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Italian unrest returns with a vengeance

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- New referendum aims to repeal major labor market reform
- Rising risks of early elections
- Ongoing political turmoil negative for Italian bonds

Though the Italian government bond market has just calmed down since last **month's** referendum, a new referendum is already looming. This referendum **aims to repeal Renzi's labor market reform.** Early elections are also becoming increasingly likely. We are therefore negative on Italian bonds.

The root cause of Italian problems: a chronic lack of growth

Several Italian problems are making headlines: banks struggling with non-performing loans (NPLs), political instability and Europe's second-highest debt-to-GDP ratio (after Greece), to name a few. All of these issues are directly related to the structurally weak economic growth: on average, the Italian economy has shown no growth over the past 15 years and Italian productivity has not grown over the last 20 years.

As regards NPLs: many Italian companies struggle to repay their bank loans due to a lack of domestic demand. Furthermore, support for protest parties is rising as unemployment remains high, with 36% youth unemployment. And the government debt has risen to more than 132% of GDP as GDP hardly grows and successive governments try to boost growth with further spending. Italy needs structurally stronger growth in order to address all of these problems, and stronger growth requires structural reforms. Renewed political turmoil obviously does not bode well for further reforms. Italy can hardly afford to roll back reforms – or to discuss leaving the Eurozone lightly, as the leader of the anti-Euro Five Star Movement (M5S) is currently doing.

Italy needs more reforms, not less

Another Italian referendum…

Italian labor unions have collected the necessary signatures to hold a referendum, aiming to repeal the recently implemented labor market reforms. These reforms were the main achievement of Renzi's government. Employment finally started to grow last year, which was likely related to this reform. On 11 January, the Constitutional Court will decide if all requirements have been met and if so, set a date for the referendum. According to the Italian newspaper *Il Sole 24 Ore*, there is a legal requirement to organize the referendum by no later than 15 June. Unlike the referendum last December, this referendum will have a quorum, meaning the turnout must be more than 50%. But given the importance of the topic and the previous referendum's 70% turnout, the quorum can be met.

… Or new general elections

The Italian government apparently shares this view and is worried about the referendum. Labor Minister Poletti stated that if the court approves the referendum, the government will ask the president to dissolve Parliament and call early elections. As a result, any forthcoming referendum would be postponed by twelve months. However, general elections also pose risks. According to the polls, the governing centre-left PD party is in a neck-and-neck race with M5S. Its leader Beppe Grillo is advocating a referendum on Italy's membership of the Eurozone. While calling such a referendum is legally complicated, the sole aim to do so could upset markets. Refinancing Italy's two-trillion euros of sovereign debt at affordable rates would be challenging in the case of an abrupt Italian Euro-exit.

But even if M5S will not be part of a new government, Berlusconi's party seems the most reasonable coalition partner for Renzi's PD party. This does not bode well for political stability and with a fragmented coalition it will be more difficult to push through reforms.

But under which electoral law?

Another complication is that the electoral law is currently being contested before the Constitutional Court. Calling new elections without a proper electoral law is a recipe for political turmoil. After the December referendum (on reducing the powers of the Senate), President Mattarella has tasked the current government with aligning the electoral laws for the Parliament and the Senate. Under the current incongruent laws, political gridlock is highly likely. Furthermore, under the current electoral law (the Italicum) the most popular political party will automatically have a majority in Parliament. This increases the likelihood of M5S achieving an absolute majority. The Constitutional Court will rule on the Italicum on 24 January. The decision to call elections could be postponed until after this ruling.

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Italian government bonds likely to come under pressure

While Italian government bonds have recovered since last month's referendum, the outlook is not good. Early elections pose risks, given the rise of the anti-Euro M5S in the polls and the uncertainty about the electoral law. But a potential repeal of the main reform implemented by Renzi is also a negative. The necessary further reforms are unlikely to be implemented in either scenario, irrespective of whether early elections are called or the referendum is held. We are therefore negative on Italian government bonds and positioned our portfolios, including Robeco Global Total Return Bond Fund, Robeco All Strategy Euro Bond Fund and Robeco Euro Government Bonds, for rising Italian government bond yields.

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