

Talking About Italian Politics

Alert: (And Now) Reform, Matteo Reform!

European Parliamentary elections this weekend have given a boost to PM Matteo Renzi's center-left PD, at the expense of both the challenger Five-Star Movement and the center-right. How will Renzi make use of this additional political capital? **A cabinet reshuffle could emerge in the short-term**, and the likelihood of early elections has increased, though we still do not foresee this taking place in 2014. We also can't also rule out that **President Napolitano might now resign** to facilitate the election of a pro-Europe/pro-reforms new President, while providing further support to Renzi. **For investors, this development is positive for Italy's reform and growth prospects, even though numerous obstacles remain – particularly the persistently weak macro-environment.**

Once again, Italy surprised with an election output that was quite different from what the polls were indicating. Whereas Italian newspapers had implied a potential deadly "sorpasso" of M5S movement led by Beppe Grillo at the expense of Matteo Renzi's PD, eventually Renzi managed to lift PD to heights never seen before (40.8%) – nearly doubling M5S (21.1%). Berlusconi's Forza Italia was a distant third (16.8%), while the two junior members of the government scored very poorly: while Alfano's NCD got 4.4%, Mario Monti's Scelta Europea ended up with a "telecom prefix" of 0.7%.

Although a surprising result, the above outcome was in line with what we wrote in our The Sorrows of Young Matteo Renzi dated February 24: "Rather than implementing full reforms, Mr. Renzi might opt to be more pragmatic and use the 100 days before the European elections to win small battles in an effort to convince Italians that: i) Italy needs reforms; ii) he is the only politician who can implement such reforms; and iii) only full electoral support will allow him to implement these reforms".

And while Matteo Renzi has been a master at building consensus (see Same Old Risks, New (Potential) Opportunities), his opponents have either missed unique opportunities (Grillo), faced an unstoppable decline (Berlusconi, due to age and personal issues), or experienced very modest (if not poor) results (Alfano and Monti).

In particular, **Grillo's movement missed a unique opportunity to play an active role in reforming Italy.** We can't rule out that his angry anti-establishment sentiment against practically everything might have alienated Italian voters.

Mauro Baragiola
+39-02-8906-8703
mauro.baragiola@citi.com

Tina M Fordham
+44-20-7986-9860
tina.fordham@citi.com

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Few Italian voters would prefer a party that wants more than 50% of votes to govern, as this probably sounds too close to what Italy experienced nearly 100 years ago. During the campaign, Beppe Grillo said that he would leave if his movement didn't win the election. And he loses, being both 20% below PD and down 4% since last year's election. **So M5S might be close to its key moment: if Grillo goes, the Movement is likely to fade away; if he stays, his anti-politic message would be much weaker.** Although we believe that M5S is unfit to run the country, we think that M5S might have a very positive impact on Italy, in effect by highlighting the chronic problems.

Such a surprising outcome in our view might be a signal that Italians are ahead of the curve in the Vox Populi storm that hit other European countries during the week-end. Why's that? We believe that a key reason might be that Italy is no longer in a state of denial as Italians have been gradually changing their cultural mindset (also thanks to a push from Beppe Grillo). However, after having flirted with Vox Populi sirens, Italian might have decided that it's time to be pragmatic and support people like Matteo Renzi, who (at least on paper) wants to reform Italy. What Next?

Renzi might now finally start to change Italy as he promised when elected. Although he is unloved by the current Parliament (who was elected under the previous PD's secretary and doesn't reflect yesterday's vote), **we believe that Matteo Renzi will have enough power to either force the current Parliament to follow him on the reform path or – unlikely in the short term – call for new elections**, blaming the current parliament for not supporting him in his efforts to reform.

In particular, **we would expect Renzi to re-shuffle the government**, taking onboard some former M5S MPs who left the Movement because of Grillo's unwillingness to discuss reforms, while limiting the power of Alfano and Monti's parties; we believe that MPs of these parties will accept, knowing that if there are new elections they might not be re-elected. Finally, we expect PD's MPs to finally support the former secretary turned PM whose government has been validated by an election vote.

Finally, **we can't rule out that President Napolitano might resign to allow the current pro-Europe parliament to vote for his successor.** In this way, he might provide more support to Matteo Renzi's efforts for reform.

We maintain our positive view on Italy (see [Same Old Risks, New \(Potential\) Opportunities](#)), as years of underperformance leave room for further outperformance of Italian equities in a broader positive equity market environment. **However, investors should bear in mind that gains would result in multiple expansion** given both the macro picture (see [Italy - Q1 GDP Downward Surprise and Political Uncertainty](#)) and the limited scope of the Italian Stock Exchange.

Again, we would advise investors to implement a barbell strategy, favoring banks/financials and quality stocks, while avoiding fully domestic stocks. Our Buys include **Autogrill** (AGL.MI; €6.78), **Luxottica** (LUX.MI; €41.62), **Prysmian** (PRY.MI; €17.00), **Yoox** (YOOX.MI; €22.98) and **WDF** (WDF.MI; €9.93), as well as **Unicredit** (CRDI.MI; €6.23), **Mediobanca** (MDBI.MI; €7.12; 1H) and the asset gatherers **Banca Generali** (BGN.MI; €20.87) and **Mediolanum** (MED.MI; €6.11).

Appendix A-1

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