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PICTET WEALTH MANAGEMENT

2024 outlook - Italian and Spanish sovereign bonds

Spreads to remain range bound

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AUTHORS
NADIA GHARBI, CFA
ngharbi@pictet.com
LAURÉLINE RENAUD-CHATELAIN
lchatelain@pictet.com
MILENE DUMONT
mdumont@pictet.com

FLASH NOTE

SUMMARY

- With no major improvements in economic outlook or public finances in sight, we expect 10-year Italian and Spanish sovereign spreads versus the Bund to be range bound next year (between 150 bps and 200 bps in Italy and between 80 bps and 110 bps in Spain). Decent yields of 3.7% for 10-year Italian government bonds and 3.0% for their Spanish equivalents (on 15 December) mean that we have raised our stance on periphery sovereign bonds from underweight to neutral.
- At the same time, we remain overweight core euro sovereign bonds as core countries have more fiscal space than either Italy or Spain where risks to medium-term fiscal sustainability remain. Market participants are likely to be unforgiving should we see fiscal slippage or should governments in these countries fail to implement much-needed structural reforms.

FISCAL CONCERNS AT THE FORE FRONT AGAIN

Growth in euro zone periphery countries has been relatively resilient this year thanks to strong construction activity in Italy and a pickup in tourism, especially in Spain. We expect growth to be subdued in early 2024 before picking up somewhat. In Italy, weak global demand, the impact of high interest rates and the gradual phasing out of tax credits (the so-called 'Superbonus') are the main risks. At the same time, rising real household income should still support economic activity. We expect Italian GDP to expand by 0.8% in 2024, slightly up from 0.7% in 2023. Meanwhile, we expect Spain's GDP to expand by 1.2% in 2024 thanks to resilient household spending, but this would be down from 2.4% in 2023.

Fiscal policy will remain a key focus next year amid risks of fiscal slippage, particularly in Italy. The Italian government raised its budget deficit forecast for 2023 from 4.5% of GDP to 5.3% and for 2024 from 3.7% to 4.3%. Although forecasts for 2025 and 2026 were also revised up, the government still expects the budget deficit to fall just

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below 3% (2.9%) by 2026. The large upward revision of the 2023 budget deficit primarily reflects the statistical treatment of the 'Superbonus'. In Spain, the newly re-elected Socialist-led government is planning to reduce the fiscal deficit to 3% of GDP in 2024. Even if we expect the EU Commission to use some discretion, both countries are at risk of an Excessive Deficit Procedure (EDP) in spring 2024. A lot will also depend on whether we have a deal on EU fiscal rules or not.

More positively, the EU's post-pandemic recovery fund, Next Generation EU (NGEU), is likely to continue to support economic activity in 2024. Its roll-out so far has been relatively successful in Spain, whereas Italy is struggling to meet many of the plan's objectives on time. Any further delays in payouts from the EU's recovery fund could hurt the growth outlook and raise worries about Italy's debt sustainability in a context of still-high interest rates.

MANAGEABLE CHALLENGES AHEAD

Euro periphery bonds have put in a resilient market performance. Ten-year Italian and Spanish sovereign bonds have outperformed their French and German counterparts, posting a positive total return performance year-to-date of 12.1% and 7.9%, respectively, on 15 December (in euros). This is partly due to the more elevated yield they offer (3.7% on Italian 10-year bonds and 3.0 % on Spanish ones) and partly due to spreads tightening against German Bunds.

This was particularly true for the 10-year Italian government bonds (called BTPs), the spread on which narrowed from 210 bps to 170 bps between the start of this year and 15 December. The right-wing Italian government's pragmatic approach in terms of budget and European policies, resilient (albeit slowing) growth and ongoing disinflation have helped stabilise market pricing of Italian debt. The existence of the ECB's Transmission Protection Instrument (TPI) backstop in the background has been another important factor helping reduce spreads.

Furthermore, the three main rating agencies, Fitch Ratings, S&P Global and Moody's, have maintained their investment-grade (IG) ratings of Italian sovereign debt. Moody's produced a positive surprise in November when it raised its outlook on Italy's rating from 'negative' to 'stable'. As Moody's has the lowest rating among the three (at Baa3, the bottom of the IG scale), this significantly reduces the risk of a downgrade of Italy's rating to high yield (HY) next year. Yet the spread on 10-year BTPs over Bunds (170 bps on 15 December) compared to Italy's average rating suggests that market participants continue to discount a significant risk of a downgrade to HY (*see chart 1*).

Moody's had lowered the outlook on Italy's rating to negative in August 2022, around the time that technocrat Mario Draghi resigned as prime minister. The November revision of the outlook back to neutral reflects Moody's acknowledgement that Italy's economic and public debt dynamics have stabilised. Moreover, Italy's rating is supported by implementation of Italy's recovery and resilience plan and the ECB's pledge to counter any unwarranted rise in a country's borrowing costs (through the TPI).

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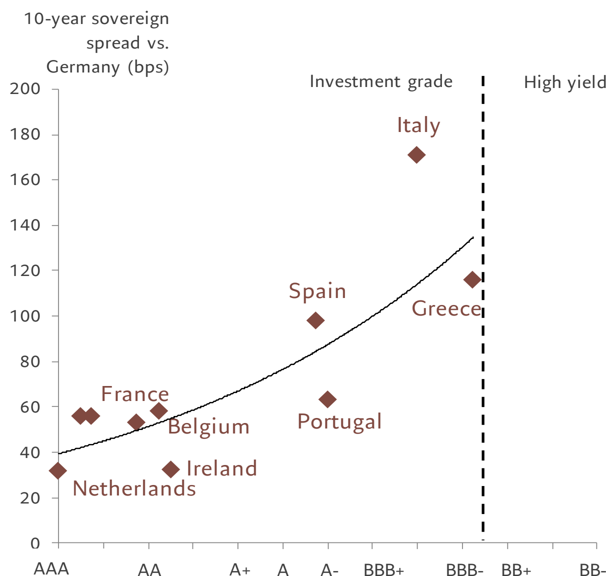
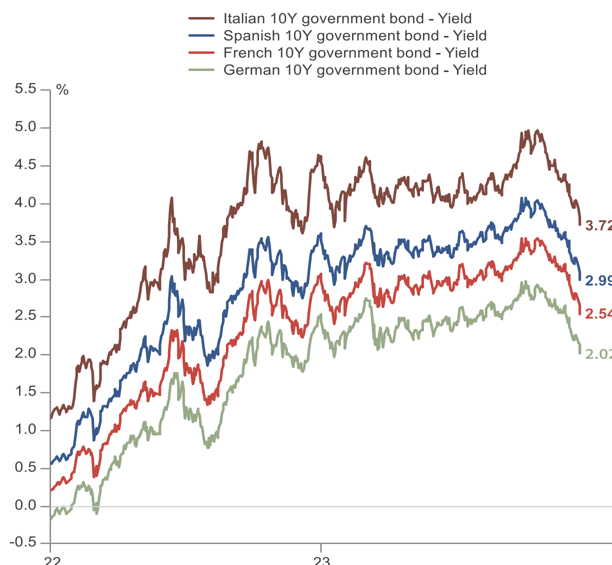
Chart 1: Euro area sovereign spread and ratings



Source: Pictet Wealth Management, FactSet, Bloomberg Finance, L.P., as of 15.12.2023
Average rating based on long-term local currency rating from Moody's, Fitch Ratings, S&P Global and DBRS

Chart 2: Euro area 10-year government bond yield



Source: Pictet Wealth Management, FactSet, as of 15.12.2023

A NEUTRAL STANCE ON PERIPHERAL BONDS

With no major improvements in terms of economic outlook or public finance in sight, we expect 10-year Italian and Spanish sovereign spreads versus the Bund to be range-bound next year (between 150 bps and 200 bps in Italy and between 80 bps and 110 bps in Spain). At 170 bps and 97 bps, respectively on 15 December, both spread levels remain well above their historic lows, but are not particularly wide either. Even if the outlook for Italian spreads has brightened recently (hence our expectations for spreads to remain range-bound next year), there are factors that could potentially lead to spread widening from current levels. Among them, we can mention the risk of fiscal slippage, resulting in the budget deficit overshooting the official target and the potential launch of an EDP. In theory, an 'excessive deficit' procedure could make Italian government bonds ineligible for the TPI, though we would not underestimate ECB's "flexibility" in dealing with this type of situation. There are also risks of further delays in the execution of Italy's recovery and resilience plan, which could lead to renewed investor nervousness around rating reviews and Italy's debt trajectory. A sharper than expected growth slowdown could also be a risk.

On the positive side, one uncertainty has been removed with ECB's announcement to taper its Pandemic Emergency Purchase Programme (PEPP). Indeed, at its December meeting, the ECB announced a very gradual phasing out of the reinvestments under the PEPP in the second half of 2024. The decision did come earlier than expected but the ECB chose to take a more cautious approach than some feared. Reinvestments will continue in full during H1 2024, and then in H2 the ECB intends to reduce the PEPP portfolio by €7.5 billion per month. Since PEPP reinvestments are estimated to be around €15bn per month of which roughly 15% are in BTPs, we're

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talking about relatively small amounts compared to the ECB's aggregate balance sheet and to the gross issuance of Italian bonds expected next year. The gross issuance minus gross purchases (where gross purchases refer to the reinvestment of PEPP bonds) is expected to decrease slightly. It will still remain at a relatively high level compared to previous years.

With the PEPP decision out of the way, the focus will be the (inflation) data in the next couple of months to determine the timing of the first rate cut. Our baseline scenario has been for the ECB to start cutting rates in June, with a risk of an earlier move in April, but a lot will also depend on the Fed, whether the ECB likes it or not. Any aggressive pre-emptive move from the Fed might force the ECB's hand too, which is the reason why markets are close to pricing in a full ECB rate cut in March.

In all, at 3.7% and 3.0% respectively (on 15 December, *see chart 2*), Italian and Spanish 10-year government bonds offer historically decent absolute yields and therefore a comfortable coupon. Hence, we have changed our stance on euro periphery sovereign bonds from underweight to neutral.

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