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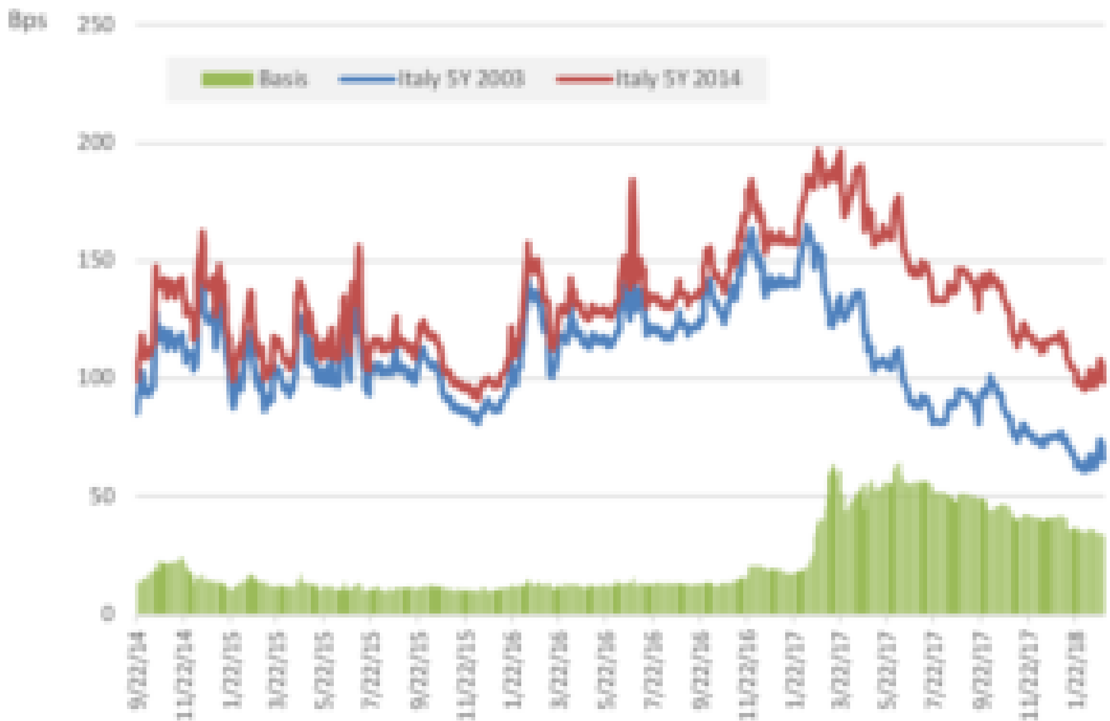
Markit Recap – 2/26/2018

THE LEAD | March 1, 2018

Italy election – markets are sanguine



We noted at the end of last year that the coming 12 months would probably be low on political risk, at least in comparison to the election-packed 2017. The one highlight in Europe would be Italy's general election, unless talks on a Brexit transition unravel spectacularly.

So here we are, days before the Italian public cast their vote on March 4, and it seems that markets are sanguine about the result. We have certainly seen volatility in recent weeks but this wasn't caused by concern over Italy.

This should be no surprise. European credit investors are all too familiar with Italy's capricious political system – a change of regime is unlikely to trigger wild oscillations in spreads. After all, Italy has had over 60 governments since World War II.

Nonetheless, Italy is a core eurozone member and the result clearly can't be ignored. Polls indicate that no party or coalition – the new electoral system incentivizes the latter – will win the necessary number of votes. In other words, there will be a hung parliament. The coalition that has the best chance of getting a majority is led by Silvio Berlusconi, an unappetizing, but familiar prospect for most.

What does the CDS market tell us about this outlook? There is little evidence of contagion, though markets remain jumpy. The Markit iTraxx Europe – the primary hedging tool for investors – has traded in the 51-57bps range since the sharp move wider early in February. This is 11-17bps wider than where it started the year.

This is in stark contrast to Italy's single name CDS, which is 18 bps or 10bps tighter over the same period for the 2014 and 2003 contracts respectively. Volumes are high and clearing house data shows that open interest has increased significantly. Italy is one of the most liquid names in the CDS universe, so heavy volumes aren't unusual. But there is little doubt that the election has piqued interest.

The 2014 contract explicitly provides for denomination risk from a country leaving the euro, and this risk helps explain why the 2014 spread is wider than the 2003 equivalent. But the basis has contracted in recent weeks, suggesting that the markets see this risk as declining (though still elevated from the pre-election period last year). This is despite the presence of the euroskeptic Northern League in Berlusconi's coalition. Perhaps the markets are discounting the coalition winning a majority, or that the Northern league will moderate its rhetoric as it gets a scent of power (as the Five Star Movement did recently). If the risk of an anti-euro party gaining power has been underpriced by the market, then we can expect 2014/2003 basis to widen. But if the hung parliament, muddling along scenario that is all too familiar from past Italian elections arises, then we will be in a state of stasis. Meanwhile Italy's spiraling, debilitating public debt – 130% of GDP – goes unaddressed.

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