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An Unconventional New Government in Italy

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Two months after the Italian election, the country is on the verge of a new government led by the right-wing La Lega and left-wing Five Star movement. While markets take some time to digest the full implications of this unusual tie-up, David Zahn, Franklin Templeton's head of European Fixed Income, offers his analysis of the political situation.

In our analysis immediately after the Italian election in March this year, we felt a tie-up between Five Star and La Lega (The League), two populist parties at opposite ends of the political spectrum, would be the worst outcome for markets.

Now, two months after voting, it seems likely that those two parties will attempt to form the next Italian government.

How Might Markets React?

So far, markets have reacted relatively calmly to the news.

However, we think there are already signs that this coalition of opposites could try to implement policies that will raise the hackles of the financial markets.

The two sides have been good at talking about how they will spend money and not so good at telling us how they will raise money.

For example, some of the broad themes that have emerged from their discussions include operating a low, flat tax rate, reducing the retirement age (at a time when most other countries are doing the opposite) and introducing a form of universal basic income for the poor.

These are noble causes but they all cost money. Italy already has a fairly large budget deficit. It runs a primary surplus excluding interest payments, but its debt-to-gross domestic product (GDP) is more than 130%. So in our eyes, more spending doesn't seem to be the answer.

Furthermore, Italy is viewed as having one of the weakest major economies in Europe.

Lower Demand for Italian Government Bonds

We think the Italian government should be looking at reforms that could generate long-term growth, rather than trying to drive that growth through government spending.

The European Central Bank's (ECB) reduction of its bond-buying program might present a further challenge for the incoming government's ambitions.

Last year the ECB spent €60 billion a month buying European government and corporate bonds. Italy accounted for a fair portion of those government bond purchases and the program was quite supportive for Italian government bonds.

The ECB has now reduced the monthly purchases to €30 billion month and the program is scheduled to end in September. We think the bank will extend the asset-buying program into 2019, but our expectation is that it will focus more on corporate bonds.

As the ECB steps away, demand for Italian government bonds is likely to be less than it was a year ago. Therefore, the Italian government will have to find other buyers, and we imagine the funding costs for Italy will likely go up.

Given the unknowns of a new administration, our expectation would be more domestic buyers. But domestic buyers may require higher yields to encourage them to buy.

How Supportive Will France and Germany Be?

Although we think that fears about the League/Five Star coalition's euro skepticism are over-played, we recognize there could be tensions between Rome and Brussels in particular over the new government's spending plans.

Italy's current constitution would not allow a referendum on the country's membership either of the euro or the European Union. And at the moment League/Five Star would be unlikely to have the requisite three-quarters majority in parliament to change the constitution.

However, the spending plans of the new administration could cause some friction in the euro area.

There's a question of how supportive the governments of France and Germany are going to be of the new Italian government's plans. Perhaps surprisingly, we believe there are reasons to suggest they could be quite supportive.

Given the more aggressive trade stances being taken by the United States and China, Europe may want to maintain a more unified front.

Overall, we expect to take a negative view on Italian government bonds in the short to medium term. They're quite high yielding compared with the rest of Europe, but we think the new government could struggle either to deliver on its program or to keep financial markets on side.

What Are the Risks?

All investments involve risks, including possible loss of principal. Bond prices generally move in the opposite direction of interest rates. Thus, as prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of the portfolio may decline. Investments in foreign securities involve special risks including currency fluctuations, economic instability and political developments. Investments in developing markets involve heightened risks related to the same factors, in addition to those associated with their relatively small size and lesser liquidity.