Markit Recap – 9/24/2018

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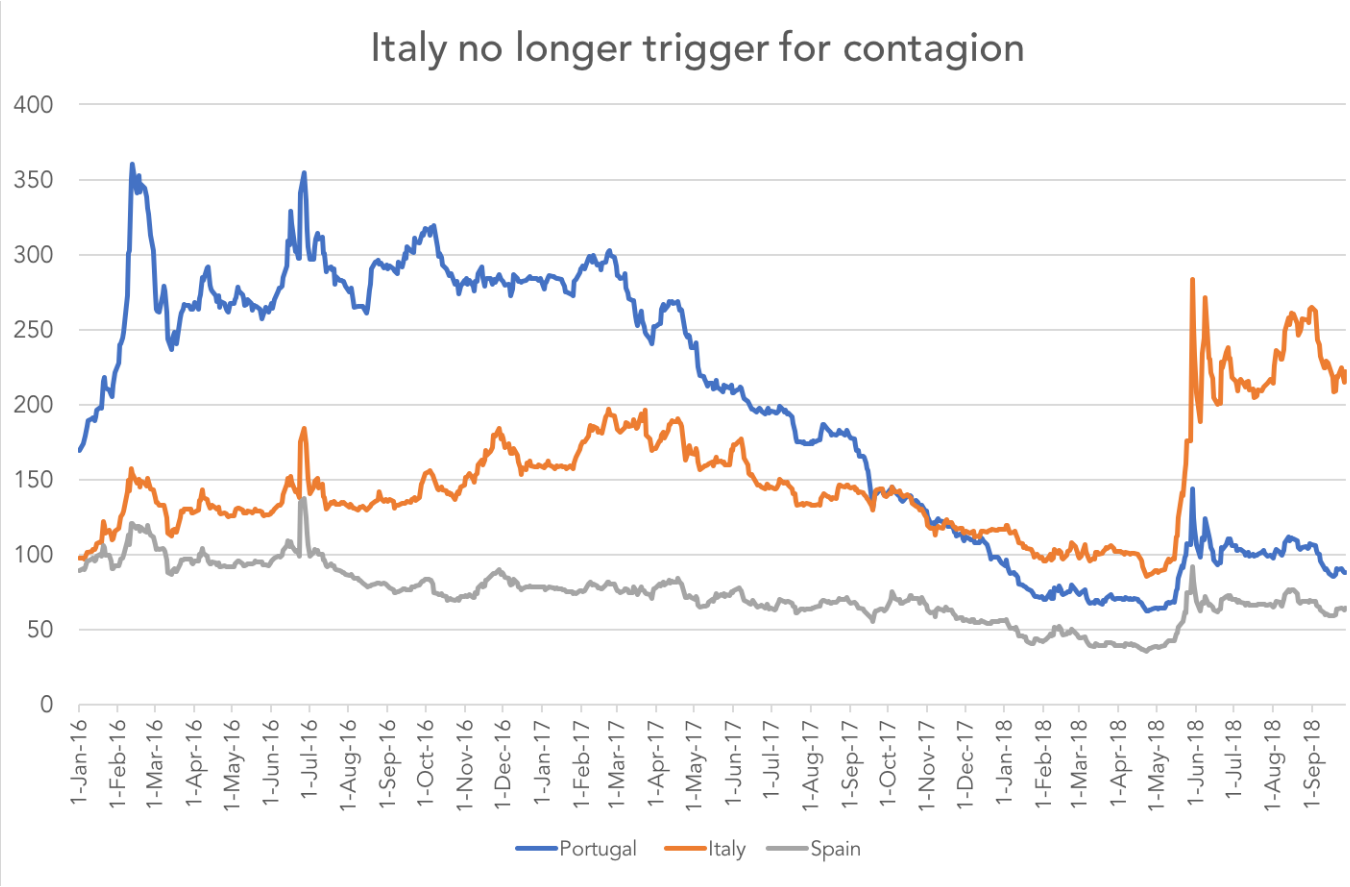
Chart



The appeal of populist, often nativist agenda to electorates disgruntled with economic stagnation and rapid demographic change has been underestimated in recent years, not least by bond markets. Nonetheless, the performance of Italy's credit spreads over the summer suggests investors are reluctant to wholly embrace political risk aversion.

Five-year CDS spreads did indeed widen sharply when the Five Star/Lega coalition was voted in earlier this year, moving from a 100bps level pre-election to over 284bps in the following weeks. Since then they have been trading in the 200-260bps range, with a marked tightening in September. This was probably attributable to soothing words from finance minister Tria that the 2019 budget deficit would be limited to 2%. The government promised some expensive tax and spending commitments, so Tria's statements were reassuring to the market. Italy's debt burden – currently around 130% of GDP – weighs heavily on the sovereign's credit standing.

So it was concerning that the Luigi Di Maio and Matteo Salvini, the respective leaders of the governing coalition parties, are reportedly pushing for a wider deficit. They are no doubt trying to balance their commitments to their voters with the demands for prudence from the EU. At the time of writing this apparent conflict was unresolved, adding more uncertainty to Italy's outlook.

This might be expected to cause significant spread widening, and there was some pressure on the sovereign and Italy's banks earlier in the day. But by the end of the session Italy was back trading at 220bps, just 5bps wider. Was this evidence of yet more complacency? Perhaps, but maybe it was a reflection of the relatively minor difference between the government members. It is also possible that a compromise could be reached that would also keep the EU content and head off a damaging confrontation.

We will no doubt see more volatility in Italy's spreads until the budget is fully resolved. But the other peripheral eurozone sovereigns have been relatively immune to the headlines, unlike previous periods of heightened political risk. Spain and Portugal are both trading tighter than Q1 2016 levels, when concerns around Dutch and French elections caused some modest contagion. Italy, on the other hand, is trading around 100bps wider. The bulwark protecting the euro constructed by the EU in 2012 is holding firm, for now.

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