Weekly Update

C0 | EXTERNAL PUBLICATION

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In sospeso – Italy's elections

Italy's parliamentary elections on March 4 will be closely followed across the continent. Among Europe's major capitals, only Paris is enjoying clear majority rule. Angela Merkel has still to form a working coalition, five months after the Germany's Federal elections. In Spain, Mariano Rajoy only leads a minority government. In the UK, Theresa May was forced into coalition with Northern Ireland's unionists after last June's inconclusive snap election. What does the Italian election hold?

Next month's elections will be the first under the Italy's new electoral law, known as the Rosatellum. In both houses – the Chamber and the Senate – around 37% of new members will be chosen in first-past-the-post contests, the remainder under proportional representation. In order to encourage the formation of coalitions and more stable governments, the new law has abolished the previous system of bonus seats given to the largest party.

Under Rosatellum, it is estimated that a coalition would need to reach at least 40% of all votes cast in order to form a government. However, the left-hand chart below shows that this is unlikely – the centre-right is closest to this threshold, but has rarely exceeded it in recent polls. What are the likely scenarios?

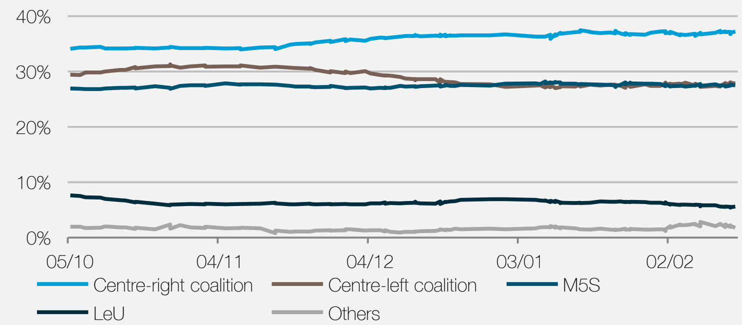
1. A grand coalition. If neither coalition can form a government, we would expect an attempt to form a grand coalition, most likely led by the Forza Italia (FI – centre right) with support from the Partito Democratico (PD – centre left) and perhaps the Lega Nord (LN – populist right) or even the Movimento 5 Stelle (M5S – populist centre). Such a grouping would be likely to converge to a broadly pro-EU stance as the parties seek the middle ground, providing a measure of continuity with Italy's current PD government.
2. A majority centre-right government. This would be led by FI, with support from the LN and some smaller parties. A more EU-sceptic stance would ensue but, with a slim majority of Italians still in favour of the EU and of keeping the euro, "Italexit" would not be imminent.
3. A minority government. Italy's "perfect bicameralism" makes this difficult to implement. All laws must be approved by both houses – a recipe for stasis without a working majority.
4. New elections. In our view, no party or coalition is gaining sufficient momentum to risk prolonging uncertainty by pushing for fresh elections. However, there may be no viable alternative if other avenues peter out.

Economic backdrop. Despite well-known structural weaknesses – most notably, public debt and demographic decline – Italy has experienced a cyclical recovery on the coat-tails of global growth. In addition, progress made last year in dealing with weaknesses in the banking system – bailouts of two Veneto banks and Monte dei Paschi – has restored investor confidence, as witnessed by the rally in bank credit default swaps.

Bottom line. To date, financial markets have remained sanguine in the run-up to the elections. The MSCI Italy index has outperformed the MSCI EMU by 11.4% over the past year. While the outcome of the election remains highly uncertain, it seems unlikely to undermine the economic recovery in Italy.

No clear majority ahead of the elections

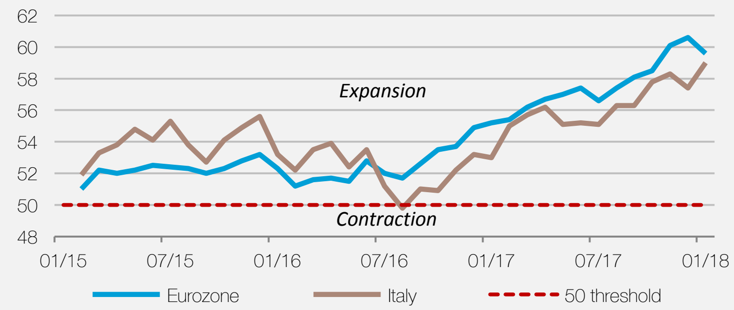
Poll of polls



Sources: SGPB, Wikipedia, 22/02/2018

Improving Italy still lags eurozone

Manufacturing PMI



Sources: SGPB, Bloomberg, 31/01/2018

This week and next

EUROZONE

- Consumer confidence declined slightly from 1.3 to 0.1 in February but remained close to its 18-year high.
- Manufacturing purchasing manager confidence fell for the second consecutive month printing to 58.5 in February – still well above the 50 threshold signalling expansion – after having reached a three-year high in December.
- Overall, both consumer and business confidence indicators still bode well for the eurozone activity in coming months.

Next week's key events		Per.	Prev.	Cons.
27 Feb	EC survey - Economic confidence	Feb	114.7	--
28 Feb	CPI estimate YoY	Feb	1.3%	--
01 Mar	Unemployment rate	Jan	8.7%	--

UNITED KINGDOM

- After five months at 4.3%, UK saw its unemployment rate edge up to 4.4% in December.
- Real GDP grew 0.4% QoQ in Q4 2017, revised down from the first estimate of 0.5%. The British economy has seen a gradual slowing in growth over the past three years, from 3.3% YoY in Q4 2014 to 1.4% YoY in Q4 2017, on sluggish business investment and weaker domestic demand.

Next week's key events		Per.	Prev.	Cons.
28 Feb	Gfk Consumer confidence	Feb	-9	-10
01 Mar	Manufacturing PMI	Feb	55.3	55.2

UNITED STATES

- Contrary to expectations, the preliminary manufacturing PMI for February was up to 55.9 from 55.5 the previous month. At the same time, PMI in services rebounded to 55.9 after six months of slowdown.
- Existing home sales unexpected declined 3.2% MoM in January for the second month in a row.
- Weekly initial jobless claims continued their decline last week, from 230k to 222k.

Next week's key events		Per.	Prev.	Cons.
27 Feb	Conf Board consumer confidence	Feb	125.4	126.0
28 Feb	GDP QoQ ann. (second estimate)	Q4	3.2%	2.5%
03 Mar	ISM manufacturing confidence	Feb	59.1	58.6

ASIA & EMERGING COUNTRIES

- In Japan, export volumes increased 9.2% YoY in January, beating forecasts, while imports rose 2.6% YoY. Overall, the seasonally-adjusted trade balance remains in surplus: +¥373.3bn in January for the 27th consecutive month.
- Manufacturing confidence fell slightly in February, with preliminary Japanese PMI down from 54.8 to 54.

Next week's key events		Per.	Prev.	Cons.
28 Feb	Japan: Industrial production MoM	Jan	2.9%	-4.2%
01 Mar	China: Caixin manufacturing PMI	Feb	51.5	51.3

Sources: Datastream, Bloomberg, 23 February 2018, Note: YoY = year-on-year; QoQ = quarter-on-quarter; MoM = month-on-month, P = preliminary figure, A = advanced figure, F = final figure, seasonally adjusted, ECB = European Central Bank

Our 6-month targets

CURRENCIES & COMMODITIES

	Thursday close	6mth target
EUR/USD	1.23	1.25
GBP/USD	1.40	1.28
USD/RUB	56.4	60
AUD/USD	0.78	0.72
EUR/CHF	1.15	1.18
USD/CNY	6.35	7.1
USD/CAD	1.27	1.37
USD/JPY	107	118
Brent	$66.4	$55
Gold	$1329	$1225

No change to our 6-month targets this week.

Forecast figures are not a reliable indicator of future performance

Question time

Past performance should not been seen as a guarantee of future returns.

%

Emerging Market Equities
What is the outlook for Turkish and Brazilian equities?

The MSCI Turkey surged last year (+49% in local currency terms). The recovery in both domestic and external demand, combined with fiscal stimulus, resulted in a rebound in real GDP growth to 5.1% (IMF estimate) from 3.2% in 2016. Measures to extend guarantees on loans to businesses have driven strong credit growth, leading in turn to robust corporate profits due to the high weight of financials in the index (40% in the MSCI Turkey).

Looking ahead, the context appears less supportive for the equity market. With the impact of fiscal stimulus fading and rising economic imbalances, Turkish economic growth should moderate. The IMF forecasts that real GDP growth will slow to 3.5% this year. In addition, the Lira's depreciation has led to rising inflation – 11.9% YoY in December 2017 from 7% a year earlier – making it difficult for the central bank to cut rates if necessary to support economic activity.

With the 12-month forward P/E at 8x – a 10% discount compared to its 10-year median – valuation of the MSCI Turkey may appear attractive. However, external vulnerabilities due to widening current account deficit and ongoing political and geopolitical risks could justify valuations remaining low.

Overall, we are cautious on this equity market.

Conversely, the outlook for Brazilian equities seems more attractive. Strong export performance and gradual recovery in domestic demand allowed the economy to return to growth last year (+0.7% est., source IMF), after falling 3.6% in 2016. The IMF forecasts real GDP growth will accelerate to 1.5% in 2018 this year.

High excess capacity in the economy after two years of recession has helped inflation to fall sharply, from a peak at 10.7% YoY in January 2016 to 2.9% in January 2018, allowing the central bank to ease monetary policy, a support to the economy.

In addition, as a major commodity exporter, the Brazilian economy has benefited from the rebound in commodity prices over the past two years, as has the equity market.

Against this background, corporate profits have recovered over the past few years and are expected to continue to maintain robust growth this year: +15% according to the consensus of analysts after +19% in 2017 for the MSCI Brazil.

However, despite this positive macro and fundamental context, there are headwinds. Valuations of are not compelling, uncertainties remain about structural reforms and political risks are elevated.

Market performance

Past performance should not been seen as a guarantee of future returns.

Interest rates

Interest rates	Last	1wk		3mth	YTD	12mth
EONIA (EUR)	-37 bp	-1 bp	→	-1 bp	-2 bp	-1 bp
3mth Euribor (EUR)	-33 bp	0 bp	→	0 bp	0 bp	0 bp
3mth Libor (USD)	194 bp	7 bp	↑	48 bp	25 bp	89 bp
3mth Libor (GBP)	56 bp	2 bp	↑	4 bp	4 bp	21 bp
10-year US Treasury bond	292 bp	-1 bp	↓	60 bp	51 bp	50 bp
10-year German bond	65 bp	-6 bp	↓	30 bp	23 bp	38 bp
10-year French bond	86 bp	-2 bp	↓	32 bp	20 bp	-17 bp
10-year UK bond	156 bp	-10 bp	↓	24 bp	34 bp	37 bp

Credit

Credit	1wk		3mth	YTD	12mth
BAML EURO Corp. IG	0.2%	↑	-0.7 %	-0.4 %	1.6 %
BAML EURO Corp HY	0.1%	→	-0.5 %	-0.4 %	4.7 %
BAML GBP Corp IG	0.8%	↑	-0.7 %	-2.0 %	2.6 %
BAML US IG	-0.2%	↓	-2.2 %	-2.7 %	2.6 %
BAML US HY	0.2%	↑	-0.1 %	-0.5 %	4.3 %
JPM Global EM Sov. Plus	0.0%	→	-0.8 %	-2.0 %	6.6 %

Exchange rates

Exchange rates	Last	1wk		3mth	YTD	12mth
EUR/USD	1.23	-1.4 %	↓	4.3 %	2.7 %	16.8%
EUR/CHF	1.15	-0.3 %	↓	-0.9 %	-1.7 %	7.8%
GBP/USD	1.40	-1.0 %	↓	4.7 %	3.4 %	12.1%
USD/JPY	107	0.6 %	↑	-4.0 %	-5.2 %	-5.8%
USD/BRL	3.25	0.7 %	↑	0.8 %	-1.9 %	6.1%
USD/CNY	6.35	0.0 %	→	-3.9 %	-2.4 %	-7.7%
USD/RUB	56.4	0.1 %	→	-3.4 %	-2.1 %	-2.7%

Government bonds*

Government bonds*	1wk		3mth	YTD	12mth
United States (3-7yr)	0.0 %	→	-2.0 %	-1.6 %	-0.8 %
United Kingdom (3-7yr)	0.4 %	↑	-1.0 %	-1.2 %	-1.4 %
Germany (3-7yr)	0.2 %	↑	-1.3 %	-0.8 %	-2.2 %
Japan (3-7yr)	0.0 %	→	-0.2 %	0.0 %	-0.1 %

Equities*

Equities*	Last	1wk		3mth	YTD	12mth
MSCI AC World	518	-0.5 %	↓	3.8 %	1.3 %	19.1 %
Eurostoxx 50	3,432	1.3 %	↑	-3.3 %	-1.8 %	6.2 %
DAX	12,462	0.9 %	↑	-4.3 %	-3.5 %	3.9 %
CAC 40	5,309	1.7 %	↑	-0.6 %	0.0 %	11.9 %
S&P 500	2,704	-1.0 %	↓	4.6 %	1.4 %	16.7 %
FTSE 100	7,252	0.5 %	↑	-1.4 %	-5.0 %	3.5 %
SMI	8,967	0.6 %	↑	-3.5 %	-4.4 %	7.9 %
Topix	1,746	1.6 %	↑	-1.6 %	-3.9 %	14.5 %
IBOV Brazil	86,686	2.8 %	↑	16.3 %	13.5 %	26.4 %
MICEX Russia *	2,337	3.2 %	↑	8.2 %	10.8 %	10.9 %
MSCI EM	1,201	-0.1 %	→	4.3 %	3.9 %	29.5 %
SENSEX 30 India	33,820	-1.4 %	↓	0.9 %	0.1 %	18.7 %
Hang Seng (H-K)	30,966	-0.3 %	↓	3.5 %	3.7 %	33.1 %
Shanghaï Composite	3,269	2.2 %	↑	-4.7 %	-1.2 %	0.2 %

Commodities

Commodities	Last	1wk		3mth	YTD	12mth
Brent	\$66	4.1 %	↑	5.3 %	-0.4 %	19.0 %
Gold	\$1,329	-1.7 %	↓	3.1 %	2.0 %	7.8 %
Silver	\$16.6	-0.4 %	↓	-3.0 %	-2.2 %	-7.3 %

Source: Datastream, on 22 February 2018. 1wk = 1-week change, 3mth = 3-month change, 12mth = 12-month change, YTD = year-to-date change, YoY = year-on-year change, BAML = Bank of America Merrill Lynch, JPM = JP Morgan, IG = Investment Grade, EM = emerging markets. * Price return for MICEX equity index. Equities; total return in local currency. Government bonds = 3-7 year returns. Figures are rounded.

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