AquilaUpdate

Italy's politics unsettle the markets

The attempt to install a functioning government in Italy has collapsed.
The result of recent Italian elections reflects a chronically sluggish economy, excessive regulation and taxation as well as political exhaustion, especially within the established parties.
The proposed coalition of parties on the alternative left and alternative right had seemed strange as about the only thing these parties have in common is contempt for the established parties, the technocrats and the traditional way of doing things. Italy has opted for "la totale anarchia a tutti i costi". The mantra is "Italy first; there's no point in saving; it's the others that are at fault; and now we're going to change everything".
But Italy's President, Sergio Mattarella, has thrown a spanner in the works. He has prevented the election's winners – Movimiento 5 stelle and the right-wing Lega Nord - from implementing their agenda, by refusing to accept the coalition's proposed Finance Minister Paolo Savona and instead asking the former IMF technocrat Carlo Cottarelli to form an interim government. By not accepting the Euroskeptic Mr. Savona, Italy's President is hoping to block the coalition's self-defeating economic and financial program. Mr. Savona would have thrown Italy's future compliance with its international treaties into question.
These recent developments suggest that the next Italian elections will in effect become a referendum on Italy's future membership of the Eurozone.

The financial markets have already voted and their conclusion is that previous risk premia for Italian bonds and equities, especially the shares in Italian banks, were too low.
The other European bourses as well as the euro have been hit by the fall-out.
Earlier satisfaction at Euroland's positive growth surprise in 2017 has given way to a more sober assessment, although we are still a long way from panic. One problem is that Europe's economy seems set to weaken somewhat in the next few months quite independently of what may happen in Italy.
Our view is that Italian bonds, equities and bank shares, despite recent losses (which have more than erased previous gains since the start of the year), do not yet offer a sufficiently attractive risk premium for investment. Thus we advise against purchases for the time being and currently run a higher than normal cash position in accounts. This should allow us to build up positions, perhaps even in Italian investments, at more attractive prices in future.
As the will of the Italian electorate will not be reflected in the interim government, the upcoming Italian election could be extremely dangerous. Frustrated and defiant voters could insist on radical programs that seriously disturb Europe's financial markets.

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