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ITALIAN REFERENDUM: NIKKO AM EUROPE FIXED INCOME COMMENTARY

Italy voted recently on the constitutional reforms proposed by Prime Minister Matteo Renzi's Democratic Party Government. The final results showed the 'No' vote win with almost 59.1% of the votes cast compared to 40.9% for the 'Yes' vote. The result matched what polls had predicated in the run up to Sunday's vote and a clear majority of the electorate voted against the proposed reforms. In the immediate aftermath of the result Renzi resigned in the early hours of Monday morning and the Euro has fallen to 20-month lows against the US Dollar, caused by the market uncertainty facing Italy and Europe.

Unlike the UK "Brexit" referendum, the referendum that took place on the planned reforms was mandatory. This was because the proposed piece of legislation failed to pass a 2/3 majority in the 2nd reading of both Houses of the Italian Parliament. The key element of the reforms was the abolition of "perfect bicameralism" which gives the Chamber of Deputies (Lower House) and the Senate of the Republic (Upper House) an equal standing in the eyes of Italian constitutional law. Under the existing system both the Chamber and the Senate have legislative powers and the government needs the approval of both Houses to pass proposed legislation in Parliament into Italian Law. In the past, differing composition of majorities of the houses led to lengthy mediation processes to approve new legislation. Renzi wanted to streamline the approval process for new legislation by increasing the constitutional rights of the Chamber and watering down those of the Senate. If the referendum had been successful, the constitutional reforms would have reduced the Senate to a small regional assembly with powers largely confined to a local level.

In the run up to the referendum, polls indicated that almost 1/3 of eligible voters were undecided. This gave Renzi hope that despite the lead of the "No" campaign he still might have the opportunity to gain enough backing to pass his reforms. Support in the actual referendum was weak among younger voters who had been frustrated about the persistent high youth unemployment rates of close to 40% during Renzi's premiership. The final result also saw southern regions of such as; Apulia (67.2%), Campania (68.5%) and Sicily (71.6%) all voted overwhelmingly against Renzi's reforms. It is also worth noting that Renzi had hoped to gain a lion share of the 4 million eligible Italian expat voters that could vote. However, with it being not a national election, the referendum attracted less interest expats and only 1.1 million voted which also helped to impact the final result.

The referendum went hand in hand with the electoral reform, "Italicum," which was not part of the referendum, as it had already gained approval by parliament. This proposed reform aimed to ensure that the winning party from the general election would be able to form a government with a clear majority in the Chamber. The finer details of the reform stated that if a single party were to have won the general election by more than 40% of the votes cast, it would receive 340 out of 630 seats in the Chamber. If no party were to have reached 40% in the first round, the two most voted parties would then enter into a second round and the winner would then receive 327 seats.

To help limit the influence of smaller parties in the Chamber, it was also proposed that if a party or coalition did not account for at least 3% of the total votes cast, they would not be permitted to hold a seat in the Chamber. Italicum had been heavily criticised before the referendum, as it would have granted significant power to the Prime Minister of the day. Even the left wing of Renzi's own party had been critical about the proposed new reform. Some parties had attempted to negotiate, by asking to amend features of Italicum in return for their support in the referendum. However, Renzi was only willing to do this after the vote took place. It is now very likely that after the success of the "No"-campaign, the government will need to amend Italicum, as it was only targeting the composition of the Chamber and not the Senate. The proposed reform was merely tailored to be in place in case of a positive outcome of the referendum (and even then it would have had to face a review from the Constitutional Court).

Before the referendum Renzi had linked his political career to the outcome. After the defeat he resigned immediately in the early hours of this morning. However, with still being the leader of the strongest party in parliament he is likely to have a say in the formation of a new government. Italy's Finance Minister Pier Carlo Padoan appears currently to be the front runner to become the next Prime Minister. The risk of a snap election appears low and the most likely solution for the near term future seems to be the formation of a "caretaker government", which will last until spring 2018, (when the next general election is due) with the main task of revising, Italicum. Nevertheless the risk of a snap election has increased given the margin of Renzi's defeat in the referendum.

Before the referendum the Italian fixed income markets were negatively impacted by the looming uncertainties of the result and Italian government bonds underperformed German Bund's over the last couple of months. Long dated Italian BTPS, maturing in 2026 have widening by approximately 79.2 bps QTD. In addition, the Italian stock market has declined this year by -19.5%, while the Euro Stoxx 50 index is only down 6.3%.

However, part of the underperformance was also caused by the Italian banking crisis. Monday's morning markets opened weaker, although they have already recovered quickly from very early lows. Yields of 10 year BTPs are up by 8.7bps to 1.98% and the stock market is up by 0.8%.

We expect Italian assets to underperform until it becomes clear who will be able to form and lead a new government and when the general election will likely take place. Nevertheless the outcome of the referendum was already priced into financial markets. Italian bonds and stocks since the middle of last week had started to recover, as valuation for both assets classes had become attractive. Italy's President Sergio Mattarella is supposed to start discussions today about who might form the next government. A quick solution to the current crisis might turn Italian assets into an attractive investment. But future market direction will also very much depend on this week's ECB decision and the extent of its bond buying program and whether it continues to get prolonged. At the moment, the consensus is for a 6 months extension of EUR 80bn worth of monthly bond purchases. In addition, investors will also watch very closely if the incoming government will be able to recapitalise its ailing banking sector.

Important Information