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View on Italy: beyond the short term

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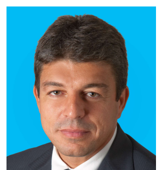

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- ***The end of the political crisis and next steps for the new government:*** *The new pro-European government looks to be willing to move in a different direction vs the previous one, with an agenda focused on green and socially inclusive policies. It is difficult to project how long this new coalition will last, but it will certainly have to address the next budget law. We expect to see some expansionary measures (lower labour costs plus investment spending), but without putting public finances at risk. However, the available room for manoeuvre is narrow.*
- ***Italy vs the EU:*** *The change in the relationship with the EU is the most important shift regarding this new coalition, keeping in mind that it voted for Ursula von der Leyen as new President of the European Commission. The new Italian Finance Minister will likely be able to obtain the maximum level of flexibility allowed at the EU level, but this will not lead to meaningful fiscal expansion in Italy. The good news is that momentum is building with the EU for some accommodative fiscal measures, but completely new rules are not something that Italy should hope for in the short term.*
- ***Structural outlook for Italy:*** *The most likely scenario, in our view, is one in which some of the international uncertainty is removed (such as no-deal Brexit) and where trade dynamics normalise gradually yet remain subdued vs the historical average. In this environment, where a certain degree of uncertainty remains, Italian growth could gradually pick up, but remain around the potential level (0.6-0.8%). In a low yield environment, with interest rates below nominal GDP growth, the debt/GDP ratio could stabilise and eventually fall, leaving some fiscal room for manoeuvre.*
- ***Investment implications:*** *Given a lower probability of confrontation with the European Commission, spreads on Italian BTPs have been falling. We expect this trend to continue, thanks to ECB support. ECB vigilance is critical: in a low growth scenario, it gives some guarantee that low yields will be maintained relative to nominal GDP growth, meaning the debt/GDP ratio (high for Italy) will remain on a sustainable trajectory, thus providing some fiscal room compared to the past. Moreover, the ECB is ready to act in case of crisis. De facto, the ECB is behaving like a sort of "Treasury" in a changing framework of "fiscalisation" of monetary policy and monetisation of budgetary stances.*
- ***The appeal of Italian bonds for investors in search of yield****: Our preference is for the longer part of the curve (30Y). Given our cross asset allocation view, we favour BTPs vs Italian equities which look more vulnerable to the external uncertain scenario (trade war and economic slowdown).*
- ***Equity dependent on trade****:* ***Possible some relief in the medium term.*** *Moving ahead, we could see more IPOs from Small to Midsized companies and interest from ESG investors, which could potentially benefit the Italian market. Relief from trade wars does not appear to be likely in the short term, but could materialise in the coming quarters, and this could support more constructive Italian and EU equity outlooks.*

"The new pro-European government is willing to diverge from the policies of the previous one, with an agenda focused on green and socially inclusive policies".

A NEW AGENDA, ON A NARROW PATH

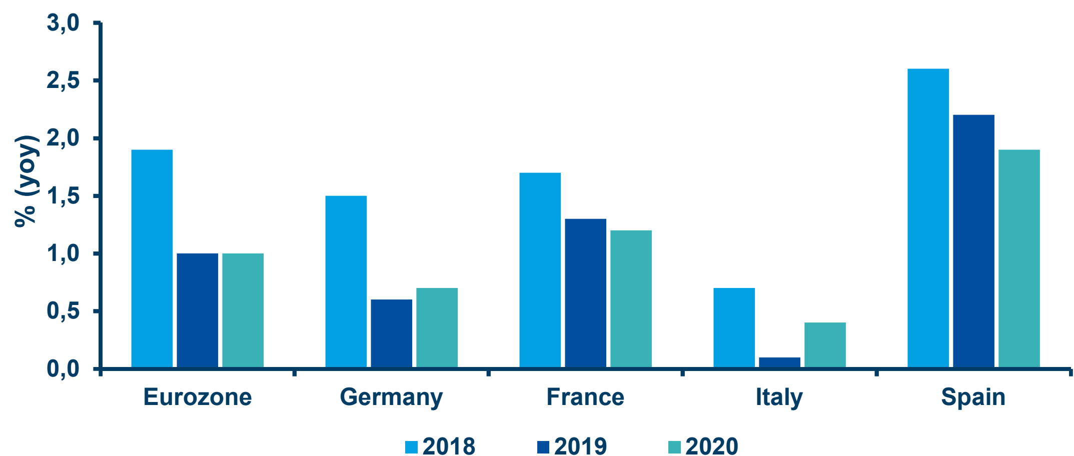
The new Italian government is now fully functional. The government crisis ended with **M5S shifting from being allied with probably the most Euro-sceptic (and confrontational) party (the League) to being allied with likely the most pro-European party in Italy** (Democratic Party), with **Mr Conte being confirmed as prime minister**.

In order to remove any doubt regarding continuity with the previous government (given the confirmation of the PM and the significant presence of the M5S), **the current coalition has made significant efforts to mark its divergence from** the previous government's programme and positions on many issues via its support of EU insitutions and its changed political agenda.

This is focused on green and more socially inclusive policies, stressing the centrality of the EU project for Italy.
If from a political point of view the communication of a marked difference is key for the support of governement stakeholders, from an economic standpoint, **it is important for the government to focus with pragmatism on the problems faced by the Italian economy, which remain unchanged and partly unresolved** (tax evasion, low productivity, inefficiencies in the labor market, North vs South divergences, low level of competition, high dependence of the productive system on bank financing, to name a few). Therefore, for the new government, **it would be appropriate to identify those areas where continuity of policy action should be granted to remove uncertainty and to strengthen the effectiveness of already implemented policies.** In particular, we think **it would be reasonable to expect continuity, extensions or enhancements of "Industry 4.0" policies** (to support an **increase in private investment and a rise in productivity)**, policies **to attract and retain human capital**, and **"social inclusion"** policies. These may require a re-design and rationalisation of the tools introduced so far (eg, social inclusion policies, inclusion income, citizenship income-*reddito di cittadinanza*); these (appropriately reshaped) could address the increased inequality and marginalisation of large parts of the population.

In this sense, **the right questions to ask perhaps would be: Is this current government likely to be long-lasting** and able to implement structural reforms throught the entire legislative period? Or, will the once strong antagonism between M5S and PD resurface soon, once again putting at risk the stability of the government? It is still too soon to draw conclusions: the regional elections in the coming months will be the first test for the coalition, but we believe that the election of the President of the Republic in 2022 (by members of parliament) will be a key deadline regarding whether the coalition holds together.

Italy: Weak real GDP growh



Source: Amundi Research forecast, Bloomberg. Data as of 17 September 2019.

"We expect some expansionary measures (to lower labour costs and increase investment spending), without putting at risk public finances, but the path is narrow…"

Looking at the political programme of the new coalition, it is designed around the **willingness to implement expansionary fiscal policy without putting at risk public finances**. The fiscal effort, in our view, is aimed at:

- avoiding the VAT increase (cost estimated at approximately EUR 23bn)
- supporting lower income households and introducing a minimum wage level
- reducing costs attached to labour (social contribution – not clear how a reduction could modify the proportion between that paid by employers and paid by employees)
- promoting investment in education, infrastructure, green energy, and in southern regions; in part, this should be financed by looking for flexibility from the EU or trying to have some investments not accounted for the EU budget compliance

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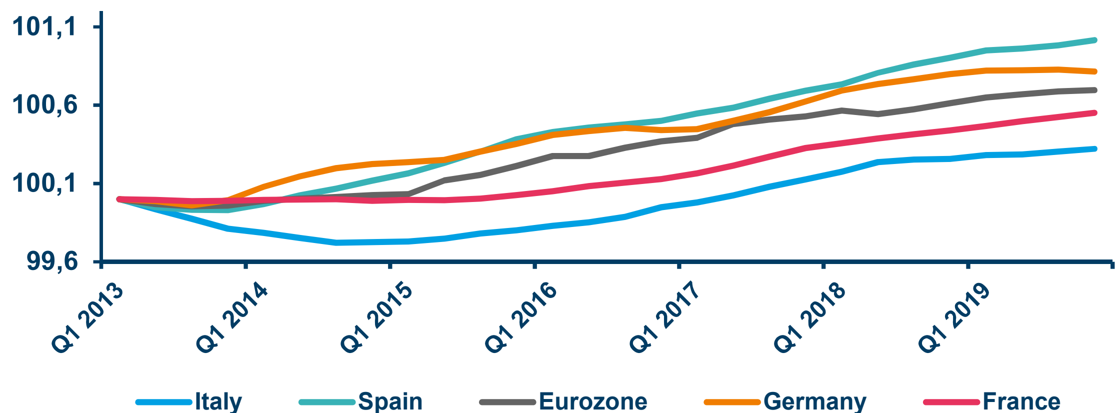
- launching broader tax reform (including a review of tax brackets, a review of tax expenditures, and progress with the spending review)
- launching a “Green New Deal”, promoting ESG behaviour at all levels of society, from consumers to businesses
- progressing with the reduction in the number of MPs and the subsequent electoral system and law changes
- promoting technological innovation as a key factor in economic growth, favouring an increase in private investment, which is still lower than the European average, in start-ups and innovative SMEs

The government has not provided any estimates of costs regarding these measures or of the economic impact and timing of implementation. It is reasonable to assume that the next budget law will introduce measures to avoid the VAT hike, coupled with a spending review that could allow for some reduction in labour costs (perhaps initially favouring employees) and some investment spending (to justify the request to the EU institutions for higher flexibility).

The full programme is unlikely to be deployed all at once, especially if the key measures of the previous governement (citizenship income and early retirement) should be financed for 2020 too (according to recent interviews with the newly appointed Finance Minister, these measures will not be dismissed). Yet, some extra savings could derive from a lower take-up rate of both measures which are estimated at EUR 2.4bn for early retirement, but are actually difficult to estimate for the citizenship income, which was EUR 1.2bn in 2019, due to the delayed start of the implementation of these measures. In July, though, almost 30% of applications were rejected, so there could be some savings in 2020 vs the estimated spending.
A comprehensive change in the tax system, if any, would likely be introduced in the future, given this requires deeper analysis of the impact on public finances. But, as previously stated, there could be some enhancement of measures that started to address important issues (eg, promoting investment in start-ups and innovative SMEs).

“…while infrastructure, EU governance, and the national wage bargaining system will represent more problematic issues”.

Italy: Need to boost lagging gross fixed capital formation



Source: Amundi Research forecast, Bloomberg. Data as of 17 September 2019. Gross Fixed Capital Formation, 2013=100.

We currently can project only as far out as the next budget law. The 2020 budget law is the first important deadline for the new government: the update of the April fiscal document, which should become the basis of the Draft Budgetary Plan for 2020, should be presented to Parliament by 27 September to start the review process. The budget law should be submitted to the European Commission by 15 October and then approved by year-end.

Looking ahead, estimating an economic impact of the programme would require assuming this government lasts for a significant period, but the M5S and PD coalition

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cohesiveness could well be tested soon with regard to key themes such as infrastructure, EU governance, and the national wage bargaining system.

ITALY-EU: MORE FLEXIBILITY, NOT NEW RULES, IN THE SHORT TERM

The new government has positioned itself clearly in continuity with regard to respect of EU rules and framework, as the first point of its programme is designing a budget law for 2020 aimed at avoiding the VAT hike while introducing a framework of "expansionary fiscal policy without putting at risk public finances".

"The new Finance Minister will likely be able to obtain the maximum level of flexibility allowed, but not meaningful fiscal expansion".

Although we do not expect the situation to become as confrontational as was the case in the previous government, **we do not view implementing economically meaningful expansionary fiscal policy and being fully compliant with EU rules as easy tasks**, especially in the current weak economic environment (both domestic and international), as outright compliance would require a tighter budget. So, **we expect at some stage to see a request for some additional degree of flexibility from the current government**, which could potentially be granted within the current EU Stability and Growth Pact framework. In this context, **the new Finance Minister, Mr Gualtieri,** is well known in Brussels (having served as the Chair of the EU Parliament economic affairs committee); he reportedly played a key role during the negotiations to avoid the EDP (Excessive Deficit Procedure) both in December 2018 and July 2019, and therefore **may know how to start an effective dialogue within EU institutions in order to obtain the maximum level of flexibility allowed.**

Broadly speaking, we believe that the momentum is building with regard to the new EU Commission to revamp the Stability and Growth Pact framework in order to allow for more room for countercyclical fiscal policy at the EU, not just the country level, at a time when the effectiveness of monetary policy tools may be limited. We think it interesting to note, in this context, the nomination of Italy's ex PM Gentiloni to the role of the EU Economic Affairs Commissioner. We do not expect this to favour Italy in any way. Per Ms Von der Leyen, however, this may "give good balance to the portfolio in an intelligent combination of different points of view with Mr]Dombrovskis, who he will work with".

"Momentum is building for more accommodative fiscal measures at the EU, but new rules are not something that Italy could hope in the short term".

Even if we assume that changing rules to allow for more fiscal room will be the new direction set by the EU Commission, we do not think doing this will be easy or swift, first of all because of the different stances on fiscal discipline among EU countries and the subsequent need to negotiate and compromise. **New rules are not something that Italy could hope in the short term, in our opinion**. In the near future, we believe that any fiscal room for Italy will take the form of additional flexibility eventually granted within the structure of the current SGP framework. In this respect, however, as Italy is now well represented in pro-EU key roles (Mr Gualtieri as Italian Finance Minister, Mr Gentiloni as Economic and Financial Affairs Commissioner, and Mr Sassoli as President of the European Parliament), it could be of help with regard to smoothing negotiations.

STRUCTURAL OUTLOOK FOR THE ECONOMY AND DEBT

"We see three possible scenarios for investors over the next three years, depending on trade war evolution, EU fiscal stimulus, and the domestic political landscape".

The Italian economy continues to be characterised by the continuation of a phase of sluggishness: The second quarter saw stagnation in Italian GDP and our growth forecasts do not foresee increased momentum in the short-term supporting a more marked economic recovery. In fact, our forecasts point to modest positive growth in the second half of the year, but the probability of error and a potential shift to negative territory (therefore, technical recession) could be high (ie, close to 45-50%). Risks currently continue to be tilted to the downside: our forecasts are based on the stability of anaemic domestic household consumption, in line with the first half of the year, and on a slight recovery of both fixed investments and exports. However, recent developments on the international side, with protracted uncertainty, could further negatively affect the economic situation and weigh on investments and new orders.

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Italy: Possible scenarios ahead in the next two years (annual real GDP)

Central Scenario (70% probability)	Upside scenario (10% probability)	Downside scenario (20% probability)
Some international uncertanties removed (no-deal Brexit excluded), global trade gradually improving but converging to slower growth than in the past, industrial sector rebound, resilient domestic demand, stability in the domestic political landscape leading to a mild fiscal effort (industry 4.0, social inclusion, support to private investments). ECB ultra-dovish stance	Broad fiscal stimulus at the European level (green deal/infrastructure investment plan) accompanied by ECB ultra-dovish stance, increased short-term flexiblity for 2020-2021 budget, strong domestic reform momentum (anti-corruption, fight against tax evasion, fiscal reform) with pickup in sentiment (both domestic players and markets)	Further trade war escalation, extending to Europe, weak EU reaction and limited fiscal stimulus at domestic and EU levels amid decreasing monetary policy effectiveness, domestic political instability, with no reform momentum and populistic policies against the EU institutions (adverse market reaction on BTPs)
GDP growth in 0.6-0.8% range over the horizon	**GDP growth 1-1.5%** where this higher range could be more sustainable longer term, with effects of reforms seen (increase in potential growth)	**GDP growth contracts by 1.5% or more, in negative spiral of weak growth and falling confidence**

Source: Amundi Research, as of 17 September 2019.

"The most likely scenario is for modest growth of around 0.6-0.8%".

External demand drivers (risk factors are further trade disputes, EU partners growth, global growth) **and domestic demand fundamentals** (consumer and business confidence, labour market and income growth, investments incentives) are key drivers to watch to define the different scenarios for the economy. **Over the next couple of years, we could therefore see a central scenario in which some of the international uncertainty is removed** (such as no-deal Brexit) and where **trade dynamics normalise gradually**, but remain subdued vs the historical average. In such an environment, **where a certain degree of uncertainty remains, Italian growth could gradually pick up, but remain around the potential level (0.6-0.8%, depending on estimates).**
Drivers of growth are a gradual improvement of investment (supported by increased production and external orders) which would benefit from lower uncertainty and contained financing costs (more accommodative ECB, lower long-term yields). **In this context, domestic conditions in the household sector could gradually improve** via decent growth in aggregate income (not deteriorating labour market conditions).

The articulation of upside and downside scenarios works around domestic and external factors. On the **domestic side**, positive developments could be relative political stability coupled with policies that foster investments and support labour income in a framework in which markets' readings of the Italian situation remain benign.
A clear headwind would be further political uncertainty leading to inconsistent or ineffective policy action, loss of time for reforms and adverse market reactions. On the **external side**, growth and trade performance at both global and European levels represent key factors that could either support or depress the Italian economy (which has a considerable degree of openness).
In an "all good" scenario (where everything is supportive of reforms, growth and confidence), we could see growth pick up and we could take the 2017 performance as a benchmark (strong domestic demand, with pick-up in investment and strong external support via global trade). In this scenario, **Italy could experience growth in the 1-1.5% range**, but this would likely be temporary: in order for such growth to be sustainable, the country would need to see structural reforms, which could take few years to pay off. But, potential growth in the longer term could still increase and rise above the 1% area.

In an "all bad" scenario (where all factors work against reforms, confidence and market perception), if we take recent events as a benchmark, such as 2012-2013, then **the outcome could be asymmetric compared to the upside scenario** (with the potential contraction of growth stronger than the potential bull scenario); this clearly highlights the vulnerability of the Italian economy, especially in relation to its high level of debt limiting its capacity to implement countercyclical fiscal measures.

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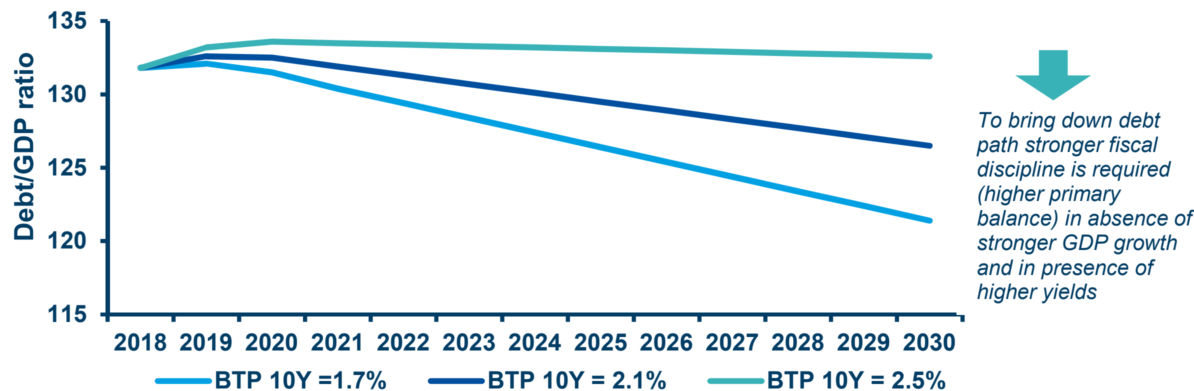
"In a low yield environment, with interest rates below nominal GDP growth, the debt/GDP ratio could stabilise and eventually come down, thereby opening up some fiscal room".

How will this work regarding debt sustainability concerns? Given the structural challenges the Italian economy faces and what we have said above, it is difficult to foresee a significant pick-up of potential growth in the short term; hence, **the key variables regarding debt sustainability are linked to the fiscal discipline of the government and to the dynamics of the primary balance, deficit and interest rates.**

Debt/GDP projection, based on different scenarios for 10Y BTP rates



Source: Amundi Research simulation as of 17 September 2019. Simulation based on our growth projection (1.5% nominal GDP growth, in the medium term), primary balance at 1% of GDP, changing scenarios on rates from 2020 stable onwards

Needless to say, a more dovish central bank, coupled with a decline in marginal interest rates, would have important positive impacts on the sustainability of Italian debt. For instance, from April 2019 to September 2019, the 10Y BTP yield has declined approximately 150 bps, which in turn, has lowered the average cost of debt and projected interest payments (in case of stabilisation of the 10Y yield at these levels). If these levels hold, Italy could potentially save between EUR 4bn and EUR 7bn in 2020 and 2021 in interest payments.

As a rule of thumb, if we assume nominal GDP growth remains in the 1.5%-2% area (eg, in the medium-term, GDP growth at around 0.5% and inflation at around 1.0% on average or slightly higher) and interest rates remain stable (eg, 10Y BTP at 1.7% on average), the debt/GDP ratio could decrease by 0.7-1% a year, while allowing a Primary Budget of 1%, meaning some fiscal room compared to the past (an average of 1.39% of GDP since 2011). Hence, a sustainable downward path for the debt/GDP ratio could materialise while allowing for some fiscal support even in a low growth, low inflation environment (1.5% nominal GDP), thanks to stable lower yields. Should higher-than-assumed nominal growth be delivered, there could be even more fiscal room for manoeuvre.

"We expect Italian debt to continue to attract investors, with the most appealing segment of the market being the long part (30Y)".

INVESTMENT IMPLICATIONS

Fixed Income

Despite the sluggish outlook for the Italian economy, other parameters have improved significantly. The sharp decrease in interest rates is assisting with interest payments. As the new government could opt for a more constructive approach with the EU, there should be less volatility in Italian spreads. Political risk is on hold, but we keep in mind that the current coalition remains fragile.

If volatility regarding Italy remains at recent levels, the risk/return profile of Italian debt should improve significantly and attract new investors.

The cheapest segment of Italian government bonds is the longer part of the curve (30Y) which remains very steep compared to peers, and Italian inflation linked bonds could provide another source of opportunity, given the low inflation expectations (30 bps cheaper than peers). With the reopening of the ECB's bond buying programme, we believe that the premium should resume tightening. On that basis, the Euro corporate segment remains attractive.

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“Despite the recent rally, the Italian market remains cheap vs the EU”.

“We could see more IPOs from small and midsized companies and interest from ESG investors”.

Equities

The Italian market has rallied strongly in 2019, but is still cheaper than the Eurostoxx (12M P/E ratio of 12x vs 14x for Eurostoxx). The rally gained strength thanks to the news that the Italian Parliament was able to find a quick solution to the political crisis. It’s too early to predict what we might see in the budget law, but the first reaction from investors has been to buy the more pro-Europe attitude.

We remind that the PIR Law (Piani Individuali di risparmio – Individual saving plan law favouring investments in small and midsized – SMID – Italian firms that produced more than EUR 20bn of inflows from 2016) was introduced by the PD party, so we could potentially see a renewed incentive plan. If confirmed, this could **result in new IPOs (especially in the SMID segment) and help the real economy in a period in which banks have balance sheet constraints with regard to pushing loans.**

Italian companies are also interesting for investors with a focus on ESG dynamics. The large caps are better structured and started some years ago to provide transparency on ESG. Regarding the SMID segment, the situation is different; The companies have to understand the importance of ESG and they have to work on the communication and on the transparency of their internal ESG dynamics. **SMIDs are becoming more open to discussing and to linking ESG targets to their economic targets**. On governance, the speed-up is more concrete: over the last few years, there has been a consistent increase in the number of independent members of boards of directors.

“From a multi asset perspective, we prefer BTPs vs equities”.

Multi Asset

Italian BTPs is one of the spaces offering positive yields in Europe. In Europe, we also like the credit spreads. Company fundamentals remain solid, with no excessive leverage, and the recent ECB announcement on the QE front will give an additional boost to this space.

On the equity side, the assessment is currently more uncertain. European equities are appealing from a valuation perspective compared to other developed markets, such as the US, and among them Italian equities are quite attractive. If we look at the composition of the revenue of Italian companies in the MSCI Italy, we see that more than 50% comes from abroad. This makes the market very sensitive to the international environment. Should we see a stabilisation of trade tensions, and a mild rebound in global trade, this could be positive for the market. However, in the short term, we think a trade deal is unlikely, but the risk of further escalation of the trade war to Europe looks unlikely too. The auto sector accounts for a weight of about 12% for Italy, which is something to consider in the context of trade tensions. **This explains why we are cautious on equities vs bonds regarding Italian assets.**

“Relief from a trade war is not likely to come soon, but looks possible in the coming quarters, and this could support more constructive outlooks on Italian and EU equities”.

With reference to European equities, broadly speaking, the space is still being negatively affected by the political uncertainty related to Brexit, but most importantly from the effects of the trade war on the European economy and on investor sentiment. Therefore, we are currently cautious on this space too.

A trigger for the market would be a strong fiscal push to counterbalance the manufacturing slowdown and/or a strong improvement on the trade front. A combination of aspects of these two factors at some point, possibly in the next quarters, could materialise. However, it is still too early to make a strong call on Europe. Nevertheless, there are areas of opportunities in companies more linked with internal demand that investors can exploit.

So, all in, we prefer to play Europe via credit markets rather than via equity markets, and with reference to Italy, we favour govies vs equities. Given continued uncertainty regarding Europe, but also possible positive surprises on the horizon, **our approach to the markets remains agile: we seek to adjust quickly when we see signals of changes in the market environment.**

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- **BTP-Bund Spread:** differential between the yield on the 10-year Italian BTP vs 10-Year German Bund.
- **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

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