

Navigating Italian political risks: What's next?

Although a 5SM-League government will be announced later today, we take a step back and outline four potential scenarios from the benign to severe and their implications for markets

Navigating Italian political risks: Four scenarios for the future of Italy

	Italian political environment	Eurozone growth implications	ECB monetary policy stance	Financial market implications
1	European dream Italian political risk recedes and pro-EU sentiment drives market sentiment	EU-friendly Broad support for populists decline and euro-friendly government forms	Steady growth Economic risks fade & Eurozone GDP bounces back from recent soft patch	Gradual QE taper adjustment ECB extends QE until Dec 2018
2	Muddling through Risks stemming from Italian politics remain idiosyncratic	EU co-operative Populists gain in opinion polls but keen to co-operate	Soft patch Recovery not over but slower growth dynamics continue	Prolonged QE ECB extends QE at least until Dec 2018
3	Contagion creeps in Italian political risk starts to feed through to the Eurozone economy & signs of contagion	EU-sceptic Mainstream parties struggle; populists set political agenda	Italy GDP risks Hit to Italian GDP significant enough to impact EZ GDP	Lower for longer QE purchases ECB extends QE at least until Sep 2019
4	'Quitaly' in sight Heightened political risk feeds through to Eurozone growth and broad-based contagion	'Italy first' Mainstream parties wiped out & 'Italy first' populist govt	Broad slowdown Eurozone growth overall slows down substantially	QE extended ECB extends QE even further and in higher amounts
				10Y BTP-BUND spread 100-200bp 10Y US yield 3.50% Markit Europe CDS index 60bp EUR/USD 1.20-1.30 10Y BTP-BUND spread 200-300bp 10Y US yield 3.25% Markit Europe CDS index 80bp EUR/USD 1.15-1.25 10Y BTP-BUND spread 300-400bp 10Y US yield 2.50% Markit Europe CDS index 150bp EUR/USD 1.05-1.15 10Y BTP-BUND spread 400-1000bp 10Y US yield 1.50% Markit Europe CDS index 300bp EUR/USD 0.85-1.00

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Italy's populist Five Star Movement and the far-right League have sent jitters across markets with their proposals to form a government on an openly euro-sceptic agenda. The President's veto of a proposed Euro-sceptic finance minister at one point threatened a constitutional crisis.

Concerns over mini-BOTs

Concerns that populists might consider the idea of issuing mini-BOTs, a short-term debt instrument often described as a disguised parallel currency, have especially fanned investor fears over Italy, where support for the EU is relatively low.

Fresh elections early next year?

So far a crash in Italian debt markets have pulled populists back from the brink, and at present, their leaders are trying to form a less confrontational government. Yet, the prospect of fresh elections early next year remains.

Brussels' stance matters

The degree to which financial market discipline curtails populist policies – and Brussel's stance to draw the string from populist support – will be key in determining Italy's political path.

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