GENERALI INVESTMENTS

Focal Point

Harm from Catalan referendum to prove temporary

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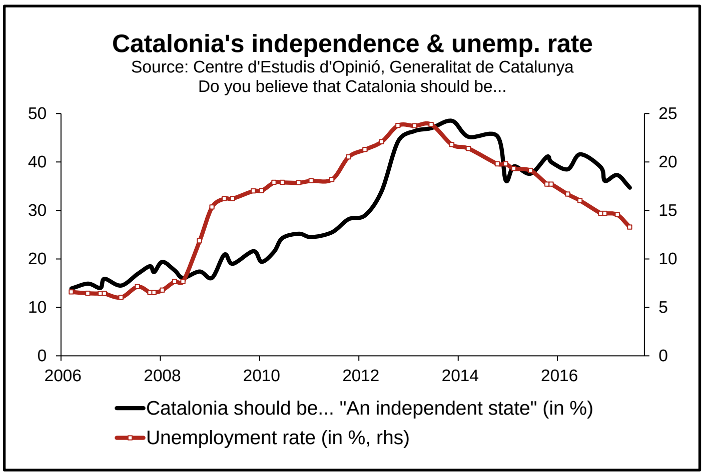
- The clash between the Catalan and the Spanish governments over the independence referendum has escalated in recent days. The vote is scheduled for October 1, but uncertainty on it actually taking place remains high.
- Should the vote occur, the pro-independence front could secure a support close to 70%, with a turnout slightly above 50%. However, even such an outcome is unlikely to lead to independence as several hurdles remain in place.
- Indeed, Spanish authorities can further tighten the control over the Catalan institutions if needed. Moreover, Catalonia is heavily dependent on central state's liquidity and a unilateral secession would likely force it out of the EU.
- We expect the dialogue between Spain and Catalonia to ultimately resume, though a comprehensive response to separatists' demands will require lengthy negotiations. Spanish assets can keep underperforming in the short term, but we expect Bonos to prove more attractive vs BTPs in the run-up to the Italian general election in H1 2018.

Since the start of September, the tension between the Catalan and the Spanish governments has intensified markedly. Indeed, the Generalitat de Catalunya, led by president Puigdemont, has undertaken decisive steps to push forward the plan for independence. On September 6, the Catalan parliament approved the law to hold the separatist referendum – scheduled on October 1 – and soon afterwards the so-called "Ley de Transitoriedad", i.e. the juridical framework intended to regulate the process of secession from Spain. These measures were immediately suspended by the Spanish Constitutional Court, but the Generalitat continued its preparations for the consultation. On Wednesday last week, however, the Spanish police arrested 14 top Catalan officials and seized nearly 10 million ballot papers, making the holding of the referendum more and more uncertain. Also, on Saturday, Spain's Interior Ministry assumed the coordination of the Catalan police (Mossos d'Esquadra) to further tighten its control ahead of the vote.

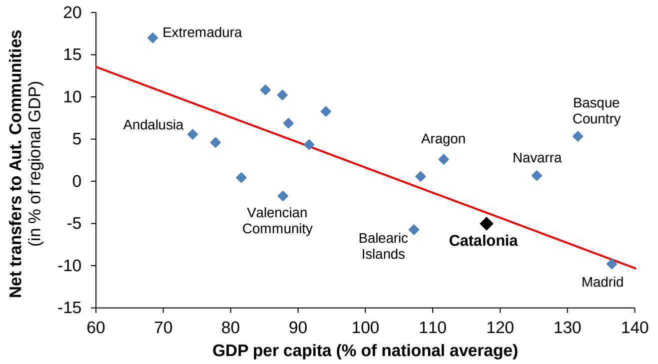
The Catalan rationale for independence

Over the recent years, Catalan regionalist parties have increasingly pressured the central authorities in order to secure more autonomy over language, civil justice and public finance. In May 2006, the Spanish parliament approved a proposal to incorporate many of those requests under the revised Statute of Autonomy of Catalonia, which was then ratified in a referendum a month later, with 78% of voting Catalans backing it. However, in June 2010 the Spanish Constitutional Court (CC) ruled against the revised statute, eliminating most of the augmented competences. In particular, the CC abolished the mechanisms aimed at reducing the distortions of the Spanish tax and transfer system. The latter requires Catalonia to be a net contributor in favor of the less wealthy Autonomous Communities (ACs). Such a decision – combined with the deteriorating macro conditions (higher unemployment rates in particular) across the country due to the Great Financial Crisis in 2008/09 and the Spanish sovereign/banking crisis in 2012 – fueled the nationalist sentiment in Catalonia and the support for independence.



Focusing on the mere economic perspective, the rationale for independence presented by Catalan separatist parties looks only partially justified. The separatist front argues that Catalonia deserves a better fiscal deal – similar to the one enjoyed by the Basque Country and Navarra – and blames the excessive penalization of the current system, which results in a net fiscal transfer from Catalonia to other ACs of around 5% in terms of regional GDP (based on 2014 data, the most updated ones).

Net transfers to Aut. Com. & GDP per capita
Source: Ministry of Finance and Public Function, 2014 data

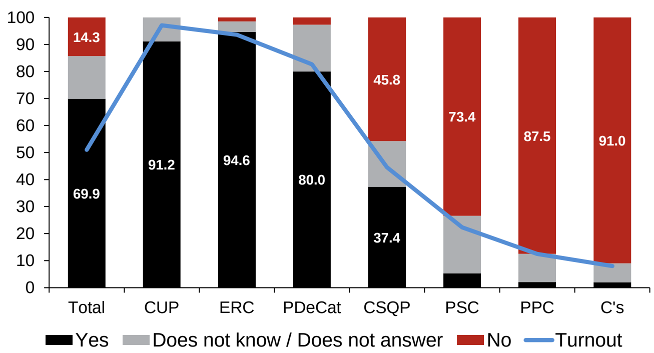


On the one hand, the fiscal framework for the Basque Country (positive net transfers of 5.3% of GDP) and Navarra (+0.6%) is more advantageous compared to the Catalan one, given also the fact that these two ACs have the second and third highest GDP per capita in Spain (Catalonia is fourth in this ranking, with a GDP per capita at 19.3% above the national average). This is the result of the preferred status of the Basque Country and Navarra enshrined in 1978's the Spanish Constitution. On the other hand, Catalonia is treated in a broadly fair way when compared to the remaining ACs once the different level of GDP per capita is taken into account (see chart above). The negative net transfers of Catalonia are consistent with the constitutional provisions envisaging solidarity across regions. Applying a Basque Country-style framework to Catalonia would undermine such a principle, given also its large weight in terms of national GDP (19.0% of the total).

Polls show huge polarization across parties

The recent crackdown led by the Guardia Civil and the tighter control of Spanish authorities over the expenditure of the Generalitat have materially reduced the chances of the referendum taking place in full on October 1. We expect only a partial vote to be held, if any.

Catalan referendum: Voting intentions
Source: Opinòmetre/Ara (Sep 16)
turnout and voting intentions by party, in %



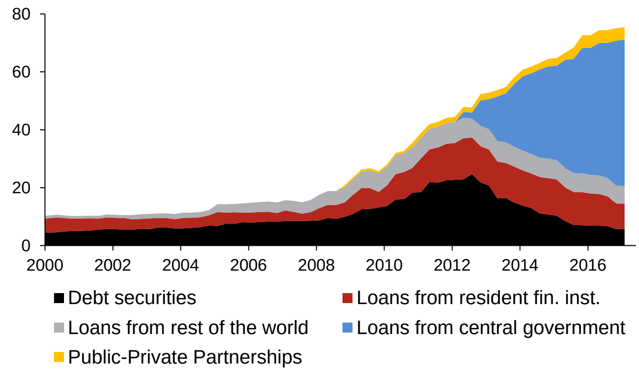
That said, it is worthwhile to have a look to opinion polls to assess the popular support for independence. The latter has fallen markedly over the past four years. According to data collected by the Centre d'Estudis d'Opinió – the body of the Generalitat dedicated to electoral polls – the support for Catalonia as an independent state peaked in November 2013 at 48.5%, then dropped to 34.7% in June 2017 (a 5-year low), with 30.5% backing the status quo.

However, most of the polls still point to a victory of the pro-independence should the referendum actually take place. Moreover, the support for independence is even higher when taking into account the different propensity to vote across parties. Indeed, the expected turnout could exceed 90% among the regionalist parties (ERC, PDeCat and CUP), whose support for independence usually stands above 80%. On the other hand, the last poll by Opinòmetre showed that the expected turnout among nationalist parties (PSC, PPC and C's) could be as low as 8%. Opinòmetre expects the "Yes" to independence to prevail with 69.9% of total votes, with a turnout barely above 50%.

Too many hurdles to Catalan independence

Even in case of a "Yes" victory, we believe that a Catalan independence remains unlikely. Indeed, several hurdles stand against an outright secession. First, the Spanish authorities can further tighten the control over the Catalan institutions. In particular, there has been an intense political debate on the opportunity to activate Article 155 of the Spanish Constitution. The latter would lead to the suspension of the Catalan regional autonomy, with the central government taking over the control. The activation of Article 155 is a prerogative of the Spanish Senate, which is controlled by the People's Party (PP). However, also the Socialists (PSOE) have recently lifted their previous veto against its usage should the separatist defiance continue.

Catalonia: Debt breakdown by owner
Source: Bank of Spain, in EUR bn

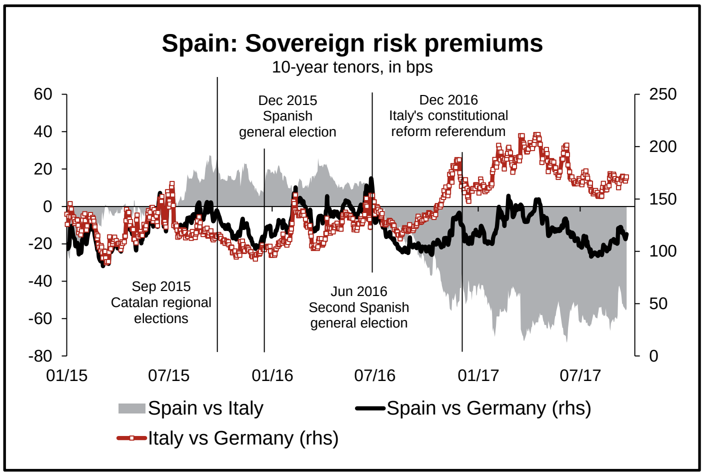


A second argument against the feasibility of the secession is the poor state of Catalan public finance. While the fiscal deficit fell from 2.9% of GDP in 2015 to 0.9% in 2016 on the back of the strong economic recovery (real GDP up by 3.5% in 2016), Catalonia's debt-to-GDP ratio is one of the highest among ACs (35.2% at end-March 2017 vs an average ratio of 24.8% for ACs). Moreover, Catalonia is heavily (and increasingly) dependent on central government liquidity tools to meet its debt obligations. Since the creation of the Fondo de Liquidez Autonómico (FLA) in July 2012, Catalonia has received €68.5 bn in liquidity assistance, the highest among ACs. As a result, the share of Catalan debt owed to the central government was 67.1% of the total in March 2017. The Generalitat has not tapped financial markets since 2011 and market spreads on existing bonds are consistent with a B+ rating. Catalonia's short-dated bonds have significantly underperformed since July (e.g. the Gencat 06/18 bond spread over Bunds has risen from 150 to 270 bps), while the risk premiums of the longer-dated one (maturing in 04/2035) have surprisingly tightened (while remaining at around 400 bps), though liquidity remains poor. Refinancing the maturing debt and the fiscal deficit at much higher rates than the ones available at the FLA would add to the likely negative impact on economic activity resulting from the secession-led uncertainty, with adverse implications for debt sustainability.

Last but not least, a unilateral secession would likely result in Catalonia been pushed out of the EU, while a successive immediate re-entry can be excluded as the Spanish government would use its veto power to oppose it. While there is no legal precedent for that, this position was recently expressed by the presidents of the European Commission and the European Parliament. A poll conducted by Metroscopia in May showed that the support for independence among separatist parties would decline between 6 to 10 pp should Catalonia be forced out of the EU.

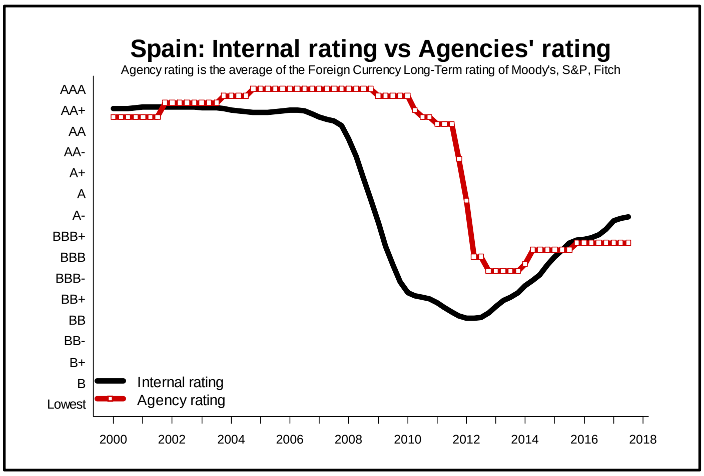
Despite high tension, market impact to be limited

Headlines over the confrontation between the Spanish and Catalan government will dominate until October 1 and tension will remain high in the immediate aftermath of the vote, probably favoring a continuation of the (so far mild) underperformance of Spanish assets in the short-term. The MSCI Spain index has underperformed the MSCI EMU by 4.2 pp since the start of August, reversing most of the outperformance seen earlier this year. Also, Spanish Investment Grade corporate bond spreads have increased by 8 bps (to 102 bps) since August, twice the widening experienced by their peers (+4 bps to 98 bps). Finally, the 10-year Bonos-BTP differential – a good proxy for political tensions in both Italy and Spain – temporarily hit the highest level since January (BTP yield 40 bps higher than the Spanish one vs above 70 bps in early June, when snap election in Italy was a clear possibility; the spread has then widened back to 50 bps).



While there is not easy way out to the current crisis, we expect negotiations between the parties to ultimately resume. We see the role of the PSOE to be crucial in trying to bridge the opposing views of PM Rajoy's government and the Generalitat. Indeed, on Thursday last week the PSOE secured the support of the PP and Unidos Podemos to start a committee over the revision of the Spanish territorial model, a necessary step to reform the constitution. Negotiations will be lengthy and difficult, but we expect Catalan independence to be avoided.

A new round of regional election in Catalonia after the referendum on Oct 1 – it would be the fourth vote since 2010, excluding the Nov 2014 non-binding self-determination referendum and national elections in 2011, 2015 and 2016 – cannot be excluded. This would further weigh on sentiment in the near term. That said, we expect the negative impact on Spanish assets to be limited, given the strong economic recovery, the prospects of rating upgrades for Spain by rating agencies – both S&P and Fitch have a BBB+ rating, with positive outlook – the progress in banking system's consolidation and reducing external imbalances. We therefore prefer Spanish Bonos over BTPs in a medium-term perspective, in particular in the run-up to the general election in Italy in H1 2018.



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