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Italian budget proposal under scrutiny

INVESTMENT TALKS

Matteo GERMANO
Head of Multi Assets,
CIO Italy

- ***The key points of the budget law.*** *The Italian Government negatively surprised the markets by announcing a substantially increased budget deficit target for 2019-2021 to 2.4% in a move that could undermine the potential to reduce the Italian debt burden (130% of GDP) in the coming years.*
- ***Market reactions****: The Italian move has triggered a selloff on Italian assets (bonds, equities and banking sector in particular). Uncertainty will remain high with debt sustainability under scrutiny by markets and rating agencies expected to reassess the country rating by end of October. A downgrade is now more likely.*
- ***Our view:*** *On Italian debt we have a neutral view and will continue to monitor the details of the budget law and developments in the economic outlook. We stay cautious on Italian equity where we focus on less leveraged companies. Short-term volatility could impact European equity, but we are more constructive on mid-term outlook.*

"The new budget deficit targets for 2019-2021 of 2.4% of GDP represent a significant upward revision and a move that will put Italian debt path under scrutiny"

What are the key points of the Italian budget proposal on 27September?

In an unexpected eleventh-hour move, the Italian Government negatively surprised the markets by announcing a substantially increased budget deficit target for 2019-2021 to 2.4% of GDP. This move was in clear contrast with the reassuring communication of a much more contained budget maintained in the past weeks, which helped the 10year BTP-Bund spread to tighten by 60bp reaching 236bp between 31 August and 27 September.

These new deficit targets are in stark contrast with those presented in the 2018 Economic and Financial Document and agreed with the European Commission, of respectively -0.8%, 0.0% and +0.2% of GDP. The EU in fact requires not only to remain below the 3% level of Deficit/GDP but also, to the most indebted countries, to follow a path of reduction of their debt. This number is challenging this move. As we write, there are not many details on the GDP growth hypothesis and on the composition of the budget that contains a number of measures announced during the electoral campaign by the parties forming the government coalition, with no clarity on the final mix that will come only after the parliamentary debate. The few details available show a budget skewed towards transfers rather than investments and structural reforms.

"We see a transitory phase of high political uncertainty especially with frictions with European bodies that will further delay talks on a European budget."

What do you expect as major impacts of this new budget proposal?

From here, we could anticipate the risks of a **prolonged period of uncertainty** stemming from:

- Loss of Credibility of the Finance Minister Tria and Government as they go well beyond the limits they have been using to reassure the markets. The Finance Minister, who reportedly was ready to resign, remains in his role following the Italian President's request, to avoid further uncertainty. But his ability to contain government pressure may be perceived as very weak;
- Debt sustainability under scrutiny: the lack of pro-growth structural reforms now slowly emerging about the 2019 budget questions again the sustainability of the Debt/GDP path, in a context of the evident lack of fiscal consolidation.
- Rating agencies response (mid to end of October), where the risks of a downgrade increased given all the above;
- Likely mounting tensions with Brussels linked to the relaxation of structural fiscal consolidation implicit in the new Deficit targets. With a deficit/GDP at 2.4%, the EU will likely trigger the procedure for excessive deficit for Italy. We see a transitory phase of high political uncertainty especially with frictions with European bodies that will further delay talks on a European budget.

All of the above occurs in a context of a decelerating momentum for the Italian economy, where domestic political risks come in addition to external ones, such as geopolitical and trade tensions.

With the contribution of

Claudia Bertino, Laura Fiorot, Annalisa Usardi

"The deficit figures included in the budget proposal increase significantly the risk of downgrade of the Italian debt."

What are the next steps? Do you see the risk of Italian debt downgrade?

By 15 October, the 2019 Draft Budget will be submitted to the EU Commission that has to make its assessment by no later than 30 November. The Italian Parliament debate/vote on the Draft Budgetary Plan must be completed by the end of the year; the Budget Law will be discussed in the House in November and in the Senate in December.

By the end of October rating agencies will review the country rating. The deficit figures included in the budget proposal increase significantly the risk of downgrade of Italian debt.

In fact, the downgrade would be triggered by measures that signal weak commitment in fiscal consolidation. The announced measures risk undermining the possibility for Italy to reduce its debt burden (130% of GDP) in the coming years, unless GDP growth offsets the effects of higher deficit. It is also worth noting that currently there is still no clarity about the coverage of these measures: if they are achieved by structural spending cuts, this could provide relief to the market. Italy is currently rated Baa2 by Moody's (in downgrade revision) and BBB by Fitch (negative outlook).

"On Italian debt we have a neutral view and will continue to monitor the details of the budget law and the economic outlook evolution."

What is your view on Italian assets and financial markets?

Immediate market reaction has been quite strong with the spread on the 10 year Italian Government bond moving up towards 270 basis points and the Italian equity market posting losses above 4% as we write, with the banking sector particularly affected.

On **Italian debt, we have a neutral view but we are becoming increasingly cautious**. While this short-term moves reflect the reassessment of market expectations, which were somewhat more positive, moving forward we expect higher scrutiny on Italy and higher risk premiums compared to other European markets to counterbalance the uncertainty on the fiscal policy. With non-resident investors already cautious on Italian debt, we don't expect further massive deterioration in the short term. However, the markets will carefully monitor budget law coverage and mix to understand how this will impact on future debt and growth dynamics. A weakening outlook for the Italian economy could put Italian bonds under pressure again at a time when the ECB is starting to reduce its purchasing. An increase in duration in core bonds can help mitigate this stress phase on Italian assets.

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On the broader **European fixed income** market we do not expect for the moment a contagion as this remains an idiosyncratic issue, but it cannot be excluded that rising fiscal indiscipline among countries could trigger more stress in the market.

On the **Italian equity market we are very cautious** too as it is highly exposed to the banking sector exposed to government bonds and also other sectors such as utilities may discount some uncertainty on future regulatory and tax policies. A strong focus on less leveraged companies which are not so exposed to rising yields can help to mitigate volatility in this phase. Italian credit markets will also reflect the volatility of the government side, with banks the most exposed.

We expect a **wait and see outlook for European equity** in an environment of higher short-term volatility. Here we are more constructive in the medium term. This year we have seen strong US equity supremacy and a strong repricing in EM, with Europe in a range bound. We believe, that once this political uncertainty subsides, European equity will be back in focus, with very attractive valuations.

Amundi ASSET MANAGEMENT

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