Focus on Italy: Bonds and Banks after Trump and before the referendum

Market environment

The Italian referendum is scheduled for this Sunday 4th December. Since the US elections we have seen that rates have risen across the globe.

US bonds were very expensive with unprecedented sharply negative term premiums (-70bps at the year low on 10y bonds) before the US elections. The low volatility through the summer was evidence of complacency. On the monetary side, Janet Yellen argued in her Boston speech that the Fed could let the economy 'run hot' temporarily. These comments only added to speculation that the Fed is already behind the curve. The unexpected election of Donald Trump as US President rocked markets. A political risk premium is now priced in US bonds, considering the uncertainty surrounding the complicated nomination process of the new Administration and future fiscal and foreign policy. Deficits may increase significantly which would put additional pressure on long-term bond yields. It is very difficult to gauge bond issuance risk at present. Protectionism would be inflationary and detrimental to growth. This bodes well for US TIPS and steepeners. Spot CPI inflation will likely rise to 2.5% by March, which should raise the floor under US yields in the coming months.

The political uncertainty associated with the upcoming constitutional referendum on Sunday in Italy is the main reason for the selloff in Italian bonds. Spreads on Italian debt have steadily widened since mid-October from about 140bps to as high as 190bps versus Bunds. Then, on Monday 28th November, Mr Draghi said the "ECB Purchase Program is sufficiently flexible" to buy Italian bonds if necessary and spreads came down to 170 bps as of today. In the past month, there has been a series of polls showing that the "No" vote will likely prevail. Renzi may step down if the outcome is indeed "No". However, snap elections are unlikely (we think that it is not in the interest of the center-left and center-right to open the door for a possible M5S government). Instead, the President could nominate Letta or Padoan (current Finance Minister) as new Prime Minister, so that there would a continuation of policy. The 2018 general elections would be maintained. We nevertheless stress the possibility that Renzi could stay in power regardless of the vote. Prominent political figures like Monti (although campaigning for "No") would favor status quo in government.

As concerns market strategies, BTP spreads have the potential to widen further and the Italian yield curve should steepen. After the results, spreads may shoot up to about 200bps. In our view, liquidity of the BTP futures enable investors to hedge all kinds of peripheral risks. There are hence unwelcome side effects on the Italian bond market. Institutional investors in Italy may nevertheless step in at 2.30-2.50% 10-year yields.

Impact of the referendum on Italian banks

In case the outcome is "No" we project negative market sentiment on Italian banks. Conversely, the impact would only be limited in case of a "Yes" vote.
Regarding banks' fundamentals, we do not expect any impact in the short run – whether the outcome is "No" or "Yes". Indeed, a victory of a "Yes" would not be a catalyst to improve the situation of Italian banks. In the long run, the impact of a "No" vote or a "Yes" vote would be indirect. First it could impact the Italian economy and have second round effects on banks.

Potential negative impact on market sentiment in case of a "No" vote

We remind that the Italian banking system is plagued by a huge stock of non-performing loans (NPL). The system is also heterogeneous and fragmented.
On one hand, there are the strongest Italian banks which we consider are long term survivors (Unicrédit, Intesa, Ubibanca, Mediobanca etc.) Even if these banks are not the most robust on a global basis, we take comfort on their ability to solve their NPL issue and clean their balance sheet.
On the other hand, there are distressed banks such as Monte dei Paschi or Carige which suffer from extremely poor asset quality leading to huge solvency issues.
Some banks (Unicrédit, Monte dei Paschi etc.) have announced capital increase plans. They are subject to execution risk driven by the political risk embedded in the referendum. Indeed, a "no" victory could lead to political uncertainties which would impact negatively investors' sentiment. This could impede banks to execute the announced capital increases. It is also paramount for some banks to maintain, or regain investors' sentiment and access to capital markets for their funding.
Lastly, it is to keep in mind that Italian banks still have large holdings of Italian governments bonds. Should their valuations be volatile in case of a "no" vote, that would be a mildly negative for the system through higher volatility in capital. That again would be a problem for weak banks, making them look even worse.

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