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Amundi
ASSET MANAGEMENT

August 2019

INVESTMENT TALKS

Italian politics take centre stage

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- ***Political crisis and possible scenarios:*** *The Deputy PM Matteo Salvini recently withdrew his party's support to the coalition government headed by PM Giuseppe Conte, calling for a vote of no-confidence against the PM and subsequent snap elections. On the 20th of August, after addressing the Senate, PM Conte resigned. President Sergio Mattarella will now weigh three options – consult political parties to form a new government (with the same forces of the current coalition or new ones), appoint a caretaker government or call for fresh elections.*

- ***Key dates and events to watch.***

Date	Event
20 August	PM Giuseppe Conte resigned
26 August	Deadline for appointment of Italian European Commissioner
6 September	Moody's rating review
Mid-September	First budget law draft to be submitted to Parliament
27 September	Start of the review process of the Italian budget law
After 20 October	The earliest date when elections could be held
25 October	S&P Global rating review
By 31 December	Budget law approval

Source: Amundi Research. Tentative dates only.

- ***Italy and Eurozone:*** *The current Italian political situation is a challenge for EU leaders, as domestic rhetoric seems to be on the rise in the country. The crisis is also happening in a deteriorated economic scenario for Italy and the Eurozone. It's still early to foresee how long the crisis will last and its implications on the economy: much will depend on which of the possible scenarios will emerge in the coming weeks. The preparation and approval of the budget law (by the end of the year) are key priorities for the country as well is the need to avoid the VAT increase. These milestones will ultimately influence the evolution of the crisis, pressurising for its quick resolution or, at least, for a transitory solution that safeguards Italian public finances. We believe the risks of contagion to other peripheral countries are limited at the current stage, especially thanks to the ECB support. The monetary policy package expected in September will likely be a combination of rate cut (we expect 10 bps cut), a tired reserve system to protect Europe's fragile banking sector and reopening of quantitative easing (QE). Moreover, several EZ countries (starting with Germany) will probably be "forced" to use fiscal policy to stem the effects of a manufacturing recession that intensified in H1 2019. In addition, low-interest rates could support countries in their plan to stabilise their debt-to-GDP ratios and service public debt. But this would not be a long-term replacement for implementing robust fiscal rule.*

- ***View on Italian assets:*** *The opening of the political crisis and the emergence of the resultant risk premium is quite evident. From a risk adjusted return perspective, BTPs could fare better than equities if the political crisis deepens or is prolonged to 2020. In fact, given the recent generalized fall in bond yields across the board, we believe the hunt for yield will keep investors' interest in Italian bonds. Our analysis shows that the value of the Italian BTPs makes for half of the value of the remaining positive yield assets in the EUR denominated IG fixed income space, while representing just 12% of overall outstanding debt. Despite recent volatility, we expect that investors' demand will remain very high, limiting the upside pressure on bond yields in the short term.*

POLITICAL CRISIS, POSSIBLE SCENARIOS AND MILESTONES

Where do we stand in the current Italian political crisis?

"President may 1) select a new government supported by the majority of current elected leaders, 2) hold new elections or 3) appoint a caretaker government."

On the 8th of August, Deputy PM Matteo Salvini declared that the governing coalition does not have a majority to hold office. In a press conference after this announcement, PM Giuseppe Conte took note of the request but did not resign, announcing he would like to report to the parliament first. After speaking to the Senate on the 20th of August, PM Conte submitted his resignation to the President of the Republic.

The President will now hold consultations with current parliament representatives to verify whether a new government could be formed. Should these attempts fail, the President would call for fresh elections to form a new parliament. The options available with the President are whether to have a new government supported by a majority of the current elected members of the parliament or to hold new elections instead. A third option is that the President may appoint a caretaker government that could present the autumn budget and approve the spending cuts required to avoid a VAT increase.

At this stage, albeit elections appear to be the most likely scenario, **the possibility of a grand coalition government cannot be completely ruled out**. Indeed, some parties within the current parliament have very little incentive to push for early elections, as they may lose seats. In particular, M5S and the Democratic Party (PD) could suffer a defeat, albeit the latter is split on the opportunity to support a grand coalition.

"While elections appear to be the most likely scenario at this stage, the possibility of a grand coalition government cannot be ruled out."

Any political party or coalition needs 316 Deputies and 161 Senators to form a government. If M5S and PD set aside their differences and attempt to form a government, they would collectively have 327 Deputies and 158 Senators, assuming all their elected leaders act unanimously. However, elected representatives of the PD are split in groups – a section that is close to the former PM Renzi, and then there are others. If the first group votes in favour of making a government, the M5S chips in and they even manage to seek support of local autonomous regions, the resulting grand coalition would have 322 MPs in the Lower House and 166 members in the Senate. This would be just enough to scrape through and avoid elections. The key question is whether this government would have a specific objective (and therefore a given time horizon) on hand?

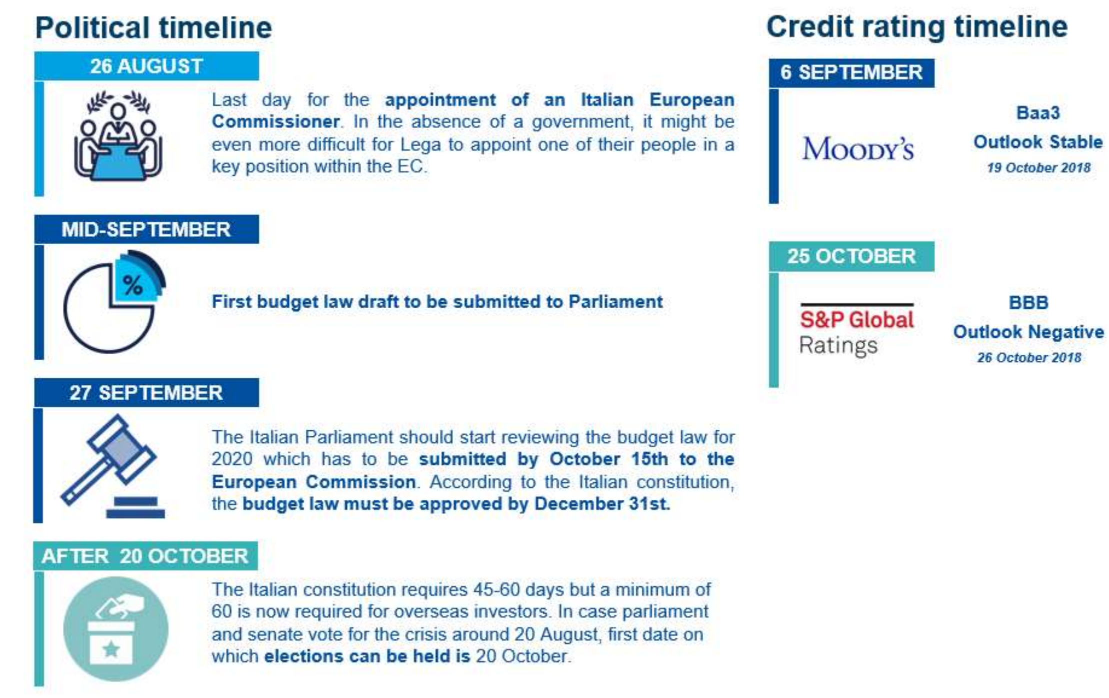
The short-term task would be to deliver the 2020 Budget, following which early spring could bring-in elections. But if the aim of the grand coalition is to reduce the number of MPs (already in advanced process of Constitutional change), the time horizon may be longer then, eventually delaying elections to late spring at least. However, reducing the number of MPs could be detrimental to the interests of the grand coalition. Therefore, they are unlikely to call for fresh elections at that time and may continue to hold office till 2022, right on time to nominate a new President of the Republic.

"If new elections do happen, the success of a potential Centre-right coalition between the League, which now leads the polls, and other two parties will be key for future relationship with the EU".

Coming back to the present, **if no party is able to form a government, we may see elections between mid-October and early November,** provided speedy consultations happen between the President and political parties. In both cases, the success of a Centre-right Coalition (possibly formed by League, Fratelli d'Italia and Forza Italia or eventually only the first two parties) is almost certain according to most recent polls. The key questions would be by what margin the League wins? How it needs the other two parties to have a strong majority in the Lower House and in the Senate? This would decide whether the League, that has been more confrontational with the EU union on multiple fronts (immigration, fiscal policy, and more recently, not backing Ursula Von der Leyen at the EU commission), is able to promote its programme

"The next couple of months will be crucial for the country as a new government decides the national budget, and markets expect ratings' agencies review."

Key events and their timelines



Source: Amundi Research. Tentative dates only

ITALIAN ECONOMY AND IMPLICATIONS AT THE EU LEVEL

What is your view on Italian economy? How is it reacting to the more complex global scenario?

Data available so far depicts a very weak start to the year, with GDP growing at 0.1% and 0.0%, QoQ, in Q1 and Q2 2019 respectively (-0.1% and 0.0%, YoY terms). Should growth remain in mildly positive territory in H2, it would be fair to expect the Italian economy to grow around 0.1% on average this year. This indicates a stagnation on account of feeble domestic demand — decelerating investments and weak personal consumption — and weak export performance, which was subdued in H1.

"The current global environment poses downside risks to Italian growth, given the degree of openness of Italian economy and the links of domestic manufacturing with the German production chain."

The current global and European environment poses some downside risks to Italian economic growth, given the interconnectivity of domestic manufacturing with the German production chain and the openness of the Italian economy. These risks are likely to arise from a possible weakness in Germany (negative Q2), and the uncertainty related to geopolitical risks and trade disputes, which have the potential to negatively affect existing production and supply chains. In addition, the current political uncertainty in Italy could weigh on investment decisions.

Do you see any implication of the Italian situation at the European level? Do you see the resurgence of political risk in Eurozone and what could be the implications?

The Italian political situation is a challenge for EU leaders and particularly for those in the Eurozone (EZ). That said, as in all countries where nationalist/populist movements are on the rise, it is important in Italy to distinguish domestic rhetoric from political action. While Salvini knows very well that he operates in a tense economic climate that does not allow EZ leaders to treat Italy firmly, he is also aware about the limits of what he can achieve. It is clear that relations between a potential Salvini government (in case of elections) and the European Commission would be strained, but Italians have no intention of leaving the EZ. Therefore, they would seek to compromise, if it comes to that.

"We believe that the risks of contagion to other peripheral countries are minimal".

Italy will continue to benefit from a fall in interest rates in the EZ and from ECB's exceptionally accommodative monetary policy. On the eve of the ECB's interest rate cuts and the announcement of a new major asset purchase programme in September, we believe that the risks of contagion to other peripheral countries are minimal. This is because several EZ countries (starting with Germany) will probably be "forced" to use fiscal policy to stem the effects of a manufacturing recession that intensified in H1 2019.

In the short run, in a low interest rate environment, investors will continue to hunt for yield and this should limit market pressure. However, in the medium term, Italy faces a real challenge. In the absence of structural reforms to boost its growth potential, public debt will not be sustainable (the public debt-to-GDP ratio would continue to rise). That said, it should be noted that in a context of structurally lower interest rates, it will be easier for all countries in the region to stabilise their debt-to-GDP ratio.

Beyond the Italian experience, it is the fiscal rules and the implementation of stabilisation instruments to deal with asymmetric shocks (via a common unemployment insurance scheme) that will come back to the fore once the new European Commission is in place. In this environment, Italy would have more to lose than to gain from an acute confrontation with the European institutions.

INVESTMENT IMPLICATIONS

What is your view on Italian BTP, looking at supply/demand dynamic, ECB measure and investors' risk appetite?

"Italian BTP spreads are likely to remain volatile and above the low levels seen in July, given the uncertainties around the new elections and the approval of the budget law."

The opening of a political crisis in the coalition government led to a sudden reaction by the financial markets, and as a result, both Italian bonds and equities underperformed. In the coming weeks, Italian BTP spreads are likely to remain volatile and above the low levels seen in July, given the uncertainties around the new elections and the approval of the budget law. Lower liquidity this summer and geopolitical uncertainties arising from the global picture are likely to increase this volatility.

Having said that, the 10-yr BTP spread over bund, recently moved back to the starting levels of early July, a month recording a remarkable compression in risk premium. When we examine the behaviour of the different segments of the BTP curve, initial market reaction seems quite sober. The upward shift in 2-yr and 10-yr yield was quite similar and the slope failed to compress meaningfully, signaling limited investor concerns on Italian credit quality. Furthermore, Fitch confirmed Italy's existing mid BBB rating along with its negative outlook. The timing of the decision coincided with the day this political crisis broke, softening the short-term pressure on BTPs.

Despite the return of electoral uncertainties, we expect the impact on Italian spreads to be limited in comparison to the previous phases of political pressure seen since May last year. In fact, over the coming months, a supportive combination of technical factors and relative valuations will be at work, at a time when the ECB is likely to reopen net QE purchases.

"The only real 'competitor' left to Italy offering positive yield within the high-grade universe is represented by BBB-rated corporate bonds."

From the supply side, as of August beginning, the Italian Treasury has completed almost 70% of yearly scheduled new issuance of mid-to long-term bonds, at a time when just 40% of yearly redemptions took place. As a result, considering both bonds and bills, BTP net issuance reached its peak at EUR 85bn and it should become negative in the remaining months of 2019, falling to a level close to EUR 50 bn by year-end. September and October look mostly supported on the technical front by huge redemptions of existing bonds worth EUR 43 bn and EUR 26 bn respectively. Together with some relief coming purely from supply numbers, it is worth mentioning the successful issuance of long and extra-long BTPs by the Italian treasury. While the latter issued extra-long BTP deals with duration of

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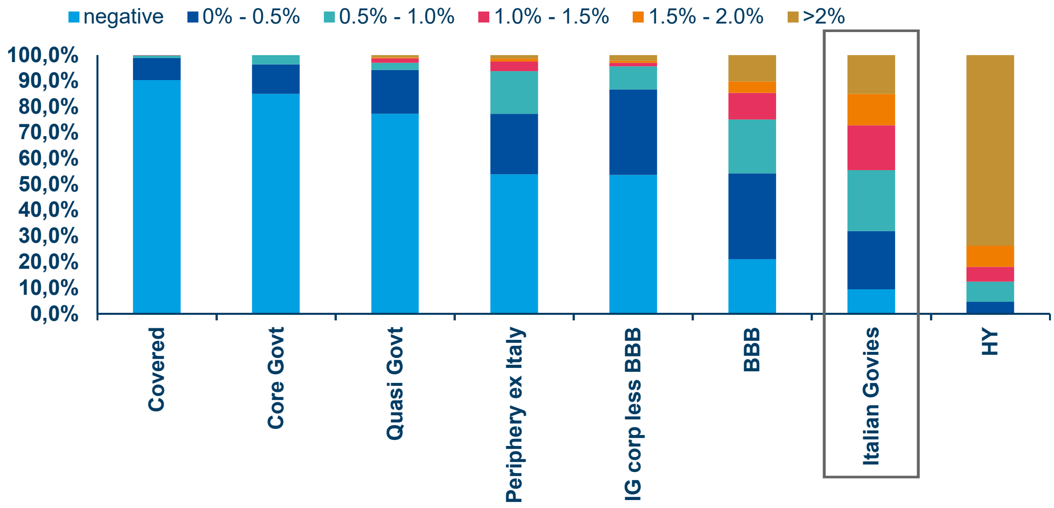
15yr, 20 yr and 30yr maturities throughout the year, the July re-opening of the BTP 50-yr met with strong demand from foreign investors.

As a result of these deals, the average maturity of year to date supply is close to 10-yr, quite high by comparable historical standards. This indicates that the remaining yearly issuance is not only likely to be limited in size but also lower in duration adjusted terms, which is likely to weigh less on longer curve buckets.

The second factor supporting BTPs has to do with relative valuations. We ran some analysis on yield concentration within the entire EUR denominated IG fixed income market. Given the recent generalized fall in bond yields across the board, results show that the value of the Italian BTPs make for half of the value of the remaining positive yield assets in the EUR denominated IG fixed income space, while representing just 12% of overall outstanding debt. The only, real “competitor” left to Italy offering positive yield within the high-grade universe is represented by BBB-rated corporate bonds, which, now make for just 21% of remaining yield with a similar debt weight (10%).

Breakdown of Euro-fixed income assets by yield buckets



Source: Bloomberg and Amundi Research, as of July 31, 2019.

“An additional cut in the deposit rate further into negative territory, would support an even stronger hunt for yield.

This leads us to the third and more important factor, which should make BTPs more resilient to political uncertainties in the following months, namely the upcoming easing package from the ECB in September. An additional cut in the deposit rate further into negative territory, coupled with a possible QE2 run on sovereign bonds, would support an even stronger hunt for yield. This could make the environment favourable for BTPs when compared with the less attractive alternatives across the European bonds space. Our view is further supported by the most recent numbers available from Banca d’Italia. The June inflows in BTPs were €34.7 bn, the highest monthly inflows so far this year.

In conclusion, we expect BTPs spread to remain volatile in the short-term depending on political developments. Nonetheless, the volatility should remain contained by yield search and favourable technicals – the medium to long-term curve segments remain more supported by the combination of relative valuations and an eventual reopening of ECB asset purchase programme (APP).

"While we recognize the potential political risk in the country amid a challenging global environment, we maintain our moderately positive view on Italian govies so far.

From a cross asset perspective, what is your view on Italian assets?

We maintain a cautious stance from a cross asset perspective as we reach a more mature phase of the global financial cycle. Risks are now on the downside given that the exacerbating geopolitical tensions are already depressing global trade and manufacturing sector. In particular, the Italian political crisis is an idiosyncratic risk and not a systemic one for the markets.

However, political risk premium is quite evident and we maintain our preference for BTPs vs Italian equities. It is important to note that Italian assets are cheap in relative terms if we compare equity multiples and govies spreads with other European countries. Current and expected price/earnings ratios for Italian equities are quite below European ones and dividend yield close to 5%. Profits expectations in the country are not overly optimistic so they should not be disappointing even in a challenging political environment.

From a risk adjusted return perspective, BTPs could fare better than equities if the political crisis deepens or is prolonged to 2020. In fact, the exceptionality of this late cycle regime is the extraordinary Central Banks dovishness and their commitment to contain any contagion risk to interest rates markets. But extremely low rates at global level provide few opportunities to invest in positive govies yield, at least in the developed world. While we recognize the potential political risk in the country amid a challenging global environment, we maintain our moderately positive view on Italian govies so far.

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- **BTP-Bund Spread:** differential between the yield on the 10-year Italian BTP vs 10-Year German Bund.
- **Volatility:** a statistical measure of the dispersion of returns for a given security or market index. Usually, the higher the volatility, the riskier the security/market.

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