Macro Keys

Political risk back in focus: long 10yr Spain vs Italy

Global Macro Strategy

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Lefteris Farmakis
Strategist
lefteris.farmakis@ubs.com
+44-20-7568 8305

Nishay Patel, CFA
Strategist
nishay.patel@ubs.com
+44-20-7568 8298

Jeremy Chalder, CFA
Strategist
jeremy.chalder@ubs.com
+44-20-7567 1223

Themos Fiotakis
Strategist
themos.fiotakis@ubs.com
+44-20-7567 7215

Daniel Waldman
Strategist
daniel.waldman@ubs.com
+1-203-719 4281

SPGBs and BTPs have been trading fairly closely for a few years now…

Spanish and Italian government bonds have been trading fairly closely over the last few years. This is due to a similar assessment by the market regarding the overall creditworthiness of the respective sovereigns, albeit due to different reasons for each one.

…with residual differences likely reflecting perceived political risk

Perceived political risk has likely accounted for residual differences in market pricing during most of the time since 2013. Such differences, however, have generally been fairly modest.

We think the market is now mispricing political risk facing the two countries

This, however, may well change in the coming months. In our view, the market is currently mispricing political risk facing the two countries until the end of the year.

The Italian referendum in November is a significant risk to political stability

The upcoming referendum on Constitutional reform expected to take place in November has the potential to reintroduce the spectre of political uncertainty in Italy. Polling evidence regarding the referendum outcome is inconclusive at a time that the anti-establishment 5-Star Movement has become a serious challenger to the ruling PD.

A number of options are available to resolve the Spanish political impasse…

On the contrary, in Spain a number of options are available to resolve the political impasse there. These are: 1) a pact between PP and PSOE for the formation of a grand coalition (or a minority PP-led government supported by PSOE); 2) a wider PP-led coalition with support from the smaller parties in Parliament; and finally, option 3) is early elections.

… which are all fairly benign for markets

Importantly, all these options should be fairly benign for markets. The only scenario that is not discounted, in our view, is one where PSOE forms a left-wing coalition. However, the June elections outcome has increased the difficulty of this task.

Enter long positions in 10yr Spain vs Italy

In light of the above we prefer Spain over Italy and envisage the 10yr spread tightening from the current level of -15bp to -35bp within the next 3 months. Separately, investors looking to express bearish positions in Italy may also wish to consider selling 10yr Italy vs US Treasuries above 35bp (targeting a move to zero), while we also see value in being short 10yr Italy on an outright basis (with a tight stop).

10yr Spain vs Italy: similar spread, different risks

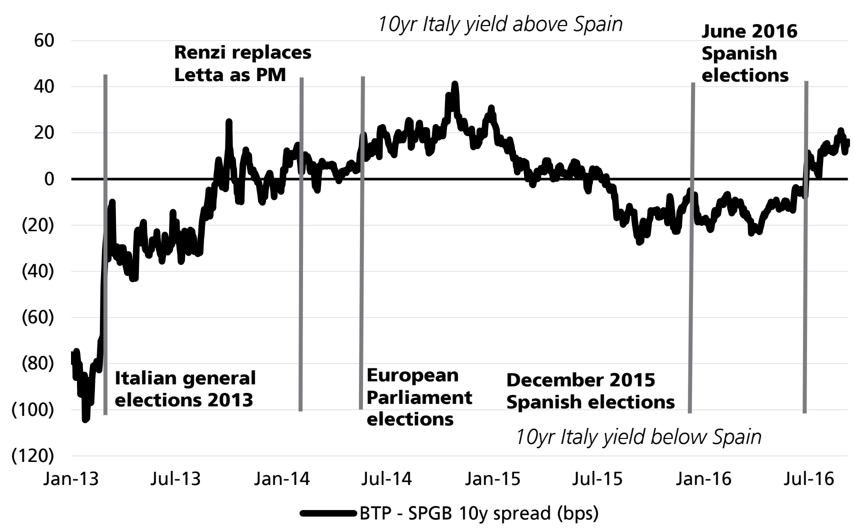
Spanish and Italian government bonds have been trading fairly closely for the better part of the last few years. From the standpoint of fundamentals the two countries have been viewed as quasi-equivalent in terms of creditworthiness, albeit for different reasons. Since the Eurozone sovereign debt crisis, Italy is characterised by a slow economic recovery, high public sector indebtedness and a strong fiscal position. On the contrary, Spain's recovery is considerably faster, yet public sector indebtedness is also high (albeit lower than Italy's) and its fiscal position considerably worse. Similar credit ratings match the market's assessment that the different pros and cons of the two countries on balance yield a fairly similar credit profile.

Perceived political risk has all too frequently accounted for residual differences in market pricing during the post-crisis period. First in 2013 when Italian political turmoil forced the realignment of the spread of the two countries and subsequent SPGB outperformance; then from late 2014/early 2015 following Matteo Renzi's consolidation in power and Podemos' rise in Spain, which led to a protracted period of BTP outperformance until the last Spanish elections three months ago; and, finally, since the June elections, which produced a marked shift to the right via PP's better-than-expected electoral performance, leading to renewed SPGB outperformance (Figure 1).

Those shifts in pricing, however, have generally been fairly modest. At no point during the last three years has the 10y SPGB vs BTP spread surpassed 40 bps in either direction, while most of the time the range has been +/- 20bps.

This, however, may well change in the coming months. Visibly stronger Spanish fundamentals are one possible source of divergence over the medium-to-long term. In the shorter-term, however, attention is likely to shift yet again to relative political risks.

Figure 1: 10y BTPs have traded within a fairly tight range vs SPGBs since 2013



Source: UBS, Bloomberg

Politics and its market pricing back into focus

In our view, the market is currently mispricing political risk facing the two countries until the end of the year. Indeed, the political predicament Italy faces could well turn out to be far deeper than Spain's own.

The Italian referendum: a formidable challenge for PM Renzi

As we have explained elsewhere, the upcoming referendum on Constitutional reform in Italy, which is expected to take place in November, has the potential to reintroduce the spectre of political uncertainty in Italy after a long period of calmness. This is because PM Matteo Renzi has explicitly linked his job as PM with the constitutional reform being approved by the electorate at a time that the picture regarding the outcome is very fuzzy.

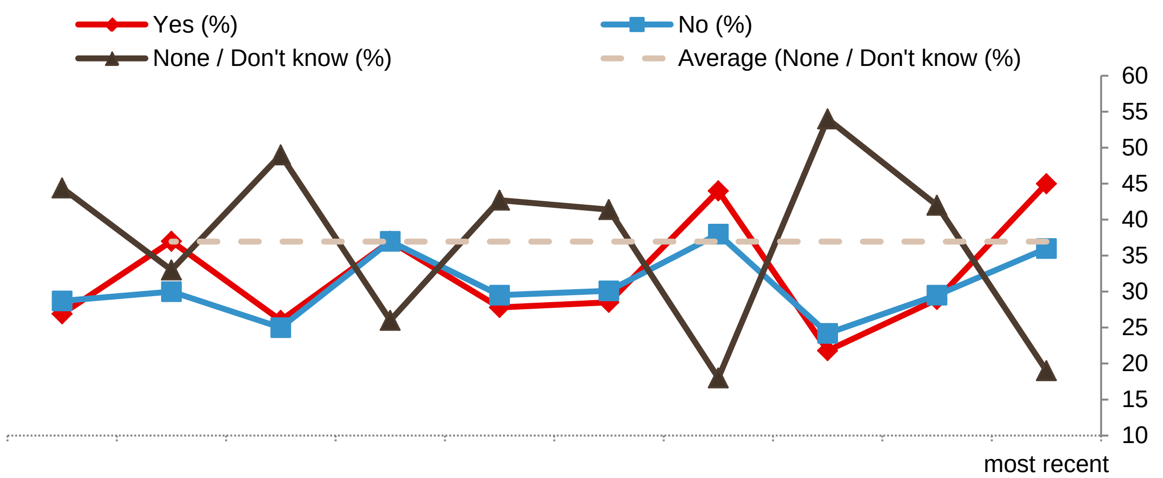
Although it is still early to have concrete evidence of the likely outcome of the referendum given the very large share of undecided voters, the latest set of opinion polls point to a close outcome (Figure 2). And while if Mr Renzi were to resign, it would not by itself lead to new elections (in fact Mr Renzi himself has indicated that a new government would be formed by the current Parliament), a defeat for him would arguably raise the probability of new elections.

What is worse, this would happen at a time when the anti-establishment 5-Star Movement is neck-to-neck with PD in recent polls (Figure 3), with a serious chance of winning the next elections. Indeed, most recent polls indicate that the 5-Star Movement would prevail over PD in the second round of voting (as prescribed by the new Italian electoral law – known as *Italicum* – in the event no party manages to muster more than 40% of the vote in the first round (Figure 4)).

Spanish politics: a number of scenarios, almost all benign for markets

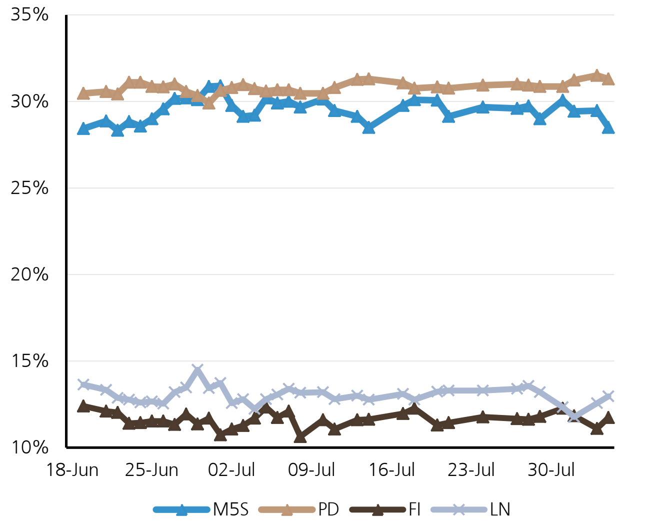
Spain too has been in political limbo for some time now, as the formation of a new government is still in the air even after two back-to-back elections. Spanish acting PM Mariano Rajoy failed to win the Parliament's confidence in the two votes held last week. Failure to win the first of those votes set the clock ticking towards the two-month deadline for the formation of a new government. Should this prove impossible, early elections will have to be called for a third time in a year (likely on 18 December according to El Pais).

Figure 2: Polls on the 2016 Italian referendum (last ten) indicate a large amount of undecided voters



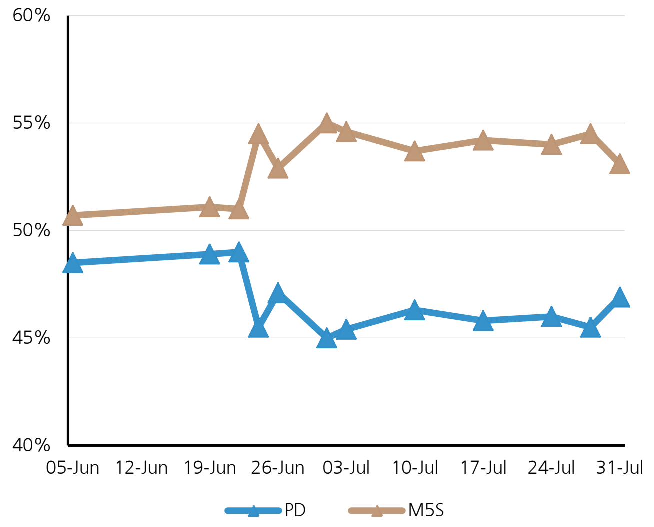
Source: UBS Research, various polling agencies (EMG Acqua, IPR Marketing, Euromedia Research, Istituto Ixe, Demos&Pi, Ipsos SRL

Figure 3: Polls for the next Italian election suggest a tight race between PD and the 5 Star Movement (M5S)…



Source: UBS, EMG, Scenari Politici, Demopolis, Ixe, SWG, Piepoli, Euromedia.

Figure 4: … with the latter having the upper hand in voting intentions for the second round



Source: UBS, EMG, Scenari Politici, Demopolis

There are, nonetheless, important differences between the two cases that suggest markets are under-pricing political risk in Italy vs Spain.

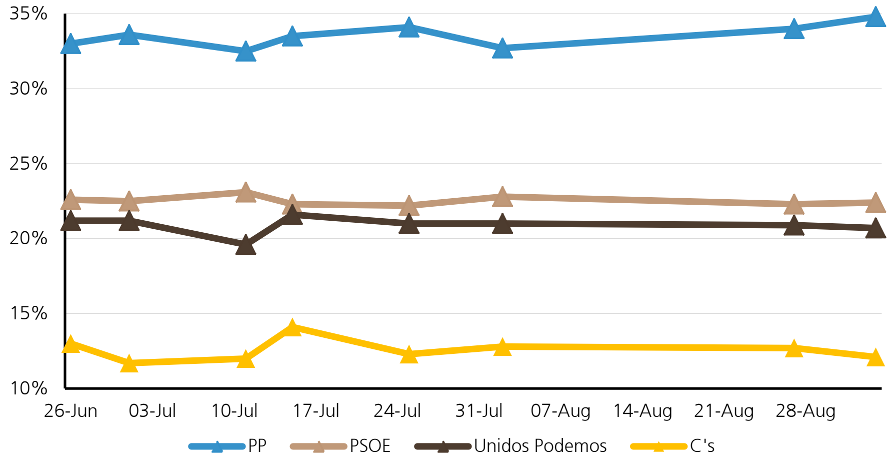
First of all, Mr Rajoy's failure to win the Parliament's confidence was expected. Arithmetically, it was already known that Mr Rajoy needed the support of major opposition party PSOE or, alternatively, a number of smaller parties to reach the requisite number for majority (176 MPs). Given the well-publicised refusal of PSOE leader Mr Pedro Sanchez to support Mr Rajoy's candidacy and the practical difficulties in Mr Rajoy receiving the support of a large number of other parties, the outcome of the votes was more or less pre-determined. In the end, Mr Rajoy was supported by centrist Ciudadanos and the Canarian Coalition, mustering 170 MPs (6 short of majority – Figure 5).

Figure 5: Parliamentary seat distribution after the December 2015 and June 2016 elections

Party	Seats	
	2015	**2016**
PP - Partido Popular *(centre-right)*	123	137
PSOE - Partido Socialista Obrero Español *(centre-left)*	90	85
Unidos Podemos *(left-wing)*	69	71
C's - Ciudadanos *(centrist)*	40	32
IU–UPeC - United Left–Popular Unity in Common *(left-wing)*	2	w. Podemos
ERC - Republican Left of Catalonia *(left-wing separatist)*	9	9
CDC - Democratic Convergence of Catalonia *(centrist, separatist)*	8	-
PDC - Catalan Democratic Party *(centrist, separatist, successor to CDC)*	-	8
EAJ/PNV - Basque Nationalist Party *(centre-right, nationalist)*	6	5
EH Bildu - Basque Country Unite *(left-wing, separatist)*	2	2
CC - Canarian Coalition *(centrist, nationalist)*	1	1
Total	**350**	**350**
PP + C + CC		*170*

Source: UBS

Figure 6: Opinion polls since the June elections favour PP



Source: UBS, NC Report, Celeste-Tel, JM & Associados, Simple Logica, CIS, Invymark

Secondly, as we have discussed before June's elections have left Spain with three realistic possibilities. These are: 1) a grand coalition between PP and PSOE (or, more likely, a minority government led by PP with PSOE's tolerance); 2) a PP-led government in coalition with a number of the smaller parties in Parliament; and, finally, 3) early elections.

Importantly, all three scenarios should be fairly benign for markets. The grand coalition option because it offers the best conditions for stability and consensus; the PP-led wider coalition because it solves the problem of governability, at least in the short-term. And, lastly, even if snap elections are called again, the market may well remain relatively unfazed, at least as long as polls point to further gains for PP vs its rivals (as per current preliminary polling evidence – Figure 6).

The only scenario that is arithmetically possible and we think is not priced in is one where PSOE forms a left-wing coalition with Unidos Podemos plus some other smaller parties. However, as we have already explained in some detail, the June elections outcome has increased the difficulty of this task.

In fact, one should not even rush to exclude the potential for a grand coalition (or PP-led minority government based on a pact with PSOE). If PP gains even more in the event of a snap election, as polls currently indicate, while PSOE risks yet another disappointing performance, then the path of least resistance may well be a decision by PSOE to cross the Rubicon and support a PP-led government. Hence, a positive surprise for markets should by no means be considered impossible.

How to position

The macro backdrop continues to remain favourable for selective periphery exposure. **In light of the above we prefer Spain over Italy and envisage the 10yr spread tightening from the current level of -15bp to -35bp within the next 3 months.** Setting a stop at -5bp makes the risk-reward of being long 10yr Spain vs Italy attractive. To be clear, we are not tempted to be long Spain on an outright basis as the anticipated rise in core euro area yields over the balance of the year could put some upward pressure on 10yr Spanish yields. Instead, we prefer having exposure to Spain on a spread basis.

Separately, investors looking to express bearish positions in Italy may also wish to consider selling 10yr Italy vs US Treasuries above 35bp (targeting a move to zero). We also see value in being short 10yr Italy on an outright basis (with a tight stop).

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