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Developed Markets
Western Europe

Euro Rates Strategy

S&P upgrades Ireland, downgrades Italy – market implications

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- **S&P upgrades Ireland by one notch to A from A-:** On Friday 5th December, S&P upgraded Ireland from A- positive to A stable. This was largely driven by S&P's view on Ireland's "*solid economic growth prospects*". S&P have raised their average 2014-2016 growth forecasts to 3.7% from 2.7% and also noted that the "*National Asset Management Agency, which has benefited from a recovering property market, has now repaid about half of its original government-guaranteed senior bonds*". Separately, S&P projects Ireland's "*current account surpluses to average close to 4.8% of GDP through 2017*".

  – **Implication – Ireland to continue its gravitation to France/Belgium:** In our view, the upgrade further supports Irish bond yields' gravitation towards sovereigns such as France (AA/Aa1) and Belgium (AA/Aa3) and we expect further decoupling from the periphery.

- **S&P downgrades Italy from BBB to BBB – (the lowest IG rating):** On Friday 5th December, S&P also downgraded Italy from BBB negative to BBB- stable, the lowest investment grade rating. According to S&P "*The downgrade reflects the recurrent weaknesses we see in Italy's real and nominal GDP performance, including its eroded competitiveness, which are undermining the sustainability of its public debt.*"

  – **Implication - spread to Spain justified:** Although Italy had been rated BBB with a negative outlook since September 2013, we still think the downgrade will come as something of a negative market surprise on Monday morning. S&P now rates Spain BBB (stable) and Italy BBB- (stable) and the last time Italy has had a lower rating than Spain was back in early 2012. We continue to believe that Italy is likely to trade with a positive spread to Spain – which did reach 40bp earlier in October.

- **EMU credit quality a function of growth dynamics:** A single rating masks a complex matrix of credit quality assessment factors which can range from fiscal, economic and political institutional strength as well as incorporating susceptibility to event risk. At the heart of most ratings is the assessment of ability and willingness to repay debt. For the euro area, this hinges on debt-to-GDP dynamics which in turn is a function of the growth outlook. This is why it is so important to appreciate growth drivers at the sovereign level and monitor these closely because in turn they can affect credit quality which in turn can determine market risk premia.

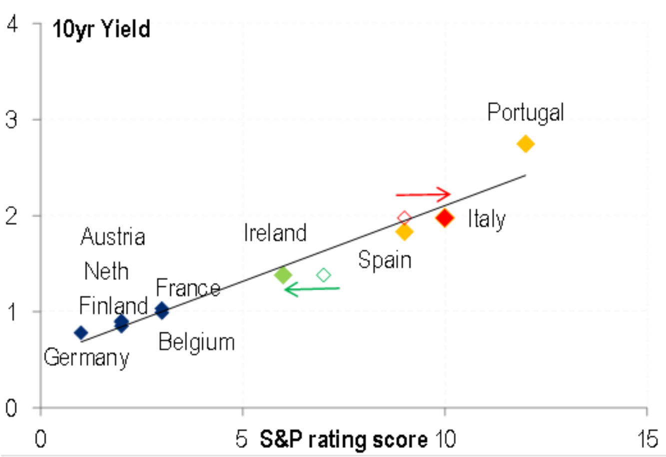
- **Don't miss our Sovereign Ratings Outlook:** Further details regarding such views can be found in our Sovereign Ratings Outlook in *Prospects for Economies and Financial Markets in 2015 and Beyond*.

Rating volatility remains for the euro area

(1) Ireland upgraded by one notch to A from A- by S&P

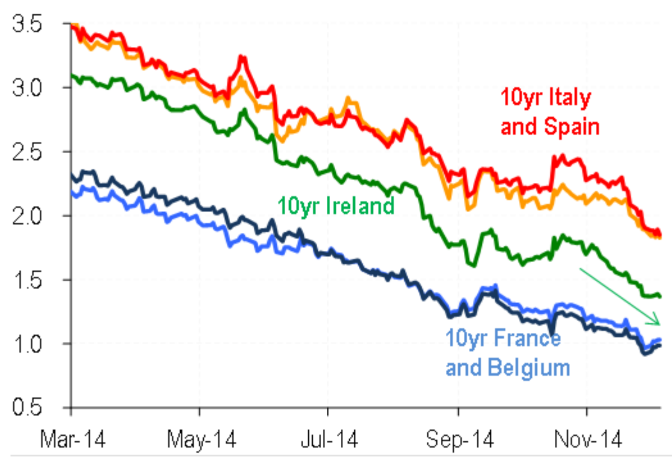
S&P upgrades Ireland by one notch to A from A-: Today, S&P upgraded Ireland from A- positive to A stable. This was largely driven by S&P's view on Ireland's "*solid economic growth prospects*". S&P have raised their average 2014-2016 growth forecasts to 3.7% from 2.7% and also noted that the "*National Asset Management Agency, which has benefited from a recovering property market, has now repaid about half of its original government-guaranteed senior bonds*". Separately, S&P projects Ireland's "*current account surpluses to average close to 4.8% of GDP through 2017*".

Figure 1. 10yr yields vs S&P rating score (%)



Source: Citi Research, S&P

Figure 2. Ireland likely to continue gravitating to the soft core (%)



Source: Citi Research

Upgrade drivers: The sovereign was last upgraded to A- with a positive outlook by S&P in June (*Euro Rates Strategy - Ireland upgraded by S&P to A- Positive Outlook*). We had expected another upgrade by S&P of Ireland over the medium term given the growth outlook, S&P's positive rating outlook and Ireland's declining debt-to-GDP trajectory. Specifically, S&P expects net general government debt to peak at 117% in 2013 and for it to decline to 91.4% in 2017. It states that "*this pace of debt reduction stands out in the context of high and static public debt levels in most of the eurozone*." This positive rating action today comes earlier than we had anticipated.

Ireland had already "outperformed its rating": The credit curve of yields vs (S&P's) rating is shown Figure 1 and in general, the ordinal ranking of yields tends to confirm (in varying degrees over time) to such assessments of fundamental credit quality. However, we had noted that Ireland had already rallied beyond where a A- credit would trade on this simple regression (*Dissecting spreads among Ireland/Spain/Italy)*. As such, although this is a marginal spread positive, the market had already moved to price Ireland as a higher rated credit perhaps limited the scope for significant further performance.

Spread and rating outlook: The outlook on the rating is now stable and we do not expect any further upgrades by S&P over 2015. S&P's rating is now two notches higher than Moody's which rates Ireland Baa1 stable. In our view, the upgrade further supports Ireland's gradual gravitation towards sovereigns such as France (AA/Aa1) and Belgium (AA/Aa3) and we expect further decoupling from the periphery (Figure 2).

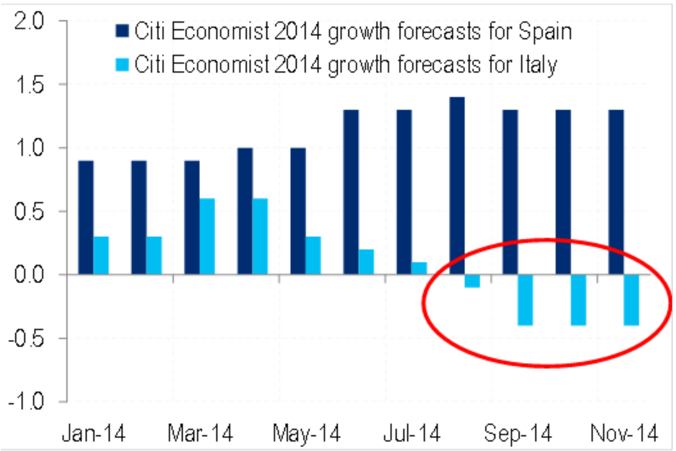
(2) S&P downgrades Italy to BBB- (lowest IG) from BBB

S&P downgrades Italy: On Friday 5th December, S&P also downgraded Italy from BBB negative to BBB- stable, the lowest investment grade rating. According to S&P "*The downgrade reflects the recurrent weaknesses we see in Italy's real and nominal GDP performance, including its eroded competitiveness, which are undermining the sustainability of its public debt*". Italy is now rated the same on S&P's scale as Russia, Bulgaria and Romania which are also all BBB-.

Downgrade drivers: Specifically, S&P now expects Italy's GDP growth in 2014 to be -0.2% (previously 0% and before that 0.5%). For their forecast horizon of 2014-2017, S&P have lowered average real and nominal GDP growth projections down to 0.5% and 1.2%, respectively, from 1.0% and 1.9%, as persistently low inflation and a difficult business environment continue to weigh on Italy's economic prospects. In their opinion, debt dynamics are being undermined by this weak growth environment and S&P now expect Italian general government debt to be €2.256tn by the end of 2017 (€80bn higher than previous estimates or 4.9% of estimated 2014 GDP). Under their critera, "***such a large increase in debt, combined with consistently low growth and eroded competitiveness, are not commensurate with a 'BBB' rating***."

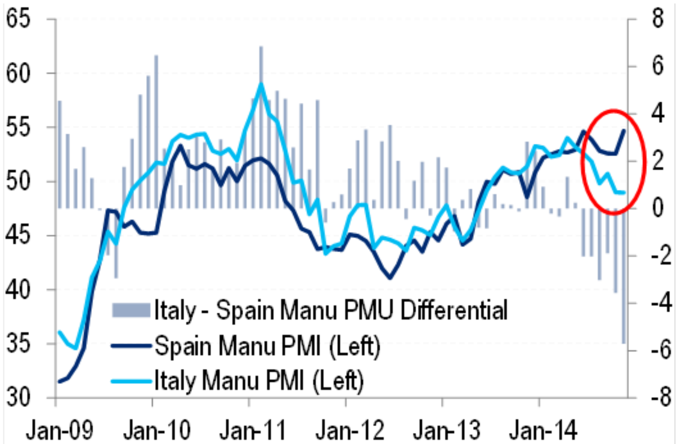
Index implications: The first thing investors are grappling with are the index implications. Italy is now rated BBB-, the lowest investment grade rating by S&P. However, it is still rated Baa2 stable by Moody's. Index inclusion into EGBI requires an investment grade status by at least one of either Moody's or S&P. Therefore, although headroom has diminished by another notch, and Italy is now just one notch by S&P form being sub-IG, it would require the simultaneous two notch downgrade by Moody's and another notch downgrade by S&P for EGBI ejection. This is not our base case over the near or medium term. Italy remains in EGBI.

Figure 3. Citi expectations for 2014 growth over time (%)



Source: Citi Research

Figure 4. Diverging PMIs between Italy and Spain (index level)

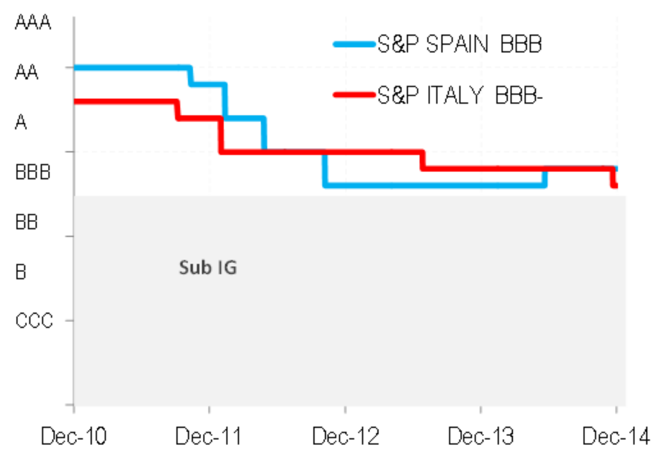


Source: Citi Research

Diverging growth dynamics: We have been highlighting the persistent divergence in forward looking indicators regarding Italy's and Spain's growth dynamics for some time. For one, Citi economists have progressively downgraded their 2014 growth expectations for Italy down to -0.4% whereas Spain has seen upward momentum in expectations to 1.3% for 2014 growth (Figure 3). A similar picture can be made for progressive forecasts for 2015. Divergence growth dynamics have also been evident in PMI data when drilling into the single country split. The Manufacturing PMI split is shown in Figure 4.

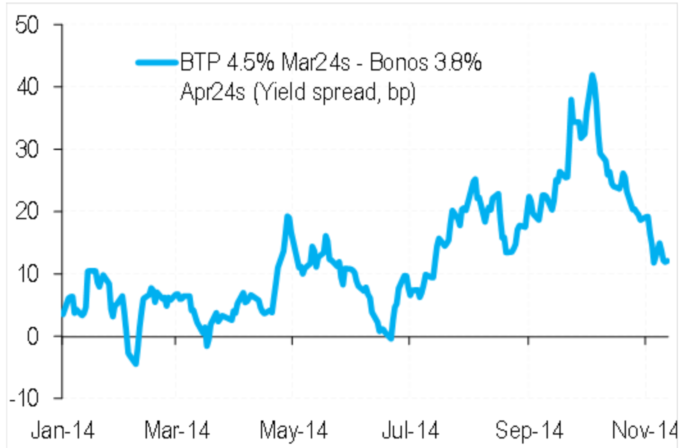
Spread to Spain justified: We had expected "*Spain to be rated higher than Italy*" (*Sovereign Rating Outlook*) but of course, while this is technically true now, we believed Italy would remain BBB whereas Spain would be upgraded by Moody's to Baa1. We still believe that the latter will happen in 2015 and note that Moody's currently rates Spain Baa2 with a positive outlook. Although Italy had been rated BBB with a negative outlook since September 2013, we still think the downgrade will come as something of a negative market surprise on Monday morning. S&P now rates Spain BBB (stable) and Italy BBB- (stable) and the last time Italy has had a lower rating than Spain was back in early 2012 (Figure 5). We continue to believe that Italy is likely to trade with at a positive spread to Spain – which did reach 40bp earlier in October (Figure 6).

Figure 5. S&P's rating of Italy and Spain



Source: Citi Research, S&P, Bloomberg

Figure 6. Italy likely to trade at a positive spread over Spain (bp)



Source: Citi Research

Conclusion: EMU credit quality largely a function of growth dynamics

Sovereign rating outlook for 2015: A single rating masks a complex matrix of credit quality assessment factors which can range from fiscal, economic and political institutional strength as well as incorporating susceptibility to event risk. At the heart of most ratings is the assessment of ability and willingness to repay debt. For the euro area, this hinges on debt-to-GDP dynamics which in turn is a function of the growth outlook. This is why it is so important to appreciate growth drivers at the sovereign level and monitor these closely because in turn they can affect credit quality which in turn can determine market risk premia. In this specific instance we believe the implications of S&P's action may prove limited over the medium term. The market is already well underway to repricing Ireland towards sovereigns such as France/Belgium and has already priced Italy at a consistently higher yield to Spain for much of 2014. The rating actions affirm these market dynamics in our view which are likely to persist for 2015. Further details regarding such views can be found in our Sovereign Ratings Outlook in *Prospects for Economies and Financial Markets in 2015 and Beyond*.

Appendix A-1

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