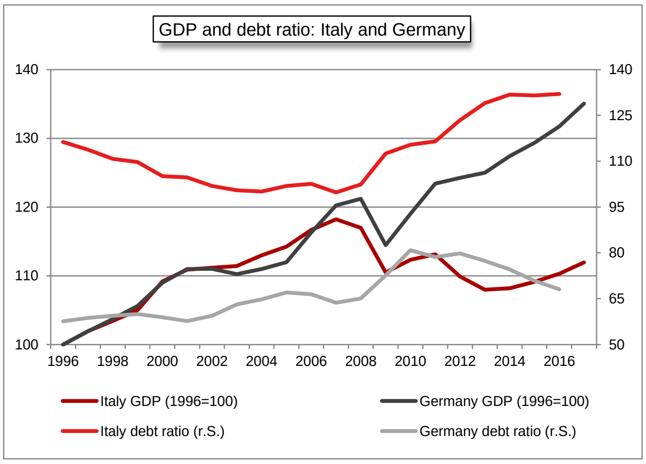
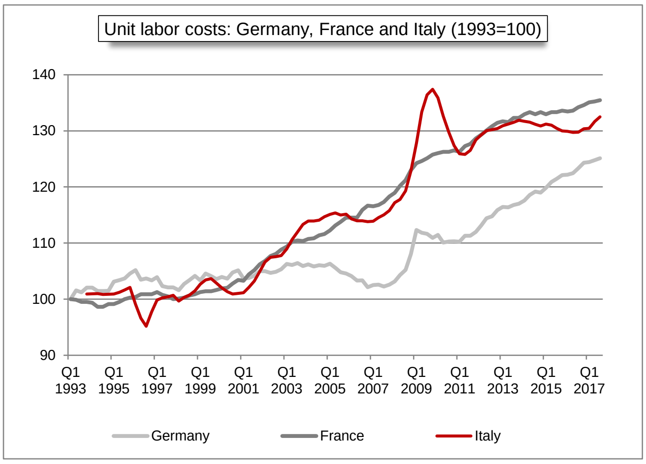
Italy votes: Event or non-event?

Italians will go to the polls on Sunday. Matteo Renzi, a native of Florence and member of the Democratic Party, was celebrated at home and abroad initially, but had to resign at the end of 2016 after losing a constitutional referendum. Paolo Gentiloni, having served as minister of foreign affairs until then, though oddly without much recognition abroad, succeeded Renzi in the office of Italian prime minister. Not much has been accomplished in this time, but at least the country's election law has been reformed. The new law is known as the "rosatellum" and provides that in both houses of parliament (Chamber of Deputies and Senate of the Republic), 37% of the seats are allocated by majority vote in single-member districts ("winner take all"), and 61% by proportional vote (another 2% go to constituencies abroad). This enables an alliance with less than 50% in the proportional vote to win the election by getting enough votes in single-member districts. The change of election law and passage of the 2018 budget enabled Italy's President Sergio Mattarella to dissolve parliament in December 2017 and thus set new elections. Last year, there was great concern about new elections in Italy. This has clearly changed, and the market seems hardly interested. Is it right?



How is the situation in Italy?

Italy is still the "sick man of Europe". Recently somewhat stronger economic growth – fueled by the strong global trend – should not obscure that fact. Ten years on, Italy is still unable to achieve production levels from before the financial crisis, and that will take a few more years at the current pace of growth (2017: +1.5%). Even though the unemployment rate has improved to 10.8%, it is still significantly below the EU average of 7.3% (EMU: 8.7%). Only Greece, Spain, and Cyprus exhibit higher unemployment rates. Italy's public debt problem is even more dramatic. Its debt ratio is 132%, and only Greece has greater debt by European comparison. Moreover, there is no improvement of Italy's situation in sight. On the one hand, the country's economy will grow on average by just 1% in the years at ahead. At the same time, the primary surplus, at about +2%, is not large enough to significantly reduce the debt ratio given an average interest burden of over 3% of GDP. The reasons for Italy's economic problems also do not lie in the European "austerity policy" denounced by the Italians. Instead, they are structural in nature. For example, the country's productivity has been low for decades and is even below its level in 2000. The very low productivity growth also suggests that this will not change quickly. Another structural problem in Italy is high labor costs combined with an overregulated labor market. The Renzi government did implement at least some reforms, but the labor market remains inflexible by European comparison. In addition, Italian banks are not the best growth partners for the business community because of their high level of non-performing loans. Excessive bureaucracy and corruption, especially in the south, and the slowness of the justice and administrative systems must also be noted.



But how do Italy's leading political parties and coalitions view these problems, and what do they propose to ensure a sustained growth trend?

Saving is no issue

In short, none of the political alliances seems to take Italy's structural problems seriously. Quite in keeping with tradition, they promise only election gifts that cannot be financed and demand a dismantling of the EU's fiscal pact.

For example, the center-right alliance under Silvio Berlusconi and his Forza Italia party are calling for an end of the "austerity policy," tax breaks with a flat income tax rate (below 23%; Lega even calls for 15%; current maximum: 43%), issuance of new bonds to pay off debts of companies and households, higher pensions, and a lower retirement age). Furthermore, they want to make the Italian constitution supersede the European constitution and introduce a more restrictive asylum law. They do not explain how all this will be financed, but the plan is still to reduce Italy's debt ratio from 132% to 100%.

The center-left alliance also proposes to cut income taxes for families and corporation taxes (from 24% to 22%). Moreover, a minimum wage and a minimum retirement benefit are to be introduced. These parties are the only coalition striving for a pro-European course. In this connection, however, they add the introduction of euro bonds and a European finance minister to the platform and demand an easing of the fiscal pact. In direct contradiction to this, they also set the goal of reducing the debt ratio to 100% in ten years.

The euro-skeptical Five Star Movement sees its political salvation in a guaranteed basic income for Italian citizens, earlier retirement, and a focus on pursuing national instead of European interests. Refugee policy is to become much more restrictive with reductions and border controls. The government is to become leaner, and debt to be reduced by 40% in ten years. A bank separation act and a government investment bank are to be introduced to stabilize the banking sector.

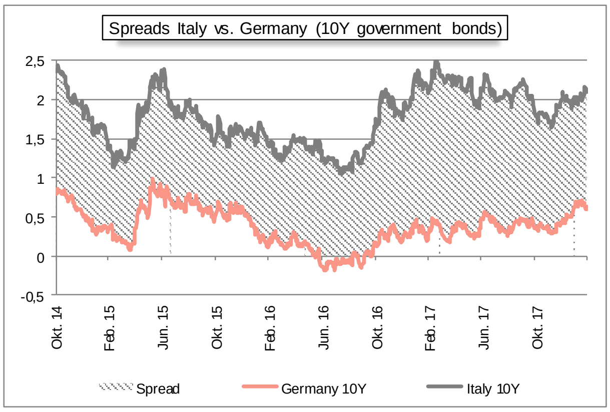
Coalition	Centre-left-coalition	Centre-right coalition	Five-stars-movement
Political parties	Democratic party, christian-democratic alliance, progressive alliance, pro-european alliance	Forza Italia, Lega, Brothers of Italy (Fratelli d'Italia), Central-christian-democratic alliance	Five-stars-movement (no coalition)
Lead candidate	Matteo Renzi	(Silvio Berlusconi)	Luigi di Maiao
Last survey (26.02.2018)	25,5%	37,5%	26,3%

However different the parties may be in their world views, all the campaign platforms have one thing in common, which is that they thoroughly ignore adequate structural reforms necessary for stable long-term growth as much as they do compliance with the Stability and Growth Pact. Instead, they prefer to indulge in a five-year spending spree. Despite all this, the financial markets remain calm regarding the election. The spread between German and Italian bonds has tightened lately rather than widened, and the Italian stock market has not been more conspicuous than other European indexes. So, returning to our original question, what is this calm attributable to and is it justified?

Market calm is justified

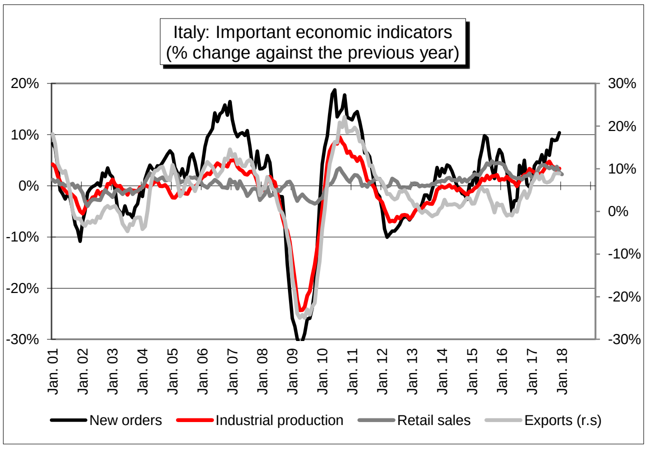
The answer is affirmative. The hostility of Italian political parties to Europe has diminished considerably. A few months ago, the Five Star Movement was still promising a referendum on exiting the euro if it won the election. But in view of modestly better economic data, there is no more talk of that (not to mention that it would be unconstitutional). Almost all parties are now in favor of the euro and the EU and only advocate divergences from the fiscal pact. The specter of "Italexit" should be off the table for now, and with it the greatest source of uncertainty.

However, the question remains as to who will be considered for the next government and what effects that will have. None of the three coalitions has a sufficient majority according to the latest polls, which were taken on February 16 (publication of polls is prohibited two weeks before an election). The center-right coalition will presumably be the strongest. But at just under 37%, it is also very unlikely to suffice for a majority. The center-left coalition is far behind at about 26% and will not be able to come close to achieving its results of the 2013 election. The Five Star Movement will probably be the strongest party. But with a forecast 26% of the vote, a majority is also nearly out of the question. Since the Five Star Movement's relations with the other parties are anything but good, it is very unlikely that it will participate in the government – also because the party itself is not seeking a coalition. So, there will probably be difficult and lengthy negotiations in which the central parties, PD and Forza Italia, will have to join forces with smaller parties from the middle and, if necessary, from the left and right fringes to form a government. The largest common denominator of such a government would be the demand for fiscal easing and hence a more flexible deficit ratio. However, that would directly conflict with the EU and would only be possible with the promise of structural reforms. But it is extremely doubtful whether a corresponding consensus can be found in such a coalition. It is more likely that under such a government, current policy would remain in place due to the lack of consensus, and the necessary reforms, which none of the parties is calling for in any case, would not take place. In short, Italy's situation will probably not change. But if such a coalition does not come about, new elections will be the logical next step. The resulting continuation of political uncertainty would negatively affect the Italian economy and the stock and bond markets, but one cannot infer a shock on the markets from that. After all, the alternative (standstill) would scarcely be better.

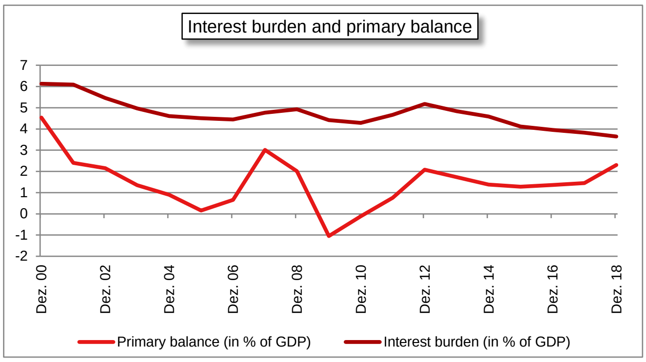


Rating not in danger

So, the elections are probably not going to affect the markets much, simply because little will change. But that is precisely the problem for the long term. Sustained growth will not happen in Italy without reforms. That inevitably raises questions about Italy's ability to carry debt and about its rating. The most important factors here are the country's high government debt and simultaneously low growth rates, and the conclusion to draw from them is clear. But that is not the whole story. Expansionary monetary policy combined with bond purchases by the ECB has also benefited the Italians. They have been able to significantly increase the average maturity of their bonds on declining average interest paid. While the average maturity was still about 6.8 years when quantitative easing began, it has risen to 7.4 years now. Sensitivity to rising interest rates has thus decreased markedly. Moreover, market interest rates are significantly below the interest paid on maturing bonds. Italy's interest burden may thus be reduced further even on gradually rising key interest rates, which we expect from mid-2019 onward. The country's ability to carry debt should thus not worsen noticeably in the years after the election. Accordingly, we do not expect that the elections will have an influence on Italy's rating and that its investment grade rating will remain intact (S&P: BBB; Fitch: BBB; Moody's: Baa2).



Overall, we may conclude that the elections should have hardly any influence on the markets. After the elections, however, Italy will continue with meager growth rates to lag behind most EMU countries due to a lack of far-reaching reforms. The world economy will pull Italy along with it, but the country will not be able to return to its halcyon days that way.

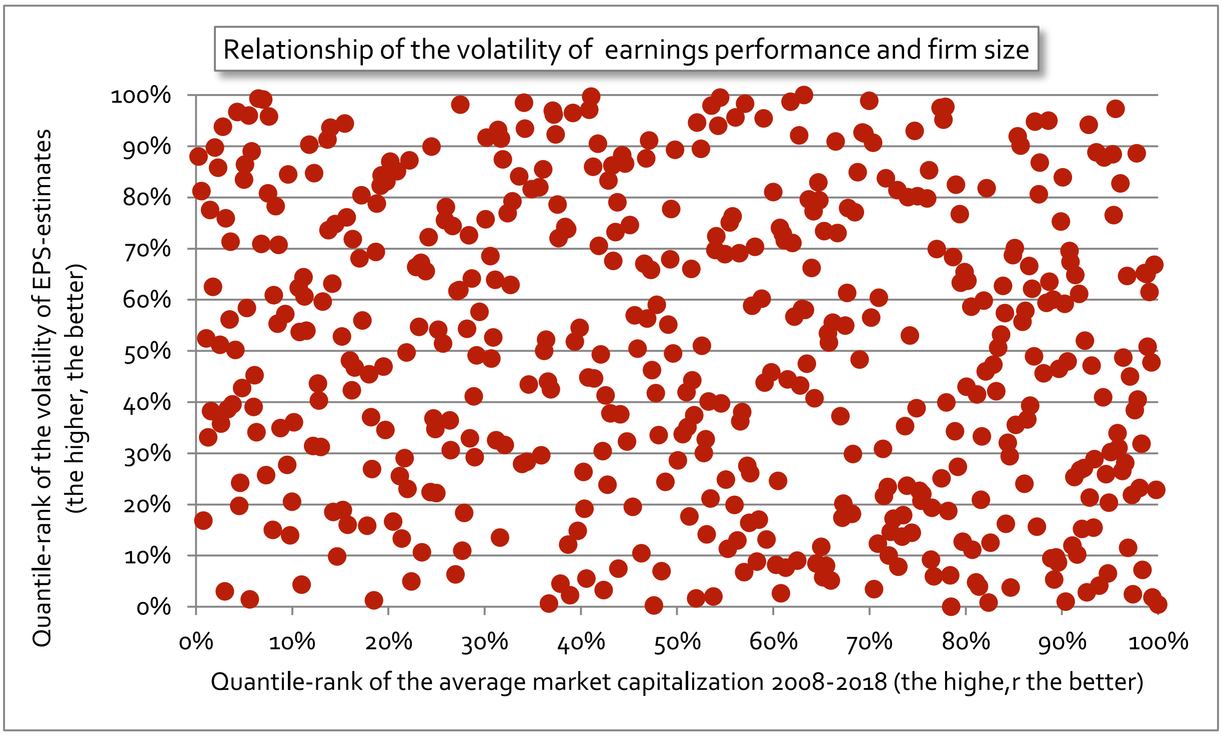


Weekly outlook for March 5-9, 2018

	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Release
DE: PMI, services, final	54.7	54.3	55.8	57.3	55.3		March 5
DE: New orders, m/m	0.7%	-0.1%	3.8%	-1.2%			March 8
DE: New orders, y/y	7.2%	9.1%	6.8%	13.1%			March 8
DE: Industrial production, m/m	-1.2%	3.1%	-0.6%	0.3%			March 9
DE: Industrial production, y/y	2.8%	5.4%	6.7%	5.7%			March 9
DE: Exports, m/m	-0.3%	4.1%	0.0%	0.4%			March 9
DE: Exports, y/y	6.6%	8.0%	10.0%	8.3%			March 9
DE: Imports, m/m	1.8%	2.2%	1.1%	0.2%			March 9
DE: Imports, y/y	8.3%	8.2%	9.0%	6.6%			March 9
EUR19: PMI, services, final	55.0	56.2	56.6	58.0	56.7		March 5
EUR19: Sentix	29.7	34.0	31.1	32.9	31.9	30.2	March 5
EUR19: Retail sales, m/m	-1.2%	2.0%	-1.1%	+0.7			March 5

MMWB estimates in red

Chart of the Week: Small-cap companies not necessarily unstable



Probably the most common reason cited to buy large caps rather than small caps is that the former are diversified enterprises whose size means less susceptibility to fluctuations in their development. But we have long doubted that empirical support exists for this thesis. True, relatively small businesses often operate in a niche market and are thus naturally more subject to related fluctuations than a corporate group with many business areas and product lines. On the other hand, small businesses are often managed better and are inclined to be less activist and hence pro-cyclical. Moreover, they often "understand" their product niches very well and hence can better anticipate and react early to weak phases. So, there should be no significant connection between fundamental metrics like earnings and market capitalization. It is comparatively easy to test this statistically. We have performed this test for the stocks in the STOXX 600 index in the period from 2008 to 2018 and conclude that there is actually no visible connection between the two metrics, as the loose point cloud in our Chart of the Week shows. So, anyone who has refrained from buying shares in small caps for fear of excessive risk should definitely reconsider.

Stock marktes	As of 02.03.2018 15:24	Change versus 22.02.2018 -1 week	31.01.2018 -1 month	30.11.2017 -3 months	29.12.2017 YTD
Dow Jones	24609	-1,4%	-5,9%	1,4%	-0,4%
S&P 500	2678	-1,0%	-5,2%	1,1%	0,2%
Nasdaq	7273	0,9%	-1,9%	5,8%	5,4%
DAX	11942	-4,2%	-9,5%	-8,3%	-7,6%
MDAX	25263	-4,0%	-5,8%	-6,5%	-3,6%
TecDAX	2490	-3,6%	-6,0%	-1,0%	-1,5%
EuroStoxx 50	3340	-2,7%	-7,4%	-6,4%	-4,7%
Stoxx 50	2955	-3,1%	-8,0%	-6,4%	-7,0%
SMI (Swiss Market Index)	8678	-3,2%	-7,0%	-6,9%	-7,5%
Nikkei 225	21182	-2,6%	-8,3%	-6,8%	-7,0%
Brasilien BOVESPA	84673	-2,3%	-0,3%	17,6%	10,8%
Russland RTS	1255	-3,5%	-2,1%	11,0%	8,8%
Indien BSE 30	34047	0,7%	-5,3%	2,7%	0,0%
China Shanghai Composite	3255	-0,4%	-6,5%	-1,9%	-1,6%
MSCI Welt (in €)	2090	-1,5%	-4,4%	-3,1%	-3,2%
MSCI Emerging Markets (in €)	1192	-0,9%	-3,8%	2,4%	0,3%
Bond markets					
Bund-Future	163,14	438	432	42	146
Bobl-Future	131,22	42	77	-29	-39
Schatz-Future	112,01	8	20	-18	4
3 Monats Euribor	-0,33	0	0	0	0
3M Euribor Future, Dec 2017	-0,27	-1	0	0	0
3 Monats $ Libor	2,02	7	24	53	32
Fed Funds Future, Dec 2017	2,09	2	4	28	0
10 year US Treasuries	2,84	-8	13	42	43
10 year Bunds	0,63	-3	-1	26	20
10 year JGB	0,07	2	-2	3	2
10 year Swiss Government	0,06	-2	2	18	19
US Treas 10Y Performance	560,36	0,5%	-1,2%	-3,5%	-3,6%
Bund 10Y Performance	597,47	0,4%	0,3%	-2,1%	-1,6%
REX Performance Index	478,14	0,4%	0,4%	-1,0%	-0,5%
US mortgage rate	0,00	0	0	0	0
IBOXX AA, €	0,74	-3	-2	5	7
IBOXX BBB, €	1,33	-3	5	17	10
ML US High Yield	6,43	-4	26	25	28
JPM EMBI+, Index	813	0,3%	-2,2%	-2,1%	-2,7%
Convertible Bonds, Exane 25	7288	-0,6%	-1,7%	-1,3%	-1,5%
Commodities					
CRB Spot Index	443,89	0,4%	0,1%	3,3%	2,6%
MG Base Metal Index	356,07	-0,9%	-2,3%	5,2%	-0,8%
Crude oil Brent	63,48	-4,4%	-7,5%	-0,5%	-4,7%
Gold	1324,18	-0,4%	-1,3%	3,5%	1,6%
Silver	16,43	-1,3%	-4,6%	0,6%	-3,4%
Aluminium	2153,50	-2,2%	-3,0%	5,9%	-4,5%
Copper	6894,50	-3,3%	-2,6%	2,4%	-4,3%
Iron ore	76,52	-0,7%	0,9%	20,8%	7,4%
Freight rates Baltic Dry Index	1196	2,5%	3,8%	-24,2%	-12,4%
Currencies					
EUR/ USD	1,2304	0,2%	-1,2%	3,8%	2,6%
EUR/ GBP	0,8934	1,1%	2,0%	1,4%	0,6%
EUR/ JPY	129,70	-1,3%	-4,4%	-2,5%	-3,9%
EUR/ CHF	1,1510	0,0%	-1,0%	-1,6%	-1,6%
USD/ CNY	6,3428	-0,2%	0,9%	-4,1%	-2,5%
USD/ JPY	106,68	-0,1%	-2,3%	-5,2%	-5,3%
USD/ GBP	0,73	1,2%	3,3%	-1,7%	-1,7%

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