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Italy: populist undercurrents

Key views

The strong performance of populist parties in Italy is balanced against Germany forming a new government. We see scope for pressure on Italian and peripheral eurozone bonds.

A government involving populist parties might take a confrontational stance against the EU and loosen fiscal policy. We see an increased probability of another election this year.

At the EU summit this month, the UK will seek agreement on a transition deal that avoids a cliff-edge Brexit in March 2019.

Results of the Italian election point to a hung parliament, with no party or coalition winning enough votes to form a government. The strong showing of populist parties complicates the Italian political outlook but is balanced against a new government forming in Germany. We see scope for pressure on Italian and peripheral eurozone government bonds but don't see this as a sustained negative for the euro or regional equities.

The nationalist Lega party is emerging stronger than Silvio Berlusconi's Forza Italia within the centre-right coalition. The Five Star Movement's performance beat poll forecasts, making the anti-establishment party a likely linchpin in any potential government. Yet neither party campaigned on an anti-euro message, focusing more on domestic issues. The defeat of Marine Le Pen's National Front in France last year spurred even the most euroskeptic parties to tone down their euro exit talk. Anti-European sentiment was largely absent through the election campaign.

We believe it unlikely that Five Star will partner with Lega to form a government. Lega's ambition is to lead the center-right coalition rather than be a junior partner in an unstable alliance with Five Star. At some point, an increasingly mainstream Five Star and the center-left Democratic Party may warm up to each other. A new Italian parliament needs to be convened by March 23, yet negotiations are likely to drag on beyond then. Political noise is poised to remain high until a sustainable coalition emerges.

At the same time, a healthier Italian economy looks likely to cushion some of the short-term hit. Real GDP growth of 1.5% in Italy looks realistic for 2018-2019, though ongoing political uncertainty may be a drag. The debt-to-GDP ratio should start falling from this year. Italy's banking sector appears to have turned the corner and is making progress in dealing with the large non-performing loans on its books.

We now see an increased probability of new elections after the summer. Any government involving Lega or Five Star is likely to take a confrontational stance against the European Union, especially on immigration. We believe a government involving those parties would partially roll back fiscal prudence and economic reforms.

Yet Germany's new government bodes well for renewed momentum behind deeper European integration, we believe. On Sunday the Social Democratic Party (SPD) membership voted in favour of a coalition. The pro-Europe SPD will take over key ministries such as finance and foreign affairs. The outcome should boost corporate sentiment and could give the European Central Bank more confidence in its growth and inflation forecasts.

Meanwhile, a key date on the UK's Brexit calendar looms: the European Council meeting in Brussels on March 22-23. Expectations are high, especially in the UK, that a transition deal can be reached that would avoid a cliff-edge Brexit in March 2019. Compromise is far from certain, and we see volatility in Brexit-sensitive assets – particularly sterling – rising ahead of the March meeting. Clarity on a transition deal is a key factor for companies deciding on contingency plans. The issues around the Irish border appear likely to be kicked down the road beyond any agreement on a transition deal.

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