

## Italy's new coalition might not prove that scary

### Investors should not read too much into the joint program, unveiled by Italy's populist new coalition.

Three months ago, we argued that "Markets may well be in for another Italian surprise." In our election preview, "[An Italian muddle](#)", we described why it would be wrong to read too much into Italian polling data. "Many market participants may be underestimating the risk of Five Star and, perhaps, the Lega and the far-right Brothers of Italy doing better than expected", we felt.

The anti-establishment Five-Star movement and the far-right Lega duly went on to win. Now that the two populist groups appear on the verge of forming Italy's new government, we would suggest a similarly cautious approach. Do not read too much into their "Contract for a Government of the Change", the 58-page joint governing program unveiled last week.

Italy is widely considered to be difficult to govern. Giuseppe Conte, the designated new prime minister, may find the task even harder than most of his predecessors. While the new coalition has a comfortable majority in the Chamber of Deputies, its hold in the Senate appears razor-thin. This partly reflects the oddities of Italy's electoral and constitutional system, including the presence of a handful of life-time appointees in the Senate. As both chambers are co-equal, it would only take a handful of defections to defeat the new coalition on any given measure.

Already, a number of key proposals regarding economic policy have been watered down. Those in the latest version of the program include a repeal in parts of the 2011 pension reform, a universal minimum income and "flat-tax" regime with a 15% income tax for incomes below 80,000 euro a year and 20% for all others. Together with the spending increases, lower income taxes could amount to a fiscal boost of about 5% of gross domestic product (GDP). Plenty of legal obstacles to fiscal expansion remain, however, under both Italian and European Union law.

A lot will depend on the details. Calls to revisit the Basel banking rules might mean almost anything. To take another example, the latest set of proposals on a "universal" minimum income, would only benefit job seekers, rather than all adult citizens. That sounds a lot like the kinds of labor-market reforms that actually worked quite well in other European countries, including Germany.

In coming days, it will be interesting to watch whom Mr. Conte, a law professor, proposes for key cabinet posts. This should offer some early pointers as to how much autonomy he may have as the new head of government. The choice of finance minister is likely to come under particular scrutiny. Another interesting question will be whether the new government can win support beyond the new

### In a nutshell

- Governing Italy has never been easy. Giuseppe Conte, the designated new prime minister, might find the task even harder than his predecessors
- In all the excitement over specific ministerial choices or policy proposals, investors and foreign commentators may be overlooking the bigger picture
- For stock pickers, this Italian turmoil could create opportunities

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coalition, particularly among deputies of the Lega's one-time right-wing partners, Forza Italia and Brothers of Italy.

One way or the other, however, we are likely to be talking about a very inexperienced and fractious government. This was already underlined by the tumultuous process of agreeing on the joint program. On a number of occasions, highly unconventional proposals were made, leaked, and scrapped again. Investors should expect more unnerving headlines – and resulting periods of market unease as a result.

Could these constitute buying opportunities? That rather depends on what assets and what headlines we are talking about.

Take fixed income and Italian sovereign bonds as an example, we would argue that there is some justification to the recent spread widening compared to German Bunds. For now, it looks unlikely, that Five Star and its coalition partner Lega would be willing or able to make good on some of their more radical ideas. Pushing for debt forgiveness of Italian bonds held by the European Central Bank (ECB) has already been scrapped for now. Equally unnerving proposals to introduce small-denomination bonds (so-called Mini-BOTs) to firms and individuals owed money by the Italian state remain on the table, but appear similarly hard to implement unilaterally.

Unlikely, however, does not mean impossible. Nor should investors get their hopes up too much that the ECB might be swiftly coming to the rescue. The current quantitative easing (QE) program was implemented to counter deflationary risks. It was not intended to prevent the widening of spreads of any particular country, even one as vital as Italy. Moreover, the Outright Monetary Transactions (OMT) program was designed specifically to shield countries from market attacks, and to counter any "unjustified" redenomination risk. The activation of OMT requires a country to comply with rules and measures imposed by a rescue program. A populist government might not be willing to sign up to such rules, which in turn would bind the ECB's hands.

As for Italian equities, we would reiterate that earnings growth looks very solid. Indeed, Italian companies remain on track to deliver the fastest earnings growth within the Eurozone in 2018. Meanwhile, Italian equities are trading at 13-times forward earnings, compared to 14-times for European equities as a whole. Of course, such aggregate comparisons hide as much as they reveal. Resurgent fears over Italian sovereign solvency would certainly hurt banks. Moreover, Italian banks might find it even harder to further cleanse their balance sheets from non-performing loans under the new coalition's latest proposals. By contrast, other sectors, notably oil and gas, as well as luxury goods, have done pretty well this year. They also look well insulated from domestic political turmoil. For stock pickers, this could create opportunities.

Which takes us to three final, related points. In all the excitement over specific ministerial choices or policy proposals, investors and foreign commentators may be overlooking the bigger picture. First, Italy's problems do not stem from a lack of international

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competitiveness of its export sector. Indeed, it is a bit of a mystery to us why an economy with a current account surplus of 46 billion euros should constantly have its competitiveness questioned, notably in the foreign press. Another misconception is that the improvement in Italy's external balance is just a function of weak imports. In our view, domestic rigidities, such as inefficient and costly public services, and a slow judiciary system, are the likely culprit for Italy's growth malaise, not its competitiveness vis-à-vis other countries. Any evidence that a government intends to take on these rigidities are welcome.

Second, the overwhelming support of the new program among both Five-Star and Lega supporters over the weekend suggests plenty of political momentum. Some of that could prove constructive. As populist outsiders, they might be able to effectively take on vested interests. At the root of Italy's problems is low productivity growth in the domestic sector. A renewed push for justice reform and fighting corruption would be a clear positive, if a touch surprising. (Five-Star led municipal governments had similar intentions already, with limited success.) But just as the choice of Giuseppe Conte as prime minister came as a welcome surprise, given some of the alternatives, the new coalition could well outperform negative market perceptions.

Third, however, the real, longer-term impact of this unconventional coalition may go well beyond the immediate ones of a few misguided proposals, deteriorating government finances or even fresh elections before too long. Several times now, clear majorities of Italian voters have rejected broadly centrist and euro-friendly policies. The short-term scope for pursuing some of the more radical alternatives, including an Italian exit from the Eurozone, may be limited. However, we believe this will do nothing to endear the common currency to Italian voters. As the American journalist Henry Louis Mencken famously remarked: "there is always a well-known solution to every human problem — neat, plausible, and wrong".

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## Glossary

### Bunds

**Bunds** is a commonly used term for bonds issued by the German federal government with a maturity of 10 years.

### European Central Bank (ECB)

The **European Central Bank (ECB)** is the central bank for the Eurozone.

### European Union (EU)

The **European Union (EU)** is a political and economic union of 28 member states located primarily in Europe.

### Eurozone

The **Eurozone** is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

### Five Star Movement

The Five Star Movement is a populist political party in Italy. It is led by the popular comedian and blogger Beppe Grillo, who was also among its founders in 2009. It is considered anti-establishment, environmentalist, anti-globalist and Eurosceptic.

### Gross domestic product (GDP)

The **gross domestic product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

### Lega

The **Lega** (formerly "Lega Nord") is a right-wing populist party in Italy. It was founded in 1991 through the merger of various parties. It is considered anti-globalist and Eurosceptic.

### Non-performing loans (NPLs)

Non-performing loans (NPLs) are loans on which scheduled payments have not been made for (usually) at least 90 days.

### Outright Monetary Transactions (OMT)

Outright Monetary Transactions (OMT) is a program of the ECB under which the bank makes purchases (outright transactions) in secondary, sovereign bond markets, under certain conditions, of bonds issued by Eurozone member states.

### Quantitative easing (QE)

**Quantitative easing (QE)** is an unconventional monetary-policy tool, in which a central bank conducts broad-based asset purchases.

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## Spread

The **spread** is the difference between the quoted rates of return on two different investments, usually of different credit quality.

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