GENERALI INVESTMENTS

Focal Point

Italian election: Not that threatening anymore

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- Opinion polls for Italy's general election (Mar 4) leave the door open for a center-right majority, but a hung parliament is still our base case. An unprecedented very large grand coalition may prove necessary to overcome the impasse.
- Encouragingly, the threat of an Italexit referendum is not on the agenda anymore as Eurosceptic parties have softened their stance. The main risk is posed by a deviation from fiscal discipline and stalling structural reforms.
- While we advise some caution regarding Italian BTPs and the EUR/USD in the run-up to the elections, the immediate reaction to the outcome is expected to be muted. The benign economic environment is likely to pave the way to slightly lower BTP premiums and an appreciation of the single currency over the course of the year.
- Italian equities kept outperforming year-to-date, thanks to robust earnings growth, progress in banks' restructuring and fiscally incentivized inflows. Current market multiples look dearer and we suggest a more cautious approach.

Exactly fifteen months after the rejection of the constitutional reform in the referendum held in December 2016, Italy will face general election on March 4 to renew both chambers of the national parliament. The political forces supporting the current government are trailing in the polls and some discontinuity seems inevitable. During 2017, the increasing support for Eurosceptic forces fueled concerns over a more abrupt shift in policies. However, more recently investors have shown a much more relaxed attitude, which has benefitted Italian assets. We hereby analyze the implications of the most likely election outcomes for politics as well as for financial markets.

A hung parliament remains the base case

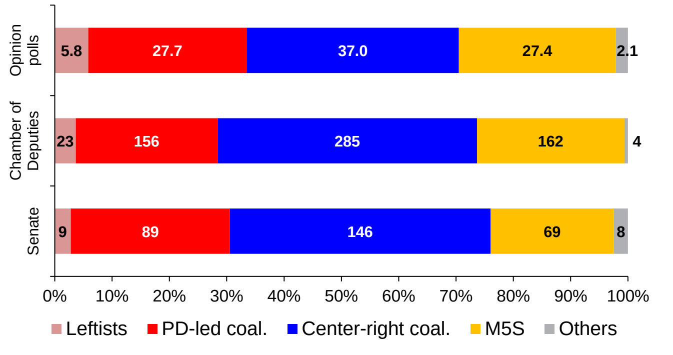
After the severe defeat suffered in the constitutional reform referendum, the ruling center-left Democratic Party (PD) has gradually edged lower in opinion polls. The situation escalated in late February 2017, when the left-wing minority left the PD, launching a new political project (initially MDP, now LeU), with an estimated consensus of around 6%. The approval of the new electoral law (Rosatellum 2.0) in October 2017 – with 36% of seats assigned on a first-past-the-post system and the remainder via a proportional one – and the difficulty of former PM Renzi to form a competitive electoral coalition have further worsened the prospects of the PD-led alliance. The latter enjoys an estimated consensus of 27-28%, neck-and-neck with Eurosceptic Five Star Movement (M5S), whose support has proved very stable over the past two years. On the other hand, the center-right coalition – formed by Mr. Berlusconi's Forza Italia (FI), the moderate NcI and the right-wing Northern League (LN) and Brothers of Italy (FdI) – has constantly crept higher in opinion polls, reaching an average consensus of around 37%, not too far from 40%, the implicit threshold needed to secure an outright majority.

Predicting the composition of the next parliament is a challenging exercise given the peculiarities of the new electoral law. That said, the algorithm we developed to project the seat distribution suggests that none of the coalitions should reach the absolute majority. The center-right alliance – which seems to be the only one with some possibility to form a majority government – is likely to secure around 60% of the first-past-the-post seats, but it is still projected to fall short of controlling the two chambers. Consequently, we currently assign a probability of 70% to our base scenario of a hung parliament.

Italy: Seat projections by coalition

based on Rosatellum 2.0 and last 10 opinion polls (Feb 2-8)

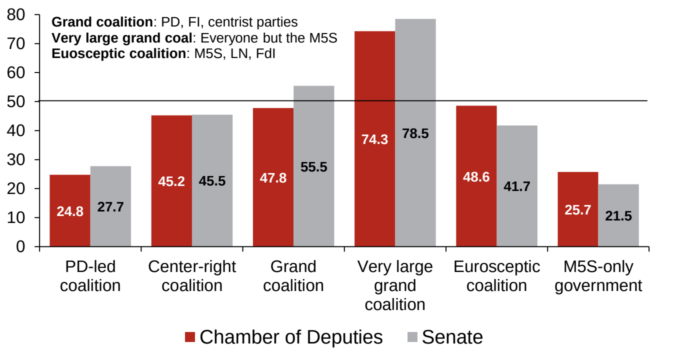
PD-led coal. = PD, SVP, others; Center-right coal. = FI, LN, FdI, NcI



"Standard" grand coalition may not suffice either

Should the election result in a hung parliament, government composition will likely prove very difficult. Indeed, even a "standard" grand coalition, including the PD, FI and pro-EU centrist parties is likely to fall short of an outright majority in the Chamber of Deputies. As a result, either the left-wing LeU or the right-wing LN and FdI would at least have to join the coalition. This will require long negotiations and the resulting ruling majority will likely prove very fragile. A failure to reach an agreement may well lead to a repeat election, likely to take place by H1 2019 (possibly after the approval of the budget law at end-2018 and new changes to the electoral law). We assign a conditional probability of 30% to this occurrence.

Italy: Possible coalitions after the election
based on Rosatellum 2.0 and last 10 opinion polls (Feb 2-8)
% of total seats



Italexit debate faded, but fiscal discipline at risk

While the next government coalition is likely to prove unstable – even the unity of a center-right alliance may be tested due to the substantially different stances on the EU – markets seem reassured by the low chances to have a cabinet supported by Eurosceptic forces. We assign a probability of 5% to such an event, as a Eurosceptic majority in the Senate looks particularly unlikely.

That said, even in such a scenario, it is important to stress that the debate over an Italexit is unlikely to escalate. Following the defeat of Marine Le Pen in the French presidential election last year, both the LN and the M5S have significantly softened their calls for a euro-exit referendum. Moreover, the procedure to call a non-binding consultation on this matter is particularly burdensome and consequently we deem such a prospect very unlikely. Market-based indicators measuring the probability of an Italexit – proxied by the difference between 5-year CDS contracts based on 2014 and 2003 ISDA definitions, with the former including debt redenomination, i.e. the exit from the euro and the return to the lira, as a default trigger – have fallen to the lowest level since February 2017.

The main risks posed by the Italian election are related to fiscal discipline and the possible reversal of structural reforms. The program of the center-right coalition envisages large tax cuts and the reversal of the pension reform approved in December 2011 under PM Monti's government, mainly funded via higher deficits. While the short-term implications for the debt trajectories would likely prove limited – a fiscal stimulus would be supportive for growth, largely offsetting the negative impact of higher budget deficits – a significant and persistent deviation from the needed budget consolidation path would be harmful over the longer run. Indeed, we found that keeping the structural primary surplus at the current levels instead of improving it by 1.5 pp of GDP over the medium term would increase the probability of explosive debt trajectories to 30% vs less than 5%.

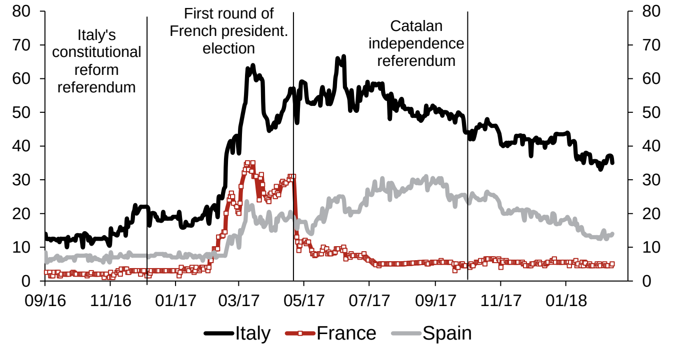
BTPs expected to weather the election well

Despite the uncertainty about the election outcome and the involved fiscal risks, Italian BTPs have performed rather well in recent weeks. Although the widening BTP/Bono spread indicates the pricing of a moderate political risk premium, the BTP/Bund spread has trended lower since the determination of the election date (10-year BTP/Bund spread down by around 30 bps to 125 bps).

Financial markets' complacency is noteworthy and taking into account the non-negligible possibility of adverse election outcomes, some caution appears warranted in the run-up to the election. Considering the fact that the current sovereign CDS premium for Italy is at the lowest level in more than two years, the risks appear asymmetric. Accordingly, we sound a note of caution as there is scope of an underperformance of BTPs until the election day.

Of course, the impact of the election on BTPs depends essentially on the vote outcome. In most scenarios the effect is likely to be muted. Only in case the Eurosceptic M5S is seen to enter the new government, BTPs are forecast to underperform and the BTP/Bund spread is expected to widen considerably. However, as the party has softened its stance on an Italexit in recent weeks, a possible spread widening is forecast to remain orderly even in this case. Our base case is the formation of a coalition government with the participation of the center-right parties. We regard this as a rather bond market friendly outcome and expect the BTP/Bund spread to tighten moderately after the vote. The (very unlikely) confirmation of the current pro-EU coalition would lead to an even more significant decline in the spread.

Market-implied risk of Italexit
difference between 5-year CDS contracts based on ISDA 2014 definition vs ISDA 2003, in bps

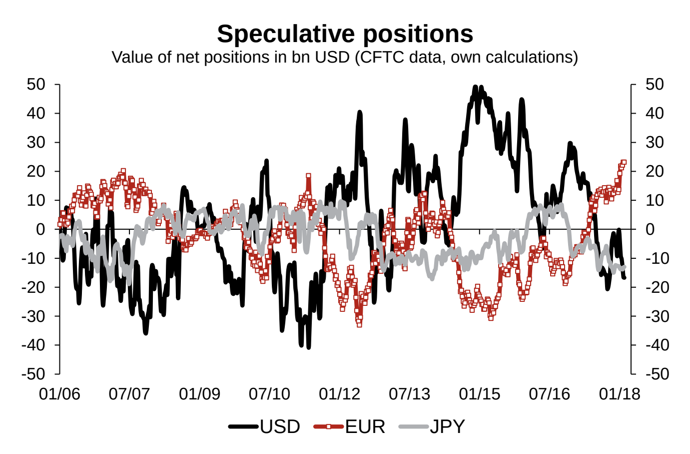


Looking further down the road, the improved economic backdrop for Italy (expected growth rate for 2018: 1.3%, almost 1% above the potential) and the clean-up of banks' balance sheets have been important credit positives. S&P upgraded Italy to BBB in October 2017 and Moody's may decide to remove the negative outlook should political risk stay contained. In combination with a low risk of a euro referendum, this will likely put BTP spreads on a firmer footing. Moreover, as it has become a consensus view that euro area core bonds will perform poorly in 2018 and concerns about debt sustainability have taken a back seat in the current solid growth environment, the carry is a welcome buffer for investors and increases the attractiveness of BTPs. These factors are seen to gain the upper hand over the shrinking ECB support given the likely termination of the QE net asset purchase programme in Q4 2018.

This rather constructive outlook for 2018 should not be confused with a structurally strong assessment. The expected looser fiscal policy will weaken the debt sustainability and increases the probability of explosive debt trajectories. In times of a weakening economy, this will come on markets' radar screens again and is expected to trigger a re-widening of BTP spreads in the longer run.

Only mild and temporary headwinds to EUR

A hung parliament in Italy may pause, but will unlikely reverse the structural strength in the EUR/USD. Accompanying the steep rise in the euro by more than 15% since early 2017, speculative long EUR positions have reached historical highs this year. With political uncertainties around Italian elections so far widely ignored by markets, this makes the euro somewhat vulnerable to a temporary setback.



That said, we expect such a setback to be muted and temporary. It will be muted, since it is unlikely to prove a source of systemic risk to the euro area. In particular, as long as higher risk premiums are fairly limited to Italy, this will not deter foreign investors from investing in euro area assets more generally. It will be temporary, since we do not expect political uncertainties in Italy to dent the strong economic momentum in any significant way. On this ground, the structural trend for the EUR/USD remains to the upside, underpinned by markets' focus on the ECB's first rate hike (likely in H1 2019), the high C/A surplus (vs. a deficit in the US) and an anticipated growing appetite of international reserve managers to rebalance their EUR holdings from historically still depressed levels.

Italian equities: More caution recommended

Since the beginning of 2017, Italian equity indices outperformed European equities by a very wide margin (performance ranging from +20% for the FTSE MIB to +37% for the FTSE Star vs +10% for the MSCI EMU). Even in the recent market correction, Italian indices suffered to a somewhat more limited degree. The solid performance of Italian indices was driven by the stronger-than-expected economic growth, higher profits (+24% in 2017 vs +11% for the MSCI EMU) and a significant decline in the equity risk premium. The latter was driven south by the strengthening of Italian banks (higher regulatory capital, faster disposal of non-performing loans amid a growing market and rising prices for impaired loans, more intense M&A activity), the reduction in systematic risk following Mr. Macron's victory in the French presidential elections and the reduced chances of an Italexit. Finally, Italian equities also benefitted from large inflows linked to the new Italian PIR funds (nearly 11 bn inflows in 2017), defined as long-term saving plans which receive high fiscal incentives for five years. They invest 70% of their assets in Italian financial instruments, including equities. During the last year, they created additional demand for Italian stocks (and IPOs), adding liquidity to the small cap market and boosting demand from international investors.

Currently, Italian equity market multiples, even after the recent pullback, remain high, much higher indeed than in November 2016, when we recommended buying Italian equities. In other words, investors' sentiment is lingering on the bullish side. In particular, the Italian small cap and the large cap index (FTSE MIB) show market multiples – like PE, price book or price cash flow – which are well above the historical average (+23%). They are also more expensive if compared to the EMU index (+13% using similar historical comparison). Broader indices like the Milan Comit are less expensive (+3%). We think that, while Italian equities can enjoy a total return of around 6% in 2018 – similarly to the EMU index – investors should maintain a cautious approach, also putting more attention to stock selection. In addition, the Italian market is also exposed to short-term risks emanating from the repricing in global equity volatility. The recent spike in volatility was driven by higher inflation expectations, rising yields, changing central banks' stance and peaking macro surprises. The correction in equities and higher volatility may cause de-risking and further downward pressure on stock prices. In such circumstances, the Italian equities could eventually perform not distantly to the EMU index if volatility remains overall contained and the election outcome is close to our base scenario. Some underperformance (up to 8 pp in the worst case scenario of a Eurosceptic-led government) looks likely in case risk aversion remains high or macro indicators stall.

last available date: 08/02/18

Indices	PE		PB		PCF		DY		Avg.	Avg.
	12m f	Discount	12m f	Discount	12m f	Discount	12m f	Discount	Discount	Disc. (-1M)
EMU	13.5	-5.0	1.5	0.7	7.7	21.0	3.5	-8.8	6.4	14.4
EMU (since 6/2009)	13.5	9.3	1.5	13.3	7.7	21.4	3.5	-10.1	13.5	22.2
FTSE MIB INDEX (since 6/2009)	13.6	11.7	1.3	31.3	6.4	43.6	4.0	-6.1	23.2	29.5
MSCI ITALY	12.5	-18.3	1.2	1.0	5.7	22.5	4.3	-7.6	3.2	8.0
MILAN COMIT GLOBAL	12.5	-15.8	1.2	-7.8	5.6	9.2	3.4	-16.4	0.5	6.8
S&P ITALY : Large/med.	13.5	-12.1	1.3	6.1	6.2	34.6	3.9	-15.7	11.1	6.0
S&P ITALY :Small	16.6	11.5	1.5	36.4	9.1	42.0	2.8	-13.7	25.9	22.2
S&P ITALY: Broad Index	13.9	-8.5	1.3	11.6	6.5	35.7	3.7	-15.1	13.5	8.6

Note: Discount in % to long-run norm; blue and negative numbers = undervaluation. Red and pos. numbers = overvaluation; PEs are since 1987-'90, the rest is since 2004 (**MIB 6/2009**). In case of DY, a discount means the market had a higher DY, meaning the market is at premium for this multiple. 12m f = expected in 12 months

Source: Thomson Reuters Datastream, IBES estimates.

Looking further down the road, some structural hurdles on the macro side are likely to persist and will keep weighing on investors' sentiment and relative equity performance over the medium term: high public and non-financial corporate debt, low productivity, high unit labor costs and the need of structural reforms (the latter unlikely to be tackled by a future hung parliament). So, overall, we recommend adopting a more caution stance on the FTSE MIB within the equity space and would wait for setbacks before increasing positions again.

Imprint

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