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Amundi
ASSET MANAGEMENT

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INVESTMENT TALKS

Italy: no short-term confrontation with the EU, but uncertainty in the mid-term.

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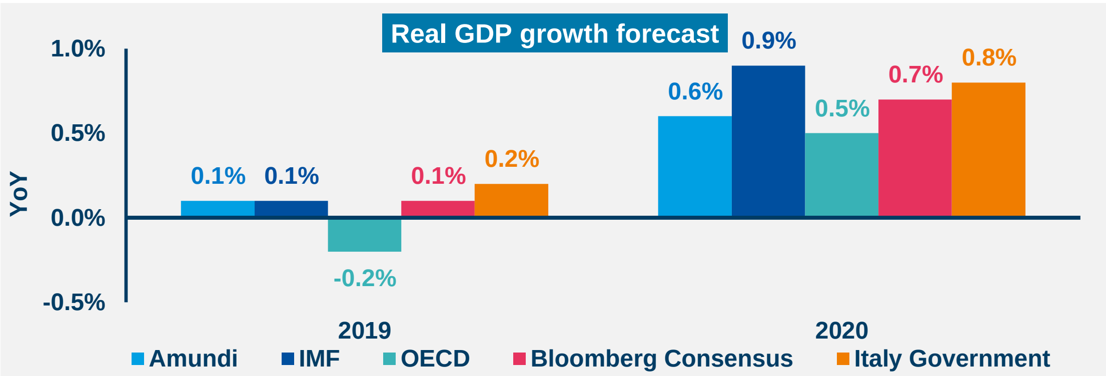
- ***Italy economy: weak growth****. The Italian government has revised down the 2019 GDP growth forecast in its latest economic blueprint. Italian growth is expected to pick up in H2 2019, returning at or slightly above potential from 2020, with projections much closer to consensus than previous ones.*
- ***Italian deficit and debt: no short-term confrontation, but uncertainty in the mid term****. If the Italian government manages to stick to its new declared deficit and debt targets, there should be no confrontation with the EU for the time being. However, the medium-term debt trajectory remains an area of risk, as the current downward projections depend on an ambitious privatisation programme. Guidelines also include additional measures (flat tax reform and no VAT hikes) but with no clarity on how to finance them.*
- ***Fixed Income – Italian BTPs back in demand, favour short-term BTPs:*** *After a difficult end of 2018, investor demand for BTPs rebounded strongly in the first quarter of the year, especially among foreign investors. This revival of demand is due to the agreement with the EU on budget, the overall limited reaction of rating agencies and the new ECB communication on its monetary policy stance. In the desert of yield, short-term BTPs offer an attractive risk/return profile given the stabilisation in Bund-BTP spread levels.*
- ***Equity – cautious in the short term.*** *Over the short term we are cautious on Italian equity markets given the still high economic and political uncertainty. Looking ahead further, opportunities could materialise as the market is exposed to the global cycle, which we expect to pick up in the remainder of the year.*
- ***Italian banking sector – improving fundamentals, but still exposed to areas of uncertainty.*** *On the fundamental side, Italian banks have been focusing on de-risking and reducing costs, as well as domestic consolidation. Banks' profitability still remains under pressure (interest rates margins, in particular) and this is the key reason behind the lower valuation of the Italian vs. the European banking sector.*

What is the current growth outlook for Italy?

In the new forecasts for the 2020 budget and beyond from the Italian government (from the latest economic blueprint, of 9 April: "The Stability and Growth Path, SGP"), its economic projections come much closer to consensus than previous ones, pointing to weaker GDP growth. With regard to GDP growth, baseline projections forecast an 0.1% year-on-year expansion in 2019, but the Italian government expects growth of an estimated 0.2% for 2019 as the two recent Law Decrees (the so-called "growth decree" and "unlock Italy decree" are both being converted into law) take effect.



Source: Amundi Research, OECD, IMF, Bloomberg, Datastream. As of 15 April 2019.

"If the Italian government manages to stick to its new declared deficit and debt targets, then there should be no confrontation with the EU for the time being."

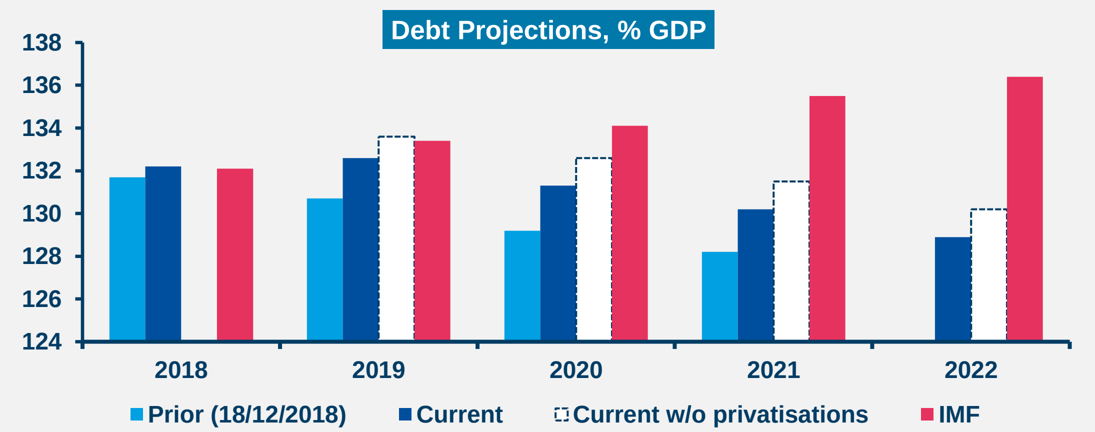
What is your view on the budget deficit for Italy and on the debt trajectory?

Italy's economic blueprint also reported a higher 2019 budget deficit target (from 2.0% to 2.4% of GDP), with the goal to gradually reduce it towards 1.5% by 2022. This downward trend should be supported by both an improvement in the primary balance and a gradual increase in nominal GDP. The primary balance is expected to move gradually higher and converge to 2.0% of GDP in 2022, from 1.2% in 2019, but fall short of the 3.0%-3.5% range that would be required to set the debt/GDP ratio on a stable downward path, given the weak nominal GDP trajectory.

The structural deficit should decline from 1.6% in 2019 to 0.8% in 2022, thus suggesting a progressive improvement in the direction of EU requests (and perhaps avoiding confrontation with the EU on this specific theme until the next budget discussion in 2020).

The debt to GDP ratio is expected to increase from 132.2% in 2018 to 132.6% in 2019 due to a combination of worsening growth prospects, a reduction in the primary surplus and an increasing deficit. However, the ratio is expected to decline afterwards, pointing to a target of 128.9% for 2022. The output gap is expected to remain essentially open and not to close over the horizon (approx. 1.7%-1.6%), and this should allow for less adjustment on the structural balance from EU rules.

"The medium-term debt trajectory remains an area of risk, as the current downward projections depend on an ambitious privatisation programme."



Source: European Commission, IMF, Amundi Research. As of 11 April 2019.

If the Italian government manages to stick to its new declared deficit and debt targets, then there should be no confrontation with the EU for the time being, as its projections are compliant in principle with EU rules.

"The guidelines also include additional measures (flat tax reform and no VAT hikes) but with no clarity on how to finance them."

However, we observe that the proposed deficit trajectory is based on current laws that contemplate, among others, a significant raise in value-added tax (VAT) from January 2020 (approx. €23bn in hikes). Savings from spending reviews (€2bn, €5bn and €8bn expected from 2019 to 2021, respectively) and a safeguard clause worth €2bn (to be implemented in July 2019 if the public finances are deemed inadequate in respect of the deficit target set) are also accounted for.

The proposed debt path also depends on an ambitious privatisation programme, estimated at approximately 1% of GDP (c.€17-18bn) in 2019 and 0.3% of GDP (c.€5bn) in 2020.

Hence the medium-term debt trajectory remains an area of risk. Although the Parliamentary Budget Office (PBO), Italy's fiscal watchdog, has refused to validate the government's budget plan in the past, it has formally validated the government's projections on this occasion. It did, however, highlight risks on the debt trajectory, and the Bank of Italy has also called attention to the same issue. Guidelines for the government's action until 2022 are outlined at very high level. While it is mentioned the government has declared an intention to proceed with the flat tax reform and to avoid the VAT hikes planned for 2020, there is no information on how it plans to finance these measures.

"Tensions at the head of the governing coalition have recently increased. "

What is your view on the Italian political landscape moving towards European elections?

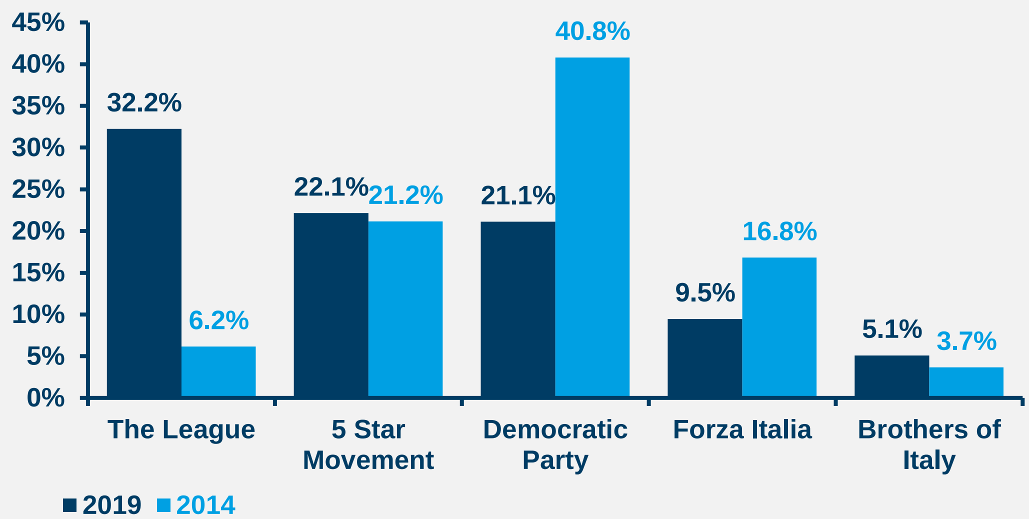
With one month to go before the European elections, both parties in the governing coalition are experiencing high tensions. The opening of an investigation into corruption targeting the Secretary of State for Transport, Armando Siri (Salvini's economic adviser in the League), was a detonator. He is accused of taking bribes, and has been suspended from office by his responsible minister, Danilo Toninelli, a member of the 5 Star Movement (M5S).

The approach of the European elections is at the root of the tension. In local elections in recent months, the League has made significant progress while M5S has seen a dramatic decline. The most recent projections for the European elections give 31-32% of the votes for the League vs. 21-22% for the M5S. This is a far cry from the 2018 legislative elections: the M5S won nearly 33% of the votes, and the League (which ran in coalition with several other right-wing groups, including Forza Italia) won 17% of the votes on its name alone. The balance of power has been completely reversed between the two parties. At the national level, the League governs with the M5S while Forza Italia (FI) and the small coalition parties are in opposition. But at the local level, in many cities and regions, the FI-League coalition has won six of the last seven regional elections.

"The probability of new elections in the second half of the year has risen."

The voting intentions of the League / FI exceed the 40% threshold, which would make it possible for a new coalition in the wake of new general elections. Matteo Salvini could be tempted by new elections. But it is not certain that he will benefit. First, because the Italian economy fell back into recession in H2 2018 and new elections would increase uncertainty again. Secondly, politically speaking, it is not said that Salvini would have more room for manoeuver by joining forces with Silvio Berlusconi. In short: Salvini has the wind in his sails, the probability of new elections in the second half of the year has risen. But new elections are anything but certain: Salvini has every interest in raising doubts about his intentions: this is the best way to maintain pressure on M5S.

Italian EE Polls - 2019 vs 2014



Source: POLITICO. Data as of 23 April 2019.

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On the fixed income side, how do you see the demand for Italian BTPs evolving and where are the opportunities for investors?

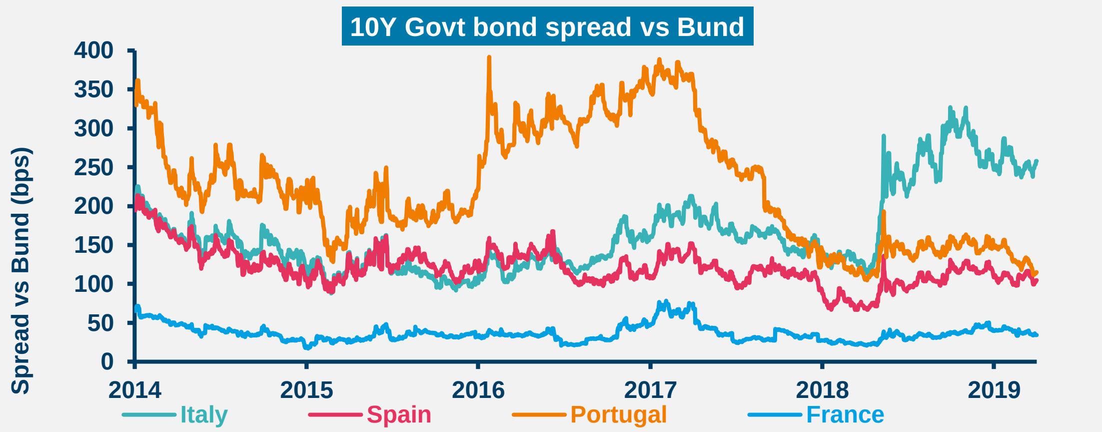
"After a difficult end of 2018 with a sharp de-risking on Italian government debt, demand for Italian BTPs rebounded in Q1 2019, especially from foreign investors."

Fixed income is heavily sensitive to domestic political turbulence. This can be seen in the evolution of the demand for Italian BTPs. Non-domestic investors sold a record amount of Italian debt between May and December of last year (€92bn in just eight months) during the period of higher confrontation on the Italian deficit plan. Although domestic demand was positive over the same period (€74bn), the overall change on net holdings of BTPs was negative.

Starting 2019, the very light positioning, the agreement with the EU on budget, the overall limited reaction of rating agencies, and especially the new ECB communication and decision on its monetary policy stance, were all elements that contributed to the January rebound in demand. As a result, all major holders increased their net holdings. Indeed, the new 15-year BTP issued in January and 30-year BTP issued in February both met strong investor demand, confirming the interest shown for Italian government bonds.

"In the desert of yield, short-term BTPs are an attractive oasis."

The return of strong demand for long-term paper from foreign investors supported the issuance of extra long bonds in size, raising the average maturity of new debt to almost 10 years, higher than the almost seven-year average maturity of the overall stock of the debt. The longer duration of issued debt means that Italy now has a buffer of flexibility in managing next month's auctions if needed. Therefore, supply could slow down in the mix of volume/duration in the very next future.
As a result we expect the BTP-Bund spread to remain stable in the short term, making the short-term end of the curve (one to three years) attractive, especially given the low yield environment in Europe.

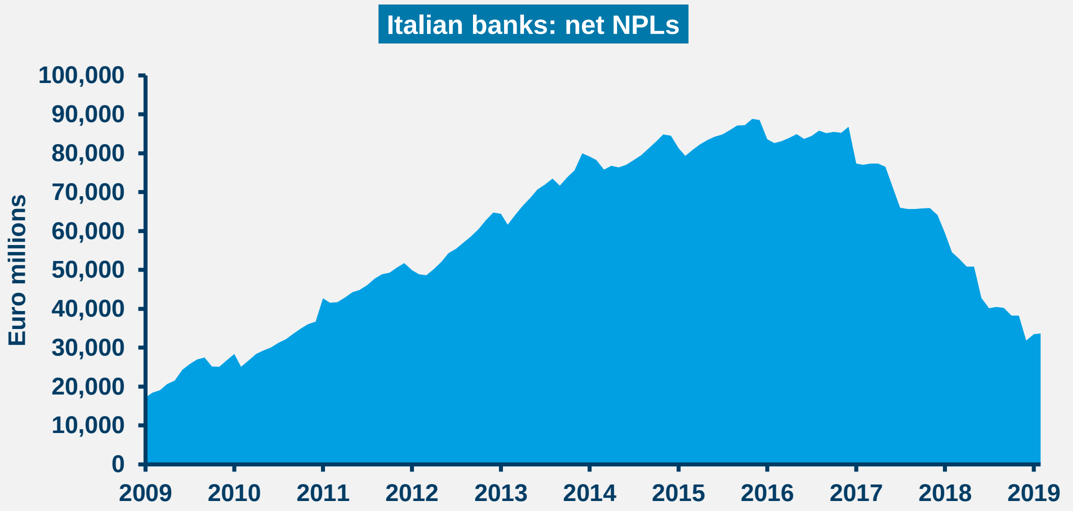


Source: Bloomberg, Amundi. Data as at 19 April 2019.

What is your assessment of the Italian banking sector?

"Italy's banking sector remains exposed to political turbulence. Revenues under pressure (on interest rates margins, in particular) and the economic outlook are the key factors to watch."

The Italian banking sector is heavily exposed to political turbulence as spread widening directly affects banks' capital and capital ratios. Over the last months, the stabilisation of spread levels and the decline of spread volatility has been beneficial. In our view, Italian banks are a good place to look for restructuring stories and there is still scope for some re-rating. However, the risk/return profile now looks less compelling, with some uncertainty on the global economic outlook, so we recommend caution and a highly selective approach. The time is approaching for TLTRO funding replacement. According to our analysis, no banks will be forced into early repayment, though the TLTRO will offer good protection against deleveraging and, at the margin, will reduce tail risk and the likely cost of capital.
Italian banks have been focusing on de-risking and reducing costs, as well as domestic consolidation. They have improved their funding mix, relying increasingly on deposit funding, and improved asset quality risk by reducing non-performing loans (NPLs).



Source: Bank of Italy, Amundi Research. Data as at 28 February 2019.

However, banks' revenues remain under pressure (interest rates margins, in particular) and this is the key reason behind the lower valuation of the Italian vs. the European banking sector (0.6x price to book value compared with the European banking sector at 0.8x price to book value).

The two ingredients that could support Italian banks' profitability are higher interest rates and/or a further decline in loan loss provisions, but that appears challenging given the weak economic outlook in Italy. For the moment the situation on credit risk is still good, with new non-performing loan inflows at historically low levels, but there is still the risk that a further deterioration of the domestic growth outlook would affect credit quality in the future.

"Over the short term we are cautious on Italian markets given the still high economic and political uncertainty."

From a multi-asset perspective what is your view on the Italian equity market?

The Italian equity market has been the top performer in Europe year-to-date (FTSE MIB Index +19% vs +16% for the EuroStoxx 50, at 23 April[1]), though investors' participation has been light so far. The reporting season with first quarter results and forward guidance will be crucial to confirm the solidity of fundamentals and facilitate a further re-rating in the run-up to European elections. From an asset allocation perspective, we are cautious on the top down country specific story, due in part to the lack of visibility on the medium-term economic and political perspective with the forthcoming European election. At the moment, we prefer the European credit market to the European equity market where overall we have a neutral view. Looking ahead, further opportunities could materialise in Europe and in Italy as well, as these markets are exposed to the global cycle, which we expect to pick up in the remainder of the year.

[1]Source: Bloomberg.

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- **BTP-Bund Spread:** differential between the yield on the 10-year Italian BTP vs 10-Year German Bund.
- **NPL (Non Performing Loans):** a bank loan is considered non-performing when more than 90 days pass without the borrower paying the agreed instalments or interest.
- **Price to Book Ratio P/B:** is a financial valuation ratio that measures a company's market price in relation to its book value.
- **TLTRO:** The targeted longer-term refinancing operations (TLTROs) are Eurosystem operations that provide financing to credit institutions for a predefined period of time. They offer long-term funding at attractive conditions to banks in order to further ease private sector credit conditions and stimulate bank lending to the real economy.
- **Volatility:** a statistical measure of the dispersion of returns for a given security or market index. Usually, the higher the volatility, the riskier the security/market.

Important Information

Unless otherwise stated, all information contained in this document is from Amundi Asset Management and is as of 23 April 2019.

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