Market commentary

Tsunami risk for the financial markets?

Italy's crisis: "The decisive question is whether the new government will last"

The coalition of two populist parties in Italy shocked the markets at the end of May. Italy's strategic role in the European Union (EU) puts Europe at great risk.

"The xenophobic and anti-Brussels stance seems pretty much the only thing that unites the five-star movement and the Lega party," says Lukas Daalder. Robeco's chief investment strategist and his Investment Solutions team dedicate this month's outlook to the question of how the situation in Italy could create waves in the financial markets.

Rotterdam, 11 June 2018 - This crisis has slowly begun. Italy's parliamentary elections in March were initially not considered noteworthy by the financial markets. After the ballot, the interest rate gap between ten-year Italian government bonds and government bonds of the same maturity increased by only four basis points, and Italy's stock market lost just 0.3 percent. The losses were quickly offset in the weeks that followed, as Italian bonds and equities outperformed the rest of the eurozone.

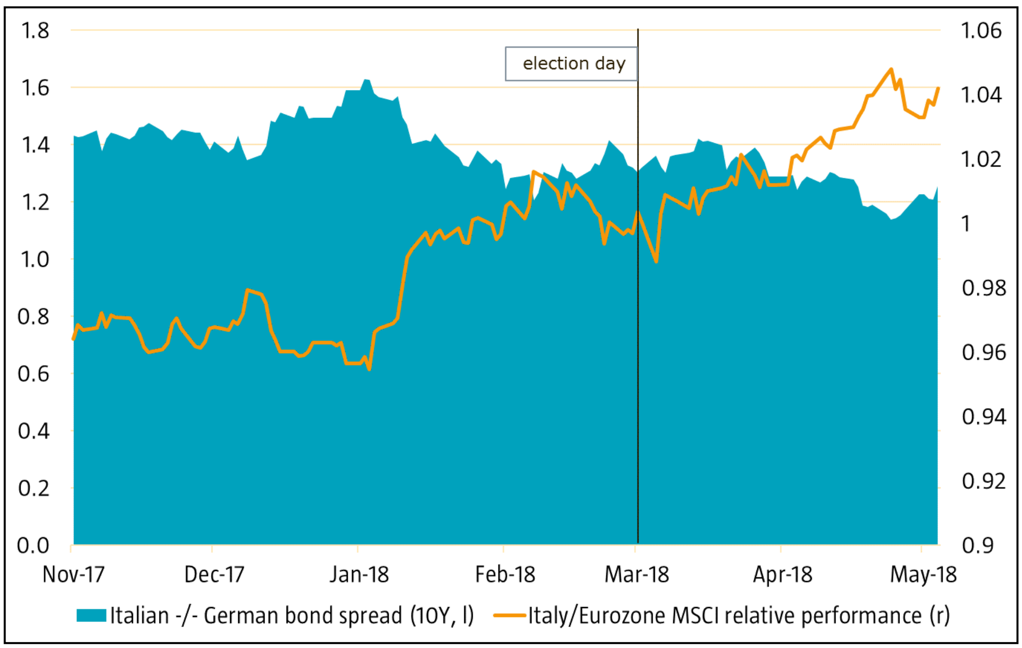

Fig. 1: *When does the panic start after the elections in Italy? Source: Bloomberg, Robeco.*

But at the end of May the situation turned around when it became clear that the negotiations between the two election winners - the five-star movement and the Lega Party - could be successfully concluded against all odds and political odds.1 "The xenophobic and Brussels-oriented stance seems pretty much the only thing that binds the two parties together," says Lukas Daalder, Chief Investment Officer of Robeco Investment Solutions.

1 The Lega is seen as an extremely right-wing party that wants more autonomy for the prosperous north of Italy, tax cuts and less interference by the central government. The five-star movement, on the other hand, campaigned for a universal basic income, higher government spending and a policy more close to the voters' hearts in the less prosperous south of the country.

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The financial markets responded very strongly this time: the yield on two-year Italian government bonds rose by more than 180 basis points to 2.8 per cent in a single day, so that the yield gap to the government bond of the same maturity widened to almost 300 basis points. And the Italian equity market lost
12.5 percent. So does the water's previous ripple turn into a wave?

Is the Greek tragedy repeating itself in Italy?

That depends on further development. "One could be tempted to join the camp of those who fear a new edition of the Greek drama. However, from our point of view there are several factors against it," explains Daalder with a view to Italy's much larger economy: According to the Robeco expert, its share of the total economic output of the Eurozone is about 15 percent, compared with only 1.6 percent in the case of Greece.

"In addition, Italy's economy and banking system are much more closely integrated with the rest of the euro zone. In addition, according to Deutsche Bank figures, Italy has a debt ratio of
130 percent is the world's third largest debtor after the USA and Japan. Only 40 percent of this is domestic debt. Italy owes the lion's share to about 35 percent of foreign investors and about 18 percent to the Eurosystem," explains Daalder.

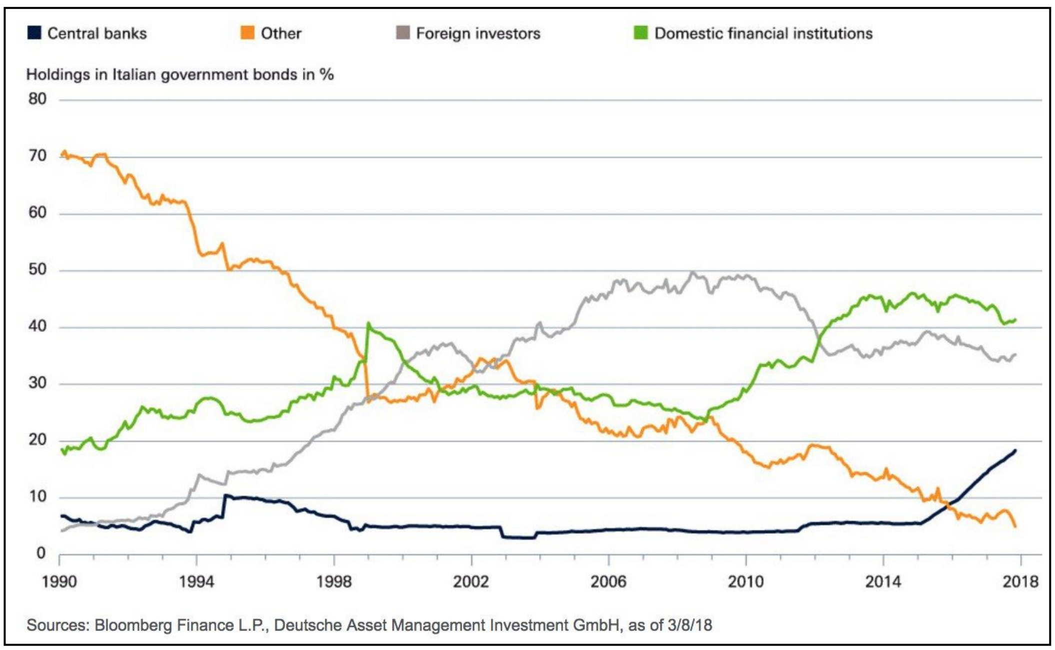

Fig. 2: Contrary to a wide
Italy's creditors are not only its own countrymen and - women

While Greece was forced into a corner and faced with an ultimatum to accept creditors' terms or become insolvent, Italy, as a founding member of the EU, is in a much stronger negotiating position vis-à-vis the other member states of the Eurozone. "Italy is simply too big to fail," says Daalder. A second important difference: the crisis in Italy is above all a party political issue, while the Greek crisis was essentially the result of an unsustainable government policy. "Despite the very high national debt, Italy has succeeded since 2012, to respect the deficit ceiling of 3 percent.

Marktkommentar

In addition, the current account surplus is quite respectable at 2.5 percent of GDP, and economic momentum has increased in recent years," explains Daalder.

Coalition on collision course with EU

Will the events lead to a concrete crisis? For example, from a rather pessimistic perspective, a joint government of populist parties makes progress in reforming the weak banking system unlikely. And it is quite possible that the new government will work to fulfil its election promises with budget planning that will put the country on a collision course with the EU Stability Pact. This could lead to a serious confrontation later this year. "It is difficult to predict whether the financial markets would just sit back and wait in such a scenario," Daalder said.

A more positive view is that the newly formed government may not be able to hold out long enough to cause serious damage. "Italy's north-south divide is heading in the direction of a gulf. Trying to bring the two elements together in a government would be difficult even under normal circumstances. Moreover, the fact that the two parties are located at opposite ends of the political spectrum makes the task they face seem practically impossible. The likelihood that the two rival parties will come into conflict increases with each day they share government responsibilities," Daalder expects.

The viability of the new government is crucial

This last scenario appears to be the most favoured by the financial markets at present, as market tensions have eased since the inauguration of the new government.

"Whether the development in Italy will turn into a wave will ultimately depend on whether the new government will be able to survive - which is not particularly likely at the moment," says the Robeco expert.

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About Robeco
Robeco was founded in 1929 and focuses on international asset management. Robeco currently has 15 offices around the world. The company is headquartered in Rotterdam (Netherlands). Thanks to the unique integration of fundamental, sustainability and quantitative research, Robeco can offer institutional and private investors a wide range of actively managed investment strategies covering a wide range of asset classes. As of 31 December 2017, Robeco's assets under management amounted to 161 billion euros. Of these, 70 percent were institutional assets. Robeco is a subsidiary of ORIX Corporation Europe N.V., which managed assets of 293 billion euros as of December 31, 2017.

Further information can be found at www.robeco.de.