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Italy threatens to produce antoher Eurozone crisis

Italy's referendum on its constitution could bring renewed turbulence to equity, bond and currency markets.

Italy's constitutional referendum on December 4 could have big consequences, not limited to the impact on the Italian economy. Should Italy's voters reject the constitutional reform proposal, confidence in the Eurozone might be seriously undermined, with the euro likely to sell off.

As the critical plebiscite draws near, markets are increasingly nervous. Already, investors are demanding that Italian government bond prices now incorporate a higher risk premium. And the euro is trading at its lowest level against the US dollar since December 2015. Indeed, current market trading patterns suggest that investors are worried about more than just the issue to be decided in the referendum. From an investor perspective, the reform proposal should be well-received. If the proposal goes through, Italy's complicated two-chamber parliamentary system will be simplified and bureaucratic procedures reduced. The Senate will become much smaller and lose power and the executive will be strengthened. A strengthened executive will be better placed to implement reform and reduce the regulation, which currently acts as a powerful brake on the Italian economy.

Is Italy really able to reform itself?

Far more important than the specific proposal on constitutional reform is the broader issue of whether Italy is fundamentally capable of reform. Should the referendum proposal fail, other reforms, vital for Italy's economy and political processes, would less likely get implemented. Such reforms are urgently needed if Bella Italia is to boost its growth trend – currently less than 1%pa. – and reduce its enormous government debt burden.

The state has a mountain of debt while Italy's banks are awash with bad loans

The Eurozone's third largest economy has a massive debt overhang, currently equivalent to 135% of Italian GDP. In the Eurozone debtor's league only Greece stands higher. Italy's banking sector is also in bad shape. Bad and doubtful credits are thought to amount to some EUR 360bn. Restructuring the banking sector, to put it back on an even keel, will be no easy task.

Many investors sold their equity holdings in Italy's banks a long time ago. Even so, a "no" result in the referendum is likely to hit bank stocks in particular, not least because the investment climate would probably deteriorate further.

Italy's anti EU forces could be strengthened

If the referendum proposal fails, Prime Minister Matteo Renzi would go as, when introducing the referendum, Mr. Renzi linked his own future tightly to the referendum result. A Renzi departure need not, in itself, be such a bad outcome. But, in such a situation, financial markets would move rapidly to focus on Mr. Renzi's likely successor and the consequences for the EU. Given the widespread hostility to "elites" and the strong populist trends now evident in Europe and the US, it is likely that a "no" result would boost anti-EU pressures significantly. Were this to happen, Italy might join the UK in seeking to distance itself from the EU. The EU's existing confidence problem would get worse. With national elections scheduled next year for France, the Netherlands and Germany and real uncertainty regarding the future relationship between the EU and the UK, markets face a period of considerable instability.

Increased pressure on the ECB

Uncertainty about the upcoming referendum result looks likely to pressure the euro in the near term. And, given the referendum-related risks for the EU and the Italian economy, a "no" result would probably hit Europe's equity markets in general. Depending on how markets behave, the ECB might feel itself obliged to extend its monthly multi-billion euro bond purchase program by an additional 6 months, or even to push its policy interest rates further into negative territory. The latter step, were it to happen, would pressure the SNB to make a matching interest rate move. Indeed, SNB policy chiefs have in recent days repeatedly suggested this scenario as a possibility.

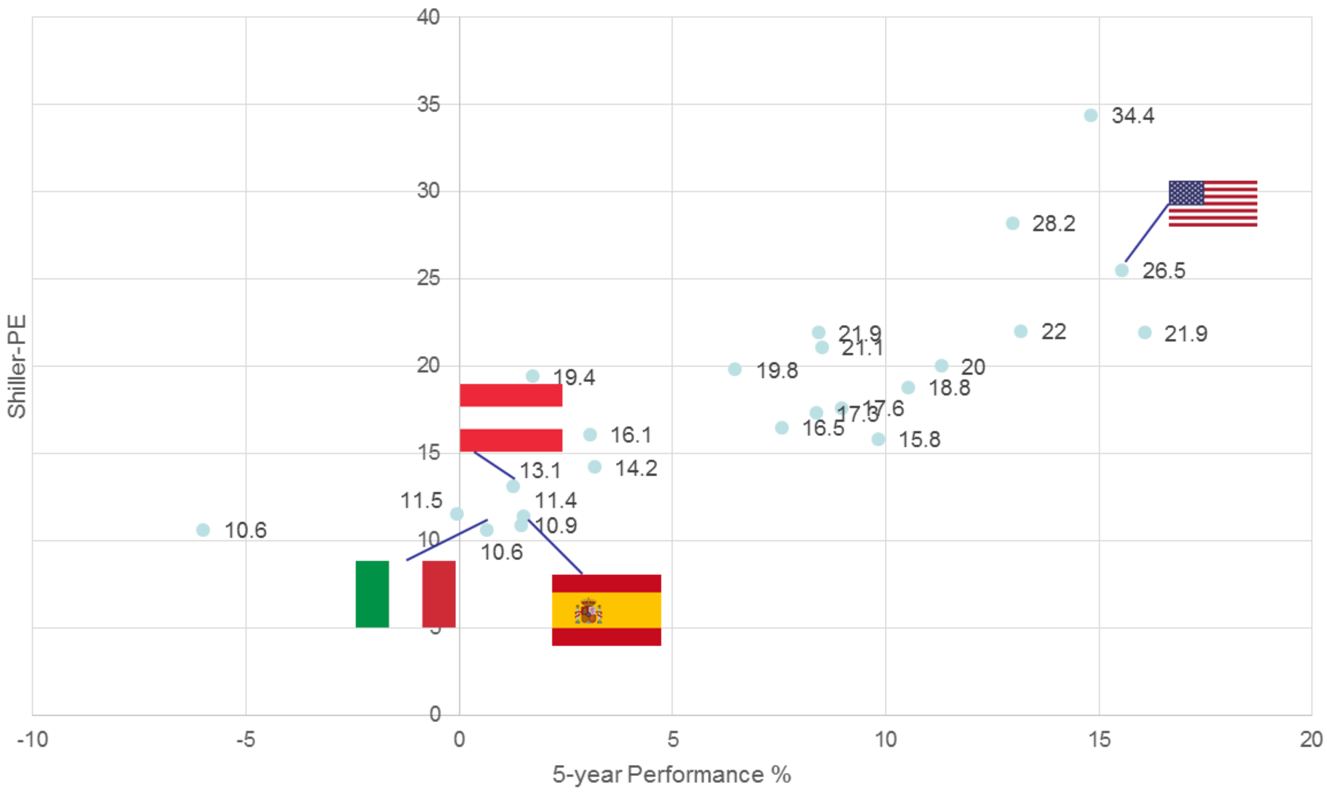
Italian equities are atractively valued

As always, the investor has to make the assessment as to how much of this bad news has already been "priced in". As the chart below shows, the Italian stock market, trading on a Shiller-adjusted price to earnings ratio of 10.6, has one of the lowest valuations of all equity markets world-wide. One can observe that, on this metric, US equities are two and a half times more expensive. Investors have thus already priced in a lot of good news so far as Mr. Trump and US stocks are concerned and a lot of bad news so far as the Italian equity market is concerned. Opinion polls failed to predict both the UK referendum result and the US Presidential election result. Right now, the polls suggest that Mr. Renzi's constitutional reform proposal will be rejected. Should they prove to be wrong again, with the referendum proposal being accepted, Italian stocks might rise sharply, with Italian banks leading the charge. A "yes" result would smooth the path to reforms which are long overdue and assuage investor anxiety about anti-EU pressures in Italy gaining the upper hand.

What happens if the “consensus scenario”, whereby Italy’s reform proposal is rejected, comes to pass?

As the overwhelming majority of investors assume that the referendum proposal will fail, such a result must already to some extent have been priced into markets. But this “pricing in” is probably not complete. The stronger the majority for rejection, the more likely it is that investors will assume that anti-EU and anti-establishment parties, especially Cinque Stelle, will turn out to be the winners in fresh Italian elections. Thus could lead to significant market turbulence. But, even then, developments in Italy will still retain their ability to confound and surprise.

Italian shares are lowly valued



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