Political noise remains an issue on the euro area’s southern periphery. While there are no general elections scheduled either in Spain or in Italy in 2022, the presidential election in Italy, scheduled to commence on 24 January, is receiving unusual attention. The outcome of the election is highly uncertain, but it could trigger considerable friction since one of the contenders is the current prime minister, Mario Draghi. While his election to the presidency may ensure institutional stability, it could also cause ructions within the fragile coalition that currently governs Italy.

Although the probability of snap elections, the worst-case scenario for markets, was pretty low at the time of writing, such an eventuality has started to be priced in by market participants, with the 10-year Italian sovereign bond spread vs. the Bund widening from a low of 98 bps (on 24 September) to 132 bps (on 17 January). Early elections could push 10-year Italian spread further up towards 160 bps. They might even go higher, but we would not expect spreads to move above 200 bps.

The most likely scenarios in our view are for the 10-year spread to tighten towards 110-120 bps by mid-year before moving up slightly towards 130-140 bps by the end of 2022, either because Draghi stays on as prime minister or because one of his senior ministers takes over, thereby ensuring reforms continue.

The second half of 2021 brought an unexpected upgrade of Italy’s sovereign rating by Fitch Ratings from BBB- to BBB and an upgrade to its ratings outlook from stable to positive by S&P Global. The structural reforms being undertaken by the Italian government in return for sizeable EU funds (as part of the Next Generation EU (NGEU) package) are seen as beneficial to Italy’s growth outlook, leading rating agencies to expect a faster reduction in its debt-to-GDP ratio. Ratings agencies could further upgrade Italy’s prospects this year. By contrast, we do not exclude S&P Global downgrading Spain by one notch to A- in its upcoming Spring review of the country’s sovereign rating.

Political noise is always around the corner

Italy and Spain were two of the countries worst hit by the pandemic in 2020, with output falling by 9% and 10.8%, respectively. But the recovery in Italy was strong in 2021, with the appointment of Mario Draghi as prime minister in February 2021 helping to restore consumer and business sentiment, as well as investor confidence. Draghi managed to build a broad cohesion in parliament to agree on a well-received national recovery plan, which paved the way for Italy to start to receive almost €200 bn under the Next Generation EU recovery fund. In Spain, the recovery was more disappointing last year, dragged down by only a partial recovery in tourism, together with weak consumer spending and construction activity. This winter will be tough for both Italy and Spain, but we expect economic activity to rebound in Q2 as covid restrictions are gradually removed.
While general elections are scheduled neither in Spain nor in Italy in 2022, politics is centre stage in both places, particularly in Italy, where the election for the next president of the Republic is about to take place. The event has the potential to trigger considerable friction since one of the contenders is the current prime minister, Mario Draghi. While his election as president could inject stability into Italian institutions, it could also cause some short-term instability within the fractious governing coalition.

The Italian president is elected by parliament and regional parliamentary representatives. In accordance with the Italian Constitution, the ballot is secret, with 321 Senators, 630 Deputies and 58 regional representatives making up a constituency of 1,009 voters in total. Each of the 20 regions will have three representatives except for the Aosta Valley, which will only have one. Voting takes place in rounds. In the first three ballots a candidate must obtain at least two-thirds (673) of the total votes to win the contest outright. If no winner emerges, a simple majority of 505 votes is enough to win from the fourth round on. Voting continues until someone is elected. The first round will take place on 24 January and there will be probably one vote in parliament per day.

The fact that the ballot for the presidential election is secret (which limits party discipline) makes it extremely difficult to call the winner in advance.

While political formations in Italy are still mulling their strategy towards the presidential election, we see three main scenarios, each with a different impact on Italian bond spreads.

<table>
<thead>
<tr>
<th>Short-term scenarios for the Italian presidential election</th>
<th>Likelihood</th>
<th>10-year BTP-Bund spread (bps)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Best</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Another president is elected and Draghi remains prime minister</td>
<td>Likely</td>
<td>110-130</td>
</tr>
<tr>
<td>Mario Draghi becomes president and a new prime minister is appointed to take his place</td>
<td>Most likely</td>
<td>120-140</td>
</tr>
<tr>
<td>Worst</td>
<td>Less likely</td>
<td>160-200</td>
</tr>
<tr>
<td>Mario Draghi becomes president and snap elections are called</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: PWM - AA&MR, own calculations, 14.01.2022

1) Mario Draghi becomes president and snap elections are called

If Draghi is elected and there is no consensus on a new prime minister to replace him, parliament will be dissolved, and an early general election will be called.

This development would probably mark the return of political instability to Italy and has already started to be priced in by market participants. The 10-year Italian sovereign bond spread vs. the Bund widened from a low of 98 bps (on 24 September) to 132 bps (on 17 January). Although the 10-year spread level remains low by historical standards, it is higher than the recent post-pandemic average of 105 bps (between January and October 2021).

The holding of snap elections could potentially push 10-year Italian spread further up towards 160 bps. It might even go higher, but we would not expect it to shoot up above 200 bps. The Italian political landscape is highly fragmented, with either centre left or a
right-wing coalition just as likely to emerge from fresh elections. A far-right coalition made up of the Brothers of Italy and the League would be the most negative scenario for Italian sovereign bonds (BTPs) as these parties’ eurosceptic stance and the chance such a coalition would adopt a looser fiscal position and slow down structural reforms would not bode well for Italy’s debt trajectory. We could even see spreads pushed more durably above 160 bps, although we think spreads over Bunds would remain below than the average of 248 bps seen between May 2018 and August 2019 when the populist 5Star Movement and the League were in power together.

Early elections cannot be ruled out, but remain unlikely, in our view. With the exception maybe of Brothers of Italy, no political party is in favour of them, especially as some parties have been losing momentum in opinion polls. For example, even though 5Star is the largest group in Parliament with almost 25% of total seats, polls show it enjoys less than 15% of support among voters. In addition, the number of parliamentary seats will be drastically cut at the next election (from 945 to 600), so many parliamentarians will lose their jobs.

2) Mario Draghi becomes president and a new prime minister is appointed to take his place

If Draghi were elected president, he would probably try to give the mandate to form a new government to one of the senior ministers in the current cabinet—although a new government would still need approval from parliament and the risk of early elections could not be dismissed.

The level of support a new government without Draghi at its head would enjoy remains to be seen. Hence, we would not expect Italian sovereign bond spreads vs. the Bund to tighten significantly. Our forecast in this scenario would be a spread of 120 bps for mid-year and 140 bps for end-2022.

3) Another president is elected and Draghi remains prime minister

Electing somebody else as president of the republic with Draghi staying on as prime minister until the general election scheduled for the first half of 2023 would avoid political and market volatility in the short run and provide respite for BTPs. Moreover, it would give more time to the current government to implement planned structural reforms, thereby increasing the chance that Italy receives its full quota of NGEU funds. We would expect the 10-year spread to tighten towards 110 bps by mid-2022 in this scenario before moving up slightly towards 130 bps by the end of this year as scheduled elections approach (see chart 1).

Among the three possible scenarios, in our view early elections remains the least likely at this stage, although speculation will keep the BTP market agitated in the coming weeks. As we await more clarity, we prefer to remain cautious in the short term, with an underweight stance on euro periphery sovereign bonds overall.
**EURO PERIPHERY SOVEREIGN BONDS 2022 OUTLOOK**

**POLITICS AT A CROSSROADS**

**DEBT SUSTAINABILITY REMAINS KEY IN THE POST-PANDEMIC WORLD**

Beyond short-term volatility triggered by politics, bond investors will also look at the debt trajectory in euro periphery countries, which is determined by macroeconomic fundamentals. Both Spain and Italy experienced significant rises in their debt-to-GDP ratios during the pandemic, with ratios reaching 120% and 155%, respectively, in 2020 (see chart 2). Both countries pushed through large scale fiscal stimulus to counter the impact of covid restrictions, especially Italy.

**CHART 2: ITALY AND SPAIN – DEBT TO GDP RATIO**

Arithmetically, a country’s debt-to-GDP ratio is governed by three key variables: the primary balance as a percentage of GDP, the average cost of debt and the GDP growth rate (interest rates on government debt and the nominal growth rate are often used as a proxy for the latter two, see Appendix for the formula). If nominal growth exceeds the
nominal cost of funding, countries can run a primary deficit while keeping the debt ratio constant.

For several years, European Central Bank (ECB) monetary policy has helped keep borrowing costs low. More recently, its Pandemic emergency purchase programme (PEPP), introduced shortly after covid first hit Europe, has been key to dramatically reducing funding rates. The PEPP is set to terminate in March, but the ECB has announced a temporary increase in its more conventional Asset Purchase Programme (APP) from €20bn to €40bn per month in Q2 2022 (a figure set to be reduced to €30bn in Q3 and back to €20bn in Q4).

The net supply of euro area government bonds (excluding short-term bills) is expected to fall in 2022 as governments continue to reduce their pandemic-related policy support, but it is likely to fall less than ECB purchases. As such, after two consecutive years of negative supply to market participants, net supply of euro government bonds less ECB purchases should grow again this year (see chart 3). However, with the exception of France, the increase is likely to remain small. Along with the ECB’s firm commitment to avoid “market fragmentation related to the pandemic”, this means we do not expect the reduction in the central bank’s purchases to have a meaningful impact on sovereign bond spreads. In this context, we note the ECB’s willingness to be gradual in moving away from easy monetary policies.

Economic growth is even more important. Growth prospects have improved, particularly in Italy, which is good news from a debt sustainability perspective. The NGEU fund will be key to further boosting underlying growth prospects and improving debt sustainability.

Rating agencies recognise reform drive and improved growth prospects

The second half of 2021 saw an unexpected upgrade of Italy’s rating by Fitch Ratings from BBB- to BBB and an upgrade of Italy’s rating outlook from stable to positive by S&P Global (see chart 4, and Appendix). Country reports from the three main rating agencies (Fitch Rating, S&P Global and Moody’s) all make the same observations. Structural reforms carried out in exchange for NGEU funds are seen as beneficial to Italy’s growth outlook, with Fitch revising up Italy’s growth potential by 0.2 pp to 0.6% per annum until 2025. As explained, economic growth is key for countries’ debt sustainability, and potentially stronger growth in Italy is leading rating agencies to expect a faster reduction in its debt-to-GDP ratio.

Although Fitch has been the first to upgrade Italy’s rating since 2002, S&P Global’s decision to upgrade the country’s credit outlook leads us to anticipate an upgrade to its sovereign rating of Italy from BBB to BBB+ (although this is more likely in H2 than during its scheduled ratings review this Spring). An upgrade would be conditional on the thorough implementation of structural reforms and the full receipt of NGEU funds to which they are linked. The same is true for Moody’s, although the latter would probably first decide to upgrade Italy’s credit outlook at its upcoming review (see Appendix) before acting on the rating.

The emphasis all three rating agencies place on structural reforms highlights the importance of keeping the current Italian government in place (with or without Draghi) and having it concentrate on structural reforms rather than snap elections. The further
away Italy’s rating moves from high-yield status (BB+ and lower), the more resilient BTP spreads will be to the next downturn (see chart 4). Fears about rating downgrades sent Italian spreads sharply wider in April 2020, near the start of the pandemic. In the end, only Fitch downgraded Italy, while S&P Global and Moody’s waited to see if the ECB and EU policies could attenuate the pandemic’s negative effects on Italy’s debt sustainability. Luckily, it seems this was the case.

As in Italy, in Spain politics is complicating the implementation of structural reforms with the Socialist-led government lacking a parliamentary majority to push through some proposals. As explained in our 2022 outlook for Spain, Spain’s post-pandemic recovery has been lagging Italy’s, and although it could catch up, the risks are tilted to the downside. We cannot exclude the possibility that S&P Global will downgrade Spain’s sovereign rating by one notch to A- in its upcoming review (see Appendix). But unlike Italy’s, Spain’s sovereign rating is well inside investment-grade territory, meaning that market participants are unlikely to care much unless its debt sustainability deteriorates because a lack of reforms lowers Spain’s GDP growth potential.
EURO PERIPHERY SOVEREIGN BONDS 2022 OUTLOOK
POLITICS AT A CROSSROADS

APPENDIX

Debt ratio equations:

\[ d_t = \frac{1 + i}{1 + g} \cdot d_{t-1} - s \]

where \( d_t \) and \( d_{t-1} \) are the debt-to-GDP ratios in time periods \( t \) and \( t - 1 \), respectively; \( i \) and \( g \) are average cost of debt and growth rates (interest rate and nominal growth rate are often used as a proxy), respectively; and \( s \) is the primary budget balance as a percent of GDP. The difference between the average cost of debt and the nominal growth rate \((i - g)\) is key for the sustainability of public finances. If nominal growth exceeds the nominal cost of funding (i.e. if \( g > i \)), countries can run a primary deficit while keeping the debt ratio constant.

<table>
<thead>
<tr>
<th>COUNTRIES</th>
<th>DBRS Rating</th>
<th>S&amp;P Rating</th>
<th>Moody's Rating</th>
<th>Fitch Rating</th>
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<td>Baa3</td>
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<td>22 April</td>
<td>1 April</td>
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<td></td>
<td>Review</td>
<td>4 March</td>
<td>18 March</td>
<td>14 January</td>
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* Upgrade/downgrade over last 12-month

Source: PWM - AA&M, Bloomberg, Rating agencies’ websites, 14.01.2022
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