ClearBridge Investments

Political Uncertainty Weighs on Italian Banks

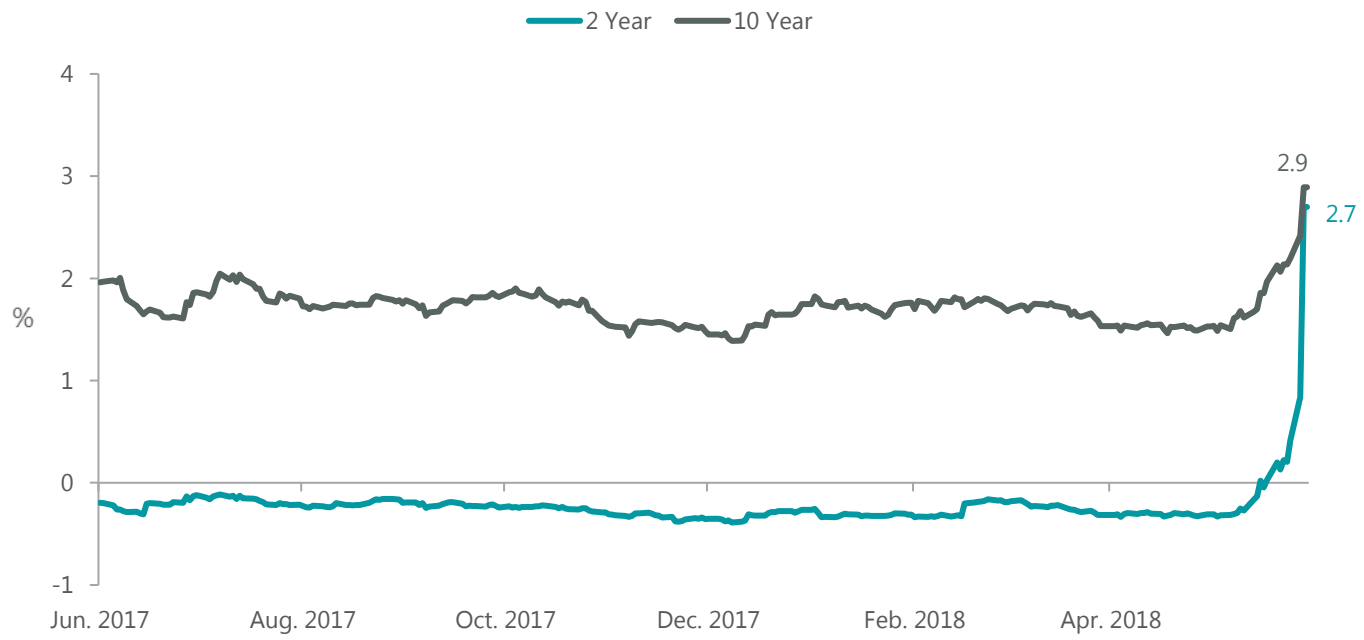
May 30, 2018

Key Takeaways

- Italy's failure to form a government and the threat of a new election have caused bond spreads to widen sharply, signaling market concerns.
- Political unrest in Italy could cause the ECB to delay its rate tightening plans, creating a less conducive environment for most European financials and calling into question our bullish view of bank earnings growth.
- Uncertainty is impacting Italy's GDP growth, which combined with the broader impacts on European financials, has caused us to reduce our exposure to Italian banks in our growth strategies.

The political situation in Italy, where on Sunday President Sergio Mattarella blocked the nomination of a euro-skeptical minister, is important to follow. Yields on Italian 2-year and 10-year bonds have spiked over the last several days (Exhibit 1) as have spreads vs. their German equivalents. Moody's put Italy on watch for a downgrade — losing its investment grade rating would make financing debt much more expensive. Currently the average maturity of Italian debt is seven years and the cost is manageable, but with higher rates for a longer period, the affordability question will come into the discussion.

Exhibit 1: Italian Bond Yields Have Spiked



2-Year and 10-Year Italian Government Bonds as of May 29, 2018. Source: Bloomberg.

The current prime minister, Carlo Cottarelli, is a technocrat nominated by President Mattarella and is likely to lose the confidence vote with the winning parties; new elections are therefore probable, most likely in September. The current situation favors the populist parties Northern League and the Five Star Movement. It is also unclear if in preparation for the elections these factions will push for a euro exit. So far, the rhetoric is hostile to the euro, particularly from the Northern League. The Italian constitution does not allow for an immediate exit, but in the case of a two-thirds majority, the constitution could be changed. We believe the pressure from Germany and France will be very strong to keep Italy in the euro and the EU. You will see a lot of headlines which will create volatility and uncertainty.

We will be watching closely how the voters react in the weeks to come. The economy in Italy, which was finally on good footing, is starting to show weakness according to early indicators. The uncertainty will have an impact on GDP growth for the second quarter. Will the slowdown in the economy change their vote?

The ECB meeting in June is another big milestone. Will the ECB signal that QE will end in 2019 or be more open-ended? Will rate increases be pushed back compared to market expectations? Pushing out interest rate hikes in Europe will also lead to slower EPS growth in European financials in general.

The international growth team was initially attracted to Italian and other European banks as structural growth stories trading at discounted valuations that would benefit from rising rates and a better political backdrop. We have recently decided to reduce our Italian banking exposure due to the reasons mentioned above.

Italian banks were the last banks to recover in Europe. Given current uncertainty, non-performing loan reductions might be slower than is priced in. The cost of risk for new loans might increase and write backs might not occur as they did in the last several quarters. A GDP slowdown could also lead to less loan growth in Italy. A worst-case scenario — Italy leaving the euro — would create a deposit flight from Italy to Germany, as happened in Greece. Deposits are the blood line of retail banks and this flight would damage the Italian banking system.

Italy completed an auction of 5- and 10-year bonds this week, but the pricing suggests that much is still to be resolved in the EU's third-largest economy. We prefer to await more clarity before returning to Italian financials in our growth strategies.

About the Author

Michael Testorf, CFA
Managing Director, Portfolio Manager

- 31 years of investment industry experience
- Joined ClearBridge Investments in 2015
- BA in Business and Economics from the Wirtschaftsakademie Hamburg (Academy of Business and Administration), Hamburg, Germany

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