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Global investment event

Political uncertainty intensifies in Italy and Spain

- Italy's President, Sergio Mattarella, has refused to appoint the Five Star Movement (5SM)/League coalition's candidate for Finance Minister, Paolo Savona. Another set of elections will now likely take place. This has coincided with a vote of no confidence being called against Spain's Prime Minister
- Increased uncertainty in Italy and Spain has contributed to greater market volatility, but there are a number of reasons that support a constructive stance on European assets

Rising political uncertainty in Europe

Italy's President, Sergio Mattarella, has refused to appoint the Five Star Movement (5SM)/League coalition's candidate for Finance Minister, Paolo Savona. The President has handed the task of forming a caretaker government to former IMF official Carlo Cottarelli. There will be a confidence vote for this government in the coming days.

If Cottarelli wins the vote, he is likely to pass the 2019 budget in the autumn and prepare the country for new elections in early 2019. However, if he loses, elections could take place sooner.

Looking ahead, it will be important to watch how 5SM/League campaign in the run-up to the next election, particularly any signs of increasing euroscepticism, which could exacerbate the recent selloff in Italian assets.

Meanwhile in Spain, on 25 May the country's socialist party (PSOE) called a confidence vote against Prime Minister Mariano Rajoy. The vote is due to take place on Friday 1 June.

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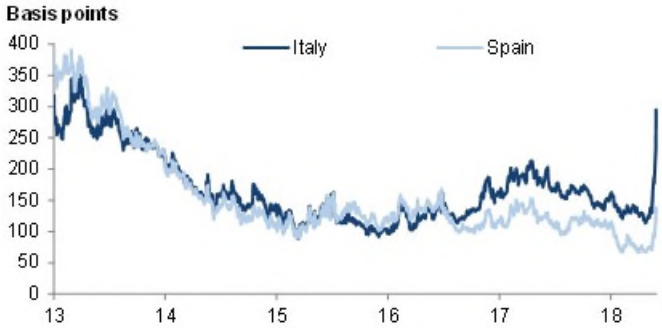
Market reaction

Recent developments in Italy have seen a notable selloff in the country's government bonds, with 10-year yields breaching 3% for the first time since mid-2014. The selloff has also been significant in Spain, although unlike in Italy, government bond spreads remain within their one-year range (Figure 1).

Figure 1: 10-year bond spreads over German bunds



Source: Bloomberg, as at 29 May 2018

European stock markets have also declined, with Italy's FTSE MIB index underperforming regional peers since mid-May (down 11%). However, year-to-date losses are roughly in line with the pan-European Euro Stoxx 50 index (2%). The euro has also declined since-mid May, losing 3% against the US dollar.

But there are reasons for calm

Higher uncertainty in Italy and Spain has contributed to greater market volatility, but there are a number of reasons that support a constructive stance on European assets. With regard to **Italy:**

There will not necessarily be a shift to greater euroscepticism. Although according to polls, the 5SM/League coalition are likely to do well in upcoming elections, they will not necessarily campaign on a significantly more anti-EU platform. Leaving the eurozone also remains highly unlikely. Following the failed government bid, League party leader Salvini stated that quitting the euro **"wasn't in our programmes"**.

Markets and the Italian parliament will act as a constraint. Given Italy's high debt pile, much of which is held domestically, enacting policies that push spreads wider can be seen as counter-productive. Also, the 5SM/League coalition only captured a small majority in the Senate at the March elections. A similar performance at the next vote would see a limited possibility to pass key legislation, including the 2019 budget. Finally, the president has the power to block budgets that contravene the constitution's balanced budget principles.

In **Spain**, **Rajoy is unlikely to be toppled**. Votes of no confidence in Spain are constructive, meaning that the vote requires a successor to be nominated at the same time. This is highly unlikely given differences between opposition parties.

More generally, **eurozone economic fundamentals remain solid**, despite a moderation in Q1 activity. Furthermore, Italy and Spain's current account balances have shown a significant improvement in recent years, making them less reliant on financing from international investors. In addition, the **ECB may deploy policy instruments** to safeguard financial stability.

Overall, we are entering a period of protracted uncertainty in Italian politics, which arguably outweighs risks stemming from Spain. But even in the event of 5SM/League eventually forming a government, there is little indication they wish to pull the country out of the eurozone. There are also significant constraints to implementing a large fiscal stimulus. Amid solid economic fundamentals in the region, the potential for the ECB to safeguard financial stability, and relatively attractive valuations, we maintain our overweight stance in **eurozone equities**. Meanwhile, prospective returns on Italian **government bonds** are likely to have improved following the recent selloff. However, we retain a cautious view on this asset class amid considerable uncertainty highlighted above.

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