

## EUR: Looking through Italian politics

The outcome of the Italian elections doesn't alter our bullish EUR/USD view. The hung parliament is not enough to offset the positive Eurozone economy cyclical story and the ECB's steps towards policy normalisation



Source: Shutterstock

The negative EUR reaction to the stalemate result of the Italian parliamentary elections over the weekend has so far been rather muted.

In our view, this is not surprising given:

- (a) the general market ex-ante expectations of a hung Italian Parliament, which in turn reduced the negative surprise effect;
- (b) the EUR/USD sensitivity to Eurozone political uncertainty was declining materially since 2015;
- (c) the SPD members agreement on the German Grand coalition which in part offsets the effect of the Italian election result on EUR.

## A hung Italian Parliament not a surprise

While the outcome of Italian election is not a positive factor for the EUR, the odds of a hung parliament ahead of the vote were high and in line with the overall expectations. Hence, the impact is not overly EUR negative, and the EUR/USD price action reflects the currency's recent trend of a degree of insulation from the negative political risk events (see below).

Looking ahead, given the likely composition of the Italian parliament, bearing in mind we don't have the final result yet, the negotiations among the parties will likely be protracted, and the new Italian government may not be in place before the summer. Note that the talks will only start in early April, once the leaders of two branches of parliament are elected at the end of March. That said, we also cannot rule out early elections, possibly in 4Q18.

On paper, the most challenging scenario for markets at this point seems a coalition of the Five-Star movement and the Northern League. We believe that the bar for such an outcome is set very high (we see it as a possible but not a very probable event).

In our view, such a coalition would be perceived as too risky for each of the parties, notably the Northern League. This is because the Northern League electorate is strongly rooted in the rich North and a coalition with the Five-Star movement and its populists' policies would not resonate too well with the Northern League voting basis.

We also note that even if such a coalition is created, the odds of a referendum on the EUR or the EU are ultra-low. Not only the Five-Star movement and the Northern League don't have it in their programmes, but the referendum would be impossible to call under the current Italian constitution. For this to happen, both parties would have to change the law.

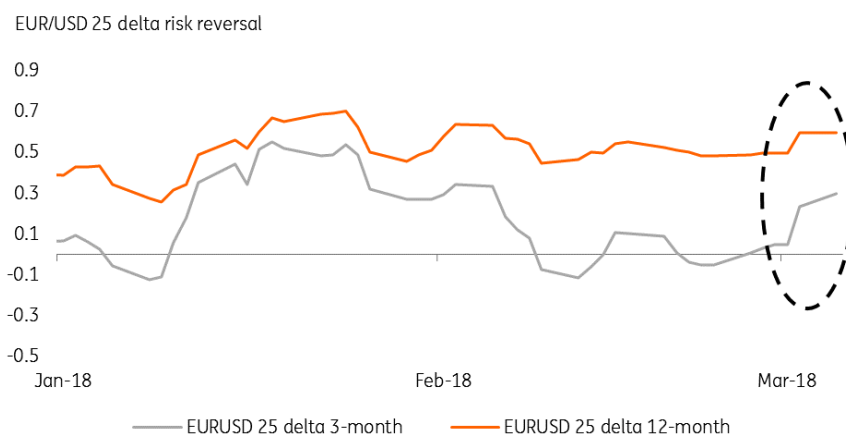
## Lower EUR sensitivity to Eurozone political uncertainty

Since 2015, the EUR/USD sensitivity to Eurozone political uncertainty has declined significantly.

From the 2015 Greek crisis, Italian banking woes in 2016 and the run-up to the French Presidential elections last year to the breakdown of the German coalition talks, as well as the run-up to and the eventual outcome of the 2018 Italian Parliamentary elections, the EUR/USD spot hasn't reacted meaningfully and/or for a prolonged period of time.

At this point, EUR/USD does not exert any meaningful risk premium (based on our short-term financial fair value model), and EUR/USD risk reversals also do not show a sudden shift in favour of EUR/USD downside.

## EUR/USD risk reversals not reacting to Eurozone political risk



Source: ING, Bloomberg

## German coalition partly offsetting the Italian election result

The SPD agreement on the German Grand coalition with the CDU (66% of SPD member votes were in favour of the grand coalition, a larger than expected majority) in part offsets the effect on the Italian elections on EUR, as it brings political stability to the largest Eurozone economy. Moreover, as per [Germany: It's a 'GroKo'](#), the new German government should cautiously and slowly push forward with European and Eurozone integration (albeit not in bold steps).

### Bullish EUR/USD view intact

Overall, the outcome of the Italian Parliamentary elections does not alter our bullish EUR/USD view. We target 1.30 by year-end. From the EUR side of the equation, the current hung Italian parliament is not enough to offset the positive Eurozone economy cyclical story and the ECB steps towards the policy normalisation (the end of the QE first, raising the deposit rate second).

As recent years suggest, the effect of negative Eurozone political news on the EUR have diminished significantly.

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