

Italy towards new elections



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Prof Carlo Cottarelli, an economist, former IMF representative and in charge of the spending review of Enrico Letta's Government, is now in charge to form the government.

- **Political uncertainty:** On May 27th, the designated Prime Minister Giuseppe Conte gave up his mandate to form a Government. The Italian President acted promptly and gave Prof Carlo Cottarelli, an economist, former IMF representative and responsible for the spending review of Enrico Letta's Government, the mandate to form an interim government with clear commitments. Yet, this government is unlikely to win a confidence vote in Parliament, given the opposition of 5 Star Movement and League; it will probably therefore be a "caretaker government", in charge of governing till the next elections, which will take place probably in Autumn or at beginning of 2019 at latest.
- **Fixed Income:** Investors will continue to ask for a significant uncertainty premium. In the meantime, a short position on Italy is quite costly and this should prevent any strong spread widening. Due to the high uncertainty, we also expect limited spread reduction until the next election. Until the completion of a full budgetary and political integration in the Euro Zone, political risk will remain in investors' minds. The actions taken by the ECB since 2010-2012 have removed tail risk and the market still believes in the ECB's ability to manage the situation; otherwise the Euro equity market would not be that resilient.
- **Equities:** Despite relative cheapness, the Italian market is underperforming due to political uncertainty, as more than 30% of the main Italian index is represented by financials that are domestic players. Italian banks are now stronger than in the past in terms of capital and are in a positive restructuring trend for both cost cutting and reduction in Non-Performing Loans. In the short term, we keep a prudent view, but when there will be more clarity from politics, Italian banks could rebound thanks to their cheap valuation.

Where do we stand with the Italy's new government formation?

Usardi. On May 27th, the designated Prime Minister Giuseppe Conte gave up his mandate to form a Government. After a lengthy process lasting almost two-weeks to define a "contract" between the two parties that tried to form a majority (5 Star Movement and League), on May 23rd Professor Giuseppe Conte's name was submitted to the President of the Republic as Prime Minister, and consequently President Mattarella designated him to form a Government. The designated Prime Minister, as customary, accepted "with reserve", i.e. conditional on finding a majority to support his Government and receiving approval by the President for the Cabinet. But as President Mattarella publicly explained on May 27th, while he agreed with all names proposed to form the Cabinet, in his full Constitutional powers and role of guarantee, he could not accept the proposed name for the Economy and Finance Ministry, an openly Euro and Eurozone- sceptic; both parties decided not to back that name, not even while the President asked to nominate a standing political personality from the majority already identified. So, consequently to this irremovable stance of the two parties, the Prime Minister gave up his mandate due to the impossibility to form a Government.

What can we expect next?

Usardi. The President acted promptly and gave today May 28 a mandate to Prof Carlo Cottarelli, an economist, former IMF representative and in charge of the spending review of Enrico Letta Government, to form an interim government. The government formation should take place within a few days from the designation and then Parliamentary vote of confidence should take place. At the time of writing Prof Cottarelli has accepted the mandate "with reserve". This government, in agreement with the President, has a clear mandate: Should the government succeed in the confidence vote, it will be tasked with the budget law for 2019 and then immediately after it will resign, to give way to elections in early 2019. Should the government not get parliamentary support, it will immediately resign, and will therefore be tasked with ordinary administration, and elections will be called immediately after August. This

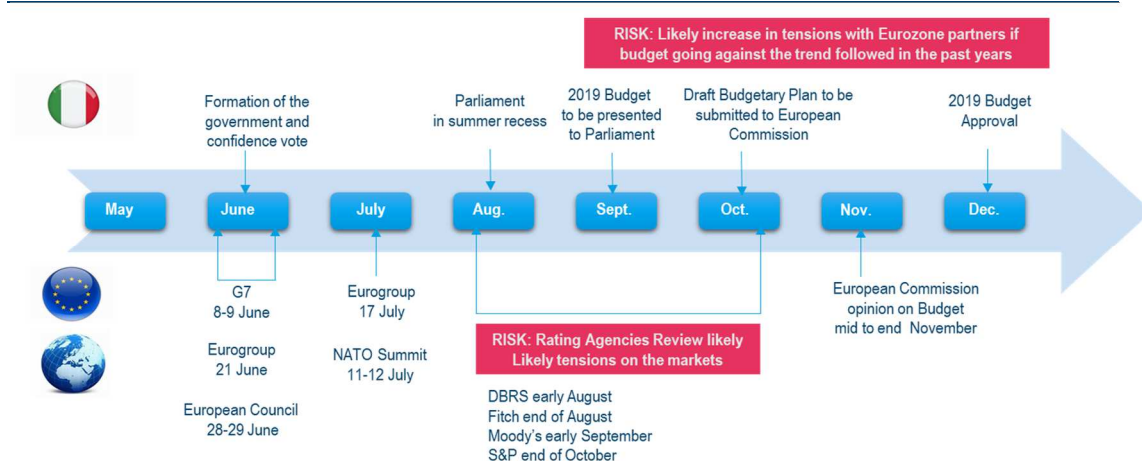
It will likely be then a “caretaker government till next elections, which will take place probably in Autumn.

last possibility seems the most likely given the opposition of 5 Star Movement and League. From a political point of view, in the evening of the 27th, in reaction to the lost opportunity to form a government, the 5 Star Movement announced they would ask for the President of the Republic's impeachment, a long process that could be pursued, according to the Italian Constitution, only in the case of high treason of the Country or of the Constitution and that can be initiated only by the Parliament. This is a long and complex process designed to protect the President, as the Institution guaranteeing the adherence to the rules and laws of the Country, from any abuse of parties. Yet, these are worrying signs that the electoral campaign has already started and likely fought along the lines of populist anti-system vs system (should they be Italian or European Institutions) with harsh tones. Hence, we see this development, although being perceived as a relief by markets, to be temporary, as the moment is a very delicate one, setting the basis for risky political developments.

What do you expect from the end of June European Council meeting? Is the current Italian situation going to weigh on it?

Usardi. The Agenda of the European Council taking place on June 28-29 2018 covers, migration, security and defense, jobs, growth and competitiveness, innovation and digital Europe, long-term EU budget (MFF), external relations, and EU leaders will also address the *Brexit*. Certainly, the unstable political situation in Italy would weigh on the progress in the discussions, as many items in the agenda would require a government in its full powers to address and properly plan with European partners a number of items that critically touch the country. But, as it is likely to be a caretaker Government participating in this meeting, it is difficult to anticipate any significant misalignment with the partners or strong positioning against the lines of the previous Government.

Next important deadlines for Italian public finance



Source: Amundi Research, as of May 28 2018.

Do you think that the worst could be over on Italian bonds?

Vic-Philippe. With such an unclear Italian political situation, investors will continue to demand a significant uncertainty premium. The last development should lead to new elections after the summer, if the technocrat government Italy is heading towards is unable to obtain a vote of confidence in Parliament. The most recent polls show that League will be part of the next government either with M5S or within a Center right coalition. Whatever the outcome, the Euro issue will remain at the front stage. In the meantime, a short position on Italy is quite costly (200bps on 10 year would cost 66bps of carry until October) that should prevent any strong spread widening. At the same time, we expect a limited spread reduction until the next election.

¹ Basis point (bps) refers to a common unit of measure for interest rates. One basis point is equal to 1/100th of 1%, or 0.01%.

The next auctions, early this week, will give a first indication of investor split and appetite. Until then, we believe it is worth keeping a neutral view on Italian debt.

Do you see any issue related to future refinancing needs?

Vic-Philippe. The strength of Italy lies in its private savings, highlighted by the domestic holding of the debt (65%). Nevertheless, we can have the combined effects of the reduction of the ECB buying program by the end of September – we do not forecast the ECB to change its timing because of Italian developments –, a further reduction of foreign participation and potentially higher issuance needs. So the supply/demand equation can end up with higher Italian yields. In the short term, the foreign participation will be key.

How do you see Italian corporate bonds compared to sovereign? Is liquidity becoming an issue?

Vic-Philippe. Italian corporate bonds have suffered with sovereign bonds; the widening is in line with BTP for corporate bonds; Financials are more severely hit and the lower the capital structure, the higher the blow. Covered bonds remained quite resilient outperforming Sovereigns by roughly 50bps. As in every risk aversion period, liquidity is drying up. The cyclical nature of liquidity has been increased by regulation: any increase in volatility triggers a reduction of the ability of investment banks to intermediate. This is not new. It is important to manage this phase with dedicated liquidity monitoring tools and adopt a flexible approach.

Do you see a re-emergence of the Euro break up risk? What are the main factors to monitor in this respect?

Vic-Philippe. Until the completion of a full budgetary and political integration in the Euro Zone, political risk will remain in investors' minds. The higher this risk, the bigger the risk aversion, the lower the German (safest) rates, the weaker the Euro versus USD, and the wider the spreads (Sovereign and credit). The actions taken by the ECB since 2010-2012 have removed tail risk and the market still believes in its ability to manage the situation; otherwise the Euro equity market would not be so resilient.

Is the equity market discounting higher rates and their impact on corporate balance sheets or is this just a risk aversion phase?

Franzin. The Italian market was the best performer in the euro segment until few weeks ago. Reasons of the recent underperformance are linked to political uncertainty and to the fact that more than 30% of the main Italian index is represented by financials that are domestic players. Italy still does not have a government and markets continue to wait and see what will be the outcome of this difficult puzzle. With this scenario, profit taking is quite understandable.

What is your view on the banking sector?

Franzin. Italian banks are still very much dependent from net interest income even if less than in the past, so in the case of an interest rate increase the impact should be positive. Another important element in the earnings trend is the spread: in the case of an increase, negative impact is likely both on the cost of funding and on mark-to-market sovereign holdings. Italian banks have already greatly reduced their NPL (non-performing loans) exposure but still there are other important reductions that should occur by 2020/2021 (depending on different parameters we estimate €40-60 bn). From the buy side, prices on NPL sales are linked to the competitive landscape, funding costs and required internal rates of return. An increase in political uncertainty could reduce the panel of potential buyers and provoke higher internal rate of return requirements. In general, because banks are perceived as country risk players, we think that the recent weakness is linked to politics. On the other hand, Italian banks are now stronger than in the past in terms of capital and are on a positive restructuring trend for both cost cutting and reduction in NPL. In the short term, we keep a prudent view, but when we see more clarity in the political landscape, Italian banks could rebound thanks to their cheap valuations.

Until the completion of a full budgetary and political integration in the Euro Zone, political risk will remain in investor's mind.

Market still believes in ECB ability to manage the situation; otherwise the Euro equity market would not be that resilient.

In the short term, we keep a prudent view on banks, but when there will be more clarity from politics, Italian banks could rebound thanks to their cheap valuation.

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