Morgan Stanley

INVESTMENT MANAGEMENT

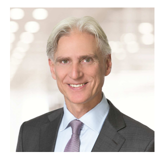
Intra-Month Update: Italy

SOLUTIONS & MULTI-ASSET | GLOBAL BALANCED RISK CONTROL TEAM | MARKET PULSE | 1 June 2018

What Happened

Since Italy's general elections, held in early March, failed to deliver a clear result, the Northern League and 5 Star Movement parties have been working together, seeking to form a new government. Over the past week, markets have been rocked by the political events unfolding in Italy, but ultimately after weeks of turmoil, a government has successfully been formed. The recent volatility was triggered on Sunday 27 May, when Italian President Sergio Mattarella opposed the allied parties' nominee for finance minister, bringing the process to form a new government to a temporary, but abrupt halt. Nominee Paolo Savona has in the past expressed 'Eurosceptic' opinions, but as the issue of Italy's place in the Eurozone had not been debated during the campaign (and was not included in the two parties' contract), President Mattarella instead called for a technical government led by Carlo Cottarelli to carry the country through to new elections, potentially in September. With Paolo Savona now nominated as Minister of European Affairs, this revised list of ministers has been accepted by Mattarella, allowing the parties to successfully form a government.

AUTHORS



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One key concern for investors has been that Mattarella's action could be used by the populists to claim the election result has been overturned by external pressures, meaning that any subsequent election might be framed as a vote on Italy's continued membership of the Eurozone. We believe Mattarella chose to oppose Savona's name to force the two parties to clarify their position on the euro before forming the government.

There are in fact a number of reasons for which they are unlikely to pursue an anti-euro position:

- The majority of Italians favour remaining in the euro, as the most recent polls suggest around 60% of Italians would choose to remain in the currency union. Of the remaining 40%, only around 20% would want to exit the currency union, whilst the remaining 20% is undecided[1];
- The Northern League's main voter base is in the North of Italy, which is arguably the region which has benefited the most from the euro, so is probably also generally more favourable to a 'remain' vote;
- The Italian constitution does not allow for a referendum on international treaties such as the one on Eurozone membership. Pushing an anti-EU agenda would entail either having to change the constitution or exiting the European Union completely.

Further, we believe that as the populist parties are performing well in polls, there is no political incentive to tackle such a controversial and challenging topic. In fact, since Mattarella's announcement on Sunday, both party leaders clarified that they do not intend for Italy to leave the euro, but prefer a constructive dialogue seeking to improve the currency union from within. As a result, while there may be short-term volatility, we feel the latest development could actually remove the uncertainty on Italy's stance towards the euro.

The renewed alliance between the 5 Star Movement and the Northern League is a similar contract to the one they agreed previously, but with the reduced threat of an exit from the euro, as they have been forced to clarify their stance on the issue.

This outcome appears to us to be improvements on the situation before this week, so we do not see a further significant escalation in risk as our base case.

Market reaction

BTP Bund spreads had moderately widened in the run up to these events (the spread was approximately 200 bps as of Friday 25 May[2]), as details from the contract between the two populist parties emerged, whilst concerns rose over Italy's debt trajectory, given an aggressively expansionary proposed fiscal programme. Details included the introduction of a flat tax system, a form of 'citizenship income' being introduced to aid the unemployed and the wind down of the Fornero pension reform, introduced in 2011 to alleviate the pension burden on state finances. Following Mattarella's announcement, the BTP bund spread rose sharply and touched an intraday high above 300bps on Tuesday 29 May[2].

In our opinion, the BTP spread should be wider than the low reached in April 2018, as both populist parties' policies are likely to worsen Italy's fiscal balance. However, the size of the recent movement was not necessarily justified by economic fundamentals and was more likely amplified by increasing political uncertainty in Spain, deteriorating market sentiment in general, and most importantly a 'knee-jerk' reaction to the perceived increase in the risk of Italy exiting the euro. The spike in two-year Italian yields that we saw at the start of this week (the biggest one-day move since 1996), was mostly driven by fears of a euro breakup and exacerbated by scarce liquidity. Pressure on Italian bonds also weighed on equity performance, especially on European financials, as they hold a significant portion of Italian debt. As previously explained, we believe an Italian exit from the euro is unlikely, so would expect some reversion

[1] Source: Il Giornale, 20 May 2018.
[2] Source: Bloomberg.

in spreads after such extreme movements. Today's (30 May 2018) smooth government bond auction of 5 and 10-year BTPs reinforces this view.

Conclusion on Italy

In our view, Italy's macroeconomic picture has modestly improved over the last few years, with a decrease in the budget deficit, ongoing QE purchases and a recovery in growth leading to a stabilisation of the debt to GDP ratio. The share of non-performing loans to total loans also came down last year. Given 'Italexit' is not our base case scenario, the modest strengthening in Italian economic status and the continued recovery in the global economy lead us to believe that the Italian BTP spread is unlikely to reverse back to the heights seen in 2012. Moreover, the contagion risk should be limited thanks to an improving internal and external environment in the Eurozone. That said, we believe the political situation in the country remains very fluid and warrant investors being vigilant.

Overall portfolio positioning

Our broad asset allocation is the main driver of returns and our funds are highly diversified. Therefore, whilst we continually factor in risk events such as those in Italy and any related impact in our analysis, our positive view remains that fundamentally the global economy is strong.

With specific reference to our mutual funds range, we have provided below the target asset allocations of each of our four Luxembourg SICAV Funds, as of 30 May 2018:

	VOLATILITY TARGET P.A.[1]	EQUITY %	FIXED INCOME %	COMMODITIES %	CASH %
MS INVF Global Balanced Risk Control Fund	4% – 10%	63.5	32.5	3.0	0.5
MS INVF Global Balanced Income Fund	4% – 10%	63.5	32.5	3.5	0.5
MS INVF Global Balanced Fund	4% – 10%	63.0	32.0	3.5	1.5
MS INVF Global Balanced Defensive Fund	2% – 6%	30.5	63.5	3.0	3.0

Source: Global Balanced Risk Control team, Morgan Stanley Investment Management.
Allocations are subject to change on a daily basis and without notice.
MS INVF standards for Morgan Stanley Investment Funds.
1. Volatility targets are indicative ranges. There is no assurance that these targets will be attained.

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