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Focal Point

Italian referendum: Future governability at stake

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- The upcoming Italian constitutional referendum (Dec 4) will be a key vote on Italy's future governability and PM Renzi's economic reform agenda alike. The "No" camp has steadily led in opinion polls (+5 pp) over the recent weeks.
- A "No" victory would be a blow for the reform process and harm governability in the longer-run. It would increase the risk of a rating downgrade and trigger further losses on both BTPs and Italian equities.
- That said, a caretaker government will likely remain in charge until elections in H1 2018, thus avoiding an early vote. Continued ECB purchases and a more attractive carry could bolster demand for BTPs over time.
- If the "Yes" prevails, the recapitalization of troubled Italian banks would be easier and political woes will subside for some months. The recent underperformance will partly reverse in the ensuing weeks, with banks performing well.
- In any case, the possibility of a Five Star Movement's majority in 2018 – under the current Italicum electoral law – may yet limit financial market euphoria on concerns over low growth and weak fiscal metrics further out.

Last week, the unexpected victory of Mr Trump in the US presidential election provided the second political shock this year after the Brexit vote. While in the latter case equity markets suffered the most, this time the largest correction has taken place in the bond arena, with government bond yields moving sharply up on both sides of the Atlantic. Italian assets underperformed most of their peers in both occasions. The MSCI Italy equity index fell 12.7% the day after the Brexit vote, the sharpest drop in history, while in last days the BTPs has suffered heavy losses. The 10-year yield rose above 2% for the first time since July 2015 and the spread over the 10-year German Bunds surged close to 180 bps, the highest level in more than two years.

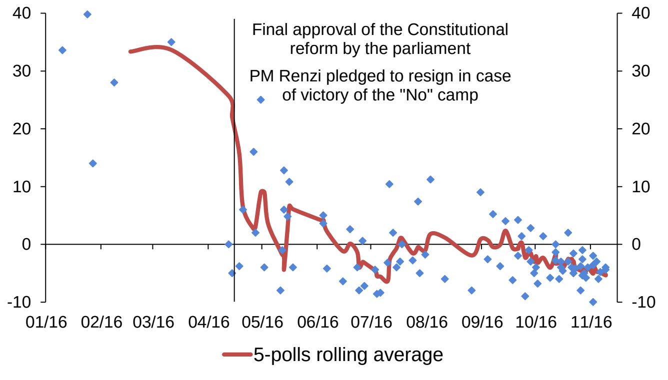
What is more, Italy itself will soon face a crucial vote, testing again investors' nerves. On December 4, Italian voters will have to decide whether or not to accept the changes envisaged by the constitutional reform eventually approved by the parliament on April 12 after two years of discussion. While the "Yes" camp enjoyed a double-digit advantage last spring, the most recent polls put the "No" steadily in the lead (+5 pp on average), albeit with a still large share of undecided voters. We will hereby investigate the implications for Italian politics and financial markets.

PM Renzi vs all: The personification of the vote

The referendum – which does not require a quorum to be valid – is a necessary step since the constitutional reform did not secure the required two-third qualified majority in the parliament following the decision of the center-right Forza Italia to withdraw its initial support. In strict terms, the vote is about to approve or reject the amendments to the second part of the Italian constitution. The reform aims at streamlining the legislative process by eliminating the so-called perfect bicameral system and by assigning to the Lower Chamber alone the confidence power on the government. The other key feature of the reform is the strengthening of the central state's powers over regions, a step that should – according to the supporters of the "Yes" camp – facilitate infrastructural investments amid the removal of the veto power by local governments.

Italy: Constitutional referendum

net % lead of "Yes" over "No", excluding undecided voters

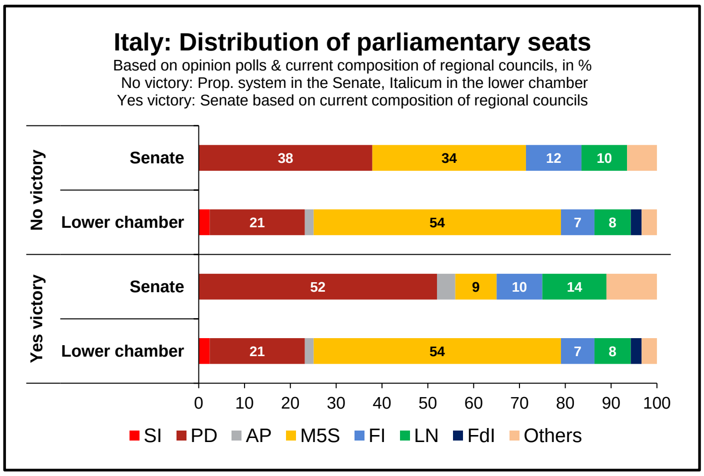


There is much more at stake than the reform itself though. In April, PM Renzi announced to resign in case of a "No" victory and while he has watered down his pledge later on, all opposition parties call for his resignation and early elections in case of a defeat. Even the left-wing minority of PM Renzi's Democratic Party (PD) announced it would vote against the reform but refrained from asking for his resignation. Opinion polls confirm the polarization in voting intentions. Nearly half of the voters will vote in favor or against PM Renzi rather than on the content of the reform.

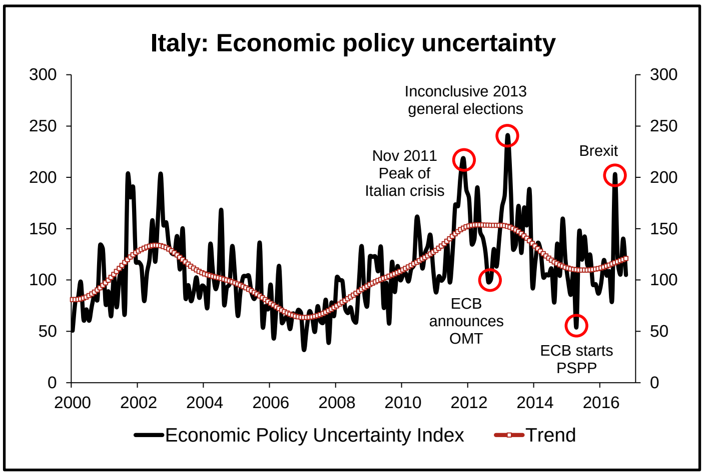
No early elections if the “No” prevails

Given the unfavorable opinion polls, the weak economic momentum, the increased public tension with regard to the immigration crisis and the deterioration in the relationship between the government and the European Commission, PM Renzi looks more and more in difficulty in his attempt of building a consensus ahead of the referendum vote. We believe that a “No” victory represents the baseline scenario, albeit it is far from being a done deal (around 60% probability).

Should the “No” prevail, financial markets may start to speculate on the possibility of early elections and the subsequent rise of Eurosceptic forces, like the Five Star Movement (M5S) or the right-wing Northern League. However, we consider such an evolution as rather unlikely. In case of a defeat, PM Renzi will likely offer his resignation to President Mattarella, but will then receive a new mandate and secure the confidence vote with a broadly unchanged parliamentary majority. Only in the case of a substantial margin between the “No” and the “Yes”, he may decide to definitively step down and would then be replaced by a new Prime Minister. Nevertheless, also in this case the parliamentary majority supporting the government would remain broadly the same – with a possible additional support from Forza Italia – as several small forces supporting the existing government would likely fail to confirm their seats in case of early elections. The caretaker government will carry on current policies, albeit with less impetus, until general elections in H1 2018, and will focus on a new electoral law, in order to reduce the differences between the two chambers in terms of electoral mechanism. Currently, a pure proportional system – with high thresholds at a regional level – applies to the Senate, while the Italicum electoral law assigns a majority premium to the winning party in the lower chamber.



The most immediate and negative consequences of a “No” vote would be felt by the Italian troubled banks. In particular, Monte dei Paschi di Siena seems the most at risk as foreign investors would pull out of the recapitalization process, thus forcing larger losses on existing subordinated bondholders. In the longer run, the rejection of the constitutional reform would also harm governability. The different electoral laws for the two chambers combined with the current national polls would lead to a very fragmented parliament, resulting in a political gridlock even more severe compared to the one emerged as a result of the last general elections in February 2013.



“Yes” wins: Short-term relief, long-term woes?

A victory of the “Yes” camp would undoubtedly strengthen PM Renzi’s political capital and contribute to ease investors’ concerns at least in the short-term. This could induce firms and households to unlock investments and to reduce precautionary savings, thus supporting economic activity after a lackluster growth momentum in the last quarters. In addition, the recapitalization process of troubled banks could advance more swiftly, opening the doors to a more intense M&A activity and a deeper restructuring of the banking system.

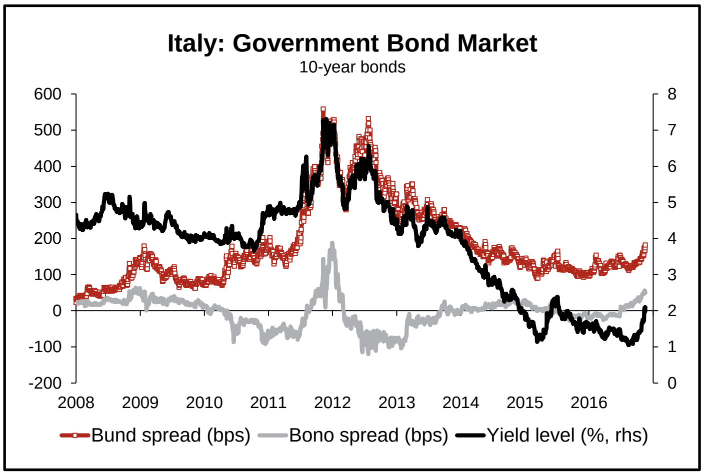
While PM Renzi’s support would benefit from a “Yes” victory, the medium-term outlook for Italian politics remains challenging. Indeed, the combination of the new institutional framework and the Italicum could allow the Eurosceptic M5S to come to power after the 2018’s vote. This has sparked a harsh debate on possible changes to the electoral law, with the ultimate goal to avoid such a scenario. Moreover, the Constitutional Court will have to rule on the legitimacy of the Italicum, with the majority premium under scrutiny. A rejection of the latter mechanism would lead to a proportional system, further aggravating political fragmentation and undermining governability, but it would also reduce the chances of a M5S government.

A less stable political system could exacerbate investors’ concerns over Italy’s long-term issues, including low growth, an uncompetitive economy, a fragile banking system and weak public finance.

BTPs short-term outlook depends on referendum

Financial markets have increasingly priced the risks of a rejection of the constitutional referendum. Since summer the 10-year BTP/Bund spread has widened 65 bps close to 180 bps – the highest level since summer 2014. Even more noteworthy, the BTP/Bono spread has risen to 55 bps. This is a spread level last marked at the start of 2012.

In case of a “No” victory a further considerable BTP spread widening is on the cards. Given the heightened political uncertainty and growing concerns about the situation of the Italian banking sector in combination with a further deterioration of the economic outlook, rating agencies would consider a further downgrade. DBRS put Italy on Credit Watch negative in August and Fitch has recently cut its outlook to negative, suggesting that the downward pressures on the rating could rapidly materialize. That said, a loss of the investment grade rating is very unlikely as e.g. DBRS still rate Italy with single A(low). Therefore, the ECB will be able to continue to purchase Italian BTPs and could even speed up purchases moderately to calm markets. What is more, our models show that the underperformance of BTPs has already gone a bit too far. Therefore, the attractive carry and the fact that the fallout is likely to be less severe than some market participants currently fear (see above) is forecast to bolster demand. Consequently, a rerun of the 2011/12 crisis seems unlikely.



Bond markets would receive a "Yes" with relief and some of the underperformance would be reversed subsequently. However, as many structural problems will remain unsolved a complete unwinding cannot be expected. This applies all the more as there are many other factors which can impact the development of BTPs (e.g. extension of QE by the ECB, key elections in France and Germany in 2017, the political agenda of US President-elect Trump).

Italian equities: Cheap valuation vs political risk

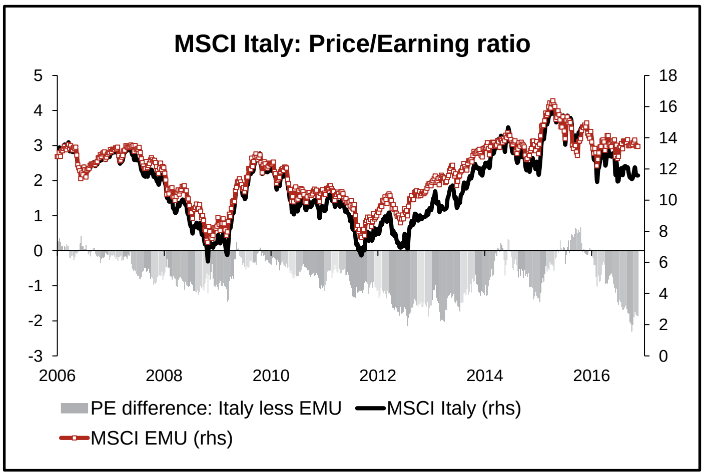
The Italian stock market has severely underperformed its peers year-to-date. The MSCI Italy has lost nearly 20% while the MSCI EMU has declined only by about 3%. The underperformance has been driven by the concerns over Italian troubled banks – the weight of financials in the Italian index (33%) is much larger compared to the EMU one (19%) – the subdued growth outlook and the heightened political risks.

Our valuation indicators suggest that investors have already largely priced in the risks of a "No" victory in the December referendum. Italy's Price/Earnings (PE, 12-month forward) is close to 11.6 which is one of the lowest globally. Moreover, the PE difference with the MSCI EMU (-1.8 points, as the MSCI EMU PE is 13.4) is comparable to the levels seen in July 2012 (just before the "Whatever it takes" speech by ECB President Draghi) and March 2013 (after the inconclusive general elections in Italy).

Our regression models based on financial variables – euro area GDP, Italian inflation and unit labor costs, the oil price, the real effective exchange rate, the BTP-Bund spread and the degree of policy uncertainty – confirm this view. However, it is worth noting that policy uncertainty plays a key role in driving Italian assets' performance. In case of a "No" victory, a rise of this stress indicator (see chart in the previous page) to the levels seen following the general elections in February 2013 – this may happen in the case of an immediate early vote in H1 2017 – would justify a further significant correction in Italian equity prices.

A "No" victory in the constitutional referendum would inevitably exacerbate investors' risk aversion in the short-term, leading to further losses. Banks are likely to be the most affected in this scenario amid the negative repercussions on the recapitalization process of troubled institutions, the losses caused by the wider spreads on the large exposure to the BTPs and eventually also due to the deterioration in the growth outlook.

On the other hand, a "Yes" victory would work as a trigger for a market repricing towards higher "fair value" levels. However, given the long-term issues faced by the Italian economy, a complete reversal of the large underperformance seen earlier this year looks unlikely. Indeed, more impactful structural reforms remain key to end the decade-long period of stagnant growth and below-average equity market returns.



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