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DEF AND BOND VOLATILITY RISK BROADENING THE SPREAD

DEF and bond volatility risk distributing the spread

by Giancarlo Salemi

Fluctuation returns to the spread despite the Italian Treasury having successfully launched the Treasury Bill (BOT) and Treasury Bond (BTP) auctions. The DEF figures have taken their toll, but so has the American recession, which is not so far off – at least according to analysts

Are we back at it again? The Document of Economy and Finance (DEF), which the Italian government is currently finalising and will present before 10 April, **has put the see-saw of the spread back into motion**. Last week it fell below 230 basis points before hiking up to 263, breaking out of the 250-point psychological threshold where it had been for over a month. The growing difference in yield is also dictated by the rally characterising the Bund, with Germany's 10-year government bond falling to -0.06% of the lows from 2016. U.S. 10-Year Treasury yields (2.36%) and the JGB (-0.067%) are also falling.

CONFINDUSTRIA ZERO GROWTH, GOVERNMENT GDP DEFICIT 2.4% - Looking to Italy where **the downward revisions in growth have hit hardest**. Confindustria's research department has updated the estimates and sees zero growth in 2019, while the Italian government would be willing to drastically cut the estimates in the next DEF to 0.1%, instead of the previous 1%, with the debt-to-GDP ratio to be revised upwards from 2.04% to 2.4% of the gross domestic product, which was the very bone of contention last autumn between the European Union and Italy in the budget law talks. Even if there are to be no corrective measures, the Minister of the Economy, Giovanni Tria, and the Deputy Prime Minister, Luigi Di Maio, are reiterating in chorus that **the markets fear the "disorderly accounts" of the Italian government**, which must scrape together at least € 23 billion to reduce the effect of the safeguard clauses, avoiding a VAT increase when campaigns for the European elections are in full swing.

STRONG MARKET VOLATILITY: IS A US RECESSION ON THE WAY? - "It is a time of great volatility on the bond markets", explains Enrico Vaccari, Head of Corporate Clients at Consultinvest. "And **the finger should be pointed at the United States, not Italy**. For the first time in a decade, the yield curve is inverted, with the 10-year yield lower than the 3-month yield. This is the most significant event affecting all bond markets. Tensions are very high, including on periphery country spreads in relation to the fact that this about-face by the Central Banks **causes embarrassment to the markets**. It is not clear if they tightened too early, the Federal Reserve, or if, on the other hand it is only a temporary slowdown." Currently, a 3-month American Treasury Bond yields around 2.453%; at 6 months, 2.469; at 1 year, 2.444; at 2 years, 2.325. When we get to 10 years, we are talking about a yield of 2.36. That means that investing today in a three-month bond yields more than investing in a ten-year bond. The last time this happened was in 2007, just before the explosion of the big economic crisis. Historically, the yield curve inversion (where the long-term rates fall below the short-term rates) is viewed by analysts as "**a first sign of recession**".

Discussion:
The anomalous rise in low-risk bond prices

AND ITALY? TREASURY BILLS ARE FINE BUT ACCOUNTS ARE WORRYING - Italy's price to pay in this context is as **the weakest link in the European issuing countries**, even if the last Treasury Bill auction went well, with the allocation of six-month securities for € 6 billion. The mean return on allocation was -0.069% (down from -0.007%), at the lowest levels since April 2018. The return was negative for the third consecutive month, with a demand that remained constant with requests for over € 9.55 billion. Francesco Dalla Libera from the Investments Team at Euclidea Sim identifies three factors that could affect the spread. "The decisions of the ECB", he explains, "which are already aimed at keeping the rates below zero until the end of the year, and which have flattened German ten-year rates to 0%. The second aspect is the potential **agreement between the United States and China, which would calm things down** on the trade front and largely lead to a hike in German rates. Finally, the instability of the Italian political situation: the 'Quota 100' and 'Citizens' Income' measures, though weakened, represent an important tax commitment, especially when these provisions will not be compensated by a recovery in GDP and consequent higher tax revenue."

EVERYTHING WILL ALSO DEPEND ON THE NEW EUROPE POST-ELECTION - "**A scenario of surges in the spread must not be ruled out**", explains Angelo Meda, Head of Shares at Banor Sim. "Regardless of political evaluations, history shows us that, on the one hand, austerity policies only created difficulties in the countries that adopted them (Greece being the prime example), and on the other hand, Europe’s rigidity has always created tensions. It will be interesting to see what European Commission and Parliament come from the upcoming European elections before expressing an initial opinion, but a subsequent widening of the spread before a macroeconomic slowdown, like the Bund is showing with negative rates, and then policies to reduce the deficit, seems an entirely plausible scenario.”