

Italian bonds: low yields portend rising deflationary risks

Summary

- The discount of Italian BTPs over US Treasuries is driven by disinflation, not improved creditworthiness. CDS spreads suggest credit risks remain above pre-crisis levels.
- Italy's economic stability is at risk, and until the ECB's targeted loans program starts to support Italy's SMEs, deflationary risks could undermine sentiment on BTPs.
- The May sell-off in BTPs on slumping Q1 output suggest bond investors are jittery. It offers investors a perspective on considering shorting BTPs as macro data may disappoint.
- Investors who share this sentiment may consider the following Boost ETPs:
www.boostetp.com/products

Short Italian government bonds:

Boost BTP 10Y 3x Short Daily ETP (3BTS)

Chart 1: Too bullish on Italian BTPs...

Credit spreads: cash vs CDS markets (in bps)

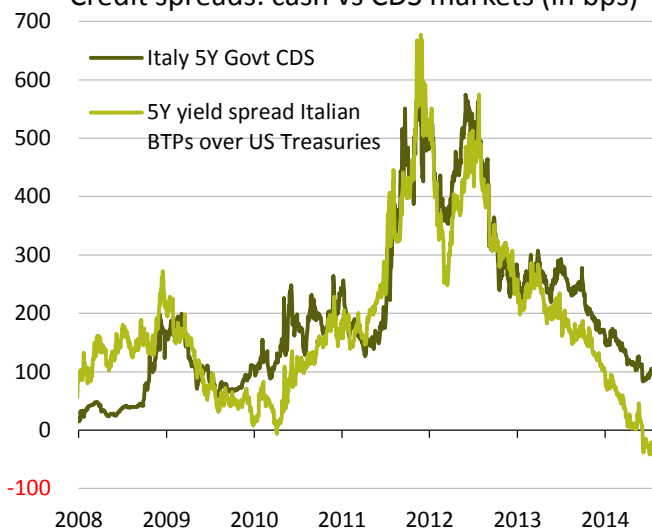
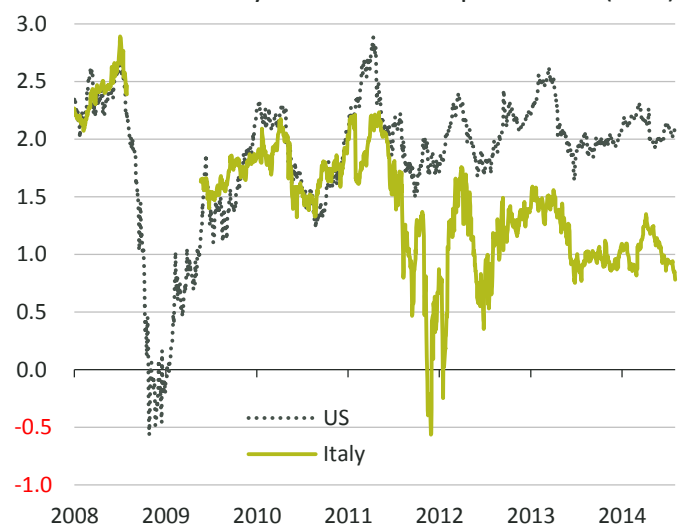


Chart 2: ...on rising threat of deflation

5 year inflation expectations (in %)*



Source: Boost ETP Research, Bloomberg. Data as at 31 July 2014

* 5Y nominal bond yield minus 5Y yield on equivalent inflation-linked securities

Downside risk to Italian government bonds has risen. Disinflation, itself a symptom of economic weakness, drive the low yields in Italy and give a false sense of security. If anything, Italy's negative government bond yield spreads over US Treasuries suggest rising deflationary risks that pose a growing threat to Italy's economic stability. A better gauge for Italy's creditworthiness may be the CDS spreads which, at 100 bps is indicative of significant risks lurking beneath the surface. Investors who share this sentiment may consider the following short debt ETPs:

Short Italian government bonds:

1. Boost BTP 10Y 3x Short Daily ETP (3BTS)

Italy's CDS spreads reflect credit risk better than the spreads on cash bond markets

Italian credit spreads have fallen to unusually low levels. As shown in chart 1, the yield spread of longer dated bond yields of BTPs (Italian government bonds) over equivalent US Treasuries has shrunk to such a degree that it is now in negative territory. At approximately -40 bps, this current spread is a marked reversal from the positive spreads of 100 bps at the start of the year and of several 100 basis points just a few years ago, seemingly suggesting that, with BTPs yielding 1.3% and 2.8% on 5Y and 10Y maturities respectively, sovereign credit risk in Italy is now lower than in the US. On the surface, this seems rational when considering that, at the same time that the ECB's OMT program (i.e. Draghi's implicit promise to support Eurozone's credit markets 'whatever it takes') has

remained supportive of BTPs effectively since 2012, the Fed has been reducing its government bonds buying program to the tune of USD 10 billion per month since December 2013 which, on the back of a more upbeat outlook for the US economy coming from the Fed in recent months, is on schedule to end by end of the summer.

However, the spreads of Italian sovereign credit default swaps (CDS) tell a different perspective. On CDS markets, it will cost investors around EUR 100,000, or 100 bps, to insure EUR 10 million of BTPs, an insurance premium that while having shrunk substantially from the peaks of 500 and 600 bps attained in 2011 and 2012, has failed to fall back to pre-crisis levels. Prior to 2008, Italy's 5Y sovereigns CDS spreads traded well below 20 bps, indicating the BTPs carried very low default-risk. In fact, given the much larger government indebtedness of the Italian economy than the US's, the price stability-focused mandate by the ECB (unlike the dual mandate of the Fed to target both price stability and growth) has ironically led longer-term inflation risks to drive Italy's bond markets more than (outright) default risk. As a result, up until 2008, Italy's longer dated government bonds yielded approximately 100 bps more than US Treasuries, a spread that also was about 80 bps higher than the spreads of equivalent CDS. Following the onset of the credit crisis in 2008 however, Italy's CDS spreads aligned with the spreads over US Treasuries. This is because without the additional extraordinary monetary stimulus levers, the ECB's successive interest rate cuts alone would unlikely have been sufficient to save the Eurozone from breaking up, or for that matter prevent Italy from devaluing its own currency as the inevitable consequence. With rising default risks feeding inflation risks, Italy's CDS spreads moved in lockstep with Italy's yield spreads over US Treasuries, rising several 100 bps as the crisis intensified.

Rising deflationary risks poses a destabilising threat to Italy's economy

While spreads have come down significantly following Draghi's implicit promise to support Eurozone's bond markets in 2012, the yield spread of Italian BTPs over US Treasuries and the CDS spreads on Italian equivalent bonds have since grown apart. In fact, while Italian BTPs now yield less than US Treasuries on cash markets, Italy's default risk, as gauged by the 100 bps in spreads on CDS markets, remains as high as it had been in 2010. Herein lies the new risk for Italian credit, which in contrast to pre-crisis periods is one where prolonged disinflation is feeding through into weaker expectations and in the process raising deflationary risks. As shown in chart 2, 5 year inflation expectations¹ in Italy have continued to weaken and having fallen to 0.8%, are now 1.2% below those of the

US. This inflation gap explains why Italy's CDS spreads have started to deviate from the yield spreads of BTPs over US Treasuries.

The lagged impact of ECB stimulus presents an opportunity to be bearish BTPs in the interim

In normal times, all else being equal, lower inflation expectations create bullish conditions on bond markets. Unfortunately, we are not finding ourselves in normal times. Amidst a drought of affordable credit, small and mid-sized businesses are not reinvesting and rehiring at a rate fast enough for Italy to grow to regain traction. Failing to attain escape velocity and break out from moribund growth, the economy of Italy is at risk of destabilizing further as the threat of deflation looms larger. For it will take at least a year before the ECB's latest monetary stimulus package, coming in the shape of lower short-term interest rates coupled with new cheap 4-year term loans targeted specifically to revive non-residential private sector lending, to fully impact Eurozone's weakest links, including Italy's SMEs. That leaves plenty of opportunity for market sentiment to sour again on new disappointing macroeconomic releases. Bond investors already got a taste of that this year when the Italy's national statistics institute ISTAT released preliminary Q1 GDP on 14 May. Against expectations, the actual contraction of GDP was -0.1%. While seemingly small and much lower than previous contractions in 2013, it was enough to send bond markets reeling. Following the announcement, Italy's 10 year BTPs fell 2.9% over the next three days. Italy's government debt burden, at 130% of GDP, can be shaken off by investors as a non-issue so long as the denominator can sustain it. Japan, which has a government debt to GDP ratio of 226%, serves as a prime example of overleveraged economies enjoying ongoing support of bond investors so long as the economy continues to grow. As soon as indications suggest the contrary, in particular when the disinflationary trend could be perceived by investors as a prelude to output contractions further down the road, sovereign debt markets become vulnerable. Underpinned by rising social-political tensions, economic stability is put at risk. Underneath the low yielding bond environment lurk risks the market may not fully appreciate. Set against actual inflation readings of 0% and with no visible turnaround of labour market or a major reform agenda to drive it, investors may need to cut back their longer term inflation expectations even more, potentially providing an opportunity to sell rather than buy BTPs.

All data is sourced from Boost ETP, and Bloomberg

¹ Derived from Italian 5 year nominal bond yields and equivalent inflation-linked securities

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