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Amundi ASSET MANAGEMENT

INVESTMENT TALKS

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Italian political transition following unclear paths. Wise to wait and see.

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- *The political situation in Italy is still uncertain, with some indication, but no formal appointment of the Prime Minister. We may witness a somewhat unusual state of affairs over the next few days, a sort of “technical government” of no parliamentary extraction, subject to a political contract. This could prove challenging in the medium-term, undermining the independence of the Prime Minister and the Government. The appointment of the Minister of Economy and Foreign Affairs will be key to reassure European partners in respect of EU rules, the euro and international cooperation. On these topics the positions of the two main parties are still unclear.*
- *The contract between Movimento 5 Stelle (M5S) and Lega Nord (League), as it has been formulated, presents a number of challenges. Its implementation risks not being consistent with Stability Pact and the Constitutional principle of a balanced budget. The programme as it stands, does not respect the characteristics necessary for being considered a proper budget. It is likely to be modified, should the Government be formed.*
- *On Euro fixed income, despite a sharp widening of the spread, uncertainties around the implementation of the measures announced by the coalition and their financing would suggest playing the market with tactical positions and a limited amount of risk. Investors need to get more accurate information on those aspects before implementing a strategic position in Italian government bonds.*
- *Contagion effect on other peripheral markets should be contained if the issue stays focussed on the degree of the Italian fiscal expansion. Should the discussion ramp up to challenge European unity, the contagion could be much broader and detrimental to other peripheral spreads.*

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How is the political situation evolving in Italy? What are the next steps?

Usardi: The political situation in Italy is still uncertain and articulated in three main key points.
1. On May 21st the M5S and League party leaders submitted their selected name to be Prime Minister to President Mattarella; reportedly it will be Prof. Giuseppe Conte, a University Professor, and an “external” figure that has not been elected in Parliament. President Mattarella asked for at least one day to evaluate if the candidate is suitable for the position: the President will meet both Senate and House Presidents, but he is not expected to summon the Prime Minister to be before Wednesday this week.
2. Despite claims that this will be a political government with full rights and powers, open question marks remain over the role that the Prime Minister will have: his powers and autonomy should be granted by the Constitution but, in reality, these would be limited by the “contract” and by the directions of the two leaders of the parties that gave birth to this government.
3. Reportedly, there is still disagreement between M5S and League on the key Ministers (Domestic Affairs, External Affairs, Justice, Economy, Defence, Finance, Economic Development), although it is - by Constitution - the President of the Republic’s responsibility to nominate them, taking into consideration the Prime Minister’s suggestions. And we still believe that the nominee will need to be a person of international standing. We may witness a somewhat unusual state of affairs over the next few days, a sort of “technical government” (meaning of no parliamentary extraction), subject to a political contract.

Do you see the fiscal plan outlined in the programme as sustainable? What are the main risks linked to it?

Usardi: There are a number of points in the contract that appear potentially at odds with the Stability Pact on the trajectory of deficit and debt and that, therefore, would be difficult to implement within this framework and also within the framework of a balanced budget (art 81

There are a number of points in the contract that appear potentially at odds with Stability Pact regarding the trajectory of Deficit and Debt.

of the Constitution, introduced in May 2012). Based on the 17th of May programme, the *Osservatorio dei Conti Pubblici* (*Università Cattolica Milan*) tried to estimate the impact on expenditure and revenues of the measures "explicitly" mentioned. According to these estimates, the increase in the expenditure side and the decrease in revenues linked to fiscal changes ("dual-tax"), would result in expansionary measures of €108.7 – 125.7 billion; while "explicitly" mentioned cuts to costs and expenditures would amount to just € 0.5 billion. On May 21st the Italian financial newspaper, *Il Sole 24 Ore*, reported a somewhat more optimistic estimation of uncovered expenditures for approx. € 50 billion in the first year.
Yet, the "contract", as it is, appears to be neglecting details and principles sufficient to evaluate it as a proper budget, underscoring the likelihood that it could be modified should the Government be formed. In fact any law proposal on the budget would be under the scrutiny of the State Accounting office (*Ragioneria dello Stato*).

Do you think that the potential new Government foreign policy could impact the equilibria within the Euro area and globally?
Usardi: Looking at the new "contract", the amount of topics that could put Italy in contrast with its partners is still far from negligible: changes to the immigration policy; proposals to modify sanctions on Russia (and indirectly in contrast with the U.S.); suggestion for the promotion of "Made in Italy" for the agricultural sector by reforming the Common Agricultural Policy (CAP); the commitment to pursue "a foreign policy putting at the core the national interest". The programme would therefore make the possibility of confrontation with the EU inevitable, even if this could be further watered down in practice during the parliamentary works. As a first stage, we would expect the EU partners to be carefully monitoring the developments: key to the perception of the Italian stance would be the nomination of the Foreign Affairs Minister, which should be a person able to quickly catch-up with open international dossiers in order to reassure partners.

Do you see the Italian debt rating at risk?

Investors need to get more accurate information on budget measures before implementing a strategic position on Italian govies.

Vic-Philippe: As a result of the recent political developments in Italy, we expect rating Agencies would want to get a more precise view on the measures and their financing before re-assessing the Italian rating. In the short-term, this will prevent any upgrade/positive outlook. We do not see a material risk of a downgrade on a short-term horizon because of the Italian economic results.
On a long term basis, the ability of Italy to remain on track with the improvement of debt metrics will be key and thus linked to the calibration and the implementation of the main measures of the coalition.

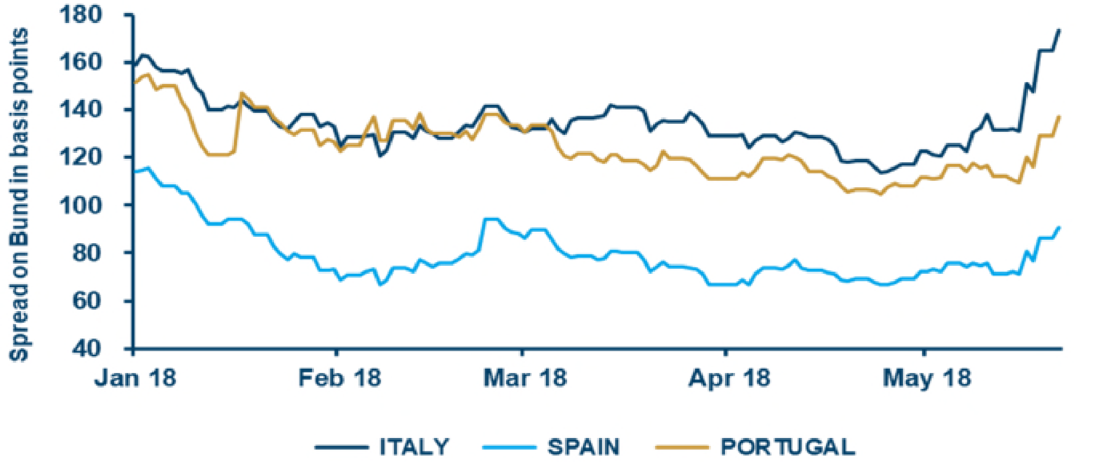
Are these levels of spread a buy opportunity for a long term investor?
Vic-Philippe: Long term investors are highly sensitive to the credit quality of their investments. The Italian spread has widened by 60 basis points[i] since the end of April. It stands now at 180bp but, for long-term investors, it doesn't seem to be sufficient with regards to the uncertainties around the implementation of the measures announced by the coalition and their financing. Investors need to get more accurate information on those aspects before implementing a strategic position.

Do you see a contagion risk to other peripherals? How should investors play the current phase of the market?
Vic-Philippe: For the time being, the spread widening on Italian debt has been contained as well as the contagion effect on other peripheral markets. If the issue remains limited to the degree of fiscal expansion in Italy, without derailing to a hard argument with other European countries, the contagion should remain limited. If the argument deteriorates so that the Eurozone unity is again at risk, then the contagion could potentially be much larger and detrimental to other peripheral spreads (well experienced negative loop of flight to quality).

[i] Basis point (bps) refers to a common unit of measure for interest rates. One basis point is equal to 1/100th of 1%, or 0.01%,

For this reason, we believe investors should only play the current phase of the market with tactical positions and with a limited amount of risk.

Governement spreads vs Bund – 10 year bonds



Source: Bloomberg, as of May 21 2018.

The Italian situation may not have enough time to worsen so significantly as to derail the ECB exit process.

Do you see the Italian situation having any impact on the ECB exiting QE?

Vic-Philippe: The ECB should formally announce soon how it intends to end its purchasing programme. Our central scenario is a progressive reduction of purchases to an end in December 2018. Despite the Q1 softening, the current economic expansion is still sustained in Italy and in any other Eurozone countries. In the meantime, the Italian situation may not have time to worsen significantly enough to derail the ECB exit process.

On the other hand, the end of the ECB bond purchase scheme could have an impact on the global interest rates and, potentially, on the spread levels across EU countries, as investors decisions will be driven by different parameters (i.e., constraints on ratings or credit worthiness) than ECB's purchases.

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