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R&R Weekly Column
By Brunello Rosa

Italy's Government Puzzle About to Be Solved (One Way or the Other)

After more than two months after March 4th general election, Italy's government puzzle is likely to be solved in the next 2-3 days, although we still don't know the exact details. Until a week ago, it seems that Italy was destined to have a politically "neutral" government, led by a technocrat appointed by President Mattarella, to take the country to new elections in July or September 2018, or – at the latest – March/May 2019. This government would have run as a minority government, with or without a confidence vote from parliament (in the latter case, it would have been only in charge of current affairs). Parties in parliament got scared of a possible election at the end of July, when the collapse in turnout would likely imply a random result, and an assured punishment to those parties that were unable to find a compromise for months. At that point, Five Stars and League took the lead – with the benevolent consent of Berlusconi's Forza Italia – and started negotiations (which are still ongoing) to form a government between the two. In theory, this Five Stars - League coalition government (which we discussed in our comment after the elections) could count on a relatively solid majority in the Chamber, and a quite thin majority in the Senate. At this point, there are two main possibilities: 1) *Less likely* - M5S and Lega do not succeed in finding a compromise, especially on the name of the prime minister, acceptable to Mattarella. This would mean the failure of any attempt to form a political government, and the return of the "neutral" government option on the table, which would likely be formed this week, with new elections likely to occur relatively soon; 2) *More likely* - M5S and Lega do succeed in finding a compromise, especially on the name of the prime minister, a "third" figure between Matteo Salvini and Luigi Di Maio – both likely to be part of the government team (possibly as Interior and Foreign minister, respectively).

So, by the end of this week Italy is likely to have a new government, one way or the other. A few considerations: *First*, a "neutral" technocratic government is better than the current situation, in which Gentiloni's administration (however good it might be in people's opinion) is expression of the past parliament, with no political legitimacy (and in fact only in charge of current affairs) and unable to make politically binding decision. Also, technocratic governments have often represented a good solution in difficult political and economic transition periods. However, we would be inclined to think that, in this case, even a weak political government would be preferable to a technocratic solution, which would be unlikely to find the necessary legitimacy in parliament and the country to make politically strong and binding decisions such as those the country needs to face in coming months (starting with the June EU Council meeting). *Second*, a M5S-Lega government would face a number of obstacles to succeed, including: a) unless Salvini and Di Maio agree that one of them becomes PM (or possibly both, in succession), the "third figure" would be subject to continued and opposed political pressures from both side; b) the "government contract," instead of being the "intersection" between Lega and M5S's respective programs, seems to be the "union;" so, for example, both the "citizenship income" and the "flat tax" are there, not to mention various forms of reduction/abolition of the pension reform approved by Monti in 2011. This means that implementing this program would likely imply a severe deviation from Italy's fiscal consolidation program, likely resulting in a clash with markets and the EU at some point; c) Salvini – as still being formally part of the centre-right coalition – will tend to remain more loyal to that coalition than to that with Di Maio's Five Stars. Given this background, we reiterate what we said in our latest Italy trip report. While in the short run we believe the country has the means to muddle through, without clashing excessively with the EU and the markets, in the medium term (especially once the ECB's umbrella will be diminished), its structural fragility will likely re-emerge.

Our Recent Publications:

BOE Stays on Hold and Remains Data Dependent
By Brunello Rosa, 10 May 2018

The Week Ahead

US - April retail sales are expected to slow down (*c:* 0.4% y-o-y; *p:* 0.6%).

***The second round of Sino-US trade negotiations is due next week, but could be postponed*.** Talks might be delayed because of: *a)* continuing rifts in the Trump administration; *b)* unfinished preparatory discussions; and *c)* mounting pressure from the US business community, worried about a trade war.

EZ - Both growth (GDP Q1, *c:* 2.5% y-o-y; *p:* 2.5% y-o-y), ***and inflation*** are expected to remain stable (CPI, April, *c:* 1.2% y-o-y; *p:* 1.2%).

The Quarter Ahead

***US - The Fed will likely increase its policy rate*.** The market-implied likelihood of a 25-bps hike at the June 12-13 FOMC meeting remain unchanged at 100%, while the likelihood of *"at least three"* and *"at least four"* hikes in 2018 are at 90% (*pw:* 86%) and 46% (*pw:* 38%), respectively (CME).

***Europe - Italian "populist" parties are close to forming a government*.** The anti-establishment M5S and the far-right League moved closer to forming a government. The yield on Italy's 10-y bond rose to a six-week high of 1.87%, reflecting mounting investor jitters.

EMs - Equities and currencies are under pressure. EM equity funds suffered their worst outflows in nearly a year. JPMorgan's EM currency index is down ~4% since April 1st. The Argentinian peso continued to slide (USD/ARS rose by 6.2% w-o-w) in spite of the ~12.75 pps increase in the policy rate (to 40%) in the previous two weeks. The government's request of IMF support is likely to cause social tensions.

Turkey- Remains vulnerable, given that 56% of its debt is denominated in foreign currencies (second only to Argentina at 64%). The TRY depreciated by 2.1% w-o-w to USD/TRY 4.32. The CBT intervened announcing new measures to support the TRY.

Rising risks threaten growth and increase demand for safe haven assets. Rising uncertainty could result in: *a)* the postponement of economic activities, putting global growth under strain; and *b)* rising demand for safe haven assets (by year-end, analysts expect an increase of 12% in the spot price of gold to around 1,480 USD/oz.).

***Iran - Further sanctions are probable*.** Sanctions could be extended from the energy and banking sectors to others. An alternative deal with the US is unlikely and the risk of Iran resuming the development of nuclear weapons has risen. The risk of military conflict between Israel and Iran or Hezbollah—strengthened after the Lebanese May 6 election—also rose this week.

Oil prices will remain above 70 USD/bbl during the next quarter, supported by constrained supply. By 2019, Iranian oil exports could decline by 0.5mb/d. Brent prices rose 2.8% w-o-w to 77.1 USD/bbl and the analysts' 2018 average price forecast rose to 68 USD/bbl.

Last Week's Review

US - On Tuesday May 8th, the country pulled out of the Iranian nuclear deal*,** announcing the re-imposition of the nuclear ban and "the highest level of economic sanctions" on Iran, which will be reinstated by the end of a six-month "wind-down" period. ***US March CPI rose in line with expectations (*a:* 2.5% y-o-y; *c:* 2.5%; *p:* 2.4%), while core CPI remained stable at 2.1% (*c:* 1.9%; *p:* 2.1%), keeping the Fed on its path of gradual monetary policy tightening. ***Earnings remain on track to reach an eight-year record*.** With data on 89% of the S&P500 firms, 78% have reported a positive EPS surprise, with a blended earnings growth rate of 24.5%, the highest since Q3 2010.

US Markets - Stock markets reacted with gains*.** The S&P500 rose by 2.4% w-o-w—best week in two months— driven by energy and financial stocks, due to benefit from rising oil prices and interest rates. Volatility decreased to 12.6 (-2.2 points w-o-w). ***The 10-y UST yield rose by 2 bps w-o-w to 2.97%. The ***USD was flat*** against: *a)* a basket of currencies (DXY down by 0.1% w-o-w); and *b)* the EUR (EUR/USD unchanged w-o-w at 1.195).

UK - The BoE kept its policy rate on hold (*a:* 0.50%; *c:* 0.50%; *p:* 0.50%) to support economic activity in the second half of the year. The GBP remained flat w-o-w at GBP/USD 1.354.

Iraq - held parliamentary elections. Polls do not show a clear outcome. Preliminary results will be published on Monday 14th.

Pablo Gallego Cuervo *and* ***Renata Bossini*** *contributed to this Viewsletter.*

The picture in the front page comes from this website

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Abbreviations, Acronyms and Definitions

a	*Actual*
AKP	*Justice and Development Party*
ann.	*annualized*
ARS	*Argentinian Peso*
bn	*Billion*
BCB	*Central Bank of Brazil*
BoC	*Bank of Canada*
BoE	*Bank of England*
BoJ	*Bank of Japan*
bpd	*Barrels per day*
bps	*Basis points*
c	*Consensus*
C/A	*Current account*
CB	*Central bank*
CBK	*Central Bank of Kuwait*
CBO	*US Congressional Budget Office*
CBR	*Central Bank of Russia*
CBT	*Central Bank of the Republic of Turkey*
CDU	*Christian Democratic Union of Germany*
CNY	*Chinese Yuan*
CBT	*Central Bank of the Republic of Turkey*
CPI	*Consumer Price Index*
DJIA	*Dow Jones Industrial Average Index*
d-o-d	*Day-on-day*
DXY	*US Dollar Index*
EC	*European Council*
ECB	*European Central Bank*
EIA	*US Energy Information Agency*
EM	*Emerging Markets*
EP	*European Parliament*
EPS	*Earnings per share*
EU	*European Union*
EUR	*Euro*
EZ	*Eurozone*
Fed	*US Federal Reserve*
FM	*Future Movement*
FOMC	*US Federal Open Market Committee*
FRB	*US Federal Reserve Board*
FX	*Foreign exchange*
FY	*Fiscal Year*
GCC	*Gulf Cooperation Council*
GBP	*British pound*
GDP	*Gross domestic product*
GOP	*Grand Old Party (US Republican Party)*
IMF	*International Monetary Fund*
INR	*Indian Rupee*
IPO	*Initial public offering*
IS	*Islamic State*
JPY	*Japanese yen*
k	*thousand*
KRG	*Kurdistan Regional Government*
KSA	*Kingdom of Saudi Arabia*
LN	*Northern League*
M5S	*Five Star Movement*
m-o-m	*Month-on-month*
mb	*Million barrels*
mb/d	*Million barrels per day*
MENA	*Middle East and North Africa*
MHP	*Nationalist Movement Party*
mn	*Million*
MPM	*Monetary Policy Meeting*
NAFTA	*North-American Free Trade Agreement*
OECD	*The Organization for Economic Cooperation and Development*
Opec	*Organization of Petroleum Exporting Countries*
p	*Previous*
pw	*Previous week*
PCE	*Personal Consumption Expenditures*
PE	*Price to earnings ratio*
PM	*Prime minister*
PMI	*Purchasing managers' index*
pps	*Percentage points*
QCB	*Qatar Central Bank*
QAR	*Qatari Riyal*
QE	*Quantitative easing*
q-o-q	*Quarter-on-quarter*
RBA	*Reserve Bank of Australia*
REER	*Real Effective Exchange Rate*
RUB	*Russian Rouble*
tb/d	*Thousand barrels per day*
tn	*Trillion*
TPP	*Trans Pacific Partnership*
TRY	*Turkish Lira*
UAE	*United Arab Emirates*
UK	*United Kingdom*
US	*United States*
USD	*United States Dollar*
USD/bbl.	*USD per barrel*
UST	*US Treasury bills/bonds*
VAT	*Value added tax*
VIX	*Chicago Board Options Exchange Volatility Index*
WTI	*West Texas Intermediate*
w-o-w	*Week-on-week*
y-o-y	*Year-on-year*
y-t-d	*Year-to-date*
ZAR	*South African Rand*
10-y	*10 year*
ZEW	*Centre for European Economic Research*