

The Italian election and European risk

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Key points

- > An inconclusive election in Italy, which has put a cloud over whether it will continue with economic reforms, has seen the return of worries regarding the Euro-zone.
- > Uncertainty is likely to linger for several weeks, but as we have seen in recent times in Europe there is a danger of overreacting as blow ups have tended to settle down without the feared collapse of the Euro.
- > Our assessment is that while the correction in share markets may have a bit further to go, not helped by Italy, the broad rising trend in markets will likely continue.

Introduction

While the Italian election didn't produce the worst possible outcome – which would have been the return of Silvio Berlusconi as Prime Minister – it does look to have produced the second worst outcome, ie a hung parliament and a return to political uncertainty in Italy. The prospect of which has frightened investors with falls in share markets, a fall in the Euro and increases in Italian bond yields on fears that the Euro-zone crisis is set to return with a vengeance after settling down over the last year.

Election outcome

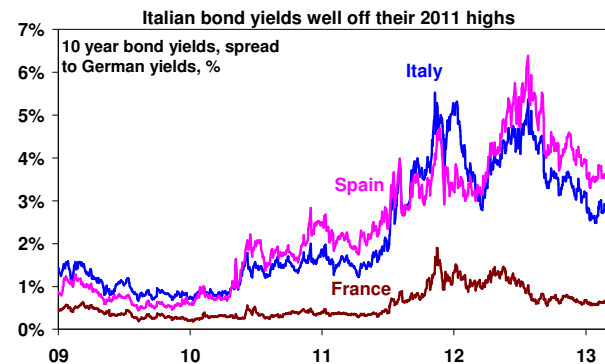
The Italian election saw Pier Luigi Bersani's centre-left coalition win a majority in the lower house, albeit a very narrow one. In the upper house Senate though it failed to win a majority, even if previous Prime Minister Mario Monti's party is included thanks to a strong showing by the populist Berlusconi and the anti-establishment Five Star Movement.

To govern in Italy requires majority support from both houses. Bersani will likely try and form a coalition in the Senate, a process that could take several weeks. But while he can probably count on Monti's support it may prove difficult getting the Five Star Movement on side and eventually a new election may be required.

Why the Italian election matters so much?

Government in Italy has been unstable for decades, so there is nothing new here. But the weekend Italian election was always seen as a potential threat. While Italy is now running only small budget deficits (around 2.7% of GDP last year) and a budget surplus of 2.6% of GDP if interest payments are excluded, thanks to huge deficits over a decade ago it has a very high level of public debt at around 127% of GDP. So when the Greek, Irish and Portuguese debt crises erupted, Italy, along with Spain was seen to be at risk which ultimately culminated in a sharp spike higher in its bond yields in late 2011. However, since Berlusconi stepped down as PM in November 2011 and interim PM Monti took over implementing a range of austerity measures and structural

reforms to boost long term growth, its bond yields steadily settled down.



Source: Bloomberg, AMP Capital

Italy's economy is over-regulated and uncompetitive and it's been estimated by the IMF that labour and product market deregulation could raise its GDP by 10% over ten years.

It was hoped that Bersani – who had a good track record as a minister in previous governments – possibly in coalition with Monti would continue the reform process (albeit with less aggressive austerity) following the election.

In the event, the backlash against austerity, as evident in the support for Berlusconi and the Five Star Movement in the Senate, was overwhelming with the divided parliament likely making it difficult in the short term for the reform process to continue.

If the reform process does not continue, not only does it raise questions about Italy's long term growth potential (it has had virtually zero growth over the last 14 years) thanks to an over-regulated and uncompetitive economy, but it also raises questions as to whether it would be able to qualify for support from the European bailout fund and hence for support from the European Central Bank if a surge in its borrowing costs made that necessary.

Hence investors are fearful that stalled reforms and political uncertainty in Italy will lead to soaring Italian bond yields, the renewed risk of a break up in the Euro should Italy choose to leave, and a renewed threat to the global economy.

The associated uncertainty could weigh further on share markets in the short term.

A danger in overreacting?

However, while it's clear that the risks in Europe have increased again following the Italian election, there is a danger in overreacting.

- First, there is still a chance that the final results will show Bersani and Monti doing better than currently expected in the upper house and/or that they will be able to form a coalition that leads to a workable Government.
- Second, if a new election is required it will clearly add to short term uncertainty, as occurred following the initially failed election in Greece last year. But following the Greek election example it's possible that Italians, having

now had their protest vote, will vote for a more rational and stable outcome in any follow up election, just as occurred in Greece last year. Or at least enough of them will. It's hard to believe that most Italians want to leave the Euro.

- Third, market forces will likely force a return to the reform path in Italy. Just as they – via soaring bond yields – forced the resignation of Berlusconi in late 2011 and the subsequent adoption of reform measures.
- Finally, it's worth noting that in recent times the Eurozone has seen numerous flare ups only to see it settle down and continue to muddle along ultimately in the direction of “more Europe, not less”. The same is likely to happen this time.

The correction we had to have

After strong gains - +14% for global shares and +18% for Australian shares since their last correction in November – shares had become overbought and due for a pullback. The Italian election result, coming on the back of worries about whether the US Federal Reserve will slow its monetary easing, worries about the US “sequester” spending cuts due to kick in this Friday and worries about corruption allegations against the Spanish Prime Minister, has come along at a time when shares are vulnerable.

Some of these fears are a bit overblown. It's hard to see US quantitative easing cut back just yet given that global and US growth is still sub-par and the spending cuts to defence, health, etc, due to start this Friday are likely to amount to less than 0.5% of US GDP this year.

In the short term the correction could well go a bit further. However, the broad rising trend in share markets is likely to remain in place. Equity valuations remain reasonable, the mildly strengthening growth outlook points to stronger profits ahead and investors are likely to increasingly switch from low yielding cash and bonds into shares as confidence continues to build. A pick up in M&A activity is also likely to be positive for shares. So it's unlikely that the latest flare up in Italy will be enough to derail the recovery in share markets.

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