Q&A on the Italian Elections

Key takeaways
- Italy will be holding general elections on March 4, 2018.
- In today’s report, we cover key questions some investors have asked us heading into elections this weekend. Generally speaking, we see little evidence of a resurgence in eurozone breakup risk.

What it may mean for investors
- We believe that financial markets are pricing in a low likelihood that Sunday’s elections will produce a negative outcome for the European Union (EU) or Italy’s financial markets. With that said, investors should be positioned for the potential of a short-term market volatility spike.

Why is Italy having an election?
In light of all of Italy’s political dysfunction in recent years, Sunday’s vote actually comes as a result of its regularly scheduled five-year general election cycle. Voters in Italy will head to the polls on March 4 to select members of both the upper and lower houses of Parliament that they hope will represent their interests. Three main factions are vying for control over the government, including the incumbent Democratic Party, the former Euroskeptic Five Star Movement (S5M), and the Center Right coalition which includes Forza Italia, the Northern League and the Brothers of Italy.

What’s the risk of Italy leaving the EU?
We believe that the risk of Italy leaving the EU is low at this point in time—for two key reasons. First, the Five Star Movement, one of the most vocal Euroskeptic groups in Italy, recently has backed away from its anti-euro rhetoric. While other Euroskeptic parties have risen through the ranks lately, most notably the Brothers of Italy, their direction is largely tied to the Center Right coalition, which is heavily influenced by pro-business (and euro supporter) Silvio Berlusconi’s Forza Italia.

Further, populist momentum across Europe appears to have peaked in 2017. Indeed, investors became acutely aware of the potential for EU breakup risk following the U.K.’s referendum vote in June 2016. Over the past 18 months, however, we have seen elections in the Netherlands, France, and Germany move toward more establishment-oriented parties that favor greater European integration—and not disintegration.

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Thus, for those investors whose principal concern is that the outcome of Italian elections on March 4 could usher in a new wave of EU breakup talks, we believe that the risks likely are contained.

Second, while some polling indicates that Italians have become disenchanted with the European Union, particularly as it relates to broad EU policies surrounding immigration, support for the euro currency remains strong. Political developments in Greece and the U.K. over the past few years have provided important case studies for supporters of leaving the economic and currency union. For Greece, one of the loudest arguments against leaving the currency bloc has been the prospect of Greek citizens having their pensions revalued into drachma, and also the prospect of using a newly devalued drachma to pay back mortgages and auto loans to German and French banks in euro.

What’s at stake in this weekend’s vote?

The health of the Italian economy and the trajectory of European integration are likely to be affected by the outcome of this weekend’s elections. In recent years, the Italian government has struggled to pass necessary legislation that could have helped the country’s economy recover from a double-dip recession fueled by the global financial and eurozone debt crises. Legislation passed in October 2017 (Rosatellum) now encourages coalition building that likely will make it easier to pass reforms through both chambers of Parliament. While the Italian economy is showing signs of improvement, many challenges persist—and much-needed reforms could help bolster growth in the years to come.

Also, with the imminent departure of the U.K. from the EU, Italy’s economy will be the third largest in the economic union. To this point, the outcome of Sunday’s election may determine the tenor of future EU policy direction, most notably, whether Italy will be a supporter or detractor of greater European integration espoused by France’s president, Emanuel Macron. None of the three major Italian political factions have cited support for a departure from either the EU or the eurozone. However, France’s (and to some extent, Germany’s) desire for greater European federalism could be undermined by an Italy-first mentality expressed by some in the S5M party and Center-Right coalition.

What is the likely outcome of Sunday’s vote?

Sunday’s vote is likely to be a toss-up. The Rosatellum law complicates any effort to predict the potential composition of Parliament based solely on national polls. For example, the new law allocates the first 36% of seats in Parliament to the faction with the highest number of votes, and the remaining 64% on a proportional vote basis. Coalitions will need to garner at least 10% of the vote, and independent parties will require 3%, in order to make this cut—so a percentage point here or there in voting results could affect the ultimate composition of Parliament. Further, popular polls have been poor predictors of European political outcomes in recent years. With many voters responding “undecided,” and no clear majority being reflected in recent polls, we assume that anything is possible in this election cycle. We believe the most likely outcome, however, is that a grand coalition comprised of varying interests will govern.
What are financial markets pricing in?

Heading into the March 4 election, fixed income, equity, and currency market participants appear to be taking the election in stride. Italy’s bond markets have been a notable measure of financial-market stress as various economic, financial, and political concerns have come and gone over the past decade. Today, various measures of bond-market sentiment reflect a benign risk environment. For example, the spread between 10-year Italian BTPs and German bunds has risen in recent weeks, but remains well below levels even 12 months ago, let alone 6 years ago (during the height of the eurozone debt crisis). This also is reflected in credit default swaps (a form of insurance) on Italian sovereign bonds when measured over a similar point in time.

Italian financial stocks and the euro currency are painting a similar picture. Italian financial-sector stocks have broadly outperformed the MSCI European Monetary Union index (a proxy for eurozone stocks), even with last month’s global equity market sell-off. Similarly, the euro currency has held its ground in recent weeks (despite having faced notable headwinds from market participants in past crises). While U.S. dollar weakness has biased the headline view on the euro to a certain extent, little recent price change in the yen/euro and GBP/euro currency pairs suggest that market participants are not yet pricing in Italian election concerns.¹

How should investors prepare for Sunday?

Our analysis indicates that the election is unlikely to produce a result with immediate implications for financial markets. First, the new election law encourages coalitions, and the polls do not suggest that any one party is likely to control the new government alone. Market pricing ahead of the election also suggests no clear conclusion. Second, if a coalition does become necessary, it may take weeks or longer to form a new government. Finally, improved economic growth seems to have bolstered support for membership in the EU. We therefore recommend no portfolio changes.

¹ GBP is the British pound sterling.
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Definitions

The **MSCI EMU Index (European and Monetary Union)** captures large and mid-cap representation across Germany, France, Austria, Belgium, Finland, Ireland, Italy, Netherlands, Portugal and Spain. With 248 constituents, the index covers approximately 85% of the free float-adjusted market capitalization of the EMU.

An index is unmanaged and not available for direct investment.

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