

Italy: Navigating the political waters

Regional elections in Italy on Sunday have shifted the market's focus back to the volatile political landscape. While we think a break-up of the coalition at the national level is not on the cards yet, political risk will remain an important factor driving European markets. We look at what this means for rates and FX near-term, and in the long-run

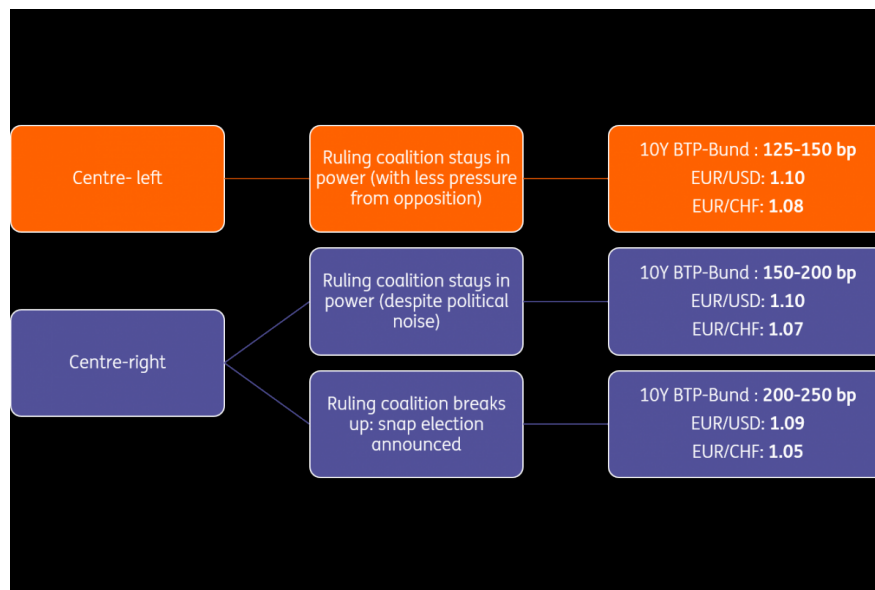


A centre-right win in Emilia shouldn't prompt snap election

Our economist in Italy has widely addressed the implications of the regional election in Emilia Romagna in ["Italy's regional vote may be a national test"](#). Our central view is that even if the centre-right League candidate wins in Emilia (upending 50 years of left and centre-left rule in the region), the political noise that would follow is unlikely to lead to a break-up in the ruling Democratic Party-5 Star coalition and therefore trigger snap national elections.

From a market impact perspective however, investors may not have a similarly constructive view. Instead, a League win may trigger a knee-jerk reaction in Italian government bonds (BTPs) and the euro/Swiss franc exchange rate. In this article, we estimate the near-term impact of the two different outcomes of the election (a snapshot is provided in Figure 1) and discuss the outlook for Italy-related assets in the months ahead.

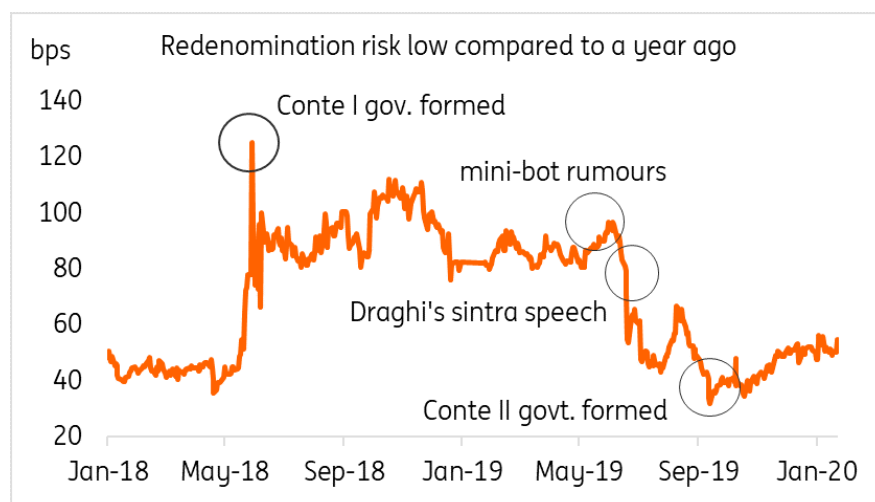
Fig. 1 - Three scenarios ahead of this weekend's regional election



Source: ING

One key takeaway ahead of this election is that markets seem much more relaxed about Italy this time around. Although the economic outlook remains weak, as risks to global growth are tilted to the downside on the back of geopolitical tensions, both fiscal and redenomination risks are contained. Firstly, the risk of a direct confrontation with the EU over its public finances has receded. Secondly, [redenomination risk](#) – measured as the spread between sovereign CDS contracts based on ISDA 2014 and those based on ISDA 2003 (Figure 2) – is still very low compared to [a year ago](#) when there were rumours that senior League officials of the Conte I government were considering issuing mini-BOTs (often described as a disguised parallel currency). This reinforces the view that Italy is seen more as an idiosyncratic risk and therefore broader market contagion is perceived as fairly limited.

Fig. 2 - Redenomination risk contained



Source: Bloomberg, ING

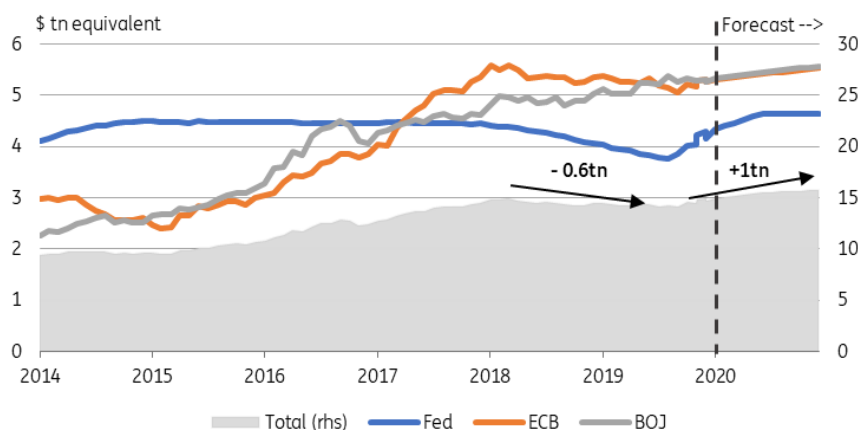
A carry-driven market should be positive for Italian bonds...

In the current environment, BTP spreads would normally tighten relative to other government bonds. But political worries have kept yields elevated. How long the current government is able to stay in place will be key for the performance of the Italian market. We argue that the short-term pain of national elections would be better for the long-term prospects of the Italian bond market.

On paper at least, all conditions are in place for 2020 to be a carry-driven year in fixed income markets. The European Central Bank, Federal Reserve, and Bank of Japan have all resumed asset purchases (Figure 3), liquidity is plentiful, and sentiment is improving thanks to signs of improvement in economic data, and receding risks. In this environment, and after the large capital gains in 2019, we would expect carry to be a major driver of fixed income performance in 2020.

This places a special focus on the prospective volatility of each bond market. Carry has to be assessed in light of the risk it is compensating investors for. In the case of Italian government bonds, political instability is the main impediment to investors seeking the carry offered by BTPs. This is why the length, and intensity, of political worries will continue to drive their performance.

Fig. 3 - Global central banks are a tailwind to Italian bonds - if politics permit it



Source: Bloomberg, ING

...but politics are preventing investors from fully endorsing them

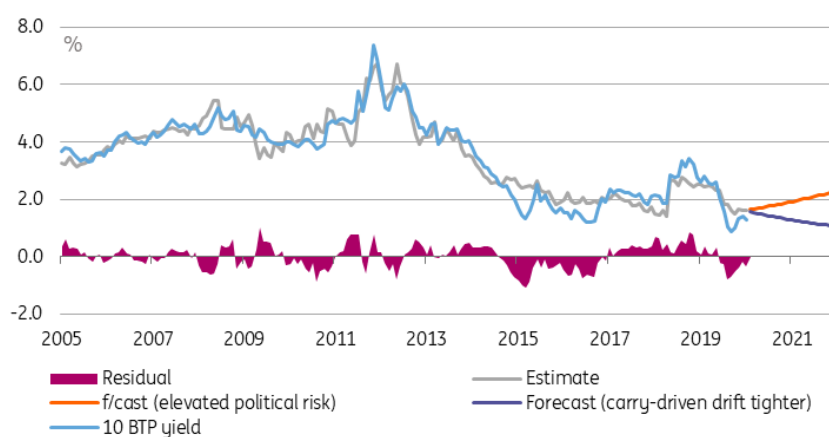
Our Italian economist has highlighted that his base case is for the current government to stay in place, even in the event of a centre-right victory in Sunday's regional elections. A key plank in his argument is that it would be political suicide for the incumbent parties, PD and M5S, to call national elections at a time when the opposition is primed for victory. The risk of a near-term government collapse would be reduced even further if the PD incumbent were to win on Sunday (the two candidates are currently running neck and neck), affording BTPs a modest relief rally.

But the key to investors strongly endorsing the BTP market is knowing just how long this government will remain in place. In a scenario where tensions within the coalition remain high and national elections are expected to be called in the first half of 2020, the 'pre-budget window', we think investor attitudes towards Italy will remain cautious. In this instance, we anticipate the most

risk-averse investors will steer clear of the Italian bond market in anticipation of higher volatility. The difference between 10-year Italian and German bond yields could reach 200 basis points in the run up to the vote.

Should the coalition make it past the summer, however, the market might assume no change until 2021, given the difficulty of organising elections in the middle of the budget cycle. This in our view is too long a period for investors to remain underweight Italian bonds and miss out on almost a year's worth of carry. In this instance, BTPs would be free to converge with other European bond markets, provided this period of stability is telegraphed in advance. 10-year Italy-German spreads could reach 115 basis points by end-2020 (Figure 4).

Fig. 4 - Two scenarios for Italian yields, political uncertainty or stability



Source: Bloomberg, ING

In the long-run, snap elections are positive for Italian bonds

This may seem like a counterintuitive conclusion, but we think the best outcome for Italian bond investors would be for national elections to take place as soon as possible. Granted, the proximity of a vote, and Matteo Salvini's abrasive style, would usher in a period of higher volatility and wider spreads. Once the dust settles however, investors would be judging a new, League-led government along three axes:

- Will the new government take Italy out of the eurozone, or take steps in this direction? Here we think the market's base case will be that it won't.
- Will the new government materially damage Italy's debt dynamics? It is too early to say but we suspect tax cuts could be offset to an extent by spending cuts. A more growth-friendly policy stance would also go some way towards easing investors' concerns about debt sustainability.
- Will the new government grip European institutional reform, particularly relative to economic governance? Here, we think the most commonly-held view is that Salvini's bombastic style is driven by a need to extract concessions from the EU on subjects that are more central to his voter base, for instance on immigration.

In short, BTPs are in for a volatile ride if elections are called. But provided elections are conclusive and political stability is achieved, Italian spreads will be free to tighten further.

To conclude, Italian markets remain hostage to political developments. How long this coalition can stick together will determine if BTP yields tighten relative to Germany or if they continue to widen. Ultimately, national elections would be a way to resolve the political uncertainty although any vote would be preceded by a period of higher volatility, and of wider spreads.

FX: More headaches for the SNB?

The stubborn low volatility in EUR/USD recently has been a function of the euro's reduced sensitivity to political dynamics in Italy. Politics proved to be a major drag on the common currency in 2018, when a stormy budget season spurred market risk aversion in the eurozone. Since then, the euro has become less sensitive to both market data and the political backdrop; the fall of Italy's previous government in August left no mark on EUR/USD.

In line with this, we expect the impact on EUR/USD to be broadly limited, and may only become evident (on the downside) in the event that an early election is called and the market prices in more significant political risk. Even in such scenario, we think it is unlikely that EUR/USD will fall below 1.09 and cannot exclude an even less pronounced downward move.

We expect most of the FX impact of the regional election to be channelled through the Swiss franc. EUR/CHF has faced renewed pressure this week – after losing 75 basis points in the previous week – on the back of the ECB rate announcement. The prevailing question in the market remains, at what point will the Swiss National Bank allow the franc to appreciate before it intervenes?

For now, our suspicion is that markets will keep trying to test the SNB's patience, and Italian political risk is indeed a potential catalyst considering the high sensitivity of EUR/CHF to this specific risk factor. Accordingly, a victory by the centre-right candidate may well prompt another leg lower in EUR/CHF. If, as we expect, the government confirms it will stay in power, some of those losses should be reversed within a few days of the vote. In the worst case scenario for risk (snap election) the pair may instead fall more sharply, possibly to the 1.05 area. However, a win by the centre-left should help to price out some of the short-term uncertainty and allow EUR/CHF to head towards 1.08.

In the longer-term, political risk in Italy appears to be a ticking bomb for EUR/CHF and even if we expect the current government to survive through 2020, the risk of a sudden break-up in the coalition remains quite material, as the past few years have taught us.

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