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Italy: Where do We Go from Here?

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Checks and Balances Work but Volatility to Remain

Italy has been through a political whirlwind over the last two weeks—better yet, over the last three months. What was the worst-case scenario prior to the March 4 election has now become the best-case outcome for European government bond markets: A populist coalition consisting of the Five Star Movement (5SM) along with the Lega Nord (League).

The list of Executive Ministers has been announced, with Giuseppe Conte now sitting as prime minister and key minister positions filled by more moderate candidates, such as Giovanni Tria as Minister of Economy and Finance. Worryingly, Matteo Salvini, the League's leader, and Luigi Di Maio, head of 5SM, will both sit as Deputy Prime Ministers, while the hotly contested Paolo Savona will take the job of Minister of European Affairs and be in charge of EU negotiations.

Savona is in charge of European Affairs, but his ad-hoc position is far less important compared to the Economy and Finance or Foreign Affairs roles. Our interpretation is that we'll see a government that is highly prone to making headlines and experiencing Facebook or Twitter lash out; but this government is far less "Eurosceptic" than originally feared. Therefore, our ex ante view is that there is little redenomination risk for Italy.

This is All About Fiscal

The fiscal policies and objectives of the 5SM and League are something akin to oil and water. The 5SM voters were promised a minimum guaranteed income to support economically challenged households, while the League voters understood a more regressive-type flat tax was on its way. It is a miracle that these two parties are able to form a government; but given that their policies must be combined, it suggest more, not less, expansionary fiscal policy.

The market must price both the headline risk associated with more extreme views from Salvini or Savona and the risk of financing fiscal policy that could top 7% of GDP, according to Osservatorio CPI.

If pushed through in any size, fiscal policy is likely to cause headwinds for the Italian Economy Minister, as this level breaks many institutional fiscal rules included in the Maastricht Treaty. Looking forward, we expect spread volatility within the Italian ten-year government bond to remain around the target range of +185 to 200 basis points (bps) with spikes probably needed to push the new government toward a policy that adheres to EU limits. This base case is clearly not without risks.

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Spillover Risks Limited?

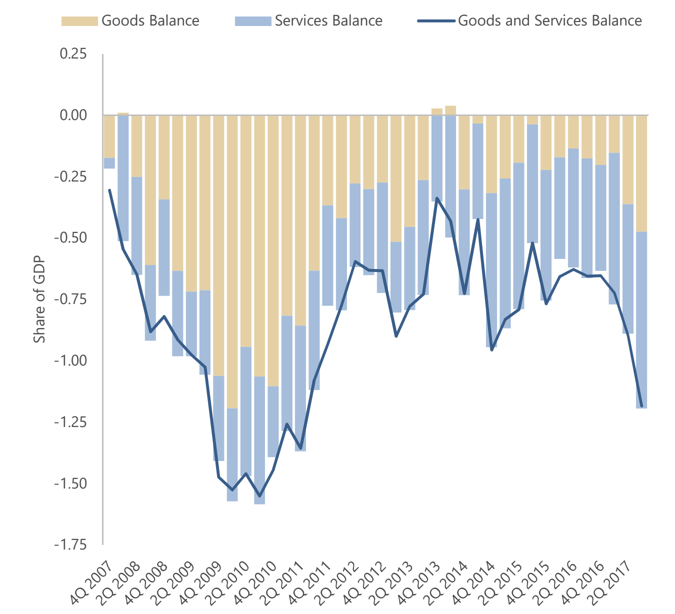
In our view, it is too early to tell how consumers and firms will react to the new government and whatever policies they are able to pass. However, financial outflows, such as direct investment, which has been a steady €17 billion since 2016 and portfolio inflows of €29 billion in 2017, could be at risk. Furthermore, if sticky investors started selling en masse without the domestic bid on the other side, we may have a broader financial problem in the large European government bond market. So financial instability could impact real assets and potentially broader risk sentiment. We believe spillover risk should be limited to the macroeconomic reaction function, for now.

The IMF estimates for every 100 bps move in spreads, growth declines by 0.4%, all else equal. This means that, even within our range of spread target above, growth suffers as banks pass on higher funding costs to borrowers and the economic momentum slows, holding policy constant.

It will seep out via trade balances. All of the discussion has been Italy-specific, but Italy provides demand to the region, as the goods and services balance with the rest of the euro area is in a deficit of 1.2% of GDP despite running a large surplus with the rest of the world. Therefore, any material hiccup within Italy's economy will be passed through to the rest of the euro area via trade.

Our conclusion remains that risks are an idiosyncratic risk for Italy and its bond market, but the economic spillover will be real if sentiment declines. We think the European Central Bank (ECB) will tread quite lightly at this juncture and policy will be pushed back as needed.

Italy: Goods and Services Balance Vis-à-Vis the EA 19



Source: Macrobond data with Standish calculations as of June 1, 2018

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