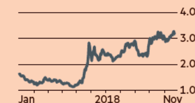
Fixed income. Budget wrangle

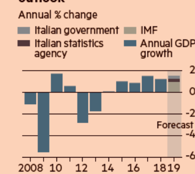
Investors in Italian paper adjust to reality of Rome-EU stalemate

Finance minister Giovanni Tria in Brussels this week. Italy is sticking to its 1.5% growth forecast for next year
Olivier Hoslet/EPA-EFE/Rex/Shutterstock

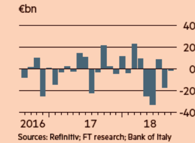
Spread of 10-year Italian bond yield over German equivalent
Percentage points



Italy's disputed growth outlook
Annual % change



Net change in foreign investors' holdings of Italian government debt securities
€bn



Sources: Refinitiv; FT research; Bank of Italy

Yields fail to take another step higher despite poor showing for retail debt sale

KATE ALLEN — LONDON

After six months of turbulence investors in Italy's bond market are acclimatising to the new normal as Brussels and Rome prepare for a long drawn-out stalemate over the country's budget.

This week Brussels announced that Italy's budget plans were in "particularly serious non-compliance" with commitments Rome had made, and justified the opening of an "excessive deficit procedure" against the country. It will be long into next year before any resolution emerges.

This week's poorly subscribed retail bond sale has dashed hopes that Italian households would provide a fresh source of debt market demand for government paper. The sale raised €2.2bn over four days, far lower than the usual €7bn-8bn that BTP Italia sales fetch.

Despite this, yields have edged downwards since the start of the week, with 10-year paper dropping 7bp to 3.41 per cent, while its spread over the equivalent German bond yield is down 5bp at 306bp.

Yields' failure to take another step higher is being taken by some investors as an indication that the market is settling at about its current level, or might even retrench.

"The excessive deficit procedure will be a long process, and we've probably seen most of the negative headlines that could push spreads wider," said Adam Kurpiel, head of rates strategy at Société Générale. "In the absence of a major re-widening of global credit spreads, the 10-year BTP-Bund spread should be closer to 200bp than 300bp."

The next steps in Rome and Brussels' tango have been well flagged. Questions over investor demand for Italian debt can be postponed, as the country has raised more than 95 per cent of this year's funding needs.

With little further drama expected in the coming weeks, investors are in a position to take stock.

"We expect Italian tail risks to abate," said Peter Chatwell, head of rates strategy at Mizuho, who argued that this week's move by the commission "marks the end of this phase of the Italian budget saga", and the prospect of less intense headline risk "would support BTPs going forward".

Some investors are venturing back into the market.

Stéphane Monier, chief investment officer at Lombard Odier Private Bank, said there were "reasons for looking at owning" Italian debt given the market's "overly conservative pricing of Italian political risk. And our assessment is that there is no solvency risk" for Rome.

"A lot of the risk is priced in, with yields closer to those of some emerging economies than other developed economies," he said.

Lorenzo Codogno, founder of LC Macro Advisers and former chief economist at the Italian Treasury, put a 70 per cent likelihood on Italy "muddling through until the European elections" next May.

"Interest rates will keep moving higher amid high volatility, with the 10-year government bond spread within a 300-400bp range, high enough to produce a slow-burning banking and economic crisis but not a major accident," he said.

"After the European elections, the Italian government may well start adopting a more constructive attitude and gradually become more mainstream. However, this is far from granted."

That leaves investors focused on the economic outlook as one source of any potential bad news.

Italy's growth prospects have caused heated debate. Premier Giuseppe Conte this week wrote to the European Commission to insist that the country was sticking to its much-disputed forecast for next year of 1.5 per cent.

The IMF forecasts that the Italian economy will grow 1 per cent in 2019, while on Wednesday Italy's statistics agency cut its forecast, saying GDP would grow 1.3 per cent in 2019.

> 'The excessive deficit procedure will be a long process, and we've probably seen most of the negative headlines'
> Adam Kurpiel, SocGen

"If Italy's growth environment starts to show signs of strain" in the early months of next year the BTP-Bund spread might face fresh upward pressure, Mr Kurpiel said.

Another risk that Mr Codogno flags is the substantial supply of fresh Italian government debt which bond investors will be asked to soak up next year.

Rome needs to raise about €260bn of bonds in 2019, of which about €200bn will refinance paper that is due to mature. That is likely to pose a challenge as foreign investors have been shedding Italian bond holdings.

Foreign investors in Italy's bond market cut holdings by a net €1.5bn in September, taking their scaling-back since the coalition took power to €68bn, according to Bank of Italy figures.

And this week's bond sale has provided further evidence of weakening demand for Italian paper.

"There is no risk of an immediate liquidity crisis, but there is a large issue about flows on a three- to-six-month horizon," Mr Codogno said. "This is not only due to shrinking foreign demand for government paper but also to creeping capital outflows; demand and supply of government paper can only match at much higher yields."

As a consequence, Italy's regular debt sales may become investors' most closely watched indicator, and any plateau in the country's bond yields might not be long-lived.

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Tail Risk

Coco bond buyers need cash buffers when markets turn

ROBERT SMITH

Specialist investors who bought banks' contingent convertible bonds at the start of 2017 were being roundly toasted by the end of the year for pulling off the best trades in fixed income.

These risky securities, which are not quite debt but also not quite equities, look a lot less clever this year, however. So-called cocos are down on average seven cents on the dollar, as concerns about the Italian banking system have seeped into the wider bank bond market.

The real irony is that these financial instruments, designed to help solve the problem of "too big to fail" banks, could end up testing the stability of the asset management industry.

Regulators devised the coco bond in the wake of the financial crisis, in an effort to shield governments from the moral hazard of bank bailouts. The chaos of Lehman's bankruptcy exposed just how interconnected modern bank funding markets are, making it difficult to impose losses on bank creditors without taking down the whole financial system.

Cocos are part of the new breed of bank bonds that can be "bailed in" during the collapse of a financial institution, meaning that bondholders bear the burden of losses instead of taxpayers.

Regulators put in place rules to stop retail investors buying these complex and risky bonds and taking these losses directly. But there is nothing stopping fund managers from putting ordinary people's pensions to work in the many specialised coco funds that have sprung up. Some of these funds are truly gargantuan now that the overall market has swelled to more than €200bn in size.

And many offer investors daily liquidity, which means that in theory, those pension fund managers could hop out of the asset class with very little notice. That could be a problem, because cocos are not a liquid asset class when things go wrong.

Shrewd coco fund managers have large cash buffers. Others have not been so cautious. One fund's largest position is half a billion euros of a single coco bond, a position that would be near impossible to liquidate in a torrid market. That fund's cash buffer? Less than 4 per cent.

As this year's fiasco at GAM, the Swiss fund manager, shows, daily liquidity coupled with illiquid assets is a combustible mix.

Fiasco at Swiss manager GAM this year was result of liquidity issues

Alternative assets

Chinese recycler turns Michelangelo masterpiece into millions of $10 shares

DON WEINLAND — HONG KONG

A Chinese company known for recycling bricks and concrete has made a detour into fine art, offering a securitised version of a Michelangelo painting depicting the crucifixion.

Nasdaq-listed Yulong Eco-Materials said it had agreed to buy *Crucifixion* for $75m. To pay for it, Yulong will sell 7.5m shares at $10 a piece, in effect securitising the 16th century masterpiece.

Until recently the company described itself as a waste hauler and vendor of eco-friendly building products operating in China. Its pivot comes just months after it said it had bought a sapphire for $50m, paying for it with a similar sale.

The company now describes its main line of work in acquiring fine art, organising exhibitions and offering an opportunity to own a piece of the masterpiece "to anyone with a brokerage account".

Daniel Mckinney, executive chairman, said: "[Yulong] has today pioneered this new disruptive business model by the acquisition and securitisation of fine art through a Nasdaq-listed security."

A corporate profile from S&P Capital IQ for Mr McKinney said he had experience in "mining ventures and geological explorations in Burma, Thailand, Columbia, China, several African countries and Mongolia".

Shares in the company surged on the announcement of the painting and stone purchases. In mid-August, on disclosing it had bought the so-called millennium sapphire, Yulong's shares rose more than 670 per cent to $11.75, before declining. The announcement that it would buy the Michelangelo work pushed the shares up this week.

Chinese investors have become prominent in the global art market. In recent years Asia has hosted record-breaking art auctions, among them the $170m sale of Amedeo Modigliani's *Nu couché (Reclining Nude)* to Liu Yiqian, the Chinese tycoon, in 2015. Mr Liu paid for the work with his American Express card.

Works by Vincent van Gogh, Francis Bacon and Jenny Saville have been snapped up at record prices by Asia-based collectors, mostly from China.

Asia has also seen a rapid expansion of auction businesses such as Sotheby's and Christie's, which were allowed entry to China only in 2013. A Chinese company with links to Mao Zedong recently bought a stake in Sotheby's.

Many Chinese companies in sectors such as manufacturing and construction have in recent years sought to revamp their business models and cash flows by buying into industries such as gaming and entertainment.

Last year, Song Liao Automotive, a Chinese company that had for years produced car components, infant formula and medical instruments, changed its name to Cultural Investment Holdings and agreed to buy a majority stake in Framestore, the British visual-effects company that worked on Hollywood films such as *The Dark Knight* and *The Martian*.

'Crucifixion': Yulong Eco-Materials is paying $75m for the painting

Commodities

CME Group weighs Brazilian soyabean contracts to relieve pressure on prices

JOE RENNISON — NAPLES, FLORIDA
GREGORY MEYER — NEW YORK

CME Group, the largest futures exchange operator, is considering the launch of new contracts on Brazilian soyabeans as US-China trade tension unsettles prices for the oilseed, its chief executive said.

Beijing imposed a 25 percentage-point tariff increase on US-grown soyabeans in retaliation for duties on its goods imposed by the Trump administration. Brazil's farmers have benefited as China seeks alternative supplies.

The shifts have pushed up the price of Brazilian soyabeans, with cargoes at the port of Paranaguá selling for $384 a tonne compared with $336 a tonne at the US Gulf of Mexico, according to Reuters.

While US farmers and merchants can manage soyabean price risks using CME's Chicago-based futures contracts, no similar market exists in Brazil.

A soyabean futures contract listed on the B3 exchange in Brazil has zero volume.

Farmers typically make advance sales to a handful of international grain trading houses.

"There is really nowhere to get the liquidity in Brazil on a futures market or even a forward swap in agribusiness to lay off," Terry Duffy, CME chief executive, said in an interview.

Charles Carey, a CME board member, was "leading an effort to see how we can co-operate on a derivatives product between a Brazilian exchange and the CME", he added, but declined to identify the exchange.

CME already has a strategic partnership with B3 that includes the cross-listing of certain products, said CME.

The cross-listing includes CME's "mini-sized" soyabean futures contract.

> 'There is really nowhere to get the liquidity in Brazil on a futures market or even a forward swap'

The Chicago Board of Trade, a futures exchange acquired by CME in 2007, tried such a contract before but decided not to pursue it, Mr Duffy said.

One obstacle to creating a successful contract is that deals for international exports of soyabeans are done with a handful of trading houses. Such companies do not necessarily benefit from more transparent prices.

"For this to get the necessary traction I firmly believe the trading houses will need to be behind it," said Pedro Dejneka, managing director of MD Commodities, which is an agricultural adviser with offices located in Brazil and the US.

In July S&P Global Platts, the commodities information service, began publishing daily price assessments for soyabeans at Paranaguá and the port of Santos, as well as soyabeans delivered in northern China.

CME already lists some cash-settled futures contracts based on S&P price indices.

Mr Duffy did not expect the US trade dispute with China to end soon and added that he was "very" concerned about it, although he did not anticipate that it would develop into a full-blown trade war.

Donald Trump, US president, and Xi Jinping, his Chinese counterpart, are scheduled to meet at the G20 summit in Buenos Aires at the end of the month, raising hopes of a resolution that have put pressure on Brazilian soyabean prices in recent weeks.

"China is a very patient, communist nation. You are not dealing with Canada or Mexico when you are dealing with China," Mr Duffy said. "China is not going to buckle."