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Italy: staying positive

Key takeaways

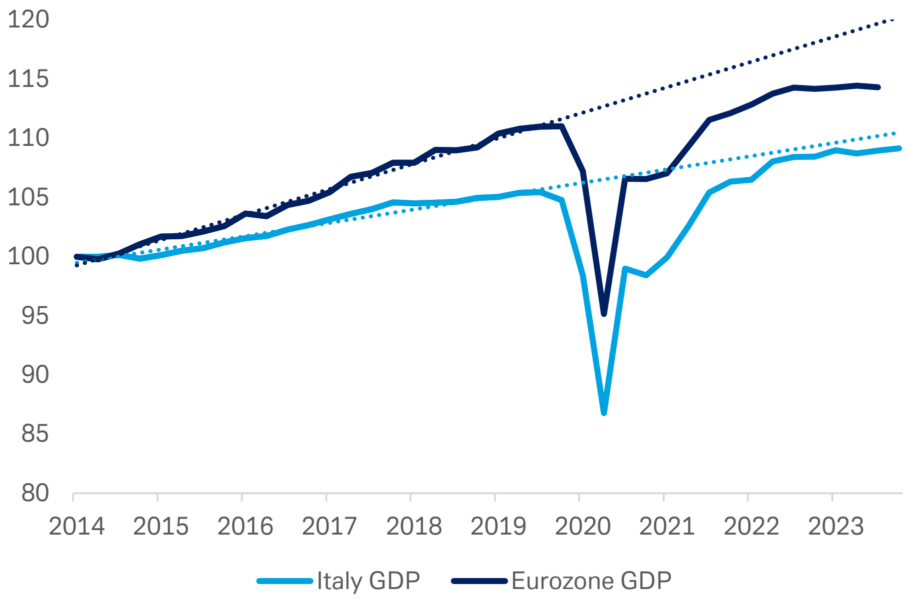
- Italy has weathered recent crises well, thanks in part to EU funding. Rising Italian industrial production, coupled with services' resilience, bodes well.
- Disinflation, business confidence, investment and consumer purchasing power are amongst positive factors. But debt and deficit levels remain a concern.
- Italian equities have performed well, thanks in part to FTSE MIB sector composition. BTP spreads are low, with positives still outweighing negatives.

01 Macro backdrop

Italy has weathered recent economic crises (i.e. COVID-19 and the European energy crisis) well. As shown in Figure 1, Italy had already returned to its pre-pandemic (relatively slow) growth trend by the start of 2022, while the rest of the Eurozone was still below trend. By Q4 2023, Italy's GDP was 4.2% higher than in Q4 2019, vs. an increase in Eurozone GDP of 3.0%.

In sequential terms, Italy's GDP growth came in at +0.2% QoQ in Q4 2023, compared to 0.0% for the Eurozone. For the full year 2023, growth was 0.7% vs. 0.5% for the Eurozone. No recession is in sight for Italy, although some other major economies in the Eurozone have been stagnating.

Figure 1: GDP growth (Index 100 = 2014)



Source: LSEG Datastream, Deutsche Bank AG. Data as of April 16, 2024.

Various factors have assisted this recovery. NextGenerationEU (NGEU), in combination with the EU's long-term budget, has constituted Europe's most substantial stimulus package to date with a combined value of EUR2.018tr in current prices. Within NextGenerationEU, the main instrument is the Recovery and Resilience Facility (RRF) providing grants and loans totaling EUR723.8bn to support reforms and investment in EU member states. To access these funds, member states must prepare plans on their investment strategies. The European Commission assesses their progress against milestones and targets before disbursing funds.

Italy is to receive the largest absolute amount of funds and grants of any country from this stimulus package – EUR194.3bn. The amount received will be equivalent to almost 11% of 2021 GDP. Greece and Spain have been the only countries to receive a larger allocation in relative terms, however in absolute terms they have been endowed with lower funds. Greece was granted with EUR39.95bn while the allocation to Spain amounts to EUR163.0bn. By the close of 2023, the European Commission had disbursed to Italy over half of the targeted RRF's funds. The tranches received annually were equivalent to 1.5%, 2.4%, and 2.0% of GDP for the years 2021, 2022, and 2023, respectively.

The pandemic and the European energy crisis also forced Eurozone member states to adopt looser fiscal policy in a countercyclical manner (unlike after the Global Financial Crisis). Previously, Italy had limited fiscal policy leeway due to its struggles to keep its fiscal deficit at acceptable levels under then-prevailing EU rules.

Italy has also been a beneficiary of the so-called revenge spending trend (higher spending after an adverse shock), boosting sectors like tourism and luxury in the post-pandemic re-opening boom. The Italian luxury goods industry has long been a significant contributor to the country's economy, accounting for 6.9% of Italy's GDP in 2019. The tourism and travel sector represented 13.1% of Italy's GDP in 2019.[1]

While these factors were conducive to growth, they also contributed to the resurgence of inflation. Supply side shocks (e.g. to energy supplies after Russia's invasion of Ukraine), coupled with strong demand in the aftermath of the pandemic, further stoke inflation. The ECB's subsequent monetary tightening has had varying impacts across the Eurozone, with Italy particularly affected. The rate paid on new mortgages for households from 1.45% to 3.60% between January 2022 and January 2023, a rise of 2 percentage points (vs. just under 1.8 percentage points for the Eurozone).

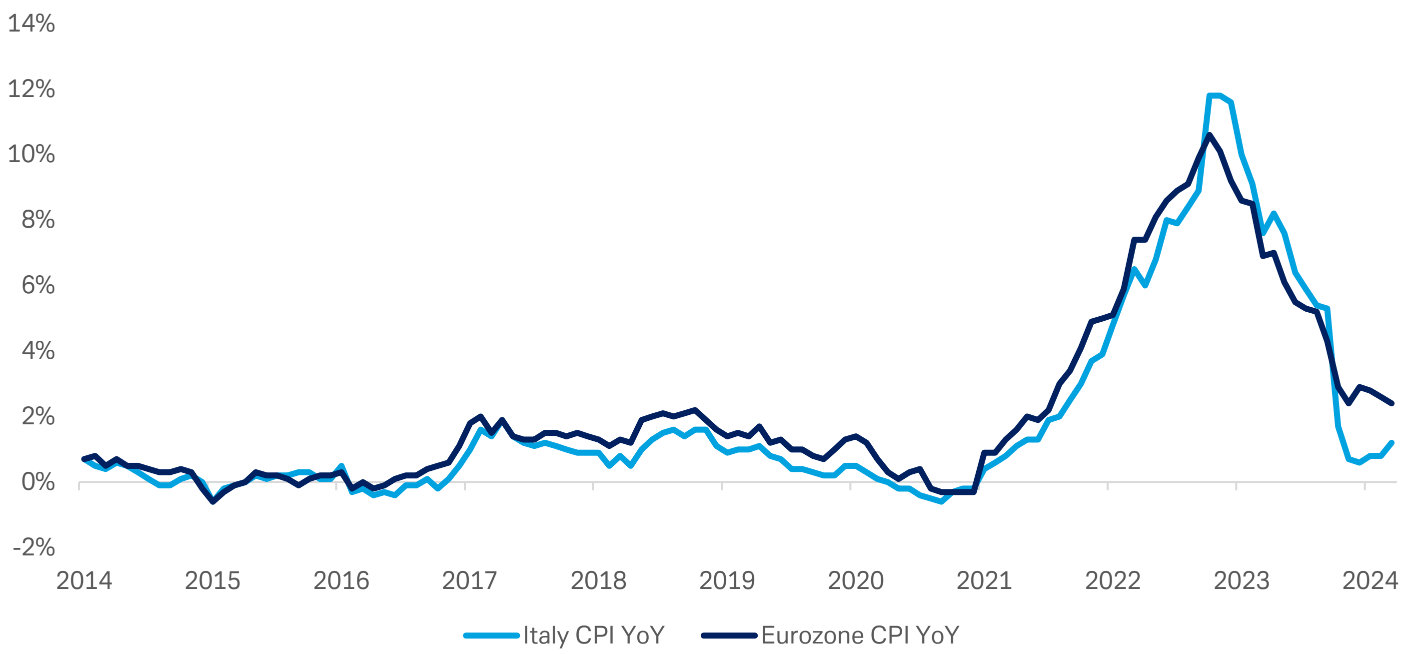
02 Recent developments

The manufacturing sector, the second-largest in Europe, has felt the pressure of tighter credit conditions. But while Italy's industrial production lagged Eurozone manufacturing activity in 2021 and 2022, more recently it has reaccelerated, outstripping the rest of the Eurozone countries and Germany in particular.

The recent surge in Italian industrial production, coupled with services' resilience, bodes well for the Italian economy. In Q4 2023 the Italian economy grew while Germany's stalled. We believe this momentum is likely to continue. Eight reasons for this are summarized below.

Disinflation progress. Italian CPI already below the ECB's target of 2%, as shown in Figure 2. Inflation has come down faster in Italy than in the overall Eurozone due to a more substantial decline in energy prices.

Figure 2: Inflation rate



Source: LSEG Datastream, Deutsche Bank AG. Data as of April 16, 2024.

Business confidence. The Eurozone PMI data confirm the picture of an Italian economy rebounding more rapidly than the other "core" Eurozone countries in both manufacturing and services sectors, and there are hopes this could translate into better "hard" economic data as well.

Fixed investment. This recovered quickly from the pandemic, helped by extremely generous tax credits for housing renovation (the so-called "superbonus") as well as RRF funds (see above). Fixed investment growth may not be sustained at current levels, particularly in the residential construction sector which has a high current share of GDP (Figure 3). But any slowdown in fixed investment growth will likely take time.

Credit supply. The credit impulse is also coming back up from recent depressed levels. Loans to households appear to be bottoming out, while loans to domestic non-financial corporations have recently increased from minimum levels.

Consumer purchasing power. Rising prices over the last years have eroded consumers' purchasing power but, looking forward, a recovery may be in store. As mentioned earlier, inflation has decreased more rapidly in Italy than in the Eurozone, reducing the pressure on Italian households. Employment growth though higher numbers of permanent positions rather than temporary workers may also add to confidence.

Productivity. Growth in employment so far has not been at the expense of lower overall productivity. The ratio between GDP and employment is currently higher than the pre pandemic level, suggesting increases in workers' productivity.

Wages growth. In Q4 2023 real wages were up 5.7% in Italy compared to 3.7% for the Eurozone. However, real wages growth in Italy has lagged the Eurozone countries over the last 10 years, leaving Italian workers room to catch up and further boosting spending power.

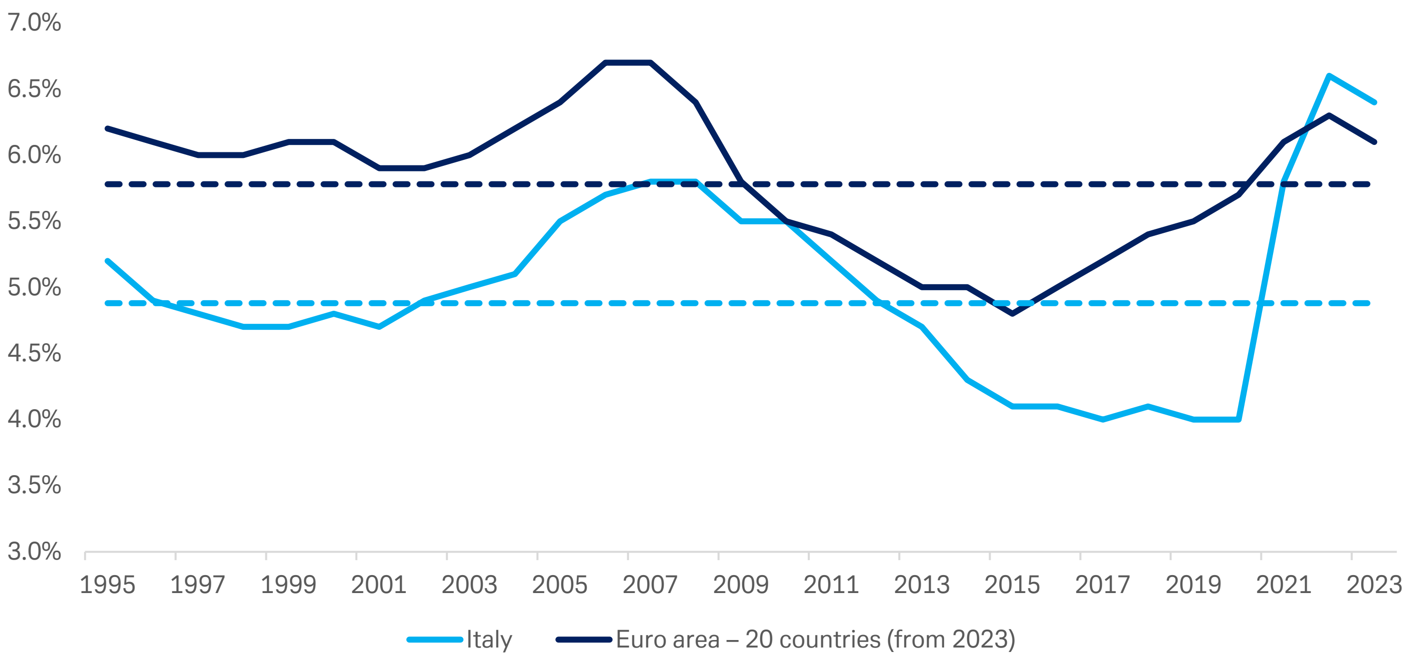
Savings. These are still in the upper range of pre-pandemic levels. The gross domestic savings rate stands at 21.1% of GDP, while the pre-COVID average saving rate in the period 2003-2019 was 20.4% A normalisation of the savings rate towards this value should offer an additional boost to consumption.

03 Debt and deficits

The debt burden is always Italy's Achilles heel, and budget deficit levels are also a concern. The Italian Statistical Agency (ISTAT) recently published its first estimate of the deficit/GDP ratio. At -7.2% this was way above the government's forecast of -5.3%. This is particularly problematic given the high level of debt compared to GDP (137.3% in 2023, Figure 4). Maintaining the "superbonus" incentive is expected to prevent substantial declines in the ratio of debt to GDP in the short term (payments here, in fact, are added to public debt when the tax credits are actually repaid).

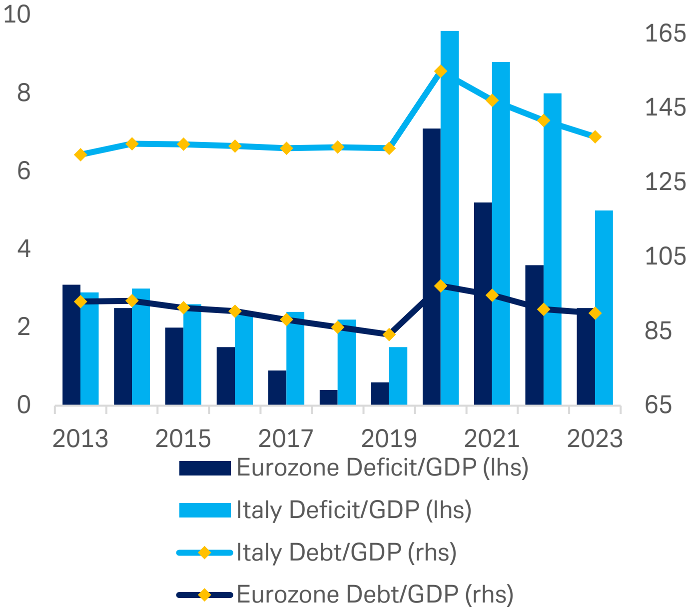
The need for fiscal adjustment has been recently highlighted by the International Monetary Fund (IMF)[2]. Higher levels of debt require smaller primary deficits in order to stabilize the debt to GDP ratio going forward and the IMF reckons that the likelihood Italy will reach the target deficit necessary to stabilize its debt level, estimated at 0.5% of 2024 GDP, is below 50% - implying that the government will probably have to tighten its belt further. (Note however that Italy is not alone here – about a third of advanced economies have primary deficits higher than compatible with stabilizing debt relative to GDP.)

Figure 3: Residential construction (% of GDP)



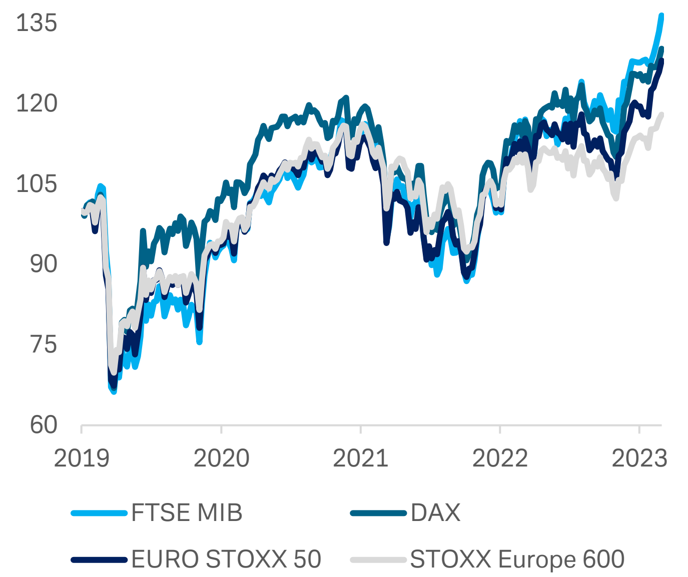
Source: Eurostat, Deutsche Bank AG. Data as of April 16, 2024.

Figure 4: Government deficits and debt as % of GDP



Source: Eurostat, LSEG DataStream. Deutsche Bank AG. Data as of April 16, 2024.

Figure 5: European equity indices (Index 100 = 2019)



Source: LSEG Datastream, Deutsche Bank AG. Data as of April 16, 2024.

Italy's efforts to limit government spending will be important as fiscal consolidation in the Eurozone will intensify in 2024 after some years of loose fiscal policy. According to new rules, member countries with excessive debt will be required to reduce it on average by 1% per year if their debt is above 90% of GDP (as is Italy's), and by 0.5% per year on average if it is between 60% and 90%. If a country's deficit is above 3% of GDP, it will have to be reduced during periods of growth to reach 1.5% and build a spending buffer for difficult economic conditions. If this is not done, the country will be forced to an Excessive Deficit Procedure (EDP).

However, NGEU funds could provide a buffer to the required reduction in fiscal stimulus, with implementation of the National Recovery and Resilience Plan (NRRP) of great importance to boosting economic growth and improving public finances.

The latest government's projections, the so-called Update of the Economic and Finance Document (NADEF), point to higher budget deficit forecasts over 2024-2026 and a return to the 3% threshold of the Maastricht Treaty not before 2026. This could lead to issues with the European Commission over fiscal consolidation going forward.

04 Equities

The FTSE MIB has outperformed pan-European indices and most single country indices (apart from Greece) since the outbreak of the pandemic, as shown in Figure 5.

Recent outperformance has been helped by the industry composition of FTSE MIB, which has a much larger share of banks/financials and energy companies than other European indices: financials account for 32% of the index, with energy around 11%. Higher interest rates have boosted banks' profitability while energy companies have been supported by higher fossil fuels prices triggered by Russia's invasion of Ukraine. Exposure to consumer cyclical industries (such as autos & luxury) has also supported the Italian stock market too as confidence in an economic "soft landing" has grown.

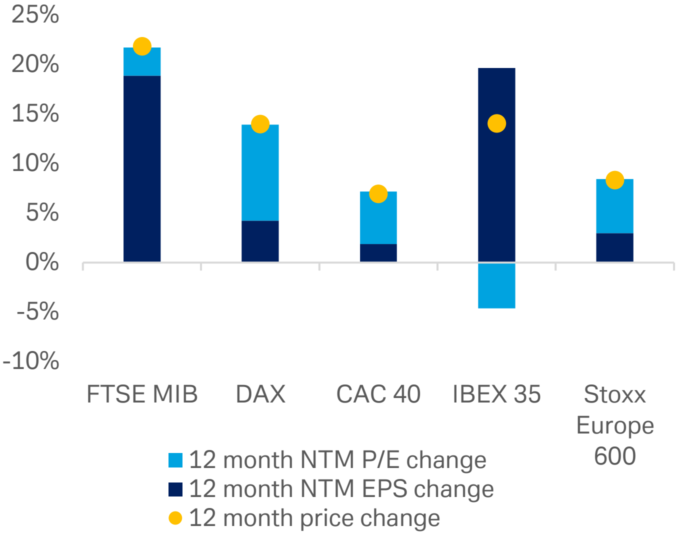
As highlighted in Figure 6, NTM EPS change accounted for most part of the FTSE MIB performance, while the change in NTM Price-to-Earnings (P/E) gave only little help. This was in contrast to the German DAX, which relied more heavily on NTM P/E re-rating thanks to the larger share of tech companies in that index, the valuations of which expanded more rapidly.

Although we expect the ECB to start easing monetary policy from current levels in June, a steepening of the EUR yield curve, as also forecast, should be beneficial for banking as it increases the difference between the rate banks can earn on their assets and the rate they pay on their liabilities. But there are some potential negatives for banks too. If the ECB keeps rates high for longer than expected, this could affect households and companies' ability to pay their debts leading to a deterioration in banks' asset quality. An increase in the rate at which banks pay overnight deposits (which is low compared to key interest rates) could also erode banking business profitability.

European energy companies have been making faster progress on the global energy transition than their global peers. This could help change investor perceptions, and re-rate these stocks upwards. Finally, consumer cyclical industries like autos and luxury companies are expected to benefit from future global economic recovery and rising consumption – including in China.

Italian companies have been characterized by low valuations not only against developed markets, but also versus their main European counterparts. Since 2012, the FTSE MIB has had an average NTM P/E of 13.9 versus 14.4 for Euro Stoxx 50, or an average discount of 4%. However, FTSE MIB NTM P/E currently is 7.9 versus the 13.8 of Euro Stoxx 50 implying a much larger discount. Moreover, compared to its average value over the

Figure 6: NTM EPS, NTM P/E and price change for selected European indices



Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of April 16, 2024.

Figure 7: Italian spread versus German 10 year bond (bps)

Source: LSEG Datastream, Deutsche Bank AG. Data as of April 26, 2024.

same time horizon, the ratio between the two indices' NTM P/Es sits below 1 standard deviation. Such low levels have usually in the past been followed by a relatively strong rebound in Italian companies' valuations.

05 Fixed income

Italian sovereign bonds have also done well, albeit with volatility as a constant feature. In the middle of pandemic, for example, the BTP-Bund spread spiked towards 300 bps but rapidly moved down reaching 100 bps over the course of 2021 thanks to the ultra-loose monetary policy implemented by the ECB and the subsequent global economic recovery. Spread widening returned in 2022 on the back of ECB monetary policy tightening and the regional energy crisis. Highly-indebted countries like Italy saw their cost of debt increasing a lot, negatively affecting their economic situation. However, the flexibility of the Pandemic Emergency Purchase Programme (PEPP) reinvestments and the introduction of the Transmission Protection Instrument (TPI) prevented the BTP-Bunds yields differential reaching 250 bps in autumn 2022 (Figure 7).

Autumn 2023 was another difficult period for Italian sovereign bonds, due not only to the global bonds' selloff but also to a busy calendar of rating agency assessments. In the event, these turned out to be positive, with S&P, Morningstar and Fitch confirming current ratings and outlook. Moody's went a stage further and changed its outlook to stable from negative given "*a stabilization of prospects for the country's economic strength, the health of its banking sector and the government's debt dynamics*". According to the rating agency, Italy's economic prospects had improved not just due to the National Recovery and Resilience Plan but also to a positive development in energy supplies and prices.

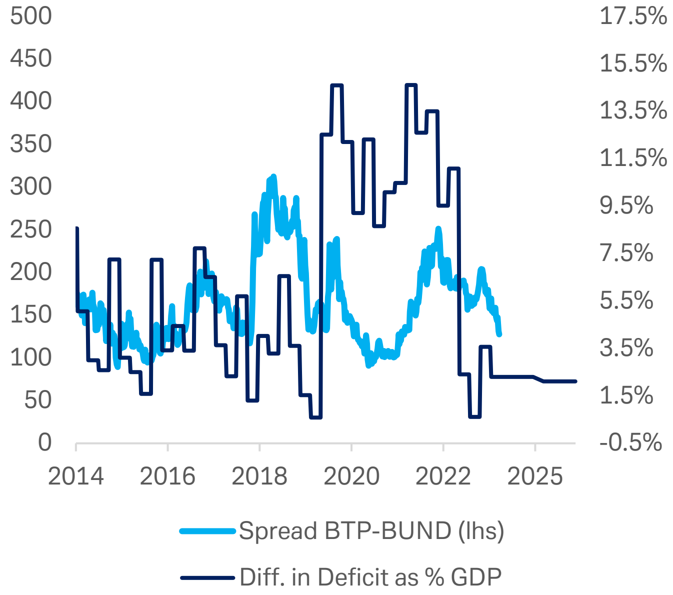
Since then, the spread with bund yields has moved down to levels last seen during 2021 and currently stands at 131 bps, as of April 24. Spreads have been kept down by further evidence of decent relative Italian GDP growth against Germany (which itself is facing structural and cyclical headwinds), and expectations that this will continue into the medium term, given that Italy is set to benefit from NGEU funds more extensively than other European countries.

Another driver of the BTP-Bund spread is the deficit/GDP ratios of both countries. As Figure 8 shows, there is a link, albeit with a decoupling occurring in 2021. The current spread level seems reasonable and (according to official forecasts) the difference in deficit/GDP measures between the two countries is expected to compress, also suggesting the spread could stay low. Historically, there is also a tendency for peripheral yields to compress versus Bunds when PMIs are recovering from sub-50 levels.

The current absolute yield levels for BTPs have also attracted domestic retail investors, who now again see them as attractive investments. Figure 9 shows the different shares of participation in the Italian sovereign bond market since 2007 by different market actors. Pre-pandemic holdings of BTPs from retail were as low as 8%. Despite a quite notable increase recently, some upside is still possible here. Domestic retail investors' demand continues to increase, as confirmed by the latest issue of BTP Valore, and the 2007–2013 average was as high ~17-18%.

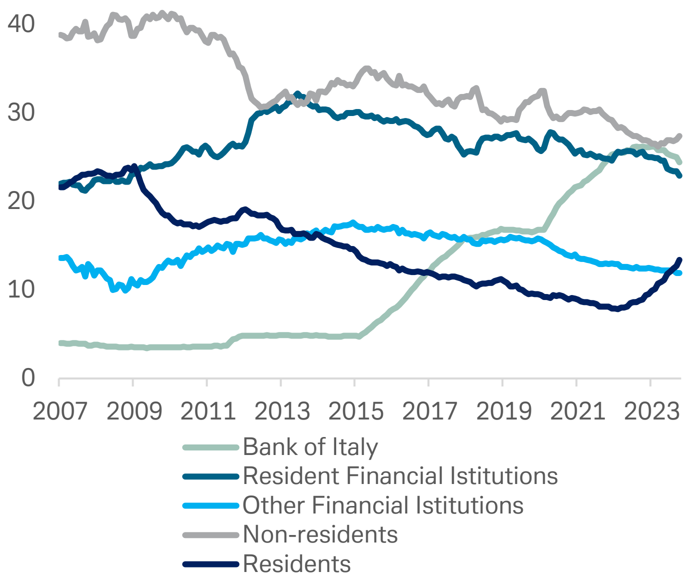
Upcoming issuance is however expected to be heavy at the Eurozone level. The rolling 4-weeks average of Euro Government Bonds (EGBs) supply since the beginning of the year reached almost EUR180bn, the largest since 2016 is expected to remain high for the rest of the year. However, the recent Italian government update on its 2024 funding activity is not too concerning. According to the draft plan, net cash borrowings should amount to EUR130bn this year. Factoring in redemptions, which amount to EUR265bn, total borrowing needs will therefore be EUR365bn, lose to last year's EUR360bn.

Figure 8: BTP-Bund spreads and government deficits



Source: Bloomberg Finance L.P., LSEG Datastream, Deutsche Bank AG. Data as of April 16, 2024.

Figure 9: Share of BTP holders by category of investors (%)



Source: Bank of Italy, Deutsche Bank AG. Data as of April 16, 2024.

While the macro environment appears positive, there remains however a risk of spread widening as debt sustainability concerns have not disappeared completely. Note also that the European Central Bank (ECB) will soon start reducing its PEPP (Pandemic Emergency Purchase Programme) portfolio. The ECB's Governing Council has also announced that it intends to discontinue reinvestments under the PEPP at the end of 2024. Italy benefited more from the PEPP than other European countries. This could encourage longer end yields to climb higher over the next 12 months, posing some risk to valuations but carry remains attractive, nonetheless. The end of PEPP reinvestments represents an additional potential headwind for BTP, but the effects could be mitigated by the increasing participation of Italian retail investors.

Moreover, if Italy is not able to stick to communitarian rules about fiscal discipline, it could lose one the four requirements to potentially benefit – in the extreme case of huge spread decompression – from the TPI. Among others, an important criterion to be met to benefit from TPI's protection is "Compliance with the EU fiscal framework" indeed.

An additional factor to consider is that, despite the current low spreads, the absolute value of both interest rates is higher than in the past, increasing the cost of debt for Italy more than for Germany. If inflation proves to be stickier than forecast, leading the ECB to slow down its expected loosening cycle, the burden on the Italian public budget could be substantial, with an impact on government bonds.

A final factor here will be the implementation of reforms under Italy's National Recovery and Resilience Plan. Failure here would constitute a significant headwind for the Italian economy, slowing down investment growth with repercussion on GDP growth both in the medium and long-term, again with an impact on government bonds.

06 Conclusion

Italy has managed recent crises better than expected, with a robust and swift recovery after the pandemic downturn. As we outline above, there are good reasons to hope that this positive backdrop should be here to stay, despite remaining risks to the downside.

Italian capital markets performed well versus the rest of Europe in 2023 and have generally continued to do so in 2024. In the equity space, the FTSE MIB has outperformed pan-European indices and most single countries' indices (apart from Greece) since the outbreak of the pandemic. This outperformance is based on various drivers and could continue, but with some risks. The FTSE MIB appears still cheap both by historical standards and compared to other developed markets.

Italian spreads to bunds have tightened strongly in recent months, albeit with some temporary reversals. With the macro backdrop appearing constructive, there are reasons to believe the BTP spread could stay around current levels. The risk of widening remains as debt sustainability concerns have not disappeared completely, perhaps turning market sentiment negative. In our view, the positives on BTP still outweigh the potential negatives for now.

Bibliography

1. Challenges and opportunities from the pandemic in Europe: The case of Italy | Stanford Institute for Economic Policy Research (SIEPR)
2. Fiscal policy in the great election year

Historical Performance

Performance	8.5.2019 - 8.5.2020	8.5.2020 - 8.5.2021	8.5.2021 - 8.5.2022	8.5.2022 - 8.5.2023	8.5.2023 - 8.5.2024
DAX	-10,5%	41,2%	-11,2%	16,7%	16,0%
Euro Stoxx 50	-14,9%	38,7%	-10,0%	19,8%	15,9%
STOXX 600	-10,8%	30,5%	-3,4%	8,6%	10,5%
FTSE MIB	-26,5%	33,6%	-8,1%	10,7%	21,1%
IBEX 35	3,8%	39,4%	-35,0%	5,6%	35,8%

Source: Bloomberg Finance L.P. Data as of May 10, 2024.

Glossary

BTP (Buoni del Tesoro Poliennali) are Italian government bonds.

Bunds are longer-term bonds issued by the German government.

The CAC 40 is a price index, which includes the 40 most valuable French companies that trade on the Euronext Paris exchange.

The consumer price index (CPI) measures the price of a basket of products and services that is based on the typical consumption of a private household.

The DAX is a blue-chip stock-market index consisting of the 40 major German companies trading on the Frankfurt Stock Exchange; other DAX indices include a wider range of firms.

Earnings per share (EPS) are calculated as a companies' net income minus dividends of preferred stock all divided by the total number of shares outstanding.

The Economic and Financial Document (DEF) sets out the public finance and economic strategies for the mid-term.

EUR is the currency code for the euro, the currency of the Eurozone.

The European Central Bank (ECB) is the central bank for the Eurozone.

The European Commission (EC) is the executive body of the European Union (EU) representing the interests of the European Union as a whole.

The EuroStoxx 50 Index tracks the performance of blue-chip stocks in the Eurozone; the Stoxx Europe 600 has a wider scope, taking in 600 companies across 20 European Union countries.

The Eurozone is formed of 20 European Union member states that have adopted the euro as their common currency and sole legal tender.

The Excessive deficit procedure (EDP) is an action launched by the European Commission against any European Union (EU) Member State that exceeds the budgetary deficit ceiling imposed by the EU's Stability and growth pact legislation.

Fitch Ratings is a credit rating agency.

The FTSE MIB Index includes the 40 most trade stocks on the Italian national stock exchange.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

The IBEX 35 is the benchmark stock market index of the Bolsa de Madrid, Spain's principal stock exchange.

The International Monetary Fund (IMF) was founded in 1994, includes 189 countries and works to promote international monetary cooperation, exchange rate stability and economic development more broadly.

Moody's is a rating agency.

Morningstar Rating is a credit rating agency.

The National Recovery and Resilience Plan (NRRP) is the instrument which using Next Generation Europe funds will make Italy more equitable, sustainable and inclusive

NextGenerationEU is a temporary recovery instrument to support Europe's economic recovery from the coronavirus pandemic and build a greener, more digital and more resilient future.

NTM stands for next twelve months in the context of earnings and thus price/earnings ratios.

The ECB's Pandemic Emergency Purchase Programme (PEPP) is a temporary asset purchase programme introduced in march 2020 of private and public sector securities in order to counter the serious risks to the monetary policy transmission mechanism and the outlook for the euro area posed by COVID-19 outbreak

Price/earnings (P/E) ratios measure a company's current share price relative to its per-share earnings. In this context, LTM refers to last twelve months' earnings.

Purchasing manager indices (PMI) provide an indicator of the economic health of the manufacturing sector and are based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. The composite PMI includes both manufacturing and services sectors. They can be published by public sector or private agencies (e.g. Caixin, Nikkei).

A spread is the difference in the quoted return on two investments, most commonly used in comparing bond yields.

Standard and Poor's (S&P) is U.S. financial services company, providing research and ratings.

The Transmission Protection Instrument (TPI) supports the effective transmission of monetary policy and ensure that the monetary policy stance is transmitted smoothly across all euro area countries.

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