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European economy

Italy: Politics remain complex, but systemic risks abate

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Matteo Ramenghi, strategist, matteo.ramenghi@ubs.com; **Thomas Wacker**, CFA, analyst, thomas.wacker@ubs.com; **Fabio Trussardi**, analyst, fabio.trussardi@ubs.com; **Elena Guglielmin**, analyst, elena.guglielmin@ubs.com

- **Outlook:** Italy's four largest parties failed to reach an agreement in discussions to reform the country's electoral law towards a proportional system; talks will resume in September. As a consequence, Italy will likely hold general elections only next year. Meanwhile, anti-euro forces have moderated their rhetoric on the single currency. Of equal importance, the long-awaited restructuring of Italy's three troubled banks – MPS, Veneto Banca and Vicenza Banca – reached a conclusion.
- **Markets:** In the last few weeks, markets have acknowledged reduced systemic risks in Italy, and banks' shares have gained as a result. Italy's sovereign spread has declined both relative to German Bunds (-35bps to 175bps) and Spanish government bonds (-13bps to 60bps). We think Italian assets will remain sensitive to political developments, potentially diverting market focus from progress in the economy.
- **What we're watching:** ECB press conferences in July and September; Parliamentary discussion on the electoral law starting in September; German elections and the ECB's Governing Council, also in September.

Source: iStock

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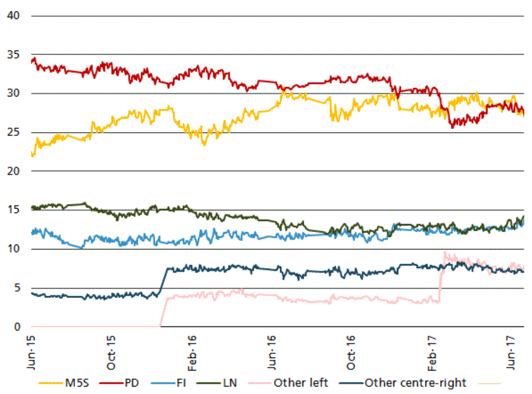
Our view

Talks among Italy's four largest parties regarding a new proportional electoral system collapsed. Parliamentary discussions to reform the electoral law will resume in September – this implies that elections will likely take place at the end of the legislature, i.e. in early 2018.

The latest polls (see Figure 1 and Figure 2) based on current electoral law suggest that no single party would be able to achieve the majority required (currently triggered at 40%) and there would be no clear majority for any possible coalition. For the time being, based on the latest opinion polls, the largest possible coalition would be one involving moderate forces – the Democratic Party (PD) and Forza Italia. Yet, even those two parties would not reach 50% of the electoral vote at present.

While political newsflow remains mixed, systemic risks have abated over the past few weeks with a conclusion finally being reached on Italy's three troubled banks. Veneto and Vicenza were sold to Intesa Sanpaolo for 1 euro each, having carved out NPLs, burden sharing for subordinated bonds and a state capital injection of EUR 4.8bn. Monte dei Paschi di Siena finally received the green light from the European Commission to receive EUR 5.4bn in state capital after burden sharing of EUR 4.3bn. Following these steps, systemic risk in Italy's main banks has retreated significantly. In the medium term, this should remove an obstacle to economic recovery and improve market sentiment.

Fig. 1: Italian political parties' popularity
No clear direction yet



Note: Based on the 5-poll moving average of various pollsters. Five Star Movement "M5S," Democratic Party "PD," Forza Italia "FI," Lega Nord "LN." The spike in "Other left" comes from the creation of new leftist political parties. Source: Index, EMG, Demos, Ixè, Demopolis, Ipsos, SWG, Piepoli, Bidimedia, Lorien, Tecnè, IPR, Scenari Politici, UBS, as of 4 July 2017

Talks of new electoral law reform to resume in September

Talks among Italy's four largest parties regarding a new proportional electoral system collapsed at the first parliamentary vote. Discussions will now have to wait until after the summer meaning that general elections will likely only take place from February 2018 onwards, after the current legislature ends.

Based on the latest polls and on current electoral law (see Figure 1 and Figure 2) none of the major coalitions would win a majority as things stand. The largest possible coalition would be one involving moderate forces – the Democratic Party (PD) and Forza Italia –, but together they would not reach 50% of the vote, and a minority government, while possible in principle if some political parties decided to abstain from a confidence vote, would have limited room for maneuver and a short lifespan, in our view. The unwillingness of the Five Star Movement (M5S) to join any coalition implies that it has little chance to be part of a cabinet in the foreseeable future. Thus, one cannot exclude further elections in 2018 in the absence of a change to the electoral law or a swing in the polls.

However, the last quarter's polls show some interesting trends (Fig. 3). The Five Star Movement has been the main loser (falling over 2%) possibly as a result of its perceived lackluster performance in running Rome and Turin (two cities with M5S mayors) and concerns surrounding its anti-euro stance. Indeed, in the last month M5S has been progressively toning down its anti-euro rhetoric suggesting that any referendum on the euro (not possible under current law) is no longer an immediate priority.

Torn by internal divisions, PD and the other leftist parties were unable to attract the votes lost by M5S and their share of the vote, as per polling data, remained broadly stable. On the contrary, the centre-right, and in particular Forza Italia – the political party led by Mr Berlusconi, rose over 2%. Forza Italia's political campaign appears to be centered on a mix of fiscal reform (i.e. household tax cuts), a more assertive approach to the EU, while confirming its commitment to the euro, and a tougher approach on illegal immigration.

Fig. 2: Possible alliances' cumulative polls (%)

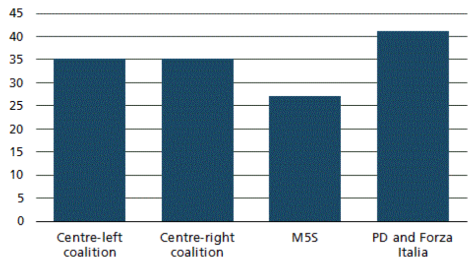


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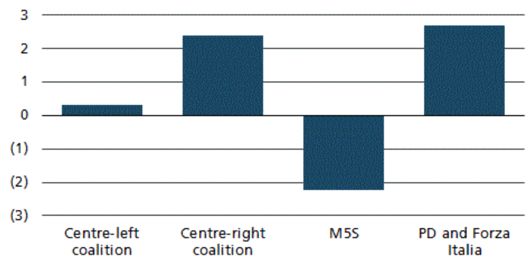
Fig. 3: Winners and losers in the last quarter, % change



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Banks restructuring in details

Good progress has been made in restructuring the Italian banking sector over the past few months and markets have been quick to react to these developments. The Italian minister of finance, Mr. Padoan, stated that: "there are no further trouble hotspots such as the ones solved in the last few days". While we agree in principle, one can not rule out that small, non-systemic banks may still need support in the future. However, we think the EUR 20bn that has been set aside by the Italian government to shore up financial institutions' balance sheets, of which roughly half has been used in the current recapitalizations, puts the banking sector in a more comfortable position.

The recently approved precautionary recapitalization of Banca Monte dei Paschi di Siena (MPS) has resolved a major uncertainty that had weighed on the sector over the past year. In doing so, the Italian government will hold roughly 70% of the lender's capital. The public disbursement will amount to EUR 5.4bn, of which EUR 3.9bn will be paid through a capital increase and the remaining EUR 1.5bn will be used to reimburse retail subordinated debt bondholders following the conversion of their bonds into shares.

In the past couple of weeks the acquisition of Veneto Banca (VB not covered) and Banca Popolare di Vicenza (BPV not covered) for the symbolic price of EUR 1 by Intesa Sanpaolo marks a further positive achievement for the Italian banking sector. Intesa Sanpaolo's acquisitions were supported by government intervention of some EUR 4.8bn to offset the potential negative impact arising from the deal and make the transaction regulatory capital-neutral for Intesa Sanpaolo. Senior bondholders and depositors will be unaffected by the deal, while equity and institutional subordinated bondholders will suffer full loss absorption. Retail subordinated bondholders, who are able to claim being victims of mis-selling, will be reimbursed. For further details please see:"Intesa Sanpaolo: A1-EUR deal for the Veneto banks", dated 28 June 2017.

Both deals are positive for the Italian banking system as they show the government's willingness to ensure financial stability and protection of senior bondholders within complex restructuring processes. In addition, the state's intervention avoided the higher costs associated with the use of the guarantee deposit fund in the case of a disorderly liquidation. On a less positive note, some of the costs involved in the clean-up of these troubled institutions have been borne by tax-payers.

Italian government bonds benefited on various fronts

The recent relative outperformance of Italian government bonds over both Bunds and rating peers is a reflection of the reduced risks in the banking sector and a retreat of radical parties in the polls and regional elections. However, we think the ECB, which bought EUR 9.3bn of Italian bonds in June and EUR 274bn since inception of its QE program, has also contributed to this development. This year, the ECB has regularly bought a higher amount of Italian government bonds through its QE program than it should do according to its Capital Key rules. At the same time, it has bought Spanish bonds roughly at the required pace and shown a EUR 0.5bn shortfall in German Bunds in each of the last three months, with the latter likely due to scarcity issues.

Higher carry yield, but no compelling investment case

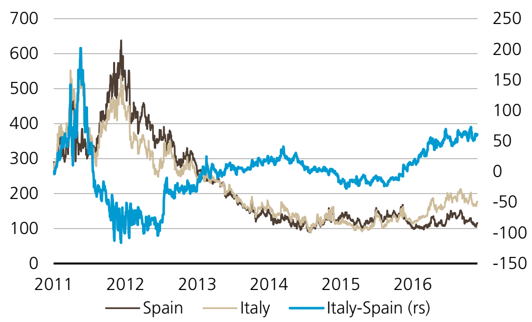
Even if the ECB's purchasing pattern continues, it increases the potential pressure on Italian bonds should the ECB announce a reduction in its purchasing volume in September, effective from January 2018. We think that in the absence of heightened political uncertainty in Spain, the outperformance potential of Italian bonds over the next six to twelve months is likely limited to earning a higher carry and benefiting from a steeper yield curve (resulting in a higher curve roll-down return).

From an expected return perspective, the best place on both yield curves is currently in the five- to seven-year range, where the curves are quite steep and the potential to earn carry is well balanced compared to the risk of valuation losses resulting from a possible further rise in risk-free interest rates.

We think it would require further positive news out of Italy, or longer and larger ECB purchases than we currently expect, to trigger a spread tightening to less than 150bps over 10-year Bunds. We expect market volatility in Italian bonds to continue to exceed that of its peers and currently do not see a compelling investment case for a relative trade.

Fig. 4: Risk premiums declined somewhat more for Italy than for Spain

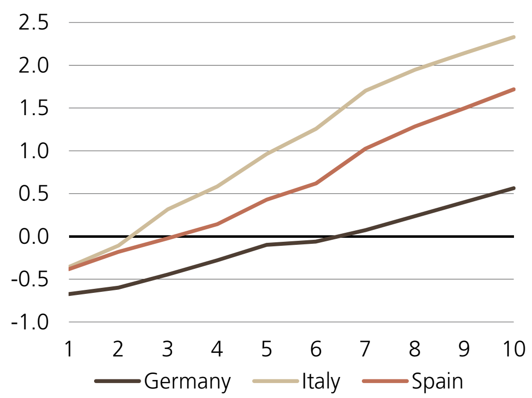
Spread over Bunds in basis points (bps)



Source: UBS, Bloomberg, as of 10 July 2017, 8:30am CET

Fig. 5: Yield curves are steep for Italy and Spain

Yield in %



Source: UBS, Bloomberg, as of 10 July 2017, 8:30am CET

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COM	Common shares	E	expected i.e. 2011E
MP	Marketperform: The stocks expected performance is in line with the sector benchmark	NAV	Net asset value
Shares o/s	Shares outstanding	UP	Underperform: The stock is expected to underperform the sector benchmark
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