June 4th 2018

# Italian markets caught up in political turmoil

**Despite the formation of a new coalition government, uncertainties still remain on the Italian political situation and its potential impact on the financial markets. Read Ostrum Asset Management's experts analysis and outlook.**

Italy has been stuck without a government for almost three months, since the March 4 parliamentary elections saw the anti-establishment Five Star Movement, led by Di Maio, take a strong lead with 32% of votes, while extreme right-wing party the League (formerly known as the Northern League), led by Salvini, made real inroads with 18% of votes. After a series of lengthy and unproductive negotiations, a coalition finally emerged between the two parties in mid-May, but just as they were about to form a government, President Giuseppe Matarella stepped in on May 27 to veto prime minister-in-waiting Giuseppe Conte's proposed appointment of Paolo Salvona as finance minister, due to his vocal opposition to the single currency. Conte's subsequent resignation triggered a real political crisis, particularly as the President asked former IMF economist and budgetary stickler Carlo Cottarelli to form a technocratic government before fresh elections were called later in the year. In yet another surprise move, the President suspended the creation of a technocratic government on Wednesday May 30 to give the Five Star Movement and the League some more time to find a way out of the deadlock and come up with a new government. They finally came to an agreement on Thursday May 31: lawyer and law professor – and political novice – Giuseppe Conte will be prime minister, while the two party leaders will be deputy prime ministers, each with a key ministry, with Di Maio on economic development and labor, which will enable him to get to work on universal basic income, and Salvini as minister of the interior, implementing strict immigration policy. The finance minister, economics professor Giuseppe Tria, is keen to keep Italy in the euro area, but seeks to reform European institutions. Meanwhile, Paolo Salvona will be minister for European affairs. This announcement puts an end to the political crisis and reassures onlookers that Italy is set to stay in the euro area, but yet uncertainty remains on measures the government will actually take, as well as on its long-term viability.

## How did we end up here?

Italy's vote to bring in these populist parties at the recent parliamentary elections clearly reflects a deep-seated malaise. The country is still light years away from pre-crisis GDP per capita performances, which remain nearly 10% below 2007 levels. GDP plummeted during the crisis primarily as a result of very restrictive fiscal policy and has only slightly picked up since 2014. This problem is a longstanding one and translates sluggish growth in Italian productivity as well as the country's inability to generate additional revenues to break free from these shackles, while to top it all off, the population is ageing fast, so all these factors combine to drag down long-term growth. This electoral success for Italy's populist parties also reveals a wave of rising anti-immigration and eurosceptic sentiment across the country. The anti-euro stance that initially featured in the initial coalition manifesto was admittedly removed in the final version, but the very hint of this possibility was enough to trigger uncertainty.

## What can we expect from a coalition government?

The coalition plans a massive hike to public spending by providing universal income, cutting taxes and reducing the retirement age, and no measures to bolster potential growth …far from it. Growth is not strong enough to finance these measures, so they are poised to trigger a surge in the public deficit (of more than 5% of GDP) and an increase in debt, which is already sky-high at 132% of GDP. This prospect prompted ratings agency Moody's to put Italy's long-term rating (Baa2) on review for a possible downgrade on Friday May 25, and it also placed 12 Italian banks along with several companies on review for a possible downgrade. It will issue the results of its review on September 7 and could probably downgrade Italy's rating in a move that will have severe consequences for banks. Meanwhile, Fitch will announce its verdict on August 31. If interest rates come under severe pressure with an ensuing risk of default on Italian debt, the ECB could intervene via its OMT program, launched in 2012 and as yet unused. However, the procedure is governed by very strict conditions and the country would first have to request help from the European Stability Mechanism and agree to follow a public finance adjustment program supervised by European institutions. However, this is firmly at odds with the measures planned by the populist government, so intervention from the ECB and the ESM looks unlikely against this backdrop.

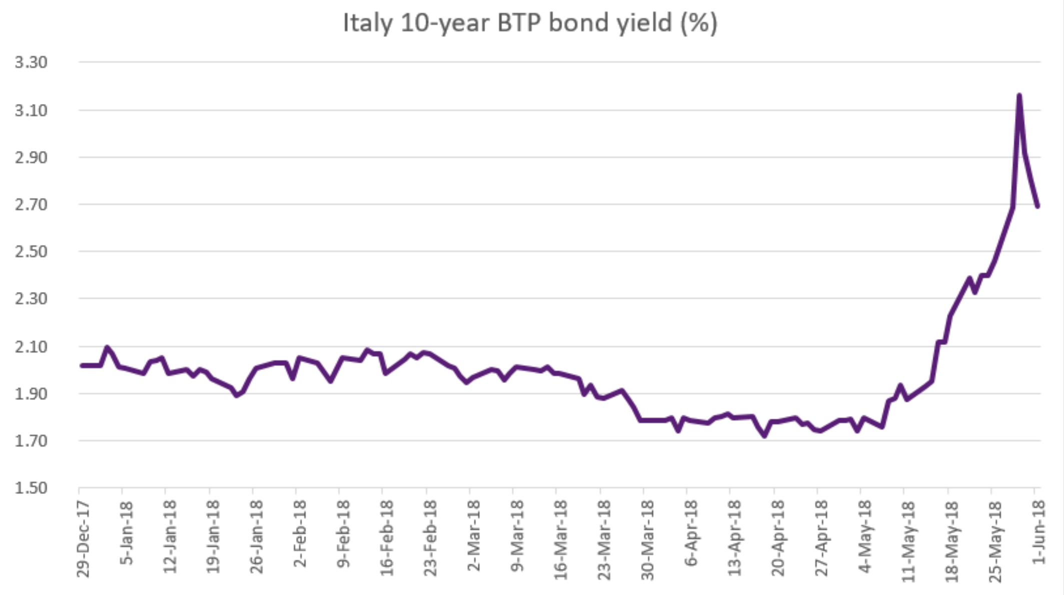
## Market consequences

The prospects of fresh elections with euroscepticism featuring heavily in the electoral campaign platform triggered a wave of panic on the financial markets on Monday 28 and Thursday 29 May. The Italian 10-year bond yield ended the day at 3.16% on Tuesday May 29, hitting a four-year high, but remaining well below the 7% in late 2011/early 2012 at the very peak of the sovereign debt crisis. The spread with the German 10-year widened considerably, momentarily moving beyond the 300bps mark during trading on May 29. Meanwhile, the stockmarket took a severe hit, wiping out all its gains notched up since the start of the year. Banking stocks suffered the most due to their dependence on Italian sovereign debt, while the euro also weakened, then moved back to $1.15 on Tuesday.

The markets recovered somewhat from Wednesday onwards on the back of hopes of a compromise on a coalition government between the Five Star Movement and the League, thereby avoiding fresh elections and the ensuing risk of even more uncertain results for the Italian economy. Investors were also reassured after Italy successfully managed to sell its bonds on May 30.

The knock-on effect on other markets has been fairly contained. German, French and US yields eased slightly on the back of a flight to safety, while yields in peripherals such as Spain and Portugal tightened to a much lesser extent than during the 2011-2012 sovereign debt crisis. These economies have implemented reforms and made it back on the path to growth, which Italy has woefully failed to do. The nomination of a coalition government and the reduced risk of an Italian exit from the euro area have reassured investors, but yet uncertainties remain, and the government's policy program will provide some insight into its planned measures for the near term and the potential future consequences for public finances.

We have cut back our exposure to Italian sovereign debt as a result of political uncertainty and the potential impact on the markets. Now that a coalition government has been set up and the risk of Italy exiting the euro area has been sidelined, we go neutral on short maturities, with the 2-year spread looking particularly high, while we maintain our negative stance on maturities over 5 years. We will closely monitor potential announcements from the new government going forward and assess the impact on public finances and, by extension, the financial markets.




Source: Bloomberg, Ostrum AM

# Legal information



www.ostrum.com

Ostrum Asset Management
Registered Office: 43, avenue Pierre Mendès-France – 75013 Paris – Tel. +33 1 78 40 80 00
Limited Liability Company, Share Capital €50,434,604.76
Regulated by AMF under n°GP 90-009
Company Trade Registration (RCS) Number 329 450 738 Paris