Made in Italy
Fund

Bayes Investments

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Our thoughts on Italian events

Dear Fellow Investors,

It has been an interesting month.

In our first quarter letter (sent on 21 April, one and a half months after the 4 March elections) we wrote:

> Undoubtedly, the electoral outcome was not our or the market's favourite. A hung parliament dominated by untested newcomers is likely to result in a fractious government and possibly in a new electoral round before the end of the year. But at the same time it means that the likelihood of a new government adopting a substantive EU-defying stance – the only meaningfully disruptive possible development – remains remote, as reflected in the steadfastness of the 10-year BTP, which at 1.80% is 15 basis points below year-end and remains 50 basis points below its level of 12 months ago. This is no reason for complacency – we need to remain vigilant and open to a change in outlook.

Much has happened since then. We spare you the chronology of events, which all of you know in at least some detail. The bottom line is that, after another one and a half months of commotion, at the end of May a 5Star/Lega government was formed.

Clearly, the March elections were not the neutral event that we expected and hoped for. Far from staying at 1.8%, the 10-year BTP shot up to 3.3% and is now around 2.5%. The stock market saw indiscriminate selling, with the FTSE MIB index ending the month down 7.5% and our Fund down 5.6%.

Does this outcome require a change in outlook? We believe the answer still depends on the probability that the new government will at some point enter on a collision course with the EU.

We think this probability is very low. The purpose of this note is to explain the reasons behind our conclusion.

A good starting point is this excellent note by Blanchard, Merler and Zettelmeyer, which came out on 24 May. By then, the bond market was already in a state of alert, with the 2-year BTP moving from -0.27% (15 May) to +0.26% (24 May). The note concluded that a catastrophic escalation was possible but unlikely, because a financial crisis would be hurtful and electorally damaging. Hence, using it as a threat via an aggressive EU-defying stance was not a credible bargaining tool. In addition, any attempt to use the tool would likely be opposed by Parliament, and certainly rejected by the Italian President.

Just a few days later, the two parties got a taste of what this meant. As President Mattarella vetoed their attempt to appoint Paolo Savona, a vocal promoter of EU defiance, as Economics minister, the 2-year BTP shot up to 2%, on the expectation that a new electoral round, as early as late July, would have led to an outright political and financial clash, amid an institutional void. This article, which came out the day after the 2-year BTP reached 2%, well described the situation.

As it turned out, this was enough for the two parties to blink, retreat and accept the President's veto. Having an early experience of what it is like to play with fire has been an important watershed. The appointed Economics minister, Giovanni Tria, is also an EU critic – who isn't these days? – but has the wherewithal to oppose unilateral exit. He is joined by a very safe pair of hands in the name of the Foreign minister, Enzo Moavero Milanesi, an experienced EU diplomat who was part of the Monti and Letta governments.

On this basis, we regard the likelihood of further EU-related turmoil as remote for the foreseeable future. The new Italian government has an incentive to gain European respectability. The EU is no. 29 of their 30-point program and says nothing about the Euro. The May melodrama has most likely made sure that they will stick to the plan.

For a good summary of the current state of play in European integration, we found instructive to read outgoing ECB Vice President Vítor Costâncio's concluding remarks to the recent ECB colloquium in his honour. See also his interview with Der Spiegel in the midst of the Italian chaos. The Colloquium was a great source of valuable contributions. In particular, Paul De Grauwe's presentation on Core and Periphery in the EMU should be taken as the inspiring force for much needed reform. His conclusions:

> Long run success of the Eurozone depends on a continuing process of political unification. Political unification is needed because the Eurozone has dramatically weakened the power and legitimacy of nation states, without creating a nation at the European level. This is particularly true in the field of stabilization.
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> Budgetary union (and thus political union) is needed but is far away. Willingness today to move in the direction of a budgetary and political union in Europe is non-existent. This will continue to make the Eurozone a fragile institution. Its long-term success cannot be guaranteed.

This could be the silver lining of the May turmoil: a wakeup call to De Grauwe's warnings (see also his latest interview).

Conclusion

Politics plays no role in our investment process. Occasionally, however, political developments require our attention. We do not expect to see a repeat of May volatility. If anything, we believe that, while steering clear of EU confrontation, the new Italian government will have some leeway for fiscal stimulus, with beneficial effects on aggregate demand and consumer confidence.

Our positive outlook remains unchanged.

Kind regards,

Massimo Fuggetta