ITALY: THE PATH TO STABILITY

Key takeaways:

- After almost three months since general elections were held, Italy finally has a new government.
- The gridlock that has taken over Italian politics is certainly not new, but it shook markets at the end of May.
- Not only did the Italian spread (relative to Germany) go up, but also stock markets around the world were affected.
- Now that things are returning to normal, the country will need to start facing some overdue economic challenges: low growth, high unemployment, and ballooning levels of public debt.
- The good news is that the populist rhetoric has not escalated – with reassuring statements that the country is not looking for a way out of the euro area – and, more importantly, the European Central Bank is still committed to helping the country avoid a crisis.

Brexit was not a one-off

After French President Macron's electoral victory last year, it seemed like Europe was leaving behind the populist wave that had taken over many of its countries, most notably the U.K. during the 2016 Brexit vote. But Italy has reminded us this year that this is not the case. Even though Italian political parties went on for months without being able to reach an agreement after the general election of March 4th produced no clear winner, it was only during the last week of May that markets finally quivered in reaction to events in the peninsula. What happened then, or why did it take so long to see an effect on markets? In this paper we examine the recent events in Italy, a country where government crises have been more the norm rather than the exception for the past 70 years.

March: general election

The election of March 4th brought some big surprises. First, the two top vote-getters – amassing more than half the vote – were out-of-the-mainstream parties. On one hand, the Five Star Movement (M5S), an anti-establishment party created to rally popular discontent with corruption and overall political dysfunction, came in first. On the other, the League, formerly a party almost exclusively focused on Northern Italy and the idea of seceding, which now had taken a hardline approach against immigration, making it a major part of their plank. The League ran in coalition with former Prime Minister Silvio Berlusconi's party, and was not expected to be the most voted party of the bloc. But it was, laying to rest the most cited forecast, where Mr. Berlusconi, ineligible himself for the office of PM, would play kingmaker. Although no party was expected to emerge with a governing majority – partly because the design of the Italian electoral system, despite some recent reforms, still aims to prevent any one party from getting too much power – the results surprised analysts in that no government coalition seemed possible.

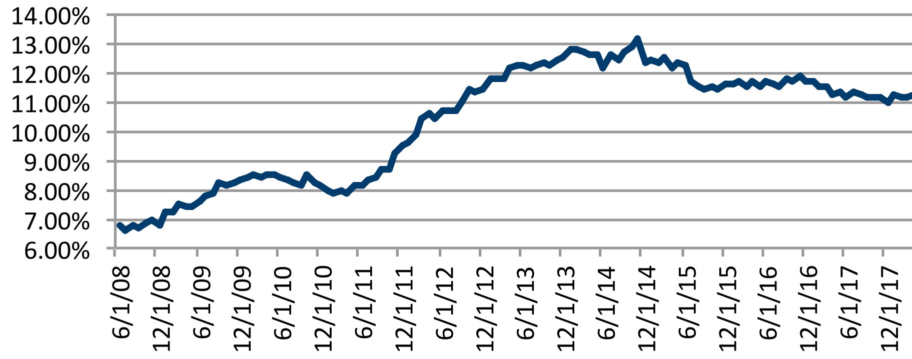
The election also highlighted the stark and well-known differences between the wealthier north and the poorer south: while the former voted the League, the latter supported the M5S. The League took over Mr. Berlusconi's party as the most important right-of-center party, and the M5S cast a large shadow over the socialdemocratic left (the Democratic Party of former PM Matteo Renzi).

Figures 1 and 2

UNEMPLOYMENT IN ITALY HAS RECEDED, BUT IT IS STILL HIGH

Fig. 1: Monthly data from 6/30/2008 to 4/30/2018.
Source: Innealta Capital using data from Bloomberg.

Fig. 2: Data for Greece and UK is from February; data for Hungary, Estonia, and Norway is from March.
Source: Eurostat (EU).



Unemployment rates, seasonally adjusted (April 2018)

Greece
Spain
Italy
France
Croatia
Cyprus
Finland
Slovakia
Portugal
Latvia
Lithuania
Sweden
Belgium
Ireland
Estonia
Luxembourg
Slovenia
Denmark
Bulgaria
Austria
Romania
United Kingdom
Norway
Netherlands
Poland
Hungary
Germany
Malta
Iceland
Czech Republic
Euro Area
EU

0.00% 5.00% 10.00% 15.00% 20.00% 25.00%

Euro Area EU (non-euro) EEA

March to May: growing uncertainty

The country spent almost three months following the general election without being able to form a government. Finally, in May, the leaders of M5S and the League finally announced an agreement to form a joint government. They released a 50-plus-page "contract" with a program for the new coalition. Strangely enough, both leaders declined to head the new government, preferring instead to serve as ministers. Even more bizarrely, they asked President Sergio Matarella to appoint a complete stranger as prime minister, a lawyer named Giuseppe Conte (who had no previous political experience and did not even run for Congress in the last election). The president agreed, and Mr. Conte proposed a cabinet.

The president approved the list, but for the name of the prospective new Minister of Economy and Finances, Paolo Savona. The president cited Mr. Savona's well-known support to leave the euro as a major concern, worried about how investors (domestic and foreign) might react. This, as expected, muddied the waters. The leader of M5S called for the president

to be impeached, even though it is within his powers to veto a cabinet appointment. Mr. Conte said he would not try to form a government, and the president called on Carlo Cottarelli, a former IMF official (for whom no one voted), to form a government. The two main parties reacted stating they would not support his appointment. The only way out was then a new election, which would have brought even more uncertainty. Polls showed that the League would do much better than in March, so analysts began wondering whether this party would in effect sabotage any coalition agreement so as to force a new vote. The problem with a new election in Italy was that the scenario where no party emerged with a governing majority was still very likely, fueling the prospect of more and longer gridlock. After all, the country has had to resort to so-called technocratic governments in recent years after no consensus has been possible.

The political saga ended on Friday, June 1st, when the parties agreed to a cabinet that removed the controversial choice of Mr. Savona as Minister of Finance (although he was still appointed to the cabinet, albeit in a different post). In our view, the president played his hand extremely well, forcing the coalition to moderate and lower their tone, thus avoiding further rattling of already uneasy investors. Given the situation, the outcome was extremely good and signals that there is still some oversight over the new government. Moreover, it avoided a new election that could have been taken as a de facto referendum on the euro, which would have further increased uncertainty. This in spite of polls showing that Italians would massively support remaining in the eurozone if given the chance to vote directly on the issue.

Figure 3

ITALIAN DEBT IS FAR ABOVE THE 60% STIPULATED BY THE STABILITY AND GROWTH PACT

Yearly data from 1980 to 2017.

Source: Innealta Capital using data from Bloomberg.

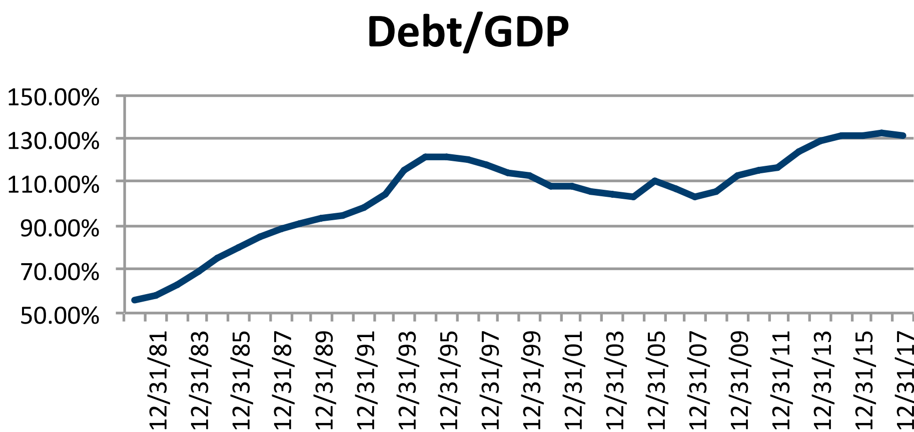
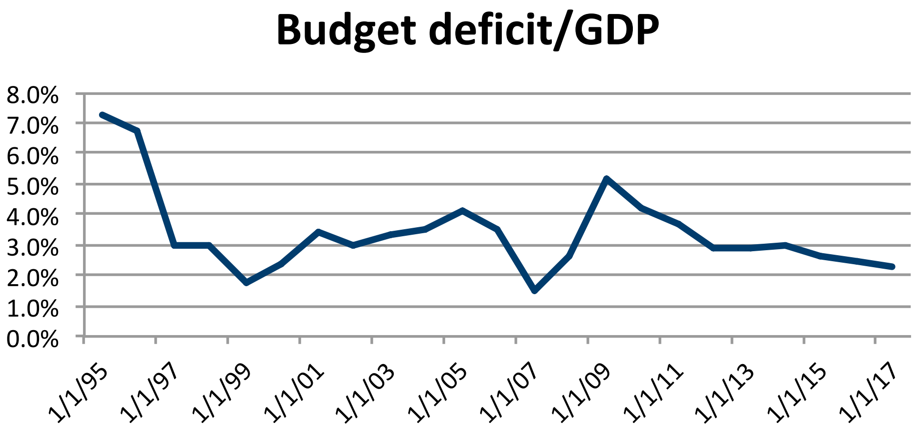


Figure 4

AND SO ARE BUDGET DEFICITS, WHICH SHOULD BE NO LARGER THAN 3% OF GDP

Yearly data from 1995 to 2017.

Source: Innealta Capital using data from Bloomberg.



Economic context

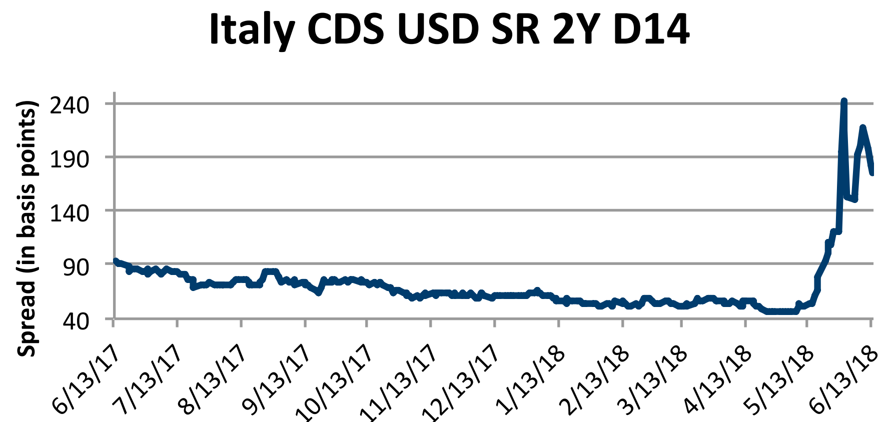
The thrashing of traditional parties occurred at a time when Italy, unlike other Western European economies growing at rates of 2% or even 3% (Spain last year, e.g.), is virtually stagnated, as it has been for almost two decades now. While many of its neighbors have left the worst of the financial crisis behind, Italy is still displaying dismal growth (close to 1% annually) and high rates of unemployment. Overall output is lower than before the crisis began and many young people are leaving the country, hit by an unemployment rate of more than 15% for 25 to 34-year-olds. (Data by *Fondazione Migrantes* show that 50,000 people aged 18-34 left the country in 2016.) The long-term prospects are made even bleaker by the lowest fertility rate in the EU (Eurostat) and a mean age for Italian residents that surpassed 45 this year for the first time in recorded history (partly because of increased life expectancy, of course). However, 2017 saw more foreigners coming in (up by 12%) and fewer locals leaving (down by 3%). Yet Istat expects the total population in the country to fall by 7 million over the next 50

years.

More specifically, Italy has a debt problem. First, its banking sector holds around a fourth of risky (a.k.a. toxic) loans in the eurozone. The government had to intervene to save banks last year, including the third largest in the country.

Figure 5

RISK PERCEPTIONS SHOT UP AT THE END OF MAY, AS REFLECTED BY THE TWO-YEAR CDS



Daily data from 6/13/2017 to 6/13/2018.

Source: Innealta Capital using data from Bloomberg.

The last week of May: markets unsettled

Even though the election was held in March, it was only on the last week of May that markets became alarmed. What changed was the prospect of a new election that could turn into an in-all-but-name referendum on the euro. The two major parties did not campaign on leaving the common currency, opting to avoid the issue for the most part (another cause for uncertainty). However, past statements praising the UK's departure from the EU or openly embracing "euroskepticism" gave reasons to worry.

On Tuesday, May 29th, the effect was felt in the U.S., with the Dow losing approximately 400 points, and the S&P 500 dropping 1.2%. The euro lost value against the dollar and the spread for Italy's debt (versus Germany) went up. Italian two-year yields went from 0.94% to 2.42% that Tuesday. They had not reached 2% since 2013. Contagion was limited in this area, as proven by Spanish yields, which barely moved. As expected, US Treasuries rose, as investors sought safer assets: the 10-year yield was down 15 basis points that day (2.78%).

A main concern was the banking sector, as we explained above. It is hard for investors at this point to know how any particular bank would fare if another euro crisis arose. Consequently, Italian banks' shares were down that Tuesday, but also foreign banks': Spain's Santander, France's BNP Paribas, Germany's Commerzbank, and America's JPMorgan, Citigroup, Bank of America and Morgan Stanley all lost at least 4% of their value. Japanese banks were hit the next morning, for they are known to invest heavily on global sovereign bonds.

Leaving the euro and going back to the lira (or whatever name is chosen for a local currency) would effectively mean devaluation, which would destroy a good portion of people's savings and also effectively increase the already large debt. Furthermore, the ECB would probably stop buying Italian-government bonds, which would make interest rates in Italy soar.

Italy is the fourth-largest EU economy (third in the eurozone), and it accounts for roughly 15% of the eurozone's GDP. But it represents around 23% of its public debt: Italian debt now stands at 130% of GDP. More importantly, two-decade economic stagnation and high unemployment make the levels of debt look even worse. In spite of all this, the governor of the Bank of Italy said the reaction of markets had been mostly emotional, as there were no facts to make sense of it.

Aftermath

After the turbulence at the end of May, it took roughly a week for the new government to take hold and the markets to examine it. The fact that the new prime minister and the two parties supporting him were inexperienced in government affairs made it harder for analysts to predict the course the new administration would take. A clash with the EU over economic affairs – budget deficits especially – threatened to destabilize the euro. Tensions over immigration, as more and more countries vote hardliners on the subject into office, were growing and presented a threat to the EU itself.

But markets rallied back to Italian debt and equities after Giovanni Tria, the new Minister of Finance and an independent, said in an interview with Corriere della Sera published on June 10th:

> *The position of the government is clear and unanimous. There is no discussion about leaving the euro. The government is determined to prevent any emergence of market conditions that would lead to leaving the euro. It's not just that we don't want to leave it: we will act in such a way that conditions that could call into question our presence in the euro area don't start to emerge. As Economy minister, I have the responsibility to guarantee, on a government mandate, that these conditions do not take place. The statements of the Prime Minister are along these lines and the government as a whole is responsible to the country.*

First, Tria stated very clearly that no plans to exit the euro were being considered by the government. Second, he said the debt was a threat to financial stability and that reducing its current levels was an explicit objective of the current administration. As a result, the two-year bond's yield reached 1.172%; the week before it had been close to 2.8%, after the new prime minister, after being sworn in, had vowed to implement an array of populist polices. Italian banks, which hold a big chunk of the government's debt, benefitted the most from this turn of events, leading the market rally.

Politically, things have changed fast. The March election left the M5S as the largest party. The League, which was expected to play sideshow to Mr. Berlusconi's party, ended at the top of the right-wing coalition, yet far behind M5S. But in the three months after the election, the League has grown fast. Polls were showing this, and municipal elections on June 10th confirmed it. If the ~17% of the vote they received in March was a great result, they are now close to 30%. Moreover, the party has tightened its grip on the government, and no longer acts as the smaller party. Economically, the League holds some market-friendly views (e.g., lower taxation and a flat tax), and some that are more worrisome (e.g., protectionism). Still, markets would probably endorse their policies over the coalition partners'.

Conclusion

It would be fair to say that now Italy has a government that comprises two populist parties (with no further allies). These are two parties, additionally, that seemed to have very little in common just a few months ago. Their ascent to power has been driven by enormous discontent with the state of the economy and with the way traditional parties have handled power. Anxieties over mass irregular immigration have only made the backlash worse. Undoubtedly, the profound resentment against Brussels (i.e., the EU) that has fueled their ascent has been brewing for a long time. The EU is seen by many as too strict in matters like fiscal deficits and, more recently, the handling of migrants. Animus against the EU is relevant: there is danger that a contagion effect might ensue, leading to other populist movements gaining power in other eurozone or EU countries, increasing the uncertainty about the future of the common market and currency. (Countries already governed by EU-critical parties include Hungary, Poland, Czech Republic, and Austria, with Slovenia potentially joining the group soon.) However, we view these countries as pushing for reforms from within the EU, and not seeking a way out. Internally, an additional peril is the lack of effective power of the new PM, basically a subordinate of two members of his cabinet. He has been called the weakest PM in Italian history. In his favor is the fact that the coalition supporting him is the smallest possible, increasing the likelihood of a stable, long-term government. Having a stable government in power should not be underestimated given what Italian politics has looked like in the last 70 years. Moreover, the new government has taken some important steps in the right direction to assuage investors' concerns, especially regarding the issue of the euro. Debt and deficits should follow, but even now the outlook looks much better than just a month ago.

Last revised: June 4th, 2018.

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