COMMENTARY

GLOBAL ALPHA

June 22, 2018

Dear clients and colleagues,

Fears regarding the political landscape in Italy began in May. A new coalition government was formed at the beginning of June between the populist Five Star Movement and the right-wing League. It appears that the economic program of this new government is to run a fiscal deficit to help improve household incomes. Below are some of the economic programs that were initially proposed:

- The introduction of two flat tax rates for households and companies at 15% and 20% depending on income level. This measure is expected to cost 2.8% of GDP.
- Initiation of a guaranteed minimum income of €780 per month for every citizen. This measure is expected to cost 1% of GDP.
- Partial repeal of the 2011 pension reform, which is expected to cost 0.8% of GDP.
- Abolition of the value added tax (VAT), expected to cost 0.7% of GDP.

The spending plans and new potential reforms proposed by the new government had a strong impact on investor sentiment, as exemplified by the effect on Italian government bond yields. The 10-year Italian government bond yield gained 140 basis points in less than a month and hit a recent high of 3.1%. This is bad news considering that the country represents the third largest economy in the eurozone and its debt to GDP stands at around 130%. Also, Italy could face further credit rating downgrades, which would negatively impact the cost of debt for Italian companies.

Since the majority of the country's debt market is owned by the local buyers (68%), Italy cannot rely on foreigners to finance its proposed fiscal deficit. This low capital mobility between Italy and the rest of the world would certainly lead to an increase in interest rates.

Sentiment has improved slightly in recent days, but until uncertainties fade away, Italian risk premiums could remain elevated in the short term. In October, Italy will deliver its budgetary program to the European Commission, and then we will have the details of the measures proposed by the new government. After acceptance by the European Commission, Italy's parliament will vote on its 2019 budget by the end of this year. Finally, we do not expect that the current political situation will lead to a referendum on the Euro as 75% of Italians are pro-Euro.

At this time we believe it could be risky for the new government to conduct an expansionary fiscal policy. Italy's fundamentals have improved a lot since the eurozone debt crisis, with both its primary balance and current account balance in surplus. The unemployment rate has been declining over the past three years to reach the lowest level since 2012, disposable income has been improving and private consumption is close to pre-crisis levels.

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Although our portfolios remain slightly overweight Italy, our holdings are in world-class companies that are financially healthy. These companies have grown faster than their peers and have positioned themselves to benefit from international markets. We observe that, on average, the Italian companies we own are generating more than 85% of their revenue outside Italy.

The Italian market is currently trading at around 12x the forward price-to-earnings ratio compared to 16x and 14x for France and Germany respectively. While Italian financial markets offer an interesting valuation discount, a challenging economic environment and the current political situation remain major sources of uncertainty. For that reason, we would remain cautious for now.

Have a good weekend.

The Global Alpha Team

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