Italian political turbulence unlikely to turn into a thunderstorm for markets

The Italian government looks set to face an imminent crisis. With early elections still looking unlikely, we think the market impact should be contained. We expect the BTP-bund spread to remain tight and do not see Italian politics as likely to hinder the EUR/USD and EUR/CHF appreciation path in 2021

Italian Prime Minister Giuseppe Conte

Source: Shutterstock

Worst scenario for markets (elections) should be averted

Italy is on the brink of another government crisis after a small partner in the current ruling coalition (former Prime Minister Matteo Renzi's "Italia Viva" party) looks set to withdraw its support. This could happen as early as today, when the two Italia Viva ministers currently in the cabinet hand in their resignations.

Should the government lose parliament majority, here are the possible scenarios (sorted from the least to most market-adverse):

- A simple cabinet reshuffle, where Italia Viva is granted some more influential ministers, but current PM Giuseppe Conte remains in office

- A cabinet reshuffle with a new PM (no clear candidates have emerged so far)
- Conte forms a new coalition with other smaller parties, but with a very thin and unstable majority in the parliament
- A technocrat-led national unity government, with the aim of implementing the EU's Recovery and Resilience Plan (RRP)
- Early elections, possibly in May: latest polls suggest a right-wing coalition led by Matteo Salvini's "Lega" should be able to secure a majority.

Considering all parties in the current ruling coalition would not have any political interest in going to the polls, we think a reshuffle (even with the possible removal of Conte as PM) is by far the most likely outcome of a government crisis.

Please see our economist's article: Italy: Risk of a government crisis rapidly increasing for a more detailed analysis of the possible scenarios.

The case for tight sovereign spreads is still solid

Political uncertainty is a temporary threat to our high-conviction view that the stars are aligned for Italian spreads over other eurozone bonds to tighten. Our argument rests on a rare conjunction of factors: aggressive European Central Bank purchases, low interest rates globally, and the promise of fiscal transfers between eurozone sovereigns. For a more detailed analysis, see the section dedicated to sovereign spreads in our Rates 2021 outlook.

> *Approval of the RRP this week lowers the stakes of the ongoing tensions*

So how much of a threat exactly? We think not much. Once the possibility of a reshuffle has been ruled out, two of the alternative outcomes, a new Conte-led coalition or a national unity government, would be benign for financial markets. Approval of the RRP this week is good news as it effectively lowers the stakes of the ongoing tensions. In case no majority can be found for a new coalition, a national unity government would be in charge of implementing the RRP. Only new elections are a serious threat to its timely implementation, and we doubt Italy is headed that way.

90bp

10Y Italy-Germany

Our spread tightening target for this year

Political instability and sovereign spreads: this is not 2018

But let's contemplate this last unlikely scenario for a moment. Even in the case of new elections, we doubt a repeat of 2018 is on the cards. On the left, Conte's M5S is already in power and has reined in its most fiscally profligate instincts. On the right, none of the main parties are pushing their eurosceptic tendencies as far as questioning Italy's eurozone membership. No doubt a

Salvini-led government would prove a lasting irritant for the EU, but it should not call into question the three pillars of our constructive structural view on sovereign spreads.

Italy does not need new bond buyers

At most, a protracted period of political uncertainty would cause new potential buyers of Italian bonds to sit on their hands. In the unlikely event of new elections, this could be months. The point is however, Italy does not need new buyers. ECB purchases this year of around €160bn in our estimation should more than absorb net sovereign bond supply of €117bn. This should allow 10Y spreads over Germany to remain well within 150bp, and to resume their tightening when a new government is formed.

FX: Not enough to dent our bullish EUR views

Any implication for the FX market will mostly be a function of any material moves in the BTP-Bund spread. As long as there is no significant widening in the spread – that may not happen even in the unlikely scenario of elections, as discussed above – the spillover on the euro should be relatively contained.

If anything, any adverse market reaction will likely be channelled through a weaker EUR/CHF - which showed good inverse correlation with the BTP-Bund spread in recent periods of heightened political risk (like 2018) – rather than in EUR/USD. Even more so in the current environment, where we see the USD bear trend further consolidating on the back of the Federal Reserve's intensive money printing paired with rising inflation expectations that are further crushing USD real front-end rates. This should continue to offer support to EUR/USD and we are targeting 1.30 by year-end, as per our latest monthly update (FX Talking: Painting in broad brush strokes).

Looking at EUR/CHF, we do not see the recent developments in Italy as likely to offset the unwinding of precautionary CHF buying and global reflationary environment that are the pillars of our bullish view on the pair in 2021 (we expect 1.15 by 4Q21). Incidentally, the Swiss National Bank is likely to step in with more FX intervention if needed despite the US Treasury labelling Switzerland a currency manipulator in December, therefore limiting the downside room for EUR/CHF even in the most market-adverse scenarios for Italian politics.

For the moment, the lack of any risk-premium embedded in either EUR/USD or EUR/CHF, according to our short-term fair value model, suggests there is very little concern in the FX markets about the political developments in Italy, in line with our view.

Author

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

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