

Italy's election should avoid a worst-case scenario

European political risks have receded over the past 12 months, following several key election results in 2017. However, concerns remain that the rising tide of populism in Europe has not been entirely squashed and this weekend's election in Italy will be another barometer in measuring anti-establishment feeling.

Compared with previous sovereign events in Europe over recent years, financial markets are relatively calm ahead of the weekend with the forthcoming election having a negligible effect on Italian assets so far. The Italian stockmarket is a top performer in Europe year-to-date supported by strong corporate and economic fundamentals, while in the bond market, the yield difference between the ten-year Italian government bond and the equivalent German sovereign maturity has modestly narrowed since the start of the year. Much of this sanguinity is down to the economic improvements Italy has seen since the second half of 2017, helped by the recovery in manufacturing, improving consumer confidence levels, and receding deflation risks. A more supportive economic environment has also helped to neutralise some of the more extreme policies of the anti-establishment parties.

Nonetheless, Italy remains an underperformer economically relative to its other European peers and the country has one of the lowest labour productivity rates in the G7. While efforts to reform Italy's economy have been ongoing since 2012, there is still further to go to address high rates of unemployment, particularly among the young. As a consequence, immigration has been the dominant issue of this election campaign, despite Italy having one of the lowest immigration rates in Europe. Moreover, the economy remains fiscally constrained by a high debt to GDP ratio of 133% and, with interest rates tightening globally, some economists argue that the window for more government investment has now been missed. Further pressure has been piled on by the European Commission, which has also admonished Italy for potentially breaking agreed budget deficit targets for 2018.

Against this backdrop, many observers believe that this election is the most unpredictable in Italy's recent political history. Opinion polls, which closed on 16 February, suggested a hung parliament, which for Italian politics probably maintains the status quo. However, what is more difficult to ascertain is how parliament will likely be configured across the political dividing lines. This will be the first election since the implementation of a new electoral law, passed in October, where parliamentary seats are now determined by a mix of first-past-the-post (one-third) and proportional representation (two-thirds). In addition, Italy's political landscape has been further fragmented by the rise of grassroots populist movements since 2011. The anti-establishment Five Star Movement is now the most popular party in Italy, having cut across traditional voting patterns based on left/right ideologies as well as geography. As has been the trend with a number of Western democracies in the post-crisis years (including the UK), Italian politics is no longer simply about assessing the balance between the centre-left and centre-right, but also the mainstream versus the non-mainstream.

Reduced prospect of a populist government

With all that said, we nonetheless believe that the prospect of a populist government has been greatly reduced. The pre-blackout polls indicated no outright majority expected for any single party, and the Five Star Movement has refused to form a coalition. The new electoral law deems that a viable



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government has to obtain a majority in both the lower and upper houses of Parliament. In effect, these constitutional changes have lessened the prospect of a minority populist government. The chances, therefore, of a centrist government (albeit a mix of parties whether of the left or right) have increased.

More recently, the centre right bloc of parties, Forza Italia, Lega Nord and Fratelli d'Italia, led by the former Prime Minister Silvio Berlusconi, has been gaining ground, especially in southern Italy. Meanwhile, internal divisions and a banking scandal have meant that the ruling Democratic Party (PD) has been losing popular support to the Five Star Movement. In the event a coalition government is unable to be formed, President Mattarella may reappoint the current Prime Minister Gentiloni to lead a new technocrat government until fresh elections are called.

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