UBS Asset Management Flash commentary

May 2018 | Political developments in Italy

Erin Browne, Head of Asset Allocation, UBS Asset Management

Why has volatility increased in European assets?
Italian political developments have triggered fresh attention on European institutional fragility and a sharp rise in European asset volatility. Over recent weeks, Italy's 'populist' far-left Five Star Movement (5SM) and the far-right 'League', attempted to form a coalition government under the watch of Italian President Mattarella. During the election campaign, both parties had significantly toned down anti-EU rhetoric, while focusing on still EU-relevant domestic issues like immigration and fiscal spending. But a draft agreement between the two parties leaked earlier this month suggested a much more confrontational approach towards the Eurozone. While the parties downplayed this draft and ultimately settled on a less controversial document, their proposal of a euro-skeptic finance minister was vetoed by President Mattarella. Mattarella argued that the populist coalition did not have a mandate to take Italy in a direction towards confrontation and possible exit of the Eurozone, and therefore any movement in this direction would require new elections.

This veto effectively ended the formation of the non-mainstream government, prompted President Mattarella to call for a new technocratic government under former IMF director Cottarelli, and saw Five Star Movement leader Di Maio demand an (unlikely) impeachment of President Mattarella. With the forthcoming confidence vote in this unelected technocratic government highly likely to fail, Italy looks headed for a fresh set of elections in the coming months. These developments sparked a sharp rise in the spread between Italian and German 10 year government bond yields. Spreads have spiked 80 basis points since May 25 and 160 basis points since the start of the month, bringing them to their highest levels since 2013. European equities, paced by Italy, and the euro have weakened in concert.

Italian political developments are fluid and there are a number of variables that could influence the state of play and knock-on effects on Italian and European assets. But perhaps the most important question is whether the 5SM and the League form a renewed pact in the new elections with a much more explicit confrontational approach towards renegotiating Italy's position within the Eurozone. Amid such a backdrop we would likely see greater market pressure in the form of higher Italian bond yields and weaker equities, as markets are forced to discount some probability of a disorderly exit from the Eurozone's third largest economy. If outgoing ECB vice-president Victor Constancio's speech[1] is to be taken at face value, the ECB is unlikely to extend its Quantitative Easing program, which is expected to end this year. Constancio also reminded that to qualify for the ECB's reinvestment, Italy would have to retain at least one investment grade credit rating. This could come under threat if Italy is seen to loosen fiscal standards and Moody's has already placed Italy's rating on negative watch. In short, the ECB is unlikely to serve as a stopgap for Italian market stress, and would probably use interest rate guidance as opposed to asset purchases as a means to prevent the tightening of financial conditions from threatening the ECB's price stability goals for the entire Eurozone.

A more constructive political development would be for the populist parties to distance themselves from each other in favor of more traditional political ideologies. For example, instead of aligning with the 5 Star Movement, the League could form a coalition with the more centrist Forza Italia. Such a development would likely involve a less confrontational approach to the Eurozone from Italy. Another possibility is that both populist parties lose political support as market stress becomes increasingly apparent, much as Marine Le Pen lost support ahead of the French elections. But this by definition would imply market price action needs to get worse before it gets better, and there is no guarantee that current Centrist parties are strong enough to garner support in the current environment.

What is the outlook from here?
Despite the reaction of markets, we should not discount the possibility that public pressure within Italy may force a U-turn from Mattarella and a political solution, however unlikely that currently seems. But without a swift political compromise, the investment case for European assets has weakened. The ECB has certainly played a strong role in reducing Italian debt vulnerability, with its ownership of outstanding Italian bonds rising from 4% to 19% since the

[1] http://www.spiegel.de/international/europe/interview-with-ecb-vice-president-vitor-constancio-on-italy-a-1210093.html

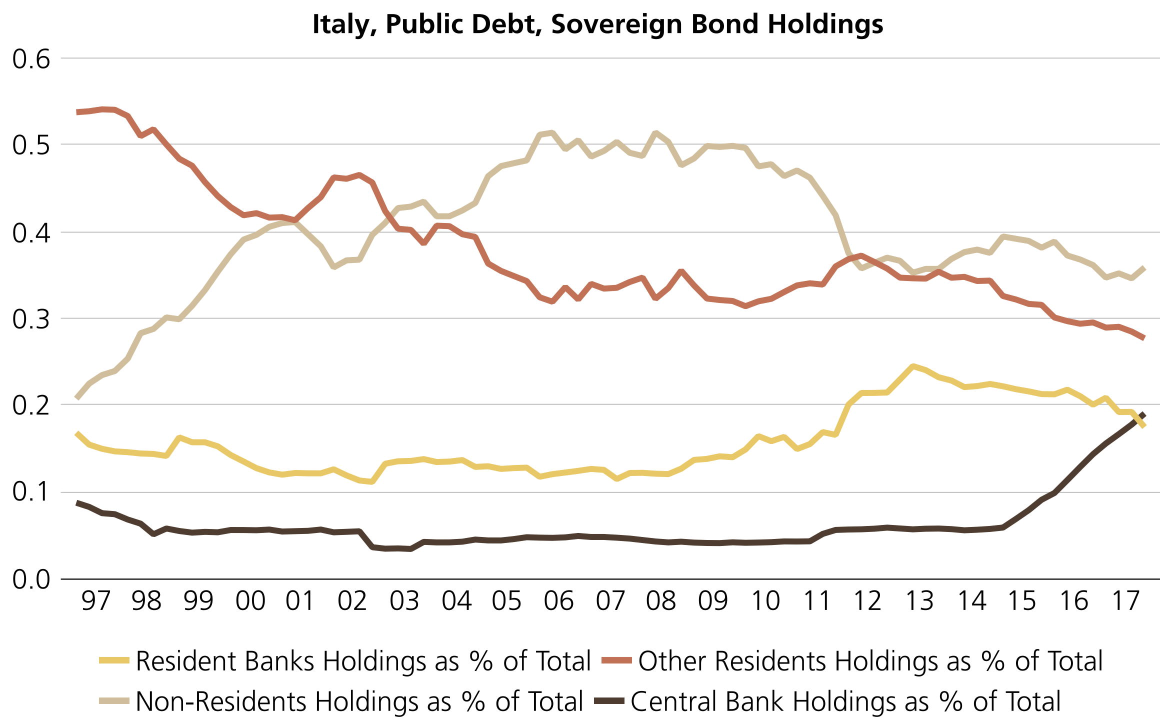
ECB began purchasing bonds in 2015 (Chart 1). But more than 80% of Italian debt is owned by more price sensitive buyers. And without a political turnaround or an abrupt change from the ECB, which we view as unlikely, there does not appear to be a strong backstop for Italian debt. And while Italy has improved its current account and fiscal balances (Chart 2) since the 2011-12 sovereign debt crisis, the overall stock of Italian debt has risen to 132% of GDP, which would rise further under League-5SM policies. For now, we anticipate continued volatility in Italian government bonds and could potentially see further widening of the spread between Italian and German government debt. With the ECB still likely to end QE but potentially keeping interest rates lower for longer, we could see a steepening of the Bund yield curve. A delayed tightening of monetary policy and questioning of the Eurozone as an attractive investment destination is likely to keep the euro weak against most crosses.

The recent EUR weakness does provide some support to export oriented companies and equity sectors. As such, within European equities, we favor large cap stocks and individual country indices that source a significant share of their revenues from outside the Eurozone. That said, we think that the sharp increase in volatility caused by recent developments will increase the risk premium on European equities and constrain upside potential until more clarity emerges around Italian politics. Overall, while we see clear short term headwinds to European assets and equities, our base case remains positive for European equities over the longer term based on still above-trend economic growth and inexpensive valuations.

Conclusion

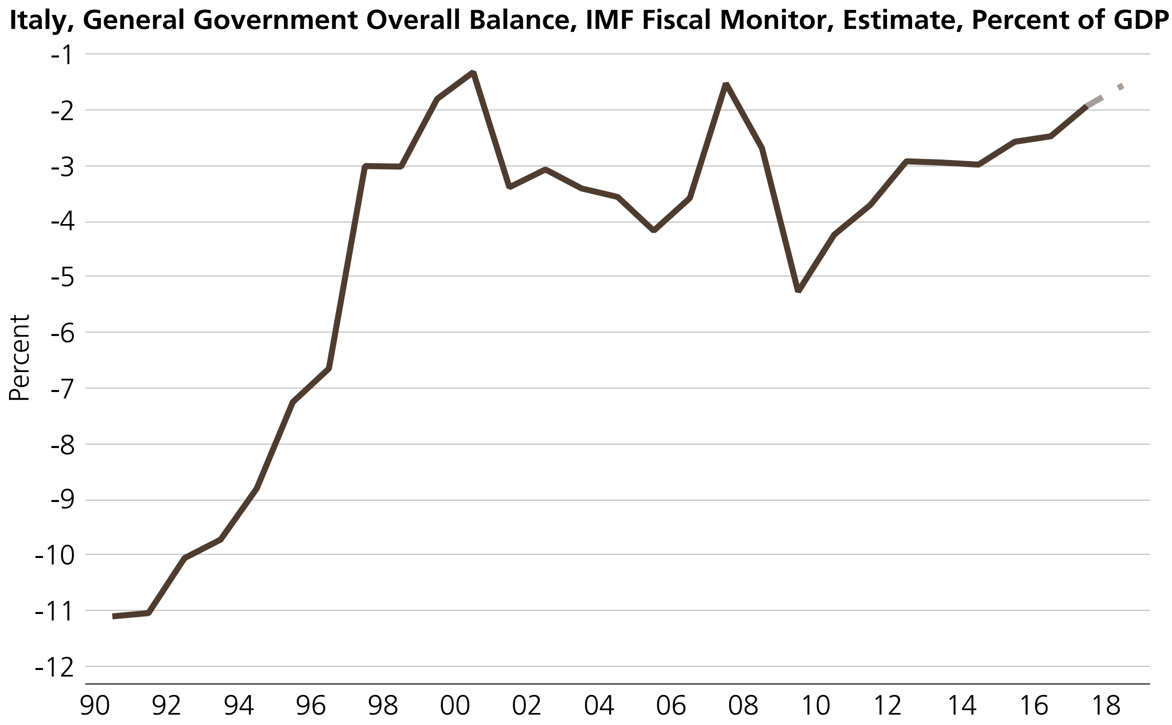
Without a swift political solution to the situation in Italy, we believe that the risk-return trade-off for European assets has deteriorated. As things currently stand, we are likely to see a period of heightened volatility in Italian and broader European equities and bonds amid Italian political dynamics and their interactions with ECB policy. That said, we do not see Italian political developments as presenting material systemic risks beyond Europe at this stage. Both populist parties have signaled they will not attempt to leave the Eurozone (and according to the Italian Constitution this would be extremely difficult in any case), even if their desired fiscal policies put them on a collision course with the core of Europe and the ECB. We ultimately expect market and political pressures to constrain these parties, and Europe will find a way to muddle through political uncertainty as it has in the past. Still, we recognize the path to resolution is likely to be bumpy and have downgraded our outlook on European assets to account for recent developments.

Chart 1: Change in Composition of Italy's Sovereign Bond Ownership



Source: UBS Asset Management, Macrobond.

Chart 2: Italy's General Government Balance



Source: UBS Asset Management, Macrobond.

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