The Markets & Italian Politics

• Talk is building of a fresh election in Italy
• This speculation has been accompanied by talk of a "fiscal shock" of tax cuts
• The market has yet to respond. However, this doesn't mean it won't

One of the key stories for the EUR over the past 18 months has been changing political landscape in Italy. With fresh noise emerging in recent days it’s worth considering recent developments and what they might indicate.

One of the defining political stories for Italy last year was the rise in popularity of the hard right Lega in the polls during the period from the election in March through until mid-October.

Over this period, the party moved from polling under 20% to regularly achieving scores in the mid-thirties while, in contrast, support for its coalition partner, M5S, fell from close to 40% to the mid-twenties.

It’s hard not to notice that the period that saw this rise in popularity coincided pretty exactly with the government’s battle with Brussels over its proposed budget for 2019, and that momentum faded as an agreement of sorts was reached.

One of the defining political

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Newswatch

1. US/Mexico: President Donald Trump says in a statement that US customs officials will begin imposing duties of 5% on Mexican imports from June 10. These tariffs will rise in stages to as much as 25% by October 1, where it will stay “until the Illegal Immigration problem is
Stories for Italy last year was the rise in popularity of the hard right Lega

Events this week seemed to fit with this narrative. With the EU parliamentary elections largely confirming what the opinion polls had been saying, there seemed a good chance that party leader Matteo Salvini would be emboldened to press for new elections this year.

While he currently insists that he is not in favor of a snap election (according to a Reuters report), the mood music is that one is coming, possibly before the end of September.

It therefore made sense that in the aftermath of the EU elections Mr Salvini called for a “fiscal shock” of tax cuts.

Equally inevitably (and probably to the delight of the party’s political strategists) the European Commission has sent a letter this week to the Italian government asking for explanations about the deterioration of Italy’s public finances.

This is a procedural step that could pave the way for the launching of disciplinary steps against Rome next week (the Italian government must reply to the letter by the end of this week).

Last year it took a surprisingly long time for the market to respond to the developing political uncertainty in Italy

This is straightforward enough. However, what was interesting has been the market’s relative lack of interest in the story with the two, five and 10-year Bund/BTP yield spreads failing to move out beyond the levels reached in February.

Similarly, our iFlow data show little sign of outflows developing from the local market (see chart).

Remedied".

2.

US/Mexico: Mexican deputy foreign minister Jesus Seade said that he was unaware this would happen and that the tariffs would be "disastrous". Seade added, “If this is put in place, we must respond vigorously”.

3.

China/US: Bloomberg (citing “people familiar with the matter”) says that “Beijing has readied a plan to restrict exports of rare earths to the U.S. if needed”.

4.

China: The NBS manufacturing PMI for May drops to 49.4 from 50.1 in April. (Reuters consensus forecast 49.9)

5.

Japan: Industrial production rose by 0.6% m/m in April following a 0.6% m/m drop in March (Reuters consensus forecast 0.2% m/m)

On the
There are two possible explanations for this. The first is that in a broad environment of risk aversion, investors are seeking the security of sovereign debt in a wide range of markets. With Bund yields hovering near record lows, Italy might seem a sensible alternative.

The alternative explanation may prove just as valid. Last year it was noticeable that it took a surprisingly long time for the market to respond to the developing political uncertainty in Italy.

While it was clear from early March that there was a chance of a M5S/Lega coalition forming, the market didn’t respond until late April.

With so much else to distract attention at present, it’s perfectly possible that this is happening again.

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