Rates Strategy Focus
BTPs – NOT GIVING UP

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We remain TACTICALLY NEUTRAL. *The reason is two-fold:*

1. *Following the recent sharp rally, BTPs trade very expensively across the board.*
2. *The BTP-Bund spread is approaching 100bp. This level was last reached when the ECB was absorbing more than the yearly net issuance of Italian govies. We see it as a strong support.*

However, given the positive momentum and the lack of a catalyst to reverse the current trend, **we suggest an opportunistic approach: buy at 3.80% and sell at 3.40% (10Y).**

Strategically, we remain OVERWEIGHT. *For the following reasons:*

1. *The risk-on and low volatility environment is positive for BTPs.*
2. *In terms of macro fundamentals, peripheral countries are "converging" on core countries.*
3. *Demand flows from underweighted EGBs investors may prefer periphery to core, and within periphery, BTPs, which have the highest yield pick-up vs. core.*
4. *EA political architecture continues to improve. This downgrades fragmentation risks to "tail" level.*
5. *BTPs continue to show strong correlation to Bund and USTs.*

We remain tactically NEUTRAL

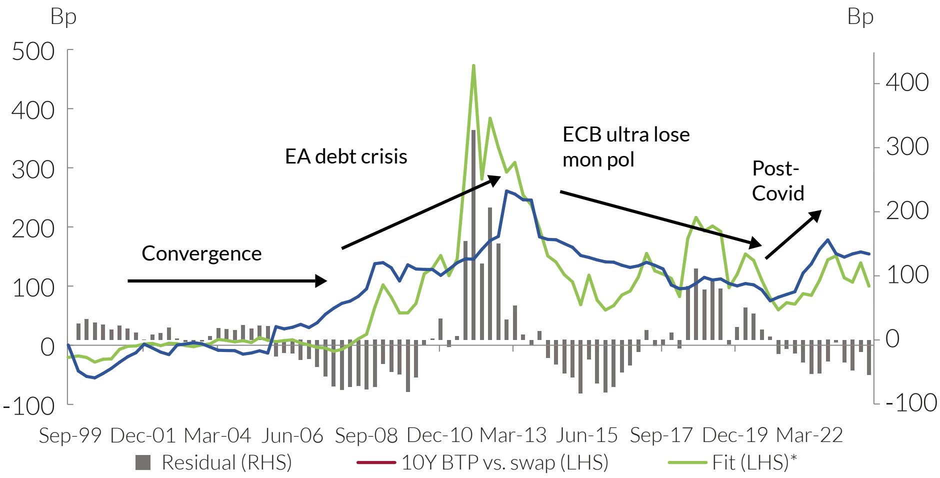
Following the recent sharp rally, we remain TACTICALLY neutral on BTPs. For the following reasons:

A. BTPs are expensive vs. core, as well as vs. periphery

Figure 1 shows that according to macro fundamentals, 10Y BTPs should trade at a spread of 150bp vs. swap, around 50bp wider than current levels. Such negative residual was only observed at the beginning of QE in 2015.

FIGURE 1.

BTPs trade expensive vs. swap

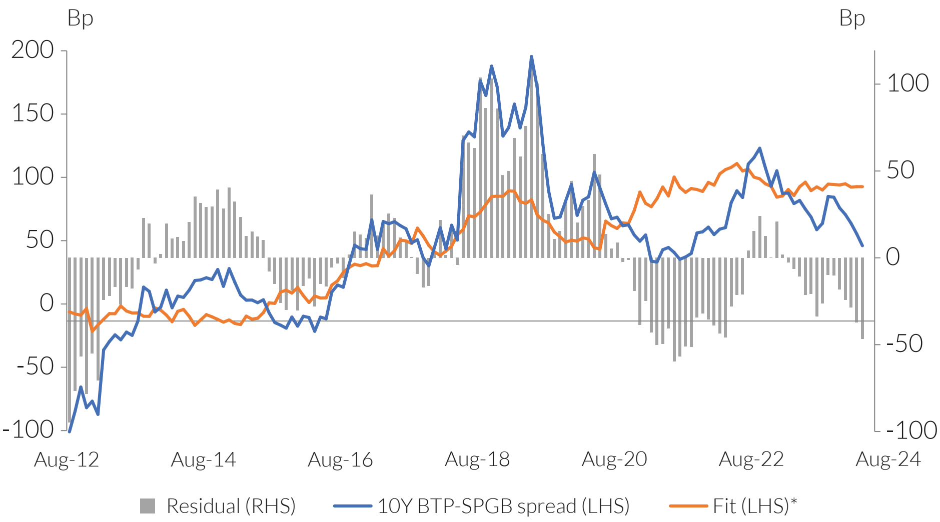


**The model regresses the 10Y BTP /swap spread on potential growth, unit labor costs, interest payments on public debt (as a flow) and debt/GDP ratio. The model is run on quarterly data in a sample from 2000 until present.*
Source: Bloomberg, EC, Haver, Anima ResearchThe term premium remains in negative territory

BTPs are also rich vs. SPGBs (**Figure 2**). Our fair value model indicates that the 10Y BTP-SPGB spread should trade at 95bp. It reached 45bp recently. In line with evidence from Figure 1, such negative residual was only observed in the first period of QE.

FIGURE 2

BTPs trade expensive vs. Spain

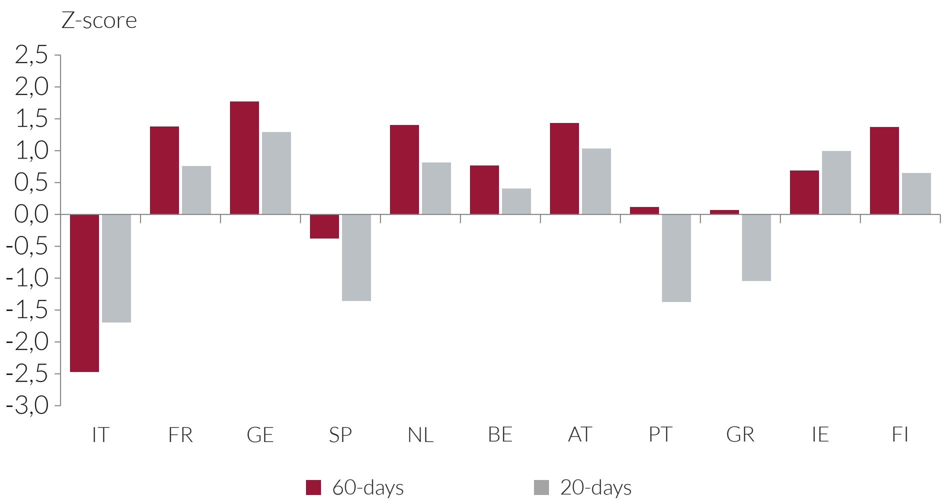


**The model regresses 10Y BTP/SPGB spread on macro differentials, volatility, the difference between central banks' holdings in the two countries, the difference between foreigners' holdings in the two countries and the EPU spread. The model is run on monthly data in a sample that goes from 2004 until present.*
Source: Bloomberg, Haver, EC, Anima ResearchFigure 3.

Last but not least, **Figure 3** shows that, while in a near-term perspective (60-and 20-days Z-score) all peripheral countries trade somewhat expensive in spread vs. swap, Italian govies are by far the most expensive.

FIGURE 3

BTPs trade expensive vs. all EGBs
Source: Bloomberg, Anima Research

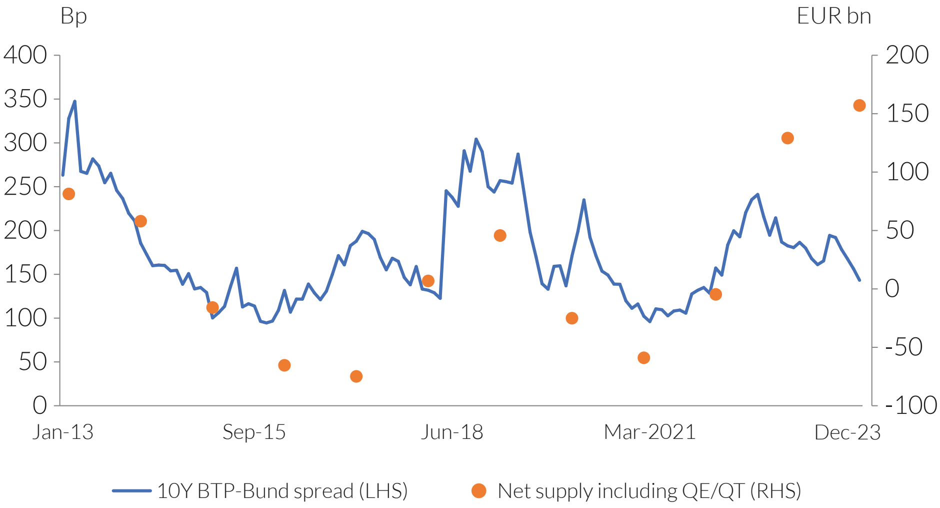


B. We see 100bp in BTP-Bund as a very strong support

10Y BTP-Bund spread is approaching 100bp. This level was reached at the start of 2021 and at the end of 2015 when the ECB was absorbing more than the yearly net issuance of Italian govies, resulting in net negative supply (**Figure 4**). While since 2023 net supply has increased to unprecedented levels and the ECB has gone from being a net buyer to a net seller, the strength of retail and more recently of non-resident flows has more than offset the increase in net supply, as both categories of investors came from heavily underweight position post-Covid.

FIGURE 4.

100bp is a very strong support for the 10Y BTP-Bund spread



Source: Bloomberg, Haver, EC, Anima Research

However, we think that 100bp represents a very strong support and a difficult level to break in a sustainable way. The reason is two-fold:

- We believe that current buying flows are coming from a combination of retail investors (relatively stable, but very price-sensitive) and most importantly of foreign investors[1], which are traditionally the most volatile and price-sensitive investors. On the other hand, in the past, 100bp in 10Y BTP-Bund spread were only reached when the ECB was the main buyer of BTPs. ECB's buying flows were predictable and continuous and came from the most "stable" and price-insensitive investor.

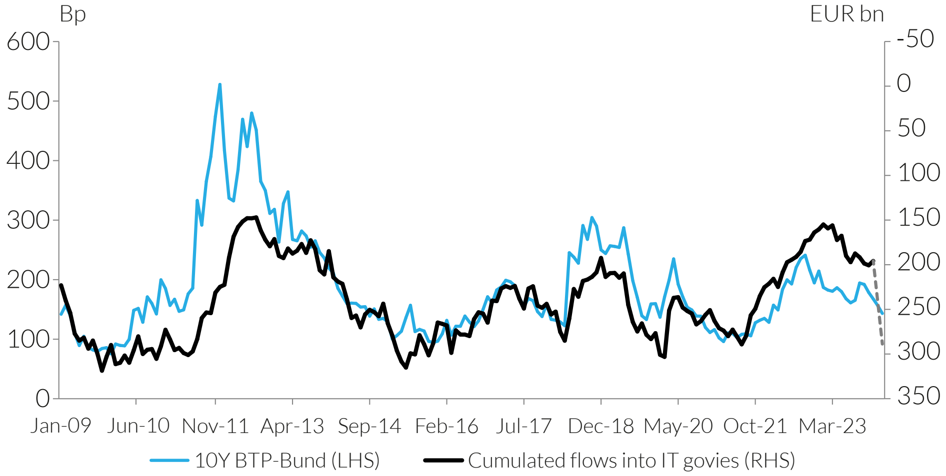
- We estimate that foreign officials' inflows since December 2023 (latest data officially available) were EUR 60-90bn. **Figure 5** shows that, if we are right, at these levels non-resident inflows would be not too far from past peaks in inflows.

Note that this does not mean that foreign investors have no room to increase further their BTPs holdings in the medium-term (as we argue below among reasons why we remain strategically overweight). Simply that looking at past evidence, such strong inflows from foreign investors are usually followed by sudden reversals.

1 In the case of Italy, the biggest part of foreign investors are asset managers and hedge funds.

FIGURE 5.

100bp is a very strong support for the BTP-Bund spread



The black line shows the cumulated non-resident flows into Italian govies since 2011
Source: Bloomberg, Haver, ECB, Anima Research

However, given the positive momentum and the lack of clear catalysts for a reversal of the current trend in the near-term, we suggest an opportunistic approach: buy at 3.80% and sell at 3.40% (10Y).

We remain strategically OVERWEIGHT

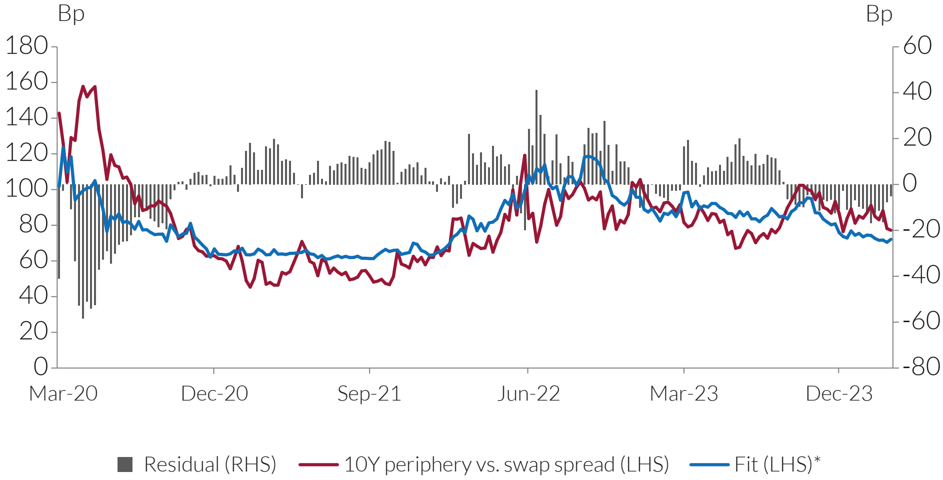
For the following reasons:

A. **A risk-on mood in the market supports all risky-assets and BTPs are no exception.** The risk-on mood has been strongly favored by the soft-landing narrative in the US and by a dovish turn in central banks rhetoric. This has led to an overperformance of periphery vs. core bonds in EA, and among periphery the biggest winner has been BTPs.

   Figure 6 shows that the recent performance of periphery spread vs. swap can be largely explained by the performance of credit markets in general, where spreads have also greatly compressed. As we expect the risk environment to remain constructive, this should favor periphery and BTPs.

FIGURE 6.

Compression of periphery spreads is the result of a risk-on environment



The blue line is the fit of regression between the 10Y periphery spread vs. swap and the iTraxx Xover 5Y. We run the regression on weekly data starting from 2020 until present.
Source: Bloomberg, ECB, Anima Research

B. In terms of macro fundamentals, peripheral countries are "converging" to core countries.

Table 1 shows the result of a ranking of the main EA countries according to a group of selected activity, fiscal and markets variables which all refer to 2024 (see the Appendix for a detailed explanation of our scorecard). **Table 1** shows that:

- Spain and Portugal are better positioned than some core and semi-core countries owing to their better expected growth performance this year.
- Periphery countries, Italy in particular, display a lower amount of debt held by foreigners. In the current risk-on environment this is positive, as there is more room for foreigners to increase their debt holdings in these countries relative to core countries.
- While periphery countries score poorly in terms of implicit interest rate on public debt and in terms of public debt/GDP ratio, they score very well in terms of primary balance, as they are all undergoing some consolidation of their public finance.
- While implicit interest rate on public debt is generally higher for periphery countries than for the rest of EA, the recent spread compression and expectations of upcoming rate cuts by the ECB will lead to an improvement in this metric in the medium-term.
- **Figure 7** shows that in terms of growth potential in the next years, periphery countries will rank better than core and semi-core countries, according to the European Commission.

TABLE 1.

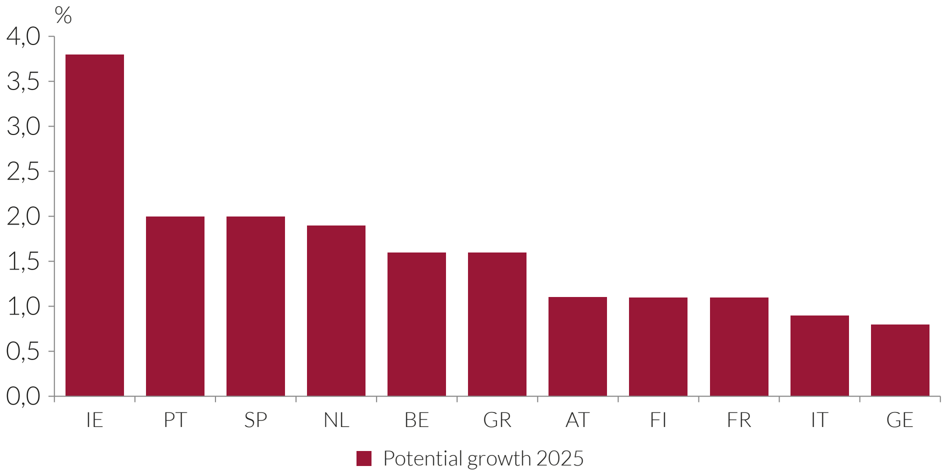
Scorecard for EA countries

		IE	NL	GE	PT	SP	BE	AT	FR	FI	GR	IT
Growth	GDP Growth (YoY)	3,0%	1,1%	0,8%	1,3%	1,7%	1,4%	1,0%	1,2%	0,8%	2,3%	0,8%
Debt	Primary Balance (as % of GDP)	1,3%	-1,0%	-0,7%	2,4%	-0,6%	-2,8%	-0,9%	-2,4%	-2,0%	2,5%	-0,2%
	Implicit Interest rate (as % of Public Debt)	1,6%	1,7%	1,4%	2,2%	2,5%	2,0%	2,0%	1,9%	1,7%	2,2%	3,1%
	Current expenditure ex interest (as % of GDP)	18,3%	39,8%	42,4%	37,8%	40,2%	49,1%	45,3%	48,6%	49,0%	39,1%	42,4%
	Public Debt (as % of GDP)	41,4%	46,6%	63,6%	100,3%	106,5%	106,4%	75,6%	109,5%	76,9%	151,9%	140,6%
	Delta Net supply (incl. ECB) 2024 vs. 2023 (as % GDP)	0,3%	1,4%	-0,2%	4,9%	0,7%	0,9%	2,4%	1,3%	1,7%	4,7%	2,1%
	% of Public Debt held by foreigners	55,3%	40,1%	43,8%	42,2%	39,1%	55,5%	56,7%	48,9%	49,5%	76,8%	26,9%
Trade	Avg. Share of Imps & Exps of Goods ex intra-EU trade (% of World Trade)	0,4%	1,8%	3,5%	0,1%	1,0%	0,9%	0,3%	1,5%	0,2%	0,2%	1,4%
Market	Cheap/rich market indicator (Z-Score)	0,15	0,19	0,19	-0,10	-0,63	-0,07	-0,19	-0,16	-0,27	-0,27	-1,60
	Beta to Swap rate	0,84	0,91	0,85	1,11	0,94	0,92	0,84	0,88	0,87	0,93	1,02

Table 1 shows EA countries ranked from the best to the worst (left to right) according to a group of selected macroeconomic, fiscal and market variables, all referring to 2024.
Source: Bloomberg, Haver, EC, Anima Research

FIGURE 7.

Growth potential to be higher on average in periphery countries

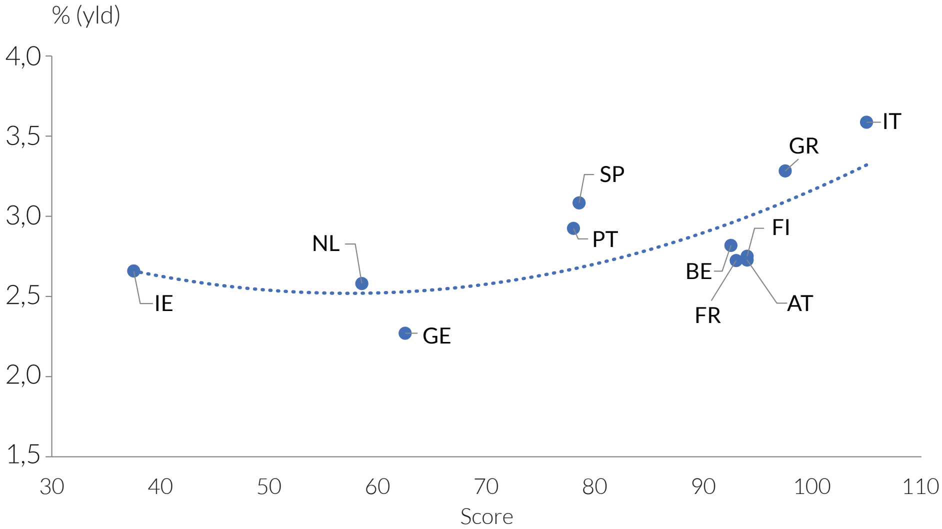


Source: EC, Haver, Anima Research

Figure 8 confirms that in a purely static perspective, considering the score assigned by our scorecard to the different EA countries, core and semi-core countries still trade moderately expensive relative to periphery countries.

FIGURE 8.

Periphery still cheap relative to core and semi-core countries



Source: Bloomberg, Haver, EC, Anima Research

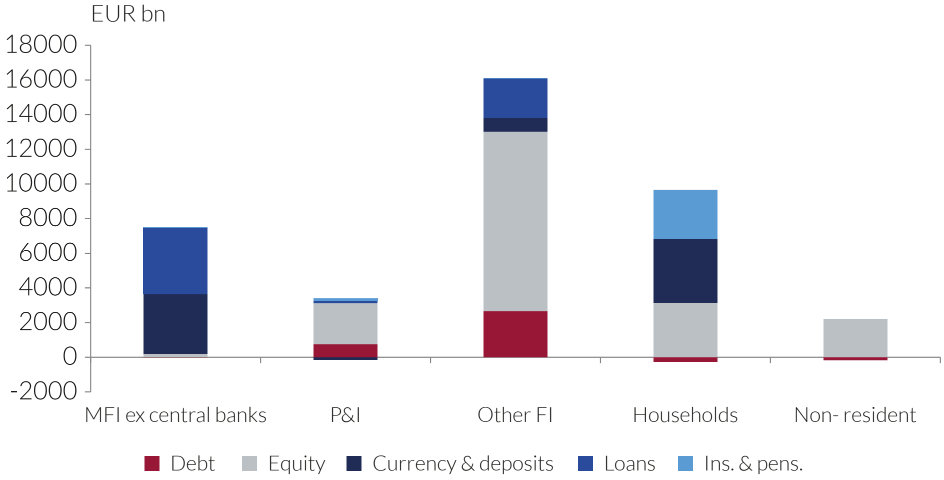
C. Underweighted EGBs investors may prefer periphery to core and within periphery, BTPs, which display the highest yield pick-up vs. core.

Figure 9 shows that in Q3 2023 (latest data available in the flows of funds) households and foreigners were moderately underweight EA debt securities compared to their historical average. That said, beyond households and foreigners, we see room for extending exposure to EA debt securities by all categories of investors for the following reasons:

- Total assets in Q3 2023 were sizably higher that their historical average for all categories of investors (**Figure 9**).
- The increase in EA investors' assets in recent years has been disproportionately invested in equities (**Figure 9**). This is most likely due to the very low debt securities yields in the 2008-2021 period, but rebalancing could take place now that government bond yields are well into positive territory and volatility in rates has declined compared to 2022.

FIGURE 9.

EA domestic investors and non-resident are underweight in debt securities compared to the past



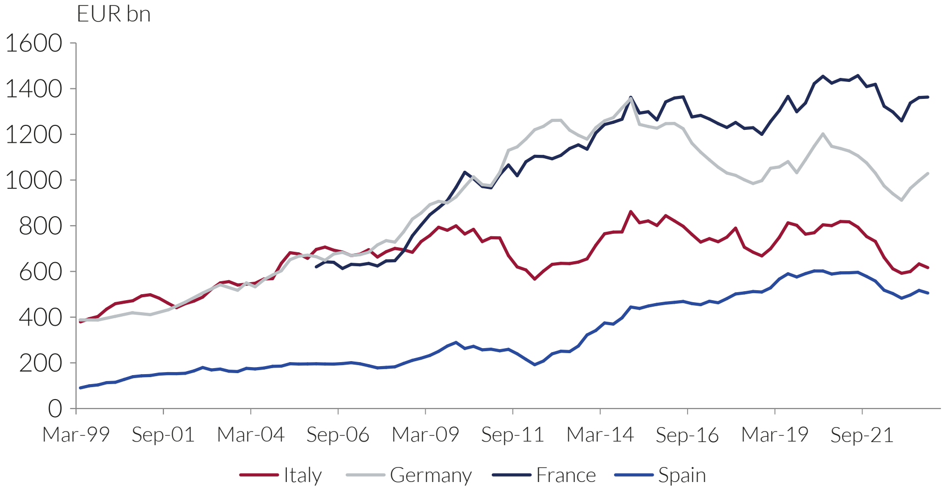
Each bar shows the difference between Q3 2023 holdings of assets by different categories of investors and their long-term average. For resident categories, data are taken from the flow of funds and refer to total debt securities (not only govies) of all jurisdictions (also outside EA), while data for non-resident refer to holdings of EA govies by non-European investors.
Source: EC, Haver, Anima Research

Periphery bonds and in particular BTPs could benefit more than core countries from a rebalancing to debt securities for two reasons:

- Within EA, Italy and Germany are the two countries that have experienced the most sizeable outflows from foreigners during QE years (**Figure 10**).
- In a relatively low volatility environment and with low idiosyncratic risk, BTPs will look like a better opportunity than core for some less conservative investors for yield pick-up reasons.

FIGURE 10.

Italy and Germany experienced the biggest outflows from foreigners during QE



The chart shows the evolution of external liabilities in general government bonds of different EA countries according to International Investment Position data (IIP).
Source: EC, Haver, Anima Research

D. EA political architecture continues to improve. This downgrades fragmentation risks to tail level.

While proceeding very slowly, the EA political architecture continues to improve. In particular, we would consider the following:

- With the creation of the Transmission Protection Instrument (TPI), the ECB has enhanced its credibility in tackling the issue of fragmentation of government bonds markets in EA (and has overcome the rigidity of the Outright Monetary Transactions, OMT).

- The new ECB monetary policy framework keeps the floor system in place in the EA and should help keep volatility and fragmentation in money markets contained.

- The NGEU has opened up the road to a common EA debt tool. While it is far for granted that there will be an NGEU 2.0, the increasing need of public spending related to defense, climate change and the need to boost productivity in the EA might push towards a bigger EU budget in the medium-term.

- While fiscal policy in EA remains far less friendly than in the US, the new fiscal framework rules are flexible and give countries more time to reduce their debt/GDP ratio.

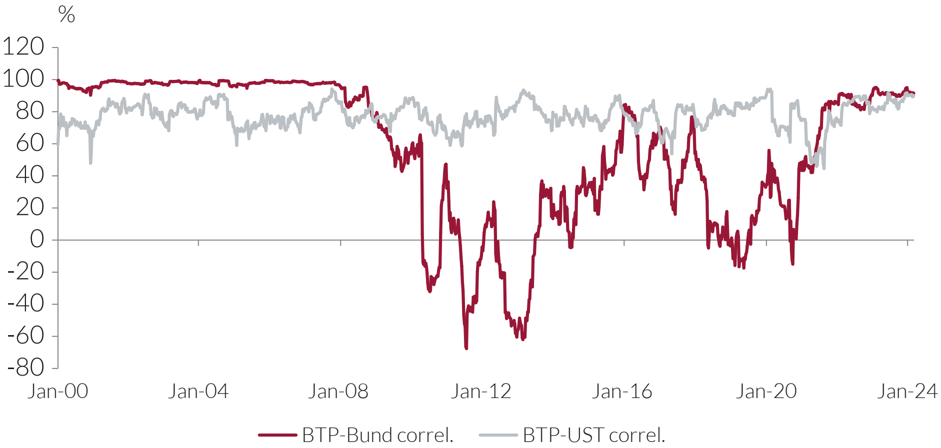
- While progress on the completion of the EU banking union and capital market union (CMU) have been extremely slow, the ECB has become very vocal at the last meeting in underlying the need for a quick completion of the CMU.

E. BTPs continue to display a strong correlation to Bund and USTs.

While BTPs benefit from a risk-on environment, like a spread product, they do no longer widen aggressively vs. core when core yields increase. **Figure 11** shows that their correlation to Bunds and Treasuries is indeed at its historical highs.

FIGURE 11.

Increase in correlation between core and BTPs



Source: Bloomberg, Anima Research

APPENDIX

Variables: Our scorecard ranks major EA countries based on GDP growth, a few public debt metrics, market valuation and their sensitivity to ECB's rate hikes.

More in details, we consider the following variables:

1) GDP growth expected in 2024
2) Primary balance/GDP ratio projected for 2024
3) Implicit interest rate/public debt ratio projected for 2024
4) Current expenditure ex interest/GDP ratio projected for 2024
5) Public debt/GDP ratio projected for 2023
6) The difference between net supply in 2024 and 2023 (including buying or selling from the Eurosystem) as a percentage of GDP in 2023
7) The portion of public debt held by foreigners to capture how much room there is for underweighted foreign investors to buy a certain country debt
8) The share of trade ex intra-EU trade of each EA country as a portion of world trade
9) An indicator of richness/cheapness of each country government bond market based on its performance in the last 3 months
10) The beta of weekly changes in 10Y yield to 10Y swap rate over the last 3 months.

Ranking: In order to assign a score to each country, we rank the countries from the best to the worst according to each variable and then we calculate a weighted sum of their scores. We assign higher weights to GDP growth, public debt, the implicit interest rate on public debt and the portion of public debt held by foreigners.

In the following set of charts, we show how EA countries position in terms of a selection of indicators (from **Figure 12** to **Figure 19**, we always rank from the best country to the worst).

FIGURE 12

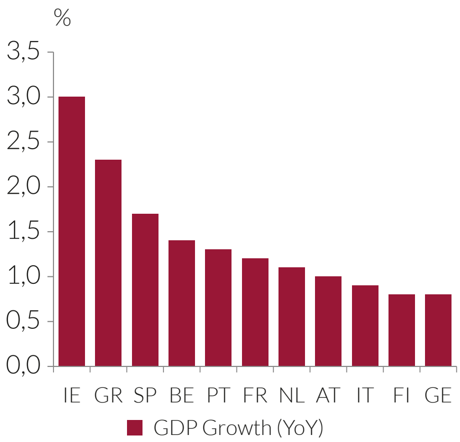


FIGURE 13

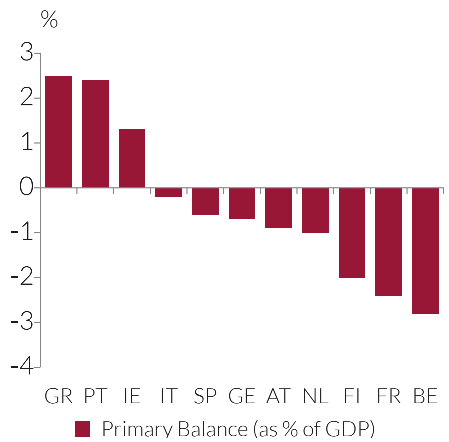


FIGURE 14

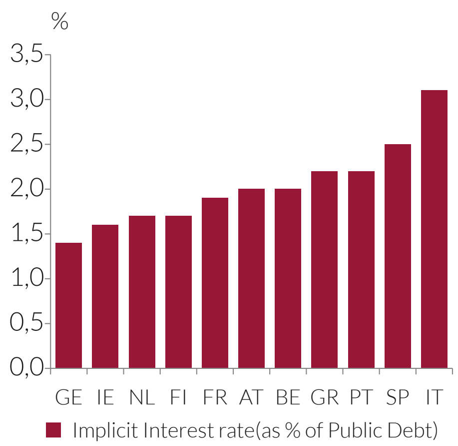


FIGURE 15

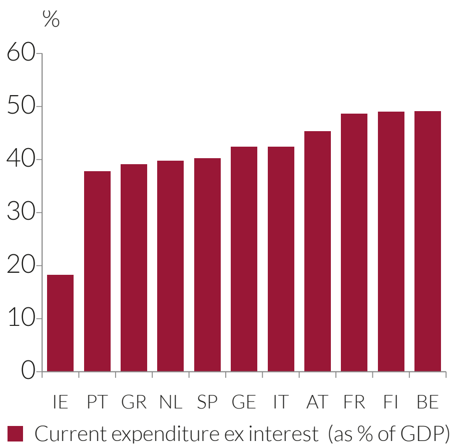


FIGURE 16

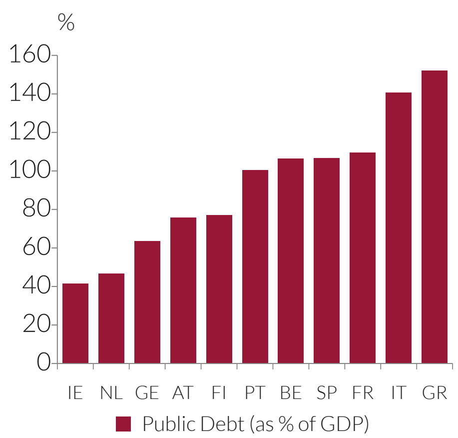
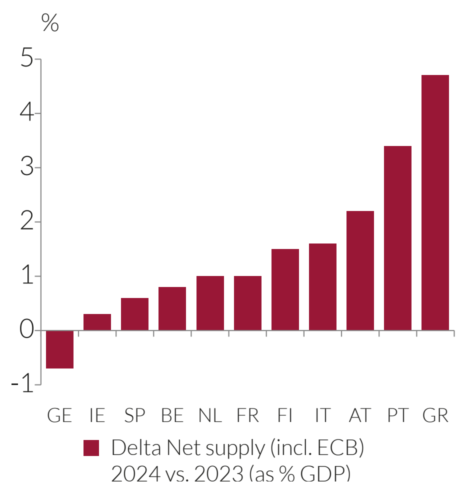


FIGURE 17



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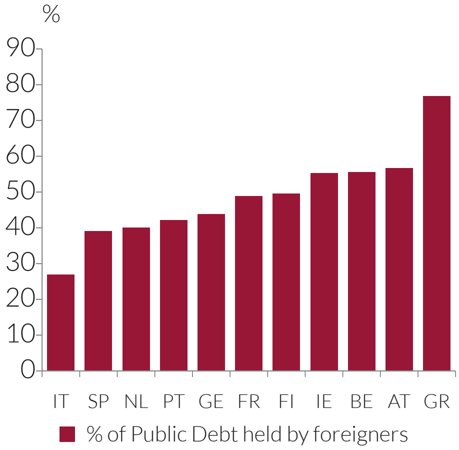

FIGURE 19