19 October 2018

Heartwood Investment Management

Our thoughts

Market observation

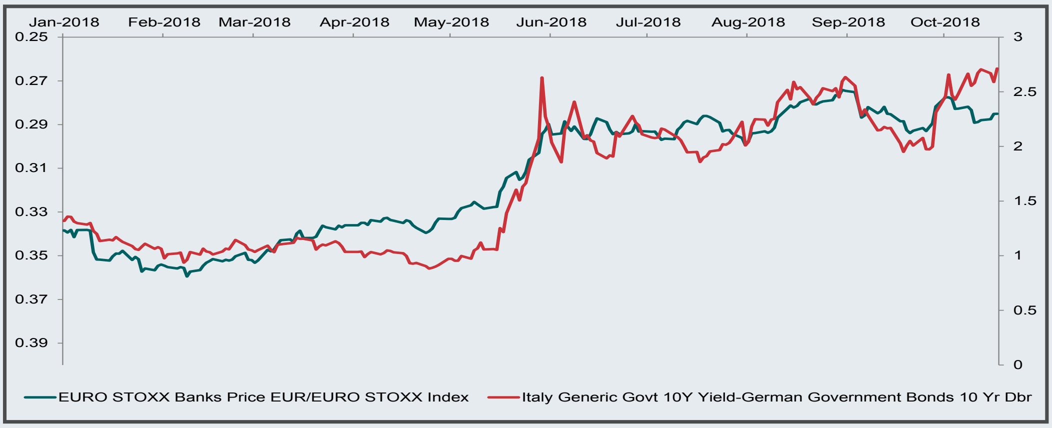
The casualties of a populist budget deficit: Italian banks stocks and bonds

Since the June formation of Italy's new coalition government, political commentary on Italy has tended to focus on redenomination risk (the possibility of Italy leaving the euro). The coalition's two major parties – The League and Five Star – have both expressed anti-immigrant and anti-austerity sentiment, alongside varying degrees of euroscepticism. This week, with Italy's budget deficit submission to the European Commission (EC), the first shot across the bows may have been fired. Plans to fiscally retrench (introducing measures to reduce borrowing and debt) have been replaced by a more expansionary approach, with a proposed budgetary deficit of 2.4% (in itself perhaps an underestimation of the true costs). The EC is very likely to reject this proposal, sending rebellious Italian authorities back to the drawing board.

The primary casualties in the short term have been Italian bank stocks and Italian government debt. The spread between Italian and German bond yields has ballooned (although nowhere near 2011 levels), while European/Italian bank performance has been poor, as the chart shows (the left hand axis, showing relative Italian bank stock performance, has been inverted). Investors should expect more near-term turbulence ahead as the EC and the Italian government lock horns over any budgetary revisions, with eurozone officials keen to retain credibility and Italian authorities eager to determine their own financial future.

Investment markets are nervous about Italy's rebellion

Relative performance of Italian bank equities (LHS - inverted), Italy-Germany 10-year government bond yield spread (RHS)



Source: Bloomberg

Past performance is not a reliable indicator of future results

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Important Information

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