



Investment Note

5 December 2016

Should investors care about Italy's Referendum?

On 5 December 2016, Italian Prime Minister Matteo Renzi said he has resigned after a defeat in a referendum over his plan to reform the constitution. Manulife Asset Management's Head of EAFE and European Equities, David Hussey, considers how would the outcome matters to investors.

Latest update¹

Italy voted against the constitutional referendum yesterday (4 December 2016). An exit poll for state broadcaster RAI suggests 42 to 46% voted to back reforms, compared with 54 to 58% voting "No". At a news conference held late last night, Matteo Renzi said he took responsibility for the outcome and the "No" camp must now make clear proposals. The euro touched its weakest point against the US dollar in 20 months in early Asian trading hours as Prime Minister Matteo Renzi conceded defeat and said he'll resign.

Italy's FTSE MIB index has lost more than 20% this year, with banks bearing the brunt of the selloff². As of 2 December 2016, Italian 10-year government bond yielded 1.902%, which was 162 basis points higher than same tenor German government bond, but lower than the 171 basis points on the previous day.

Why Should We Care?

According to Manulife Asset Management's Head of EAFE and European Equities, David Hussey, Italy's referendum is the latest macro-political event markets will have to deal with in what has been an eventful and mostly surprising 2016.

At its heart, the event is about Italy's willingness to restructure its political system, reducing the power of the Senate and enabling the country to be governed more efficiently. While clearly admirable, it is uncertain whether Italy wants this outcome or would favour the "muddle along, nothing changes" approach.

This explains the frequent demise of a multitude of Italian governments over the years and their lack of any real mandate for power. Italy seems to like the status quo, prompting some commentators to describe it as "an ungovernable country".

In terms of Italy's place in the European Project, any expectation of an early exit from the EU is wide of the mark (far from what is required or expected). Should the more adventurous political parties such as the Northern League or Five Star Movement gain more power, an exit via referendum would require constitutional change, which by definition could take a very long time.

¹ Bloomberg, BBC, as of 5 December 2016.

² Bloomberg, as of 2 December 2016.

Currency depreciation, while superficially helpful for the export sector, could cause massive problems in the debt markets as government bond spreads would no longer be subdued (due to the ECB's involvement). Italian debt to GDP is high, so this would be a bad outcome; Italy needs the EU and the ECB.

So Do We Care?

Well, yes. Even if Italy votes for reform, these changes will take time, meaning Italy will remain “low-growth” and uncompetitive in the near future. Furthermore, attracting foreign capital investment into Italy would remain a difficult sell. It also highlights the fragmented nature of European politics, and a large but diverse economy that is under-achieving its real potential.

The market has over-discounted how bad things are for Italian banks and their non-performing loans (NPLs). Commonly cited calculations are based on the current clearing prices for NPLs in a very illiquid market, as they are being traded between forced sellers – the capital-light banks – and aggressive distressed debt funds – that is not a real market. It doesn't reflect the actual value of the better quality NPLs in the Italian banking system.

As ever, it is incorrect to tar all with the same brush. The solution is speedier resolution of seizing collateral through the courts. Frustratingly however, this tardiness typifies Italy's problems. Regardless of what happens next, Italian banks are not for the unprepared. But I believe a few select opportunities exist for those willing to do their homework.



Investment Note

Disclaimer

Manulife Asset Management is the asset management division of Manulife Financial. This material, intended for the exclusive use by the recipients who are allowable to receive this document under the applicable laws and regulations of the relevant jurisdictions, was produced by and the opinions expressed are those of Manulife Asset Management as of the date of writing and are subject to change. The information and/or analysis contained in this material have been compiled or arrived at from sources believed to be reliable but Manulife Asset Management does not make any representation as to their accuracy, correctness, usefulness or completeness and does not accept liability for any loss arising from the use hereof or the information and/or analysis contained herein. Information about the portfolio's holdings, asset allocation, or country diversification is historical and is not an indication of future portfolio composition, which will vary. Neither Manulife Asset Management or its affiliates, nor any of their directors, officers or employees shall assume any liability or responsibility for any direct or indirect loss or damage or any other consequence of any person acting or not acting in reliance on the information contained herein.

The information in this material may contain projections or other forward-looking statements regarding future events, targets, management discipline or other expectations, and is only as current as of the date indicated. There is no assurance that such events will occur, and may be significantly different than that shown here. The information in this material including statements concerning financial market trends, are based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons. This material was prepared solely for informational purposes and does not constitute a recommendation, professional advice, an offer, solicitation or an invitation by or on behalf of Manulife Asset Management to any person to buy or sell any security. This material should not be viewed as a current or past recommendation or a solicitation of an offer to buy or sell any investment products or to adopt any investment strategy. Nothing in this material constitutes investment, legal, accounting or tax advice, or a representation that any investment or strategy is suitable or appropriate to your individual circumstances, or otherwise constitutes a personal recommendation to you. Past performance is not an indication of future results.

Investment involves risk. Investors should not base on this material alone to make investment decisions and should read the offering document (if applicable) for details, including the risk factors, charges and features of any investment products.

Proprietary Information – Please note that this material must not be wholly or partially reproduced, distributed, circulated, disseminated, published or disclosed, in any form and for any purpose, to any third party without prior approval from Manulife Asset Management.

This material is issued by Manulife Asset Management (Asia), a division of Manulife Asset Management (Hong Kong) Limited.

This material has not been reviewed by the Securities and Futures Commission (SFC).