



Italy on a narrow path

Marco Bertotti

MMCG Member

Chiara Manenti

Fixed Income Research Team

Macroeconomic Analysis

Research Dept.

Italy: key events until end-2018

- 26 September: 6M BOT auction
- 27 September: 5Y BTP, 10Y BTP & CCT auctions
- **27 September: update of the Stability Programme (DEF) with new public finance targets**
- 10 October: 12M BOT auction
- 11 October: 3Y BTP, 7Y BTP & >10Y BTP auctions
- **15-20 October: 2019 Budget Law submitted to EU Commission**
- 26 October : 2Y CTZ & BTPei auctions
- **26 October: rating review by S&P (BBB/ stable outlook)**
- **26 October: rating review by Moody's (Baa2/ negative rating watch)**
- 29 October: 6M BOTs auction
- 30 October: 5Y BTP, 10Y BTP & CCT auctions
- **30 October: 3Q18 GDP preliminary data**
- 12 November: 12M BOT auction
- 13 November: 3Y BTP, 7Y BTP & >10Y BTP auctions
- 27 November: 2Y CTZ & BTPei auctions
- 28 November: 6M BOT auction
- 29 November: 5Y BTP, 10Y BTP & CCT auctions
- **End-November: EU.Comm assessment of 2019 Budget**
- 12 December: 12M BOT auction
- 27 December: 6M BOT & 2Y CTZ auctions
- 28 December: 5Y BTP, 10Y BTP & CCT auctions
- **By 31 December: 2019 Budget Law approval**

Economic and Financial Document 2018 (April 2018)

	2016	2017	2018	2019	2020	2021
General Govt Borrowing Requirement	2.5%	2.3%	1.6%	0.8%	0.0%	-0.2%
EUR Bn	42	40	28	15	0	-4
State Sector Borrowing Requirement	3.4%	3.0%	2.7%	1.6%	0.7%	0.6%
EUR Bn	56	52	47	29	14	11
Public Debt	132.0%	131.8%	130.8%	128.0%	124.7%	122.0%
EUR Bn	2,219	2,263	2,310	2,333	2,342	2,353
Public Debt net loans & EFSF	128.6%	128.4%	127.5%	124.8%	121.6%	119.0%
EUR Bn	2,162	2,205	2,252	2,275	2,284	2,295
Interest expenditure (cash basis)	3.9%	3.8%	3.5%	3.5%	3.5%	3.5%
EUR Bn	66	65	62	64	66	68
Primary balance	1.5%	1.5%	1.9%	2.7%	3.5%	3.7%
EUR Bn	26	26	34	49	66	71
Privatisation	0.1%	0.0%	0.3%	0.3%	0.3%	na
Real GDP %	0.9%	1.5%	1.5%	1.4%	1.3%	1.2%
GDP Deflator %	0.8%	0.6%	1.3%	1.8%	1.7%	1.5%

Source: Ministero dell'Economia e delle Finanze, Intesa Sanpaolo

2019 budget close to «lower growth scenario» of DEF

- Compared to when the DEF was published, macroeconomic and financial market developments have restored the overall outlook very close to what the in DEF itself was defined as a “slow growth scenario”, namely a scenario in which GDP grows at a pace 0.5% slower than potential, and interest rates are higher by 100bps.
- Based on the sensitivity analysis run on public finance balances, the slow growth scenario outlines a worsening of the deficit by 0.2% of GDP in 2018 and by 0.7% in 2019 (table below), as well as a worsening of the debt/GDP ratio by over one per cent of GDP in 2018, and by almost three per cent in 2019 compared to the targets. In actual fact, the impact on public balances could be even stronger than indicated by the MEF’s analysis, as the 10Y forward rates currently priced in by the market for the end of 2019 are higher by around 100bps than they were last April, whereas on the 2Y segment, forward rates are higher by a hefty 220bps.
- In conclusion, the new scenario under unchanged legislation should include an increase in deficit from 1.6% to 1.8% of GDP this year, and from 0.8% to 1.5% of GDP in 2019. Debt should be up from 130.8% to 132% of GDP in 2018, and subsequently decline to 130.9% of GDP in 2019, compared to a previous target of 128%.

Economic and Financial Document 2018 (April 2018)(% PIL)

		2018	2019	2020	2021
Real GDP	Baseline scenario	1.5	1.4	1.3	1.2
	Low-growth scenario	1.1	0.9	0.8	0.7
General Govt Deficit	Baseline scenario	1.6	0.8	0.0	-0.2
	Low-growth scenario	1.8	1.5	1.3	1.5
Structural Deficit	Baseline scenario	0.9	0.4	-0.1	-0.1
	Low-growth scenario	1.0	0.9	0.9	1.2
Public Debt	Baseline scenario	130.8	128.0	124.7	122.0
	Low-growth scenario	132.0	130.9	129.5	128.9

- If, as announced by members of the government in recent interviews, the deficit target for next year is kept below 2%, the government’s new expansionary measures will have to be entirely financed with saving measures/spending cuts.
- All the above is also based on the assumption that around 12.5 billion euros in additional revenue will be generated by the VAT hikes.

Source: Ministero dell’Economia e delle Finanze, Intesa Sanpaolo

Refinancing risk is limited in the next months...

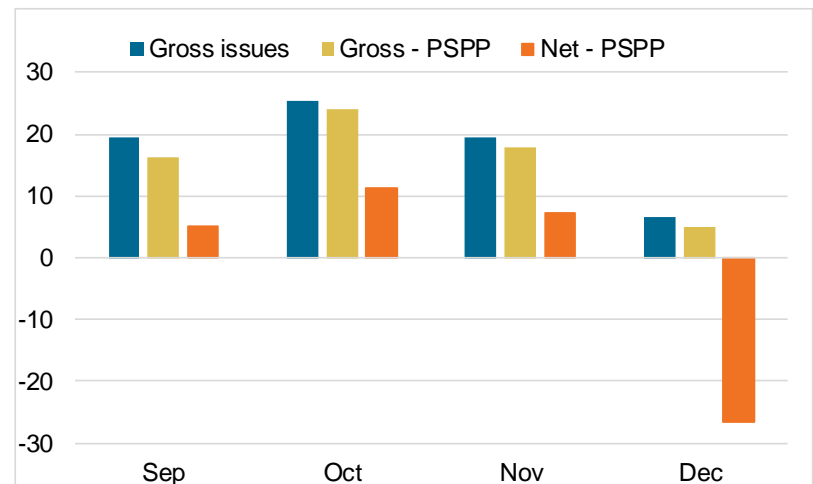
Remaining gross issuance expected in 2018
(EUR Bn)

	Sep	Oct	Nov	Dec	Total
BOTs	13.0	13.0	10.8	4.3	150
CTZs	2.5	3.0	2.0	-	28
CCTs	1.8	2.0	3.5	2.0	27
BTPs	12.5	9.8	11.3	4.5	153
of which					
3 yr	1.5	2.0	3.5	-	29
5 yr	3.8	2.0	2.5	2.0	31
7 yr	4.0	2.0	2.0	-	30
10 yr	2.3	2.5	2.5	2.5	36
15 yr	1.0	0.8	-	-	6
20 yr	-	0.5	-	-	12
30 yr	-	-	0.8	-	7
≥50 yr	-	-	-	-	1
BTP inflation	1.5	4.0	1.0	-	27
Eurobonds	-	-	-	-	-
TOTAL	31	32	29	11	384

Source: Bloomberg, Intesa Sanpaolo

- In the last four months of the year, ECB purchases may continue to offer support to the market: according to our estimates, ECB purchases of Italian government bonds will amount, between September and December, to around 8 bn/eur with respect of 5 bn/eur net issuance.
- So net issuance net of ECB purchases will be negative by 3 bn/eur across the 4 mths

Italy: 2018 issuance ex BOTs (EUR Bn)



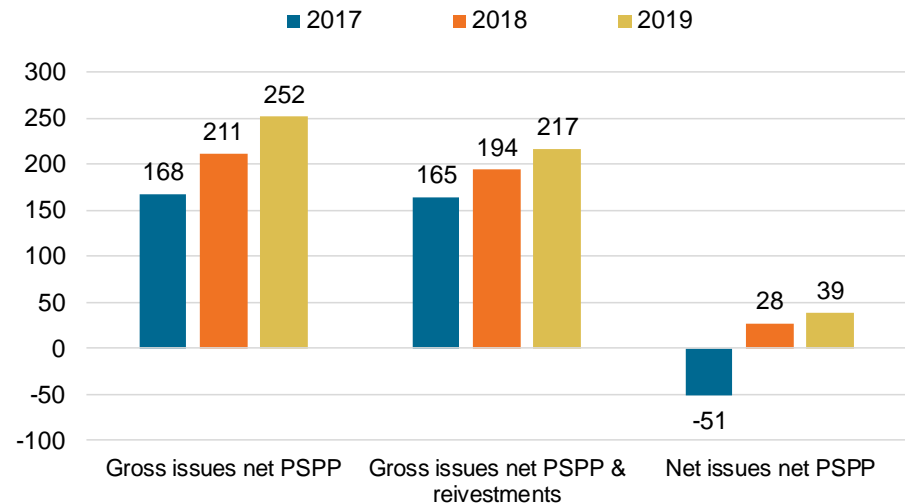
Source: Bloomberg, Intesa Sanpaolo

... but will be challenging in 2019

2019 Issuance (EUR Bn, ISP forecast*)

	1Q	2Q	3Q	4Q	Total
Redemptions	87	76	97	100	360
BOTs	40	37	39	33	147
CTZs	0	11	0	25	36
CCTs	0	0	0	13	13
BTPs	48	28	39	29	144
BTP inflation	0	0	17	0	17
Eurobonds	0	1	2	0	3
Gross Issuance	127	98	93	83	400
BOTs	46	37	37	29	149
CTZs	12	7	8	5	31
CCTs	7	8	6	10	31
BTPs	57	37	32	35	159
BTP inflation	6	10	11	4	31
Eurobonds	0	0	0	0	0
Net Issuance	40	21	-3	-18	40
BOTs	7	0	-2	-4	1
CTZs	12	-4	8	-20	-5
CCTs	7	8	6	-3	18
BTPs	9	9	-7	5	15
BTP inflation	6	10	-6	4	14
Eurobonds	0	-1	-2	0	-3

Issuance net of ECB purchases and reinvestments (EUR Bn, ISP forecast)



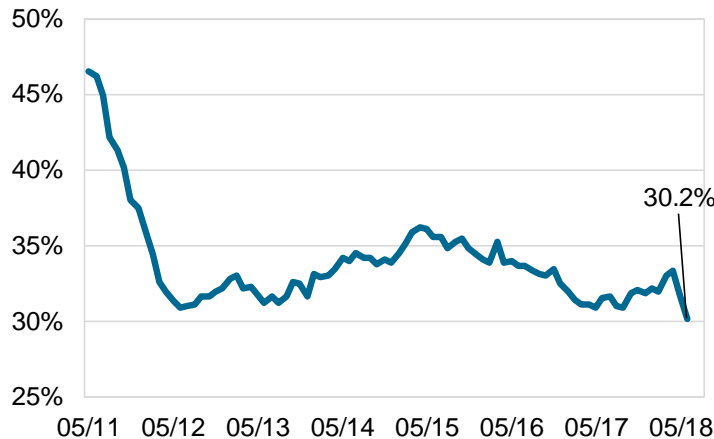
- In 2019, medium and long-term bond maturities will increase by around 29 bn/eur compared to this year and gross issuance are expected to increase to EUR 400 bn/eur, from 380bn/eur estimated in 2018.
- BTP's expected net issuance should be close to 30 bn/eur, of which 15 bn/eur of nominal BTPs and 14 bn/eur of inflation-linked BTPs.

(*) Assuming a State Sector borrowing requirements of around 50 billion euros.

Fonte: Bloomberg, Intesa Sanpaolo

Foreign investors important for refinancing in 2019

Italian government bonds held by the foreign sector % of total outstanding amount



Source: Bank of Italy, Bloomberg, Intesa Sanpaolo

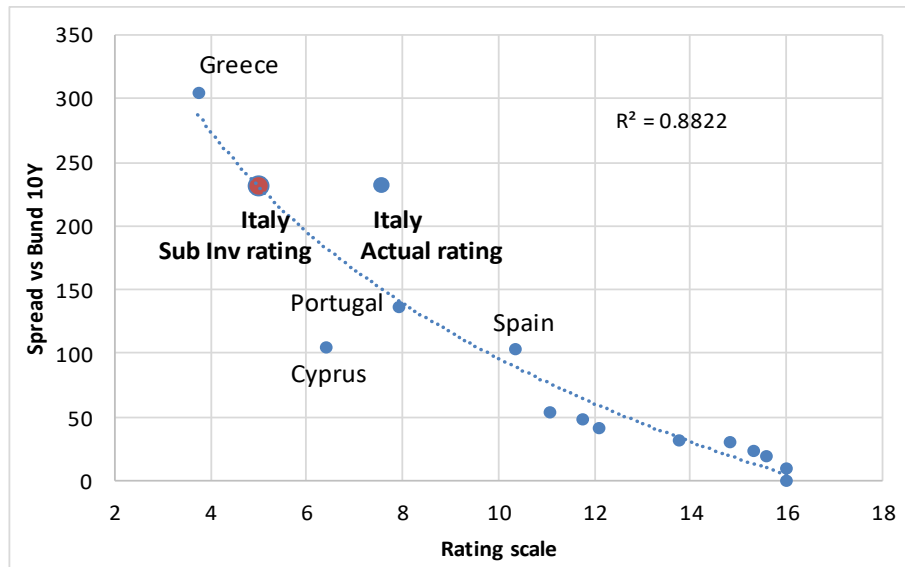
Italian Government bonds by holder

	Amount EUR Bn	% tot.
Bank of Italy	380	19%
ECB	70	4%
MFIs	387	20%
Other fin. intermediaries	444	23%
Households	93	5%
Foreign sector	490	25%
Foreign investment funds attributable to Italian investors	105	5%
Total	1969	100%

Source: Bank of Italy, Bloomberg, Intesa Sanpaolo

- Italian banks and monetary funds, together with insurance companies, will keep decreasing the share of government bonds in their portfolios and reducing the home bias in light of possible regulatory changes.
- In the past few years, Italian households have gone from being direct holders of government bonds to indirect holders via shares in mutual funds and other forms of asset management, in line with the behaviour of other Eurozone partners, and this trend is unlikely to reverse, even in a context of increasing yields.
- Since the launching of the PSPP, foreign investors have reduced their portfolios of Italian government bonds by 66 billion euros. Based on our estimates, the share of debt held abroad, excluding the Eurosystem, decreased to 30.2% of the total outstanding at the end of June 2018 from a 33.3% high in April (see chart). Of this share around 5% is held by foreign investment funds attributable to Italian investors, therefore the share of debt held abroad would be of close to 25%, a very low level with respect to pre-crisis situation.
- It is hard to forecast the evolution of demand for Italian government bonds generated by the foreign sector, as the latter includes very diverse investor types, guided by different investment logics

BTP-Bund spread prices in a downgrade to sub-inv

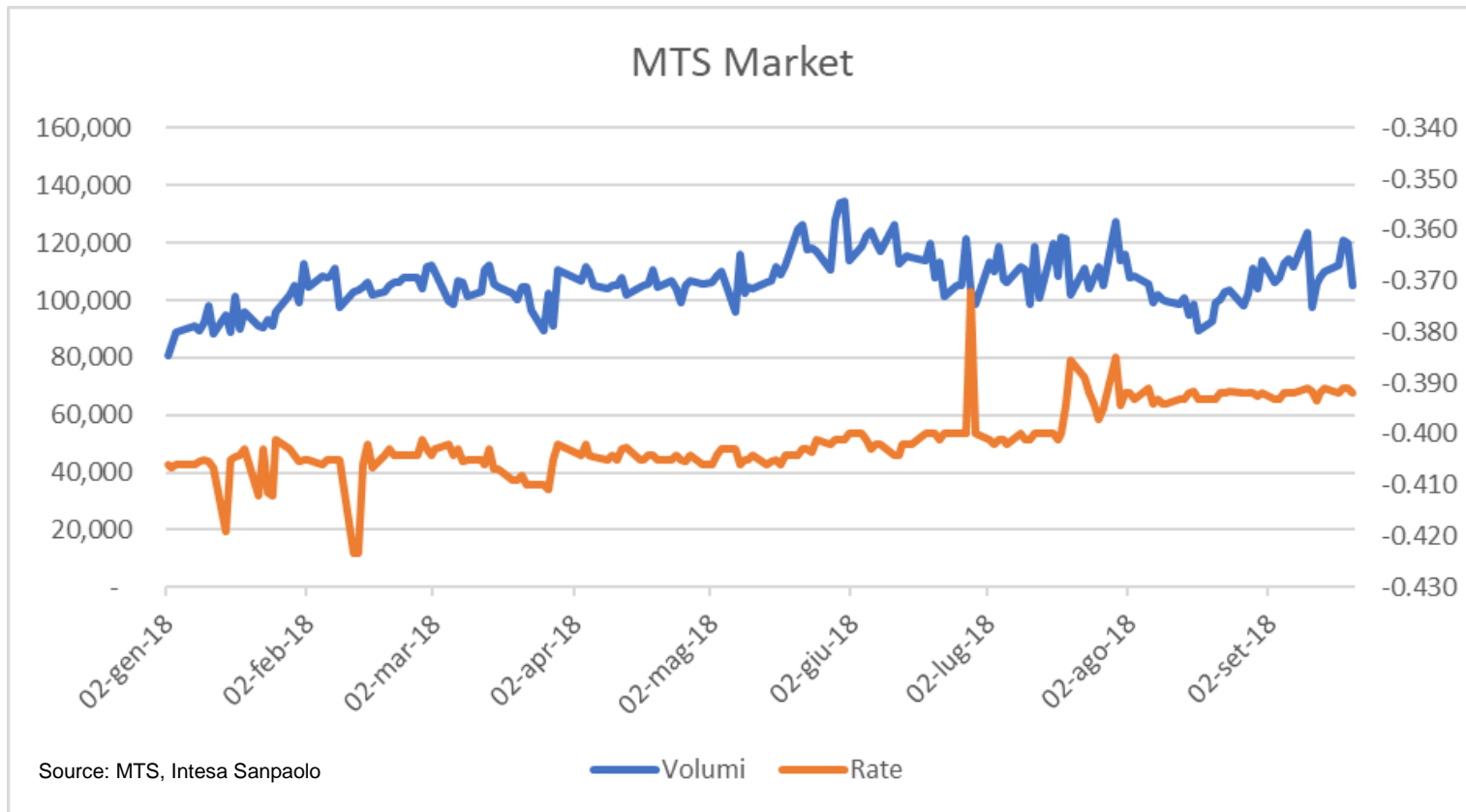


- Based on the simple relation between the government bond spreads and the rating scale, at current prices BTPs are already trading at sub-investment levels.

EMU credit ratings	MOODYS	S&P	FITCH	DBRS				
Austria	Aa1	STABLE	AA+	STABLE	AA+	POS	AAA	STABLE
Belgium	Aa3	STABLE	AA	STABLE	AA-	STABLE	AAH	STABLE
Finland	Aa1	STABLE	AA+	STABLE	AA+	POS	AAH	STABLE
France	Aa2	POS	AA	STABLE	AA	STABLE	AAA	STABLE
Germany	Aaa	STABLE	AAA	STABLE	AAA	STABLE	AAA	STABLE
Greece	B3	POS	B+	POS	BB-	STABLE	BH	POS
Ireland	A2	STABLE	A+	STABLE	A+	STABLE	AH	STABLE
Italy	Baa2	NEG	BBB	STABLE	BBB	NEG	BBBH	STABLE
Luxembourg	Aaa	STABLE	AAA	STABLE	AAA	STABLE	AAA	STABLE
Netherlands	Aaa	STABLE	AAA	STABLE	AAA	STABLE	AAA	STABLE
Portugal	Ba1	POS	BBB-	POS	BBB	STABLE	BBB	STABLE
Spain	Baa1	STABLE	A-	POS	A-	STABLE	A	STABLE
Slovakia	A2	POS	A+	STABLE	A+	STABLE	AH	STABLE
Slovenia	Baa1	STABLE	A+	POS	A-	STABLE	AH	STABLE
Cyprus	Ba2	STABLE	BBB-	STABLE	BB+	POS	BB	POS
Malta	A3	POS	A-	POS	A+	STABLE	AH	STABLE

Fonte: Bloomberg, Intesa Sanpaolo

MTS Market: volumes and rates show stability



Analyst Certification

The financial analysts who prepared this report, and whose names and roles appear on the first page, certify that:

- (1) The views expressed on companies mentioned herein accurately reflect independent, fair and balanced personal views;
- (2) No direct or indirect compensation has been or will be received in exchange for any views expressed.

Specific disclosures

The analysts who prepared this report do not receive bonuses, salaries, or any other form of compensation that is based upon specific investment banking transactions.

Important Disclosures

This research has been prepared by Intesa Sanpaolo S.p.A. and distributed by Banca IMI S.p.A. Milan, Banca IMI SpA-London Branch (a member of the London Stock Exchange) and Banca IMI Securities Corp (a member of the NYSE and FINRA). Intesa Sanpaolo S.p.A. accepts full responsibility for the contents of this report. Please also note that Intesa Sanpaolo S.p.A. reserves the right to issue this document to its own clients. Banca IMI S.p.A. and Intesa Sanpaolo S.p.A. are both part of the Gruppo Intesa Sanpaolo. Intesa Sanpaolo S.p.A. and Banca IMI S.p.A. are both authorised by the Banca d'Italia, are both regulated by the FCA in the conduct of designated investment business in the UK and by the SEC for the conduct of US business.

Opinions and estimates in this research are as at the date of this material and are subject to change without notice to the recipient. Information and opinions have been obtained from sources believed to be reliable, but no representation or warranty is made as to their accuracy or correctness.

Past performance is not a guarantee of future results.

The investments and strategies discussed in this research may not be suitable for all investors. If you are in any doubt you should consult your investment advisor.

This report has been prepared solely for information purposes and is not intended as an offer or solicitation with respect to the purchase or sale of any financial products. It should not be regarded as a substitute for the exercise of the recipient's own judgement.

No Intesa Sanpaolo S.p.A. or Banca IMI S.p.A. entities accept any liability whatsoever for any direct, consequential or indirect loss arising from any use of material contained in this report.

This document may only be reproduced or published together with the name of Intesa Sanpaolo S.p.A. and Banca IMI S.p.A..

Intesa Sanpaolo SpA and Banca IMI SpA have in place the Conflicts of Interest Management Rules for managing effectively the conflicts of interest which might affect the impartiality of all investment research which is held out, or where it is reasonable for the user to rely on the research, as being an impartial assessment of the value or prospects of its subject matter. A copy of these Rules is available to the recipient of this research upon making a written request to the Compliance Officer, Intesa Sanpaolo SpA, C.so Matteotti n° 1, 20121 Milan (MI) Italy.

Intesa Sanpaolo SpA has formalised a set of principles and procedures for dealing with conflicts of interest ("Rules for Research"). The Rules for Research is clearly explained in the relevant section of Intesa Sanpaolo's web site (www.intesasnpaolo.com).

Member companies of the Intesa Sanpaolo Group, or their directors and/or representatives and/or employees and/or persons closely associated with them, may have a long or short position in any securities mentioned at any time, and may make a purchase and/or sale, or offer to make a purchase and/or sale, of any of the securities from time to time in the open market or otherwise.

Intesa Sanpaolo S.p.A. issues and circulates research to Major Institutional Investors in the USA only through Banca IMI Securities Corp., 1 William Street, New York, NY 10004, USA, Tel: (1) 212 326 1199.

Disclosure 2/3

Residents in Italy: This document is intended for distribution only to professional clients and qualified counterparties as defined in Consob Regulation no. 20307 of 15.02.2018, as subsequently amended and supplemented, either as a printed document and/or in electronic form.

Person and residents in the UK: This document is not for distribution in the United Kingdom to persons who would be defined as private customers under rules of the FCA.

US persons: This document is intended for distribution in the United States only to Major US Institutional Investors as defined in SEC Rule 15a-6. US Customers wishing to effect a transaction should do so only by contacting a representative at Banca IMI Securities Corp. in the US (see contact details above).

This document is for the exclusive use of the person to whom it is delivered by Banca IMI and Intesa Sanpaolo and may not be reproduced, redistributed, directly or indirectly, to third parties or published, in whole or in part, for any reason, without prior consent expressed by Banca IMI and/or Intesa Sanpaolo.

The copyright and all other intellectual property rights on the data, information, opinions and assessments referred to in this information document are the exclusive domain of the Intesa Sanpaolo banking group, unless otherwise indicated. Such data, information, opinions and assessments cannot be the subject of further distribution or reproduction in any form and using any technique, even partially, except with express written consent by Banca IMI and/or Intesa Sanpaolo.

Persons who receive this document are obliged to comply with the above indications.

Valuation Methodology

Trading Ideas are based on the market's expectations, investors' positioning and technical, quantitative or qualitative aspects. They take into account the key macro and market events and to what extent they have already been discounted in yields and/or market spreads. They are also based on events which are expected to affect the market trend in terms of yields and/or spreads in the short-medium term. The Trading Ideas may refer to both cash and derivative instruments and indicate a precise target or yield range or a yield spread between different market curves or different maturities on the same curve. The relative valuations may be in terms of yield, asset swap spreads or benchmark spreads.

Coverage Policy And Frequency Of Research Reports

Intesa Sanpaolo S.p.A. trading ideas are made in both a very short time horizon (the current day or subsequent days) or in a horizon ranging from one week to three months, in conjunction with any exceptional event that affects the issuer's operations.

In the case of a short note, we advise investors to refer to the most recent report published by Intesa Sanpaolo S.p.A's Research Department for a full analysis of valuation methodology, earnings assumptions and risks. Research is available on IMI's web site (www.bancaimi.com) or by contacting your sales representative.

Disclosure 3/3

Disclosure of potential conflicts of interest

Intesa Sanpaolo S.p.A. and the other companies belonging to the Intesa Sanpaolo Banking Group (jointly also the “Intesa Sanpaolo Banking Group”) have adopted written guidelines “Modello di Organizzazione, Gestione e Controllo” pursuant to Legislative Decree 8 June, 2001 no. 231 (available at the Intesa Sanpaolo website, webpage http://www.group.intesasanpaolo.com/scripts/sir0/si09/governance/eng_wp_governance.jsp, along with a summary sheet, webpage <https://www.bancaimi.com/en/bancaimi/chisiamo/documentazione/normative>) setting forth practices and procedures, in accordance with applicable regulations by the competent Italian authorities and best international practice, including those known as Information Barriers, to restrict the flow of information, namely inside and/or confidential information, to prevent the misuse of such information and to prevent any conflicts of interest arising from the many activities of the Intesa Sanpaolo Banking Group which may adversely affect the interests of the customer in accordance with current regulations.

In particular, the description of the measures taken to manage interest and conflicts of interest – related to Articles 5 and 6 of the Commission Delegated Regulation (EU) 2016/958 of 9 March 2016 supplementing Regulation (EU) No 596/2014 of the European Parliament and of the Council with regard to regulatory technical standards for the technical arrangements for objective presentation of investment recommendations or other information recommending or suggesting an investment strategy and for disclosure of particular interests or indications of conflicts of interest as subsequently amended and supplemented, Article 24 of Regulation on the Organisation and Procedures of Intermediaries providing investment services or collective portfolio management jointly adopted by the Bank of Italy and Consob, FINRA Rule 2241 and NYSE Rule 472, as well as the FCA Conduct of Business Sourcebook rules COBS 12.4 - between the Intesa Sanpaolo Banking Group and issuers of financial instruments, and their group companies, and referred to in research products produced by analysts at Intesa Sanpaolo S.p.A. is available in the "Rules for Research " and in the extract of the "Corporate model on the management of inside information and conflicts of interest" published on the website of Intesa Sanpaolo S.p.A.

At the Intesa Sanpaolo website, webpage http://www.group.intesasanpaolo.com/scripts/sir0/si09/studi/eng_archivio_conflitti_mad.jsp you can find the archive of disclosure of interests or conflicts of interest of the Intesa Sanpaolo Banking Group in compliance with the applicable laws and regulations.

Furthermore, in accordance with the aforesaid regulations, the disclosures of the Intesa Sanpaolo Banking Group’s interests and conflicts of interest are available through the above mentioned webpage. The conflicts of interest published on the internet site are updated to at least the day before the publishing date of this report.

We highlight that disclosures are also available to the recipient of this report upon making a written request to Intesa Sanpaolo S.p.A. – Macroeconomic and Fixed Income Research, Via Romagnosi, 5 - 20121 Milan - Italy.

Banca IMI S.p.A., one of the companies belonging to the Intesa Sanpaolo Banking Group, acts as market maker in the wholesale markets for the government securities of the main European countries and also acts as Government Bond Specialist, or in comparable roles, for the government securities issued by the Republic of Italy, by the Federal Republic of Germany, by the Hellenic Republic, by the European Stability Mechanism and by the European Financial Stability Facility.