

## ITALIAN CREDIT MARKET UPDATE

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We view the recent Italian developments as another reminder of the challenges of monetary union without fiscal union. Like most black swan events, while the effect of a new euro crisis would be quite large, the actual probability of such an event is still relatively small. Look for markets to play the role of vigilante and force the Italian government and European Central Bank (ECB) to respond (and possibly take action).

At this time, the Italian political developments have not materially changed our cautionary stance toward Italian credit. Some immediate observations:

- **Headline risk.** Until there is resolution on the government structure there is going to be constant headline risk. There is a very good chance that there are elections in September 2018 (possibly sooner) that, given the stance of the 5 Star and League parties, would likely become a de facto referendum on Italy's euro membership. The challenge with binary events like this is that they are all or nothing, and hence can become black swan-ish given the associated outcome. Thus, it will likely result in heightened headline risk over the summer months as the deluge of election polls come out (think pre-Brexit vote on steroids).
- **US economic risk.** Limited implications for the US economy at this point, we are not changing our forecasts (which are below consensus). Should a crisis develop in Europe, the financial markets would be a much more rapid transmission mechanism than economic and trade channels.
- **US rates.** Our year-end forecast for the 10-year US Treasury remains 3.10%. As yields recently tested that level, we added duration, believing that the market was exhibiting peak optimism and that a further upward move in rates would be hard to come by. Should a crisis develop, US rates would receive a flight-to-safety bid that could take rates materially lower.
- **Federal Reserve.** The recent developments would support the dove camp for slower or fewer rate hikes (which is part of our base case scenario).
- **Credit.** Through the elections we have been, and continue to be, cautious about Italian credit risk. Recent developments have only solidified our view. The combination of the political uncertainty, the weakening economic climate in southern Europe, and the continued potential for the ECB to unwind quantitative easing stimulus will likely sustain headwinds for the Italian economy. We continue to closely monitor the situation and potential effects of these pressures on companies, and remain wary of Italian credit risk except for a few instances where we see strong bottom-up fundamental support.

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