GENERALI INVESTMENTS

Focal Point

Italy: Political risks unlikely to abate anytime soon

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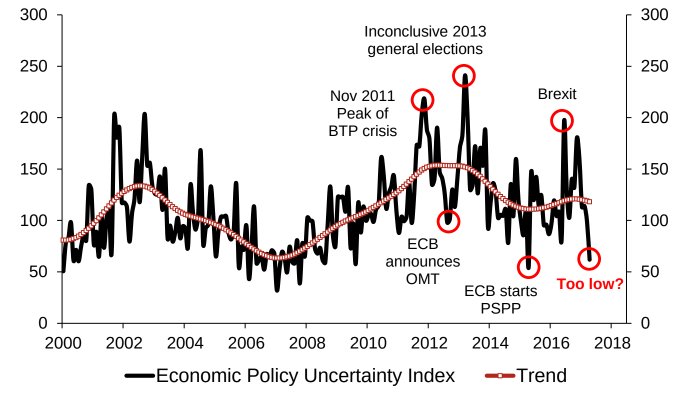
- With the “Frexit” risk being averted, investors’ focus is likely to turn to Italy as the next battlefield for Eurosceptic parties. According to opinion polls, the latter would secure almost 50% of seats in the next parliament.
- While an “Italexit” remains highly unlikely, the projected increase in political fragmentation may well exacerbate Italy’s structural weaknesses (low growth, high public debt) at a time when the ECB will likely start to taper its QE program.
- We expect investors’ unease to mount, with the new elections approaching. Mr. Renzi’s victory in PD’s primary has kept the probability of an early vote in autumn high (40% prob.) but spring 2018 remains our base case.
- The positive market sentiment after the French vote could last for a while. However, we foresee the BTP-Bund spread to creep higher eventually and exceed 200 bps before the next elections as uncertainty persists. Italian equities are likely to remain under pressure as well although they seem to have already discounted political risk more than BTPs.

The defeat of Marine Le Pen in the French presidential election marked the second setback for Eurosceptic parties this year after the Dutch vote in March. The market relief rally was much larger this time though, as Macron’s victory has put the risk of a “Frexit” off the table.

Italy: Economic Policy Uncertainty Index



However, political risks in the euro area are far from over. While the French vote has dominated the headlines until now, investors are likely to gradually focus again on Italy as the next battlefield for Eurosceptic parties. The Economic Policy Uncertainty Index for Italy – a news-based measure on economic and political risk – hit a 2-year low in April. This seems inconsistent with the likely increase in political uncertainty over the coming months. We hereby discuss the most likely scenarios for Italian politics and the possible repercussions on domestic assets.

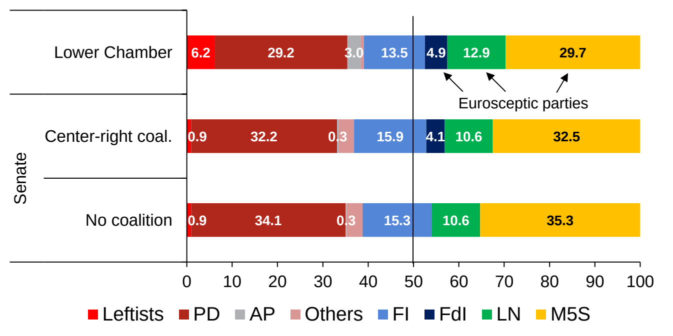
Five Star Movement takes the lead in polls

The defeat in the constitutional reform referendum and the internal fight between former PM Renzi and the left-wing minority has weighed on the support for the Democratic Party (PD). Since the split in late February – several members of the minority left the party to form a new movement, called MDP – the PD’s share of voting intensions has remained under 30%, the worst faring since the end of 2013.

The Five Star Movement (M5S) has benefitted from the situation. According to some pollster, the support for the M5S has exceeded 30%, while the average of last 10 surveys puts the lead over the PD to around 1 pp (29.0% vs 27.9%). A hypothetical center-right coalition including Forza Italia (FI) and the right-wing Northern League (LN) and Brothers of Italy (FdI) would be at the top in terms of voting preferences (30.1%). However, an electoral alliance remains difficult amid the different stances on Europe, where LN and FdI support a referendum on the euro exit, while Mr. Berlusconi endorsed Macron’s vision.

Proportional system exacerbates fragmentation

In order to project the composition of the next parliament, we based our analysis on the latest opinion polls. In addition, we assumed that the current electoral laws will not be substantially changed. While the debate over possible modifications is heating up, we believe that none of the proposals under discussion have the necessary backing by the parliament. In particular, the calls for a shift towards a more majoritarian system (50% seats assigned with a proportional calculation and 50% with the first-past-the-post system, supported by the PD) or for an upward revision of the thresholds to access the lower chamber (currently at 3%) are firmly rejected by the centrist AP, PD's junior partner in the current government coalition. AP is hovering around 3% in the polls and its chances to gain seats after the next elections require the current electoral system to be kept as it is.



Italy: Parliamentary seats projections
in % of total. "Leftists" includes MDP, CP and SI. "Others" refers to seats assigned abroad, Bolzen, Trento, Aosta Valley, senators for life. Eurosceptic parties: M5S, LN, FdI

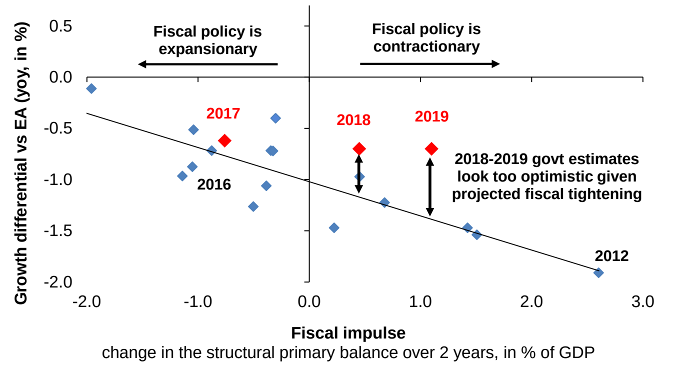
Looking at the projections, two tendencies are worth mentioning. Firstly, Eurosceptic parties (M5S, LN, FdI) would secure around 47% of seats in both chambers, sharply up compared to the 15 to 20% they currently have. Secondly, the pro-European front will be much more fragmented than today, especially in the lower chamber due to the lower threshold needed to enter the parliament.

The combination of the two will likely result in lengthy and complex negotiations for government formation. A pro-European government should eventually emerge, as a coalition among Eurosceptic parties looks difficult amid the different agendas on several topics other than the stance towards the EU and the euro. However, a Spanish-style gridlock leading to a second general election – after the approval of a more majoritarian electoral law supported by the PD and the M5S – is a clear possibility.

Early vote a material risk but not the base case

Given the political scenarios we presented above, we see the increase in investors' unease over Italian assets more a matter of when rather than if. The lack of progress over the harmonization of the electoral laws and the unfavorable opinion polls for the PD and its government allies support our base scenario of a vote in spring 2018, the natural end of the legislature. However, Mr. Renzi's comeback as leader of the PD – following the landslide victory in the party primaries held on April 30 – keeps the chances of snap elections in autumn at high levels (40% probability).

Anticipating the elections could allow Mr. Renzi to avoid the political responsibility of the likely switch to fiscal austerity in 2018 after a 4-year long period of budgetary expansion. Indeed, the interim budget update presented by PM Gentiloni's cabinet in April foresees a fiscal adjustment worth 0.6 pp of GDP next year, followed by an even larger one in 2019 (0.8 pp). Government estimates for real GDP growth in 2018 (+1.0%) look inconsistent with such a fiscal effort. The European Commission anticipates a similar pace of expansion, but with a fiscal easing worth 0.4 pp of GDP. Based on historical fiscal multiples, a budget correction as depicted by the government would push annual growth to a mere 0.5%, without considering the potential negative impact caused by political uncertainty.

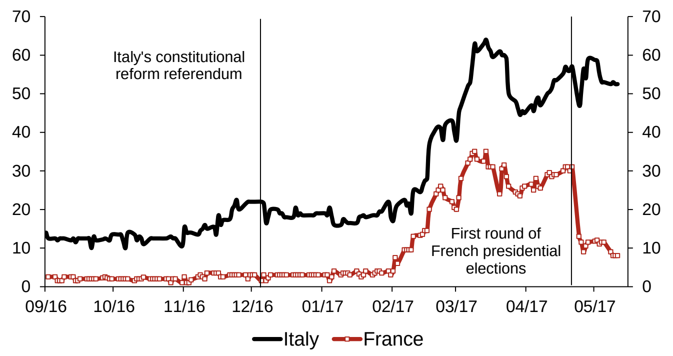


Italy: Growth sensitivity to fiscal impulse
Data sample: 2000-2016. Government projections for 2017-19 in red

Another reason for Mr. Renzi to trigger early elections is the upcoming debate over the tapering of the ECB's QE program. We deem January 2018 to be the most likely date for the start of the process. The reduction of the ECB's support may well contribute to market volatility at a very critical time for Italy.

Redenomination risk to keep weighing on BTPs

Italian assets have joined the relief rally triggered by the French vote. The 10-year BTP-Bund spread (currently at 186 bps) has tightened by 25 bps from the peak reached the week ahead of the first round of the French presidential election. However, it has only reversed half of the widening experienced this year, trailing the performance of French and other Southern European government bonds.



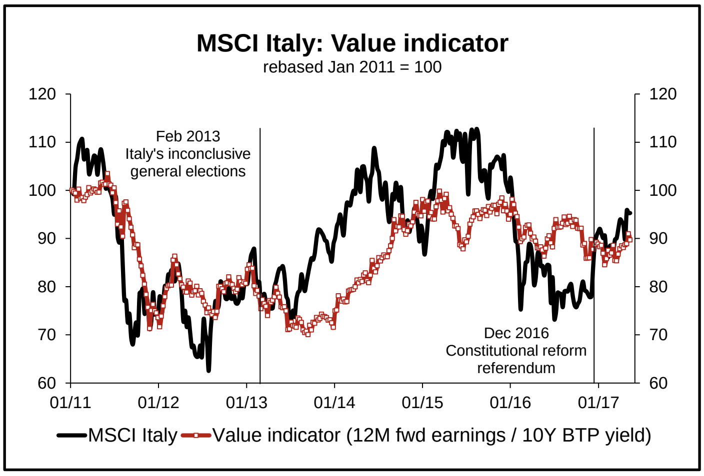
Italy: CDS-implied redenomination risk
difference between 5-year CDS contracts based on ISDA 2014 definition vs ISDA 2003, in bps

The CDS market provides some insights that can explain the underperformance. We focus on the difference between the 5-year CDS contracts under ISDA 2003 and 2014 definitions. This is a good market proxy for the risk of redenomination of sovereign debt into a new currency. Such a risk for French bonds has collapsed almost back to pre-crisis levels after Macron's victory, but this is not the case for BTPs. While an "Italexit" remains a highly unlikely event – a referendum on the euro would have to follow the complex procedure foreseen for constitutional amendments – we do not expect the redenomination risk to abate as long as the support for Eurosceptic parties remains so high. We believe that the combination of Italy's structural weakness (low growth, high public debt, fragile banks) with the projected increase in political uncertainty – which could further delay the path towards structural reforms – will eventually push the 10-year BTP-Bund spread above 200 bps as we get closer to the next general elections.

Italian equities to show increasing risk premium

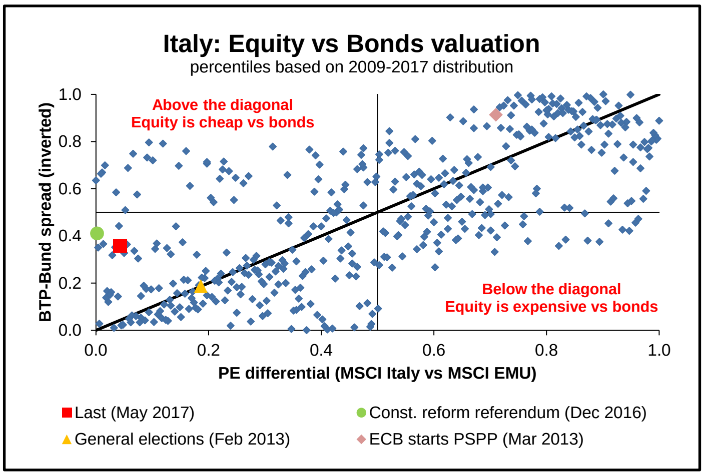
Similarly to other equity markets, Italian stocks enjoyed the relief rally. The MSCI Italy has risen by 9.5% since the first round of French presidential elections, bringing the year-to-date total return to 10.3% and cutting the relative underperformance vs the MSCI EMU to 2.3% vs 5.2% ahead of the vote. The reduction in political tail risks in the euro area (EA) led investors to focus again on the solid macro momentum, the more reassuring environment for banks – which represent 35% of the Italian equity index – and improving corporate profits. Italy's 12-month forward earnings' forecasts increased by 7% since January, reflecting stronger sales growth and subdued wage pressures.

Despite these positive factors, the medium term outlook for Italian equities remains challenging. After the rally, Italian multiples lie above the historical norm, but still show a discount to peers. The Price/Earnings ratio (PE, 12-month forward) is 13.5 vs 15.2 in the EA and 17.7 in the US, but this largely reflects Italy's lower GDP growth and higher political uncertainty. Such uncertainty should mount as elections approach, affecting business confidence and earnings' growth. Thus, the equity risk premium has scope to increase, weighing on Italian equities. The absolute market valuation could be a negative aspect, too, as it has entered into an expensive territory. This is confirmed both by our regression models based on macro and financial variables and by our "value indicator", which is a function of 12-month forward earnings and the 10-year BTP yield.



That said, some mitigating factors come into play, especially in the short term (i.e. before the election likely to be held in Q1 2018). Firstly, the current PE discount vs the EA is close to its historical highs: since 2009 only 4% of times such discount has been higher. A similar statistics for the BTP-Bund spread shows that Italy's sovereign risk premiums have been higher 36% of the times since 2009. This suggests that markets have priced a higher discount on equities than on bonds. Secondly, the global macro momentum remains favorable to Italian equities, due to the cyclical nature of the index and the high weight of financials, which tend to outperform when yields increase.

To conclude, we favor a prudent approach on Italian equities going forward, although the relative cheaper valuations versus other European equities and versus the BTP spread could mitigate the negative influence of the political risk, but mostly so in the short run.



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