Italian Elections: What do investors need to know?

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With Italian voters going to the polls this Sunday, **Paolo Zanghieri**, Senior Economist, and **Mauro Valle**, Head of Fixed Income, explain the key points investors need to be aware of.

- A Center-Right conservative coalition is widely expected to win but a numbers of factors may moderate their appetite for confrontation with the EU
- Political uncertainty is likely to remain elevated over the next few months given the differing views of the coalition parties on a number of key issues, such as fiscal expansion and Russia
- The 2023 fiscal budget will be the first reality check for the new government given the challenges of rising borrowing costs, a looming recession, and an energy crisis over winter
- Italian BTP-Bund spreads are much less volatile compared to the 2018 election, but volatility may increase post-election

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MACRO OVERVIEW

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A comfortable majority expected by the Center-Right

The latest polls give the Center-Right coalition a comfortable 20% lead over the Center-Left. Other main parties are scoring no higher than 20% combined. Owing to the mixed proportional, first-past-the-post electoral system, the bloc constituted by Fratelli d'Italia (FdI), Lega and Forza Italia should win between 55% and 60% of the seats in both the Camera and Senate.

Reduced appetite for EU conflict is reassuring…

The confrontational attitude taken in the past towards the European Union, the lukewarm support (especially by Lega) towards efforts to help Ukraine, coupled with some radical proposed fiscal measures (e.g. a drastic income tax cut and retirement age reduction), have raised concerns about the political and economic fallout of the new government.

Yet there are three reassuring points to acknowledge. First, while polls have historically underestimated the true strength of the conservative parties, it is unlikely that the coalition will get the two-thirds of the seats in both chambers required to change the constitution without having to call a confirmative referendum. This reduces the risk of disruptive reforms in the fiscal framework and in the relationship with the EU.

Secondly, FdI, by far the senior partner of the coalition, has significantly toned town its anti-establishment rhetoric. It fully supports the shipment of weapons to Ukraine, has pledged not to breach EU fiscal rules, and plans to appoint "EU friendly" figures in key cabinet posts, such as Finance and Foreign Affairs. Of course, only time will tell whether this attitude will remain once the party is in power.

Thirdly, the appetite for confronting the EU over the fiscal stance and the Next Generation EU-related obligations is drastically reduced by the fact that EU money is vital for the growth prospects. Clearly, the large amount of resources already committed to cushioning the impact of the energy crisis leaves little scope for further fiscal expansion, at least in the 2023 budget.

...although a long-lasting coalition is not guaranteed

And yet, political uncertainty may remain elevated over the coming months. Despite the large electoral win expected, the formation of a cohesive, long-lasting ruling coalition is not guaranteed. The members' views differ widely in some key policy areas: in particular, Lega is loudly calling for large fiscal expansion and is very critical of the EU stance towards Russia. Lega's electoral performance and its leverage in the coalition will be important to monitor. Given the tense global outlook and the need to comply with the Reform and Recovery plan, a potential collapse of the Center-Right government early in the term would cause renewed political uncertainties. That said, such an outcome, after a period of high volatility, may ultimately lead to another grand coalition like the one that supported the Draghi government.

The new government, to be sworn in by the end of October at the earliest, will have to make difficult decisions on energy rationing and the economy, as Q4 will probably see the worst of the energy crisis impact. It will need to quickly agree on a 2023 fiscal budget, which will be the first reality check for costly promises in the electoral campaign. While the government inherits a stronger than expected economy boosted by a strong tourist season, the headwinds from high energy prices and tighter financial conditions will mount this autumn. Year to date, borrowing requirements are in line with the healthy pre-pandemic average, thanks to strong tax revenues, but rising borrowing costs and the looming recession will pose new fiscal challenges.

FUND MANAGER INSIGHT

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Italian BTPs are calmer than 2018, but monitor post-election volatility

Over the last few years, Italian elections – and Italian political events generally – have always led to volatility for Italian government bonds. In the 2018 general election, 10-year BTP-Bund spreads were close to complacent in the lead up to the ballot box, and then suddenly widened by more than 200 basis points when the market recognized that the new government was set to be unfavourable towards the European Union and the Euro.

This time around, the market reaction is quite different. From relatively high spread levels due to the end of the ECB bond purchases programme, the Italian 10-year widened by 50 bps and settled close to 250 bps immediately after Mario Draghi lost the confidence of Parliament in mid-July. Since then, Italian BTPs have moved between 200 and 240 bps vs German bunds. As polls clearly indicate a Center-Right majority, investor concerns are relatively low.

Moreover, the ECB's recent decision to hike rates and manage inflation expectations is dominating the fixed income narrative.

Fiscal policy will take center stage in October

Markets will likely resume their focus on Italy once the new government is formed in October. The government's approach to fiscal policy will take center stage: fiscal law for the next year (the deficit, debt-GDP), proposals for a new tax plan, a new pension scheme, to name a few key areas.

Investors may worry that the new government may be too expansionary for a country with a high debt-GDP ratio. On the other hand, the electoral campaigns have not indicated an anti-EU approach. Furthermore, the ECB has already delivered the TPI anti-fragmentation scheme to avoid further widening of unjustified large spreads, and the geopolitical and energy scenarios add further complexity. All these factors should support the view that the new government will have a different attitude compared to 2018.

Post-election volatility may provide tactical BTP opportunities

For now, we should expect Italian BTP spreads to move within the range observed in the past few weeks, but volatility may increase after the elections. In my view, at the peak of volatility, the 10-year spread could reach around 280 bps in the worst-case scenario, which is the lowest of the range observed in 2018, and the level expected by some investment banks. It would therefore make sense to consider tactically managing exposure to Italian BTPs after the election to take advantage of potential spread volatility. The two key risks are that a European recession hurts Italian growth, thus weakening the trend of the improving Italian debt-GDP ratio, or that the new government switches its non-confrontational stance towards the EU.

IMPORTANT INFORMATION

1) Full company name is Generali Insurance Asset ManagementS.p.A. Società di Gestione del risparmio. 2) Full company name is Generali Investments Partners S.p.A. Società di Gestione del risparmio.