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Amundi ASSET MANAGEMENT

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INVESTMENT TALKS

Complex Italian election outcome should not threaten the positive European story

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The electoral result could raise uncertainty around future Italian economic policy, but it should not derail the positive European story.

- ***Outcome:*** *The electoral outcome (the very positive result of Five Star Movement, now the largest party, and of the Lega Nord in the center right coalition) was not priced by the market. With these results, if confirmed, the process of forming a government can be quite long and market uncertainty will remain high.*
- **Economy:** *Italy is currently showing three main signs of improvement: competitiveness, investment and corporate access to the market. We believe that the electoral outcome should not derail the economic momentum. However, the market may react considering the new scenario with higher uncertainty for the country, as some of the positions of the winning parties during the electoral campaign where controversial in respect to reforms implemented by the past government, the Euro, and with electoral plans missing coverage details. In the medium term, a lot will depend on the actual policies that the new government will implement.*

  Markets: *In the short term, we expect some volatility in the markets, at least until the new government is formed and it has announced its economic and fiscal program. However, this time, we believe, the economic recovery in Europe and worldwide is much more resilient than in the past and the balance sheets of the companies are much stronger after many years of restructuring programs.*

What are your key take aways of the electoral result in Italy?

AB: The electoral outcome (the very positive result of Five Star Movement and of Lega Nord) was not priced by the market and opens a new phase with multiple scenarios ahead. The new Parliament will meet on March 23rd and then the President will officially start consultations with party leaders to explore the possibility of forming a government and appointing a Prime Minister. The country also looks geographically divided, with the Northern part voting for the center right coalition (and Lega in particular), and Five Star Movement winning by far in the South. This will not help the two winning parties to find an agreement, which is the scenario that could scare the market the most, as some of their positions were controversial with respect to reforms implemented by the past government, and their critical attitude towards Europe. With these results, the process of forming a government can be quite long and market uncertainty will remain high, in fact any kind of “grande coalizione” hypothesis imagined before the vote lost ground.

What is your assessment of the Italian economy, also in light of the recent result?

AB: The Italian economy is currently showing three main signs of improvements. First, the country recovered some external competitiveness as evident from the good performance of exports (in the first 3 quarters of 2017 Italy was above France and Spain in terms of export growth, while only slightly below Germany). The stabilizing current account surplus (despite stronger domestic demand) and a stabilizing share of world exports also confirm the improved competitiveness. Second, Italian corporates resumed- investing in machinery and equipment that is growing now in line with Eurozone average. Third, corporates have clearly started tapping capital markets much more than in the past and this is a clear change: a more complex and modern debt structure (more differentiated than the basic bank lending) is forcing firms to open to new partners, new managers, and to become more growth oriented. These three factors suggest that growth potential is slightly higher than the one calculated by the EU Commission (just above 0), and that the Italian economy can grow persistently in the range 1-1.5% with an inflation rate in the range 1.5-2%. If this is true, debt is bound to decline and Italian assets will benefit from a reduced risk premium.
The first reaction of the market will be characterized by the fear that these achievements will be put in danger. The risk is also that a new government will stop pursuing fiscal discipline.

This could create friction with the European authorities and other countries (at the Eurogroup). Then, in the medium term, a lot will depend on the actual policies that the new government will implement.

How does this result change your view on political risk in Europe?

AB: With this outcome, as the major winning parties have been very critical about the idea of Europe, it is likely that the Government will not be of help in the process of strengthening the European project. Any progress in terms of integration, will be very difficult with one of the original founding members having a neutral or even negative stance. There is also the risk of having very distant positions in terms of relevant policies such as migration. On the other hand, in Germany, the SPD just agreed to enter the new grand coalition government. This will give impetus to actions to enhance and strengthen European integration on the lines put forward by the French President Macron. So overall, we don't see a material increase of political risk in Europe, but Italy will have to redefine its role within the European architecture.

This time, economic recovery in Europe and worldwide is much more resilient than in the past and the balance sheet of the companies are much stronger after many years of restructuring programs.

How do you expect this electoral outcome will affect European equities? What will be the key drivers for the market going forward?

DF: In the short term we expect some volatility in the markets, not only the Italian but the European as well, at least until the new government will be formed and it will announce its economic and fiscal program. It will be crucial to understand the attitude towards the euro and what kind of interventions in pensions, tax incentives and debt reduction will be taken. It is difficult to predict the size of the correction. However, the Italian market is the cheapest in the Euro area. Compared to the previous crisis (July 2012 Euro crisis and December 2016 Referendum) the discount is smaller. From a peak of around - 50% in price to book (P/B) and - 30% in price to earnings (P/E), the Italian market is trading now around a discount of – 35% on P/B and -15% on P/E. There is a major difference between now and the previous political crisis: this time the economic recovery in Europe and worldwide is much more resilient than in the past and the balance sheet of the companies are much stronger after many years of restructuring programs.
We already had some examples in Europe where a weak political situation didn't damage too much the economic recovery and after the very first reaction markets tend to be driven by economic fundamentals. The long term drivers will be in any case the capacity of corporates to generate earnings.

Do you believe that this political outcome could bring significant changes to the institutional framework of the Italian stock market?

DF: The PIR[1] (Piano Individuale Risparmio) Decree was a real success in terms of net inflows and new IPOs. In 2017 inflows were more than 10bn euro. If equity markets are weak we could expect a weaker collection and less IPOs. However, we don't expect huge redemptions on the 10bn inflows of last year because the subscribers will lose the fiscal benefit otherwise. We don't expect a radical change to the PIR decree, so companies will continue to become public, possibly at a lower speed.

We don't expect the electoral result driving a deep risk off phase, but temporary weakness in risk assets.

What is your view on small and mid cap market in Italy going forward?

DF: We keep our constructive view for the medium term suggesting to take advantage if market reaction will be too aggressive. Our positive stance is driven by the favourable institutional framework but also by the strong fundamentals. The Italian Small Cap segment had great performance in 2017 even before the introduction of PIR Decree because most of the listed companies are much more export oriented compared to large caps that are traditionally more linked to domestic macro trends. We expect the positive trend to continue: Mid-size companies are the core of the Italian economic structure. They are very much specialised in niches of business with strong capacity in exporting and innovating. These companies are usually managed by the founder with an incredibly high dependency to banking loans. The PIR decree

[1] The Budget Act 2017 (Legge di Stabilità 2017) has introduced the Individual Saving Plans (PIR): tax exemption for retail investors on capital gains associated to long term investments, subject to certain conditions.

should speed up the succession theme and should help to enhance efficiency as investments, growth and acquisitions become subject to market dynamics. In the last five years, small cap total earnings doubled versus a +30%[2] for the large caps. For 2018 the market consensus is for another double digit growth for mid-caps and a positive trend for large caps too. Selection and focus on quality will be crucial for benefit from opportunities in the area.

What are the cross asset implications of the Italian electoral results?
MG: We don't expect the electoral result will cause a strong and persistent risk off phase, but rather temporary weakness in risk assets. These are also linked to the evolution of Central Bank policies and to the maturing conditions of the financial cycle. In the short term, we would expect a widening of BTPs spreads to 170-190bp as a benign outcome was priced before the elections. In the equity market, we expect an increase in volatility affecting not only the financial sector but overall the FTSE MIB Index that has been outperforming EuroStoxx 600 by almost 6%. We also see a temporary weakening of the Euro vs the USD. What will happen in the medium term will depend on the direction that the new Government (when formed) will take. Leaving aside the election outcome, we believe that, as the economic cycle in developed markets matures, markets are moving towards a higher volatility regime. While we are still moderately constructive on risk assets (equity in particular), we believe that structural hedges will remain crucial to smooth any increase in volatility.

[2] Bloomberg consensus data.

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