MyStratWeekly
Market views and strategy

Ostrum ASSET MANAGEMENT

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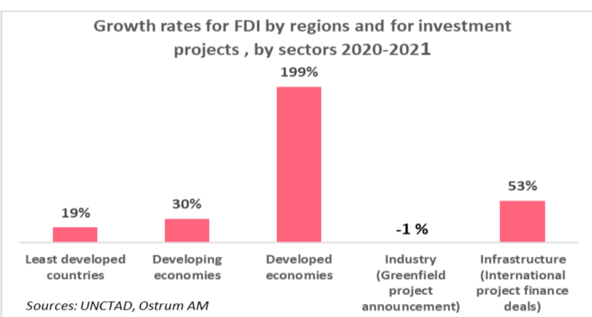
Topic of the week: Importance of the Italian presidential election

- **This election is important since the current President of the Council, Mario Draghi, can be elected President of the Republic;**
- **Due to his key role in the development and implementation of the recovery and resilience plan, his election constitutes a potential risk to the continuation of reforms and investments necessary to benefit from European Union funds;**
- **The real risk lies in that of early legislative elections which would be likely to generate a political crisis. This risk seems reduced;**
- **In a second paper, we deal with a related topic with an econometric approach to peripheral spreads that provides a relevant signal to investors.**

Market review: Nasdaq in correction territory

- **Nasdaq drawdown continues, European stocks prove resilient;**
- **Rally in risk-free rates amid Ukraine tensions;**
- **Credit indices worsen;**
- **PBoC: renewed monetary easing measures.**

Chart of the week



Strong rebound in global foreign direct investment flows (FDI) by 77% in 2021, compared to 2020, to reach $1.65 trillion, thus exceeding the pre-pandemic level. However, the recovery of FDI is not homogeneous and remains driven by advanced countries (199%). Investors have a strong interest in infrastructure, which benefits from favorable long-term financing conditions as well as budgetary stimulus. It is a support for the prices of raw materials, in particular metals. On the other hand, the attraction for industry, especially for production chains, remains weak.

Figure of the week

-12%

Source : Ostrum AM

The correction of the Nasdaq US technology index (-12% in 2022) is accelerating due to the coming monetary tightening, weaker earnings growth prospects for some richly valued stocks and a troubled international climate.

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Topic of the week

Importance of the Italian presidential election

This week, the Italian presidential election will take center stage in financial markets. It is possible that Mario Draghi, the current President of the Council of Ministers, will be elected President of the Republic. Due to his key role in the implementation of the reforms and investments necessary to benefit from the payments of the European Union, the fears lie in the fact that his election generates political instability and constitutes a risk in the continuation of the reforms. We will see that if Mario Draghi is elected President, the risk of political instability seems reduced, which should reassure financial markets.

Why is this election important?

On February 3, 2022, Sergio Mattarella's term as President of the Republic comes to an end. Elections will be held this week to elect his successor. Generally, the Italian presidential election does not attract much attention from investors since the President of the Republic has only limited power, policy being decided by the President of the Council of Ministers (the equivalent of our Prime Minister) and implemented by his government. This election has a special character since the current President of the Council, Mario Draghi, could be elected President of the Republic. This would be a first in Italy and could be a source of political instability.

An opaque and complex process

The election of the President of the Republic is by universal indirect suffrage. On January 24, the two chambers of Parliament and the representatives of the regions, i.e. 1,009 voters in total, are called for the first vote.

This election is special since the votes are kept secret and there is no list of official candidates.

Several votes are usually required. The first three votes are by two-thirds majority and from the fourth, the votes are by absolute majority. Since 1946, only two Presidents of the Republic out of 12 have been elected after the first round. On the other hand, 23 votes were necessary to elect Giovanni Leone in 1971.

Mario Draghi could be elected president

Currently, many parties want Mario Draghi to remain Prime Minister in order to ensure the stability of the government and to continue the reforms and investments necessary to benefit from the funds of Next Generation (the European recovery plan). But given the current composition of Parliament (small majority) and the positioning of the regions, the risk is that the votes of parliamentarians and regional representatives may not generate a sufficient majority to appoint a President after several votes. This is also reinforced by the secret nature of the vote and therefore the absence of guidelines to be followed by party members.

In the event of inconclusive votes, Mario Draghi could thus come to the fore and achieve unanimity. Although he was careful not to declare himself a candidate, during an intervention in December, he presented himself as a man and a grandfather in the service of institutions and declared that he had fulfilled his missions in 2021 at the head of the government, particularly with regard to the recovery and resilience plan that it has drawn up and begun to put in place.

If Mario Draghi is elected president, he would have to resign from the government, which could represent a source of uncertainty for investors given his key role for nearly a year at the head of the government. He was called by Sergio Mattarella, in February 2021, after the breakup of the ruling coalition following the departure of Matteo Renzi. Its main achievements were to manage the Covid-19 crisis, with the rapid development of the vaccination campaign, to adopt recovery plans to strengthen the recovery of the economy and then to develop and implement the recovery and resilience plan, in order to benefit from European Union funds within the framework of Next Generation EU.

Risk on the continuation of the recovery and resilience plan

This plan is a real opportunity for Italy to emerge from two decades of sluggish growth and set itself on a lastingly higher trajectory. On this subject, see *MyStratWeekly* (May 10th 2021): “European recovery plan: a real opportunity for Italy"[1].

[1] https://www.ostrum.com/sites/default/files/Strat%C3%A9gie%20h ebdo/2021/05.2021/2021-05-

Mario Draghi and his government drew up the recovery and resilience plan in record time to benefit from European funds. Italy has applied for the entire grant envelope and is one of the few countries to have applied for the entire available loan envelope. This represents a total of 191.5 billion euros between 2021 and 2026, or 11.7% of 2020 GDP (including 68.9 billion in subsidies). To benefit from these payments, Italy must carry out a certain number of reforms and investments, in green energy and digital technology in particular. In August, it received 13% pre-financing from the EU, or 24.9 billion euros.

The next payments are conditional on the achievement of specific targets set with the European Commission (EC) in terms of investments and reforms to be carried out. Italy made a first request for funds in January 2022, amounting to 21 billion euros, pending validation by the European Commission. The Prime minister declared that the 51 steps necessary for the payments had been completed. Mario Draghi has de facto tied the hands of future governments by implementing this recovery and resilience plan since abandoning investments and reforms would amount to doing without the support of the European Union. This is a significant incentive to remain a good student.

If Mario Draghi is elected president, investors fear the new government will not be as keen to deliver the reforms and investments needed to benefit from EU funds. If the next government does not meet the targets, the EC will suspend the disbursement of funds. This would then weigh on the outlook for growth and public finances and would be likely to generate tensions on the bond markets.

Limited role of the president

According to the Constitution, the role of the President of the Republic is more limited than that of the President of the Council. His powers are nevertheless important in the event of political instability since he appoints the President of the Council and, on his proposal, the ministers. In May 2018, Sergio Mattarella notably refused to appoint as finance minister Paolo Savona, eurosceptic, when he was presented by Giuseppe Conte and supported by the parliamentary majority. The President can also dissolve the 2 chambers. Before promulgating a law, he can also send a reasoned message to the 2 chambers. If they decide to re-enact the law, it must be signed into law by the President. He therefore does not have the power to act directly in terms of budgetary decisions, hence the importance of his choice concerning the President of the Council of ministers, then the ministers on the latter's proposal. Mario Draghi notably appointed to the post of Minister of Economy and Finance a man of confidence: Daniele Franco, one of the best public finance experts in Italy, having spent most of his career at the Bank of Italy until becoming number 2.

Four possibilities

This election can give rise to four outcomes.

Mario Draghi remains President of the Council of ministers

If Mario Draghi remains Prime minister and a new President of the Republic is elected, investors will be reassured. He will thus remain at the head of the government until the next legislative elections, scheduled for spring 2023, and will continue investments and reforms to benefit from EU funds. However, tensions within the government could arise between now and the end of the year in view of the legislative elections, with the risk that the government could become unmanageable in the run-up to the elections.

Mario Draghi elected President of the Republic

If Mario Draghi is elected president, three scenarios must be distinguished: the first with the maintenance of the current coalition or at least in large part, the second with a smaller coalition but without legislative elections and the third with early legislative elections.

Mario Draghi President and maintenance of the current broad coalition

Mario Draghi will no longer be at the head of the executive but, as President, he will have to appoint the President of the Council and, on the latter's proposal, the ministers. By appointing a man of confidence at the head of the government, capable of maintaining the current coalition, the government will be able to continue the reforms and investments until the next legislative elections. At the end of these, Mario Draghi will be in charge of appointing the new President of the Council and the ministers on the latter's proposal. He will thus be in the background to ensure the implementation of investments and reforms. This will also allow Italy to benefit from a certain political stability and strengthen Italy's credibility internationally, with Mario Draghi as President for 7 years.

Mario Draghi President without managing to keep the current large majority of his government

Another option would be for Mario Draghi to be elected President but fail to retain his current government. There are

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no early legislative elections, since the vast majority of parties have no interest in them, but the new government has a more limited capacity for action due to a weaker coalition. Delays in the implementation of the reforms to be carried out cannot be ruled out.

Mario Draghi elected President and early legislative elections

It's the worst case scenario. Mario Draghi is no longer Prime Minister and fails as President to keep the current coalition or to form a new government with a smaller coalition. Early legislative elections would then be organized with an uncertain outcome given that no party is currently in a position to win them in view of the latest polls. The risk is that the new government will no longer meet the targets to be achieved under the recovery and resilience plan. This would generate mistrust on the part of investors.

Limited risk of early legislative elections

The risk of early legislative elections seems limited for five reasons.

Significant reduction in seats in Parliament

Following the constitutional reform of 2019, the number of seats in Parliament will be reduced by more than a third in the next legislative elections (from 900 to 645). In view of the latest polls, only the Brothers of Italy would win seats, all the others would come out losers. This clearly limits the likelihood of early elections.

Constraint of elected officials of the 5 Star Movement

The elected members of the 5 Star Movement can only run twice according to the statutes of the party. Since the vast majority of M5S deputies are in their second term, they will either lose their place in the next election or change their label.

Containing the sharp resurgence of Covid-19

The government's priority is currently to deal with the strong resurgence of the epidemic and the uncertainty linked to the appearance of the Omicron variant. He must be able to act quickly to try to stem it. The organization of early legislative elections would constitute a real handicap in this regard.

Benefit from funds from Next Generation EU

With the exception of the Brothers of Italy, all parties support the government in the implementation of the recovery and resilience plan in order to benefit from payments from the European Union. This is a real opportunity to finance the investments and reforms necessary to improve Italy's potential growth. This pleads for the maintenance of the current coalition.

Parliamentary pensions

Finally, a last element comes from the fact that parliamentarians must sit until September in order to benefit from their retirement.

In view of these five factors, the possibility of early legislative elections seems reduced if Mario Draghi is elected President.

Consequences for the Italian spread

Mario Draghi reassures the markets

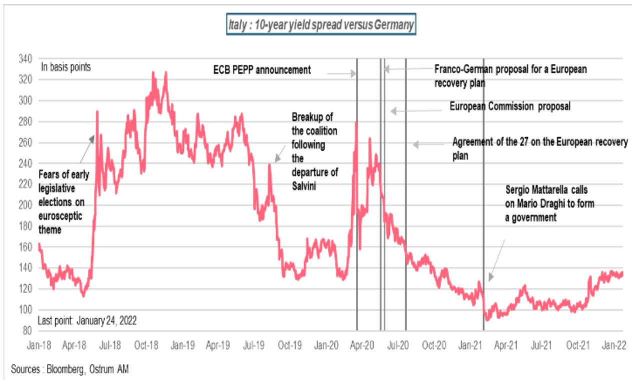
The arrival of Mario Draghi as head of the Italian government on February 12, 2021 was welcomed by the financial markets. This was seen through the tightening of Italy's 10-year rate spread vis-à-vis Germany, which temporarily fell below the symbolic threshold of 100 basis points (83 bp), for the first time since December 2015. The markets were reassured by his desire to draw up and quickly implement the recovery and resilience plan, likely to increase Italy's potential growth and reduce public debt.

The progress made in this area also led the rating agency Fitch to raise the rating of Italian sovereign debt, on December 3, 2021, from BBB- to BBB, attaching a stable outlook.

Political uncertainty weighs partly on Italy's spread

Since October, tensions have arisen on the Italian spread. This stems in part from concern over the end of the ECB's Pandemic Emergency Purchase Program (PEPP) at the end of March 2022. To avoid a sharp reduction in its purchases, the ECB announced that the asset purchase program (APP) would be temporarily increased. It will increase to 40 billion euros per month in the 2nd quarter of 2022, then 30 billion euros per month in the 3rd, before returning to the level of 20 billion per month in the 4th quarter. This turned out to be smaller than expected by the markets (they were expecting an APP of 40 billion per month at least until the end of the year), which contributed to these tensions.

The second factor weighing on the spread lies in the uncertainty linked to the presidential election. Investors are on hold, which translates into a relatively stable spread around 130-135 bp since the end of November, compared to a level around 100 bp from mid-June to October 20. The presidential election could give rise to some volatility in the markets in the event of prolonged uncertainty beyond January 27.



As we have seen, the risk of political instability appears to be reduced. If Mario Draghi remains President of the Council, the spread should partly tighten. If elected President, it is very likely that the current coalition will remain in place, or at least for the most part. He will appoint a trustworthy man to head it. This could be the current Minister of Economy and Finance. The spread should therefore also tighten. In both cases, it is unlikely that it will come back below 100 basis points, given the lower purchases of the ECB and the strong issues of the Italian government at the start of the year, but the spread could return to around 120 bp.

On the other hand, in the least probable scenario where Mario Draghi would be elected President but legislative elections were to be organised, the spread will widen significantly and will probably settle at around 150 bp or even beyond.

Conclusion

At the end of the Italian presidential election, the current President of the Council, Mario Draghi, could be elected President of the Republic. In this case, the real risk lies in that of early legislative elections which would be likely to generate political instability and jeopardize the continuation of the reforms and investments to be made. This risk seems limited due to the constitutional reform reducing the number of seats in Parliament by more than a third, broad support from parties to pursue reforms and investments, the need to act quickly to deal with the resurgence of the health crisis and, finally, the question of pensions for some parliamentarians. It therefore seems unlikely that the markets will be disappointed after the presidential election. In the two most probable cases, either Mario Draghi remains President of the Council of ministers, or he becomes President of the Republic and will be able to rely on a government bringing together a vast coalition to continue what he has started. Italy's spread vis-à-vis Germany could thus narrow significantly.

Aline Goupil-Raguénès

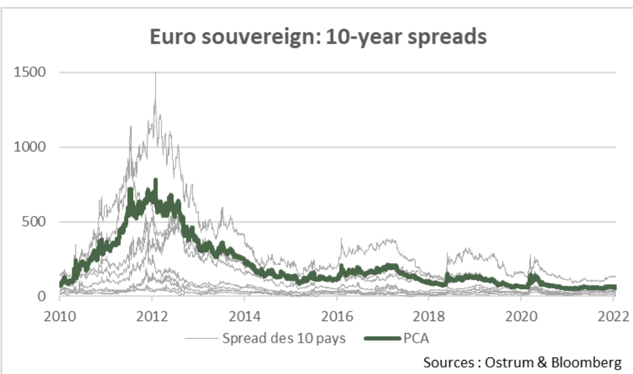
A model of sovereign spreads

This short article presents an econometric approach to European sovereign spreads. With several ideas relevant to investors.

How does it work?

The idea is to "summarize" in a single series the 10-year rate spreads to Germany of 10 countries: Austria, Belgium, Finland, France, Ireland, Italy, Netherlands, Portugal and Spain (Greece is excluded because it's been too erratic over the period). For this we use a "principal component analysis". The aim is to generate a time series that is as close as possible, i.e. the most correlated, to all countries.

The result obtained, using data from 2010 on, is shown on the following graph.



Three conclusions

1. Very little specific risk

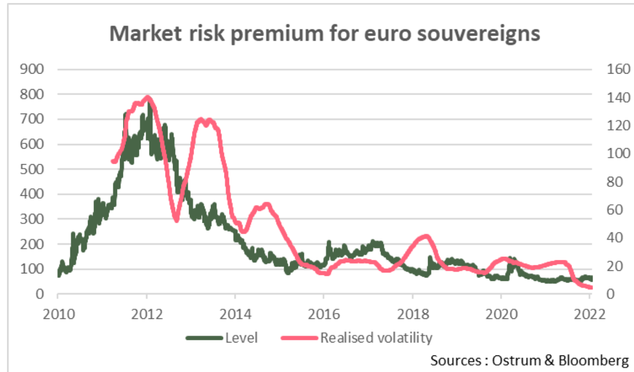
The series we generated explains 89.5% of the sovereign spreads' variance. That's a huge proportion. In the case of Portugal, our series correlates 98% with historical spreads, 90% with Spain and 79% with Italy.

Even in the case of peripheral countries, **the idiosyncratic risk is therefore a very small part of the risk premium,** the lion's share in terms of spread variations is explained by the aggregated market risk.

Much energy is used to comment on the specific risks for each country, the reality is that the market pays very little attention to them.

2. The calm after the storm

Another conclusion, unsurprisingly, is that market risk has dropped considerably as spreads have plunged over the past decade. More interestingly, and not surprisingly either, the volatility of this risk premium also collapsed over the past decade.

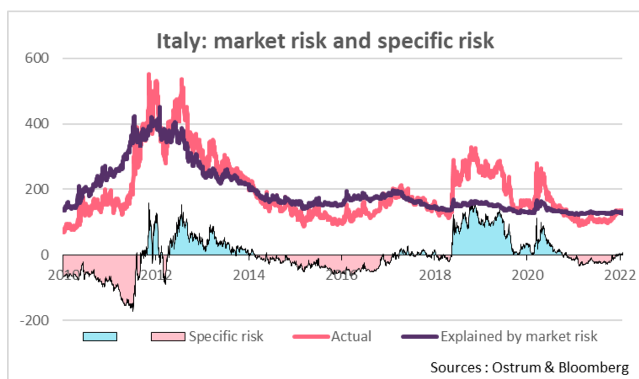


So **we live in a world not only less risky** (risk premiums are lower) **but also with more visibility** (the volatility of risk premium has collapsed).

3. Divergences are temporary

Last point, important for investors, the idiosyncratic differences are temporary. We provide an illustration below, using Italy as an example. When spreads are abnormally high (or low) in comparison to the market, they tend to return to normal and recede (increase).

This is also the case for all other countries: we find that there is a strong mean reverting force towards the market trend. Therefore, **the idiosyncratic risk generally dissipates quickly.**



This is an important point for investors, it means that any overshoot of the market, even for valid fundamental reasons (the Italian political crisis in 2018 for example), is corrected afterwards.

Stéphane Déo

Market review

Nasdaq in correction territory

Higher real yields and Ukraine tensions weigh on stock valuations

Volatility remains elevated in global financial markets. The sharp pullback in the Nasdaq market gauge last Thursday (to the tune of a 4.5% intraday loss) is evidence of the fragile market environment described last week in this weekly review. The tech-heavy equity index is down 10% since its peak in November. The VIX volatility index hit 26%. Monetary tightening in the form of higher real rates, even as monetary authorities provide extensive policy guidance, always implies a paradigm shift for equity valuations. The growth investment theme is most exposed to higher yields with speculative asset classes, including crypto-currencies (Bitcoin down 20% in 2022) or shares of non-profitable small cap companies also taking a beating. In truth, the challenge for 2022 is to figure out downside risk, after sharp 20%+ gains in equities in 2020. However, monetary tightening is not uniform across the globe. In contrast to G10 monetary tightening, the PBoC lowered interest rates further, providing an haven of financial stability, on both bond and currency markets. The BoJ made no changes to monetary policy. Likewise, the ECB, paralyzed by the differences in views within the Governing Council, will maintain an accommodative monetary policy. This policy stance continues to dampen the volatility of sovereign bond spreads despite a busy political agenda starting with the Italian Presidential election next week. Credit spreads are slightly wider, with nevertheless some overreaction of credit derivatives as market participants used the iTraxx Crossover index as an hedge. The US greenback is stable, whilst risky currency positions were trimmed in favor of the Japanese yen or the Chinese yuan.

The Nasdaq's drawdown occurred as upward pressure on bond yields seemed to slow as US policymakers turned silent imposed before the FOMC scheduled for January 26th. Market participants expect an explicit signal of an initial Fed funds rate hike in March, hence immediately after the end of quantitative easing. Balance sheet contraction will be the next policy step in the monetary cycle. Unlike 2017, outright sales of securities cannot be ruled out because the rise in long-term mortgage rates (the 30-year mortgage is now 3.65% according to the Mortgage Bankers Association) currently slows the amortization of the Fed's MBS portfolio. Also, inflationary pressure obviously requires a more restrictive approach than in 2017. In the United Kingdom, Andrew Bailey now sound more hawkish after another upside surprise on consumer prices. UK inflation stood at 5.4% in December (the RPI index even reached 7.5%) despite a negative monthly contribution from energy prices. The rebound in oil prices in 2022 may prolong the period of high inflation. The BoE will probably opt for a 25bp hike in February. In the euro area, the account of the December meeting shows deep disagreements within the Council. The persistence of inflation is no longer an improbable scenario, but the withdrawal of monetary support measures involves asymmetrical risks. The communication of Christine Lagarde on February 2 may move markets.

Volatility has notably increased in equity markets. The Nasdaq plunged 7% this week. Europe and Asia resist but lose 1 to 2%. Disappointing quarterly earnings from US banks, due to a lower contribution from trading activities weighed on markets. Revenue growth is also slowing in the sectors that benefited from lockdown measures during the pandemic. However, the earnings season is still OK. Looking at the first 61 releases for the S&P 500 companies, the annual growth of profits still fetches 20%. Pressure on margins will nevertheless increase given the challenging inflation environment.

On the fixed income markets, the geopolitical backdrop is pushed risk-free yields lower towards the end of the week. Biden's warning to Putin over Ukraine portends escalation and sanctions even if military intervention should be avoided. After peaking at 1.90%, the T-note yield declined towards 1.75%. The bid for safety weighed on long-term rates, as investor demand proved solid at the 20-year US bond issuance. Other Anglo-Saxon bond markets followed the direction of US Treasuries. Bund yields briefly returned to positive territory for the first time in three years. The subsequent pullback to -0.06% contributes to modest widening pressure on swap spreads. However, sovereign spreads remained completely insensitive to the high volatility on risk-free rates. At the same time, Bund purchases shrank breakevens, which appear to ignore the persistent tensions on energy prices. Brent crude traded above $89 this week before easing on higher US inventory data. Long-term breakevens continue to suffer from expectations of monetary tightening.

Credit spreads proved relatively resilient. The euro IG market is trading around 99 bp against Bunds (up 2 bp last week). The market was however heavier on long maturities and securities that are not eligible for the CSPP (hybrid bonds, financial debt securities). The underperformance of credit derivatives continued. The iTraxx crossover (+12bp last week) is tracking equity volatility breaking above the 270bp threshold. Adjusted for risk, we nevertheless observe a compression of spreads between CDS indices (IG/XO). As regards the covered bonds segment, the very busy primary market at the start of the year is well absorbed (spreads are down 1bp in 2022). In high yield space, the primary bond issuance remains substantial (€3 billion) and generally well received by the markets. As concerns secondary market action however, high yield spreads widened by 7 (BB) to 15bp (B) in five sessions.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	24-Jan-22	1wk (bp)	1m (bp)	2022 (bp)
EUR Bunds 2y	-0.66%	-10	+2	-4
EUR Bunds 10y	-0.1%	-8	+15	+7
EUR Bunds 2s10s	54.9bp	+2	+13	+12
USD Treasuries 2y	0.99%	+2	+30	+26
USD Treasuries 10y	1.72%	-6	+23	+21
USD Treasuries 2s10s	72.6bp	-9	-7	-5
GBP Gilt 10y	1.14%	-5	+22	+17
JPY JGB 10y	0.14%	-1	-15	-10
€ Sovereign Spreads (10y)	24-Jan-22	1wk (bp)	1m (bp)	2022 (bp)
France	37.9bp	0	+0	+0
Italy	131.9bp	+0	-3	-3
Spain	68.4bp	+0	-6	-6
Inflation Break-evens (10y)	24-Jan-22	1wk (bp)	1m (bp)	2022 (bp)
EUR 10y Inflation Swap	1.96%	-5	-11	-13
USD 10y Inflation Swap	2.61%	-3	-10	-16
GBP 10y Inflation Swap	4.25%	+0	+4	+5
EUR Credit Indices	24-Jan-22	1wk (bp)	1m (bp)	2022 (bp)
EUR Corporate Credit OAS	100bp	+2	+4	+5
EUR Agencies OAS	49bp	+1	+0	+0
EUR Securitized - Covered OAS	47bp	+2	+0	+1
EUR Pan-European High Yield OAS	328bp	+17	+0	+10
EUR/USD CDS Indices 5y	24-Jan-22	1wk (bp)	1m (bp)	2022 (bp)
iTraxx IG	58bp	+5	+10	+10
iTraxx Crossover	279bp	+20	+37	+37
CDX IG	60bp	+6	+10	+10
CDX High Yield	338bp	+31	+46	+45
Emerging Markets	24-Jan-22	1wk (bp)	1m (bp)	2022 (bp)
JPM EMBI Global Div. Spread	387bp	+3	+11	+18
Currencies	24-Jan-22	1wk (%)	1m (%)	2022 (%)
EUR/USD	$1.132	-0.833	-0.018	-0.5
GBP/USD	$1.348	-1.311	0.643	-0.4
USD/JPY	JPY 114	0.588	0.369	1.0
Commodity Futures	24-Jan-22	-1wk ($)	-1m ($)	2022 (%)
Crude Brent	$85.9	-$0.6	$10.1	10.45
Gold	$1 832.2	$12.9	$22.0	0.17
Equity Market Indices	24-Jan-22	-1wk (%)	-1m (%)	2022 (%)
S&P 500	4 301	-8.19	-9.42	-10.2
EuroStoxx 50	4 049	-5.89	-4.85	-5.8
CAC 40	6 779	-5.88	-4.35	-5.2
Nikkei 225	27 588	-2.63	-4.15	-4.2
Shanghai Composite	3 524	-0.50	-2.60	-3.2
VIX - Implied Volatility Index	37.61	95.99	109.41	118.4

Source: Bloomberg, Ostrum AM

Additional notes

Ostrum Asset Management

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