ITALY: ECONOMY AND SOVEREIGN BONDS

THE ROUGH WATERS COULD GROW CALMER

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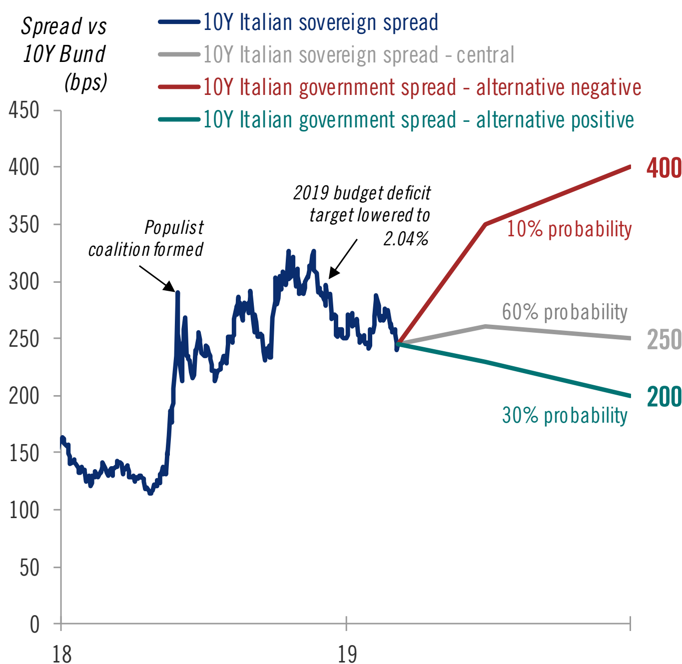
SUMMARY

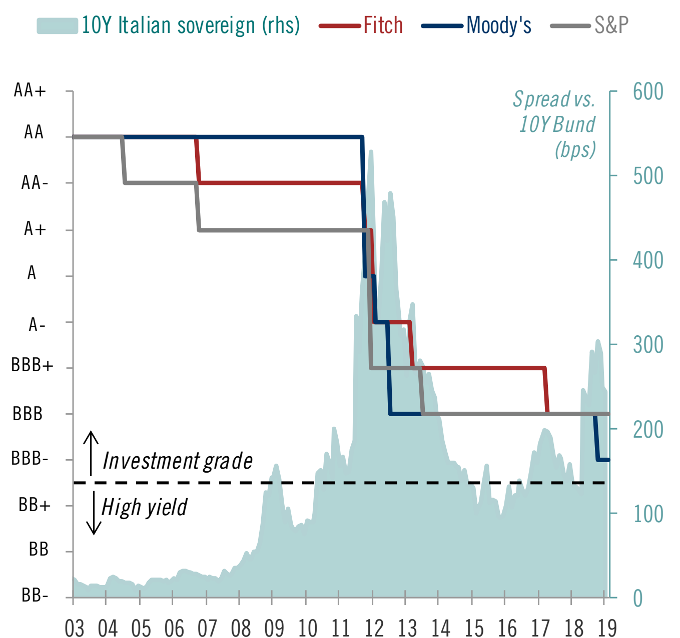
- The main leading indicators are pointing towards the recession continuing in Q1 2019 in Italy. We expect the Italian economy to grow by 0.3% in 2019. Our forecast assumes growth edging marginally back into the black in Q2 2019.
- Even though we have ruled out a snap 2019 election from our central scenario, the chances of one being called are significant enough not to be overlooked. Should a snap election be held in 2019, it would be unlikely, in our view, to happen before September/October.
- We remain underweight on peripheral sovereign debt, as we expect the 10-year Italian sovereign spread to remain volatile and within a range between 240-280bps. We are sticking with our year-end target at 250bps, as the economic downturn is continuing, and uncertainties remain high with regard to the next steps to be taken by the governing coalition or rating agencies.
- However, the possibility of an early election and potential improvements in sentiment that might ensue if a right-wing coalition takes office increase the chances of our positive scenario to 30%, where we see the 10-year spread tightening to 200bps, and lower the probability of the negative one to 10%.

CHART 1: THREE SCENARIOS FOR THE 10-YEAR SOVEREIGN SPREAD



Source: PWM - AA&MR, Bloomberg, 07.03.2019

CHART 2: ITALY'S SOVEREIGN DEBT RATING AND THE 10-YEAR SPREAD



Source: PWM - AA&MR, Bloomberg, 28.02.2019

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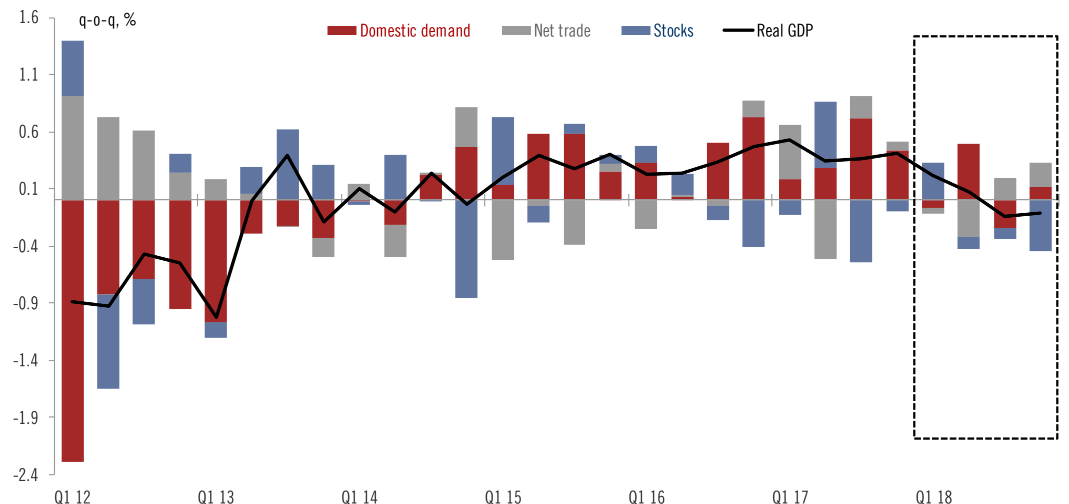
Technically in recession, but not all was bad

The final estimate of Q4 GDP, while confirming that Italy's economy had technically entered into recession, was slightly upgraded from the preliminary release. In Q4, Italian GDP shrank by 0.1% q-o-q, following similar contraction in Q3 2018. **The breakdown provided some interesting insights into the economy and were better than expected**. First, data showed that the quarterly contraction was driven by inventory destocking, which subtracted 0.4 percentage points (pp) in Q4 (see *Chart 3*). Second and more importantly, the other main components turned out to be growth-positive: gross fixed capital formation and private consumption contributed 0.1pp each to quarterly growth, while net trade contributed 0.2pp.

Overall in 2018, Italy's economy grew by 0.8%, slowing from 1.7% in 2017. Part of the slowdown has its roots in domestic soil. Greater political uncertainty in the aftermath of March elections and the 2019 budget wrangling between Rome and Brussels led to tightening financial conditions and a slide in business confidence. But not everything can be blamed solely on the government. **The recession also has roots outside Italy**. Italy is one of the most integrated countries in the European industrial value chain, with the slowdown in Germany in the second half of 2018 having knock-on effects on Italy. Furthermore, Italy also has a more manufacturing-dominant economy: industry accounts for 20% of total value added, more than in France and Spain, but less than in Germany.

CHART 3: REAL GDP GROWTH BREAKDOWN



Source: PWM - AA&MR, Istat

Looking ahead, we remain cautious about Italy's near-term growth outlook. The main leading indicators are pointing towards the recession continuing in Q1 2019, but there were some bright spots in the details of some surveys. Notably in the latest PMI survey, new export orders, employment and manufacturers expectations regarding the year ahead outlook for output improved in February. **We expect the Italian economy to grow by 0.3% in 2019**. Our forecast assumes growth edging marginally back into the black in Q2 2019, but risks to our growth forecast are still tilted to the downside.

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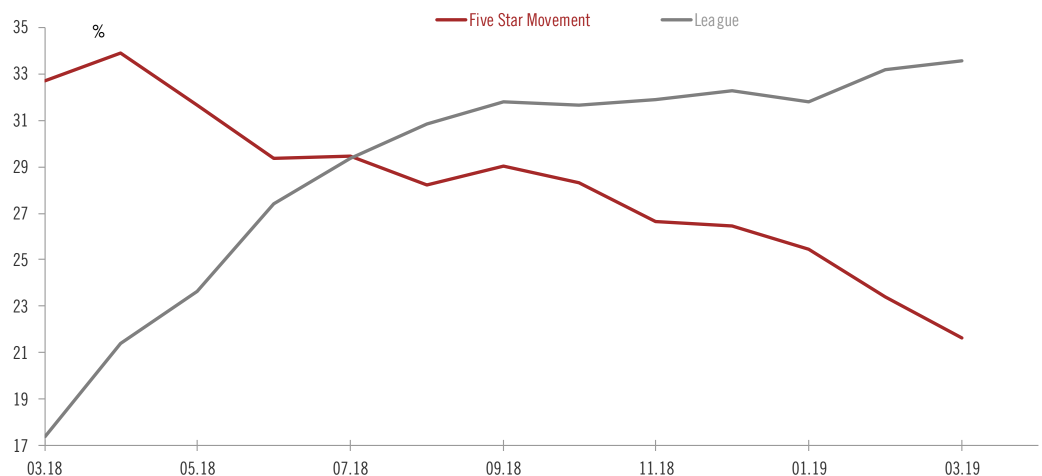
Early elections or not?

Since the current coalition government was stitched together between the Five Star Movement (5SM) and the League in May last year, there has been plenty of speculation over just how long the government might last, not only because both parties disagree on many policies, but also on account of how both parties have been faring in the opinion polls. The League, originally the junior coalition partner, is now running well ahead (see *Chart 4*). Moreover, regional elections confirmed the ruling 5SM's waning popularity. Yet, the question is whether Matteo Salvini, the League's leader, will seek to trigger early elections. For several reasons, the path to a snap election is not straightforward. First, the decision to dissolve parliament has to be taken by the President of the Republic, Sergio Mattarella. He might opt for stability instead of calling a snap general election and ask parties to weld together a new coalition based on the existing parliament, for example between the 5SM and the Democratic Party. Second, the absence of viable alternatives is keeping the government *in situ*. Tensions within the government are likely to mount in the autumn, as the government drafts its 2020 budget. With lower growth and higher borrowing costs, government finances will be even more tightly squeezed this year than last year. Furthermore, the government will need to find extra revenues of EUR12bn to avoid a scheduled VAT hike in January 2020.

Even though we have ruled out a snap 2019 election from our central scenario, the chances of one being called are significant enough not to be overlooked. Should a snap election be held in 2019, it would be unlikely, in our view, to happen before September/October. Elections to the European Parliament in May will be a key test for both parties. According to opinion polls, the League is likely to perform quite strongly. **Should the gap between the two coalition parties widen unmistakably, talks about early elections will bubble back to the surface**. If a vote was to take place soon, a centre-right coalition (League and Forza Italia) could get an absolute majority, polls say, and perhaps be less fiscally expansionary and more conventional in its policy mix. From a markets' perspective, a centre-right government would be viewed as more market-friendly.

CHART 4: NEXT GENERAL ELECTIONS – AVERAGE MONTHLY OPINIONS POLLS



Source: PWM - AA&MR, various polls

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Light at the end of the tunnel for sovereign bonds?

As expected, since December last year, market participants' worries have shifted from the 2019 budget saga to the growth slowdown in Italy. This has kept Italian sovereign spreads versus German Bunds wide, the 10-year spread hovering between 240bps and 280bps. It reached the lower end of the range following the European Central Bank's dovish shift at its March meeting, however, we continue to expect high volatility going forward. One cause of concern is the fact that Italy technically slid into recession in the second half of 2018, and the likelihood is that growth will stay in negative territory in Q1 and close to zero in the quarters that follow. Risks for Italian sovereign yields are obvious: subdued growth, coupled with a higher fiscal deficit, pushes the debt-to-GDP ratio higher, which, in turn, will rekindle worries about debt sustainability. The most direct consequences would be a likely one-notch downgrade from S&P Global and Fitch which have Italy on a 'Negative' outlook (see *Chart 2*).

Events unfolding along those lines are factored into our central scenario (60% probability), **under which the 10-year Italian sovereign spread would remain highly volatile, but inside the current 240-280bps range and maintain our year-end target at 250bps.** According to this scenario (see *Chart 5*), the populist coalition would remain in place despite ongoing stresses and strains aggravated by heated 2020 budget negotiations. **Moreover, Fitch and S&P Global would act on their 'Negative' outlooks by downgrading Italy's rating by one notch in H2, leaving their outlooks 'Stable'**, thereby following in Moody's footsteps (see *Chart 6*). This would put Italy just one notch away from high-yield (HY), but the 'Stable' outlook tag would somewhat ease fears about a potential downgrade to HY.

CHART 5: THREE SCENARIOS FOR ITALY AND ITS SOVEREIGN SPREADS

Source: PWM - AA&MR, 06.03.2019

In the alternative positive scenario (30% probability), the advent of a market-friendly government following snap elections could provide a boost to investor, business and household confidence. Though not engineering Italy's economic resurgence, it could still brighten growth prospects going forward. Assuming that the Eurosceptic rhetoric would remain moderate with no 'Italexit' threats, S&P Global might well be persuaded by this political shift to remove its 'Negative' outlook and Fitch to refrain from downgrading Italy's rating, with both persevering with their wait-and-see approach (see *Chart 6*).

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Overall, the threat of a more severe downturn and a downgrade to HY would be pushed back, **probably leading to further tightening of the 10-year Italian sovereign spread towards 200bps.** However, the spread would still remain wider than before the populist coalition was formed (see *Chart 1*).

Lastly, making allowance for the less strident Eurosceptic noises coming out of the current coalition, along with the ongoing dialogue with the EC, we have lowered the probability of the negative "deep crisis" scenario from 30% to 10%, in favour of the positive "relief" scenario, the chances of which have been lifted from 15% to 30% (see our previous Outlook for euro periphery).

CHART 6: THREE SCENARIOS FOR ITALY'S CREDIT RATING

	S&P Rating	*S&P Outlook*	Rating review	Moody's Rating	*Moody's Outlook*	Rating review	Fitch Rating	*Fitch Outlook*	Rating review	Prime
Current	BBB	*NEGATIVE*	26.04.2019	Baa3	*STABLE*	15.03.2019	BBB	*NEGATIVE*	22.02.2019	**Investment grade**
AA&MR central	BBB-	*STABLE*	*25.10.2019*	Baa3	*STABLE*	06.09.2019	BBB-	*STABLE*	09.08.2019	Investment grade
AA&MR positive	BBB	*STABLE*	*25.10.2019*	Baa3	*STABLE*	06.09.2019	BBB	*NEGATIVE*	09.08.2019	Investment grade
AA&MR negative	BBB-	*NEGATIVE*	*25.10.2019*	Baa3	*NEGATIVE*	06.09.2019	BBB-	*NEGATIVE*	09.08.2019	Risk of downgrade to high yield

Source: PWM - AA&MR, Bloomberg, 06.03.2019

Conclusion

Overall, we remain cautious on Italian sovereign debt, as the economic downturn is continuing, and uncertainties remain high with regard to the next steps to be taken by the governing coalition or rating agencies. **This underscores our expectation for a volatile 10-year sovereign spread, with our year-end target at 250bps, inside the current 240-280bps range**. However, taking stock of the mounting likelihood of an early election and potential improvements in sentiment that might flow from the advent of a right-wing coalition, we have raised the probability of our positive scenario to 30%, where we see the 10-year spread tightening to 200bps and lowered the chances on the negative one to 10%.

All in all, our stance remains unchanged at underweight on peripheral sovereign debt, and we will be continuing to monitor the Italian situation closely.

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