Italy: The sovereign downgrade trend continues

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The Moody's downgrade, BTPeis, BTPs and market access risks

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Moody’s downgrades Italy by two notches – the current policy mix argues for more to come

Moody’s two-notch downgrade of Italy – from A3 to Baa2 – and maintenance of a Negative outlook reinforces, yet again, the deep-rooted problems associated with the eurozone’s current policy response to the crisis. The current policy mix of pro-cyclical fiscal tightening, pro-cyclical financial sector re-regulation, and insufficiently loose monetary policy is creating a policy backdrop which is driving non-core countries into deep and prolonged recessions, which is in turn pressuring the capital base of domestic banks by reducing the quality of their assets and – by lowering revenue – undermining fiscal consolidation efforts. We forecast Italian GDP to fall 2.2% this year and have already highlighted the risk of four consecutive years of economic declines (see *Italy: Tacking into the headwinds*, 5 July). We forecast the 2012 budget deficit to measure 2.8% of GDP this year compared to the target of 1.7%. With Europe failing to provide any policy backstop at the regional level (we have already highlighted the problems inherent in the EFSF/ESM frameworks – see *European Rates Insights: The EU Summit - Why the rally?,* 29 June), the outlook for non-core Europe is for continued credit deterioration.

Solvency trends mean we eschew Italy-Spain spread trades

While Spain is the non-core country currently in most immediate risk of losing market access due to the heightened pressure on its banking system (with no international buyer’s of Spanish debt, the government’s fiscal financing is increasingly reliant on buying by domestic banks, but the banking sector as a whole is losing deposits, which naturally limits their absorption capability), current economic trends in Italy point to growing solvency concerns. This is the reason why we have recently eschewed trade recommendations such as short-Spain/ long Italy, since one of our strategy rules is that we have to like both legs of a spread trade. To go long Italy runs the risk of encountering gap risk/ liquidity risk in the event of the market turning.

BTPeis are out of the linker bond index: a 30% off-index position?

That said, the immediate implication of the Moody’s downgrade is more focused on the BTPei market. We recall that the rules of inclusion of eurozone inflation-linked bonds for the main indices require the middle rating between S&P, Moody’s and Fitch to be A3/A- or higher. This downgrade now places Italy below the rating threshold as the middle rating drops to Baa1/BBB+ (Moody’s Baa2 is below S&P’s BBB+ and Fitch’s A-). Italy, the fourth-largest linker market globally, has an outstanding nominal size of about €115bn and comprises 30% of the Barclays Euro Government Inflation Linked Bond Index. This could generate forced selling of these bonds from investors unable to alter their index. The index rebalancing takes place at month–end, therefore the BTPeis may remain under pressure. One hope for investors is that many large holders of BTPis will have sufficient flexibility over their mandates/ benchmark tracking to enable them to maintain their existing exposure as an off-index position. Indeed, the widespread anticipation that Italy could drop off the linker indices in recent months means that many investors may have had time to pursue

this possibility. After all, given the size of the BTPei market, it could be difficult to reallocate this exposure to other countries. Nonetheless, it is clearly hard to build even a neutral case for BTPeis following the downgrade. Aside from the rating criteria, these assets also have the problem of tending to trade as “pro-risk” assets into times of heightened solvency and liquidity risk in Italy, which runs the risk of further underperformance and a slump in break evens. We believe French linkers may benefit in the near term from the BTPei outflows as their share goes significantly higher in the index (from around 56% to 80%), coupon/redemption payments of about €20bn and cheap valuations in the belly. Nevertheless, some investors – mainly domestic – may be inclined to a watch BTPeis for buying opportunities once index selling pressure subsides as breakevens drop to fundamentally exceptionally cheap levels over a medium- to longer-term timeframe (breakevens are inching closer to zero/negative levels like end-2011). Our European inflation strategy team’s existing trade recommendations for entering long-end inflation flatteners and buying ultra-long-end breakevens against the belly (see *Monetary easing to support breakevens*) were positioned to benefit from a bearish view on Italian solvency trends (see *Trading BTPei as credit*) and have been performing well in this context. Although of course, in times of forced selling and/or when linkers trade with a liquidity discount, fundamental valuations can take a long time to attract demand. The 2008/2009 experience of JGBis remains a cautionary tale for the performance of linkers during periods of event shock and illiquid markets.

The rating “step-risk” is far lower for BTPs than BTPis and for Italy relative to Spain

In terms of nominals, we clearly remain negative on BTPs, but it is important to note that for these debt instruments, Moody’s rating action does not have the same degree of “step-risk” that occurs for BTPeis. The Fitch (A-) and DBRS (A-high) sovereign ratings for Italy are still above the BBB+ threshold rating, in which category that would require the ECB to impose an additional 5% haircut on BTPs that are pledged as collateral. S&P already rates Italy at BBB+. This contrasts with Spain, where should DBRS downgrade the country to the BBB bucket – which is a growing possibility over the next couple of months – we would anticipate a 5% collateral call on the approximately EUR200bn in SGBs that are likely to have been pledged by Spanish banks as collateral with the ECB. Spanish banks currently hold EUR256bn in sovereign debt, down EUR5bn in May, and EUR8bn from the peak in March of EUR264.5bn. Although this is a marginal positive with respect to the sovereign/bank feedback loop it raises questions on banks’ propensity to buy government debt and who will continue to be the marginal buyer of SPGBs. Similarly, Italy remains within the nominal bond indices for now, which limits the likelihood of forced selling of these assets. (Although again, it is worth noting that many North European investors have already changed their bond indices to exclude non-core countries such as Italy and Spain, suggesting that a good portion of international selling pressure on nominals has taken place already.)

Italian banks can fund their sovereign longer than their Spanish counterparts, but we need a policy response

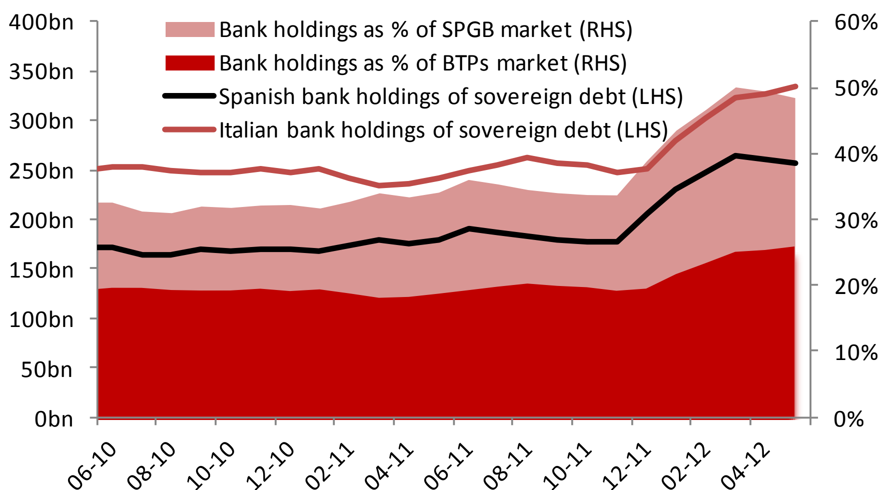
However, the downgrade and – in our view – the bias towards higher BTP yields will prove painful for the Italian banks which have notably increased their exposure to government bonds through the ECB’s LTRO. They have also increased direct exposure to sovereign debt with holdings rising to EUR334.5bn, an increase of EUR80bn this year. However, the subsequent BTP weakness is already placing pressure on bank capital by reducing earnings through mark-to-markets. This correlation risk between sovereigns and banks is acute and the proposed path to reduce this link – to implement direct EFSF/ESM recap of banks – is not expected to be ready until mid-2013. In the meantime, one risk in Italy is that domestic banks reduce their appetite to expand further their exposure to BTPs, which would create the risk of Italy losing market access – a risk which is so acute in Spain. On a more encouraging note, in terms of this risk, latest data shows that while foreign deposits

at Italian banks dropped at a 20% annual pace in April and foreign funding of domestic banks declined by a net EUR94bn in the 12 months to April, aggregate bank deposits rose by 1.7% in May after a 1.2% increase in April. Moreover, Italian households increased their holdings of BTPs in Q4 2011 by 27.7% to EUR200bn. Italy's large pool of domestic savings means that the country has potentially greater capacity to fund public debt issuance through domestic sources for a longer period of time than Spain.

Spanish contagion risk remains a concern

Indeed, on this point, when looking at the outlook for BTPs, we are concerned about contagion from Spain if the country loses market access over the next four to six weeks, which is possible if the banks prove unable to expand their liabilities enough to finance fresh SGB buying and if there is no policy response from eurozone policymakers sufficient to provide more breathing space for Spain. Ultimately, this policy response will need to involve an appropriately sized, targeted and structured QE, but we would not expect the ECB to be forced into this policy option before Spain loses market access. The ECB tends to be reactive rather than proactive during times of financial stress. Instead, in terms of more stop-gap measures that could provide Spain with market access for longer than currently appears likely, we could see a pledge to pursue a banking license for the ESM (to ease its inability to fund itself in sufficient size and at a sufficient pace by enabling it to access the ECB's balance sheet) and/or the ECB suspending variable margining and/or imposing a standard haircut for government bonds of those eurozone countries not in an IMF program at the level of Bunds, which would reduce the step-risk associated with further Spanish rating downgrades. Meanwhile, we continue to stress our concerns that the market is underestimating how immediate the need is for a policy response that is truly proportional to the crisis, given the threat that domestic banks – especially Spanish banks – may be less able to absorb non-core sovereign debt issuance. Latest ECB data have reinforced this risk, with Spanish bank borrowing from the ECB rising to EUR337bn in June against EUR288bn in May. We believe this ECB funding mainly replaces deposit withdrawals rather than represents an aggregate increase in liabilities that could fund the purchase of more SGBs.

Fig. 1: Spanish and Italian bank holdings of sovereign debt



Source: Nomura, ECB.

Disclosure Appendix A-1

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