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Investment Strategy Bulletin

Italian elections: Uncertainty unlikely to curb recovery

Investment Solutions

February 2018

Italian elections:
Uncertainty unlikely to curb recovery

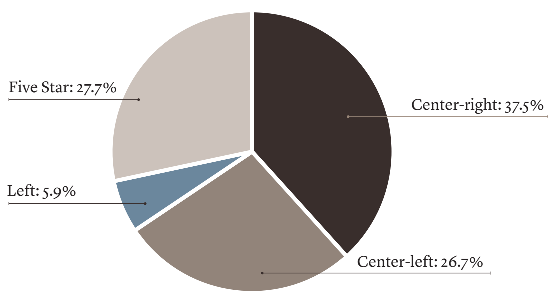
- Risk of a negative surprise that could have severe repercussions for the Eurozone has greatly reduced.
- No party is calling for a euro exit, and the nature of the new electoral law limits the influence of non-mainstream parties.
- Nevertheless, post-election volatility is a distinct possibility given the fragmentation of the Italian political system.

Italy's upcoming elections (due to take place on 4 March 2018) have so far generated little concern among market participants as the risks surrounding them appear greatly reduced. This is in line with our judgement, although we would not discount the possibility of a period of increased volatility following the vote. It is also worth highlighting that the combination of a new electoral law, a high number of undecided voters, and polls with a less-than-stellar track record make it hard to forecast the outcome with much confidence.

Three main blocks are taking part in the elections: the centre-right coalition (led by Silvio Berlusconi's Forza Italia (FI) and including the more right-wing parties Lega and Brothers of Italy) the centre-left coalition (led by Matteo Renzi's Democratic Party (PD), along with some smaller allies); and the anti-establishment Five Star Movement (M5S) running on its own (and generally opposing coalitions). Given the nature of the new electoral law[1], translating vote shares into House and Senate seats is not straightforward, but a key takeaway from recent polls is that the only side with a real shot at a majority is the centre-right.

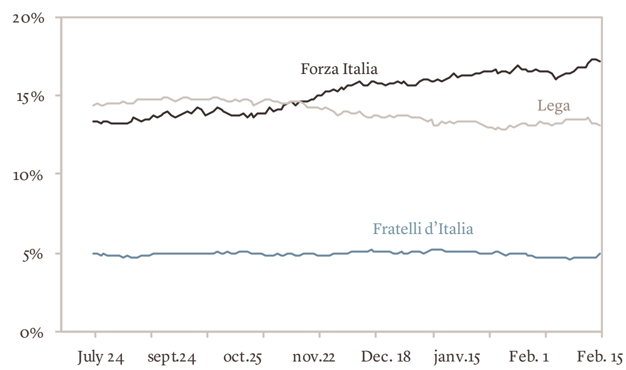
The centre-right camp looks set to gain the largest share of votes, based on the last set of polls (published by the end of last week[2]. As shown in Chart 1, its percentage is close to 37%. The electoral law favours coalitions, and as a result their share of seats in parliament tends to be higher than their percentage of the total vote. However, even accounting for this effect, expert estimates suggest that the centre-right would need to get 40% of the vote in order to have a majority in parliament (in fact, a majority in both houses would be needed). No poll has given the coalition as high a percentage, although it stands just a few percentage points below this threshold, a modest outperformance on voting day could hand it a majority.

I. Centre-right coalition holds the lead in the polls
Vote intention based on average of 10 most recent polls



Sources: Bloomberg, Italian poll agencies, Lombard Odier calculations

II. Within the centre-right, Forza Italia is ahead of Lega
Vote intention based on average of 10 most recent polls



Sources: Bloomberg, Italian poll agencies, Lombard Odier calculations

[1] The electoral law allocates about two-thirds of the seats on the basis of a proportional system, and almost one-third on a first-past-the-post (FPTP) basis, with the small number of remaining seats determined by the vote of Italians abroad.
[2] The law imposes a two-week blackout period ahead of the voting day.

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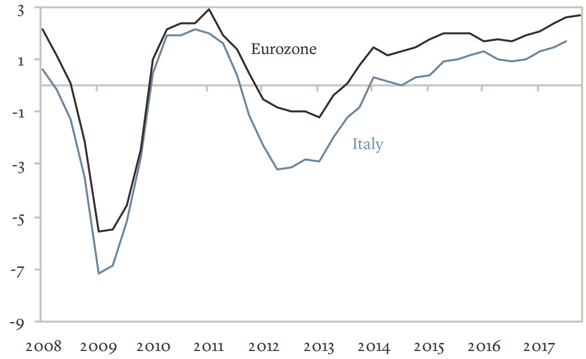
Data as of 21 February 2018 unless otherwise stated.

III. GDP growth has accelerated in Italy, having lagged behind the Eurozone

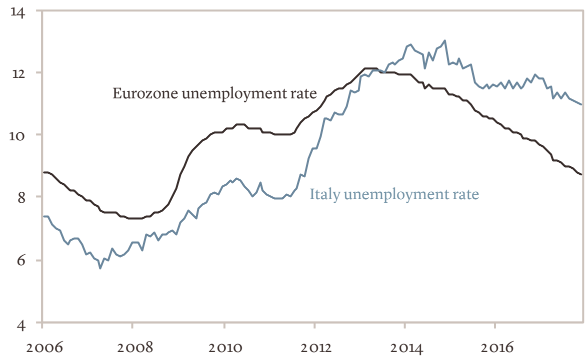
Real GDP growth (in percent), Eurozone and Italy



Sources: Bloomberg, Lombard Odier

IV. In turn, the employment picture is also improving

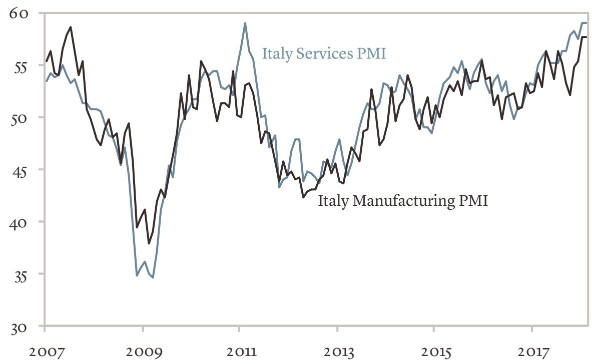
Unemployment rate (in percent), Eurozone and Italy



Sources: Bloomberg, Lombard Odier

V. Forward-looking indicators suggest the trend is likely to last

PMI surveys



Sources: Bloomberg, Markit

By contrast, M5S – despite polling at around 27% and looking like the favourite for winning the largest number of votes of any single party – is far from forming its own majority. The centre-left coalition also polls around 27%, while the smaller left-wing party Free and Equal (LeU) stands at 6%.

The main scenarios

The prevailing dynamics suggest the following scenarios are possible:

- the centre-right achieves a majority
- some form of coalition is formed among mostly centrist parties (FI, PD, and some others)
- a M5S-led coalition gets formed
- absence of any clear majority leads to new elections.

If the first scenario were to materialize, this would probably become clear immediately after the results are announced, as it would require a centre-right majority in both houses. A negotiation process between the parties making up the coalition would follow with the dynamics determined, to a large extent, by the vote share that each party achieves. Assuming FI wins more votes than Lega, as most polls currently suggest (Chart 2), Silvio Berlusconi, who is barred from holding public office due to a tax fraud conviction, would pick his preferred candidate for the role of prime minister. The chosen candidate would likely be a figure of mutual acceptance (Antonio Tajani, the President of the European Parliament, is often cited as a possible candidate) that Lega would accept as leader. We expect the direction of such a government to be fairly moderate, with the eurosceptic element losing ground in the discourse, and issues such as taxes, pension and labour-market reform, as well as immigration, becoming the focus. Still, deep divisions separate Lega and FI, and there are reasons to believe that the stability of such a coalition and its ability to govern are not assured. Unlike in the past, FI will not be the single dominant force in the coalition, and the rising profile of Lega, combined with Berlusconi's absence from office, can make the divisions increasingly evident over time – and even pose a risk to its viability.

What if there is no clear winner? President Sergio Mattarella, who has considerable discretion in such circumstances, would set off the process of government formation, assigning the mandate to the leader he deems most able to form the necessary coalition of forces. This process would either eventually succeed by bringing about a government that manages to win a vote of confidence in the parliament, or could lead to new elections if it fails repeatedly and brings about a deadlock.

A scenario that has received a fair amount of airplay is the possibility of a grand coalition, with FI and PD as the major partners, supported by some smaller centrist allies. While this would be seen as a market-friendly development – with the policy path likely to be pro-European and ensuring stability – it would face a number of hurdles before seeing the light of day. These would include the need for some form of agreement to be reached between two parties (and leaders) that often maintain a hostile stance against each other, the need for a sufficient number of seats controlled by centrist parties to ensure a vote of confidence, and a figure of common acceptance being agreed as PM (this could be incumbent PM Gentiloni or a figure like Tajani).

The least preferred outcome for financial markets would be a coalition government that is led by M5S. This is also, in our view, by far the least likely scenario: it would require an outperformance by M5S relative to its current poll numbers, a change in its stance against coalitions and an ability to find common ground with other parties. It is not hard to see why this would be the least market-friendly outcome given past anti-euro comments by M5S leaders, but it is worth noting that the party's stance has moderated considerably over time. Exiting from the euro is no longer mentioned, and the party's focus has shifted to issues such as the amount of flexibility allowed by the EU budget and the idea of eurobonds.

Finally, if no government coalition can be formed, the possibility of new elections would arise. Italy, however, has no history of back-to-back elections, and it is not clear that a repeat election would end the stalemate. This is because the fragmentation would still be in place and the high threshold for reaching a majority would pose the same issue (unless the electoral system is changed – again – in the meantime). Heading into new elections would certainly not be a constructive outcome, given the uncertainty it would generate. Nevertheless, it would be unlikely to cause a particularly sharp market reaction given that such uncertainty would by no means be a first in Italian political history. In addition, a caretaker government, possibly still led by Gentiloni, would stay in place in the meantime. It is also possible that, in an agreement brokered by the President, a government of technocratic character gets formed and stays in power for a limited amount of time. This has been a fairly common occurrence in Italian political history and could be used as an interim solution, especially if a pressing issue needs to be dealt with.

Meanwhile, an increasingly solid recovery has taken hold in the Italian economy. We think that the strong economic backdrop limits the risks stemming from the 4 March election. The recovery has been under way for the Eurozone as a whole for a while, but a marked improvement in the macroeconomic outlook is finally also evident in Italy, where a recovery has taken hold despite having lagged most other Eurozone economies. Not only has growth been positive since 2014 – and accelerated notably over the past couple of years (Charts 3-4) – the current growth momentum looks likely to remain strong, as suggested by Italy's PMI surveys currently printing at their highest levels in over a decade (Chart 5).

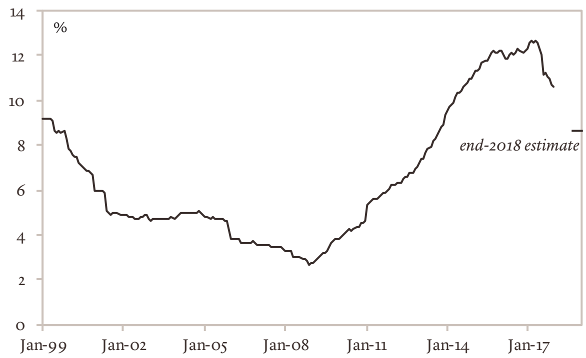
The outlook for growth and inflation benefits from the ECB's commitment to keep providing stimulus despite the upturn in growth. Critically for Italy, an improved nominal growth trend, combined with lower cost of interest (benefiting from the ECB's asset purchases) and a budget consistently in primary surplus (currently 1.5% of GDP) should allow the country's debt/GDP ratio to begin falling.

The Italian banking system is on the mend: high levels of non-performing loans (NPLs) were a key concern, forcing the ECB to apply pressure for them to be reduced. The government dealt with the most significant problems in the system over the course of 2017 (notably, the precautionary recapitalization of Banca Monte Paschi di Siena). Italian banks have also been raising capital and disposing of NPLs. Combined with the slowdown in new NPL formation, thanks to the improved growth environment, NPL ratios in the Italian banking system are coming down. Further progress looks likely in coming quarters given a number of transactions that are already in the pipeline (Chart 6).

Given the above, current market pricing ahead of the elections appears reasonable. Italian government bond spreads versus Bunds at about 130 basis points suggest a market that feels comfortable with the upcoming event risk – the spread is tighter

VI. Banking system: bad loans falling (and likely to drop further)

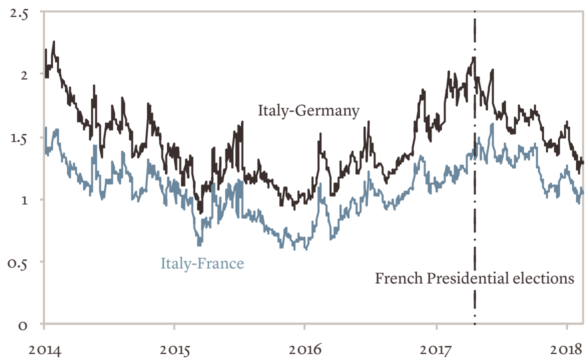
Non-performing loans to total loans ratio, including end-2018 estimate



Sources: Datastream, Banca d'Italia, Lombard Odier calculations

VII. Bond market shows little concern about political risk...

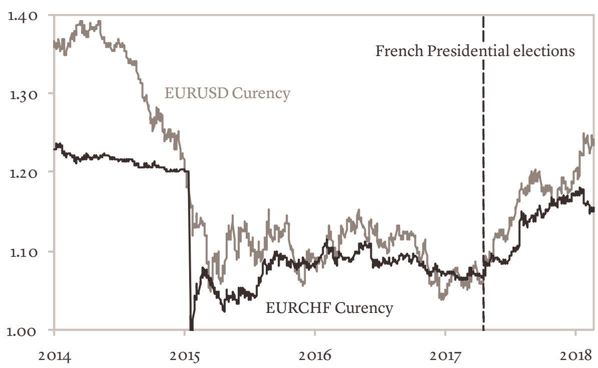
Italian bond 10-year spreads vs. Germany and France (in basis points)



Sources: Bloomberg, Lombard Odier

VIII. ...and so do the FX markets

EUR/USD and EUR/CHF spot exchange rates



Sources: Bloomberg, Lombard Odier

today than it was ahead of the French presidential elections last year (Chart 7). Similarly, FX markets show few signs of concern with the EUR close to the top of its range against the USD, after a substantial rally from its sub-1.05 lows in early 2017. Moreover, EURCHF, currently trading just above 1.15, is off its recent highs but substantially higher than the range that prevailed before the French elections, sending the same message (Chart 8).

Risks under control, but worth monitoring

Politics is rarely the most significant driver of financial markets, although it can certainly have a significant impact, especially in extremes. Recent history reminds us that asset prices can react calmly in the face of electoral upsets –even if these were seen as highly risky ahead of the vote – when the overall macroeconomic outlook remains solid.

The extreme scenarios surrounding the upcoming Italian elections (namely exiting the euro or the possibility of a referendum on this question) are highly unlikely, in our view. The euroscepticism of M5S appears greatly reduced, and the anti-system tendencies of Lega have been losing prominence since it became part of the broader centre-right coalition.

It is also worth considering the broader conditions when assessing the overall balance of risks: the capacity of a negative political development in one country to materially affect confidence in the Eurozone is undoubtedly smaller today than it was at the start of the decade. The improved economic backdrop, the backstop provided by the ECB, and the lessons the market has learned from the various kinds of political noise that failed to alter the macroeconomic trajectory, all contribute to that.

Nevertheless, it is worth keeping in mind that the upcoming elections are unlikely to bring about positive economic developments for Italy. Almost all plausible scenarios include a period of uncertainty, which in some cases can be protracted. A stalling of the reform momentum seen during periods of the Renzi government is highly likely. Campaign rhetoric used from most sides points to increased probability of post-election fiscal slippage. And reduced governing effectiveness is the common thread running through most possible coalition scenarios. While we think that the net effect of the 4 March elections is more likely to be negative than positive, none of these spells disaster for Italy, nor pose an existential threat to the Eurozone.

Bill Papadakis, Macro Strategist

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