

From A to B, the Italian Way

This article by MOI Global instructor Massimo Fuggetta is excerpted from a [quarterly letter](#) of Bayes Investments, based in London.

Our quarterly return would have been higher but for the last day of September, when the MIB index lost -3.7% and our Fund fell -1.9%. This was the day after the Italian government disclosed its 2019 budget deficit provision, which came out at 2.4%, 50% higher than the 1.6% that Finance minister Tria had until then assured it would be.

This unwelcome development was in contrast with our expectations, which, as articulated in our 4 June [note](#), envisaged an acceptable compromise between the government coalition's electoral promises and the need to keep public debt to GDP ratio on a declining path. This would have avoided a mutually damaging confrontation between Italy and the EU, resulting in a positive outlook for Italian equities in the second half of the year.

We were wrong. Defying what, backed by Mr. Tria's pledge, had become a consensus scenario, the 5Star party, which had been losing ground to its coalition partner Lega in the latest polls, imposed the higher deficit number as a means to bolster its popularity. The Lega, in EU defiance mode, followed suit, and Mr Tria was side-lined. As a result, an event we were expecting to bring about a resolution of uncertainty ended up increasing it. We will now have to wait until the end of October, for the actual budget law to be presented in Parliament and then evaluated by the EU and the rating agencies.

We still think that a conciliatory compromise will eventually be reached – in Italian affairs the path from A to B is never a straight line. The real issue is not EU wrangling per se – this is not the first dispute between the EU and a national government, and it won't be the last – but the overall credibility of the government plan to stimulate the economy and increase GDP growth beyond the current consensus forecast of around 1%.

The government's best intentions are well summarised in a [document](#) issued in early September by the European Affairs minister Paolo Savona (the English translation follows the Italian original). As you will recall, Savona was at the origin of the May turmoil, as the new party coalition's proposal to appoint him as Economics minister was vetoed by President Mattarella on the grounds of Savona's association with the notorious 'Plan B', detailing a course of action for Italy to leave the Euro zone by stealth. Savona, who subsequently entered the government in a different ministry, has been adamant since then to shed his 'Eurosceptic' image and to clarify his vision, which stresses the need to change the EU's economic policy architecture and endow it with effective fiscal instruments to boost aggregate demand. This essentially coincides with Paul De Grauwe's position we highlighted in our June note ([here](#) again his F&W June interview).

The risks to the government stance are well summarised, with usual clarity and composure – raising high above the cacophony of caricature and insult on both sides – in this [article](#) by ex-ECB Director Lorenzo Bini Smaghi (only in Italian – sorry):

1. Italian fiscal policy has been expansionary and pro-cyclical for most of the last 20 years. Doing more of the same runs the risk of requiring drastic corrections in the future.

2. Lower growth in Italy has more to do with structural bottlenecks than with low aggregate demand. More debt-financed public expenditure may be ineffective and even counterproductive.
3. If North-European 'populist' parties replicate the 5Star/Lega success in next year's European elections, the EU aversion to South-European high debt countries may actually increase rather than decrease.
4. It is wrong to assume that, in case of a loss of credibility and a consequent sharp jump in bond yields, ECB intervention through Outright Monetary Transactions (OMT) would be unconditional. Italy cannot rely on being too big to fail: OMT could only be conditional on a sharp correction of fiscal excesses, enough to regain market confidence.

We shall see in the next few weeks how the saga pans out. But whatever happens, it is important to keep in mind that, whereas heightened uncertainty may depress market prices, the intrinsic value of our companies does not change. First half results have been strong across the board and there is no reason to expect the second half to be any different. A good example is Landi Renzo Group, a company we recently presented at [European Investing Summit 2018](#), hosted by MOI Global.

In these circumstances, price volatility creates opportunities to increase our positions at cheaper prices.

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