

# Market Bulletin

September 2018

## The Italian budget - pushing the boundaries

Markets have been nervously awaiting the new Italian government's budget proposal. Having made a number of costly promises to the electorate in the run-up to the election, it was unclear until last night which of these promises would be honoured and the implications for Italy's public finances.

A deficit of 2.4% has now been proposed following tense negotiations between the coalition partners. This borrowing requirement is above market expectations and the Italian sovereign market has reacted negatively.

The additional spending will finance the introduction of a "citizens' income" and a revision of the pension law that reduces the retirement age, among other initiatives. A flat tax will be introduced very gradually and will be fully implemented in 2021. Very few details are available on the new initiatives and public investments that are intended to boost economic growth and reduce unemployment.

The final approval of the budget into law could take some time, which could continue to feed political anxiety. The Draft Budget Plan (DBP) will be submitted to the European Commission on the 15 October. Shortly after, the budget law will be discussed in the Italian parliament. We expect the European Commission to present its remarks on the DBP at the end of November.

It seems unlikely that the European Commission will be pleased with this proposal given the deficit plans are unlikely to stabilise Italy's already high debt-to-GDP ratio. Similarly, the budget may result in a downgrade from one or more of the major credit rating agencies. Fitch has already revised down its outlook for Italy to negative but maintained the country's BBB rating. Standard & Poor's (S&P) revised down its expectations of GDP growth for 2018 and 2019 to 1.1% (down from 1.3% and 1.2% respectively). In late October, we expect further reviews from S&P and Moody's.

A rating downgrade from either agency could force outflows from Italian bonds, largely from foreign investors, which in turn could increase the cost of financing Italy's large sovereign debt. There would also be negative implications for the Italian banking system, which is highly exposed to national government bonds. Given the ECB is ending its quantitative easing programme in the coming months, it will no longer serve to backstop the sovereign markets in the way it did in recent years, which may add to market volatility.

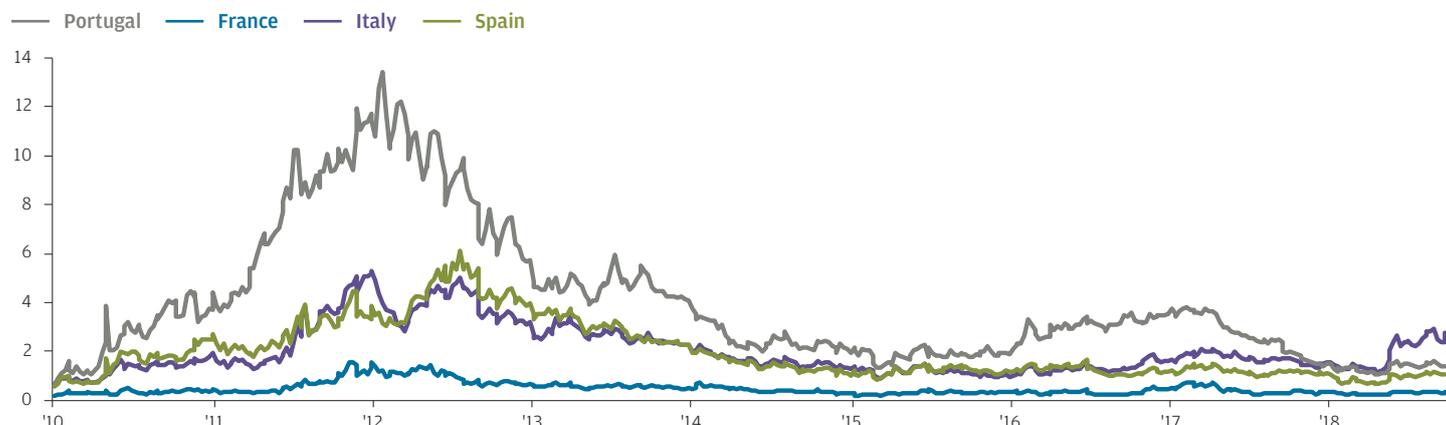
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## EUROPEAN 10-YEAR GOVERNMENT BOND SPREADS

% points, spread over German 10-year government bond yields



Source: Thomson Reuters Datastream, J.P. Morgan Asset Management. Data as of 28 September 2018.

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