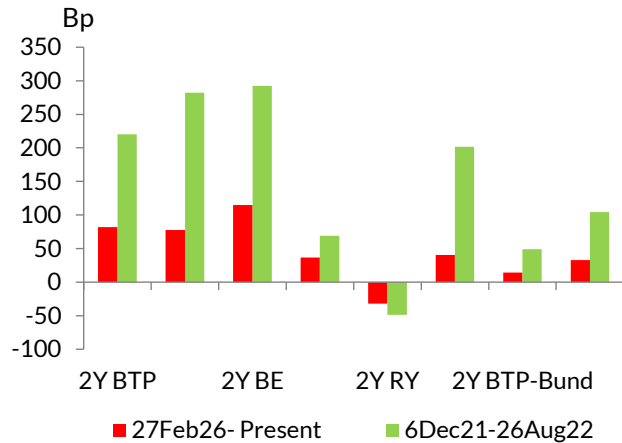
1) BTPs have underperformed EGBs, but much less than in 2022

Since the start of the Middle East conflict, volatility on BTPs has increased and BTPs have on average underperformed the rest of EGBs across the curve (Figure 1). This is because Italy is more vulnerable than other EA countries to an increase in energy prices, has little fiscal space to offset the adverse impact of higher energy prices and suffers more when the cost of funding rises. That said, compared to the energy shock in 2022, BTPs underperformance has remained very contained (Figure 2). While this is partly due to the fact that the current shock to energy prices is much less severe than the one in 2022, we believe this is only part of the story.

Figure 1**BTPs have underperformed EGBs in the conflict**

The chart shows changes in yields since the end of February

Source: Bloomberg, ANIMA Research

Figure 2**BTP less impacted by volatility vs. 2022**

Source: Bloomberg, ANIMA Research

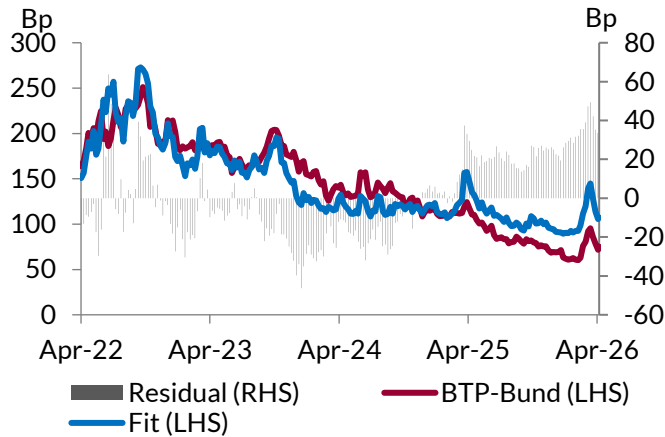
2) The idiosyncratic premium of BTPs

We think that what is currently shielding BTPs from a more pronounced increase in spreads in episodes of volatility spikes is the idiosyncratic premium that has built up over the last few years.

- 1) Figure 3 shows that despite the recent increase in volatility, the BTP-Bund spread continues to trade much tighter compared to credit spreads.
- 2) Both our long-term BTP spread model (Figure 4) and our model on the 10Y BTP/SPGB spread (Figure 5) confirm that over the last few months the idiosyncratic component of Italian bonds has gone from weighing negatively on BTP valuations to weighing positively.
- 3) The BTP-Bund spread sensitivity to changes in financial conditions is lower in this episode of volatility compared to past episodes, confirming once again the enhanced stability of Italy in rates markets (Figure 6). This is a very positive result, especially if we consider that the holder structure of Italian debt has become more reliant on price-sensitive investors (especially foreigners) compared to 2022.
- 4) Figure 7 shows that since the start of the Middle East conflict, the BTP-Bund spread has widened driven by hawkish monetary policy expectations and the risk-off context, while the idiosyncratic component has acted as a tightener of the BTP-Bund spread, de facto preventing an even more pronounced widening of the spread. Moreover, Figure 8 shows that the idiosyncratic component is a much more important driver of the BTP-Bund spread in the current energy shock compared to the 2022 episode, representing a more sizeable protection against any widening driven by external components than in the past. This is despite the fact that the starting point of the Italian economy is weaker compared to 2022.

Figure 3

BTP spread still tighter compared to credit spreads

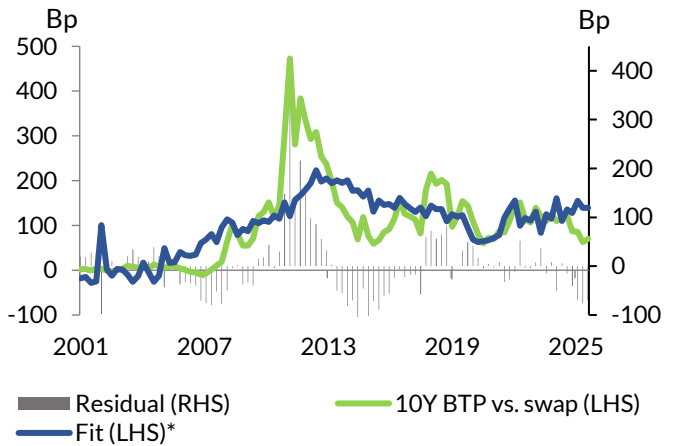


10Y BTP-Bund spread regressed on iTraxx Main 5Y.

Source: Bloomberg, ANIMA Research

Figure 4

BTPs are rich vs. swap compared to fundamentals

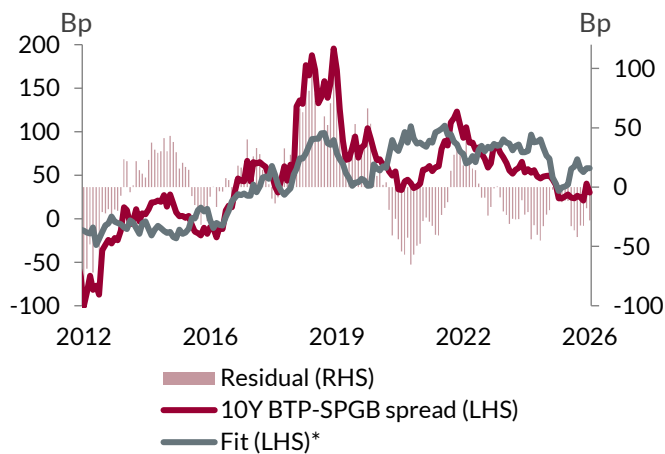


Our model regresses the 10Y BTP-swap spread on unit labour cost, interest payments, potential GDP, debt/GDP and the share of public investment on GDP. The model is estimated on quarterly data from 2001 to the present.

Source: Bloomberg, Haver Analytics, IMF, ANIMA Research

Figure 5

BTPs are rich vs. Spain compared to fundamentals

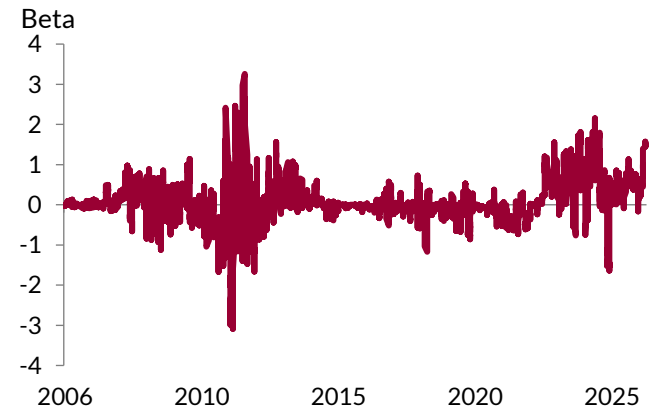


Our model regresses the 10Y BTP/SPGB spread on macro differentials, volatility, the difference between central banks' holdings in the two countries, the difference between foreigners' holdings in the two countries and the EPU spread. The model is run on monthly data in a sample that goes from 2004 to the present.

Source: Bloomberg, Haver Analytics, IMF, ANIMA Research

Figure 6

Declining sensitivity to tighter financing conditions

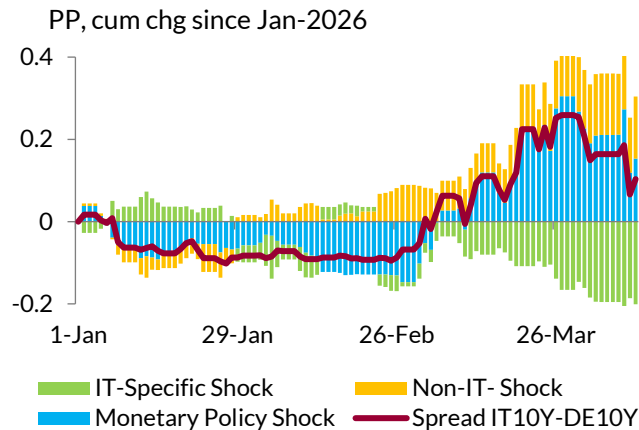


20-day rolling beta between daily changes in the ANIMA research EA financing conditions index and daily changes in the 10Y BTP-Bund spread

Source: Bloomberg, Haver Analytics, IMF, ANIMA Research

Figure 7¹

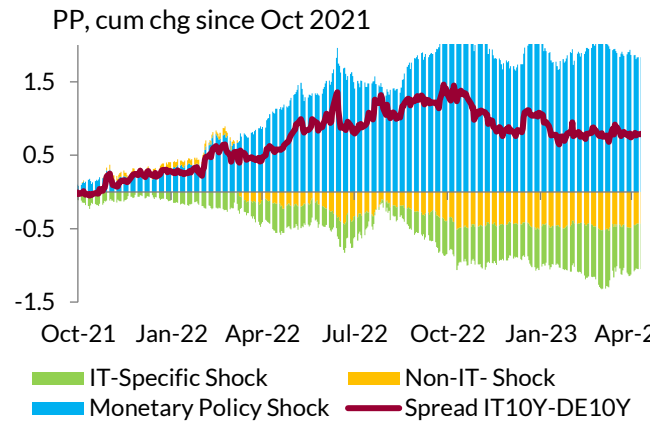
Idiosyncratic component has shielded BTPs...



Source: Bloomberg, Haver Analytics, ANIMA Research

Figure 8

...as it has become more relevant than in 2022



Source: Bloomberg, Haver Analytics, ANIMA Research

The sizeable increase in the idiosyncratic premium in BTPs is the result of three factors in our view:

- 1) Domestic political stability.
- 2) Fiscal discipline and compliance with fiscal rules.
- 3) Improvements in the European infrastructure.

BTPs: What's next

We expect the idiosyncratic component of BTPs to remain a positive contributor to BTP valuations in the next few months, for the following reasons:

1) Political stability is not at risk for the time being

We do not see any threat to political stability in the near term.

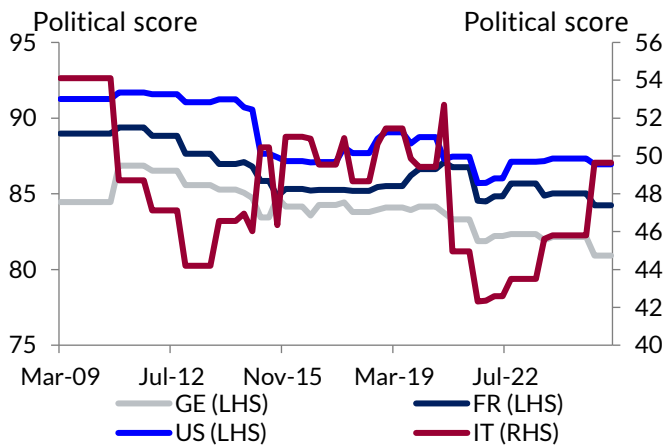
The country's political risk score has improved over the last few years, contrary to the trend in other developed countries (Figure 9). Moreover, voting intentions as captured by a combination of polls show that while losing a bit of ground the governing coalition maintains its average advantage over the rest of the parties (Figure 10).

With general elections scheduled next year, we believe that the earliest time markets will focus again on political stability will be in the fall, when the 2027 budget process will start.

¹ We use a BSVAR model to decompose domestically induced spread dynamics from movements due to external events and monetary policy. The SVAR model comprises the change in the spread of the 10-year BTP yield versus the German bund yield, the change in the Italy stock market relative to the German one, and the change in the 10-year euro-area OIS rate. Our sample includes daily observations starting January 1999. The model expresses every variable as a function of its own past and the past of other variables, plus a new information component. We split each day's new information component into the effects of the three underlying drivers based on an assumed sign pattern of the effects of the drivers on the variables, using the algorithm of Rubio-Ramirez et al. (2010).

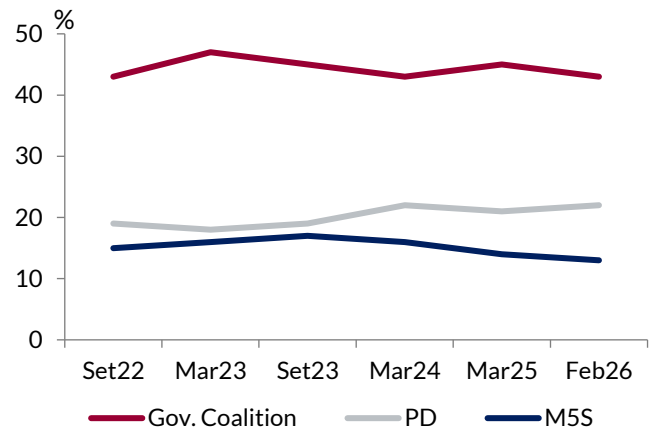
Monetary Policy Shock: IT_DE_spread: (+), IT_DE_STOCK (0), EA_10Y_OIS (+). NON-IT Shock: IT_DE_spread: (+), IT_DE_STOCK (+), EA_10Y_OIS (-). IT-specific Shock: IT_DE_spread: (+), IT_DE_STOCK (-), EA_10Y_OIS (-).

Figure 9
Italy improving political risk relative to GE, FR, US



Source: Bloomberg, ANIMA Research

Figure 10
Governing coalition retaining its advantage



Source: ISPOS, Youtrend, SWG, Tecne, ANIMA Research

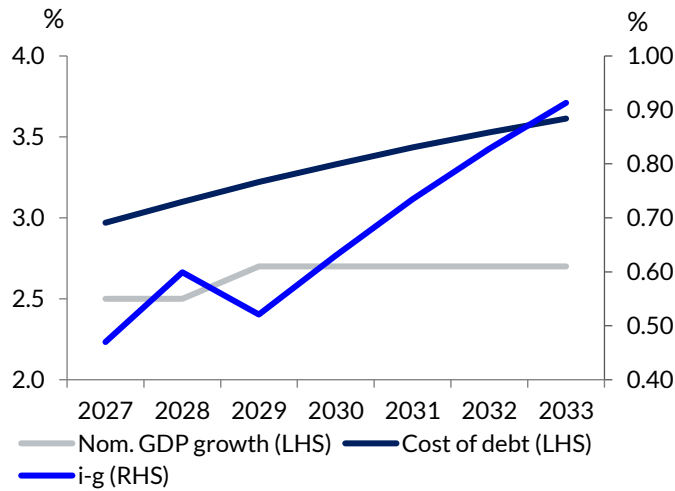
2) Fiscal: the recent increase in financing costs is no game changer

We believe that the increase in financing costs stemming from the war in the Middle East is more than manageable in terms of its impact on public finances.

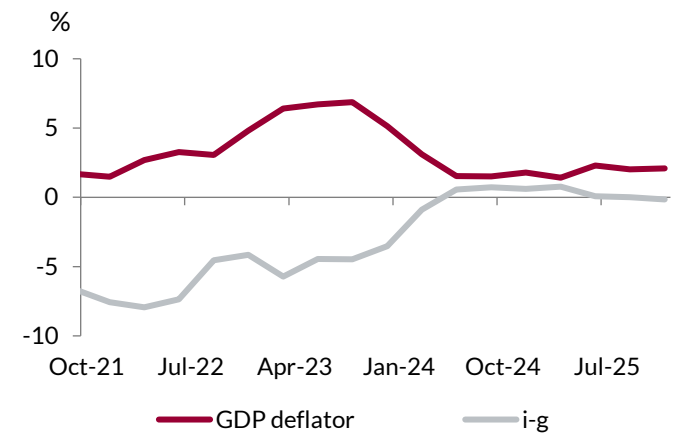
Italy is more vulnerable compared to other EA countries to a rise in financing costs given its high debt burden. That said, with an average maturity of debt of 7Y, higher financing costs take a while to drive the cost of debt much higher.

Figure 11 shows that with an average cost of issuance of 3.5% and under rather pessimistic assumptions of yearly nominal growth of 2.5-2.7%, the cost of debt would rise to almost 3% at the end of 2027 and to 3.5% only by 2032. In this scenario, the ratio $i-g$ would increase, reaching 1% by 2032 and debt/GDP would stabilize if primary surpluses in the range of 0.8%-1.5% of GDP are produced. Taking into account the positive track record of Italy in terms of primary surpluses and our rather pessimistic assumptions about growth, this exercise confirms that the increase in financing costs coming from the war is more than manageable.

The main challenge to this view could come from a protracted conflict in the Middle East. In our view, this would increase the risk of sizeable growth-supporting fiscal measures that would not be offset by higher nominal growth as in 2022. Indeed, in 2022, real GDP growth was much higher than at present and the rise in inflation was more pronounced and translated into a sharp rise in the GDP deflator, taking the ratio $i-g$ into negative territory (Figure 12). We do not expect such a sharp rise in the GDP deflator this time around even in the event of protracted tensions in the Middle East. Against this backdrop, a large fiscal stimulus would lead inevitably to a higher debt/GDP ratio this time.

Figure 11**Evolution of funding costs in adverse scenario**

Source: Bloomberg, ANIMA Research

Figure 12**GDP deflator and real GDP growth will not come to the rescue as they did in 2022**

Source: Bloomberg, Haver Analytics, ANIMA Research

3) Improvements in the European political and financial infrastructure

There is no doubt that the recent improvements in the European political and financial infrastructure have been one of the drivers of lower sovereign spreads in the EA, as they have helped lower idiosyncratic risk. We expect the progress so far to continue to act as a “protection” against any volatility coming from external factors, but we do not expect further sizeable progress in the near-term that could support a further increase in the BTP idiosyncratic premium.

BTPs: We remain strategically NEUTRAL

Strategically, we remain NEUTRAL at this stage. While we expect volatility to remain contained and BTPs to continue benefiting from their idiosyncratic premium, we do not see the case for 1) structurally lower core yields 2) lower BTP-Bund spread in the medium-term.

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