

# Investment viewpoint

# An Italian remake of a Greek tragedy

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23 May 2018

## Executive summary

**The nervous reaction of investors to political developments in Italy highlights concerns over the implications for Eurozone stability. While it is too early to have a clear view of how the situation will develop, we believe that now is the time for investors to assess their exposure to European assets, especially Italy and the rest of the periphery.**

With Italy close to forming a Eurosceptic, populist coalition government – one that would reduce taxes, increase spending and openly question the rules and agreements imposed by European institutions – increased friction in the EU seems likely.

This situation is reminiscent of the events that rattled Greece in 2015 following the election of the Syriza government. However, Italy is the third-largest economy in the Eurozone. And with Italian government debt accounting for a little more than 20% of the total government debt issued by Eurozone countries, together with Italy's sizeable banking system, the stakes are higher.

While the new Italian government's policies are likely to create friction with the EU and to increase uncertainty over whether Italy might leave the euro, we believe at this point that it will not lead to a major crisis. That said, investors would be ill-advised to ignore the issue.

## Investment implications

We believe that:

- Investors need to be ready for the possibility of a further increase in Italian bond yields, widening of spreads and equity market underperformance in Europe, given the high level of uncertainty that is likely to persist in the absence of changes in government policy. There are also likely to be increased tensions in the banking sector. This uncertainty could put downward pressure on the euro against other major currencies.
- The heightened uncertainty and the risk to the stability of the common currency could delay any policy changes by the ECB.
- The situation could have a spillover effect on Brexit: on one hand, the EU – busy sorting out a possible Italian economic crisis – might soften its stance on Brexit; on the other hand, it might lose patience and make a take-it-or-leave-it offer. Either way, increased tensions in Europe and the risk of a crisis would likely bolster support for the Brexiters' view that the only way out of the EU is a clean break, thus increasing somewhat the risk of a hard Brexit, in our view.
- Investors should carefully assess their exposure to European assets, especially Italy and the rest of the periphery.



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## An Italian remake of a Greek tragedy

More than two months after its general election on 4 March, Italy is close to having a Eurosceptic populist government in the form of a coalition between the 5-Star Movement and the Northern League. They intend to govern based on a programme that includes greater fiscal support for the economy via lower taxes and greater spending. At the same time, they openly question the European institutions (budget rules, bank bail-in rules, opposing new trade agreements like CETA, Russian sanctions); both of which are likely to create friction with the EU.

It is almost impossible not to compare the situation in Italy to the events that rattled Greece in 2015 following the election of the Syriza government. However, the big difference is that the Italian economy is the third biggest economy in the Eurozone – ten times larger than Greece's. Moreover, the amount of Italian government debt represent a little more than 20% of the total amount of government debt issued by Eurozone countries. The Italian banking system is also much bigger.

All these developments raise the spectre of an economic crisis possibly leading to Italy leaving the euro, despite no longer including a proposal to create a mechanism that allows the country to leave the common currency. With the increased uncertainty, we have seen Italian assets – bonds, bank equity, credit default swaps (CDS) – underperform significantly. In addition, as a sign that investors once again doubt the stability of the Eurozone, we have seen some of the underperformance spread to other European periphery countries, while German bunds have rallied. While it is too early to have a clear view of how the situation will develop, we believe now is the time for investors to assess their exposure to European assets, especially in Italy and the rest of the periphery.

### A populist programme: picking up a fight with the EU

The agreed programme between the 5-Star Movement and the Northern League remains relatively vague and short on details around implementation. Nevertheless, it is clear that the policy pledges are likely to put the Italian government in conflict with the EU institutions. The policy pledges include:

- To overhaul all EU fiscal and monetary rules
- To review of rules related to the single market
- To oppose “all aspects” of the CETA (EU-Canada Comprehensive Economic and Trade Agreement) and the TTIP (Transatlantic Trade and Investment Partnership)
- To propose a radical review of the bank bail-in rules
- To propose the withdrawal of sanctions on Russia and to be much tougher on immigration

The most eminent conflict is likely to come from the fiscal policy aspects, where the coalition's flagship proposals include:

- A simplification of the tax code by introducing a two-tier flat tax rate of 15% and 20%
- A guarantee of EUR 780 a month to Italians below a certain income level
- Scrapping the pension reforms that were agreed in 2001

It is estimated that those pledges would cost about EUR 100 billion<sup>1</sup> but the government believes that this would be done over the next five years and compensated by a EUR 70 billion increase in fiscal revenue from ending many tax breaks, less “wasteful spending” and stronger growth. It remains to be seen whether those increases in revenues would materialise to prevent an excessive budget deficit and an increase in the debt level.

In addition, many have pointed to the Italian constitution, which preclude an excessive deficit by forcing the government to balance their budget while taking into account the economic cycle. They argue this is why the new government may not be able to increase the Italian deficit by much. If it was the case, President Mattarella could veto the new law. However, it is all subject to interpretation and there could be ways to go around the restrictions with favourable fiscal forecasts or by using creative accounting.

### Preparing for the exit?

While the explicit reference to the creation of a mechanism to leave the Euro has been removed from the government programme, some measures contained in the programme could be viewed as the creation of a new quasi-national currency. The coalition intends to issue small value Italian treasury bills or “mini-BoTs” to finance some fiscal pledges. These securities are euro-denominated non-interest bearing Treasury bills and would be bearer securities secured by tax revenues. The mini-BoTs would be printed by the state lottery's presses.<sup>2</sup> This makes the mini-BoTs very close to banknotes. The main difference is that they are not legal tender, so private parties would not be obliged to accept mini-BoTs as payment.

While the coalition insists that this is not the creation of a parallel currency, it can be viewed as a step towards that direction. Nothing prevents the government passing a law in the future making those mini-BoTs legal tender and forcing acceptance as a mean of payment. This is often what happens in dollarised countries when they drop the USD to issue a new national currency: they issue IOUs that then become legal tender in the new currency. The discount on those securities relative to the standard Treasury bills should provide, once in circulation, an indication of the probability of Italy leaving the euro.

<sup>1</sup> Source: FT “Is the euro's Italian nightmare about to come true?”, 15 May 2018.

<sup>2</sup> Source: FT “March of Italy's mini-BoTs may split the euro”, May 2018.

## What to watch out for

At this point, most of the increase in government yields, widening in spreads between Italian and German bonds and increase in CDS spreads can be seen as the market catching up with the political risk inherent to Italy following the election of a populist government – one that appears openly ready to defy the EU. As such, one can argue that Italy's sovereign spread versus Germany's was too narrow following the latest election considering the political uncertainty and the strong support for populist parties.

While these spreads are wide, they remain below the levels reached a year ago, following the December 2016 constitutional referendum and the increased likelihood of an early election. What matters now is whether we see some stabilisation of sovereign and CDS spreads. Political development in the coming weeks will be important as all eyes will be on whether the government waters down some of its policy proposals.

We see three ways the situation could evolve:

### 1. Watering down the policies

The new Italian government softens its rhetoric and some policies, moving away from the path of direct confrontation. In this case, asset prices should normalise to the pre-coalition announcement level. While this would be the best case, we believe it is unlikely the new government would follow that path in the short term, given a recent poll shows that 60% of voters are either favourable or very favourable to the new government, an increase from only receiving 50% of the vote in the election. As long as the government has popular support, it will be hard for them to back down.

### 2. Confrontation and then capitulation

Given the strong support from the population for its coalition, we believe the government is likely to follow the path of confrontation and to try to implement most of its programme. The result could be very similar to what we saw in Greece in 2015. We would see the further widening of sovereign spreads, with some likely spillover to other countries in the periphery, and would also likely lead to a deterioration in the funding conditions for Italian banks. Given the size of the Italian banking sector, this could put some pressures on the banking sector of countries with big exposures to Italian banks.

The ECB may need to intervene to stabilise the bond market using OMT, but Italy is likely to be untouched until its policy are deemed in compliance with EU rules. This would increase the pressures to choose between the Euro or the new Lira. However, support for the Euro in Italy, while one of the lowest in the EU, remains close to 60% according to the Eurobarometer and it may be hard to convince Italians to leave. This could lead to popular pressures forcing the government to adjust its path accordingly to reduce tensions.

### 3. Confrontation leading to Italexit

The lead up would be very similar to the previous scenario. The main difference is that the government decides to leave. This could be done following a referendum or it could be decided as a national emergency. Here, the mini-BoT becomes legal tender and the new local currency and all contracts governed by Italian laws are re-labelled in the new local currency; those governed by foreign laws remain unchanged. Given the size of the Italian economy, it would have big ripple effects on the rest of Europe and the global economy (without going into detail here).

Currently, we believe that a version of Scenario 2 is the most likely outcome and that the severity of the impact on market will depend on the tenacity of the coalition. One thing for sure is that given the importance of the Italian economy in the Eurozone, there will be some negative spillover impact to the rest of the Eurozone. However, the situation remains fluid, as the details of the policies and their implementation remains vague, and needs to be monitored closely. As such, the identity of the Finance Minister will be of interest to investors.

The sharp increase in yields over the past week may affect the Italian economy, with yields having increased by about 50bp. The cost of borrowing for firms and households is likely to also increase, causing a headwind for growth. More specifically, a higher cost of funding for Italian banks could be important as it affects the profitability of the sector and could increase their vulnerabilities, especially in a context where Italian banks have huge amounts of non-performing loans on their balance sheets. Investors could look at the Eurosystem TARGET2 balance for Italy to see whether depositors are starting to worry about the risk to the banking system or are pulling their money out of Italian banks.

### Investment implications

Our base case is that while the new Italian government's policies are likely to lead to friction with the EU, we believe that it will not lead to a major crisis. However, investors need to be ready for the possibility of further Italian bond yield increases, widening in spreads and equity market underperformance in Europe, given the high level of uncertainty that is likely to linger for some time, unless we see some changes in the government policies. The euro could also come under pressure and depreciate against other major currencies. Investors should carefully assess their exposure to Italy and ask themselves whether they are comfortable with that exposure and level of risk. The same should also be considered for any exposure to periphery countries.

The increased uncertainty and risk to the stability of the Eurozone, both political and financial, could force the ECB to delay any change to its monetary policy. As such, the ECB could be forced to delay the end of the Asset Purchase Programme to offset some of the negative impact an increase in uncertainty would have on growth.

Another consideration is the impact on Brexit negotiations. In a case where the EU is too busy trying to prevent an economic crisis in one of its member states, it is likely to have little time to negotiate the terms of Brexit. This could go both ways where the EU makes a take-it-or-leave-it offer or softens its stance to ensure a deal

because it does not have time to engage in lengthy negotiations. At the same time, the increased tensions in Europe and risk of a crisis would likely bolster support for the Brexiteers' view that the only way out of the EU is a clean break, increasing the risk of a hard Brexit, in our view.

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