IE
Global Investment Event

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Italy election preview: more of the same?

- On Sunday 4 March, Italy will go to the polls to elect seats in the country's Parliament
- At the time of writing, a centre-right coalition of parties is ahead in the opinion polls. The stability of such a government is uncertain and major policy shifts are unlikely
- Meanwhile, a "hung parliament" could lead to the nomination of a "consensus" politician as leader. Again, significant policy changes are doubtful in this scenario
- The balance of risks points to "more of the same" in Italian politics. Given that the macroeconomic picture in the eurozone continues to look very good, we remain overweight in eurozone equities. We retain a cautious view on Italian government bonds in a bond-unfriendly environment

Life after the upcoming Italian elections: more of the same?

On Sunday 4 March, Europe faces its next political challenge as Italy will go to the polls to elect new members of the country's Parliament.

Recent opinion polls suggest that a centre-right coalition consisting of Forza Italia (FI) and the Eurosceptic Lega Nord (LN) have a ten percentage point lead over both the centre-left grouping – which includes the main incumbent Democratic Party (PD) – and the Five Star Movement (5SM).

However, translating voting intentions into seat projections is complicated by Italy's new electoral law. This combines a "Proportional Representation" (PR) system (seats allocated in proportion to votes cast) with a First-Past-the-Post (FPTP) method (the candidate with the most votes takes the seat).

The establishment of a **centre-right coalition government** could see Italy adopt a more anti-European stance, and implement looser fiscal policy. Nevertheless, the stability of such a government is questionable. LN and FI differ on many policy areas, with the latter wanting to abolish European fiscal rules and membership of the eurozone. Policy shifts are likely to be constrained by the relatively moderate FI in this scenario.

A **5SM-led government** is also possible, but the party will be disadvantaged by the FPTP system given that it has not entered into a pre-electoral alliance. It may also struggle to form a working coalition after the election.

Importantly for eurozone stability, 5SM have also dialled back on their previous Euroscepticism. Their 20-point programme released in January makes no mention of a referendum on Italy's membership of the eurozone, which was previously a source of concern for investors.

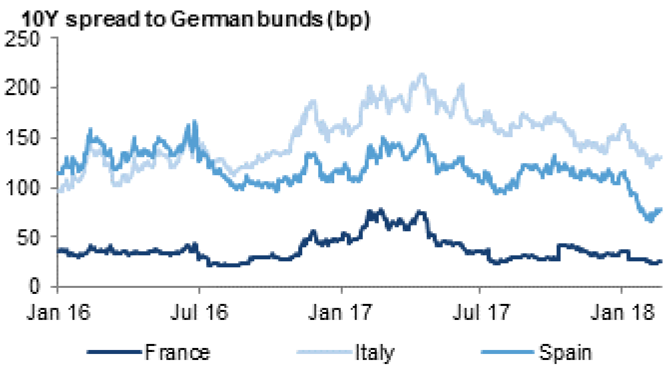
There is also a good chance that no single party or coalition will gain an absolute majority of seats in either house of Parliament (known as a "**hung parliament**"). This prospect is heightened by the PD and FI having dismissed the idea of governing together, and the likely difficulties 5SM will face in finding ruling partners.

This scenario could see the current government remaining in charge, until the Italian President appoints a candidate to take over. They would then need to win a vote of confidence in Parliament to govern. This "consensus" candidate will need to straddle both sides of the political divide, and may therefore face major obstacles in implementing any significant policy changes.

Investment implications

All in all, the balance of risks points to **"more of the same" in Italian politics**. A prolonged period of political uncertainty in Italy is more likely than a full-blown eurozone crisis. The market doesn't anticipate any major risks, as shown by the premium that investors demand to hold Italian government debt over safer German bunds (the "bond yield spread"), which has changed very little over the past year (Figure 1).

Figure 1: Eurozone government bond yield spreads



Source: Bloomberg

In this context, and given that the macroeconomic picture in the eurozone continues to look very good, we remain **overweight in eurozone equities,** where we find valuations attractive compared to other assets. But it is worth highlighting that a continuing lack of reforms in Italy amid "policy paralysis" could see the country remain a relative underperformer in the region.

Meanwhile, prospective returns on **Italian government bonds** are reasonable, in our view. However, we retain a **cautious view** on this asset class given that we are in a bond-unfriendly environment (strong growth, building cyclical inflation pressures), while ECB policy normalisation is also a key risk. A potential new government's support for fiscal policies that may widen the budget deficit adds to the downside risks.

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