What to watch as Italian politics faces yet another crossroads

After prime minister Conte's resignation last night, a new majority or snap elections are the two options. But the difference will be implications either limited to Italy or negative spill-over to the broader European sentiment. The balance of risks is likely tilted to the downside and EUR/CHF may be the key underperformer

This is an update from our latest article: Italian politics: What now?

Yesterday: Conte resigns

The Italian prime minister Giuseppe Conte resigned yesterday bringing the Italian populist coalition to an end. Conte attacked deputy prime minister Salvini in a speech saying that it wasn't in Italy's interests to hold elections every year, therefore closing the door on speculation of a reshuffle within the current majority. At the same time, market expectations of a new coalition pact between the left-wing Democratic Party (PD) and the populist Five-Star Movement have mounted.

Today: Markets await clarity from PD and Five Star

President Sergio Mattarella will begin consultations on a possible alternative government starting from today, although major parties will only meet tomorrow.

Meanwhile, the Democratic Party is holding internal talks to weigh the possibility of a coalition pact with the Five-Star Movement. While former PM Matteo Renzi has been fiercely pushing for this, the current party leader Nicola Zingaretti has been reticent so far.

Media reports suggest negotiations between the two parties have kicked off already. Therefore, markets will keep a close eye on any headlines underpinning the possibility of a new majority, which would be considered a relatively more positive outcome for market sentiment compared to snap elections.

Tomorrow: Mattarella seems to be in a rush

Two options remain on President Mattarella's table. To issue a new mandate to form a government or call snap elections.

The first options may involve incumbent PM Conte, who may be the preferred leader of a PD-Five Star coalition, although the Italian press has been speculating on a number of alternative options. However, if president Mattarella decides to call elections, the dates would be either 27 October or 3 November. Elections remain the most concerning option for markets, along with a tight deadline for budget approval, Matteo Salvini becoming the new prime minister (as polls suggest) and anti-EU stance further weighing on European sentiment.

The president will meet with all party leaders tomorrow, which is quite unusual given that previous consultations were generally spread throughout several days, which seems to suggest that he is seeking a quick resolution to the current crisis, especially in view of the tight budget deadlines in case of new elections.

Rates: BTP market increasingly focused on the ECB's September meeting

Current pricing in Italian bonds (BTPs) reflects the greater probability of the most benign of the three scenarios we identified in our note on 9th August: one where the M5S and the Democratic party manage to find an agreement to get a 2020 budget over the line and avoid elections this year.

As a result, the 10-year Bund-BTP spread is lingering around the level we identified for this scenario: 200bp. As far as spreads are concerned, it doesn't matter much if the new government is a political or a technocratic one, as long as the near term event risks of elections this year and budget crisis are avoided.

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By the same token, elections around springtime next year would also be taken as a fairly benign outcome. The reason is that it is difficult for the BTP market to price medium-term political risk when an ECB easing package is around the corner. Provided the dual election and budget crises are avoided this year, politics will thus take the back seat in pricing Italian rates in the coming months. This means upside (on a disappointing package) or downside (if the ECB exceeds expectations) will be determined by monetary policy.

FX: EUR/CHF downside risk remains in place

The euro has proven to be quite resilient to the latest developments in Italy. This is likely due to markets still attaching a relatively high probability that a new majority will be found and snap elections will be averted for now. If these expectations prove wrong, new elections would likely have the potential of adding pressure to the euro outlook, already clouded given the ECB ultra-dovish stance.

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We suspect that any euro downside will likely be mirrored in a weaker EUR/CHF rather than EUR/USD. Indeed, the franc has been historically well correlated to movements in BTP rates and may also benefit from a further escalation in global trade tensions as well as ECB easing. Our 3Q19 forecast for EUR/CHF is 1.07.

> The key difference – in terms of market impact – between a new majority and snap elections is that the first one would have implications limited to the Italian sphere, while the latter may have a negative spill-over effect on the broader European sentiment. Italian-related uncertainty keeps suggesting a balance of risks that is tilted to the downside for the euro.

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