Confidence must be earned

Amundi ASSET MANAGEMENT

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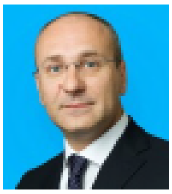
INVESTMENT TALKS

Italy on watch list



Diego Franzin
Head of Equities

Cosimo Marasciulo
Deputy Head Alpha Fixed Income Euro

Annalisa USARDI
Senior Economist

With the contribution of:
Elena Ferrarese
Senior equity portfolio manager
Giuseppina Marinotti
Investment Insights Unit

- *Political uncertainty in Italy remains high. The probability of a Government formed between the 5Star Movement (M5S) and the League (the most voted party in the centre right coalition) has increased in recent days, but the process of government formation is not straightforward. We believe there is a 50% probability to reach an agreement. If not, the next step can be a "neutral" government appointed by the Italian President and, eventually, should this option also fail, a snap election.*
- *In case of a preliminary agreement between M5S and the League, it is worth noting that despite their electoral rhetoric, the Italian institutional and constitutional framework imposes on any new government to respect three pillars: the Euro, the Eurozone and Nato. Any explicit deviation from these international agreements would likely prompt the President of the Republic to alt any further step of government formation and would push for a "neutral" government or, if not voted in Parliament, for a snap election.*
- *On the economic front, like for the Eurozone, we expect the Italian growth to have peaked and moderate its pace into this year and the next, albeit remaining above potential. The sentiment deterioration and the moderation of growth so far are still in line with our outlook and not too concerning, but a protracted political uncertainty could weigh on domestic drivers.*
- *On Italian equities, main market drivers will be the recovery of financial and energy sector. We prefer the small and mid-cap segments, with idiosyncratic stories less exposed to political risk.*
- *On Euro fixed income, at the current level of spreads and allowing for some short-term volatility, we think most of the political risk related to a populist government is priced in. However, because of this event, the higher risk premium will likely remain. We reiterate that high flexibility applied to portfolio management is necessary in order to benefit from the expected volatility that will undoubtedly arise as the ECB tapering phase approaches.*

Where do we stand in the Italian political deadlock? How is the Italian political situation likely to unfold?

Usardi. On May 7th, after a deadlock of more than 60 days, the Italian President Sergio Mattarella confirmed that political parties were not able to overcome their crossed-vetoes and sticking points. He announced his decision to appoint a "neutral" government until December 2018 at the latest and with specific tasks (including the approval of the 2019 budget law and legislating in such a way as to deactivate an automatic rise in the VAT which would kick in in January 2019). Were this government unable to find parliamentary support, President Mattarella would dissolve the Chambers and call for a snap election. But both the Five Star Movement (M5S) and the League leaders (the former is the most popular party, the latter is the leading center-right coalition party) judged this proposal unacceptable and insistently called for a snap election, as soon as on 7th of July. Yet, as the hours passed, and likely parties started to realise the implications of this timing in terms of number of voters and risks of losing further support (in particular, this could be true for Forza Italia, the other center right main party), there was a sudden change of tide. Berlusconi (whom M5S said would have never governed with) decided not to participate to the government, letting the League and M5S progressing with the talks on a new government formation. M5S and the League asked for more time to fine tune their agreement.

Despite electoral rhetoric a government M5S-League can not easily and explicitly depart from three key principles: Euro, Eurozone, Nato.

On the likelihood of reaching an agreement between M5S and the League, it looks this time, that serious talks are progressing although the government formation is not straightforward, due to the distance of the two parties. How far these topics could find final approval of the Italian President, is a different story. In fact, we must keep in mind at least three key articles of the Italian constitution: art. 81 (fixing obligation of a balanced budget), art. 11 and art.

117.1, establishing that international pacts must be respected. A warning shot was given by the President to remain on the path of international relations taken by former governments. So the new government's international stance should not in principle question those three pillars: the Euro, the Eurozone and the Nato.

With the premise that the situation is very fluid, as we write, it appears that an agreement has been reached about the fact that both M5S and the League leaders will not have a candidate for the prime minister's role; yet, it seems that there is still some difficulty in finding one. In terms of timeline, should events progress in line with the tradition of the last 70 years, we would expect President Mattarella to meet delegations of the future majority supporting the proposed government and then he would give a mandate "*con riserva*", i.e. with the obligation to return to him in a few days with an update and a proposed Government; the list of ministers, though, must be very carefully drafted as, per art. 92 of the Italian Constitution, it is the President who nominates the Prime Minister and who finally decides whether to approve or not each minister. The vote on the Government (*voto di fiducia*) would then follow.

In terms of votes, the League and M5S should be able to get the support needed in the lower House. More complex is the situation in the Senate where the M5S and the League have a majority of only few votes, so the League is now trying to get the support from Brothers of Italy (the minority part in the center right coalition), implying some compromise on ministerial nominations and a program.

Is the Italian reform path at risk in your view?

Usardi. Although the electoral rhetoric of M5S and the League has been quite negative versus the previous government reforms (labor market, pensions system to name a few), we think it would be particularly difficult for a government whose task is to approve the new Budget Law and to find room to avoid the automatic VAT hike in order to implement bold expansionary measures at this stage, unless it explicitly decides to breach EU fiscal rules and risk confronting the market and domestic consequences of such moves, which at the moment is not our central scenario.

In this sense, any abrupt departure from reforms would clearly put into question the commitment to the European framework, putting at risk government finances in the short-term, debt sustainability and potential growth in the long-term.

This is a very peculiar junction of a decelerating pace of expansion, particularly vulnerable to a loss of confidence and sentiment which could arise from political uncertainty.

What is your assessment of the Italian economic situation? And how can the political situation affect it?

Usardi. During 2017, the Italian economy saw three drivers underpinning a somewhat surprising economic performance: a gain in competitiveness, translating into a better export performance and current account balance; an expansion in equipment and machinery investment, supported by a better outlook for domestic and international demand; a better access to credit for companies, in particular small and medium sized ones. At the beginning of the first quarter of 2018 though, in line with other Eurozone Countries, both sentiment and hard activity indicators suffered a marked slowdown that could be due to a number of factors, like climate factors, the strength of the Euro or protectionist talks. In line with our global scenario, like for the Eurozone, we expect Italian growth to have peaked and the pace to slow down during this year and into the next, albeit remaining above potential. Yet, this is a very peculiar juncture of a decelerating pace of expansion, which is particularly vulnerable to a loss of confidence and sentiment. Although we think that a decline in confidence and the moderation of growth so far are still in line with our outlook and not worrying, a protracted political uncertainty could weigh on domestic drivers of growth such as investment decisions and consumption and could impact our broadly constructive outlook. Hence the urgency of the new government to approve the 2019 budget law and to avoid an automatic rise in VAT which would kick in from January 2019.

In this enviroment, what is the earnings' outlook for Italian corporates, where do you see opportunities? And what are the main drivers going forward?

Franzin. From 2017 onward, Italian companies have been enjoying nice growth in earnings. If we analyze the trend in detail, we discover that the main recovery is coming from the

In Italian equities, we favour small and mid-size stocks linked to idiosyncratic stories, which should be less exposed to systemic risk.

banking sector, after the very painful past years of clean up, and from the energy sector, thanks to the nice rebound in the oil price. In terms of market cap, the Italian stock market is highly concentrated in the financial and energy sectors, but in terms of numbers of companies, the industrial sector is very much represented by mid-sized companies with a very high export capability. For 2018, the market consensus has a +20% in EPS growth, for 2019 estimates are for nearly +10%. Due to the sector composition, as explained before, the main drivers will be Italian recovery (positive for financials) and world GDP growth for industrial mid-size companies. In this segment, we focus on a selection of companies which are exposed to idiosyncratic stories (i.e. luxury fashion), which should be less affected in case of a systemic risk on Italy.

From a Euro fixed income perspective, how do you assess the Italian country risk?

Marasciulo. Since the beginning of the year, we have seen an underperformance in Italian BTPs (Italian government bonds) vs other peripherals, the main drivers being weaker fundamentals, slower structural reforms and the political risk premium. It is difficult to see a fundamental change in the outlook, also considering the potential worsening of the budget deficit. Hence a reduction of the debt/GDP ratio under a populist Government led by League and M5S is unlikely. Having said that, the choice of the Prime Minister by President Mattarella will be very important to assess how market friendly the new Government could be; moreover, and as already mentioned, the overall Constitutional framework will help to contain populist measures.

At the current level of spreads and allowing for some short-term volatility, we think most of the political risk related to a populist government is priced in.

Do you see the carry of the Italian government bonds to pay for the political risk? What are the main strategies to generate value in Euro fixed income?

Marasciulo. At the current level of spreads, and allowing for some short-term volatility, we think most of the political risk related to a populist government is priced in. However, because of this event, the current higher risk premium will likely remain. There is a degree of complacency regarding the situation, but options are limited for the market participants. We believe that any episode of spread widening would soon be considered as an opportunity by the market and thus would trigger inflows. We continue to see peripheral markets tactically as a valuable source of carry together with credit exposure. We reiterate that high flexibility applied to portfolio management is necessary as to benefit from the expected volatility that will undoubtedly arise when the ECB tapering phase approaches.

AMUNDI INVESTMENT INSIGHTS UNIT

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