



WHAT ITALY'S ELECTION RESULT MAY MEAN FOR THE MARKETS AND YOUR INVESTMENT PORTFOLIO?

KEY TAKEAWAY

Given that Italy's poll result is inconclusive, several media sources like *The Washington Post* and *BBC* are signaling a period of uncertainty in the coming weeks when Italy's various political groups, with conflicting stated positions on the country's economic agenda, are expected to stitch together a coalition government.

Global equity and bond markets have reacted sharply to the outcome of Italy's elections on February 24-25. The poll result is inconclusive, with no clear winner. And apparently, Italians have voted against the austerity measures and reforms that are widely believed to have improved international confidence in Italy last year. Consequently, several media sources like *The Washington Post* and *BBC* are signaling a period of uncertainty in the coming weeks when Italy's various political groups, with conflicting stated positions on the country's economic agenda, are expected to stitch together a coalition government. According to Italian rules, a re-election will be scheduled within months if political parties fail to form an alliance that can garner the confidence of both houses of Italy's parliament.

A life-saving operation on Italy — Europe's fourth largest economy — last year yielded some early positive results, but the surgeon — incumbent prime minister Mario Monti — has garnered the least number of votes in the election. If the patient can't make a comeback to fair health, the Euro-zone's members may be hard put to stay in their current country configuration and to keep the euro as their common currency.

Over the past few quarters, the painful austerity and reform policies of Monti have enabled Italy to rebuild some investor confidence and sell its sovereign debt at reasonable interest rates. Failure to issue debt would have forced Italy to ask for a bailout from the European Union and IMF. The new government likely needs to continue this austerity and reform agenda to retain the world's confidence in Italy's ability to cure its fiscal problems. If the nation's current policies are abandoned, its cost of selling debt will likely surge, as in the first half of 2012. This could trigger a wave of risk aversion, affecting debt and equity investors worldwide.

WHY ITALY'S POLITICAL SITUATION HAS A BEARING ON ITS ECONOMIC LANDSCAPE?

Italy has the second largest public debt in Europe after Greece. Its economy has deep-rooted structural problems — such as falling competitiveness in the global export market largely due to an unproductive labor force. In recent quarters, the country has been mired in recession, hobbled by public spending cuts and high unemployment. Given its mammoth debt, the Italian government relies on the sale of large volumes of bonds regularly to finance its expenses and debt-servicing costs.

Hence, Italy is vulnerable to any spurt in its sovereign yields, a proxy for its borrowing costs. For example, in late 2011 and nearly all through the first half of 2012, the European crisis intensified as Italian and Spanish sovereign bond yields climbed rapidly on concerns that the two countries might need bailouts just as Greece, Portugal, and Ireland have. And now that the election has produced a political stalemate and created uncertainty, investor sentiment has weakened and Italian sovereign bond yields have started rising again, with collateral damage on Spanish sovereign bond yields.

WHAT IS THE POLITICAL BACKGROUND OF THE RECENT ELECTION?

In late 2011, after Silvio Berlusconi lost his parliamentary majority amid scandals and a surge in Italy's borrowing costs, Mario Monti was appointed to head a technocratic government until scheduled general elections in mid-2013.

After coming to office, Monti implemented reforms and austerity-focused policies, which are perceived to have improved international confidence in Italy but upset a large number of Italians. In fact, along with the European Central Bank's September 2012 pledge to buy unlimited amounts of Euro-zone government bonds, Monti's reforms are widely believed to have played a role in stabilizing Italy's borrowing costs in the second half of last year, as *The New York Times* has pointed out. But Berlusconi's center-right PdL party withdrew its support for the Monti government in early December, which led to polls on February 24-25, a few months ahead of schedule.

WHAT ASPECTS OF THE ITALIAN ELECTION RESULTS ARE A SOURCE OF CONCERN FOR THE GLOBAL FINANCIAL COMMUNITY?

Italy has a complex system in which a political party or formation has to secure a majority in both houses of the Italian parliament — Senate and the Chamber of Deputies — to be able to form a government.

If no party secures a majority in the Chamber of Deputies, the party or formation with the largest percentage of votes is automatically considered the majority group. But in the Senate, that formation has to try and form an alliance with other parties to secure a majority.

This is at the root of the uncertainty surrounding the Italian election results. While there is no problem in the Chamber of Deputies due to the "automatic majority" rule, no group has a majority in the Senate. Moreover, some of the formations that campaigned against austerity measures have done well while Monti's pro-austerity group has emerged the least popular formation in the election.

WHO ARE THE KEY PLAYERS IN THE POLITICAL ARENA NOW?

POLITICAL FORMATION	STATED POSITION	POST-ELECTION STATUS
A center-left group comprising the Democratic Party (PD) and SEL party. PD leader Pier Luigi Bersani is the head of the formation	To continue Monti's reforms agenda as well as take additional steps to promote growth and job creation	Has emerged the largest single group in the Chamber of Deputies and hence, it automatically has a majority in that house. But now this group has the difficult task of forming an alliance with one or more of the other groups to secure a majority in the Senate and become eligible to form a government. Owing to the fractured results in the Senate, the center-left group may have to align with at least one of the anti-austerity groups to form a government.
A center-right alliance between the People of Freedom (PdL) party and Northern League. Three times prime minister Silvio Berlusconi is the leader of this formation	To reverse Monti's austerity steps and introduce tax cuts if returned to power	Although, this group has done better than expected in both houses, it is not in a position to form a government on its own . According to media reports, Berlusconi has hinted at a "grand coalition," which means he is open to the idea of forming an alliance with the center-left group . In such an eventuality, whether or not Berlusconi imposes his anti-austerity agenda on the coalition remains to be seen.
The Five Star Movement, an anti-establishment citizens' movement led by comedian and blogger Beppe Grillo	Riding on an anti-austerity platform, this party has secured the third position ahead of Monti's centrist group in both houses	Has emerged surprisingly strong in the election. According to <i>Bloomberg</i> , Grillo's Five Star Movement is likely keeping its distance from other formations and preparing for a re-election.
A centrist alliance including Monti's own "Civic Choice with Monti for Italy" and the Christian Democrats. Monti is the head of this group.	Pro austerity and radical structural reforms	Has secured around 10% of the votes in each house of parliament. Although it may eventually join a coalition led by the center-left , it is unlikely to play a significant role in the coalition-building process . Until a new government is formed, with or without re-election, Monti will continue in office.

KEY TAKEAWAY

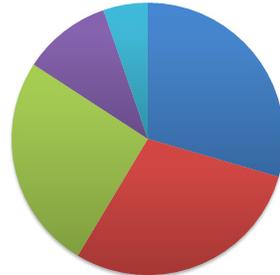
Since no political formation has secured a majority, the group with the largest percentage of votes has to try and create an alliance with other groups to form a government.

WHAT IS THE POST-POLL SITUATION NOW AND WHAT ARE INVESTORS WARY OF?

CHAMBER OF DEPUTIES, 630 SEATS

No group has a majority in the lower house

But according to Italian rules, the winning bloc, Bersani's center-left group, automatically gets a majority in this house



- Bersani-led center left group, (29.5% votes)
- Berlusconi-led center right group, (29.1%)
- Grillo-led group, (25.6%)
- Monti-led centrists group, (10.5%)

SENATE, 315 SEATS

No group has a majority in this house too

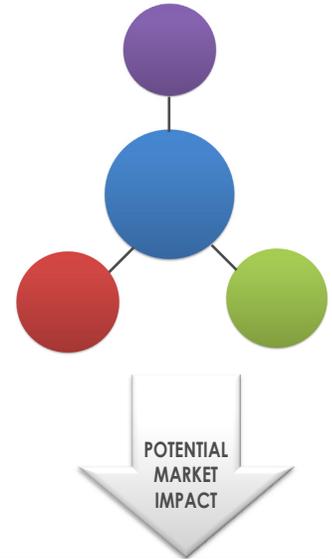
But according to Italian rules Bersani's center-left group, having got an automatic majority in the lower house, can partner with other groups to form a government



- Bersani-led center left group, (31.6% votes)
- Berlusconi-led center right group, (30.7%)
- Grillo-led group, (23.8%)
- Monti-led centrists group, (9.1%)

CENTER-LEFT GROUP TO TRY AND FORM A COALITION

Media reports indicate this is likely to be difficult owing to the conflicting economic agendas and stated positions of the various formations



KEY TAKEAWAY

According to media reports, investors are wary that international confidence in Italy may wane in any of these events:

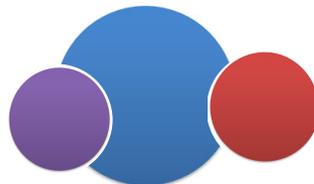
1) Owing to their often conflicting agendas, political parties may not succeed in forming a coalition in the Senate, which will certainly lead to a re-election and more uncertainty in Italy and Europe.

2) If a coalition government with groups from across the political spectrum is formed, it may not have the political will to continue the already unpopular austerity and reforms agenda of the Monti group.

POSITIVE

CENTER-LEFT + CENTER-RIGHT + MONTI COALITION

If Monti's centrist group is included in the grand coalition between Bersani's center-left group and Berlusconi's center-right group, markets are likely to see the development as positive considering Monti's image as the architect of Italy's austerity and reforms agenda

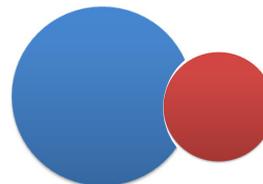


NEGATIVE

CENTER-LEFT + CENTER-RIGHT COALITION

A grand coalition between Bersani's center-left group and Berlusconi's center-right group, as Berlusconi himself has hinted at, is formed

Media sources such as The Guardian have said a right-left alliance would be "unworkable." In any case, going by their stated positions, such a bloc is unlikely to pursue austerity and reforms strongly



NEGATIVE

COALITION-BUILDING FAILS COMPLETELY

Failure of political groups to form a coalition will certainly lead to a re-election within months and likely more uncertainty in Italy and Europe in the short term



IS THERE ANY OTHER REASON FOR CONCERN?

In the Italian system, the president or head of state conducts the negotiations among political parties in the Senate to try and form a coalition. But Italian President Giorgio Napolitano's term is slated to end on May 15, and the process to appoint his successor has to start well in advance. If negotiations to form a majority group in the Senate take longer than a few weeks, the next president may have to be elected by the two houses of parliament that have emerged after the recent election.

But before that, the two houses must have speakers. The BBC reports that the election of the Senate Speaker may not be easy given its fractured state now.

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— Thomas S. White, Jr.,
Portfolio Manager

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